

# ECONOMIC REFORM

## Issue Paper

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## Entrepreneurship

Starting a business requires courage even in the best of times: courage to take the risk of putting your own money into an idea; courage to take on the competition; and courage to take a leap into an unknown future. Throughout the world, millions of entrepreneurs display such courage as they create new businesses. This creative process is the lifeblood of the strong private sectors that drive growth and propel nations forward.

But there is much more to opening a business than having the right idea and willing to take a risk. For entrepreneurial ideas to take root, the right environment needs to be put in place. It includes entrepreneurial training and development programs as well as government support and assistance programs, such as access to risk capital. More importantly, business-friendly environment requires sound legal and regulatory framework that rewards entrepreneurial initiatives, ensures fairness, protects and enforces private property rights, and promotes efficiency.

This paper looks at the essence of proper market structures that help business thrive. Often, business opportunities are limited by inefficient regulations, corruption, and micromanagement of the economy. The experience of some private sector associations, think tanks, and chambers of commerce highlighted in this paper suggests that the private sector, through effective advocacy campaigns, can evaluate the costs of inefficient regulations and work with governments to address institutional deficiencies that prevent countries from reaping the benefits of a vibrant market economy.



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**The Center for International Private Enterprise** is a non-profit affiliate of the U.S. Chamber of Commerce and one of the four core institutes of the National Endowment for Democracy. CIPE has supported more than 700 local initiatives in over 80 developing countries, involving the private sector in policy advocacy, institutional reform, improving governance, and building understanding of market-based democratic systems. CIPE programs are also supported through the United States Agency for International Development.

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## Introduction

Starting a business requires courage even in the best of times: courage to take the risk of putting your own money into an idea; courage to take on the competition; and courage to take a leap into an unknown future. Throughout the world, millions of entrepreneurs display such courage as they create new businesses. This creative process is the lifeblood of the strong private sectors that drive growth and propel nations forward.

A strong private sector is the backbone of successful economic growth. It is the ability of business to generate capital, create jobs, and increase value that allows it to play a key role in the strengthening of markets and poverty alleviation. Yet it is the large domestic companies and multinational corporations that often attract the attention of investors and domestic regulators, while the interests and concerns of small business are often ignored. In such environments, entrepreneurs often find themselves excluded from the formal economy, forced into illegal or semi-legal operations, without avenues to participate in policymaking. The result of such a lack of attention to small business is the inability of countries to take full advantage of the vast entrepreneurial potential they hold.

Experience has shown that nations that support their courageous entrepreneurs have grown and prospered over the last several decades, while nations that have placed barriers to the growth of their small business enterprises have done poorly. Small- and medium-sized enterprises have been the backbone of the economic strength of the developed countries and of recent economic growth in many developing countries.

Resources available for entrepreneurs in developing countries are scarce, and the ability of business to grow and develop is hindered by ineffective policies and regulations and poor infrastructure. Efforts, therefore, should be concentrated on creating a stable, predictable, and efficient business environment – an environment that provides incentives for legal entrepreneurial activities.

The responsibility for unleashing entrepreneurship lies in the hands of governments. Such responsibility goes beyond grandiose statements that declare a government's support of the private sector. Rather, it comes down to local governance and the ability of regulators to create an environment where entrepreneurs don't have to spend their resources on dealing with regulatory barriers to business on a day-to-day basis. Also, it extends to government's ability to foster private sector participation in reform efforts. In countries where dialogue between business and government is conducted in a top-down style – with government dictating and businesses complying – private sector growth opportunities are often compromised by government over-

regulation and micromanagement of economic activities. And finally, governments are also responsible for ensuring fair and consistent enforcement of rules and regulations, and only then will the necessary conditions for economic growth arise.

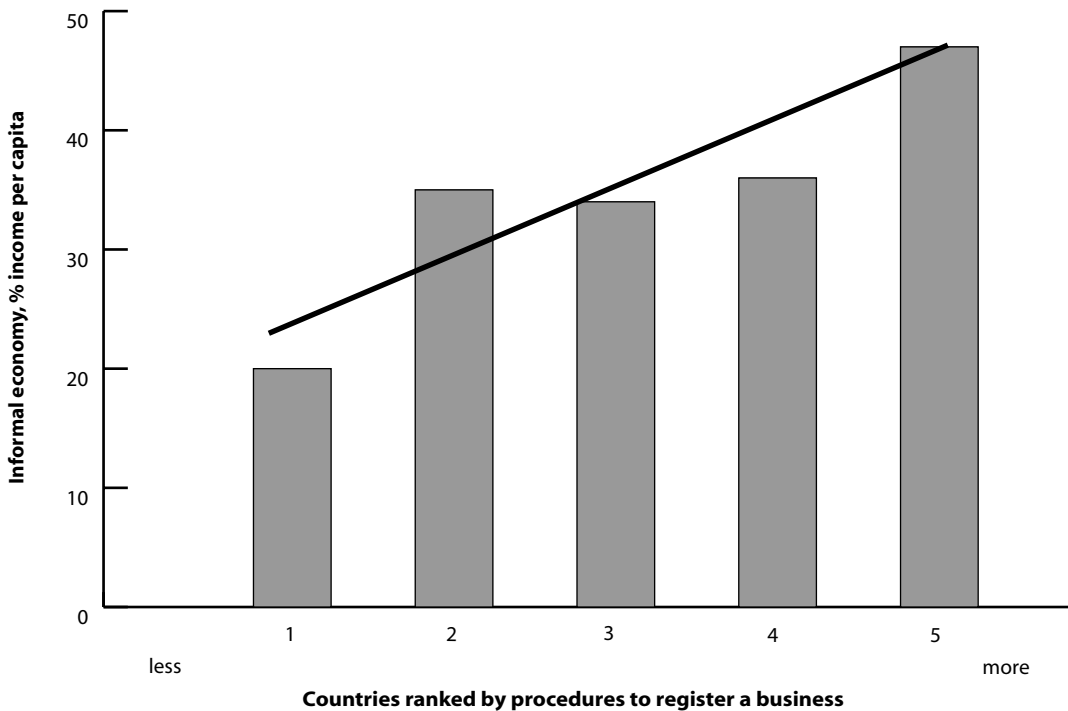
Starting a business is fairly easy in developed market economies – aspiring entrepreneurs have access to a plentiful supply of financial resources, technical knowledge and expertise, physical and social infrastructure, and friendly policies and regulations. In many developing countries, on the other hand, access to such resources is limited. Due to inefficient regulations, poor enforcement, and corruption within government agencies, entrepreneurs in developing markets are forced to operate in the informal sector. Such entrepreneurs, operating outside of the formal economy, have significantly limited access to public services, credit institutions, legal protection, proper contract enforcement, and reliable information.

Countries increasingly recognize the importance of a functioning private sector for their development. Even among nations that have previously discouraged or prohibited such activity in favor of the state as the driving force for economic growth, there is growing recognition of the importance of fostering entrepreneurial activity. Governments play a crucial role in helping their entrepreneurs blaze a trail of prosperity by implementing appropriate policies and support programs. Even countries such as Japan and South Korea, which today boast thriving private sectors, did not achieve success until after the right elements were in place. For countries newly embarking upon the path of market-oriented reforms, the task is the same – the right elements must be in place before sustained growth and progress can be achieved.

The bottom line is clear – for private sector activity to flourish, governments must help establish an environment that rewards entrepreneurial initiative. But what are the elements of such an environment? The answer, of course, will not be exactly the same for every country, but there are some basic principles that serve as a framework. Three key points are:

- **There is a need to establish a market-oriented policy environment based on sound legal and regulatory structures.** Business cannot operate in a vacuum – the government needs to set the rules governing principle market activities. At its essence, these rules should be the same for everybody, as fairness is one of the keys to a functioning market economy. This role of government is often not implemented correctly, as public officials and the policies they enact end up overregulating markets. In such cases, overregulation leads to the growth of an underground economy, where entrepreneurs remain outside of

### Heavy Entry Regulation is Associated with Informality



Source: World Bank "Doing Business in 2004: Understanding Regulation"

the formal economy, trying to escape costly compliance with numerous regulations. Underground economies become a breeding ground for corruption, which – by wasting resources, reducing efficiency, and limiting access to credit – further limits the ability of entrepreneurs to conduct business.

- **The right environment also requires entrepreneurial training and development programs.** Starting a business requires more than just having an idea and being willing to take a risk. If an entrepreneur is to succeed, he or she needs to have basic entrepreneurial skills, such as knowing how to manage finances and communicate well. The need for effective entrepreneurial training is even more profound in countries where traditional educational systems rarely provide it even on the basic level. In such environments, there is a need to foster an entrepreneurial culture, introducing entrepreneurial principles not only within the general population, but also among government officials. As countries move toward free-market economies, entrepreneurial culture and education play a more prominent role in development.

- **There is also a need for government support and assistance programs, such as access to risk capital for new and small business.** Entrepreneurial spirit and risk-taking

must be rewarded. Often, aspiring entrepreneurs have to put their life savings on the line, and with little or no government assistance to reward such initiative, people often prefer to forgo such risky opportunities. The possibility of failure – of losing these life savings and living in poverty – curb business enthusiasm. Therefore, helping aspiring entrepreneurs hedge the risk should be one of the functions of any government aspiring to have a strong private sector. Many developing countries have various assistance programs, financial and technical, available to people trying to start their own business.

All three of these elements are vital. It is not enough just to provide training and technical assistance or to create small, special lending programs. In too many countries, entrepreneurs must deal with laws and regulations that have become so complex that it is nearly impossible to start a new firm or expand existing operations. In a now-famous example of bureaucratic overkill and its stifling effects on economic activity, the Institute for Liberty and Democracy (ILD) in Peru discovered that to register a business required 11 different procedures lasting a total of 289 days.

Since ILD's audit of Peru's legal environment in the early 1980s, many indigenous groups around the world

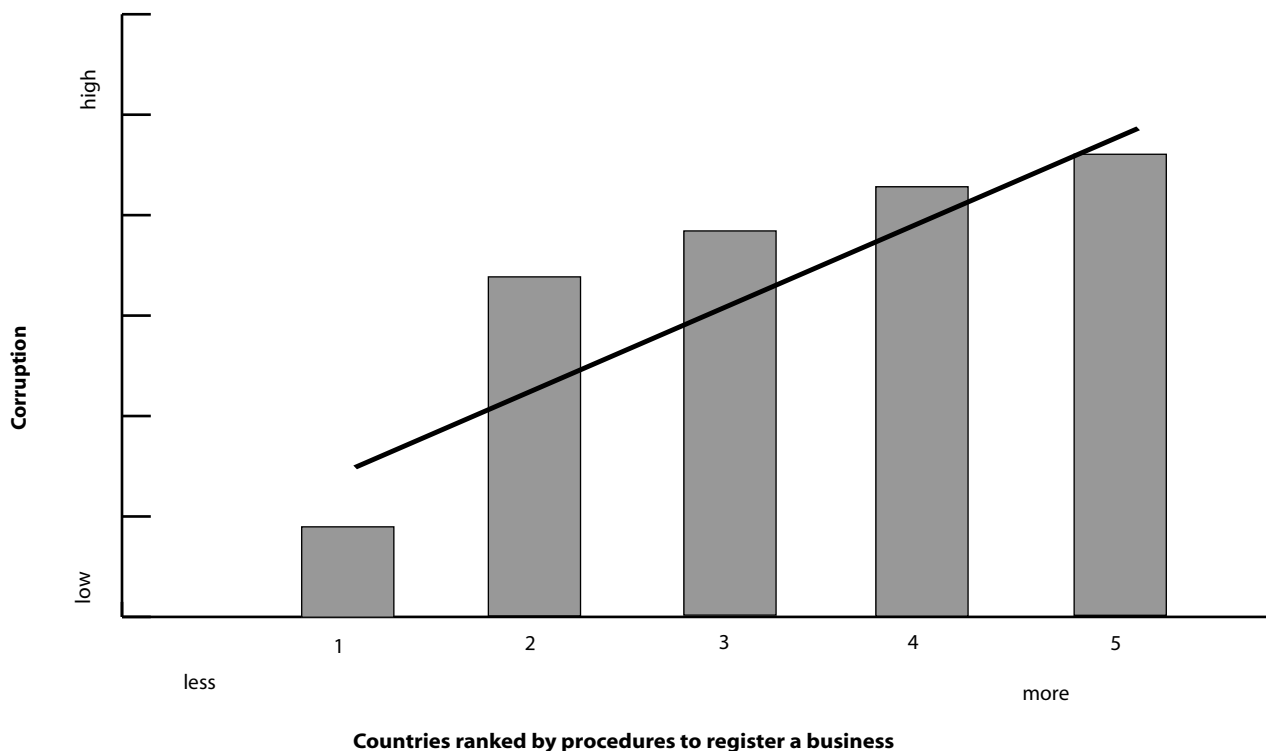
have implemented similar studies. The results show a similar pattern – overregulation hampers business development and hinders economic growth. A 2004 study by the World Bank<sup>1</sup> exemplifies this fact and, by evaluating data from most of the OECD and developing countries, shows that countries with less burdensome entry regulations are richer in terms of income per capita and have lower levels of informality and corruption. Also, looking beyond entry regulations, the report also shows that higher levels of procedure complexity are associated with higher levels of corruption and that developing countries regulate business more on all scales – including entry, contract, employment, and court procedures.

The experiences of the last decade suggest that countries that have adopted a private-sector-led approach to economic growth have witnessed encouraging results. The case of Poland and some other former Communist states shows how the removal of barriers allows private enterprise to flourish. After decades of central planning, following the collapse of Communism, Poland established policies that encouraged development of the private sector. In just a few years, in response to the Polish government’s open-market policies, millions of new private legal enterprises sprouted across the country, as Poland quickly became one of the favored destinations worldwide for foreign invest-

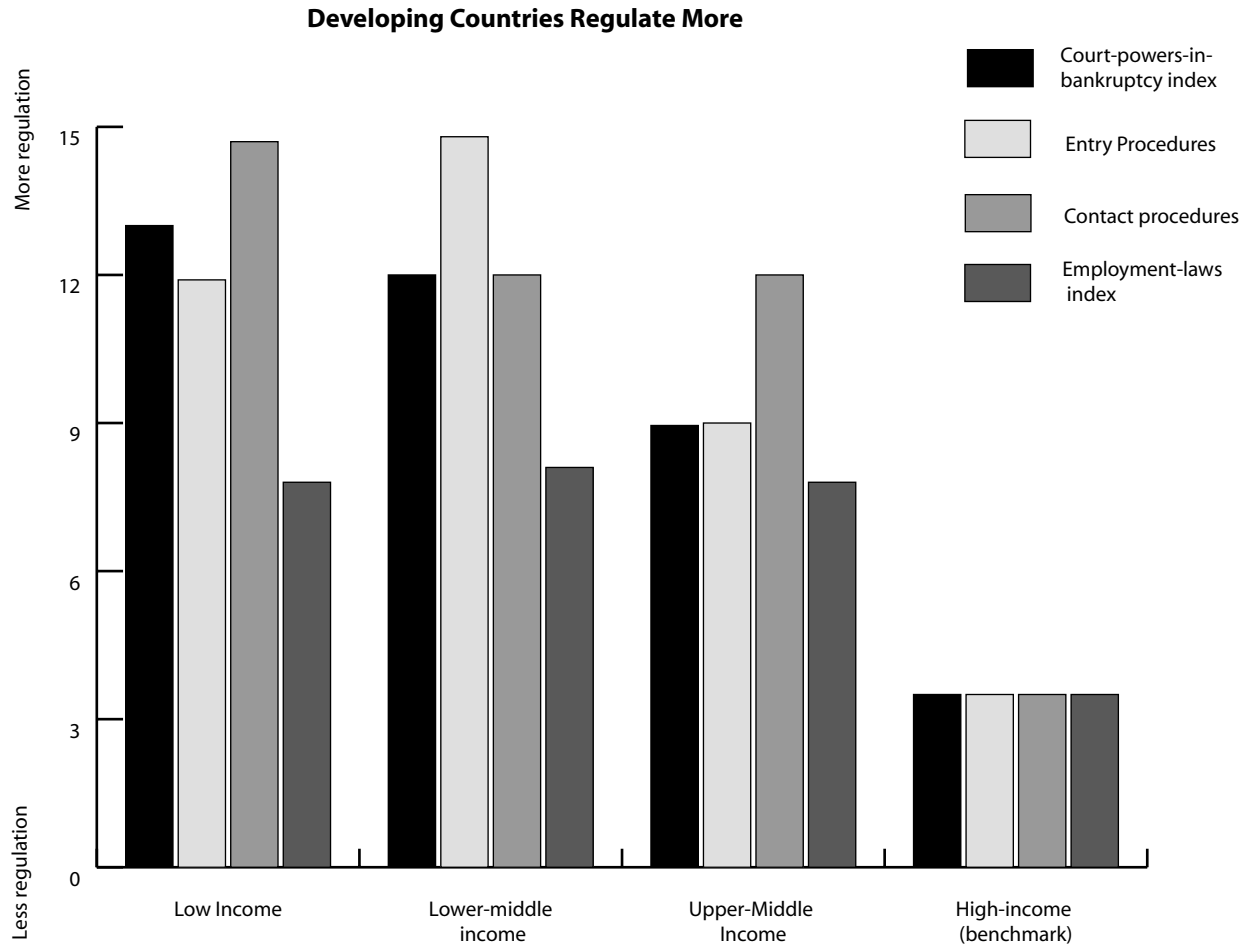
ment. On the other hand, countries that refused to let go of the practices of central planning and overregulation, such as Romania, have not seen significant investment flows and faced low levels of economic growth throughout the 1990s due to a weak and uncompetitive private sector.

Although the link between effective rather than numerous regulations, a vibrant private sector, and stable economic growth is becoming more evident, economic reforms should be carefully approached. Countries vary in their level of development and reforms that work in some countries may bring by completely different results in others, due also to historic and cultural differences. It is what the Nobel Prize-winning economist Douglass North calls “the value of local knowledge” that largely determines the success of institutional reforms. Building institutions that create market-oriented systems requires a great deal of in-depth local knowledge. Therefore, the input of entrepreneurs themselves, those people who face legal and regulatory challenges on a day-to-day basis, can largely determine the success or failure of economic reforms. The urge of policy-makers to tell business what to do and what is best must be tempered by a will to listen and meet the needs and concerns of the private sector.

**Cumbersome Entry Regulation is Associated with Corruption**



Source: World Bank "Doing Business in 2004: Understanding Regulation"



Source: World Bank "Doing Business in 2004: Understanding Regulation"

## The Policy, Legal, And Regulatory Environment

The path to prosperity begins with governments creating an environment in which the private sector can flourish. This enabling environment arises from policies in several basic areas:

- Private property rights
- The legal system
- Efficient government administration
- Infrastructure

### Private Property Rights

The right to own private property is a vital aspect of building up the private sector. In fact, private property rights and their enforcement lie at the root of free-market economic theory, where the principle idea is that without protected private property rights markets will simply fail to function properly. As Hernando de Soto states in *The Other Path*:

*“The economic importance of property rights is not that they provide assets which benefit their holders exclusively, but that they give their owners sufficient incentive to add value to their resources by investing, innovating or pooling them productively for the prosperity and progress of the entire community.”*

It is this aspect of property rights that drives market economies. As entrepreneurs obtain rights to their property they can increase its value and use that property as a source of capital. Moreover, private property can foster the development of new markets, such as insurance and secondary investment markets.

In establishing private property rights several issues require special attention. The experience of the former Communist states in transitioning from a collective to a private property rights system suggests that one of the keys to success is transparency. Lack of transparency in the process limits access to information and allows insiders and elites to gain control and acquire large amounts of prop-

erty significantly below the real market value. In many countries, the lack of transparency in national privatization programs and subsequent failures of those programs is illustrative. The local-level examples are similar – insider groups take advantage of citizens, who do not have any access to information or any means to enforce contracts, by obtaining their property well below the market value.

On a more fundamental level, the problem in many countries is that citizens don't have secure rights to the basic property they "own" – their homes. In yet another study, Hernando de Soto showed that 90 percent of the population in Egypt held its assets outside of the formal system and that the estimated value of those assets was nearly \$250 billion – 55 times more than that country's foreign direct investment inflows. The poor had assets, but formalizing those assets was a costly and timely process that could take as long as 17 years. The result: regular citizens were unable to mortgage their assets to receive business start-up capital.<sup>2</sup>

Another issue that should be addressed is enforcement. It is often the case that property rights laws are enacted but not implemented. As such laws only exist on paper and enforcement is lacking, citizens continue to operate in the informal economy, facing limited options for expanding their entrepreneurial activities and presenting an easy target for bribe-seeking government officials.

Governments undertaking property rights reform should be careful also to avoid violating the property rights of others. For market systems to flourish governments cannot take property from individuals and corporations arbitrarily or without providing just compensation. Unchecked government seizures of property weaken private property rights and the private sector as a whole.

## The Legal System

The legal structure of a market economy creates a marketplace that functions smoothly and efficiently for both producers and consumers. Contracts evolved as a legally enforceable way to establish the conditions and obligations under which transactions take place. An impartial judicial system is the key to enforcing contracts.

As an example, imagine a manufacturer that feels one of its suppliers did not live up to the terms of a contract. Perhaps not enough parts were delivered, or maybe they were of a poor quality. In any of the developed countries, that manufacturer would be able to resolve the dispute through the court system. Since legal disputes are costly and time-consuming, the manufacturer and supplier would probably first attempt to reach a solution between themselves. If they are unable to solve the problem, they could then go to court, knowing the legal system will give

both sides a fair hearing before a settlement is reached. The impartiality of the system gives the manufacturer and supplier the confidence to enter into a contract.

Legal systems in many developed countries also protect the rights of consumers. For example, if a manufacturer sold a defective product to a customer, that customer would try to work out an agreement with the manufacturer to resolve the problem, usually by exchanging the defective product for one that worked properly. Since manufacturers do not want to alienate their customers, most manufacturers offer guarantees that their product will work as advertised, and that they will provide an exchange or refund if it does not. These guarantees are known as product warranties. However, if customers are still not satisfied they can get help from government-associated or -run consumer protection agencies or they can pursue their complaint in court. Without these protections, consumers would be less likely to purchase products, meaning that manufacturers would sell fewer of these same products.

It is the ability of firms and customers to enforce contracts that helps markets function more efficiently. A study of the global business environment by the World Bank, mentioned above, makes a direct link between contract enforcement and countries' income per capita. The findings suggest that contract enforcement is cheaper, faster, and requires fewer procedures in more developed, higher-income countries. On average, in high-income countries the cost of contract enforcement is 6.6 percent of income per capita, while it requires 18 procedures and takes 210 days. On the other hand, in the least developed countries, the costs are significantly higher at 30 percent of income per capita and the number of procedures is almost double that of developed countries – 30.

To create an environment that supports business activity by ensuring cheap and time-sensitive contract enforcement countries need to pay a greater attention to creating a more efficient judicial system. At the core of this process lies simplification of procedures; the inefficiency of judicial systems should not be looked upon as an isolated problem, but rather the result of underlying structural weaknesses – and overly complex regulations is one such weakness. Also, special attention needs to be paid to the education level of public officials within the judicial system, as well as the system's level of technological advancement.

What happens when the legal system doesn't function and contracts cannot be properly enforced? In that case entrepreneurs, lacking the legal means to ensure the other party upholds its part of the deal, often choose to operate in closed environments with those few with whom they have already established relationships, either through

### Designing Business-Friendly Policies: Recommendations for Policymakers

**Business Entry** – simplify business registration and licensing procedures

**Disclosure** – establish proper disclosure requirements so that information is readily available to consumers and investors

**Information** – provide equal access to government information on regulations, requirements, and financial resources

**Property rights** – define and ensure strong enforcement of property rights

**Financing** – establish a strong domestic financial system by privatizing state banks and introducing private sector governance principles

**Labor** – establish simple and efficient labor laws; allow wages to be determined by market forces

**Competition** – remove restrictions on competition, eliminate subsidies to inefficient enterprises, open up industries reserved for SOEs

**Trade** – reduce tariffs and non-tariff barriers, eliminate export-import licenses granted to a select few

**Taxes** – simplify procedures and/or reduce tax rates, which can increase tax revenues through increased compliance

**Price controls** – remove price controls and let markets determine prices

**Bankruptcy** – establish proper bankruptcy procedures

**Capacity-building** – establish programs that provide entrepreneurs with technological, managerial, and financial skills

previous deals or personal recommendations – yet, even in such cases, cheating takes place. Otherwise, business opportunities are simply forgone. As a result, the ability of small entrepreneurs to expand their operations is limited, as they are forced to operate in small, personal markets.

### Public Administration

Government institutions play a central role in creating an environment that encourages business. Effective government institutions are open, decentralized, stable, and impartial. They create conditions that allow citizens to participate and compete in the marketplace on an equal footing. They permit citizens the freedom to engage in economic activities as they choose, without weighing them down with too much regulation.

It is especially important for the private sector to be able to voice its concerns and participate in the formation of laws that will affect business operations. In many countries, this is accomplished through voluntarily-formed business associations that make sure their members' interests are represented as national policies, laws, and regulations are developed.

The success of participatory economic reform process has been well documented. CIPE's own experience provides numerous examples from many countries where indigenous groups successfully influenced public policy, and such a grassroots approach to reform has two major benefits. First, it allows countries to avoid the top-down reform process, which, as experience suggests, often leads to unresponsive policies that fail to address the real economic problems. Second, it legitimizes political institutions, in that it creates truly participatory political systems where citizens don't feel excluded from the policy-making process.

### Infrastructure

Finally, a healthy business environment must feature adequate infrastructure and support services for the private sector to flourish. Information must be easy to obtain. Accounting standards must be developed to ensure that financial information is accurate and meaningful. Infrastructure, such as roads, ports, and telecommunications facilities, must be modern and in good condition. Financial markets must be developed sufficiently to allow private firms access to capital when they need it. Support services, such as legal assistance, insurance, accounting, and consulting firms must be allowed to operate in response to market demand.

When it takes an entrepreneur months or even years to install a phone line, the efficiency of daily business operations is reduced. When an entrepreneur does not have a timely access to ever-changing information regarding business registration, licensing, or taxation, he or she cannot stay in business legally and becomes easy prey for corrupt public officials. When a small business does not have access to a functioning banking system, its operations are compromised due the higher risk associated with cash-only arrangements.

### Government Policies

A government's first priority for unleashing the power of entrepreneurship lies within creating incentive systems that pave the way for small businesses to become operational and enter the formal economy. In addition to creating an environment conducive to business activities, government policies can help establish a prosperous

private sector through attention to three basic areas: sound government policies; policies that allow business to enter new markets; and policies that allow businesses to remain profitable over the long term.

Government policies that directly affect business are critical. The most important policy area of this type is economic policy making. A more detailed listing of policy elements is presented following the main text.

Government can create obstacles for entrepreneurs who want to set up businesses, either intentionally or as a consequence of other policy decisions. These entry barriers have a significant impact upon the growth of business activities. For example, when the government places a great deal of regulation on particular markets, these regulations raise the cost of conducting business in those markets for producers, which of course cuts into profits and makes it less attractive for firms to conduct business. Restrictive regulations often arise in the areas of access to capital, tax rates, labor laws, wage and price controls, access to information, and restrictions on competition.

Once they decide to enter markets, private sector firms must be able to earn enough profits to continue operating over the long term. The costs of operating are a major factor in the firms' profitability. Therefore, government policies that raise firms' operating costs hurt their profits and damage the growth of the private sector in general. Three major policy areas in this context are: tax rates, labor laws, and government regulations and bureaucratic procedures.

Clearly, excessively high tax rates will lower profits and discourage business activities. Labor laws may raise costs by requiring a high minimum wage or extensive benefits, or by making it difficult to dismiss employees if a business finds it necessary. Compliance with government regulations forces companies to divert time and other resources from other productive uses to meet those regulatory requirements. In many cases, when the cost of doing business is too high for small firms to make a profit, these firms will choose to operate underground, outside of the formal economy.

Special emphasis must be paid to local governance. Local governance, which deals with creation and implementation of policies and regulations on a local level, ultimately shapes the business environment. On a national level, government may pass favorable tax regulation, but it does little good if a firm is a subject to a dozen various local taxes, which can be selectively applied by local tax authorities. Similarly, national government may pass new regulations that simplify the judicial process, but if courts are corrupt, enforcement is weak, and grievances cannot be redressed, contract enforcement will remain subject to

judges' discretion. If a country's leader publicly announces his support for the private sector, but at the same time corrupt inspectors demand bribes from entrepreneurs for phony violations, the legitimacy of a government's efforts is threatened.

How do countries go about addressing the problem of local governance? It can be looked at and approached from two sides. On one side, it is to the benefit of these same local governments to reform and become business-friendly. The development of markets and a reduced informal economy mean higher revenues and increased ability to provide public services. It also means reduced unemployment, higher standards of living, and, as a result, increased support for and stability of political institutions. In many developing countries it has been the case that some local governments have been more successful than others in making their regions prosperous by simply creating favorable non-discriminatory business regulations. As a result, businesses from the neighboring regions would often relocate to those more favorable markets. Implementing internal measures that reduce opportunities for selective application of laws and developing friendly business regulations should therefore be a priority for local governments. They can benefit in a greater way by taking such reform measures than by over-regulating markets and allowing corruption to flourish.

On the other hand, when governments refuse to take the lead in establishing good governance, the solutions can

#### Removing Barriers to Entrepreneurship: Creating More Efficient Governments

- **Transparency and Accountability** – make government agencies transparent and allow them to be held accountable for actions or inactions.
- **Operational rules** – introduce new technology and provide education to reduce processing times, increase professionalism and knowledge, and remove opportunities for favoritism
- **Conflict of interest** – establish clear rules on conflict of interest and proper enforcement of those rules, which will help eliminate insider- and self- dealing
- **Wages** – increase the wages of government officials to make them more competitive with the private sector
- **Monitoring** – introduce monitoring to ensure proper implementation of procedures and fair application of rules and regulations

come from the private sector. Through representative organizations such as associations and chambers of commerce, entrepreneurs can push for greater transparency and accountability in government agencies and decision-making. This tackles the “will” aspect of bad governance – those government officials who are not willing to be efficient and are bribe-seeking. The private sector can also help design more efficient government agencies, helping them develop better standards and identify better structures through advocacy. This tackles the “capacity” aspect of local governance – those agencies that simply lack the organizational and technological capacity to be more efficient.

## Supporting Entrepreneurs In Developing Countries

### Institutional, Regulatory and Policy Reform: The Case of Peru

One of the biggest problems in Peru in the late 1980s was that queues and excessive paperwork and bureaucratic procedures cost most Peruvians a lot of lost time and resulted in unnecessary expenses and other constraints on economic activity. The Institute for Liberty and Democracy (ILD) created a draft of the law and designed an administrative strategy to streamline bureaucratic procedures and facilitate institutional reform. This draft legislation was based on public hearings and debates throughout the country, which featured legal specialists and members of congress. Such events, which went on for two years, not only added substance to ILD’s proposal, but also created an enormous wave of support for it.

In June 1989, ILD’s draft was unanimously approved in Congress by all political parties and, with no major modifications, became the Law for Administrative Simplification. Government now had the mandate and means needed to decrease or eliminate unnecessary red tape, streamline public administration, and substantially reduce transaction costs. The new law rested on four pillars: 1) substituting most *ex ante* requirements that create legal bottlenecks with *ex post* controls; 2) keeping the costs of operating legally below those of operating illegally; 3) decentralizing decision-making procedures; 4) promoting participation to control the application of all decisions.

Shortly after the law was enacted, President Alan García Pérez called upon ILD to manage the implementation of the simplification process. ILD designed a unique mechanism called “The Administrative Simplification Tribunal” to gather and evaluate proposals from citizens for deregulation and to check up on how various bureaucracies were responding to the dictates of the law. To facilitate public participation, bright yellow boxes were placed in ILD’s headquarters and in several government offices

as well as at all radio, television, and newspaper outlets to make it as convenient as possible for people to voice their grievances. The media was encouraged to review the grievances it received, and when media agents got a lead on an astonishing or outrageous story, they covered it, creating the kind of public pressure that was impossible for politicians to ignore. The complaints were dealt with in a publicly televised tribunal every second Saturday morning managed by ILD and presided over by the President of the Republic and the televised proceedings quickly racked up high ratings.

In addition to the administrative simplification program, the government took related structural reform measures. For example, a property registration program was developed to strengthen the private property rights of business owners, particularly those who operated in the underground economy. The registry program also sought to legitimize peasant landholders in the rural areas. Along with the simplified procedures for incorporating a business, this measure represented a significant breakthrough in bringing underground entrepreneurs back into the national economy.

The government also removed price controls, allowing the market to dictate prices. Interest and exchange rate subsidies were removed. A tax reform program reduced and simplified the number of taxes and tax exemptions that applied to business enterprises. Inflation and government spending were brought under control. The government announced a plan to privatize state-owned enterprises and restored relations with the international financial community.

### Removing Barriers: Regulatory Simplification in Ecuador

ILD’s efforts of the early 1990s have been replicated by local organizations in a number of countries. For example, the efforts of the National Association of Entrepreneurs (ANDE), a voluntary private business association in Ecuador, illustrate a similar approach to reducing the regulatory burden on business in the country. ANDE, whose efforts were focused on reducing corruption, recognized that opportunities for corruption in the country arose from a broken, inefficient regulatory system. To address the problems of corruption and legal reform in Ecuador, ANDE proposed to significantly reduce the opportunities for corruption by identifying and eliminating commercial laws that were duplicative and conflictive.

To identify the roots of corruption ANDE reviewed the country’s commercial laws concerning such themes as production, foreign trade, establishment of official prices in the private sector, and technology transfers. ANDE’s

### Administrative Simplification in Peru: Accomplishments

- The process of legally incorporating a business was streamlined so that it required only two days, instead of the previous 289 days. After this Unified Registry law went into effect, the number of new businesses registered increased dramatically.
- Licenses and procedures required for importing and exporting goods were streamlined and eliminated, together with government agencies such as the National Importers Registry and Foreign Trade Institute. Fees and other unnecessary requirements were also eliminated.
- A decree established the free use and movement of foreign currency by corporations or individuals, encouraging capital repatriation and expanding sources of credit.
- Procedures for obtaining national and international transport concessions were simplified. The new procedures have encouraged investment, stimulated the creation of new domestic carriers, and resulted in improved passenger service.
- Individual employment contracts for fixed periods were legalized to address problems caused by the rigid provisions of the Labor Stability Law. These contracts had previously been informal and thus risky for both workers and employers because they could not be enforced legally. By giving employers greater flexibility, this measure helps combat unemployment and underemployment, particularly during economic downturns.
- Procedures were simplified for beneficiaries of the state Social Security Administration, making it easier for widows, orphans, and disabled persons to obtain their benefits.
- The domestic airline industry was deregulated, and procedures for registering aircraft and obtaining an operating license were simplified. New airlines have emerged to provide both passenger and cargo service; service between Lima and other cities has also expanded.
- Deregulation was also carried out in the agriculture, communication, and health sectors. In the health sector, for example, private firms may now compete with the state Social Security Administration.

studies showed that since the Republic of Ecuador was founded over 150 years ago, some 92,250 legal norms have been created of which 52,774 were in force in 1997. The sheer number of overlapping, unclear, and contradictory laws has created an environment of legal chaos and left the application and enforcement of laws to the discretion of bureaucrats.

ANDE ensured the support of chambers of commerce, industry, agricultural entities, labor unions, ministries, and other non-governmental organizations and proposed legal changes to the government. Despite the political turmoil that plagues relations between the private sector and government in Ecuador, ANDE has been able to eliminate approximately 1,310 outdated and conflicting laws regarding commercial transactions in the country. More importantly, perhaps, was the clear enunciation of the guiding principles underlying the legal simplification effort, including the importance of creating and maintaining juridical security; the primacy of the Constitution as the basis for the validity of subsequent rules, norms and decrees; consistency across executive branch agencies in their rule-making; and better transparency and account-

ability for the decisions reached by public sector officials. ANDE continues to work with the Chamber of Commerce of Quito to pressure the government into adopting legislation that would eliminate still more conflicting laws now on the books.

The experience of ANDE and other think tanks and associations suggests that they play a key role in legal simplification. Often, governments are compelled to make decisions and execute “top-down” reforms as a solution to the problem. Yet in legal and regulatory reform, input from private sector representatives is key – the private sector knows first-hand the inconsistencies that hamper business growth and present opportunities for corruption for both business and government officials. Such a grassroots approach to reform is more effective in designing and implementing reforms that work.

### Administrative Barriers to Entrepreneurship in Central Asia<sup>3</sup>

Recognizing the magnitude of the entrepreneurial gap in Central Asian economies that results from high barriers to market entry, CIPE, together with key local

business associations, organized a series of roundtables to better identify specific administrative barriers to development and design private sector responses to problems. These roundtables, held in 2002, were attended by 110 entrepreneurs from several Central Asian countries.

One of the issues that surfaced during the roundtables was that fact that the regulatory and licensing barriers are the continuation of the Soviet “system of permissions” whereby one must obtain approval from the authorities to embark on even the smallest tasks. Although Central Asian governments are vocal in their support and praise for the open and free market system, businesspeople appear to have to seek permission from the government at every step of operations. The “permissive” entrepreneurial climate, characterized by abundant overregulation, continues to inflict losses on entrepreneurial activity across all sectors of the economy. When entrepreneurs attempt to seek legal redress to register, they soon discover a different level of hurdles: those who pay bribes can keep prices artificially low and force competitors out of business. Such arrangements have extremely negative effects on the overall competitive nature of the economic system and the free interplay of market forces. Many see joining the informal sector as the only way to remain in business.

Once a firm is registered and does manage to operate, administrative barriers are reinforced by constant inspections. They serve to exhaust the firm’s owner(s) and virtually facilitate the firm’s transition into the informal sector. Indeed, inspectors themselves openly hint that should bribes be paid from the start, everyone will be spared time and aggravation.

The tax burden was also identified as a problem. In Uzbekistan, for example, a rigid and confusing tax system often drives SMEs out of the market. In addition to unreasonably high taxation rates, the taxation framework seems to be in a state of constant flux, and regulations seem to be formulated in an arbitrary manner – a major disincentive for starting (and if started, for continuing to operate) an SME. Because the tax system is complicated, voluminous, confusing, and rapidly changing, businesses are driven into the informal sector either by not registering or by conducting part or all of their activities in cash, not reporting most of their activities for tax purposes.

Entrepreneurs also voice concerns with a poorly functioning banking system. In Uzbekistan, entrepreneurs are unable to withdraw their own money from the bank. Cash withdrawals are allowed only for two purposes – salary payment and travel expenses. Banks use the excuse that they lack cash reserves and cite numerous confusing regulations that prohibit them from dispensing cash. As a result, purchasing even the most basic products or supplies

requires that the purchaser find a supplier who has a bank account and accepts payment via a bank transfer mechanism. Consequently, entrepreneurs avoid depositing funds, further perpetuating the cycle of low cash reserves.

But the biggest issue identified is the lack of political will to institute changes. The business community in Central Asia perceives that their governments are doing little to reduce administrative barriers impeding investment and regional trade. Entrepreneurs across the region blame their governments for having few qualifications and a poor understanding of the importance of addressing these problems. In fact, they contend that the government has a poor understanding of how a free market works and how it benefits the whole society. As a result, the informal sector continues to grow and the income the governments would have otherwise collected is lost, in turn reducing the funds needed to pay their employees. In short, the institutionalization of the system of bribery allows some government workers to profit greatly from the situation and resist any changes in the status quo. The “government profiteers” have an entrenched interest in preserving the current policies and legislative acts that give rise to the administrative barriers. But the lack of government will doesn’t mean that it can’t be addressed – this is where professional business associations play an important role.

### **Associations: Business-Friendly Environment through National Business Agenda**

A false notion associated with market economies is that if governments get out of the way markets will flourish. On the contrary, markets require governments to set rules and regulations that govern market activities and ensure proper and fair enforcement of contracts. Therefore, in building a market economy, governments require timely and comprehensive information, so that regulations address the needs and concerns of the business community. When business is excluded from participation in policymaking, governments run the risk of producing ill-designed policies as well as overregulating and micromanaging market activities to the detriment of the private sector.

One business entity has little chance of affecting government decision making. But associations and chambers of commerce have a unique ability to bring together needs, concerns, and recommendations for reform of various businesses and deliver them to regulators. Business associations can foster participatory political systems by including private sector input in design and implementation of rules and regulations.

Through tools like the *National Business Agenda* (NBA), produced by CIPE and modeled after the U.S. Chamber of Commerce’s business agenda development

program, associations can help government create a business-friendly environment. The NBA approach outlines a step-by-step process by which private sector leaders from business associations, professional organizations, and other interested parties can come together, discuss issues of concern, identify common interests, and develop proposed solutions. The NBA model has become a vital tool for business communities in many transitioning countries to encourage investment and stimulate business activity and economic growth. But its value extends beyond the effect on public policy. The process of collaboration forges identity among independent actors and strengthens the private sector's capacity to act as a balance to unchecked government authority and a watchdog for the public good.

The NBA approach helps identify laws and regulations that hinder business activity and offers concrete recommendations to remove these barriers and improve the economic climate. Developing a national business agenda also educates the private sector on public policies that affect them and allows them to present the concerns of the business community to government officials with a unified voice, increasing the likelihood that their agenda will be adopted. The advocacy component of the NBA program comes in the final stage – working with government officials to implement proposed solutions to private sector concerns – but it builds on all the earlier stages.

In Ukraine, for example, the NBA approach has been used successfully since 2002 to unite a diverse group of business associations from across the country. The Ukrainian NBA put forward a wide-ranging platform of issues, with its most significant achievement being passage of a law that requires a period of public comment and cost analysis by all levels of government wishing to amend regulations. This disclosure legislation provides associations with the tools they need to hold government more accountable, to fight against poor regulation, and to suggest improvements that foster growth.

Today, the NBA approach has been successfully implemented in Russia. The uniqueness of the Russian NBA program is that business associations in eight different regions of Russia organized into coalitions, and through such coalitions they started to develop NBA programs on the local level. Through such Regional Business Agendas (RBA) these coalitions addressed various issues pertinent to failures of local governments to create a business-friendly environment. In Perm region, for example, the emphasis was put on improving access to information for entrepreneurs, developing microcredit opportunities, and protecting the rights of entrepreneurs. In other regions RBAs addressed issues such as taxation and administrative barriers to doing business.

In the course of the program, the Russian Enterprise, Association, and Chamber Terminal (REACT) network was established. This information network was developed to provide business associations from the eight initial regions where RBAs were created key advocacy information and help them share their experiences and success stories. The program has also helped to build the capacity of associations through seminars, training programs, and roundtables. The success of the program has led to its replication in eight other regions of Russia. The interest of associations representing entrepreneurs in the business agenda program is remarkable, as one of the coalitions was able to secure the membership of 26 associations. Also, the effectiveness of the RBAs in gathering together entrepreneurs, formulating an effective model of public-private dialogue, and addressing institutional deficiencies on the local level gave impetus to a similar program on the national level, through the Russian Alliance of Small and Medium Entrepreneurs (OPORA).

### **Earlier Efforts: Fostering Entrepreneurship in Post-Communist Environments**

Business training and development programs are important, especially in countries where the private sector has not flourished for decades. As such countries move toward market economies, many of their citizens may be interested in starting and operating a privately-owned business, but may not know how to go about doing so. To meet this pressing need, countries have devised a variety of innovative programs. More importantly, the private sector has successfully addressed such a professional education void in the past.

Following the collapse of the communist regime in Romania, the International Center for Entrepreneurial Studies (CISA), an independent association of business persons and economists, undertook measures to try to help the country build a private sector in an environment that relied on the State as the primary supplier of jobs and income for decades. As the market economy started to emerge and a growing number of people became increasingly interested in opening up their own business, CISA recognized the crucial need for the development of specific entrepreneurial skills, as the typical entrepreneur of the time lacked even the basic knowledge of how to manage finances and how to develop a business plan.

In their efforts to educate local entrepreneurs, CISA developed an intensive one-week course to provide training in market economics and the fundamentals of organizing a successful business venture. Eight English-speaking Romanians were trained in the United States as instructors for this pilot course. By introducing new knowledge, skills,

and attitudes, the Romanian instructors hoped to promote the legal, economic, and political reforms necessary to support small enterprise development.

CISA's first course, *Entrepreneurship and Private Enterprise in the Free Market: A Course for Entrepreneurs*, outlined an introduction to private enterprise and free-market economics; lessons on entrepreneurship, competition, risks and rewards; discussions on the fundamentals of starting a successful business venture; instructions on how to make a business grow; investigations into how entrepreneurs cope with the challenges and opportunities of international business; and an entrepreneurial roundtable discussion.

CISA employed lectures, group discussions, guest speakers, panel discussions, practical exercises, and individual consultations. Instructors included recognized experts, policy makers, and representatives from public sector organizations and research institutions.

In general, programs like the one in Romania are essential to providing the knowledge necessary for the development of a thriving private sector. Such programs need strategies for reaching and attracting their target audience of entrepreneurs, as well as for building support and awareness among the general public. These programs also help combat negative attitudes toward business that exist in some societies. Public support is a necessary element of a successful transition to a market economy and for the successful development of the private sector.

### Entrepreneurship Development Program in Montenegro

In the late 1990s, many private enterprises in Montenegro found it difficult to compete against larger corporations and expressed concern about being discriminated against by banks, hampered by unreasonable taxes, and offered few opportunities for legal self-defense. In 1999, leading local economists and business leaders established the Montenegrin Business Center to support entrepreneurship, economic reforms, and privatization.

One of the first issues the Business Center set out to address was the inadequate level of business knowledge in Montenegro. The Center developed a capacity-building program targeting both potential entrepreneurs and existing businesspeople requiring advanced skills. For aspiring entrepreneurs, the Center implemented the course "Introduction to Starting a Business," to stimulate interest in starting business activity, generate discussion about entrepreneurship, and provide a basic outline for business start-ups, including market assessment, business plan development, securing financing, introducing new products or services, and marketing strategy development. In the first nine months, over 200 people participated in this

roundtable-style course, and 82 of the participants went on to open their own businesses, creating over 150 new jobs. By April 2001, over 1,200 people attended business seminars, over 300 new businesses were opened, and over 1,000 new jobs were created in Montenegro.

As the number of newly-opened businesses grew, the Center expanded its efforts to build a good business environment for existing and newly formed firms. Recognizing that private sector participation in public policy is essential to creating business-friendly regulations, the Center went on to develop programs to strengthen existing and build new business associations. It introduced groundbreaking capacity-building programs for associations in Montenegro while actively supporting development of new associations and promoting the important role that associations play in a nation's development. By mid-2001 the Center helped create nine new private business associations. With their help, the Center identified the issues of most concern to the business community – cumbersome business registration process, isolation from foreign trade and investment, inadequate funding for business development, poor private ownership protections, and weakness of the rule of law – and pushed for government focus on resolving these and other issues hampering the growth potential of the private sector.

Next came the establishment of the Montenegrin Business Alliance (MBA), a business representative organization that took a visible, active, and consistent role in advocating economic policy reform. By 2003 over 300 individual business owners and seven associations had joined the Alliance, which, among many accomplishments, successfully worked to change several key laws (including the Enterprise Law, the Concession Law, and tax laws) and helped develop the country's code of business ethics.

Another important accomplishment of the program was the development of business environment surveys. Such surveys, distributed yearly to hundreds of business owners, managers, and employees, have helped the Center identify the real needs and concerns of business. These surveys have also led to development of studies that targeted specific issues, such as a study that reviewed the mechanisms that make the business registration process costly and inefficient and provided a list of proposals for reform. The network of associations helped the Center effectively present reviews of problems and recommendations for reform to policymakers. The government, also interested in a strong and efficient private sector, recognized the value of the Center's work, as public officials often participated in discussions and roundtables with business leaders and praised the efforts of the Center to create a better business environment in Montenegro.

## Conclusion

Fostering entrepreneurship essentially means creating the right environment. Such an environment includes business-friendly regulations, the free flow of information, and capacity-building programs for aspiring entrepreneurs. Too often the entrepreneurship potential of countries is wasted in a daily struggle to deal with burdensome and conflicting regulations. Similarly, entrepreneurial potential withers in countries where aspiring small business owners lack access to key resources such as credit and professional education. In markets where institutions fail to reward entrepreneurial initiative, business is forced into the informal sector, with little prospect for growth, expansion, and development.

The responsibility for establishing a business-friendly environment lies in the hands of public officials, while private sector representatives can provide invaluable input into the design of specific policies and implementation of capacity-building programs. Associations play a key role in this research and consultation process as they have the unique ability to voice the interests of business. It is not enough for government to profess an interest in fostering small business. Ideas should translate into actions, and only when changes are introduced and properly enforced on the local level and when regulations actually help businesses, not create obstacles, will countries be able to reap the benefits of having a strong economy led by the entrepreneurial spirit of its citizens.

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<sup>1</sup>The World Bank, "Doing Business in 2004: Understanding Regulations."

<sup>2</sup>For more, please see a joint publication by the Appraisal Institute, CIPE, Fannie Mae, and IRPF. "Real Property Markets: The "Real" Solution for Economic Development," available at [www.cipe.org](http://www.cipe.org).

<sup>3</sup>This sections presents some of the findings covered by Zlatko Kovach and Elena Suhir in CIPE Feature Service article "Administrative Barriers to Entrepreneurship in Central Asia," June 30, 2003. For a full text of the article please visit [www.cipe.org](http://www.cipe.org)

## Appendix A: Policy Options to Promote Entrepreneurship (Summary)

Policy Option	Performance Indicators
Low/uniform non-tariff barriers	Visible, clear, and consistent implementation of quotas, import reference prices, import licenses, restrictive foreign exchange regulations, discriminatory quality standards
Low/uniform tariff barriers	Tariff rates; tariff ceilings; number of tariff categories; clarity; consistency in implementation
Local content regulations	Mandatory requirements or market-distorting incentives to utilize local inputs
Market-determined exchange rate	Number of exchange rates; level of government intervention; existence of a parallel exchange market; gap between free and parallel exchange rates; real effective exchange rate over time
Minimal exchange controls	Extent of restrictions on capital transfers, import operations, remittances, hard currency, and bank accounts
Market-driven real interest rates	Maintenance of real positive interest rates
Minimal preferential interest rates	Distorting effects of special credit program for exports, agriculture and development
Equal access to capital	Lack of discrimination in allocation of capital resources
Limited wage and price controls	Extent of official control over prices and wages
Minimal subsidies	Extent of subsidized goods and services; degree of effective targeting of subsidies
Balanced budget	Deficit/surplus as a percentage of GDP
Reduction in marginal tax rate	Reduction in personal and corporate taxes to spur savings and investment
Equitable/uniform tax collection	Measures to promote fair tax collection
Divest non-strategic state firms	Actual sale or closure of state companies
Franchise state services	Turn over management control of state-owned enterprises to private operators
Simulated privatization	Enterprise decentralization; employment reduction and other cost-reducing measures; improved state-owned enterprise management training; other efficiency and profit-maximization measures
Non-discriminatory treatment	Same rules for foreign and local firms; equal incentives
Proactive promotion	Foreign investors welcome; government sponsorship of trade shows; effective investment promotion administration
Information	Timely and reliable government statistics, regulatory, and financial information; existence of a free press
Private property rights	Clear and enforced laws ensuring the right to hold private property; effective safeguards for intellectual property; adequate space for private owners to operate in; steps to reduce reach of the state sector
Efficient government admin.	An honest, skilled, and responsive government
Legal and accounting systems	Existence of legal and accounting institutions; compliance with international standards
Infrastructure	Existence of basic functioning infrastructure to support private business operations; government efforts to upgrade infrastructure

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