

Improving the Business Climate through Private Sector Collective Action

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INTRODUCTION

Fifteen years after the collapse of the Soviet Union and the beginning of what János Kornai has called “The Great Transformation,” it is clear that creating an attractive investment climate requires a fundamental restructuring of basic institutions.¹ Kornai notes that the relative gap in performance between the most successful and least successful reformers can be explained by the degree to which they tackled the transformation of both the political and economic systems. While Central European countries can now be considered fully successful, many of the countries in Central Asia are illustrative of the difficulties faced by transition economies in establishing sound investment climates. Even in those countries that have made substantial progress in recent years, such as Georgia and Ukraine, much remains to be done. In others, such as Russia, there are growing indications that a system of state capitalism may be substituted for the emerging market institutions.

Efforts to improve the business climate are closely linked to the establishment of democratic governance systems throughout the region. Countries that have successfully included the private sector in the decision-making process have also had more success in creating open economies. Without systems of accountability, efforts by the private sector to generate support for reform are less effective than they would be in countries with a more open political system. To be clear, private sector participation has to mean more than the selective inclusion of a few favored firms, rather, it has to mean the inclusion of the broad base of small- and medium-sized enterprises (SMEs) as well as the larger corporations.

It has become obvious to all, especially the international investor community, that economic reform and building market institutions is going to be a long-term effort and that much remains to be done. This essay will review some of the progress that has been made and identify areas in need of further reform by looking at the basic elements of the investment climate and how Georgia rates on various investment-climate indicators.

The overview of the investment climate is actually the first step in a process called Designing the Reform Agenda. The reason why this step is so crucial is that it is essential to gain a common perspective on the issues to be tackled. Too often, collective action becomes paralyzed

¹János Kornai, “Presidential Address,” delivered at the 14th World Congress of the International Economic Association in Marrakech, Morocco on August 29, 2005.

by deep disagreements between private actors, such as business associations and think tanks, on the priorities. Even when there is a consensus among private actors, it is vital to be armed with an objective analysis of the situation in order to define the terms of debate with national decision-makers, political leaders, and civil society. Finally, given the prominent roles played by the World Bank, the Millennium Challenge Corporation, and national donor agencies, any coalition for change must be credible and able to establish the facts on the ground.

Following a discussion on defining the investment climate, a seven-point system for designing a reform agenda will be presented. The plan includes (1) defining the initial conditions, (2) locating the key points of institutional change, (3) mobilizing for collective action, (4) generating specific reform proposals, (5) managing the expectations of results, (6) mounting an advocacy campaign, and (7) recognizing supporters. Several case studies will also be presented to demonstrate how this system of collective action can work in practice. The paper concludes with some general lessons learned through collective action reform programs around the world. A set of resources is presented in the appendix.

DEFINING THE INVESTMENT CLIMATE

The Center for International Private Enterprise (CIPE) has identified a number of lessons learned through work in Central and Eastern Europe, Russia, Ukraine, and other countries in the region. Most investors, especially international institutions, have come to realize that the centerpiece of economic reform has to be creating a strong institutional environment. Market institutions, democratic institutions, and institutions of accountability and transparency are essential to guaranteeing a sound investment climate.²

The text box below presents a list of the 12 major factors that most foreign direct investors evaluate when deciding whether or not to enter a particular market. The list was drawn up by the U.S. Chamber of Commerce based on surveys of multinational firms. However, experience has shown that the same factors will be used, to one degree or another, by major domestic investors and those interested in portfolio investment as well. As can be seen, decision-making on investment is more of an art than a science. A country like China can afford to score substantially lower on some ratings simply because of the size of its market. A smaller country, like Georgia, has to work much harder on the fundamentals in the areas of institutional reforms, macroeconomic stability, rule of law, and the like. Similarly, countries endowed with abundant natural resources such as oil or gas find that foreign investors will overlook key factors simply because there very few alternative sources of energy that they simply have to assume the risk in most cases. For most countries, however, it is vital to work on these key issue areas.

² Much of the insight from this comes from the field of the new institutional economics, pioneered by Ronald Coase and Douglass North. Their insights tended to be ignored in the 1990s in the rush to simply free prices and to hope that shock therapy would generate large-scale reforms. In fact, that did not occur in most cases. See the International Society for New Institutional Economics (www.ISNIE.org) for an introduction.

THE TWELVE FACTORS FOR RATING INTERNATIONAL INVESTMENT

The following factors are generally accepted as the principal criteria guiding a company's overseas investment decisions:

1. Internal Market — the size and potential for growth of another country's domestic market, especially the purchasing power of its customers are key. You don't invest in a market where you have little potential to make a profit.
2. Freedom of Access to the Market — the strength of the competition as well as the degree of government (theirs and ours) interference to entering a country's market. The freer the market, the more attractive it becomes as an investment opportunity.
3. Labor Force and Raw Materials — while the investor brings capital, technology and management to the table, the quality of the indigenous work force and the availability of in-country raw materials are also important ingredients in the recipe for success.
4. Protection from Currency Devaluation — simply stated, if you make an investment in dollars, and then the local assets (valued in the local currency) are devalued, you have lost part (or possibly all) of your original dollar-based investment.
5. Remittance of Dividends, Interest, Royalties and Technical Assistance Payments — if you can't get your money out of the country, then why invest?
6. Property Rights Protection — likelihood that a company's property, real or intangible (patents, copyrights, etc.), will be stolen.
7. Export Potential — ability to source from an operating unit in one market to serve nearby markets or maximize a company's global efficiency by trading among its various operating entities in different countries to round out its product lines.
8. Regulatory Burdens — the cost of government intervention on business (and profits) in a country.
9. Favorable Taxation and Tax Incentives — although tax incentives geared to attract initial investments are important, the final investment decision is usually based on how a country's taxation will affect the normal operating environment.
10. Low Political Risk — an investor's ability to rely upon the integrity of the host government and its ability to maintain local law and order is essential to any long-term investment.
11. Predictable Macroeconomic Management — confidence that the economy in which the investment takes place will be managed in a competent and predictable way. Simply stated, belief that the rules of the game will not change in the middle of a contest.
12. Reliable Infrastructure Support — the ability to consummate transactions and get products and services to market is critical. Whether it is reliable transportation services, power generation, insurance and accounting services, a competent financial system, or other basics, investments cannot yield reliable returns without them.

Source: U.S. Chamber of Commerce, Center for International Private Enterprise

Analyzing the Investment Climate

Taking the general principles behind the foreign investment factors described above as a starting point, a key first step is to define the quality and issues that make up a country's investment climate. Although the conference covers the region as a whole, since Georgia is the host country, it was chosen as an example for defining issues in the investment climate. If Russia had been chosen instead, for example, the analysis might have gone into more detail on rule of law issues and the stability of the regulatory system.

Between 1991 and 2001, Georgia was mired in slow growth for a number of reasons. First off, the transformation shock resulted in a large decline in output in GDP, almost 75 percent, one of the worst of any transition economy.³ The Russian ruble crisis of 1998 was another shock, not just to Georgia, but to the entire region given the trade and economic links. Although Georgia faced a host of challenges during the transition years, corruption came to be emblematic of the issues facing both international investors and Georgian businesspeople.⁴ The deep-seated, systemic nature of corruption in Georgia became one of the central issues in the 2003 presidential campaign. To its credit, the new government of Mikhail Saakashvili has made anti-corruption a key part of the economic reform program. A recent World Bank Report that lists Georgia as one of the leading anti-corruption reformers among the transition countries confirms that considerable progress has been achieved.⁵ While significant gains have been made, much remains to be done. In fact, in 2005, Transparency International, while noting significant progress, still gave Georgia a ranking of 130 out of 158 in its corruption perception index.

In a similar vein, Georgia is also seen as having one of the largest informal sectors in the region. The informal sector is made up of those firms working without legal licenses and avoiding taxes, usually due to high barriers to entry. In 2000, some estimates indicated that the informal sector may have constituted up to 67.3 percent of Georgia's economy. Others reported the more modest figure of 50 percent of the entrepreneurial economy.⁶ Whichever estimate one wishes to accept, this is simply much too high for a country to sustain. That level of informality is in itself *prima facie* evidence of the lack of an institutional structure underpinning a market economy. Efforts to deregulate the business climate and encourage the entry of informal firms into the market system have to be given the highest priority.

³ International Monetary Fund, Staff Report for the 2006 Article IV Consultation. March 17, 2006.

⁴ In 2003, Transparency International's Corruption Perception Index ranked Georgia 124th out of 133 rankings. Georgia tied with Angola, Azerbaijan, Cameroon, and Tajikistan. www.transparency.org. However, by 2005 the ranking had improved considerably.

⁵ World Bank, "Anti-Corruption in Transition #3, Who is Succeeding... And Why," World Bank: 2006

⁶ Friedrich Schneider, "Size and Measurement of the Informal Economy in 110 Countries Around the World, 2002" posted on the World Bank's "Doing Business" web site at:

http://rru.worldbank.org/Documents/PapersLinks/informal_economy.pdf. A joint OECD-Russian State Statistical Committee on Measurement of the Non-Observed Economy held in Moscow in October, 2000 reported more modest figures of 27 percent in total output and 50 percent in output of the entrepreneurial sector. Accessed on the OECD web site at: <http://www.oecd.org/dataoecd/40/24/2069583.pdf#search=percent22Georgiapercent20Informalpercent20Economypercent20OECDpercent22>

Regulatory Burden and Corruption

As noted, there has been significant improvement in corruption levels in recent years. This is particularly true as a result of the reforms that were put into place on the demand side of corruption by the current government. High-ranking government officials were forced to resign, were punished, and in many cases, were forced to provide restitution to the government. While nearly everyone acknowledges that progress has been made (see the recent World Bank Report, “Anti-Corruption in Transition #3”), there are numerous critics who question the methods used. Transparency International recently published a fairly lengthy critique that cites reports from the Georgian Young Lawyers Association and others stating that the lack of transparency in settling cases out of court raises fundamental questions about the issues of rule of law and due process.⁷ Simply put, some of these payments may have been made by guilty parties to avoid prosecution; others may have been simply forced to make payments to avoid the threat of prosecution. More reforms are clearly needed in this area.

Moreover, many of the reforms that were put into effect to reduce corruption benefited mainly the larger firms. It is still not clear that the informal sector has experienced any significant reduction in size. Transaction costs are still very high for small- and medium-sized enterprises. Despite the 2005 law on business registration, which mandates a dramatic reduction in the number of types of firms required to obtain business licenses from 900 to around 150, there is still fairly strong evidence from recent surveys by the World Bank that transaction costs for SMEs constitute a significant burden. The following chart from the World Bank’s “Investment Climate Survey” provides an overview of the inter-linked issues of over-regulation and corruption.

	Georgia	Small (1-49 Employees)	Medium (50-249 Employees)	Large (250+ Employees)	Europe and Central Asia	Lower Middle Income
Regulatory Burden and Corruption Indicators						
% of Firms Identifying Corruption as Major Constraint	19.6	20.3	20.5	11.5	17.1	34.9
Unofficial Payments to Get Things Done (% of Sales)	0.5	0.5	0.3	0.4	1.0	2.5
% of Firms Expected to Give Gifts in Meetings with Tax Inspectors	14.6	13.8	16.7	16.7	22.0	23.1
% of Firms Expected to Give Gifts to Obtain Operating Licenses	7.4	8.1	8.0	0.0	13.6	22.3
% of Firms Expected to Give Gifts to Obtain Import Licenses	10.0	10.3	12.5	0.0	11.5	16.0
% Senior Management Time Dealing with Government Regulations	4.6	3.6	6.7	8.5	5.6	8.3
Time Spent in Tax Inspection Meetings (Days/Year)	7.1	6.9	7.3	7.8	2.8	3.8

Source: Investment Climate Survey, Georgia 2005, World Bank www.Enterprisesurveys.org.

⁷ Transparency International, “Global Corruption Report 2006,” Country Chapter on Georgia, pp. 160-164.

This is evidenced by the fact that output as measured by GDP, while higher than in recent years, is still below 1989 levels. Progress has been made in areas like privatization, infrastructure development, and as mentioned, combating corruption. The administration of the tax code has also improved dramatically, with the number of business taxes being dramatically reduced from 22 to eight.

However, challenges still abound throughout the economy. The regulatory burdens mentioned earlier are still a problem. Even though substantial progress has been made, Georgia must continue to improve in order to maintain a level playing field with other reforming economies, not to mention the rapidly growing economies of countries such as Ireland.

The World Bank has conducted a survey measuring the ease of doing business around the world for several years. The scores provide a way of comparing how Georgia's business climate compares to the business climates of other countries. The chart below provides a summary of two of the doing business measurements: starting a business and enforcing contracts. To provide an example of what a small open economy can achieve when it reforms its system, Ireland is included as a relative benchmark. Ireland is a country that, until the economic reforms of the 1980s and 1990s, was widely regarded as one of the sick men of Europe. As a result of the relative advantages in business costs that are shown in the following chart, Ireland is, for the first time, attracting the Irish Diaspora to return. Creating a transparent, simple, and easy regulatory process has benefited Ireland dramatically.⁸

THE COST OF DOING BUSINESS

	Georgia	Ireland	World Average
Starting a business			
Procedures	8	4	6
Time (days)	21	24	22.5
Cost*	13.7%	5.3%	9.5%
Minimum Capital*	46.8%	0	23.4%
Enforcing Contracts			
Procedures	18	16	17
Time (days)	375	217	296
Cost (percent of debt)	31.7%	21.1%	26.4%

* = Percent of Per Capita Income Source: World Bank, Doing Business, 20006, www.doingbusiness.org

For Georgia to sustain its recent seven percent growth rate, it will have to make significant progress toward reaching Ireland's scores. Small open economies cannot afford to maintain high regulatory barriers, social protection, and other measures that OECD countries perhaps can.

⁸ For a summary of the Irish reform programs, see (former) Prime Minister Garret FitzGerald's presentation to a USAID-CIPE conference on economic reform held in Budapest in 2002, available at: <http://www.cipe.org/programs/roundtables/budaconf/fitztor.php>

This is also reflected in the World Bank's "Business Environment and Enterprise Performance Survey." While it indicates that Georgia has made major progress, there are still significant issues to be addressed. Tax administration was cited in 2002 as a significant problem by 84 percent of entrepreneurs answering the survey. That number declined to 23 percent in 2005. Similarly with corruption – 66 percent of entrepreneurs answering the survey reported corruption to be a very significant problem in 2002. That declined to 39 percent in 2005. Less progress is reported in licensing, permits, and the customs regime.⁹

Corporate governance is another area where Georgia has the opportunity to implement strong reforms that will attract investors. The European Bank for Reconstruction and Development (EBRD), in its work in Georgia, has highlighted corporate governance, for the private sector, non-listed companies, and listed companies, as well as the remaining companies that stayed in the public sector, as an area where Georgia can gain a large windfall. If one is seeking to attract investors, evidence is mounting throughout the world that creating a strong, transparent, and fully enforceable corporate governance system can be a mechanism for a small open economy, like Georgia, to signal its commitment to reform.¹⁰ Further, corporate governance is an area where the private sector has a strong incentive to take aggressive action. Experience in Egypt, Colombia, Romania, and other countries has shown that private sector coalitions can take a very positive position in establishing corporate governance codes and legal reform, thereby ensuring that the reform process is market driven.¹¹

It has to be acknowledged that few firms are currently listed on the Georgia Stock Exchange (<http://www.gse.ge>) and share trading is quite limited. Nevertheless, there is a substantial degree of minority shareholding in non-listed companies and a considerable amount of funds invested by foreign companies in Georgian firms. At present, the EBRD reports that the primary ways that minority shareholders gain protection is by "asking courts to appoint an independent auditor and/or calling for a general shareholders' meeting to question company management..." – neither of which are deemed particularly effective.¹² While improving the corporate governance system in emerging markets with weak rule of law is difficult, it is possible to strengthen the capital markets authorities, introduce systems of binding arbitration, require all state-owned firms to corporatize and become fully transparent, and generally strengthen the legal rights of minority shareholders.

Private actors, such as think tanks, business associations, private banks, and shareholders' associations have frequently joined together in coalitions to drive the corporate governance reform process at three levels. At the national level, coalitions in Colombia, Romania, Peru, the Philippines, and Egypt have pressed for changes in the capital market authority to spearhead the

⁹EBRD-World Bank Business Environment and Enterprise Performance Survey (BEEPS), Feb. 2006 available online at

<http://siteresources.worldbank.org/INTECAREGTOPANTCOR/Resources/BAAGREV20060208Georgia.pdf>.

¹⁰ European Bank for Reconstruction and Development, "Law in Transition – 2006: Strengthening Corporate Practices," EBRD, 2006 available at <http://www.ebrd.com/pubs/legal/6716.pdf>.

¹¹ For an overview of Corporate Governance reform programs go to http://www.cipe.org/programs/corp_gov/index.php.

¹² EBRD, "Law in Transition 2006," European Bank for Reconstruction and Development, 2006, p.43. Available at www.ebrd.com/law.

development of the legal framework for corporate governance. At the company level, institutes of directors and investor protection associations have begun demanding voluntary compliance with the OECD corporate governance principles and the development of corporate governance codes. Finally, a number of associations whose members comprise mainly family owned companies have implemented education and training programs designed to improve the ability of such firms to attract capital (debt or equity), improve performance, and help ensure an orderly succession to the next generation. The lesson to be learned here is that if the private sector waits for the international community and/or the national government to lead the improvements in the corporate governance system, the private sector is likely to be very displeased with the outcome. In countries such as Egypt, Brazil, Romania, and others where private sector collective action led the way, they were able to define the terms of the debate and build market-enhancing corporate governance cultures

Although it is vitally important to analyze the investment climate using indicators such as those presented above, a note of caution in interpreting their meaning is warranted. In Russia, a “reality gap” presented itself during the reform process. The gap occurs when the law on paper at the national level is not what is practiced in day-to-day transactions. It is essential to verify that the national law actually is being implemented throughout the entire country, not followed by only the very large firms in the capital city.

The Center for Economic and Financial Research (CEFIR) in Moscow has been carrying out a program since 2002 to measure the barriers actually faced by firms on the ground.¹³ It has consistently reported a gap between what the law stipulates and what entrepreneurs actually experience when attempting to deal with governmental agencies. The chart below is from CEFIR’s original survey.

The Reality Gap in Russia

Activity	Legal Mandate	Reality (average/mean)
Registering a Business	5 Days	26-29 Days
Registration Cost	2,000 Rubles	4,692 Rubles
Number of offices required to visit	One	Three
Licensing Costs	Not to exceed 1,000 Rubles	16,600 Rubles

Source: CEFIR and World Bank Survey 2002

As can be seen, the old Russian proverb “trust but verify” continues to be applicable. The difference between the law on the books and the law in day-to-day life can be the difference

¹³ Center for Economic and Financial Research, “Monitoring the Administrative Barriers to Small Business Development in Russia, 2002-2005 at <http://www.cefir.ru/index.php?l=eng&id=32>.

between successful reforms and a façade of progress. For this reason, it is vital to ensure that the analysis of the investment climate found through an examination of the law actually represents day-to-day life.

The reality gap developed soon after Georgia's independence, notably with the passage of the Administrative Code in 1999. A very carefully constructed international best practice code was written with the assistance of international experts based on international best practices. The significance of the code was that it provided a framework by which businesses, NGOs, and citizens could gain access to information and hold government officials accountable for their performance. However, the Partnership for Social Initiative (PSI), a Georgian think tank, found that the code was not actually implemented in many cases. This was a result of a lack of training, a lack of citizens' and entrepreneurs' knowledge of their rights, and a sense that no one would be held accountable. PSI undertook a program to mobilize business associations to educate their members and begin to demand implementation of the code's provisions. PSI even went to court in some cases to force government agencies to honor the freedom of information provisions.¹⁴ Some of the programs described below in Russia and other countries are working on the same issue of implementation and enforcement.

Overall, efforts to analyze and define the quality of the investment climate have to be seen as a blend of science and art. Measurements, like those quoted from the World Bank's "Doing Business" database or analysis of perception data such as that drawn from the various business surveys, can provide a baseline from which to work. However, it is vital to look at the business climate from the point of view of investors: international foreign direct investors, local entrepreneurs, and other investors such as private equity or sources of debt capital. Balancing the pros and cons in the investment climate can be a challenge but it is essential to understand what the needs of firms are in order to create the conditions for investment and growth. Finally, publicizing this information to decision makers, opinion leaders, political leaders, and the business community is an essential first step in building the political will for reform.

BUILDING A REFORM PROCESS

Identifying the initial conditions, as has been done through the various measures outlined above, is simply the first step. It is a necessary step because achieving consensus on reform issues is essential to mobilizing supporters and defining the terms of debate. CIPE has identified six key steps in designing a reform program. The first step, identifying the initial conditions, was described above. In addition, publicizing those initial conditions through media; town hall meetings; and other activities carried out by private sector associations, think tanks, universities, and government agencies, is also a key step in building and sustaining public interest.

¹⁴ For more information see Elena Suhir, "Building Partnerships in the Republic of Georgia: Tracking the Administrative Code," October 2002, at <http://www.cipe.org/pdf/publications/fs/PSI.pdf>.

Steps in Building a Reform Agenda

1. Identify the initial conditions – what are the most important barriers to market entry and what are the true costs of doing business? Publicize these findings in both the financial and popular press.
2. Locate the key points of change – what are the institutional reforms that will generate a private sector supply response? Demonstrate the benefits to business, to the economy, and to society as a whole.
3. Mobilize business associations, think tanks, and other civil society organizations to join in a collective action program to advocate for institutional reforms.
4. Generate specific policy recommendations such as reductions in entry barriers, reform of customs procedures, or simplification of tax administration. Be as specific as possible; general ideas such as “reduce tax rates” are rarely addressed.
5. Manage expectations by setting out achievable goals that can demonstrate to the business constituencies and to the public that reforms can be achieved.
6. Mount an aggressive advocacy campaign that effectively communicates complex ideas in simple and attractive ways to build the case for policy reforms.
7. Recognize the government officials, political leaders, and businesspeople who act upon the reform agenda.

Identifying key points of change

The second step in the reform process, identifying the key points of change, may be the most strategically important step. When there is a crisis, as in the early days of transition or in the midst of a financial meltdown, it is possible to take a holistic approach by targeting fundamental reforms and galvanizing support for these reforms. Shock therapy in the case of Poland is a familiar example. Another would be the comprehensive system overhaul undertaken by the well-known Estonian reformer Mart Laar. Estonia is an excellent example of a country that implemented fundamental reforms that transformed the system through a currency board, privatization, comprehensive tax reform, and, interestingly, supplying free internet to the entire population. Conversely, János Kornai’s recent work shows that sequential reforms in countries like Hungary had the same cumulative effect through a process of incrementalism.¹⁵ Lacking the clear and present effect of a crisis, reformers were not able to mount a holistic set of major reforms. Rather, a series of reform packages were put into place that created major changes and built the institutions of a market system.

¹⁵ János Kornai, “Presidential Address.”

Fundamental reforms can work in times of crisis because the choices are limited and the need for action is clear. Absent a crisis, the incentives and choices facing political leaders are very different. In these instances, it is important to identify institutional changes that are feasible and that will actually benefit entrepreneurs, workers, and citizens. Further, it is important to be able to show success in order to maintain credibility. Whether the issue is reducing corruption, simplifying the customs regime, or streamlining business licensing and procedures, the private sector and the general public has to believe that it is possible to spearhead reform, to generate change, and to have a positive effect. Success breeds success.

One way of identifying small changes that will produce systemic change is to determine the facts on the ground – the issues and barriers being experienced by the entrepreneurial sector. There are a number of useful techniques that can be used to identify barriers and to demonstrate their impact on businesses. One technique that has been used in a number of countries is known as the national business agenda (NBA). Building an NBA actually follows all of the steps outlined above. The crucial strategic step of locating the key points of change is accomplished through focus group meetings held with small representative groups of businesspeople throughout the country. CIPE has worked with groups in countries as diverse as Russia, Peru, and Egypt to carry out such programs.¹⁶

¹⁶ The “National Business Agenda Guidebook: The Voice of Business,” is a handbook on how to develop a business agenda and includes case studies. Go to: <http://www.cipe.org/publications/papers/index.php>

Key Features of Successful National Business Agendas

Several CIPE-funded projects have assisted various groups – businesses associations, coalitions of think tanks and associations, and other private sector organizations – to formulate policy positions, represent a unified voice before the government, and educate their members on policies that affect them by helping them develop a national business agenda. The key to any national business agenda is participation. For example, the Montenegro Business Alliance National Business Agenda for 2005 contained the following steps:

- Analyzing policies and forming recommendations;
- Meeting with members in open forums to discuss alternatives;
- Publishing in the media to gain input from concerned parties;
- Formulating policy reform programs;
- Publicizing the agenda; and
- Engaging in advocacy directed at the government, including the executive and the legislative branches.

These activities strengthen democracy by giving the private sector a greater role in shaping economic reform and commercial policies. In the next section, you will find examples of how business associations in different countries contributed to reducing barriers to formality and high business costs by developing national business agendas as a basis for advocating for market-oriented policy reform.

CIPE's National Business Agenda Handbook is available at www.cipe.org

Mobilizing for Collective Action

The third point, mobilizing business associations, think tanks, and other groups to advocate for institutional reform can differ markedly from country to country. In some countries, the principle business associations, often including the chamber of commerce, are under the direct or indirect control of the government. This can be the case when the national law on associations is modeled on the Continental European system of mandatory membership, resulting in a corporatist form of associations. In other cases, the control can be more indirect, such as when the associations are controlled by a handful of firms with close ties to government or even rent-seeking organizations. Such associations are often known as redistributive coalitions, whose major goal is to maintain the status-quo that favors their interests.¹⁷

However, it is possible in nearly every country to identify countervailing associations that represent the interests of smaller firms, firms with an interest in access to the international

¹⁷ Mancur Olsen described many of these issues in *The Logic of Collective Action: Public Goods and the Theory of Groups*, Harvard University Press, 1965.

system, and others who want to see a free-market economy develop. In addition, think tanks or public policy institutions have developed in many countries around the world that aim to develop democratic, market-oriented economies. How these organizations develop and the techniques that they use to advocate for change has become a major focus of new thinking in the multilateral development agencies, in the Organisation for Economic Co-operation and Development (OECD), and for organizations like CIPE.¹⁸ The most important criterion in putting together an effective coalition for reform is to ensure that all of the individual members demonstrate an understanding and a commitment to market economics and democratic practices.

Policy Recommendations

Generating specific policy recommendations is the fourth step. The focus group approach mentioned above, as well as a larger survey of the investment climate, can help identify the barriers and the issues. However, actually formulating specific reforms that can address these issues requires both creativity and some degree of expertise in policy analysis. The next section of the paper will present some case studies that will illustrate the types of specific reforms that tend to be most useful. One of the key points to recall in this step is to resist the temptation to simply say, for example, that the tax system needs to be *fundamentally reformed*. Policymakers, legislators, the media, and others need to know what specific reforms are most important. Is it a reduction in the level of taxes, a simplification of the tax payment system, or the outright elimination of some portion of the types of taxes? The beauty of the flat tax, which was part of the reforms used by Mart Laar in Estonia, is that it is simple to explain, easy to administer, and generates the necessary revenues. The challenge is that it is difficult to mobilize sufficient support, absent a crisis, to overcome the resistance to such a major change. In cases where a crisis is occurring or a political leader is willing to undertake such a major reform, the flat tax is clearly an excellent choice. In other cases, it might be better to attempt a simplification of the administration or reductions in the numbers of taxes.

Managing Expectations

Managing expectations is also a key part of the reform process as shown in step number five. The key point to recall here is that holding the coalition of associations, think tanks, and others together requires a sense of momentum. People need to feel that their efforts are having an effect and that further progress is possible. Certainly, the most committed members will be willing to persevere over a long stretch of time. However, gaining enough support to be effective in the public policy arena also requires that all actors involve gain a sense of accomplishment. In times of normal politics (absent a crisis or change of system), setting some specific but important goals for reforms helps maintain this momentum. It is also important to manage the expectations of the coalition members and the general public by promising progress but being realistic about what it will take to accomplish the coalition's goals.

¹⁸ For a collection of essays on the rise and effectiveness of think tanks see James G. McGann and R. Kent Weaver (eds), *Think Tanks And Civil Society*, Transaction Publishers, New Brunswick, 2000.

The Advocacy Campaign

Designing and launching the advocacy campaign is also a blend of art and science. It is vital that each of the policy reforms are well-researched and fully developed to be able to demonstrate to the policy makers, the technocrats, and the international community that the reforms are viable and in the best interest of the country. In some cases, this may involve some sophisticated economic research and analysis. In other cases, the issue may be so clear cut that research is not entirely necessary, but the analysis and presentation still must be completed and made available to the public. However – and this is absolutely vital – the actual advocacy campaign has to take these analytical materials and transform them into simple public policy messages that take into account the practical politics of decision-making. In those countries in the process of building a democratic system, this is obviously easier since access to the media and to the political process is more or less open. However, even in many authoritarian regimes, substantial progress in advocacy is possible, albeit much more difficult.¹⁹

Perhaps the most well-known example of a brilliant reformer who took very complicated institutional and economic analysis and transformed it into a simple and powerful public policy message is Hernando de Soto. De Soto's think tank, the Institute for Liberty and Democracy asked a powerful question about Peru. The question was, "why do average Peruvians succeed in developed countries but cannot succeed in Peru?" As de Soto himself attests, he put down his books and opened his eyes by visiting the shanty towns and talking with street vendors, backyard manufacturers, and others in the underground economy. What he found and documented brilliantly was a vast informal economy comprising some thirty to forty percent of the economic activity in the country. The analysis stage of this argument produced several brilliant books, including *The Other Path* and *The Mystery of Capital*. In addition, de Soto's communications strategy was to create a new awareness that informal entrepreneurs were blocked out of the system by a wall of red tape. He created the famous saying that it takes 289 days to legally register a small business in Peru. That one sentence galvanized a coalition and created a process of change. Interestingly enough, the World Bank's "Doing Business" indicators cited earlier are based on de Soto's early work.

Recognition

It is also vital to recognize those who assist the campaign by actually implementing the policy reforms as noted in step 7. While this may seem obvious, it is often forgotten that politicians, government officials, the media, and others need public acknowledgement of the role they played. In both new and established democracies, the incentives for policymakers to advance reforms are to garner votes, funding, and publicity.

¹⁹ Hernando de Soto, *The Other Path*, Harper and Rowe, 1989 and *The Mystery of Capital*, Basic Books, 2000. For an interview with de Soto on "The Economic Answer to Terrorism," see CIPE's *Overseas Report*, Fall 2002, at: http://www.cipe.org/publications/overseas/pdf/CIPE_HDSinterview.pdf

CASE STUDIES ON BUILDING REFORMS

Russia

One of the larger coalition-based advocacy campaigns to generate reform taking place now in Russia. The program is a partnership between the Russian Chamber of Commerce and Industry (RCCI), the Russian Union of Business Associations OPORA, and CIPE. The first step was to conduct a business community survey, which produced the following results: high administrative barriers to doing business, widespread corruption, complicated tax codes, poor protection of property rights, limited access to information, and a poor perception of business, meaning that the general public held a very low opinion of entrepreneurs and the business community in general.²⁰

The first major decision that had to be made in constructing the program was where to identify the key points of change (step 2). After much deliberation, the choice was made to focus first on the administrative regions of Russia and, only much later, return to the national level. This decision was made for two reasons. First, the analysis of the reality gap described earlier demonstrated that a key issue was that national law was not being implemented by local administrations. Therefore, it was determined that creating grassroots coalitions at the local level could create a demand for implementation (political will) that could then force reform to be implemented throughout the country. The second reason was that the national executive authorities in the years 2002-2005 had been preoccupied with other issues. The coalition partners felt that the best strategy would be to generate successes in the regions and then bring that evidence back to the national level as proof that further changes were needed at the national level. As show below, that approach has paid off.

The approach that was taken to generate a reform program was to first identify potential partners in the different cities and regions of Russia. The next step was to carry out training programs for them to build strategic plans and the advocacy skills needed to mount campaigns at the city level that would promote economic reform. Coalitions were formed that included think tanks, business associations, and like-minded civil society organizations interested in creating a better business climate. Based on the focus groups and the work that was done, regional business agendas were laid out for eight different regions of Russia. These business agendas identified very specific barriers and proposed very specific reforms to deal with those barriers. CIPE, as well as the Russian Chamber, provided technical assistance to these associations to sustain their advocacy campaigns.

The results that were attained are examples of the cumulative power of collective action. In terms of administrative barriers, in the Krasnodar region, for example, the governor signed a single-window decree simplifying land transactions. Although the number of required documents remained at 20, the time for reviewing the documents was reduced from a period of six to 24 months to a period of two to six months. The mayor of Khabarovsk signed a similar decree on November 30, 2003, introducing a single-window procedure for small-business

²⁰ The material is based on a case study, "Strengthening Local Democracy in Russia: the Case for Business Associations," February 2006 at <http://www.cipe.org/publications/papers/pdf/IP0505.pdf>.

registration. This decree reduced the time for registration procedures from 30 to between seven and 15 days. The Primorsk Coalition reduced the number of documents required to register a business from seven to one and the time to register from 40 days to seven. Similar kinds of reforms were put into place in the area of inspections, information, property and leasing, finance, taxes, and capacity and services.

The impact of this was a 45 percent growth in coalition membership during the project period. As each reform policy was implemented, others could see that it was having a positive effect and joined the reform effort. Policy changes in administrative barriers, taxation, microcredit, protection of entrepreneurs' rights, and rental costs all sustained strong reform programs across the regions.

The recommendations were incorporated into a federal law signed by President Putin on the SME taxation systems, which reduced the list of business activities that require licensing from 125 to 103, extended protection of property rights, gave entrepreneurs' rights to challenge inspections by state licensing bodies, and guaranteed protection to SMEs in state contracting competitions. As a result, there was a new willingness to engage in dialogue, which is a fundamental component of the democratic process. There was also a growing recognition and acceptance that the business community has a constructive role to play in the policymaking process, and that business is a legitimate segment of society, worthy of protection and promotion.

One of the lasting impacts that CIPE hopes to be able to generate in the program in Russia is by training, building organizational capacity, and making information widely available. Coalitions that have been formed have begun to contribute to the process in which businesspeople synthesize resources and experiences for the common good. They begin to act as catalysts for change.

Ukraine

A similar program has been carried out in Ukraine over the last two years. Again, the first step was to identify the barriers by conducting surveys of entrepreneurs and associations. One barrier identified was that only five percent of businesses had formally signed rent contracts from the local governments. Bureaucratic corruption was also extremely high in Ukraine, as in many of transition economies. Other issues raised by entrepreneurs included unclear land ownership rules; poor access to information; few mechanisms to include the private sector in decision-making; and a business community with little capacity to articulate, support, and advocate for reform.²¹

Two regions with especially active business communities were selected for a pilot project. The Institute for Competitive Society (ICS), which is a think tank, and its coalition of business associations developed a model to understand the ability of local governments to

²¹ CIPE, the Ukrainian Center for Independent Political Research, and the Institute for Competitive Society, "The Business Climate in Ukraine: The Current Climate and Expectation," November 2005 found at: http://www.cipe.org/regional/eurasia/pdf/BA_survey_eng.pdf.

implement selected aspect of new legislation. Business-only roundtables, working groups, focus groups, and in-depth interviews with public and private sector representatives were held to assess the problem of access to information and other barriers. Public hearings were held on key agenda issues, and a "Your Right to Know" brochure was printed. Informational network nationwide campaigns raised public awareness with newsletters, policy briefs, informational pamphlets, brochures, and wide media coverage.

Through this process, the issues to address in a national business agenda were identified. The results were ratified in other regions of Ukraine. The resulting agenda includes a number of key provisions that reflect a broad consensus of the Ukrainian business community, including:

- Protection of property rights, registration of property, judicial protection of property, and countering the state's excessive influence.
- Improvement of relations between business and the government by devising a procedure that allows the public to challenge illegal actions of state authorities. Obligate civil servants and local authorities to provide public justification of their decisions.
- Improvement of the investment climate, simplifying tax procedures, reducing excessive tax rates for large firms and foreign investors, and improving the stability of Ukrainian legislation.
- Support of small business development and preserving the simplified tax and reporting systems for small business.

The impacts generated by the advocacy program were also carefully documented. During the course of the project, the grassroots advocacy contributed to the passage of a number of significant laws and mechanisms, including:

- *Law on principles of state regulatory process in the sphere of business activities, passed by the parliament in July 2003 and signed by the president in September 2003.* This law requires the executive and legislative branches of the government to establish a set period for public review and comment on all draft bills and regulations. In addition, the government is now required to provide a cost-benefit analysis of changes.
- *Law on state registration of legal entities and physical entities, passed in May 2003.* This law creates a new position, the state registration officer, which now exists in every regional administration. The registration officers handle the entire business registration process, thus creating a single-window system. This law significantly simplifies the registration process for entrepreneurs, who previously were required to go to five different government offices in order to complete their business registration.
- *Law on simplified system of taxation, accounting, and reporting of subjects of small enterprise as part of the 2004 national budget.* The Institute for Competitive Society and the Ukrainian Center for Independent Political Research launched a successful campaign to remove the amendment that would have abolished the simplified tax system.

Some of the lasting changes in the political culture that are considered a result of these accomplishments have increased the level of public-private dialogue, increased private sector involvement in policymaking throughout the country, strengthened the business community's capacity to articulate its needs and participate in the reform process, and encouraged the implementation of policy changes advocated in the national business agenda.

CONCLUSION – DEMOCRATIC GOVERNANCE

One theme that runs throughout the case studies and the earlier explanation of the steps in designing a reform agenda is the issue of democratic governance. In countries where the basic decision-making processes are open, transparent, and participatory, it is far easier to advance fundamental institutional reforms. This is equally true of the legislative process as it is of the regulatory process and other executive branch decision-making systems. For example, CIPE worked in Hungary with a coalition of think tanks, business associations, academic experts, and financial media over a seven-year period in the 1990s. For most of that time, it was impossible to gain access to draft legislation. This was true both while it was being composed by the executive branch officials, as is common in parliamentary systems, and after it had been submitted to parliament. The legislation only became available to the public after it had been passed.

In response to this situation, CIPE and its partners became experts at holding public conferences, roundtables, discussion forums, and other types of briefings. At each event, the government officials responsible for drafting the proposed legislation or policy document were invited to discuss the issue and present the government's rationale. The advocacy coalition was then able to respond to the issues, address alternative points of view, and follow up with media campaigns and other advocacy activities to have an impact on the decision-making process.²²

All too often, the process of building systems of democratic decision-making is neglected in the quest to improve the investment climate or the effort to build democratic systems. The economic reform advocates tend to focus narrowly on the institutions of a market economy, on macroeconomic performance, and the business climate. Conversely, those working to build democratic institutions tend to focus on election processes and institutions, political and civil liberties, freedom of the press, and the overall values of the democratic culture.

Thus, the day-to-day process of governance is treated as an afterthought. Often, it is assumed that in a democratic system (defined by free and fair elections), governance will automatically become democratic governance. Others conflate the quest for good governance, defined as a set of outputs, with the fairness of the decision-making process. Singapore's famous and quite effective former leader Lee Kuan Yew was a proponent of good governance. However, no one would have considered it to be democratic governance.

²² For a full description see the independent evaluation prepared by Dr. Paul Marer, "CIPE's Contributions to Strengthening Private Enterprise and Building Democracy in Hungary, 1989-1999," July 1999, available at http://www.cipe.org/programs/evaluations/pdf/hungary_evaluation.pdf.

The following is a working definition of democratic governance that may address the democracy deficit defined above.²³ Democratic governance comprises the traditions, institutions, and processes that determine how government decisions are made on a daily basis, and addresses the following questions:

- How and to what extent are citizens given a voice (not simply representation) in day-to-day policymaking?
- How efficiently are public resources and services managed?
- How are abuses of governmental power prevented?
- How are government officials held accountable for their actions?
- How are grievances redressed?

The goal is to create feedback systems where government proposals can be vetted and issues anticipated. These same feedback systems can help governments realize when and why their policies are not working. (See the reality gap discussion above.) The text box showing the work carried out by Hernando de Soto and his Institute for Liberty and Democracy (ILD) gives a very comprehensive list of democratic decision-making reforms that have stood the test of time and illustrate democratic governance in action.

Major Legal Reforms Designed by the ILD

Reforming decision-making procedures

Bringing the people's voice into the law-making process has become an established political ideal in Peru after the ILD completed its first project, handing President Belande a draft for legislation, the goal of which was to keep lawmakers informed about the public's concerns and make them accountable by giving the people an opportunity to comment on the drafts of the laws as well as their effects.

Activating Peru's First Ombudsman

In 1984, the ILD mounted a campaign for an independent national "ombudsman" to represent the interests of citizens, no matter how poor they might be. The ILD's hard work of setting the ombudsman concept into motion turned out not to be in vain: Peru's Constitution of 1993 incorporated the Office of the Ombudsman as an autonomous entity.

Access to Public Information

Throughout the 1980s, the ILD continued to work toward making the Peruvian government more accountable to the people. Seven years later the proposed law was incorporated into the 1993 Constitution.

²³ From John D. Sullivan, Aleksandr Shkolnikov, and Catherine Kuchta-Helbling, "Democratic Governance: The Key to Political and Economic Reform," Economic Reform Issue Paper, CIPE, January 2004, found at: <http://www.cipe.org/publications/papers/index.php>.

Bringing Extralegal Property into the Legal System

The ILD launched a campaign to probe public opinion about what informal legal arrangements people actually had to secure and transfer their assets in the extralegal sector. The information gathered from these meetings allowed the ILD to draft the “Property Registry Law,” which was unanimously ratified by the Peruvian Parliament.

Administrative Simplification

To deal with the queues, paperwork, and excessive bureaucratic procedures that caused most Peruvians so much lost time, unnecessary expense, not to mention the general constraints on economic activity, the ILD created a draft of the law and an administrative strategy to streamline bureaucratic procedures and facilitate institutional reform. As a result, the ILD’s draft was unanimously approved in Congress by all political parties and became a law.

The Unified Business Registry

In September 1990, the ILD presented the president with a draft law aimed at reducing the time required to obtain a license to operate a business legally. The existence of the new government agency, established by the government, reduced red tape and costs dramatically: the nearly 300 days it took to obtain a business license were cut to one day, and the cost was slashed by seven times.

The Municipal Operating License

The ILD proposed in May 1990 to all of Peru’s municipalities a public ordinance for simplifying the granting of municipal operating licenses. Some ten municipalities adopted the ILD’s model ordinance and thereby cut the costs for obtaining municipal licenses for a business from \$690 to \$70 and reduced the bureaucratic gauntlet from two months to one day.

The System of Arbitration

To create a conflict resolution system that would be accessible to the poor, the ILD studied the limitations of the official legal system along with the relatively efficient extralegal mechanisms that the poor themselves used to resolve their disputes. The ILD’s draft of the law was included in General Arbitration Law No. 25935.

Like de Soto’s action plan, the national business agenda programs described earlier frequently lead to the development of new feedback systems and of greater participation in governance processes. The program on the Administrative Code run by PSI in Georgia is also an excellent example of an effort to reform and open up government – to add democracy to governance – in order to effectuate improvements in economic laws and regulations. Many of the individual coalition programs described above in Russia and Ukraine aimed to create new and more participatory decision-making systems. By democratizing the governance process, it is possible create a system where reform is an ongoing process, not a special program.

Whichever method one uses to create a program designed to reform the investment climate, ultimately success is based on a multitude of factors, not the least of which is the

commitment and creativity of those involved. The best conclusion may simply be to return to the theme of basic values. In order to prevail in the public policy process, it is a good idea to keep in mind four principles: intellectual excellence, integrity, public good, and leadership development.

Intellectual excellence means delving deep into a country's unique situation. It is not enough to be well-versed in academics; one must also understand the country and its culture to succeed. This involves asking a simple question: why are things the way they are? Far too often, we plunge ahead with an "international best practice" without stopping to ask, "why does this particular law or policy exist?" and "who benefits and who stands to gain from reform?" Only when these simple questions can be answered is it possible to begin thinking about what type and shape of institutional reform will be accepted and implemented. One of the many lessons learned and re-learned from Iraq, from the transition economies, from endless rounds of reforms in Latin America is simply: *if you don't ask why and don't talk with the people involved, there is not a chance that the reform will take hold.*

Integrity is often thought of as an ethical value synonymous with honesty, but it is much more. The integrity of a process, for example, is the degree to which it follows a set of procedures from start to finish and that the same procedures are used for every occasion. One often speaks of the integrity of the investment decision or the integrity of the legislative process. At the same time, integrity also means that the reform measure is completed and that it integrates into the other reforms being pursued.

Public good is easily understood, but reformers often overlook how essential it is in promoting institutional reforms. For a reform to be adopted and implemented, it must benefit the community as a whole. In the process of reform, there are winners and losers – this is inevitable. But on the whole, is the country better off after the reform is adopted? A major part of the advocacy campaign is to convince the stakeholders and decision-makers that this is the case.

Finally, leadership development is vital to sustaining all of these other values and to sustaining the reform program. Keeping the coalitions together requires a constant infusion of new leaders. First new leaders are needed to expand the reform program into every part of the country and second, new leaders are needed to pick up where the first generation left off. Passing on to others the skills needed to solve the collective action problem, the intellectual excellence needed to identify the reform agenda, and the sense of public good essential for reform to be embraced is essential to sustain the continuous improvements essential for life in the era of global competition.