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MACRO ECONOMIC REFORM FOR BUSINESS ENABLING ENVIRONMENT: DOES IT WORK AND DOES IT HAVE AN IMPACT ON THE POOR?

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EXECUTIVE SUMMARY

Conference Theme 2: Managing Successful Business Environment Reforms in Asia
Much of the analysis, programs and effort for developing a Business Enabling Environment (BEE) have focused on specific interventions in the regulatory environment. However, work also occurs at the macro-economic level, though this is seldom directly targeted at SMEs or thought of as BEE activity. Yet, these macro-economic reforms in terms of inflation, exchange rates, interest rates, fiscal and monetary policy are just as important, if not more so, for enabling SMEs to thrive. The impact on the poor is more difficult to measure but nevertheless, an argument can be made that such macro economic reforms have implications for the poor. It is argued in this paper that macro economic reforms, when well targeted, enhance the effect and can work with more traditional BEE activities. [1]

Hot Topic 1: Increasing the impact of business environment reform on poverty reduction
These issues are investigated through the case study of a technical facility (TAMF) operating in Indonesia since 1999. Over a period of seven years and with expenditure exceeding US$30 million, the facility has had significant success in supporting macroeconomic reforms. This paper explores how success was achieved and how reforms improved the BEE and impacted on the poor. More specifically, key lessons learned and how such facilities can work in conjunction with more traditional BEE programs are discussed.

Lessons learned
From the case study of TAMF, as well as, based on observations from several other facilities, a number of lessons could be identified which have implications for similar facilities, these include:

- (i) Identify a champion/change agent and require demonstration of reform by counterpart
- (ii) Build long term relations and physically locate close to counterpart agency
- (iii) Provide senior advisers with excellent technical and country experience
- (iv) Retain flexibility to respond to new opportunities within a focused area
- (v) Focus on specific outcomes as opposed to more generic capacity building
- (vi) Create an advisory board with senior stakeholders for ownership and guidance
- (vii) Advisers should not be overly identified with a particular donor
- (viii) Work with host government's priorities, strategies and systems
- (ix) Develop end points and exit strategies:
- (x) Need for an overarching strategy to give a cohesive goal to the sum of the parts:

Macroeconomic reforms and business enabling reforms are not opposite ends of a dichotomy; nevertheless, in a donor world that is increasingly placing more emphasis on performance and better development outcomes, they do compete for funding. However, the case study in this paper suggests that the best design is where the two approaches complement and leverage of each other. Macro economic reforms are likely to work best in conjunction with more direct BEE interventions. In order to improve PSD and conditions for SMEs there is a need to address both issues.

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[1] The views expressed in this paper are those of the author and do not necessarily represent those of AusAID.

CONTENTS

1. Introduction

Economic growth is generated primarily by the private sector. It accounts for most increases in employment and improvements in living standards, including for the poor. In recent years the critical role of the private sector in bringing about economic growth has become a central focus of the aid industry (OECD 2004). For example, in 2002, the World Bank Report identified the importance of institutions for markets and in 2005 it focused on the importance of the investment climate for economic growth. More recently, the Australian government launched its new development strategy identifying economic growth and private sector development (PSD) as one of several key themes. It is now common for development agencies of all kind to talk about how pro-poor economic growth can achieve the millennium development goal of reducing extreme poverty by half. In this context, it is an opportune time to ask; how effective are macro economic reforms for improving business enabling environment (BEE) and in achieving better pro-poor growth outcomes?

Development agencies have come to the issue of BEE from different perspectives. Broadly, there have been two paths through which agencies have approached the issue (White 2004). First, many agencies have an extensive history of working directly with small and medium enterprises and/or the informal sector. These agencies have increasingly found that it also important to work at the enabling environmental level. The second path in contrast has been developed through agencies working for several decades on issues of macroeconomic reforms. Such macro economic interventions are often undertaken with minimal consideration of Small and Medium Enterprises (SMEs) and have as their immediate goals public sector efficiency, better service delivery and greater stability and accountability. Moreover, large donor agencies through different departments have often sponsored both approaches. In the best case scenarios, such agencies have designed macroeconomic reforms and business enabling reforms so that they complement and leverage of each other.

Where agencies have approached the issue of BEE from a macro-economic position rather than an SME focus, it raises the question first of how effective have they been in developing the BEE and second, what are the implications for pro-poor growth? These questions can be further broken down into, first, under what conditions, in terms of design and operations, do macroeconomic reforms work best for developing BEE, and secondly, are such approaches a more efficient means of achieving pro-poor growth outcomes compared to more direct BEE interventions that have a specific SME focus? While the two approaches are not opposite ends of a dichotomy, nevertheless, in a donor world that is increasingly placing more emphasis on performance and better development outcomes, these are important questions in terms of where funding should be directed. To put it more directly; are development dollars aimed at developing BEE best spend on direct intervention or at the macro reform level, and what has a greater impact on the poor? While the answers to such questions are subject to locational and context specificities, it is, nevertheless, useful and informative to ask, since the answers will generate lessons that can be learned and identify elements which may be carried over to a more universal understanding of what works.

To give substance to the questions raised in the previous paragraph, this paper explores these issues through the case study of a technical facility (Technical Assistance Management Facility - TAMF) that has operated in Indonesia since 1999. Over the last seven years the facility has spend over US$30 million on programs of macro economic reform. However, before turning to the study of TAMF, the next section reviews and ties together some of the conceptual arguments of macroeconomic reform programs, BEE, PSD and pro-poor growth. This is then followed by the case study, in which the performance of TAMF and its impact on BEE and the poor is analysed. Having done this, an attempt is made to extract what lessons can be learned and how useful are these lessons for considering future programs and interventions. Finally, the paper presents a brief conclusion, drawing together the various lessons and identifying where gaps in the knowledge continue to exist.

2. Conceptual framework

There exist two lines of thinking and actions that are often kept quite separate, yet have distinct overlap and work towards similar outcomes. On the one hand, there is the line of argument that focuses on macro economic reform as essential for economic growth and notes that much of this occurs through the privates sector which then has an impact on poverty reduction. On the other hand, a second line of thought focuses on improving the business-enabling environment as essential for SMEs activity and poverty reduction. There are obvious overlap in terms of improving outcomes for the poor through the privates sector and SMEs. Yet, in practice, these approaches of focussing on either the macro economy or the BEE are often seen as very much separate and implemented as quite different programs, projects and approaches.

Before bringing the two lines of thought together, it is worthwhile exploring the rationale in each line of thought. Beginning with macro economic reforms, it can be seen that there is a clear conceptual link between macro economic policy reform and poverty reduction. Statistical studies show that macroeconomic stability is essential for economic growth. For example, Easterly and Kraay (1999) using cross-country analysis show that growth is positively related to macro economic stability. The logic is simple that most investors seek relative stability and predictability in making an investment. In the absence of such stability, most investors will withhold their investment or seek other opportunities in more stable environments. While some capital accumulation can be contributed to the public sector, it is mostly the private sector that drives capital accumulation and therefore growth.

It is the economic growth generated by the private sector that accounts for the greatest impact on those in poverty. Again, this is born out by statistical evidence. For example, Dollar and Kraay (2000) found in a study of 80 countries over four decades, economic growth was as important for the poorest one-fifth as it was for the entire population.

Generally, economic growth and macro economic stability benefit the poor who are usually more vulnerable to economic fluctuations. In Asia, the importance of macro stability for the poor was highlighted during the 1997 Asia Financial Crisis. During the immediate aftermath, it was the poor who suffered and were most affected by rapid changes in income generating opportunities and rising prices of basic commodities.

The second line of argument draws on similar logic but from a different approach. It recognizes that the privates sector generates most of the accumulated wealth and argues that improving the business-enabling environment is essential for increasing private sector activity and this will lead to increased SMEs activity and poverty reduction. In this approach emphasis is placed on identifying what are the necessary conditions for an enabling business environment and how can the identified impediments be reduced or eliminated. Its central focus is on SMEs which are endemic to all economies in the developing world.

In the BEE approach there is an explicit recognition that SMEs account for a large share of employment and much of this occurs at the lower income level. Therefore, increasing SMEs numbers and rate of growth has a direct impact on the poor through creating income generating opportunities for entrepreneurs, as well as, employment opportunities. In contrast to the macro economic approach, the focus is much more on what business needs are, as opposed to what is required for economic stability. The emphasis is more than semantics. It has implications for the types of interventions that donor agencies undertake and focus on.

Nevertheless, there is also a degree of commonality in so far that both look to reduce poverty and see economic growth generated by the private sector as central to the economy. In doing so, both approaches focus on policy and regulatory reform – although, from quite different aspects. The macro economic approach tends to emphasise public sector efficiency, macro economic stability and improved service delivery as opposed to the BEE more direct approach of focussing on increasing business activity through regulatory and institutional reform which directly impact on the SME sector.

Therefore, the argument can be made that while the two approaches are often seen as quite separate with different goals, they balance each other and should be viewed as complementary paths for improving the private sector and achieving pro-poor growth. Macro economic stability and reform are a precondition for the growth of the private sector, as are business friendly regulatory environment and functional and appropriate institutional structures.

3. Case study: TAMF III

Starting in 1999, there have been three TAMF facilities. These have all focused on macro economic reforms. In 1997 the financial crisis highlighted the need by key agencies in the Indonesia government for economic governance advice. In the second half of 1998 the Indonesia government agreed to the establishment of a flexible facility to provide such advice. All three TAMF facilities have involved the sustained and managed provision of advisory services to key Indonesian Government agencies. TAMF operates as a flexible and responsive mechanism capable of providing assistance quickly and efficiently. The goal of the program is to support public sector policy-making and program implementation consistent with the Indonesian Government's reform agenda, particularly focusing on economic reform.

Early 2004, TAMF III began operations with a five year program and a budget of A$ 26 million. This budget was later supplemented up to A$ 30 million. This was done by including additional funding and responsibilities in the design. Progressively building on earlier work, TAMF III began with the overall goal of "reduce poverty in Indonesia by supporting economic and financial reform". It focused on supporting the Government of Indonesia in three key areas:

(i) achieving fiscal sustainability,
(ii) protecting GoI's financial position, and
(iii) strengthening the financial sector.

In late 2004 a fourth pillar of promoting economic growth was added and activities under pillar two of protecting GOI's financial position were either curtailed or reallocated to pillar one and two. Early 2006, the facility undertook to do scoping work on public sector management. By late 2006 the structure had further metamorphosed into what became known as sub-facilities, each with a long term lead adviser located in ministries with their counterpart and a program of activities, including training, planning and short term advisers as needed. In addition to the new work on public sector management and retained capacity to identify new and emerging issues, the sub-facilities were as follows:

(i) Infrastructure policy development
(ii) International trade policy
(iii) Treasury management
(iv) Tax administration reform
(v) Financial sector strengthening

The facility structure also included a central office which provided management and support services. This included a part time principal economic adviser which carried out evaluation work and provided strategic support to the lead advisers. The structure included an advisory board, comprising senior government officials and academics, chaired by the facilities hosting agency the Coordinating Ministry for Economic Affairs and the donor, Australian Agency for International Development (AusAID). The board was provided with evaluation reports and a six month forward looking work program for each sub-facility.

By late 2006, the Infrastructure and International trade were new and growing areas so that limited results were available. Although under infrastructure work had been done and was continuing in helping the government auction of the 3G radio spectrum. In interviews with government officials it was clear that they credited the successful auction and the large revenue gained from this partly to the assistance they were given under

TAMF. Previous sales of radio spectrum had been done as 'beauty contest' and had been less successful in raising revenue.

However, it was possible to demonstrate significant results under the longer running sub-facilities of; (i) Treasury management; (ii) Tax administration reform and; (iii) Financial sector strengthening. Despite some issues about quantifying and allocating credit amongst other donors and the agencies themself, interviews with government officials and donors universally credited a large proportion of the success to the various long term lead advisers and their program of work. This success has been acknowledged to the extent that anecdotal evidence was given of key GOI Ministers acknowledging their appreciation of TAMFs contribution to various government of Australian officials.

While the focus of this paper is not on quantifying the success, it worth briefly mentioning outcomes so as to place it in the context of the discussion. First, the, treasury management work built on previous work under TAMF I and II, and in successive stages built a professional debt management unit. The unit has been able to manage Indonesia's debt which has led to a reduction in Indonesia's debt-to-GDP ration of below 50 per cent. A further outcome of the unit's activity has been the continued improved rating of Indonesia's sovereign domestic and international bonds. In early 2006, the latest improved credit rating was by Moody's from B2 to B1. The reduced debt has improved Indonesia's fiscal position and the better rating has reduced the cost of international borrowing.

Second, in 2002 Tax administration reform began. Under the new Minister of Finance appointed in 2005 it became a priority. TAMF has been involved in assisting the GOI in modernising its tax system since the beginning. TAMF was particularly important in the early years of tax modernisation when most of the other donors had pulled out. The lead adviser play a key role in assisting in the provision of better tax services, setting up the compliant handling procedure, adoption of self assessment principles along with better remuneration packages for tax officials. It is currently involved in broadening the tax base, tightening internal control and improving inter-agency cooperation. As a result of these measures tax revenue collected has significantly increased. Nevertheless, in Indonesia, tax revenue as a percentage of GDP remains low by international and regional standards. Indicating there remains significant work still to be done.

Finally, in Financial sector strengthening considerable results have also been achieved, but these have been across a much wider range of issues and with a number of different agencies within the Ministry of Finance and the Coordinating Ministry of Economic Affairs. Briefly, results include assistance with:

- developing a new deposit insurance scheme which replaces the government's blanket guarantee,
- Bank Indonesia recently introduced Emergency Loan Facility to assist banks that have liquidity problems,
- Assisting in improved coordination between Bank Indonesia and Ministry of Finance,

- The development of a comprehensive Package of Financial Sector Reform, announced in June 2006 and signed up to by four Ministries and agents, and
- Assistance with anti money laundering measures which has resulted in the delisting in February 2005 from the list of non-cooperative countries.

Thus, for a relatively small facility, TAMF III has been able to have a significant impact on several key economic governance issues in Indonesia. This view was supported by an independent team, of which the author was a member. In September 2006, the review team carried out a mid-term evaluation of the Facility. It found that the Facility had made significant contribution in the three areas where it had a long term engagement. In the above three areas it was clear that the Facility had worked within the governments own priorities and systems and the gains were likely to be sustainable beyond the life of the Facility. In the areas of Infrastructure and International Trade it was too early to tell what the long term result were likely to be.

4. Lessons learned

Before more closely looking at what this means for the questions we originally started with, it is worthwhile reviewing what are the element that have led to the success of TAMF and also, what has not worked so well. In reviewing the facility a number of recurring themes emerged that have relevance for other similar flexible facilities. First the lessons that led to success are briefly presented, followed by some aspects that perhaps did not work so well.

The following are some lessons learned from TAMF I - III:

(i) **Identify a champion/ change agent:** A strong prerequisite for engagement in specific areas was the identification of a champion or change agent. In some cases this was a reform minded Minister in other instances it was a senior government Bureaucrat.

(ii) **Require demonstration of reform by counterpart:** a champion or change agent itself was not considered enough. There had to be some demonstration of willingness to implement reforms. This may be through development of specific policies or recruitment of key reform minded staff.

(iii) **Build long term relations:** In all cases counterparts commented on the long term relationships and trust that had been built up since 1999. TAMF and lead consultants were seen as more than the usual consultants that parachute in and deliver a report and leave again.

(iv) **Provide senior advisers with excellent technical and country experience:** the lead consultants were senior people that could draw on a range of experience and networks and often had extensive knowledge of the country and counter part agency. Ministers respected their judgement.

(v) **Physically locate close to counterpart agency:** All advisers were located close to their counterparts. Often they had the office next to their main counterpart and worked in the location of the section where the reforms were taking place. It kept them in touch with developments and made them accessible.

(vi) **Retain flexibility to respond to new opportunities within a focused area:** Within sectoral issue, advisers retained flexibility to respond to emerging opportunities. In a dynamic political and economic environment, it is necessary to be able to respond to changes and take advantage of opportunities. These could be in capacity building, advancing reform policies or institution building.

(vii) **Focus on specific outcomes as opposed to more generic capacity building:** All capacity building, whether in the form of training, strategy planning or human resource development, took place in the context of specific reforms. For example, training in tax occurred with a focus on building the capacity to implement new systems and procedures.

(viii) **Implement an advisory board for ownership and guidance:** The advisory board chaired by the Deputy Minister from the Coordinating Ministry of Economic Affairs provided ownership. But more important, was able to provide guidance on which issues were likely to move ahead and which would find political resistance. In turn, senior board members could see the reform process and reinforce support for them through their own agencies.

(ix) **Need to demonstrate results from long term engagement:** While this might seem self evident, it should not be underestimated how important measurable success has been to further the reform program and bringing in other donors to the reform agenda.

(x) **Advisers should not be overly identified with a particular donor:** A number of GOI counter part agencies indicated they trusted the long term advisers more than other donor's advisers because they were not promoting loans or other donor products. Other donors also indicated that TAMF advisers were often seen as more independent than their own organisation. Nevertheless, it was widely acknowledged by GOI that the Facility was funded by Australia.

(xi) **Begin with broad engagement and progressively focus:** Almost all the sub facilities started off by working in broad areas of potential reform (i.e. identified a champion and demonstrated reform in the economic governance area), before narrowing the scope of work to more specific targets. This took anywhere from a year upwards.

(xii) **Work with host government's priorities, strategies and systems:** All reform process worked with the government's priorities and strategies. All solutions were tailored to the needs and involved counterpart inputs. In no case were solutions or reform taken ‘wholesale’ from somewhere else.

(xiii) **Develop rolling work plan and review process:** The lead consultants were required to identify a rolling six month work program and on going reviews were carried out on sub facilities. In the context of long term engagement, this provided short term goal setting and regular reviewing of achievements.

While there were a range of ‘positive’ lessons, there were also some lessons identified of what didn’t work or should have been done that would have enhance the facility’s operation. Briefly these included:

(i) **Avoid aligning the start of the facility with major political change**: TAMF III started about the same time that the new Indonesian Government was elected and given that the facility was designed for five years it may face the same problem if a fourth funding round occurs. For most of the first year TAMF III was unable to engage many of their counterparts. It took about a year for Ministers and their senior bureaucrats to be allocated and settle down.

(ii) **Develop end points and exit strategies:** Many of the activities were ongoing and did not have an exist strategy or a well defined end point. Some decision needs to be made at some stage about identifying an appropriate end point. That is, identify what you want to achieve (in terms of functions rather than structures) and an exit strategy for when this is to be achieved.

(iii) **Need to manage donor’s expectations**: Facilities by their nature usually start with ambiguously identified outcomes or outputs. The flexible nature creates a certain amount of angst amongst donors responsible for them. This is caused by the slow steps forward in a progressive engagement strategy and the greater ambiguity around identifying predetermined outputs.

(iv) **Need for an overarching strategy to give a cohesive goal to the sum of the parts:** While there is ambiguity around outputs, it is nevertheless possible to develop a strategy that should provide guidance to the facility and some comfort to the funding agency. This should be more precise than the all encompassing “poverty alleviation” goal and should be measurable. Such a strategy will also prevent ‘capture’ by key government officials.

The above lessons were derived from the mid term review of the TAMF facility, as well as, observed and related to the experience of several other facilities that are funded by AusAID. This suggests, while any application of lessons learned needs to be time and place specific sensitive, the lessons above can be used to inform future design.

5. Conclusion

Returning now to the question asked at the beginning of this paper of how effective are macro economic reforms for improving business enabling environment (BEE) and for achieving better pro-poor growth outcomes? In answering the question, it is assumed we accepted the conceptual argument made in the earlier section of this paper which related to the link between macro economic stability leading to economic growth and the impact this has on the poor. If this is the case, then TAMF has demonstrated that it has implicitly contributed to the improved outcomes for the poor. To be more precise, improved tax services and collection, greater financial stability and lower cost of financing international borrowing, will contribute to improved conditions for businesses and service delivery by government. However, given that there a range of intervening variables at work, such as other reform processes, including a large scale decentralisation process and an open economy susceptible to external shock and natural disasters, it is impossible to make a quantified link between, the broad goal of poverty reduction and the activities of TAMF III.

Originally, the above question was further divided into two subsidiary questions that asked under what conditions, in terms of design and operations, do macroeconomic reforms work best for developing BEE and are such approaches a more efficient means of achieving pro-poor growth outcomes compared to BEE interventions that have a specific SME focus? The answer to this is a little more obtuse, in so far that this is probable the wrong question to ask. Rather, it is not so much about one or the other being better, but more about the complementarities of the two approaches. As has been shown in this paper, macro economic reforms do have an impact, but are likely to work best in conjunction with more direct BEE interventions. In order to improve PSD and conditions for SMEs there is a need to address macro economic issues, as well as, more direct BEE issues. This argument can be taken one step further, in so far it is hypothesised that macro economic and BEE interventions which actively seek to leverage of each other are likely to have an even greater impact (van Diermen 1997). While this paper has not examined this hypothesis it should provide fertile grounds for future analysis.

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