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**ASIA CONSULTATIVE CONFERENCE**  
**Creating Better Business Environments for Enterprise**  
**Development; Asian and Global Lessons for More Effective**  
**Donor Practices**

**Asia Overview Paper**

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## ABBREVIATIONS

ABAC	–	APEC Business Advisory Council
ADB	–	Asian Development Bank
AFTA	–	ASEAN Free Trade Agreement
APEC	–	Asia-Pacific Economic Cooperation
ASEAN	–	Association of Southeast Asian Nations
BE	–	Business Environment
CPI	–	Corruption Perceptions Index (Transparency International)
DCED	–	Donor Committee for Enterprise Development
DfID	–	Department for International Development (United Kingdom)
EFI	–	Economic Freedom Index (Heritage Foundation)
FDI	–	Foreign Direct Investment
FIAS	–	Foreign Investment Advisory Service
GCI	–	Global Competitiveness Index
GDI	–	Gross Domestic Income
GDP	–	Gross Domestic Product
IC	–	Investment Climate
ICAs	–	Investment Climate Assessments
IFC	–	International Finance Corporation
IMF	–	International Monetary Fund
MIGA	–	Multilateral Investment Guarantee Agency
MPDF	–	Mekong Private Sector Development Facility
NGOs	–	nongovernment organizations
NIEs	–	newly industrializing economies
ODA	–	Official Development Assistance
OECD	–	Organization for Economic Cooperation and Development
PSD	–	private sector development
SME	–	small and medium enterprise
TA	–	technical assistance
UN	–	United Nations
USA	–	United States of America
WB	–	World Bank
WBG	–	World Bank Group
WTO	–	World Trade Organization

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## I. EXECUTIVE SUMMARY

### A. Overview

1. Remarkable recovery since the Asian crisis. Less than a decade after the Asian financial crisis, many Asian economies are again booming. Increased business investment, rising productivity and employment have played a major role in reducing poverty and increasing incomes and living standards.
2. Innovation and productivity growth have been crucial to sustained growth. In their East Asian Renaissance study, Gill and Kharas (2006, p. 9) concluded ‘as societies accumulate knowledge – the stock of useful ideas – they can grow seemingly without limit. In contrast, there are strict limits to a pattern of growth that is based only on accumulation of people and capital’.
3. With sharp declines in poverty. The percentage of people living in poverty in Asia fell to about 19% today from 32% in 1990. While a remarkable achievement, there are still many poor people in Asia.
4. But not all are benefiting. Not all countries, nor all regions, have benefited equally. The link between growth and poverty decline has been weaker in South Asia than East and Southeast Asia. This is (at least) partly due to labor market rigidities in South Asia. More needs to be done to address remaining barriers to investment and employment growth. This will require substantive country and sub-national level diagnostics of barriers in areas where poverty incidence remains high.
5. Further improvements needed. Experiences from economic growth in the 1990s highlight the importance of productivity growth in economic growth and poverty reduction. Improvements in the investment climate are crucial to achieving productivity growth.

### B. Some Key Experiences from Asia’s Business Environment Reforms

6. Modest changes in addressing regulatory and institutional bottlenecks can have big impacts. Studies of international and Asian experiences show that modest changes that address priority bottlenecks can lead to rapid increases in business investment. Implementation of modest changes are often more politically feasible.
7. No single model. Different approaches are effective in different Asian countries: similar approaches in different Asian countries have generated different results. There is no single model that can be applied to implement improvements in the business environment. Much more substantive country level analysis is needed to design programs of support to address country specific bottlenecks.
8. Limited knowledge. Expert knowledge about designing and implementing business environment (BE) reforms in Asia and elsewhere are limited. The accepted wisdom (e.g., about the pace of reform and reform sequencing) has often found to be lacking. Analysts struggle to identify and measure indicators of national commitment to reform, or the bureaucratic and social attitudes that can play such a major impact on investment decisions. Various indexes designed to provide internationally comparable measures of the BE provide insights and have helped stimulate and focus debate, but provide only limited insights into the practical barriers to

business development, priority bottlenecks and future development outcomes. Limited knowledge makes planning difficult and suggests a need for flexibility to take advantage of windows of opportunity for reform.

9. Start with credible reforms that have short-term impacts (e.g., simplifying business licensing and other regulations). This can be very useful in building support for reforms. Simplifying business start-up procedures can help increase the number of potential advocates of further BE reforms.

10. Learn from experiences. Many Asian experiences have benefited from both domestic and international reform experiments. Sub-national authorities have been the ‘laboratories of reform’<sup>1</sup> in China, India and Viet Nam. Experimentation and pragmatic approaches to learning from experiences in other countries has led to innovative approaches to resolving bottlenecks (e.g., Korea and Taiwan learned from Japanese experience; South Asian and transition economies appears to be learning from East Asia).

11. Sustained consultations with business are essential at all stages of the reform process. Consultations have been crucial to identifying priority BE bottlenecks in Asia, and to developing practical actions to address these trouble spots. Consultations need to be sustained during implementation to maintain support and to identify newly emerging bottlenecks and issues.<sup>2</sup>

12. Anticipate resistance. Losers from reform will resist reform at all stages. Broad-based support needs to be actively sought to address this resistance. Consultations help. Reformers also need to work with business associations, the media and other groups to inform the broader public of the benefits and costs of reform.

13. Resist pressures to backtrack. Vested interests will continue to exert pressure for change that will have adverse impacts on the business environment. Measures need to be introduced and institutionalized to improve quality control over new regulatory and policy documents. The Organization for Economic Cooperation and Development (OECD) work on regulatory and policy impact assessment provide some directions for improvement.

14. Land reform can be particularly difficult. Land reform can be important, but it has also been one of the most contentious areas of reform in Asian transition economies. Implementing land reform has also been problematic in India and Bangladesh. India has approved ‘a large body of land reform legislation since its independence. However, the efficiency of this legislation is subject to extensive debate... Bangladesh’s experiences with land reform are similar to India’s’.<sup>3</sup> An effective land rights enforcement system is essential for developing private sector access to financing. The lack of effective systems is a major constraint to the development of bank lending to the private sector in some Asian countries (e.g., Cambodia and Laos).

15. Reform is a process. Reform in Asia typically takes time and sustained effort. Strong (or at least strongly motivated) institutional capacity is needed to plan, implement and sustain BE reforms. It also often requires the combined efforts of multiple agencies at central and sub-national levels. Motivated leadership and effective coordination mechanisms have been important in sustaining reform momentum.

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<sup>1</sup> A term used by Kikeri, et al. 2006. p. 17, with respect to China.

<sup>2</sup> Resource material on private-public sector dialogue can be found at [www.publicprivatedialogue.org](http://www.publicprivatedialogue.org).

<sup>3</sup> Quibria. 2002. pp. 58-9.

## C. Some Common Priority Issues in Planning Business Environment Reform

### Priority reform areas

16. Basic property right protection is critical. Little can be done to improve the business environment in the absence of the protection of basic property rights. Criminality and corruption can erode property right protection and incentives to invest. These issues need to be addressed as a matter of priority in countries where significant numbers of businesses highlight these issues as binding constraints. Developing effective land property management systems (including mortgages) are also important in mobilizing capital for business expansion.

17. Regulatory reform. Removing regulatory barriers to business investment has the potential to generate short-term gains in all economies, and is very important for small and medium enterprises (SMEs). Facilitating business start-ups is an important prerequisite that can generate quick returns from investments in reform. The need for regulatory reform is an ongoing process. Most countries (developing and developed) stand to benefit from sustained efforts to improve the regulatory environment. OECD guidelines on regulatory review processes provide valuable lessons for Asian economies.

18. Competition. Competition has driven the innovation and productivity that has generated economic growth in Asia. Many transition countries found it politically easier to introduce policies aimed at promoting competition (investment and trade reforms) than it was to reform state ownership of business. The impact of increased competition on productivity and growth had relatively immediate impacts on economic development. Some (maybe most) Asian countries may find that the key priority is to remove barriers to competition, rather than establishing antimonopoly agencies (which require substantial institutional capacity).

19. Employment growth and labor market flexibility. A greater focus on improvements in the business environment that generate maximum employment opportunities can help maximize poverty reduction impacts and build support for further reform. ‘The impact of economic growth on poverty works primarily through labor markets by means of the impact on wages and employment. Labor market institutions have a critical bearing on both growth and on how it is distributed’.<sup>4</sup> The greater labor flexibility in East Asia appears to have encouraged more labor-intensive investments than in South Asia where labor has traditionally been more regulated. More attention needs to be given to labor market issues in planning improvements to the business environment. Economic growth that increases both employment and labor productivity should ensure pro-poor outcomes.

20. Openness to imports and FDI is crucial in promoting competition and in generating the innovation and productivity increases that underpin growth. The impact of increased openness is greatest in countries with broad-based human development with the skills needed to adopt new ideas and technology.

### Processes

21. Need to change official and social attitudes towards the private sector. The importance of changing attitudes is often underestimated. High-level recognition of the contribution of the business sector to socio-economic development, and more informed public debate (especially through the mass media) could help develop more positive attitudes.

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<sup>4</sup> Quibria. 2002. p. 34.

22. Increase use of consultative approaches. Using consultative approaches to identify bottlenecks and solutions to these bottlenecks is critical to (i) ensuring that limited capacity is focused on addressing priority bottlenecks and (ii) to building the awareness and support needed to facilitate implementation of proposed reforms.

23. Practices – not just formal policies – matter. Policy uncertainty and uncertainty about how policy and regulations will be implemented is a major concern in many Asian economies. Policy makers need to aim to reduce uncertainty, corruption and bureaucratic intervention in business decisions in order to improve the enabling environment. OECD guidelines on policy and regulatory reform provide practical suggestions for improvements.

24. A supportive administrative apparatus. Given the above, public administration reform plays a critical role in improving the business environment. Public servants (at all levels) need to have incentives to facilitate private sector development, and be accountable for achieving tangible results in terms of increased business start-ups, investment and business employment. The best business environment recommendations mean little if the administrative system lacks the capacity and/or incentives to implement change. Better performance indicators and accountability are important in developing incentives, as are merit-based recruitment and results-based promotion policies for public service officials.

25. Media and information dissemination. Reformers need to proactively engage the media in reform debates both to (i) build support for reform and (ii) hold officials accountable for implementing agreed reforms. Reduce barriers to the emergence of a strong business media and to the adoption of new information and communications technology.

#### **D. Implications for Donor Support to Improve the Business Environment**

##### **Develop country specific approaches**

26. Country specific bottlenecks. The types of institutions best suited to provide a sound business environment in each country depends on local factors and conditions. Donors need to initiate (or build on existing) substantive analysis of country, sector and sub-national specific bottlenecks to business investment in Asia when planning assistance. Where such analysis is lacking, donors should work together to support national institutions to take the lead in undertaking substantive diagnostic studies.

27. Differentiate between urban and rural bottlenecks. Priority bottlenecks can be quite different between rural and urban areas. Any such differences need to be highlighted. Addressing rural priorities may be expected to have significant pro-poor outcomes and encourage more balanced development.

28. Need for more analysis and attention to sector/industry specific bottlenecks. Many bottlenecks are sector and industry specific. Sustained efforts are needed to identify and address key micro-level bottlenecks.

29. Fewer, but more substantive, analytical studies of national level issues. The Investment Climate Assessments (ICAs) provide an important tool in providing an internationally comparable country assessment of business perceptions of constraints. Donors should cooperate to ensure coordinated efforts to provide substantive analysis of BE issues, rather than each donor funding separate (and less substantive) country studies.

### Coordination

30. Coordinate and specialize. Donors need to specialize and cooperate with other donors to minimize duplication, to reduce the administrative costs of delivering and receiving assistance, and to allow more substantive and sustained diagnostics and assistance with reform efforts. Donors should aim to facilitate strong national ownership of donor coordination and in setting priorities for utilizing assistance.

31. Competition in ideas is desirable. Attempts at harmonization should not stifle policy innovation. There are no magic bullets to improve the business environment: knowledge of how to implement reforms is limited. Thus, there will be differences in views on best ways to improve the business environment. The challenge for donors is to work with host governments to develop mechanisms to share information and experiences, to be aware of policy differences, and avoid unnecessary duplication of effort. Differing advice based on different country experiences can be an important element of the learning and innovation process.

32. Policy coherence. Policy incoherence weakens the efficiency and impact of efforts to improve the business environment. Opportunities for complementarity are lost when policies contradict each other. For example, developed country agriculture subsidies may undercut donor efforts aimed at support farmers and agri-business in developing countries. More focus on the impacts of non-aid policies for development should be an important priority.

### Initiating and planning programs of support

33. Be humble. Donor agencies need to be humble about what is known. There are no infallible models that policy makers can apply to guarantee success. Donor agencies can help in facilitating country, industry and sub-national diagnostics and performance monitoring that take account of regional and international experiences.

34. And do no harm. Recent ICAs identified policy uncertainty as a leading businesses constraint in Asia. Donors need to be careful to consult closely with businesses and other stakeholders before advocating policy change. Extensive dialogue and analysis is needed to see what is feasible in terms of the pace and sequencing of reforms. Planners also need to ensure that donor-supported initiatives do not crowd out private suppliers of business services.

35. Don't try to do everything at once. Limited capacity to implement reforms is a fact. Both donors and recipient agencies often face capacity constraints. Prioritization is essential. Rodrik (2006, p. 12) advocates targeting binding constraints 'where the bang for the reform buck is greatest'. Private sector analysis should focus on identifying and addressing priority bottlenecks to business investment, rather than attempting comprehensive assessments of everything that needs to be done. 'Master planning' for private sector development is likely to be futile.

### National ownership of reform processes

36. Changing attitudes. Changing mindsets (official and social) towards the private sector and the market economy can be an important part of the reform process, especially in transition economies. It can be as critical to encouraging increased investment as changing laws and regulations. Thus, business environment programs need to look beyond technical policy and regulatory constraints to business. Donors may need to be more pro-active in supporting the efforts needed to raise the status of the private sector, in order to counteract any previous bias against the private sector (e.g., under central planning).

37. Aim to strengthen capacity of existing institutions. Governments should avoid the temptation to establish new institutions and/or ‘stand-alone’ project offices to deliver support to improve the business enabling environment. This rarely generates the institutional capacity needed to sustain improvements in the business enabling environment, and it is not conducive to building national ownership of reform efforts. Donors have committed to integrating support into government programs under the Paris Agreement on Aid Effectiveness. The challenge is to turn this commitment into action.

### **Sustaining gains from business environment reforms**

38. Improving policy and regulatory making processes. Efforts to improve the business environment are an ongoing process. The quality of new policy and regulatory instruments are often inconsistent and may introduce new barriers to increased private investment. Private-public dialogue on key policies and legislation is becoming more common practice in Asia, but more could be done to institutionalize best practices to improve quality control over new policies and regulation. Well-documented OECD experiences with regulatory reform can help guide policymakers in this regard.

39. Better advocacy. Further strengthening of the capacity of business groups in terms of applied policy analysis and advocacy, could help in sustaining reforms, as could efforts to strengthen the capacity of media organizations to understand and debate business uses.

40. Identify adjustment costs. Donors also need to consider more substantive and long-term support to identify both adjustment costs and the winners and losers from business environment reforms in Asia. Rapid economic growth is contributing to rapid urbanization in much of Asia. This needs to be well-managed to mitigate potential social and environmental costs.

41. Medium-term support to developing market institutions, including: the legal and regulatory framework; the formal mechanisms and the support from society needed to facilitate compliance and enforcement; land and labor markets; standards and certification; industry and professional associations; education and training; information services; commercial arbitration centers; and professional services, standards and ethics.

### **Sustainability: accountability, monitoring and evaluation**

42. Improve results-based monitoring. Key indicators of progress in addressing priority bottlenecks should be identified during diagnostics and planning. Regular surveys of business environment indicators can facilitate better monitoring.

43. Ensure frank, independent evaluation of major donor programs. Internal evaluations can be seen as an opportunity to prepare promotional material aimed at sustaining program activities. Truly independent evaluations are needed to assess the relative impacts of combined donor support to improve the enabling environment at the country level. Adequate resources would need to be provided to produce credible evaluations. Independent peer reviews (especially of methodology) would help ensure credibility of the evaluation studies.

44. Public Sector Accountability. Improvements are needed in the collection and dissemination of information on key performance indicators. This will help develop mechanisms to make officials delivering tangible BE improvements more accountable for achieving outcomes.



## II. BUSINESS ENVIRONMENT AND INVESTMENT CLIMATE ISSUES

### A. Background

45. The interest in improving the business environment stems from the fact that a sound business environment contributes to increased investment and sustainable economic growth. Increased incomes generated by economic growth help reduce income poverty and also lead to more general improvements in well-being, such as improved health, better nutrition, higher levels of education and reductions in child labor.<sup>5</sup> Most Asian governments and development agencies working in Asia explicitly recognize the key role of the business environment and private sector development in achieving economic and social development goals.<sup>6</sup>

46. A sound business environment stimulates increased growth via greater productive investments. Increased business investment and productivity growth in Asia is changing the global balance of economic power (see Section 3). Empirical studies have shown that strong economic growth contributes to sustained poverty reduction.<sup>7</sup> The ‘investment climate is linked to poverty reduction by the impact of better investment climates on private sector activity, and thus on economic growth and employment’.<sup>8</sup> Employment is ‘the key link between output growth and poverty alleviation (UN, 2005, p. 7).

47. World Bank studies of households that have escaped poverty have found that ‘in more than 80% of cases the decisive factor was the head of the household getting a new job’. The World Bank estimated that ‘investment climate improvements in China, India and Uganda contributed to employment growth of more than 2% percent a year between 1985 and 2000’.<sup>9</sup> A recent firm level survey concluded that ‘investment climate matters for the level of productivity, wages, profit rates, and the growth rates of output and employment at the firm level’.<sup>10</sup> The study found that if cities in South Asia had the same investment climate characteristics as Shanghai, productivity improvements would be 81% for firms in Karachi, 78% in Calcutta, 43% in Dhaka and 18% in Bangalore.<sup>11</sup>

48. Quibria argues that rapid growth (‘not always distributionally favorable to the poor’) was the key contributor to poverty reduction in East Asia. ‘The proximate cause of high economic growth was sustained high investment that was fostered by a congenial investment climate. The congenial investment climate... was underpinned by favorable policies and institutions... The

<sup>5</sup> Ricardo Hausmann, Lant Pritchett and Dani Rodrik (2005), *Initiating a Growth Boom*, World Bank.

<sup>6</sup> See for example, United Nations. 2005. *Unleashing Entrepreneurship*. UN. New York; OECD. 2006. *Promoting Private Investment for: A Better Investment Climate for Everyone*. Washington. and; World Bank. 2006. *Doing Business in 2007*. Washington. ADB (2006, p. 24) argues that ‘Most economists would agree that sustained economic growth is the surest way to fight poverty. There is considerable evidence, both at the macro and micro levels, that good governance and a competitive investment climate are important in achieving and sustaining high growth rates’.

<sup>7</sup> WB. 2005. *Economic Growth in the 1990s: Learning from a Decade of Reform*. p. xii stresses ‘Poverty declines where growth is rapid and sustained. Poverty stagnates when growth is tepid. A few exceptions notwithstanding, the unambiguous impact of rapid growth on poverty reduction was confirmed again in the 1990s’.

<sup>8</sup> WB. 2006. *Improving Investment Climates: an Evaluation of World Bank Group Assistance*. p. 65.

<sup>9</sup> WB. 2005. *A Better Investment Climate for Everyone*, p. 32.

<sup>10</sup> Dollar, et al. 2005.

<sup>11</sup> ADB. 2006. p. 24.

most critical element of the policy package was openness to trade and technology, which gave the economies the opportunity to exploit trading possibilities in the international market and to access new technologies and raw materials. This later was vital both to sustain international competitiveness and to modernize the economy.<sup>12</sup>

49. The link between output growth and employment is greatest when output growth is driven by growth in labor-intensive businesses (e.g., agriculture, light industry and services).<sup>13</sup> Weak investment climates tend to deter investment in competitive labor-intensive industries, where profit margins are low. East and Southeast Asia have experienced a much higher employment elasticity of growth than South Asia.<sup>14</sup> East and Southeast Asian growth has been largely business-led, employment-intensive growth that has contributed to poverty reduction.<sup>15</sup> Some argue that the impact of growth on formal employment in South Asia has been muted by greater labor market rigidity, but that recent reforms are breaking down that rigidity.<sup>16</sup> The World Bank's *Doing Business Report 2007* ranks East Asia and the Pacific as having the most flexible policies for hiring employees and South Asia as having the second most rigid rules (after Sub-Saharan Africa). Within these groups there are major differences. Indonesia and the Philippines have rigid regimes, while regimes in Bangladesh and Sri Lanka are very flexible.

50. A sound business environment may also contribute to more equitable development, both via direct impacts on employment, and the fact that bad investment climates are typically biased against smaller enterprises and labor-intensive industries. The World Bank argues that surveys 'show that firms that are private, newer, and smaller; that are not recipients of foreign direct investment (FDI); and that cater to the domestic market report more acute business constraints than do firms that are older and larger, that export, that have FDI, or that are State owned'.<sup>17</sup> Smaller enterprises are more likely to invest outside major urban areas, and thus contribute to balanced development. New business entrants are more likely to introduce innovations. Thus, improving the business environment is crucial to broader development efforts.

51. While there is broadly shared understanding of the link between improvements in the business environment and economic growth, there has been disagreement about reform priorities, the optimal sequencing of reforms, approaches to support institutional reform and development, and what encompassing reforms need to be in order to have an impact. These issues are an important focus of this paper.

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<sup>12</sup> Quibria. 2002. p. 5.

<sup>13</sup> E.g., see Rizwanul Islam. 2004. *The Nexus of Economic Growth, Employment and Poverty Reduction: an Empirical Analysis*. ILO Geneva. p. 5.

<sup>14</sup> Islam. 2004. p. 1. As Islam also notes (p. 5), too high an elasticity (i.e., greater than one) would also be a concern as it would imply declining labor productivity (and likely declines in real wages).

<sup>15</sup> 'Rapid growth, which was nurtured by a commensurate increase in employment, led to a quick dissolution of the poverty problem' in the 'miracle' Asian economies. Quibria, M. G. 2002. *Growth and Poverty: Lessons from the East Asian Miracle Revisited*. ADB Institute. Tokyo.

<sup>16</sup> Quibria quotes (pp. 32-33) findings from another study that 'In India, liberalization accelerated growth in formal sector employment, but decelerated (though did not reduce) the growth of real wages... [While] employment in the informal sector declined significantly... the net impact was positive.' He argues (p. 35) that labor market flexibility in East Asian experience 'contrasts sharply with South Asia's experience, where ... labour market regulations ... have been excessive in relation to the country's stage of development', and that this has constrained economic growth.

<sup>17</sup> WB. 2006. *Improving Investment Climates: an Evaluation of World Bank Group Assistance*. Washington. p. 4.

## B. Report objectives and background

52. The aim of this paper is to provide a brief overview of developments, trends and issues in improving business environments throughout Asia,<sup>18</sup> and the role of donor assistance in this process. The Business Environment Working Group<sup>19</sup> (the Working Group), which commissioned this report,<sup>20</sup> views the terms ‘investment climate’ (IC), ‘business environment’ (BE) and ‘enabling environment’ (EE) as synonymous.<sup>21</sup> The World Bank states that the *‘investment climate reflects the many location specific factors that shape the opportunities and incentives for firms to invest productively, create jobs and expand.’*<sup>22</sup> Thus, the business environment and investment climate can be seen in broad terms to include such issues as stability, market institutions, infrastructure and human development.<sup>23</sup>

53. The focus of this paper is on a more narrow set of issues related to the economic institutions (including the policy, legal, regulatory and administrative framework),<sup>24</sup> which have an impact on business performance, from business start-ups, ongoing operations and business development and business closure. Impacts on businesses may be felt directly via (i) product markets (registration, licensing, pricing, research and technology transfer); (ii) trade policies (including tariffs, quotas, product standards and other potential barriers to domestic and external trade); and (iii) industry and sub-national institutions.

## C. Outline of Report

54. The following section includes a discussion of recent successes in improving the business environment in Asia, the factors that contribute to success and the economic impacts of these improvements. This is followed by an overview of recent trends in donor approaches to supporting improvements in the business environment and a review of attempts to assess the impact of donor support. The subsequent section includes a discussion of issues relating to the design and implementation of donor support to business environment reforms.

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<sup>18</sup> The ‘Asia Region’: The Bangkok Conference will focus predominantly on business environment reforms in the following Asian economies: Afghanistan, Bangladesh, Bhutan, Brunei, Cambodia, China, India, Indonesia, South Korea, North Korea, Laos, Malaysia, Maldives, Mongolia, Myanmar, Nepal, Pakistan, Philippines, Sri Lanka, Taiwan, Thailand and Viet Nam. Please note: this list does not include developed countries in Asia or the countries of the Middle East or Central Asia.

<sup>19</sup> Established in 2001 as a Working Group reporting to the Committee of Donor Agencies for Small Enterprise Development. The Working Group requested this study.

<sup>20</sup> Work on this paper was commissioned in September 2006, and had to be completed with 25-days input: it should not be seen as a comprehensive review of donor support to improve the business environment in Asia.

<sup>21</sup> Source: About the Working Group, <http://www.se donors.org/resources/download.asp?id=163>. Despite an initial focus on small and medium sized enterprises (SMEs), ‘the Working Group takes an all inclusive approach to its work on the business environment’.

<sup>22</sup> World Bank. 2005. A Better Investment Climate for Everyone.

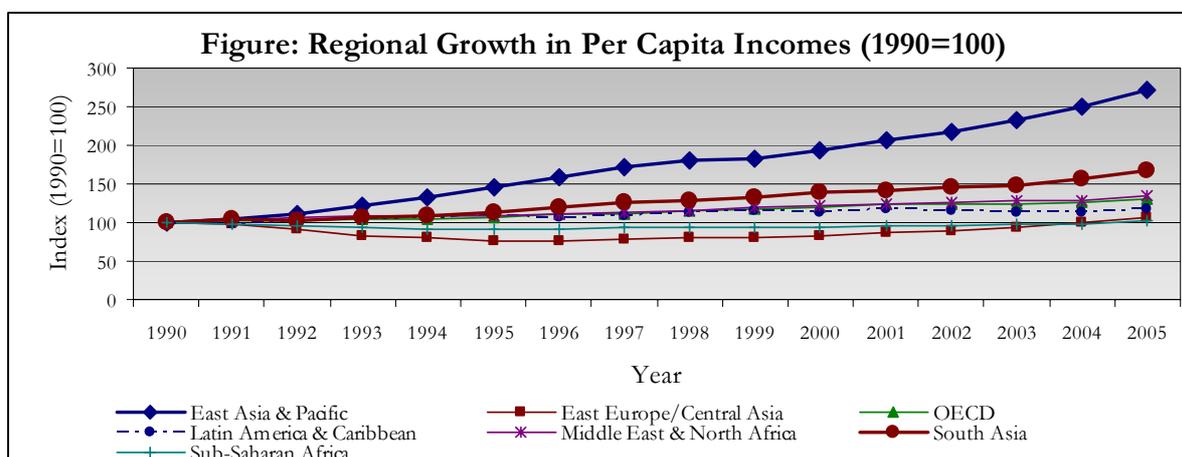
<sup>23</sup> The World Bank (Improving Investment Climates. 2006. p. 90) defines core investment climate (IC) themes as (i) judicial and other dispute resolution mechanisms; (ii) legal institutions for a market economy; (iii) corporate governance; and (iv) regulation and competition policy. Non-core IC themes comprise (i) tax policy and administration; (ii) infrastructure services for private sector development (PSD); (iii) other financial and private sector development; (iv) export development and competitiveness; and (v) trade facilitation and market access.

<sup>24</sup> Economic institutions are the rules of the game for investors, and include formal rules, informal norms and systems of enforcement (North. 1990). A country’s economic institutions develop over time and are influenced by history, political systems, culture and socio-economic structures.

### III. REFORMING ASIAN BUSINESS ENVIRONMENTS

#### A. Asian Economic and Business Performance in a Global Context

55. When the Asian financial crisis erupted less than a decade ago, many analysts predicted that the structural weaknesses exposed by the crisis – including corruption and poor governance – meant that Asia was likely to experience a sustained period of stagnation.<sup>25</sup> Despite this initial pessimism, East Asian emerging economies have recorded average annual growth of 9% since 1998, and regional gross domestic product (GDP) has almost doubled.<sup>26</sup> And South Asian economies have grown by more than 7% per annum.<sup>27</sup> While India is leading regional growth, the improvement in performance in South Asia is broad-based.<sup>28</sup> Most of the world's developing economies that have been 'catching-up' to OECD countries in terms of per capita incomes are located in Asia.<sup>29</sup> Despite the financial crisis, the average growth in economic output and per capita incomes, and success in reducing poverty in Asia, exceeds global averages. The proportion of Asia's population living in poverty fell to 19% in 2005 from 32% in 1990.<sup>30</sup>



Source: Data from World Bank Development Indicators Online.

56. Patterns of economic performance have surprised many analysts.<sup>31</sup> Some countries managed to sustain rapid growth with just modest reforms, while others could not grow even after implementing a wide range of reforms. A World Bank study, *Economic Growth in the 1990s: Learning from a Decade of Reform*,<sup>32</sup> tried to identify the reasons for variations in development performance. The study suggests the need for a broader focus on promoting growth, and not just economic efficiency. It also emphasizes the need for county-specific strategies. The study revealed that despite decades of research, knowledge about what triggers business and economic growth is limited. A strong message coming from research on development performance is the need *'to be humble'* in advising what reforms are needed to promote accelerated growth.

<sup>25</sup> World Bank. 2005. *Economic Growth in the 1990s*, p. 4 argues that 'What is remarkable about East Asia is not that it experienced a crisis in 1997, but that it experienced so few crises over the preceding decades.'

<sup>26</sup> Kikeri, et al. 2005. *Privatization: Trends and Recent Developments*, p. 1.

<sup>27</sup> Limited progress has been made in reducing poverty, including Afghanistan, Myanmar, Nepal, and North Korea.

<sup>28</sup> ADB. 2006. p. iii.

<sup>29</sup> World Bank. 2005. *Economic Growth in the 1990s*, pp. 4-5.

<sup>30</sup> ADB. 2006. [www.adb.org/poverty](http://www.adb.org/poverty)

<sup>31</sup> 'Many of the economic successes of today—Bangladesh, Indonesia, Korea or Mauritius—were considered 'basket cases in the 1960s' (World Bank. 2005. *Economic Growth in the 1990s*, p. 4).

<sup>32</sup> World Bank. 2005. *Economic Growth in the 1990s*.

57. China began introducing private property rights, liberalizing trade and implementing other business environment reforms beginning in the 1980s. Domestic resource mobilization increased rapidly. China accounted for more than 20% of total world revenue generated from privatization in the period 2000-2003.<sup>33</sup> India began liberalizing trade and licensing systems in the mid-1980s, and accelerated reforms in the 1990s. Viet Nam began introducing private property rights and market-based allocation of resources the mid-1980s. These reforms have had unprecedented success in reducing poverty.

58. Improvements in the investment climate were identified as the root cause of the sharp reductions in poverty in Asia's two most populous nations: China and India.<sup>34</sup> Poverty fell in both countries as the governments implemented reforms that nearly doubled the ratio of private investment to GDP.<sup>35</sup> Such changes were felt globally because China and India together have 37.5% of the world's population and 6.4% of the value of world output and income at current prices.<sup>36</sup> Other Asian economies have also experienced dramatic reductions in poverty through reforms aimed at increasing business investment.

59. However, there are differences in patterns of growth in South Asia, compared with East and Southeast Asia. Strong growth in imports and manufactured exports, and high levels of domestic and foreign investment were pivotal in generating innovation and productivity growth in East and Southeast Asia. In contrast, 'growth in South Asia is primarily driven by domestic demand; the services sector is a key driver of growth; investment rates, while rising, are still low; and remittances from workers living abroad exceed foreign direct investment inflows'.<sup>37</sup> However, even in South Asia, investment rates are on the rise: from 22.3% of GDP in 2001 to 29.1% in 2005. Savings increased from 21.9% to 27.0% of GDP over the same period. While still much lower than elsewhere in Asia, foreign direct investment (FDI) is increasing rapidly, rising by 43% in 2005. Stock market values nearly doubled from January 2004 to August 2006 in Pakistan, Sri Lanka and India.<sup>38</sup> Despite these improvements, many analysts consider that South Asia remains over-regulated. McLeish and Martin (2005) estimate that 'if South Asian countries would improve the quality of regulations to the level of Thailand, the additional GDP growth could amount to 0.8% of GDP in Bangladesh and Pakistan, and 1.6% in India'.<sup>39</sup>

## **B. An Asian Renaissance?**

60. Recent rapid economic growth throughout Asia is changing the global balance of economic power. Less than a decade after the Asian financial crisis, Asia's share of world exports, GDP and international reserves are rapidly increasing. Gill and Kharas discuss recent developments in terms of an East Asian renaissance,<sup>40</sup> but major changes are also taking place in South Asia.<sup>41</sup> The Economist magazine recently projected that the total GDP of China would

<sup>33</sup> Kikeri, et al. 2005. Privatization: Trends and Recent Developments, p. 7.

<sup>34</sup> Gill and Kharas. 2006. An East Asian Renaissance: Ideas for Economic Growth. This was achieved despite the use of 'highly unconventional' policies. Rodrik (2006, p4.) argues that 'With high levels of protection, lack of privatization, extensive industrial policies, and lax fiscal and financial policies throughout the 1990s, these two economies [China and India] hardly looked like exemplars of the Washington Consensus'.

<sup>35</sup> World Bank. 2005. A Better Investment Climate, pp. 7-27. The share of people living in <USD1/day fell from 64% in China in 1981 to <17% in 2001, while India recorded a decline from 54% to 35% over a similar period.

<sup>36</sup> Winters, Yusuf (eds). 2006. Dancing with Giants, p. 1. The same study projects that their share of world GDP will increase to 10.3% by 2020 assuming no change in relative prices (p. 4).

<sup>37</sup> ADB. 2006. p. iii.

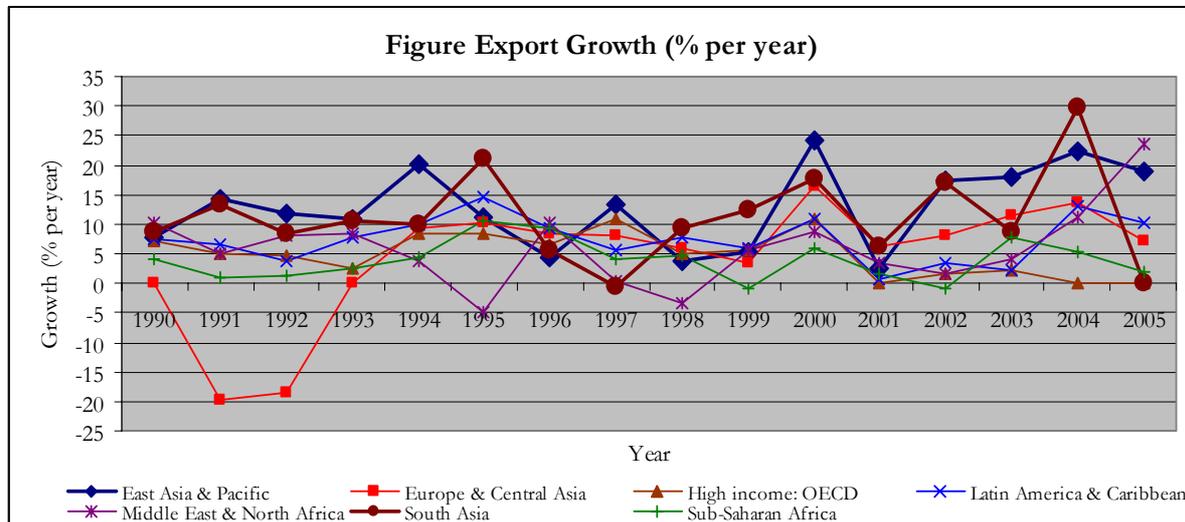
<sup>38</sup> ADB. 2006. p. 4-5.

<sup>39</sup> Quoted in ADB. 2006. p. 25.

<sup>40</sup> Gill and Kharas. 2006. An East Asian Renaissance: Ideas for Economic Growth.

<sup>41</sup> Despite significant recent improvements, the numbers of poor and levels of poverty incidence in South Asia remain very high (see, for example, Qubria 2002, p. 1).

equal that of the USA by 2040, and that India and Japan would be the third and fourth largest economies by that time.<sup>42</sup> Given the important role that private sector investment (and economic integration) has played in this rebalancing of economic power, it is important for development agencies and policy makers to better understand the factors that have contributed to increased private investment.



Source: Data from World Bank Development Indicators Online.

61. Gill and Kharas (2006) argue that economic growth spurred by innovation and increasing integration will ensure that 95% of East Asians will be living in a middle-income country in a few years. Their study emphasizes the impact of innovation and economies of scale as a driving force in East Asia's economic success, and that this has led to intra-regional trade patterns that reflect the increasing importance of regional production networks. They argue that regional flows of goods, finance and technology are helping even smaller East Asian countries benefit from economies of scale. A key message from the study is that the new East Asia is characterized by a competitive business environment that encourages innovation and the development of the increasingly complex regional production networks that have helped drive economic success.

62. The Asian Development Bank (ADB) (2006, p. 1) notes that the 1990s was a decade of reform in South Asia. Reforms were broad-based and addressed similar issues in all South Asian economies, including measures to: (i) enhance macroeconomic stability; (ii) improve the environment for private sector development; (iii) accelerate banking reforms; and (iv) liberalize trade. Key measures aimed directly at private sector development included: 'abolition of investment licensing arrangements; deregulating and eliminating most price controls; privatizing or providing greater managerial autonomy for state-owned enterprises; and generally expanding space for private sector activities, including areas that were traditional government monopolies such as telecommunications, electronic media, and power generation and distribution'. Despite some progress towards trade liberalization 'obstacles to trade remain high... [I]ssues such as complicated customs procedures at borders make intraregional trade difficult and costly'.<sup>43</sup> Intra-regional trade and cross-border production networks in South Asia remain much less developed than in East and Southeast Asia.

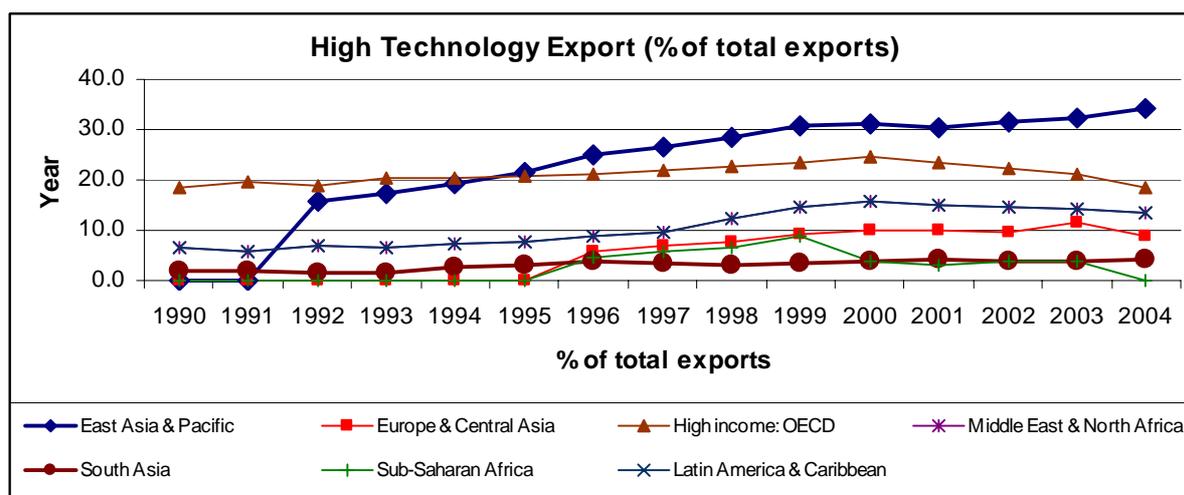
<sup>42</sup> The Economist. 16-22 September 2006. 'A Survey of the World Economy', p. 11.

<sup>43</sup> ADB. 2006. p. 13.

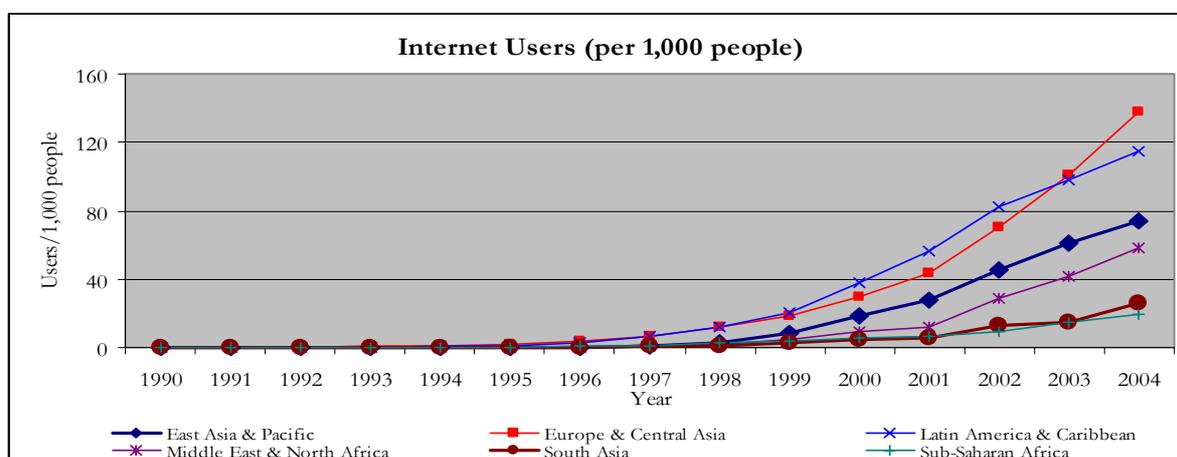
**Table: Innovation Indicators.**

Region	ISO Certification Ownership (%)	Spending on R&D (% of sales)
East Asia & Pacific	26.51	1.26
South Asia	17.01	0.29
OECD	14.53	0.17
Europe & Central Asia	13.37	0.31
Sub-Saharan Africa	12.54	0.58
Latin America & Caribbean	11.12	0.71
Middle East & North Africa	8.88	0.62

Source: [www.enterprisesurveys.org](http://www.enterprisesurveys.org)



Source: Data from World Bank Development Indicators Online.



Source: Data from World Bank Development Indicators Online.

### C. Measuring Success in Improving the Business Environment

63. Improving the business environment is not a goal in itself, but rather a means to reduce poverty and improve living standards. Equity in the distribution of business investment and employment is an important objective in itself: it may also help in sustaining high long-term growth in business investment. Thus, broad-based increases in business investment and employment are important indicators of a better business environment.

64. Recently, a range of indexes have been developed to provide information on trends in key business environment elements. Global interest in business environment-related indexes has mushroomed in recent years. This has helped stimulate and focus debate about business environment issues and helped generate demand for business environment reforms.

65. While Asia has recorded the strongest performance in terms of economic and business performance, it is the non-Asian economies that have dominated the ‘top 10’ rankings of the World Economic Forum’s Global Competitiveness Index (GCI),<sup>44</sup> the Heritage Foundation’s Economic Freedom Index (EFI),<sup>45</sup> the Corruption Perceptions Index (CPI)<sup>46</sup> and more recently the Ease of Doing Business Index.<sup>47</sup> Japan (ranked seventh) was the only Asian economy included in the ‘top 10’ of the 2006 rankings of the GCI. Only two (relatively small) Asian economies (Singapore and Taiwan) make the ‘top 10’ of the EFI. Only two Asian economies (Singapore and Hong Kong, China) make the ‘top 10’ of the World Bank’s ‘Ease of Doing Business’ rankings. And Asian economies that were consistently ranked relatively low (such as China, Viet Nam<sup>48</sup> and India) have recorded the strongest growth in economic output, exports and employment in the world over the last decade.<sup>49</sup>

66. Movements in key business environment indexes provide little indication of the dynamism of business and economic performance in Asia in recent years. The following graphs suggest that there has been little change in economic freedom in Asian economies over the last decade. (The most significant changes were the reported declines in Thailand.) Despite obvious differences in economic and business structures and performance, North Korea, Viet Nam and Bangladesh have had similar rankings of economic freedom in recent years.

67. Corruption indexes provide further apparent paradoxes. Many of the fast-growing economies, and countries attracting relatively high levels of FDI, are ranked very poorly in terms of Transparency International’s Corruption Perceptions Index.<sup>50</sup> Evidence from the WB’s ICAs suggests that ‘corruption is not a major constraint to business in all Asian economies... (L)ess than one-third of firms surveyed considered corruption a “severe or major constraint” to business in China, Thailand, Malaysia or Viet Nam. Firms in Cambodia, Indonesia, and the Philippines saw corruption as a more serious constraint’.<sup>51</sup> Results depend partly on the nature of the questions, and the nature of the survey sample. For example, the ICA surveys found that when asked do businesses pay bribes, the percentage of firms answering ‘yes’ was similar in Viet Nam and Cambodia. However, when asked if corruption was a severe constraint to business,

<sup>44</sup> [www.weforum.org/en/index.htm](http://www.weforum.org/en/index.htm)

<sup>45</sup> [www.heritage.org/research/features/index/](http://www.heritage.org/research/features/index/)

<sup>46</sup> [www.transparency.org/policy\\_research/surveys\\_indices/cpi](http://www.transparency.org/policy_research/surveys_indices/cpi)

<sup>47</sup> [www.doingbusiness.org/EconomyRankings/](http://www.doingbusiness.org/EconomyRankings/)

<sup>48</sup> A decline of six positions (from 99/155 to 105/175) in Viet Nam’s Doing Business ranking in 2006 provoked major domestic debate. For example, reports about concerns about the issue dominated the October 2006 edition of the Viet Nam Economic Times. One report correctly noted that a major reason was the inclusion of 20 additional countries, 10 of which had a higher ranking than Viet Nam.

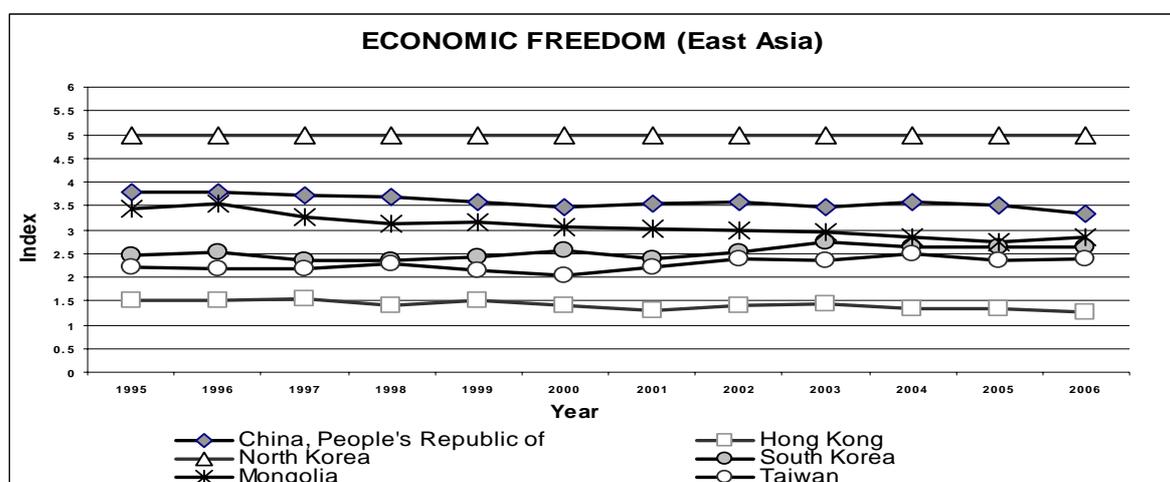
<sup>49</sup> While recognizing the value of the Doing Business reports, McLeod (2006b p.5.) sees a need for further improvement. ‘Of greatest concern is that some of the sub-indices, or their component measures, are focused on legal inputs – “black letter law” – rather than actual outcomes. The undesirable consequence of this is that countries are ranked highly if their black letter law and institutional arrangements happen to conform to what researchers consider to be sound, regardless of whether their performance is superior’. McLeod includes practical examples from Indonesia (and the USA) of limitations with the ‘protecting investors’ and ‘getting credit’ sub-indices.

<sup>50</sup> The East Asian Renaissance study highlights this paradox: ‘how could high levels of corruption co-exist with rapid economic growth?’ The study (p. 25) notes that ‘a centralized corrupt system has an incentive to promote economic growth, even while extorting benefits from firms’.

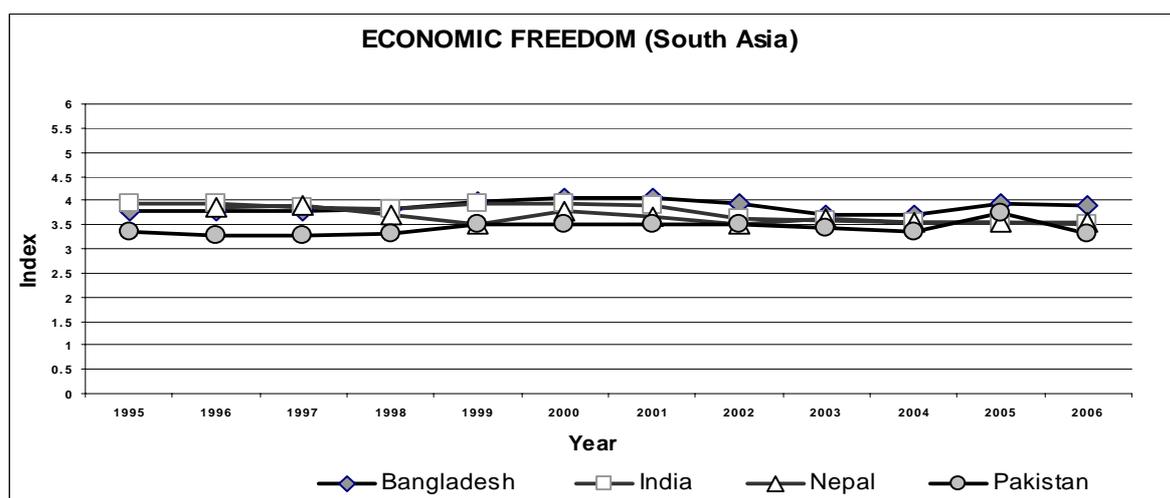
<sup>51</sup> See WB. 2006. An East Asian Renaissance. p. 267. Chapter 7 of this report provides a detailed discussion on corruption in East Asia.

56% of Cambodian respondents (the highest level in Southeast Asia) said ‘yes’, but only 14% in Viet Nam saw it as a severe constraint (the lowest level in Southeast Asia). Researchers also differentiate between the economic impacts of corruption that is organized to reduce uncertainty, and corruption that adds to investment risk.<sup>52</sup> The later tends to have strong adverse impacts on economic growth.

68. This suggests that internationally comparable country rankings provide only partial information about an individual country’s medium-term business development prospects and constraints. One problem is that many key aspects of institutional quality (social norms, honesty, trust and beliefs about legal enforcement) are difficult to measure. The indexes are useful in identifying possible areas for further analysis. But more substantive analysis is needed to provide practical suggestions for future reform. Hopefully, ongoing research will lead to further improvement in measures of the quality of the business environment to capture the many sector- and micro-level issues that can stifle business innovation and investment.

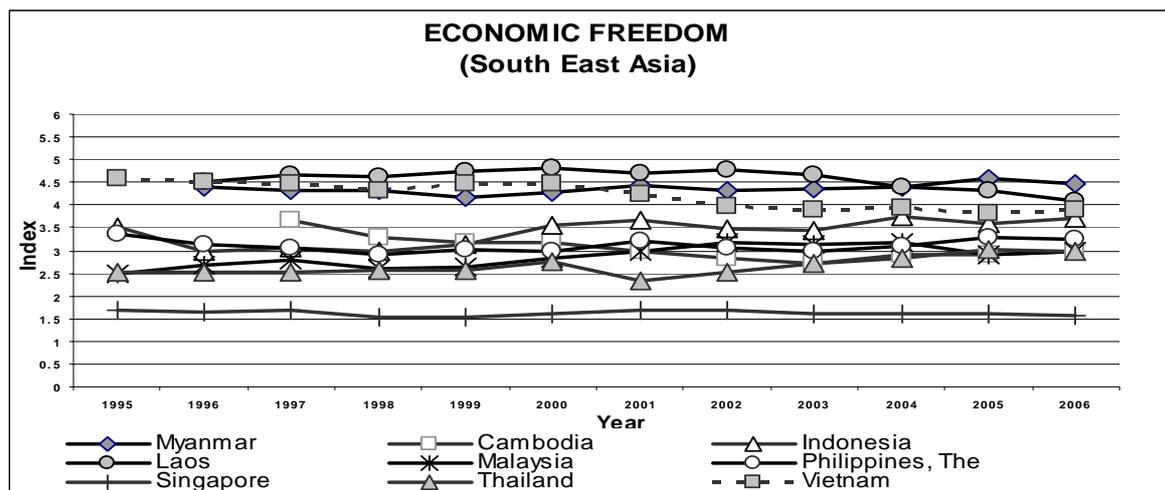


Source: Data from Heritage Foundation: Economic Freedom Index. [www.heritage.org/research/features](http://www.heritage.org/research/features)



Source: Data from Heritage Foundation: Economic Freedom Index. [www.heritage.org/research/features](http://www.heritage.org/research/features)

<sup>52</sup> This, of course, does not imply that some forms of corruption are “good”. From an ethical, equity and long-term efficiency perspective, corruption is bad. However, from an economic growth perspective, some types of corruption are not as bad as others. See Chapter 7 of WB. 2006. An East Asian Renaissance for a recent overview of research on the impact of corruption on economic growth and equity.



Source: Data from Heritage Foundation: Economic Freedom Index. [www.heritage.org/research/features](http://www.heritage.org/research/features)

69. This is important because an effective growth strategy is more about mobilizing the creative forces of society to achieve higher levels of productivity, than it is about achieving some ideal economic model for achieving economic efficiency.<sup>53</sup> The key problem in trying to identify indicators of the business environment (and/or prospects for future business and economic development) is that institutional quality, bureaucratic and social support for reform, and other factors that impact on innovation, risk-taking and investment decisions, are difficult to measure.

70. The ultimate indicators of success in improving the business environment are increased levels of business investment, employment generation, export growth and FDI inflows. Most countries in Asia are doing well in terms of these key indicators. As noted earlier, there are close links between efforts to improve the business environment, to increase productivity (and competitiveness) and to sustain strong economic growth. The new economic growth literature is highly relevant to the recent renewed donor interest in supporting improvements in the business environment. A key lesson from the reform experiences of the 1990s is the need to focus on productivity and growth. This implies a need to focus on improving the investment climate and 'providing predictable conditions for investors and other economic agents'.<sup>54</sup>

71. Recent reform experiences suggest the need for fewer, but more detailed, country diagnostics about the priority bottlenecks to economic and employment growth, and also a need for more detailed assessments of sub-national and industry level barriers to growth. Donors can then work with governments and other donors to ensure that adequate resources are available to target reforms that address bottlenecks.

#### D. Key Actors Engaged in Business Environment Reform in Asia

72. Central Government/Parliament. Central governments or national parliaments are generally responsible for approving business climate reforms and for overseeing reform implementation. Gaining the support of these institutions is vital to reform implementation. While national interest arguments for reform should be adequate to gain the support of these institutions, the political reality is that pressures from vested interest groups can stifle reform initiatives. Better analysis and widely disseminated information on the costs and benefits (and distributional consequences) of improving the business environment can help overcome resistance to reforms.

<sup>53</sup> WB. 2005. Economic Growth in the 1990s, p.11.

<sup>54</sup> WB. 2005. Economic Growth in the 1990s, p.10.

73. Sub-national public sector institutions. Local governments and other public sector agencies often implement administrative policies, regulations and procedures that impact on the business environment. Sub-national institutions can be vulnerable to pressures by vested interests to sustain barriers to business entry and increased competition. Disaggregated analysis of provincial-level bottlenecks, and better information dissemination about bottlenecks, can help generate pressures for reforms to address sub-national business environment constraints. Country-specific analysis is needed to identify opportunities to work at sub-national levels. Quibria argues that ‘No strict functional relationship exists between local-level accountability and the nature of political regime at the national level. While some democracies have done a poor job of fostering local-level participation and ensuring local accountability, some authoritarian regimes have fared well in creating participatory regimes at the local level’.<sup>55</sup> The International Finance Corporation (IFC) has recently published a ‘toolkit’ with practical recommendations related to the simplification of business regulations at the sub-national level.<sup>56</sup>

74. Business Associations and Other Professional Groups. Strong business associations representing a broad range of private sector interests can play a pivotal role in stimulating demand for business environment reform. Business associations can be effective in building support for reform through direct submissions to governments and parliaments, and by working with the media to build broader public support. For example, the Viet Nam Chamber of Commerce and Industry (VCCI) helped stimulate demand for reform in Viet Nam by publicizing the social and economic costs of weaknesses in the business environment through the mass media, as well as through meetings with its members, government and Communist Party officials, and National Assembly members.<sup>57</sup>

75. On the other hand, more narrowly based business associations, which benefit from a distorted business environment (e.g., industry associations whose members operate in a protected industry), may face strong incentives to lobby for continuing barriers to competition. Firms in protected industries in highly distorted economies can face strong incentives to participate in narrowly-based business organizations to protect their privileged positions.

76. Trade unions. Trade unions whose members are broadly representative of the whole workforce are potential supporters of business environment reforms that are expected to generate increased employment. However, trade unions are often strongest in protected and/or monopoly industries that may face reduced employment with economic reform.<sup>58</sup> Unemployed and new workforce entrants, who are often most likely to benefit from pro-business reforms, are not members of trade unions.

77. Research Institutes/Academics. Researchers have tended to become more active advocates of business climate reforms as countries develop. The role of researchers in promoting reform also depends to some extent on whether the political and funding arrangements governing research institutes are conducive to truly independent research. Truly independent

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<sup>55</sup> Quibria. 2002. p. 71.

<sup>56</sup> IFC. 2006. Simplification of Business Regulations at the Sub-National Level: a Reform Implementation Toolkit for Project Teams. IFC, Washington.

<sup>57</sup> Mallon. 2004. Managing Investment Climate Reforms: Viet Nam Case Study for WDR 2005.

<sup>58</sup> E.g., the strongest trade unions in Thailand often represented workers employed by State-Owned Enterprises (SOEs), especially utilities such as the Electricity Generating Authority of Thailand (EGAT). These unions have tended to resist privatization reforms that might have had positive overall impacts on employment creation, but negative impacts on employment in their industry. Similar problems have been evident in attempting to implement SOE reforms in South Asia. In Viet Nam, where most trade union members have been state enterprise workers (who have tended to slow SOE reform), the trade union is now actively targeting private sector workers (the most rapidly growing segment of the labor market).

research institutions appear to have been pro-active in advocating improvements in the business environment in market economies with relatively strong academic institutions (e.g., Korea, India and Thailand). In former centrally-planned economies like China and Viet Nam, research institutes closely linked to central agencies, such as the Central Institute for Economic Management in Viet Nam, have been pro-active advocates of business reforms.

78. The Media. An independent media (press, radio, television and increasingly the Internet) can play an important role in exposing corruption and in securing political accountability. It also plays a key role in influencing public opinion about business environment reforms, and is thus crucial if reforms are to be successfully implemented. Experiences in Asia suggest that the role of the media in promoting business environment reforms can be both positive and negative. The media are more likely to play a positive role if it is independent, and if those promoting reform actively engage with the media to help build media awareness of the key issues, such as the potential benefits from business environment reforms and the distributional consequences of reform. Reformers also need to be aware that those losing from reforms can be expected to use the public media to organize opposition. Planning a communications strategy should be an integral part of all reform programs. Reformers should regularly produce media-ready summaries of studies and submissions.

79. Independent Enforcement Agents. The courts, judges and arbitrators have a pivotal role to play in developed market economies. Asian businesses tend to rely on more informal enforcement mechanisms. Thus, courts and lawyers tend to have a significantly reduced role in contract enforcement in developing Asia. However, the demand for independent enforcement agencies tend to increase as trade develops and economic transactions become more complex.

## **E. Role of Market Institutions in Improving the Business Environment**

80. Strong market institutions are crucial to a sound business environment and effective governance. Institutions are the interrelated systems of rules, social norms, beliefs and organizations that motivate, guide and enable commercial transactions in a market economy. Greif<sup>59</sup> distinguishes between differences in societies' technological features (geography, knowledge and capital stock) and their 'different "non-technological" features, such as laws and enforcement methods, ways of allocating and securing property rights, and levels of corruption and trust', which 'are often referred to as institutions'. From an economist's perspective, the demand for formal institutions arises because of their potential to reduce the transactions costs of conducting business. Institutions influence decisions about what and when to invest, save, work, trade, produce, and innovate.

81. The WB argues that 'macroeconomic and structural reforms are necessary conditions for growth, but modern institutions are needed to sustain it.'<sup>60</sup> The nature of effective market institutions is country specific. Countries like China have sustained strong growth with what some would argue are less than 'modern' institutions. More generally, both formal and informal institutions have played a pivotal role in business development in Asia. The IMF argues that 'Many forms of institutions can deliver good outcomes, and institutional change has to be designed and driven by countries themselves', and that donors should only aim to play a supporting role in institutional development.<sup>61</sup> The IMF also argues that a greater degree of economic openness was 'associated with better economic institutions'.

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<sup>59</sup> Greif. 2006. p. 5.

<sup>60</sup> WB. 2006. p. 4.

<sup>61</sup> IMF. 2005. p. 152.

82. Quibria argues that ‘whether politically autocratic or not, the miracle [East Asian] economies provided an economic framework that allowed critical economic freedoms and a structure of market supporting institutions to blossom’.<sup>62</sup> He cautions that ‘policies and institutions cannot be “cherry-picked” from one empirical context to another’. Institutions are dynamic: they need to respond to social and economic changes. Demands for institutions differ between countries and over time. Typical areas of demand for formal institutional development in developing market economies include (i) establishment and enforcement of clear property rights (especially for land); (ii) legislation governing the business environment (e.g., corporate, commercial, bankruptcy and competition laws) (iii) financial service institutions; (iv) information institutions (market information and the media); (v) business services (legal, accounting, marketing, etc.); and (vi) mechanisms for greater political and corporate accountability. Because of WTO requirements, increased democracy and other factors, today’s ‘developing countries have less policy flexibility than ever before’.<sup>63</sup>

83. Formal Institutions. Economists and development experts tend to focus on formal institutions with politically determined rules that are imposed on a ‘top-down’ basis. Experience in much of Southeast Asia and China suggests that substantive progress can be achieved despite major weaknesses in market institutions. This is important because it takes time to develop effective institutions: it is not simply a matter of passing laws and setting up new agencies. Development efforts need to focus on priority institutions. Getting land markets and mortgage mechanisms in place appears to be an important foundation for providing the private sector with access to bank credit (a key indicator of a private sector development). In societies where social institutions and trust have collapsed (e.g., after civil disorder), developing alternative mechanisms for enforcing simple contracts may be a priority.

84. Informal institutions provide alternative mechanisms for protecting property and rights. They can be especially important (i) for small, less complex businesses where the costs of using formal institutions outweigh the benefits; (ii) where government regulations act as a disincentive for firms to formalize their operations (as was the case in many transition and South Asian economies prior to liberalization); and (iii) where formal institutions are not effectively protecting property rights (e.g., the large private investments in security required by some businesses in Cambodia and the Philippines). Informal networks linked to reputations played, and continue to play, an important role in most Asian market economies,<sup>64</sup> where recognition that a reputation is important to securing future business transactions provide strong incentives to adhere to informal agreements. Given that the Doing Business 2006 reports that East Asia faces higher costs of contract enforcement (about 60% of the debt involved) than any other region, it is important that East Asian firms have this option.

85. Demand for formal institutions as economies develop. The limitations of informal institutions emerge as economies develop. As businesses develop and transactions become more complex the transaction costs of conducting business with informal institutions increases. Thus, the demand for formal institutions to reduce transaction costs increases. As businesses grow and specialize there is increased need to conduct business with ‘outsiders’ (suppliers and traders where trust has not been established. Firms need to access finance from larger commercial financial institutions that typically require formal contractual arrangements (to reduce transaction

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<sup>62</sup> Quibria. 2002, p. iv.

<sup>63</sup> Quibria. 2002, p. iv.

<sup>64</sup> Pistor, Katharina and Philip Wellons (1999). The Role of Law and Legal Institutions in Asian Economic Development. Hong Kong, OUP. See also: Brian Van Arkadie ‘The Role of Institutions in Development’, Proceedings of the First Annual World Conference on Development Economics 1990 (World Bank, Washington) for a more general discussion of the interplay between formal and informal institutions.

costs and risks in assessing and enforcing debt repayment). Moreover, informal arrangements can break down in crisis periods (e.g., as happened during the Asian financial crisis).<sup>65</sup>

86. Both formal and informal institutions are important. Formal institutions have developed alongside existing informal institutions in Asia. This has facilitated reforms in economies undergoing major change. Informal institutions play a valuable role. Attempts to control informal institutions will reduce options and harm businesses. The development of formal institutions must be driven by demand. Little progress is likely to be achieved by top-down approaches. The sequencing of institutional development is also important. For example, no amount of assistance to strengthen the institutional capacity of formal financial institutions to lend money to SMEs is likely to have much impact without effective systems for registering and enforcing mortgages over land title. Without effective formal mortgage systems, SMEs will remain dependent on informal money lenders. Reducing regulatory and policy disincentives to formalizing business activity, trade liberalization, and increased competition will all help create demand for formal institutions. In order to encourage formality, policy makers and researchers need to recognize the costs and benefits to firms of informality.<sup>66</sup>

87. Reforming Institutions. A recent International Monetary Fund (IMF) study<sup>67</sup> concluded that ‘while changes in economic institutions were triggered by many different factors, there appear to be a number of underlying similarities in their economic circumstances’. These included a desire for rapid modernization (to ‘catch-up’); to be near other countries under transition (a regional demonstration effect); and to not have a large natural resource sector. IMF econometric analysis found that the following factors could help bring institutional change:

- Trade openness is significantly associated with a greater likelihood of institutional transitions. Greater openness increases the role of export sectors that are ‘rent-proof’ and require innovation, and create momentum for further reform. Increased competition from imports reduces the scope for domestic producers to sustain monopolistic rents.
- Transitions are more likely to occur in countries with high levels of press freedom, a broad indicator of political accountability. Greater accountability tends to lead to policies that are beneficial to the broad economy, and not to vested interests close to policy makers.
- Countries are more likely to improve institutions if their neighbors have higher institutional quality. Demonstrated effects, social demand to keep up and the fact that neighbors are likely to be important competitors, contribute to pressures for improved institutions.
- The probability of economic transition is also greater for countries with higher levels of education. Better educated people are more likely to be effective participants in broader decision-making.
- Aid levels appear to have negative impacts on the probability of transition to a higher institutional level. This may be because those countries receiving relatively high aid transfers are those with constraints that limit institutional development.<sup>68</sup>

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<sup>65</sup> Borrowers continue to operate loss-making businesses longer than they should, losses increase and financial problems can spread to suppliers and creditors.

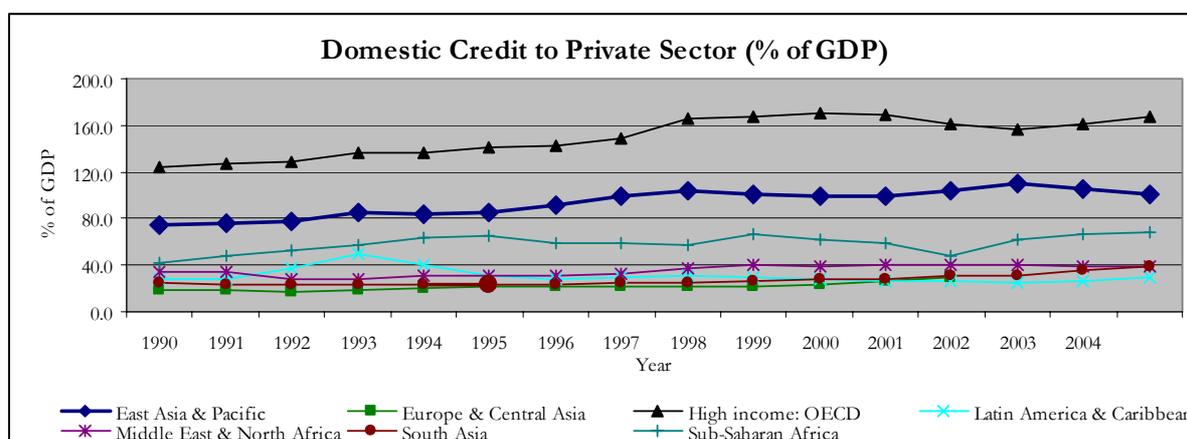
<sup>66</sup> As an extreme example, *Doing Business 2006* reports that the cost of enforcing a contract in Indonesia amounts to 126.5% of the debt involved. McLeod (2006b, p. 11) notes: ‘Small wonder, then, that private sector entities in Indonesia largely avoid using the courts for contract enforcement—relying instead on other means of protecting their interests, such as the use of private debt collectors, or simply being very careful in their choice of people to do business with’.

<sup>67</sup> IMF. 2005. *World Economic Outlook*, September 2005: Building Institutions, Chapter 3.

<sup>68</sup> IMF. 2005. *World Economic Outlook*, September 2005: Building Institutions, pp. 138-9.

88. This last point is obviously disconcerting for those involved in Official Development Assistance (ODA) delivery. Attempts to empirically establish positive causal links between development assistance and development at the macro-level have at times generated ambiguous results. The World Bank recognizes that debates over the contribution of ODA 'to growth have been frequent and heated' 'there has been a major change in the aid model... With this evolution, many of the earlier critiques become less applicable---not wrong, just less relevant'.<sup>69</sup>

89. Developing effective market institutions is pivotal to mobilizing capital for business development. Strong market institutions and investor confidence is critical in facilitating access to finance. The following charts provide comparative data. East Asia -- and the best performing East and Southeast Asian economies<sup>70</sup> -- has relatively high ratios of domestic credit to the private sector. The ratio of domestic credit to GDP is considerably lower in South Asia. Within Southeast Asia, there is considerable variation with low levels in Indonesia and the Philippines (similar to most South Asian economies) and very low levels in Laos, Cambodia and Myanmar. The ratio in Viet Nam was once low, but has increased since the late 1990s as market institutions developed and investor confidence in the enforceability of property rights was enhanced. Viet Nam's experience suggests rapid 'catch-up' is possible.



Source: Data from World Bank Development Indicators Online.

90. Efforts to reform and strengthen market institutions are both complex and time consuming. Substantive analysis, the development of mutual trust with counterpart agencies, and a willingness to make a medium-term commitment to support institutional development, should be prerequisites for donor consideration of support for institutional development and reform.

## F. Drivers of Change

91. The forces that drive reform are not well understood. This is a major gap in terms of designing effective donor support, because ensuring sustained pressure for reform is critical to successful implementation of reforms. The following points are based on personal observations of business environment reforms in Viet Nam and other Asian transition economies, as well as a review of other recent studies.<sup>71</sup> However, it is also important to recognize that existing institutions have a major impact on the process of imitation, experimentation and learning by doing, which lead to institutional change. Existing institutions 'influence the costs and benefits of

<sup>69</sup> Borguignon, Frances and Danny Leipziger. 2006. Aid, Growth, and Poverty Reduction: Towards a New Partnership Model. World Bank, Washington. An overview of the heated debate can be found in William Easterly. 2003. Can Foreign Aid Buy Growth. *Journal of Economic Perspectives*, Vol. 17(3). pp. 23-48.

<sup>70</sup> See Appendix \_.

<sup>71</sup> Kikeri, et al. 2006 was a particularly useful starting point in terms of reviewing current thinking.

introducing new institutional elements; and bias new institutions towards ones that interrelate with and do not depart greatly from their elements'.<sup>72</sup>

92. National advocates of reform. Having national advocates of reform who are passionate about improving national well-being, and who have the capacity to mobilize broad-based support for reform, is often crucial to successful implementation of reform. Articulate and passionate advocates of reform have helped mobilize the support (from grassroots to senior level leaders) to implement business environment reforms throughout Asia. Some Asian think-tanks have helped build political support for reform, and/or have supported the efforts of political leaders advocating reforms.

93. Better understanding of the impacts of constraints. Information about the impact of specific policy and institutional constraints can also help stimulate demand for change. In Viet Nam, well-designed studies about the costs of red-tape in terms of business investment and employment generation -- and about who was benefiting from red tape -- helped counter opposition to a process of institutional changes (including a new Enterprise Law) aimed at reducing barriers to business investment.<sup>73</sup>

94. Policy experimentation, learning and innovation have been important in building information and understanding about the benefits of reforms. Sub-national authorities have been the 'laboratories of reform'<sup>74</sup> in China, India and Viet Nam. While policy experimentation tends to result in 'piecemeal approaches' to reform, policy experimentation has generated successful reform outcomes. Experimentation, and pragmatic approaches to learning from experiences in other countries, has led to innovative approaches to resolving bottlenecks. (For example, Korea and Taiwan learned from Japanese experience and South Asian and transition economies appear to be learning from East Asia.)

95. Information: international benchmarking. Emerging public interest in regional and international benchmarking has helped stimulate debate about comparative performance. This has increased pressures on underperformers to address bottlenecks. The World Economic Forum's Global Competitiveness Index and the World Bank's Doing Business and Investment Climate Assessments are frequently referred to in the press and in political debates about business reform in Asia.<sup>75</sup>

96. Information technology. Dissemination of information on reform experiences has been aided by the recent development with information technology: 'The rapid proliferation of the Internet, mobile communications, and other technologies allows reformers and citizens in developing countries to learn what has been tried elsewhere, what has worked and what has not... [T]hese new sources of information have helped put pressure on governments to

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<sup>72</sup> Greif. 2006. p. 22.

<sup>73</sup> Mallon. 2004.

<sup>74</sup> A term used by Kikeri, et al. (2006, p. 17) with respect to China.

<sup>75</sup> McLeod (2006, pp. 3-5) notes that Indonesia referred to its low 2006 ranking (115/155 countries) to push for further reforms in the business enabling environment. He notes that the present government is '*making much of the fact that it takes 151 days to establish a new business there, by comparison with only about 30 days on average around the world*'. Viet Nam's new five-year plan (2006-2010) refers to the country's poor ranking in Transparency International's Corruption Perceptions Index as an argument for renewed efforts to improve governance and the business environment. OECD and country and overview study findings related to regulatory reform were translated into Vietnamese and circulated to policy makers (e.g., the regulatory review of Hungary and South Korea). Findings from the Doing Business and other studies have been translated into local languages and widely discussed in many Asian economies.

reform'.<sup>76</sup> The Internet is helping to disseminate information about corruption and best practices in most Asian economies. Even countries that control press and Internet content (such as China, Singapore and Viet Nam) recognize the importance of information and the new information technology needed for business development and innovation. Moreover, Internet content is much more difficult to censor than other media. Growth in the number of Internet users has been high in most Asian countries, including some that actively control press content.

97. Mobilizing support for reform. This is another crucial element of successful implementation. The media (business and other) and business associations have played key roles in mobilizing support for reform. Improvements in the coverage and quality of debate in a broad range of media outlets in most Asian economies over the last decade has helped in implementing reforms to improve the business environment. The challenge for reformers is to provide quality appropriate information that can be used by those that can help mobilize support.

98. External shocks can generate demand for reform. For example, the Asian financial crisis contributed to pressures for corporate governance and financial sector reforms throughout Asia, especially in the worst affected countries (Indonesia, Malaysia, Philippines, South Korea and Thailand).<sup>77</sup> Many predicted that the structural weaknesses exposed by the crisis would lead to economic stagnation in East Asia. Instead East Asian countries responded to the crisis with reforms that led to improvements in corporate governance and the broader business environment, fuelled a rapid increase in privatization,<sup>78</sup> and contributed to a sharp increase in cross-border mergers and acquisitions.<sup>79</sup> Thailand and South Korea introduced new competition policies aimed at curbing monopoly power following the Asian crisis. East Asia quickly emerged from the crisis with strong growth in investment, output and employment. Total GDP has doubled since 1988 and East Asia is now the major destination for FDI.<sup>80</sup> The Asian financial crisis also helped accelerate the formulation and implementation of reforms to remove barriers to the development of the domestic private sector in Asian countries not directly affected by the crisis (e.g., Viet Nam<sup>81</sup>). Earlier, economic shocks in India in the early 1990s led to an acceleration of its ongoing reform program. And the economic fallout from the break-up of the former Eastern bloc countries increased pressures for reform in Cambodia, Laos and Viet Nam.

99. Economic openness and competition. Recent strong economic performance in Asia has been associated with economic openness. Exports and FDI have played a crucial role in the transfer of ideas and technology, which have generated the productivity growth that has helped underpin economic growth throughout Asia. Foreign competition has encouraged innovation and increased domestic demand for reform.<sup>82</sup> Improvements in the regulatory environment that

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<sup>76</sup> Kikeri, et al. 2006. *Reforming the Investment Climate: Lessons for Practitioners*, p.14.

<sup>77</sup> The WB (*East Asian Renaissance*. 2006) remains concerned over 'declining FDI in the Philippines, Indonesia and Thailand, noting that macroeconomic risks remain a key constraint to investments in the entire East Asia... The trailing off of FDIs in the Philippines, Indonesia, and Thailand 'is of more concern'...[T]hese economies had recorded FDI inflows equivalent to 2%-3% of GDP before the 1997-1998 financial crisis, but...FDI flows to these economies averaged about 1.8% last year'.

<sup>78</sup> Kikeri, et al. 2005. *Privatization: Trends and Recent Developments*, pp. 4-5.

<sup>79</sup> The WB (*East Asian Renaissance: Ideas for Growth*. 2006 (citing a report by Mody and Negishi (2001)) said cross-border mergers and acquisitions in emerging East Asia rose to \$22 billion in 1999 from \$3 billion in 1996, as foreign firms purchased distressed assets from the banking sectors.

<sup>80</sup> WB. 2006. *East Asian Renaissance: Ideas for Growth*. 2006, p.i.

<sup>81</sup> Mallon, Raymond. 2004. *Managing Investment Climate Reforms: Viet Nam Case Study for World Development Report*. 2005. 'Investment Climate, Growth and Poverty'.

<sup>82</sup> Palmade 2005, p. 6, for example, argues that 'Andhra Pradesh reformed its power sector in part because its manufacturers were under increased pressure from imports following India's reduction in import tariffs. This is why lowering barriers to trade and FDI is probably the best way for countries to get started on the reform agenda.'

generate increased competition can also generate demand for further reform. Firms operating a competitive environment are likely to be more aware of, and sensitive to, regulatory barriers to improved business performance.

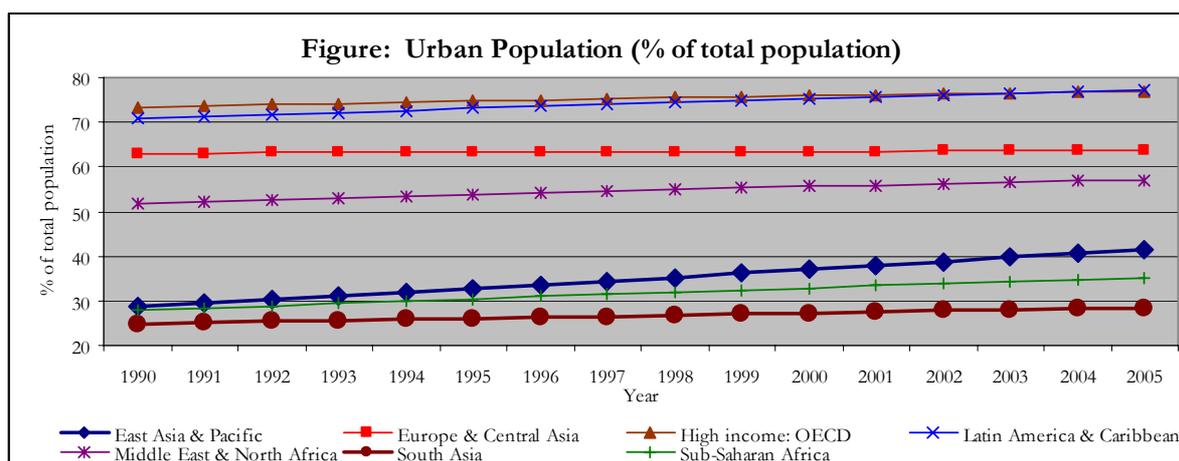
100. International agreements. Commitments under the ASEAN Free Trade Agreement (AFTA) have helped mobilize support for trade and investment reforms amongst the Association of Southeast Asian Nations (ASEAN) countries. A desire to join the WTO has contributed to the introduction of business environment reforms in Cambodia, China, Laos and Viet Nam. Practical improvements in the business environment are a major priority in the Asia-Pacific Economic Cooperation (APEC) discussions.<sup>83</sup>

## G. Broader Socio-economic Impacts

101. Growth generates major structural change and stimulates further policy and institutional reforms. National production is likely to become more diversified, but individual producers may become more specialized. Investors will invest in new machinery, technology and organizational structures: work practices will change. Risks to individuals may increase.

102. Strong economic growth is generating major rural-urban migrations: the rural-urban transformation taking place in China is unprecedented. The proportion of Asians (especially East Asians) living in urban areas is increasing rapidly. Greater investments will be needed in human capital and infrastructure. Some informal networks and institutions will break down, and there will be increasing dependence on formal networks and institutions. Skills requirements change. These changes generate winners and losers, which affects economic and political power. Strategies to sustain reform momentum need to reflect these changes.

103. Planners need to be able to recognize the major structural, social and distributional impacts of an improved business environment and rapid growth.<sup>84</sup> Better analysis and understanding of the distributional dynamics and social impact of rapid growth could facilitate better planning.



Source: Data from World Bank Development Indicators Online.

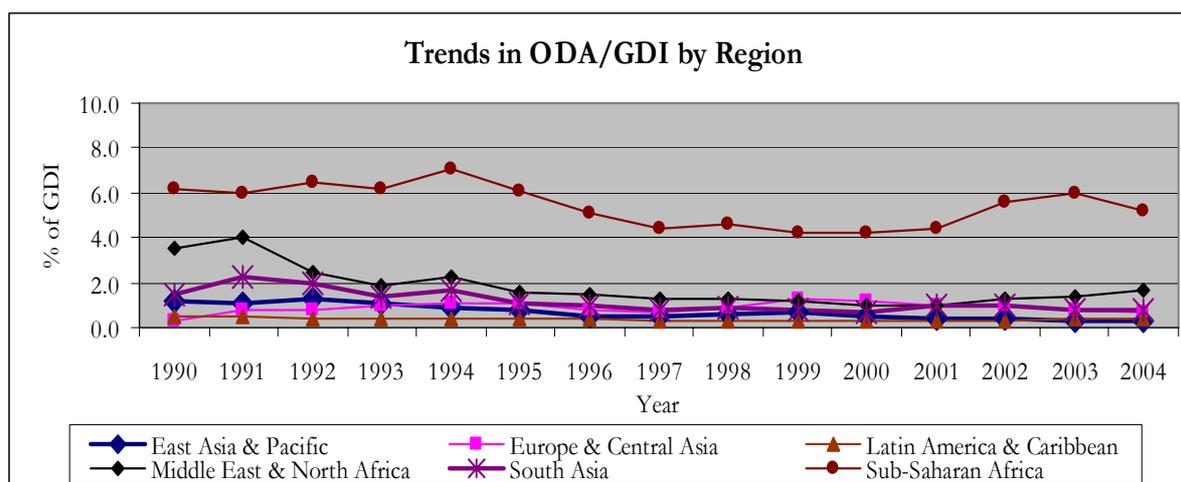
<sup>83</sup> Most Asian APEC members now allow visa free entry for those holding an APEC Business Travel Card.

<sup>84</sup> WB. 2005. Economic Growth in the 1990s, p.11.

## IV. DONOR SUPPORT FOR BUSINESS ENVIRONMENT REFORM IN ASIA

### A. Donor Support for Business Climate Reforms

104. Donors support the broader issue of private sector development (PSD) in Asia in many ways.<sup>85</sup> However, the overall levels of ODA (as a percent of Gross Domestic Incomes (GDI) are much lower in East and South Asia, than in other developing areas, as shown in the following chart. Within Asia there are enormous country variations in ODA inflows.



Source: Data from World Bank Development Indicators Online

105. More traditional donor programs aimed at infrastructure and human development still have potentially important role to play in addressing medium- to long-term constraints to PSD. Both good infrastructure and human skills are needed to facilitate innovation and productivity growth. Donors need to assess recipient country needs and their own comparative advantage in delivering assistance, when deciding where to focus support for private sector development.

106. Donors also provide technical assistance aimed at helping to strengthen institutional capacity, better understand bottlenecks to business development, formulate and implement policy and administrative reforms aimed at improving the business environment, and share international experiences. Direct funding is provided to support policy and institutional reforms.

107. The number of donors providing direct support to improve the enabling environment for the private sector has increased rapidly in recent years. Direct support has been provided to:

- (i) Improve the policy, regulatory and administrative framework for business (including trade facilitation);
- (ii) Develop market institutions (including financial institutions and business advocacy); and
- (iii) Improve business development services.

108. Despite the increased donor interest in directly targeting business environment reforms, there is little concrete empirical evidence of the impact of donor assistance in improving the business environment. A recent WB survey of country case studies on business environment

<sup>85</sup> Country studies presented to this conference are expected to provide concrete examples.

reforms concluded that ‘Donor pressure to initiate reforms was not an important factor... Instead, reform was largely a domestic process driven by local champions... Investment climate reforms are still relatively new to the agenda, and donors, like policy makers, are on the learning curve... Where donors were involved...they focused largely on providing diagnostic support rather than...on imposing conditionality’.<sup>86</sup>

## **B. Increasing Donor Support to Improve the Business Environment**

109. Most donors state that a major goal of providing assistance is to reduce poverty. Many donors justify (to their national constituents) the provision of development assistance for both altruistic and self-interest reasons (e.g., to promote stability and/or increased economic opportunities). Improvements in the business environment are seen as important in reducing poverty and stimulating the growth in incomes and trade that will benefit developed countries. The global economy benefits from increased trade with rapidly growing emerging economies.

110. Concerns about the need to improve ODA effectiveness, and greater awareness of the potential links between private sector development, employment generation and poverty reduction, has contributed to increased donor interest in supporting efforts to improve the business environment. A recent OECD report argues that a key rationale for supporting improvements in the business environment is that the ‘private sector has a central role to play in the war on poverty’ and that ‘mobilizing private investment is imperative for promoting the broad-based and sustained growth that will help drive poverty reduction’.<sup>87</sup> Some of the major international organizations involved in promoting improvements in the business environment are highlighted below.<sup>88</sup>

111. The Donor Committee for Enterprise Development (DCED), established informally in 1979,<sup>89</sup> comprises funding and inter-governmental agencies supporting private sector development. The DCED operates under the principle that sustainable development can only be driven, in the long-term, by a dynamic private sector; and that external agencies can only contribute to that dynamism if their efforts are coordinated. DCED works on:

- Defining best practice in priority themes, in participatory ways;
- Disseminating best practice and successful experiences between countries; and
- Increasing capacity of development practitioners to improve their effectiveness.

112. The DCED established the Business Environment Working Group in 2001.<sup>90</sup> The objectives of this group are to:

- Improve donor practices in (i) assessing the business environments in which small enterprises operate, and ii) designing, implementing and evaluating reform programs.
- Contribute to the broader body of knowledge and experience in creating a more enabling business environment for small enterprises.<sup>91</sup>

<sup>86</sup> Kikeri, et al. 2006. *Reforming the Investment Climate: Lessons for Practitioners*, p.14.

<sup>87</sup> OCED. 2006. ‘Promoting Private Investment for Development: the Role of ODA’, p.11.

<sup>88</sup> Several of these organizations will be making separate presentations to this conference.

<sup>89</sup> Until 2005, DCED was known as the Committee of Donor Agencies for Small Enterprise Development.

<sup>90</sup> Originally the Working Group on SME Enabling Environment. [www.enterprise-development.net/resources](http://www.enterprise-development.net/resources). Details of the activities of this group will be provided in another conference paper.

<sup>91</sup> For example, the Working Group organized an international conference in Cairo on ‘Reforming the Business Environment – from assessing problems to measuring results’ in late 2005. The objectives were to: (i) exchange information on practices in reforming the business environment; (ii) identify key challenges for donor agencies working to reform the business environment for small enterprises and priorities for research and development; and (iii) identify practical measures to help accelerate the implementation of business environment programs.

113. Since its first summit in 1993, a key objective of APEC has been to improve the enabling environment for trade and investment. APEC works in three broad areas to meet the goals of free and open trade and investment in the Asia-Pacific region by 2010 for developed economies and 2020 for developing economies: (i) trade and investment liberalization; (ii) business facilitation; and (iii) economic and technical cooperation.<sup>92</sup> APEC support to business facilitation focuses on reducing the costs of business transactions, improving access to trade information and aligning policy and business strategies to facilitate growth, and free and open trade.

114. The APEC Business Advisory Council (ABAC) stresses the need to promote good business ethics and eliminate corruption. ABAC recommends that APEC help improve business ethics through continuing to: (i) press for regulatory reforms and clear laws and regulations to remove fundamental sources of corruption; (ii) enforce laws and regulations objectively and be fair when dealing with corporate disputes; (iii) support measures which encourage businesses to voluntarily practice ethics in management; and (iv) implement incentives to ensure compliance with laws, rules and regulations as they impact on business. On corruption, ABAC urges leaders to: (i) expedite implementation of commitments to sign the UN Convention Against Corruption; (ii) deny safe haven to corrupt officials and individuals; and (iii) develop innovative and effective training programs and technical assistance for those in the field.<sup>93</sup>

115. The Monterrey Conference<sup>94</sup> stimulated renewed interest in the role of private investment in promoting economic development and poverty reduction. The Monterrey Consensus emphasized that private investment is a powerful catalyst for economic growth and poverty reduction, and that improvements in the business environment were critical to attracting increased foreign investment. The Monterrey Consensus stated that ‘ODA can be critical for improving the environment for private sector activity and can thus pave the way for robust growth’.<sup>95</sup> While the evidence to support this statement may be nebulous, it increased pressures on donors to be seen to be doing something about improving the business environment.

116. OECD launched an ‘Initiative on Investment for Development’ in 2003, with one aim being to provide ‘policy advice for donors on using ODA more effectively to promote private investment for development’. The initiative also aimed to use ‘peer reviews to build capacity for investment policy in developing countries’. OECD noted that donors spend ‘20% of their aid on a variety of investment enhancing activities, and highlighted the need for donors to be more strategic, better coordinated and guided by more systematic learning of what works and what does not’. The OECD guidelines argue that ‘donors should focus on helping to lower the costs of investment, reduce risks, improve competition, and develop human and institutional capacities’. It stresses that ‘economic infrastructure, financial market development, and building the capacity of enterprises are priority areas for mobilizing investment... and that reforming the investment climate requires political will, drive and leadership to take on entrenched interests and inertia’.<sup>96</sup> OECD also issued a ‘Policy Framework for Investment ‘intended to assist governments to create an environment that attracts domestic and foreign investment’.

117. The United Nations Commission on PSD submitted a report to the UN Secretary-General in 2004 entitled ‘Unleashing Entrepreneurship: Making Business Work for the Poor’

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<sup>92</sup> See [www.apec.org/content/apec/about\\_apec/scope\\_of\\_work.html](http://www.apec.org/content/apec/about_apec/scope_of_work.html).

<sup>93</sup> See [http://www.apec.org/apec/publications/all\\_publications/apec\\_business\\_advisory.html](http://www.apec.org/apec/publications/all_publications/apec_business_advisory.html).

<sup>94</sup> The 2002 International Conference on Financing for Development in Monterrey.

<sup>95</sup> UN. 2002. Final Outcome of the International Conference on Financing Development, Monterrey (para. 39).

<sup>96</sup> OCED. 2006. ‘Promoting Private Investment for Development: the Role of ODA’, p.3.

that provided recommendations on ‘how the major actors – governments, public development institutions, the private sector and civil society organizations – can modify their actions and approaches to significantly enhance the ability of the private sector to advance the development process’. The report also attempted to highlight ‘best practices’ in encouraging private investment to accelerate development and poverty alleviation.

118. The objective of improving investment climates in client countries ‘has recently moved to centre stage’ in the World Bank Group’s approach to sustainable growth and poverty reduction.<sup>97</sup> A 2005 World Bank study emphasized the need to give greater attention to generating economic growth, rather than focusing simply on economic efficiency concerns.<sup>98</sup> This study found that both economic growth and the rate of poverty reduction during the 1990s were higher in East Asia than in South Asia, and higher in South Asia than in the rest of the world. The study found the ‘experience highlights the importance of the investment climate, and of providing predictable conditions for investors and other economic agents’. The focus of the World Bank’s World Development Report in the same year was on ‘Improving the Investment Climate for Everyone.’<sup>99</sup> These reports emphasized the need for better analysis of country specific barriers to growth and development, including weaknesses in the business environment. The World Bank’s increasing focus on the business environment is also reflected in the resources being devoted to the Investment Climate Assessments and Doing Business studies.

119. The Asian Development Bank approved a revised strategic framework for PSD in February 2006<sup>100</sup> that recognizes the critical importance of PSD in reducing poverty. This framework calls for private sector development to be included as a core theme of all ADB operations. However, the framework recognizes that the ADB faces a central challenge of finding ‘how to transform itself from an institution focused broadly on public sector lending into a more agile bank that can meet its overall objective of poverty reduction’. The revised framework recognizes that institutional weaknesses had hampered past ADB attempts to meet the growing and more diversified private sector needs. Support for PSD (including support to improvements in the enabling environment) now has to be included as a key monitorable outcome in all new ADB country strategies and program documents.

120. Most bilateral donors have also included a stronger private sector development focus in their development assistance strategies. Many include efforts to improve the business environment as part of their current strategies.

### **C. Trends in Donor Support for Improving the Business Environment**

121. OECD estimates that its donors spend about 15-20% of ODA on efforts to support improvements in the business environment at the macroeconomic, enabling environment and enterprise level.<sup>101</sup> The 2005 World Development Report found that ‘assistance provided by major bilateral and multilateral development agencies for investment climate improvements averaged USD 21 billion per year between 1998 and 2002 – or about 26% of all development assistance. The bulk of that assistance went to infrastructure development, followed by policy based support and technical assistance.’<sup>102</sup>

<sup>97</sup> WB. 2006. Improving Investment Climates: an Evaluation of World Bank Group Assistance, p. xix.

<sup>98</sup> World Bank. 2005. Economic Growth in the 1990s: Learning from a Decade of Reform, p.10.

<sup>99</sup> World Bank. 2005. A Better Investment Climate for Everyone.

<sup>100</sup> ADB. 2006. Private Sector Development: A Revised Strategic Framework. Manila.

<sup>101</sup> OCED. 2006. ‘Promoting Private Investment for Development: the Role of ODA’, p. 12.

<sup>102</sup> World Bank. 2004. World Development Report 2005, p. 190.

122. Most donors are planning increased support to improve the business environment, especially in the least developed and transition economies. Donors have recently formulated stand-alone programs to support the business environment in Viet Nam, Cambodia and Laos, at both central and sub-national levels. There has also been a rapid increase in the number of donor interventions supporting trade facilitation (a subset of the business environment). The rapid build-up in external assistance has caused considerable challenges in coordination and led to some overlap of assistance. Some donors are trying to work more closely with sub-national agencies to reduce duplication of effort and to facilitate decentralized development. Donors also face major challenges in identifying appropriate expertise to assist in program implementation.

123. In several countries (e.g., Cambodia, Laos and Viet Nam), new institutions have been established to support SME development and to take central responsibility for managing implementation of rapidly increasing levels of ODA. This has facilitated coordination, but the capacity of these newly established institutions to effectively utilize this ODA, while at the same time developing institutional capacity and networks to work closely with local firms and business associations, has yet to be developed.<sup>103</sup>

124. A range of donors has also provided long-term (almost a decade) of support to SMEs in Cambodia, Laos and Viet Nam through the Mekong Private Sector Development Facility (MPDF). While recognizing some significant tangible achievements, a recent IFC evaluation of four of its facilities designed to support SME development (including the MPDF) concluded that ‘Although the facilities have been concerned with strategic issues, their choices of approaches, programs, and clients suggest an inadequate strategic focus. The facilities have adopted a range of approaches without clearly articulating what market failures they sought to address... without giving adequate attention to strategic priorities and the most economic use of their resources. And, in some cases, the facilities accepted clients and granted subsidies without adequate concern about displacing private service providers’.<sup>104</sup> The key message is that while SMEs have played an important role in economic development and poverty reduction, donors may need to be more strategic in planning assistance in order to effectively support SME development. Efforts to improve the business environment tend to be particularly beneficial to SMEs because they tend to be most adversely affected by a poor enabling environment. ABAC asked APEC summit leaders in Hanoi in November 2006 to:

**‘Support the growth of SMEs.** ABAC continues to emphasize the importance of removing regulatory obstacles to SME growth and improving access to financing, technology and information and of measures to enhance the capacity and competitiveness of SMEs. It encourages region-wide efforts to promote credit rating agencies, the development of business associations and network linkages to encourage information dissemination and of policies that reflect the importance of SMEs in the client base of banks and financial institutions. It likewise encourages financial sector participation to support the commerciality of guarantee schemes and the development of credit evaluation capacities as they relate to SMEs’.<sup>105</sup>

125. Some development experts and agencies are now re-emphasizing that donors should include support to human development and infrastructure development as core elements of their

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<sup>103</sup> Some researchers argue that donors should aim to strengthen the overall business environment for all firms rather than focusing specifically on SMEs. E.g., see Beck et al. (2004).

<sup>104</sup> IFC Operations Evaluation Group. 2005. A Synthesis Evaluation of Four IFC-Supported Small and Medium Sized Enterprise Facilities. IFC Washington.

<sup>105</sup> See ABAC website at [www.abaconline.org](http://www.abaconline.org).

efforts to support PSD.<sup>106</sup> Donor agencies need to take into account recipient priorities and their comparative strengths, the administrative costs and efficiencies of alternative approaches, and clearly specify the market and/or government failures they intend to address when planning support for private sector and SME development.

#### D. Evaluating the Impact of ODA in Improving the Business Environment

126. The OECD recently raised concerns that while ‘Donors are supporting a vast range of activities -- at the macro-economic, enabling environment and enterprise levels – that affect investment...little evaluative material on the impact of interventions on mobilizing investment is available’. This report argued that donors ‘need to change the way they do business’ if they are to be effective in supporting improvements in the business environment.<sup>107</sup> In particular, OECD argues that internal systems should not work against staff pursuing longer-term and riskier interventions.

127. The most detailed evaluation of donors support to improve the business environment was the WB’s recent evaluation of the WBG’s support to improving the investment climate. This study identified the following ‘lessons on what worked and what did not, the factors that led to success and failure, and lessons that can be generalized to the [World] Bank’s IC activities’:

- Often, crisis or opportunity has politically enabled IC reform.
- Loan conditionality was sometimes helped by strengthening the hand of reformers.
- Local champions often initiated reforms, but broad support was necessary to sustain them.
- The implementation of reforms would get bogged down at lower levels of bureaucracy if incentives were not changed.
- Modest, piecemeal efforts have been less successful than a comprehensive set of reforms<sup>108</sup>

128. The above study identified four main challenges in its attempts to achieve better outcomes with global investment climate activities:<sup>109</sup>

- **Focus on reforms at the institutional level more than at the policy level.** There is a lack of knowledge about what kinds of institutional arrangements will work in different environments and about the dynamic process of change that is needed. There is a need to recognize that ‘unorthodox arrangements sometimes work’.
- **Customize interventions to country needs.** It is important to identify country specific priorities for reform and institutional development to remove barriers to PSD. More detailed country-level understanding needs to be developed using local knowledge and expertise.
- **Political economy and the sequencing of reforms.** Better analysis is needed of the capacity and incentives facing public sector organizations to implement reforms, and to be aware of the distribution of costs and benefits of reforms. It is important to recognize that the sustainability of reforms depends on broad stakeholder support.
- **Organizational challenges.** The broad nature of investment climate issues creates challenges in terms of developing consistent and coordinated support that reflect the comparative advantages of different parts of the organization.

<sup>106</sup> E.g., OECD. 2006.

<sup>107</sup> OCED. 2006. ‘Promoting Private Investment for Development: the Role of ODA’, pp.7-9.

<sup>108</sup> This contrast with the findings of WB (2005) and Kikeri et al. (2006) which stress that gradual reform can work, and in some case will be the only practical and politically feasible option.

<sup>109</sup> WB. 2006. Improving Investment Climates: an Evaluation of World Bank Group Assistance, pp. xix-xxi.

129. The study found that establishing causal links between the quality of technical assistance ‘and outcomes in terms of implementation of recommendations to impacts on the ground is problematic without good monitoring data. Changes to policies, laws and practices– or their failure to materialize– often result from numerous actions, or from the inaction of various stakeholders and other internal and external forces’.<sup>110</sup> A review of the Department for International Development (DfID) activities in the enabling environment also concluded that ‘Current evaluation and progress reports offer scant information to determine impact and there is a clear need to strengthen monitoring and impact tracking aspects of enabling environment’.<sup>111</sup> Econometric estimates from a recent IMF study suggested that higher levels of aid could be a ‘hindrance to transitions’ to good institutions, and cautioned both recipient countries and donors ‘to analyze carefully the potential institutional implications of increased aid ‘to minimize any potential adverse effects’.<sup>112</sup>

130. Where country level evaluations have been made they are often heavily qualified. For example, an OECD-funded evaluation of ODA support in encouraging private investment in Viet Nam concluded that ‘Despite the generosity of international donors and the remarkable success of some programs...the overall effectiveness of the ODA program in the area of soft infrastructure has not been so clear. For the issues are diversified, and there is often sensitivity when they deal with administration, the ODA programs in this area are not large and their effectiveness changes from case to case’.<sup>113</sup> It may not necessarily be that ODA is not having an impact, but simply that resources have not been provided to undertake a study that would provide convincing evidence one way or the other about the impact of ODA on the business environment.

131. More work is required to provide an even rudimentary assessment of the contribution of ODA to the remarkable improvements in the business environment, and to the resulting rapid increases in business investment and employment in the region.

## **E. Donor Institutional Challenges**

132. OECD has raised concerns about the need to ensure that internal systems should not work against staff pursuing longer-term and riskier interventions needed to support improvements in the business environment.<sup>114</sup> Many donors are also recognizing that they face special institutional challenges in supporting private sector development (PSD).<sup>115</sup>

133. Opportunities to support Asian business environment reforms have emerged quickly; the window of opportunity for initiating effective assistance can be narrow. Donor policies often lack the flexibility and incentives for staff to ‘take risks’ in identifying and responding to new opportunities to support business environment reform. There are often major time gaps between request for support and project approvals and implementation. New mechanism may be needed to better respond to emerging opportunities to respond to BE reforms.

134. Another institutional challenge is the sheer number of different agencies providing assistance in BE issues. This can greatly increase the costs of both giving and receiving assistance. For smaller countries with limited institutional capacity (such as Laos), competent

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<sup>110</sup> WB. 2006. Improving Investment Climates: an Evaluation of World Bank Group Assistance, p. 15.

<sup>111</sup> DfID. 2004. A Review of DfID Activities in the Enabling Environment, p. 7.

<sup>112</sup> IMF. 2005. World Economic Outlook, September 2005: Building Institutions, pp. 152-3.

<sup>113</sup> Le Thuc Duc et al. 2004, p.11.

<sup>114</sup> OECD. 2006, p.12.

<sup>115</sup> OECD. 2006, p.35.

government officials and other stakeholders responsible for BE issues can spend a large portion of time meeting with donors.

135. A recent World Bank evaluation<sup>116</sup> identified organizational challenges as a major issue to address in providing more effective support to investment climate (IC) reforms. Most of the major agencies within the WBG (the WB itself, the IFC, the Multilateral Investment Guarantee Agency (MIGA) and the Foreign Investment Advisory Service (FIAS)) have mandates to assist in improving the business environment.<sup>117</sup> The WBG has also supported the establishment of other regional institutions (e.g., the Mekong Private Sector Development Facility (MPDF)), which also has been tasked with helping improve the BE. The WB evaluation notes ‘At the country level, coordination across the WBG on IC issues has been weak, both between the Bank and IFC and across sector units with the Bank’ and that competition with the WB ‘for the IC agenda has become pervasive and led in some cases to a lack of coordination and information sharing’. The evaluation recommends that ‘At the country level, coordination and consistency across the WB on IC diagnosis, priorities, results focus, and assistance needs to be improved’.<sup>118</sup>

136. With most bilateral donors also having at least one agency (sometimes with multiple project offices) proving support for BE related issues, the issue of coordination can be a major challenge for host countries. Greater specialization, and the consolidation of aid delivery offices at the country level, could increase the effectiveness of ODA delivery.

137. The ADB also recently included a frank assessment of recent support to PSD in Asia; recognizing that ‘Despite its PSD efforts in 2000-2005, ADB was unable to fully meet the growing and diversifying needs for PSD’.<sup>119</sup> The ADB identified the following contributing factors: (i) weak leadership (on PSD issues); (ii) limited understanding of, and exposure to, the private sector at management and staff levels; (iii) lack of clear performance indicators and targets; (iv) an incomplete operational framework for support and confused operation priorities; (v) weak implementation (partly due to inadequacies in policies and skills); (vi) lack of accountability for achieving results; and (vii) limited teamwork. The ADB’s revised framework for private sector development emphasizes the need for stronger corporate commitment and management systems, and strengthening of staff skills to address these weaknesses.

138. Most donors, and staff and consultants working for development agencies, have limited practical and/or advisory experience in improving the BE, and they often lack insight into what challenges need to be overcome in order to make reform happen. There are no established models that can be easily transferred to Asian developing economies. While there may be some ‘best practices’ in terms of processes of formulating policy reforms, implementation strategies in Asia have been country specific.

139. A more limited number of longer-term coordinated programs of donor support may help national authorities to focus more on longer-term institutional development and reform implementation, and allow donors to use limited expertise more effectively. It could also help reduce the overhead costs of delivering donor support to BE reform.

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<sup>116</sup> World Bank . 2006, pp. 19-21.

<sup>117</sup> The WB is meant to focus on macroeconomic, trade, and microeconomic policies and institutional development. IFC aims to influence the IC through TA to public and private sector and through its investments. MIGA influences the IC via political risk guarantees and TA to boost investment promotion.

<sup>118</sup> World Bank . 2006, P. xx1.

<sup>119</sup> ADB. 2006. Private Sector Development: A Revised Strategic Framework. Manila, pp. 5-6.

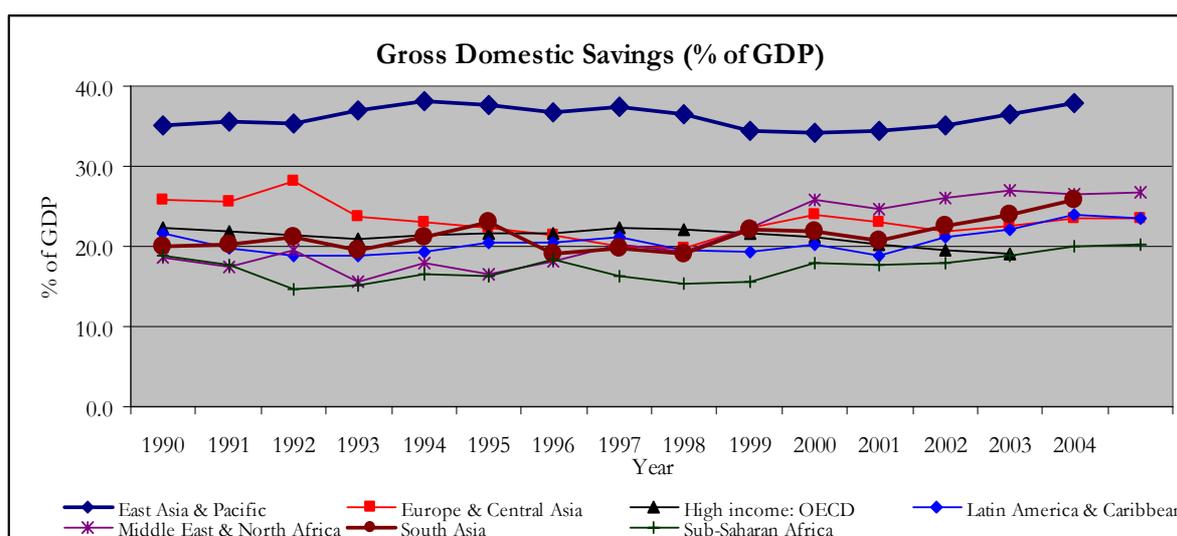
## V. MANAGING DONOR SUPPORT FOR BE REFORMS IN ASIA

### A. Overview

140. Experiences in supporting broader economic policy reforms are directly applicable to efforts to improve the business environment in Asia. The goal in both cases is to promote growth in economic output and employment to reduce poverty. Increased business investment and productivity is pivotal to making this happen. Thus, important lessons can be learned from donor experiences in supporting broader economic reforms. And a key lesson is that the current state of knowledge is limited. There are no easy fixes.

141. Michael Klein, a World Bank Vice-President recently cautioned that ‘Economic policy making remains more an art than a science... We know a few things about the technicalities of reform, for instance how to streamline customs procedures or simplify the process of business registration. But it is less clear how one gets these and other more complex policies agreed upon and implemented. Some believe that we can study the matter and develop typologies and recipes, almost a manual. I very much doubt this makes sense... [T]he process of reform and implementation is about humans agreeing, compromising and acting together. In the process, innovation is possible’.<sup>120</sup> This suggests a need to avoid being too narrow or dogmatic in our attempts to understand what drives business environment reforms.

142. However, it is important to re-emphasize the need for the basic elements to be in place to give investors confidence that their property rights will be protected. Another recent study notes that while ‘different policies can yield the same result, and the same policy can yield different results...’, there are four prerequisites to sustain strong growth: (i) rapid accumulation of capital; (ii) efficient resource allocation; (iii) technological progress; and (iv) sharing of the benefits of growth. While progress towards each of these four elements varies between countries, ‘successful countries have achieved a balance among them over time, and disruptions have ensued when the balance was not achieved’.<sup>121</sup>



Source: Data from World Bank Development Indicators Online.

<sup>120</sup> Kikeri, et al. 2006, p.iv.

<sup>121</sup> WB. 2005. Economic Growth in the 1990s, p.12.

143. Many Asian economies are reasonably well-placed in terms of achieving these prerequisites.<sup>122</sup> East Asia has been particularly successful in mobilizing domestic savings as indicated in the above graph. Earlier discussion also highlighted the relatively large share of credit allocated to the private sector (an indicator of efficient resource allocation), and relatively high indicators of technological progress in Asia, and especially in East Asia.

144. Notwithstanding the difficulties in drawing generally applicable lessons, some suggestions to guide those planning support for business environment reforms are presented below.<sup>123</sup> The suggestions relate to the need for (i) better country, industry and sub-national level diagnostics of bottlenecks to business development; (ii) better awareness of and support to generate demand for business environment reforms; (iii) strengthening public and private sector governance to facilitate implementation; and (iv) ensuring greater coherence in donor support. The process of designing and implementing reforms is often more important than actual reforms. ‘Good’ processes help change attitudes. And social support for reform facilitates implementation.

## B. Country Specific Business Constraints

145. Country specific reform experiences. While all countries need essential prerequisites for private sector development, they achieved these prerequisites in different ways. The reform experiences of the newly industrialized economies (NIEs) in Asia were different from each other. And the NIE experiences differed from that of the former centrally-planned economies (China, Viet Nam, Cambodia and Laos), and the varied experiences of the other Southeast Asian economies. While Southeast Asian economies started their transitions to rapid growth with a relatively pro-private sector bureaucracy, some Asian bureaucracies have had to overcome a long tradition of seeing their role as controlling rather than facilitating private sector development.<sup>124</sup> The former centrally-planned economies had to build market institutions from the beginning, often by transforming those institutions that underpinned central planning. They also faced major challenges in changing bureaucratic and social attitudes with respect to the private sector.

146. Different countries face different binding constraints. While Asian countries face similar sorts of investment climate issues, the relative importance of these issues varies substantially between countries. In the longer-term, the aim is to achieve progress with the four above-mentioned functions, but the nature of shorter-term priority issues and constraints are country specific. Failure to adequately analyze and target country specific priorities is a frequent weakness in donor support to reform programs.<sup>125</sup> Asian experience highlights the importance of understanding country specific issues and challenges.<sup>126</sup> Priorities, and measures to target priorities, need to be addressed on a country specific basis.<sup>127</sup>

<sup>122</sup> Although Quibria (2002, p. 3) argues that ‘by international standards the levels of inequality were already very high in Hong Kong, China; Malaysia; and Thailand. In Thailand, inequality has increased secularly over the last three decades’

<sup>123</sup> This and the remaining paragraphs in this section draw on Mallon. 2002.

<sup>124</sup> For a detailed overview of how differing political systems influence the capacity of nations to generate and implement reform initiatives see Fukayama. 2006.

<sup>125</sup> Rodrik. 2006, p.1. argues that the ‘Chief failing of the Washington Consensus was represented an approach based on ‘rules of thumb’. As such it was not well grounded in economic theory or the reality of actual countries’. Rodrik argues for an approach that does not focus on a list of prescriptions, but rather on developing a ‘much more strategic and much more diagnostic approach to developing growth strategies’.

<sup>126</sup> A past tendency of some donors to provide standardized solutions (e.g., the Washington Consensus) focusing on getting everything right are discussed in Hausmann (2005) and Rodrik (2003).

<sup>127</sup> Even within countries there are major differences. Palmade (2005, p. 14) notes that ‘Southern States in India enjoy much higher land security tenure than Northern States. This is the main reason for why land market prices are lower and the share of modern retailers is much higher in the Southern Indian States’.

147. Unequal enforcement and informality. Differences between countries in the degree and consistency of enforcement are often more distinct than differences in formal policies, laws and formal institutions would suggest. Weaknesses in enforcement can become more pronounced as developing countries attempt to develop more sophisticated formal institutions with limited implementation capacity. This can encourage increased informality. An overly complex business environment can increase the costs (disincentives) for firms to operate formally. While informal enterprises play a vitally important role in generating incomes and employment in a sub-optimal environment, disincentives to entering the formal sector can be a major barrier to the development of larger internationally competitive business firms. The challenge is to better understand the reasons for informality, and to reduce the disincentives for firms to enter the formal sector.<sup>128</sup>

### **Pace and Sequencing of Business Climate Reforms**

148. Pace of Reforms. A recent WB study of reform experience during the 1990s<sup>129</sup> argues that ‘pragmatic, incremental approaches...are more effective’ and that ‘there is no unique universal set of rules... [We] need to get away from formulae and the search for elusive “best practices”, and rely on deeper economic analysis to identify the binding constraints on growth.’ In another WB study, Kikeri<sup>130</sup> argues that ‘Agenda change can often be sudden and radical... But the processes of reform tend to be more incremental... [R]adical change, while it may be desirable, may not always be feasible, especially in systems with many checks and balances...’ Reformers can only do what is doable.

149. Incremental reforms have generated dramatic results in Asia (notably in China, Viet Nam and India). China began by providing rudimentary property rights to most of its population, and gradually implemented reforms to attract FDI, increase trade and facilitate the emergence of a growing private sector. More recently, China joined the WTO. Reforms have now been implemented to improve transparency and reduce corruption. While by most standards<sup>131</sup> the Chinese business environment still has many weaknesses, results have been impressive with an average growth rate of eight percent per year over the past two decades. The share of the population living on less than USD1 a day fell to 16% in 2001 from 64% in 1981. These gains have helped sustain support for reform.

150. Flexibility. Bottlenecks to business development -- and opportunities to accelerate reform -- can emerge unexpectedly. Priorities can change quickly. Static plans (government or donor) are of limited use in planning support for business environment reforms. Assistance programs designs should include monitoring mechanisms and the flexibility needed to allow donors to respond to the new information gained and lessons learned during implementation. Mutual professional respect between government and donor agencies can facilitate flexible responses to changing needs. Sustained support to industry and local institutions can help. Donors should take a medium-term (5-10 years) perspective in developing support to promote private sector development.

151. No need to ‘get everything right’ at once. Asian experiences suggest that major increases in business investment can be achieved in a less than perfect business environment. The WB recently argued ‘Clearly not everything can be right at once, and not everything needs to be ‘right’ for growth to take place – as witnessed in examples from Bangladesh, China, India,

<sup>128</sup> Palmade (2005, p. 16) reports that ‘informality typically affects around 40% of the non-agriculture workforce in middle-income countries – this proportion rises to 70% and above in lower income countries’.

<sup>129</sup> WB. 2005. Economic Growth in the 1990s, p.23.

<sup>130</sup> Kikeri, et al. 2006, p.16.

<sup>131</sup> E.g., Investment climate assessments and international rankings of competitiveness.

Indonesia and many other countries'.<sup>132</sup> The key is getting policy makers to take concrete actions to address binding constraints (identified in consultations with business representatives). This builds investor confidence and generates short-term benefits that can strengthen the position of reformers to address other priority constraints. This is important because institutional capacity is often limited.

152. Prioritize. Many constraints, limited capacity. Establishing priorities is important because business environment reform covers a broad range of issues, and few (if any) governments have the capacity and/or political clout to tackle all reforms at once. Capacity constraints can be particularly important in developing countries. Implementing reforms is often institutionally difficult, requiring coordinated and sustained actions across ministries and different levels of administration. Reform losers can be expected to actively resist reforms.<sup>133</sup> Experience suggests that reformers often fail because they try to do too much at once, or start with reforms that were not of sufficiently high priority to key leaders and/or those responsible for implementation. Rodrik (2003) argues it is not essential to 'get everything right'; the key is to identify the binding constraints, and focus limited capacity and 'political capital' on addressing those constraints.<sup>134</sup>

153. Political change is not a prerequisite for economic change. A recent IMF report notes that 'many Asian countries did not witness dramatic changes in political institutions ahead of improvements in economic institutions'.<sup>135</sup> The report identified two phases of economic transition in Asia. The newly industrialized economies (NIEs)<sup>136</sup> went through a major transition in the 1960s, experiencing rapid industrialization and economic integration. The second phase included China in the late 1970s, and 'also included Indonesia, Malaysia, Thailand, and some smaller countries'. The IMF report argues that 'Spurred by the visible success of some economies in the region, transformation of economic institutions was also undertaken in India and several other countries'.

### C. National Ownership: Building Support for Reform Implementation

#### Building Support for Reform Processes

154. National ownership of business reform processes. National ownership and commitment to reform has been a feature of Asian reform efforts. Donors have been able to facilitate, but not push, business environment reforms in Asia. National ownership implies a need for donors to provide support that is integrated into the core responsibilities of a counterpart agency. Donor support for applied analysis about the employment (and thus poverty reduction) impacts of business development can help build public support to push forward business reforms in Asia.

155. Building social support for reform is an important issue that deserves more attention from donors. Understanding the attitudes of key stakeholders is important to changing mindsets (official and social) towards the private sector and the market economy. Former Vietnamese Prime Minister Pham Van Dong stressed that changing society's way of thinking was a key challenge to implementing reform, noting that the low social status attached to merchants under Confucianism -- and to any business activity under Communism -- 'is not easily undone overnight'.<sup>137</sup> Strategies are needed to mobilize existing and potential support of reforms. Donors

<sup>132</sup> WB. 2005. Economic Growth in the 1990s, p.12.

<sup>133</sup> Losses from reform are often highly concentrated amongst the ruling elite (or at least the better connected members of society), while benefits tend to be distributed over a much larger number of less connected persons.

<sup>134</sup> Dani Rodrik, 2003. 'Growth Strategies'. Cambridge, USA, NBER Working Paper 10050.

<sup>135</sup> IMF. 2005. World Economic Outlook, September 2005: Building Institutions, p. 136.

<sup>136</sup> Hong Kong, Singapore, Republic of Korea and Taiwan.

<sup>137</sup> Referred to in Tuong Lai, 1999, p. 5.

need do consider how they can support such strategies. Kiekeri (2006, p. 19) et al. propose the following set of strategies.

156. Effective dialogue with key stakeholder (including public-private dialogue) is a key tool in building support and in adequately understanding and addressing pressures for change.<sup>138</sup> Dialogue is essential for (i) identifying and understanding key bottlenecks; (ii) designing appropriate and practical reforms to address these reforms; (iii) building support for reforms; and (iv) developing strategies to address resistance to reforms.

157. Informing and educating the public. This is particularly important for reforms that are not well understood, and where vested interests may be effective in mobilizing resistance to reform. Better information is crucial to effective education. Linking reforms to issues that matter to the majority of the population is important. South Korea introduced regulatory reforms as part of an anti-corruption drive, and Viet Nam emphasized the impact of its business regulation reforms on employment generation and poverty reduction.

158. Compensating direct losers. Reformers can try to directly or indirectly compensate losers for both equity reasons and to minimize resistance to reforms. For example, in Viet Nam the equitization (partial privatization) of state enterprises gave preferential access to (often undervalued) shares to their managers and workers. Officials at line ministries responsible for the equitized enterprises were also often better positioned to purchase shares.

**Figure: Strategies for Managing Different Stakeholder Groups**

Support	<p><b>A. Stakeholders who support reform, but are less influential</b> Mobilize and empower this group through education programs and opportunities to participate in the reform process.</p>	<p><b>B. Stakeholders who are strong and have strong influence</b> Leverage this group by using them to promote and champion reform.</p>
	<p><b>C. Stakeholders who oppose reform, and are less influential</b> Follow similar strategies as for D, but with lower priority.</p>	<p><b>D. Stakeholders who oppose reforms and are influential</b> Diffuse and mitigate opposition from this group by informing and educating the public, fostering consultative approaches and compensating where appropriate.</p>
Oppose	<p>Low <span style="float: right;">High</span></p> <p style="text-align: center;">Influence <span style="float: right;">→</span></p>	

Source: Kiekeri et al. (2006, p. 19)

**Learning from Practical Experiences**

159. Policy experimentation, information and learning by doing. Informal changes to facilitate business investment, often at the sub-national level, sometimes preceded changes in policies and/or legislation in China,<sup>139</sup> Viet Nam and Laos.<sup>140</sup> Businesses and officials reached informal

<sup>138</sup> For example, while some formal consultations were organized to discuss the new Business Law in Laos, these consultations were limited to a small number of representatives from the Lao National Chamber of Commerce and Industry. In contrast, the formulation of the Enterprise Law in Viet Nam involved frequent and extensive nation wide debate through local meetings, the media, Peoples’ Councils and the National Assembly. The end result was broad public support for the reforms, and relatively rapid implementation.

<sup>139</sup> Rodrik. 2006, p. 10 notes that Chinese policy makers provided ‘incentives for policy competition and innovation among the country’s regions’.

<sup>140</sup> See, for example, the Adam Fforde and Stefan de Vylder (1996) discussion on ‘fence breaking’ in Viet Nam.

arrangements (often at the sub-national level) to accommodate emerging realities. Connections were important to succeed in business in such an environment. While not competitive nor transparent, these arrangements helped provide compelling evidence of the benefits of increased business investment.<sup>141</sup> More generally, better information (including applied studies and international benchmarking) has helped build support for reform in Asia.

160. Regional experiences and benchmarking. Asian policy makers are also keen to learn from experiences elsewhere in the region. The dissemination of information on regional and international experiences, and comparative studies, can stimulate domestic debate about the need for business environment reforms and help build support for reform.

161. Predictability. The need to ‘learn by doing’ and to innovate needs to be balanced by investor demand for certainty and predictability. Again close consultation with the private sector during reform planning and implementation is important in getting an appropriate balance.

## **D. Implementation, Accountability and Sustaining Reforms**

### **Process for better governance**

162. It is possible to distinguish two inter-linked phases of reform: (i) initiating and designing reforms; and (ii) implementing and sustaining reforms.<sup>142</sup> These two phases are closely linked. Successful implementation depends very much on both public and official support for reform that was built during the design process and the practical aspects of how reforms were designed. All too often the later aspect receives inadequate attention by planners and donors. Planners need to think more about (i) implementation/enforcement incentives and capacity; and (ii) performance indicators, monitoring and oversight mechanisms. A policy or regulatory reform has no impact unless economic agents and officials are motivated to comply with the change.

163. Implementation/Enforcement. Efficient implementation and enforcement of business reforms have been a challenge for many Asian economies, and especially for Asian transition economies. Enforcement agencies often lacked the skills, experience and expertise needed to implement reforms and enforce regulations. And some regulatory and policy reforms were applied and others were ignored. Laws and regulations were often issued in transition economies over a relatively short period with minimal public consultation. Thus, in some cases there was minimal public awareness of the rights and obligations of businesses. Moreover, the judiciary in many Asian transition economies is weak: the role of courts in enforcing regulations, contracts and/or property rights is minimal. This contributes to high business establishment costs, delays in securing approvals, reduced competition, greater opportunities for corruption and disincentive to enterprises moving from the informal to formal sector.

164. Monitoring and accountability. Public and media debates about the results of reform initiatives provide incentives for reformers to succeed. Performance indicators and targets -- and effective collection and dissemination of information on key indicators -- can help stimulate such debate.<sup>143</sup> Improvements in the collection and dissemination of information on key performance

<sup>141</sup> Much of Viet Nam’s success with private business development can be attributed to a willingness to experiment (i.e., to implement pilot reforms: often at decentralized levels), to analyze and learn from experiments, and to apply the lessons of success in developing broader reform initiatives.

<sup>142</sup> As suggested by Kikeri et al., 2006: ‘Reforming the Investment Climate: Lessons for Practitioners, p. 2.

<sup>143</sup> Data on comparative provincial performance (e.g., enterprise registrations, time needed to complete administrative formalities, employment growth, investment levels and the provincial competitiveness index) increased pressure on provincial officials to improve the business environment in Asian economies such as Viet Nam.

indicators should be a priority. Donors should support governments to develop mechanisms to make central and provincial level officials more accountable for delivering tangible improvements in the business enabling environment.

165. Performance indicators for ODA. Clear indicators should also be established to monitor the impact of ODA on business environment reforms. There is need for more substantive analytical work to better understand the impact of alternative donor approaches to improving the business environment and supporting private sector development. More research is needed to improve the database and methodology for impact assessments.<sup>144</sup>

### **Planning Business Environment Reforms.**

166. Efforts to improve governance related to the business environment should focus on developing effective systems for dialogue and for information collection and dissemination. Officials (government and donor) need to have incentives to be pro-active in looking for practical solutions to address constraints. This requires action from planning to implementation, and to monitoring results.

167. It is important to work with domestic stakeholders to understand priority bottlenecks and strengthen the position of potential advocates of improvements in the business environment. In practice those planning and implementing donor support to improve the BE need to:

- Consult regularly with key stakeholders (business associations, research institutes, the media and others) to identify and document key issues and bottlenecks and develop actions to improve the business environment;
- Develop mechanisms to ensure that relevant officials are held accountable for ensuring tangible progress in addressing priority bottlenecks identified during private-public sector dialogue;
- Engage national proponents of reforms to help design and implement programs of support;
- assist domestic institutions to publicize – and publicly debate – policy studies, draft legislation and related documentation, which can help build support for change;<sup>145</sup>
- Use national consultants wherever feasible to facilitate consultations and implement studies. They can be important advocates of reform;
- Develop the national management and analytical capacity to monitor and evaluate which interventions to improve the business environment are working and which do not; and
- Where appropriate, facilitate dialogue between officials of neighboring countries to discuss development experiences and practical constraints to increased business investment.<sup>146</sup>

<sup>144</sup> The DCED has established a Working Group to help develop common methodologies for the measurement of performance and impacts across all donor-funded interventions to support enterprise development. <http://www.enterprise-development.net/groups/group.asp?groupid=5>.

<sup>145</sup> However, there may be times where too much public debate about reform may be counter-productive. Mallon (1993, p. 221) argued with respect to Viet Nam that ‘it would have been preferable to have had a clear idea of what sort of economic system would evolve at the end of the reform process. ... However, even if decision makers had a clear vision of the type of economic system that would evolve, the very enunciation of this vision could have reduced the likelihood of success’.

<sup>146</sup> Refer to the finding quoted earlier from IMF (2005): ‘Countries are more likely to improve institutions if their neighbors have higher institutional quality’.

### Decentralization issues: business reform at the sub-national level

168. Administrative Discretion at Sub-national levels. Sub-national authorities in some Asian economies (especially the transition economies) exercised a greater degree of autonomy than that indicated by law. For example, Gillespie (2002) argues that in Viet Nam, ‘it suits all levels of government to invest local authorities with discretionary power that technically exceed their statutory powers, to “soften law” to suit local conditions...a process that produces new and innovative adaptation of corporate law’.<sup>147</sup> This has facilitated the policy experimentation discussed earlier.

169. However, administrative discretion can also have negative impacts. It can contribute to counterproductive distortions in tax policies as provinces provide tax and other incentives to attract increased levels of investment. There is also some evidence in Asia that, depending on sub-national systems of governance and accountability, decentralization can lead to increased corruption.<sup>148</sup>

170. Donors need to be aware of sub-national differences in treatment of businesses, and design programs accordingly. Substantive, consultative studies should identify such differences and provide insights into the incentive structures affecting the behavior of key stakeholders. Opportunities should be sought to use differences in sub-national performances to learn what can be achieved. For example, in Viet Nam, differences in provincial economic performance<sup>149</sup> became an increasingly frequent topic of public debate, contributing to pressure on poorer performing provinces to adopt a more pro-business stance.<sup>150</sup>

### E. Coordination and Competition in Ideas

171. Because there are no simple answers to the best way to improve the business environment, donor agencies and development experts often provide quite different, and at times contradictory, advice on approaches to improving the BE. This problem can be compounded by the fact that some bilateral agencies must be expected to be (at least partly) motivated by their country’s own economic interests. This can affect the quality of advice. Recipient governments need to recognize these realities, and develop the capacity to identify what advice is most appropriate for their country.

172. Donor harmonization and coordination. Donors can help recipient governments by coordinating with each other to avoid overlap of effort and to minimize inconsistencies in advice. This is particularly important in smaller Asian countries where administrative capacity to work with large numbers of separate donor agencies is limited. The Paris Declaration on Aid Effectiveness establishes an agreed framework for coordination. The declaration commits donors and recipient governments to promote local ownership of reform efforts; harmonize

<sup>147</sup> Gillespie, John. 2002. pp. 662-3.

<sup>148</sup> WB 2006. An East Asian Renaissance, pp. 259-290.

<sup>149</sup> Initially the focus of discussions was on key economic indicators, success in attracting FDI and new business registrations. More recently, VCCI has developed a provincial-level competitiveness index (with support from the Asia Foundation and USAID).

<sup>150</sup> While not all government agencies have been equally impressed by the results of the provincial competitiveness index, the Communist Party Central Committee website includes a news headline ‘**2006 Vietnam Provincial Competitiveness Index: Driving Local Governance Reforms**’, which goes on to note that ‘The first PCI release was followed by enormous coverage in the national and local media, including being cited as one of the “Top 10 economic events” of 2005 by Vietnamese national VTV1 news. Also, provincial governments moved quickly to request assistance in understanding their ranking and initiating reform, leading several donors to make the PCI central to their efforts to promote provincial private sector development’.  
[http://cpv.org.vn/details\\_e.asp?id=BT160662679](http://cpv.org.vn/details_e.asp?id=BT160662679)

their support; align donor support with government development goals and strategies; and to effectively measure results. The challenge now is to find practical ways to make this happen. The DCED may be able to assist in developing mechanisms for coordinating support for improvements in the business environment.

173. Competition in ideas. Because there is no single model, and because knowledge about how to make reform happen is weak, competition in ideas can help promote the innovation needed to succeed in identifying and addressing priority bottlenecks. While fewer, longer-term donor-supported programs is desirable, efforts at harmonization should not stifle competition in ideas. Earlier ‘conventional wisdom’ about economic reforms have been wrong.<sup>151</sup> Asian policy makers often succeeded because they were willing to experiment with reform. For example, when Viet Nam actively sought differing views on its corporate and competition law,<sup>152</sup> some donors expressed concerns about possible duplication of effort and the impact of conflicting advice. But a desire to gain differing perspectives contributed to a better national understanding of key issues, and to the drafting of legislation, which had strong national ownership.

174. Strong national ownership. Thus, the challenge is to both develop systems to filter differing advice and adapt this to national circumstances, while at the same time implementing coordination mechanisms to avoid unnecessary duplication of efforts. Effective information systems can be particularly important in this regard. This implies a need for strong national ownership of systems to plan, monitor and implement donor assistance. Given the various vested interests and incentive structures, strong national leadership in the coordination and prioritization of donor assistance is the optimal solution.

175. Information sharing. Better information can greatly help avoid duplication of effort. Donors are increasingly operating in a more transparent manner, and most have adopted much more open public disclosure policies. Combined with new information technology, this provides greatly enhanced opportunities for the sharing of information about activities and lessons learned, both within countries and between countries. The Viet Nam Development Information Centre has served an important role in sharing information among donors and researchers, but it is also important to develop mechanisms and strategies for getting information out to wider audiences via the business media and increasingly the Internet.

176. Donor working groups. Experiences in Cambodia, Laos and Viet Nam suggest that such groups can be useful in sharing information and discussing ideas. Governments can use such groups as effective mechanisms for more efficiently keeping donors informed of new policies and developments. This can be very important for smaller, less developed countries with limited staff capacity to deal with large numbers of donors individually (e.g., Laos). Fewer, more substantive programs of support can also be very useful in reducing the transactions costs of receiving ODA, especially in smaller economies with limited capacity.

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<sup>151</sup> ‘In retrospect, it is clear that in the 1990s we often mistook efficiency gains for growth. The “one-size fits all” policy reform approach to economic growth and the belief in “best practices” exaggerated the gains from improved resource allocation and their dynamic repercussions, and proved to be both theoretically incomplete and contradicted by the evidence.’ (WB. 2005. Lessons from a Decade of Reform, p. 11).

<sup>152</sup> At one workshop at the later stage of drafting of Viet Nam’s first Enterprise Law (enacted from 2000), the government invited the different experts from Germany, Hong Kong/Canada, New Zealand and the USA to discuss together (over five days) key articles of the draft Enterprise Law.

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## Appendix 1: Poverty and Inequality in Selected Asian Economies

DMC	Population in Poverty (%) (National Poverty Line) <sup>b</sup>				Proportion of Population Below \$1 (PPP) a Day (%)		Gini Coefficient <sup>d</sup>
	Total	Urban	Rural				
<b>East Asia</b>							
China, People's Rep. of	3.1	...	...	(2003)	13.4	(2003)	0.447
Hong Kong, China	...	...	...		...		0.434
Korea, Rep. of	3.6	...	...	(2000)	...		0.306
Mongolia	35.6	39.4	32.6	(1998)	18.9	(2003)	0.303
<b>Southeast Asia</b>							
Brunei Darussalam	...	...	...		...		...
Cambodia	34.7	...	...	(2004)	33.8	(2003)	0.450
Indonesia	18.2	14.5	21.1	(2002)	6.5	(2003)	0.343
Lao PDR	33.5	...	...	(2002)	28.8	(2003)	0.347
Malaysia	7.5	3.4	12.4	(1999)	0.2	(2003)	0.443
Myanmar	26.6	20.7	28.4	(2001)	...		...
Philippines	30.0	...	...	(2003)	14.1	(2003)	0.461
Singapore	...	...	...		...		0.425
Thailand	9.8	4.0	12.6	(2002)	0.7	(2003)	0.420
Viet Nam	19.5	...	...	(2004)	9.7	(2003)	0.370
<b>South Asia</b>							
Bangladesh	49.8	36.6	53.0	(2000)	30.3	(2003)	0.318
India	26.1	23.6	27.1	(1999)	30.7	(2003)	0.325
Maldives	21.0	...	...	(2004)	1.0	(2004)	...
Nepal	30.9	10.0	35.0	(2004)	25.3	(2004)	0.472
Sri Lanka	22.7	7.9	24.7	(2002)	1.0	(2003)	0.402

a Note that data sources of the different indicators vary, hence consistency across indicators is not assured.

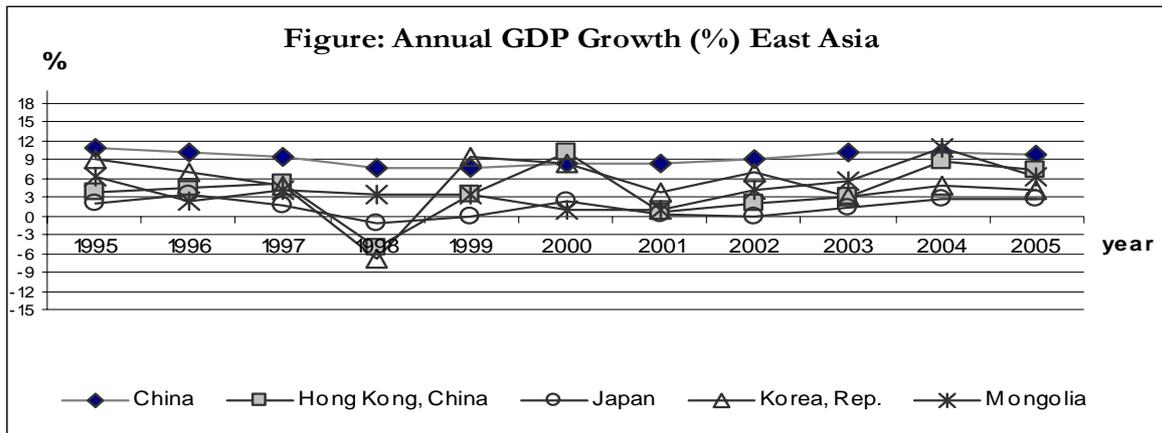
b When available, official poverty lines are used. In some countries, no official poverty line is available, and data may have been computed by non-governmental agencies.

c Refers to income or expenditure.

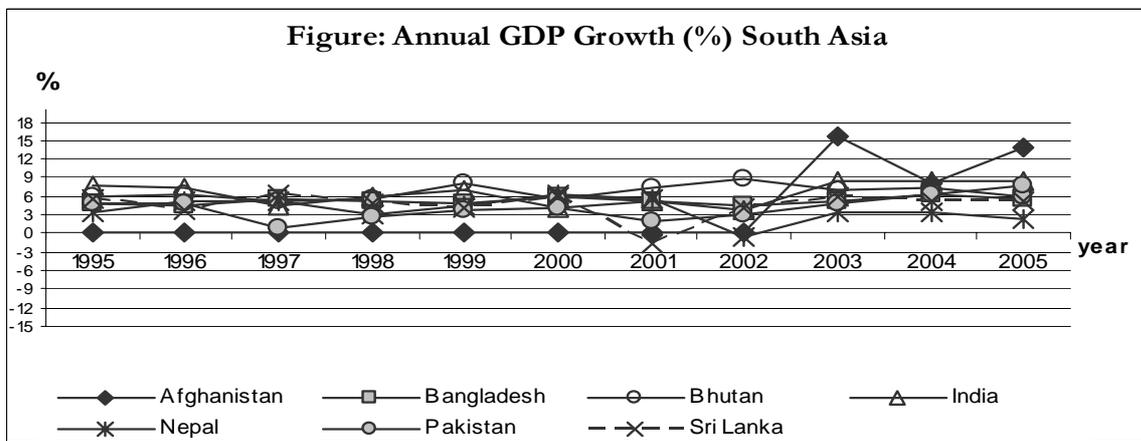
d Calculated based on income or expenditure and refers to the same year as that of the Income Ratio except for Philippines whose GINI coefficients are for years 2002 and 2003, respectively.

Asian Development Bank (ADB) - Key Indicators 2006 ([www.adb.org/statistics](http://www.adb.org/statistics))

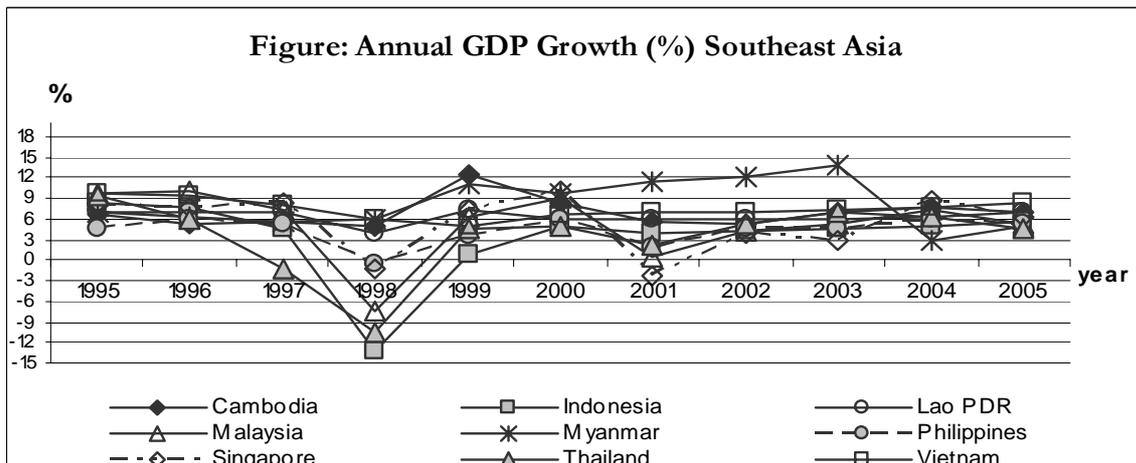
**Appendix 2: Average Annual Rates of Growth in Asian Economies**



**Source:** Data from World Bank Development Indicators Online

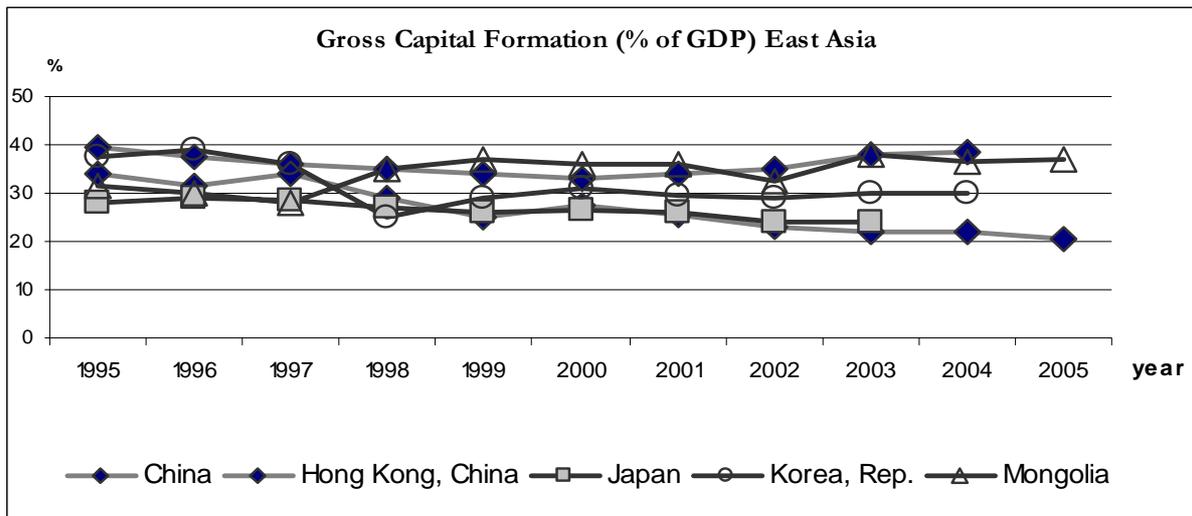


**Source:** Data from World Bank Development Indicators Online

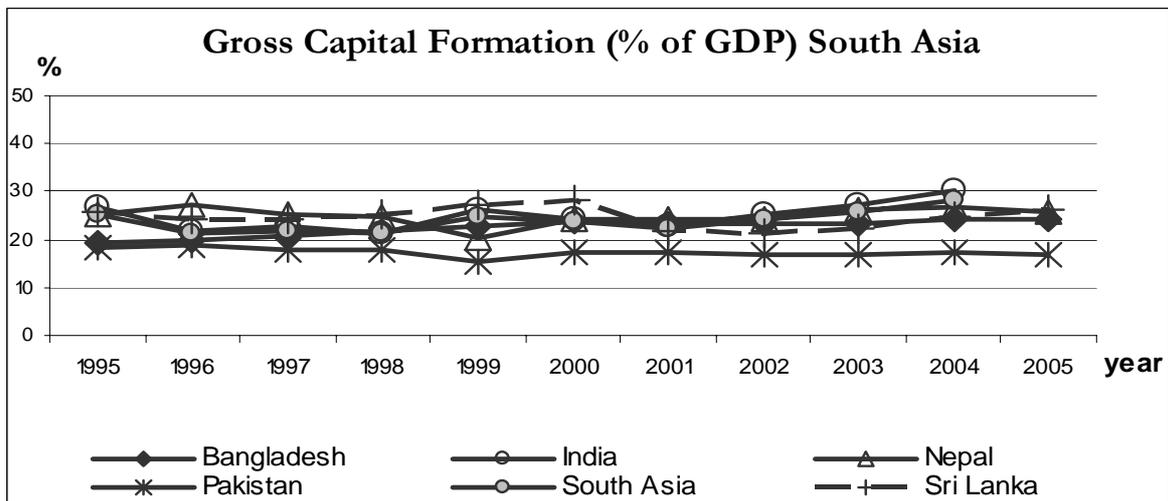


**Source:** Data from World Bank Development Indicators Online.

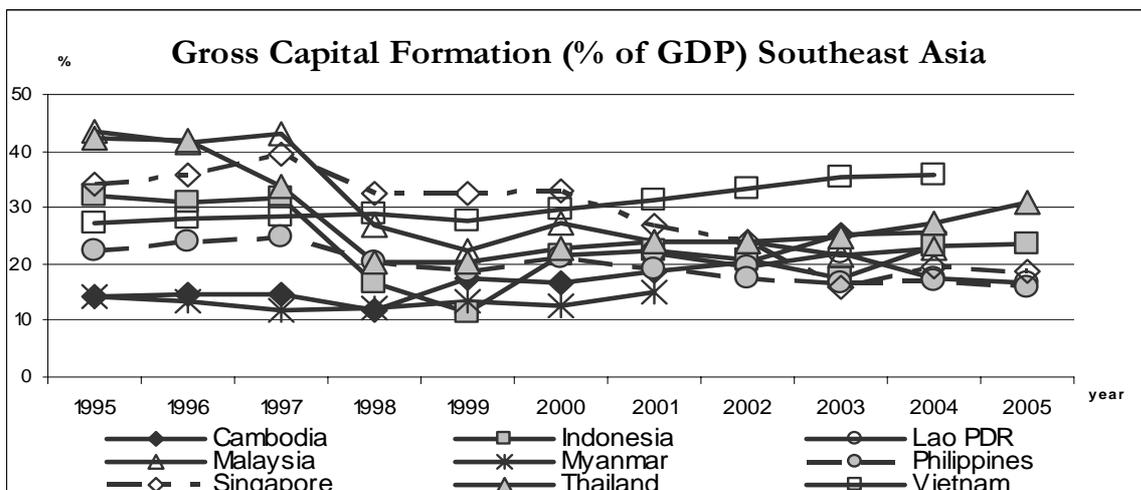
### Appendix 3: Average Capital Formation in Asian Economies



Source: Data from World Bank Development Indicators Online

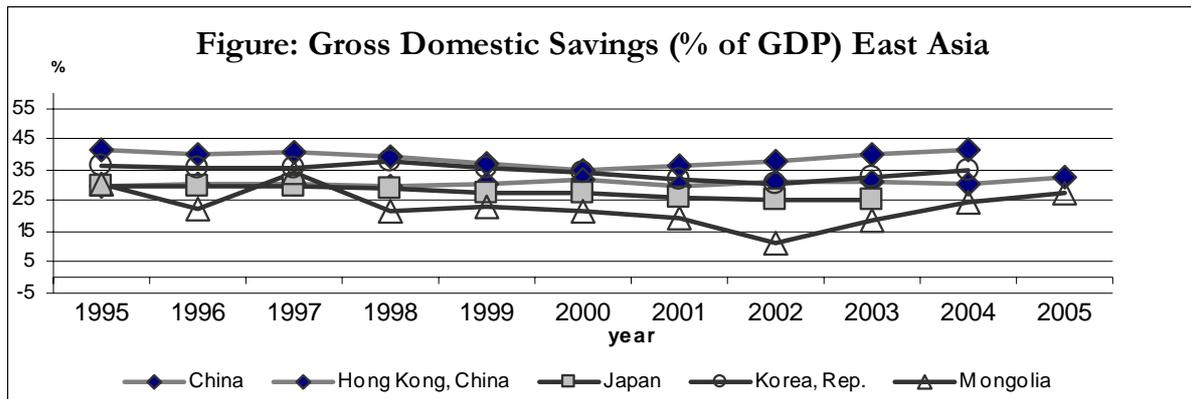


Source: Data from World Bank Development Indicators Online

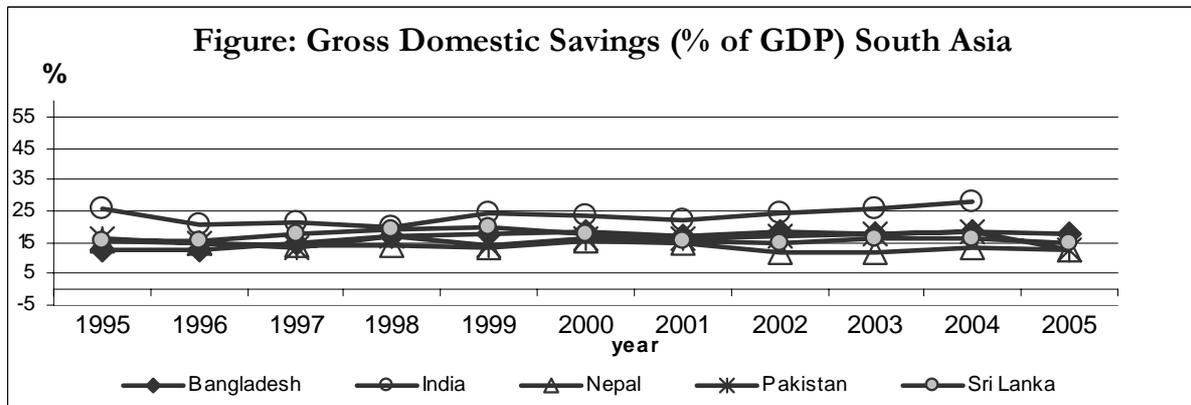


Source: Data from World Bank Development Indicators Online

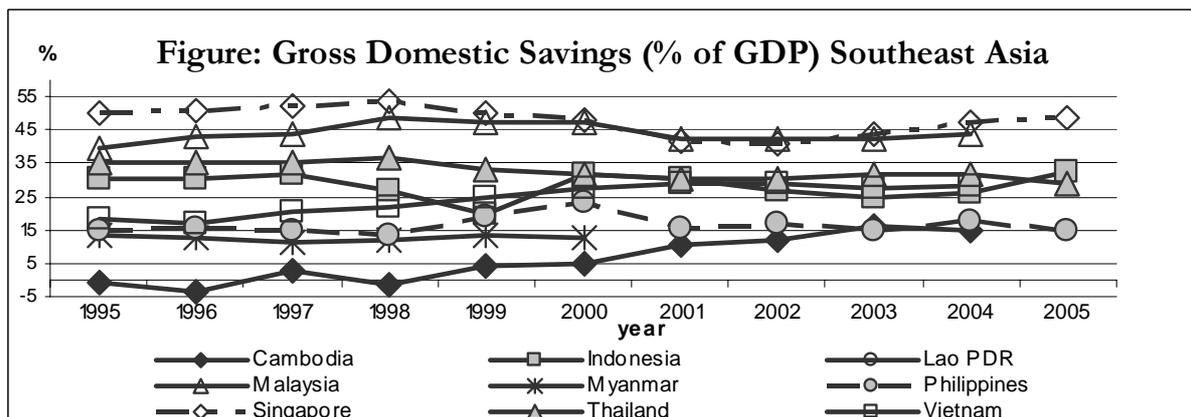
## Appendix 4: Gross Domestic Savings in Asian Economies



Source: Data from World Bank Development Indicators Online

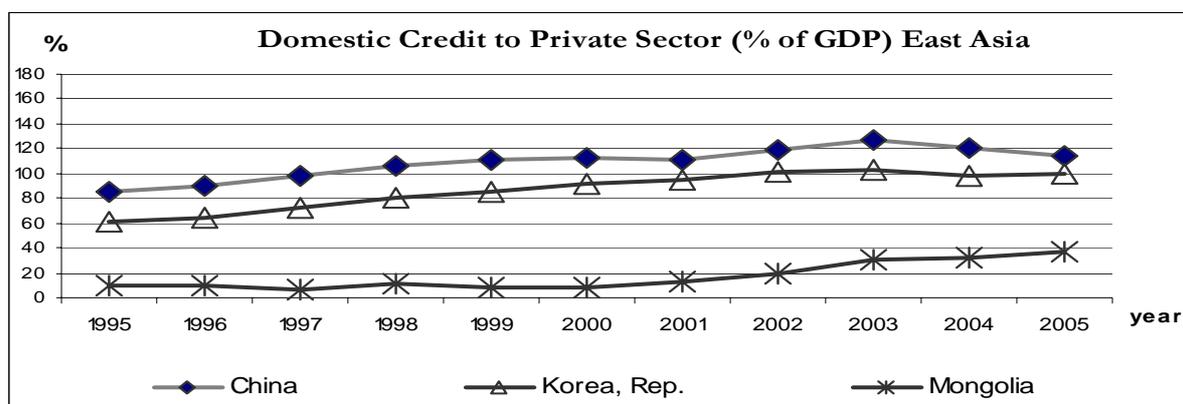


Source: Data from World Bank Development Indicators Online

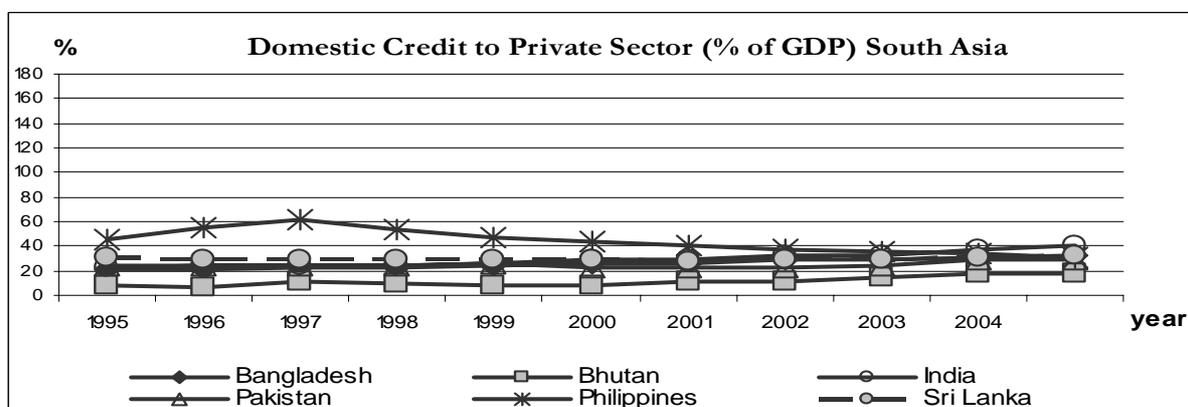


Source: Data from World Bank Development Indicators Online

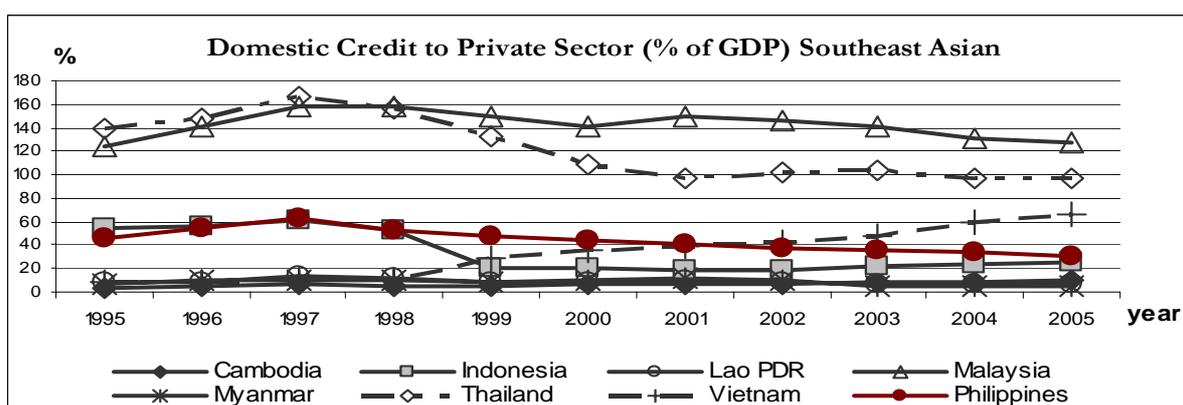
## Appendix 4: Domestic Credit to Private Sector in Asian Economies



Source: Data from World Bank Development Indicators Online

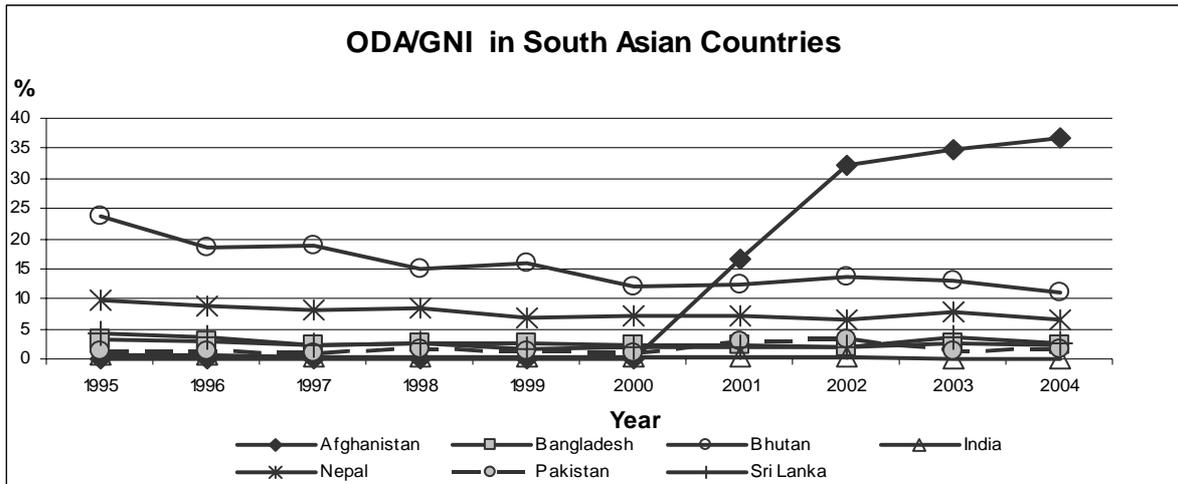


Source: Data from World Bank Development Indicators Online

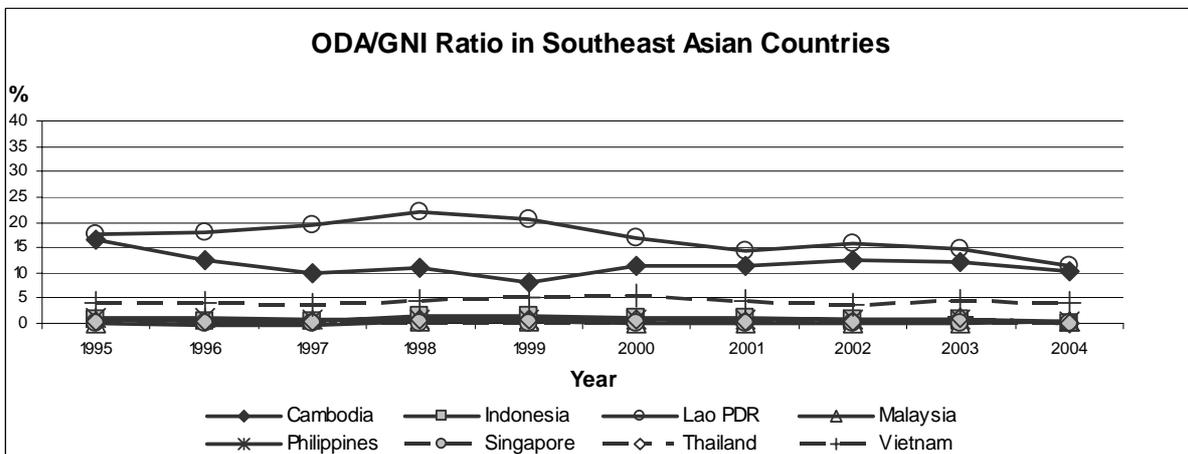


Source: Data from World Bank Development Indicators Online

## Appendix 5: ODA in South and Southeast Asian Economies



Source: Data from World Bank Development Indicators Online



Source: Data from World Bank Development Indicators Online