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ADVANCING INVESTMENT POLICY REFORM IN AFRICA

NEPAD-OECD AFRICA INVESTMENT INITIATIVE

CHALLENGES OF STRUCTURING A PRODUCTIVE INVESTMENT CLIMATE

The Policy Framework for Investment and SME Development

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Challenges Of Structuring a Productive Investment Climate

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Executive Summary Version

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Introduction

Because of their size, depth of staff and wealth, large enterprises often have disproportionate influence on economic regulation. They have easier access to government policy making bodies and can afford to dedicate time and staff to analysing and lobbying for changes to the investment climate. In contrast, small businesses verge on the invisible. If a small business fails, few notice. If it succeeds, few people may know or understand why. However, in terms of economic importance, the statistics of small and medium enterprises tell a different story.

Despite their low profile, SMEs actually account for a majority of economic activity and employment. In affluent OECD countries, SMEs represent 95 percent of the number of enterprises, account for 60 to 70 percent of jobs and represent from 40 to 80 percent of employment in manufacturing. A European Union study found the average SME had 7 employees but in all they account for some 75 million EU-based jobs. Similar figures hold in developing countries.

This paper is a supplement to the OECD's Policy Framework for Investment (PFI). Its purpose is not to repeat the advice found in the PFI itself. Rather it is to highlight the key areas where SME dynamics or interests deserve extra attention because of the tendencies for big business to overshadow small business.

Planning for the Diversity of Small Business

Appreciating the diversity and complexity of small business is arguably the first challenge of effectively regulating the SME investment climate. SMEs are involved in every industry and range from high tech to survivalist traders on the street. There are vastly more small businesses than large ones, they employ more people and have a greater impact on GDP in almost every country. Thus a well managed investment climate should treat SME issues as the norm rather than the exception.

Several key factors set SMEs apart from their larger business cousins.

Inability to Influence: Arguably the most important consequence of size is the different level of capacity to engage with policy makers and raise objections to existing or planned regulations. In general, the smaller the business, the less staff and the more costly it is to divert those staff away from productive activity toward the analysis of rules and participation in policy-setting dialogues. Larger businesses can afford to have specialised lobbyists, researchers and lawyers on staff and can fund highly organised industry lobbying associations to represent their interests. Small businesses generally cannot. Unless special attention is paid to the interests of SMEs, the views of big business will predominate.

The Limits of Specialised Agencies: Although many countries establish investment promotion authorities, which attempt to offer business one point of interface with government, in reality regulations from many departments of government affect SMEs. It is thus not enough for the investment authority to be sensitised to SME concerns. But tax authorities, health and safety inspection services, banking regulators, insurance and pension bodies, environmental and educational institutions all should factor into consideration that SMEs will be poorly equipped to represent their own interests, even though their combined economic impact frequently is greater than that of big business.

Governments frequently appoint an agency or department to head SME affairs and believe that having done so will increase the attention paid to SME issues. However, the reverse can occur as a result of such institutional arrangements. Many industry sectors – agriculture, textiles, steel, shipping, transport, telecommunications, finance – are regulated by dedicated departments, each of which can impose rules affecting SME fortunes. The existence of an SME ministry can contribute to a perception that these industry regulators need not pay particular attention to SMEs.

Flexible, Predictable Legal Frameworks: The easier and faster it is to create new firms, comply with employment laws and obtain services, the more quickly SMEs can adapt and add value to an economy. Policies that limit the flexibility of labour, finance, technology or land markets can significantly retard SME growth and also impede the spread of new technology and innovative production approaches. Denmark, for example, has identified labour market flexibility as a key aspect of the investment climate and designed policies to make it easier for workers to move between firms while making health and pension benefits portable. Such flexibility has had significant positive benefits in reducing structural unemployment and is particularly valuable to SMEs.

Professional and Technological Services: Compared to large-scale manufacturing, SMEs are often thought of as involving less technology. But they can be very sophisticated and very knowledge intensive. In many countries, the majority of people employed in technical professions organise themselves as small businesses, rather than as employees of large service providers. This includes doctors, dentists, a variety of medical specialists, architects, lawyers, tax advisors, and quantity surveyors. Such organised professions tend to have set standards and industry associations that set regulatory standards and maintain professional ethics. Other key technical SMEs include software programmers, computer repairs, and website design. Shortages of skills in these areas can thus have major knock-on effects in an economy, which are far larger than the revenue lost in the small business provider itself. For example, electronic ordering of parts through the internet can improve production efficiency and scheduling and reduce working capital tied up in inventory. But without the small businesses that provide website design and maintenance, many small and medium manufacturers would have great difficulty building this kind of internet capacity themselves. The following sections supplement the PFI with discussion of a selection of the most prominent issues deserving consideration in a well-managed SME investment climate.

General Investment and Regulatory Policy Considerations

The first PFI question expresses essential principles that apply in all of its 10 chapters. It calls for consideration of both the implementation and enforcement of regulation to ensure that rules are "clear, transparent, readily accessible and do not impose unnecessary burdens." This is vital to all business, but even more so to SMEs. Because of their small size, they cannot afford to have legal specialists on staff and the time and effort needed to understand complex regulation thus has a disproportionately negative effect on small business. Such steps as drafting regulations in straightforward, everyday language, making forms simple and posting regulations and forms online can be particularly beneficial to SMEs.

Regulations impose costs and compliance takes time; the smaller the firm, the higher the costs are in proportion to total revenues. Simply put, regulation that might seem reasonable for large firms can be oppressive to small firms.

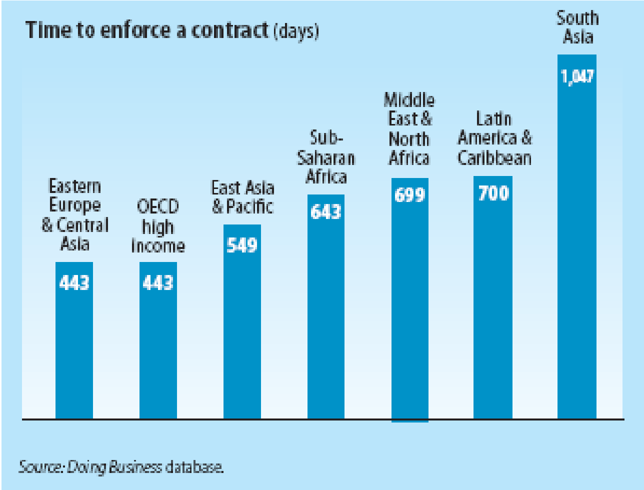
Horizontal and Vertical Issues: In reality, businesses small and large are affected by vertical issues – concerning particular industry sectors – and horizontal issues, which concern the overall business and regulatory environment affecting all businesses.

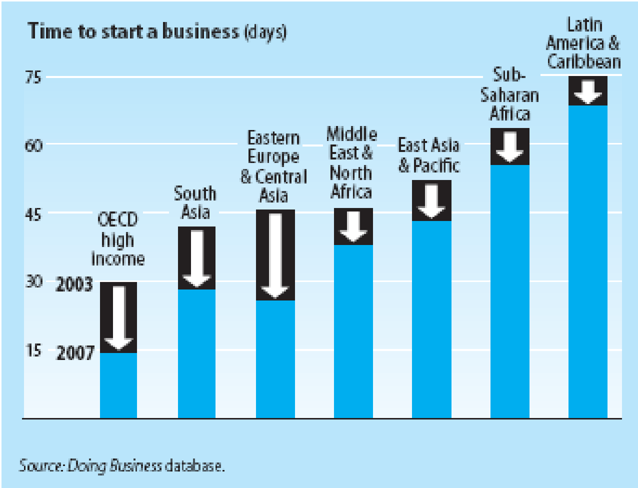
In a well managed investment climate, all of the arms of state would be aware of the small business sector and engage in outreach to ensure that policies are based on solid evidence and widespread input from those subject to regulations. They would be cognisant that every industry includes both large and small businesses, sometimes working cooperatively – for example as manufacturer and parts suppliers in the automobile industry – but also as competitors, where the regulatory interests of the small participants can be dramatically opposed to the interests of large enterprises.

Horizontal regulations can be further subdivided. There are the general regulations of business, which include how companies are registered, the rules that apply to opening bank accounts, how businesses are closed or reorganised when bankrupt, trade rules, customs procedures, competition law, employment law and tax compliance.

Various forms of labour and employment law are horizontal issues of particular concern to SMEs. Overly strict labour regulation can dissuade SMEs from adding employees and contribute to firms operating outside of the formal sector, where they do not pay taxes and may evade labour market laws. Particular SME issues include rules allowing temporary employment, rules permitting or restricting the dismissal of workers during business downturns, and rules requiring mandatory wage rates, paid leave, maternity/paternity leave and health and pension contribution requirements. Rules that require high wages and benefits won't necessarily produce the intended effect and may discourage employment or push SMEs out of the formal sector where workers have even fewer protections.

The Dangers of Opting Out: Faced with enough regulatory costs, small businesses adjust by reducing employment or working outside of the law without licenses, taxes or quality controls. This is harder for big business but is a reality of the SME sector, which can cost the state tax revenue and lead to health, safety, pension and environmental problems.





To return to the construction example, the evidence from many countries is that the more onerous the approval processes, the more construction occurs outside the law. In some countries the majority of buildings are unlicensed and often suffer from fatal structural problems. Authorities often respond by adding ever-more difficult approval steps, only to find that more regulation backfires. Ostensibly to combat unlicensed construction in Harare, Zimbabwe, authorities required that all buildings be inspected personally by the chief or deputy chief building inspector, creating a choke point that helped produce an enormous approval backlog. The 2008 Cost of Doing Business report found it took 952 days and US$38,347 to secure all the permits needed to build in Harare.

Similar problems occur with taxes, customs, health and safety rules, and labour laws. In different ways in each field, excessive regulation brings inflexibility, imposes distortions and higher costs and eventually leads to SMEs opting out of the formal sector. Simplifying regulation, cutting its cost and reducing the time needed to comply increases the level of compliance. However, the idea that regulation imposes costs does not suggest that regulation should be abandoned. Regulation needs to be evaluated both for its intended effects, for its unintended effects, for its efficiency in achieving its aims and whether alternative approaches to achieving the same objectives are possible at lower cost.

Evaluating Total Regulatory Burden

The implementation and enforcement of regulations should be evaluated to ensure that they are "clear, transparent, readily accessible and do not impose unnecessary burdens."

Governments should accept that with time, regulation accumulates. Each proposed regulation should be evaluated on its merits but also in light of the overall regulatory burden. The PFI calls for periodic regulatory impact reviews to evaluate the total burden and seek ways to remove outdated or unnecessary procedures. Countries have employed a variety of successful strategies to reduce regulatory burdens including: incorporating sunset or expiry clauses into regulations, passing laws that say lack of response by government within a set period amounts to consent, requiring regulatory departments to conduct SME impact assessments, putting diverse types of approvals under one licensing department, allowing online applications, and turning certification and inspection duties over to private firms.

The Problem Of Myriad Agencies: It is important to note that the burdens imposed by horizontal regulations often results from the myriad government agencies separately controlling pieces of the regulatory picture. For example, permission to build a warehouse might require inspection and certification by the fire department, by land use and zoning bodies, by environmental affairs, by building safety departments. In addition building plans must be approved, electrical and plumbing work inspected, health and safety plans approved. In some countries even archaeological authorities must approve land use. These myriad regulations affect more than the construction trade. The total impact of so many procedures has the effect of drastically suppressing the amount of approved construction, limits the supply of warehouses and other buildings and provides owners of existing facilities with oligopolistic control of an artificially limited supply of buildings, which drives up prices. The World Bank's Cost of Doing Business surveys find a very strong relationship between the cost of business property and the complexity of obtaining construction permits.

This example illustrates a key issue: regulations are imposed by a wide variety of bureaucracies, each with its own priorities and complex procedures. As a result, getting control of overly complex regulation requires strong political will at the highest levels. Many countries have streamlined by lodging authority for regulatory reform with the prime minister's office and taking steps to transfer authority for fire, safety, construction and other permits into a single construction approval agency.

Minimizing Transaction Costs and Disputes: Dispute settlement is a key issue throughout the business world, but particularly so for SMEs. By virtue of size, big businesses has greater political influence and more resources to defend its interests in commercial disputes. SMEs do not and thus are much more dependent upon efficient processes for settling or preventing disputes. The courts are one option, but can be extremely costly. In many countries the cost of recovering a debt through court can exceed the value recovered.

Efficient courts, arbitration and private dispute resolution, creditor protection laws, bad debt registers and clear rules for the liquidation of loan collateral all help resolve commercial disputes efficiently. They also together can significantly boost the amount of credit available to business, which is frequently cited in surveys as a major constraint for SMEs. The 2008 Cost of Doing Business study found "in countries with expedient courts, such as Lithuania, adopting a creditor protection law increases bank lending by 27% on average."

Regulating Major Types of Property: In addition to the courts, laws also play an important role in establishing a predictable commercial environment and eliminating the need to go to court. Several types of property are frequently the cause of disputes and a lack of legal clarity can both deter investment and lead to costly litigation. The PFI argues that clear, easily accessible property laws and property registration systems have the effect of minimising disputes, offering clarity about how disputes should be settled and provide clear standards that assist in the event of business disputes involving property. Four areas of property regulation are of particular concern to business: land, state expropriation (of land or businesses in their entirety), intellectual property and ownership shares in businesses. Ideally, regulations provide sufficient clarity about rights and obligations and allow for effective ownership registration systems in each of these areas so that many types of disputes never need go before courts for settlement.

Investment Promotion Authorities and the Needs of SMEs

The second chapter of the PFI concerns the operation of government entities set up to deal with investors, evaluate the regulatory climate and propose regulatory changes. How governments discharge this responsibility is vital to the prosperity of the SME sector, but in practice SME considerations often are given less attention than the issues affecting big business and foreign investment. SMEs, particularly in the developing world, cannot afford to evaluate laws or lobby government. As a result, SME concerns are often neglected. To ensure that SME needs are taken into account, a well run IPA needs to build active outreach into its planning and management. This can take the form of surveys, consultation with business bodies, trade shows and reviews with individual businesses. Such outreach should actively and regularly assess the investment climate and whether government needs to take action in response to shifting global or national conditions. Care should be taken not to assume that policies beneficial to big business necessarily reflect the interests of SMEs.

Investment Promotion Policies: Investment authorities generally have a dual mandate. They are responsible for evaluating the investment climate and proposing necessary regulatory changes. They also are responsible for actively seeking new investment. This can come in the form of marketing efforts to tout the general advantages of the national investment climate, through networking, trade shows and various forms of targeted outreach. However, investment promotion also can take the form of specific incentives – such as tax holidays, duty free imports, construction of special infrastructure or subsidised loans or financial guarantees.

Exactly how efforts are split between these two goals can be very significant for SMEs. In some instances, political pressures can lead to an overemphasis on winning high-profile foreign investments through incentives and comparatively less work on improving the overall business climate. Every incentive costs the government revenue. If some businesses receive substantial tax concessions or other subsidies, taxes implicitly must be higher on other taxpayers, which can be tantamount to taxing small business in order to subsidise large ones.

Direct SME Support Programmes

Governments around the world offer a wide variety of SME support programmes that can be roughly divided into five main types: financial assistance, enterprise culture, advice and assistance, technology, and management training. It is not the intention of this paper to evaluate or compare best practices in delivering such SME services. But it is important here to highlight significant managerial and administrative challenges that can help ensure that SME support programmes are well conceived and realistic.

Weighing SME Specific Programmes Against Alternative Approaches: Offering support to a specific industry – such as mining or textiles – can be conceptually and administratively easier than trying to offer support programmes for all SMEs, which are in highly diverse businesses. For example, a support programme aimed only at textiles would allow administrative staff to learn the particular issues in that sector and effectively evaluate business proposals presented by SMEs. But a programme designed to cater for all possible SME sectors would have to have far more diverse expertise on staff or would have to make lending decisions about business sectors in which the state lender had little familiarity.

This example suggests that one approach to supporting SMEs would be to identify the most promising business sectors and to offer SMEs assistance as part of sector-specific support efforts that include elements for both large and small businesses. Such an approach could focus limited support funding to those areas where the nation has the most comparative advantage or can realistically expect to realise the most gains in employment.

Just as the merits of SME specific promotions should be weighed against a sector specific approach, so too should SME programmes be compared to the general benefits to SMEs that could come by applying the same amount of funding and political capital to regulatory reforms aimed at simplifying approval processes, certifications, tax compliance and delivering a stable macroeconomy that keeps interest rates and inflation down.

Facilitating Business Linkages: Large businesses procure a wide variety of services, from landscape maintenance to cleaning services, printing, accounting, canteen services, repairs, health services, uniforms and supply of a wide variety of inputs and supplies – all of which can be supplied by small businesses. Similar services also are purchased in large volume by government agencies. Having explicit programmes to help SMEs participate in such procurement activities can significantly aid the small business sector.

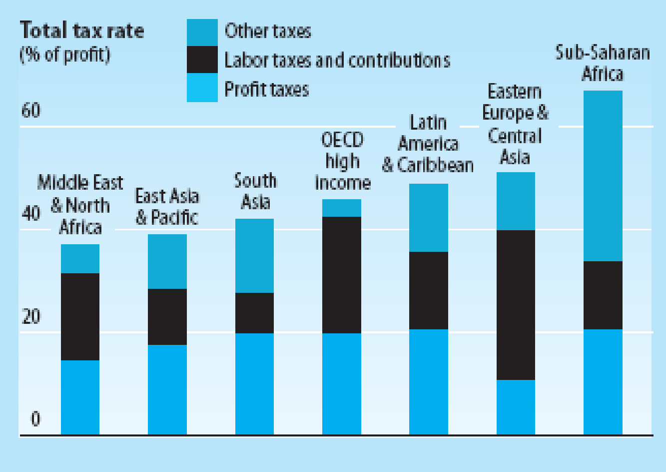
Clear Goals and Evaluations: Business support programmes are well-intentioned but unless they have clearly defined goals and funding for periodic evaluations, it can be difficult to know if they are making the intended impact. Such evaluations, should be part of broader effort to ensure that SME needs and challenges are factored into all forms of business policy (see PFI question 2.7). Without careful evaluation against control groups and consideration of alternative methods, SME support programmes can lose focus or relevance as economic conditions shift over time.

Anticipating the Challenge of Generic SME Programmes: One important lesson of evaluations so far is that SME support efforts can consume far more human resources than programmes only aimed at big business. The sheer number of SMEs and the limited staff available at investment authorities mean that it can be difficult for government programmes to affect but a small proportion of SMEs. For the same reasons that SMEs have a hard time lobbying government – limited staff and the high opportunity costs of diverting staff away from the direct conduct of business operations – SMEs can have a hard time finding out about or navigating the required application processes involved in government SME support programmes. An SME survey by Finmark Trust provided dramatic evidence of this in South Africa. It found that only 28 percent of SMEs had ever heard of various government SME support programmes and only 8 percent had used such government programmes. Of all SMEs in the South African survey only 2 percent had taken out a loan to start a business, with most relying on capital from friends and family. Of those in the least sophisticated category, 99 percent were not registered with government.

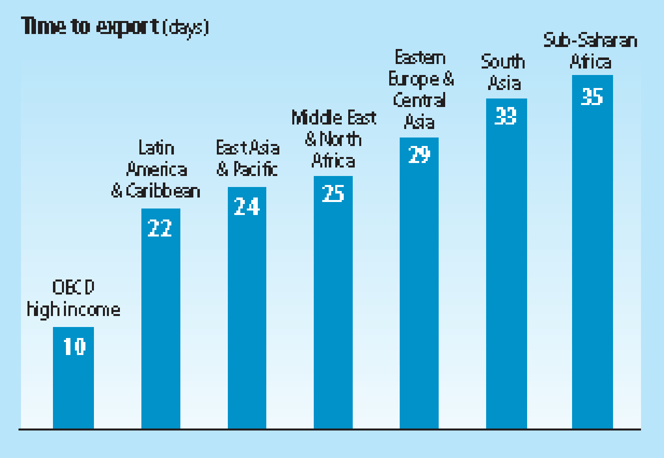
Tax Policy

Tax policy is the subject of its own chapter in the PFI, but it is a logical part of the discussion of the overall cost of compliance with business regulation and is closely linked to the phenomenon of SMEs opting to work as unregistered businesses.

As with other sections of the PFI, questions of balance feature prominently in deciding on appropriate tax policy. Ideally government would like to maximize revenue, but as tax levels rise they have a negative effect on business and personal incentives. If taxes took 100 percent of profits, there would be no incentive to work and businesses would close down or seek to avoid paying taxes, leaving the state with less revenue than if it adopted more moderate rates. The *Cost of Doing Business* notes that "a burdensome tax system disproportionately hurts smaller businesses, especially in the services sector."



Source: Doing Business database.



Source: Doing Business database

Trade Policy

Trade policy is a vital component of any investment climate and can have major impact on the fortunes of business, both large and small. However, the cost and complexity of complying with trade procedures – customs procedures, cross-border insurance requirements, rules of origin compliance, phyto-sanitary standards – can weigh much more heavily on SMEs, who have fewer staff and cannot afford to keep inventory and working capital tied up in goods delayed at border crossings.

Competition Policy

Laws restricting anti-competitive behaviour are not normally focused on small and medium businesses. Because small firms are small they rarely have the kind of market power needed to restrict competition or prevent new firms from competing. Typically large firms and monopolies are the target of competition laws, but SMEs can be the beneficiaries if such laws enable SME participation in the market.

Human Resource Development

The PFI calls for a comprehensive policy framework for human development that is periodically reviewed in light of the investment strategy, implementation capacity and new economic developments. Such a human resource strategy should take cognisance of the overall SME employment picture and the skills required, particularly by fast growing, high-employment sectors. Having a framework that is reviewed stands in contrast to ad hoc policy-making, which can result in policy remaining unchanged for years despite dramatic changes in circumstances.

Compliance with core labour standards can also be a significant SME issue, particularly in developing countries. Eight core labour standards are defined by the International Labour Organisation, which include eliminating all forms of forced or compulsory labour, abolishing child labour, non-discrimination based on employment or occupation, and ensuring the freedom of association and collective bargaining rights. While large businesses are often far more tightly regulated when it comes to labour issues, many instances of violations of core labour standards occur in the SME sector, particularly in the developing world where labour inspection regimes are weaker, unions less common and child labour more prevalent. In effect, SMEs can get away with more than large, formal businesses. However, violations of core labour standards are considered contrary to good investment practice.

Infrastructure

Both large and small firms are affected by poor infrastructure but it can be more daunting to SMEs. Big businesses may be more able to build some of their own infrastructure when government underperforms, but such self-provision is more difficult for SMEs. When governments fail to provide sufficient quantity and quality of infrastructure, they effectively impose a silent tax on business that is manifest through slower government services – such as customs clearances – higher transport costs due to congestion and damage to vehicles created by poor roads, higher costs due to self-provision of electricity, water and other services. Like other areas of the PFI, the section dealing with infrastructure calls for an approach that is systemic and based on a rational, inclusive process for setting priorities.

A related areas are the regulations concerning public infrastructure tendering, which can be a tempting target for corruption, collusive business practices and political interference. As a result a sound investment climate should include clear guidelines and various forms of transparency to ensure that infrastructure funds are spent fairly and in the best interest of the country. Public tendering rules should set out selection criteria, prevent collusion or corruption from influencing decisions and prevent conflicts of interest from influencing the decisions of procurement officials. Designing processes so that SMEs may partake in public tenders can be an important SME promotion strategy.

Once contracts are signed, investors also should be protected from unilateral changes to contract conditions by governments. A balance must be struck between the public interest – which seeks the highest quality infrastructure at the lowest price – and business interests, which need to make a fair return on their efforts.

Particular infrastructure sectors affect SMEs disproportionately. Long held as government monopolies that have often underperformed, new technology and regulatory practices is allowing some countries to involve the private sector much more effectively in these areas. They include telecommunications, electricity provision (including co-generation), and transport infrastructure and management (including roads, toll-roads, ports, rails, airport management and specialised export services, like agricultural handling terminals and cold storage depots. Water infrastructure can be crucial to many businesses, particularly in agriculture, mining and agriprocessing.

Financial Sector Development

Given the present global crisis, financial services infrastructure and regulation deserves particular attention as it has great impact on SMEs. This includes the regulation of banks and lending, laws protecting creditors, the systems for resolving commercial disputes, regulations of the rights of borrowers and creditors, rules on repossession of collateral, credit registries and the associated enforcement mechanisms.

Laws permitting repossession of collateral pledged in exchange for loans are in important component of the regulatory framework necessary for debt collection and the provision of credit. Without them financial institutions may be reluctant to lend to business. Another important component of the financial system, which assists banks in providing credit, is a credit registry. Their function is to record the loan repayment histories of all borrowers. Having a record of repayments can objectively help identify those with a sound repayment history and those who have defaulted on loans.

Laws effectively regulating bankruptcy and allowing for the orderly closure or rehabilitation of distressed firms are an important part of the financial regulatory environment. By providing for commercial courts, the appointment of private bankruptcy trustees to supervise reorganisation or liquidation of bankrupt firms, and creditor protection laws, among other areas, can create a more predictable financial environment that will provide credit more easily to SMEs.

Regulating the financial reporting and disclosure practices of banks and other credit providers also is an important component of a sound investment framework. Public trust in financial institutions is an important component of modern economies.

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