

# Obstacles to Business Development

For businesses in Latin America and the Caribbean, credit is scarce and expensive, taxes and regulations can be excessive, and policies are often unstable. Despite noteworthy progress toward macroeconomic stabilization in the region, inflation also continues to have a negative impact on business. Compounding all of that in some countries are problems of crime and corruption, severe deficiencies in infrastructure, and other problems that hinder the development of businesses and limit productivity.

This chapter examines the results of world business environment surveys that point to a series of problems that can affect the operation and growth of companies. These surveys cover 73 countries from all the major regions of the world, including 20 Latin American and Caribbean countries surveyed in 1999 and 2000 by the World Bank in association with the Inter-American Development Bank. While the surveys make it possible to identify the concerns of existing companies, they naturally cannot tell us much about businesses that do not exist but that might emerge if conditions were different. Part of this bias can be corrected by taking into account differences in the composition of firms in each country. Another option is to seek evidence that the environment in which firms operate determines their characteristics and is likely to be reflected, for example, in the size of the largest companies, which presumably are located at the outer limit of possibilities offered by each country (see Chapter 3).

The central aim of the business environment surveys is to learn what business communities think about the quality of the macroeconomic and institutional environment in which their firms operate. The surveys cover a rather broad range of issues, including the main areas of government services that affect businesses (security, justice, roads, customs, mail), public or private infra-

structure (electric power, telecommunications), financial services, and the legal and regulatory framework (operating licenses, tax rules, labor legislation, regulation of competition, and business freedom).

This chapter focuses on two overall questions that make it possible to compare the seriousness of obstacles that can affect business: “Which of the following factors is the greatest obstacle to the growth and operation of your business?” and “On a scale of 1 to 4, how problematic are the following factors for the operation and growth of your company?” The first question will be used to detect the greatest obstacles to business development, and the second to analyze the severity of those obstacles for the average company in each country.

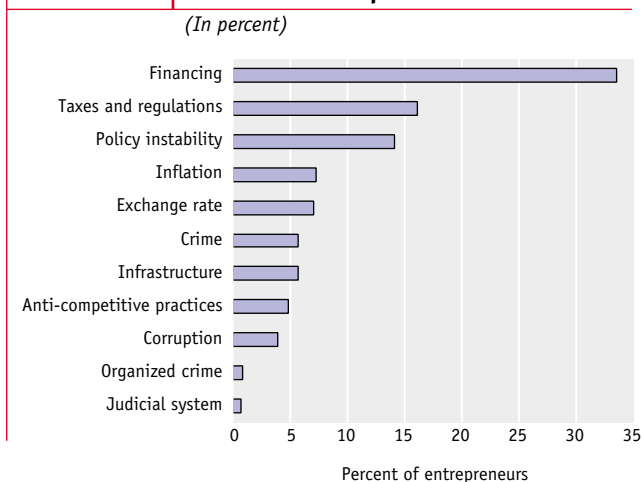
The surveys were applied to samples of at least 100 companies in most of the 73 countries.<sup>1</sup> Given the small size of the samples, the surveys are not representative of sectors, types of companies, or cities or regions within the countries. Rather, they reflect essentially the typical point of view of business people nationwide,<sup>2</sup> leaving aside the fact that the proportions of companies by size and sector vary between countries.<sup>3</sup>

<sup>1</sup> Only in smaller countries such as Belize are smaller samples of 50 companies used.

<sup>2</sup> Nevertheless, in order to compare results between countries, 15 percent of the samples were from small companies (between 5 and 50 workers), 60 percent from service sector companies, 15 percent from companies located outside the main cities, and a smaller number from companies with some state or foreign ownership. The results were adjusted to correct for possible biases resulting from these manipulations in constructing the samples. For that purpose, the ordered logit model was used. Details are found in Lora, Cortés and Herrera (2001).

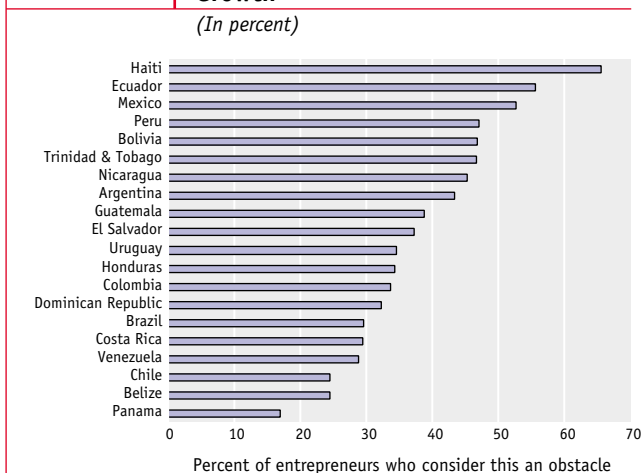
<sup>3</sup> Another option would have been to weight the opinions by the composition of companies by size and sector in each country, but doing so would require knowing what this composition was in reality (not in the sample).

**Figure 2.1 Major Obstacles to Latin American Business Development**



Source: World Business Environment Survey (WBES) and IDB calculations.

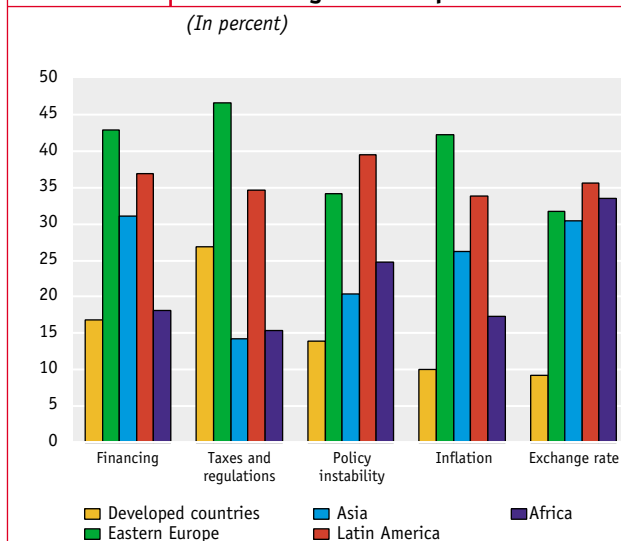
**Figure 2.2 Financing as an Obstacle to Business Growth**



Source: WBES and IDB calculations.

As the region’s business communities see it, the greatest obstacles to the operation and expansion of business in Latin America have to do with the financial and regulatory environments. One of three business people considers the most serious problem to be the lack of financing (Figure 2.1); next comes excessive taxes and regulations, mentioned by one of six business people. With slightly less frequency, business people point to policy instability, and, less frequently, to inflation and the exchange rate. There is also an awareness of problems of a social and institutional nature, such as crime, corruption and the ineffectiveness of the justice system. While these problems are rarely considered as prin-

**Figure 2.3 Severity of Obstacles to Business Growth: Regional Comparison**



Source: WBES and IDB calculations.

incipal obstacles to business development, they have an indirect influence through other constraints mentioned more often by business people. It must be noticed that the survey did not inquire about problems related to the availability or quality of the labor force.

Figures 2.2 to 2.8 show the *severity* of these problems in the major world regions and in individual Latin American countries. The results were likely influenced by the macroeconomic problems affecting many countries in Latin America when the surveys were taken in 1999. The region grew by 0.3 percent that year, and seven of 20 countries surveyed showed negative growth rates.

## Lack of Financing

According to the business communities of Latin America, the biggest obstacle to business development is lack of financing. Over half of those surveyed in Haiti, Ecuador and Mexico consider this to be a serious obstacle for their companies, and only in Panama, Belize and Chile is it regarded as a serious problem by less than 25 percent of business people (Figure 2.2). For the average of all Latin America, the problem seriously affects 38 percent of business people, a rate only surpassed by Eastern European countries as a group (42 percent) (Figure 2.3). As business communities see it, the severity of

Table 2.1 Latin American Business Characteristics Associated with the Severity of Obstacles to Development

|   | Financing | Taxes and regulations | Unstable policies | Inflation | Exchange rate |
|---|-----------|-----------------------|-------------------|-----------|---------------|
| <b>Sector (with respect to service sector)</b>                  |           |                       |                   |           |               |
| Manufacturing   | -         | -                     |                   |           |               |
| <b>Size (with respect to large firms)</b>                       |           |                       |                   |           |               |
| Small   | +         |                       |                   | +         | +             |
| Medium  | +         |                       |                   |           |               |
| <b>Location (with respect to main city)</b>                     |           |                       |                   |           |               |
| Medium-size city  |           | +                     | +                 | +         |               |
| Small city or rural   |           |                       |                   |           |               |
| <b>Legal organization</b>                                       |           |                       |                   |           |               |
| Single proprietorship   | -         |                       |                   | +         | +             |
| Partnership   |           |                       |                   |           |               |
| Cooperative   | +         |                       |                   |           |               |
| Corporation, privately held                                     | -         | -                     | -                 |           |               |
| Corporation, listed on a stock exchange                         |           |                       |                   |           |               |
| <b>Control of the firm</b>                                      |           |                       |                   |           |               |
| Individual owner(s)   |           |                       |                   |           |               |
| Family  | +         |                       |                   |           |               |
| Company groups (conglomerate)                                   |           |                       |                   |           |               |
| Bank  |           |                       |                   | +         | -             |
| Board of directors or supervisory board                         |           |                       | -                 |           |               |
| Managers  |           |                       |                   | +         | +             |
| Workers   |           |                       |                   |           |               |
| Government  | +         | -                     | -                 |           | -             |
| <b>How was the firm established?</b>                            |           |                       |                   |           |               |
| Private from the time of start-up                               |           |                       |                   |           |               |
| Privatization of a state-owned firm                             |           |                       | -                 |           |               |
| Private subsidiary of a formerly state-owned firm               |           |                       | -                 |           |               |
| Joint venture, domestic and foreign private owners              |           | -                     | -                 |           |               |
| <b>Age</b>  |           |                       |                   |           |               |
| Start-up year of the firm                                       | +         | -                     | -                 | -         | -             |
| <b>Other characteristics</b>                                    |           |                       |                   |           |               |
| Foreign company with a financial stake in ownership of the firm | -         | -                     |                   |           |               |
| Export firm   |           | -                     |                   | -         |               |
| Shareholders  |           |                       |                   | -         |               |

Note: Plus (minus) signs show whether each feature of the firm is directly (inversely) related in a statistically significant way to the severity of the obstacle. Source: IDB calculations.

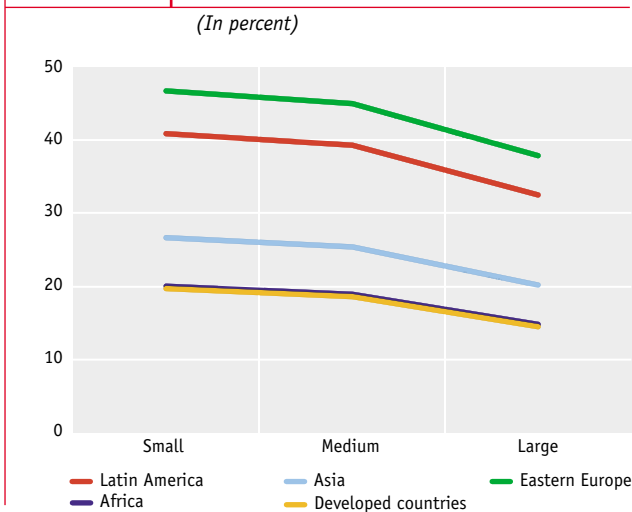
the financing problem is related to the more direct indicator of the availability of financing—that is, the ratio between the supply of credit available to the private sector through the entire financial system, and GDP. (The correlation between the two variables is 0.52.)<sup>4</sup>

Not surprisingly, in Latin America as in other regions, financing problems more severely affect smaller companies. Nevertheless, not even the largest companies can escape constraints to financing. Indeed, what is surprising is that the differences in the seriousness of the problem between countries and even between

regions of the world are much larger than differences between companies according to size within each country. Figure 2.3 shows that the average difference between Latin America and the developed countries in the proportion of business people who regard this problem as serious is 20 percentage points. By contrast,

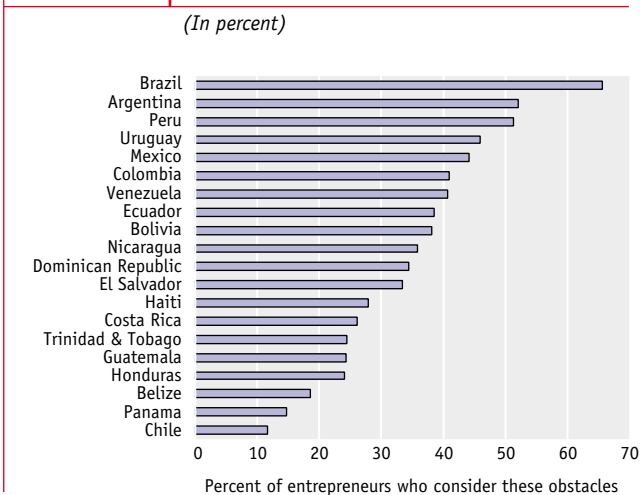
<sup>4</sup> Except otherwise indicated, the correlations between survey results and objective data presented in this chapter refer to the Latin American countries only.

**Figure 2.4** Financing as an Obstacle to Business Growth: Regional Comparison by Size of Firm



Source: WBES and IDB calculations.

**Figure 2.5** Taxes and Regulations as Obstacles to Business Growth



Source: WBES and IDB calculations.

Figure 2.4 shows that the difference between small and large companies in Latin America is only 6 percentage points. This suggests that especially in less financially developed countries, the policy emphasis should be placed on the macro and institutional factors that affect the financial sector as a whole, rather than on those variables that affect differential access to credit by companies depending on their size.

Of course, size is not the only characteristic of a company related to its difficulty in accessing credit. In

Latin America, companies in the manufacturing sector have better access to credit than companies in service sectors. Also having better access to credit are sole proprietorships or privately held companies not listed on the stock exchange, and those companies that have foreign investment. By contrast, companies organized as cooperatives face significantly greater problems, as do family firms, companies controlled by the government, and newer companies (Table 2.1).<sup>5</sup> These characteristics suggest the influence of legal factors that may impact the feasibility of providing easily recoverable guarantees to back up the loans, and possibly even of factors that affect costs of information and loan monitoring by creditors.

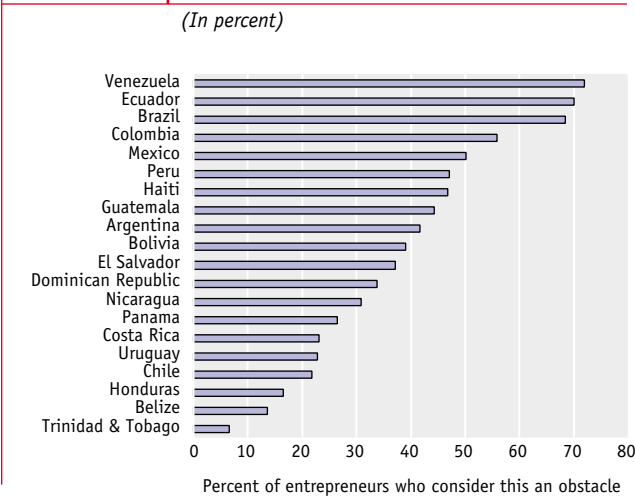
## Taxes and Regulations

The second greatest obstacle to the development of companies in Latin America is excessive taxes and regulations. Two of three Brazilian business people, and approximately half of those in Argentina and Peru, believe that excessive taxes and regulations hinder their companies' development. The countries least affected by this problem are Chile, Panama and Belize, where it is mentioned as serious by fewer than 20 percent of business people (Figure 2.5). The seriousness with which Latin American business communities regard the problem of taxes and regulations is relatively independent of other relevant indicators. The most adequate indicator for contrasting these opinions is the index of the quality of the regulatory framework prepared by Kaufmann, Kraay and Zoido-Lobaton (1999a and b), which considers the legal environment in which markets operate and the degree of government interference in economic decisions, calculated on the basis of various sources.<sup>6</sup> The correlation between this index and the average opinion of Latin American business people regarding taxes and regulations is only 0.07. Nor is there

<sup>5</sup> The characteristics of companies that are significant for at least 10 percent in regressions for Latin American countries as a whole are mentioned. For a more detailed explanation, see Lora, Cortés and Herrera (2001).

<sup>6</sup> The index uses an econometric method with non-observed components, making it possible to combine information from the different sources in order to obtain estimates of maximum consistency for a broad range of countries.

**Figure 2.6** Policy Instability as an Obstacle to Business Growth



Source: WBES and IDB calculations.

a significant correlation with a country's tax burden or with the highest tax brackets of companies (-0.096).

Only business communities in Eastern European countries single out tax and regulations problems more frequently than do those of Latin America. However, the problem is also very significant in developed countries, where 27 percent of business people regard it as serious. By contrast, there is less concern in Africa or Asia, where it is considered to be serious by fewer than 15 percent of business people. This pattern might lead one to expect that the more formal and larger the company, the more affected it would be by this problem, since regulations and oversight tend to impact larger firms. However, the companies most affected are generally those of medium size. The reason may be that large companies rely on scale to more easily absorb the fixed costs entailed in regulation, and use their channels of influence to tilt the rules and their application in their own favor.

Taxes and regulations also affect companies differently according to other characteristics. In Latin America, those suffering most from this problem are companies located in medium-sized cities, presumably because these firms have less access to decision-making centers. Taxes and regulations pose less of a problem for privately held companies (those not listed on the stock exchange), companies controlled by the government, those established as a result of mergers between private and foreign companies, those with foreign ownership or export companies, and those recently created (Table 2.1).

## Policy Instability

Venezuela, Ecuador, Brazil, Colombia and Mexico are most affected by policy uncertainty and instability. At least half of the business people in these countries believe that instability is a major problem. The countries where business communities enjoy a more stable and predictable policy environment are Trinidad and Tobago, Belize, Honduras, Chile, Uruguay, and Costa Rica. In these countries, fewer than 25 percent of the business people regard instability as a serious problem (Figure 2.6).

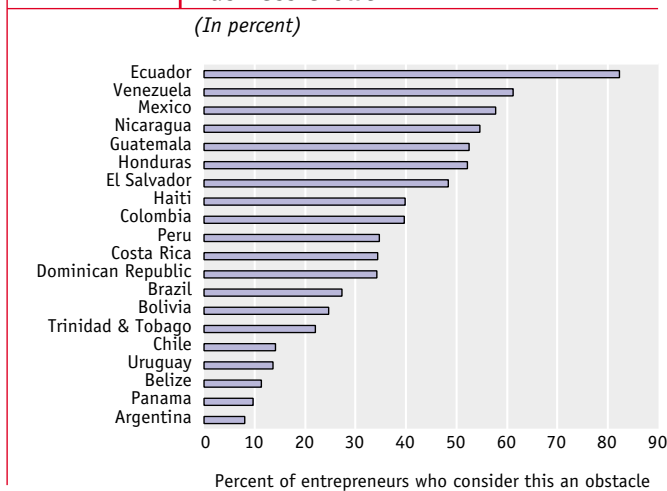
There is no objective measurement of policy stability that could be compared with the subjective opinions of business communities. However, there is an indicator of political instability, which is presumably correlated to *policy* instability (and is perhaps one of its main causes). This is the index that combines various sources of objective and expert information on the stability of the political environment.<sup>7</sup> This index exhibits a 0.48 correlation with the averages by country of the opinions of business people. By contrast, correlations are much lower between these opinions and a number of macroeconomic instability variables.<sup>8</sup> Hence, the opinions may reflect more conditions of instability of the policy environment than other factors of instability.

According to the survey results, Latin America is the region most affected by an unstable and unpredictable policy environment, surpassing even the countries in transition in Eastern Europe. Whereas in Latin America policy instability is regarded as a major problem by 38 percent of business people, in Africa that proportion is 25 percent, in Asia 20 percent, and in the developed countries only 14 percent (Figure 2.3).

Policy instability is a problem that can affect companies anywhere in the world with equal severity, regardless of size. In Latin America, the problem is less severe for privately held companies (not listed on the stock exchange), those managed by boards of directors or by the government, companies with prior ties to government ownership, and newer companies. The problem is more serious for companies located in medium-sized

<sup>7</sup> See Kaufmann, Kraay and Zoido-Lobatón (1999a and b).

<sup>8</sup> For example, the correlation with the volatility of growth in the last 10 years is small and negative (-0.12). With the volatility of inflation it is 0.26, and with the volatility of the exchange rate it is 0.24.

**Figure 2.7 Inflation as an Obstacle to Business Growth**

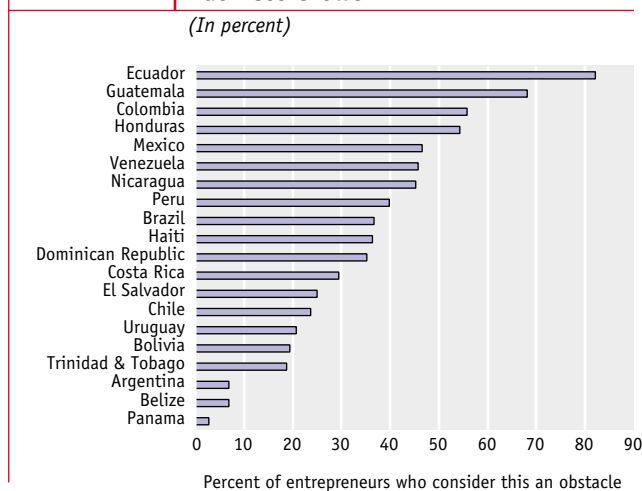
Source: WBES and IDB calculations.

cities. All these factors suggest that companies that have better sources of information and are closer to the sources of government decision making are better able to deal with policy changes.

## Inflation

Despite great advances by Latin America in controlling inflation, it remains a major problem for business development. Its importance is perceived as quite similar (and much connected) to the problem of the exchange rate. In Ecuador, inflation is mentioned as a serious problem by 8 of 10 business people, and in Mexico, Nicaragua, Guatemala, Honduras and Venezuela by more than half. Business communities regard themselves as less affected by inflation in Argentina, Panama, Belize, Uruguay and Chile. In these countries, fewer than 15 percent of business people regard inflation as a major problem (Figure 2.7). The general view of a country's business community very closely reflects the inflation situation of its economy (the correlation between these two variables is 0.81).<sup>9</sup>

Only in Eastern European countries in transition is the problem of inflation more severe than in Latin America. Despite recent advances, the region still has a long way to go to reduce inflation to levels of other regions, particularly the developed countries (Figure 2.3). Inflation is a more serious problem for small and medium-size companies than for large ones in all regions

**Figure 2.8 Exchange Rate as an Obstacle to Business Growth**

Source: WBES and IDB calculations.

of the world, possibly because large companies have better information mechanisms and financial management, and can take advantage of economies of scale in managing their cash balances.<sup>10</sup> Nevertheless, as is the case with other macro problems, this does not mean that large companies escape the effects of inflation, and indeed it is surprising how little difference there is between opinions from different-sized companies.

Inflation is more severe not only for smaller firms, but also for those located outside a country's main city, for individually owned companies, and for those controlled by their own administration or by a bank. On the other hand, inflation is less severe for younger companies, those that export, and those that have stockholders. These factors may be associated with the possibilities that companies have to minimize unremunerated liquid balances and diversify their financial assets.

## Exchange Rate

The exchange rate is cited as a serious obstacle to business development about as frequently as is inflation. But there are large differences between the countries of

<sup>9</sup> Strictly speaking, this correlation comes from calculating the loss in purchasing power of money as  $1 - [1/(1+p)]$ , where  $p$  is the variation in the price index.

<sup>10</sup> For similar reasons, poorer people are more affected by inflation, which therefore operates as a regressive tax.

Latin America. At one extreme is Ecuador, where over 80 percent of the business community regards the exchange rate as a serious problem. At the other is Panama, where only 3 percent considers it serious (Figure 2.8). Although the average opinions of the business community by country show relatively high correlations with the behavior of the nominal exchange rate,<sup>11</sup> their opinions primarily reflect the contemporary *inflation* rate of their economies: the correlation with this variable is very high (0.77).<sup>12</sup> Surprisingly, there does not seem to be any relationship with changes in the *real* exchange rate.<sup>13</sup>

In all regions of the world, large companies are those least affected by the exchange rate, regardless of the sector in which they operate.<sup>14</sup> Larger companies seem to have greater defense mechanisms, but again it is striking that the differences between large and small companies in the same region (or the same countries) are much less pronounced than the differences between regions of the world, and particularly than the differences between countries. In Latin America, exchange rate problems are greater for individually owned companies and for companies controlled by their own administration, and are significantly less for companies controlled by a bank or by the government, and for more recently created companies. Once more, this list of factors suggests the importance of access to information.<sup>15</sup>

## Other Obstacles

Other problems cited as obstacles to business development in Latin America include street crime (cited by 41 percent), corruption (36 percent), and organized crime (33 percent). These percentages are higher than they are in any other region in the world. Other problems such as unfair competitive practices, lack of infrastructure, or the ineffectiveness of the justice system are mentioned as serious by lower percentages of respondents. However, it is important to keep in mind that these problems are not frequently mentioned in any region. In any case, most of these problems are considered more serious in Latin America than in other regions.

Although the reason may be that Latin American business people are more predisposed to express their problems, it is important to point out that their opinions are related to other indicators of these phenomena. For example, between the average opinion on organized crime and the rule-of-law indicator calculated by Kaufmann,

Kraay and Zoido-Lobaton the correlation is 0.45; between opinions on corruption and their corruption control indicator, it is 0.64; and between the problem of lack of infrastructure and the infrastructure quality indicator from the 2000 edition of *The Global Competitiveness Report*, the correlation is 0.83. And although these factors may not be mentioned very frequently by the business community, they may have harmful indirect effects on the operation of businesses. For example, difficulties in accessing credit, which are mentioned as a main problem, may be due to the fact that the financial system perceives excessive risks due to the weakness of the law.<sup>16</sup>

In short, the opinions of Latin America's business communities reveal great dissatisfaction with the economic and institutional environment in which their companies operate. The seriousness of these problems varies strongly between countries of the region, usually reflecting the diverse national situations as measured by objective indicators. Hence, although these opinions are subjective, they are not merely the expression of moods or cultural tendencies toward dissatisfaction. In comparison with other regions of the world, Latin America stands out as the region most affected by many of the problems analyzed, thereby suggesting that the possibilities there for successful business development are more limited than elsewhere in the world. Is there any evidence that this is the case? Is there any trait of Latin American companies that shows that they do in fact suffer from serious constraints? While answering these questions is difficult due to limited information to compare the business sectors of different countries, information available on larger companies does indeed reveal one distinctive trait: Latin American companies are very small in the amount of assets that they handle and in the employment they generate, which suggests the presence of severe difficulties for business development.

<sup>11</sup> For example, the correlation with devaluation rates in the past year is 0.57 and with their standard deviation 0.36.

<sup>12</sup> Also calculated on the basis of the loss of the purchasing power of money.

<sup>13</sup> The correlations with changes in the real exchange rates in the last year and last five years for which information is available are 0.04 and 0.12, respectively.

<sup>14</sup> These comparisons control for the difference between tradable (industry) and nontradable (services) sectors.

<sup>15</sup> Surprisingly, export sectors seem to be just as affected by the exchange rate as non-export sectors, when the other characteristics of companies are controlled.

<sup>16</sup> See Part II of this Report.

