Business Environment Analysis: Testing a Context-Specific Approach in Ethiopia

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Abstract
A number of prominent business environment rankings have achieved outstanding results from their efforts to promote legal and regulatory reform around the world. Such tools help to raise awareness of general constraints, but lack the specificity and rigor to produce context-specific information to guide policy and programs supporting business and economic growth, especially in contexts with high levels of economic informality. We review four commonly referenced business environment rankings and identify their respective strengths and weaknesses. To address the identified shortcomings, we present a business environment assessment methodology that (1) provides investors and policy makers with a means of collecting rigorous evidence on local business constraints and (2) is representative of a particular population. The paper closes with a description of our experience applying the methodology to assess the business environment of Addis Ababa, Ethiopia.
Introduction

Business environment rankings, such as the World Bank’s Doing Business initiative, have achieved outstanding results from their efforts to promote legal and regulatory reform around the world. As useful as these tools can be in raising awareness of general constraints, however, the information they provide is often insufficient to guide economic policy or design economic development initiatives. Supplementary economy-specific information is needed that corresponds to policy makers’ interests and can be reliably used to design policy and programs. In low-income countries, such data can be difficult to come by.

In this methods report, we present a methodology that complements popular business environment rankings by providing more finely grained, local economy-specific data that policy makers can act upon. Importantly, the methodology uses a sampling strategy that allows for collecting data from a representative sample of firms, even in the case of high levels of economic informality. The report closes with a brief description of a pilot study applying the methodology in Addis Ababa, Ethiopia.

Background: Existing Methods of Business Environment Analysis

The business environment comprises a set of macroeconomic and microeconomic factors that facilitate or constrain business growth and, in the aggregate, economic growth. Moreover, while macroeconomic analysis measures broad trends of a nation’s economy, microeconomic analysis focuses more on factors that directly influence economic behavior. For this reason, business environment studies typically focus on microeconomic factors, such as the nature and efficiency of formal laws and regulations, social norms that govern economic behavior, the level of business sophistication typical in the economy, and the presence of coordinating mechanisms usually associated with clusters that allow businesses and industries to compete effectively (Porter, 2002).

Because the business environment is a direct determinant of a country’s potential for economic growth and standard of living, it is important that economic policy makers have an effective methodology to analyze the business environment. Such a methodology would

- pose questions specific to the target economy,
- recommend and prioritize activities that are within the scope of the investigating organization, and
- use a rigorous means of data collection.

In many lower-income countries, however, detailed data on the business environment are not readily available to policy makers. Reasons behind the lack of data are complex and involve both research constraints (e.g., lack of skills, relevant models) and resource limitations. Approaches used in wealthier nations are not readily transferable to the distinct sectoral, institutional, and technological/infrastructural characteristics of developing countries. In particular, the high levels of informality of businesses confound methodologies relying on business registers, phone books, and similar commonly used means of identifying respondents.

In the absence of context-specific data on constraints in the local business environment, investors, policy makers, and economic development practitioners often use influential business environment rankings to identify barriers to improving the productivity of a particular country or region. Four of the most common annually recurring studies are Doing Business, the Global Competitiveness Report (GCR), the Index of Economic Freedom, and the World Bank Enterprise Surveys. These studies produce rankings (which is how we refer to them here) that indicate how well an economy is performing relative to others. Rankings are based on more detailed analyses of different aspects of the business environment that can suggest starting points for prioritizing constraints within an economy. These rankings are often announced with fanfare and given a high level of attention by policy makers. For example, in the same week as the release of the Doing Business 2014 rankings in October 2013, the Indonesian vice president announced 17 initiatives to improve the country’s investment climate to demonstrate the
government’s commitment to sustaining investments through reforms (“Indonesia continues,” 2013).

Below we review four commonly referenced business environment rankings and describe how well they meet the three methodological criteria above.

Doing Business

Doing Business is the perhaps the most commonly used and cited business environment ranking. The central theme of the report is that formal government regulation is an important determinant of economic growth. In Doing Business, the World Bank set out to create a transparent, objective comparison of the efficiency with which governments across the world implement a set of policies, regulations, and institutions. The purpose of the report is to advance the World Bank’s “strategy for tapping private initiative to reduce poverty” (World Bank, 2004, p. ix).

In 2013, the regulations that Doing Business assessed were starting a business, obtaining a construction permit, getting electricity, registering property, getting credit, paying taxes, trading across borders, and hiring and firing workers. The Doing Business report measures two aspects of these regulations. The first is the cost and time required to comply with a set of regulations. The second is the efficiency of government institutions that are required for businesses to operate. The efficiency is measured by calculating the time needed to carry out activities, such as the time a court takes to enforce a contract and the swiftness with which investor rights are protected.

The World Bank initiated Doing Business in 2004 to overcome three shortcomings it perceived in existing cross-border business environment rankings. In the World Bank’s view, most other cross-border business environment methodologies served as tools to inform investors rather than policy makers. This limited their usefulness for reducing poverty in developing countries. Secondly, the World Bank recognized that few, if any, popular assessments focused on the poorest of the poor countries. Lastly, the World Bank was concerned that other business environment rankings relied on perceptions and attitudes that are “notoriously difficult to compare across countries or translate into policy recommendations” (World Bank, 2004, p. viii).

Doing Business was groundbreaking when it was conceived. It was the first report of its kind based on easy-to-understand concepts that were indisputably linked to measures of prosperity. It was also first to present a transparent and easily duplicated methodology. Perhaps most importantly, because Doing Business ranked countries based on objective, easily verifiable factors, it captured the attention of people all over the world, who then put massive amounts of pressure on public officials to improve their country’s performance. Since its inception, it alone has moved advocates and government officials around the world to reform over 1,700 regulations.

Doing Business has two clear weaknesses. The first is related to data collection. It surveys a small number of an elite group it calls “aggregators” rather than business people. Aggregators are people who deal with a large number of businesses, such as lawyers. Surveying only aggregators means that the concrete experience of many individual businesses in each country may be missed. For example, Doing Business misses the experience of a large number of businesses in countries with high rates of economic informality. In countries like Egypt, for example, this means businesses that together are worth as much as 30 times the Cairo stock exchange and responsible for 43 percent of employment are not represented (De Soto, 2011). Further, it misses the experiences of businesses that cannot afford to interact with aggregators or wish to attempt compliance on their own.

Doing Business’s second limitation is found not in the World Bank’s execution of the index, but rather the manner in which people and public officials misuse it. The report’s main point is that poorer countries regulate the most, and heavy regulation is correlated with bad economic outcomes. Its suggestion is that countries that rank low in its report need to explore why they regulate business heavily and to reform so that they operate more efficiently. However, the intense public attention that the index receives may have driven policy makers around the world to prioritize improving how Doing Business’s indicators are described in legal documents rather
than the positive or negative effects of specific laws or to attempt to understand the distinctions between supportive and constraining regulations in their particular context (World Bank Independent Evaluation Group, 2008).

**Global Competitiveness Report**
The World Economic Forum has produced cross-border business environment rankings since 1979. In 2005, it created the GCR in its current form. The GCR is based on the Global Competitiveness Index, which “measures the microeconomic and macroeconomic foundations of national competitiveness” (Sala-i-Martín et al., 2012, p. 4). The GCR defines competitiveness “as the set of institutions, policies, and factors that determine the level of productivity of a country” (Sala-i-Martín et al., 2012, p. 4). The GCR ranks countries on each of the 12 pillars that it believes determine national competitiveness and provides an aggregate ranking of the 142 countries it studies. The GCR’s 12 pillars are institutions, infrastructure, macroeconomic environment, health and primary education, higher education and training, goods market efficiency, labor market efficiency, financial market development, technological readiness, market size, business sophistication, and innovation.

Clearly, the 12 pillars that the GCR measures are interrelated. As the authors of the index have pointed out, “a strong innovation capacity (pillar 12) will be very difficult to achieve without a healthy, well-educated and trained workforce (pillars 4 and 5)” (Sala-i-Martín et al., 2012, p. 8). Also, while the authors believe that all of the pillars are important to all economies, “it is clear that they will affect them in different ways” (Sala-i-Martín et al., 2012, p. 8). Specifically, more basic requirements are important to a country that is in an early stage of development, while more complex requirements drive competitiveness for developed economies. The GCR reflects this in its ranking by assigning “weights to those pillars that are more relevant for an economy given its particular stage of development” (Sala-i-Martín et al., 2012, p. 9). To accomplish this, the report organizes the pillars into three subindexes: basic requirements, which are factors most important for a country at the earliest stage of development; efficiency enhancers for countries that are past factor-driven economies and are moving to a middle income stage of development; and the innovation and sophistication factors subindex for those countries at the most advanced stage of development.

The GCR is very influential. Upon its release every year, newspapers and business magazines in countries around the world discuss the ranking of their country compared with previous years. The GCR does an excellent job of emphasizing the findings of research on national prosperity with a comprehensive ranking that aims to tell countries how they compare with each other overall and in each category. Importantly, the report highlights factors such as public health and the environment, in addition to government regulation, that are important for economic success. As is often the case for aggregated measures, however, what the measurements and rankings mean is not transparent, making them difficult for decision-makers to translate into policies and programs. Each pillar is an aggregate score of a large number of measurements. For example, the score for pillar 1—institutions—is an aggregate of scores from 21 separate issues ranging from enforcement of property rights to the presence of organized crime. More specifically, though, the methodology by which the GCR’s data are collected is flawed. The GCR’s most significant source of data is the World Economic Forum’s Executive Opinion Survey. This survey is administered to a small number of leading executives in each country and asks for their perception of a range of issues that affect competitiveness. Clearly, a perception-based survey of a small number of people from a particular population does not provide information about the common experience of the great majority of businesses.

**Index of Economic Freedom**
The Heritage Foundation and The Wall Street Journal have produced the Index of Economic Freedom since 1995. In 2007, the Index went through a major revision that involved incorporating a review from an academic advisory board, using data from the Doing Business report, and streamlining the report and its associated website. The net effect was an easier to use report and increased robustness of the data that inform the report’s rankings.
The Index of Economic Freedom is an interpretation of Adam Smith's contention that “basic institutions that protect the liberty of individuals to pursue their own economic interests result in greater prosperity for the larger society” (Heritage Foundation, 2008, p. 1). The Index seeks to objectively measure and rank each country in the world by the quality of these basic institutions. The Index of Economic Freedom refers to and measures 10 institutions: business freedom, trade freedom, fiscal freedom, freedom from government, monetary freedom, investment freedom, financial freedom, property rights, freedom from corruption, and labor freedom.

Whereas Doing Business correlates the efficiency with which government operates with economic productivity, the Index of Economic Freedom seeks to correlate the size of government with prosperity. For example, the fiscal freedom score ranks countries that have the lowest tax rates and revenue as freer than countries with higher rates and revenue. Similarly, labor freedom is a ranking of countries based on regulations of “wages, hours, and other restrictions.” Although significant research, including that done in support of Doing Business, has clearly demonstrated the correlation between a country’s prosperity and its level of freedom, the connection between prosperity and the Index of Economic Freedom’s 10 factors is less well-grounded.

The Index of Economic Freedom reinforces the point that free nations are prosperous nations. It uses research to support that idea. However, the definitions of its indicators measure the size of government rather than its effectiveness. It also fails to differentiate between regulations that promote freedom and those that constrain it. Rather, it views all regulations as counterproductive and recommends across-the-board reform to reduce regulatory burdens. Similar to Doing Business, the Index of Economic Freedom encourages decision-makers to remove all regulations, rather than considering specific positive or negative of individual regulations on businesses.

World Bank Enterprise Surveys
In addition to Doing Business, the World Bank directly surveys businesses in 135 countries. These surveys cover 11 topics: corruption, crime, finance, gender, informality, infrastructure, innovation and technology, performance, regulation and taxes, trade, and workforce. The surveys are standard and the same questions are asked in each country. The team that conducts the surveys publishes reports on each country and makes a large amount of raw data available for researchers. The country reports take two formats: country notes, which summarize a country’s economy compared with other countries in its region, and country profiles, which show how a country scored on each topic compared with other countries in its region and income group.

The World Bank Enterprise Surveys are a unique source of data for researchers around the world. They also provide an interesting perspective for policy makers who wish to know how various aspects of their country’s business environment compare with those of other countries. However, the surveys are difficult to use to inform policy in a specific economy mainly because the survey’s sampling strategy is flawed. Although a stratified random sample is specified for the surveys, implementers often rely on the phone book to identify respondents. This approach leads the surveyors to businesses that engage in formal economic activity and misses businesses that either operate informally or for some other reason choose to stay out of the phone book. For example, businesses in Ethiopia are charged higher utilities rates than individuals. For this reason, some property is listed under the individual owner’s name rather than the business. Businesses such as these would be missed in the Enterprise Surveys.

Methodology
A Context-Specific Approach to Business Environment Analysis
Based on the above review, the most frequent weaknesses of popular rankings are the rigor with which business environment data are collected and the specificity of identified constraints. Here we present a business environment assessment methodology that builds on the studies we
summarized to provide local investors and policy makers with a means of collecting rigorous evidence of the specific constraints to increasing economic growth for a particular population.

Our methodology relies on three principles:

1. Studying the efficiency with which firms carry out common business activities most clearly reveals the specific factors that constrain economic growth.

2. Business environment assessments yield the most useful recommendations when they take into account the interests and capacity of their audience to act on them.

3. Business environment assessments are most meaningful when they survey a representative sample of firms.

Understanding Business Activities

Several of the business environment rankings discussed earlier in this report measure broad characteristics of business environments, such as efficiency of regulation, aspects of economic freedom, or the perception of business friendliness. Although these broad categories are effective for motivating reform, the information they provide is insufficient to create economic policy or design economic development initiatives. A second source of information is needed that directly identifies specific constraints to efficiently carrying out the firm-level activities that are the foundation of wealth creation and economic growth.

Our assessment gauges the constraints to business activities specific to the economy we are assessing. It identifies these constraints by examining the way business environment factors directly influence business activities. Figure 1 provides examples of business activities and the constraints that limit their efficiency, drawn from the first author’s experience with a similar survey in Egypt and from the literature. Business environment factors constrain economic growth by undermining the efficiency with which firms across an economy conduct business activities, as represented by the value chain (see Figure 1).

The value chain is “the many, discrete activities a firm performs in designing, producing, marketing, delivering, and supporting its product” that one analyzes to understand how business environment factors constrain or facilitate increases in firm-level productivity (Porter, 1985, p. 33). In our methodology, we used the value chain to identify those business environment factors that lead to inefficient business activities—and that are common to enough businesses to lower productivity across the economy.

In exploring constraints to efficiently carrying out business activities, we looked at three types of constraints. The first type was the quality of first-order economic principles. These principles include property rights, contract enforcement, market-based competition, appropriate incentives, sound money, debt sustainability, and others required to provide incentives that lead to economic growth. We looked at these principles within the local sociopolitical context to understand whether they are delivered by formal or informal institutions and whether institutions exist that could deliver them better. Understanding local context is important to ensure that the results of the analysis inform recommendations that policy makers could realistically implement rather than attempting to recommend a common set of policy recommendations across many different sociopolitical systems and cultures (Rodrik, 2005).

Second, we looked at the capacity of firms to transact. In our assessment, we explored arrangements among economic actors to discover whether more productive arrangements were possible. Particularly, we looked at two types of arrangements. The first was a buyer-seller arrangement between a supplier and a business, and the second was between a business and a final customer. Following the guidance of Oliver Williamson (1979), we focused on three aspects of these transactions: (1) their effectiveness at reducing uncertainty, (2) the ability of transacting parties to realize efficiencies through repeated transactions, and (3) the importance of opportunism in decreasing the productivity of transactions. We focused on these arrangements because, as Oliver Williamson once succinctly stated, “private ordering is central to the performance of an economy whatever the condition of lawfulness” (Williamson, 2005, p. 2). In many developing economies, especially lower-income countries, a state of lawlessness exists because the
### Figure 1. Examples of activities at different stages of the value chain and associated constraints

<table>
<thead>
<tr>
<th>Primary Value Chain Activities</th>
<th>Illustrative Constraints</th>
<th>Likely Effect of these Constraints</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inbound Logistics</td>
<td>Government monopoly on cargo transportation.</td>
<td>Lack of competition in transportation raises prices of inputs and reduces number of services offered to businesses.</td>
</tr>
<tr>
<td>Operations</td>
<td>Government inspections are inconsistent and lack a published protocol.</td>
<td>Improper inspections protocols lead firms to remain informal or possibly incur large and unnecessary expenses.</td>
</tr>
<tr>
<td>Outbound Logistics</td>
<td>The process of obtaining an export license is cumbersome.</td>
<td>Businesses cannot reach foreign markets in a timely fashion, thus reducing profits and closing markets to goods.</td>
</tr>
<tr>
<td>Marketing and Sales</td>
<td>High levels of informality lead to businesses marketing only through personal networks.</td>
<td>Businesses do not compete on merit of goods and services, thus slowing innovation and value creation.</td>
</tr>
<tr>
<td>After-Sales Services</td>
<td>There is a lack of consumer protection laws.</td>
<td>Unnecessarily high risk in purchasing lowers demand, especially for new or innovative products or businesses.</td>
</tr>
</tbody>
</table>

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**Firm Infrastructure**

- **Illustrative constraint:** Zoning laws highly restrict facilities available to types of businesses.
- **Likely effect of this constraint:** Lack of appropriate workspace or business facilities drives prices up, reduces innovation in business practices, and limits business and job creation.

**Procurement**

- **Illustrative constraint:** Most businesses must pay cash up front to receive supplies.
- **Likely effect of this constraint:** Lack of trade finance slows supply of goods to consumers, thus raising prices while lowering profits.

**Human Resource Management**

- **Illustrative constraint:** Search costs for skilled labor are high.
- **Likely effect of this constraint:** Hiring skilled labor is a high-risk activity, thus lowering value creation in the economy and removing incentives for workers to invest in developing their skills.

**Technology Development**

- **Illustrative constraint:** Certain classes of business receive fuel or utilities subsidies.
- **Likely effect of this constraint:** Artificially lowering the costs of potentially less productive businesses makes it difficult for innovative, productive businesses to compete and thrive.

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state’s policies, even if well crafted, are unreliable and enforced selectively. In these economies, the institutions required for voluntary exchange are developed informally and over time. Though informal institutions that evolve over time are often effective, they are frequently suboptimal, even compared with other, possibly informal institutions.

A third type of constraint that we explored was constraints that were the result of coordination failures. Coordination failures are economic constraints caused by “individuals’ inability to coordinate their choices lead[ing] to a state of affairs that is worse for everyone than some alternative state of affairs that is also an equilibrium” (Hoff, 2000, p. 3). For example, a fundamental form of coordination failure occurs when the nature of competition creates disincentives for innovation. Economies that demonstrate intense, fair competition are most likely to create productivity increases (Porter, 1990; Ayyagari, Demirguc-Kunt, & Maksimovic, 2007). Societies that reward bureaucratic behavior over entrepreneurial behavior, for example, create disincentives to fair competition that will constrain productivity. Another example concerns spillovers from research and development. An economy’s failure to prevent others from benefiting from a firm’s research and development advances creates disincentives for the firm to invest in innovation and certainly creates disincentives to be the first firm to invest in innovation (Hoff & Stiglitz, 2001).

Coordination failure takes place in labor markets with high search costs. Firms may not train employees if training is expensive and if trained employees have an incentive to switch firms. Likewise, job seekers may not choose to invest in skills development if it is difficult to find firms that have innovated. The market does not organize these complementary changes, so they must be addressed by other organizational forces.

Information gaps, either due to underinvestment in information or barriers to the flow of information, also exemplify a coordination failure. Underdeveloped markets may lack information and therefore could reinforce suboptimal institutional arrangements, such as networking through personal connections rather than competing on the basis of goods and services in a marketplace. Similarly, a lack of information on the part of government makes it almost impossible to regulate business and encourage formality. Finally, an inability of businesses with similar interests to coordinate activities constrains productivity (Anthony, 2005). Individual and collective business interests can align to increase productivity. However, if there is a general belief that individuals will attempt to free-ride on a collective investment, it may be difficult to initiate the collective investment in the first place.

Understanding the Audience

Cross-border business environment rankings compare countries based on a standard list of indicators. However, policy makers in any country may not have the interest or capacity to improve its ranking on any one indicator. One reason they may lack interest is that the indicator is not important to their particular economy. For example, Doing Business ranks countries on the efficiency with which businesses can obtain a construction license to build a warehouse. However, a country whose economy does not depend on industries that require warehouses may not wish to focus limited resources on reforming this indicator. Israel, for example, ranks low in the Doing Business report on this indicator. With an economy dependent on the IT industry and diamond cutting, Israel would not see a lot of economic benefit from improving its warehouse construction regulations. As a result, its policy makers probably do not find their ranking on the construction license indicator useful.

Another reason that countries may not be interested in particular indicators is that initiatives may already be in place to make improvements related to that indicator. Working to improve a score on a particular indicator can take longer than the annual cycle on which countries are ranked. For example, Ethiopia has adopted a multiyear effort to improve its infrastructure. Nonetheless, while the effort is underway, Ethiopia’s ranking on the GCR’s infrastructure indicator remains low. After all, you can’t bake half a cake. Until this effort is completed, the yearly ranking provides no new information on which Ethiopian policy makers can act.
Lastly, some indicators may be difficult for policy makers to act on given a country's political climate and the resources or time frame they have at their disposal. Hot topics such as land reform or labor rights are certainly worthy of attention. However, policy makers are often under pressure to make changes in the short or medium term that improve economic prospects. Understanding where their political will and resources allow them to make changes is crucial to designing an effective business environment assessment.

Representative Sample

Commonly used methodologies tend to rely on expert perceptions of general business environment constraints or the experience of only the largest firms. For example, much of Doing Business's data are collected by surveying experts such as lawyers and accountants rather than business people. Likewise, the GCR relies on the Executive Opinion Survey, which collects perceptions of a small number of business leaders in each country. The information that these rankings collect excludes the experience of large groups of economic actors. Doing Business does not capture the experience of businesses that choose to remain informal, as many do in developing countries, or businesses that choose to comply with regulations on their own. The GCR does not capture a representative sample of economic actors whose activities are influenced by the business environments they assess.

Policy makers need information on how the specific business environment they regulate influences economic activity. Ensuring that data come from a representative sample is the foundation on which good policy is built. Our methodology uses a unique strategy for ensuring a representative sample, called respondent-driven sampling, discussed in more detail in the following section.

Applying the Context-Specific Approach

In this study, we developed and implemented a methodology for uncovering the business environment factors that influence firm activities among small- and medium-sized enterprises in Addis Ababa, Ethiopia. We developed a survey methodology, described below, to identify those business environment factors that most constrained productivity and that could be addressed in the short to medium term by local business associations, government, or other advocates for economic development. We surveyed 608 owners and managers of businesses. Our hope was that the study would result in contextually appropriate recommendations for initiatives that had the potential to increase economic growth among the represented population. The survey was referred to as the Kal Addis (The Voice of Addis) Business Survey (KABS).

We chose Ethiopia because it has sustained a high rate of growth for several years. It is investing significant resources in economic reform, through its Public-Private Consultative Forum, as a means of sustaining economic growth. It also has a clearly articulated strategy for raising standards of living and creating jobs through an export-led strategy based on the success of South Korea. The government has invested heavily in improving the country's infrastructure. It has also reduced inflation by nine percentage points. The government of Ethiopia is aiming for middle-income status by 2025.

The survey's audience was the government-created system of chambers of commerce and trade associations, particularly the Addis Ababa Chamber of Commerce. The Addis Chamber promotes reform through its own initiatives and, more recently, through the Public-Private Consultative Forum, a government-mandated collaboration between the chambers of commerce, trade associations, and the government of Ethiopia. The Forum is an attempt to reform regulations collaboratively and drive longer-term growth. The Forum's discussions have focused on issues such as the amount of paperwork required to export products.

Nonetheless, Ethiopia's economy is dominated by a huge number of small businesses and a few very large businesses. Most of these businesses are located in Addis Ababa. As Dani Rodrik (2005) points out, the policies that spark economic growth are very different from the policies that sustain economic growth. Ethiopia's growth is a result of heavy public-sector spending and involvement in the economy. Though the government has improved its policies, it
has done little to establish the first-order economic principles that it requires to transition to a market-based economy. The result may be that, even if the government of Ethiopia’s reform efforts are successful, businesses lack the proper incentives to take advantage of the improved regulatory environment.

To ensure the specificity lacking in popular business environment rankings, we began developing the survey by identifying indicators that were most likely constraining productivity increases for a wide range of businesses in Addis. We interviewed key informants from 25 businesses\(^1\) in trade, manufacturing, and service provision to develop our indicator list. The interviews enquired about each activity in each business value chain. Our starting assumption in each interview was that economies grow when businesses invest time and resources, creating value for customers. Businesses create this value by continually improving the management of their value chain. We searched for the constraints to growth that occur when business managers invest time and resources conducting activities that do not create value for customers or improve value chain management, for example, repeatedly negotiating routine transactions, spending excessive amounts of time dealing with government regulations, planning production in response to cues other than market signals, or spending time making political contacts rather than marketing goods or services. Based on the indicators emerging from the key informant interviews, we developed a survey instrument that underwent two rounds of peer testing. The final questionnaire covered supplies, operations, outbound logistics, sales and marketing, finance and legal support, and future plans, as well as demographics, screening, and debriefing questions (see the appendix for the full questionnaire).

To address the problem of obtaining a representative sample of small and medium businesses in the developing world, we used a sampling technique called respondent-driven sampling (RDS). RDS had been used in other countries around the world but not in Ethiopia. Further, RDS had never been applied to businesses. RDS is a form of snowball sampling whereby a diverse group of respondents is recruited through personal and business networks to take the survey. It was developed to study networked populations that are difficult to sample (Heckathorn, 1997) and was therefore well-suited for capturing the population of both formal and informal businesses relevant to our study. In RDS, an initial (seed) group of respondents is recruited and then asked to recruit other relevant individuals in their network to take the survey. The major difference between snowball sampling and RDS is that in RDS tracking who invites whom is crucial. This tracking is accomplished by giving respondents paper invitations to distribute to potential respondents. Those paper invitations contain a brief summary of the study and a unique identifier that allows the survey team to track who invited that person to the study. This information is then used in statistical weighting to produce a representative sample.

For KABS, the research team recruited a convenience sample of 24 individuals through the research team’s personal networks. After passing a screening interview, these “seed” respondents were given three paper invitations to extend to businesses in their personal networks. The appendix includes guidelines for explaining to respondents how to recruit additional respondents.

The survey consisted of an in-person, paper-and-pencil interview of 608 entrepreneurs. Eligible respondents were owners or senior managers of small and medium businesses (between 3 and 99 employees) based in Addis Ababa. The survey was administered by professional interviewers in the Amharic language. The mean administration time was 29 minutes (standard deviation = 9 minutes). Data collection lasted approximately 6 weeks.

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\(^{1}\) To select businesses to provide input into the indicator list, we hired an Ethiopian consultant to interview respondents from 20 businesses for which (1) the respondent was either the owner or manager with extensive knowledge about the businesses’ strategy and operations, (2) the number of part- or full-time employees ranged from 3 to 99, (3) the sector of operations was manufacturing (including agro-processing), trade, or service, (4) the respondent was aged 18 years or older, and (5) the geographic location was Addis Ababa. Businesses could be either formal or informal and were identified through the consultant’s existing networks. Additionally, RTI’s research team interviewed five businesses meeting the same criteria to spot-check the results of the consultant’s interviews.
Pilot Results and Discussion

The KABS results highlighted several business environment constraints that hinder economic growth in the targeted population. Below, we detail key constraints at different stages of the value chain that, if eliminated, could enhance business and economic growth.

Inbound Logistics: Arrangements with Suppliers

38% said they have no access to trade credit. Of those, 72% said they would sell more if they had access to trade credit. 66% responded that they always receive receipts when they buy supplies.

The data we collected on the arrangements businesses make with suppliers indicate a lack of trust and a lack of incentives for productive behavior. Over a quarter of the businesses surveyed said that they would sell more if their suppliers would extend trade credit. Offering trade credit should increase the revenue of suppliers and the businesses they sell to. If the procurement of supplies were a one-off transaction, one could understand the absence of sufficient trade credit in the market. However, 90 percent of respondents whose business was at least 3 years old said that they had used their main supplier for more than 1 year, and 60 percent had for more than 3 years. In spite of the fact that these are ongoing relationships, trust between suppliers and businesses is lacking.

These findings provide a useful illustration of how the more fine-grained data available through the KABS build on the results of popular rankings. The Global Competitiveness rankings for 2012–2013 show that “access to financing” is the most problematic factor for doing business in Ethiopia (Schwab, 2012, p. 164). Similarly, Doing Business notes that “getting credit” may be a worsening problem (World Bank, 2014). While both of these instruments highlight the challenge of attaining financing, they do not suggest how it could be addressed. In contrast, the KABS results indicate that if Addis authorities or the Chamber of Commerce would organize programs that extend short-term loans or act as guarantors for qualified businesses, they could potentially bridge the lack of trust, address the bottlenecks in trade credit, and enhance the productivity of the city’s businesses.2

Thirty-four percent of respondents did not agree that they always receive receipts with transactions. This finding suggests that businesses and their suppliers may intentionally neglect documenting transactions to avoid taxes. This puts businesses in an awkward position. Buyers can either fabricate documents for tax purposes, which could cause trouble with authorities; overpay their taxes through the government’s estimates of what they owe in the absence of documentation; or overpay taxes by not reporting the expenses at all.

Operations: Permits and Licenses

61% said that all of the businesses they know have all of the necessary licenses and permits.

Informality distorts competition in a way that favors unproductive businesses over productive businesses. Our survey revealed the perception that a large portion of businesses operates informally. The Ethiopian government’s efforts to reform have assumed that it was either the cost or complexity of compliance that was driving people to remain informal. We explored those issues but also added other incentives to operating informally to understand the factors that influenced business people’s decision to comply or not comply with regulations. We found that 77 percent of the respondents felt that businesses remained informal to avoid paying higher taxes and 53 percent thought businesses remained informal to avoid inspections. Forty-two percent felt that frequent new or revised regulations made it difficult to stay in compliance with the government’s requirements. These findings indicate that disincentives other than the cost and

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2 The survey also asked about access to formal financial instruments. Notably, 80 percent of respondents said that they had not applied for loans. Of that 80 percent, 59 percent said that the reason they did not apply was that they did not need it. Additionally, a central principle of our methodology was to make recommendations that our audience had the interest and capacity to act on. Ethiopia’s finance sector is tightly controlled by the central government and politically sensitive. Given the respondents’ relatively low interest in formal credit and the fact that credit market reforms were outside our audience’s interest and capacity, we did not include financial sector constraints and recommendations in the analysis.
complexity of compliance are driving informality in Addis Ababa’s economy. It may be that even if the government were to make the process of registering or obtaining licenses frictionless and free, a large number of businesses may still not comply in response to other disincentives.

**Operations: Inspections**

55% of businesses had been inspected more than three times in the previous 12 months. 24% of those had been inspected more than five times in the previous 12 months.

Inspections that facilitate fair competition cause productivity increases if, for example, they protect consumers and build trust in the marketplace or assist businesses in hitting high and consistent standards for domestic and international markets. However, when they are inefficient, the costs of regulation serve as a significant drag on the economy. The frequency with which the businesses we surveyed are inspected seems excessive, especially considering that 87 percent of the businesses that we surveyed are in either the trade or service sector.

In addition to the large number of inspections, inspectors do not follow a protocol. We found that inspectors failed to identify themselves almost 25 percent of the time, explained the nature of the inspection 62 percent of the time, and informed the business of the results only 38 percent of the time. Frequent and inconsistent inspections cause unnecessary work slowdowns and offer a large number of opportunities for rent-seeking.

**Sales and Marketing: Market Orientation**

96% of respondents marketed products and services through word of mouth.

85% marketed products and services through personal introductions.

26% used some form of advertising.

Direct competition for market share produces incentives that bring innovations and value to customers. In Addis, personal networks, rather than competition based on the merit of products, are the most pervasive means of finding new customers. This implies that businesses are investing time in building personal networks rather than attempting to devise products and services that would bring new value to the market. Whereas competing in the marketplace generates clear information about market values and areas for innovation, personal networks are opaque and block information flow throughout a supply chain so that business people interested in growth have no information to direct how they build their business.

**Sales and Marketing: Arrangements with Customers**

Only 35% of businesses said that customers they extended credit to often paid back on time.

58% of businesses said that after they deliver a product or service, the customer tries to renegotiate the price.

In individual transactions, the negotiating positions of the parties change over the course of the performance of the agreement. For example, in a client and contractor transaction, a client may start in a stronger negotiating position as the contractor wants business and the client has options among many competing contractors. After an agreement is reached, the contractor may gain advantage as the construction is midway through completion and requires specific knowledge and assets to finish. At the end of the agreement, the client may regain negotiating power as the contractor’s investment is completed and the client could opt to withhold payment until new conditions are met. For the transaction to happen productively, the parties need a common way to anticipate these changes and establish an initial agreement. Renegotiating the transaction at each turn in the project wastes resources. A customer may perceive that he or she has gained a better value through a reduced price, but the time wasted and the uncertainty in the next transaction about what will be delivered and at what price greatly reduce the value. In the aggregate, it reduces the productivity of the economy.

These results illustrate the advantages of ensuring a representative sample for the population of interest. The Doing Business ranking for “enforcing contracts” is Ethiopia’s highest, indicating it is not a major constraint for the aggregators surveyed and the businesses with which these respondents interact.
Business Environment Analysis: Testing a Context-Specific Approach in Ethiopia

The informal and formal businesses surveyed using RDS, however, report frequent problems with ensuring agreed-upon terms of transactions with customers. Whereas policymakers guided by Doing Business would not prioritize contracts enforcement, KABS results suggest that the Addis Chamber of Commerce should explore mechanisms that enhance the stability of business contracts.

Human Resource Management: Employee Search Costs

24% agree that it is easy to find workers with the right skills.

71% agree that they can afford to hire skilled workers.

92% agree that workers have many opportunities outside of their business.

As in many economies, Addis has businesses that “may adopt new technology or not” and employees who “may become trained to use new technologies or not” (Hoff & Stiglitz, 2001). Whether firms invest in new technologies and job seekers invest in new skills may largely depend on the existence of innovators already present in the marketplace. Firms are more willing to innovate if they expect the quality of the workforce to improve in the future. Likewise, workers are more willing to invest in skills development, either through paying for training or accepting lower wages with training, if they expect potential employers to invest in innovation development (Acemoglu, 1997). Firms in Addis Ababa appear to have a difficult time finding workers with the right skill sets. They also may refuse to train workers because they believe their investment in training will benefit future employers.

Technology Development: Equipment and Technology

91% agree that buying updated equipment or technology would make their business more money.

37% had not purchased updated equipment or technology in the last 12 months.

Our survey identified a large gap between business owners who believed that updated equipment and technology would make them more money and those who were actually purchasing equipment or technology. The brevity of the survey made it difficult to explain this gap. However, we did uncover a few possible causes. Seventy-seven percent of respondents agreed that updated equipment or technology was too expensive for their business. “Too expensive” in this sense indicates that even if the business would earn more money, the risk (cost) of purchasing the new equipment does not match the anticipated return. This risk may come from a lack of nontradeable inputs, for example, properly skilled workers. Another example may be availability of parts or qualified maintenance options. Forty-one percent of respondents did not agree that repairing equipment or technology was easy. A lack of appropriate services or support firms in the market may dissuade business owners from updating equipment and technology despite the perception that updating would lead to greater earnings.

Again, the KABS findings help to illuminate business environment rankings. The Global Competitiveness Report ranks Ethiopia’s technological readiness 140th of 144 countries ranked in 2012–2013 (Sala-i-Martín, 2012). In Addis, the low level of technology development can be attributed to cost constraints, and the anticipated low returns can be attributed to technological investments whose productive lives are shortened by the dearth of skilled workers to maintain them. Providing insurance on common machinery and using the premiums to train maintenance workers would be one program option for the Chamber of Commerce to explore.

Conclusion

We conducted a business environment assessment among a population of small businesses in Addis Ababa, Ethiopia. Our goal was to develop and test a methodology assessing the degree to which specific business environment factors were constraining economic growth for a particular population. We focused on the business activities of the population in an effort to describe direct constraints to increasing productivity. We also created and delivered a survey instrument using RDS to provide a representative sample of businesses.

Our survey revealed direct constraints to increasing productivity. We discovered that the way businesses
arrange transactions is inefficient. We also discovered that coordination failures hamper the development of a skilled workforce, the adoption of new technology, and the basis of competition among businesses in Addis Ababa. We also identified government policies that directly constrain productivity. The first was the nonstandard and inefficient implementation of inspections, and the second was the disincentives to engage in formal business activity. With respect to the latter, the disincentives for engaging in formal business activity seem to extend beyond the cost and time required to comply. This is important because the Ethiopian government has invested a good deal in streamlining regulatory processes. However, if businesses choose not to comply because they do not wish to pay more taxes or subject themselves to more inspections, streamlining processes may be ineffective.

Addressing these constraints has a high chance of increasing productivity, leading to economic growth. However, it is unlikely that these constraints will change without policies and initiatives that create new incentives in the marketplace. These new incentives will have to address the risk and reward of engaging in new behavior and will have to distribute the spillover costs of serving as the first to invest in business activity innovation. This methodology represents a first step toward implementing the findings of the many distinguished academics and researchers. The design and implementation of the methodology was limited by the time and resources we had to invest in its development, and we recognize that there is room for improvement. Particularly, we hope to improve the way we identify the initial list of indicators, narrow that list down to the most binding constraints, and create a survey instrument that will result in a prioritized list of constraints for business people, civil society, and government to address.

We believe it is important that economic development advocates and practitioners build on the tremendous success of Doing Business and other cross-border studies to assist those who are interested in creating economic development in a specific location. Building on that success requires context-specific assessments that use rigorous sampling techniques to compare current economic status to desired and feasible economic status. Economic development advocates and practitioners should then design initiatives that address the direct constraints to increases in economic activity.

References


Appendix

Kal Addis Business Survey (KABS) Questionnaire

The appendix is not included in this PDF file. To access the appendix, click here and select the complete report.
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