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The importance of a good business environment for a thriving private sector

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Development cooperation has become highly interested in the contributions the private sector makes towards achieving the Sustainable Development Goals. Therefore, increased funding has been made available to the private sector in recent years. Against this background a continued focus on the business environment (BE) is needed. The BE is vital because it determines whether companies – from micro-enterprises to multinational corporations – have an incentive to invest and to create jobs. Improving the BE in developing countries often presents challenges as difficult reforms must often be implemented simultaneously across four economic sectors.

Stability and security

By definition, investment decisions entail uncertainty since they involve assumptions about customer and competitor reactions, and technological developments. While entrepreneurs accept such uncertainties, political and macro-economic instability (high or volatile inflation rates, for example) and arbitrary regulation act as deterrents to domestic and foreign investors. Consequently, it is crucial for governments to ensure predictable policies and a stable legal framework. The protection of property rights is particularly important in this regard, including the protection of land rights, the enforceability of contracts, the reduction of criminal activity and the avoidance of expropriations without compensation.

Taxation, regulation and rules of competition

A good business environment entails reasonable taxation laws, transparent regulation and functioning competition. If these conditions are not met, the cost of doing business becomes very high and thus hampers private investment.

Even though taxation generates the income necessary to finance public services like healthcare and education, it is important to design corporate taxation in such a way that it does not undermine investment opportunities and incentives for firms. Key factors include the level of taxation but also the effort required for submitting tax returns and the transparency and complexity of the tax system.

Good regulation strikes a balance between the interests of companies and social or societal objectives. In contrast, an environment with excessive regulation and bureaucracy increases costs by increasing the amount of time needed to apply for a licence, register a company or receive customs clearance, for example. As with taxation, it is also important to find the right balance in regulation.

Although competitive restrictions benefit some (frequently state-owned) companies, they increase costs for other companies. Furthermore, they weaken the incentives for the protected firms to innovate and increase their productivity. In developing countries, it is common for the majority of companies to be state-owned. In circumstances like these, it is important that state companies are not afforded preferential treatment over private companies (for example through subsidised loans or preferential access to foreign currency). Instead, the same rules should apply for all.

Financial markets and infrastructure

Well-functioning financial markets connect companies to lenders and investors. Sound infrastructure connects firms to their customers and suppliers. Yet, in many countries, major shortcomings exist:

Financial markets are often hampered by state interventions, such as state banks, controlled or state-subsidised loans, and barriers to competition. In addition to reducing state intervention, measures like reinforcing the rights of creditors and shareholders, establishing credit information mechanisms (similar to Schufa) and bank regulation contribute to more efficient financial markets.

From a private sector perspective, infrastructure deficiencies, especially in telecommunications, energy supply and transport (i.e. road construction, ports), have a particularly serious impact. Moreoever, inadequate infrastructure deters new companies from entering the market. The effect is that existing unproductive and insufficiently innovative companies are shielded from competition. Expanding infrastructure is therefore crucial for improving the business environment in many ways.

Employee qualifications and labour markets

For companies in emerging markets, the often inadequate skills of the workforce and over-regulated labour markets constitute significant constraints. They are detrimental to both companies and the workforce since they tend to lead to increased informal employment. Adjustments to labour markets should take into account workers' various skill and experience levels (i.e. those that are well and less-well qualified, the unemployed, and workers in the informal economy), and the needs of companies.

The role of development cooperation

Development cooperation continues to play an important role in improving the business environment for the private sector in developing and emerging markets by promoting Good Governance, education and vocational training, by financing infrastructure and by strengthening financial markets, for example.■

Further reading

Skibbe, Claudia (2018): The importance of the business environment for a thriving private sector (full version) www.deginvest.de