CHAPTER 2

ECONOMIC GROWTH AND BUSINESS ENVIRONMENT - A LITERATURE REVIEW

2.1 Introduction

Economic growth and its causes have been the focus of study by economists for centuries largely because growth has the potential to reduce or remove poverty, improve the standard of living, help achieve social goals such as education and healthcare and substantially improve the quality of life of the people. Adam Smith’s treatise on the “Wealth of Nations” focused on the economic growth. The term economic growth in economic literature is differentiated from economic development. Economic growth means an increase in per capita income or an increase in gross national product (GNP). Economic development, on the other hand, means a process whereby an economy's real national income as well as per capita income increases over a long period of time. In addition, economic development effects changes in the resource supplies, in the rate of capital formation, in demographic composition, in technology, skills and efficiency, in institutional and organizational set-up. In short, economic development is a process consisting of a long chain of inter-related changes in fundamental factors of supply and in the structure of demand, leading to a rise in the net national product of a country in the long run (Meier and Baldwin (1957); Benard Okun and Richard W. Richardson (1964) and United Nations Expert Committee).¹ ²

¹ Todaro and Smith (2009) note that “development should be perceived as a multidimensional process, involving the reorganization and reorientation of entire economic and social systems. In addition to improvements in incomes and output, it typically involves radical changes in institutional, social and administrative structures as well as in popular attitudes and, in many cases, even customs and beliefs. Finally, although development is usually defined in a national context, its widespread realization may necessitate fundamental modification of the international economic and social system as well.”

² Prof. Kindleberger (as cited in Somashakar 2006) has differentiated growth and development as: “Growth may well imply not only more output but also more inputs and more efficiency, i.e., an increase in output per unit of input. Development goes beyond these to imply changes in the structure of outputs and in the allocation of inputs by sectors”.
In the context of a developing country like India, both economic growth and development are required. In the present study, therefore, the term economic growth shall be used interchangeably with economic development. The process of economic growth is a highly complex phenomenon and is influenced by numerous and varied economic and noneconomic factors. Economic factors consist of natural resources, capital formation, technological progress, human resources, population growth, social overheads and organization. In addition to economic factors, there are a number of non-economic factors that also play an important role in the process of economic growth. The important non-economic factors include: political factors, social factors, education, urbanization and religious factors. In the modern economic system, it is the entrepreneur who performs the duty of an organizer and bears all risks and uncertainties. Entrepreneurs perceive the business environment consisting of economic and non-economic factors and decide whether to take risk of making investment and organizing the resources to produce goods and services. This results in an increase in economic output and thereby economic growth.

The present chapter is structured as follows: First, the theories of growth and development have been discussed. Second, the role played by State in the economic growth and its relationship with market has been analyzed. Third, the importance of state-business relationship has been examined. Fourth, the role of the institutions has been presented. Fifth, the entrepreneurs and their role in economic growth have been investigated. Sixth, the business environment and its relation with economic growth have been identified. Seventh, a review of studies linking economic growth and business environment has been provided. Lastly, an integrated model showing relationship between business

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3 The land area and the quality of the soil, forest wealth, good river system, minerals and oil resources, good and bracing climate, etc.
4 Stock of capital.
5 Like schools, colleges, technical institutions, medical colleges, hospitals and public health facilities.
6 Complementary to capital and labour and helps production to reach the maximum level.
7 Cairncross has rightly observed: "Development is not just a matter of having plenty of money, nor is it purely an economic phenomenon. It embraces all aspects of social behaviour; the establishment of law and order; scrupulousness in business dealings, including dealings with the revenue authorities; relationships between the family, literacy, familiarity with mechanical gadgets and so on”.
8 Political stability and strong administration are essential and helpful in modern economic growth.
9 Social attitudes, social values and social institutions which change with the expansion of education and transformation of culture from one society to the other.
10 Greater progress has been achieved in those countries, where education is wide spread.
environment, entrepreneurs, investment and economic growth has been proposed.

2.2 Theories of Growth and Development

There are several growth and development theories that have been suggested by economists over time. Early development economists such as Rosenstein-Rodan (1943 and 1961), Nurkse (1953) and Lewis (1954) emphasised the role of capital accumulation in growth. Given a constant capital–output ratio, the Harrod–Domar model predicted that the higher the savings rate, the higher would be the rate of growth\(^\text{11}\). However, since capital accumulation was regarded as central to growth, the assumption of a constant capital–output ratio was considered unrealistic (see Solow, 1956), in that the phenomenon of diminishing returns could soon be expected to reduce and finally eliminate all per capita income growth. Based on such models, which emphasize capital accumulation, it is difficult to foresee how growth can continue beyond a few decades given the assumption of diminishing returns. Krugman (1994) has highlighted the similar point of view about the East-Asian miracle: it was largely based on input growth. It would therefore not be sustainable.\(^\text{12}\)

Neoclassical growth theory (e.g., Abramovitz, 1956; Solow 1956 and 1957) regards growth largely as the outcome of exogenous technical progress, which effectively offsets the law of diminishing returns to which inputs are subject. From the policy perspective, this theory has little to offer since technical change is unexplained and therefore not amenable to policy. The theory predicts a convergence of living standards of different economies to a common level, but the evidence suggests no such convergence.\(^\text{13}\) Modern endogenous growth theory has partly emerged to explain this lack of convergence and

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\(^{11}\) This would, however, be true if growth is not labour constrained. In line with Lewis (1954), one has to assume unlimited supplies of labour.

\(^{12}\) Popular enthusiasm about Asia’s boom deserves to have some cold water thrown on it. Rapid Asian growth is less of a model for the West than many writers claim, and the future prospects for that growth are more limited (p. 64).

\(^{13}\) Another of Kaldor’s stylised facts is that there are wide differences in the rate of growth of productivity across countries.
partly to evolve a theory.\textsuperscript{14} It seeks to explain why per capita income growth in capital abundant countries is often faster than in capital poor countries and defies the operation of diminishing returns.\textsuperscript{15} It also claims to explain the phenomenon of ‘increasing returns’ which appears to underlie the continuing high per capita income growth in rich countries.

Paul Romer, in his 1986 paper, “Increasing Returns and Long-Run Growth”, essentially set the foundations for the endogenous growth theory. In that paper, he proposed a model where economic growth is driven by the accumulation of knowledge, which is the really important form of capital (Romer 1990). Romer essentially tried to discard the neoclassical hypothesis of diminishing marginal returns in capital investments, permitting for increasing returns in aggregate production and focusing on the role of externalities (specifically knowledge spillover effects) in determining the rate of return on capital investments (Todaro and Smith 2009). According to Romer, investment in knowledge leads to increasing returns in marginal products, since technological innovation can lead to the deployment of new technologies, which can reduce the cost of production and put one company ahead of its competitor. Romer’s last point in his 1986 paper was that knowledge has what he described as a “natural externality”, since it cannot be perfectly patented or kept secret. Hence, new knowledge has a spillover on the production possibilities of other firms as well.

In his 1990 paper, “Endogenous Technological Change”, Romer set out the preconditions for the deployment of endogenous growth. His model has four basic inputs: capital, labour, human capital (education, training) and an index of the level of technology. Romer’s key intuition is that the most important precondition of growth lies not in the population dynamics but in the human capital dynamics. Hence, it is investments in new research, education and human capital rather than investments in physical capital accumulation that should be fostered.

\textsuperscript{14} Whilst it is true that lack of evidence on absolute convergence stimulated the development of endogenous growth theory, it was subsequently emphasized that Solow’s model only predicts conditional convergence (see, for example, Mankiw et al., 1992).

\textsuperscript{15} One of Kaldor’s (1961) six stylised facts is that output per worker shows continuing growth with no tendency for a falling rate of growth of productivity.
In general, the endogenous growth theory, by focusing on knowledge and externalities, provides a way for countries to enter the new knowledge economy by making the best use out of their available resources. The main weakness of this model, however, is that it overlooks inefficiencies that arise in developing countries (poor infrastructure, poor capital and goods markets) that can significantly affect one country’s growth prospects.\textsuperscript{16}

Moreover, there is a question about the strategies and policies a natural resource-rich country should follow in order to develop and to improve the quality of jobs. A World Bank study report has proposed three recommendations: Foster openness to trade, market access and FDI flows; build new endowments in human capital, knowledge, better institutions and public infrastructure; Play to your strengths: don’t turn your back on your natural advantages.

The study has shown that natural resource-based activities can have high productivity growth, technical spillovers, and forward and backward linkages, as much as modern manufacturing. Such activities can become knowledge industries. They are in no way incompatible with the new knowledge economy. The key to success is to complement natural resource wealth with good institutions, human capital, and knowledge. Natural resources and knowledge are proven growth recipes. Developing dynamic natural resource-based sectors is not incompatible either, with building new comparative advantages in footloose and high-tech manufacturing. It is found that both sectors coexisting not only in natural resource-rich developed economies, but also in the already highly diversified export structure of Brazil and Mexico, and in small Costa Rica and the Dominican Republic. To what extent successful development will be based more in natural resource-based activities or in footloose manufacturing or service activities will depend largely on other trade.\textsuperscript{17} Here the role of state, particularly in developing countries

\textsuperscript{16} Modern endogenous growth literature, which took off with Romer (1986, 1987), has been growing in importance with many other important contributions in this area such as: Romer (1989, 1990), Krugman (1990, 1993), Murphy et al. (1989a, 1989b), Shaw (1992), and Aghion and Howitt (1998).

\textsuperscript{17} Natural resources-based activities can lead growth for long periods of time. This is patently evident in the development history of natural resource-rich developed countries, such as Australia, Finland, Sweden, and the United
becomes important.

2.3 State, markets and Growth Strategy

The relative roles of state and markets in economic growth have always been an area of fundamental importance in economic theory and policy. Whereas, some economists have favoured the market, it’s ‘invisible hand’ and its planning and implementation capabilities. Others have opposed the free play of market forces and advocated more active role for the State. From Adam Smith’s laissez faire to Keynesian interventionism, from the old structuralist school to neoclassical economics, the pendulum has swung from one extreme to another, generating many intellectual controversies and many policy failures across the developing world.

Mainstream economists had long held the position that a reduced role for the state and market liberalization by itself would lead the price mechanism to allocate resources efficiently, leaving no room for an active complementary industrial policy. Such mainstream economists acknowledged the presence of market failures in theory, but in practice these were not thought to be sufficiently wide ranging to justify a strong intervening role for the state. The global financial crisis and the need to address climate change, but also other developments, have affected the belief that the market, or government, can do everything on its own. A more balanced view of the respective roles of state and business, and their interaction is now being considered.

States. Mining was the main driver of growth and industrialization in Australia and the United States over more than a century, as forestry has been in Finland and Sweden. These countries continue to be significant net exporters of natural resource-based products, along with high-tech products. The recent success of Chile, with the highest growth rate in the region in the last 15 years, has been almost fully led by exports of natural resource-based products. Natural resource-based activities can be knowledge industries. Mining was the “national learning experience” in the United States that led to building a strong technological system from which modern manufacturing developed. Forestry and forest products are highly knowledge intensive in Finland and Sweden, which explains why they remain competitive compared to countries with much lower wages. Fresh-fruit production and marketing in Chile has high-tech content. Biotechnology is as high tech as chips and semiconductors, if not more.

In recent years, a broad consensus has emerged that both states and markets play a key role in the transformation of all economies – especially developing ones. It is now widely accepted that even the most advanced economies need constant and strategic state action to support and regulate private businesses and help generate and disseminate on a large scale the technological progress that sustains economic growth (Aghion 2009; Romer 1990). However, economic theory is still struggling to offer a convincing and practical policy framework to maximize the potential of public and private agents (Lin 2009, 2010; Lin and Monga 2010). The main theoretical justification for government intervention in economic development is twofold: the need to account for externalities beyond the realm of any individual firm and the need for coordination.

As an economy grows over time, it diversifies its economy from agriculture to industry and service sector. Within the industrial sector also, it attempts to move from low-tech to high-tech sectors over time. This industrial diversification and upgrading is a process of innovation, in which pioneering firms generate public (non-rival, non-excludable) knowledge for other firms in the economy. The consumption of the new knowledge by one firm does not reduce its availability for others, and no-one can effectively be excluded from using it. Adequate public compensation is desirable for the information externality that the pioneer firms generate. Meanwhile, in most cases improvements in infrastructure, both hard (such as transportation) and soft (such as financial and legal institutions), cannot be internalised in an individual firm’s investment decision, yet they yield large externalities to other firms’ transaction costs. The idea that some business activities exhibit externalities that increase with the size of the industry and that arise through localised industry-level knowledge spillovers, input-output linkages and transportation costs has been well documented (Harrison and Rodriguez-Clare 2010). This can give rise to geographic concentration and labour pooling among firms in the same industry (Krugman 1991; Marshall 1920).

19 With the emergence of new growth theory, new trade theory and new institutional economics, significant advances have been achieved towards a systematic comparison of market and governments (or centrally operated mechanisms—Acemoglu et al., 2008).
As a country climbs up the industrial and technological ladder, many other changes take place: the technology its firms use becomes more sophisticated and capital requirements increase, as does production scale. Markets grow and transactions increasingly take place at arm’s length. A flexible and smooth upgrading process therefore requires simultaneous improvements in educational, financial and legal institutions and hard infrastructure, so that firms in the newly upgraded industries can produce sufficient amounts to reach economies of scale. Clearly, individual firms cannot internalise all these changes cost-effectively, and spontaneous coordination among many firms to meet these new challenges is often impossible. A change in infrastructure requires collective action or at least coordination between the provider of infrastructure services and industrial firms. It falls to government either to introduce such changes itself or to coordinate them proactively. Thus, on top of an effective market mechanism to allocate resources at each stage of economic development, government needs to play an active facilitating role in the industrial diversification and upgrading process and in the improvement of infrastructure.

There is also a realization that whereas some key elements of success is the same in all growth strategies (sustainable government finances and sound money, healthy institutional environment, some degree of market orientation), different regions require a different set of policies. As it is found that the characteristics of development policy for developing countries have changed overtime. During the 1950s and 1960s, it was “big-push, planning and import-substitution” policies that dominated the development agenda of reformers in poor nations (Rodrik 2003). These ideas started losing prominence in the 1970s, when more market oriented approaches started being adopted. By the late 1980s views had converged around a vector of policies that John Williamson dubbed “The Washington Consensus”. As Rodrik notes, these policies remain at the heart of conventional understanding of a desirable policy framework, even though they have been augmented and expanded in the last years. The Washington Consensus, in particular has been catastrophic for the developing world. It is not accidental than only those that decided to embark on different growth strategies were the ones that showed the highest growth rates and the most significant poverty reduction. It is now accepted that different regions need
different development strategy. Even the role of state is undergoing a change. More and more good relationship between state and business is suggested for the economic growth.

2.4 Effective State Business Relations

The general concern with state involvement in economic development is its propensity to create suboptimal business arrangements and practices, inefficiencies and costly distortions that open the way to rent seeking. In this context establishing successful State Business Relations (SBRs) requires an appropriate policy framework which allows the state to support industrial development and technological upgrading but also minimizes opportunities for rent seeking. Effective SBRs can help solve information related market and coordination failures in areas such as skills development (Lall 2001), infrastructure provision, technological development and capital markets (Stiglitz 1996).

Countries that succeed in adopting and implementing effective SBRs are those where government’s industrial development goal is consistent with its comparative advantage, which reflects the accumulation of human and physical capital and the change in its factor endowment structure. When firms choose to enter industries and adopt technologies that

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20 Business associations and government departments may help to coordinate dispersed information among stakeholders. The coordinating action of these agents allows a country to create wealth at a faster rate. A good example is where business association and good quality education and infrastructure, which is unlikely to be supplied through a fragmented private sector which relies on a price mechanism based on incomplete markets. Public support may fail to correct market failures, for several reasons. Governments are unlikely to have perfect information and perfect foresight: government intervention can suffer from moral hazard problems (Hausman and Rodrik, 2002), in that the private sector may not act once the government has provided an incentive; private non market means can solve market failures; joint action may raise collective efficiency, by internalizing externalities, and this could be more appropriate than state intervention; national level coordination failures based on scale economies are probably the most far reaching in scope and hence the most risky; and government intervention carries the risk of misallocation and rent seeking behaviour.

Effective SBRs (e.g. a democratic way of conducting SBRs underpinned by the principles enshrined in an effective competition policy) provide a check and balance function on government policies and their tax and expenditure plans. SBRs can help to address coordination failures, as government action on its own is risky. Any intervention needs to be updated when new information becomes available, and it is therefore essential to consult the market through effective SBRs. Stiglitz argues that flexibility of policy interventions is important in securing a positive outcome.
are consistent with the comparative advantage determined by the country’s factor endowments, they are viable in an open, competitive market and the economy is most competitive. As competitive industries and firms grow, they claim larger market shares and create the greatest possible economic surplus in the form of profits and salaries. Reinvested surpluses earn the highest return possible as well, because the industrial structure is optimal for that endowment structure. Over time, this strategy allows the economy to accumulate physical and human capital, upgrading the factor endowment structure as well as the industrial structure, and making domestic firms more competitive over time in more capital- and skills-intensive products. As new firms in the process are viable, the role of the state in industrial diversification and upgrading is limited to providing information about the new industries, coordinating related investments across different firms, compensating pioneer firms for information externalities and nurturing new industries through incubation and encouragement of foreign direct investment (Lin 2009; Lin and Chang 2009). Large subsidies and protection for new firms are not required. Opportunities for rent seeking and other distortions are therefore limited.

Following the economy’s comparative advantage will also allow developing countries to tap into the potential advantage of backwardness. At each stage in their development, firms can acquire the technologies (and enter into industries) that exist in more advanced countries and that are appropriate for their endowment structure, rather than having to reinvent the wheel (Gerschenkron 1962; Krugman 1979). This use of off-the-shelf technology and entering into existing industries has allowed some of the East Asian newly industrialized economies to sustain annual GDP growth rates of 8 per cent and even 10 per cent for two or even more decades, and is being emulated successfully by many other countries around the world.

Effective State – Business Relations play an important role in the creation of good institutions and governance, and establishment of a better investment climate (Qureshi and TeVelde 2007). It may help to reduce policy uncertainty. Firms operate in an uncertain environment and frequently face risks and resource shortages. They undertake decisions
concerning technology, inputs and production facilities based on anticipated market conditions and profitability. Uncertainty can have significant negative effects on investment and hence wealth creation, when investment involves large sunk and irreversible costs and there is the option to delay the decision to make the investment until further information becomes available (Dixit and Pindyk 1994). Policy uncertainty is an important source of uncertainty. Businesses that have a better relation with the government may be able to anticipate policy decisions; when this relation becomes too close. Collusive behavior may result in capture of policy to the benefit of few, not all, firms. A key problem is to understand when State – Business Relations are of the collusive type and when they are developmental. A study by Rojid et al. (2009) on Mauritian firms suggests that improvements in State – Business Relations over the past three decades have led to more appropriate growth enhancing policies and more fixed capital formation crucial for wealth creation.21

2.5 Institutions and Economic Growth

In explaining growth and development, Ricardian theory has a fundamental assumption that an economy’s potential, defined by its resources and technology, is fully realized. In reality, it has been observed that the problems of less developed countries are not a lack of potential but an inability to achieve that potential (see de Soto 2000; Parente and Prescott 2000 and Guest 2004). The obstacle to their development is not a lack of resources or technology, but a failure to exploit the resources and technology available. This caused economists to look further afield for explanations of growth and development. In development economics and in economic history, attention has therefore shifted to how and to what degree economies succeed in realizing their potential. This led to the interest in the study of institutions.

Institutions have been defined as formal and informal rules and practices, which enable

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21 Evidence from around 1,000 firms in a number of Sub-Saharan African countries finds that firms that are a member of a business association pay a lower percentage of revenue as informal payments to government officials, face lower lost costs of insufficient water supply and make more use of information and communication technology facilities.
and shape economic activities. At the formal level, they include public and private law, standard operating procedures and the principles ordering structures in governments, firms and various types of association. At the informal level, they include traditions, routines, norms and shared but tacit assumptions about the functioning of the world \(^{22}\) (Duina 2011).

In addition to looking only at resources and technology, economists have started studying institutions, in the social and political structures that facilitate, or impede, productive economic activity.\(^{23}\) This has led to a shift from focusing on process of production to the economic environment or business environment in which that process takes place. The role of entrepreneurs who perceive the business and economic environment and accordingly organize the production process has become important. The following section looks at the role of entrepreneur in economic growth.

### 2.6 Entrepreneurs and Economic Growth

As discussed above, the development economists have suggested a large number of economic and non-economic variables that may influence economic growth (Sala-i-Martin 1997; Bleaney and Nishiyama 2002). Entrepreneurship has not been included in this list of variables (Bleaney and Nishiyama 2002). Baumol was among the first to urge his fellow

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\(^{22}\) Although there is no universally accepted definition of institutions, a number of groups have developed indicators that purport to measure institutional quality. Some examples include the World Bank Doing Business indicators, the World Bank Environment Survey, the World Economic Forum’s Global Competitiveness Index, the Heritage Foundation’s Index of Economic Freedom, the Fraser Institute’s Economic Freedom of the World Report, the IMD’s World Competitiveness Yearbook, and Transparency International’s Corruption Perceptions Index. These indicators seek to measure various aspects of both the de jure and the de facto institutional environment such as regulation as encoded in laws and policy frameworks, judicial competence and independence, corruption, quality of enabling infrastructure, and labor force quality and availability. The indicators are often used to rank countries and to monitor changes within countries over time. They can serve to spur debate and policy reform.

\(^{23}\) In particular, economic development and political development are increasingly seen as being closely related. This revival of interest in institutions was pioneered by economic historians—particularly North and Thomas (1970) and Jones (1988). But many others have made important contributions—economists such as Buchanan and Tullock (1965) and Olson (1982), and historians such as McNeill (1982) and Macfarlane (2002). Development economists, too, have begun to take an intense interest in economic and political institutions (see Shirley 2005).
mainstreamers in a 1968 *American Economic Review* article to start paying attention to the role of entrepreneurship in economic development.

Entrepreneurs play an important role in economic growth and development. This has been a key insight since the contribution of Schumpeter\(^\text{24}\) (1911) and others (Naudé 2011a). Entrepreneurs are also vital in the process of structural change or industrialization (Gries and Naudé 2010), a process without which development is not possible. As formalized in Gries and Naudé’s (2010) model of entrepreneurship and structural change, entrepreneurial innovation leads to the reallocation of resources from the traditional (agricultural) sector to the modern (manufacturing) sector.

Entrepreneurs are a key component of successful economies. It is true that the overwhelming majority of businesses is small in size and, due to their small size, may operate at an inefficient economic scale, but entrepreneurs make up for this disadvantage by sparking competition, experimenting with new ideas, and relentlessly venturing into markets previously uncharted. By finding new ways to transform existing resources into outputs that create extra value above the resource cost to consumers, entrepreneurs serve a critical function in economic development.

Entrepreneurs have been defined as “persons who are ingenious and creative in finding ways that add to their own wealth, power, and prestige”. Entrepreneurship is also defined as the resource and process whereby individuals utilize opportunities in the market through the creation of new business firms. As a resource, entrepreneurship results in

\(^{24}\) Schumpeter in an article entitled “Theoretical problems of economic growth” published in 1947 (Schumpeter, J. A. (1947). *Theoretical problems of economic growth*, Journal of Economic History Supplement, 1–9.), shows that the literature has considered different factors that are economic growth enhancing. Some of these factors that he identifies are physical environment, social organizations, institutions and technology (Schumpeter 1947, pp. 2–3). However, from his point of view, all these factors are not enough to explain the economic growth process, because “economic growth is not autonomous, being dependent upon factors outside of itself, and since these factors are many, no one-factor theory can ever be satisfactory” (Schumpeter 1947, p. 4). However, at the end of the article, he concludes that, “Since creative response means, in the economic sphere, simply the combination of existing productive resources in new ways or for new purposes, and since this function defines the economic type that we call the entrepreneur, we may reformulate the above suggestions by saying that we should recognize the importance of, and systematically require into, entrepreneurship as a factor of economic growth” (Schumpeter 1947, p. 8).
innovation, risk-taking and arbitrage—the classic functions of the entrepreneur as identified by Joseph Schumpeter, Israel Kirzner and others. Entrepreneurship is studied as the various activities undertaken by entrepreneurs throughout the lifecycle of a firm, from conception to exit (Acs and Naudé 2011).

There are various ways in which entrepreneurship may affect economic growth. Entrepreneurs introduce innovations and may play an important role by entering markets with new products or production processes (Acs and Audretsch 1990, 2003). Entrepreneurs may increase productivity by increasing competition (Stel et al., 2005). Gries and Naudé (2010) provide a model to illustrate the role of the entrepreneurial innovation in industrialization. Here entrepreneurs provide three essential roles. First, they create new firms outside the household, offering new products and introducing new processes that provide information as a ‘lead’ activity. Second, they grow firms (and wage employment) by making use of scale economies. Such larger firms tend to specialize, and the clustering of specialized firms can give rise to localization economies, further encouraging innovation and specialization. Third, entrepreneurs can raise the returns to human and physical capital and so provide incentives for further investment and education.

Entrepreneurs may not automatically provide these functions, as they will be constrained by market failures. Industrial Policy (IP) may thus be justified. Rodrik (2007) recognizing this, discusses a number of such entrepreneurship inhibiting market failures. This can occur in financial, labour, product and knowledge markets. He remarked that in developing countries ‘the deck is stacked against entrepreneurs who contemplate diversifying into non-traditional areas’.

Schumpeter used entrepreneurs as the most relevant factor in promoting economic growth. An entrepreneur is profit seeker and needs an adequate social environment to

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25 There is a lot of literature about such a relationship; Acs et al. 2004, 2005; Stel et al. 2005; Audretsch and Keilbach 2008; Audretsch et al. 2008; Audretsch and Keilbach 2004a, b, among others. 
In recent years, the field of development economics and entrepreneurship have converged on the realization that the institutional framework in a country or region, where institutions are broadly understood as the ‘rules of the game’, are important for understanding the outcomes observed in each field. Thus, development economists now routinely advocate the building and strengthening of appropriate institutions for development, such as the rule of law, property rights, contract enforcement, and accountability and good governance, to name but a few (Chang 2007), and entrepreneurship scholars now accept that the allocation of entrepreneurship towards particular activities, be it productive or unproductive or even destructive (e.g., Baumol 1990), are the outcomes of institutions (Henrekson 2007; Acs et al. 2008).

Some have raised the issue of supply of entrepreneurship and its impact on development. Leff’s (1979) has argued that the supply of entrepreneurship is not a binding constraint on development; it is the way in which entrepreneurship is allocated may constrain development. It is again linked with some features of the incentive structure in an economy that are placing constraints and impacting the activities of entrepreneurs (Baumol 1990; Acemoglu 1995 and Mehlum et al. 2003). Stiglitz (2006: 7), for instance, has described these incentive structures to result either in a ‘rent economy’ or a ‘productive economy’, to explain the relative economic performance of developing countries. In contrast to a ‘productive’ economy, a rent economy is characterized by the distribution of resources in a manner that results in a zero-sum game—and this most often results in conflict (Stiglitz 2006; see also Naude 2004).

Entrepreneurship is important for the continued dynamism of modern economies and for job creation. Policymakers need to know how new firms get started and what financial and institutional factors promote entrepreneurial activity. There is a strand of literature which posits that governments cannot raise the supply or quantity of entrepreneurship, but can merely influence the allocation of entrepreneurial ability. According to this view, all that

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26 On the role of entrepreneurs in society, see Audretsch 2006, 2009; other related topics, see also Benz 2009; Caruana, Ewing and Ramaseshan 2002; Gert-Jan Hospers et al. 2009; Kearney et al. 2008; and Mas-Verdu  et al. 2009.
the government should do is “get the institutions right”, i.e. ensure the protection of property rights and a well-functioning legal system, and maintain macroeconomic and political stability and competitive tax rates. Not all scholars agree. The wide range of entrepreneurship emerges across countries, even when controlled for variations in institutional quality, would suggest that specific policies, interventions and regulations—relating to start-up costs or innovative activities—may have an influence on the supply of entrepreneurs.

The nature and capability of the state vis-à-vis a country’s level of economic development needs to be considered in the design of these policies. At an early stage of development a country’s entrepreneurial base will still be small, with private sector activity in dispersed, low-productivity traditional activities. At this stage, states are very often fragile, and a major development challenge is to build state capacity to establish and maintain an environment conducive for business so as to allow core entrepreneurship to emerge in accordance with the country’s comparative advantage.

At the intermediate stages of development, efficiency-driven growth may be pursued by the state to expand its intervention in the economy in order to “defy” the comparative advantage. Examples from East Asia, but also the USA and Europe spring to mind. During this stage firms will grow in size, and state-owned enterprises (SOEs) and multinational enterprises (MNEs) will play an increasing role. It may also be important for policy to take into account the nature and profile of indigenous entrepreneurs at this time. For example, in the 1950s and 1960s in Singapore and South Korea, where a strong local entrepreneurial base was judged to be lacking, policies at first aimed to complement and strengthen the domestic entrepreneurial base, through encouraging much more foreign entrepreneurship and by providing much financial support to allow entrepreneurs to take on more risks in imitation and foreign technology adoption. In Taiwan and Japan, where the entrepreneurial base was fairly strong to begin with, more limitations were initially placed on foreign entrepreneurs.

At some point, the country’s development will have progressed to the extent that further
growth will increasingly depend on highly-innovative entrepreneurship. For this, a shift from being interventionists and selective, towards being less interventionist is needed, as this is often a requirement for creativity and innovation to flourish. Many countries embark on trade liberalization during this phase. Examples include the EU, the USA and India. China’s two-track approach since 1978 can be seen as a variant of this shift, whereby the shift is gradually introduced by allowing a more liberalized private-sector economy to develop without dismantling state-owned enterprises. China’s growing class of entrepreneurs has also had an impact on the policy—a form of “institutional” entrepreneurship. During this stage, also described as the “entrepreneurial economy”, where the economy is dominated by knowledge, policies have focused on the formation and function of regional clusters and their linkages with the rest of the economy, on technological innovation, and on venture capital support; MSEs have returned to again assume a leading role in the economy.

It is obvious that for economic growth entrepreneurs are critical. ‘The level and quality of entrepreneurship make a difference in the economic vitality of communities, regions, industries and the nation as a whole’ (Hart 2003, p. 4; Baumol 2009; Kanniainen and Keuschnigg 2005; Malecki 1994). They need support in terms of sound business environment and effective institutional support.

There are mainly three relevant characteristics of the entrepreneur. First, the Kirznerian alertness (Kirzner 1973, 1979, 1985, 1992 and 2000) and arbitrage of opportunities, which encompass both Schumpeterian creators (Schumpeter 1934) and individuals ‘acting entrepreneurially even when they might not be seen as Schumpeterian creators’ (Kirzner 2009). Second, the creation and exploitation of opportunities by investments in new knowledge (Acs et al. 2009) as endogenous growth models suggest (Romer 1990; Aghion and Howitt 1992). Third, the Schumpeterian exploitation of existing knowledge, totally or partially unused by incumbent companies, through the transmission of knowledge spillovers (Audretsch 1995; Acs et al. 2009).

The rationale for shaping a business friendly environment, a regulation which does not
hamper entrepreneurial culture, and is not burdensome to entrepreneurs, is rooted in the very essence of the entrepreneurial function. As Kirzner (2009, p. 151) highlights:

“... it does seem intuitively obvious that alertness can be “switched off” by the conviction that external intervention will confiscate (wholly or in part) whatever one might notice ... public policies that to any degree deaden the excitement inspired by the prospect of pure entrepreneurial profit must surely lower the level of entrepreneurial alertness.”

These kinds of policies, i.e. cutting the red tape of a burdensome regulation, granting the rule of law and reducing taxes are, according to Naudé, a ‘necessary, but not sufficient condition for development’ (Naudé 2007, 2009a and 2009b). Important literature has recently emphasized the pivotal role played by knowledge and skills in the processes of innovation, development and catching up, highlighting how competences are becoming a conditio sine qua non in all economic sectors in a global competitive environment.

It can be summarized that entrepreneurs are important actors in the process of economic growth. They need friendly business environment to operate. Therefore, how do they perceive the business environment become important. A friendly business environment will encourage them to make investment. A bad business environment will discourage them to invest. The following section discusses the business environment.

2.7 Business Environments and Economic Growth

A conducive business environment is one of the pre-requisites for economic growth and poverty reduction. While poverty reduction requires more than just economic growth, growth is an essential ingredient. Business friendly environments that underpin rapid and sustained economic growth include the macroeconomic and financial market environments, infrastructure, labour market skills and efficiency, and governance and institutions. Obtaining licenses and credit to start a business, finding and managing labour,
ensuring investor protection, enforcing contracts, paying taxes, trading across borders, and identifying the requirements for closing a business are all important factors in assessing the operating climate for doing business (Schou-Zibell and Madhur 2010).

To be more precise, the business environment is defined as a combination of policy, legal, institutional, and regulatory conditions that govern business activities. Simon White (2004) has defined the term Business Environment as ‘all those factors external to businesses that either inhibit or favour their development”. Stern (2002) defines that it is the “policy, institutional, and behavioural environment, both present and expected, that influences the returns, and risks, associated with investment” in a specific location. In other words, the business environment covers whatever external environment that affects the returns and risks faced by investors. This general definition includes three broad categories. The first category covers macroeconomic aspects such as fiscal, monetary, and exchange rate policies, which clearly affect investors’ returns. High tax rates, for example, would lower return, while inflation would increase the variability of returns. The second category includes governance, institutions, and political stability. Rule of law, for instance, affects investors’ decisions about how much to invest and what organizational form it should take. Institutions also include informal ones, such as the general level of trust, social capital, and social network (North 1990; Knack and Keefer 1995; Zak and Knack 2001; Shirley 2008), which would facilitate new transaction relationships and, therefore, firm expansion. The final category includes infrastructure necessary for productive investment, such as transportation, electricity, and communications (Xu 2010).

It is the business environment that affects economic activity throughout the economy and particularly through its influence on incentives to invest. An improvement in the business environment increases returns to current lines of activity and so increases investment in these. It also creates new opportunities—for example, through trade or access to new technology. It influences the psychology of entrepreneurs—the Keynesian “animal

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27 There is no unanimity in the business environment literature on what should be included in the term. White has shown that development agencies currently use a number of rival terms to cover the same or similar ground. These include “Business Climate”, “Investment Climate” and “Enabling Environment
spirits”—affecting their assessment of whether innovation will pay off. It puts competitive pressure on firms that have enjoyed privileged positions as a result of import or other protection, or special access to government officials. As a result of greater competition, it may cause some firms, perhaps those closer to technological frontiers, to succeed—even as others fail.

Given the complexity of effects that changes in the business environment elicit, different firms, industries, and regions will be affected in different ways. Moreover, growth fueled by the business environment is not simply a shift towards some technological frontier. Developing countries must overcome or reduce all kinds of obstacles to efficiency, dynamic and otherwise, without any illusions that the economy will soon reach the frontier. Indeed changes in the business environment may have their most crucial impact far from the technological frontier.

A weak business environment, on the other hand, may not only discourage investment, it can also lead businesses to take costly or counterproductive steps to defend themselves from the consequences of its weaknesses. If social order and control are weak, firms typically have to invest heavily in defensive measures such as private security. If the power supply is unreliable, firms will invest in backup electricity generation capacity. If it is difficult to get goods through or to ports, trade is discouraged and larger, more costly inventories are held. Many such constraints on development are not quickly or easily reversed.

On the contrary, improvements in the business environment could generate extra growth dividends through political economy mechanisms if they increase the number of people and enterprises with a stake in a better climate. For example, if trade reforms create an export-oriented sector, that may increase pressure for further reforms to trade policy or trade-related infrastructure. And higher incomes might lead to pressure for an improved business climate in other ways, as people seek rules governing the protection of wealth or capital.
The differences in investment and productivity among economies can largely be explained by differences in their respective business environments. A good business environment can reduce the cost of doing business and lead to higher and more predictable returns on investment. A good business environment also plays a central role in promoting national competitiveness, which underpins rapid and sustained economic growth.

2.7.1 Macroeconomic framework

A sound macroeconomic framework consisting of prudent fiscal and monetary policies—coupled with flexible exchange rates, a commitment to market-friendly regulation and transparency, skills development, steady institution building, and an adaptive attitude towards change—can not only boost investment and lead to higher and more predictable returns, but can also ensure that the quality of investment will generate the economic gains required for poverty reduction. A business friendly investment environment requires good rules: rules that establish and clarify property rights, reduce the cost of resolving disputes, increase the predictability of economic interaction, and provide contractual partners with core protections against abuse. Such regulation needs to be efficient, accessible to all, simple to implement and, importantly, it requires a sustained commitment from policymakers to improving competitiveness. Furthermore, enabling economic growth and ensuring poor people can participate in its benefits requires an environment where new entrants can easily start businesses and firms can confidently invest and grow. Small- and medium-sized enterprises are crucial to competition, growth, and job creation, particularly in developing economies. Where regulation is transparent, efficient, and simple to implement, entrepreneurs can more easily operate within the rule of law and benefit from its opportunities and protections. But where regulation is burdensome and competition limited, business success can sometimes depend more on whom you know than on what you can do. In such an environment, firms may be prevented from entering the formal sector by cumbersome bureaucracy and regulation. In many developing economies, up to 80 per cent of economic activity takes place in the informal sector.
2.7.2 Infrastructure

A strong infrastructure enhances the competitiveness of an economy and improves the quality of life of its residents. Good infrastructure connects firms to their customers and suppliers, and enables the use of modern production technologies. IMF suggests that infrastructure paves the way for production, which in turn provides resources to repay the infrastructure construction loans (IMF 2011). Conversely, deficiencies in infrastructure create barriers to opportunities and increase costs for all firms, from micro-enterprises to multinational corporations.

World Bank-Macedonia (2005) captures the dual challenges of providing strong infrastructure: the physical construction of roads, power lines, water systems, etc.; and the development of institutions that effectively provide and maintain public services.

The study has identified three sets of indicators to measure infrastructure. The first set of indicators shows how firms perceive two components of infrastructure as constraints. Inadequate transportation and problems with electricity increases cost, disrupt production, and lower revenue. The second set of indicators measures the quality of infrastructure — the number of days with power interruptions, the related loss in sales, and the number of days of insufficient water supply. The third set of indicators evaluates the efficiency of infrastructure services by quantifying the delays in obtaining electricity and telephone connections. Service delays impose unnecessary costs on firms and may act as barriers to entry and investment.

An essential prerequisite for achieving growth and sustainable development is the availability of a host of infrastructure facilities in adequate and proper quantity. Infrastructure can be defined as the physical framework of facilities through which goods and services are made available to the public. Infrastructure can be broadly categorized into economic and social infrastructure. The economic infrastructure covers services such as transportation (roadways, railways and water transportation), power supply and telecommunication. They have direct impact on production through external economies; help “crowding in” of private investment (both domestic and foreign) in the concerned
region. They facilitate economic growth through lower transportation cost, supply of the factors conducive to production and required monetary facilities. They create multiplier effects through investments, employment, output, income and other ancillary development. On the other hand, social infrastructure facilitates enrichment of human resources in terms of education, health, and housing. They contribute to economic development, indirectly, by enhancing the quality of life and improving the productivity of labour. Thus, the availability of adequate infrastructure facilities is an imperative for the overall economic development of a country. They affect each of the economic activities such as production, consumption, distribution, trade, etc. directly or indirectly having both positive and negative externalities. Infrastructure adequacy helps determine success in diversifying production, expanding trade, coping with population growth, reducing poverty. A large body of theoretical literature exists confirming the association between infrastructure development and economic growth. In the last three decades the issue on the association between infrastructure availability and growth/development is being resurrected. While some of the studies on the developing economies conclude that the impact of infrastructure on economic development is positive and substantial, studies on developed countries found positive but not considerable influence of infrastructure on economic growth.

Good infrastructure is also found to facilitate international integration. Using a sample of firms in Bangladesh, Brazil, China, Honduras, India, Nicaragua, Pakistan, and Peru, Dollar, Hallward-Driemeier, and Mengistae (2005) examine how the business environment affects international integration. Relying on within-country variations by controlling for country effects—and using the city-level average of the investment climate measures as proxies of the local business environment—the authors find that good infrastructure explains foreign ownership and exporting.

The effects of physical infrastructure seem to differ by countries. China is richer than most of the countries mentioned earlier that feature positive infrastructure effects, and China has invested a large amount of money on physical infrastructure. Using within-China variations, Hallward-Driemeier, Wallsten and Xu (2006) find that their proxies of physical
infrastructure at the city level are not significantly associated with firm performance. Thus, the positive association between infrastructure and firm performance seems to be particularly strong in countries with a worse stock of infrastructure—due perhaps to its decreasing marginal return.

2.7.3 Finance

Developed financial markets provide payment services, mobilize savings, and finance investment. Efficient financial markets reduce the reliance on internal funds and money from informal sources such as family and friends by connecting firms to a broad range of lenders and investors. World Bank study provides three types of indicators of how firms perceive their financial environment and finance their investment.

The World Bank study included three sets of indicators to measure micro economic business policies. The first set of indicators measures the degree to which firms perceive access and costs of finance as constraints to investment. Inadequate financing possibilities create difficulties in meeting short term payments for labour and supplies as well as longer term investment. The second indicator compares the relative usage of various sources for financing investment. Excessive reliance on internal funds is a likely sign of inefficient financial intermediation. The third set of indicators focuses on the burden imposed by loan requirements, which is measured by collateral levels relative to the value of the loan. Excessive loan collateral requirements are likely to constrain investment opportunities.

2.7.4 Institutions and the Policy Environment

Regulations and policies that directly influence firms’ daily operations are among the most critical determinants of a country’s business success. Even with sound macroeconomic monetary and fiscal policies, a nation’s expected economic growth may not be forthcoming because problems remain with its microeconomic policies.
Microeconomic business policies are often a legacy of colonial times and the continuation of time-consuming and outmoded local regulations. According to Amy Cogan (2005), “While the fees associated with these procedures may be a source of revenue for the government, and local labor regulations may have noble intentions, the actual results of these policies can be less than favorable for small businesses.” Because of such regulations, risk-averse small businesses may prefer to stay in the informal sector, even with limited opportunity for growth, less protection for workers, greater uncertainty, little access to credit, and no ability to enforce contracts.

The manner in which governments regulate plays a significant role in shaping investment decisions and how firms do business. Effective regulations address market failures that inhibit productive investment and reconcile private and public interests. Yet, regulations present major administrative and financial burdens on firms when poorly designed or ineffectively implemented. Often, these costs are in the form of “unofficial” payments to public officials to get things done.

The first set of indicators focuses on the perception of firms regarding general corruption and the amount of unofficial payments, i.e., the “bribe tax”. The second set of indicators identifies the extent to which specific administrative and regulatory functions require bribe payments. The third set of indicators captures the “time tax” imposed by regulation. Excessive time taken away from managing the productive aspects of their firms and spent dealing with government regulations and tax inspectors impose additional costs on firms.

Pande and Udry (2005), as well as Dollar, Hallward-Driemeier and Mengistae (2005), find compelling evidence that long-run growth is faster in countries that have higher quality legal institutions, better law enforcement, increased protection of private property rights, improved central government bureaucracy, smoother operating formal sector financial markets, increased levels of democracy, and higher levels of trust. World Bank (2004) finds that one of the useful insights of these macro-analyses is that secure property rights and good governance are central to economic growth.

The precise channels through which business climate variables affect economic growth are
still not well understood, and recent studies have been more cautious in their interpretation of the evidence. Durlauf, Kourtellos and Tan (2008) find some evidence that institutions play a role as determinants of GDP growth rates but they question the robustness of these results and state that the effect is likely to flow through the influence of institutions on physical capital accumulation rates and not via TFP growth directly. Straub, Vellutini and Warlters (2008) find some evidence of a positive effect of infrastructure on growth, especially in poorer countries, but conclude that in general the results from studies using aggregate data lack robustness. Recent infrastructure elasticity estimates are much lower than earlier calculations which were often fraught with econometric problems such as not accounting for endogeneity or inefficient proxy variables (Romp and de Haan 2005). Other econometric problems, such as the failure to account for model uncertainty in cross-section studies, persist.

Cross-country evidence suggests that countries with worse property rights tend to have lower aggregate investments, worse access to finance, and slower economic growth (North 1990; Knack and Keefer 1995; La Porta et al. 1997, 1998, 2000; Acemoglu, Johnson and Robinson 2001). Glaeser et al. (2004) find that human capital is a more basic source of growth than are institutions, and that poor countries get out of poverty through good policies, often initiated by dictators, and subsequently improve their political institutions. Further complicating the matter, property rights at the country level are often subjective and not precisely defined and measured.

2.7.5 Labour

Jobs are the main source of income for people—and the main pathway out of poverty for the poor. A sound investment climate contributes to the creation of employment opportunities, investment in the workforce, increases in wages, and, ultimately, a more productive and prosperous society.
World Bank-Macedonia (2005) has three indicators that measure the extent to which firms perceive labour regulations and the skill level of workers as constraints. The first indicator relates to the inability to hire or fire for due causes and the lack of qualified workers leads to inefficient production and higher costs. The second indicator highlights firm investment in the skills and capabilities of their workforce. Incidence and intensity of training is measured by the percentage of firms that offer formal training and the share of skilled workers receiving formal training. However, the OECD forewarns us that attempts to boost workforce skills through vocational training without considering their interaction with basic educational attainment or flanking labour market policies are likely to be ineffective (OECD 2010). Human resource development requires a comprehensive strategy that takes full account of the linkages between, for example, improved population health on educational attainment and, depending on employment policies, on labour productivity. The third indicator presents the composition of the firms’ workforce by skill. Policies that encourage firms to invest in the human capital of their workforce can play a critical role in increasing the skills and wages of men and women.

The labour factor in fact pertains to the overall human resource development policy of a region that, in turn, is considered important in regard to the quality of labour force and the regulation of the labour market (OECD 2010). Quality in turn is a function of basic and higher education, training programmes and the overall health of the population. The quality and adaptability of the labour force is a key driver in creating a favourable environment for both domestic and foreign enterprises to grow through new investment and to adapt quickly to changing circumstances.

Referring to the rules and regulations by which governments control how firms manage labour, labour regulations are tighter when firms have less discretion in freely choosing and adjusting the quantity, quality, and prices of labour. Particular types of labour regulation include employment protection through severance payments, advance notice of dismissal, administrative authorization, and prior negotiation with trade unions (Cahuc and Zylberberg 2004). The study of the effects of labour regulations at cross-country level
is often inconclusive, partly because the data on labour regulation are available only for a limited number of industrialized countries. The estimated effects of labour protection on the level of unemployment ranges varies from positive (Lazear 1990) to negative (Nickell 1997) to insignificant (Bertola 1990). Thus the existing cross-country studies on labour regulations cannot offer much guidance for developing countries. Recent firm-level studies of labour regulations in developing countries have substantially improved our understanding about how labour regulations work in these countries. They suggest that labour flexibility facilitates better firm performance, faster factor adjustments, and a more efficient distribution in firm sizes. Why does labour flexibility improve firm performance? Dong and Xu (2009) have found that in case if China, firms, facing adverse demand shocks, with more nonpermanent workers find it easier to adjust their labour forces and therefore to reduce costs and restore optimal factor allocations. Furthermore, firms with a flexible labour force do not have to fear labour hold-ups when considering technology and investment decisions, and the choices of technology and capital–labour ratios would thus be more efficient.

2.7.6 Competition and Entry Regulation

There is evidence that entry deregulations improve productivity and macro-performance (Loayza, Oviedo and Serven 2005a; Crafts 2006; Barseghyan 2008). Moreover the positive effect of deregulation is found to differ by the initial level of regulation. Gorgens, Paldam and Wurtz (2003), using the Index of Economic Freedom, find that deregulation from a high to a moderate level of regulation has a large effect on growth of about 2.5 percentage points, but further deregulation has no effects. This explains why such deregulation in countries like China and India has spectacular effects, but barely noticeable ones in OECD countries. Recent firm-level evidence of entry regulation sheds light on the specific channels through which entry regulations affect economic outcomes.

An important channel for deregulation effects is by allowing for an easier entry.
Investigating the effects of entry regulations with a database of firms in Western and Eastern Europe, Klapper, Laeven and Rajan (2006) interact industry characteristics with country-level regulation indicators to examine whether regulation-vulnerable industries are more hampered by certain regulations. After controlling for country- and industry-specific factors and using the difference-in-differences approach, they find that entry regulations hamper entry, especially in industries featuring high entry (judging by what happens in the United States). Value added per worker in high-entry industries grows more slowly in countries with more onerous regulations on entry. Interestingly regulatory entry barriers do not hamper entry in corrupt countries, but do so in less corrupt ones. Similarly, using the United Nations Industrial Development Organization’s (UNIDO) industry-level data in 45 countries to examine the effects of entry regulations on entry patterns across industries, Ciccone and Papaioannou (2007) find that countries featuring less registration costs see higher entry rates in industries featuring stronger global demand and faster technology changes.

The importance of incentives for deregulation to work is also manifested in the telecom deregulation movement in the 1980s and 1990s, during which period national carriers were privatized, new competitors licensed, and new services allowed (Li and Xu 2002). More than 150 countries introduced new legislation or modified existing regulation. Using a comprehensive country-level panel dataset between 1990 and 2001 augmented by operator-level data on privatization and competition—and relying on the difference-in-difference approach to identify the reform effects—Li and Xu (2004) study how telecom liberalization and deregulation affect performance. They find that new entry into the sector improves both factor allocation and productivity. Most importantly, new entry and privatization are complementary in deepening network penetration and restraining the rise in service pricing.

Interestingly competition (and privatization) also reduces corruption. A study, using the World Business Environment Survey data of 21 transitional countries in East Europe and Central Asia, finds that utility employees are less likely to take bribes in countries with
more competition in the utility sector and where utilities are private or privatized (Clarke and Xu 2004)

2.7.7 Innovation and Technology

In order to survive and prosper in a competitive marketplace, firms must innovate and increase their productivity in response to the pressures they face from rival businesses. A sound investment climate encourages firms to experiment and learn; it rewards success and punishes failure. The World Bank study provides indicators that describe several dimensions of technological efficiency and innovation. The first set of indicators measures the degree to which firms innovate and their investment in research and development. Innovation here encompasses the development or upgrade of product lines, the introduction of new production technologies, and the acquisition of new licensing agreements. The second set of indicators measures the impact of competition on the innovative activities of firms. Driving forces of innovation in open markets include pressure from domestic and foreign competitors. The third set of indicators demonstrates the utilization of information and communications technologies (ICT) in business transactions by firms. ICT, such as the Internet, are important tools for firms because they provide even the smallest of enterprises with the ability to reach national and international markets.

2.8 Research studies linking Economic Growth and Business Environment

There is a growing literature that assesses the effects of the set of factors, policies and institutions, commonly known as business environment or investment climate, on the performance of firms and economic growth. The methodologies used by these studies are very diverse. A number of studies have focused on cross-country variation to identify the effect of labour regulations (Botero et al 2004; Heckman and Pagés 2004), regulation of entry (Djankov et al. 2002) or a wide set of regulations (Loayza, Oviedo and Servé, 2006).
These studies relate objective (*de jure*) measures of regulation at the country level to aggregate country outcomes. Although the results are suggestive of the importance of appropriate regulations for business development, they suffer from important methodological constraints ranging from omitted variable bias to endogeneity concerns.

Another group of studies employ a difference-in-differences method first developed by Rajan and Zingales (1998). These studies analyze the effect of different aspects of the business environment at the country-industry level. They show that financially dependent industries grow faster in financially developed markets, and that firms in industries dominated by small firms grow faster in more financially developed markets (Beck et al. 2008). Studies have also found that industries in which entry is more important exhibit less growth in countries with restrictions to firm entry (Klapper, Laeven and Rajan 2004). Finally, Micco and Pagés (2006) show that industries that are inherently more volatile create fewer jobs and are less developed in countries with very restrictive hiring and firing regulations.

While improving on cross-country studies, these studies suffer from three potential shortcomings. First, in most cases variation in business environment conditions is captured with country level variables that reflect *de jure* regulations or conditions, that is, the procedures and costs that would be incurred if firms fully complied with what is on the books. However, there can be large gaps between what is on the books and what is experienced on the ground. This is particularly true in lower income countries and those with higher levels of corruption (Hallward-Driemeier and Aterido 2007; Kaufmann, Kraay and Mastruzzi 2007). In that regard, it is desirable to have measures of de facto regulation.

Second, it is important to explore variation in the business environment not only across countries but also within country boundaries—across sub-national areas and especially, across firm size and ownership. Having disaggregated variables allows for hypotheses to

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be tested without having to assume that one country is the benchmark or “best” case against which to compare other countries.

Third, while most studies look at the effects of individual dimensions of the investment climate, our focus is on regressions that combine multiple dimensions in a single regression. This not only addresses potential bias in the estimates, it allows us to test directly which dimensions have the biggest impact on firm performance.

A number of recent studies make use of the World Business Environment Survey (WBES)\(^{29}\) firm-level dataset with 4,000 firms across 54 countries—to study the effect of the business environment on firm growth. Using subjective firm-level data measures of the business environment these studies show the importance of finance, corruption and property rights (Batra, Kaufman and Stone 2003; Ayyagari, Demirgüç-Kunt and Maksimovic 2006). Some other studies examine the relationship between business environment and firm growth using the newer Enterprise Survey, but for individual or small groups of countries (Dollar, Hallward-Driemeier and Megistae, 2005, for India, Pakistan, Bangladesh and China; Fisman and Svensson, 2007; Rienikka and Svensson, 2002, for Uganda; and Bigsten and Soderbom, 2006, which reviews the literature for Africa).

In the past decade, the World Bank has promoted improving business environments as a key strategy for development, which has led to a significant effort in collecting surveys of the investment climate at the firm level across countries. Several lessons have emerged from the papers using these new data. The key finding is that the effects of business environments are heterogeneous and depend crucially on industry, initial conditions, and complementary institutions. Some elements of the business environment, such as labour flexibility, low entry and exit barriers, and a reasonable protection from the “grabbing hands” of the government, seem to matter a great deal for most economies. Other

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\(^{29}\) Despite their similar names, the World Business Environment Survey (WBES), a one-off survey in 1999, is not part of the larger and ongoing World Bank firm survey effort, the Enterprise Surveys (ES). The earlier round primarily collected perception data regarding constraints and some information on firm performance. In some regions firms only provided information on their employment range, i.e., small, medium, large, making it impossible to use that data to study differences between small firms below and above 10 employees.

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elements, such as infrastructure and contracting institutions (that is, courts and access to finance), hinge on their initial status and the size of the market (Xu 2010).

In a recent paper by Kiichi Tokuoka (“Does the Business Environment Affect Corporate Investment in India?” IMF Working paper, March 2012), it is stated that not only macroeconomic factors but also structural factors, in particular, the business environment, affect corporate investment in India. Macroeconomic factors can largely explain corporate investment, but they do not appear to account fully for recent weak performance. While it is not entirely clear how important structural factors are in explaining the recent weakening of investment, analysis of micro panel data suggests that improving the business environment by reducing the costs of doing business, upgrading the financial system and developing infrastructure, could stimulate corporate investment. The study has found that there exist large differences in the business environment within India.

This paper argues that both macroeconomic factors and the business environment affect corporate investment. The analysis of macro data suggests that high and volatile inflation and heightened global uncertainty may have dampened corporate investment. While monetary easing since the global financial crisis provided important support for corporate investment, the monetary tightening since early 2010 may have started hurting corporate investment at the margin. The analysis of micro panel data implies that to stimulate corporate investment, improving the business environment is essential. India has considerable room to improve its business environment. Specifically, priority areas include cutting various costs of doing business and improving financial access. There is also some evidence that developing infrastructure, especially transport, could support corporate investment. Business-environment-related factors that are not tested in the present study can also be important in stimulating corporate investment in India. The empirical analysis in the study was able to examine only factors that vary enough within India and whose data are available for multiple years. However, there are many other factors that are likely to play an important role in supporting corporate profitability and investment. Such factors include stable provision of electricity, ease of land acquisition,
less restrictive regulations in product and labour markets, simpler administrative procedures, and higher quality education and skills. In many of these areas, India falls behind other emerging economies.

2.9 Developing a Framework

The literature on economic growth emphasizes the importance of a friendly business environment, as a pre-requisite for achieving higher economic growth. A sound macro economic environment; good governance, institutions and political stability and robust economic and social infrastructure, have a significant bearing on the perception of entrepreneurs. Entrepreneurs are encouraged to take risk in the presence of these favourable business environment factors. These factors define the cost and ease for doing business and predict the certainty of the policy environment, considered critical by the entrepreneurs. A friendly business environment encourages entrepreneurs to invest and an unfriendly environment makes them turn their back. Entrepreneurs are indispensable and inseparable part of any framework dealing with business economics. They introduce innovations; play a significant role by entering markets with new products or production processes. They lead innovations in industrialization and cause higher productivity. They grow firms by making use of scale economies and raise returns to human and physical capital. In essence, entrepreneurs and the quality of entrepreneurship are critical for raising investments and economic growth. Figure 2.1 below displays the proposed framework of the present research study and depicts the inter linkages between critical business environment factors and their effect on investment and growth. The process goes on. Eventually, a higher economic growth, caused by favourable business environment improves the business environment further, prompting even greater investments and growth.
Economic growth is also a direct function of capital formation. In the study of economic growth, wide interest has been attached to the proportion that capital formation constitutes of national product (Kuznets 1959: 70). Kuznets adds, ‘the larger it is (i.e., the larger the part of current product retained for use in further production), other conditions being equal, the higher the rate of growth of national product that can be generated.’ On the other hand, low capital formation proportions would imply low rates of growth of national product, unless capital-output ratios decline, i.e., unless more output can be turned out per unit of capital. Kuznets empirically shows that ‘the proportion of gross national capital formation to gross national product, i.e., gross savings ratio, is positively associated with income per capita’ (Kuznets 1959: 71).
In a globalizing world economy, governments increasingly need to address the challenge of development in an open environment. Foreign direct investment (FDI) can play a role in meeting this challenge. The relevance of FDI to the host economy underlines the importance of a thorough understanding of the role of FDI in the development process and appropriate policies for attracting FDI and maximizing its benefits. In this respect, Lall and Narula (2004) state that “it is difficult to see how host countries that have FDI can tap its potential fully without such strategies as local content rules, incentives for deepening technologies and functions, inducements to export and so on”. Chang also suggests that trade liberalization and the abolition of TRIMs (trade-related investment measures) means “kicking away the ladder” (Chang 2002) for technological upgrading of firms in developing countries.

Other scholars hold converse opinion. Moran, Graham and Blomström (2005) argue that FDI has favourable implications for host country development in general only if it is not subject to trade and trade-related restrictions, whereas FDI in protected host country markets leads to an inefficient use of local resources and subtracts from local economic welfare. Foreign investors in such countries deploy production techniques lagging far behind the frontier in international industry. Foreign affiliates with older technology and less efficient plants are not good candidates to develop from an infant industry to a robust world competitor.

From the theoretical point of view, the idea that the business environment could impact on output and productivity is based on the capacity of these factors to create incentives to invest. However these incentives operate at the level of the firm, where there is likely to be a differential impact by firm, which will depend on a myriad of interdependent factors – industry, size, location within the country etc. Hence in order to understand the role of the business environment and its possible impact on growth it is important to consider this at the firm level (Augier, Dovis, and Gasiorek 2010).

It follows from the above discussion and the proposed framework that the interlinkages between macroeconomic environment, governance and infrastructure affect the decision
of an entrepreneur, investment and economic growth. The review of theoretical literature on business environment and economic growth, as contained in this chapter, has enabled us to gain familiarity with the subject and has helped significantly in conceptualizing the research approach and design for the present study, which is dealt with in the next chapter – Chapter 3. Chapter 4 containing an analysis of exploratory research will discuss these factors in further detail, with the help of the secondary data. The results thus obtained therein will be juxtaposed with that of the data collected through a field survey of a relatively large sample of industries in four districts of Orissa and analysed in detail, using quantitative methods of research, in Chapter 5.