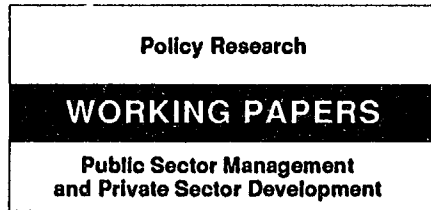


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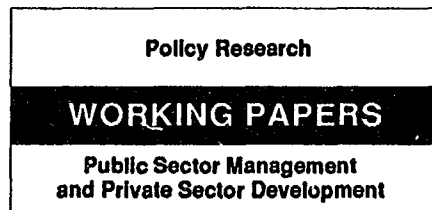


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Côte d'Ivoire: Private Sector Dynamics and Constraints

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and
Andrew Stone

Taxes weigh heavily on private firms, while the burden of labor regulations is reduced by informal responses. But the essential precondition for a substantial supply response is continued macroeconomic policy reform.



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This paper — a product of the Public Sector Management and Private Sector Development Division, Country Economics Department — reflects an early application of a methodology for private sector assessment developed by the Division to identify constraints on, and priorities for, the development of a country's private sector. Copies of the paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Priscilla Infante, room N9-059, extension 37642 (November 1992, 48 pages).

Private sector assessments provide information and analysis essential to formulating strategies for alleviating constraints on private sector development. They are meant to contribute both to the Bank's policy dialogue with borrowing governments and to the formulation of country assistance strategies.

Rueda-Sabater and Stone examine the constraints on growth faced by private enterprises and how these relate to the policy and institutional environment in Côte d'Ivoire. They employ new data sources as well as surveys of, and in-depth interviews with, private entrepreneurs. They focus on:

- The effects of taxes and labor regulation on private firms.
- The impact of public spending on private sector development.
- The role of informality in enterprise activity.

Among their findings:

Tax policy and enforcement impose a heavy financial burden on a shrinking base of formal enterprises, whose regulatory burden has also grown. Taxes are increasingly independent of a firm's profits. This substantial fixed cost may lead some businesses to exit prematurely and may discourage others from formal entry. The overall tax burden on small and medium-size enterprises has risen disproportionately, to levels that discourage formal participation in the

economy. Informal firms pay some taxes, but there is considerable leakage in collection.

Unnecessary rigidities in labor policies weigh less heavily than expected on firms, because they avoid their full costs through such means as subcontracting and apprenticeships. The restrictions nonetheless limit firms' flexibility of operation and ability to reward merit.

In the 1980s, public spending increasingly channeled limited financial resources and human capital toward nondevelopment purposes, including poorly performing enterprises and elite-oriented services, precluding their use in the private sector. The methods of financing public spending (such as withholding taxes and accumulating arrears) have sharply curtailed the capital available to private enterprises. The public sector's dramatic accumulation of arrears and growing reputation as a bad customer are undermining the competitive private supply of goods and services to the government.

Government employment policies attract many of the most qualified potential entrepreneurs and business professionals to government employment.

Rather than a sharp divide, there is a continuum between small informal and large formal firms. Some medium-size and large formal firms engage in informal behavior, and large firms sometimes lower their costs through links with informal firms — including purchases of inputs that have escaped regulation and taxes.

The Policy Research Working Paper Series disseminates the findings of work under way in the Bank. An objective of the series is to get these findings out quickly, even if presentations are less than fully polished. The findings, interpretations, and conclusions in these papers do not necessarily represent official Bank policy.

CÔTE D'IVOIRE

PRIVATE SECTOR DYNAMICS AND CONSTRAINTS

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PREFACE

This paper reflects an early application of a methodology for private sector assessment [PSA] developed by CECPS¹ to identify constraints to and priorities for the development of a country's private sector. PSAs provide information and analysis essential to formulating strategies to alleviate constraints to private sector development (PSD). They are intended to contribute both to the policy dialogue with borrowing governments and to the formulation of country assistance strategies. They are not strategies themselves, but rather. Generally, PSAs include: (i) an analytic description of the private sector and its role in the economy; (ii) a discussion of policy, institutional and other factors that limit efficient private sector economic activity; and (iii) identification of priority areas for government actions and World Bank Group assistance.

Specifically, two steps are recommended at the outset of a PSA to determine its focus:

- First, collect and review existing knowledge about the private sector by reviewing documents and talking with operational staff. In the process, learn what experts currently understand to be the priorities for promoting PSD.
- Second, identify gaps in knowledge on key issues and on the role and structure of the private sector.

In this case, consultation with Bank staff in Washington and in Abidjan revealed a particular concern with the stagnation of urban enterprise, and a desire for more information about labor market issues, the informal sector, tax and other regulatory constraints, and the interaction of public investment and expenditure policy with private sector development [PSD]. Thus, we focused our investigation on these four issues -- *instead* of conducting a more sweeping analysis that might have scratched the surface of a broader range of issues. While in Côte d'Ivoire, we consulted informed officials and other experts, but most of our time and resources were devoted to speaking with entrepreneurs themselves: individuals whose day to day confrontation of their country's economic, physical and institutional constraints makes them an invaluable source of information on priorities for policy reform. The study made use of both in-depth interviews with businesses and a firm-level survey that elicited information from 37 firms of all types in Abidjan and Bouaké on problems confronted, emphasizing constraints to future growth and operation.

Initial analysis of the data revealed that legal status provides the best clue to the dominant problems of an Ivoirian enterprise. Grouping firms by legal status (rather than age, size, or activity) elicits most clearly the key characteristics of enterprises and the problems they face. Thus, a good many of the results reported here are organized by the legal status of the firms studied.

¹ CECPS is the Public Sector Management and Private Sector Development Division of the Country Economics Department of the World Bank.

Following the completion of field work for this study in 1990, CECPS has continued to refine its field surveys, in terms of both the survey instruments themselves and their design and analysis. Nonetheless, the current study demonstrates the power of this type of survey to generate policy-relevant information. This is perhaps best exemplified in the study by the startlingly high importance firms place on the obstacle imposed by tax regulation compared to labor regulation: in the institutional environment of Côte d'Ivoire, apparently restrictive labor law is avoidable, while imposing tax requirements are not.

Finally, since this study and other studies on competitiveness and the regulatory framework were carried out in 1990, a number of policy changes have been agreed to by the government of Côte d'Ivoire aimed at easing constraints to the private sector. These measures include: competitiveness-oriented reform of labor regulation (including hiring, firing and overtime regulations); reduction of taxes on labor, profits and commercial transactions; commitment to a program of divestiture of a number of state-owned enterprises, endorsement of a human resources development plan moving public expenditure away from elite-oriented services towards more socially productive and equitable ends; and financial sector reform.

I. INTRODUCTION

Côte d'Ivoire's economic tale of the last two decades is starkly reflected in the collapse of private investment in the 1980s. During the 1970s private investment had fluctuated moderately around 14% of GDP (a level higher than the Sub-Saharan African average, see table 1), while GDP was growing at a healthy 6% annual average (with significant, crop-driven fluctuations). Public sector investment soared from 7% of GDP in 1971-2 to 13% of GDP in 1978-9, reflecting sharp growth in earnings from the country's main export commodities during most of this period. Since the early 1980s, though, both gross investment and the private sector's share of it (see Table I) have plummeted, even by Sub-Saharan African standards, to about 3% of GDP.

This dramatic decline of private investment (to levels well below what would be necessary even to replace worn-out plant) reflected both a worsening economic environment and the powerful crowding out effect of a public sector which had failed to respond to macroeconomic change. The worsening economic environment was plainly visible in the contraction of demand for all kinds of goods and services. One clear sign of the public sector's negative impact on the economy has been the drying up of bank finance for private investment.

**Table 1: Public, Private and Total Investment in Cote d'Ivoire
(in Percentage Points of Nominal GDP)**

Sector / Year	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988
Private Sector	13.2	13.6	16.6	16.4	14.7	14.7	15.8	11.1	9.8	4.0	3.6	1.7	2.9	4.5
Public Sector	9.2	9.4	10.8	13.3	13.3	13.6	10.2	23.1	10.8	6.9	9.0	9.3	10.1	10.0
Total Inv. CDI	22.4	23.0	27.3	29.8	28.0	28.2	25.9	23.2	20.6	10.9	12.6	11.1	13.1	14.5
Total Inv. SSA	23.4	22.9	22.7	23.3	22.1	23.1	22.4	22.5	18.2	17.2	18.5	18.7	18.4	18.2
Total Inv. OECD	24.6	24.5	24.5	23.4	24.2	24.4	23.1	22.5	20.8	21.5	21.1	21.3	21.9	22.8

Note: SSA = Sub-Saharan African Countries; OECD = High income OECD Countries
Source: DEC Analytical Database

While the accuracy of aggregate investment figures may be questionable (they probably miss most of non-formal private investment), there is no doubt about the significance of the trend they depict. The information from macroeconomic aggregates is fully consistent with enterprise-level data from both secondary² and primary³ sources. Together, they show the private sector's role as more

² Banque des Données Financières (BDF) data show, for instance, that the average enterprise in Côte d'Ivoire became decapitalized, by about 4% in nominal terms, between 1982 and 1988. Privileged access to resources by public enterprises, though, postponed their day of reckoning while it accelerated the crisis of large private enterprises -- which faced a dramatic disinvestment process:

of a dependent (farmers excepted) than a partner in economic growth. Thus, when the public sector's resources started to dry up, much of the private sector went into a sharp decline. Public policy limited the flexibility with which private firms could react to changing circumstances, making the decline almost irreversible.

In this context, one must underscore the impact of the real rate of exchange⁴, which has helped to reduce the competitiveness of exports and encourage an inward-orientation among the majority of private enterprises. Most enterprises now struggle to find markets for their production in the face of a shrinking overall domestic market. The efficacy of protection of domestic manufacturing is declining: every increase in import duties (to generate revenues and to compensate for the real appreciation of the currency) appears to reduce actual protection by enhancing the incentives for smuggling.

Public expenditure (through both agencies and parastatals)⁵ has always had powerful impacts on private enterprise, both positive and negative. Over the last decade, the effects of public expenditure and the need to finance tremendous fiscal deficits have turned sharply negative. While expenditure in the 1970s arguably supported and encouraged private investment, in the 1980s public expenditure has increasingly channeled limited financial resources and human capital towards uses that served neither development nor poverty alleviation, precluding their potentially more efficient use in the private sector. Government's financing methods (such as forfeiture taxes and accumulation of domestic arrears) have further curtailed the capital available to private enterprises. Furthermore, the government has denied the private sector open, competitive access to up- and downstream linkages with public enterprises. Finally, it has prohibited competition with parastatals, further limiting potential private investment.

The "creativity" of tax authorities has become a serious threat to business. Among the most egregious recent outcomes: export premia are counted as income when they are due (not when they are paid) and thus subject to profit taxes, often in advance of their actual receipt by exporters; and the latest tax (a 5% withholding tax on gross sales) is at best a tax pre-payment measure in times of tight liquidity and at its worst an inflationary surcharge. Not surprisingly, the CECPS survey showed

19% in nominal terms and between 1982 and 1988.

³ The CECPS mission of June 1990 surveyed 38 private SMEs (the sample was not randomly selected but it appears to be reasonably representative), and interviewed a dozen larger enterprises and a number of microentrepreneurs. Obviously, few of the conclusions derived from the survey and interviews have their basis in statistical inference.

⁴ The real exchange rate is often measured by multiplying the nominal exchange rate by the ratio of foreign to domestic prices (although technically it should be multiplied by the ratio of the prices of tradable to nontradables goods). It is thus a critical determinant of the competitiveness of exports in international markets and that of imports in domestic markets.

⁵ In 1988, current expenditure totalled about 33% of GDP.

that taxes were perceived by all types of enterprises as a threat to their survival and as the leading obstacle to expanding their activities.

Rigidities in labor regulations are also a significant concern. This is not so much because of what they imply for the cost structure of enterprises -- labor costs are considered a relatively minor constraint by most entrepreneurs -- but rather because the regulatory system tends to favor enterprise shut-downs over enterprise restructuring by, *inter alia*, making selective employment reductions much more difficult than massive, across-the-board ones. In addition, there may be dire dynamic consequences of restrictions on performance incentives for productive efficiency.

An intricate web of import protection and concessions completes the picture and provides a large part of the explanation for the exorbitantly high cost of many intermediate imported inputs. Such a system depends both on anti-competitive regulations and on similarly uncompetitive policies in neighboring countries. As some neighbors have increased their competitiveness, the system has eroded, making the much of "modern" Ivoirian industry unsustainable.

II. TAXONOMY OF THE PRIVATE SECTOR⁶

The non-farming private sector in Côte d'Ivoire consists of: about 800 "large" enterprises (with at least 50 employees); several thousand "medium" enterprises (with between 10 and 50 employees); many thousands of "small" enterprises (with up to 10 employees); and several hundred thousand microentrepreneurs (mostly just generating self-employment). Total employment in the private enterprise sector is roughly divided as follows: large 10%, medium and small 15%, and micro 75%⁷ This "pyramid" of enterprise types has at its top twenty very large public enterprises employing an average of 1,400 people each. The pyramid is also quite rugged -- with a very marked shortage of small and medium enterprises poised for growth.

Essentially all large enterprises and a small group of medium enterprises appear to receive the bulk of the benefits of "formality" (bank financing, investment incentives, etc.) and, in exchange, face the greatest rigidities and collect the bulk of the indirect taxes. A very large proportion of the "medium" size enterprises are not in manufacturing and would seem to be very vulnerable to the adjustment Côte d'Ivoire's economy is, belatedly, undergoing. These enterprises represent the lower end of the scale of an artificially modern (i.e. uncompetitive) sector and have been the first to suffer the impact of the current crisis. Because many of these are owned and run by expatriates they are also less resilient. Meanwhile, the indigenous entrepreneurs (other than the privileged larger ones) have found it extremely difficult to obtain the resources to grow from a very small size -- stunted by a regulatory and financial system that has been private sector oriented only in a very narrow, large-biased sense.

Large private enterprises employ an average of 145 people each and represent a varied group including subsidiaries of multinational corporations, joint private-public ventures (with state minority shareholding), enterprises owned by Ivoirian nationals, and those owned by other nationals (mostly French and Lebanese). The nationality mix of the owners and managers of these large private enterprises is reflected in the fact that nearly one-fifth of payroll expenditure in 1988 was for

⁶ The classification of enterprises by size follows the practice of the Ivorian Ministry of Industry, which incorporates a relatively low threshold for classifying enterprises as "large": 50 or more employees. The information on which the analysis in this section is based comes from the following sources: "Banque des Données Financières" (1988); SME Survey by Centre Gama (1989); Informal Sector Survey by Centre Gama (1988); and by the survey and interviews conducted by the June 1990 CECPS mission. Our access to microentrepreneurs in Bouaké was greatly facilitated by M. Maurice Djan of OIC International.

⁷ These figures are rough, illustrative estimates based on a variety of sources. Data for the nearly 800 large private enterprises show total employment of about 120,000. Medium and small enterprise employment is estimated -- with a wide margin of error -- to approach 200,000. According to A. Touré, an authoritative observer of the informal sector, there are over one million people working in Côte d'Ivoire's urban informal sector. His definition ("petit métiers") is broader than that of microenterprises employed here (activities involving some specialization and continuity).

expatriate employees (who represent 3% of their labor force). Mostly oriented to the domestic market, these nearly 800 enterprises account for over 20% of GDP and of tax revenues, and for more than half of all corporate income taxes. They form the hard-core modern sector and represent the only significant part of the economy where the basis exists for a reasonable implementation of the VAT system⁸.

Large enterprises are generally registered as corporations and comply with tax regulations (including the workers' social security, the CNPS, which appears to be the most frequently evaded form of taxation). This does not necessarily mean that their tax burden is higher since they also have the bookkeeping and negotiating capacity needed to obtain exemptions and allowances from the tax authorities. Between 1982 and 1988, for instance, gross value added among large private enterprises grew only by about 13% (compared to accumulated inflation for that six-year period of about 25%) and their total tax bill by more sizeable 28%. Weakening demand compounds the pressure resulting from a growing tax burden (22% of gross value added in 1988, compared to 19% in 1982 for the large enterprises) and resulted not only in the decapitalization noted above, but also in a 24% reduction in total employment by large private enterprises (from a 1982 average of 190 workers to a 1988 one of 145) -- just about sufficient to keep total payroll expenditures constant in nominal terms.

Bracing for the lean years ahead, large private enterprises have reduced their stock of medium and long-term debt (with which they were highly leveraged) by 18% between 1982 and 1988. The balance between long and short-term debt worsened -- most likely not by choice but because of increasingly difficult access to long term funds. Meanwhile, public enterprises increased their stock of long-term debt by 23%. Private enterprises have not managed to reduce their reliance on short-term debt, given that new tax withholding measures and mounting public sector receivable arrears have significantly increased liquidity pressures on enterprises by forcing upon them additional parts of the deficit financing burden.

Until recently, many⁹ large private enterprises had suffered relatively little from the economic crisis that plagues the country. Their privileged access to resources, their public sector connections, and their protection from external and internal competition had buffered them. The deepening fiscal and financial crisis, the collapse of domestic demand, and the growth of uncontrollable competition are now seriously menacing most of them. While there is no avoiding the adjustment ahead for the large enterprise sector, its impact on the economy (and on the enterprises themselves) will depend significantly on the role regulatory rigidities play in the adjustment process.

⁸ It would be wrong, though, to conclude that they are the most heavily taxed because they collect the bulk of the VAT receipts. Where the burden of the VAT falls depends on the factors behind demand and supply elasticities.

⁹ Textile manufacturers being one of the most notable exceptions. Production of the most popular textile items is at less than half (in physical terms) the 1985 level due to the combined effect of illegal imports and reduced demand.

The distribution channels (for final products) which used to be controlled at the wholesale level by large, formal enterprises with heavy overheads (reflecting comfortably protected margins) now largely depend on aggressive smaller wholesalers of a less tractable nature. These lean, competitive traders (a majority of them Lebanese) are gradually replacing the large colonial trading houses (now left with at most one-third of the total wholesale market). The much maligned Lebanese traders could be considered an economic asset: they serve the consumer well and have probably reduced distribution margins significantly from the prior ones. Nevertheless, it is a less controllable system which does not keep complete accounting records and is prepared to tap into irregular sources of supply when they offer favorable terms -- thus evading the prevailing distortions and rigidities.

This evolution of the distribution system for domestic manufactures and imports is symptomatic of the erosion of a partnership between the state and large enterprises which for two decades extracted considerable consumer surplus (increasing the cost of living) and created an artificially modern system. The central government's tax structure was designed with this modern system in mind and is unlikely to be well-suited to the post-adjustment private enterprise sector.

Small and medium scale enterprises (SMEs) are a particularly interesting subject of study because of the key role their flexibility equips them to play in resource reallocation processes, in pursuit of efficiency. In Côte d'Ivoire, SMEs fall into two fairly distinct categories which are not separated so much by size as by enterprise culture. At one end of the spectrum are fully documented corporations and unincorporated limited liability enterprises (ULLEs) and at the other are sole proprietorships which keep few records.

The present situation is particularly bleak for the smaller enterprises attempting to comply with all legal requirements. The characteristics of corporate SMEs are reasonably well-known, on the basis of the records submitted by over 1,500 of them to the Government (see table 2). They are a rapidly declining breed¹⁰ that in 1988 employed 22% fewer people than in 1982 and that, over that six-year period, has seen:

- (i) turnover and operating margins decline (in nominal terms, the value added of the average enterprise dropped by 19% but payroll costs were only 12% lower); and
- (ii) tax burdens increase in both relative (from 16% of value added to 27%) and absolute terms (although SME's value added was 27% lower in 1988 than in 1982, they contributed 19% more to the public coffers).

¹⁰ Between 1982 and 1988 their total number declined by over 10%, with 173 enterprises either dropping out of sight (becoming informal operations) or (most likely) just closing down.

Table 2: Formal Enterprises: Evolution 1982-1988

	Large Public	Large Private	Private SMEs (<50 emp)
Change in Numbers (No. in 1988)	-41% (20)	0 (762)	10% (1,510)
Change in Avg. Value Added per Enterprise	*	13%	-19%
Change in Total Employment (Avg. employment in 1988, per enterprise (Total Employment, 1988))	-18% (1,400) (28,006)	-24% (145) (110,565)	-22% (9) (13,713)
Tax Burden/Value Added:			
in 1982	0.16	0.19	0.16
in 1988	0.20	0.22	0.27
Change in MLT Debt	23%	-18%	-23%
Change in Total Expatriate Employment (expatriate employment in 1988) (expatriate payroll/total payroll, 1988)	* (140) (3%)	-40% (3,206) (19%)	-44% (1,467) (32%)

SOURCE: BDF/CECPS

* Not meaningful

Note: Large enterprises are those with 50 or more employees.

Another significant characteristic of these smaller corporations and ULLEs is the large proportion of them that is owned and/or managed by expatriates. A recent survey¹¹ found that nearly half were owned by non-African expatriates¹², and a further third by non-Ivoirian Africans. Eleven percent of employees were expatriates who account for 32% of all payroll costs (in spite of a significant reduction from an astonishing 15% of employees who were expatriates in 1982). In view of their close external connections, it is a remarkable indication of anti-export distortions in the economy that only one-eighth of these enterprises have had any exporting experience and that not a single one is primarily engaged in exports.

¹¹ Gama Centre, 1989.

¹² Of the non-African expatriates one-third were French and two-thirds other nationalities (mostly Lebanese). Less than half of the French-owned enterprises, compared to three-quarters of the others, intended to expand.

SME owner/managers, regardless of nationality, are well-educated: all of the respondents to the survey had at least secondary education, and a majority of the expatriates had higher education. Education emerges as an important determinant of "formality": it is the enterprises with the more educated owners/managers that are registered as corporations or ULLEs, pay the full range of taxes, and in turn benefit from bank financing and technical assistance.

SMEs which are registered as sole proprietorships (or unregistered) are much more likely to be owned by Ivoirian and other African nationals. Their owners are less educated, they tend to employ fewer people, they rely much more on apprentices, and they seldom receive technical assistance or Bank financing. It is particularly ironic that there is such a clear relationship between education and technical assistance: the needier the SMEs (because of the low level of education of their principals), the less likely they are to be the recipients of technical assistance.

The larger, more formal SMEs seem to be facing considerable difficulties and, in many cases, their very existence will be threatened by the adjustment process. On the other hand, the smaller, indigenously owned/managed SMEs are accustomed to facing obstacles and to having their growth stunted; they are bound to be much more resilient and could more easily respond to a less rigid and distorted environment.

Microenterprises. An extensive recent survey¹³ provides reliable, basic information on urban and peri-urban microenterprises. This survey depicts a complex and varied sector (see table 3) which ranges from embryonic SMEs in the manufacturing sector (22% of the enterprises) and industrial support services (20% are repair workshops of all kinds) to the more stereotypical vendors (29% of the enterprises).

There are clear specializations by gender, with females much more likely to be involved in vending and food-related activities, and males much more likely to be involved in services and in those manufacturing activities where sales most often take place at the point of production. For the majority of microentrepreneurs (male and female alike, although by a lower margin for the latter), their activity constitute the main source of household income.

The large majority of microenterprises are not formally registered -- which is probably related to the low level of education of their owners (table 4). Only 14% of the microentrepreneurs have a secondary education, while 48% declared themselves to be illiterate. Illiteracy is more common among females (53%) than among males (46%), and among non-Ivoirians (52%) than among Ivoirians (44%).

¹³ Gama Centre, 1988. Mssrs. Guibony Sinsin and Zilma Badiel were instrumental in gathering and processing this unique data source. The survey systematically sampled several urban and peri-urban areas in Abidjan and its vicinity and obtained information on 1,588 microentrepreneurs involved in 55 different types of activities. We have classified these 55 activities into five sub-sectors: commerce; other services (ranging from typists to hairdressers); bars and restaurants; repair workshops; food processing; and other manufacturing.

TABLE 3: Microenterprises

Subsector	No. of Different Activities	No. of Enterprises	Distribution of Enterprises	Average Annual Turnover (US\$'000)
Commerce	16	466	29%	7.4
Bars/Restaurants	3	91	6%	5.4
Other Services	12	358	23%	6.6
Workshops	11	318	20%	N.A.
Food Processing	7	161	10%	7.4
Other Manufacturing	6	194	12%	22.7
6 Subsector Total	55	1,588	100%	9.4

SOURCE: GAMA Center/CECPS

Note: All data applies to the sample in the GAMA survey, which is not a census of all firms.

Virtually all microentrepreneurs report paying taxes (although the survey data do not illuminate exactly what type of taxes they pay). Those with activities requiring fixed premises most often reporting payment of licensing taxes. Their annual turnover averages over US \$9,000 equivalent, while their costs average close to 50% of turnover. Net incomes (which vary more with activity than with education, gender, or nationality) appear, on average, to be above the level of the minimum wage (SMIG).

TABLE 4: Microentrepreneurs

	Percent of Sample	Illiterate	Primary	Secondary/Higher	Total
Ivoirian Female	(21)	52%	33%	15%	100%
Other Female	(7)	43%	43%	14%	100%
Ivoirian Male	(31)	36%	39%	23%	100%
Other Male	(42)	52%	30%	10%	100%
All Microentrepreneurs	(100)	48%	38%	14%	100%

Source: GAMA Center/CECPS

III. FORMALITY, INFORMALITY AND PSD CONSTRAINTS

Classifying private enterprises according to their form of registration provides a clear picture of Côte d'Ivoire's formality-informality continuum. The CECPS private enterprise survey, conducted among 37 firms¹⁴ in Abidjan and Bouaké, illuminates both firm characteristics and respondents' perceptions of the binding constraints to their growth and future operation. On one extreme are foreign-owned corporations paying a wide array of taxes and complying with burdensome labor regulations. On the other extreme are unregistered microenterprises paying rudimentary taxes and escaping much of the burden of labor regulations. The former benefit from access to bank financing and legal recourse, as well as from investment incentives and other government-sponsored assistance programs. The latter fend for themselves, subject to considerable arbitrariness in their exposure to revenue-raising from government representatives. Informality emerges not as the deliberate choice of entrepreneurs but as their response to a tax and regulatory system that assumes away the realities of the large majority of the existing enterprises -- as reflected, for instance, in the unrealistic record-keeping requirements of the VAT and in the biases (favoring large enterprises) of the incentive structure. While *informal status* characterizes only rather small enterprises, *informal behaviors* are engaged in by enterprises of many sizes.

Naturally, the majority of enterprises fall in between the two extremes described above -- paying some taxes and managing to capture some of the benefits of formality. SMEs cover the full spectrum from informality to formality (as indicated by enterprise registration, which provides the clearest distinction in firm characteristics). Table 5 shows four indicators which point very consistently to the utility of registration status in segmenting the continuum of SMEs: education, bank financing, taxation, and employment of apprentices.

Table 5: SME Characteristics by Type of Registration

	% Of Owners/Managers With Secondary or Higher Education	% Paying Licensing Tax		% Receiving Bank Loans	% Of Apprentices in Total Employment
			VAT		
Unregistered	43	75	0	13	47
Sole Proprietorships	58	85	46	36	34
ULLEs	100	90	90	70	17
Corporations	100	100	100	75	2

SOURCE: CECPS Survey

¹⁴ While 37 entrepreneurs were administered a structured questionnaire, many others were interviewed in depth in a less-structured interview format for other parts of our analysis.

Legal Status and Education. There is a strong apparent correlation between education and formality. One manifestation is that entrepreneurs opting for the "higher" forms of registration (corporate and unlimited liability) tend to be more educated. Interpreting this unsurprising correlation in light of discussions with a wide range of entrepreneurs leads to the following explanation: better educated entrepreneurs feel more confident in their relations with Government and other super-institutions and, thus, see formality as a beneficial option. Less educated entrepreneurs, faced with an arbitrary, predatory state feel forced to retreat into relative obscurity, shunning formal obligations, thus forsaking formal sector privileges in the process. This suggests that the intensive involvement of the state and the complexity of its regulatory interventions make lack of education a more serious obstacle to growth than it would be otherwise.

Bank financing. As an indicator of the benefits of formality, the incidence of bank loans also varies significantly by type of enterprise -- although it is likely to have been overstated in the survey that was unavoidably biased towards "accessible" SMEs. The incidence of bank lending also suggests that the banking system in Côte d'Ivoire (at least in major urban areas) has a relatively broad reach among formal enterprises. Nonetheless the firms identified access and cost of bank financing as a substantial obstacle to growth (see below). This may reflect two factors: first, a "crowding out" of private finance by the need to finance massive public debt; and second, a record of poor portfolio management and politically influenced loans whose high default rates have dried up the current supply of capital. For international banks, the risk associated with political and macroeconomic uncertainties deters commitment of new capital.

The main source of start-up financing for all types of enterprises is savings, closely followed by contributions from partners and relatives. There is, though, an apparent discontinuity with respect to project financing: while virtually none of the SMEs were able to rely on loans for initial financing, one-sixth of the microentrepreneurs surveyed report having borrowed part of their start-up funds. At the other end of the spectrum, more than a third of ULLEs and corporate SMEs received start-up bank loans -- a proportion that increases to over half in the case of foreign-owned SMEs. The most likely explanation is that the larger, better connected enterprises have preferential access to bank financing, while microenterprises can tap the informal financial system for their limited needs, and those in between find it harder to interest formal lenders in their investment projects.

Taxation. Taxes are the favorite villain of entrepreneurs in Côte d'Ivoire (a detailed analysis is presented in chapter IV). Some taxes are paid by virtually every enterprise, but their relative impact is not easily comparable, due to inconsistent enforcement of tax law. Enforcement falls into three different categories of assessments: based on well defined parameters (e.g. accounting profits); calculated from proxies (e.g. lump-sum estimates for VAT collections); and determined arbitrarily (e.g. forfeitures and customs assessments).

Apprenticeship. The proportion of apprentices in an enterprise's labor force is a rich indicator of formality. Labor regulations (see chapter V) appear daunting on paper yet, in our survey, were not ranked high as an obstacle to growth by either SMEs or larger enterprises. On the one hand, corporations may have adjusted to labor rigidities by increasing their capital/labor ratio; on

the other hand, smaller SMEs have had to resort to loopholes such as an increasing reliance on apprenticeship. In either case the adjustment appears to have been effective enough to downgrade labor costs and relations as an obstacle to growth.

Obstacles to Growth

Overall For the entire sample, lack of access to finance, problems of taxes, and political and economic uncertainty weighed most heavily on respondents (see Figure 1). It is interesting to note that high interest rates were rated a considerably smaller constraint than access to finance, perhaps reflecting credit rationing under controlled interest rates. A number of the most interesting conclusions lie in the details of these aggregated results, broken down by firm category. For example, finance poses an obstacle for all groups of enterprises, although corporations are clearly less hindered by it than other firms (see Figure 2). Not surprisingly, the smallest firms, which have the greatest trouble obtaining finance, thus have the least complaint about the high cost of finance -- unregistered firms and sole proprietorships regard this as a lesser obstacle than ULLEs and corporations.

Taxes, as discussed below, were difficult both in their magnitude, as the government tried to maintain its revenue from a shrinking tax base, and in terms of their bureaucratic requirements. Not surprisingly, microenterprises rated taxes a much smaller constraints than other firms. Uncertainty about the country's economic and political future made investment decisions difficult, underscoring a pressing need for credible government commitments to political and economic reform. A number of the most interesting conclusions lie in the details of these aggregated results, broken down by firm category.

TABLE 6: Property Rights Problems of Larger Firms

Corporate Status	(Memo item: Average Employment)	Political/Economic Uncertainty	Failure of Justice	Fraudulent Competition	Bureaucratic Procedures
Unregistered (n=9)	(6)	L	L	n.a.	L
Sole Proprietorship (n=14)	(12)	H	M	L	L
ULLE (n=10)	(21)	H	M	M	M
Corporation (n=4)	(77)	H	M	M	M

Key: H = High obstacle; M = Moderate obstacle; L = Low obstacle

Source: CECPS survey

Figure 2

Cote d'Ivoire: Obstacles to Growth

(details by type of registration status)

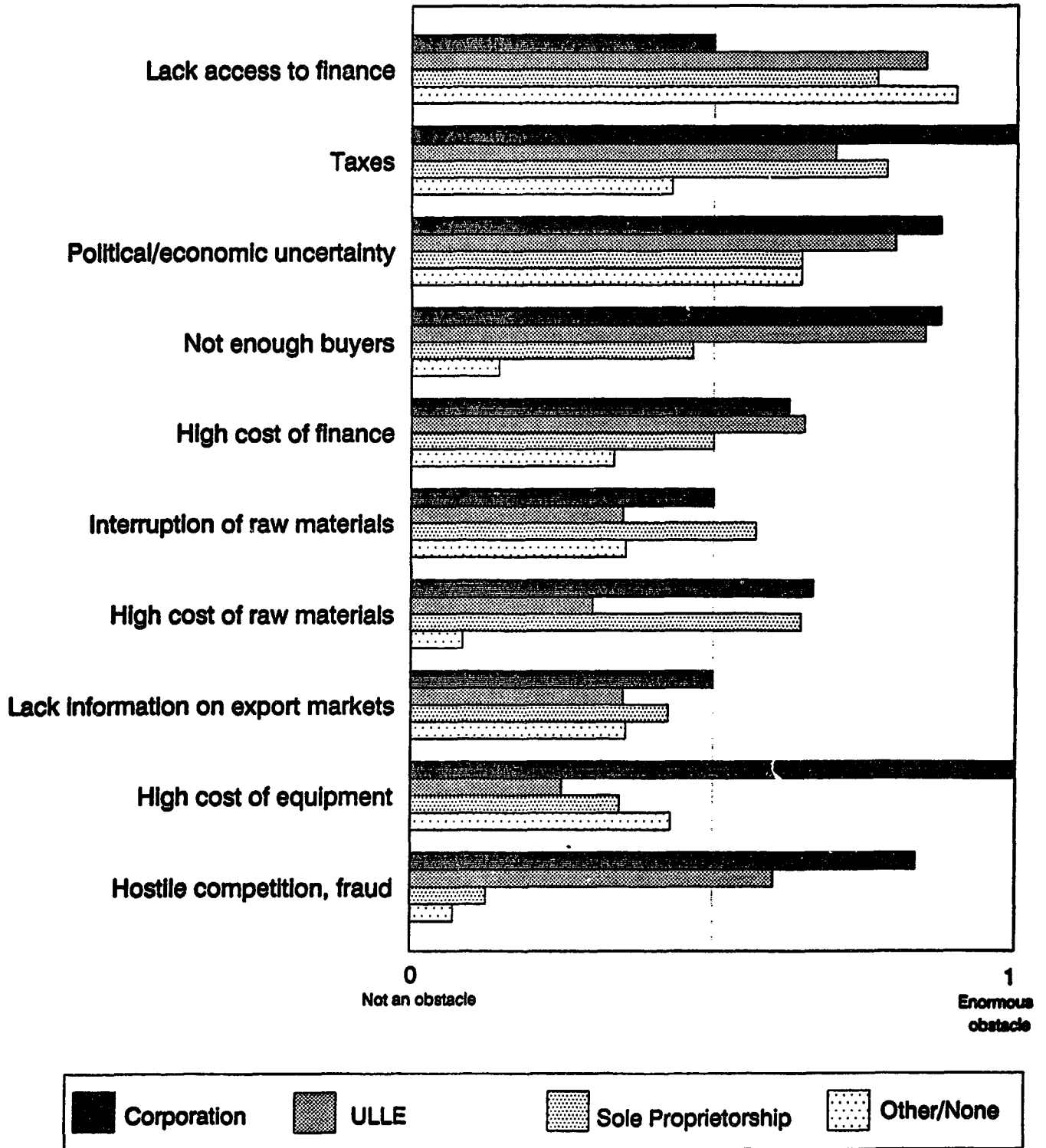
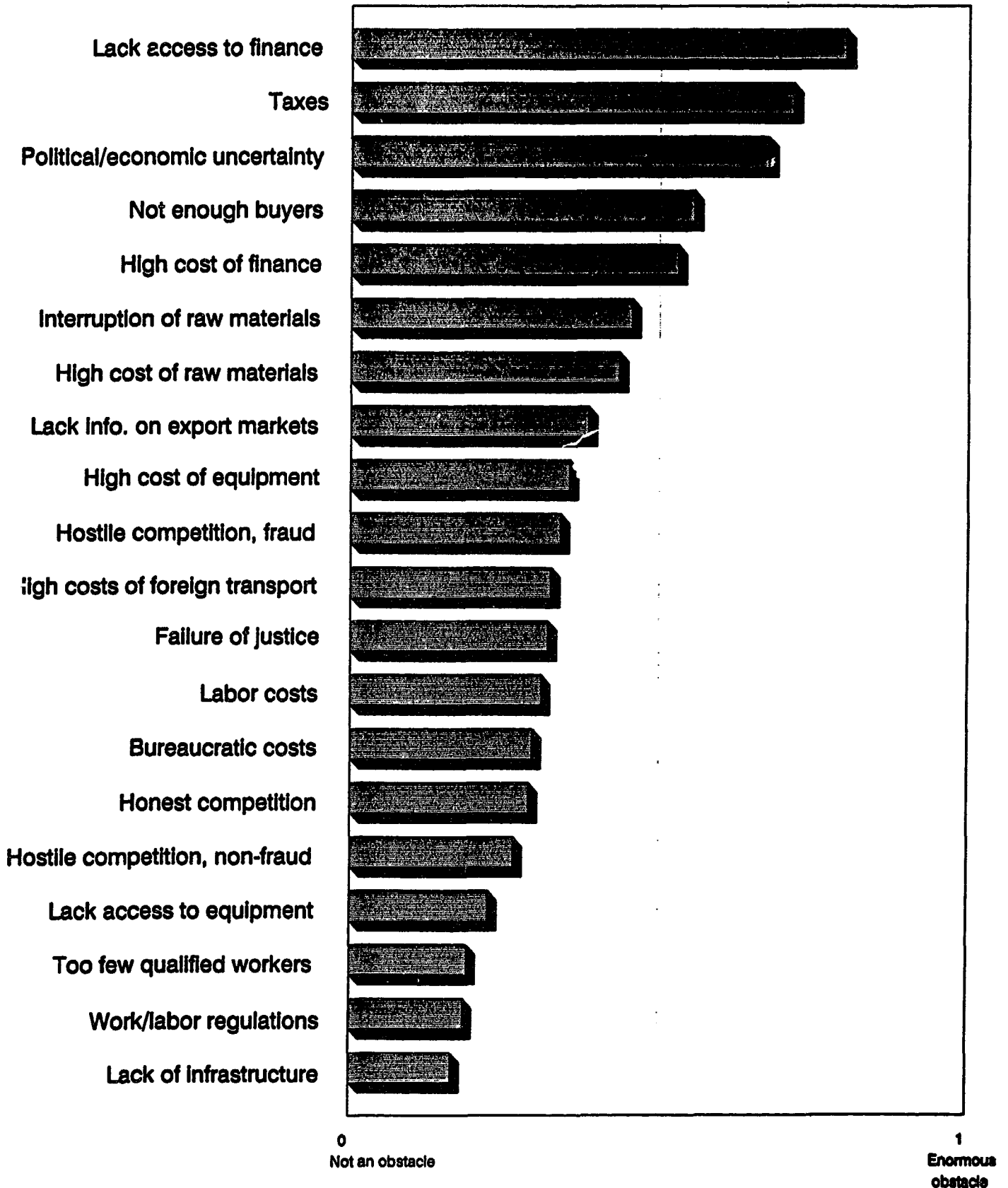


Figure 1

Cote d'Ivoire: Obstacles to Growth



Property rights and larger firms The problems particular to larger firms (ULLEs and corporations) are interesting both for their immediate effect and because of what they portend for the growth potential of smaller, less formal enterprises. A major concern appears to be related to the security of property rights, in the broadest sense. Policy uncertainty, failure of justice, fraudulent competition (i.e. competition by those not complying with laws and regulations), and bureaucratic procedures cover various different aspects of the same problem: the failure of public institutions to generate, enforce and adjudicate good law.¹⁵ Each of these emerged as a moderate to large obstacle for ULLEs and Corporations in our sample. For contracts to be reliable, and income from investment and productive activity dependable, businesses need a system of consistent, equitable, understandable laws and regulations, and the institutions to assure equal protection under law, and its impartial and speedy enforcement. Yet interview data suggests that access to the formal legal system is essentially unavailable to informal firms and that, within the formal sector, adjudication is neither speedy nor impartial.

While most larger, formal enterprises (corporations and ULLEs) report litigation experience, few sole proprietorships and unregistered firms have been so involved. Once engaged in litigation, the experience has been uniformly frustrating, with corporate litigation requiring many years to resolve (an average of four and a quarter in the CECPS survey). This is bound to result in high transaction costs and, thus, increase the profitability threshold for private investments to be sustainable. Furthermore, the system of justice is regarded as anything but just.¹⁶ The combination of unfairness and slowness has discouraged many entrepreneurs from the use of legal recourse. This weakens the contracting system, forcing businesses to rely less on credit and to deal more with known trading partners. For new entrants, these conditions can be extremely restrictive and the net effect is likely to be reduced competition -- and efficiency.

Finally, uncertainty over the nation's political future and stability of policy appears to most as a significant obstacle to growth. The high degree of concern with political uncertainty is common to all registered entrepreneurs; unregistered entrepreneurs have little to lose. Political uncertainty appears to reflect a perceived worsening and reduced predictability of the security of property rights. Its negative effect on the prospects for private sector development cannot be overemphasized.

¹⁵ One representative of a trade association described public regulation in this way: "Regulation is a machine that lives on its own without control of the state. The chance to live when the cost of living is highest lies in having power and monetizing it. The result is a system of corrupt, bad management. The State goes from being the motor of development to the brake of development."

¹⁶ The fairness of civil suits was reportedly largely undermined by payments to court officials or jurists. One respondent felt that the only honest judges were those who were independently wealthy. In many cases, one contracting party is able to avoid enforcement of contractual obligations by the other party (hence payment of debts) by corrupting the civil legal process.

IV. THE WIDE-RANGING IMPACT OF PUBLIC EXPENDITURE ON PSD: CROWDING IN AND OUT

Through multiple nexuses of public/private interaction, public spending inevitably influences the characteristics of the private sector, including the opportunities for entry, growth and competitiveness of private enterprises. Public expenditure is often discussed in terms of its specific purposes and its aggregate macroeconomic consequences. In addition, recently, it has become common to refer to the impact of any specific public activity on the private sector as "crowding out." This implies that resources utilized by the government are taken away from the private sector and the functions of public agencies and officials can be seen as activities denied to private entrepreneurs. Yet, public-private interactions are far more complex than the simple, zero-sum game implied by this terminology, and public expenditure to redress market failure is a positive sum game.¹⁷

In the case of Côte d'Ivoire, public expenditure (and related regulations and fiscal policies) have evolved over time and have tended, recently, to hinder private sector development. Policies designed to assure that Ivoirians fully participate in their country's management and wealth were weakened both by their design and by limitations in the administrative capacity of the state. Expenditure policy influences the emergence of the private sector in two broad ways: macroeconomically, it affects the economic stability in which firms operate and the supply of finance available to the private sector; microeconomically, policies associated with government expenditures have introduced a variety of distortions and obstacles.

The impact of public expenditure can be divided into economy-wide effects and those that are sector, input or industry specific. Macroeconomic considerations include the impact of financing government expenditures, and the impact of the level of expenditures themselves.¹⁸ Government borrowing to finance deficit spending is thought to exhaust or drive up the price of an inelastically supplied pool of credit, thus "crowding out" otherwise profitable private borrowing. Conversely, government surpluses create the potential for "crowding in" investment if the government's savings rate is higher than that of the private sector. Public expenditure in Côte d'Ivoire illustrates clearly both the positive and negative impacts.

The microeconomy of public expenditure focuses attention on its impact on individual sectors and factors of production. Expenditure policy and related regulation affect the path and pattern of private sector development: where the private sector is free to develop, where it is encouraged to

¹⁷ Thus complementarities between this kind of public spending and private investment can be described as "crowding in."

¹⁸ While many economists agree that public deficits can "crowd out" private investment, there is an ongoing debate in the literature over the mechanism through which this occurs: some believe that any deficit ultimately crowds out an equal amount of private borrowing, while others believe the means of financing the deficit is critical -- that taxation and public borrowing have different affects.

develop, and where it is impeded from development. Government spending decisions affect not only the opportunity for new PSD but also the cost of inputs and transactions to existing enterprises. Further, in Côte d'Ivoire, the government role in the economy has left it with revenue flows and economic interests (such as those of public enterprises, see below) that it actively protects, often at the expense of private enterprises.

For nearly two decades after independence, the Government of Côte d'Ivoire (GCI) provided one of the most welcoming policy environments for private enterprise in West Africa, attracting enormous foreign investment and bringing the benefits of rapid economic growth to its citizens. Government investment in infrastructure, education and health services have in many respects improved opportunities for private investment. It could even be argued that, up to a point, the government's commodity price stabilization policies schemes effectively mitigated the adverse effects on farmers of declines in coffee and cocoa prices and improved productive efficiency in the sector.

On the other hand, where government takes on activities which private enterprise is better able to perform (which may include the provision of publicly financed goods), it may reduce social welfare. Furthermore, where resources for private activity are scarce or where government financing of its activities is expensive, a dollar of government expenditure can cost more than a dollar in foregone private activity. In these cases, an argument may be made for the reduction in scope of government activities in favor of imperfect private markets.

In Côte d'Ivoire, the general burden of deficit spending and the specific burden of inefficient public investments and government monopolies have rightly brought into sharp question the contribution of government spending -- both its composition and overall level -- to development. The relatively low cost of foreign goods compared to domestic goods has compounded this imbalance. This, in turn, has resulted in a loss of competitiveness and has led to contractionary policies of a kind particularly damaging to the private sector -- and to long term development.

Government Expenditure -- Crowding In: In the Côte d'Ivoire's heyday, the first eighteen years of independence, it can be plausibly argued that public investment and its financing "crowded in" private investment in two ways. First, the government was able to finance its deficit by borrowing abroad instead of depleting domestic savings, expanding the total pool of money and hence the amount of money available for private investment.¹⁹ Second, by undertaking projects (e.g. infrastructure development) complementary to private sector activity, it encouraged private investment to grow alongside with public investment. Whether or not this argument is valid, however, the situation

¹⁹ "...foreign borrowing broadened the monetary base causing credit to expand and thus helped to "crowd-in" private investment. With a pegged interest rate and no limitations on credit, public investment induced steady increases in income and therefore savings. Indeed, with declining levels of indirect tax rates, increased savings could have financed alone [sic] the large fiscal deficits. With foreign borrowing, the surplus savings was available for domestic capital formation." [J. P. Hiey, "Ivory Coast - Stabilization and Adjustment Policies Study", WIDER, 1987]

changed as public investment strayed into areas (e.g. manufacturing) which could have been left to the private sector, and which failed to generate the income required to service its debt financing.

**Table 10: Public Investment in Cote d'Ivoire and Comparators
(as a Percentage of Total Investment)**

Sector / Year	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988
Côte d'Ivoire	41	41	39	45	48	48	39	52	52	63	72	85	78	69
SSAfrica	40	42	42	41	44	43	46	45	49	48	44	46	47	46
OECD	18	17	17	17	16	16	16	17	17	16	16	15	15	14

Source: DEC Analytical Database

Public Expenditure -- Crowding Out: The high level of government spending maintained after the end of its economic boom of the mid 1970s began to bid scarce resources away from the private sector. Public expenditure reached a record level in response to revenues associated with the 1976-8 boom and stayed high, resulting in a fiscal deficit that grew to 12% of GDP in 1981. Government investment began to drive up costs to the manufacturing sector, reducing its competitiveness. By initially failing to reduce its investment in response to the terms of trade shock following the 1976-78 boom, the government drove up the price of nontradables (e.g. construction services), raising costs to both import-substituting and export-oriented industries. The result was a less competitive manufacturing sector and an effective appreciation of the real exchange rate -- further aggravating the balance of trade deficit. Although the Government eventually managed to reduce investment expenditure, other expenditures continued to grow, in large part because of the large cadre of politically influential public employees. As the financial crisis deepened, public investment virtually cannibalized private investment. By 1989, the estimated fiscal deficit amounted to a record 16% of GDP. By the mid-1980s (see table 10), the public sector's share of total investment was at record levels for a non-socialist economy.

Financing Expenditure -- Borrowing: Government spending in Côte d'Ivoire is financed in three principal ways: through borrowing in financial markets, through taxation (discussed in section V), and through the accumulation of arrears.²⁰ Each appears to have behaved as a mechanism for crowding out private sector activity. One legacy of excessive expenditure has been a tremendous debt burden. The government's voracious need for credit was supplied in part by private international and domestic capital markets, crowding out private borrowing.

Service on the debt now requires revenues that unproductive investment did not yield. Debt service skyrocketed to an estimated 17% of GDP in 1989, consuming nearly half of the nation's

²⁰ Because of its membership in the CFA Franc Zone, the Côte d'Ivoire cannot unilaterally resort to printing money with which to finance its public expenditures.

export earnings. In 1990, these figures were projected to exceed 20% of GDP and fully 60% of earnings from the export of goods and services, before declining later in the decade.

Increasingly, the government has been unable to meet its external and internal debt service obligations. The indebtedness of the central government and public enterprises has, *inter alia*, contributed to an apparent exhaustion of the capital of many banks. Aggregate data show that private investment dropped dramatically in the mid 1980s, beginning to recover in nominal (but not real) terms only by the end of the decade.

Crowding out must be considered not just in static, but also in dynamic terms. Even a fairly brief excess in public expenditure may lead to many years of diminished resources to the private sector, for two reasons. First, government borrowing to finance a deficit involves a promise of a stream of payments that will last for many years, thus policies to compensate for a deficit will also endure. For example, a recent World Bank study found that countries respond to external debt by reducing investment, rather than by increasing savings.²¹ Second, recurrent expenditure commitments (for personnel, inputs, and operation and maintenance) are required in the wake of large public investments.

Taxation: As detailed in Section V, GCI derives its revenue from a complex network of taxes. One principal source of revenue from the rural economy, the Agricultural Financial Surplus (AFS), actually turned into a revenue hemorrhage during the later half of the 1980s. The complex web of urban taxes became increasingly onerous as the government attempted to draw greater revenue from a withering urban private sector. The number of large formal enterprises declined slightly between 1982 and 1988, but their taxes increased by more than twice the increase in value added (28% vs. 12%). For small and medium enterprises (PMEs), the story is worse: the number of formal sector PMEs (those reporting statistics to the government) declined by 10%, value added dropped by 27%, yet taxes paid actually increased by 19%. The percentage of GDP captured by taxes has actually declined slowly during the 1980s: it was 20.4% in 1980; 19.8% in 1985, and 18.1% in 1989. With the rapid decline of non-tax revenue (due, *inter alia*, to the growing deficit of CAISSTAB and of the public enterprise sector), an increasing share of the fiscal burden (i.e. public revenue generation) appears to be shifting to a narrowing base of urban enterprises.

Arrears to the Private Sector: Individual businesses and investors have unintentionally assumed a large burden of government debt through the government's use of domestic payment arrears to finance its deficit. By the end of 1989, the central government and other public entities had accumulated arrears totaling 556 billion CFAF (over \$2 billion, or about 18% of GDP).²²

²¹ Luis Serven and Andres Solimano, *Private Investment and Macroeconomic Adjustment in LDCs: Theory, Country Experience and Policy Implications* (Washington, DC: Country Economics Department, World Bank, 1991)

²² There are indications of cross arrears, so this figure may exaggerate the net indebtedness of the state to the private sector.

Interviews suggested that this practice extends far beyond nonpayment of interest and principal on loans from private banks. In addition, the government no longer pays many of its bills owed to its private suppliers and contractors, fails to refund excess taxes paid by private firms, and fails to pay premiums due to exporters (a centerpiece of Côte d'Ivoire's effort to compensate for the overvaluation of its currency). Adding insult to injury, in spite of the fact that the government is failing to pay the export premia, exporters are expected to treat (for tax purposes) putative premia receipts as income, and may end up paying taxes on income from the Government which has not materialized.

Almost every firm supplying the government, exporting or paying taxes with a refundable component (such as the FNI investment and FNR training taxes) is owed money by the government. For private firms, government payment arrears create pressure on their cashflow, diminish potential investment funds, and reduce the profitability of staying in business. Given the near exhaustion of financing from banks, few businesses manage to find external resources for investment or even working capital. Before the worsening of the financial crisis in 1988, the government was said to commonly take a year to pay its bills. Now, it has become common for the government agencies and public enterprises to simply ignore their debts and arrears.

A small, informal survey²³ of SMEs supplying the government found all of them suffering from the government's financial practices, some waiting three or more years for payment of substantial contracts. For those firms with private sector options, this has meant a substantial reduction in the percentage of business transacted with the government. For those without this alternative, it has meant missed payments or default on loans, missed payrolls, layoffs and financial losses.

Why have private companies allowed the government to build up such huge arrears? First, the government in the past has been a dominant force in the economy. It is by far the largest consumer in numerous markets, hence an unavoidable customer. Second, the government may previously have been a very good customer -- for while it was slow to pay, it paid full price where other customers often insisted on discounts. Particularly in a recessionary period, a government contract with the possibility of payment may appear better than nothing. Third, some suppliers have no choice: in some cases, services are (more or less subtly) commanded, not demanded.

Finally, a recent record of poor economic stewardship and uncertainty about Côte d'Ivoire's political future clearly is deterring private investment. In particular, the continued growth of public expenditure (and its increasing consumption content) in the face of declining economic performance and government revenues has shaken the confidence of investors and lenders, both domestic and international. The failure of the government to pay its debts (combined with unpredictable attempts at incremental taxation) has reduced the security of property rights, hence the incentive for private

²³ Six suppliers of items ranging from construction services to uniforms were surveyed by SOCOGEC, as a follow-up to the CECPS mission, during the second half of 1990.

sector development.²⁴ Economic uncertainty and the loss of competitiveness contributed to the precipitous decline in private investment during the 1980s.

Public Enterprise: Public enterprises offer the richest area for exploring the impact of public expenditure on private sector development because they typically engage in activities which could be performed by either public or private sectors, and buy from or sell to the private sector. Public enterprises may crowd in by supplying or creating demand for private production of goods and services. They may crowd out by using their easy access to public investment funds to best private competitors. (Of course, their aggregate potential to drain public resources may contribute to macro-crowding out as well.)

Cote d'Ivoire's public enterprises have never been numerous -- a few dozen at their peak -- but they played an important role in both the country's modernization strategy and its economic problems today. Historically, public enterprises have drawn tremendously on social resources, contributing to macroeconomic crowding out. At the time of the coffee and cocoa boom of 1976-8, GCI embarked on a program of enormous investment in a few agricultural processing industries deemed strategically central to Côte d'Ivoire's industrialization. The government wanted these industries in the hands of Ivoirians and saw public ownership as the best or only means to this end. With large industry traditionally dominated by French and other non-Ivoirian owners, public investment offered a way to expand indigenous control of modern industry. Furthermore, the leadership is said to have viewed public enterprise as a means of developing indigenous entrepreneurial capacity to play a larger part in future private sector development.

Hence, in the late 1970s, the majority of investment in manufacturing was made by the state, predominantly in industries processing the nation's primary agricultural products such as sugar, palm oil, cotton and rubber. Following 1980, public investment in this sector quickly fell, but the industries created have continued to place powerful demands on the public purse for investment and recurrent costs. Since peaking at 138.5 billion CFAF in 1978, investment in state owned enterprises fell in the eighties to a range between 40 and 70 billion CFAF per year. While some public manufacturing enterprises yielded positive returns to the government due to their monopoly status, their net social benefit is far less clear. By reasonable measures of productivity -- per unit of fixed assets, per employee, per dollar of gross investment -- public manufacturing enterprises compared poorly to private ones.²⁵

Public enterprises were preferentially allocated resources that allowed them to bid both capital and labor away from private enterprises. For example, in 1989, they employed some 208,000 workers.

²⁴ Much of the crowding out in Côte d'Ivoire has come from the seeming insecurity of property rights arising from taxation and regulatory policy and the unpredictable, often rent-seeking enforcement of them.

²⁵ Helpful comments and information on this point were received from Klaus Lorch, then of AFICO.

Clearly, they contribute to market segmentation, where skilled workers are scarce, and all but a fortunate few of the unskilled face high rates of unemployment. However, it is the seemingly excessive and inefficient use of capital by public enterprises that represents their greatest economic impact.²⁶

Table 13: Net Financing to Parastatal Sector (CFAF billion)
(negative numbers imply public subsidy of parastatals)

Enterprise Type	Year	1982	1983	1984	1985	1986	1987	1988
100% State-Owned (number)		-49.5 (8)	-66.3 (9)	-40.4 (8)	-114.3 (8)	-97.2 (9)	-83.8 (9)	-85.2 (9)
Majority State-Owned (number)		-17.6 (20)	-13.0 (20)	-14.8 (20)	-28.8 (20)	-3.7 (20)	9.3 (21)	14.8 (22)
Minority State-Owned (number)		24.4 (35)	-8.6 (37)	-30.8 (37)	48.2 (38)	14.4 (38)	29.8 (40)	41.4 (43)
Total		-42.7	-87.9	-86.0	-134.9	-86.5	-43.7	-29.0

Source: BDF

While no comprehensive data are available on linkages to the private sector, it is clear that public enterprises have altered the course of private investment through linkages offered and those denied. Public enterprises encourage private investment through direct purchases and contracting out for services. The decision of what intermediate inputs and services to integrate in public enterprises is a significant one for private sector development -- particularly if the purchasing or contracting fosters competition instead of allocating rents.

In Côte d'Ivoire, some public enterprises did indeed "crowd in" private enterprise.²⁷ For instance, private suppliers to the large agricultural parastatals were encouraged to invest; unfortunately the crowding in often did not foster competitiveness. For example, the government encouraged entrepreneurs to launch (or jointly venture) into production of packaging for agricultural products -- granting them enduring monopolies over such supplies. The result has been that private enterprises were created and expanded with considerable dependence on their protective linkages to the public sector and are now a burden rather than an asset. More recently, even competitive suppliers have been seriously hindered by the poor payment²⁸ and management record of most public enterprises.

²⁶ As a rough indication of the low capital productivity of public enterprises, in 1988 they had (according to BDF data) a value added to investment ratio of only .37, compared to .72 for large private corporations.

²⁷ This micro-crowding phenomenon in no way suggests that the overall level of private investment is larger than if a private alternative to public enterprise has been pursued.

²⁸ The catalog of problems private enterprises have with parastatal receivables ranges from payment in kind (which SODESUCRE has employed) to non-payment (which abounds).

Once the public sector has decided to invest in a sector, private competition (and often linkage) is commonly ruled out, even when no natural monopoly (hence efficiency justification) exists. For example, rigid regulations on shipping reduce competition with the state-owned SITRAM corporation. Air Ivoire enjoys exclusive privileges for commercial domestic air travel, while access to military personnel subsidizes its operation. Although evidence from developed countries demonstrates that the efficiency losses of public enterprises are not necessarily inherent to public ownership, public ownership often leads to restrictions on competition to protect public investments.

Even when linkages with public enterprises and entities are allowed, government can make them profitable, discouraging long-term investment. In some cases, public enterprises influence the regulation of prices of privately produced products that they use. For example, a large packaging manufacturer recently had the regulated price of its cocoa and coffee sacks reduced below cost by the public agency which also happens to be its major customer.

Privatization: If public enterprises often crowd out private investment, then, conversely, privatization and accompanying reforms may be regarded as crowding in: creating new opportunities for profitable private investment where they were previously blocked. In one sense, Côte d'Ivoire may have actually led other West-African nation towards privatization.²⁹ One study reports that, at the end of 1987, twenty-eight firms, in industry, agricultural processing, tourism, commerce and distribution, and other fields had been transferred to majority or full private ownership. The means by which this was done, however, was a far cry from encouraging competitive private sector development, or obtaining a market price for the value of the firms. Instead, reports suggest that owners were often handpicked by the government and no regulatory steps were taken to mitigate existing market concentration. One of the main reasons behind this lack of transparency in the divestiture process is the government's reluctance to allow any sizeable elimination of jobs or substantial transfers of managerial authority to non-Ivoirian entrepreneurs.

In a different, parallel approach to privatization, the government has transferred management responsibility for its water and sanitation services to a private enterprise -- through concession and service contracts, and is now moving to place investment decisions in the hands of the private contractor. Further, it has recently concluded a contract with a private concessionaire to manage the deficit-plagued public electric parastatals, with the promise of substantial savings to both customers and the government. Hence, by extending private ownership and investment to previously public activities, Côte d'Ivoire is likely to bring about a substantial expansion of the private sector.

Infrastructure: Productive investment in infrastructure is generally believed to "crowd in" (accelerate the rate of growth of) private sector activity, by encouraging both domestic and foreign investment. In Côte d'Ivoire, it is credited with facilitating trade and opening up large areas of the country to commercial agricultural exploitation and extraction of natural resources. The productivity of Côte d'Ivoire's investment in infrastructure, however, has been hobbled both by some poor

²⁹ See, for example Callaghy and Wilson, *Africa: Policy, Reality, or Ritual* in Raymond Vernon (ed.), *The Promise of Privatization*, (New York: Council on Foreign Relations, 1988), pp. 179-230

investment decisions and by a highly taxed and regulated and partially monopolized transportation industry that inhibits the efficient use of infrastructural investment. In this sense, transport policy largely determines the extent to which transportation infrastructure can crowd in by controlling the profitability and legality of its private use.

Highway investments illustrate the expensive consequences of a preference for prestige over productivity, and construction over maintenance. During the recessionary first half of the 1980s, the government continued to emphasize the creation of new, over-designed capacity over the upkeep of old capacity. Resources flowed to the construction of European-style highways where more rudimentary designs and surfaces would have sufficed. (Donors often prefer design criteria familiar to their own engineers, hence can heavily bias public investment decisions in this regard.) In the meantime, the value of existing highway investment was not fully realized due to underinvestment in its maintenance. For example, in 1985, the budget for road maintenance was some 35% below the level deemed desirable from an efficiency perspective.³⁰

With regard to the utilization of public investment, the railway, airports and ports each provide examples of how inefficient transport policy reduces infrastructural efficiency (or the "crowding in" effect). The social utility of public investment in the railway was minimized by the actions of a joint Burkinabé-Ivoirian railroad monopoly, which operated inefficiently, accumulated a hundred billion CFAF debt and was owed some 68.7 billion CFAF by the two governments. In air travel, the value of huge investments in international airports is minimized by the market power granted to Air Afrique (and its French counterpart) -- while would-be exporters are deterred by prohibitive air-freight rates. Similarly, sea shipping is (with regulatory complicity) controlled by SITRAM and three foreign companies, and protected by a "code of conduct" that all but bars competitive entry. Even the use of highways is diminished by freight licensing procedures that strengthen local monopolies and contribute to truck overloading and fleet underutilization.³¹

The strongest complaints we received, however, concerned electricity. Until quite recently, electric power generation and distribution was handled by a public enterprise, EECI [Energie Electrique de la Côte d'Ivoire]. Plagued by chronic mismanagement, the company ran substantial operating deficits, losing some \$US 350 million in a few years and falling deeply into arrears to the public sector. In spite of provisions of a Bank financed Energy Sector Adjustment Loan [ESAL] to stimulate improved management, EECI has failed to improve its performance, suffering cost overruns

³⁰ Two other psd issues surrounding highways are worth noting. Highways were inefficiently used because pricing did not reflect costs attributable to different users, with heavy vehicles implicitly subsidized. Force account, rather than contracting, was used for several types of maintenance and rehabilitation work, because private capacity was not perceived to exist. Yet from a private sector development perspective, consideration should be given to encouraging the creation of new private capacity, not simply utilizing that which already exists.

³¹ As a result of regulatory action and/or permissiveness of cartel-type arrangements, trucks are often prevented from carrying freight in both directions. This, of course, considerably and unnecessarily increases the cost of transport to the whole economy.

and an increase in receivables, due to failures in billing and collection of charges for electricity. Manufacturers we spoke to uniformly complained about the cost of electricity and corruption of the billing system. One manufacturer, who said electricity comprised 15% of his total costs, suggested that his competitors were able to reduce their bill 99% by paying bribes -- leaving those who would not or could not bribe to foot the full cost of the system. Another believed that his competition in Nigeria paid one eighth as much as he did for electricity. (The state has recently turned management of the electric utility over to a private company under a 15 year lease.

The lesson, then, is that infrastructure cannot be assumed to crowd in private enterprise unless the policies governing its use allow (better yet, foster) competition and the infrastructure itself is well managed. When the government does not attend to ensuring competitive pricing and open access to the use of these investments, full value cannot be realized. When government is concerned with carefully controlling the use of infrastructure to privilege some and exclude others, as well as to protect its own enterprises, efficient private sector development will be hindered.

Procurement: Given the substantial presence of the government in the economy, it has a large potential role as a customer for private sector goods and services.³² Formally, the procurement procedure appears designed to encourage the competitive supply of goods and services. Furthermore, officially, small and medium enterprises are actively solicited as suppliers for government contracts. In practice, both the system of payment and the bidding process mitigate against all but favored SMEs. (The horrendous problems with payment are described in earlier in this section.)

There is a formal bidding process that is intended as a transparent means of finding low cost suppliers. Anecdotal evidence suggests that this process is commonly circumvented for all but large public works contracts. For the recurrent procurement of goods (such as office furniture), contracts valued at below 8 million CFAF (about \$30,000) are directly negotiated without bidding. These contracts are at the discretion of department directors and other middle managers. Thus, there is every incentive for breaking down larger contracts into smaller pieces whenever possible to maintain discretion over the awarding of contracts, hence access to the informal benefits they can generate. While this process may, in principle, improve the chances of SMEs winning supply contracts, it awards complicity, not competitiveness. As efficient production is not the key to profit, enterprises will focus instead on seeking rents.

The lack of timeliness in the government's payment system makes it difficult for small firms without substantial financial reserves or easy access to credit to act as suppliers. First, in private-private transactions, smaller firms engaged in light manufacturing typically demand an advance from private consumers for the purchase of raw materials. This was observed in both the furniture manufacturing and clothing industries, and is reportedly true for automobile repairs as well (where

³² For example, in the United States, of \$965 million in public spending at all levels of government in 1988, \$462 million purchased goods and services from outside organizations. Donahue, 1989 (ibid).

spare parts must be paid for in advance). The government not only will no longer provide such advances, but typically demands a guarantee (or performance bond) from the company -- which favors larger, financially stronger enterprises.

More important, once the good or service is delivered, the government is notoriously bad about paying its debts. Before the worsening of the financial crisis in 1988, the government was said to commonly take a year to pay its bills. Now, it has become common for the government agencies and public enterprises to simply ignore their debts and arrears (or simply lack the means to pay). An small, informal survey³³ of SMEs supplying the government found all of them suffering from the government's financial practices, some waiting three or more years for payment of substantial contracts. For those firms with private sector customers, this has meant a substantial reduction in the percentage of business transacted with the government. For those without, this has meant missed payments or default on loans, missed payrolls, layoffs and financial losses.

The experience of a small training firm exemplifies both the potential and current problems for private businesses contracting with the government. The firm was created to meet the demand for training programs created by the government, through the training fund financed by the FNR tax. Recently, however, the government has not been paying FNR commitments, and this firm was left with an unbearable receivables balance, and forced to reduce staff by two thirds.

A shoe manufacturer reported another type of problem: after winning, and fulfilling a competitive bid and subsequent contract for the supply of shoes to the police, it took more than two years for him to be paid. His mistake was to underbid other manufacturers (who the entrepreneur indicated were setting a price three times the cost of production) and refuse to "lubricate" the convoluted process of delivery certification and of payment authorization. The result was a two and a half year wait for payment, and the end of his interest in supplying government contracts.

One consequence of the government's behavior has been a reduction in competition for those contracts submitted for competitive bidding. This, in turn, has reinforced the trend towards negotiated (*gré à gré*) procurement. Thus the procurement process is playing a progressively smaller role in the encouragement of a competitive market economy.³⁴

While the formal procedures for contracting and procurement appear to sharply limit the

³³ Six suppliers of items ranging from construction services to uniforms were surveyed by SOCOGEC, as a follow-up to the CECPS mission, during the second half of 1990.

³⁴ Why do some businesses continue to deal with the state? An official of the Ministry of Economy and Finance offered three reasons: 1) Price inflation -- some enterprises are always interested in dealing with the state because (it pays) high prices. 2) There are those who are paid quickly. 3) In some cases, when someone sells the state goods, [s]he'll deliver half to the state. The deliverer gets half for goods or services and splits the rest with government functionary. Or [s]he delivers the full order, keeps half the money, and the functionary returns half the goods to the supplier to resell, again dividing the gains.

dealings of small enterprise with the government, subcontracting opens some opportunities (see the labor issues section below). In much road and building construction, for example, initial contracts are awarded to large companies that are able to provide the guarantees required by the government. Yet these companies are able to lower their bids and minimize fixed costs by subcontracting major parts of their work to SMEs, even informal ones. Thus the absence of enforced regulation against subcontracting appear to enhance efficiency and opportunity for small firms, as well as lowering costs to the government. Until economies of scale in dealing with the government can be eliminated, not enforcing laws against this practice remains an important encouragement of small-scale private enterprise.

Salaries and Benefits -- Crowding Out Skilled Labor: GCI routinely bids away from the private sector the most educated members of the labor force. After investing well over one hundred thousand dollars in the education of its top students, the Côte d'Ivoire guarantees the graduates of its institutions of higher education employment as civil servants. Public employment thus becomes, at the professional levels, an entitlement program for graduates. In spite of two pay freezes in the 1980's, public sector salaries average 10.3 times the per capita GDP, even before adding in generous benefits (that double their cost to the government) and access to informal sources of income.³⁵ If the United States paid comparably, the average civil servant would earn about \$200,000 per year (coincidentally the salary of its President).

No competitive industry is likely to be able to afford to match this level of compensation for a substantial portion of its labor force. Few graduates are likely to be attracted to a life of entrepreneurship when offered the certain alternative of guaranteed high income of a government job. Hence, government policies serve to deny the private sector the use of the best educated Ivoirians, and drive up the wages for many other Ivoirians. Developing businesses meeting these levels of compensation would have grave difficulties staying competitive.

Equally important, the Ivoirians most capable of becoming successful entrepreneurs and employers tend not to value private business as a vocation. As modern business began to emerge, it was generally perceived to be the realm of foreigners (traditionally the French) and the most respectable roles for Ivoirians (outside of agriculture) were either as educators (a public sector job) or in government. In addition to any cultural roots this phenomenon may have, public employment policies contributed powerfully to create role models that tended to steer Ivoirians away from business pursuits.

With the most educated and articulate Ivoirians, those with the greatest leadership capacity, almost universally finding employment with the government, there is an almost irresistible constituency for continued expenditure on public employees. At the same time that "modern" [non-agricultural formal] sector employment declined 1.5% between 1985 and 1989 public sector

³⁵ This high average apparently masks substantial differences between positions. Teachers (a third of permanent state employees) earn substantially more than the average, with their wage bill accounting for 60% of the total.

employment increased by 7.2%. Thus while public investment has played a diminishing role in the budgetary crisis, the salary bill had grown by 1989 to consume some 43% of public receipts and 27% of total government expenditure. Personnel cost some 369 billion CFAF in 1989, or 11.7% of GNP.

Human Services -- Crowding In and Out. Expenditures on human services have two central impacts on the private sector: enhancing its capacity and directly employing or excluding it in service delivery. First, in the same way that highways can make natural resources available for economic exploitation, education and health services augment the economic value of human resources. Investments in human capital can thus complement investments in physical capital, "crowding" them in. An educated and healthy labor and entrepreneurial force would appear a minimal precondition to rapid private sector development.

Given the narrowing constraints faced by Cote d'Ivoire on public expenditure, efficient investment in human resources seems vital to PSD. Yet its record is poor. The standard indicators suggest the government gets little for its large investment in health and education. Specifically, over half of the substantial public budget goes to health and education, Cote d'Ivoire suffers a low life expectancy (53 years) and high rate of infant mortality (106 per thousand) for a country of its per capita GNP.³⁶ Medical resources are concentrated in Abidjan, where the doctor/patient ratio is 16 times higher than in some rural areas.³⁷ Facilities elsewhere are overtaxed and often deliver poor services. Resort to private practitioners is common. Yet government policy rules out real competition in the health sector -- there are no private hospitals. Furthermore, the regulations and paperwork tied up in working at a hospital lead some physicians with a private practice to avoid them altogether. Again, a flawed regulatory environment may prevent the full realization of the value of investments in health facilities.

The story is very similar in education, where the enormous drain of teacher salaries leaves little for investment in facilities. The shortage of facilities and abundance of personnel has led to an interesting form of crowding in. A number of private schools have arisen teaching the mandated government curriculum and using publicly paid teachers. Some of these schools offer superior facilities to public schools, yet all offer the same curriculum and draw from the same pool of classroom personnel.

Health and education appear promising areas for allowing regulated private entry. Private hospitals and privately staffed private schools hold the potential for relieving unmet demand for the

³⁶ According to one Bank source, "These figures are comparable to those of Kenya, where GNP per capita is roughly half that of Cote d'Ivoire, and health and education expenditures are only 30% of recurrent budget, life expectancy is 6 years longer and the infant mortality rate is 24 points lower."

³⁷ A rough idea of priorities is revealed in the 1990 "Special Budget of Investment and Equipment". 130 million CFAF are allocated for repair and equipment for all rural dispensaries, as compared to 200 million CFAF being spent to air condition one section in each of 2 hospitals in Abidjan.

V. TAXATION AND PRIVATE SECTOR DEVELOPMENT

Urban Taxes

Overview Taxes are seen by all entrepreneurs as the greatest obstacle to expansion of their businesses. This undoubtedly reflects the high prevailing levels of taxation,⁴⁰ which have increased with recent attempts by the Government to intensify revenue raising from a shrinking tax base. As enterprise profits decline, taxes become increasingly focused on parameters other than profits (e.g. turnover or value added) -- thus magnifying the effect of the crisis on the financial performance of enterprises in the formal sector. In addition, many components of the tax system involve pre-financing and are supposed to lead to rebates -- which tend to introduce biases favoring large enterprises over SMEs and well-connected over poorly connected entrepreneurs.

Conventional wisdom assumes the existence of a clear boundary between a heavily taxed formal sector, and an untaxed informal sector. The latter is comprised of microenterprises and larger, so called "lax" firms that have slipped out of the formal sector to avoid taxes and regulations. According to this view, if only the informal sector (including the *so-called fraudeurs*) taxed, fiscal constraints would be alleviated, the burden on formal enterprise reduced, and competitiveness would be restored.

In fact, almost every enterprise in Côte d'Ivoire (except those engaged solely in smuggling) pays some taxes. Instead of a sharp distinction between formal and informal on the basis of their fulfillment of tax obligations, there is a continuum of compliance⁴¹. On one extreme are large corporations whose high visibility (particularly if foreign-owned) makes the whole arsenal of taxes inescapable: licensing taxes, import duties, VAT, profit taxes, payroll taxes, and contributions to the investment, training, and social security funds. On the other extreme are microenterprises that pay arbitrarily assessed licensing taxes and escape most of the other burdens. The majority of enterprises fall somewhere in between, and it is unclear which type of enterprise actually bears the greater relative burden. Furthermore, linkages (such as subcontracting) between different types of firms somewhat reduce the burden of taxes on the larger, more formal ones.

Nonetheless, there appears to be a significant penalty for formalization by SMEs. This results from a combination of the financial cost of taxation, the inordinate time cost for managers of small businesses to achieve regulatory compliance, and the biases in formal benefits favoring large enterprises, such as those in the allocation of loans and investment incentives.

⁴⁰ Tax revenues in the 1980-87 period averaged 20% of GDP.

⁴¹ There also indications that "leakage" is higher for smaller, less formal firms: compliance as measured by Government revenues and as measured by enterprise payments to tax authorities are further apart for these enterprises than for larger, formal ones.

highest quality services, and may release public resources for more efficient investment in primary services for the less privileged. Indeed, many people already resort to private facilities to avoid problems of crowding, waiting and rationing in existing public social services.

Education also raises a host of issues about the specific characteristics of public expenditures in that sector. Education policy is a subject beyond the scope of this paper, but there are two aspects worth noting because of the particularly negative impact they appear to have on private sector development. The first is that, while the system produces relatively few university-level graduates each year and a large number of school leavers at early grade levels, the entire curriculum is oriented towards preparing students for advanced studies, particularly in the humanities. In absence of adequate vocational or other training for school leavers, the end result is that the major product of the schools is students with no marketable skills.

The second, subtler impact of public expenditure on education is its likely effect on attitudes towards business. Schools apparently foster attitudes that elevate the status of government service (including teaching) relative to the value of private entrepreneurship. Combined with powerful incentives created by government employment and compensation policies, this means that the best and brightest Ivoirian graduates have generally not been inclined to participate in private sector enterprises.

Support Services for Private Enterprise -- Crowding In. The Government has tried to encourage SMEs through a variety of specific programs, often aiming to broaden the role of Ivoirian entrepreneurs in the private sector. Thus, there is an Office of Ivoirian Enterprise, a Committee to Assist and Promote National Enterprise (CAPEN), and an Ivoirian Industrial Development Bank.³⁸ These efforts seem to have suffered from the budget constraints, weak administrative capacity, and conflicting incentives that pervade public administration in Côte d'Ivoire. An expensive program to "Ivorize" the retail trade failed abysmally³⁹ because it ignored business fundamentals.

Unlike tax and regulatory authorities, agents of government assistance are largely unknown to small entrepreneurs -- as they have little incentive to undertake outreach efforts. In addition, the goals of efforts and strategies of programs to reach SMEs and microenterprises have been poorly defined, caught in the dilemma of the government desire to assist small enterprises and to control them through regulation and taxation.

³⁸ There is even a quasi-governmental committee (CONOSI) to "organize" (meaning formalize) informal sector operators.

³⁹ The "DISTRIPAC" project, in the 1970s, to create a network of Ivorian shop-keepers apparently resulted in public outlays of CFAF 18 billion -- with negligible results.

Overall, the implication of this finding is that Côte d'Ivoire's resource mobilization problem is not merely one of extending taxes to an untaxed sector -- for all businesses are taxed. Instead, the problem is one of reforming taxes to encourage private sector growth, and improving enforcement on firms already paying taxes to increase and reduce leakage. For all the attention that has been given to regulation and red tape, it is clear that the complexity and inconsistency of tax regulation and enforcement constrains business more than any other regulations (recall table 6).

Taxation of Formal Enterprises As indicated above, the government of Côte d'Ivoire derives its revenue from a complex network of taxes. During the 1980s, the burden of taxes has come to fall more heavily on a diminishing number of private enterprises, with the heaviest rate among formal enterprises falling on SMEs -- for whom taxation appears to have crossed the Lafferian turning point, past which progressively higher effective tax rates tend to yield lower revenues. Table 7 also suggests that, as profits of many firms shrank, the government has increased indirect (i.e. not based on profit) taxation. This could result in an untenable burden for struggling, marginal firms.

Table 7: Firm Size and Tax Burden (in CFAF)

	Category//Year	1982	1983	1984	1985	1986	1987	1988
Large Enterprises (priv. & public)	Taxes Paid (mn)	128.11	133.21	142.75	145.37	159.84	153.37	175.75
	Number of Firms	799	806	802	793	790	779	782
	Tax/Firm (000's)	160.34	165.27	177.99	183.31	202.33	196.88	224.74
	Value Added(mn)	691.43	724.23	747.19	806.72	825.94	772.49	815.33
	Tax/VA (%)	18.67	18.39	19.10	18.02	19.35	19.85	21.56
	(Tax-Prof. Tax)/VA	16.05	16.24	16.92	15.20	16.05	16.51	18.89
Small & Medium Enterprises	Taxes Paid (mn)	17.33	17.98	21.18	24.70	23.54	20.77	20.63
	Number of Firms	1,684	1,680	1,624	1,631	1,571	1,484	1,510
	Tax/Firm	10.29	10.70	13.04	15.14	14.98	14.00	13.66
	Value added (mn)	105.37	118.39	118.33	121.16	101.50	84.55	76.63
	Tax/VA (%)	16.45	15.20	17.48	24.34	27.85	27.10	26.92
	(Tax-Prof. Tax)/VA	12.50	10.76	13.28	19.84	21.60	22.61	18.35

Source: BDF/CECPS

Licensing: The licensing tax (*patente*), is collected from virtually all enterprises with any kind of a fixed location, and is roughly assessed on the basis of the business premises' rental value. It

appears to have a roughly equal impact on large and medium companies,⁴² falling less heavily on small registered firms. As the patente is invariant with profit or sales (and tax agents have been reluctant to reduce assessments during the crisis), it represents a significant fixed cost of staying in business for many firms.

VAT: Côte d'Ivoire's value-added tax (VAT) is assessed at different rates for different items. The simultaneous existence of several rates and insufficiently precise definitions of the different categories creates strong incentives for entrepreneurs to pressure the government to classify their products in less taxed categories -- and the likelihood that large, better connected enterprises will fare better than smaller ones. Interviews suggested that the classification of a commodity could make or break its profitability, and even large international companies sometimes had products crushed by inappropriate classification, hence a high VAT rate.

Given the limitations in private accounting practices and public monitoring capacity, precise administration of the VAT or a profits tax would be nearly impossible. Since most SMEs keep at best a partial set of books, it is not rare for them to be subject to the VAT even when their book keeping is inadequate to the task. The common solution belies the whole concept of the VAT: the tax inspector assesses an estimated VAT which then becomes a negotiable but "sticky" tax liability.

Import Taxes: As a result of efforts to effectively devalue the real exchange rate, the import tariff averages 70%.⁴³ However, the rate varies widely and there are a variety of fees (e.g. for storage) and penalties that can be assessed by the customs service. As a result, customs officials are possessed of extraordinary discretion which, according to a variety of entrepreneurs and officials, is broadly abused.⁴⁴ The resulting process is not only inordinately expensive, but quite time-consuming and unpredictable. Large, specialized importing companies have professionals who deal only with customs. The difficulty of the process is particularly important for mid-sized firms that attempt to export: their managers simply do not have the time and energy to obtain exemptions for inputs used in export products.

High import tariffs (needed, in part, to compensate for the overvalued currency) are having the ultimate Lafferian effect: they so increase the incentives for smuggling that they not only reduce

⁴² The CECPS survey shows it averages about 1% of turnover.

⁴³ This figure may be tariff VAT inclusive. A study of scheduled tariff in 1989 suggests an average rate on manufactured goods of 34%, with a range from 0 to 151%. Such a range creates a substantial rent potential for those with discretion over the classification of goods.

⁴⁴ When a dozen microentrepreneurs in Bouaké were asked their first priority for removing one source of government interference in business, they unanimously pointed to custom duties and hassles.

The FNR was yet another rebatable tax: a training fund was established through mandatory contributions and then allocated to enterprises that presented credible employee training programs. While, again, this tax probably ended up discriminating against SMEs it had an unexpected (though ephemeral) PSD effect: the availability of FNR funding for training spurred the creation of numerous private enterprises to provide training services. However, more recently FNR contributions have degenerated into another source of general revenue. Payments from the training fund have stopped (and the newly created training firms are left to fend for themselves).

Other Taxes: A number of other taxes limit the resources available to the private sector (and incentives for investment at the margin), each in a distinct way. Taxes account for 65% of the pump price of gasoline. During the 1980s, water prices to a few hundred industrial customers contained an enormous tax component that apparently financed new investment in the water and sanitation sector, connections for low income neighborhoods, an ambitious rural water supply program, and even the arrears of government agencies and enterprises. Similarly, electricity prices have contained a tax component.

As deficits mounted in the 1980s and traditional revenue sources diminished, the Government increased tax rates and added new taxes. Yet higher rates fell on an ever shrinking private formal economy, yielding an approximately constant level of revenues.⁴⁷ Overall, foreign owned companies paid higher taxes than domestic-owned companies. Large private companies paid far higher effective taxes than did public enterprises (those with a majority of shares held by the Ivoirian state), which tend to benefit from special tax advantages and appear to have little taxed profit. Taxes besides the profit tax paid by public enterprises rose substantially as a percent of value added during the 1980s (see table 8). Because a large component is not based on income or profit, in recessionary years, tax assessments do not fully accommodate the reduction in income suffered by many, especially smaller firms. Even the profit tax carries a minimum assessment (often, it appears, CFAF 1,000,000), even for firms facing large losses.

Withholding Taxes and Working Capital: Yet, along with the level of taxes, their timing weighs heavily on private enterprises. The use of withholding and rebatable taxes requires firms to pay taxes before the firm has the revenue on which the tax is based. The result is to deprive the firm of working capital to purchase inventory and inputs for production, provide sales credits, or cover other current expenses. It shifts a part of the government's financing problems to the private sector. In an environment in which bank credit has been mostly exhausted, in large part due to government, this may pose a critical constraint on enterprises.

⁴⁷ The number of large formal enterprises declined slightly between 1982 and 1988, but their taxes increased by more than twice the increase in value added (28% vs. 12%). For small and medium enterprises (PMEs), the story is worse: the number of formal sector PMEs (those reporting statistics to the government) declined by 10%, value added dropped by 27%, yet taxes paid actually increased by 19%.

tax collections but also are accentuating the crisis of manufacturers facing fraudulent competition⁴⁵. By most accounts, large quantities of heavily taxed categories of goods come in through neighboring countries -- a flow that is unlikely while the relationship of domestic to foreign prices (combined with full convertibility) holds and high import tariffs are in effect.

Profits, Investment: There is a 40% tax on profits, to which until recently was added a 10% profit tax for a (theoretically refundable) National Investment Fund (FNI). As noted in the section on arrears, the government has withheld many payments owed to the private sector in recent years, including tax rebates. The FNI is theoretically refundable to industries with a government-approved investment plan. In practice, access to this Fund has proved discriminatory against smaller enterprises⁴⁶ and may have introduced extraneous factors into private investment decisions. For whatever reasons, larger firms apparently have an easier time convincing the oversight committee of the value of their use of FNI funds.

Table 8: Tax/Value Added Ratio by Enterprise Type

	Enterprise Type	1982	1988
	$\frac{\text{Total Taxes}}{\text{Value Added}}$	Small and Medium	.16
Large Private		.19	.22
Large Public		.16	.20
$\frac{(\text{Total Taxes} - \text{Profit Tax})}{\text{Value Added}}$	Small and Medium	.13	.18
	Large Private	.16	.19
	Large Public	.14	.19

Source: BDF/CECPS

Payroll Taxes: Labor inputs also fall under substantial taxation. Entrepreneurs estimated that the taxes and mandatory benefit regulations applying to labor add between 30 and 50% to labor costs. Payroll taxes include a social security tax (CNPS) and a training tax (FNR). The CNPS is probably the most widely evaded tax (or quasi-tax) and an effort to enforce its payment more thoroughly (which appears to be wisely lacking) would undoubtedly result in further reductions in formal employment.

⁴⁵ Competition from smuggled manufactures is seen as a major threat by many large enterprises (see table 6). Domestic textile production, for instance, has declined by about 50% over the last four years -- due to the roughly equal effect of demand contraction and fraudulent imports. Similarly, formal (duty-paying) importers of many consumer items are instead procuring the same imported items domestically -- cheaper.

⁴⁶ Helpful information on this was received from Klaus Lorch, then of AFICO.

The problem is growing in that Côte d'Ivoire recently enacted a new forfeiture tax. In June 1990 the already infamous 5% withholding (*prélèvement*) tax on turnover was imposed on manufacturers with the intention of extracting revenues from private traders deemed to be avoiding other forms of taxation. The theory was that this withholding tax (though having all the appearance of a VAT surcharge) would not be passed on to transfer prices but would be temporarily absorbed by the enterprises -- which would eventually be able to recover it through matching rebates on their other tax bills. Although theoretically rebatable and/or creditable against other taxes paid, it may deprive many firms of the funds they need to operate during the course of the fiscal year.⁴⁸ Given the institutional realities of the implementation of past rebates and credits, for enterprises that regularly meet all their tax obligations the 5% withholding tax would, at best, represent a liquidity drain -- in an economy where fiscal mismanagement is already a prime cause of tight liquidity. At worst -- if the rebate is only allowed from the profit tax -- it would represent additional taxation, enforceable only on the already over-taxed dutiful enterprises and quite damaging to their financial health.⁴⁹

In fact, the objective of broadening the tax base by having traders (who are presumed to pay no taxes) absorb the 5% surcharge collected through their suppliers can only be achieved with undesirable, and difficult to enforce price controls at the point of final sale. Whether or not this can be achieved, it may be unrealistic to expect that traders operating with profit margins of a few percentage points (under pressure of a highly competitive, even if informal, environment) to be able to bear a 5% turnover tax. Thus, it is unlikely that the 5% withholding will expand the tax base. In fact, if it increases taxation, it could even reduce the tax base by enhancing the incentives for informalization of the supply of manufactures (through increasing smuggling and underdeclaration of domestic production) and by further depressing demand.

Taxes and Unregistered Firms Licensing taxes (*patente*) represent, in practice, the main tax liability of most small and micro-enterprises. Anecdotal evidence suggests that the amount paid is negotiated between entrepreneurs and revenue agents, and that the agents have been loathe to reduce assessments in years of recession. Depending on the relative negotiation skills and power of entrepreneurs and agents, the payment can vary substantially. There are clear indications that there is considerable "leakage" between the amount collected by agents and the amount reaching the treasury. This may reflect, in part, the high transaction cost of this labor-intensive mode of collection, but nonetheless suggests that small informals do not escape taxation.

Attempts to tax the smaller enterprises and traders are likely to be futile under the present circumstances, and risk causing significant damage to the private sector which is not compensated by any significant public revenue gains. The 5% withholding tax is one such attempt. The unfortunate possibility is that, if fully implemented, it might drive small competitive traders entirely out of business, leaving larger oligopolies to dominate markets.

⁴⁸ The reaction of entrepreneurs to the new 5% tax is uniformly negative.

⁴⁹ But note the poor record the Government has on rebates: export premium, FNI, FNR ...

Agricultural Tax: The AFS

Traditionally, the Ivoirian government tapped agriculture as a major source of revenue through the Agricultural Financial Surplus (AFS). The government drew surplus from agricultural exports (mostly coffee and cocoa) both through a fixed tax and through the difference between the export price of commodities received and the stabilized price paid to farmers. Between 1980 and 1984, the AFS averaged 5% of GDP. Since 1987, however, the stabilization of the price of basic commodities has required net expenditures by the Caisse de Stabilisation des Prix des Produits Agricoles (CAISSTAB), due to deteriorating international terms of trade. A major source of government revenue turned into a major expenditure as CAISSTAB's net income turned seriously negative (see table 11) after 1986. Only recently have reforms related to the structural adjustment program have since lowered support prices to reduce the budgetary hemorrhage.

Table 11: CAISSTAB Operations, 1986-90

	1986	1987	1988	1989	1990
Net Stabilization Fund Revenue	135	-59	-104	-170	-50
(of which): coffee	63	-37	-59	-134	-10
cocoa	100	3	-21	-13	-40
cotton	-21	-17	-16	-21	-
other	-7	-8	-8	-2	-

Source: World Bank ("Examen des depenses publiques")

Summary The current tax structure weighs heavily on a shrinking base of urban firms. By hitting small and medium firms hardest, it acts as a substantial obstacle to growth and a disincentive to cross the threshold from informality to formality. Increased reliance on indirect taxes and new forms of taxes appears to have at least three undesirable affects: it increases the complexity of tax regulation with which firms must comply, hence the possibility for discretion and corruption in enforcement; it diminishes the relationship between firm income or profit and revenues, increasing regressiveness among formal firms; and it has shifted the timing of tax payments to turn the government's short-term financing problems into firms' working capital problem -- by requiring them to pay tax on income before it is earned. Therefore, simplification and rationalization of the tax system with fewer discretionary categories of tax status appears an important priority in promoting PSD.

VI. LABOR MARKETS, REGULATION AND PSD

In spite of a seemingly strangling regulatory environment for employment and relatively high levels of worker compensation, entrepreneurs operating in Côte d'Ivoire do not consider labor as one of their major constraints. The reason -- in addition to simply indicating that there are worse constraints -- appears to be that they are finding legal (or, at least, non-prosecutable) means to attain flexibility and reduce labor costs. Hence, labor does not appear to be a binding constraint on enterprises operating in the formal sector, because the division between formality and informality is blurred in yet another dimension.

Segments and Linkages In a sense, there are three urban labor markets: the government, the formal private sector, and the informal sector. However, the links between these markets are stronger than is commonly represented and the distinctions between them smaller. In recent years, informal employment has grown rapidly, while formal employment in the private sector has declined. While the informal sector is notoriously difficult to measure quantitatively, official statistics acknowledge urban informal sector employment to be more than three times that of formal sector employment.

Table 9: Employment Statistics and Estimates
(in 000's and annual % change over five year intervals)

	1980	%change	1985	% change	1990 est.
Agricultural Sector	3,125	2.1	3,460	2.5	3,900
Modern Sector	470	-3.0	405	-1.0	385
Informal Sector	719	5.0	910	5.7	1,200
Total Labor Force	4,314	2.1	4,775	2.8	6,335

Source: Direction de L'Emploi, Ministère du Travail

Government has traditionally provided the principal source of formal sector employment for Ivoirian graduates with a higher education. It established a generous level of compensation that appears to have shaped general expectations of skilled workers about the standard of living they deserve.⁵⁰ In spite of two pay freezes in the 1980's, public sector salaries average 10.3 times the per capita GDP, even before adding in generous benefits and access to informal sources of income.⁵¹

⁵⁰ Several entrepreneurs criticized the educational system for excessively orienting students towards being becoming civil servants, rather than business people. As a result, until recently, business was regarded as an occupation second to government service or teaching.

⁵¹ This high average apparently masks substantial differences between positions. Notably, teachers have much higher than average salaries.

The formal private sector appears to be comprised of two distinct sub-markets: that of large-scale and particularly foreign-owned enterprises, which is subject to the full force of regulatory law, and that of other enterprises (particularly Ivoirian-owned), which, while observing most or all government regulations, suffers from fewer direct enforcement activities by government officials. In the first category, regulations appear to sharply restrict performance-based incentives, hiring and firing, and compensation policy. For firms in the second category, there appears to be a degree of regulatory tolerance.

The economic crisis has led formal sector firms increasingly to find ways to reduce labor costs and expand their employment flexibility. Those attempting to stay within the law have resorted to three principal methods: greater use of day-labor as opposed to salaried labor; the expanded practice of apprenticeship; and subcontracting with informal-sector firms or individuals. The economic crisis has, thus, strengthened the links between formal and informal sectors, making an understanding of the dynamics of this relationship far more important. This relationship has improved the ability of the formal sector to adjust to economic stagnation by increasing its flexibility and reducing costs.

Greater flexibility in employment and labor costs is a key characteristic denoting informality. Wages for full time employees in the informal sector are often equivalent to or better than the mandatory minimum wage (SMIG), although compensation usually lacks the substantial non-wage benefits associated with formal employment. Compensation in the informal sector is more commonly structured to promote productivity, often taking the form of a piece-work or commission basis. At the microenterprise level, business can serve as a form of self and family employment and is often ambulant or home-based. For self-employed entrepreneurs, their family members, their apprentices and their casual employees, wages depend largely on business, and can fall substantially below the SMIG.

Formal Sector Hiring: A Government agency, IMOCI, technically still had the monopoly over labor supply intermediation at the time of our study⁵²: all hiring was supposed to take place through it. In practice, IMOCI seemed to consider itself mainly responsible for promoting the hiring of Ivoirians, and regulating the hiring of non-Ivoirians. Nevertheless, IMOCI still had the legal power of forcing employers to hire exclusively through it. In the past this resulted in a stream of often unqualified (but often well-connected) candidates sent by IMOCI. This granted IMOCI considerable arbitrary power in employment decisions, enhancing the potential for patronage and the uncertainty which formal enterprises (particularly foreign-owned ones) face. Consistently, Ivoirian-run enterprises with predominantly Ivoirian labor forces had few complaints about IMOCI. They were able to recruit their own workers and found their subsequent registration a relatively simple formality. Even firms with expatriate managers found few difficulties in hiring Ivoirians of their choosing, once they had found them through their own search processes.

Formal Sector Firing: Firing a worker for poor performance is particularly difficult in Cote d'Ivoire. Some managers found themselves running afoul of the Labor Ministry, even after

⁵². IMOCI has since been abolished.

complying with legally mandated warning procedures and even with evidence of rampant absenteeism or blatant thievery. The most frequent outcome of employee appeals to the Labor Ministry was a requirement for an exorbitant severance payment. Again, the amount of the payment appeared to be largely at the discretion of department officials, hence a source of substantial rent-seeking behavior.⁵³

However, the economic crisis gave rise to a practice that appears to encounter no significant regulatory obstacles: general "compression" of a firm's labor force. While singling out individual workers for firing led to state intervention, entrepreneurs registered few complaints about their freedom reducing drastically their overall labor force when faced with declining sales. A general rule appears to require respect for seniority in firing, although it is unclear whether this is fully enforced. An additional option is technical unemployment (temporary layoffs), which allows a firm to suspend its workers without pay for up to 90 days in response to financial hardship. One potential inflexibility of compression laws is the apparent need for enterprises to close whole facilities to justify compression, rather than having the flexibility to incrementally reduce their workforce.⁵⁴

Costs of Formal Employment: Surprisingly, the great majority of managers of large and medium formal enterprises found the SMIG acceptable at current levels. While complaining of generally elevated factor costs, entrepreneurs found the taxes and regulations applying to labor, estimated at between 30 to 50% of labor costs, to be more objectionable (and sympathized with workers' need for a living wage in the face of the high urban cost of living). These regulations include generous vacation, leave, transportation and housing benefits. Probably the most pernicious effect on competitiveness, in connection with labor costs, results from the combination of generous mandatory provisions for non-monetary compensation⁵⁵ and regulatory or administrative obstacles to firing individual workers -- which lead to uncontrollable absenteeism, and engender low productivity.

Apprenticeship Particularly interesting and telling is the tendency of moderate, small and micro-enterprises to legally evade the SMIG and other labor regulations through the expanded use of apprenticeships. Apprenticeships have traditionally served as a form of vocational education: in

⁵³ Several respondents had stories about extortionate responses of public officials to their firing workers for absenteeism, theft, or poor performance.

⁵⁴ According to a sectoral expert on labor and competitiveness policies, the evident difference between the ease of collective suspension and difficulty of results less from the formal law than from its implementation. He additionally suggested that difficulties in firing may be compounded by arbitration processes.

⁵⁵ "Fringe benefits" such as bereavement leave are rooted in tradition and cultural practice, but the present system allows workers to ignore the costs imposed by their absences and facilitates abuse.

skilled crafts apprentices sometimes have to pay for their training, while in other fields they are generally given little more than pocket money.⁵⁶

The economic crisis of the 1980s appears to have significantly expanded the role of apprenticeship. Faced with tight margins (or losses) and an excess supply of labor, employers are both extending the duration and increasing the number of apprenticeships. Thus, it is not uncommon to find workers in businesses with relatively simple skill requirements "apprenticing" for five years. Another indication of the expanded role of apprenticeship is provided by the terms of employment: the low level of compensation appears to reflect the wage an unregulated market might set for untrained workers. Clearly, there is a potential for exploitation in the use of minimally compensated apprentices, but there is also an avenue for expanding employment and reducing costs beyond that allowed by labor regulations governing regular employees.

Official statistics (which do not include the informal sector) suggest an increase of over 200% in apprenticeships from 1984 to 1989.⁵⁷ A 1985 government study of the informal sector⁵⁸ found that 21% of employees in firms surveyed were apprentices, while an additional 6% were "family aides". Apprenticeship was most common in skilled crafts, namely wood and woodwork, where they comprised 60% of the labor force (aside from the entrepreneur); metals, mechanics, and electricity, where they comprised nearly 62% of the labor force; and textiles and clothing, where they comprised over 45% of the labor force. There were virtually no apprentices found in unskilled or non-craft fields such as commerce, transport, and teaching. The study found that the average age of apprentices to be 20, the youngest of any category of workers, indicating that apprenticeship is a transitional status for younger workers, as well as a substitute for vocational education. The CECPS survey suggests that apprenticeship is also concentrated in smaller enterprises, although not only informal microenterprises. While apprentices accounted for less than 1% of the corporate labor force, they accounted for over 20% of the ULLE labor force, and about 40% of the workers at sole proprietorships and unregistered enterprises.

Subcontracting With the government treasury in deficit and many formal businesses facing many consecutive years of losses, the formal sector desperately searches for ways of reducing the cost of producing and delivering goods and services. One method employed increasingly by public and private enterprises, as well as government agencies, is the use of subcontracting with informal sector

⁵⁶ According to one World Bank official, apprenticeship in law is not nearly so flexible as it is in practice. In this view, apprenticeship is formally subject to legal constraints and obligations not reported by the firms we interviewed.

⁵⁷ According to IMOCI figures, apprenticeships rose from 4% of work contracts in 1984 to 24% of contracts in 1989. Even with the number of new contracts declining by 40%, the actual increase numbers of apprenticeship contracts more than trebled. Annuaire Statistique du Travail, 1989

⁵⁸ Ministères de l'Éducation Nationale, de l'Économie, du Travail, et de l'Industrie. Le Secteur Informel Urbain, 1985: Principaux Résultats

VII. CONCLUSIONS

Côte d'Ivoire's private sector entered the 1990s a colossus with feet of clay: once thriving enterprises were deeply mired in an economic crisis accentuated by policy and regulatory rigidities, and encumbered by a weighty public sector. Significant parts of the private sector are most likely facing a bottomless downturn. Yet, there appears to be considerable untapped potential in the indigenous private sector: ranging from manufacturing small and microenterprises with some technical skills, but little business know-how; to medium and large enterprises straight-jacketed by taxes, regulation, the uncompetitive relationship between domestic and foreign prices⁶¹, and policy uncertainties.

Much of the solution will depend on remedies previously prescribed in World Bank and Government documents following analyses of external and internal competitiveness, public expenditure, and the financial system. The prescribed reforms are crucial prerequisites in the absence of which the pursuit of private sector development will be futile. It is important to note, however, that unless overarching economic distortions are removed, entrepreneurs may well focus their ingenuity on the wrong activities from a perspective of international competitiveness and long-term growth. To fully realize the benefits of the already initiated adjustment process it will also be necessary to foster competition throughout the economy -- stimulating entry and growth at all levels of private enterprise, to enhance the security of property rights, and to raise the standards of public service.

This report has sought to provide an analysis of issues relating to the nexus of public and private sectors, drawing heavily on the perceptions of entrepreneurs themselves. It is intended to complement the existing body of economic and sector work on Côte d'Ivoire (notably the recent work on financial sector issues and public expenditure, and the extensive work underway for the Industry and Competitiveness Review). The next step should be to develop a private sector development strategy for Côte d'Ivoire that would: (i) articulate macro- and microeconomic policy reforms; (ii) identify binding constraints to private enterprise operation and growth; and (iii) assign priorities and sequence interventions to alleviate those constraints. The analysis in this report suggests the following elements should be included in such a strategy:

Taxes The tax system needs an overhaul, both to reduce its impractical regulatory burden, and eliminate powerful disincentives that result from efforts to increase revenue extraction from a shrinking tax base. In particular:

- Marginal tax rates on enterprises, imports and formal sector labor are clearly in excess of either efficiency- or revenue-maximizing optima. They must be reduced in order to halt further erosion of the tax base.

⁶¹ The pervasive impact of the real exchange rate and of the compensatory measures it has required cannot be overemphasized. It is an indication of the uncertainty-shy, inward-looking, protected nature of large segments of the private sector in Côte d'Ivoire that only a very small minority of the entrepreneurs interviewed could be counted as advocates of change.

firms. Subcontracting offers three potential advantages to large firms: it reduces fixed costs, allowing them to contract for labor as demand arises (especially important in a slack and unpredictable economy); it facilitates the use of productivity-based payment schemes; and it allows firms to evade sometimes strangling costs of regulation and taxation⁵⁹ through subcontracts with lower-visibility informal firms. For example, one textile firm that experienced a dramatic decline in sales in recent years had substantially reduced its labor force. Increasingly, it subcontracted with informal firms on a piece-work basis to manufacture its products. Many of the microenterprises with which it subcontracted were former employees working in their homes, some of whom made the equivalent of their former salaries, thanks to high productivity.

While the government cannot directly deal with firms not fully complying with its tax and regulatory requirements, it can do so indirectly. In public works, for example, large, formal-sector firms are able to reduce their bids by subcontracting major parts of their construction work to informal firms. Subcontracting is common practice among the firms contracting with them for road and building construction. While, legally, government contractors are liable for the evaded taxes of their subcontractors, enforcement is sufficiently lax that they are commonly willing to take the risk.

In the restrictive regulatory environment of Côte d'Ivoire, subcontracting adds badly needed flexibility and efficiency to some industries in heavily constrained private labor markets. Depending on the elasticity of demand for labor, it may well have contributed significantly to maintaining employment beyond what it might otherwise have been during the present economic crisis. It is, thus, important during the transition for the Government to refrain from pursuing full regulatory enforcement by small subcontractors. Nonetheless, subcontracting poses the danger of removing all worker protection and now plays the role of a short-term response to excessive regulation. It would not be necessary (as an evasion) if regulatory rigidities were relaxed.⁶⁰

⁵⁹ Clearly, salary is only one part of labor costs, about 60% for most formal sector firms. The rest of the cost is in payroll taxes, leave benefits, and a variety of other worker entitlements under the law.

⁶⁰ Clearly, even entirely legal subcontracting would offer advantages in flexibility of use of labor (reduced fixed costs) and avoidance of labor regulations applying only to firms above a threshold number of workers.

- "Rebatable" withholding taxes are depriving financially starved firms of working capital and not being rebated. Most should be eliminated.
- Given that the government is unable to protect the FNR from appropriation and that its administration has proven discriminatory against small enterprise, it should be eliminated in favor of a sufficient increase in the corporate profits tax to meet government's revenue needs.
- Discretion in tax and tariff rates appears to increase the regulatory burden and the incidence of rent-seeking. The number of categories of rates should be reduced (or rates unified) and regulations simplified to eliminate exemptions and other sources of discretion.
- Reports of enormous leakage between tax collections from small businesses and revenues reaching the Treasury suggest a need for investigation and reform. Below a certain size and turnover, enterprises should be exempted from tax.

Public Expenditure Within the macro-picture of excessive public expenditure, there are a number of opportunities for the state to improve the impact (or reduce the burden) of its spending on PSD and to create more productive linkages with the private sector:

- Relatively high public sector wages are destructive to PSD not only because of their large draw on public finance but also because of their tendency to crowd skilled workers out of private markets with the offer of high wage, high status positions, many of which contribute little to the economy. Thus, in spite of the difficult political path the must be tread to accomplish it, the government must reduce the salaries and benefits of many higher-level officials and end its policy of guaranteed employment for graduates of higher education.
- The role of public enterprises and parastatals (including "strategic" ones) in the economy appears excessive, both in their use of social resources and their power to rule out competition. Government should work to encourage greater competition in sectors ruled by public enterprises, increasing their linkages to private firms, contracting out more of their functions, and removing their regulatory power. The experience of SODECI and CIE shows the potentially huge efficiency gains of introducing private components into the management and operation of public monopolies, emphasizing their potential for activities the Government is unwilling to privatize. Additional gains may be achieved through reducing vertical integration, hardening budget constraints and exposing public enterprises and parastatals to competitive market forces. Ultimately, these gains can best be achieved and sustained through private ownership and competitive markets in fields traditionally controlled by state-sponsored monopolies.

- Government expenditure on education and health has been skewed towards the elite, those most able to self-finance provision. At the same time, the country has underinvested in facilities and supplies with the greatest social and distributional benefits (as well as the greatest potential impact on PSD): those for primary and secondary education and primary health care. Thus, allocation should be improved. Furthermore, the educational system should eliminate its curricular biases and incentives against entrepreneurial careers.

- Procurement procedures have the potential to encourage PSD. The government should assure that its procurement policies allow any firm to compete equitably, in a well-publicized and uncorrupted process. In general, lot sizes do not appear too large for small enterprises, but the government's horrendous record on payment acts as a strong disincentive for small private firms with limited access to working capital to do business with the public sector. The government should clear up its arrears and adhere to a rigid payment schedule spelled out in each contract. Discretion and associated rent-seeking should be eliminated from payment in the procurement process.

Finance Through crowding out and political interference, government has made credit scarce for all but the largest, most-established enterprises. Private banks should be given an appropriate, neutral regulatory environment in which to operate; restitution of arrears to financial institutions should be made a priority. Given its past institutional failures, government should remove itself as much as possible from administrative allocation of credit.

Labor Regulation Labor regulation has introduced burdensome rigidities that have contributed to the need for evasions of formal law through subcontracting, apprenticeship, and outright illegality. In spite of the fact that businesses do not perceive labor regulations as a leading obstacle, ultimately, more reasonable regulations would extend the government's mantle of protection (and revenue base) to a broader group of workers and enterprises. Labor regulatory reform should focus, less on the minimum wage (which few find a burden) and more on other benefits that limit the reliability of labor (e.g. leave policies), restrict performance incentives, and constrain firing for dereliction. Apprenticeships appear to provide valuable vocational training while also offering employment to workers possessing little human capital. One proposal before the Ivoirians is a "training wage" that offers enterprises a formal option to pay inexperienced individuals less than the SMIG. Past public administrative failure cautions us, however, that such a mechanism is no substitute for the current laissez-fair acceptance of apprenticeships (within reasonable limits). If adoption of a "training wage" extends bureaucratic rigidities and discretion to apprenticeships, it may actually inhibit this valuable source of training.

Education, Training and Technical Assistance Arguments for reducing the state's negative role do not diminish its potential positive role in supporting entrepreneurship through various services:

- The taxonomy of business revealed that education was highly correlated with formality -- a state of full corporate citizenship, bearing full responsibility for obligations to the state and benefiting from access to bank financing and formal channels of technical assistance. This suggests that investment in education (at least up to the secondary level) and elimination of anti-entrepreneurial biases in the curriculum may encourage expansion of the formal SME sector.
- However, as current technical assistance is reaching primarily the educated, there is a need to look for innovative intermediate-term approaches to technical assistance oriented towards the least privileged, educated and influential entrepreneurs. Models pioneered by several NGOs for microenterprise assistance, using credit conditioned on technical assistance and training to entrepreneurs, might prove useful in extending the reach of support programs to micro- and small enterprises.
- Finally, technical and financial assistance are bound to be required (at least during a transition period) for a diverse, dynamic SME sector to emerge and grow. The experience of APDF suggests that entrepreneurs with medium-to-large projects exist and would likely materialize in force in response to an improved business environment -- possibly with some (cost-effective) assistance to link up with financiers and partners. The vast potential of the SME sector (including migrants from a belt-tightening public sector) will, in particular, require assistance to get started. Promising models which involve a combination of business services, equity participation, and loan financing are being experimented with by NGOs, cooperative associations, and for-profit promoters. These models have in common a triangular arrangement in which the would-be (or expanding) entrepreneur obtains term financing from a bank, partly on the basis of an agreement with a provider of technical assistance who also takes a stake in the venture (in the form of either equity or guarantees). Variations of this model appear well worth developing to support the emergence and growth of both SMEs and productive microenterprises.

Legal System There is a need for streamlined, expedient mechanisms for conflict resolution (including effective recourse against government decisions). Courts and court officials require incentives and safeguards against corruptibility. Private businesses supplying the government should have neutral courses of appeal should problems arise during the course of the contract. Other measures are needed to reduce transaction costs and generate business confidence.

Other Support Services Existing policies have turned productive energies inward towards domestic markets. Expansion of export horizons for manufactures (beyond the francophone world) may now require approaches with limited public institutional inputs and a high level of private sector participation, such as partial financing of market exploration expeditions.

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