The Policy Practice

# Policy Practice Brief 12

# Political Economy Analysis of the Business Environment in Eleven Middle-Income Countries[1]

## Emerging Themes and Issues

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## Political Economy Analysis of the Business Environment

### Emerging Themes and Issues

> *Asked for his blueprint for reviving the economy, he said he would create a "conducive investment climate, including through incentives".*
>
> From a *Financial Times* interview with President Cyril Ramaphosa, 19 April 2018.

### Background

1. Business environment reform is always high on the list when an agenda to promote growth is being formulated. This paper and attempts to identify some key issues, draw out some common themes and set out some unanswered questions. It does this through drawing on eleven rapidly-conducted studies in a diverse set of upper and lower middle-

1 This paper is based on eleven middle-income country studies commissioned by the UK's Cross-Government Prosperity Fund, which aims to remove barriers to economic growth and promote the economic reform and development needed to reduce poverty in partner countries. The content of the country studies and this briefing paper, including the opinions expressed, are those of the individual authors alone and should not be attributed to the Prosperity Fund or its sponsors – the Cabinet Office, DFID, FCO, HMT and MOD – or to The Policy Practice. We would like to express our appreciation to William Cook, Andrew Levi, Darren Love, Joshua Owen and Funa Sepiso for their strong support and encouragement.

income countries: Brazil, Kenya, Malaysia, Nigeria, Indonesia, Pakistan, Peru, Philippines, South Africa, Turkey and Vietnam.[2]

2. Creating an environment for investment and inclusive growth is thought to be one of the most powerful means of achieving the goal of poverty reduction. Reducing poverty is a challenge by no means limited to poor countries only: a striking fact is that according to the World Bank's 2015 data, fully 73% of the world's people who live below the poverty line of US 1.90 per day live in middle-income countries.[3]

3. The focus of this paper on political economy is warranted because the environment for investment is a policy and institutional arena in which powerful economic and political interests – both public and private – interact. The business environment is a product of the political economy. Reforming the business environment needs to be understood not only as a technical challenge but, as importantly, as a challenge to the political economy. And in many countries what governments and corporations do is more influenced by the interests at play than by the technical specifics of policy. Understanding these interests, which is what this paper tries to do, is therefore central to efforts to optimise the impact of the actions of governments and corporations on growth and poverty reduction.

4. Recognising that the business environment is rooted in the political economy of a country is also to recognise that change is likely to be modest and slow (although revolutions and crises may come along from time to time). Thus it is important to focus on a limited, prioritised and feasible agenda for reform built on an understanding of the key constraints to inclusive growth which we contend are in the most part rooted in political economy.

5. While the focus of this Briefing Paper is primarily on actions to be taken within individual countries, the wider global context is also critical, especially at a time when more open trading regimes are under challenge. Specifically in the case of the UK, the issues also include the nature of the trading regime that the country will seek to develop in the years following Brexit.

## Introduction

6. **Foreign investment offers significant potential benefits for host economies but they are not automatic**. Not all foreign investment is the same: it may be seeking access to the host's domestic market or to markets to which the host has access; it may be seeking to develop natural or other resources; it may be seeking to generate economies of scale; or it may be a strategic move (eg buying out a global competitor). It can involve purchase of existing assets through mergers or acquisitions, or new investment creating new assets. It may be in the form of portfolio flows that simply augment the availability of capital. Investment may contribute to shared and inclusive growth, or to technological and institutional innovation but this cannot be assumed.

2 The country studies were undertaken by: Professor Edmund Aman, Brazil; Matthew Busch, Indonesia and Vietnam; Professor Jonathan Kydd, Kenya; Professor Terence Gomez, Malaysia; William Kingsmill, Nigeria; Adeel Malik and Rafiullah Kakar, Pakistan; Mark Lewis, Peru; John McLean, Philippines; Professor Nick Vink, South Africa; David Tonge, Turkey.

3 'Middle-income countries … account for 73% of the world's poor people', the World Bank in Middle-income countries: http://www.worldbank.org/en/country/mic/overview.

7. **Different investors will need different things from the business environment**, and will offer different things to the host. Host governments need to be clear what type of investment they want and what they expect in terms of forward, backward and horizontal linkages, and transfer of skills, know-how, and technology. They need to assess what sort of 'offer' is desirable, and how they need to strengthen their environment. Foreign investors are not always likely to be forthcoming in crafting a comprehensive offer and host governments should not expect to be passive partners.

8. For most countries for most of the time, **domestic investment is much more important than foreign investment**, in aggregate terms, and in terms of contribution to growth and poverty reduction. It is important that foreign investment complements domestic investment and the terms must not disadvantage domestic investors.

## Context and Business Environment

9. **The economies of all the countries in this sample are growing.** In most cases they are dynamic success stories (such as Indonesia with 15 years of sustained growth), but in some growth is slow or prone to sharp recessions (Brazil in 2013) or episodes of relative stasis (South Africa for the past decade, or Nigeria since the fall in oil prices).

10. **In most cases poverty is falling**[4], in some cases dramatically, such as in Turkey, Vietnam, Indonesia and Malaysia (although the total number of people living in poverty in most of these countries remains substantial). As noted earlier, it is striking that middle-income countries, such as the eleven under review, contain 73% of the world's poor people.

11. In some of the countries, **structural transformation** is underway, as in Turkey, Vietnam and Malaysia. It is not a linear process and transformation is not inevitable. The process can be slow and uncertain, and can be reversed. Several countries (such as South Africa and Pakistan) show a growth of the service sector, but manufacturing is stagnating and showing little sign yet of offering a route out of poverty for large numbers as occurred in some countries, especially in east Asia.

12. The **potential contribution of foreign investment is cherished in some countries**, but essentially ignored or only tolerated in others. Countries do not, on the whole, have well-articulated policies on how they want to leverage foreign investment to achieve their goals.

13. All the countries are ambitious to 'go to the next level,' seeking higher value-added or productivity in their economies. Several (Pakistan, South Africa, Vietnam) are concerned about **weak productivity growth**. Among other factors this is partly about improving formal, vocational and technical education, and partly about improving infrastructure. But it could also be about building **capability in government** to sustain and accelerate inclusive growth, and **capability in the private sector** to manage economic complexity[5] and deliver high productivity growth, where foreign investors can make a distinctive contribution if they face the right incentives.

4 Nigeria is an outlier, as is South Africa since 2011.
5 See 'The Atlas of Economic Complexity', 2014, Ricardo Hausmann, et al, for a discussion of complexity.

14. In many countries there is **significantly** increasing **inequality over time**[6]. Only in Malaysia and Peru have Gini coefficients improved over the past five years and those improvements have been modest. There have been serious deteriorations in Nigeria, Vietnam, Pakistan and Kenya. Identity politics[7] and economic nationalism appear to be in the ascendancy, encouraging tendencies towards more populist economic policies, as can be seen in Turkey, South Africa, and Malaysia. Is this a response to growing inequality? Or does it reflect unease about globalisation? Stronger policies and capabilities to manage foreign investment might improve voter confidence and reduce populist pressure.

15. Most of these countries can be thought of as **pursuing activist state policies** and at the same time **promoting economic liberalism** in each country in a unique way**.** This makes for a degree of policy unpredictability. Activist state policies in many cases act as a cover for the exercise of patronage and for rent-seeking for political and personal gain, as well as representing a 'developmental state' in action. One widespread manifestation of the role of the state is a heavy burden of regulation which most of the country studies, as in Indonesia, Malaysia, Peru and South Africa (the latter especially in relation to the labour market), report as hindering investment and growth, and helping to push economic activity into the informal sector. It is important to invest time in understanding the detailed specificity of the rules of the game in each country in important sectors, subsectors, and regions.

16. In all countries to varying degrees there are significant **market failures** in the financial sector (ie in capital markets), in labour markets, in product markets, and in land markets. The case studies point to the importance of these failures, but also point to the fact that they are generally not well diagnosed or systematically explored. While these market failures are a major factor in determining the health of the business environment, foreign investors could help resolve them in some cases, especially where 'missing markets' are significant. There are few instances of the analysis of the structure conduct and performance of markets that matter for ordinary people and for the poor.

17. The performance of **agricultural services and markets**, including land markets, is central to poverty reduction in many countries, including Kenya, Nigeria, the Philippines, and Pakistan. Market failures are pervasive, a host of reform issues arising in respect of seeds, fertilizer, pesticides and herbicides, output markets, storage, transport, processing and packaging. Foreign investment of a kind that enhances productivity especially of smallholder farmers (rather than encouraging farming systems that displace labour in countries in which labour is abundant) could play an important role.

18. **Macroeconomic management** remains a challenge in many instances, although there are several cases of vigorous reforms undertaken (Peru, Brazil) or where the administration shows serious intent (the Philippines). In all of the countries, fiscal policy is seen as needing reform if the business environment is to improve, in terms both of revenue generation that is often inadequate to support needed public-good provision by governments, and of poorly targeted and inefficient spending, and in some cases in terms of 'crowding out'[8]. The case studies point as much to the importance of macroeconomic policy for business, as of microeconomic policy (eg competition policy). Trade policy in several (but not all) of

6 World Economic Forum 'The Inclusive Growth and Development Report' 2017.
7 Identity in terms of religion, ethnicity, region, or class.
8 Crowding out in the sense that government borrowing absorbs significant lending capacity in the economy. This causes interest rates to rise.

the countries is perceived to contribute to inefficient resource allocation and to lend itself to capture by privileged interests. Resource-based economies (most strikingly among the countries under review, Nigeria) face particular challenges in managing volatility, which brings with it a raft of political problems. Public discourse on key macroeconomic choices and options tends to be muted.

## Political economy factors

19. The political economy analyses demonstrate that, while politics and economics are closely intertwined, when interests clash **politics almost always trumps economics**. Further, politics in each country is unique and depends much on history, geography and natural resource endowment. Political settlements[9] tend to be quite stable (in Pakistan landowners and the military have been central to the settlement for decades, while in Kenya it is based on ethnic coalitions) but do nudge forward (or backward) and sometimes suffer (or enjoy) shocks that change the rules of the game substantially, as in South Africa 25 years ago. Political settlements tend to be exclusive rather than inclusive (ie 'limited access orders' or oligarchies rather than 'open access orders'). More exclusionary political settlements tend to generate highly unequal patterns of growth. Arguably, oligarchies innovate less, although this is disputed. The development of an urban middle-class, which is widely observed in this group of countries, and a growing number of often underemployed youth, can have pervasive long-term political and economic impacts through changing the incentives of influential groups.

20. In some countries the **political settlement is insecure** with significant fragmentation and competition within the elite class(es) and violent conflict a continual threat. But the role of the military and security forces in politics seems to have been diminishing in some of the countries, in Latin America for instance, and in Indonesia, and Nigeria, but not in all (Pakistan, Kenya and Turkey).

21. **The failures of governments to fulfil functions required for a stronger business environment often reflect conscious political decisions** and political incentives, rather than in the first instance a 'lack of capacity'. Independent institutions of restraint, accountability or regulation often threaten patronage systems on which those in power rely.

22. In all of the countries, examining **economic rents and how they are created, secured and used** by powerful groups, throws light on why and how the business environment is as it is. (The Pakistan study includes an illuminating examination of how regulation and policies are used for this purpose.) In many cases rents are used for personal or political gain that hinders economically beneficial investment and inclusive growth. But there are also cases in which rents, if reinvested and used to support nascent enterprises, can be developmentally valuable (Indonesia would be an example). There are cases both of relatively structured control of rents following an established if informal set of rules, and others where the struggle for control of rents is fractious and a source of conflict.

9 The concept of a 'political settlement' is about how organisational and political power is organised, maintained and exercised (ie who is included, and the conditions that determine inclusion and exclusion). Given that political power and economic power are inter-linked, the nature of the settlement is critical for the prospects for inclusive growth, and is critical for understanding the potential pathways for positive change

23. All of the studies examined the nature of **patronage arrangements**, including in almost all cases a close relationship between the political and economic elites (the Malaysia study for instance talks about 'government-linked companies', while perhaps more positively the Kenya paper notes a 'business-owning, business-aware and business-competent segment of the [political] elite'), and their use of public policy, institutions and resources in operating the system. There is, however, great variation in the ways in which patronage functions. Several of the country studies (Nigeria, Pakistan, Philippines) note that informal relationships are often more powerful than the formal rules of the game.

24. In all the countries, corruption is noted as a feature of politics and often a major constraint on the business environment. In much of the wider business environment literature and analysis, **corruption** is defined as an unfortunate aberration in a unidimensional way. There is limited appreciation in the literature (but not in our case studies) that corruption is part of a broader system of patronage and rent management, which covers both legal and illegal practices, the boundaries of which are often ambiguous and vary between countries. (An overly simple approach leads to disappointment with the failure to tackle corruption quickly or effectively or, in some cases, to tackle it at all.) Several of the country studies (Brazil, Pakistan, South Africa, Vietnam) note growing public dissatisfaction and even anger with corruption; this may over time come to help to limit its extent and impact.

25. There is ambivalence about **informality in the economy**, that is the size of the informal sector, and the millions of people who inhabit that space. This relates predominantly to smallholder agriculture, small and medium size family enterprises, and precarious income sources. In many cases, commentators regard those people as 'trapped' in an insecure environment. But there is an alternative view that they are 'escapees' from a predatory state that seeks only to extract resources from them and imposes overly burdensome regulation to assist in that purpose. Informality is seen both as a cause and an effect of poverty. Both views are probably correct and the policy prescriptions need to reflect that[10].

26. **State owned enterprises** are prominent in all of the countries, often in privileged positions of oligopoly, and are relatively inefficient users of capital and providers of poor-quality services. They have multiple objectives placed on them, often related to social policy, but more often to political imperatives. They are 'captured' easily by politicians. They can squeeze out private operators and make the business environment toxic for investors. In most countries there is a reform agenda that has been pursued ineffectively over decades (for instance in Kenya, Nigeria, South Africa, Vietnam), although there are several examples of successful reform (for instance Pakistan's reform of telecommunications and banking, which have since become major employers, or South Africa's deregulation of state agricultural marketing boards) .

27. **Decentralisation** has often been pursued for primarily political purposes and according to the literature (and many of our countries experience) seldom seems to improve service delivery, although it may be a necessary element in managing complex and diverse societies. It tends to make the functioning of the business environment more complex

10 Dualism in the economy possibly reflects dualism in politics too, with different styles and approaches and models of political mobilisation in rural and urban areas and between ordinary people and the middle classes. The legal systems too are generally dualistic with a traditional system cohabitating the space with a modern formal sector.

and unpredictable, and means that significant resources are required to understand the diversity.

## Interests in and capacity for reform

28. **Understanding how change can happen** is vital in shaping any externally-supported programme that is intended to be designed and implemented in politically-astute ways. **Structural changes are at work** in all countries, including in some cases new socio-economic classes, rising living standards, urbanisation, literacy, a changing demographic, and so on. These changes can create new and durable interest groups capable over time of changing the 'rules of the game'. The historical perspective in the country studies give many examples: Pakistan's emerging middle class with an independent media sharing some of its values; the growing middle class in Kenya; Brazil's large-scale export-oriented enterprises.

29. In many instances **structural changes contribute both to political instability and to the creation of new and positive opportunities for investment** in financial and human capital that can enhance innovation and efficiency and can contribute to inclusive growth. However, in other cases these structural changes show few signs of improving the business environment, and indeed can entrench the concentration of political and economic power (sometimes in the same hands) which underpins the 'limited access orders' that serve to exclude large parts of the population from the benefits of growth.

30. In many cases where change is under way it is because of the emergence of **coalitions** with shared interests.

31. There are instances where damaging **macroeconomic policies** that impact on growth and investment are being addressed. Pakistan is finally making some progress with macroeconomic stabilisation, while regression can be seen elsewhere, in Nigeria and South Africa for instance.

32. There are also many instances of reforms, some of them sweeping, to the **regulatory environment**. The current Philippines president has a vigorous reform agenda (which may be crowded out by the attempt to reform the Constitution), while Peru has pursued reform with great energy. State-owned enterprises (SOEs), which in many countries are politically-convenient and therefore durable obstacles to efficiency and growth, have nevertheless in most of the countries reviewed been partly or wholly reformed (as in Turkey's telecoms and energy sectors).

33. **Weak technical and administrative capacity to reform the business environment is pervasive but the causes are complex**. They are intimately linked both to: (a) the extent to which there are influential interests intent on reform, as opposed to limiting themselves to rhetoric; and (b) past investments in institutional strengthening. Capacity is also related to the inherent complexity of particular reform areas: some macro-economic measures (such as exchange-rate policy) can be undertaken by small numbers of technocrats with political support; other changes, such as addressing weakness in the education system, require changes to the behaviour of tens of thousands of people, often within a dysfunctional public service.

34. The countries reviewed showed **a very large spread of reform capacities**. Brazil for instance appears in important respects to have world-class institutional strength to undertake reforms. In other cases, capacities are uneven within government, and sometimes available capacities are not used, either deliberately (as in South Africa where President Zuma has intentionally undermined institutions of accountability) or because of lack of interest. Sometimes the apparent capacity is, in fact, isomorphic mimicry[11] that is unlikely ever successfully to achieve the ostensible purpose (anti-corruption institutions often fall in this category: Nigeria has considerable experience of this). However, it is probably fair to conclude from the countries reviewed that where apparently desirable reforms have not happened, weak capacity is commonly a relatively minor explanation when set against the interests of influential players. Understanding the drivers of poor performance is critical before proposing support.

## Recommendations for development agencies

35. External actors, such as the international agencies, need to be aware of the changes under way (whether structural or more incremental) and **alert to opportunities to nudge** them in constructive directions, following the principle of **working with the grain of changes** which are already favoured by significant domestic constituencies. Opportunities to help bring about marked changes in structural factors do occur but they are few and far between, are unlikely to have quick payoffs, and will be hard to attribute to particular programmes, creating particular problems for assessing impact and demonstrating results.

36. **More commonly, change that development agencies can support will be modest, incremental and slow**. It should be contextualised within a frame that provides assurance that significant results are plausible in the medium and long term, usually well beyond the span of an individual programme.

37. There are major variations in the political economy contexts of the countries studied, which indicate that **change pathways and reform packages suited to one country will not be applicable in another**. It will be helpful to devise a 'theory of change' (a play book, or game plan) for interventions that is specifically tailored to the country context and maintains a line of sight between short term activities and medium term outcomes and long term impact. Monitoring should regularly revisit that logic. Plans need to 'go with the grain' of change. They also need to reflect the political electoral cycle and the options and constraints that this poses.

38. **Change cannot generally be driven by external actors** but development agencies can help **legitimise** actors and analyses, and can support the provision of **platforms for discourse**. Many agencies, including especially the World Bank, undertake excellent analysis and research, but this is no replacement for **domestic analyses and research**, and for **domestic discourse** that informs public policy. Business associations and representative organisations often have research capability that complements that of universities and think tanks.

11 According to Pritchett, Woolcock and Andrews of Harvard University, a common situation where the capability of the state is severely limited or improves very slowly, arising partly from mimicking global 'best practices' to signal intent to reform and good will (including to donors).

39. Programmes to improve the business environment **must reflect priority demands from governments** and other influential groups, although in the real world this creates sometimes insuperable obstacles where, as in some of the countries reviewed here, elite interests themselves are obstacles to taking the necessary measures. Examples of priorities include:

a. Governments are sometimes attracted by the international kudos that is generated by strong performance in **international indices** (eg Doing Business). This energy should be exploited as an entry point to frame and implement more substantive reform.

b. Some governments are attracted by membership of **international clubs**, including especially the OECD. Again this energy should be channelled in pursuit of substantive change.

c. **Productivity enhancement** is everywhere a concern and FDI can make a distinctive contribution if governments provide the right incentives. Supporting policy development in this area is a high priority, covering forward, backward and horizontal linkages and skills and technology transfer. The blockages to productivity growth, including those with their roots in interests at play, need to be investigated.

d. **Gender equality** in business is sought by most governments (but not all). However analysis on constraints is generally missing and programmes are underdeveloped.

e. Where governments are committed to poverty reduction, **understanding the performance of markets and services** that matter most to the poor, including labour markets, education and training, financial markets, land markets, and agricultural markets should be a high priority for analysis and research in-country[12].

f. In many cases government are aware of inefficient and ineffective **subnational policies and programmes,** and ineffective coordination, but complex politics is often in play and can militate against rapid or decisive reform.

g. Where political incentives to tackle problems are weak, providing support for in-country **data collection and analysis**, and for publishing this and promoting public discourse (at arm's length) can provide a foundation for change.

## Priorities for monitoring, evaluation and analysis

40. There are three reasons why programmes should invest in M&E:

- **Tracking the effectiveness of the programme** itself in improving the business climate in focus countries and creating opportunities for foreign investors for the purpose of accountability, learning and programme adaptation. In this case the agency is the principal user of the data.
- **Contributing to evidence gathering, analysis and debate in focus countries on business climate reform priorities**. In this case the users of the data are beneficiary country governments, investors in these countries and other national stakeholders.

12 The 'making markets work for the poor' approach to analysis and programming can provide a useful way forward in doing this.

- **Supporting international investors to make more informed investment decisions** based on a clear understanding of country risks and regulatory costs. In this case international investors (including UK investors) are the main user of the data.

41. There are **already a large number of available indices** on the business climate, including the World Bank's Annual Doing Business Survey, its Enterprise Surveys and Global Investment Competitiveness Report, as well as the World Economic Forum's Global Competitiveness Report and the Inclusive Growth and Development Report. In addition, the World Bank Group has developed a comprehensive Trade and Competitiveness Results Framework to cover its programmes (including the BEGP) working on business climate reforms.

42. There is not much value to be gained from developing new international comparative indicators. The priority for any new programme may be to **focus on synthesising existing information and presenting it in forms that are suited to the three purposes listed above**.

43. There is a need to develop **country specific monitoring frameworks** to complement internationally comparative indicators. As highlighted by the 11 case studies the political economy problems shaping the business climate are highly country-specific. This paper has recommended that development agencies should to work on developing country specific change strategies. To support these, it would be useful to define **country specific lists covering a small number of core indicators** that are relevant to tracking change in the key constraints targeted by the change strategies.

44. Development agencies can support change processes in the focus countries by **making available evidence on business climate constraints to inclusive growth and encouraging national processes of debate**. There therefore needs to be strategy to develop evidence in response to and in support of national sources of demand and reform constituencies. **Country specific monitoring and analytical frameworks should be developed in consultation** with national stakeholders, including government, private sector and investor organisations, research organisations and think tanks. **Strategies should be developed to promote the generation of evidence in national research and policy communities**.

45. With respect to **political economy analysis**, as far as we are aware, there is there is no regular analysis of the eleven countries. But we believe that the current analysis demonstrates that there are often opportunities for, and blockages to, business environment reform that can only be understood through understanding the PEA. It is therefore vital that programmes are able to monitor the political economy of the countries, and, especially after elections, map out where energy will be most effectively directed. Ideally such analysis would be undertaken as a collaborative exercise involving researchers in country.

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## About this policy brief and The Policy Practice

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