III. Analytic Approach

A dynamic private sector is a feature of all countries that have sustained economic growth. Besides promoting general prosperity, a rising GDP is the most effective means of reducing poverty. A flourishing private sector, therefore, is central to efforts at reducing poverty in the Pacific. Although consensus exists on the importance of the private sector, how to ensure that it is able to develop is an issue of contention.

Table 1. The Relationship Between Growth and Poverty

Economic Response	% Change in Average Incomes per Year	% Change in Poverty Rate per Year
Strong Contraction	–9.8	23.9
Moderate Contraction	–1.9	1.5
Moderate Expansion	1.6	–0.6
Strong Expansion	8.2	–6.1

Source: Easterly, William. 2001. *The Elusive Quest for Growth*. Cambridge: Massachussetts Institute of Technology Press.

The relationship between economic growth and poverty is clear from Table 1 wherein income growth is strongly correlated with poverty reduction. Private sector development is the most efficient and durable way of achieving this end.

> Private sector development promotes efficient economic growth and development and is a source of wealth, dynamism, competitiveness, and knowledge. Beyond its economic merits, however, lie compelling social and political attributes that enhance the contribution private sector development can make more generally to sustainable development, the overriding goal of all development assistance efforts (DAC[7] 1994).

The question is, what promotes growth? And more importantly, what promotes private sector growth?

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[7] Development Assistance Committee.

What Promotes Growth?

Many have advanced theories as to what promotes growth and many have been incorrect. So far, these theories have been limited in their ability to provide a panacea for stimulating growth in the developing world, particularly an appropriate application of these theories by donors to the developing world.

During the 1940s and 1950s, economic theory focused on "filling the gap" or using foreign aid to top up savings with the "necessary" investment to promote a particular level of growth (Easterly 2001). This focus arose from the Harrod-Domar model, which was based on the idea that GDP growth is proportional to the share of investment spending on buildings and machines. But it is based on the assumptions that production capacity is proportional to the machinery stock and that labor is in excess supply. William Easterly has demonstrated that there is no statistically positive relationship between aid and investment and that there is not a one-for-one relationship between increases in aid and investment as a share of GDP. Evsey Domar later disavowed his theory as inaccurate and "filling the financing gap" ceased to be considered important. But the model continues to be used by some international finance institutions (IFIs) to determine the required investment rate for a target rate of growth. In fact, "Domar's growth model became, and continues to be today, the most widely applied growth model in economic history" (Easterly 2001).

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When capital investment seemed to have little impact on growth and Robert Solow demonstrated the importance of technology in the production process, the 1950s and 1960s saw an increasing focus on the importance of boosting technology inputs to stimulate growth. But technology differences across countries do not explain income differences among them. Robert Lucas illustrated that a United States worker would need to have 900 times the number of machines to explain the income differences between the United States and India (Lucas 1990). In reality, the difference is more like 20 times the number of machines.

The failure of poor countries to grow is evidence against Solow's view. Poor countries failed to grow faster than rich.[8] Unfortunately, they have not only grown more slowly, but they are actually losing ground. The reason machines in developing countries are not as productive has little to do with the machines and more to do with incentives and the environment in which the people operate the machines.

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The 1960s saw an increasing concentration on the importance of human capital development (i.e., education). Investment in education may be socially beneficial, but studies have found a tenuous relationship between increasing education and long-run growth (Easterly 2001). In fact, the decline in growth of developing countries occurred when there was a huge educational expansion in those countries.

If the incentive to invest in the future is not there, education will have little impact on growth and will in fact create skills where there is neither technology nor the desire to invest in the technology to be used.

The 1970s introduced the idea that controlled population increases would positively impact economic growth. In other words, population growth imperils prosperity by overwhelming the existing productive capacity to generate jobs and outstripping food production. The thought was that if population could be controlled, the developing world would grow by increasing its productive capacity. But this theory is based on the assumption that an additional person has zero productivity and once again, studies found that there was no significant impact of population growth on economic growth.

A greater population may harm the environment but an additional person is an additional taxpayer for governments and the more babies, the greater the chance of innovative people being born to benefit society. In addition, new ideas will be more beneficial the more people there are to share the benefits and spread the costs, a critical point for most of the countries in the Pacific given their small population size.

The 1980s brought the recognition that IFI loans needed to be linked to policy reforms and this legacy has shaped much of the focus on the private sector to date. There were some successes, but there were problems as well. The

[8] Paul Romer demonstrated that poor countries were not growing faster than rich.

first problem with lending arose from IFIs and other funding agencies not enforcing the conditions of the loans. The second problem arose from a focus on import substitution and sectoral targeting behind high trade barriers.

Easterly has cited some successes during this time, where GDP growth was positive on average over a period. For example, Ghana, the Republic of Korea, Mauritius, and Thailand experienced positive growth, but these countries are only limited evidence of success. They are also evidence of countries that undertook serious reforms as opposed to others who continued to receive aid but made no reforms. For example, countries with severely negative interest rates received more aid than those with positive interest rates (Easterly 2001).

Unfortunately, incorrect incentives for both parties pervade the donor-recipient relationship. A World Bank study suggests that aid does not influence a country's choice of policies and that funding agencies do not necessarily consider the worthiness of a country's policies when providing aid (World Bank 1998b). The funding agencies' strategic interests determine aid, not the recipients' policy choices. The reward for better policies is only 0.25% of more aid as a percentage of GDP (Easterly 2001). And providing aid does not create the incentive for change. What is most important is a shift from an irresponsible to a responsible government. (An irresponsible government will create the illusion of change to avoid real reform, for instance, through creative accounting.)

IFIs have internal incentives to provide loans. Often a department's budget is determined by the amount of aid disbursed in the previous year. Therefore, low disbursements mean a cut in the budget. Loans then, are often disbursed according to "quota" rather than on project viability. Recipients are aware of this and so they often simply wait for the aid without making reforms. The greater their poverty, the more aid they receive—therefore, there is little incentive to change. And so develops a vicious cycle of lending. Aid should be tied to past performance, not promises of reform.[9] Both ADB and the World Bank are moving in this direction with performance-based lending.

The second problem from this period arose from a focus on import substitution and sectoral targeting behind high trade barriers. The shocks experienced by these countries during the financial crises of the 1980s, exposed the weaknesses of the inward-looking import substitution approach to development and the projected dynamism and growth were conspicuously absent.[10]

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9 Easterly suggests developing an index to measure past policy performance and doling out aid depending on the country's ranking on that index.

10 In addition, throughout these phases of development, the state had a central role in directing development and owning key industries in most countries in the developing world.

Given the failure of these attempts, the policies of those who espoused the "Washington Consensus" as the key to a strong private sector response and economic growth—rapid privatization, macroeconomic stability, trade reform, and "getting the prices right"—came into dominance in the early 1990s. It was recognized that this simplified approach did not consider many of the complexities that characterized developing economies. Nevertheless, so many distortions had been introduced by earlier attempts at targeted intervention that proponents of this approach believed that the incentives provided by prices that correctly reflected scarcities would result in rapid private sector growth. However, the private sector response has been disappointing. Small business formation has languished, and informality has increased.[11] All the various components that make up the "enabling environment" for private sector activity were absent.

What Drives Private Sector Growth?

Business Dynamism

Since economic growth and private sector development are closely linked, identifying factors that encourage the formation of dynamic private sector companies is central to formulating effective policies or programs that promote private sector development and thus reduce poverty.

The concept of "creative destruction" developed by Joseph Schumpeter provides the backdrop for a discussion of private sector development as it is based on the view that dynamism, and thus growth, depends on private sector firms having opportunities and incentives to expand in existing markets and to develop new ones. New firms are created to take advantage of opportunities, which in turn stimulates more competition among existing firms that must either respond to the new challenge or go out of business. This cycle in turn creates new demand that stimulates growth.

In Schumpeter's view, growth and new firm innovation implies large numbers of new firms being created and others failing. It is this process of "creative destruction" that leads to a dynamic private sector. This "dynamic capitalism"

[11] "Privatization advocates naively persuaded themselves that these costs could be overlooked because the textbooks seemed to say that once private property rights were clearly defined, the new owners would ensure that the assets would be efficiently managed … They failed to realize that without the appropriate legal structure and market institutions, the new owners might have an incentive to strip assets rather than use them as a basis for expanding industry. As a result, in Russia, and many other countries, privatization failed to be as effective a force for growth as it might have been. Indeed, sometimes it was associated with decline and proved to be a powerful force for undermining confidence in democratic and market institutions" (Stiglitz 2002).

Box 1. Business Dynamism

An example of the interplay of factors that give rise to business dynamism is provided from the United States by Donald Hicks, who studied a sample of small businesses in Texas over a 30-year period. He found that during this time, the half-life of small businesses had declined by 50%. The average age of businesses in the Austin area, for example, is currently less than 7 years. At the same time, this region has the fastest growing number of jobs and the highest wages in Texas. In other words, a dynamic business environment encourages experimentation and provides strong incentives for success. Defining dynamism is not easy, however. Anyone witnessing the taxi bus industries in some Latin American countries would be hard put not to describe this activity as bustling and apparently dynamic. Yet, dynamism based on the application of energy alone will not lead to sustained growth. It is the combination of energy, management skills, and technology that ultimately results in economic advance.

Source: Hicks, Donald A. 1992. Beneath the Surface and Beyond the Borders: New Dimensions of Dallas Area Economic Development. In *State of the Region 1992*. Richardson: University of Texas at Dallas.

of firm formation and growth provides some guidance on how to formulate policies that promote private sector activity. It redirects the focus of private sector policy away from trying to assist businesses through targeted interventions, toward promoting an environment that provides incentives for company formation and growth. The paradox that large numbers of businesses fail in a high-growth economy results from an economic system that encourages experimentation and risk.

It is important to remember that reforms, projects, and other interventions do not create growth, but entrepreneurs and companies do. Higher productivity, the growth of new activities, the restructuring of existing companies, and the formation of new firms must be encouraged in order for reform to be effective in promoting economic growth and reducing poverty. These elements constitute the basic criteria against which any policies or interventions should be judged.

Reforms, projects, and other interventions do not create growth, but entrepreneurs and companies do.

Transaction Costs

An important theme of this analysis is that how businesses are structured and take place is strongly influenced by the transaction costs associated with conducting business. These costs often define how economic activity is organized or whether it takes place at all. Examining these costs makes it possible to

Box 2. Examples of Transaction Costs

Transaction costs are the costs of arranging, monitoring, and fulfilling contracts. They determine the way business is organized and conducted, and have a strong influence on the time horizons for business planning and investment. Most importantly, they determine how markets function. Market failure usually occurs when transaction costs are prohibitive. Examples of transaction costs include those associated with

- buying and selling goods and services
- raising finance and capital
- obtaining information regarding business opportunities
- obtaining information regarding business associates
- forming and organizing companies
- bankruptcy for creditors
- enforcing shareholders' rights
- entering into contracts
- enforcing contracts
- hiring and dismissing workers
- transporting goods
- importing and exporting goods
- complying with regional and local government regulations
- dealing with government representatives
- securing the ownership of property
- enforcing property rights

obtain insights into the constraints imposed upon businesses, derive the implications for public sector policies, and find ways in which ADB and other funding agencies could assist the governments of the Pacific in promoting dynamic private sector growth. It is the cost of doing business, or the cost of transacting, that frequently determine the way economic activity is organized. Box 2 contains examples of transaction costs.

> The relative impact of high transaction costs is felt more by smaller businesses than by larger ones.

By examining private sector development issues through the lens of transaction costs, familiar problems are cast in a different language. But information on transaction costs is limited since collecting data on them is in its infancy.

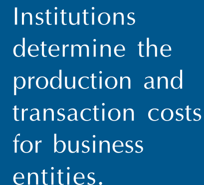
An important feature of transaction costs and the way they affect the organization of economic activity is that many have significant fixed cost components. Consequently, the relative impact of high transaction costs is felt more by smaller businesses than by larger ones. This result has a powerful effect on the size structure of firms. High transaction costs contribute to corruption and cause market failure—when the cost of transacting is high,

markets do not function efficiently or even exist at all. Also, it takes considerable resources to define and protect property rights as well as enforce agreements. It is a society's institutions and technology costs, however, that determine the transaction costs—including the time and related opportunity costs—associated with these efforts.

Institutions

Ultimately, private sector activity is driven by the environment in which it operates. This can be an enabling or disabling environment depending on the incentives provided to the business community by the state and societal institutions. The private sector assessments undertaken for this publication focused on the environment where the private sector operates, the institutions that direct and impact private sector activity, the transaction costs imposed on businesses, and ultimately, the incentives provided to private sector businesspeople. Important elements include

- governance and political stability;
- the institutions that provide the basis for private sector activity (e.g., the legal and regulatory system, the financial system, and infrastructure provision);
- the viability of property rights, contracting, and dispute resolving mechanisms within the legal system; and
- the ability of businesspeople to raise capital within the financial system.



Ultimately, factors such as mineral endowments, education levels, macroeconomic stability, and savings rates have little impact in themselves if the underlying institutional framework is missing.

Institutions reduce uncertainty in life by providing a structure in which individuals and organizations can operate. They achieve this by defining and limiting the choices available to individuals. The definitions and limitations are devised to shape human interaction. They are the framework within which human interaction takes place: the "rules of the game."

Institutions interact with the economy through the impact they have on the costs of exchange and production. Institutions determine the production and transaction costs for business entities. Especially when it is costly to transact, institutions are particularly important. They combine with the standard constraints of economic theory such as supply and demand, to establish the

economic opportunities available to business entities. Organizations are then created to take advantage of those opportunities. Depending on how institutions attempt to modify behavior, however, they can end up creating perverse incentives for organizations and increasing transaction costs. Examples include requiring useless inspections, having contradictory and/or complicated rules, or exorbitant taxes.

In the Pacific, institutions such as those operating both the legal and financial systems are weak. However, they provide the foundation for private sector activity and are fundamental to private sector growth. In addition, transaction costs are high and there are many barriers to entry for small businesses. Accurate information, however, that identifies precisely the shortcomings and transaction costs facing businesses is inadequate or unavailable in most countries in the region. This publication, therefore, suggests that a trial and error approach that analyzes in detail the conditions facing the private sector on a country-by-country level—not only for the four study countries—will help reveal appropriate private sector development strategies for these countries and for the region as a whole. This approach implies that detailed private sector analysis is a prerequisite for the successful design and implementation of private sector projects.

Given the importance of the operating environment that exists for firms, this publication suggests ways in which the state can commence the task of identifying and removing the most costly barriers to business formation and growth. It emphasizes that the private sector cannot prosper in an environment that does not provide easy access to capital and financing for entrepreneurial activity and it looks at ways in which the state can encourage financial intermediation including contract enforcement, dispute resolution, and the growth of capital markets. This publication identifies the public goods necessary to support business activity, including the provision of infrastructure and the regulation of enterprises at various levels of government, as well as the rationale and limits of public initiatives, particularly with regard to market failure, information asymmetry, and market imperfections.