

**Indigenous Private Sector Development  
and Regulation in Africa and Central  
Europe: A 10 Country Study**

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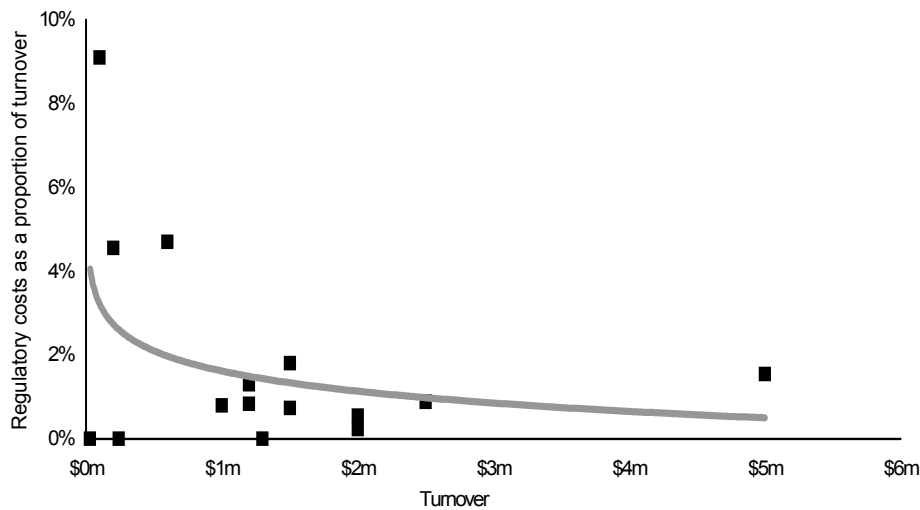
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# PRIVATE SECTOR DEVELOPMENT AND REGULATION IN AFRICA AND CENTRAL EUROPE

## EXECUTIVE SUMMARY

1. This study reviews the machinery and policies used in regulatory reform in seven countries in Sub-Saharan Africa (Ghana, Kenya, Malawi, South Africa, Tanzania, Uganda, and Zambia) and three in Central Europe (Hungary, Latvia, and Poland). The main objectives are to see whether or not there are connections between the approaches taken to improving the regulatory environment for indigenous private sector development and actual economic outcomes and to draw out implications for better practice. Local consultants wrote reports in response to a series of questions put to them on institutions and policies in their countries. These reports as well as other published material were the basis upon which this study was written. Our conclusions were arrived at independently, however, and are the sole responsibility of Bannock Consulting.
2. The social and economic structures, and particularly the levels of incomes and labour force skills, are very different in Africa compared with Central Europe. However, there are some parallels: All the countries covered underwent major political and economic reforms in the first half of the last decade as they dispensed with unrepresentative and interventionist governments. In most of the African countries self government came in the early 1960s, but all had troubled transitions to multi-party democratic systems which emerged only in the early to mid-1990s. The three Central European countries achieved independence from communist regimes in around 1990. Both regions suffer from low tax compliance and inherited obstacles to enterprise, an overly bureaucratic legislative framework and an associated tendency towards corruption.
3. In terms of economic growth the parallels between our sample countries end from the mid 1990s. From 1995 to 1999 annual GDP per capita growth varied from less than 0.3% in Kenya, Zambia and South Africa to 1.5 – 2.0% in Tanzania, Malawi and Ghana and 3.7% in Uganda. Over the same period the three Central European countries have achieved growth rates of 4.2-5.4%.
4. In the past and to this day in emerging countries of Asia and elsewhere, development in market economies has been driven by the efforts of large numbers of small firms complementing larger firms and co-ordinated by the market. 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 as the chart overleaf illustrates. The data happens to be for Jamaica but a similar pattern is observable elsewhere.

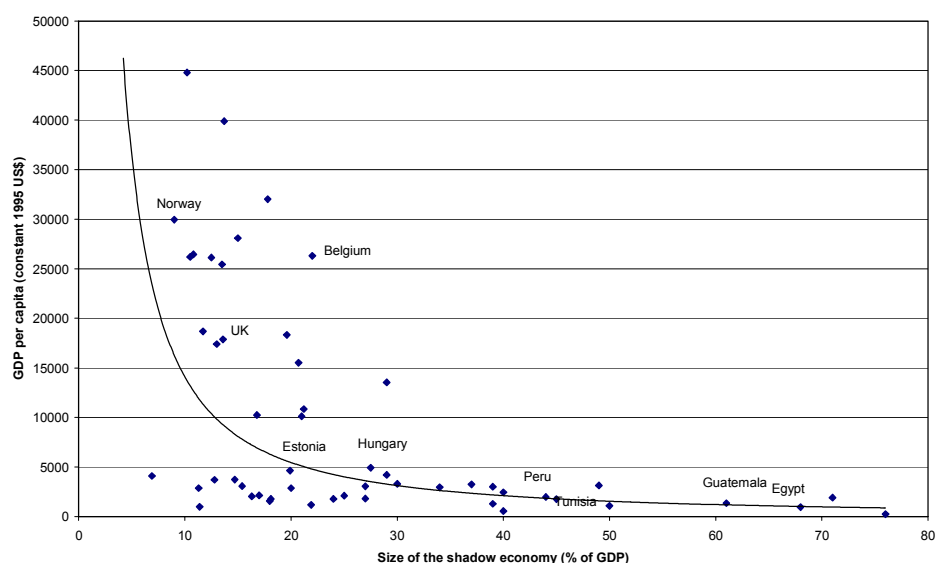
## All Regulatory Costs in Jamaica



Source: Bannock Consulting for the World Bank, 1997

5. The large number of small firms in developing countries is not in itself a sign of under-development. Rather it is that these firms are confined to subsistence and insufficiently productive activities. In the advanced countries the vast majority of business enterprises are also very small but they are participating in the modern, formal economy and account for a disproportionate share of employment creation. Even in Africa and despite the regulatory barriers which are the subject of this study, surveys show that micro and small enterprises employ more than 40% of all new entrants to the labour force and a few grow to employ 10 or more employees. These figures suggest the potential that exists if barriers could be removed.
6. Even though regulations may not be 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. A majority of the indigenous population is therefore effectively excluded from economic activity which has the potential to alleviate their poverty.
7. In fact, the size of the informal sector (shadow economy) is inversely related to economic development as the chart illustrates:

## GDP per capita and the size of the shadow economy

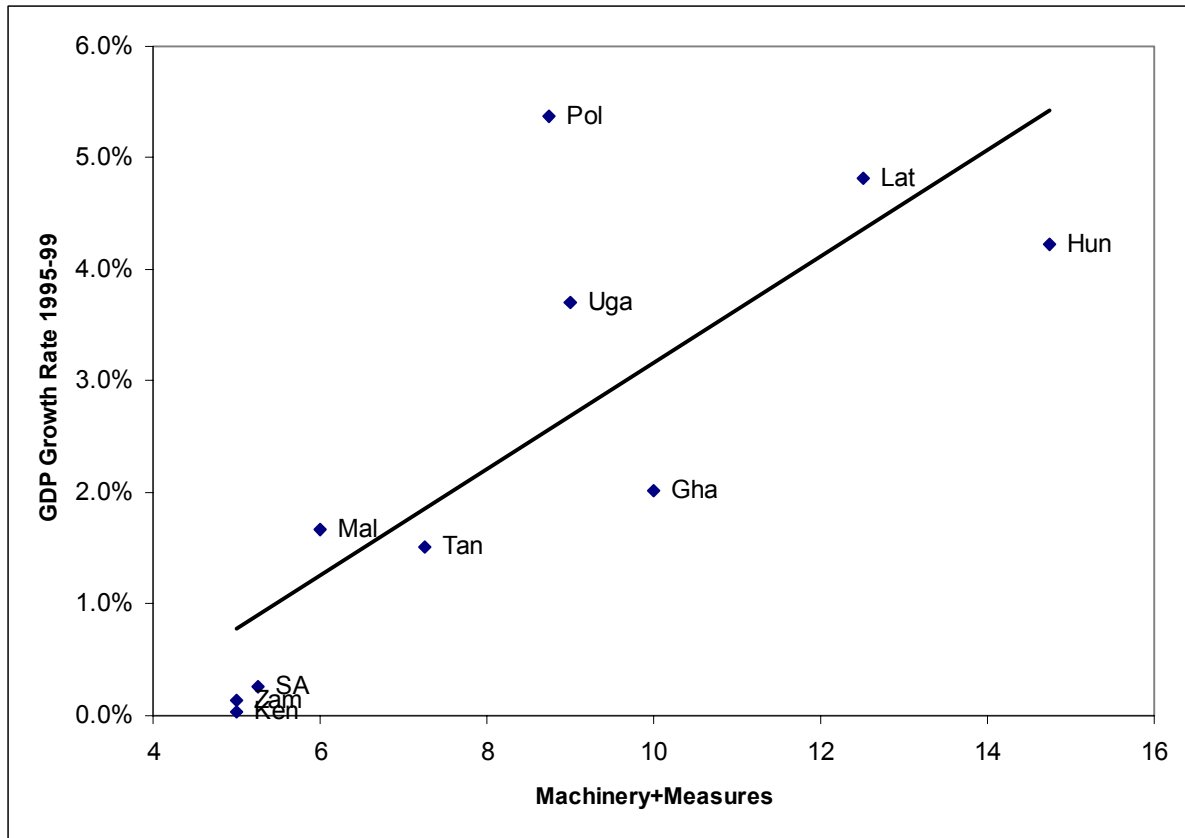


Source: Enste & Schneider, 1998 and WDI, 2001. Including 53 developed and developing countries from all continents, except Australia. The OECD country data is based on the average WB-reported GDP per capita (constant 1995 US\$) and the average informal sector share of GDP (as calculated through the physical input method by Enste et al) 1990-93, the same methods apply for rest of the countries for the period 1989-90.

8. Research also shows that tax collections and macro-economic reforms to free prices and trade are positively related to economic development as are lower relative costs of regulation, less corruption, the quality and cost of the judicial system and the availability of property rights. We show below that appropriate policies to deal with these matters are also associated with better economic performance.
9. It is a striking fact that modern day business enterprises in Africa and the transition countries suffer regulatory barriers which were largely absent in 18<sup>th</sup> and 19<sup>th</sup> Century Europe and North America when these areas were industrialising. 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. For example, business entry costs as a percentage of GDP per capita are less than 3% in the best advanced countries, 67% in Central Europe and 94% in Africa. These costs also seem to be significantly lower in industrialising South Asia than in Africa.
10. Whilst some efforts are being made to tackle regulatory reform in our African countries, there are clear contrasts in progress in policies and implementation between these countries and our Central European sample. Few countries in Africa have explicit policy rationales which bring out the need to remove legislative obstacles to private sector development, instead most focus on support services promotion, instead of removing the barriers which could render support unnecessary. In the formulation of policy the private sector is not brought in as a partner through effective consultation. Policy formulation and implementation is also excessively centralised in government, and strong lead ministries covering all aspects of private sector development are generally absent. Monitoring of policy is inadequate and the necessary statistical base is weak. Central European Countries have better institutions in all these respects.

11. The same distinctions within our sample countries emerge in comparisons of macro-economic policy, taxation, business registration, licensing, and exit procedures and in the existence of legislative barriers to finance provision. Employment law however is an intractable problem in most of Africa and Central Europe.
12. Over-formalistic legal systems inherited from the colonial period are not accessible on cost grounds in most of Africa. In Central Europe, alternative dispute resolution mechanisms are available. Clear title to property is also generally available in Central Europe but not in Africa with very few exceptions.
13. Inward investment and trade in Africa is deterred by fears that recent reforms will be short lived and by various restrictions and cumbersome procedures. Again the Central European countries have done better in improving matters.
14. Compared with regulatory reform, support services (information, training and advice) are not an effective means for promoting private sector development though there is ample scope for improving regulatory service delivery (for example by one-stop shops).
15. We note isolated initiatives to improve the enabling environment in most of our African countries. In Tanzania, for example, delays on business registration have been reduced from 90 to as little as 3 days. In Kenya, reforms to the licensing system have been introduced which, when fully completed, will reduce compliance costs by 1% of GDP annually. In Uganda, a commitment is being given to customs goods clearance within 24 hours. These examples show what can be done as does experience in Central Europe over the dismantling of the command-control economy.
16. Differences in policy and policy implementation among the countries studied are reflected in rates of growth in GDP per capita achieved. In fact there is a fairly clear continuum in these respects over the years 1995-99 between those African countries which have made little progress in regulatory reform, those that have made some changes (Ghana, Tanzania and Uganda) and our three Central European countries (Poland, Latvia and Hungary), with the highest rates of growth in the latter group. The chart below shows, for each of our 10 countries, the number of positive indications for policies and institutions (machinery) adopted (adjusted for the date of adoption) against GDP per capita growth rates.

**GDP per capita growth rate 1995-1999 on Sum of Machinery and Measures (excluding SME Act) with fractions for Machinery and Measures introduced during the period (1995-1999)**



$r^2$  is 0.63 and the co-efficient on (machinery+measures) is significant at the 1% level  
 Source: Policy matrix (Table 6.2) and WDI, 2001

17. It cannot be assumed that the adoption of the favoured institutional and policy mix alone will bring higher GDP growth. All the evidence in this report nonetheless is that much more attention should be given to the enabling environment as a means for promoting private sector enterprise and its impact on employment, output and the alleviation of poverty. Some prescriptions for action are given in the box below (see box 1).



### **Box. 1**

#### **Some Prescriptions for Governments, Donors and Other Stakeholders involved in the Business Enabling Environment:**

##### **Institutional Framework**

- Sound and stable macro-economic policies are an essential basis for development, but they are not sufficient to encourage business growth
- A lead Ministry covering private sector development needs to be strong and influential, and its role clearly identified
- 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**

- Consultation with the private sector, and with all levels of Government, is essential to design and monitor effective policies and regulations
- 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
- 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
- Mandatory policy/regulation impact assessment procedures are necessary

##### **Policy Formulation**

- 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
- The (real and informal) costs of business registration and licensing need to be brought down drastically, and uncoupled from revenue raising
- Poor people will never be able to participate fully in opportunities to raise capital until they can obtain clear legal title to property
- Banking and other financial institutions should be regulated in ways that minimise costs and promote competition
- Systems for exit from business through bankruptcy or liquidation need to be modernised
- Alternative dispute resolution mechanisms are particularly needed in Africa where relatively low cost legal services are unavailable
- Rationalisation of customs procedures is necessary so as to facilitate trade, and thereby private sector development
- Policies on business support services need to be redirected towards facilitating private provision, and providing information and easing compliance with regulations.

# 1. INTRODUCTION

## Changing views on economic development

- 1.1 Mainstream thinking of economists on development, and with it the policies of bilateral and multilateral agencies, have evolved greatly over the past 50 years. This evolution has been traced in successive editions of the World Bank's World Development Reports, the Bank having started operations in 1946 following the Bretton Woods Conference two years earlier. There was some emphasis on the importance of planning in the earliest phase of the post war period and on investment. At the outset the view was that the poor countries lacked the savings and investment necessary for growth. Poverty meant lack of savings and resulted in a vicious circle of underdevelopment. The policy response therefore was to provide loans and grants for large investments in physical capital – roads, dams, and other infrastructure and industrial and agricultural capital formation.
- 1.2 In the face of the intractability of the problem and the influence of early growth accounting studies for the advanced countries which found that quantities of inputs of labour and capital could not alone explain development, attention turned to the role of human capital (Denison, 1967). More emphasis was placed on programmes for improvements in health and education which would be beneficial to the poor and would make growth possible.
- 1.3 In the 1980s there was another shift in emphasis triggered by the debt crisis and global recession and appreciation of the different growth experiences of countries in different parts of the developing world. Attention now turned to macro economic management and allowing markets to work. It was at this time that structural adjustment programmes in Africa were drawn up to reduce budget deficits, remove price controls, free exchange rates (in some cases) and to privatise state assets. These policies, where fully implemented, brought some improvement in terms of growth and inflation but were not sufficient to transform the situation (World Bank, 1994). Once more a single set of policies, in this case macro-economic, proved insufficient.
- 1.4 In the late 1990s and into the Millennium, policies are again shifting in emphasis towards a more broadly based and comprehensive strategy towards poverty alleviation which recognises the overriding role of private sector development and the importance of institutions and the rules and regulations that affect economic activities. Again the work of economic theorists has been important and current thinking owes much to earlier work by Coase (1937), North (1981) and others which emphasises the importance of property rights and other institutional factors and of transaction costs (which are raised by inappropriate regulation).
- 1.5 The recent emphasis on institutions and markets has brought back into focus the work of the late Peter Bauer. As long ago as the 1950s Bauer argued that since all countries were once underdeveloped there could be no vicious circle of under-saving and lack of investment; if that idea were 'valid mankind would still be living in the old stone age'. Bauer initiated thinking about the informal sector, the importance of small scale traders; their role in capital accumulation and the historical fact of indigenous private sector development (see Bauer 1971 which contains references to his earlier work and Bauer 1991 and 2000). More recently De Soto (1989, 2000) has demonstrated the role of regulation and lack of appropriate institutions in constraining formal economic

activity. De Soto has shown clearly how Western Europe and the United States had to clear away legal obstacles and the extra-legality they fostered before the great economic developments that took place in the 18<sup>th</sup> and 19<sup>th</sup> Centuries. In the next Section we review briefly some of the recent quantitative research, much of it sponsored by the World Bank, which has confirmed the connections between growth, the legal framework, corruption and poverty.

## **Objectives and methodology**

- 1.6 The main objective of this study is to gain insights into connections between the adoption of machinery and policies for improving the regulatory or ‘enabling’ environment for indigenous private sector development and actual economic outcomes in a number of countries. There are formidable difficulties in pursuing this objective because economic outcomes are affected by many factors, including political changes and forces external to the countries. Cause and effect are not easily determined and in a short study our review of policies adopted in each country and the results to a large extent from the details of each country’s specific circumstances. Not least of the problems are that the desired data on progress in the private sector are just not available. Moreover, the adoption of policies for better regulation at the micro-level, – our main focus – is relatively recent in many cases and it is too early to see clearly what the medium and longer term results might be.
- 1.7 We have chosen to look at ten countries, seven in Sub-Saharan Africa and three in Central Europe where several countries are rapidly approaching private sector contributions to the overall economy on par with those in many EU member states. The countries are: South Africa, Zambia, Malawi, Tanzania, Uganda, Kenya, Ghana and Hungary, Latvia and Poland. A factor in selecting these countries (including South Africa where DFID initiated the study) was that they are all countries where Bannock Consulting has worked on the ground and where we knew of reliable correspondents who could provide us with necessary information. All these countries have undergone transitions to more market-oriented economies during the 1990s, with varying degrees of success, in establishing strong, consistent private sector led growth.
- 1.8 The social and economic structure and particularly the levels of incomes and labour force skills are obviously very different in Africa compared with Central Europe. These differences, however, do not nullify the usefulness of the comparison. Both regions suffer from low tax compliance and inherited colonial or planned system obstacles to enterprise, from outdated and overly bureaucratic legislative frameworks and governance and an associated tendency towards corruption. Both regions have state-owned sectors in need of reform, a foreign owned sector and an indigenous informal or semi-formal economy, the latter being particularly large in Africa. The two regions are also in the process of re-assessing government, private sector and NGO/service provider roles in promoting economic growth and private sector development. We think it an opportune time to take stock of this experience and to seek to draw out any lessons for policy makers in Southern Africa that arise.
- 1.9 Our method of working was first to draw up a list of questions for our in-country correspondents to answer. These questions covered the institutional machinery for formulating and implementing private sector policy including measures taken to assess and monitor the regulatory environment, and specific features of that environment including laws of contract and property rights, the labour market, taxation, access to finance and foreign trade.

- 1.10 Secondly, while waiting for responses we reviewed some of the growing literature on regulatory issues and private sector development particularly that emanating from the World Bank Group. We also devised indicators of policy measures taken and selected economic indicators that could be used to relate these measures to economic performance.

## **Plan of Report**

- 1.11 In Section 2 following this introduction we give a brief account of our view on how private sector development and particularly MSE development contributes to economic progress in both developed and advanced countries and how inappropriate regulation obstructs that progress<sup>1</sup>. We then summarise some of the recent studies on the connections between growth, private sector activity and regulation and the connections between growth and poverty alleviation.
- 1.12 The next three Sections, 3-5, look at the machinery and policy measures adopted in our ten countries in some detail, noting how the policies might be expected to work and how they appear to have worked in practice. In these sections we have drawn primarily on the material supplied by our correspondents, but we have also built-in a few examples from the literature and a series of workshops, held in Southern Africa following the completion of the study<sup>2</sup>.
- 1.13 In Section 6 we attempt to relate statistically crude yes/no indicators of selected policies actually implemented and taking account of the dates of implementation to GDP/Capita growth.
- 1.14 Finally, in Section 7, we draw conclusions and recommendations. After the bibliography, Appendix 1 contains a list of our correspondents whose assistance we gladly acknowledge. We have not necessarily incorporated the views of our correspondents in our text for which responsibility is solely that of Bannock Consulting Ltd. We also wish to thank DFID for entrusting this study to us and commenting on drafts. Finally, we acknowledge comments from Professor Allan Gibb who led discussions after the presentations at the workshops.

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<sup>1</sup> We use the acronyms SME (small and medium enterprise) and MSE (micro and small enterprises) interchangeably but the latter particularly when we are referring to the smallest firms.

<sup>2</sup> The results of the study were presented and discussed at six workshops in Botswana, Lesotho, Namibia, and South Africa 13<sup>th</sup>-24<sup>th</sup> May 2002 (referred to as “the Roadshow”).

## 2. THE ROLE OF THE PRIVATE SECTOR AND PUBLIC POLICY

### The role of the private sector

- 2.1 Growth theory in economics is concerned with the relationships between inputs of labour, capital and technological progress and the resulting outputs measured by GDP. In market economies, governments, state-owned industries apart, contribute to growth by the provision of institutional (education, rule of law, etc.) and physical infrastructure (roads, etc.) and also to some extent by scientific and technical advance (research) and finance these activities by taxing the household and business sectors. It is the private business sector alone which creates jobs and value-added by combining capital and labour to produce goods and service output. The business sector also drives economic growth not only by investment and innovation but also by shifting labour from lower value-added activities (such as agriculture) to higher value activities in manufacturing and other sectors.
- 2.2 All this is obvious enough in the advanced countries, but it applies equally in the transition and developing countries. Output per capita in these countries is lower because the private sector is not investing enough and is not employing enough people or is doing so in an insufficiently productive way. A large proportion of the population is typically engaged in subsistence agriculture or in labour-intensive low value added activities in the informal sector. The private formal sector is small relative to advanced countries and in many African countries much of it consists of foreign or state owned companies in export orientated extractive or commodity based industries<sup>3</sup>.
- 2.3 The promotion of the private sector therefore requires either attracting more foreign investment or the stimulation of enterprise creation and growth, or both.
- 2.4 In all market economies, both in the past and to the present day, the private sector has consisted of large numbers of very small firms and a small number of medium-sized and large firms that nonetheless account for a significant proportion of output and a smaller but still significant proportion of employment.
- 2.5 It used to be thought that very small firms in the advanced countries were an anachronism that would continue to diminish in importance as these economies continued to advance. Indeed there had been a long-term decline since the 19<sup>th</sup> century in both the numbers of small firms and their share in employment in most OECD countries. The view that small firms were a vestige of the past was based on a series of stylised facts about economies of scale, labour productivity, research and development, skills and management technique and globalisation which seemed to favour large over small firms.

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<sup>3</sup> The bulk of the remainder of the labour force outside the informal sector work in the public sector including parastatals and in foreign owned enterprises. Except in a few countries in Africa the indigenous formal private sector is very small, therefore we avoid entering into the controversy about definition of the informal sector and acknowledge the considerable differences in estimation of its size in various sources. We also use the terms 'shadow economy' as synonymous with 'informal sector' although on some definitions the former is broader than the latter since it includes underreported income in the formal sector.

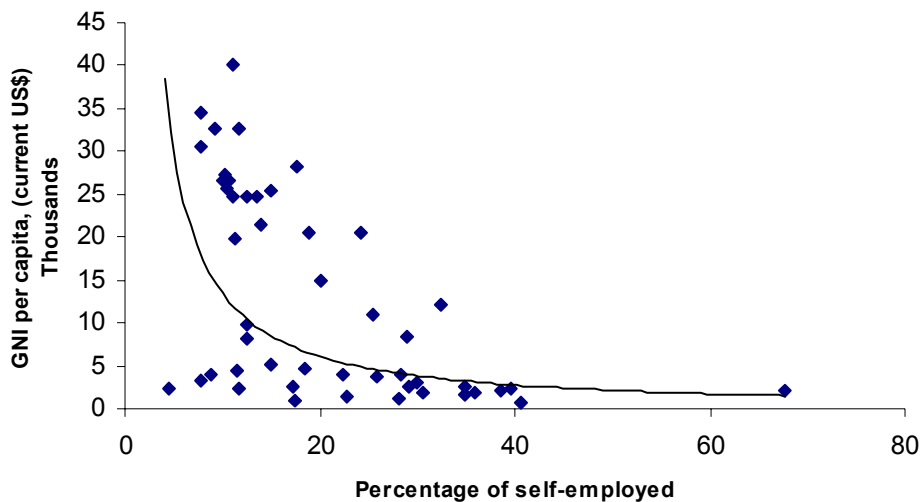
- 2.6 In fact, all of these stylised facts which suggested that small firms were a drag on the modern economy have been shown by later research to be irrelevant, misleading or even wrong<sup>4</sup> and since the late 1960's the share of small firms in economic activity has been increasing again, reversing the long-term trend (Sengenberger et al, 1990). Later it was established that in the United States, SMEs accounted for a disproportionate share (two thirds in one study but more in others) of new job creation (Birch, 1979) and these results were soon replicated for other countries, including, eventually, Third World countries (Liedholm and Mead, 1993).
- 2.7 To focus on job creation alone, however, is to grossly under-estimate the role of small firms in economic development. In the early stages of development, small firms help to develop markets through trading activities and in the process accumulate capital. They help to develop a widespread commercial culture with the necessary skills, disciplines and organisation upon which further progress can be built. In later stages these functions continue, but as larger organisations emerge, SMEs increasingly carry out specialised activities which cannot be carried out optimally on a large scale, or can be sub-contracted to them, and therefore complement large firms. People also move from large firms to small and vice-versa – this explains why at first tiny firms have played such a large role in the recent information technology boom in the West and where the flexibility, speed of reaction and openness of small firms has been so important.
- 2.8 As development proceeds large firms become increasingly capital intensive, creating value added which can increase wealth at a rapid rate. This allows new, more labour intensive small firms to serve the new markets which greater wealth creates. As new activities mature to a point where large scale activity is viable, these activities are taken over by large firms. In all these ways large and small firms complement one another.
- 2.9 The foregoing description of some of the roles of MSE in economic growth is not merely relevant to present day advanced countries. The same kinds of roles were performed 200 years ago and earlier as these countries set upon the development path of industrialisation. Similar roles are discernable in the more recent advance of the newly industrialised countries in South East Asia and elsewhere as well (Igbal and Urata, 2000). In China's economic growth in the 1980s and 1990s, growth has been driven very substantially by SMEs, remarkably operating within a communist ideology (Gibb and Li, 2002). It is also possible to see on the ground in Africa similar functions in embryo, but a dynamic MSE growth contribution has been curtailed there and elsewhere in the Third World by the regulatory iron curtain between the formal and informal sectors, lack of property rights and, in most cases also inappropriate macro-economic frameworks and governance. Countries in transition face similar problems but to a lesser degree and, in the Central European countries included in this study these problems seem to have been eased by government policy efforts.
- 2.10 As countries have developed and SMEs have contributed to the process along the lines described above, the size and composition of the small firm sector changes. More and more enterprises evolve from subsistence self-employment, small scale trading and cottage industry to more market orientated organisations (Bannock and Binks, 1994). As a result, the proportion of the workforce in self-employment tends to fall and at some point the numbers of MSEs may also fall. The available statistics are very

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<sup>4</sup> For example see Audretsch (2001)

imperfect, but Chart 2.1 shows a clear tendency for the proportion of the labour force in self-employment to be inversely related to per capita income – that is to the stage of development reached. This does not mean that the role of small firms become less important as development proceeds but rather that growth brings changes in the structure of the small business sector. Even in the European Union today enterprises employing fewer than 250 persons account for 99.8% of all enterprises and 66.2% of employment (Eurostat, 2001). There are also changes in the role of sectors: manufacturing expansion is preceded by services sector expansion which is a prerequisite for its successful operation and is followed by other structured shifts. The policy bias against trading and other service sector activities in most LDCs and countries in transition is therefore counter-productive for the development process.

**Chart 2.1: Per Capita Income and the Proportion of Self-Employed<sup>1</sup>, GNI per capita (Atlas method) & percentage share of Total Employment, 1998. Selected Industrialised and Developing Countries.**



<sup>1</sup> The proportion of self-employed includes both own account workers and employers.  
Source: ILO (KILM), 2002 & WDI, 2001

2.11 Statistics on SMEs are inadequate everywhere, including in many OECD countries, and it is not possible to illustrate their role in economic processes in any detail. For developing countries it is difficult even to delineate the outline contours of private sector contributions to the present day economies. This is partly because the UN system of National accounts does not distinguish between private and public sector enterprises, but also because there are virtually no comprehensive statistics on very small formal and informal activity other than the USAID GEMINI micro-enterprise surveys for some countries and years.

**Table 2.1: Private Firms as a Source of Job Creation, Selected Developing Countries, 1987-1998**

Country	Period	Job Creation Thousands		Ratio of Private to Public Job Creation
		Private	Public	
Mexico	1989-98	12,431.0	143.0	87:1
Cost Rica	1994-98	238.0	12.0	20:1
Turkey	1987-92	1,490.0	91.0	16:1
Kenya	1993-98	173.0	13.0	13:1
Guatemala	1994-98	47.0	4.0	12:1
Bolivia	1994-97	181.0	18.0	10;1
Uruguay	1987-92	127.0	27.0	4.7:1
Gabon	1992-96	4.7	1.3	3.6:1

Source: IMF, *Recent Economic Developments*, various years, quoted in IFC (2000)

2.12 We do know that the private sector dominates the creation of new employment (Table 2.1.). But these kinds of statistics presumably omit the informal sector. How much is omitted is illustrated in Lisa Daniel's careful 1999 study based on GEMINI surveys which demonstrates that in Kenya formal and informal MSEs accounted for one third of the labour force and 13% of GDP but even these numbers exclude agriculture and enterprises with more than 10 employees. It is relevant the 80% of MSEs in Kenya and 90% of their employment is in smaller towns and rural areas where regulation could be expected to have least influence.

**Table 2.2: Percentage share of enterprises by employment size band in total employment in enterprises with 50 or fewer employees. Selected African Countries**

Number of workers (including working proprietors)	Botswana	Kenya	Lesotho	Malawi	South Africa	Swaziland	Zimbabwe
	1992	1991	1991	1992	1991	1991	1991
1	65.0	55.1	79.5	59.5	46.6	68.8	69.6
2-5	28.1	42.7	18.0	38.4	50.1	28.4	26.9
6-10	5.1	1.9	1.6	1.3	2.8	1.4	2.3
11-19	1.0	0.2	0.5	0.5	0.4	0.9	0.7
20-50	0.9	0.1	0.4	0.3	0.1	0.5	0.5

Source: Liedholm and Mead (1993).

2.13 Table 2.2 provides comparable employment size distribution data for seven countries in Africa, also based on GEMINI surveys covering enterprises with 50 or fewer employees and working proprietors. It can be seen that the vast majority of enterprises



are very small with only 0.3 – 1.9% of employment accounted for by enterprises with more than 10 people. Although small firms predominate in these terms in all countries they are of particularly restricted size in Africa. Much more so than in transition countries which seem to occupy an intermediate position between advanced and developing countries in this respect.

- 2.14 The GEMINI surveys have established that in Botswana, Kenya, Malawi, Swaziland and Zimbabwe over the period 1980-1990 MSEs employed more than 40% of all new entrants to the labour force mostly from new start-ups. 'Although most MSEs do not grow, about a quarter do grow at least in small amounts and one per cent grow substantially. Most new jobs from expansion resulted from small additions to micro enterprises with fewer than five employees after expanding, but the process of graduation to more than 10 employees also made a significant contribution to job creation. Moreover, micro enterprises that grow provide the base for today's small and medium enterprises; more than half of today's medium sized firms began with fewer than five employees in every country except Malawi' (Mead, 1994).
- 2.15 Other surveys confirm these results, for example, surveys in Ghana, Malawi, Mali and Senegal show that micro enterprises are a seedbed for larger firms. Of the enterprises observed with 6 to 20 workers 68% had started with fewer than 6 and subsequently graduated to larger size groups (Parker et al, 1995). As in the advanced countries, firms that grow are a tiny minority but those that do account for a significant proportion of net job creation.

### **The Impact of Regulation**

- 2.16 Regulation is desirable and necessary for the raising of tax revenues and for the maintenance of reasonable environmental and health standards among other things, but it inevitably increases the costs of business entry and operation. When imposed at unrealistic levels and inadequately enforced, regulation divides the economy into formal and informal sectors and erects barriers between the two which perpetuates the division. The passive acceptance by governments in developing countries that regulation cannot be fully enforced in the informal sector is a recognition of the fact that the level of regulation is too high and too costly to be applied to all forms of economic activity. This recognition is, in fact, a necessary safety valve for what would otherwise be an unacceptable regulatory regime that, if enforced, would deprive a large proportion of the population from earning a living.
- 2.17 There are very few estimates of the overall compliance costs of regulation on business in developing and transition countries, but a few small scale studies by Bannock Consulting indicate that they may be substantially larger as a percentage of GDP than in the advanced countries. Even if these costs were the same in advanced and developing countries the opportunity costs of the scarce resources employed in compliance and non-compliance<sup>5</sup> will obviously bear more heavily in the Third World<sup>6</sup>. If we use data on business entry regulatory costs as a proxy for all regulatory costs then it seems that these costs in Africa, in relation to GDP per head, are much

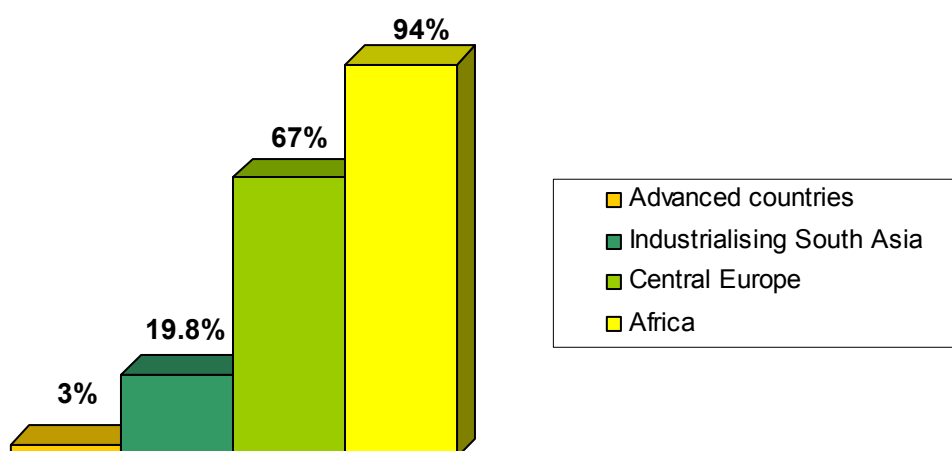
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<sup>5</sup> By non-compliance costs we mean the time and money costs of paying bribes, harassment and confiscation suffered by informals.

<sup>6</sup> There are obvious difficulties in making comparisons of this sort particularly where GDP does not fully capture informal sector output, but the point remains.

higher than those in Central Europe which in turn are higher than in South Asia and the advanced countries (Chart 2.2).

**Chart 2.2 Business Entry Costs as a Percentage of GDP/Capita today**

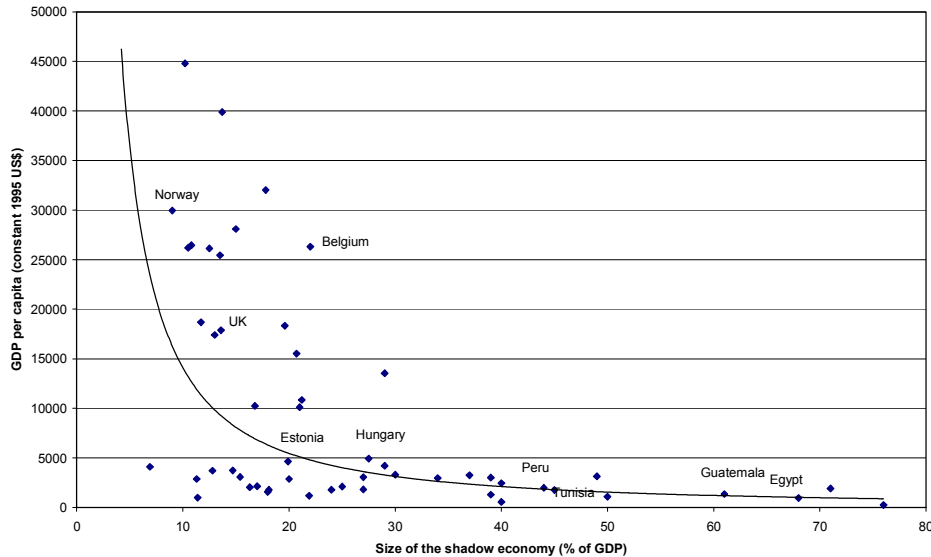


Source: Derived from Djankov et al, 2001.

- 2.18 As argued above, in all market economies in the past and to the present day private sector development has everywhere been driven largely by large numbers of micro and small firms (MSEs) the very ones that are locked-up in the informal sector in Africa today.
- 2.19 Modern day MSEs in Africa and elsewhere, including countries in transition, suffer barriers which were largely absent in 18<sup>th</sup> and 19<sup>th</sup> Century Europe and North America when these countries were developing: the presence of a ‘modern’ regulatory structure (in fact, this regulatory structure is not modern; it is a vestige of earlier colonial or communist, control systems).
- 2.20 In former British, French and Portuguese territories in Africa it is no exaggeration to say that much business regulation is based on identical laws to those obtaining in the mother countries in the 1940s or even the 1920s or earlier, even including laws intended to exclude indigenous people from certain business activities. It is very striking that these laws have remained untouched since independence, the reason being that they provide the same protection for the new indigenous vested interests as they did for the colonialists. They have in some respects been modernised, often for the worse by for example the introduction of employment protection legislation which only applies to the minority of the labour force in the public and formal private sectors and which imposes costs which LDCs and particularly MSEs cannot afford if they are to be competitive.
- 2.21 It is sometimes objected that regulations are irrelevant to the informal sector because, by definition, informals are largely unregulated and exempted from direct taxation. But regulation erects barriers to escape from the informal and into the formal sector where legitimacy confers a number of important benefits, including relative freedom from harassment over laws that do affect informal – such as those on street trading – the possibility of collateralised lending and relative security of land tenure.
- 2.22 Of course, inappropriate regulation restrains development in the formal as well as the informal sectors, but the most striking thing in Africa generally is the fact that the

majority of the indigenous population – those in the informal sector – are effectively excluded from economic activity which has the potential to alleviate poverty. It seems most unlikely that faster economic development can take place until the energies of informals are more fully harnessed. Indeed, Chart 2.3 shows clearly that the estimated size of the informal sector as a percentage of GDP has a strong tendency to shrink as countries get richer.

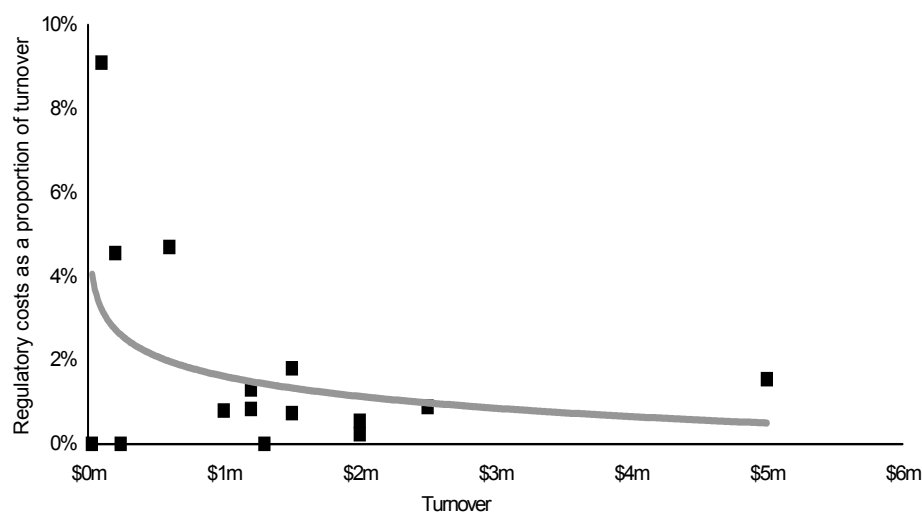
**Chart 2.3: GDP per capita and the size of the shadow economy**



Source: Enste & Schneider, 1998 and WDI, 2001. Including 53 developed and developing countries from all continents, except Australia. The OECD country data is based on the average WB-reported GDP per capita (constant 1995 US\$) and the average informal sector share of GDP (as calculated through the physical input method by Enste et al) 1990-93, the same methods apply for rest of the countries for the period 1989-90.

2.23 Because there are more or less fixed minimum levels of costs in complying with regulation, it bears most heavily on the smallest firms. It has been amply demonstrated in large scale tax compliance cost and other studies for advanced countries that regulatory costs as a percentage of sales fall steeply with firm size (Bannock, 2001). This can be demonstrated also for developing and transition countries. Chart 2.3 shows the results of a small scale study in Jamaica as an example.

**Chart 2.4: All Regulatory Costs in Jamaica**



Source: Bannock Consulting for the World Bank, 1997

- 2.24 It is to be expected that regulation will act to restrict new business entry in the formal sector, raise business costs, enlarge the informal sector and constrain the growth of MSEs and the development process. These effects can be expected to constrain tax revenues and, in the context of the poorly paid government servants that result from this, stimulate corruption. The payment of bribes to officials to cast a blind eye on non-compliance is likely to be more prevalent the more complex the regulatory structure is and the less it is enforced. Lack of enforcement is likely to be followed by a tightening of regulation leading to more complexity. These effects could be expected to be compounded where the quality of the judicial system is low and economic development will be impaired where contracts cannot be enforced and finance cannot be raised on the basis of property through lack of clear title.
- 2.25 It is also to be expected that if the rule of law can be enhanced, regulation lightened but enforced more rigorously, tax revenue collection improved and corruption reduced, all within a favourable macro-economic environment (including lower public deficits and inflation, price flexibility and openness to foreign trade), these mechanisms could operate in reverse and the development process allowed to operate.
- 2.26 These relationships have been demonstrated across large numbers of countries in recent years in a large number of statistical studies (see box 2 for examples). It has also been demonstrated that the poor benefit from economic growth and from the impact of many of the measures taken to promote growth including openness to foreign trade and the removal of price controls. These studies do not prove that, for example, reducing regulatory costs will enhance growth in any particular country or that the size of the informal sector will fall and that of the formal sector increase as tax revenues increase and corruption is reduced, but they do show that these effects are associated with one or another across large numbers of countries and they confirm the theory of what might be expected. The conclusions and the relationships are also supported by surveys of enterprises such as the BEEPS Surveys of the World Bank and the EBRD.
- 2.27 In ensuing sections we look at some individual elements in the machinery adopted and actual policy measures taken in our ten countries to lighten regulation and promote private sector development. The objective is to see whether there are any lessons for

best practice and whether the adoption of these practices has in fact been associated with success.

**Box. 2**

**Recent research on Institutional arrangements economic growth and poverty**

Djankov et al (2001). Uses measures of the number of business entry procedures in 85 countries. Number of procedures for average rich country is 6.8 against rest of sample average of 11.8 and meeting government requirements takes 24.5 days and 55.4 days respectively. Countries with heavier regulation have higher corruption and larger unofficial economies.

Friedman, Johnson, et al (1999). Measures of regulation and corruption are positively correlated with the share of the unofficial economy. Higher marginal tax rates are not associated with a larger unofficial economy.

Djankov et al (2001). Uses measures of the formalism of the procedures used by litigants to evict a tenant and to collect a bounced cheque in 109 countries. Formalism is greater in civil law than common law countries and in poorer countries and is nearly universally associated with lower survey measures of the quality of the legal system. The result suggests that an inefficiently high level of judicial formalism has been transplanted to developing countries.

Hellman et al (2000). Based on a survey of firms in 20 countries (BEEPS). Among the findings: over 40% would pay additional taxes to eliminate corruption, crime and excessive regulations; only about 40% of respondents have confidence that the legal system will uphold contracts and property rights, though this varies considerably between countries; as a percentage of revenues average bribes paid and frequency of payment falls as firm size increases.

Dollar and Kraay (nd). The incomes of the bottom fifth of the population rise by about as much as for everyone else as the economy grows. There is no general tendency for inequality to rise with development and then fall (Kuznets effect). Curbing high inflation benefits the poor more than the rest of the population as do openness to foreign trade, quality of the legal system and fiscal discipline.

Schaffer and Turley (2001). Study of 25 countries in transition in Europe shows that effectiveness of tax collection (effective tax yields versus tax rates) is positively correlated with EBRD transition indicators and inversely related to percentages of enterprise revenues paid in bribes.

World Bank (forthcoming) worldwide survey of 10,000 enterprises showed perceived constraints higher in LDCs than industrial countries. GDP growth within each of the regional grouping of countries is negatively associated with the severity of constraints imposed by taxes and regulations.

### 3. POLICY MACHINERY

#### Policy rationale

- 3.1 Few of the African countries in our sample appear to have elaborated policies which explicitly place improvements in the enabling environment as central to the promotion of private sector development and that in turn to economic growth and the alleviation of poverty. All have produced SME policy papers but these tend to place emphasis on support measures, particularly on perceived financing difficulties for SMEs, rather than upon the removal of institutional and legislative barriers that might reduce the apparent need for support. Different components of enterprise policies, including SMEs, inward investment and structural adjustment, tend to be seen as separate rather than as part of an integrated policy.
- 3.2 Most of the policy papers on private sector promotion for African countries are also very recent and our local consultants have the general impression that these have been driven more by donor pressure than by internal initiative. None of our consultants believe that an enabling environment for private sector development has been aggressively promoted in a coherent way.
- 3.3 There are exceptions to some of these generalisations. A White Paper: National Strategy for the Development and Promotion of Small Business in South Africa was published in 1995. Our local consultants write that:
- ‘The approach was based on the idea that the large enterprise sector would be able to take the ‘envisaged growth path’ with relatively limited support from government, while the small-enterprise sector required concerted policies and “the deliberate creation of an enabling environment” *Small Business was deliberately singled out as ‘a vector’ for domestic private sector growth*’.
- 3.4 According to our local consultant in Ghana, the last important policy paper on private sector growth was produced in 1983 (Economic Recovery Programme). The new Government however, with only 18 months in power, has already shown more commitment to promoting private sector development than any other Government in the country’s history. The private sector was given a prominent role in the recently presented Ghana Poverty Reduction Strategy (GPRS) to promote economic development and alleviate poverty and the President himself has repeatedly announced that he wants his time in office to be remembered as the “golden age of business. This new commitment is also reflected on the Government’s website and on the 2001 Budget statement (Ghana Data.com) which gives prominence to private sector policies, and refers to a Minister of State for Private Sector Development ‘who will work towards the... elimination of bureaucratic impediments to both domestic and foreign investors... creation of the necessary framework for the protection of property rights and business contracts... and the establishment of a positive partnership between Government and the private sector’.
- 3.5 Zambia has also produced many studies and documents on private sector growth since 1991 culminating in the Poverty Reduction Strategy Paper (PRSP) in 2001 which recognises the role of that sector in poverty alleviation. However in neither South Africa nor Zambia has policy recognition yet been translated into effective action according to our consultants.

- 3.6 Political changes in Zambia since 1991 have entailed a massive shift in attitudes to private sector development since previously there had been almost total nationalisation of larger enterprises which left over four fifths of the economy in state hands. In that respect Zambia faces transitions similar to those experienced in our sample countries in Europe where however actual policies have changed more rapidly.
- 3.7 Hungary, Latvia and Poland all have a relatively unambiguous, and deepening, commitment to private sector growth. Latvia has the least segmented policies of the three countries, for example there have been few documents exclusively related to SME development. There is a broad commitment to creating favourable conditions for business and competition among all enterprises. Similar objectives pervade policies in Hungary and Poland, much larger countries, but it is our impression that their policies are somewhat more segmented. Hungary, it is true integrated its various development programmes into one document in 2000, but it is much concerned with policies to deal with the existence of a dual economy with capital intensive foreign enterprises and labour intensive domestic ones. There is emphasis on correcting this duality by support policies for domestic enterprise, but little emphasis on further, general improvement in the enabling environment.
- 3.8 Poland too is preoccupied with specific policy issues – regional economic disparities, exports, employment and SMEs for example, but limited commitment as yet to active general enabling environment policies as such, despite the overriding commitment to the market economy. Despite these qualifications, all three of our European countries have a much more consistent commitment to private sector development than the countries in Africa. Hungary and Latvia have moved rapidly to privatise state owned industry, Poland a bit less rapidly. All three countries have given priority to the economic and institutional reforms necessary for accession to the European Union though to some extent that has resulted in the acquisition of levels of regulation which are more costly than is perhaps appropriate to their present level of development.
- 3.9 The acid test of policy rationale and commitment is of course the nature and extent of policies actually adopted and their effectiveness in practice, not the policy itself or the machinery used to formulate and implement it. When we come to discuss actual policy measures adopted in Section 4 and 5 it will become much clearer how large is the gulf between the level of commitment to private sector development in general and the enabling environment in particular between the African and European states in our sample. These differences between Europe and Africa are much greater than the differences between countries in the two regions but nonetheless the gap between what we consider to be ‘best’ practice and actuality is quite large everywhere.

### **Policy formulation and consultation**

- 3.10 Effective policies for promoting private sector development cannot be developed or implemented without the full participation of private business at both national, regional and local levels. This does not mean that business interests should be the sole determinant of policy, but that policy should take full account of the practical realities for business and that any services provided by government to promote private sector development should be demand – rather than supply – led. As a corollary to this it needs to be understood that indigenous private sector business – which in practice means mainly MSEs – are local in origin and operation so that policy needs to be developed and implemented with full participation at local as well as national levels. All this is an argument for a bottom-up rather than top-down processes. Consultation should not be confined to the formal sector (see box 3). It is a widespread experience

that policies introduced without adequate consultation may engender unforeseen consequences, for example the imposition of duties on intermediate products for manufacturing in Zambia has, according to our local consultants, ‘led to the decimation of manufacturing in Zambia since 1991’. All considered that minor details of new regulations often unnecessarily raise compliance costs and need to be changed after representations. One of the characteristics of compliance cost management for business is that costs tend to fall over time through the learning effect as systems settle down. Frequent changes cause disruptions and push up costs in a way which could be avoided had there been sufficient consultation at the outset.

**Box. 3**

**Street Hawker in Namibia:**

“Although Namibian hawkers distribute 30% of all the Coca Cola sold in the country nobody wants to talk to us or give us any recognition for that, neither the Coca Cola Company, nor the Government”.

- 3.11 Consultation, particularly if conducted in an open and transparent manner, lends a certain legitimacy to resultant policies and regulations. Whilst it may be difficult or impossible to satisfy all enterprises with a specific policy reform, most governments find policies easier to implement if firms can see that their concerns have been considered in their formation. SMEs are particularly sensitive in this respect since they generally feel that their interests tend to be neglected in favour of those of larger business or organised labour. This sensitivity is heightened by the knowledge that relatively few people in government, large firms and trade unions have practical experience of the unique pressures to which owner managers in small in particular firms are subject.
- 3.12 These problems are compounded by two further difficulties. One is that business representative bodies in countries with a weak private sector are also weak and fragmented with small memberships and inadequate capacity for research. For SMEs in particular, and this is the second difficulty, few business owners have time to participate in representation while a wide variety of sectoral interests may lead to divisions of opinion between business organisations.
- 3.13 It cannot be said that any of the countries included in our sample have evolved entirely effective means for consultation between government and the private sector. In some countries (Malawi seems to be an example) business representation is particularly weak. Even in South Africa where there are a number of fairly well funded business representative bodies for larger firms, SMEs are not strongly represented and there is a tendency for representation generally to be fragmented into large/small, sectoral and racial/ethnic divisions. Our local consultants in South Africa conclude that the role of business in policy formulation is limited (see box 4). This is despite the devotion of considerable effort by both government and the private sector to set up machinery for that purpose including the National Economic Development and Labour Council (NEDLAC), 1994, the Millennium Labour Council and the National Small Business Council (NSBC) 1996 which was dissolved in 1997.



**Box. 4**

**Anon., in South Africa:**

“The government is setting up export councils in competition with our own Chambers of Commerce: hardly a sign of partnership or support for self-help”

- 3.14 Tanzania has set up an official National Business Council (TNBC) and our consultants there report that although traditionally the private sector was never involved in policy formulation this is now changing with various business associations being increasingly involved in policy dialogues. In Uganda, an umbrella organisation, the Private Sector Foundation, was created in 1995 to improve dialogue between business representatives and government and there is an official Coordination Committee for the various representative bodies in the SME sector. It was pressure from the private sector but also donor involvement which led to the recent Micro Finance Bill which will allow certain micro-finance institutions to carry out their activities free of regulation from the Bank of Uganda, though this seems to be a very rare incident of its kind. In Kenya an umbrella organisation, The Private Sector Forum (PSF), was also set up in 2000 and supplements the official body, the Joint Industrial and Commercial Consultative Council (JICCC). The PSF in fact had some influence over the content of Kenya's PRSP, though that document has yet to be formally approved by government. PRSPs present an opportunity both to consult and involve the private sector as a partner in the process of poverty alleviation. This opportunity has not been fully taken up anywhere (see box 5).

### **Box. 5**

#### **Poverty Reduction Strategy Paper**

Once eligible to get debt relief under the Highly Indebted Poor Country (HIPC) initiative, countries must adopt a Poverty Reduction Strategy Paper (PRSP) through a broad-based participatory process, implement key reforms and maintain macroeconomic stability in order to obtain substantial debt relief from creditors. Notwithstanding, some donors such as the IMF and the World Bank provide some relief to countries that first decide to develop an Interim PRSPs (I-PRSP). An I-PRSP can act as a useful first step towards a full PRSP, in that it helps the Government to commit to and plan for the full participatory process.

Of our African sample countries, Ghana, Kenya, Malawi, Tanzania, and Zambia have all developed Interim PRSPs. However, only Uganda, Tanzania and Ghana have developed full PRSPs. In Ghana, the full PRSP which is called the Ghana Poverty Reduction Strategy (GPRS) was released only this year and is expected to form an integral part of the development plan which the President is required to present to the Parliament at the end of his second year, end of 2002.

Although most full PRSPs acknowledge that macroeconomic instability, inadequate policies, and weak governance may limit the extent to which the poor benefit from economic growth, most underlying issues such as the regulatory framework, lack of transparency, corruption etc., are only dealt with in a very limited way. Most PRSPs even lack analysis of the poverty impacts of prior and current programmes on which to base future policy, with Uganda and Ghana as possible exceptions. Ghana's poverty analysis was an exception since it was based on relatively recent and good quality data.

With the exception of Ghana among our study countries, Governments have tended to work out poverty strategies that fail to recognize the role of the private sector as a driving force behind poverty alleviation. Nevertheless, you find the occasional reference to it in most of them. Uganda's PRSP for example, mentions "smart subsidies" for rural electrification as an incentive to encourage entrepreneurs to invest in power infrastructure in rural growth centres. In Tanzania, where in the past agriculture was heavily taxed, the PRSP mentions that there would be a shift away from state involvement in the rural sector. Although neither Tanzania nor Uganda mention any measures to strengthen the financial system, Uganda referred to a new regulatory and supervisory structure for micro-finance and Tanzania stated that the government would encourage the private sector in providing rural credit without giving any details of how this would be done.

Actual involvement of the private sector in the PRSP process has tended to be limited as well. In fact, the role of the private sector has been downplayed in comparison with for example Civil Society Organisations (CSOs), even in Interim PRSPs.

- 3.15 Latvia has yet to see the emergence of effective cross-sectoral SME representation and does not rely on formal machinery such as a Consultative Council for dialogue between government and business. However, Latvia has many effective sectoral associations which have beneficially influenced policy formulation. Notable has been the work of the Foreign Investors Council which has championed efforts to reduce administrative barriers.
- 3.16 Hungary and Poland both have elaborate networks of business associations and also official machinery for consultation. Hungary introduced mandatory membership of Chambers in 1994 but abandoned it in 1998 by which time it had been found that public law status neither increased the legitimacy of these organisations nor did it contribute to effective policy formulation. It has an official Council of Economic Affairs which is not effective and an Enterprise Development Council (1995) which

also seems to have had limited influence over regulatory policies. More effective have been the Association of Large Investors and various trade associations. The four main SME representative organisations have formed an umbrella Association for Representing Small Business Interest which is being taken seriously by government.

- 3.17 Poland has a number of Acts which govern the rights of business to associate and in 1999 the Business Activity Law and in 2001 the Act on Tripartite Committee for Social and Economic Affairs and Regional Committees for Social Dialogue continued this legalistic approach. Various dispersed and competing business organisations have been able to make their voice felt in government and an SME Committee in the lower chamber of the Polish Parliament has also proved effective.
- 3.18 These various arrangements for lobbying and consultation in Central Europe are subject to internal criticism (and examples of the direct influence of consultation on policy are not easy to find). They do clearly have some influence on the stance of private sector policy, however, for example in taxation, and contrast sharply with the general lack of private business sector influence over policy in Africa.

## **Organisation**

- 3.19 The lead ministry for private sector development, including SMEs in all three of our Central European Countries is an Economics Ministry, which in Hungary and Poland integrated the Ministries of Industry and other ministries and departments, such as Internal Trade. The Economics Ministries are also responsible for regional developments. In Poland in 1999-2000 there was a separate Ministry of Regional Development but this initiative was not successful because of overlapping jurisdiction with the Economics Ministry.
- 3.20 There are also supporting institutions. In Latvia, the Latvian Development Agency, which is under the supervision of the Economics Ministry, promotes inward foreign direct investment and also administers various programmes such as the Export Marketing Support Programme. There are also several regional development agencies in Latvia. In Poland also under the Economics Ministry is the Polish Agency for Enterprise Promotion (PAEP).
- 3.21 In Africa the situation is similar except that the lead Ministry is generally Trade and Industry. In Kenya it is The Ministry of Labour and Human Resource Development and in Uganda the Ministry of Finance, Planning and Economic Development. In all cases there is a separate section or department for SMEs and also supporting institutions such as the Small Industry Development Organisations in Zambia and Tanzania.
- 3.22 In most countries, the organisation of private sector development in government has seen various changes and current arrangements are quite recent. Ghana created a Ministry of Private Sector Development only in 2001. In Poland PAEP and Ministerial arrangements were constituted in 2001. In South Africa, the Department of Trade and Industry commenced a major restructuring with creation of an Enterprise Industry Development Unit in 2000 and which is still underway. Major organisational changes were also begun in Tanzania and Malawi in 2001. There have been fewer recent changes in Kenya and Uganda but the existing arrangements only date from the mid-1990s or later.
- 3.23 On the whole, our local consultants do not regard the organisations responsible for private sector development as sufficiently strong or active anywhere, particularly in Africa. The problem is the same everywhere: all government ministries affect the

private sector. Generally the responsible ministry whether Trade and Industry or Economy sees other ministries as having control over some of the real levers for change, such as taxation or employment legislation. In many cases, for example Kenya, Latvia and South Africa the lead ministry for private sector development is not also responsible for deregulation (see below). Co-ordination with other ministries that may have different priorities is a key issue and building cross-ministerial coalitions of decision makers who understand private sector development can be effective.

- 3.24 Not only is co-ordination between the various ministries inevitably involved in private sector development necessary, but it is also important to involve all levels of government, central, regional and local. This is important both in policy formulation and implementation: local authorities need to ‘own’ the policies they are implementing and fully understand them. These authorities also need an opportunity to feed their views into the policy formulation process so that unique local conditions can be taken into account. Regulatory change in particular will not be effective unless local officials including clerks in offices and policemen on the ground know that regulations have changed and know how to interpret them.
- 3.25 As an example in Kenya, the Better Regulation Division is working with Mombassa City Council to revise by-laws affecting street trading, the location of businesses and the regulation of private minibuses. The revised by-laws will then be incorporated into Model By Laws for submission to the Minister of Local Government Act. In another example from Kenya the Better Regulation Division has conducted ‘road shows’ to ensure that local authorities are introducing the new simplified Single Business Permit regime (see Section 4 below) in the right way and that all local officials are familiar with the new regime.

### **Deregulation machinery**

- 3.26 Most OECD countries have some sort of institutional machinery for reviewing new legislation to assess its likely impact upon business and standing committees or other means to assess the scope for improving existing regulation. In a few cases there is a legislative basis for these activities, for example in the U.S. The Paperwork Reduction Act (1980) and the UK Regulatory Reform Act (2001). The European Union and many member states make the preparation of Regulatory Impact Statements mandatory for new legislation imposing significant burdens on business.
- 3.27 Approaches of these kinds have certainly not arrested the growth of regulation in the advanced countries, though they may well have contributed to better regulatory quality. In developing and transition countries regulatory impact machinery might, however, be more effective because it can act as a focus for advocacy for change within government and because the challenge is more to deal with the complex problems raised by outdated existing legislation than with new legislation. Very few developing countries have the necessary research capability in business representative bodies outside government to perform these tasks.
- 3.28 It is in the nature of the transition from centrally planned to market economies that at the outset existing legislation had to be reviewed in our Central European countries and this was an advantage over the African countries where this necessity has been absent. In Hungary from 1989, for example, every organisation was obliged to review all the regulation previously issued, retain only, what was necessary and abandon the rest. In 1994 a Deregulation Council was established but, according to our local consultant little has been achieved in regulatory reform after the ‘big push’ in 1989-90. Despite the impetus of the ‘big push’ after the collapse of communism, much new

legislation in Central Europe was carried out in haste and had to be revised later. In Hungary the SME Act (see below) requires the use of regulatory impact procedures. In Latvia, The Action Plan to Improve the Business Environment seems to reflect a regulatory impact assessment approach and has built into it regular meetings with business representatives and various surveys and other feedback mechanisms. Poland does not appear to have current machinery of these kinds though it did set up a De-bureaucratisation Council which, according to our consultants 'had neither real owners nor results'. Poland is taking part in the EU initiative The Business Environment Simplification Task Force (BEST).

- 3.29 In Africa, the mechanisms used in OECD countries (and in the transition countries to a more limited extent) for the improvement of the regulatory framework have yet to be adopted on any scale, although SME departments generally do some work in this area. There are two notable exceptions to this. In Kenya a Deregulation Section was set up in the Small Scale and Jua Kali Division of the Ministry of Planning in 1996 with support from DFID. In 2000 the Better Deregulation Division as it was renamed became part of the Kenya Institute for Public Policy Research and Analysis (KIPPRA). In Uganda, a similar unit was set up in the Ministry of Finance in 2000, also with the assistance of DFID.
- 3.30 In both Kenya and Uganda the Better Regulation units have achieved wider recognition of regulatory issues and done valuable research, although concrete achievements in terms of reform have proved modest so far (however, see the section on business registration and licensing in Section 4 below in relation to Kenya). In Uganda, the government in its Budget Background statement 2001/02, has announced that it is committed to introduce consultation on any new regulatory proposals and a regulatory impact system for new regulations.

### **SME Acts, Research and Reporting**

- 3.31 Some OECD countries have SME Acts which contain declarations of commitment to the sector, policy criteria and other matters including institutional arrangements. The pioneering Acts appear to be those of the USA (1953), Japan (1963) and the German Lander (1975). Most countries do not have SME Acts, but they may have value where a cultural commitment to private enterprise and some legal basis for it is seen to be necessary, especially where a big push or a new start is envisaged. For these reasons, several European countries in transition have enacted such legislation for example Bulgaria, The Czech Republic and Russia, though these particular examples are very limited cases in that they omit declarations of principle and are confined mainly to details of support measures.
- 3.32 In our sample, Hungary and Poland both have relatively strong SME Acts dating from 1999 although the absence of such an act, as in the UK and France does not necessarily indicate any lack of commitment to private enterprise. South Africa is the only African country in our group that has an SME Act, (The National Small Business Act, 1996). All these acts define small firms, give commitment to the support of the sector and institutional arrangements therefore including consultative councils.
- 3.33 The Hungarian and South African Acts specifically provide for reports on the impact and effectiveness of SME support strategies and the state of the sector and also on regulatory impact, but little seems to have come in either case of the provisions on regulatory impact. Regulatory impact is not covered in the Polish, SME Act.

- 3.34 The three Central European countries all have relatively good statistics, research and reports on business sector enterprise, both from government and private sources though there are problems with the removal of inactive enterprises from the official business registers and with the grey economy. These countries also have systems for monitoring the effects of policy though it is difficult to judge from our local consultants' reports how penetrating and effective these systems are.
- 3.35 In the African countries the statistical base is very poor and out of date though in some cases efforts are being made to improve it. For example in Tanzania the last census of enterprises with less than 10 employees dates from 1991. Most of the surveys of regulatory problems appear to have been initiated and financed by donors. There also appears to be no effective monitoring of policy measures. What is meant by monitoring is often tracking the processes of implementation rather than of the results in economic terms. In Malawi our consultant's report, which seems representative, says that:
- 'Malawi does not have well elaborated mechanisms to monitor the effectiveness or otherwise of the policy and regulatory environment. The Ministry for Commerce and Industry has a planning directorate; however, this is understaffed.... Because of this, the Ministry depends on groups such as the National Working Group on trade policy and the National Action Group for formal and informal feedback'.
- 3.36 Even in South Africa where the availability of research and statistics is said to be of higher standard than elsewhere in Africa there has not, for example been a manufacturing census for a number of years and there are no longitudinal data on the evolution of individual businesses over time. There are also doubts about the reliability of the statistics that are available, according to our consultants. (However, it should be noted that many OECD countries have problems with SME statistics. For example the National Statistics office in the UK cannot reliably track the evolution of individual SMEs over time).
- 3.37 A necessary first step in identifying regulatory barriers is to establish their relative importance. The three Central European countries have all carried out surveys or made use of private surveys. Not all the African countries have done this.
- 3.38 Kenya has carried out a number of surveys of obstacles to private sector development; land and title to property, trade licensing and access to finance were the overwhelmingly significant issues. In Uganda the most prominent issues in terms of compliance costs were business licensing and legislation, tax administration, customs procedures and specialised approvals for investment. No comprehensive studies have been carried out by government in Malawi or Zambia. South Africa has carried out surveys for example the National Treasury initiatives on Red Tape and Tax Reform 2001 and the National Small Business Regulatory Review (1999). The main areas identified were taxation, access to finance, labour legislation and land ownership.
- 3.39 It should be recognised that business surveys on regulatory barriers have limitations. Business managers will not necessarily be aware of the links between problems they experience and the inappropriate regulation that gives rise to them, for example, in the field of enterprise finance (see Section 4 below). All SMEs are not affected in the same way by regulation, for example the high cost of business registration may be of little concern to well-established firms (even though it might once have been) and, of

course surveys do not include firms which have not been established at all as a result of regulatory obstruction.

## **Best practice**

3.40 It is doubtful if clear conclusions on what works and what does not in terms of the machinery for private sector development can be drawn from the actual experiences of the countries in our sample. In most cases practice is some way behind what might generally be acknowledged as the best frontier in the advanced countries outside our sample<sup>7</sup>. Although it is easy to find statements of commitment to private sector development, coherent and fully worked out policies developed in full consultation with the private sector for improving the enabling environment, are generally absent. Policy statements are focussed more upon dealing with specific issues, such as regional questions and on support measures rather than upon clearing away obstacles to development such as inadequately defined property rights and regulatory barriers. In many cases government officials do not understand the needs of business (see box 6).

### **Box. 6**

#### **Civil servant, South Africa:**

“There are 65 laws to comply with in order to register a business in South Africa. People don’t know what to do or where to start, let alone who to ask for help. There is also a huge language problem. Many people don’t speak English. Information should be provided in all languages”.

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<sup>7</sup> It is not implied that the advanced countries have all the right answers or that even where these countries have developed innovative and effective solutions for improving enabling environments they are necessarily transferable to developing countries. Widespread concern among businesses about the growing weight of regulatory burdens in OECD countries and the responses of governments to these concerns are sufficient evidence that these countries do not in fact have all the right answers. However developing countries can learn from the experience of failed initiatives in the advanced countries. Frequently unworkable schemes are imported. South Africa for example has a training levy system which imposes heavy compliance costs on SMEs. Such a scheme was tried and abandoned as unworkable in the UK many years ago (See box 7).

### **Box. 7**

#### **Entrepreneur, South Africa:**

“We need more people with skills, I agree. But why are we supposed to be happy about taking in people with formal training who has no clue about what really goes on in the workplace. We constantly get people with fancy mechanics college certificates sent to us who know nothing about anything, let alone how to repair a vehicle. How do you suppose that big firms with high quality standards will employ people like that? “

#### **Small Business Project interviews with firms in South Africa:**

The problem is simply the difficulty in allocating the time of a small management cadre or sometimes a single proprietor-manager to administrative chores. The Skills Levy, introduced in 2000, was a pointed example at the time of the interviews. Companies are required by law to pay a portion of their payroll to sectoral training authority. In theory, up to two-thirds of the levy can be reclaimed. But SMEs find the administrative requirements (to reclaim) anything but straightforward. Bloxwell Steel is a firm that specialises in the computer-controlled cutting of steel plate. The company does a great deal of “on-the-job” training, not only because operating computerised steel-cutting equipment is specialised, but also, says managing director Bill Smith, because operators with a broader grasp of the field are more effective.

Bloxwell Steel’s problems start when it comes to reclaiming a portion of the levy. Smith initially tried to get his secretary to handle the process. “She was totally lost”, he says. He estimated that administering levy claims will consume “one third of time of a full-time administrator”. The company has not yet claimed back any training monies because it has not yet mastered the system. But even when it does – a process Smith suggests will probably require him to dedicate part of his own time – the additional cost might still outweigh the benefit. There are thus two costs to the business: First there is a time penalty placed on a small and already hard-pressed management cadre. ”Right now I’m trying to expand this business”, says Smith. “I really don’t need the extra hassle”. Second, there is the on-going cost of administering the levy. The Department of Labour recommends firms utilise labour consultants. Can SMEs really afford this? Smith categorically rejects the suggested course of action. Another firm a medium company (90-100 employees) – does have staff dedicated to this function but also complained that “it wasn’t worth the effort”. Of all interviewees, only one had successfully done training and been compensated for it.

- 3.41 Machinery as such, is undoubtedly less important than political will and policy coherence. Both are more evident in the Central European countries than in Africa and the machinery adopted in the transition countries is generally much closer to the advanced country frontier in terms, for example, of regulatory impact assessment and monitoring of policy implementation. Whether or not a country has an SME Act for example or where the lead ministry is located may not be at all critical.
- 3.42 A number of guidelines can be suggested for machinery based as much upon reasoning and the experience of the authors and our consultants as upon the lessons of experience in the countries examined. In all the countries covered there is a growing awareness of the importance of the enabling environment, but in most cases the impact of that upon policy is too recent for results to be evident, especially in Africa.
- 3.43 The following guidelines are suggested:
- A comprehensive policy rationale is necessary and that policy needs to be made with the fullest consultation with the private sector. Policies should be concerned more



with helping the sector to help itself, that is by removing obstacles, rather than in providing support measures.

- Consultation should make use of all possible channels of communications but formal consultative councils are no substitute for the inputs of strong private sector representative associations. Moreover consultation should be carried out at local as well as national levels.
- All levels of government: central, regional and local, need to be consulted on reforms and closely involved in both policy formulation and implementation.
- The lead Ministry for private sector development needs to be strong and influential and its role clearly identified. It should gather under it as many as possible of the levers at the disposal of government including a specific better regulation activity and it needs specific mechanisms for liaison with other ministries.
- 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. Mandatory impact assessment procedures are necessary.
- Attention needs to be given to managing and operating regulations effectively: often the most serious aspect of the problem is not in the intent of a regulation but in its practical implementation.
- 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 environment and monitoring the implementation of reforms. Policies which are not monitored are not likely to be sustained or adapted with experience.
- Most of these recommended actions depend upon the availability of a statistical base on private sector business activity if policy is to be devised, implemented and monitored effectively.
- Priorities for action need to be set. With limited resources it is never possible to do everything and efforts need to be concentrated on measures that will have the greatest impact.

## **4. POLICY MEASURES - MACROECONOMIC, DEREGULATION AND SIMPLIFICATION**

### **Macro-economic policy**

- 4.1 All our sample countries have carried out major economic reforms since the 1980s. These reforms have included measures to reduce government deficits and control inflation, moves to flexible exchange rates and the removal or reduction of price controls, financial repression (interest rate control), import controls, non-tariff barriers and privatisation, all intended to allow markets to work more freely. Some of these reforms have had mixed results<sup>8</sup>.
- 4.2 In Africa structural adjustment policies imposed by the Bretton Woods institutions were and are controversial and were nowhere fully implemented, especially in the privatisation of state enterprises. Privatisation is important, not only in the interests of efficiency and the reduction in public deficits, but also in reducing demands on the limited administrative capacities of governments. Privatisation can also have a direct impact on private sector development, provided it is done in a way which restores competition, by reducing business input costs for utilities for example and by a growth in subcontracting by the newly independent firms. However progress has been slow except in Ghana where two thirds of approximately 300 state enterprises have been privatised.
- 4.3 Macro-economic reforms are not a focus of this study but it can be asserted that they (and political stability) are generally important pre-conditions for private sector development, though not enough in themselves to ensure it. This is because institutional and regulatory barriers operating at the micro-level can and do frustrate the shifts in resources necessary to take advantage of greater economic freedoms and blunt the incentives for market operators to carry out these shifts.
- 4.4 We continue now with a review of the various aspects of policy on regulatory barriers and the improvement in the enabling environment, not necessarily in order of importance, noting what the problems are and what has been done about them in our sample countries.

### **Recommendations**

- 4.5 This section has covered a wide range of government policies which present difficulties in promoting private sector development, but which must be tackled if progress is to be made. Our conclusions follow:
- Sound and stable macro-economic policies are an essential basis for development. Prices, exchange and interest rates need to be freed and internal and foreign trade and investment opened up. Public deficits and inflation need to be controlled and reduced. Privatisation can help to reduce deficits and release resources. Without these changes, markets cannot work effectively to channel resources into private business development.

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<sup>8</sup> Parker et al (1995) and our consultants report for Malawi give some indications of how opening up foreign trade have affected MSMEs. Imported inputs have reduced costs and created new opportunities for firms for example, but also competition from imported consumer goods. Nevertheless there is evidence that small firms have adapted to the changes and become more efficient.

## Taxation

- 4.6 In all surveys, taxation ranks high, and often in first place, as a source of regulatory cost and difficulty for the private sector, though it is important to distinguish between the burden of tax rates and the compliance costs of the tax systems and of course between firms in the formal and informal sectors. Even in the informal sector some taxation is unavoidable because of indirect taxation, such as Value Added Tax (VAT), which will be payable on business inputs from formal enterprises. It is, in fact a characteristic of all our sample countries that they rely more on indirect taxes and less on direct taxation of incomes and profits than developed countries as a source of revenue.
- 4.7 Like compliance costs, taxes bear more heavily upon MSEs than larger firms if only because they rely to a large extent on the working proprietor as a source of funds for equity financing and as a guarantor of borrowings where these are available. Nominal business tax rates tend to be high in Africa (higher than in Central Europe) and there has been a recent tendency for tax bases to be broadened and tax rates to be reduced, especially in Central Europe, where lower tax rates seem to have been associated with higher compliance and government revenues. Whilst it can be argued that high indirect tax charges are less harmful to business than direct taxes, they can be regressive for the general public (bear more heavily on lower incomes). The real fiscal problem in developing countries has to do with corruption and the only partial enforcement of direct taxes.
- 4.8 All our country consultants report particular difficulties with VAT which imposes heavy compliance burdens upon small firms in advanced and developing countries alike (Sandford et al, 1989). VAT is mandatory in the European Union and our three countries in Central Europe which hope to join the Union all introduced it some time ago. So too have all the countries in our sample for Southern Africa except Malawi<sup>9</sup>. It is very doubtful whether VAT, because of its high compliance costs and because it requires reasonably high standards of bookkeeping skills, is a suitable form of taxation for Third World countries. Compared with other forms of indirect taxes, such as sales and wholesale taxes, VAT not only has higher administrative costs but it affects many more businesses. The increasingly widespread adoption in Africa of VAT systems is another example of the transfer of inappropriate regulatory forms from the developed countries<sup>10</sup>.
- 4.9 Value added tax charges theoretically, if not in practice, do not enter into business costs and are borne only by the final consumer. Businesses can offset the tax on purchases (inputs) against tax charged on outputs, if the difference is positive they remit the tax to the authorities, if negative they reclaim it. Revenue constrained governments find it tempting to delay refunds to the detriment of the cash flow of enterprises and push up working capital requirements, and several of our local consultants' reports mention this. This problem is made worse because, for example in Poland, as elsewhere in our sample, firms are required to account for tax on issue of the invoice not when the customer pays which will be later, perhaps much later. In the UK for example, firms can opt for 'cash accounting' for VAT under which tax

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<sup>9</sup> VAT was introduced in Kenya 1990, in South Africa 1991, in Zambia 1995, in Uganda 1996, in Tanzania 1998, in Ghana 1998/99. In Malawi there are on-going discussions about exchanging the current surtax system for VAT.

<sup>10</sup> For a full discussion of the advantages and disadvantages of VAT see Bannock 1990.

becomes due only from the date of receipt of payment from the customer. Zambia has adopted cash accounting for VAT however.

- 4.10 There are other ways in which the compliance costs of VAT in the advanced countries have been eased and which do not seem to have been adopted in all our sample countries. For example tax returns and payments can be made quarterly for smaller firms in some European Countries instead of monthly, special schemes can be used to reduce the need for record keeping and high thresholds used to exempt many small firms from the need to register. It is also desirable to keep the number of VAT rates and exemptions to a minimum because multiple rates raise compliance costs. Because of an understandable desire to minimise the potentially regressive impact of VAT, developing countries tend to use more rates and exemptions.
- 4.11 Some countries among our sample levy exceptionally high penalties for non-compliance. High penalties are not a substitute for effective enforcement and inspections and tend to stimulate corruption and business closures. In Tanzania, for example, according to our consultants, many SMEs simply avoid registering for VAT while of those that do, large numbers of businesses have been closed down by the imposition of penalties.
- 4.12 Many of our sample countries have taken measures to reduce compliance costs. In Central Europe, Latvia in particular has reduced tax rates and made some progress in simplifying the system since 1995. Corporate income tax was reduced to 22% in 2002 but social security charges as elsewhere in Central Europe remain high at 37% which discourages legitimate employment. In Poland the government is planning to introduce an electronic reporting system, similar to the one used for social security payments which has been well received and similar action has been taken in Hungary. In 1996, the Hungarian Ministry of Finance began to publish data on the expected incomes of the self-employed by trade and region of origin. Sole proprietors previously reporting below average incomes now tend to report higher than average incomes in the expectation of avoiding investigation so that this measure has improved compliance (Hungary has a self-assessment system). Hungary also has flat rate and simplified Bookkeeping systems for business income tax. Also in Hungary accounting firms by law share responsibility for the accuracy of tax returns, this encourages the use of external bookkeepers.
- 4.13 In Africa, tax rates have also been reduced, for example in South Africa notably by introducing a graduated corporation tax to the benefit of smaller companies. In Uganda corporate tax rates were reduced by half between 1993 and 1995. In Tanzania corporate tax rates have been introduced and income tax thresholds raised. In Malawi corporate tax allowances have been reduced permitting a reduction in corporate tax rates. There has also been a reduction in personal income tax rates but a minimum corporate tax based on turnover has also been introduced which is unfavourable for start-ups. However in 2001 Malawi did abolish provisions for advance payments of tax by start-ups. In none of these cases however, according to our local consultants, have these measures been accompanied by simplification of the systems.
- 4.14 Generally, there has been a trend towards the adoption of unitary revenue authorities though Ghana has yet to make this move. For example, the Kenya Revenue Authority from 1995 replaced multiple revenue raising departments of the Ministry of Finance and other Ministries, Tanzania introduced a unitary revenue authority in 1995. Single revenue authorities can result in the elimination of duplicate inspections and investigations and, as under the Zambia Revenue Authority, can undertake major

reforms to improve user friendliness and compliance. In various countries in Africa and Central Europe there are many complaints about instability in tax systems, variable and indeterminate interpretation of tax laws, the use of multiple personal identification numbers for various taxes and business registration, double taxation of dividends and other matters.

## **Recommendations**

4.15 This section has covered a wide range of government policies which present difficulties in promoting private sector development, but which must be tackled if progress is to be made. Our conclusions follow:

- Fiscal policies must be directed at reducing the barriers to formal sector activity. Wherever possible tax rates should be reduced and graduated in favour of SMEs and the tax base widened. Compliance costs of the tax system should be lowered by simplification and the adoption of user-friendly unitary tax authorities, the various devices available for easing compliance such as composite tax rates and cash accounting for VAT and simplified systems for the assessment for business income tax for MSEs. High penalties for non-compliance are not an effective substitute for lack of comprehensive enforcement.

## **Bankruptcy**

4.16 Enterprises cease trading and lose their identity for a number of reasons: they may be incurring unacceptable losses, they may be absorbed by another enterprise or the owners may wish to retire or do something else. Various regulatory and legal mechanisms may operate. For unincorporated businesses, without the protection of limited liability, owners wishing to cease trading can pay off any outstanding debt or if insolvent and unable to do so, reach agreement with creditors, may be forced into personal bankruptcy in which available assets, if any, are distributed among creditors by an appointed official.

4.17 For incorporated businesses the procedures are more formalised: there may be a voluntary liquidation or again formal bankruptcy proceedings. In many countries, companies can seek legal protection from creditors while they re-organise as under Chapter 11 in the United States. Provisions of this sort can be particularly important in periods of short-term economic instability. Where enterprises cease trading altogether, voluntarily or involuntarily, they are normally supposed to deregister if they were required to register in the first place, although they often have little incentive to do so and frequently do not. In Hungary for example it is estimated that 30% of registered businesses have ceased trading and the situation is similar in Poland.

4.18 There are good reasons for the regulation of business exits. It is necessary to provide some protection for creditors to facilitate lending and supply, but it is also desirable to allow entrepreneurs to exit from enterprises which have failed so that in the light of that experience they can found new businesses and the assets of the failed business can be re-deployed. It is also necessary to guard against fraudulent behaviour and to prevent the self-employed and directors of companies that have acted irresponsibly from placing other creditors at risk. Like other forms of regulation, however, exit provisions can be unnecessarily cumbersome, slow and costly.

4.19 In Africa most countries appear to have outdated, often inherited, legislation which is slow and very formalised and therefore costly in operation and do not have provisions for allowing companies to continue to operate where there is a chance that an insolvent business can trade out of its problems. Zambia does have modern insolvency

provisions in its 1995 Companies Act, though it has no arrangements of the Chapter 11 type.

- 4.20 In South Africa, the Insolvency Project Committee started work on revising outdated law from 1936 in 1987. A draft Insolvency Bill has recently been submitted to the Minister of Justice, but it has been criticised for lack of adequate measures to facilitate business exits. Uganda is also in the process of modernising its Insolvency Law which dates from the colonial period. A valuable feature of the new bill will be that it will allow all courts exercising jurisdiction over individuals to take on cases and not just the High Court in Kampala, which should reduce costs.
- 4.21 Bankruptcy provisions may have little relevance in the informal sectors, but they are an issue in countries with a large formal sectors such as South Africa and may be another, if minor, impediment to the development of the formal sector there and elsewhere. Certainly, the Central European countries in our sample have devoted considerable attention to the subject. Hungary has updated its original Bankruptcy and Liquidation Act several times over the past 10 years. In Latvia the Insolvency and Bankruptcy of Enterprises Law (1991) has gone through several and significant amendments in 1996 and in 1998-99. In 2002 it is expected that a new Insolvency Agency in Latvia will become operational to further streamline and improve the insolvency process and reduce a backlog of approximately 4000 insolvent enterprises which have ceased trading.

## **Recommendations**

- 4.22 This section has covered a wide range of government policies which present difficulties in promoting private sector development, but which must be tackled if progress is to be made. Our conclusions follow:
- Systems for exit from business through bankruptcy or liquidation need to be modernised so as to reduce costs, prevent unnecessary closures and strike a better balance between the conflicting interests of debtors and creditors and the need to prevent unscrupulous people from exploiting the law.

## **Business registration and licensing**

- 4.23 Business registration and licensing procedures generally act as a barrier to entry in the formal sector. Typical problems include:
- Excessive numbers of licenses;
  - Complex fee structures and high charges since registration and licensing are regarded as sources of tax revenue as much or more than as a form of regulation;
  - Necessity to visit multiple offices sometimes from geographically remote locations;
  - Business legislation may require several prior steps, e.g. obtaining certificates that taxes have been paid;
  - Multiple separate registration requirements for legal forms e.g. incorporation, taxation, social security and special sector needs;
  - Long delays in processing applications and in being served at government offices, and;
  - Complex documentation, sometimes not available in all local languages.

- 4.24 These problems are particularly acute in the African countries in our sample, although most countries have attempted, often unsuccessfully, to ease the difficulties (see box 8). However there are exceptions, registering a business in Ghana for example is relatively quick and inexpensive. Currently, the cost of forms and registration ranges from less than US\$ 30 for a sole proprietorship to about US\$ 75 for a limited company and often takes less than 2 weeks to get. In the past, individuals wishing to register their businesses had to visit or forward their documents to the Registrar-General's Department in Accra. Recently, however, the National Board of Small-Scale Industries (NBSSI) has come up with a scheme to facilitate the process for residents in other regions and districts. Under the scheme, the NBSSI buys the registration forms and sends them to its centres located in the regions. In turn, individuals wishing to register a business buy these forms, complete them, and hand them over to NBSSI officers who then send them on to their coordinator in Accra in bulk. After they have been processed, the final certificates of incorporation are sent back using the same route. According to the coordinator, for all these services, NBSSI charges a token fee of US\$ 1.25 equivalent to cover overheads, mainly postal charges and handling.

**Box. 8**

**Entrepreneur in the Informal Sector, Lesotho:**

“Because of insufficient meat production in Lesotho we import meat from South Africa. Every morning big South African trucks come into Lesotho to deliver meat. Many Basotho meat vendors think that they could import the meat themselves at much lower prices and sell on the meat at much more competitive rates than the South Africans. However, as a Basotho meat importer you need a special license in order to get the meat through the Lesotho customs. This license can only be obtained in the capital Maseru, which is a hassle if you live outside, and for which you need to demonstrate compliance with meat health and safety regulations, most of the time meaning that the meat is kept under hygienic conditions and refrigerated throughout the journey. Since most Basotho can't afford to buy a refrigerator-truck they are effectively prevented from entering into competition with the South Africans. It would be perfect possible to safely transport meat without refrigeration from South Africa to Maseru, especially if it were done early in the morning when temperatures are low. It's a very short journey. Plus once the meat reaches Lesotho, much of it is sold in the street under quite precarious conditions with no refrigerators anyway, without the government doing anything about that. How are we to create domestic employment and compete with international imports if we are discriminated against by our own government in this way?”

**Private supplier of business support services, Namibia:**

“When you register a business in Namibia, the authorities do not inform you that from then on you have a duty to regularly update them of your enterprise's activities and earnings. As a result, many entrepreneurs come to me after their first 3 to 5 years (sometimes just as their enterprises start to take off) with massive amounts of government tax debts and penalties which they accumulated throughout the years for not complying with government requirements that they had no idea existed but which effectively threaten them to go out of business”.

- 4.25 In South Africa, under the Business Act No. 71 of 1991, licensing requirements were abolished for almost all categories of business, except for catering and foodstuffs. It also prevented law enforcement officers from confiscating street traders merchandise

and prohibited local authorities from enforcing distance and ‘move-on’ laws<sup>11</sup>. The Act has not been fully implemented because under the new Constitution business regulation was devolved to the provinces and the Local Government Transition Act has resulted in uncertainty over the role and functions of provincial and local government, according to our consultants.

- 4.26 In Uganda, the general business license, which is required for all businesses is decentralised to the district councils which do not have a uniform system for trade classification or fees charged. Our consultants write:

‘Trading license granting is too discretionary. The system combines both revenue and regulatory goals. Several clearances and inspections are needed to obtain a license (local council clerk, health inspector, building inspector, sometimes income tax and graduated tax clearance), which are time consuming and used as a means of extracting bribes’.

**Box. 9**

**Anon., in Botswana:**

“In Botswana hawkers are being harassed by local government although they are not supposed to be according to central government legislation”.

- 4.27 Kenya has now introduced a Single Business Permit (SBP, mandatory from 2000) at local authority level. This development was taken on the initiative of the Deregulation Division. Central Government licensing is also to be reformed. The savings in compliance costs compared with the former regime have been estimated annually at 1 per cent of GDP illustrating the high costs of the old systems. As an incentive, to compensate Local Authorities for losses of revenue from the introduction of the SBP Central Government has established a Local Authority Transfer Fund (5% of Income tax receipts) the distribution of which is related to the efficiency and extent of implementation of SBP.
- 4.28 Tanzania has also demonstrated what can be done to reduce business entry costs. The Business Registrations and Licensing Agency (BRELA) established in 2000 has reduced the number of days it takes to get registered from 90 to as little as 3 days.
- 4.29 In most countries the private sector policy framework was basically created for the large scale enterprise sector, which subsequently forced SMEs to operate in a less favourable business environment than larger firms. In Malawi in 1991 a new Industrial Licensing Act eased the entry pressure on SMEs wanting to get into manufacturing by no longer requiring an industrial license in order to start up a manufacturing enterprise, excluding production of weapons, explosives, or hazardous wastes.
- 4.30 Costs of business registration and licensing seem to have been brought down in Central Europe. In Latvia, for example, from 1998 Cabinet regulations significantly reduced the number of activities to be licensed. Tax and enterprise registration are effected in a single procedure.

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<sup>11</sup> Distance laws common if not universal in Africa prevent street traders operating near established businesses. Move-on laws require street traders to shift their stands at regular intervals. Traders are subject to harassment by police in many African countries (see box 9).



- 4.31 In Hungary the time taken at Court Registries for companies is limited by law (30 or 60 days, depending on legal form). If the Registries do not react to the submitted documents within these time periods the application is regarded as accepted. From 2000 offices at local authorities organised and financed by the Ministry of Interior and which issue ID cards and other personal documents, also issue licenses for sole proprietors and tax and social security registration numbers in one place. These centres are equipped with up to date information technology and licenses are issued in a few days. According to our local consultant, business registration and licensing is relatively cheap and easy in Hungary, even though entry barriers have risen somewhat following initial reforms in 1990.
- 4.32 It appears that business entry costs in Africa are vastly higher, on average, in relation to GDP/Capita than in the advanced countries and higher than those in our three Central European countries. For the three Central European countries these costs average 67% of GDP/Capita, in Africa 90% and in four advanced countries less than 3%<sup>12</sup>.

## **Recommendations**

- 4.33 This section has covered a wide range of government policies which present difficulties in promoting private sector development, but which must be tackled if progress is to be made. Our conclusions follow:
- The costs of business registration and licensing need to be brought down drastically and uncoupled from revenue-raising. This can be done by reducing the number of licenses required, establishing strict time-limits for permissions, decentralising procedures, carrying out inspections after the issue of basic permissions, consolidating different departmental requirements and other means.

## **Employment Law**

- 4.34 Employment protection legislation is a difficult area given that there is a natural desire to prevent exploitation under the prevailing conditions of high unemployment, particularly in Africa. This legislation covers such matters as minimum wages, holidays, unfair dismissal, termination provisions, trades unions, health and safety and other matters including (in South Africa for example) racial discrimination and maternity leave. In most cases there are numerous Acts affecting employment (seven major pieces of legislation in Zambia for example).
- 4.35 There appear to have been no compliance cost studies of employment legislation in any of our sample countries in either Africa or Europe. Compliance costs are generally high, for example in at least one of the African countries, it is necessary to report details of individual wages and other contract conditions to the Labour Ministry, even though data on wages is also supplied to taxation and social security authorities.
- 4.36 Also important is the fact that the legislation does not promote labour flexibility and is not generally enforced outside the formal sector, it therefore benefits only a relatively small proportion of the labour force. Even in the formal sector, few if any allowances

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<sup>12</sup> Calculated from data in Djankov et al (2001) on direct costs (fees) and compliance costs (entrepreneurial time). The four advanced countries are Australia, UK, Canada and the USA. The African countries are Ghana, Kenya, South Africa, Tanzania, Uganda, Malawi and Zambia. There was a wide dispersion of costs in the African countries with South Africa only 20% of the average and Tanzania more than 3½ times the average.

are made for the particular difficulties of SMEs. Some aspects of the employment legislation, for example in termination provisions, are not far below advanced country standards, which of course vary, especially between Western Europe and the USA<sup>13</sup>.

- 4.37 In Africa, reform of employment legislation has proved intractable, though studies are going on in a few countries (for example by the Deregulation Units in Kenya and Uganda). Everywhere employers consider that reforms are necessary, but only in South Africa do our consultants report that recent reforms have produced a package that labour and employers 'can live with'.
- 4.38 The level of employment protection is certainly high in Central Europe. In Poland, according to our local consultant labour law is generally in compliance with the provisions of European Union Directives and often provides higher levels of protection. Until very recently this has not been the case in Latvia where a 2002 law will raise standards and costs. As elsewhere any reforms to labour employment laws are highly controversial.
- 4.39 The most prominent employment related issue in Central Europe is the high level of employers Social Security Contributions which discourage formal employment. In Latvia our consultant reports:

'On a practical level, the actual effect of the existing labour and social security legislation is best evidenced in the statistics which indicate that 88% of employees working in the private sector have salaries at the level of the minimum monthly salary. This clearly shows that employers try to evade full payment of taxes for employees by paying part of the salary in 'envelopes''<sup>14</sup>.

## **Recommendations**

- 4.40 This section has covered a wide range of government policies which present difficulties in promoting private sector development, but which must be tackled if progress is to be made. Our conclusions follow:
- Compliance cost studies for employment law are needed. Even where radical reform may be politically unacceptable, some simplification and compliance cost reduction is almost everywhere possible without sacrificing the basic objectives of employment protection laws. Where possible, further reforms are needed to improve labour market flexibility such as restrictions on temporary employment contracts.

## **Barriers to finance**

- 4.41 In all countries (including the advanced countries) unquoted companies complain about inadequate access to finance, particularly long-term finance. Even smaller quoted companies may have difficulties arising from lack of institutional interest in their shares and the limited scope for bond finance. To a large extent these problems are inevitable because of the fact that small firms are riskier than large firms (a larger proportion fail each year). It also costs proportionately more to investigate the credit worthiness of small loans and monitor them; small firms may lack collateral and may be reluctant to take external equity which could improve debt/equity ratios. Generally

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<sup>13</sup> Galli and Pelkmans (2000) show that in Western Europe the severity of employment legislation is inversely related to GDP growth.

<sup>14</sup> Not only are social security contributions high but the compliance costs of meeting them are also high. This is a particular problem in Poland.

speaking, however, these complaints are less frequently heard in most developed countries because competition in banking has increased, loan guarantee arrangements have become more widely available, credit rating services have improved and secondary stock market tiers have been developed with a continued growth in the availability of venture capital.

- 4.42 In Africa, lack of finance and bank finance in particular, is universally regarded as the major impediment to the development of SMEs. In an attempt to solve this problem governments have, until recently, focussed upon various schemes for subsidised or otherwise assisted lending by development banks and other state or quasi-state institutions. Behind the financing problems of SMEs, however, are a series of institutional and regulatory barriers which prevent capital markets working properly.
- 4.43 The most important of these obstacles is a lack of property rights and other institutional mechanisms which would allow people in the informal sector to pledge their assets against borrowings and participate in the capital markets for business assets. De Soto (2000), as mentioned in Section 2 above, has shown how these problems had to be overcome in the present developed economies before they were able to embark on rapid industrial expansion. He calculates that the world's poor have in fact accumulated savings many times greater than all the foreign aid and investment received since 1945 but that these savings are, as it were sterilised because they cannot be utilised in the capital markets of the formal sector.
- 4.44 Most of our local consultants' reports for Africa refer to the practical difficulties of placing and realising collateral for bank borrowing. Informal sector entrepreneurs have erected buildings, for example, which represent considerable collateral value but they cannot pledge these assets because the buildings are on land to which they do not have clear title, such as government land or common land. Although they may have reasonable security of occupation by usage or custom and they may have purchased the property on that basis from someone, that does not count as a legal title. Not only do banks find it difficult to obtain sound collateral but even where they have it there are often difficulties in realising it in cases of default. In Zambia for example, although collateral is legally realisable the courts are reluctant to dispossess borrowers in default and delay sales processes leading to asset dilution. Even though taking collateral and realising it are proper legal procedures in our sample countries in Africa in practice they are uncertain and protracted and banks are often reluctant to lend on a secured basis. In Kenya, the Central Bank does not allow unsecured lending to small firms and any pledging of agricultural land requires the prior permission of the Land Control Boards.
- 4.45 Most countries in our African sample liberalised their commercial banking systems in the early to mid 1990s to facilitate new entrants and also to reduce state ownership in a few cases. In Tanzania for example the National Bank of Commerce was privatised in 2000 and there are plans to privatise the Micro-finance Bank. In Zambia and Uganda new entrants were insufficiently regulated and there were some bank failures followed by a tightening of capital adequacy and other requirements. A current bill in Uganda may, it is feared lead to over-regulation. Since 1995 entry barriers have favoured new entrants in Malawi but the banking system there, as elsewhere remains highly concentrated. New entry into banking in South Africa is difficult and is highly concentrated into few established enterprises as in the UK where there has been a recent investigation by the competition authority (see box 10).

**Box. 10**

**Representative of a Development Corporation, South Africa:**

“There is market failure in the South African banking system. In fact, South Africa is still a large cash economy in which large communities are not banked. SMEs are desperate to get finance but can’t obtain any because of the lack of competition and the inability to produce the collateral banks require”.

**Anon., South Africa:**

“A couple of years ago, there was an attempt by a Saudi Arabian bank to break into the South African market. Unfortunately, the attempt failed after the established banks managed to lobby the government against it”.

**Banker, South Africa:**

“A lot of really difficult legislation comes into power as soon as an institution becomes deposit taking, legislation which pretty much prevents new entrants from coming in. The transaction payment system is an example of legislation which for example prevents retailers from offering banking services. However in some cases, retailers do it anyway, especially in rural areas.”

- 4.46 Most micro- and small enterprises in Africa are situated in rural areas, as opposed to Central Europe where most SMEs are urban. In spite of demand, the lack of rural formal credit effectively restrains private sector development in rural areas. In Ghana for example, the rural sector’s share of total formal credit was a mere 8% in 1999 (IFAD, 2000).
- 4.47 Despite the macro-economic reforms of the late 1980s high levels of government borrowing have pushed up interest rates in some if not most countries to the point where private sector borrowing has been crowded-out. In Malawi for example rates of interest were liberalised in 1987-90 but real rates of 20-30% have greatly curtailed private borrowing. In Kenya in 2000 a bill (the Donde Bill) was published to regulate the interest rates charged to borrowers over the Treasury Bill rate and this if enacted, is expected to make bank lending unattractive.
- 4.48 Asset-based finance (leasing and hire purchase) are a desirable form of borrowing where leasing is subject to competition and tax capital allowances for the lessor can be passed on to lessees who may not be making sufficient profits to offset these allowances against tax. However leasing is not well developed in Africa for a variety of reasons including over-regulation, lack of competition, inappropriate tax structures and high interest rates.
- 4.49 The development of micro-finance has been curtailed by over- or in at least one case under-regulation. But the success of micro-finance in other parts of the world has stimulated thinking on the subject. Tanzania introduced a National Micro-finance Policy in January 2001. South Africa has shown what can be done and, according to our consultants, micro-finance has ‘exploded’ there since the 1992 exemption to the 1968 Usury Act. In 1999 the introduction of the Micro-Finance Regulatory Council (MFRC) led to further exemption and some enhancement of regulatory enforcement. By July 2001 the MFRC had 1263 registered lenders with some 6800 branches. In general, excessive regulation of money lenders drives that activity underground while appropriately regulated micro-finance has the opposite effect. Most micro-finance

lending in South Africa is said to be for consumption but it also serves small scale traders and other MSMEs.

- 4.50 Stockmarkets are also beginning to develop and for example exchanges were launched in Zambia in 1993 and in Uganda in 1998. The Ugandan exchange has a second tier segment for smaller companies. Outside South Africa and to a more limited extent, Kenya, stockmarkets remain weak and illiquid with relatively high listing charges. The Johannesburg Stock Exchange (JSE) has recently updated its Listing Requirements to take account of global trends towards better corporate governance and compliance with Generally Accepted Accounting Principles. The JSE has lower tier segments for smaller growth companies and South African companies are now permitted to list on foreign stock exchanges.
- 4.51 In Central Europe a full range of financial institutions were created in the early phase of transition. Hungary for example rapidly privatised its commercial banks and was ready to see several of them in foreign hands which helped to transfer-in modern banking practice. Loans by banks to SMEs have increased strongly during the past two years. Asset based finance is also developing fast. A high standard of banking regulation is maintained in Central Europe – a case where tight regulation is both desirable and effective. Latvian capital adequacy standards for example are in excess of EU requirements. Latvia also strengthened collateral rights in its 1998 Mortgage Law.

## **Recommendations**

- 4.52 This section has covered a wide range of government policies which present difficulties in promoting private sector development, but which must be tackled if progress is to be made. Our conclusions follow:
- To improve the functioning of banking, micro-finance institutions and other aspects of the capital markets, a balance has to be struck between prudential supervision and unnecessary regulation which keeps out new entrants, limits innovation and raises operating costs. Macro-economic policy can play a major part by preventing government borrowing from crowding out private investment. Most important of all, poor people in the informal sector will never be able to participate fully in capital markets until they can obtain clear legal title to the property they now ‘own’ under informal arrangements. The provision of micro-finance should be facilitated.

## 5. POLICY MEASURES – REMAINING BARRIERS AND SUPPORT

### Rule of law

- 5.1 Market economies cannot function effectively unless contracts can be established and enforced. As economies evolve from subsistence to geographically limited cash markets to higher forms of development, involving readily marketable real estate and securities trading for example, accessible legal protection becomes more and more important. ‘Accessible’ is the key consideration here because, as Djankov et al (2001) have demonstrated, the quality of the legal system is not positively associated with legal formalism: richer countries for the bulk of dispute resolution have simpler, cheaper and more widely available remedies available. The problem in most developing countries is not that there is no legal remedy but that it is too costly and too protracted to be effective.
- 5.2 In Africa legal systems are another instance where practices transferred from colonisers long ago are impeding the efficient workings of markets. In Zambia for example our local consultants state:
- ‘The Zambian legal system is closely based upon that of England and Wales with Zambian courts widely applying principles of English common law. In addition, to the extent that these have not been surpassed or amended by subsequent Zambian legislation, pre-1911 English statutes remain wholly applicable in Zambia, as also does English case law of that period. Post-1911 English case law, although not binding, is extensively followed by Zambian courts.’
- 5.3 However, it is not that laws are outdated or not administered with impartiality that is the problem but rather that these formal legal systems are not accessible to the vast majority of business people. Those in the informal sector are excluded from them on grounds of cost. The unavailability of relatively inexpensive legal advice which can often pre-empt formal legal proceedings in the advanced countries and the alternative means available for dispute resolution that are available there are rarely found in developing countries. South Africa, where much legislation is based on Roman-Dutch or other European law does have several systems for alternative dispute resolution (ADR). This is not true, according to our consultants, for example in Ghana<sup>15</sup>, Malawi and Tanzania, though this is beginning to change. Uganda for example established a Centre for Arbitration and Dispute in 2000. In Kenya means for dispute resolution are theoretically available under an Arbitration Act, but this mechanism is little used, probably for cost reasons. A private initiative, The Dispute Resolution Centre was established in 1999 but, according to our consultants has struggled to establish itself on a sustainable basis.

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<sup>15</sup> From the local consultant’s report: “There is the general opinion that the use of the system of arbitration to settle business disputes has not been effective in Ghana. Most business persons are unaware of the system of arbitration and even those who are, have not resorted to it. The few who have used it complain that it is slow (cases can take up to 2 years for judgment) and expensive (a simple rent dispute recently cost the losing party US\$ 5,000). It is also reported that a recent case over a contract dispute that went into arbitration, involving the GoG and a foreign company, cost the GoG over UK£ 150,000 in solicitors’ fees alone over a period of 15 months”.

5.4 In contrast in Central Europe, alternative dispute resolution mechanisms are available. In Latvia, for example, our consultants say dispute resolution mechanisms are widely used. It is difficult to judge how serious a problem the prohibitive cost of litigation actually is in practice and it is possible that the availability of alternatives, even if not actually used may, by their very existence, pre-empt the problem as is the case in the advanced countries where (a relatively inexpensive) solicitor's letter may precipitate agreement. Cultural factors may also play a part. Both factors seem to be at work in Hungary where elected arbitration courts can be and are set up by Chambers of Industry and Commerce though this system is not widely used.

## **Recommendations**

5.5 This Section has dealt with a number of difficult and contentious issues. It has, however shown that progress can and is being made, albeit slowly, and some good beginnings have been identified. Our conclusions follow:

- Formalistic legal systems though essential are not enough and cheaper alternatives need to be developed. Alternative dispute resolution (ADR) mechanisms are particularly needed in African countries where relatively low cost legal services are unavailable. It cannot be assumed that ADR systems will necessarily be sustainable without donor funding.

## **Land ownership**

5.6 The specific legal issue of lack of clear title to land and the problem that this and ambiguities in the law on mortgages creates for the taking of collateral and realising it was discussed in Section 4 above (under Barriers to finance).

5.7 In much of Africa land is owned by the state but vested in communal tenure and controlled by traditional local leaders. Individual land ownership is not centrally registered and legal title cannot, therefore, be established. South Africa is again a notable exception where the principle of ownership is protected by common law and confirmed more recently by Section 25 of the constitution. According to our consultants however there are a number of complications in this situation. A land restitution process is underway to adjudicate on claims arising from forced removals under apartheid legislation. Land tenure in the former Bantustans where most Africans live is still under the control of local leaders and remains a serious problem. The Mineral Development Bill also vests ownership of mineral rights in the state which allows development under lease as indeed is the case in many countries.

5.8 Elsewhere in our sample African countries, clear legal title to land is not generally available, either because of communal tenure or for other reasons, particularly to businesspeople in the informal sector. In Uganda a distinction is made between the land owner and the user. According to our consultant the land user, if he can prove that he has settled on the land 12 years before 1955 cannot be evicted by the land owner (who cannot then use it as collateral). In Malawi much land is not registered and foreigners are not allowed to own land at all. In Zambia the state grants 99 year leases but until recently land was deemed to have no value as matter of law. Kenya has mounted a Commission of Inquiry into Land and carried out major reforms from 1950. These reforms did enable the majority of people living in rural areas to get freehold title. However, these reforms did not solve the collateral problem since the Land Control Boards prevent land being sold if the owner does not wish to sell. Tanzania has a new Land Act but it does not facilitate the use of land for collateral

and, according to our consultants, procedures for the issuing of titles are very protracted and cumbersome (this seems to be general in Africa (Emery et al, 2001).

- 5.9 In all African countries in our sample land ownership is a highly complex and contentious subject and is recognised as a problem. Efforts are being made to demarcate, adjudicate and readjust and compile land registries, but progress is slow.
- 5.10 The countries in transition in Central Europe initially had major problems over land ownership. In Latvia for example our consultants explain that under Soviet Law there was no private ownership except for residential purposes. Basically, however, pre-war institutions were quickly restored with the restoration of civil codes and land registries. In Latvia land reform started in 1991. In 1992 the 1937 Civil Law on Real Estate Property was re-enacted and in 1993 the Law on Land Books (registration) was also restored. Land ownership issues are not regarded as barriers to development and it is recognised for example in Hungary that freedom and facility to acquire land for commercial purposes is an important factor in attracting foreign investment. There are, however widespread concerns about the spread of foreign ownership of residential property and agricultural land where prices are well below levels in the EU. This is a particular concern in Poland which in its EU accession arrangements has negotiated a long transition period for the introduction of freedom to acquire property in Poland by citizens in other EU states.

## **Recommendations**

- 5.11 This Section has dealt with a number of difficult and contentious issues. It has, however shown that progress can and is being made, albeit slowly, and some good beginnings have been identified. Our conclusions follow:
- The establishment of clear titles to land is a paramount need for private sector development. In Africa where, unlike Central Europe, there are no historically viable systems to restore, there is no alternative to painstaking demarcation, adjudication and registration procedures. Cultural resistance to changes in traditional communal ownership controlled by local leaders is an obstacle. Land reform on its own may not be sufficient if other legal provisions prevent the effective use of land as collateral.

## **Inward investment and foreign trade**

- 5.12 The macro-economic reforms in Africa from the late 1980s began a process which has, or ought to have been, favourable to inward investment and foreign trade. Export and import licenses have been abolished in most cases, foreign exchange transactions liberalised, tariff structures simplified and freedom to remit profits and dividends introduced. For example Ghana claims 'easy remittance of profit and dividends' and Tanzania has reduced the number of tariff bands from 4 to 3. Several countries, including Kenya, have introduced export processing zones. Most if not all countries have set up special institutions to ease the path for inward investors, for example the Ghana Investment Promotion Centre and the Malawi Investment Promotion Agency. Institutions have been set up or re-modelled to promote exports. There are schemes for guaranteeing foreign investment, both inward and outward. Ghana and several other countries have held discussions with foreign investors to establish how they could improve the investment environment. In many respects South Africa has led the way in Africa in these efforts. It has concluded a Free Trade Agreement with the EU and a regional agreement with participating countries in the Southern African Development Community (SADC) and has loosened or removed many trade



restrictions built up in the apartheid period. South Africa is striving to achieve compliance with World Trade Organisation (WTO) standards.

- 5.13 Despite all these advances inward investment into our African countries has proved disappointing. In 1998 foreign investment flows to our seven countries totalled only \$1.36 billion of which two thirds was accounted for by South Africa, Ghana, Tanzania and Uganda, in that order (Cotton and Ramachandran, 2001).
- 5.14 Various reports by the Foreign Investment Advisory Service (e.g. Emery et al, 2000) and the Multilateral Investment Guarantee Agency (Bachmann, 1996) attribute the weakness in foreign investment to fears that reforms will be short-lived but also to various regulatory barriers. These barriers include the issues already discussed in the previous section, but also more specific problems.
- 5.15 Investment promotion agencies are criticised for delays and also because they frequently lack authority and decisions taken and permits issued may not be respected by the line ministries concerned. In most cases there are regulations limiting the use of expatriate staff. These regulations designed to protect indigenous employment are basically unnecessary because expatriate staff are very expensive indeed and investors have every interest in minimising their use.
- 5.16 Various restrictions and cumbersome procedures affect foreign exchange transactions. For example, in Malawi from 1994 allowances for the retention of hard currency export earnings were increased but are subject to various restrictions including a requirement to convert into Kwacha (the local currency) and then back again into hard currency before repatriation.
- 5.17 Customs clearances and foreign trade paperwork are costly (partly because of corruption) and slow. Emery (2000) gives a detailed account of these problems in six African countries. For example in Tanzania 'There are 20 steps and 8 organisations involved in clearing imports, and import clearance delays can exceed 80 days. Importers report having to make an average of 5-10 payoffs per shipment to customs officials in order to accelerate the clearance process'. According to calculations in *The Economist* (March 2<sup>nd</sup>, 2000) a corruptions perceptions index for a large number of countries is well correlated with the volume of FDI: the higher the corruption the less investment there is.
- 5.18 Efforts are being made to improve the situation. In Uganda extensive use has been made of IT and a commitment is being given to goods clearance and payment within 24 hours. In Kenya a selective examination and rapid release system has been introduced and approved agents appointed to clear customs. Tanzania and Uganda are introducing electronic customs declarations. Also in Tanzania the Tanzania Investment Centre has reduced the length of investment appreciations from 16 to 5 pages and sharply reduced delays.
- 5.19 In Central Europe much has been done to attract foreign investment and to improve foreign trade procedures. Latvia for example has introduced electronic customs declarations and customs procedures have been simplified. According to our local consultant, laws on exports in Hungary are very simple and have required no changes during the past 5 years. There are inevitably import restrictions in all our three countries but these are gradually being liberalised.

## Recommendations

5.20 This Section has dealt with a number of difficult and contentious issues. It has, however shown that progress can and is being made, albeit slowly, and some good beginnings have been identified. Our conclusions follow:

- Rationalisation of customs procedures is necessary if trade, an important component of development, is to be facilitated. Pilot projects in a number of African countries show what can be done.
- All of the regulatory barriers identified in this report also act to restrain inward investment, another important element in private sector development. Investment Promotion Centres can help but need necessary authority from line ministries without which these centres can actually introduce additional delays and obstacles. Restrictions of foreign exchange transactions should be minimized and profit and dividend remittance facilitated.

## Support services

5.21 Government sponsored business support services in the advanced countries largely date from the mid 1960s and early 1970s, though in a few countries they have origins which go back to the inter-war period (The Netherlands) and even earlier (Japan). The underlying rationale for these services is that SMEs lack the management and financial resources to obtain all the specialised information necessary on management technique, technology, markets, sources of finance and regulatory requirements for them to survive and expand in a competitive environment. These needs are greatest for start-ups. Although some of these services are available on a commercial basis or from trade associations it is difficult for profit making enterprises to make money out of basic information as such, which has what economists call the characteristics of public goods – though essential, like all information once assembled and disseminated it loses its discrete value and can be used by anyone; the marginal cost of delivering it may be zero. There may therefore be market failure in the provision of some business services.

5.22 On the demand side, SMEs find it difficult to anticipate what information they need or know where to obtain it. SMEs may not know what kind of advice they need. If the business is doing badly this may be the result of a range of factors, not necessary what appears to be obvious. It is a very common experience among consultants that they are called in to solve one problem (say lack of external finance) but that on investigation the real problem lies elsewhere (poorly presented applications or inappropriate sources). Moreover, because information and advice cannot be tested before they are consumed (is experiential), SMEs find it difficult, if not impossible, to assess competing suppliers without knowing in their specific case what might be on offer. This problem is compounded by a tendency for poor quality suppliers to charge less so that they may prevail over the better quality suppliers and the resulting communication of bad experience by word of mouth reduces the demand for services. There is research evidence that the demand for business services is positively size related and negatively profit related: the bigger the firm the more likely it is to buy in these services, loss making firms are less likely to use commercial services. All this may mean that the small firms which most need advice are least able to pay for it. Surveys also show that SME owners are not well informed about a whole range of business matters.

- 5.23 In theory, therefore, there is a strong case for government sponsorship of support services. In practice, however, there are apparently insuperable problems in providing services which can operate effectively and impact significantly upon large numbers of SMEs. Also there is the risk that subsidised public provision (cost recovery charging seems to close-out demand) will crowd-out commercial provision.
- 5.24 Among the difficulties are:
- Civil servants, who typically lack business experience, are not well suited to design and operate business services;
  - Engaging experienced successful business advisers is costly, the use of retired business executives from large firms, a common solution, may not be effective in an SME environment;
  - SME advice and information needs are very varied and cannot be standardised. Unlike agricultural extension services there is little scientific basis for general management advice;
  - It is not possible with any certainty to target services only at firms that will grow and bring social benefits while the costs of marketing and providing services to the whole SME population are prohibitive;
  - Training services present particular difficulties, SMEs with few people by definition have great difficulty in releasing either staff or management for training which in any event is often most effectively provided on the job, and;
  - It is extremely difficult to monitor the effectiveness of support services because their use will be self-selecting and impact on business performance cannot be separated from a wide range of other factors.
- 5.25 It can be argued therefore that support services should focus on referral to public and private sources of information and on providing information and support on regulatory services where governments may have a natural advantage.
- 5.26 All these problems for support services in advanced countries are even greater in developing countries where human and financial resources are more limited. The Committee of Donor Agencies for Small Enterprise Development (World Bank, 2001) has recently produced a report which proposes that support services efforts should focus on facilitating private provision. The report says, in part:
- ‘Motivating the search for a ‘new paradigm for Business Development Services (BDS) was the shared recognition that traditional interventions have failed to provide quality, affordable BDS to a large proportion of the target population of small enterprises. There was a general feeling that publicly-provided and publicly-funded services have not achieved their objectives: enterprise productivity and competitiveness, job creation, poverty alleviation and social mobility. Moreover, good performance measurement was lacking to be able to evaluate and compare programmes’,
- 5.27 In our sample countries in Africa probably all have some public business support services but virtually all are donor-funded. In Kenya for example there are two major programmes funded by UNDP, The Micro Enterprise Development Project and the Micro and Small Enterprise Training and Technology Project. In Tanzania, the Small Industries Development Organisation (SIDO) provides training and consultancy

exclusively funded by donors. South Africa may be an exception. Ntsika set up under the Small Business Act, provides training, advice and other non-financial services. In no case are we aware of any studies of the effectiveness of these services. Uganda plans to decentralise key government services and to create business information centres which will provide information on regulation, start-up materials and details of government programmes.

- 5.28 In Central Europe public support services are very extensive and again are funded by donors although national government resources are increasingly supplementing donor provision. In Poland, the Polish Agency for Enterprise Promotion (PAEP) coordinates a network of over 150 centres for business support. Free advisory services will eventually become available at 300 centres. There are numerous donor programmes including an EU (Phare) initiative targeted at growth companies. During the early years these efforts were financed mainly from - foreign funds – the European Union, the International Finance Corporation and the United States Agency for International Development (USAID). The Polish services provide information on regulation and there are also web-based databases of legislation and regulatory requirements. Through accreditation and referral, PAED is promoting the use of commercially provided specialist support services.
- 5.29 Poland is perhaps distinguished by the sheer scale of its support service programmes. Latvia, through the Latvian Development Agency, also has services including 5 regional development agencies supported by Phare. Latvia also posts its legislation, including draft proposals on the Internet. Hungary provides support services and, like Poland, provides subsidies for SMEs. These programmes have been supported by donors including the British Know How Fund. It has an e-governance programme under the office of the Prime Minister. Part of this programme is to provide electronic solutions to regulation related government services.

## **Recommendations**

- 5.30 This Section has dealt with a number of difficult and contentious issues. It has, however shown that progress can and is being made, albeit slowly, and some good beginnings have been identified. Our conclusions follow:
- Policies on business support services not only in Africa but also in Central Europe need to be redirected towards facilitating private provision (by accreditation and other means) and providing information and easing compliance with regulation. One stop shops in a literal sense may be only a long-term goal, but widely dispersed information centres, preferably combining some service delivery such as the issue of licenses and other documents, is realisable objective in the medium term.

## 6. POLICIES AND PERFORMANCE

### Economic and political characteristics

- 6.1 The seven African countries in our sample, all now democratic republics, were all under British influence until independence. With the exception of South Africa, which achieved independence as long ago as 1931, self government came in the early 1960s (Ghana in 1957). All have had troubled transitions to multi-party democratic full suffrage systems, which emerged only in the early to mid 1990s.
- 6.2 The Apartheid regime in South Africa ‘officially’ ended in 1994 and in this and other respects South Africa has a different history and also different economic characteristics from the other countries. Its mining, other natural resource and manufacturing activities mean that only a small proportion of GDP (less than 4%) is generated in agriculture. In US dollar terms, GDP per head in South Africa, although considerably less than half that of that of the poorest countries in the EU dwarfs that of the other six African countries, is higher than Latvia and comparable with Poland (Table 6.1).
- 6.3 The other six African countries have very small industrial sectors except Kenya which has quite a varied economic structure. Natural resource development and agriculture predominate, though generalisations are difficult to make for a group which includes for example Ghana (cocoa, gold) and Malawi 90% of whose exports are agricultural produce. What the six do share is a high degree of poverty with 60-70% or more of the population with incomes of less than US\$2 a day (South Africa 36%).
- 6.4 Economic performance has varied. In the period 1995-1999 real annual GDP per capita growth has varied from less than 0.3% in Kenya, Zambia and South Africa to 1.5-2.0% in Tanzania, Malawi and Ghana and 3.7% in Uganda. Annual inflation has varied between 2.6% per annum (Kenya) and 44.9% (Malawi) and foreign direct investment from negligible levels in Kenya to 3.5-5% of GDP in Uganda and Zambia.
- 6.5 Our three Central European countries achieved their independence from communist regimes around 1990 (somewhat earlier than the African countries transitioned to full democracies). In fact, most of our sample countries (with the exceptions of Ghana, Uganda and Poland), experienced negative GDP per capita growth rates in dollar terms between 1989 and 1994 as they went through painful periods of economic and political transition.
- 6.6 Since 1995 the three Central European countries have achieved annual average GDP per capita growth rates of 4.2-5.4%. They also enjoyed relatively high levels of foreign direct investment and reasonably well controlled inflation rates, in Latvia 2.4% in 1999, though Poland and Hungary did not do better on inflation than several African countries.
- 6.7 The Central European countries have very much lower rates of poverty than our African sample. Corruption is difficult to measure, but the Transparency International indicator given in Table 6.1 suggests that although very significant, corruption in Central Europe is on a par with South Africa, but much less than in Uganda, Kenya, Zambia and Tanzania and somewhat better than in Ghana and Malawi.

**Table 6.1: Selected Statistics on the Sample Countries**

	Ghana	Hungary	Kenya	Latvia	Malawi	Poland	S. Africa	Tanzania	Uganda	Zambia
Population million 1999	18.8	10.1	29.4	2.4	10.8	38.7	42.1	32.9	21.5	9.9
GDP/capita 1999 (in constant US\$ 1995)	409.6	5151.4	336.6	2353.8	156.5	3536.3	3903.7	188.2	347.2	388.7
GDP/capita, annual compound growth rate 1995-99	2.0%	4.2%	0.0%	4.8%	1.7%	5.4%	0.3%	1.5%	3.7%	0.1%
Inflation, % increase in consumer prices 1999	12.4	10.0	2.6	2.4	44.9	7.3	5.2	7.9	6.4	
FDI as % of GDP 1999, net inflows	0.2	4.0	0.1	5.6	3.3	4.7	1.0	2.1	3.5	5.17
Private Consolidated Investment as % of GDP			10.1		2.2	12.7	10.3			
Poverty, % of population with income under \$2 per day <sup>1</sup>	74.6	7.3	62.3	8.3		<2	35.8	59.7		87.4
Corruption Index <sup>2</sup> , 2001	3.4	5.3	2	3.4	3.2	4.1	4.8	2.2	1.9	2.6

<sup>1</sup> 1998 survey data for all countries except Kenya (1994), Tanzania (1993) and South Africa (1993).

<sup>2</sup> Scale ranging from 1-10, 10 representing no corruption.

Sources: Poverty figures (IFC, nr.44, Everhart & Sumlinski, 2001), Corruption Index (Transparency International, [www.gwdg.de/~uwwv/icr.htm](http://www.gwdg.de/~uwwv/icr.htm), 2001), all the rest (WDI, 2001)

## The Policy Indicator Matrix

6.8 To test whether or not the adoption of the key “best” practices identified in Section 3 above were related to economic performance, we first constructed the matrix shown in Table 6.2. Each element in the institutional machinery or policy elements used was given a “yes” or a “no” and in the former case, in many instances a date of adoption was noted, to indicate if it was pre-1995, post-1999 or somewhere within the sample period 1995-99. “No’s” were valued at zero and pre-1995 and 1995 “Yes’s” as 1 or a fraction thereof according to the date of adoption if adopted between 1995 and 1999, for example an adoption in 1997, halfway through the period, was given a value of 0.5.<sup>16</sup> Any post-1999 measures were counted as zero. Where a number of years were reported for each category, as a rule, the earliest data was included into our calculations and the rest left out, even in those cases where more significant changes

<sup>16</sup> Yes’s and No’s were allocated by our local consultants but in some cases the authors modified these, usually in a negative direction.

took place later. These values were then related to the average rates of growth in GDP per capita for the period 1995-99<sup>17</sup> shown in Table 6.1 using least squares regression.<sup>18</sup>

**Table 6.2: The Policy Indicator Matrix**

	Ghana	Kenya	Malawi	Tanzania	Uganda	Zambia	Poland	Latvia	Hungary	South Africa
MACHINERY										
One lead ministry for private sector development	Yes, 2001	No	Yes, Post 1999	Yes, Pre-95	Yes, 1996	No	Yes, 1994	Yes, 1991	Yes, Pre-1995	Yes, 1994, 1995, 1996
Also responsible for deregulation	No	No	Yes, 1999	Yes, Pre-95	Yes, 2000	No	Yes, 1997, 2001	No	No	No
Extensive consultation with private sector	Yes, 2002	Yes, 2001	No	Yes, 1995	No	No	Yes, 1995	Yes, 1999	Yes, 1995	No
SME Act	No	No	No	No	No	No	Yes, 1999	No	Yes, 1999	Yes, 1996
Decentralised policy implementation	Yes, Pre-1995	No	No	Yes, Pre-95	Yes, 1997	No	Yes, 1998/99	Yes, Post-1999	Yes, 1990	No
Monitoring of policy results	No	No	No	No	No	No	Yes, 1995	Yes, Post-1999	Yes, 1999	No
Policy formalisation and execution capacity	Yes, Pre-1995	No	No	No	No	No	Yes, 2001	Yes, Post-1999	Yes, 1992	No
MEASURES										
Macro-economic reforms (SAP/ESAP)	Yes, Pre-1995	Yes, 1989	Yes, 1987	Yes, 1984	Yes, Mainly Pre-1995 (1987, 1992, 1994), 1997, 2000	Yes	Yes, Pre-1995, 1997-99	Yes, 1991	Yes, 1987-89	Yes, 1996
Reduction in cost of business registration/licensing	Yes, Pre-1995	Yes, 2000	Yes, Pre-1993	Yes, 1999	Yes, 1992, although mainly Post-1999	No	No	Yes, 1997	Yes, Pre-1995	No
Effective rule of law	Yes, 2001	No	Yes	No	No	Yes	No	Yes, Pre-1995	Yes, Pre-1995	Yes, 1996

<sup>17</sup> 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.

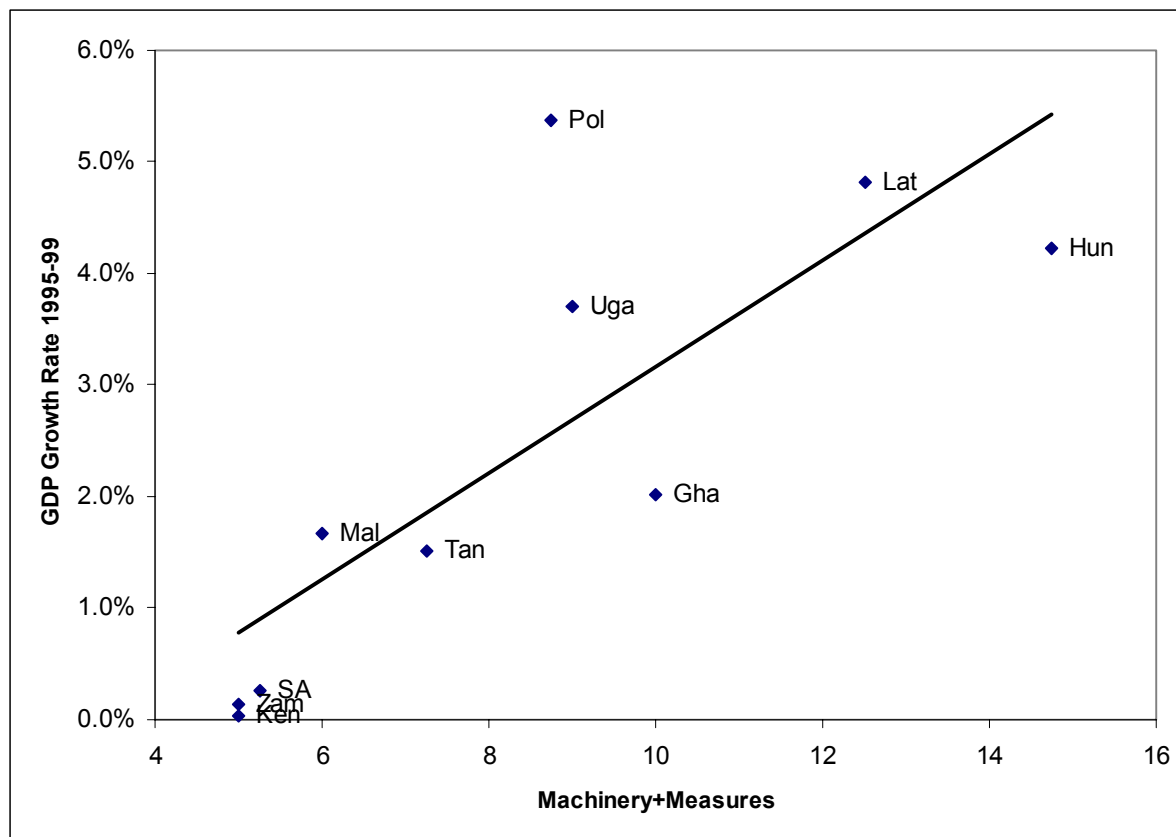
<sup>18</sup> Least squares regression is a mathematical technique which is used to calculate an equation giving the best fit to sets of independent variables (in this case policies) and dependent variables (GDP growth rates) and thus the relationship between the two.

	Ghana	Kenya	Malawi	Tanzania	Uganda	Zambia	Poland	Latvia	Hungary	South Africa
Collateral recovery possible	Yes, Pre-1995	No	Yes	No	No	No	Yes, Pre-1995	Yes, 1998	Yes Pre-1995	Yes, Pre-1995
Title to land ownership/use	No	No	Yes, Post 1999	No	No	No	Yes, Pre-1995	Yes, 1991	Yes Pre-1995	Yes, 1996
Employment law simplification	No	No	No	No	No	No	No	Yes, 1991, 2002	No	No
Taxes lowered, simplified	Yes, Pre-1995	Yes	Yes, Post 1999	Yes	Yes, mainly Pre-1995 i.e. 1986-1991/92 1993/94 1995/9 and 1998/99	Yes	No	Yes, 1995, 1998, 2001, 2002	Yes, 1996	Yes, mainly 1999-2001
Removal of barriers to finance provision	Yes, Pre-1995	No	Yes 1990-3	No	Yes, some Pre-1995, 1996/97 2001	Yes	Yes, Pre-1995	Yes, 1996 et seq.	Yes, Pre-1995	No
Extensive privatisation	Yes, Pre-1995	No	No	Yes, 1992	Yes, 1996, 1998	Yes	Yes, Pre-1995	Yes, 1991-1998	Yes, 1990-95	No
Simplified foreign trade procedures	Yes, 1995	Yes, 1992	Yes, 1990-3	No	Yes, many actions taken pre-1995, however real changes in 1999	No	Yes, Post 1999	Yes, 1991	Yes, Pre-1995	Yes, 1994, 1995, 2000, 2001
Inward investment facilitation	Yes, Pre-1995	Yes	No	Yes, 1998	Yes, Pre-1995	No	No	Yes, 1993	Yes, Pre-1995	Yes, mainly Post 1999
Delivery of regulatory services e.g. One-Stop-Shops	No	Yes	No	No	Yes, Pre-1995	No	Yes, 2000	Yes, Pre-1995	Yes, 1999	No
Effective regulatory enforcement	No	No	No	No	No	No	No	Yes, Pre-1995	Yes, Pre-1995	No

6.9 The results of this exercise are shown in Chart 6.1. It can be seen that there is a clear tendency for those countries which have adopted the most elements of machinery and policies to have the highest growth rates and vice-versa. In purely statistical terms the results are reasonably robust: the line of best fit shown on the chart accounts for over 60% of the variations between the two sets of variables and the probability that this result is by chance only is less than 1%.



**Chart 6.1: GDP per capita growth rate 1995-1999 on Sum of Machinery and Measures (excluding SME Act) with fractions for Machinery and Measures introduced during the period (1995-1999)**



$r^2$  is 0.63 and the co-efficient on (machinery+measures) is significant at the 1% level  
 Source: Policy matrix (Table 6.2) and WDI, 2001

- 6.10 The calculations included both machinery and policies, using policies alone gave a much worse fit. We attribute this to the likelihood that the “right” policies are most effectively implemented if appropriate machinery is installed. We excluded the existence of an SME Act as a variable for the reasons given in Section 3 (above); its inclusion gave a slightly worse fit.<sup>19</sup>
- 6.11 Despite the robustness of the overall result we do not consider that further, more refined analysis to separate out the impact of particular combinations of machinery and policies, would be justifiable. Some qualifications are necessary in any event. The number of years used in the analysis are few and many factors impact on economic performance in addition to these captured in our analysis, for example regional effects, commodity prices and political factors. Poland for example has benefited from its proximity to demand and investment from Germany. Poland has done better than its mix of policies would lead one to expect. South Africa has done worse than its policy and institutional mix would predict on the basis of the relationship illustrated in Chart 6.1, probably for political reasons. For these and other reasons it cannot be assumed that the adoption of the favoured institutional and policy

<sup>19</sup> The omission of the SME Act values raised  $r^2$  from 0.58 to 0.63.

mix alone will bring about higher GDP growth. All the evidence in this report nonetheless is that these elements would help considerably.

## 7. CONCLUSION

### Findings

- 7.1 Greatly expanding private sector economic activity and increasing its productivity is the only route available by which developing countries can reduce aid dependency and alleviate poverty under their own efforts. Command-control economics has not worked in Africa or, on a sustained basis, anywhere else.
- 7.2 Political and macro-economic stability are a necessary basis for private sector development, but even where these have been achieved in some measure, progress has still been disappointing. This study finds that inappropriate regulatory and institutional frameworks are a major obstacle to development and one which has yet to be tackled in poorer countries in any comprehensive or systematic way. An accumulating body of research shows that lower regulatory costs, smaller informal economies, less corruption and more effective public revenue raising as well as the alleviation of poverty are all associated with higher economic development.
- 7.3 Inappropriate regulation deters inward investment, raises business costs and erects a barrier to entry into modern economic activity, in short, it prevents markets from working to channel human and physical resources into productive use. Moreover the regulatory framework fosters corruption which deprives governments of the revenues needed to create conditions which could favour development.
- 7.4 It is a striking finding of this study that in relative terms the costs and barriers imposed by regulation in developing countries are not only higher than they were in the developed world when it embarked on industrialisation, but are higher in some cases at least, than in the advanced countries today. This regulatory and institutional framework is to a large extent inherited from the colonial or communist era but has been added to since. Not only is regulation too complex and therefore costly but it is, in general, inefficiently administered and many of the techniques recently adopted for lightening and controlling the burden in advanced countries have yet to be imported into the developing world.
- 7.5 Many examples are given in this report of cases where procedures for business registration and licensing, employment, foreign trade, taxation and other matters are unnecessarily protracted and costly. Also it has shown how regulation or in a few cases the lack of it, has obstructed the emergence of capital markets that could channel savings into productive use.
- 7.6 Finally, the report shows that the African countries in our sample in particular do not in general have fully integrated and articulated policy statements for promoting private sector development, nor do they have adequate machinery for formulating policy or implementing it.
- 7.7 At the same time our 10-country review has shown that solutions to all these problems have to some extent been found in Central Europe and even, in some instances in Africa also. Whilst donors are increasingly devoting attention to enabling environmental issues the political will to effect change in Africa in particular for a variety of reasons remains muted. These reasons include the power of vested interests, a lingering hostility to private sector activity and motivations and a lack of understanding, perhaps, of the ways in which development took place in advanced

countries and continues to progress there and in Asia and elsewhere. There are, however, clear signs in most countries of a growing appreciation that interventionist strategies for promoting private domestic activity – support systems, subsidies, state ownership and controls must give way to creating the conditions in which the indigenous population can help itself.

### **Some objections**

- 7.8 Several possible objections to the findings of this study may occur to the reader. The first objection may be that historical analysis of the path of development in the present day advanced countries is irrelevant because things are somehow different in today's globalised world.
- 7.9 The processes of private economic development in market economies however are essentially similar everywhere and in all epochs including those which saw the early industrialisation of the advanced countries of today. It is ahistorical to assert that countries cannot develop without large inflows of foreign capital or transport infrastructure or large enterprises or massive programmes for education. These may be all good things, but in the now developed countries these things followed development rather than preceded it. The argument that things are different now might have some force were it not the case that some emerging countries in Asia have broken out of the cycle of under-development to achieve comparable living standards to some OECD countries. It is true that there is controversy about the extent of government intervention in this experience and it is clear that this has varied between countries, for example between Hong Kong and Singapore. There is also dispute about the role of small firms which has been greater in say Taiwan than in Korea though of great importance everywhere (Igbal and Urata, 2002). Certainly export led growth, taking advantage of low labour costs – an advantage which African countries certainly also have – played a major part. We know of no comparative studies of the enabling environment in Asia and Africa, but it is our impression that it was and is less favourable in the latter than the former area. Virtually all studies of the 'Asian Miracle' seem to be focussed on macro-economic and cultural issues. Moreover, business entry costs as a percentage of per capita GDP (1999) averaged 19.8% in 5 of Asia's fastest growing economies (Hong Kong, Singapore, Taiwan, Thailand, and Republic of Korea) compared to an average of 67% and 94% in our Central European and African sample countries respectively (see Section 2).
- 7.10 Secondly it may be objected that experience in Central Europe recounted in this study is not relevant to Africa. Certainly, in the very nature of their situation the countries in transition had to remove the apparatus of the command-control economy. These countries were also left with relatively well-educated labour force compared with African countries which is a great advantage. However as pointed out above, Central European countries have also suffered from attitudes and a regulatory ethos inherited from their communist period including a large shadow economy.
- 7.11 The real answer to these objections, however, lies in the analysis of Section 6 which shows that there is a continuum in the relationship between policies and performance in Africa and Central Europe. Countries in Africa which have adopted policies closer to those in Central Europe have tended to perform better than those that have not.
- 7.12 Thirdly, there is the objection that simplifying the regulatory structure and reducing regulatory costs would lead to adverse social consequences, particularly for health, safety and the environment. This report does not advocate lower standards in these key areas: it is arguing for better regulation and indeed for more enforcement of a

simplified regulatory structure. Most of the changes discussed in this report for example on taxation, business registration and streamlining customs procedures, have no social implications of the kind that might be feared. Employment legislation might appear at first sight to be an exception but the protection it offers (which to a large extent is illusory if only because it does generally not apply to informal employment) could be achieved at much lower compliance costs.

- 7.13 In arguing that private sector development is the only sure route to the alleviation of poverty in democratic market economies and has been so in the past, we are not advocating naive laissez faire policies nor do we support mono-causal explanations for arrested development and its solution. We recognise that political stability and sound macro-economic policies are requisites for sustained development and that some regulation is necessary for markets to function effectively and for reasons of social cohesion. We also recognise the strong influence of local cultural and other conditions, for example constraining the role of women. What has worked in one place may not work in others without adaptation to indigenous factors. Nonetheless we believe that inappropriate regulatory policies are a major impediment to private sector growth and, moreover, that despite the formidable political obstacles, if the will exists these impediments can be reduced and that it is a priority that they should be reduced.

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# Annex 1. Terms of Reference for Country Case Studies

## (a) Background

Creating a positive enabling environment for domestic private sector growth is a key element of any economic growth strategy, and an important ingredient in any sustainable poverty reduction strategy. Without a strong local private sector offering opportunities for jobs and income, larger growth targets cannot be met.

Many observers take for granted government policies related to inflation and pricing, competition and monopoly, property rights, and contract enforcement, but it is these basic policies that provide the enabling framework for all businesses, including small and medium enterprises (SMEs), in the economy. If these general policies taken as a whole work to minimize the cost of transacting business, they make the whole economy more efficient, and allow indigenous enterprises to focus their attention on the production of goods and services for the marketplace.

If the macro-environment for business is not properly developed, then all government policy designed to promote the local private sector may suffer, because SMEs and other businesses will be less efficient in handling any business transaction. Conversely, no matter how strongly government may seek to intervene in direct services to the business community, it is unlikely to overcome the disadvantages of an adverse macro-environment. In central Europe at the beginning of the transition to a more market-oriented economy during the early 1990s, much of the resources devoted to indigenous enterprise support was wasted, because the general policy framework did not encourage investment and growth in the private sector.

Many other countries, particularly in sub-Saharan Africa, also have struggled in building a healthy environment for their indigenous private sectors. Both colonial traditions and succeeding state central-command-and-control models offered little to local entrepreneurs (though far more to foreign interests). Today most countries are seeking new directions, but there is still limited understanding of what measures are most effective in encouraging local economic initiative.

The very notion of an “enabling environment” is not well understood. Many government planners find it difficult to think beyond between direct assistance to firms and examine more indirect means of fostering growth. The linkages between policy and regulatory regimes and business investment decisions are not well understood. In all too many cases governments harm business environments through overly interventionist strategies developed in the name of protecting or nurturing domestic enterprise.

At the same time, there have been many useful lessons learned, particularly during the past ten years. A number of countries in Africa and in central Europe have determined to chart a new course, one in which the state role becomes much less a direct manager and much more of an enabler for private sector growth. In central Europe in particular considerable progress has been made, with several countries rapidly approaching private sector contributions to the overall economy at a par with those in many EU member states.

The social and economic structure, and particularly the levels of labour force skills are obviously very different in Africa compared with Central Europe. However, there are some interesting parallels: both regions suffer from low tax compliance and inherited obstacles to enterprise from outdated and overly bureaucratic legislative frameworks and governance; divisions between state-owned sectors in need of reform, and a foreign owned sector and an indigenous informal or semi-formal economy, the latter being particularly large in Africa. The two regions also are in a process of re-assessing government, private sector and NGO/service provider roles in promoting economic growth and private sector development.

(b) Overall Objectives of the Initiative

1. Identify examples of good practice in creating a more positive enabling environment for indigenous private sector growth.
2. Enhance understanding of the most effective roles for government, business service providers/NGOs and the private sector in promoting business growth and investment.
3. Share these lessons with policy makers from southern Africa through a series of regional workshops on improving the enabling environment.
4. Raise awareness of the importance of enabling environment reforms, leading to new initiatives at regional and national level (which DFID might support).

The consultants will examine measures taken over the past 5-10 years to improve the legal and regulatory environment for domestic private sector investment and growth in 7 countries in sub-Saharan Africa and 3 countries in central Europe. These are: South Africa, Zambia, Malawi, Tanzania, Uganda, Kenya, Ghana, Poland, Hungary and Latvia. All of these countries have undergone transitions to more market-oriented economies during the 1990s, with varying degrees of success in establishing strong, consistent, private sector-led growth. The three central European countries provide an interesting point of comparison because of their successful conversion from centrally-planned economic and political structures to a more market- and democracy-driven models. All three countries are making good progress towards compliance with Western European government and business standards.

Research will focus on specific White Papers, Acts and other major pieces of legislation passed during the period with the intention of promoting domestic business growth. The consultants will focus on what changes are made in the legislation, the justification for these changes, and the relative effectiveness of the measures (as reflected in macro statistics on domestic private sector performance). Where possible, we will examine available micro indicators, such as sectoral statistics or business surveys. The study will not cover macro-economic management issues – rather it will concentrate on legal and regulatory frameworks (and the institutional and organisational issues that underpin such frameworks) that affect private sector and SME development.

(c) Statement of Work for the Country Case Study

The evolution of the policy regime in the country will be examined as it has affected the main aspects of the enabling environment for indigenous private sector growth. The following aspects of the policy regime should be considered:

- Institutional
  - How has responsibility for indigenous private sector and SME been allocated in government? Which ministry (if any) has primary responsibility for the sector? How does this affect the standing of the sector with respect to other constituencies? How does the ministry relate to other government departments and to its constituents in the private sector?
  - What role does the private sector (segmented into large, medium/small, and micro) play in policy formulation, and hence changes to the enabling environment? Are more positive changes made where private sector involvement is greater or more/less structured? Are there good examples of effective private sector led policy formulation which has resulted in a better enabling environment in any of the seven countries being reviewed?
  - What specific policy papers have been issued to promote local private sector growth and investment? What was the explicit rationale behind the policy papers?
  - Does the country have an SME Act or some other measure committing it to support this part of the economy?
  - What monitoring mechanisms are in place to assess policy/regulatory effectiveness?
  - What quality of data is available on the sector – are dynamic changes in the economy able to be tracked – is SME data used in policy formulation/analysis?
  - What government sponsored programmes and research initiatives have been initiated in support of the sector, and how effective have they been?
  - Noting that the effectiveness of the policy and institutional framework is tied to issues of capacity – how does the national capacity for implementation compare across the countries to be studied?
  
- Regulatory/administrative compliance
  - What measures have been taken to make it easier to get into business and to reduce the cost of, and improve compliance with laws and regulations?
  - Has any action been taken to identify particular problem areas by surveys or other means?
  - What are seen as the main problem areas?
  - Have any remedies been proposed? If so, how effective have they been?
  - Are any measures being considered to pro-actively promote better regulation (such as regulatory impact assessment and the creation of Better Regulation Unit/Task Force as used in UK government)?
  - What effort is being made to improve the delivery by government of regulatory-related services to businesses?
  
- Contract environment
  - Have any measures been taken to make it easier to exit a business (bankruptcy provisions)?

- Are there any alternatives to courts to resolve business disputes (such as arbitration)?
- Has there been any reform of property or securities law?
- Has there been any calculation of the costs of enforcing contracts and their differential impacts on sizes/types of firm?
  
- Labour market environment
  - Has there been any analysis of the costs/effects of labour laws and regulations on the business environment? How are compensation packages affected by labour legislation (wages and benefits)? Does the country have a minimum wage law?
  - Has the government taken any steps to make it facilitate hiring/firing/movement of labour?
  - Are any alternatives to courts present to resolve labour disputes (arbitration, tribunals, etc)?
  
- Tax/fiscal environment
  - How have tax rates changed during the period?
  - Has the country changed tax systems for business transactions (ie, going from sales tax to VAT)?
  - How have thresholds for payment of income tax / VAT changed over the period?
  - How have systems for collection/reporting been modified?
  - What are the penalties for non-compliance and how are they enforced?
  - Has government looked into costs of following the system? Is there a differential effect on smaller firms? Are smaller firms' special needs taken into account?
  
- Access to finance/financial market environment
  - Has action been taken to remove legislative and other barriers to the provision of finance, e.g. banking, securities and capital markets liberalisation?
  - Does the tax and legal system promote leasing and other asset based finance?
  - Can lenders take and where necessary realise collateral?
  
- Importing and Exporting
  - Have procedures been reformed in any way?

Some aspects of the environment identified above may not have changed much, and others may have changed profoundly. The case study should focus on the main areas of change, positive and negative, which affect indigenous businesses.

(d) Document collection

In addition to preparing the case study, the consultant will collect as many recent (within the past 10 years) relevant policy documents as possible as are available in English, and

append them to the study report. They will provide brief (50-100 word) summaries of important documents not available in complete form in English.

(e) Report Format and Accompanying Documents

Your report should take the form of brief answers to all the bullet-point questions in the statement of work above. Supporting documentation should include any relevant White Papers, legislations, etc. We are particularly interested in any evaluations of policy measures taken. You do not need to send statistics or other material readily available from World Bank or other international organisations, but data on number of SMEs by employment size band for some or all years during the 1990-2000 not readily available in these international sources will be very welcome. Anything on poverty and income distribution changes will also be useful.

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