

**Creating an enabling business environment in Asia:
To what extent is public support warranted?**

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Introduction: Is a “level playing field” for entrepreneurs sufficient to trigger development?

“Once upon a time, economists believed the developing world was full of market failures, and the only way in which poor countries could escape from their poverty traps was through forceful government interventions. Then there came a time when economists started to believe government failure was by far the bigger evil, and that the best thing that government could do was to give up any pretence of steering the economy. Reality has not been kind to either set of expectations.”
(Rodrik 2004: 1)

Dani Rodrik’s quote describes the shift from an era of structuralist thinking, materialized in import substitution and other interventionist industrialization strategies, to the laissez-faire policies of the Washington Consensus. After the failure of structural adjustment policies, and especially after years of debate about the policy factors that made the “Asian Miracle” possible, a “Post-Washington” consensus seemed to have emerged about an intermediate strategy that assigns market forces and competition the main role as drivers of economic growth and social development, but equally accepts that different institutional setups are required to “govern the market” (Wade 1990) in the pursuit of welfare gains. This includes not only the use of competition policy and other market regulation, but also a broad array of public services and subsidies to address market failures, preferably time-bound, performance-based, and delivered through private agents.

In the recent private-sector development debate among donors, however, there seems to be a return to a rather fundamentalist and optimistic belief in the ability of markets (alone) to generate public welfare. Inspired by Hernando de Soto, Michael Klein and others, World Bank Working Papers – and especially the Doing Business report – as well as some other influential private sector development strategy papers¹ advocate a policy that focuses on

- simplifying procedures and regulations for businesses with regard to registration and licensing, but also closing a business;
- ensuring property rights, both by giving ownership titles to informal dwellers and improving the legal framework for contract enforcement;
- liberal trade and investment rules which includes an open-door policy towards foreign direct investment and equal treatment of foreign and domestic investors as well as simple customs procedures, low average tariffs and less spread in tariffs,
- low levels of government intervention in markets for labour, credit and final products; and
- low and simplified taxes in combination with a broadened tax base.

This “new minimalist approach” (NMA)² assumes that the key role of the state is to guarantee a level playing field for the private sector; that extensive government regulations hamper the growth of private enterprises (especially informal ones); that entrepreneurial growth will take off once a conducive business climate is in place; and that the reforms enlisted above are appropriate for achieving pro-poor outcomes. Selective (e.g. industry-specific) public policy

¹ World Bank (2004) World Bank / IFC (2004); see also Klein/ Hadjimichael (2003) and Palmade / Anayiaotos (2005), OECD (2004), de Soto (1989, 2000).

² Other, more proactive elements that are often associated with this New Minimalist Approach are the provision of microfinance and the development of private markets for business development services. These elements are consistent with the underlying market-optimistic perspective as they claim to provide solutions without recurring to subsidies and public delivery channels. See Altenburg / von Drachenfels (2006).

interventions in markets are largely dismissed as being distorting and harmful to economic development.

Benchmarking countries with regard to their level of market distortion through inappropriate government interventions has recently become popular. Especially the *Index of Economic Freedom* (IEF) and the *Ease of Doing Business Indicator* (EDBI) are worth mentioning as efforts to operationalize the NMA proposition and to rank countries accordingly. The IEF overall score of a country is the simple average of ten factors which cover various topics of an economy: trade policy, fiscal burden of government, government intervention in the economy, monetary policy, capital flows and foreign investment, banking and finance, wages and prices, property rights, regulation, and informal markets. “Economic freedom” is basically defined as low levels of government intervention, implicitly assuming that government regulations by and large hamper entrepreneurial activities. The more countries adopt measures to correct market failures, to ensure minimum standards of social protection or to improve the income distribution, the lower they rank on the IEF.

The EDBI, which is updated annually in the Doing Business Reports (DBR), is based on similar assumptions, but places special emphasis on the level of bureaucratic burdens involved in setting up and managing an enterprise, hiring and firing workers, or closing a business. Secure property rights and contract enforcement also occupy a centre stage in the EDBI. Furthermore the report specifically addresses the effect of administrative burdens as a growth constraint *for the informal sector*. The latest annual reports include additional topics, such as tax and trade policy issues.³

Both reports claim a direct link between a high place in the ranking and growth dynamics. According to the IEF “...the countries with the most economic freedom also have higher rates of long-term economic growth and are more prosperous than are those with less economic freedom.”⁴ In the same vein, the authors of the Doing Business Report titled their 2005 edition “Removing obstacles to growth”, suggesting that economic growth accelerates if governments reduce administrative barriers to private commercial activities (World Bank / IFC 2005: 4).

This paper critically reviews the assumptions of the NMA, with a special focus on evidence from Asia. It supports the view that policy reforms to ease private commercial activities are an important, but certainly not sufficient, element of growth strategies. Other growth constraints may be more important, such as lack of entrepreneurial skills, failures in technology markets, or lack of information about export market trends. These constraints however cannot be overcome by applying laissez-faire policies. The exclusive NMA focus on *government* failure diverts the attention away from the need to address market failures in a proactive way. Furthermore, the NMA systematically ignores potential trade-offs, e.g. between the need to make business procedures easier on the one hand, and certain regulations that are required to lubricate the market economy, to internalize social and environmental costs, or to achieve equity goals on the other.

Apart from the introduction, this paper consist of four parts. In the first part we use the available business environment indicators to test whether there is empirical evidence that

³ Starting a business, hiring and firing workers, getting credit, enforcing contracts, closing a business, registering property, dealing with licenses, protecting investors, paying taxes, and trading across borders are the ten topics dealt with in the ‘Doing Business 2007: How to Reform’ report.

⁴ <http://www.heritage.org/research/features/index/about.cfm> (27.10.2006)

“economic freedom” and “ease of doing business” are positively correlated with economic growth in Asian economies. We show that this is clearly not the case. The most successful Asian economies in terms of high present and past rates of GDP growth usually rank much lower on the different business environment indexes than low-growth economies in Asia and elsewhere. Furthermore we show that different indexes which all aim at measuring the quality of the enabling business environment provide extremely different rank lists, depending on the indicators used. And we demonstrate that there is also no clear positive correlation between the business climate rankings and firm level performance in terms of “innovation” and “business sophistication”, which are measured by the Global Competitiveness Index.

The second part discusses two key elements of the Doing Business Report in detail, namely bureaucratic procedures and regulations for creating, operating and closing a business; and property rights. Whereas the first chapter focused on aggregate country data, we now review case studies in search for evidence that Asian countries which have improved their business environment in line with the NMA prescriptions benefited in terms of dynamic enterprise development (especially the informal sector), aggregate economic growth, and reduced inequality. The review shows that empirical evidence is at best patchy. Interestingly not even the Doing Business Reports are able to present evidence of countries that achieved either growth or poverty reduction as a result of the recommended policy reforms. This empirical gap contrasts starkly with the enormous effort in measuring government inefficiency.

If the empirical evidence does not support the NMA proposition, what then explains economic growth? In order to answer this question the third part describes the role of selective policies of Asian countries regarding trade and industrialisation issues. It draws on country and sector case studies from the first generation of Newly Industrialized Countries (NIC) (Taiwan, South Korea) as well as more recent experiences in China and India. The chapter shows that these extraordinarily successful Asian countries clearly deviated from the NMA prescription to liberalize trade and investment rules and to abandon selective industrial policies. The case studies reveal highly varied development trajectories with different degrees and forms of public engagement. However, this engagement usually included deliberate industry-specific public interventions, comprising targeted foreign direct investment (FDI) acquisition, trade restrictions, specific human skills development initiatives, support of technological development programmes, etc.

In the forth and final part we draw some conclusions about the key elements of an enabling business environment. Our analysis corroborates the importance of the basic elements highlighted in the NMA, but it is argued that an enabling business environment requires many more elements if it is to create competitiveness in an increasingly complex and knowledge-based world economy, and if its outcomes are expected to be pro-poor and to satisfy the needs of a democratic constituency.

1. Booming despite a poor investment climate: Does economic growth in Asia correlate with the NMA version of a good business environment?

Table 1 shows growth rates for the major developing and newly industrialized Asian economies as well as the country rankings of the leading global business climate indexes. In addition to the IEF and the Ease of Doing Business indicator it shows the ranking according to three categories of the Global Competitiveness Indicator (GCI).

Table 1: GDP average growth rates compared with Economic Rankings and selected pillars of the GCI

Period / Year	GDP average growth rate in %		Ease of Doing Business Ranking	Index of Economic Freedom	Global Competitiveness Index	Selected GCI Pillars		
	1985-2005	2005-2009	2007	2006	2006-07	Institutions	Macro-economy	Market efficiency
<i>Out of # ranks</i>			175	157	125	125	125	125
Singapore	6,5 ^a	..	1	2	5	4	8	4
Hong Kong	4,6 ^a	..	5	1	11	10	9	1
Thailand	6,2	5,3	18	71	35	40	28	31
Korea	6,7 ^a	5,0 ^b	23	45	24	47	13	43
Malaysia	6,4	..	25	68	26	18	31	9
Mongolia	2,2	5,6	45	60	92	105	60	100
Taiwan	4,5 ^c	4,2 ^d	47	37	13	32	27	22
Pakistan	4,5	6,5	74	110	91	79	86	54
Bangladesh	4,7	6,4	88	141	99	121	47	83
Sri Lanka	4,3	6,0	89	92	79	82	110	71
China	9,3	8,0	93	111	54	80	6	56
Nepal	4,4	3,3	100	125	110	99	59	105
Vietnam	6,7	7,5	104	142	77	74	53	73
Philippines	3,6	5,3	126	98	71	88	62	57
India	5,8	7,7	134	121	43	34	88	21
Indonesia	5,0	6,3	135	134	50	52	57	27
Cambodia	7,1 ^e	..	143	68	103	95	101	99
Laos	5,9	6,5	159	149
Timor-Leste	1,5 ^e	4,3	174	..	122	119	82	125

^a 1984-2004; ^b 2004-2008; ^e 1995-2005

^c data from National Statistics Republic of China (Taiwan) at http://eng.stat.gov.tw/public/data/dgbas03/bs2/yearbook_eng/Y093.pdf ; ^d average for 2006-2007

The average growth rates in the column 1985-2005 are calculated: $av. \text{ growth rate } (1985-1995 + 1995 - 2005) / 2$

Sources: World Bank country at a glance; World Bank / IFC (2006); Miles et al. (2006) The Heritage Foundation/Wall Street Journal Index of Economic Freedom, Data query at <http://www.heritage.org/research/features/index/scores.cfm>; Lopez-Claros (2006).

The GCI distinguishes nine “pillars” of competitive performance. The table lists three pillars that use similar criteria as the IEF and the DBR, namely “institutions”, “macroeconomy” and “market efficiency”. The other “pillars” describe firm level capabilities, access to health and education and other prerequisites of competitiveness, reflecting a more comprehensive concept of competitiveness that goes beyond the NMA.⁵

The table reveals two interesting aspects. First, high rates of economic growth are not positively correlated with a “good business environment”. This is regardless of whether we look at the long term performance (1985-2005) or at the growth forecasts for 2005-2009. The figures even suggest an inverse relationship. Countries that have a very good growth record, with more than 6 % annual growth expected for the latter period – like China, India, Vietnam, Laos, Indonesia, Pakistan and Bangladesh – rank very low on both indexes. Regarding the IEF, Latin American countries for example have much better rankings on average, but much lower growth rates. Also comparisons within Asia do not confirm a “business climate dividend”. In a similar manner, macroeconomic performance (in terms of government surplus, high national savings, low inflation rates, stable real effective exchange rates etc.) may be very good despite a “bad” investment climate. China for example ranks in the bottom third of the IEF (rank 111) but, according to the GCI, has one of the best macroeconomies worldwide (rank 6). All this shows that it is possible to achieve a good level of “market efficiency” and macroeconomic performance despite low levels of economic freedom and high levels of red tape. This entirely contradicts the key message of the NMA.

Second, the indexes rate the business environment of countries very differently. Cambodia performs better than Thailand with regard to “economic freedom”, although it occupies one of the worst global “doing business” ranks (143), compared to an excellent 18th in the case of Thailand. India and Indonesia belong to the bottom quarter in the DB ranking, whereas the “market efficiency” ranking places both of them in the top quarter and assesses their “institutions” as comparatively efficient.

One might assume that trends are more important than current rank places. Gradual improvements of the business climate might explain the extraordinary growth dynamics even if the overall rankings are still low. The IEF however tells a different story. Table 2 shows how the IEF ranking has developed over an eleven-year period (1995-2006).⁶ Most Asian high-growth countries in fact occupy a lower position in the “Economic Freedom” ranking in 2005 than eleven years before, even if we control for the fact that the sample comprises more countries. In other words, “economic freedom” has been reduced in Asia (or at least not improved as much as in other countries), but growth still outperforms any other region in the world. Whereas the rank place of Taiwan, South Korea, Malaysia, Thailand, Sri Lanka, Philippines, Pakistan, Indonesia and Vietnam have clearly deteriorated, only two countries have improved: Cambodia and Mongolia.

Furthermore the GCI reveals that a good business performance with regard to innovation and business sophistication does not correlate well with the quality of the business environment. Especially Taiwan, China, India and Indonesia rank significantly higher with regard to firm level performance than they do on the business climate indexes. These countries are known for selective policies to attract FDI strategically, to support interfirm linkages with domestic

⁵ Institutions, infrastructure, macroeconomy, health and primary education, higher education and training, market efficiency, technological readiness, business sophistication, and innovation.

⁶ The DBR only started in 2004 and therefore does not show long-term trends.

Small and Medium-sized Enterprises (SME) and to invest in skills and technology absorption (see chapter 3). This again shows that existing business climate indexes tell us little about competitiveness, especially if they basically equate a conducive climate with deregulation.

In sum, as Phillips (2006: 2) has put it,

“the Asian growth experience challenges commonly accepted paradigms about the relationship between investment conditions and growth. For example, while the extensive literature on the investment climate places a strong emphasis on governance, many of the countries in Asia have experienced both high growth rates and high levels of investment in the past two decades despite levels of corruption and regulations which are inconsistent with ‘best practice’ as defined in the literature. Thus, parts of the Asian region demonstrate that achieving growth is certainly possible without implementing a comprehensive set of investment climate reforms.”

Table 2: Heritage Foundation Index of Economic Freedom sorted by Rank in 2006

Rank in	2006	2005	2004	2003	2002	2001	2000	1999	1998	1997	1996	1995
Out of # ranks	157	155	155	156	155	155	161	161	156	150	142	101
Hong Kong, China	1	1	1	1	1	1	1	1	1	1	1	1
Singapore	2	2	2	2	2	3	2	2	2	2	2	2
Taiwan, China	37	31	37	30	32	27	12	16	22	15	15	12
South Korea	45	45	43	55	39	35	37	33	25	25	27	17
Mongolia	60	52	60	67	65	70	69	81	74	80	91	62
Cambodia	68	64	64	53	55	67	81	81	86	108
Malaysia	68	67	89	81	80	67	50	42	37	49	36	19
Thailand	71	74	55	50	38	32	49	38	36	35	26	20
Fiji	90	94	75	110	110	104	90	89	82	74	72	65
Sri Lanka	92	74	75	73	58	55	56	53	48	38	47	42
Philippines	98	98	81	70	71	81	65	69	51	67	66	55
Pakistan	110	132	103	106	110	104	105	107	89	81	74	54
China	111	117	126	111	117	109	104	110	110	111	110	84
India	121	119	121	122	122	131	125	126	120	122	120	90
Nepal	125	122	121	127	113	116	120	106	115	123	117	..
Indonesia	134	125	136	105	110	116	109	76	67	64	53	68
Bangladesh	141	141	131	129	137	138	133	129	119	114	111	85
Vietnam	142	138	142	139	138	146	152	149	141	141	133	98
Laos	149	150	151	155	153	150	156	156	148	144	134	..

Source: Miles et al. (2006) The Heritage Foundation/Wall Street Journal Index of Economic Freedom, Data query at <http://www.heritage.org/research/features/index/scores.cfm>

2. Empirical findings regarding key assumptions of the Doing Business Report

Since the publication of the first Doing Business Report in 2004, two aspects of the business environment in developing countries have received special attention:

- Firstly, *simplification of procedures and regulations* with regard to setting up, managing and eventually closing private businesses. Cumbersome “red tape” is seen as a major constraint for private sector development and economic growth. At the same time, burdensome regulations are expected to nurture corruption because additional procedures create more opportunities to extract bribes. Djankov et al. (2002: 35) confirm empirically that “heavier regulation of entry is generally associated with greater corruption and a larger unofficial economy.”
- Secondly, an *effective property rights policy* that provides title deeds to informal enterprises is crucial to increase levels of security and to qualify them to receive credits. Properties without legal titles cannot be used as collateral for credits (de Soto 1989, 2000). Banks tend to have more confidence in borrowers and risks tend to decrease if there is no doubt about ownership. In consequence, a borrower with registered property is more likely to get credit and to obtain favourable conditions (World Bank, 2004: 81). In addition to titling it is important to develop an efficient judiciary to ensure that commercial contracts can be enforced.

Policy reforms that address these issues are expected to unleash private sector development and growth because they put “dead capital” to productive use. Furthermore the DBR alleges that these reforms are pro-poor because the cost of compliance with unnecessary regulations as well as the problem of lacking collateral for credits fall most heavily on small firms. (World Bank / IFC 2005: 3). Property titling plus simplification of business procedures is thus expected to spur investment and upgrading in the small firm economy.

It is absolutely reasonable to assume that unnecessary regulations and inefficient legal systems, where property is not secure and where contracts cannot be enforced or are even subject to arbitrariness and corruption, have a harmful effect on economic development. The question however is whether these issues really constitute *key constraints* for small enterprise development, and whether the respective policy reforms are likely to trigger more dynamic and socially inclusive patterns of economic growth. The following paragraphs discuss the available case study evidence on these questions, with emphasis on experiences from Asia.

Let us start with the issue of **simplification of procedures and regulations for business registration and licensing**. To what extent are cumbersome procedures a constraint for pro-poor growth? To our knowledge only few studies have addressed this issue specifically for Asia. Studies from Korea (Jacobs / Astrakhan 2006) and Vietnam (CIEM / GTZ 2006) describe recent reforms aimed at reducing the number of government regulations and relate this to both countries’ economic growth. However, growth in these two countries was already high before the reforms, and the studies fail to establish a causal relationship.

However we can draw on a number of cross-country analysis as well as case studies from both developing and developed countries. Box 1 presents key findings of eight studies that have, with differing methodologies, explored the relationship between simplification of procedures and enterprise development. The results are mixed. However, the broad picture that emerges from these studies is the following:

- a) The number of businesses that register and start operations increases when the respective transaction costs are reduced.
- b) Burdensome regulations create an incentive for firms to stay informal in order to escape such regulations.
- c) Red tape creates opportunities for corruption, and corruption may hamper enterprise growth.
- d) The number of procedures and the time and cost to start a business however do not seem to figure among the most important constraints for business growth. Reforms aimed at cutting down red tape therefore seem to have a minor effect and do not immediately trigger a take-off of private sector activities. Other constraints seem to be more essential, such as the lack of market opportunities, the lack of managerial and technical skills required to take advantage of them, crime, political instability and, last but not least, access to credit.

Box 1: The impact of administrative simplification on firm growth: Case study findings

- Ayyagari et al. (2006) analyze which elements of the business environment are the most constraining for enterprise growth in a dataset comprising 80 economies. They find that lack of financing, street crime, and political instability directly affect the growth rate of firms, whereas regulations and taxes have no significant effect.
- In a literature review of 13 studies Reinecke shows that “only a small share of enterprises reported taxes and government regulations as a serious problem.” He argues that these “results do not support de Soto’s (1989) conclusions, according to which government regulations are the major obstacle for small enterprises.” (Reinecke 2002: 24).
- Van Stel et al. investigate the effects of business regulations on the formation of new enterprises. They find that minimum capital requirements seem to lower business start-up rates across countries, but they find no evidence that number of procedures, time and cost to start a business have a significant impact on start-up rates. The authors “do not subscribe to the view that ‘heavily regulated’ countries (in terms of entry regulations) need only to reduce such ‘burdens’ in order to become more enterprising and by implication more wealthy. What seems more likely is that entry regulation influences the distribution of business activity between the formal and the informal economy, rather than influencing the total volume of activity.” (van Stel et al. 2006: 16)
- For European firms Klapper et al. (2006: 1,2,32) find “that costly regulations hamper the creation of new firms, especially in industries that should naturally have high entry. These regulations also force new entrants to be larger and cause incumbent firms in naturally high-entry industries to grow more slowly” which thereby slows down the selective process of competition.
- Comparing Spain and Britain, Capelleras et al. argue that Spain is by far heavier regulated than Britain. Consequently one should expect to find fewer start-ups in Spain, which should be also larger at start and grow more slowly than those in Britain. But they find that both in terms of numbers and post start-up performance new enterprises appear to be almost identical. According to the authors “this questions attempts to ease bureaucratic burdens on the process of new venture start-up and growth.” (Capelleras et al. 2005: 2)
- Fisman and Svensson (2005: 17,18) show for Uganda that corruption has an even more retarding effect on short-run growth rates of firms than taxation.
- In a recent study on factors that influence small firm growth in Romania, Brown et al. show that “among many variables investigated – including measures of corruption, permits, inspections, and problems with contract enforcement and property rights – essentially no evidence was found that they constrain growth.” (Brown et al. 2005: 62).
- Bennett and Estrin (2006) construct a model of entry of entrepreneurs in a new market to study the effects of bureaucratic delay and license fees. As assumed they find that they are reducing entry.

But they also find that if the license fee is zero excessive entry takes place. If the license fee is raised from zero welfare first increases and then declines, thus suggesting that certain levels of regulatory barriers can increase welfare. This questions the NMA (e.g. Djankov et al. 2002) assumption that welfare is optimal if all barriers are eliminated.

- A survey among 333 micro and small enterprises in Pakistan found that entrepreneurial decisions like hiring and firing workers or investments “are principally determined by the conditions of the market and second by the access to capital (...) other factors such as government regulations and incentives play a role but are all secondary to the conditions of the market” (ILO 2003: 41).

Several of these studies highlight access to external credit as one of the most important constraints for enterprise growth. This leads us to the second issue: **property rights policy**. Does the provision of property titles improve access to credit, thereby allowing for business expansion, new income earning opportunities and economic growth? Does it benefit the poor in particular? Again, not much evidence is available from Asia (and again, the Doing Business Reports does not provide much evidence to support the relevance of its argument). We therefore refer to case studies from other regions as well, especially from Peru, where a large urban property rights reform was carried out, providing legal property titles to more than 1.2 million urban households (Field / Torero 2006: 2). Empirical findings may be summarised as follows:

- a) In Thailand according to a study by Feder / Nishio (1998) title deeds increased access to credit. Leonard / Narintarakul Na Ayutthaya (2003) however, who surveyed the results of titling programs with special focus on Northern rural Thailand question their findings. In line with a an analysis of the World Bank Operations Evaluation Department (World Bank-OED 1999) they argue that access to credit had already been quite good for rural farmers even before the titling projects started in 1980. Field / Torero (2006), Galiani / Schargrotsky (2006) and Calderón (2004) coincide that land titling and property rights reforms have not made access to credit much easier. Legal property titles are only one precondition for obtaining bank loans. Even if micro and small enterprises hold titles it is still difficult for them to access bank loans: their investment projects need to reach a certain scale that justifies the necessary handling expenses; convincing business plans are required; banks must be able to effectively seize the property in case of default without incurring considerable transaction costs, etc.
- b) As property rights reforms do not solve the credit problem for micro and small enterprises, the surge in economic activity that was predicted by NMA proponents did not materialize.
- c) Field (2005) and Galiani / Schargrotsky (2006) however also find that secure property titles encourage owners to increase investment in their property.
- d) Outcomes of property rights reforms may not always be pro-poor. Following such reforms, land-market activity tends to increase (Boucher et al., 2005: 107), offering incentives for speculation and raising costs for land and housing. Leonard and Narintarakul Na Ayutthaya find that land titling in Thailand “made it possible for generally urban-based and already wealthy financiers to acquire land as a tradable commodity. The rapid increases in the value of land, held up by the Bank as evidence of the benefits conferred by the land titling programme, have benefited a new band of entrepreneurs who sought to make quick profits rather than maintain productive use of

the land.” (Leonard and Narintarakul Na Ayutthaya 2003: 14) Furthermore the use of property as collateral implies that creditors seize property of debtors who default, which may further contribute to the concentration of wealth and the marginalization of the poor (Mitchell, 2004: 26).

- e) Especially in some Asian countries informal institutions substitute for deficient property rights systems. In Vietnam for example land markets work reasonably well despite a weak legal enforceability of property rights. In particular in urban centres such as Ho Chi Minh City, private real estate markets thrive on the basis of informal transactions which are negotiated through neighbourhood committees (Kim 2004). Bai et al. (2006) show that people in China increase their political participation or philanthropic activities in order to improve their social status and influence politicians as a means to indirectly protect their properties and get access to credit. These informal institutions are probably less reliable, less egalitarian and less efficient than “Western” law-based systems, but the fact should be taken into account that “property rights can be configured in a variety of ways in order to operate in different institutional contexts.” (Kim 2004: 302).

In sum, both the simplification of procedures and regulations and property rights reforms are important to unleash private sector development, but their growth implications seem to be greatly overstated. Other constraints are more important for business development. Furthermore, the reform outcomes may be less pro-poor than alleged by NMA proponents.

3. The role of selective policies in trade and industrial development: what do we learn from Asian success stories?

If the “minimalist” set of policies cannot explain differences in economic dynamism, what can? How important are selective trade and industrial policies? Such policies are not well regarded in the mainstream debate on the “enabling business environment”. According to the NMA, governments should avoid selective interventions that favour one sector over another and thus distort market signals. Although selective interventions are not categorically disapproved, World Bank papers are very sceptical about their usefulness and tend to emphasize the risks of such intervention (e.g. World Bank 2004; Pack / Saggi 2006). Only in exceptional situations are selective interventions justified, and they should only be applied as long as necessary to restore Pareto optimal resource allocation.

As Lall (2000: 3) has correctly pointed out, this argument reflects unrealistic assumptions about equilibrium states of markets where perfect competition and absence of externalities and scale economies are the *norm*, and market failures as the temporary *exception*. Evolutionary economics has shown that certain market failures are a perpetual characteristic of innovation and technological learning. Technological learning is a complex process which involves the skilful recombination of knowledge that is partly bound to people and institutions and therefore requires a high degree of interaction, trust-building, and coordination. Moreover learning processes are cumulative, often with uncertain economic outcomes and multiple externalities (e.g. Lundvall 1992). Thus technological learning is highly vulnerable to market failure. Furthermore, technological learning takes place along specific trajectories, and efforts to accelerate learning therefore need to be partly *selective* (Lall 2000: 5).

Rodrik (2004: 6 ff.) highlights that market forces tend to under-provide innovation. Although innovation, that is the development of new markets or more productive ways of producing, has a great value for the society at large, the innovator who bears the full risk of failure can usually only appropriate a small share of the social value because competition tends to drive his temporary innovation rents down rather quickly. Hence there is a strong theoretical case for publicly subsidizing the search process for innovations.

Empirical evidence from the successful Asian economies shows that these countries have in fact made extensive use of selective trade and industrial policies.⁷ This applies to the first generation NIC's (South Korea, Taiwan, Singapore and Hongkong) as well as the second generation NIC's (e.g. Malaysia, Thailand) and the emerging giants China and India. The industrial policies pursued by the first generation NIC's triggered a long debate, and it is now widely accepted that strong strategic interventions have been crucial to achieve technological deepening, especially in Taiwan, Korea and Singapore. Recent analysis of China and India also reveal a considerable degree of public interventions in sectoral innovation systems, e.g. in the automobile, biotechnology, space and aircraft, electronics and other sectors (Altenburg / Schmitz / Stamm 2006). Although Asian technological catch-up strategies diverge with regard to the degree of intervention and the policy mix, the successful countries always had a clearly articulated ambition to develop technologically advanced industrial structures. Industrial policy was not employed to temporarily compensate for specific market failures, but as a deliberate long-term strategy which defined promising sectors and adopted a broad array of selective policies including:

- a) Quantitative and tariff restrictions on imports as well as subsidies for exports. Export subsidies were in some cases given for non-traditional exports and linked to performance requirements.
- b) Campaigns to attract specific types of FDI combined with measures to increase technological spillovers. Rather than pursuing a simple open door policy, the technologically most successful countries targeted specifically promising foreign investors and encouraged them (using selective tax exemptions and other subsidies), or in some cases even tried to oblige them, to share technologies with local enterprises. Governments supported joint ventures, technology sharing agreements, and reverse engineering. China in particular skilfully trades market access for technology transfer. In parallel, supplier development and franchise programmes strengthened the absorptive capacity of local firms.
- c) Heavy targeted investment in complementary skills development and research facilities. University education was usually focused on engineering careers. In addition, industrially oriented skills development schemes, technology research institutes, R&D financing schemes and entrepreneurship development programmes were set up.
- d) Targeted investment in certain industries which were considered either to promise excellent upgrading opportunities or to generate forward and backward linkages. In some cases these industries were even developed through state-owned enterprises. In most cases they benefited from preferential lending rates and other subsidies.

There is no doubt that these policies have sometimes produced failures and generated unproductive rent-seeking. The intention here is not to play down the risks involved in

⁷ E.g. Amsden (1989), Lall (2004), Wade (1990); Westphal (2002).

selective policies. On the whole, however, Asian countries with proactive industrial policies fared much better than countries that adopted the NMA principles. Not a single country has been able to achieve a substantial level of technological deepening without recurring to selective industrial policy.

4. Conclusions

Empirical evidence suggests that more efficient procedures to start and close a business, improved property rights regimes, better contract enforcement procedures and other business environment reforms create incentives for enterprise development, and although it is not easy to demonstrate the link between business climate reforms and economic growth empirically, it is highly plausible that such reforms are good for economic growth.

The NMA has its merits for bringing these reform needs to the forefront. There is much scope for eliminating unnecessary bureaucratic procedures, and there is also no doubt that property rights and legal systems are in urgent need for reform in many developing countries. The NMA, and especially the methodology and the country rankings of the EDBI are insofar helpful as they make reform needs transparent and put pressure on governments to systematically review their regulatory frameworks. Nevertheless, the NMA has several shortcomings:

1. It fails to provide evidence that regulatory and property rights reforms actually have a significant effect on economic growth and development. Neither do NMA authors present evaluation results of reform processes nor do they discuss the obvious mismatch between “bad” business environments and extraordinary success in the case of Asian countries (see also Hobday / Perini 2006). Furthermore, FDI data flows clearly demonstrate that Asian countries which rank rather low on business climate indicators are among the leading global recipients of FDI inflows (UNCTAD 2006).
2. Its assumption that NMA reforms are generally pro-poor is not substantiated. It is plausible to assume that certain current practices that restrict access to credit for people in the informal sector, increase unnecessary compliance costs and enable corrupt bureaucracies to extract bribes are anti-poor. However, there is some counter-evidence that property titling may also spur concentration processes which may more than compensate the benefits. Such trade-offs need to be explored empirically. The often used metaphor of a “level playing field” suggests equal preconditions for all “players”, which is definitely not the case if economic participation of the informal sector is concerned. Targeted support may be required to give especially micro and small firms a chance.
3. It has an ideological bias as it almost exclusively addresses government failure while ignoring or downplaying market failure. It is quite obvious that reforms aimed at deregulating the business environment are not appropriate to achieve high levels of innovation-oriented entrepreneurship. Market failure can be deduced from theory, and it can be shown in practice.
 - Theoretically it can be argued that entrepreneurs will only take on the substantial search costs and risks of new activities if they can expect to appropriate high innovation rents in case of success. Once an innovator obtains an innovation rent, competitors will immediately try to emulate his/her business model, thereby undercutting the innovation rent of the pioneering firm. Reforms which ease the entry of firms tend to enhance

competition and consequently reduce the returns from investing in non-traditional activities. In other words, they create a disincentive for the costly pursuit of innovations. This is likely to lead to a situation where private investment in innovations remains much lower than would be optimal from an economic point of view: a classical case of market failure (Rodrik 2004: 9). Public subsidies for investments in non-traditional industries are therefore a necessary complement of reforms that reduce entry barriers. This holds especially for the informal sector, where typically many poor people engage in a limited range of traditional activities with extremely low entry barriers in terms of skills and capital, thereby creating a vicious circle of low productivity, low returns, and low investments. In such a milieu industrial (or SME) policy should mainly support innovators who develop new markets. Promotion of traditional activities, to the contrary, runs the risk of increasing oversupply in stagnant markets and ultimately drive productivity, profits and wages down (Altenburg / Eckardt 2006).

- Also empirically, there is little evidence that the respective reforms really address the *key* binding constraints for (small) enterprise development. First, there is a considerable mismatch between business *environment* indexes and business *performance* indicators. Second, case studies of successful countries and sectors clearly demonstrate that microeconomic competitiveness does not emerge from NMA policies alone. The findings suggest that other variables may be more important, including selective and targeted policies. Especially innovation and technological learning require proactive government support which may include to provide strategic guidance, targeting of specific investors, time-bound subsidies and trade protection, differentiated tax incentives, export promotion, R&D funds, information services, and many other government activities that go far beyond the minimalist recommendations.
4. It tends to neglect that the best policy design is context-specific and often heterodox. Trajectories of successful development are diverse, building on different production factors (e.g. natural resources, unskilled labour, relatively cheap skilled labour), different sectors (e.g. garments, electronics) and different types of firms (e.g. foreign investors, national SMEs, national conglomerates). Furthermore countries have diverse degrees of market diversification and sophistication; specific culturally embedded incentive systems that may be more or less encouraging for entrepreneurial behaviour; and different administrative capabilities to “govern” markets. Policymakers are therefore well advised to enhance *specific* national strengths and to prioritize *specific* growth constraints. Accordingly the best policy framework necessarily has to be context-specific and build on experimentation. As Rodrik argues, “such specificity helps explain why successful countries – China, India, South Korea, and Taiwan among others – have almost always combined unorthodox elements with orthodox policies.” (Rodrik 2002: 6). Furthermore there is a political argument for providing “policy space” (Chang 2005): Citizens should be allowed to express their preferences when it comes to defining the right degree of public intervention in markets. Social values and preferences are quite different across societies. Some societies see a large role for governments in providing social, economic and cultural services whereas others leave more room to individual responsibility. Donors should therefore avoid to “sell” one-size-fits-all approaches.

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