A better investment climate—for everyone

1. Firms and entrepreneurs lie at the heart of the development process. Driven by the quest for profits, private firms of all types and sizes—from rural micro-entrepreneurs to multinational corporations—invest in new ideas and in new facilities that provide the foundation for economic growth and prosperity. They create jobs—providing opportunities for people to apply their talents and improve their situation. They provide the goods and services required to sustain life and improve living standards. And they contribute to the tax revenue required to underpin sustainable public funding of health, education and other services.

2. The extent to which firms make these contributions in a particular society is determined largely by the investment climate—the location-specific factors that shape the opportunities and incentives for firms to invest productively, create jobs, and expand. Improving the investment climates of their societies is a challenge facing all governments. But improvements are the driving force behind growth and poverty reduction, which makes progress especially critical for governments in the developing world—where 1.2 billion people barely survive on less than $1 a day. And the task grows more urgent by the day with demographic changes adding nearly 2 billion more people to developing countries over the next 25 years. Accelerating the creation of productive jobs in developing countries is essential to provide opportunities for young people—contributing not only to higher living standards but also to a more stable and inclusive world.

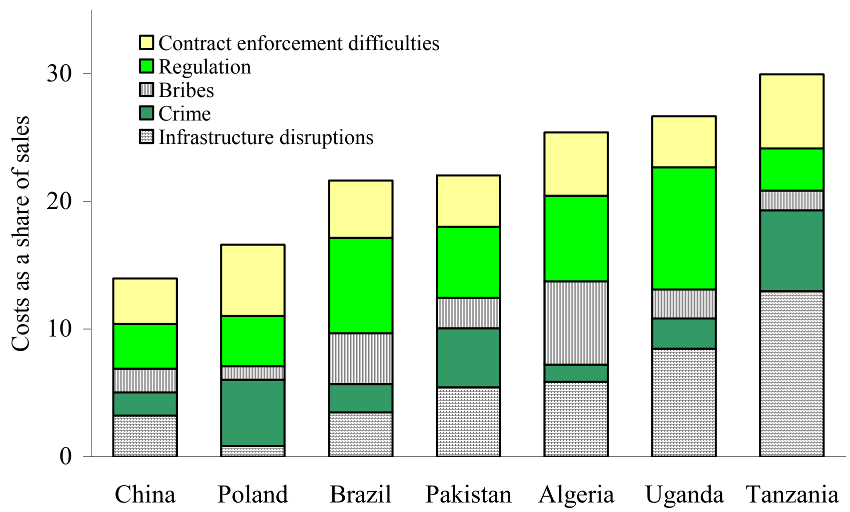
3. While many factors shape the investment climate, government policies and behaviors play a critical role by affecting the costs, risks, and barriers to competition faced by firms. New sources of micro-level evidence from the World Bank provide fresh insights into how investment climates vary around the world—and how they influence growth and poverty reduction. *World Development Report 2005* draws on this evidence and on emerging lessons of international experience to look at what governments can do to create better investment climates for all members of their societies.

How investment climates vary

4. Government policies and behaviors shaping the investment climate cover a broad domain. They include those affecting the security of property rights, from title to land and contract enforcement to crime and expropriation. Approaches to regulation and taxation, both at and within a country's borders. The provision of infrastructure such as electricity, telecommunications, and roads. The functioning of markets for finance and for labor. And broader features of governance, including corruption. When making investment decisions, firms of all types and sizes look at these measures as part of an overall package that shapes the attractiveness of a particular opportunity. They impact on the opportunities and incentives facing firms through their influence on three key but interrelated dimensions: costs, risks, and barriers to competition. All three matter for firms—and for growth and poverty.

5. *Costs*. Wages, rent, raw materials and the like are a normal part of any commercial activity. But many costs flow directly or indirectly from government policies and behaviors. Taxes are the most obvious. But governments have important roles to play in addressing market failures, providing public goods, and supporting the provision of infrastructure. Weaknesses in government performance in these areas can greatly increase the costs for firms and make many potential investment opportunities unprofitable. How greatly? Firm surveys show that the costs associated with infrastructure disruptions, crime, corruption, regulation, and contract enforcement difficulties can amount to 30 percent of sales—or three to four times what firms typically pay in taxes. And both the level and the composition of these costs vary widely across countries (figure 1).

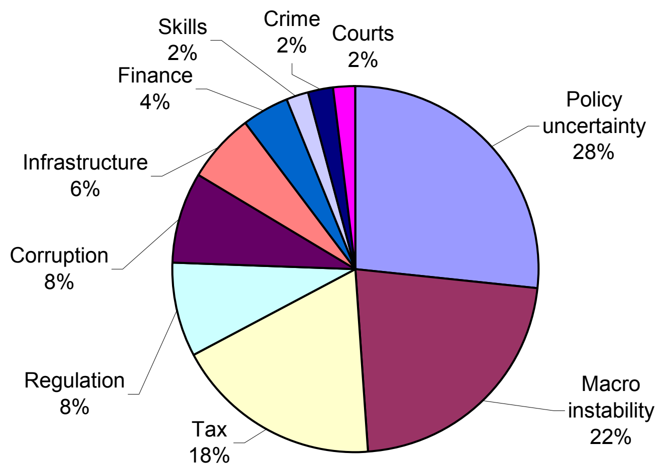
Figure 1 The level and composition of cost burdens vary widely across countries



Source: World Bank Investment Climate Surveys. Countries chosen to illustrate range of responses.

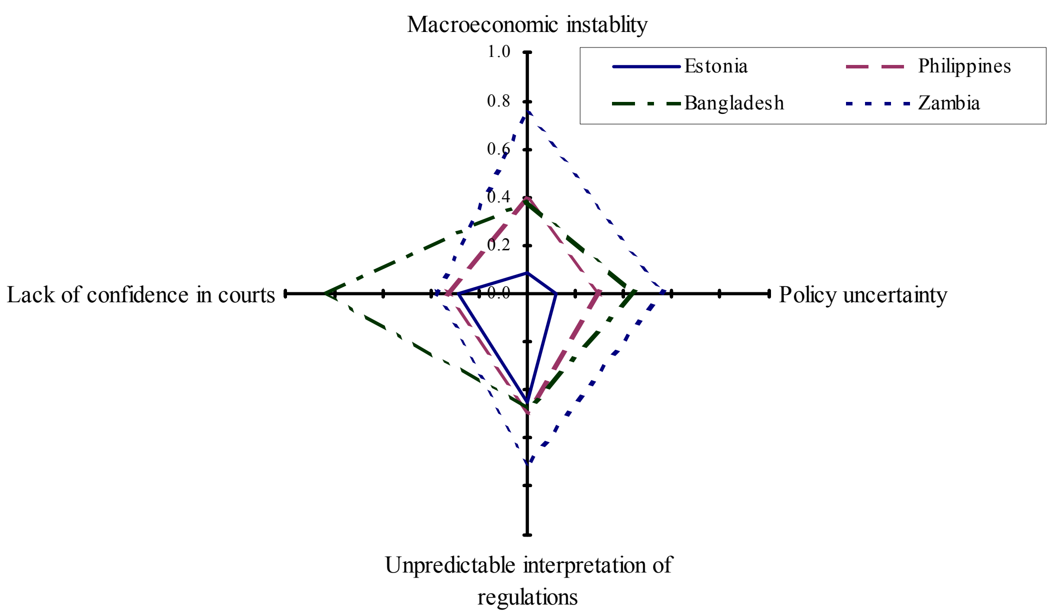
6. *Risks*. Because investment is forward-looking, judgments about the future play a big role in investment decisions. Many risks faced by firms, including uncertain responses by customers and competitors, are a normal part of investment and should properly be borne by firms. But governments have a role in helping firms deal with risks associated with insecure property rights. Government policies and behaviors can also be a direct source of risk: policy uncertainty, macroeconomic instability, and unpredictability in the interpretation of regulations can cloud opportunities and chill incentives to invest. Firm surveys show that policy uncertainty dominates concerns in developing countries (figure 2). Those surveys also highlight some of the variations across countries (figure 3).

Figure 2 Policy uncertainty dominates the investment climate concerns of firms



Source: World Bank Investment Climate Surveys in 49 countries, based on rankings by country.

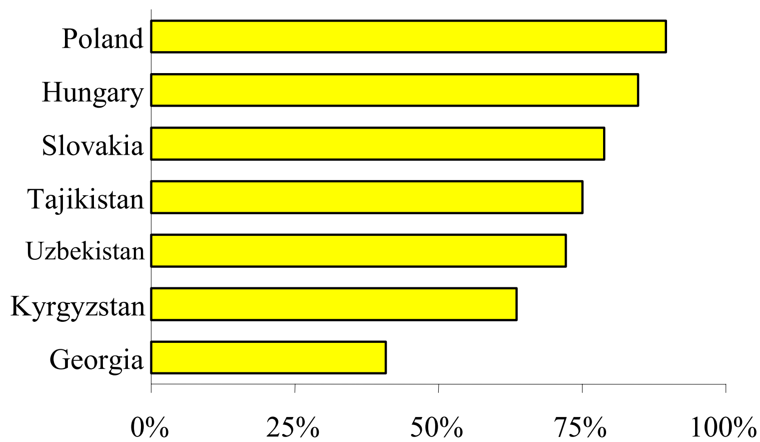
Figure 3 Concerns about government-related risks vary widely across countries



Note: Smaller numbers reflect less concern.
Source: World Bank Investment Climate Surveys. Countries chosen to illustrate range of responses.

7. *Barriers to competition*. Individual firms prefer less competition rather than more. But barriers to competition deny opportunities to other firms and dull the incentives of protected firms to innovate and improve their productivity. Some barriers stem from natural features such as distance and economies of scale. But barriers are also influenced by governments through their regulation of market entry and exit and by their response to anti-competitive behavior by firms. While difficult to measure at the aggregate level, firm surveys show how the competitive pressure felt by firms can vary across countries (figure 4).

Figure 4 Competitive pressure reported as significant for almost 90 percent of surveyed firms in Poland—but only 40 percent in Georgia



Source: World Bank Investment Climate Surveys/BEEPS II. Countries chosen to illustrate range of responses. Data limited to ECA.

Box 1 Putting firms and entrepreneurs at the center of development

The investment climate reflects the many factors that shape the opportunities and incentives for firms to invest productively, create jobs, and expand. A good investment climate is not just about generating profits for firms—if that were the goal, the focus could be narrowed to minimizing costs and risks. It is about improving outcomes for society as a whole. Many costs and risks are properly borne by firms. And competition spurs innovation and productivity, ensuring that the benefits of productivity improvements are shared with workers and consumers.

Looking at growth and poverty reduction through an investment climate lens offers three insights:

- Firms and entrepreneurs are a big part of development. Indeed, they are at the center of it.
- Firms assess investment opportunities and related government policies and behaviors as part of a package. That makes it essential to look at property rights, regulation, taxes, finance, infrastructure, corruption, and other areas of government policy and behavior as part of an integrated whole, not in isolation.
- Firms' investment decisions reflect their expectations about the future, not just current conditions. That makes it essential for governments to foster credibility and stability.

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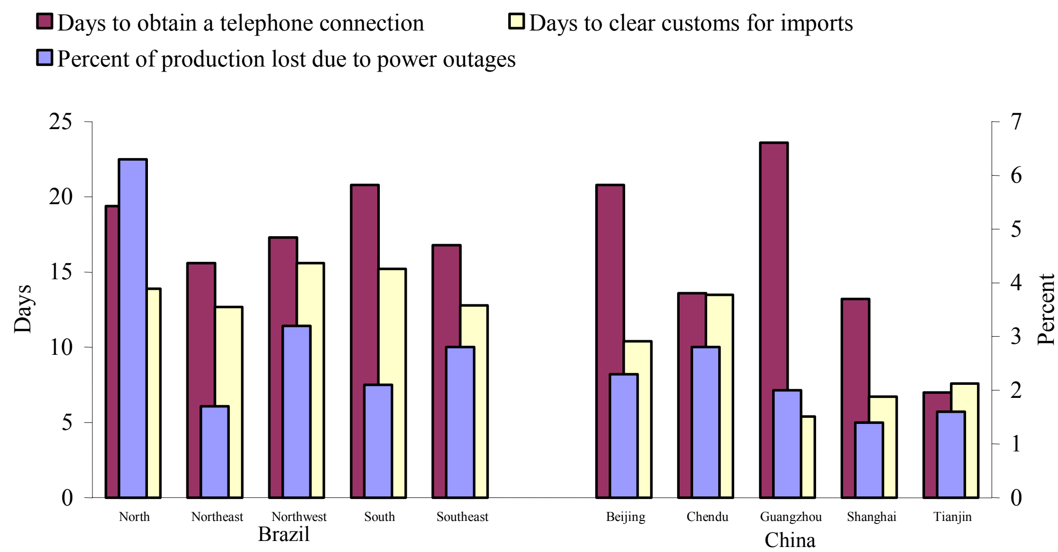
8. Investment climates can also vary significantly within countries (figure 5). This is most obviously the case when sub-national governments pursue different policies. But there can also be big differences in the way a single national law is administered in different locations, as well as in the provision of infrastructure. Investment climates tend to be less hospitable in rural areas because of the higher cost of providing infrastructure and other public services.

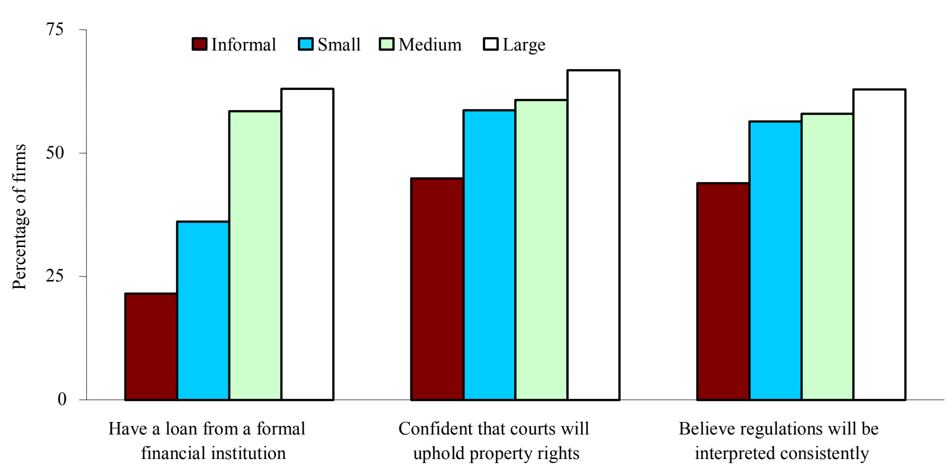
Figure 5 Investment climate conditions vary within countries



Source: World Bank Investment Climate Surveys.

9. Even within a single location, the same conditions can affect firms differently. This can be true across industries—farmers, manufacturers, miners, and hairdressers will each tend to have different perspectives and priorities. But even within industries informal and small firms are often hit the hardest by a poor investment climate (figure 6). Firms in the informal economy—which accounts for more than half of economic activity in many developing countries—are typically less constrained by taxes and regulations but have less secure property rights and face more difficulty accessing public services and finance. And constraints that constitute a fixed cost place a disproportionate burden on smaller firms.

Figure 6 Informal and small firms are often hit hardest by investment climate constraints



Source: World Bank Investment Climate Surveys and extensions to informal firms in eight countries.

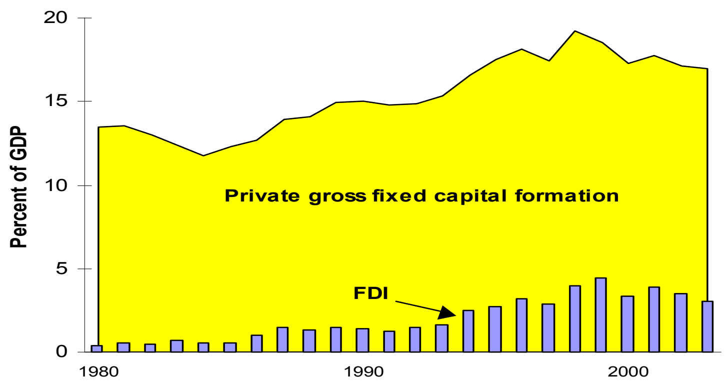
Why the investment climate matters

10. Firms obviously care about the investment climate. So should societies. Improvements in the investment climate are the driving force behind growth and poverty reduction—and thus should be a top concern for policymakers.

It matters for growth

As populations expand, economic growth provides the only sustainable basis for improving living standards. Investment underpins growth by bringing more inputs to the production process. While foreign investment in developing countries has been increasing, most private investment is domestic (figure 7).

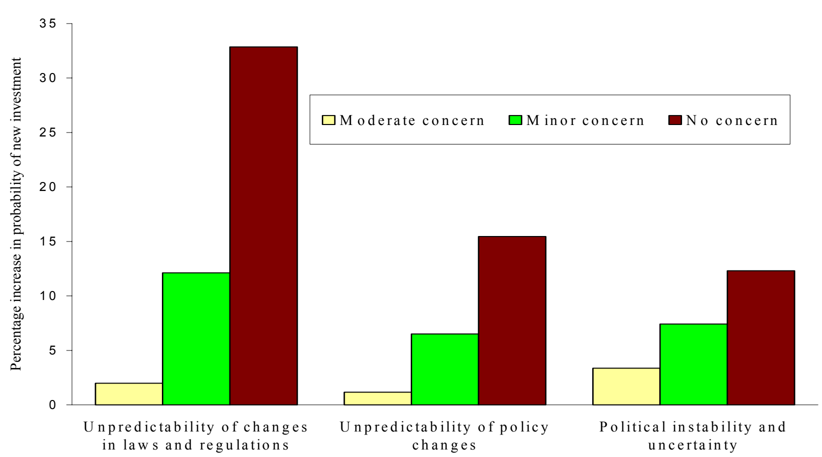
Figure 7 Domestic private investment dominates foreign direct investment



Note: Annual averages of 92 developing countries.
Source: World Bank (2003).

11. A good investment climate encourages firms to invest by reducing unjustified costs, risks, and barriers. Reducing government-related risks can increase the probability of making new investments by more than 30 percent (figure 8).

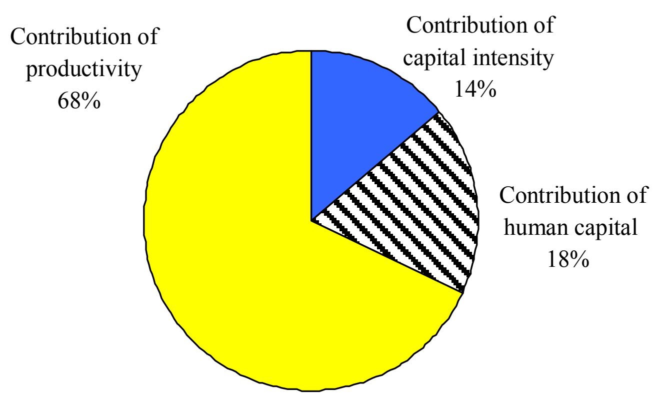
Figure 8 Reducing government-related risks increases the probability of new investment



Note: Simulations based on firm responses to World Business Environment Survey, based on 80 countries. Percentage increase is relative to firms reporting that risk was a severe obstacle.

12. But it is not just the volume of investment that matters—it is the productivity gains that result. Indeed, differences in productivity account for most of the differences in output per worker between rich and poor countries (figure 9).

Figure 9 Productivity accounts for most of the difference in output per worker

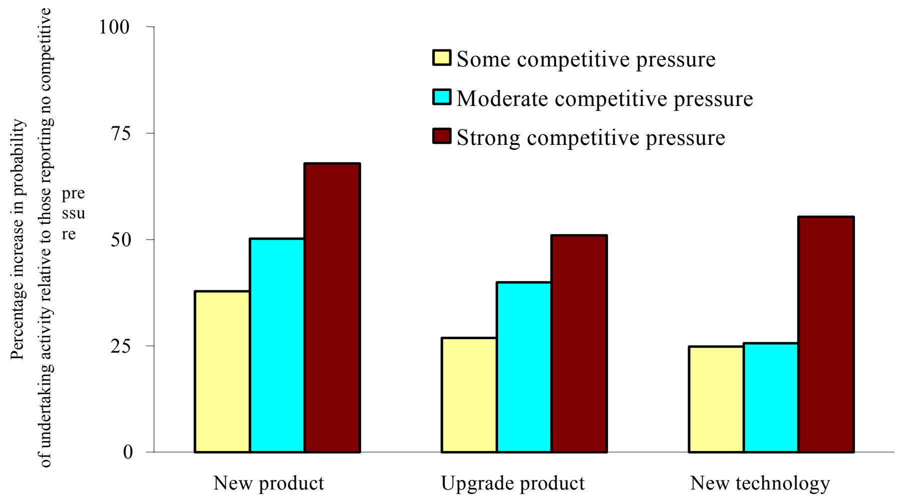


Source: Hall and Jones (1999); sources of differences between top 5 and bottom 5 of 127 countries.

13. The investment climate shapes the opportunities and incentives for firms to develop, adapt, and adopt better ways of doing things—not just innovations of the kind that might merit a patent, but also better ways to organize a production process, distribute goods, and respond to consumers. A good investment climate reduces barriers to the diffusion of new ideas, including barriers to importing modern equipment and to adjusting the way work is organized.

14. A good investment climate also fosters the competitive processes that Schumpeter called "creative destruction"—firms test their ideas, strive for success, and prosper or fail. A good investment climate makes it easier for firms to enter and exit markets in a process that contributes to productivity improvement and growth. Firm-level data confirm that competition encourages firms to improve their efficiency more than customers, creditors, shareholders, or governments do. The data also show that firms reporting strong competitive pressure are at least 50 percent more likely to innovate than those reporting no such pressure (figure 10).

Figure 10 Stronger competitive pressure increases the incentives to innovate

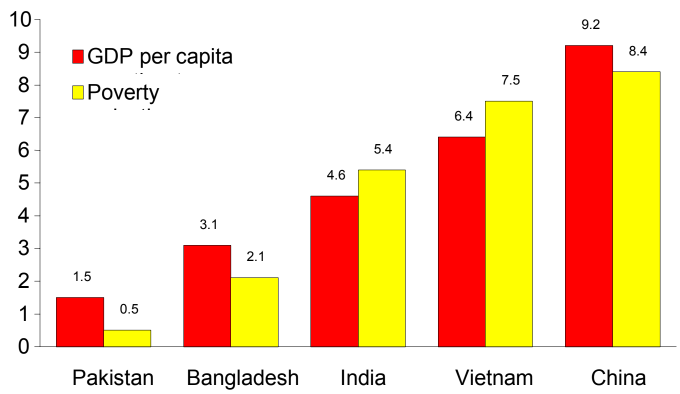


Source: World Bank Investment Climate Surveys/BEEPS II in 27 countries in Eastern Europe and Central Asia. Percentage increase is relative to firms reporting no competitive pressure.

It matters for poverty reduction

15. A sound investment climate is critical in the fight against poverty. The contribution can be seen in two ways. First, at the aggregate level, economic growth is closely associated with reductions in poverty (figure 11).

Figure 11 Growth is closely associated with poverty reduction
Percentage per year, 1992-98

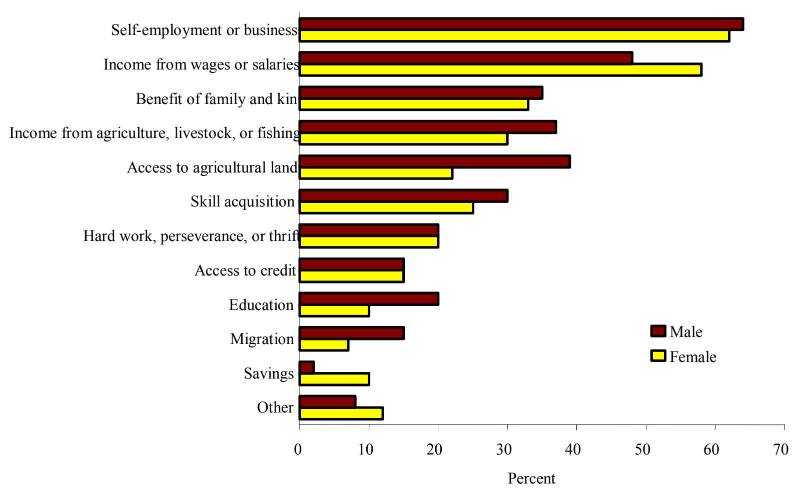


Source: Dollar and Kraay (2002). Bangladesh figures for 1992-2000. India figures for 1993-99.

16. Second, investment climate improvements can enhance the lives of people directly—in their capacities as workers, as entrepreneurs, as consumers and citizens, and as recipients of tax-funded services or transfers.

- *As workers*. The World Bank's *Voices of the Poor* study found that poor people identified "getting a job" as their top priority for improving their situation (figure 12). Expected demographic changes in the next 25 years—adding nearly 2 billion more people in developing countries—reinforce the importance of accelerating the creation of productive jobs.[1] The private sector is the engine for job creation. Better employment opportunities also increase incentives for people to invest in their own education and skills—thus complementing efforts to improve human development. More productive firms, nurtured by a good investment climate, can also pay higher wages and invest more in training.

Figure 12 How 60,000 poor people rated jobs and self-employment as pathways out of poverty



Source: Narayan and others (2000).

- *As entrepreneurs.* Millions of poor people make their living as microentrepreneurs in the informal economy—as farmers, as street vendors, as homeworkers, and in a diverse range of other occupations. Surveys undertaken for this Report show that firms in the informal economy face many of the same constraints as other firms, including insecure property rights, corruption, policy unpredictability, and limited access to reliable public services. Relieving these constraints increases the income potential of microentrepreneurs—allowing them to expand their activities and to create jobs for others.

- *As consumers and citizens*. A good investment climate benefits poor people whether or not they work or engage in entrepreneurial activities. It improves the efficiency of producing and distributing goods in society, lowering costs and improving the quality of goods. More secure property rights, less corruption, better infrastructure, and better-functioning financial markets also benefit the community as a whole.

- *As recipients of tax-funded services or transfers*. Tax revenues from a growing private sector are the only sustainable source of government funding for public services like health and education and for transfers to the disadvantaged in society.

17. Many investment climate improvements provide broad benefits across a society—such as more secure property rights and reduced corruption. Others have a more focussed impact on a particular location or activity, creating opportunities for governments to influence the distribution of benefits. Governments can design those investment climate

improvements to be even more "pro-poor" by focusing on constraints where poor people live and on constraints to activities poor people benefit from—as workers, as entrepreneurs, or as consumers. Pro-poor approaches are thus not limited to efforts focusing on smaller firms. They can involve the full range of economic actors and activities.

Challenges to investment climate improvement

18. More countries are improving their investment climates—and countries as diverse as China, India, and Uganda have been reaping the rewards of faster growth and reduced poverty. But progress is often slow and difficult. Why?

The underlying tensions

19. Societies benefit greatly from the activities of firms. But the preferences and priorities of firms are not fully congruent with those of society. This tension is most evident in taxation and regulation. Most firms complain about taxes—but taxes are important to finance public services that benefit the investment climate and other social goals. Many firms would also prefer to comply with fewer regulations—but sound regulation addresses market failures that can improve the investment climate and protects other social interests. There can also be different perspectives on market restrictions and a host of other matters. For governments to create a sound investment climate, they have to get the balance right.

20. Complicating this task are the differences in preferences and priorities between and within firms. Firms have common perspectives on many issues, but their views can diverge on others—whether on market restrictions, on the structure of taxation, or on the relative priority given to infrastructure improvements in different locations. There can also be differences in policy preferences within firms—such as between owners and managers on matters of corporate governance, or between owners and workers on labor market policies. All governments must arbitrate those preferences.

Four practical challenges

21. Responding to this tension creates four practical challenges.

22. *Restraining rent-seeking*. Investment climate policies are an enticing target for rent-seeking by firms, public officials, and other interest groups. Corruption can increase the costs of doing business—and when it extends to higher echelons of government can lead to deep distortions in policies. Capture, patronage, and clientelism—reflecting unequal information and influence in policymaking—can also create large distortions, tilting policies in favor of privileged groups at the expense of others. Markets are restricted, the allocation of property rights skewed, financial markets distorted. Eliminating unjustified interventions in the economy and improving the accountability of governments—including through greater transparency—are key.

23. *Establishing credibility.* Because investment is forward looking, uncertainty is at the center of firms' investment decisions. Firms' confidence about the future—including

the stability and predictability of government policies—determines whether and how they invest. Policy improvements that lack credibility will fail to elicit the intended investment response. Policy credibility can be undermined in many ways. Governments often face a time inconsistency problem—policies that provide long-term benefits to society can be compromised by efforts to meet shorter-term goals, whether extracting rents for the private benefit of policymakers or currying favor with particular groups of voters. A legacy of political or economic instability does not help. Credibility can also be undermined by reputation effects that the current government had no hand in making. Building credibility is fundamental to creating a sound investment climate—but requires mechanisms to restrain arbitrary behavior, and discipline and persistence as well.

24. *Fostering public trust and legitimacy.* Firms and governments do not interact in a vacuum. Trust between market participants nurtures productive exchange and reduces the burden on regulation and contract enforcement. Broader social attitudes—including trust in markets and in firms—also influence the feasibility and sustainability of policy improvements. Reducing concerns about policy sustainability also enhances policy credibility—and hence the investment response from firms. A virtuous circle. Good investment climates are nurtured by broad public support—by a social consensus that can support ongoing policy improvements regardless of the political party or group in office. Open and participatory policymaking, transparency, and efforts to ensure that opportunities for growth are shared equitably in society—all play a role.

25. *Ensuring policy responses reflect a good institutional fit*. To be effective, policy interventions need to be designed to take account of potential sources of government failure, as well as differences in local conditions, capacities, and priorities. Yet too often policy frameworks and regulatory regimes have been uncritically transplanted from other countries, with problems of poor institutional fit resulting in market failures being left unchecked—or interventions making matters worse. Problems of poor policy design often date back to colonial eras, when developing countries inherited regulatory approaches that had little to do with local circumstances. And many of these museum pieces remain on the books today, many decades later. In addition to modernizing their regulatory approaches, governments need to ensure new proposals reflect current day realities, and are kept under regular review to take account of changing conditions.

Making progress

26. While this list of challenges may seem daunting, a growing number of countries are making progress in creating better investment climates—and reaping the rewards of faster growth and sharper poverty reduction. Experience in countries as diverse as China, India and Uganda highlight some of the ingredients for success.

27. *Grappling with a broad agenda*. Government policies and behaviors shaping the investment climate play out over a broad domain, from contract enforcement and business regulation to the provision of infrastructure and labor market policy. Each can influence the opportunities and incentives facing firms. And the policy areas often interact, with the state of progress in one area potentially influencing the impact of changes in others. This implies a broad agenda for government. But no country has a perfect investment climate,

and nor is perfection on even one dimension necessary to ignite growth and poverty reduction. Experience shows that progress can be made by addressing key constraints in a credible way—and managing a process of ongoing improvements.

28. Take China and India, countries that have achieved impressive growth and poverty reduction in recent years. The share of China's population under the $1 a day poverty rate fell from 64 percent in 1981 to less than 17 percent in 2001; India's fell from 54 percent in 1980 to 35 percent in 2000. But even today neither country has an ideal investment climate. China still gives incomplete constitutional recognition to private property, and its banking sector is dragged down by nonperforming loans. Problems in India's power sector are legendary. Yet both countries unleashed growth through what appeared to be relatively modest initial reforms that addressed key constraints affecting large parts of their economies. China began by introducing a rudimentary system of property rights that created new incentives for a substantial part of its economy. India began with early efforts to reduce trade barriers and other distortions that covered a significant part of activity. And both countries have continued with a process of investment climate improvements that addressed constraints that were less binding initially.

29. Nor are such strategies limited to large countries. Uganda moved from civil conflict to respectable growth and poverty reduction in less than a decade, thanks to progress in addressing constraints in many areas of its investment climate. And the persistence of its efforts enhanced the government's credibility—increasing the confidence of firms and entrepreneurs of all types and sizes to invest.

30. Early rounds of economic reform were sometimes seen as one-off events. In contrast, investment climate improvements involve an ongoing process of policy adjustment and fine-tuning across a broad domain. This is as true in today's rich countries as in emerging economies. Current policies need regular review to reflect changes in the way business is conducted, changes in technology, and lessons of ongoing experience. Michael Porter has suggested that reforms in this area are a marathon, not a sprint. But even that assessment may understate the task.[2]

31. Strategies for managing this change process must address each of the challenges just highlighted. Because conditions and priorities vary widely between countries, there are no universal templates or formulas. But experience does offer insights into the essentials of effective strategies and their implementation.

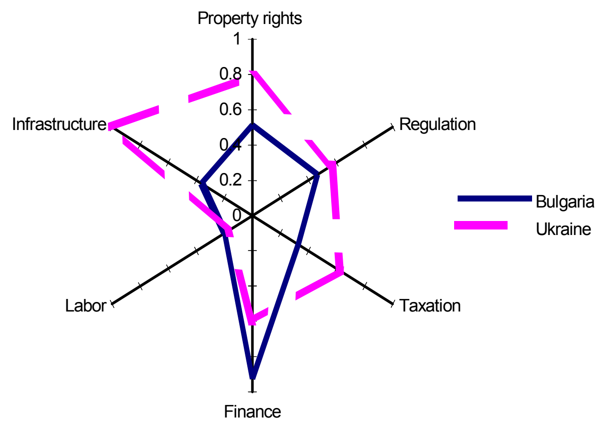
Setting priorities

32. The goal is to identify and address binding constraints in a credible way. Key constraints will be a function of a society's initial conditions, the expected benefits from improvement (including possible spillover benefits), and national or regional strategies.

33. *Assessing initial conditions*. The most binding constraint will often vary by country, and firms can help to identify them through surveys or other consultation processes (figure 13). New micro-level data also facilitate the benchmarking of a growing

number of policy variables against international comparators—to indicate the scope for feasible improvement.

Figure 13 Constraints expressed by firms—Bulgaria vs. Ukraine



Note: Indices based on surveys of formal sector firms. Values are normalized by regional maxima and minima for each indicator. Resulting indicators range from 0 (best) to 1 (worst). Countries chosen to highlight potential differences.

Source: World Bank Investment Climate Surveys.

34. When the goal is to accelerate growth, a small improvement that affects a large part of the economy may have a bigger impact than bolder reforms involving smaller groups. Progress in achieving macroeconomic stability is fundamental, as without it other policy reforms will gain little traction. Enhancing government credibility can also improve the response from reforms in other areas. A key consideration will be the impact of reforms on opportunities for poor people—as workers, as entrepreneurs, or as consumers.

35. *Leveraging possible spillovers.* When assessing the benefits of addressing particular constraints, possible spillovers beyond the firms and policy areas affected most directly also need to be considered.

- Spillovers to other firms—for example, foreign direct investment can lead to technology and other spillovers to local suppliers and customers.
- Spillovers to other policy areas—for example, securing property rights can ease access to finance.
- Spillovers to government credibility—for example, the way improvements are designed and implemented can help or harm credibility and so influence the level of investment response.
- Spillovers to government capabilities—for example, improving the administration of tax or customs administrations can increase the resources available to make other improvements.

- Spillovers to broader social goals—for example, improving infrastructure and financial markets can also provide benefits that extend beyond firms to communities.

- Spillovers to constituency building—for example, reducing barriers to new business formation may increase the pool of firms with an interest in broad-based investment climate improvements.

36. *Mapping to national or regional concerns*. A good investment climate will help to integrate the informal and rural economies, enable successful firms to expand, take advantage of international openness, and allow firms to climb the technological ladder. Constraints facing each of these objectives can differ, and the priority given to each needs to be reflected in broader strategies.

- *Integrating the informal economy*. The informal economy accounts for over 50 percent of GDP in many developing countries. While less constrained by taxes and regulations, firms in the informal economy have less secure property rights and more difficulty getting public services. Removing constraints to their integration into the formal economy involves addressing the constraints they find most binding—and reducing obstacles to going formal.

- *Integrating the rural economy*. Firms in rural areas tend to face less hospitable investment climates than those in urban areas due to lower population densities, greater distances to larger markets, and fewer public services. Improving infrastructure can make a big difference. But because infrastructure provision is usually more costly than in urban areas, governments need to weigh the tradeoffs between improving the investment climates in rural areas and allowing urbanization to move forward.

- *Unleashing constraints to firm expansion.* Small and medium-sized firms, the most numerous in most societies, tend to face disproportionate burdens in coping with poor investment climates. Some of the bolder claims advanced to justify special policy privileges for small and medium-sized firms are difficult to substantiate. But addressing constraints that place a particularly heavy burden on smaller firms can ensure successful firms have the opportunity to expand and so enhance their contributions to growth and poverty reduction.

- *Taking advantage of international openness*. Most countries have made a decisive shift toward more open economies—and firm-level evidence confirms that they are reaping the benefits in higher productivity. Beyond reducing remaining trade and investment barriers—still much higher than in industrial countries—progress often requires efforts to tackle constraints in areas like ports and customs administration.

- *Climbing the technological ladder*. Technical progress plays an important role in productivity improvement and growth. But countries do not need to invent everything afresh. Reducing policy barriers to the adoption or adaptation of technologies developed elsewhere is a first step. Skilled workers, secure property rights, and competitive pressures all play critical roles in allowing firms to move into more technologically sophisticated industries.

Catalyzing and managing change in individual policy areas

37. Any policy change has the potential to create winners and losers. Many investment climate improvements need to take on the vested interests that benefit from market distortions or other special privileges and so have strong incentives to resist change. This can apply to incumbent firms, to officials benefiting from informal payments, and to a range of other special interests.

38. Experience shows that a diverse range of factors can serve to catalyze change. But new information and a degree of competition between jurisdictions often play significant roles. Progress is possible when governments are committed, consult those affected, build coalitions for change, and, when appropriate, provide some form of compensation. If workers are hurt by change, special measures can help them cope during the transition. Moving toward a more productive and dynamic society usually implies greater job mobility, reinforcing the importance of effective social safety nets.

Maintaining momentum

39. Many governments are creating dedicated institutional arrangements to help sustain an ongoing process of improvements. These include special consultative structures to draw on the perspectives of a range of stakeholders. Policy coordination mechanisms. Policy review processes. And the institutionalization of reform champions. Experience in countries as diverse as Singapore, Mexico, Senegal, Vietnam and Turkey suggest that these mechanisms can play an important role—but ultimately depend on a high level of political commitment.

Building government capabilities

40. Individual investment climate improvements differ in their demands on resources and expertise. Substantial resources may be required to expand roads while other improvements involve fewer demands and many others enhance government revenues. The expertise required to design and administer reforms also varies across policy areas but is usually more demanding at the design than the administration stage. There is growing experience in how to leverage scarce expertise and build capability.

41. Governments also need mechanisms for monitoring the performance of their private sectors to identify trends and emerging issues and evaluate the impact of their policies. Improving the quality of national statistical systems can play an important role.

Focusing on the basics

42. Firms of all types and sizes benefit from more secure property rights, sound approaches to regulation and taxation, adequate infrastructure, and well-functioning finance and labor markets. Because industrial development is usually a process of discovery, it is difficult to predict what a country or region will be good at producing. This underscores the importance of improving the investment climate for all firms and activities in the economy—or getting the "basics" right.

43. Making investment climate improvements requires grappling with the detail of policy changes in a range of areas. International experience offers practical insights into opportunities for improvements in each area.

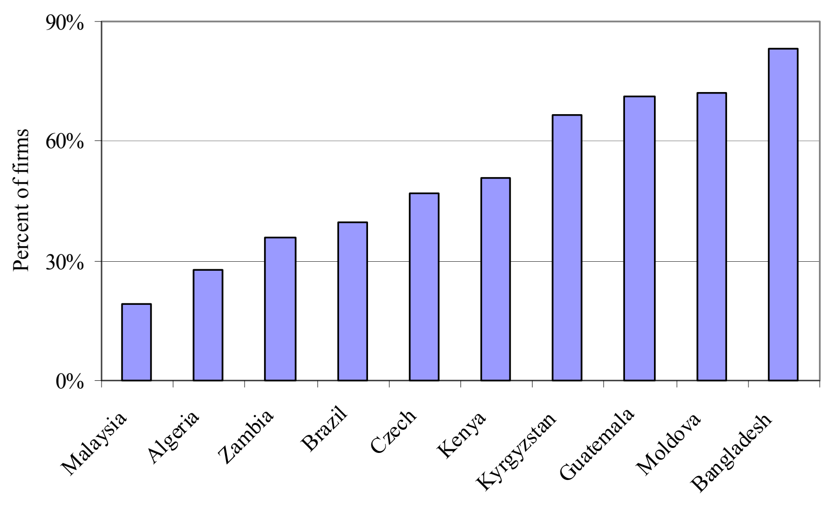
Security and stability

44. The outbreak of war or other widespread violence spells the end of almost all productive investment. But firms require more than peace to commit energy and resources to investing productively. They require an environment in which rights are secure, personnel and property are reasonably safe from criminal acts, and government policy exhibits at least some predictability. An insecure or unstable environment has its most tangible effect on property rights.

45. Secure property rights link effort with reward, assuring all firms—small and large, informal and formal, rural and urban—that they will be able to reap the fruits of their investments. The better protected these rights from government or third parties, the stronger the link between effort and reward and thus the greater the incentives to open new businesses, to invest more in existing ones, and simply to work harder.

46. New evidence confirms how important secure property rights can be. Surveys from Poland, Romania, Russia, Slovakia, and the Ukraine show that entrepreneurs who believe their property rights to be secure reinvest between 14 and 40 percent more of their profits in their businesses than those who don't. Farmers in Ghana and Nicaragua invest up to 8 percent more in their land when their rights to it are secure. And confidence that courts will uphold property rights is low in many countries (figure 14).

Figure 14 Share of firms that do not believe the courts will uphold their property rights



Source: Investment Climate Surveys. Countries chosen to illustrate range.

47. Studies across a broad range of countries find that the more secure the rights, the higher the growth. More secure rights also help poor people directly. The Report highlights opportunities for improvement in five key areas:

- Verifying rights to land and other property.
- Improving mechanisms for exchanging rights (including contract enforcement).
- Reducing crime.
- Halting the uncompensated expropriation of property.
- Reducing policy instability and uncertainty.

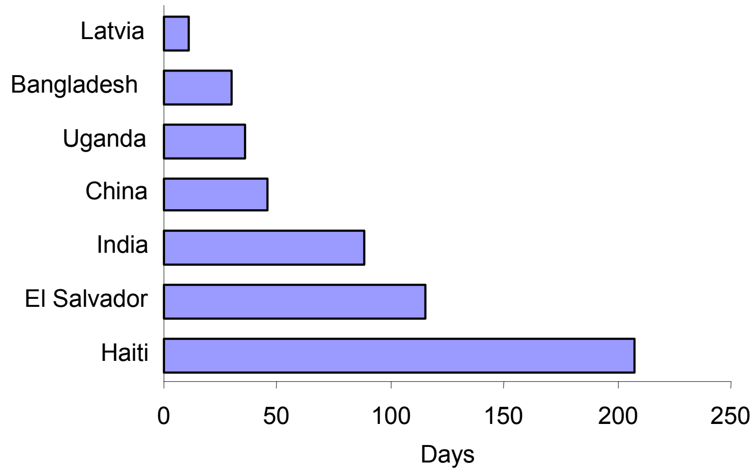
Regulation and taxation

48. The way governments regulate and tax firms and transactions—domestically and at the border—plays a large role in shaping the investment climate. Sound approaches to regulation address market failures that inhibit productive investment and reconcile the interests of firms with wider social goals. Sound approaches to taxation generate the revenues to finance the delivery of public services that improve the investment climate and meet other social objectives. The challenge all governments struggle with is how to meet these objectives without undermining the opportunities and incentives for firms to invest, create jobs, and so contribute to growth and poverty reduction.

49. While there are tensions between the preferences of firms and social goals in this area, there is huge scope for improving approaches in most developing countries without compromising broader social interests. Too often, governments pursue approaches that fail to meet the intended social objectives yet harm the investment climate by imposing unnecessary costs and delays, increasing uncertainty and risk, and creating unjustified barriers to competition. When this is so, there is scope for improving performance against both objectives without having to confront difficult tradeoffs.

50. For domestic regulation, common problems flow from two main sources. First, many regulatory systems in developing countries have been uncritically transplanted from other countries without sufficient consideration of differences in local conditions and capacities. When this is so, formal rules have little to do with practical realities and are ignored or used primarily to generate rents for officials. Second, regulatory systems in all countries are vulnerable to rent-seeking by firms, officials, or other interests, often reflected in unjustified restrictions on competition or red tape (figure 15). The Report highlights opportunities to adjust regulatory approaches to strike a better balance between market failures and government failures. The emphasis should be on tailoring regulatory strategies to local conditions, enhancing transparency and predictability, reducing red tape, and facilitating competition by removing unjustified barriers to entry and exit and addressing anticompetitive behavior by firms.

Figure 15 Number of days to register a new business—from 11 days in Latvia to 203 in Haiti



Source: World Bank Doing Business Database. Countries chosen to illustrate range.

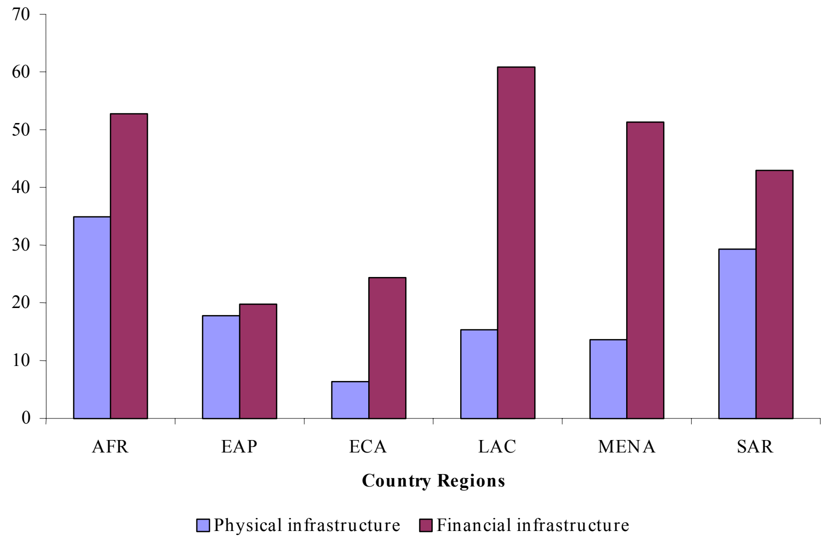
51. Tax rates in developing countries are broadly comparable to those in industrial countries. But a high level of informality coupled with poor administration and corruption reduce revenue collections, put a disproportionate burden on those who do comply, and distort competition. The most promising approach is to simplify tax structures and improve tax administrations, including autonomous tax agencies.

52. Most countries have reduced barriers to international trade and investment in recent years, with promising impacts on the productivity of firms. But barriers still tend to be much higher than in industrial countries, poorly performing customs administrations often impose large burdens on firms, and regulatory regimes for foreign investors still often involve excess red tape.

Finance and infrastructure

53. Well-functioning financial markets connect firms to sources of credit and equity to fund their ventures. Telecommunications, electricity, roads, and ports connect firms to their customers and suppliers and help them take advantage of modern production techniques. Inadequacies in both areas increase the costs and risks for firms and can act as barriers to competition. And the inadequacies can be huge in many developing countries (figure 16).

Figure 16 Many firms rate finance and infrastructure as a "major" or "severe" constraint



Source: World Bank Investment Climate Surveys.

54. The underlying problem in both areas can be traced to a specific market failure—for finance, to information asymmetries; for physical infrastructure, to economies of scale and resulting market power. But they also share a history of having been plagued by political economy problems that lead governments to intervene in ways that can make the underlying problems worse.

55. Financial markets have been held back by state ownership, monopolies, directed or subsidized credit, and other policies appealing to the short-term interests of politicians and favored groups. Those measures undermine financial sector development, firm-level productivity, and economic growth. Infrastructure has too often been handicapped by governments using state ownership or regulation to pursue objectives unrelated to efficient service provision, typically favoring some groups over broader interests, and introducing new sources of inefficiency.

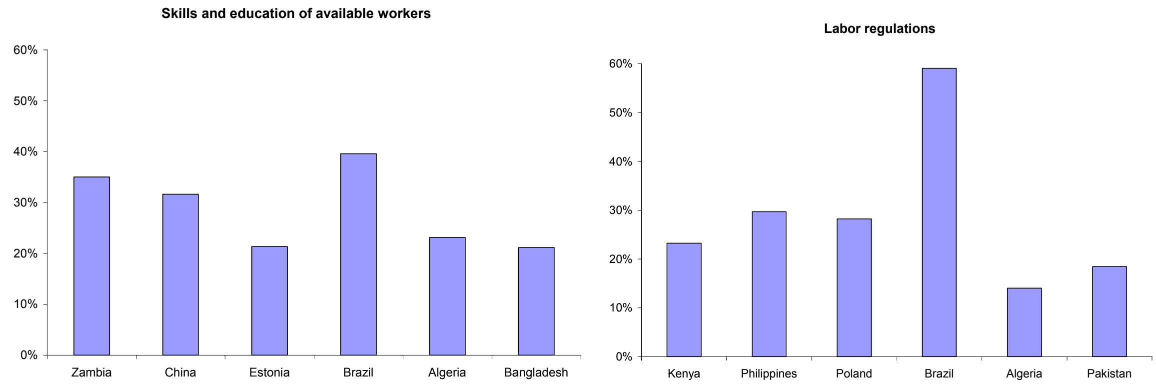
56. Governments are grappling with these issues, but progress remains uneven. New approaches require them to be less hands-on in delivering services and to focus instead on creating a sound investment climate for commercial providers of finance, telecommunication, electricity, port, and (where feasible) road services. Finance and infrastructure thus have two relationships with the investment climate: they affect the investment climate for firms in general; and the investment climate for providers of finance and infrastructure affects the overall investment climate.

57. For finance, promising approaches include strengthening creditor and shareholder rights, reducing barriers to competition (including paving the way for non-bank financial intermediaries and commercial microfinance), establishing credit bureaus and other mechanisms to address information problems, and improving bank regulation. The approaches for infrastructure share some common elements, and the Report looks at how competition, improved regulation, private participation, and better ways of managing public expenditure can help to deliver those improvements.

Workers and labor markets

58. Firms in many developing countries rate skill shortages and labor regulations as tight constraints on their operations (figure 17).

Figure 17 Firms often rate skill shortage and labor regulations as "major" or "severe" constraints



Note: Percentage of firms (20 employees or more) reporting that Labor regulations or Skills and education of available workers were a major or severe obstacle to the operation and growth of their business.

Source: World Bank Investment Climate Surveys.

59. Government policies in both areas have wide-ranging impacts on the investment climate. Shortages of skilled labor prevent firms from entering new markets or adopting more advanced technologies. And regulations can restrict the ability to adjust the organization of work, reducing incentives to pursue new opportunities. While labor is essential for firms, access to productive jobs that offer decent pay largely determines the well-being of people. Technical progress that leads to higher productivity and economic growth also improves working conditions and wages. But it also involves rapid changes in industries and firms. The Report looks at three specific issues:

60. *Enhancing human capital*. To strengthen the two-way links between human capital and the investment climate, governments can make education more inclusive and relevant to the skill needs of firms. This may also involve improving the investment climate for private providers of education and vocational training.

61. *Regulating labor markets.* In many countries, current labor regulations provide a high standard of protection to a few workers but no, or minimal, protection for most of those in the informal economy, including the young and the unskilled. Indeed, in many cases regulatory approaches contribute to informality and unemployment. Looking at the experience with labor market reforms in developing countries, the Report highlights opportunities to adapt regulations to produce greater equity in the workforce through greater access to decent jobs and better economic outcomes.

62. *Helping workers cope with change.* Helping workers cope with greater labor mobility is an important complement to a sound investment climate. Even within limited public budgets, improving the insurance component in income support schemes and the

pooling the risks across individuals can go a long way toward smoothing adjustment costs for workers.

Going beyond the basics?

63. Broad-based improvements to the investment climate—the basics just described—expand the pool of beneficiaries, reduce concerns about rent-seeking, and avoid new distortions. But many governments pursue more selective interventions that confer special policy privileges on some firms or activities—market restrictions, tax breaks, access to subsidized or directed credit, and a range of other measures. The volume of international rules and standards that deal with the investment climate has also grown dramatically over the past two decades. What role might these measures play in helping to improve the investment climates of developing countries?

Selective interventions

64. Selective interventions take many forms and have many objectives. A review of international experience in this area reveals few sure-fire strategies. Some countries in East Asia appear to have drawn on selective interventions successfully, but recent work suggests that their contributions were relatively modest. And experience shows how difficult it is to replicate similar approaches in other countries and in a very different international environment. Experience with government efforts to "pick winners" is also not encouraging. And efforts to woo investors through tax holidays or other special inducements have met with mixed success—even when investment expands, it is difficult to know whether the incentives were necessary or cost-effective. Indeed, there are many examples of selective interventions going deeply awry—at best wasting public resources, but sometimes creating large distortions that harm the investment climate rather than improve it, and distracting attention from broader-based improvements.

65. Even in the best of circumstances most selective interventions seem to be a gamble—and can go spectacularly wrong in any country. The more ambitious the goals and the weaker the governance, the longer the odds of success. This suggests that selective interventions should be approached with caution, and not as a substitute for broader investment climate improvements. Schemes with clear objectives, discipline, transparency, and regular review are less vulnerable to going astray.

International rules and standards

66. The body of international rules and standards dealing with investment climate matters has grown exponentially in recent decades. There are more than 2,200 bilateral investment treaties and more than 400 regional cooperation arrangements. There is also a plethora of new and proposed multilateral instruments on everything from trade, bribery, and corporate governance to taxation and environmental and labor regulation. International arrangements can play an important role in reducing policy barriers to international trade and investment. But the Report focuses on three other ways international arrangements might contribute to investment climate improvements.

67. *Enhancing government credibility*. Entering international arrangements can reinforce the credibility of government policy commitments and so strengthen the investment responses of firms. But by design the tradeoff is forgone policy flexibility, which means that commitments need to be considered carefully. Strategies that involve the strongest form of credibility enhancement—by allowing firms to enforce treaty commitments against government directly—benefit from efforts to enhance the transparency and perceived legitimacy of the process. Strategies that rest more on the reputation effects of governments can contribute to policy credibility, but their impact will depend on whether participants insist on high levels of compliance from one another.

68. *Reducing costs in international transactions.* To reduce costs in international transactions, many international efforts focus on harmonizing or standardizing particular regulatory requirements, with examples ranging from the harmonization of business laws in West Africa to the development of uniform accounting standards. There can be many benefits for developing countries. But there can also be tensions between adopting common standards and adapting approaches to local conditions and capacities. And there are tradeoffs between efforts focusing on multilateral, regional, and bilateral approaches to harmonization.

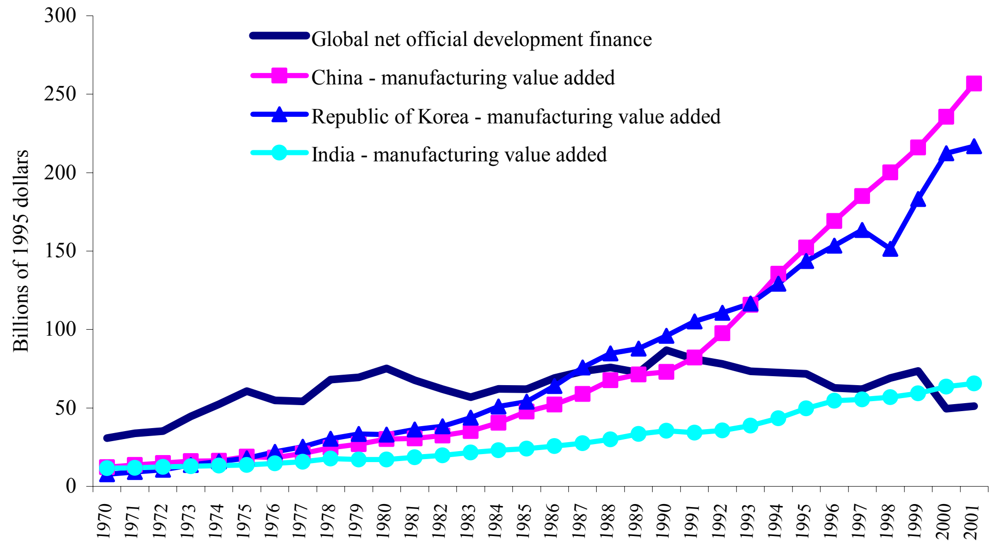
69. *Addressing international spillovers.* Over the past two decades concerted global action has been promoted for a growing number of matters of common concern—where policy actions by one country may have spillover impacts on others. Addressing international spillovers in the environmental area can be important. But when the suggested spillover is less tangible, or the benefits shared less widely, cooperative action is more difficult to justify and to attain. With taxation, for example, concerns have been expressed about the potential for competition for investment between countries to lead to a "race to the bottom" in tax collections, to the detriment of global public welfare. Similar concerns are sometimes expressed about environmental, labor, and other regulations. Experience so far suggests little evidence of the feared collapses in taxes or standards. But there are also practical issues of trying to find common ground. Proposals in these and other areas need to give due weight to the perspectives of developing countries.

How the international community can help

70. Responsibility for improving their society's investment climate lies with governments of developing countries, both national and subnational. But the international community can lend a hand.

71. Helping to improve investment climate conditions can provide huge development dividends. The manufacturing value-added unleashed by investment climate improvements in even a single country can far exceed the development assistance provided worldwide (figure 18). The international community can help developing countries reap these rewards in three main ways.

Figure 18 Manufacturing value added in a single country can far exceed net global official development finance



Source: OECD and World Bank (2003).

Removing distortions that harm investment climates in developing countries

72. Developing countries are not alone in grappling with investment climate improvements. The trade and market distortions created by policies in industrialized countries impose large costs on their own economies. But those distortions also undermine opportunities and incentives for firms to invest in developing countries. It has been estimated that removing trade protection and related distortions in industrial countries would lead to welfare gains of about 2 percent of GDP for developing countries—or almost twice the current level of official development assistance.

Providing development assistance

73. Development assistance can play an important role in helping developing countries design and implement investment climate improvements. Many issues associated with development assistance for the investment climate are common to development assistance more generally. But there are opportunities to improve the effectiveness of development assistance for the investment climate in several areas:

- Public investment can leverage rather than crowd out private initiative.

- Technical assistance on the design of regulatory regimes can place greater emphasis on ensuring approaches are adapted to country circumstances and priorities.

- Multidonor facilities can leverage resources and improve the quality of technical advice.

- The substantial support provided directly to firms and transactions can be leveraged to expand its impact on the broader investment climate.

Tackling the knowledge agenda

74. New sources of micro-data of the kind exploited in this Report represent an important step forward in understanding the microeconomic foundations of growth and poverty reduction. But a large agenda lies ahead in broadening and deepening this understanding to provide practical guidance to policymakers. Two areas warrant particular attention:

- Expanding development of comparable cross-country measures of the investment climate to help policymakers benchmark performance and monitor progress. Information of this kind can also spur reform.

- Expanding research and deepening country-level analyses to deepen understanding of the links among investment climate conditions, firm performance, and growth and poverty.

75. By working together on these themes, the international community can make a significant contribution to growth and poverty reduction in developing countries—and so help to build a more balanced and inclusive world.

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[1] United Nations (2002).
[2] Porter and others (2004).