

Deals versus Rules: Policy Implementation Uncertainty and Why Firms Hate It

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Abstract. In surveys of firms in developing countries “policy uncertainty” is frequently a major complaint and perceived as an obstacle to firm expansion. In aggregate growth regressions several recent papers have argued that it is “institutions” and not policies that matter for long-run economic growth. We reconcile these two strands of the literature by showing that what matters for firms is not (just) inter-temporal uncertainty about shifts in notional policy but uncertainty about policy implementation—how the realized policy actions taken will affect the profitability of their firm. What is meant by “institutional quality” is fundamentally related to the reliability with which the direct organizations and background institutions responsible for policy implementation translate notional into realized policy. Firms based their investment decisions by forming expectations over trajectories of profitability, which are influenced by their expectations of realized policy actions. Once these three inter-related elements of the link between policies and outcomes are acknowledged—policies are mappings, positive models of policy implementation not notional policy mappings matter, and expectations determine responses—then everything about the performance of “policy reform” can be explained. In particular, in weak institutional environments, business is done through “deals”—individual firm/person specific accommodations with the policy implementation apparatus about how their specific businesses will be treated: big business makes big deals, little men make little deals (only losers (try to) follow the rules). We show how many dimensions of the growth experience in Africa can be understood in a framework in which policy implementation uncertainty plays a large role.

Deals versus Rules: Uncertainty in Economic Policy Implementation in Africa¹

For my friends, anything; for my enemies, the law.
Oscar R. Benavides, President of Peru, 1933-1940

Introduction

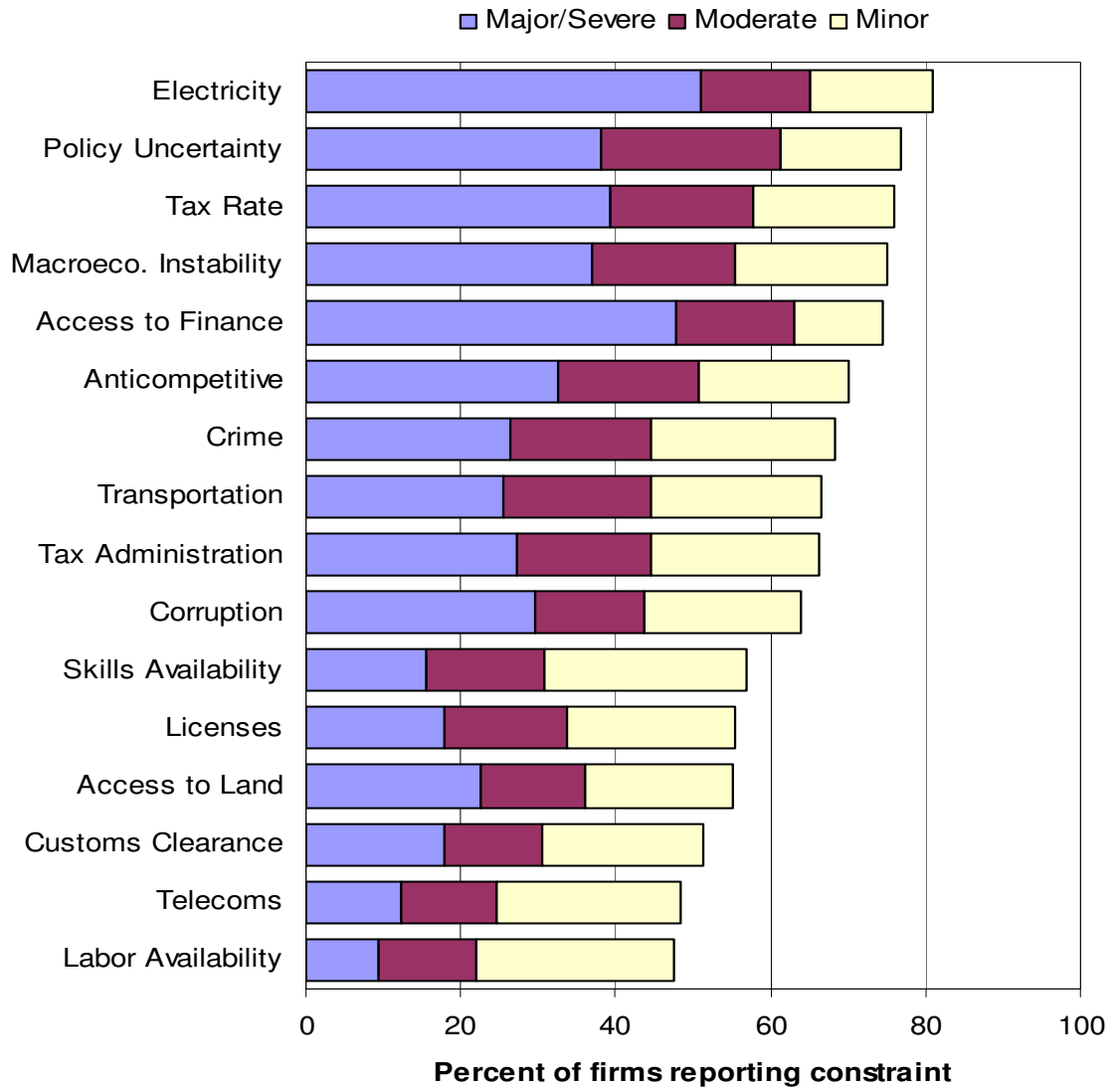
The Investment Climate Enterprise Surveys, have conducted detailed face-to-face interviews of over 80,000 entrepreneurs in 100 countries, including 11,150 in 34 Sub-Saharan countries. The issue that firms most frequently identified as an obstacle to their growth is “regulatory and economic policy uncertainty” (Smith and Hallward-Driemeier 2005). In Africa 60 percent of surveyed firms in Africa regard “economic and regulatory policy uncertainty” as an obstacle to their firm’s growth and over a third regard it as a “major” or “severe” obstacle. This finding is itself a puzzle. The other frequently identified obstacles are easy to understand: lack of electricity creates obvious production problems, macro-economic instability has its obvious consequences, firms everywhere complain about taxes, and “access to finance” as been widely investigated as a limit to firm expansion. But what exactly is “policy uncertainty” and why do firms hate so?

One view is that firms are concerned about a lack of political and policy making stability which leads to frequent and unpredictable changes in the formal rules and *de jure* policies². But what directly affects firm profitability is not “policy” but policy *actions* taken by agents of the state and in the weak organizational and institutional environments for policy implementation which are common across Africa, policy *actions*

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are not well predicted by policy. There can be substantial firm level uncertainty about the policy actions that will result from the *implementation* of “regulatory and economic policy” even when policies are unchanging.

Figure 1: “Policy Uncertainty” is commonly identified by firms as a “severe” or “major” obstacle to firm growth in Africa



² One view is that firms are complaining about the inter-temporal uncertainty and volatility in overall economic conditions created by poor macroeconomic policy—but “macroeconomic instability” is a separately identified obstacle.

Take the example of a seemingly simple policy, like an import tariff. With strong capability for implementation a firm's import tax payments collected (the policy action) are well-predicted by the firm's import value (a factual state of the world) and the tariff code (the mapping between states of the world (sales) and policy actions (tax collected)). In a "rules" world policies are implemented and are predictive of outcomes. In a study of Kenya's import tariff revenues Pritchett and Sethi (1994) compared the *ad valorem* collected rate (ratio of revenue collected to declared import value) to the actual *ad valorem* rate for the 3,392 separate items of the tariff code. There was surprisingly little connection as items with the same official rate had very different collected rates: of the 435 items in the tariff code with an *ad valorem* tariff of 40 percent which recorded positive imports, the 25th percentile of the collected rate was zero, the mean was 20 percent and the 75th percentile was 24 percent. The tariff rate any given item had very little predictive power for the tariff rate actually paid due to a large number of officially sanctioned³ deviations due to exemptions for certain purposes, exemption of certain importers, etc. which meant that even if two firms were importing exactly the same item they might pay completely different rates. In a "deals" environment the application of rules can be influenced and in a sufficiently weak environment *everything* is negotiable.

³ While naively one might imagine a regression of ad valorem revenue on ad valorem rates might yield a coefficient of 1 and an R-squared near one (e.g. items with a 20 percent rate would have 20 percent collection rates and items with 30 percent would have a 30 percent collection rate (this is not about demand elasticity as this is normalized by import value). Instead, across a variety of functional forms the official rate could only explain about a fifth of the observed variation across items in the collected rate. Of course this potentially vastly *overstates* the connection between the official tariff and tariff collected on the actual import of specific items as it does not include smuggling or mis-declaration.

I) The Varieties of “Policy Uncertainty”?

Things should be as simple as possible, but no simpler.
Albert Einstein

A recent study of the acquisition of driver’s licenses in Delhi, India (Banerjee et. al. 2008) (while obviously not Africa) illustrates nicely the distinction between *policy* and *policy implementation*. The *policy* for acquiring a driver’s license in Delhi is quite standard, it stipulates the requirements for a license, e.g. proof of identity, age, residence, and demonstrated competence in driving. The *policy* also stipulates the organization responsible for issuing driver’s licenses and the criteria they are to use in assessing whether or not an individual meets the requirements, e.g. the standards of proof for age, and the contents of the examination to assess driving competence.

The authors studied policy implementation by interviewing individuals on their way to obtain a license and asking them to cooperate in a study of the process of getting a driver’s license. The subjects were divided into a control group and two treatment groups (one of which was given a bonus if they got their license faster and one of which was given free driving lessons). The facts from the control group are almost as interesting as the comparison of treatment and control. First, most people in the control group hired a private agent to handle the process for them. Second, only 12 percent of the control group who hired an agent took the driver’s examination *required* by policy--but they nevertheless received a license. In contrast, 94 percent of control group people who did not hire an agent were required to take the driving exam and many were failed⁴. Third, the study hired a firm that teaches driving in Delhi to independently assess the driving

⁴ At least in their first attempt, many then learned and hired an agent and got their license that way.

competence of those who received licenses and found that, of those in the control group that hired an agent and got a license 69 were “automatic” failures in a driving test.

We distinguish two broad elements of a public policy: a notional policy mapping and a specification of policy implementation.

- *A notional policy mapping is a mapping from contingent factual conditions about the world⁵ to actions by an agent of the state.*
- A policy also specifies the process and procedures for implementation, at a minimum specify the *direct organizations* whose *agents* are responsible and have designated authority to act on behalf of the state within the policy design specified scope and potentially specify quite detailed elements of the processes of policy implementation.

Policy implementation has two conceptually distinguishable steps: a “*findings*” or *determination* step, in which the state of the world is administratively established, and a *policy action* step, in which the agent of the state (of the designated organization) takes an action. While conceptually distinct, these steps may be taken by the same person simultaneously (e.g. health inspector inspects the premises and issues a rating), but they may also done by different agents in the same organization (e.g. on agent gives the driving exam and another issues the licenses), or undertaken by separate organizations at distinct times (e.g. a policeman issues a citation, a court adjudicates the claim and issues a fine). Table 1 gives examples from a variety of common functions of the state: tax collection, regulation, and program implementation/service delivery just to emphasize the conceptual distinction between findings and actions. This distinction is important because many deals are not about violating the rules but rather about altering the

⁵ A completely fixed action that is not contingent is just a special case in which the mapping is from all states of the world into the same policy action (e.g. a k percent money growth).

administratively declared state of the world—irrespective of the factual state of the world--such that application of the rule produces the desired policy action.

Table 1: Policy implementation has “determination” and an “action” steps, examples		
<i>Notional Policy mapping</i>	<i>Determination</i> phase, declaration of administratively relevant state of the world	<i>Action</i> phase
Tax Collection		
<i>Import Duties:</i> Tariff code from types of goods to tariff rates	What type of good is it in the tariff code classification? Is it in an “exempt” category? What is the import value?	Apply the specified rate to the category from the tariff code and collect appropriate tax
<i>Property Tax</i> Value of property to amount owed	What is the taxable value of the property? Is it exempt?	Collect the tax resulting from applying rate to assessed value
Regulation		
<i>Urban Zoning/ Planning</i> Specification of spatially allowed types of activities	Is the activity of the designated type, Residential? Commercial? Industrial?	Issue zoning certificate for the designated activity
<i>Driver’s license</i> Personal qualifications to type of license	Does the applicant meet the specified criteria (e.g. age, residence, competence) for the type of license?	Issue driver’s license
<i>Allowable Rate of Return Utility Regulation</i> Conditions of firm providing to allowable rates/services	What is the value of the installed capital?	Allow charges sufficient to generate the stipulated return on the capital
Service Delivery/Program Implementation		
<i>Old Age Pension</i> From characteristics (e.g. contributions) to eligibility and amount	Is the person eligible? What were their total contributions/relevant earnings?	Issue a check in the appropriate amount
Contracting for public works/service provision		
<i>Road Construction</i> From “lowest cost qualified bid” to contract	Who are the qualified bidders? Which is the “best” bid on the specified criteria?	Issue the contract to the chosen bidder.

No one is directly affected by a notional policy mapping, the profitability of firms, or more broadly the well-being of economic agents, is affected directly by the

actions taken by agents of the state in the course of policy implementation. Policy actions are an endogenous outcome of choices made by the organizations/agents responsible for policy implementation. Therefore each economic agent makes both business decisions (e.g. investments, product choice, technique of production, number of workers to hire) and policy implementation influence decisions (e.g. how much to offer as a bribe, which politician to befriend) based on their positive model implemented policy (PMIP) which is a model of the behavior of implementing agents. The PMIP is specific to regulatory domain (e.g. firms could have different views about taxes versus labor regulation).

$$1) \text{ PMIP}^{i,j} : \text{States of the world} \xrightarrow{\text{PMIP}^{i,j}} f^{i,j} (\text{Policy actions})$$

The simplest assumption is that policy implementation is well described by “continuous complete compliance.” The equilibrium outcome of the optimizing calculation of all agents, both agents of the state in implementation and economic agents, *could be* that the PMIP for all economic agents *is* the notional policy mapping: rules are the rules, are applied accurately and firm voluntary truthful revelation is the equilibrium strategy. This assumption makes modeling simple as, for instance, with a *de jure* sales tax of rate τ each firm i 's revenue can be written in the textbook form as:

$$2) \text{ Revenue}^i = (1 - \tau) p^i * q^i$$

Where $p^i * q^i$ is the *factual* state of the world. With continuous complete compliance the only type of “policy uncertainty” is *inter-temporal* uncertainty about potential changes in the notional policy mapping (e.g. tax rates could do up, items could be made exempt, etc.).

Simple models are good, but too simple is bad and “rules are rules” is far too simple to be a universally held positive model of policy implementation for Africa. We argue the implicit assumptions are empirically wrong in three ways, each of which create distinct additional types of “policy uncertainty” over and above the uncertainty of “inter-temporal changes in the notional policy mapping”

First, a “rules” approach assumes policy actions are a function *only* of the state of the world and are not affected by actions of the firm. The strong version of this assumption is that policy implementation is not susceptible to influence:

$$PMPI^i(\Theta, b) = PMPI^i(\Theta) \quad \forall b \in B$$

The weaker version is just that the costs of policy implementation (balancing both direct costs and risks of enforcement) are sufficiently high that all firms optimally choose not to attempt to influence policy in equilibrium:

$$\text{Where } \tilde{b}^i = \underset{b \in B}{\text{Max}} \Pi^i(PMPI^i(\Theta, b)), \tilde{b}^i \approx 0 \quad \forall i, \forall \theta \in \Theta$$

The alternative view is that “deals” are available and that in equilibrium firms will undertake actions to influence policy implementation (at either the determination or action stages). A *deal* is just a firm specific arrangement about policy implementation and come in many types. Some deals might just allow the firm to do in a timely manner what is allowed under the rules so the deal simply avoids delay. Another deal might explicitly create separate conditions for a firm or project—e.g. waiving compliance with certain regulations, creating special definitions. Deals can be across policy domains for a specific firm, such firms with politically powerful patrons who are then treated differently in all regulations (e.g. with the tax collector, the safety regulation, land use, labor, etc.). Deals and happen with or without illicit consideration, when policy

implementation requires discretion over essentially subjective characteristics (e.g. land use for which zoning waivers are available for certain purposes) then a deal is required. Influencing deals may take the form of pure persuasion, meeting with government agents to induce a favorable decision even without consideration of any type. Deals can also be the result of illicit collusion, paying direct bribes, donations, favors. Deals can be large—between a firm and the president of the country or small between a person running a tortilla stand on the side of the road and the local police officer/precinct or anywhere in between, between a locally large real estate developer and the mayor. Subterfuge is also a type of deal, altering the policy action through attempting to avoid the implementing agents, hide sales or assets or actions, remain in an “informal” status.

The second way in which the “deals” environment differs from “rules” is that characteristics of the firm itself may alter the scope of deals available. There may be implicit or explicit “regulatory forbearance” for firms owned by the government, or by members of the President’s family, or firms of powerful families or business groups, or international firms. Fisman (2001) has shown for instance that the stock market value of firms owned by people related to the Indonesian ruler Suharto were substantially higher than otherwise because of their connection to Suharto⁶. In this case there is a different set of available deals as the influence is done “wholesale” rather than “retail.” These firms get deals that are *closed* in that the same deal may not be available to other firms. In fact, as documented in Hellman, Jones and Kaufmann (2000) dominant firms may use their influence over governments to not only improve the policy actions they face but actively

⁶ A month or so after Suharto was replaced by Megawati a businessman saw Megawati’s husband in a restaurant with prominent private sector figures. He said to his lunch companion “I didn’t know Megawati’s husband was a business man.” The response: “He is now.”

worsen policy and policy actions their competitors face: “Seize the State to Seize the Day.”

These two distinctions already create different types of environments firms might face and the associated uncertainties. One environment is whether or not the space for deals is “open” or “closed” while the second is whether the deals environment is “ordered” or “disordered.”⁷ This creates then four different notions of what “regulatory and economic policy uncertainty” might mean:

- a) Inter-temporal uncertainty in the notional policy mapping (changes in the rules)
- b) Uncertainty about the available “influence function” (the relationship between actions of the firm to affect policy actions (e.g. subterfuge, bribes, meetings, lobbying) and the sequence of policy actions (on average).
- c) Uncertainty about the durability of the deal. If I bribe the tax collector today will I have to also bribe the tax collector tomorrow (or are they in organized collusion). This affects both open and closed deals as even a closed deal may be reneged upon if conditions change.
- d) Uncertainty about the characteristics of the firm to which deals of various types are available.

⁷ This is closely related to the distinction of Shleifer and Vishny (1993) between “organized” and “disorganized” corruption.

Table 2: Relationship between rules, types of deal environments (open versus closed, ordered versus disordered) and the associated type of “policy uncertainty”

Characterization of the Positive Model of Policy Implementation				
	Rules (policy actions depend on notional policy mapping)	Deals (Policy actions depend on characteristics or actions of the firm not specified in the notional policy mapping)		
		Ordered (small ex-post uncertainty about policy implementation—deals stay done)		Disordered (large ex-post uncertainty—deals cannot secure predictability)
		Open (deals are available to all firms)	Closed (deals are available only to favored firms)	
“Regulatory and Economic Policy Uncertainty”	(a) Inter-temporal changes in the Notional Policy Mapping	(a) <i>and</i> (b) uncertainty about the “influence function” <i>and</i> (c) uncertainty about the durability of deals	(a) <i>and</i> (b) <i>and</i> (c) <i>and</i> (d) uncertainty about which type of treatment a firm will depend on its characteristics (firms have differential <i>ex ante</i> (type b) and <i>ex post</i> (type c) uncertainty depending on characteristics)	(a) <i>and</i> Type b uncertainty is much larger as the “influence function” is less known <i>and</i> type c uncertainty is much larger as deals do not stay done (as other parties may intervene) <i>and</i> type d is larger as who are the “favored” firms may change dramatically over time due to political instability

II) How to interpret “Policy Uncertainty”

The Enterprise Surveys implemented by the World Bank contains both subjective firm’s subjective assessments about the obstacles to their firms growth, but also quantitative information about how long it takes to get various things done and how much

they cost – including in terms of additional payments or gifts that might be required.

Using these data we show XXX overlapping pieces of evidence that firms complaints of “policy uncertainty” are mainly about policy *implementation* uncertainty.

First, the firms themselves believe that implementation is not consistent and predictable. Table 3 shows the proportion of firms who *disagree* with the statement “government interpretation of laws and regulations is consistent and predictable.” One suspects that this *understates* firms true disagreement, but in any case at least 40 percent of firms in Africa do not report a PMIP in which they are confident the *de jure* policy will lead to actions by agents of the state that are “consistent or predictable.” The “interpretation” of laws and regulations consists of both a “findings” and an application, and it is possible that in actual “interpretation” of laws and regulations the *administrative* state of the world and the *factual* state of the world may not be at all related.

Table 3: Fraction of firms who <i>disagree</i> (either “strongly” or “tend to”) with the statement “Government implementation of laws and regulations is consistent and predictable”	
Country/Year	Percent disagree
Cameroon2006	75.0%
Angola2006	67.5%
Nigeria2007	59.7%
Benin2004	59.2%
Guinea-Bissau2006	58.5%
Mali2007	56.4%
BurkinaFaso2006	50.0%
Zambia2007	47.7%
Uganda2006	44.4%
Lesotho2003	43.1%
Swaziland2006	42.9%
Kenya2003	40.7%
Senegal2007	40.0%
DRC2006	38.6%
Niger2005	37.9%
Guinea-Conakry2006	37.3%
Madagascar2005	36.2%
Tanzania2006	35.2%
SouthAfrica2003	33.6%
Ghana2007	32.1%
Botswana2006	32.0%
Mauritius2005	30.4%
Malawi2005	30.0%
Mauritania2006	28.7%
CapeVerde2006	28.6%
Gambia2006	26.9%
Namibia2006	26.8%
Burundi2006	18.7%
Rwanda2006	9.9%
Total	40.3%

Second, “consistent and predictable” combines two different elements of uncertainty, one about “predictability” which is about the influence function and the durability of deals while “consistent” could mean either consistent over time or across firms—that privileged firms get differential treatment. Table 4 that in Nigeria, a weak overall implementation environment, small firms are much more likely to believe that the government is not “consistent and predictable” than are large firms (64 percent versus 39

percent). In Ghana, although firms are much more likely in general to believe implementation is consistent and predictable, capital intensive firms are much more likely to think implementation is consistent and predictable than labor intensive firms (24 versus 39 percent). These results are consistent with differences in the policy implementation firms even when facing the same *de jure* policy. It would be natural that firms only become large or capital intensive if they have access to deals to accommodate the uncertainty of policy implementation.

Table 4: Fraction disagreeing that government implementation is consistent and predictable, by firm characteristics			
	Nigeria	Uganda	Ghana
Small (Employees<6)	63.9%	43.4%	32.2%
Medium(6<employees<21)	60.2%	47.6%	34.1%
Large (Employees>21)	38.6%	41.5%	31.3%
Labor Intensive	59.5%	51.4%	39.0%
Capital Intensive	56.2%	40.1%	24.6%
Services	61.2%	41.7%	30.7%
Capital City	65.9%	46.2%	28.7%
Medium/large	57.5%		40.9%
Medium/small	53.4%	42.1%	34.1%
Small city	75.1%	35.5%	
Total	59.7%	44.4%	32.1%

The third piece of evidence that policy implementation uncertainty is an issue for firms is the large *variation* across firms in the reported time it takes to accomplish regulatory policy tasks like obtaining a license, a construction permit, for imports to clear customs. Usually attention in assessing the investment climate is given only to the *average* of these responses across countries or regions—e.g. that it takes 11 days to get an operating license in Kenya and versus 30 days in Senegal. However, the standard deviation of reported days in Kenya is 30, so the firms a standard deviation above the

mean report 42.8 days to get an operating license, 12 days longer than the average firm in Senegal. Overall the standard deviation of number of days across countries is 9.8 whereas the standard deviation within countries is over 30.

The implication is that firms that get licenses quickly get them instantaneously (the standard deviation is greater than the mean) while firms that get them slowly get them very slowly—the average of the mean plus a standard deviation (*if* these were normally distributed this would be the upper 16th percentile of slow) is 48 days versus zero for the quick firms⁸. The reported standard deviation includes measurement error and some significant portion of variability could be noise, but another interpretation is that in a deals environment firm outcomes of policy implementation vary—because firms some are politically connected and some are not, some firms have connections with the particular implementing organization and some do not, some struck a good deal and some did not.

⁸ When we do this again we'll do percentiles as clearly the data are not normally distributed.

Table 5: Variation across firms in the reported days to get an operating license					
	Average Days	Std Dev Days	Mean plus one std dev	Mean less std dev (truncated at zero)	Firms responding
Benin2004	39.6	88.8	128.4	0.0	75
Mozambique2007	36.8	49.3	86.1	0.0	84
Senegal2007	35.7	98.5	134.1	0.0	79
Senegal2003	30.5	49.4	80.0	0.0	59
Swaziland2006	25.2	52.5	77.7	0.0	127
Burundi2006	24.8	25.1	49.9	0.0	19
Angola2006	24.5	36.1	60.6	0.0	154
DRC2006	23.7	45.9	69.5	0.0	106
Tanzania2003	17.8	36.3	54.0	0.0	176
Malawi2005	17.4	22.8	40.1	0.0	58
Tanzania2006	15.7	16.4	32.1	0.0	132
Cameroon2006	15.6	29.2	44.8	0.0	129
Botswana2006	14.9	25.1	40.0	0.0	230
Uganda2006	12.8	31.7	44.5	0.0	357
Ghana2007	12.8	24.4	37.2	0.0	87
Mali2003	12.5	42.1	54.6	0.0	80
Guinea2006	12.4	21.5	34.0	0.0	45
Nigeria2007	12.2	19.7	31.9	0.0	720
Kenya2003	11.2	31.6	42.8	0.0	230
Niger2005	10.6	19.5	30.1	0.0	38
Mauritania2006	10.6	11.6	22.2	0.0	18
CapeVerde2006	9.7	10.9	20.6	0.0	11
Gambia2006	9.3	17.2	26.5	0.0	112
Namibia2006	9.2	16.4	25.6	0.0	119
Rwanda2006	6.8	12.2	19.0	0.0	79
SouthAfrica2003	5.0	17.0	22.0	0.0	155
Uganda2003	4.9	22.5	27.4	0.0	260
BurkinaFaso2006	4.6	5.9	10.5	0.0	5
Average	16.7	31.4	48	0	3744
Std. Dev. Across countries	9.8				

The fourth piece of evidence that policy implementation is uncertain is that firms engage in actions aimed at influencing policy implementation, including actions, such as paying bribes, that are not a part of the *de jure* policy implementation or the notional policy mapping. The extent of policy influence activity firms report varies across countries and across firms within a country. Table 6 shows the fraction of management time spent with government officials, the fraction of firms who report paying bribes and

the proportion of revenue paid as bribes for those who do pay bribes. Obviously if the rules were followed irrespective of whether a bribe was paid the fraction paying bribes would be small. But in half of the countries more than half of the firms report paying bribes. The fraction reporting paying bribes varies from ubiquitous, over 80 percent, in Burkina Faso, DRC, Guinea to 20 percent or less in Rwanda and South Africa.

Table 6: Actions by firms to secure deals					
	Percent of management time spent with government officials		Bribes		
	Average	Std Dev	Percent paying	Average of those paying, as a percent of sales	Std Dev of bribes as percent of sales
BurkinaFaso2006	11.01	15.30	87.0%	7.15	8.59
DRC2006	7.79	11.50	84.9%	4.39	7.82
Guinea2006	3.34	6.46	84.5%	5.00	8.40
Mauritania2006	7.52	13.69	81.2%	4.42	7.04
Cameroon2006	14.06	15.42	77.4%	4.13	11.45
Niger2005	13.20	19.39	66.1%	9.47	8.06
Kenya2003	13.46	15.01	63.0%	3.84	10.25
Mali2003	8.83	14.67	59.6%	3.42	5.75
Benin2004	8.29	14.39	57.6%	4.99	6.99
Burundi2006	6.10	8.85	55.4%	4.57	6.06
Gambia2006	8.89	14.42	52.1%	4.54	8.20
Tanzania2006	4.92	7.63	50.6%	3.51	6.86
Uganda2006	5.71	7.54	49.8%	3.66	6.22
Angola2006	7.91	8.48	45.2%	3.28	7.92
Zambia2002	13.88	12.97	44.4%	1.52	3.89
Nigeria2007	6.63	9.43	41.2%	1.85	4.06
Swaziland2006	5.18	7.09	40.7%	1.23	3.03
Malawi2005	7.89	13.35	35.7%	2.19	5.69
Lesotho2003	22.11	24.77	33.3%	0.60	1.93
Ghana2007	4.05	6.57	33.0%	1.95	4.94
Botswana2006	6.09	9.81	26.0%	1.26	4.95
Senegal2007	3.96	7.19	24.2%	1.56	4.91
Rwanda2006	6.73	10.17	20.1%	2.77	9.10
Mozambique2007	4.05	6.46	14.0%	1.58	8.81
Namibia2006	4.88	8.14	13.3%	0.82	3.54
SouthAfrica2003	10.09	11.97	2.1%	0.29	4.09
Average	8.33	11.56		3.23	6.48

Just as with questions about “consistent and predictable” and the reported variation in time to obtain a license across firms, there is wide variation across firms. There is also large variation across those firms who report paying bribes in the fraction they report paying as a percent of sales. Table 7 examples the correlates of (admitting to) deal making, measured as ‘bribes paid to ‘get things done’’. Two patterns emerge. Bribe paying higher among younger firms. There is a possibility that younger firms are operated by younger entrepreneurs and that they feel more comfortable recognizing the role of such payments. Or, it could be that to become established, certain dues are expected. The finding that smaller firms are also likely to pay more corroborates this explanation. It is noticeable that foreign owned firms are not statistically different in their deal making. While for the larger global sample (the first two columns) the coefficient is negative, it because larger and positive for just the sample in Africa. For firms with some state ownership, reported bribes are considerably lower, although not statistically significant for Africa. There is also a different pattern by location within a country across Africa and the rest of the world. In the rest of the world, deals are smaller outside of the capital city. However, in Africa the effect is the opposite. Deals are actually larger outside of the capital cities – where review of officials’ behavior is likely to be less well monitored.

After controlling for the firm characteristics, we look at the role of measures of uncertainty. First, we look at the association with management time spent dealing with officials. The effect is significant and positive – and is even more pronounced in Africa than in other regions as a whole. This raises interesting questions about what time spent dealing with officials really represents. Is it time spent by the manager negotiating a

deal, with time needed to set the terms. Or, do officials spend more time so as to be able to extract a large deal in the end? Looking at specific transactions may shed more light on this.

We recognize that there is likely feedback from deals – current or passed – with subsequent time spent with officials. To address this potential endogeneity we use an instrumental variables approach. The challenge is finding a variable that meets the exclusion restriction. One candidate we use is the average time spent by similar firms in the same location and sector. What time other managers spend with officials could be seen as exogenous to the firm. However, it is also possible that entrepreneurs use the knowledge that they have on where officials spend their time and what type of deals are being struck in setting their own deal. So a case can be made that the average experience of similar firms could itself be an important variable to include.

In column 3 of table 7 we pursue a different approach. We want a proxy for how “uncertain” policy implementation facing a given firm is. Since we have observations on firms that are in the same “cell” (country, city, sector) as any given firm i , we can calculate not only how much time firm i spent with government officials, but also the *average* of all other firms in the same cell as firm i and the *standard deviation* of those firms—do some firms spend lots of time with government officials and others very little. We can do the same thing for whether firms consider policy implementation is “consistent and predictable” measuring how much to firms reports disagree with how much consistency and predictability there is in policy implementation might actually be a good proxy for implementation uncertainty overall. The table shows that once the standard deviations are included, the average levels are no longer significant. And, the

association of greater variations in time spent and greater lack of consensus about the consistency of interpretations, the more likely is a firm is to have paid a bribe.

Table 7: Let's Make a Deal			
Dependent variable: Bribes paid to 'get things done'			
	(1)	(2)	(3)
		IV	
Mngtime with officials	0.0272*** (0.0033)	0.1075** (0.0422)	
(d_AFR==1)*mngtime	0.0445*** (0.0103)		
Av – mngtime			-0.0526 (0.0580)
Std – mngtime			0.1035*** (0.0350)
Av - consistency of interpretation			-0.2942 (0.5241)
Std - consistency of interpretation			0.3208*** (0.09959)
Age>10 years	-0.2544*** (0.0773)	-0.2762*** (0.0799)	-0.1110 (0.2841)
Size(t-3) = 6-10	-0.0744 (0.0628)	0.2585** (0.0798)	0.4809** (0.2195)
Size(t-3) = 11-50	-0.4294*** (0.0717)	-0.5744*** (0.1087)	-0.5285** (0.2616)
Size(t-3) = 51-150	-0.5122*** (0.0970)	-0.6302*** (0.1173)	-0.5252 (0.4633)
Size(t-3) = 150+	-0.5501*** (0.0947)	-0.6677*** (0.1166)	-0.5716 (0.3912)
Foreign ownership	-0.0936 (0.0726)	-0.1083 (0.0752)	0.2588 (0.2475)
Government ownership	-0.4766*** (0.0682)	-0.5398*** (0.0775)	-0.4114 (0.4492)
Non-capital city	-0.1825*** (0.0527)	-0.1873*** (0.0537)	0.1545 (0.1701)
Observations	46133	46133	7759
R-squared	0.08	0.04	0.05
Robust standard errors in parentheses			
* significant at 10%; ** significant at 5%; *** significant at 1%			
Sector and country dummies included			

The previous four pieces of evidence mainly differentiate between the “inter-temporal” versus “policy implementation” interpretations of firms’ complaints about

policy uncertainty. An interesting question though is whether one can differentiate between “ordered” and “disordered” uncertainty. One bit of evidence on that is that in Nigeria firms were asked whether it was “common” for firms in their line of business to make payments. Only a third of the firms were willing to agree that this practice was common (interestingly, even less than admit that they themselves engaged in the practice). The survey also asked whether, of those establishments that did pay bribes whether they knew in advance the amount they had to pay. Only sixty percent of those who agreed bribes were common also agreed the amount of bribes was known in advance, which means that for 40 percent they felt that some bribe was common practice but the exact magnitude of the bribe was not known. This suggests substantial uncertainty in this case about the “influence function” available to particular firms.

A last interesting finding comes from the Nigeria survey, which asked a question meant to elicit whether the practice of bribery, if it was regular and predictable, in and of itself constituted an obstacle to business. The firms were given the following vignette:

Musyoka needs to renew a small business license from a local government office each year. Bribes are welcomed. Musyoka usually includes an additional bribe with his applications. When Musyoka had not included bribes, his application was sometimes lost or there were long delays such that the firm had to re-file.

And then were asked “Does corruption represent an **obstacle** to the operation and growth for Musyoka's business?” What is striking is that even when the question was framed to indicate substantial predictability—that paying the bribe was effective—businesses regarded this as a major obstacle to business—with around 80 percent of firms responding that this story represented a major (or worse) obstacle to business.

Table 8: Responses to the question of whether a hypothetical vignette detailing the need for a bribe to facilitate licenses constituted an obstacle to business in Nigeria	
	Percent
No	3.15
Minor	4.86
Moderate	11.90
Major	42.14
Very Severe	37.96
Source: Authors' calculations.	

III. Impact of deals

As a final step, we turn to examine the impact of uncertainty and the extent of deals on firm behavior. We begin by looking at firm employment decisions. The dataset includes information on employment at the time of the survey and three years prior to the survey. In calculating employment growth, we follow Haltiwanger’s approach of using the difference divided by the average. This gives a value that is between plus and minus two and minimizes the role of large outliers that can be present, particularly for smaller firms.

Again, a number of firm characteristics are controlled for, including the average size of the firm over the time period, the age of the firm, its ownership (foreign-domestic,

state-private), its sector, and location within the country. The average size of the firm is used rather than the initial size to minimize the effects of transitory changes in employment (Haltiwanger 2009). Country dummies are included to absorb country characteristics, so the variation is between firms within a country.

While we are interested in looking at the impact of the reported measures of uncertainty, the interactions with officials and evidence of deals can all be endogenous to the firm's performance. Officials may well target expanding firms, believing them to have a better ability to pay. Expanding firms may also be more impatient to get things done. We address this issue we use the information of firms like the respondent to construct location-sector-size averages of uncertainty measures and bribes (Dollar et al 2006, Aterido et al. forthcoming). One question is what is the appropriate size to use in constructing these averages.⁹ Most of the questions were made in reference to conditions at the time of the survey, for which current size might be appropriate. However, if firms' size has varied, the responses may better be reflections of the experience of firms like what they had been over a longer period. We opted for using average size. These location-sector-size averages are correlated with the individual responses and are more likely to be exogenous to the firm's own growth experience. We thus use them to instrument for the firm's own responses (col 2). However, as in the previous table we also look at whether they have direct explanatory power.

⁹ Using sector-location averages yield similar results.

	(1)	(2)	(3)	(4)	(5)	(6)
		IV				
Mngtime	0.0002** (0.0001)	0.0094** (0.0043)				
Mngtime*AFR	0.0005 (0.0003)					
Mngtime_Avg			0.0048*** (0.0011)			
Mngtime_Avg*AFR			0.0047* (0.0028)			
Mngtime_sd			-0.0013 (0.0009)			
Mngtime_sd*AFR			-0.0046** (0.0023)			
Freq_bribe				0.0086** (0.0041)		
Freq_bribe*AFR				0.0049 (0.0089)		
Freq_bribe_avg					0.0002 (0.0442)	
Freq_bribe_avg*AFR					0.0455** (0.0220)	
Freq_bribe_sd					-0.0410 (0.0405)	
Freq_bribe_sd*AFR					-0.0766 (0.0751)	
Bribe_avg						0.0120*** (0.0039)
Bribe_avg*AFR						-0.0114 (0.0071)
Bribe_sd						-0.028 (0.0193)
Bribe_sd*AFR						-0.0324 (0.0212)
Country, sector dummies	Yes	Yes	Yes	Yes	Yes	Yes
Observations	67592	12628	68177	57358	63254	62904
R-squared	0.108	0.042	0.103	0.112	0.103	0.103

(7)

(8)

Consistency_avg	0.0510***	
	(0.0119)	
	-	
Consistency_avg*AFR	0.0127***	
	(0.0024)	
Consistency_sd	-0.0263	
	(0.0240)	
Consistency_sd*AFR	-0.0070*	
	(0.0043)	
PropRights_avg		0.0288**
		(0.0136)
PropRight_avg*AFR		-0.0026
		(0.0028)
PropRights_sd		-0.0375*
		(0.0219)
PropRight_sd*AFR		0.00532
		(0.00398)
Country, sector dummies	Yes	Yes
Observations	61568	60613
R-squared	0.102	0.102
Standard errors in parentheses, *** p<0.01, ** p<0.05, * p<0.1		
Firm controls: average size, age, government ownership, foreign ownership		

Col 3 tests whether, beyond the role of the average experience of “firms like yours,” the variation in firms’ experience is also important. The standard deviation of firms in the same location and sector are thus included too.

$$Y_i = a + b * \text{management time}_{csl} + b * \text{std}(\text{management time}_{csl}) + b * \text{age}_i + b * \text{size_average}_i + b * \text{foreign}_i + b * \text{government}_i + i.b * \text{sector}_i + i.b * \text{country}_i$$

The results are repeated for five variables: overall management time with officials, the frequency of bribes to get things done, the size of the bribe payments, the consistency of interpretation of regulations and the confidence that courts will uphold property rights.

The first result is that spending time with officials is indeed associated with better firm outcomes – and this effect is even stronger in SSA than in other regions. To the

extent the time represents efforts to make deals with officials, this appears, on average, to be worth the effort. If the location-sector-size average is included directly, the effect is still positive. In areas where firms are able to make deals, growth is higher. However, the inclusion of the standard deviation is also significant – and negative. While securing a deal may be advantageous, to the extent there is uncertainty regarding what is required to secure the deal, the benefits are reduced.

The pattern holds if one looks at the frequency of bribe paying; more firms participating in making deals is associated with higher firm growth. Interestingly, the average size of the bribe is also associated with higher growth. However, the standard deviation is not. This would be consistent with greater uncertainty about whether the deal, once struck, will actually stick.

Looking at the measure of consistency of interpretation of regulations directly, greater reported consistency is positively associated with firm growth, although again, variation in the assessment detracts from growth (although no longer statistically significantly.).

As a second approach to examine the issue of variability in deal making, we use a difference in difference methodology. The approach tests whether the degree of openness and orderliness of the system of deals matters, whether deals can be had by anyone willing to pay, or whether the system is largely closed to all but those with the right (political) connections. If the system is relatively open, the average level of bribe may be high or low, but there should be relatively little variation in the size of bribes paid or in the time managers spend with officials. However, if the system is less open, the variation in bribes paid or the time spent with officials working out deals or seeking

compliance with regulations will likely be higher. If only some firms are benefitting from the deals, the greater variation in bribes and/or management time should be associated with relatively larger gaps in opportunities between the two groups.

As a first step we need to construct a measure of the extent to which sectors vary in the degrees to which they interact with officials. For firms in sectors that have a higher underlying rate of interaction, the relative openness of making deals is likely to matter more. To construct a measure of a sector's intensity of interactions with officials, we use the time spend in inspections using Germany as the benchmark. Of all the countries that have conducted an ES, it is the one whose rule of law and control of corruption are strongest. To measure the orderliness of deals in a location, we use the variation in the size of bribes paid and in the time managers spend with officials.

In determining firms that are more or less likely to have access to orderly deals, information on connections to officials would be desirable, but not information that is available to us. Rather, we use two proxies: size and age. Larger firms and older firms are more likely to have developed close relationships with officials and to benefit from the existing system of deals than smaller firms or newer firms still trying to get established. Several papers have found that smaller firms are more likely to adversely affected by red tape and corruption (Aterido et al forthcoming; Beck et al.) It is not that small firms or young firms don't try to get a deal – it is that the terms of the deal and the security of the deal are likely to be more uncertain.

Thus the regressions are testing that if larger firms are more likely to have connections and participate in orderly deals, the gap between large and small firms

performance could well be larger in those sectors that would have more interactions and where deals are less open (i.e. greater variability in the payments and time spent).

As table 10 shows, the gap between large and small firms' growth is relatively higher in sectors with more interactions with officials and in locations where deals are less orderly. This is particularly true when looking at firms by size. And the effects are more significant for bribes than management time.

Dependent variable:	Gap in growth of large versus small firms		Gap in growth of old versus young firms (by sector, country)	
	(1)	(2)	(3)	(4)
Std_Bribes _c * Intensity of Govt Interactions _s)	0.0133** (0.0066)		0.0065 (.0074)	
Std Management Time _c * Intensity of Govt Interactions _s)		0.0053* (0.0029)		0.0047 (.0036)
Country dummies	Yes	Yes	Yes	Yes
Sector dummies	Yes	Yes	Yes	Yes
R ²	0.33	0.31	0.24	0.28
N	260	260	285	285

Overall, these results underscore that just looking at the average level of deals does not capture the whole story and that uncertainty about the policy environment is itself an important dimension affecting firms' behavior.

IV) “Send Lawyers, Guns and Money”: Doing Business with Deals

*I was gambling in Havana,
I took a little risk,
Send Lawyers, Guns, and Money
Dad, get me out of this*

Warren Zevon

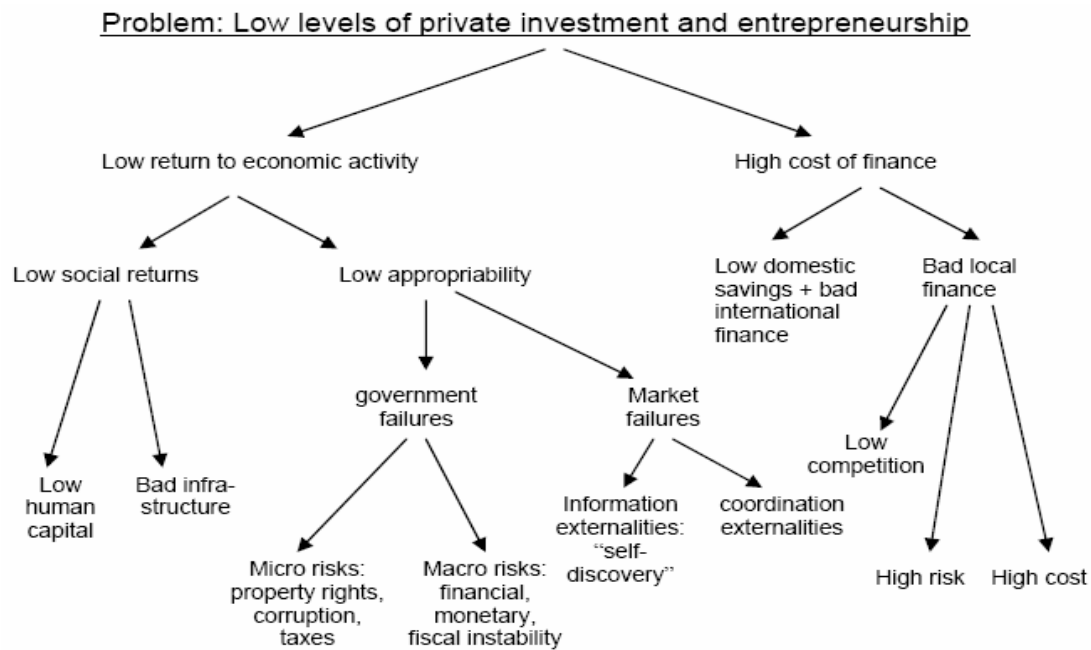
Most of the obstacles commonly identified by firms have also been recognized in the macroeconomic literature on economic growth as inhibitors of growth. The Hausmann,

Rodrik, Velasco (2004) “growth diagnostics” framework starts from the firm level first order condition for investment (marginal benefits versus marginal costs) to develop a diagnostic tree of the factors that reduce investment in an effort to identify the constraints that are the most “binding” such that their relaxation would lead to rapid growth. Figure 2 (Hausmann, Klinger, Wagner 2008) shows a simple version of the growth diagnostic tree, branching first to “high cost of finance” (firms complaints of “access to finance”), by reducing its productivity dues to inadequate infrastructure (firms identification of “electricity” or “transport”) or low human capital (“skills” as a constraint). One branch of the growth diagnostic is that, although investments would be productive they would not be reliably profitable because of “low appropriability” from either market failures (e.g. informational externalities (too little “self discovery” (Hausmann and Rodrik (2003) or coordination issues) or government failures. Government failures can lead to either macroeconomic risks (identified by firms as “macroeconomic instability”) or microeconomic risks, from either government agents themselves or from other private agents with unreliable contracting.

Our interpretation of firm complaints of “policy uncertainty” as primarily issues with policy implementation is consistent with a large number of the identified obstacles in Figure 1 are consistent with the growth diagnostic node of “low appropriability/government failure/microeconomic risk.” In addition to “policy uncertainty” more than 40 percent of firms identify as a “severe” or “major” obstacles: tax rate, tax administration, and corruption (as discussed above, the latter two clearly fit in the “implementation” concerns), with customs clearance and licenses identified by around a third. Bigsten and Soderbom (2005) review the research based on a first round

of firm surveys in Africa and concluded the uncertainty, paired with irreversibility, explains low investment in African firms.

Figure 2: Growth diagnostic decision tree



Source: Hausmann, Klinger, Wagner 2008.

As raising economic growth rates in Africa has been a development priority for decades, there have been clear responses, both programmatic and reform, to the major growth obstacles identified in the macroeconomic and microeconomic literature. Obviously addressing “macro instability”—reducing inflation, macroeconomic imbalances, exchange rate crises, debt—has been a major agenda. “Access to finance” has been addressed through both big picture policy reforms, financial sector liberalization, allowing entry into banking, and increasingly through programmatic attention to micro-credit and SME financing. Infrastructure and its shortages are again attracting enormous attention and investments.

Our argument is that inadequate conceptualization of the actual problem of policy implementation has hindered effective response to the problem. One reaction to the empirical finding of consistently high levels of firms complaining of “policy uncertainty” is that the question was dropped from the standard Enterprise Survey instrument because people did not know how to interpret the results (and translate them into programmatic action). We are not saying there have not been responses, just that those responses have been ineffective.

Table 11 uses the same classification of the types of “policy uncertainty” created by different types of implementation regimes (ordered/disordered, closed/open) but also adds the dimension of whether the notional policy mapping creates a “favorable” or “unfavorable” policy (if it were to be implemented). This simple table is useful for illustrating two possible responses to “policy uncertainty”: either “policy reform” focused on changing the *de jure* notional policy mapping or “anti-corruption” efforts aimed at moving from deals to rules. We argue that, in the African context, neither of these has, or is likely to, lead to sustained success without an acknowledgement of a long transition period in which moving to “ordered deals” could lead to huge improvements.

Table 11: Responses to “policy uncertainty”				
Nature of the Notional Policy Mapping	Characterization of the Positive Model of Policy Implementation			
	Rules (policy actions depend on notional policy mapping)	Deals (Policy actions depend on characteristics or actions of the firm not specified in the notional policy mapping)		
		Ordered (small ex-post uncertainty about policy implementation—deals stay done)		Disordered (large ex-post uncertainty—deals cannot secure predictability)
		Open (deals are available to all firms)	Closed (deals are available only to favored firms)	
Favorable (NPM conducive for firm growth)				
Unfavorable (NPM not conducive to firm growth)				

IV.A) Can “policy reform” matter?

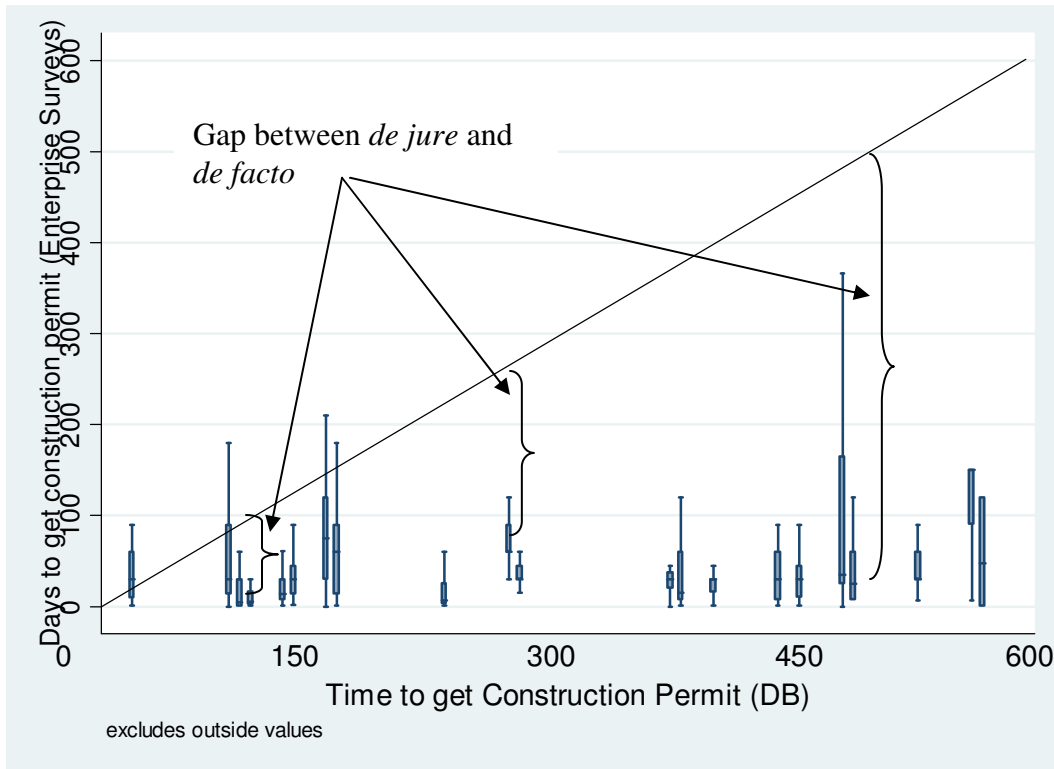
The fact that *de jure* rules are not implemented without deals is commonly known, but is difficult to translate into practice. A comparison of the *de jure* processes of registering a new export business in Chile and Brazil revealed that the regulations in Brazil were complex and time consuming compared to the simpler process in Chile. This might have suggested reforming the rules in Brazil would lead to much greater exports. However, a detailed study (Stone, Levy, and Paredes, 1991) of the *de facto* processes of business registration in Brazil found that in practice businesses hired facilitators who made registration no more complex or time-consuming in Brazil than in Chile, and only moderately more expensive. The environment of open ordered deals—all firms could hire facilitators, the facilitators made the process predictable with little ex post

uncertainty about the durability of the deal—actually replicated in many respects a regime of favorable rules.

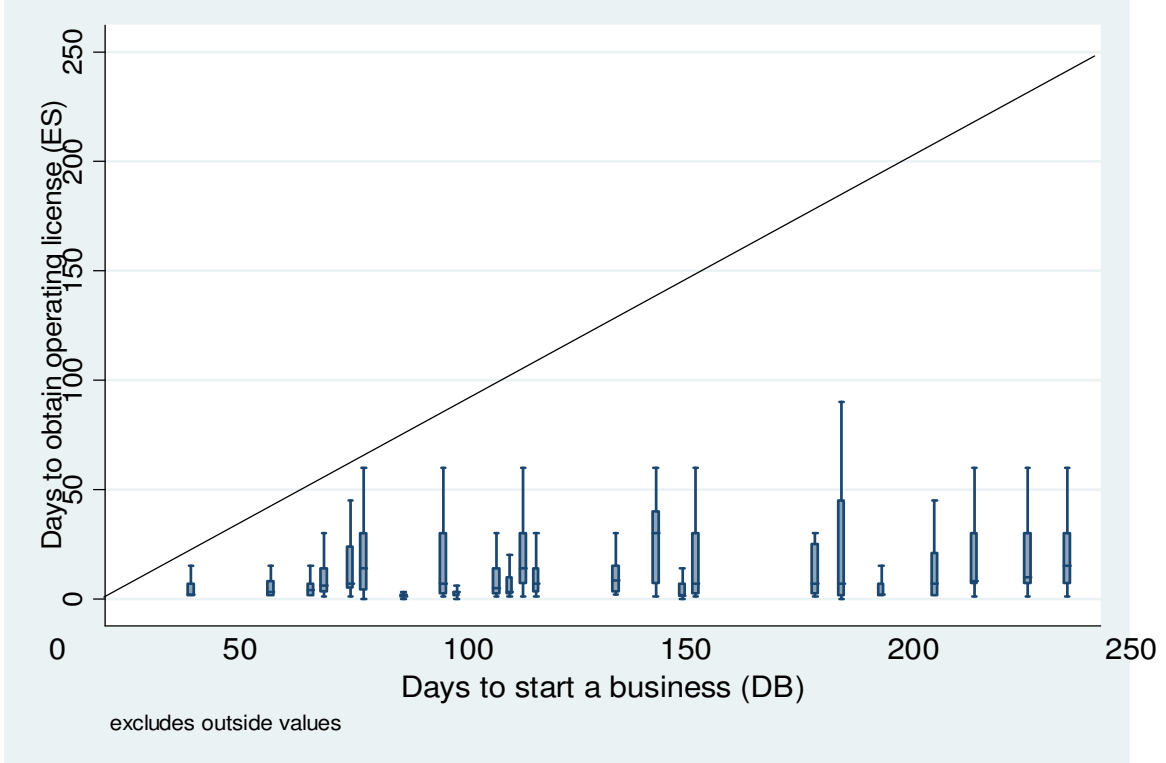
The Doing Business project has attempted to identify obstacles to private sector firms' growth by examining the *de jure* regulatory environment firms face. The existence of common indicators in both the Doing Business (derived from an examination of the regulations) and Enterprise Surveys (from firm responses) allows a comparison of the *de jure* notional policy mappings and reported *de facto* policy actions. Figure 3 shows the results for three indicators: time to get a construction permit (3a), days to start a business (3b), and time to import goods (3c). While there might not be a perfectly exact correspondence of the respective concepts there are nevertheless three striking points from these figures. First, there is almost no increase in the average enterprise survey reports with respect to the Doing Business days. Second, there is, as documented above, large firm specific variability in the reported days but, even the *worst* reported delays *de facto* are far lower than the *de jure* days (around which, in the naïve positive model of complete compliance, one might expect to find the observations clustered). In Figure 3b on days to start a business the top end (90th percentile) appears to be about 60 days—whether the *de jure* is 60, 100, 150, or over 200—the gap just grows. Third, partly as a combination of the two facts above the explanatory power of the Doing Business days for the actual policy action for a specific firm is near zero—if you tell a firm it is in a country where the time to get a construction permit 100 days or 500 days there is almost no reduction in the firms uncertainty about how many days it will actually take.

Figure 3: Variation across and within countries comparing the Doing Business days (on horizontal axis with each country observation on the 46 degree line) with the Enterprise Survey distribution of days (a box plot for each country)

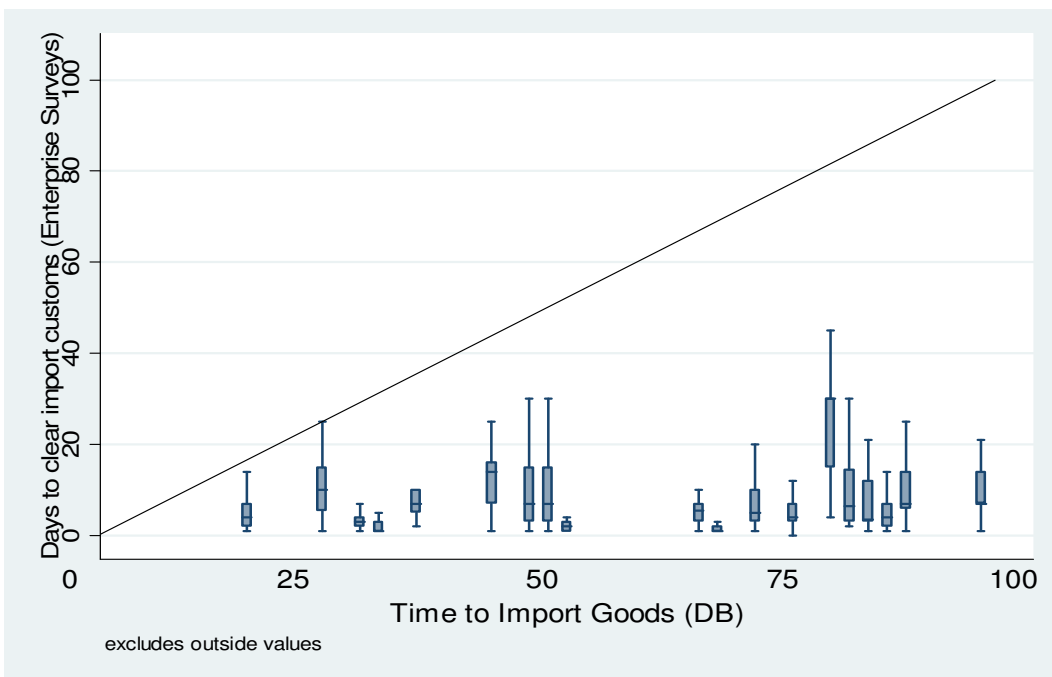
3a) Time to get a construction permit (Doing Business) versus days get construction Permit (Enterprise Survey)



3b) Days to Start a business (DB) versus Days to Obtain an Operating License (ES)



3c) “Time to Import Goods” (DB) versus “Days to Clear Customs” (ES)



This raises two questions about the “policy reform” approach to improving the investment climate. The first question is efficacy. What is the expected aggregate firm response (in investment, in innovation, in output) to changes in the notional policy mapping about taxes, labor regulations, land use regulation, licensing requirements, import procedures, etc.? All existing firms have accommodated themselves to the existing environment and have made deals just to do business (whether they are favored or disfavored in the deals process and whether the deal was expected to stay done or not). The question of the impact of *de jure* reform on firm performance is like asking how much faster submarines will go if the wind blows harder: once you are under water (doing deals) the wind might have the same impact whether you are ten feet down or 100 feet down. We are not proposing that we know that the answer about notional policy mapping reform impact on firm growth is zero, it might be but it might not, we are just pointing it is far from obvious the existing range of policy reforms independently of changes in policy implementation would have any impact on firm behavior at all.

The second question is about the political economy of reform. The simple view is that a broad coalition interested in promoting economic growth: economists, external assistance groups, potential foreign investors and the domestic “business community” have a common interest in improving the “investment climate” by pushing “up” in table 11 from less to more favorable rules. However, in a deals environment it is not obvious this approach to the political economy of reform is consistent with a positive model in which firms maximize profits. Participating in a coalition that attempts to change a rule might be a much less attractive approach in an open ordered deals environment than

acting to influence (e.g. hiring a facilitator, paying a bribe) your firm's policy action outcome.

Worse, in a closed ordered deals environment the economically and political powerful firms may have *differentially* favorable treatment in deals which gives them a competitive advantage over other firms, an advantage that would disappear in a rules environment. At least since Schumpeter's *Can Capitalism Survive?* economists have realized that successful capitalists were not reliable supporters of capitalism, not particularly caring for the "destruction" half of creative destruction. Rajan and Zingales (2003) for instance emphasize that incumbent firms often favor a weak financial sector, unable to reallocate resources into new (potentially threatening) innovations. Hellman, Jones, and Kaufmann (2000) argue that in the transition to "better" policies in the transition countries the shift in the institutional environment create opportunities for massive "closed" deals in which forces "seized the state" and then used it to favor their economic interests in both policy implementation and policy formulation.

That said, as Shleifer and Vishny (1993) have pointed out, it is not obvious that "rules" or a lack of corruption are a necessary or sufficient condition for rapid growth: most of the world's episodes of extremely rapid growth have occurred in environments in which corruption was pervasive and "closed ordered deals" was the basic structure of the formal economy (with smaller firms exposed to mostly to a dual economy with "open ordered deals" as long as their operations were not a threat). Certainly one cannot argue that the economic success of Korea in the 1960s, or Indonesia through to the late 1990s, or China today is due to a lack of corruption. In fact, one could argue that "closed ordered deals" environment in which the interests of certain large industrial enterprises

are well represented in policy making and policy implementation, whether officially (as in the large industrial groups of Japan and Korea (Wade, Evans)) or unofficially (with the conglomerates in Indonesia) can lead to *more* responsive government action on key dimensions, a *de facto* “high bandwidth” policy making (Hausmann 2008).

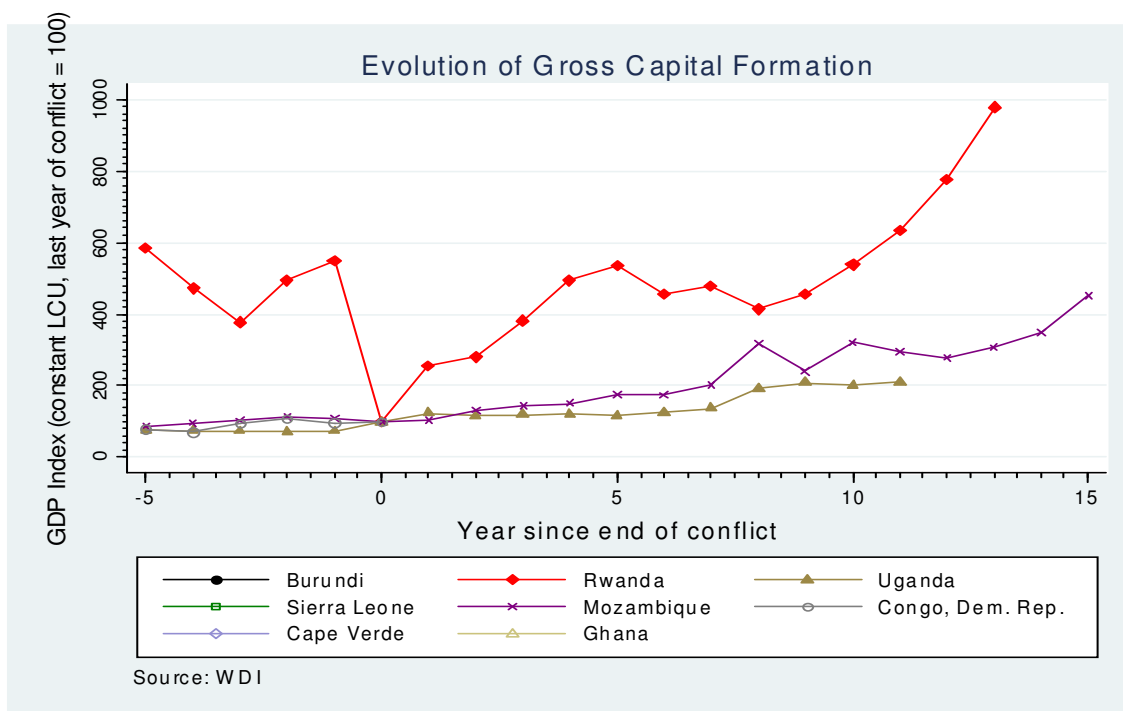
The three powerful reasons for external actors (e.g. donors, foreign firms) to push for “favorable rules.” One, as this characterizes many of the rich industrial countries this is obviously compatible with very high levels of productivity. Second, official external agencies are themselves “modern” organizations who operate in exclusively rules environments and hence it is difficult for them to openly discuss how business is actually done. They are forced to pretend that the rules matter, and hence policy reform is the most attractive option because it is organizationally difficult for them to admit to anything else. Third, foreign firms might prefer rules to deals if they have a competitive disadvantage in deals. Administrative simplification of large enough magnitude to make compliance a feasible option levels the playing field (even if it doesn’t substantially raise the profitability of domestic investors who already had access to deals).

The thrust of this argument is that one is more likely to achieve success by focusing on ways of creating reductions in policy uncertainty for some types of firms rather than across the board and that creative thinking about the mechanisms for doing this is worthwhile. For instance, special economic zones are not just about infrastructure but also about creating a designated enclave in which the government can potentially credibly commit to “rules” behavior (which is really a structured open deal for participating firms). The idea of “charter cities” is in some sense a natural, if audacious, extension of this notion (Romer 2009).

IV.B) Specific cases: Rwanda and Sudan

After the 1994 genocide in Rwanda, the country experienced a rapid recovery to pre-conflict levels of investment (Figure 4), which is typical in post-conflict countries. But, after a pause, Rwanda initiated another investment boom such that capital formation is now at roughly twice the pre-conflict level. Even more remarkable for a small, landlocked nation entrenched in a region riddled with civil war and ethnic conflict it has also managed to attract significant FDI. They did this not only by fighting corruption very aggressively, which increased the credibility of government policy implementation, but also by prioritizing specific deals. Rwanda's success in sequencing its reforms was in part due to a long-term vision of policy framework and development goals outlined by the government. Rwanda Vision 2020 provides a policy framework to reform that allows for consistency and reduces the inter-temporal policy risk faced by private investors.

Figure 4: Evolution of investment in Rwanda following the conflict (genocide)



In the past 10 years, Rwanda has made significant progress in both simplifying the rules and in enforcing them effectively, as can be seen in the cross-national tables above. In Rwanda 90 percent of firms believe regulations *are* enforced “consistently and predictably” (table 2), the level and variability of days to get an operating license are among the lowest (table 5), and in Rwanda, less than 5% of the firms identify corruption as a constraint, according to the World Bank Enterprise Survey 2006, compared to 73% of firms in Kenya or 50% of firms in neighboring Tanzania and only 20 percent report paying bribes (fourth lowest).

Rwanda appears to have put priority on enforceable policies. This avoids the common practice of not taking enforcement capacity into account before undertaking reforms. The result is often a long list of laws that are not enforced (and are often contradictory) which reduces legal and administrative clarity creates room for deals. In

Rwanda however, there has been a balance between adopting new government regulations and creating new institutions, or increasing the capacity of existing government agencies to enforce these new rules. Rwanda's judicial system reform since 2001 is an example improving institutions while maintaining stability. The country slowly transitioned from its colonialist inherited civil law system to common law. Rwanda was able to reduce the length of procedures and increase the reliability of the court system. It now takes 2 to 3 years to settle cases through the court system instead of 5 to 10 years¹⁰. According to the 2006 World Bank Enterprise Survey, 67% of firms believed the court system is fair, impartial, and uncorrupted. In other countries in Sub-Saharan Africa, this indicator is around 25% (e.g. 16% in Mozambique, 22% in Kenya). This is a particularly outstanding success given Rwanda's high volume of litigation due to the country's history of genocide.

Rwanda did more than improving the overall climate, they also made specific deals with mostly US-based multi-national companies and were able to rapidly increase its exports significantly (mainly with the US). The increase in trade due to these targeted agreements was bigger than multi-lateral trade agreements, such as the African Growth and Opportunity Act (AGOA). Owing to this targeted deal making approach, that is transparent and sustainable, the country also attracted a significant amount of FDI, mainly in the telecommunication sector, in the last six years. These special agreements with multinational companies have made Rwanda a testing ground for multi-nationals developing product for low-income countries. Rwanda has attracted unlikely investors such as Better Place, a California-based start-up company that produces batteries for

¹⁰ Overhauling Contract Enforcement: Lessons form Rwanda BIZCLIR: Business Climate Legal & Institutional Reform, Issue 17, March 2007

electric cars. Given that Rwanda imports electricity itself, the presence of such companies is testament to the country's gain in credibility and improved business environment.

The most prominent deal was in Rwanda's coffee sector. Recognizing the importance of the coffee sector for its economy (especially exports) as well as providing stable income for farmers, Rwanda conducted high-level talks and negotiated special agreements with big importers of coffee from the United States. These specific deals achieved a bigger result than a traditional bilateral country-to-country trade agreement. On one hand, the government addressed the basic needs of the coffee importers, such as security and reliability, and on the other hand, it helped coffee growers meet quality standards for export. Rwanda's highest-level government leaders approached directly the heads of specific coffee-roasting companies in the US, such as Starbucks, and CostCO.

By focusing on implementation of policy rather than just adopting them, Rwanda has been able to improve its business environment, attract foreign investors, laying the foundation for a long term economic growth. Rwanda has been able to differentiate itself, and achieve a better result with a less costly approach that is focused on reducing policy implementation induced risk.

These lessons could potentially be applied in Southern Sudan, which as part of the 2005 Comprehensive Peace Agreement had gained some degree of autonomy and, after a referendum in January 2011 may become the world's newest state. This (incipient) country is extremely poor, lacks infrastructure of every kind and has little domestic economic growth outside of the oil revenues. But in January of 2009 entire blocks of the city were being bulldozed. The government was tearing down the structures of

businesses and markets that had sprung up around the capital. These markets were often built on government land—one of the major markets was on a plot owned by the police—in part, as a residual of socialism, because the government owned nearly all of the land. No one really knew how to interpret this. Was it a “policy shift” that the government had a coherent new land use policy and this was its implementation? Or, had some of the people or departments who had been paid off to allow the squatting businesses lost power to another group within the government who wanted to reallocate the (literal) rents and hence would then take a new round of payoffs to allow these businesses in a new locale within the city (one part of the city had already been through a complete cycle of squatting business, land clearance, squatting businesses on exactly the same land)? Or, had a coalition of some businesses disliked the thriving competition and paid off some part of the government to (selectively) enforce the existing law and throw their competitors out? This was not uncertainty about whether the land use rules would change, but about every aspect of how the state would behave and why, and not just in general, but this uncertainty was specific to each enterprise.

In thinking through its potential post-independence strategy, the Southern Sudanese need to focus on regulatory and policy uncertainty, differently for small, medium and large projects. For small holder agriculture the major issues are physical security and the availability of a sufficient scale to sustain market transactions given the high costs of transport in rural areas. For the “medium” sector of services in the cities (e.g. road houses, restaurants) the key issue is avoiding a disordered deal environment in which factions of the government (and/or military) use competing regulations to extract rents. The major pressure is going to come from the temptation to cut completely non-

transparent deals to divvy up Southern Sudan's natural resources (oil, minerals, forests, arable land) among foreign bidders, while acknowledging that there is going to be no possibility of building transparent "rules" which determine outcomes.

Conclusion

This paper has three sections: conceptual, empirical, and speculative.

The conceptual section tried to establish reasonably precise distinctions between various types of "policy uncertainty" in particular distinguishing between inter-temporal uncertainty in changes in the notional policy mapping from conditions of the world to policy action and *policy implementation uncertainty* which is firm specific uncertainty in their profitability induced by uncertainty as to the actual policy action that will be taken in any state of the world even for a given and unchanging policy.

The empirical section accumulated evidence that firms are concerned about policy implementation uncertainty, act to influence policy implementation, and that policy implementation uncertainty matters for firm performance.

The final speculative section examines the ways in which consideration of deals, and in particular, deal environments that are the result of weak environments for policy implementation, differs from thinking of rules.

References

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