Chapter 2 Challenges to improving the investment climate

2.1 An investment climate that enhances the opportunities and incentives for firms of all types and sizes to invest productively, create jobs, and expand is the key driver for growth and poverty reduction. That was the message of chapter 1—a message understood by more governments around the world. But if a sound investment climate is so beneficial, and understood to be so by governments, why are there such large variations in investment climate conditions across and within countries? And why is progress often slow and difficult?

2.2 The government's role in shaping the investment climate is traditionally explained by reference to market failure—or the failure of *laissez faire* conditions to achieve efficient social outcomes. This is the textbook rationale for most government interventions in the economy, including the provision of public goods such as law and order, support to the provision of infrastructure, and regulation of firms and transactions to address information asymmetries, externalities, and market power.

2.3 But it has long been recognized that markets do not have a monopoly on imperfection. Government interventions often fail to mitigate market failures—and can make matters worse. And those failures often come to the fore in policymaking for the investment climate, where governments must confront a basic tension. Firms are the primary creators of wealth, and a good investment climate must be responsive to their needs. But a sound investment climate should serve society as a whole, not only firms, and the preferences of the two can diverge. There can also be differences in the policy preferences and priorities between and within firms. Creating a sound investment climate requires governments to arbitrate between these interests.

2.4 Responding to this tension creates four practical challenges. Differences in the way governments respond to those challenges can have a big impact on investment climates and so on growth and poverty.

- *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.

- *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. Policies that lack credibility will fail to elicit the intended investment response, no matter how well-crafted the law or sincere the policy pronouncement.

- *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. And concerns about policy sustainability can undermine policy credibility. Broad notions of trust and legitimacy can thus help or hinder progress in improving the investment climate.

- *Ensuring policy responses reflect a good institutional fit.* A government's ability to meet the challenges associated with creating a better investment climate is in part a function of the resources and expertise at its disposal. But it is also a function of crafting policy responses that take into account sources of government failure and differences in local capacities, conditions, and priorities. Inadequate consideration to questions of institutional fit can lead to poor results.

2.5 This chapter reviews the nature of the tension and the resulting challenges to understand the implications for accelerating improvements in investment climate conditions. The main message: improvements are certainly possible, but accelerating and broadening progress requires more than just building more infrastructure, writing new laws, and handing out more tax breaks. They require persistence and a willingness to tackle deeper sources of policy failure.

The underlying tension: firm preferences and the public interest

2.6 Charles "Engine Charlie" Wilson is famously misquoted as claiming, "What's good for General Motors is good for the country."[1] This sentiment lays bare the potential indifference of firms—through the ages—to the public interest. It also highlights an important tension governments face in establishing a favorable investment climate.

2.7 Firms are the generators of wealth and employment in society, and an investment climate that is hostile to firms cannot expect to promote economic growth or reduce poverty. So creating a favorable investment climate must begin with an understanding of the perspectives and preferences of firms. But firms exist to make profits for their owners—something they've done for thousands of years (box 2.1)—and their policy preferences are guided by that objective. In contrast, government policies need to balance the preferences of firms with other social objectives. This requires governments to understand where the preferences of firms may diverge from broader social interests, and to deal with the implications of differences in preferences between and within firms.

Box 2.1 Firms in history

From ancient times, people have been striving to increase their opportunities by moving from subsistence to exchange and investment. As far back as 3000 BC business arrangements in Mesopotamia went beyond simple barter. Sumerian families who traded along the Euphrates and Tigris rivers developed contracts that tried to rationalize property ownership. A thousand years later the Assyrians developed an early version of a venture capital fund.

Early predecessors of companies appeared in Rome by the second Punic War (218–202 BC). For much of the Middle Ages guilds were the most important form of business organization. In the sixteenth and seventeenth centuries governments and merchants combined efforts to create chartered companies to exploit the riches of the new world. While the twentieth century saw widespread experiments with public enterprise, the subsequent disenchantment led to a renaissance of private enterprise. Today, fixed capital investment by the private sector accounts for the bulk of investment in developing countries.

Private trade and investment are not only ancient—they are extremely hard to repress. Some private investment continues even in Somalia's war zones. And there is recent acknowledgement of private enterprise even in North Korea. In the meantime, private activities are becoming more global: trade as a share of global GDP rose from 25 percent in 1960 to 57 percent in 2001, and world FDI flows reached $1.4 trillion in 2000.

Sources: Micklethwait and Wooldridge (2003b); IMF (2003); Bates (2001); Bernstein (1996); Yergin and Stanislaw (2002); World Bank (1996); McMillan (2002); The Economist (2003); Chinoy (1998); World Bank (2003b); United Nations Conference on Trade and Development (2003).

2.8 Stable macroeconomic policy, secure property rights, reliable infrastructure, and efficient finance markets benefit both firms and society. But there is potential for divergence in some areas. Obviously, most firms would prefer to pay less in taxes—including taxes required to sustain the public services they benefit from and to fund other social objectives. Many firms would prefer to comply with fewer regulations—including those intended to safeguard the environment or other important social interests. Most firms would also welcome access to subsidized credit—irrespective of the policy justification or implications for financial sector development. And most firms would welcome monopolies or other restrictions on competition to increase their profits and reduce the pressure to innovate and perform efficiently—regardless of the implications for society. Similar tensions can arise in most areas of investment climate policy.

2.9 This does not mean that firms are rogues or bandits. Most individuals would also prefer to pay less in taxes and welcome subsidized loans. And many firms voluntarily accept obligations beyond those required by law, whether through a sense of social philanthropy, as a form of brand differentiation, to protect their reputation, or to earn the support of their workers and surrounding communities (box 2.2). And while international economic integration is increasing pressures on firms to build and maintain good reputations, this is not a new phenomenon: even the infamous United Fruit Company provided its workers in Guatemala with schools and hospitals.[2]

Box 2.2 Firms and social responsibility

The debate on the extent of firms' responsibility to social concerns has a long history. Part of it stems from different conceptions of the objectives of firms. The Anglo-American model focuses primarily on the importance of maximizing shareholder value, though corporate philanthropy has long been important. European and Japanese models put more weight on other stakeholders, especially workers. While there has been some convergence between models, there are still debates about how much firms can worry about things besides profits—or should.

Beyond taxation, some social obligations are imposed by regulation. But some firms voluntarily accept broader obligations. For example, multinationals operating in developing countries often exceed minimal local regulations—Graham documented that affiliates of U.S. multinational enterprises pay a wage premium of 40 percent in high-income countries and 100 to 200 percent of local average wage in low-income countries.

It can be hard to distinguish motives for these behaviors. At one level, it might be perceived to be in the best interests of the firm taking a broad view of reputation and risk. Firms may do it to protect their interests in a healthy workforce, like some firms in Africa that provide AIDS drugs to workers. Some consider it part of a brand differentiation strategy, such as with dolphin-free tuna, no animal testing for The Body Shop, or socially conscious mutual funds.

Other firms are responding to concerns about reputation. Nike and Disney have worked to improve working conditions in their plants in Asia, following criticisms and protests from civil society. More and more companies are adopting codes of conduct as business ethical guidance. About 20 banks worldwide have adopted the Equator Principles, a voluntary set of guidelines for managing social and environmental issues related to financing development projects, based on the policies and guidelines of the World Bank and International Finance Corporation.

Sources: Graham (2001); The Economist (1999); The Economist (2002); The Equator Principles website

2.10 Nor are there always tradeoffs between the preferences of firms and other social goals even in matters of regulation and taxation. Improving the management of regulatory or tax systems can reduce the administrative (and corruption) burden on firms, but also contribute to better regulatory compliance and higher tax revenues. When regulatory regimes have not been reviewed in decades, are only partially enforced, and are used more to extract bribes than to protect broader social interests—a phenomenon too common in many countries—the opportunities for "win-win" solutions can be huge (chapter 5).

2.11 The task of balancing the preferences of firms and broader social interests is complicated by differences in preferences and priorities between and within firms. Firms share common perspectives on many issues. But their interests may diverge on specific policy questions. This is most apparent when considering proposals to reduce barriers to competition. Proposals to lower barriers will typically be resisted by protected firms, but benefit firms that depend on products from the protected sector as inputs. For example, it has been estimated that restrictions on steel imports into the United States in 2002 cost firms relying on steel as an input two and half times the benefits to local steel producers.[3] Similarly, proposals to develop a bond market may be resisted by banks but welcomed by industrial firms.[4] Conflicts can also arise over the structure of taxation or the priority given to infrastructure development in different locations. And even when engaged in the same activity in the same location, firms of different types and sizes can face different constraints, leading to different policy priorities (box 2.3).

Box 2.3 How do firm differences affect their policy preferences and priorities?

Investment climate policymaking is complicated by differences in the preferences and priorities of firms. Those differences can relate to particular activities—farmers, manufacturers, and hairdressers can each have different perspectives. But preferences and priorities can differ along other dimensions as well.

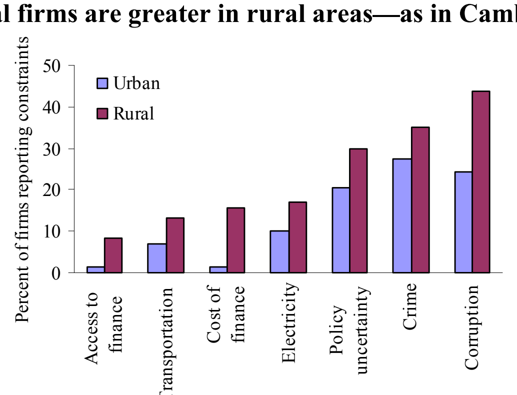
Foreign and local firms. Foreign firms still face many regulatory barriers intended to protect local firms, and foreign firms may also be more vulnerable to expropriation. Foreign firms tend to be less constrained in their access to finance than local firms, may be able to re-locate more easily in response to adverse changes in the investment climate, and may have more options for dispute resolution. Foreign firms often place more priority on infrastructure—in part reflecting more sophisticated production methods and a greater propensity to export.

Large and small firms. Fixed costs tend to impose a disproportionate burden on smaller firms. This can be true of license or permit fees or even bribes. Evidence from the investment climate surveys indicates that bribe payments as a share of sales are 50 percent larger for small firms. Large firms may make higher payments, but the burden on them may be smaller. When unreliable power supply requires firms to have their own generators, this cost can also be more significant for smaller firms. This means that smaller firms stand to benefit more from broad-based investment climate improvements than larger firms. Smaller firms also tend to have greater difficulty getting finance than larger firms and to pay higher interest rates—survey data show that small firms are 50 percent more likely to see this as a major or severe constraint. Larger firms are more likely to have a bank loan, reflecting the advantages of having a track record and holding more assets that can be pledged as collateral. Improving the operation of finance markets will thus often be a higher priority for small firms.

Formal and informal firms. Informal activities account for a significant part of economic activity in developing countries— an estimated 76 percent of GDP in Nigeria, 55 percent in Guatemala, and 50 percent in the Philippines. Although these firms operate free of many tax and regulatory requirements, they have less secure property rights and have more difficulty getting public services and obtaining finance at reasonable costs. In Peru the nominal borrowing rate for informal firms was found to be more than four times that of formal firms of similar size. And noncompliance with taxes and regulations can make them easy targets for bribes or bureaucratic harassment.

Rural and urban firms. Remoteness and lower population densities increase the costs of providing infrastructure and other public services in rural areas. Access to finance is also often more of a constraint. Informal firms in rural areas can also face more constraints than their peers in urban areas. For example, in Cambodia informal firms in rural areas reported greater concerns about infrastructure and finance than those in urban areas. But they also had greater concerns about corruption, crime, and policy uncertainty—and indeed rated these as their top three concerns.

Many obstacles for informal firms are greater in rural areas—as in Cambodia



Sources: World Bank Investment Climate Surveys. WDR survey extensions to informal sectors. Schneider (2002); De Soto (2000).

2.12 Within firms, owners, managers, and employees share some common interests but conflict on others. Recent scandals involving Enron and Parmalat highlight the potential for conflicting interests between management and shareholders on matters of corporate governance (chapter 6). There are also tensions between owners and workers over wages, benefits, and employment protection. From the owners' point of view, lower labor costs and greater flexibility in hiring and firing workers have many benefits. But workers prefer higher wages and more job protection. And regulations aimed at addressing these issues can have unintended consequences. For example, regulations that make it harder to fire workers are often seen as favoring workers over employers. But the cost of meeting those regulations is often passed on to existing workers through lower wages and to the unemployed. Some workers may benefit, but there are often subgroups with different interests (chapter 7).

2.13 These differences mean that there is no single vision of an ideal investment climate. Governments need to arbitrate between rival claims. And firms are not passive in this process. Like other interest groups, firms are often prepared to devote resources to obtain favorable policy treatment. Lobbying is an ancient art,[5] and regulated firms have a long history of trying to win favorable treatment from their regulators.[6]

2.14 Managing the tension between firm preferences and broader social interests gives rise to four practical challenges for investment climate improvements. Restraining rent-seeking. Establishing credibility. Fostering public trust and legitimacy. And ensuring policy responses represent a good institutional fit.

Restraining rent-seeking

2.15 When asked why he robbed banks, Willie Sutton was reported to have replied that is was because "that's where the money is."[7] In a similar way, investment climate policymaking can act as a magnet for rent-seeking by firms, officials and other interests.

2.16 Rent-seeking can take many forms. Corruption and outright predation are the most obvious. But it can also include a range of more subtle forms that do not necessarily involve the breaking of laws or the exchange of cash. Capture, patronage, and clientelism can all undermine the development of a sound investment climate.

Corruption and predation

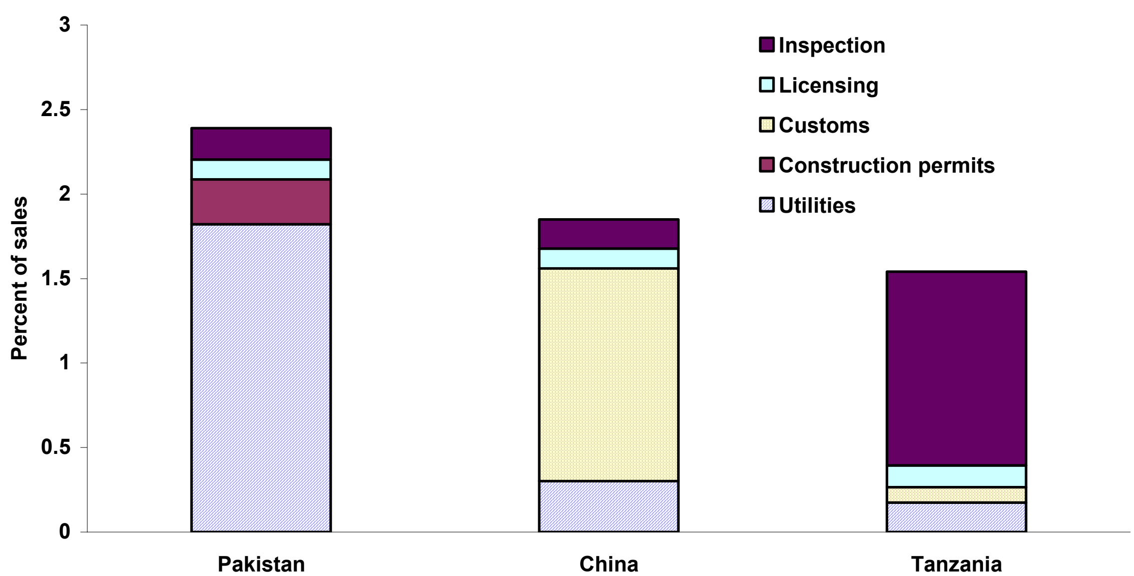
2.17 Corruption—or the exploitation of public office for private gain—can harm the investment climate in several ways.[8] When it affects the highest levels of government, it can deeply distort policymaking on a grand scale and undermine the credibility of government. But even when played out through officials at lower echelons of government, it can be a tax on private activity, another cost for firms, divert resources from the public coffers, and create a constituency for erecting or maintaining unnecessary red tape. According to the Bank's Investment Climate Surveys, the incidence of corruption varies across firms according to their size, sector, and location (table 2.1). The main locus of bribe taking can also vary from country to country (figure 2.1)

Table 2.1 Bribe payments vary by firms, industries, and regions

	Formal sector firms		Informal sector firms	
	% of firms paying bribes	*Share of sales paid as bribes*	*% of firms paying bribes*	*Share of sales paid as bribes*
Total	77.9	3.92	30.8	1.85
Firm size				
Micro (<5)	68.5	5.15	31.6	1.97
Small (5-19)	69.2	5.02	28.1	1.39
Medium (20-49)	71.5	3.91	..	..
Large (50-249)	83.3	3.46	..	..
Very large (>250)	91.2	3.15	..	..
Urban	78.0	3.97	25.9	1.63
Rural	..	..	37.0	2.05
Manufacturing	78.8	3.82	29.2	2.21
Services	57.4	6.89	35.2	2.20

Source: World Bank Investment Climate Surveys in 49 countries; WDR surveys of informal-sector firms

Figure 2.1 The main locus of bribe-taking can vary across countries



Source: World Bank Investment Climate Surveys.

2.18 Corruption is primarily a public sector phenomenon. Politicians and officials collect payments in return for favorable decisions—whether it be a high-level policy decision or more mundane matters, such as getting a connection to utilities, clearing goods through customs, or registering a business. Unlike production, rent-seeking is subject to increasing returns, in that an increase in rent-seeking activity may make rent-seeking more attractive, not less.[9] So, high levels of rent-seeking can be sustainable, and divert energy from more productive activity. No country can claim to be immune from these problems. But in the extreme a "predatory" state consumes the surpluses of the economy, as government offices come to be treated as a type of income-generating property (box 2.4).

Box 2.4 The predation of Gécamines in Mobutu's Zaïre

At independence, Congo's main asset was nothing less than a Horn of Plenty—a 300 kilometer-long, 70 kilometer-wide mining complex (*Union Minière du Haut Katanga*), renamed Gécamines after its nationalization in 1966. The Belgians had left behind a supporting network of refineries, hydroelectric installations, employee housing, schools, hospitals, and the company provided 70 percent of the country's export receipts.

The war in Katanga (Shaba) province contributed to an initial collapse of output, but by the late 1960s Gécamines had generally recovered. So important was the mine to the nation's economy that then-president Mobutu had a power line connected from the mine to electricity generators 1,800 kilometers to the north in Kinshasa as a way of forever tying the mines to the capital. The Inga-Shaba line bypassed thousands of electricity-starved villages, as well as local dams that may have supplied power to the mine more easily.

In the early 1970s the complex was producing between 400,000 and 700,000 tonnes of copper and between 10,000 and 18,000 tonnes of cobalt a year, securing annual revenues between $700 million and $900 million. For Mobutu, Gécamines was a source of ready cash. Supported by a coterie of Belgian bankers, he used diverse schemes—ranging from diverting foreign exchange receipts to presidential accounts, to forward selling of minerals with the proceeds going to the presidency—to strip the company. Not all of the proceeds went solely to the president's personal account. Gécamines was also used to guarantee state debts as well as to cover personal expenses of top executives and their families. According to one outside audit, officials were stealing around $240 million a year, often listed in corporate reports under the category *redressment exceptionnel déficitaire*—"exceptional deficit recovery."

These practices starved the company of any earnings, led to the deterioration of its fixed assets, and when copper prices collapsed in 1974, sped the company's demise. By 1990 Zairean copper cost twice as much to produce as its foreign equivalent. In 1994 production dropped to 30,600 tonnes of copper and 3,000 tonnes of cobalt a year, with zero revenues. It has been estimated that $3 billion ($2 billion to absorb the company's debts) is needed to restore annual production to 300,000 tonnes.

Source: Wrong (2001).

2.19 Some (but not all) countries that depend heavily on asset-specific, externally generated sources of income (oil and mineral exports) are also characterized by a weaker administrative apparatus and more government rent-seeking (box 2.5).

Box 2.5 Natural resource endowments: Blessing or curse?

The two main adverse effects of natural resource dependence are well known. First, a high degree of "unearned income" is likely to prompt more intense rent-seeking behavior among politicians whose incentives are influenced by the income streams from those sources. Empirical assessments of this "voracity" thesis show that sudden terms-of-trade improvements, the new discovery of natural resources, or a large stream of foreign aid can prompt a "gold rush" in which newly available rents creates a diversion from more productive activities in the economy.

Second, revenues from the rents can lead to the "detachment" of public institutions from their tax base. As the income streams from rents become the primary source of public revenue, public institutions may rely less on sound, credibly constrained tax policies, and more on the expropriation of these income streams. Far from being a boon to the state, relief from the need to develop an adequate local tax base can lead to unaccountable, inefficient, and uninformed bureaucracies.

But it is also the case that some countries have prospered thanks to resource wealth, including Australia, Canada, and Chile. How, then, to separate the positive effects of resource abundance from the adverse?

Historical and contemporary evidence suggests several possibilities. It helps if governments—colonial or indigenous—operated according to predictable, uniformly applied laws and property rights protections. It also helps if resource extraction is not dominated by monopolies. If the skill level of the workforce is sufficient to obtain productivity gains in resource-intensive sectors. And if the levels of social capital and trust are sufficient to discourage predatory behavior and destructive struggles over the sources of resource wealth. Botswana, for example, has managed to avoid many of the problems of resource wealth because of widespread trust in public institutions, fostered through many years of credible, equitable governance.

Sources: Stijns (2000), Tornell and Lane (1999), Levi (1988), Sachs and Warner (2001), Leite and Weidmann (1999), Ross (2001), Chaudhry (1997), Moore (1998).

2.20 Corruption can be traced to a combination of three things: monopoly power, discretion in the exercise of that power, and lack of effective accountability for the exercise of that discretion.[10] As Klitgaard put it:

> [C]orruption is a crime of calculation, not passion. True, there are saints who resist all temptations, and honest officials who resist most. But when the size of the bribe is large, the chance of being caught small, and the penalty if caught meager, many officials will succumb.[11]

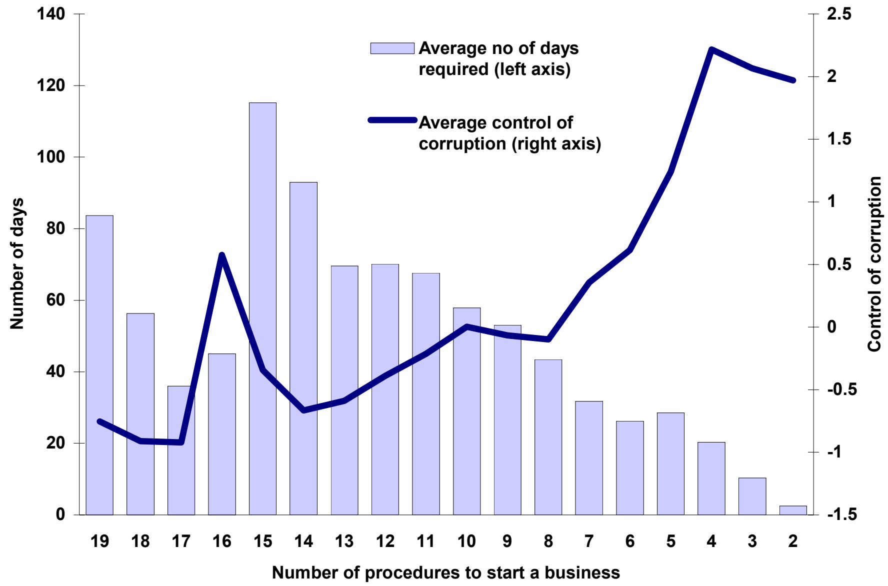
2.21 Strategies for tackling corruption focus on the same three points.

- *Reducing monopoly power*. Monopoly power can be reduced by facilitating competition wherever feasible—and reducing government interventions that do not have a compelling policy justification. Firm surveys confirm that bribe payments are higher when dealings with officials cannot be avoided.[12] And evidence suggests that countries with more interventionist approaches to business regulation tend to be associated with more corruption (figure 2.2).

- *Limiting discretion*. Discretion can be limited by reducing unnecessary ambiguity or vagueness in government policies and regulations, promptly publishing implementing regulations, and by promoting adherence to precedent by publishing administrative rulings (chapter 5).

- *Improving accountability*. Strategies include improving the transparency of government-firm transactions, developing standards of public conduct and conflict-of-interest laws, and establishing monitoring and evaluation mechanisms (including whistleblower protections).[13] A free press can play an important role in keeping potential abuses in check.[14] And a growing number of countries are creating specialist bodies to investigate and prosecute corruption and lead broader prevention strategies (box 2.6).

Figure 2.2 Less government intervention is associated with less corruption



Source: World Bank (2003a); Kaufmann, Kraay, and Mastruzzi (2003).

Box 2.6 Combating corruption in Botswana and Lithuania

In 1974 Hong Kong established a three-pronged anti-corruption strategy focused on investigation, prevention and education, and implemented by the autonomous Commission Against Corruption. Drawing inspiration from its success, similar initiatives have been adopted in countries as diverse as Botswana and Lithuania.

Botswana. Following a series of high-level corruption scandals, Botswana created a Directorate of Corruption and Economic Crime (DCEC) in 1994 with powers to investigate and prosecute suspects, prevent corruption, and educate the public. The DCEC is an autonomous agency under the Office of the President. In its first two years of operation, DCEC launched 828 investigations, bringing 141 persons before court and recovering approximately US$ 1 million in fines, forfeitures, seizures and taxes. DCEC has sustained an active publicity campaign through seminars, poster campaigns, displays at trade exhibitions, and cartoon strips, as part of the moral education of the young. In 2000 DCEC was given an additional mandate to counter money laundering.

Lithuania. In 1997 Lithuania established a Special Investigation Service that reports to the President and the Parliament. During 1995-1998, 319 prosecutions of corrupt officials were carried out, 60 percent of them involving police officers, 18 percent customs officers, and 12 percent local government officials. The number of prosecutions for bribe-taking increased seven-fold between 1997 and 2002 (from 10 a year to 73), and the cases of prosecution for abuse of office, from 2 in 1997 to 19 in 2002.

Sources: Open Society Institute (2002); Fombad (1999); Doig and Riley (1998).

Capture, patronage, and clientelism

2.22 Investment climate policies can be distorted in ways that do not involve breaking laws or the direct exchange of cash. The general idea of how the organized "few" win favors from government at the expense of the unorganized "many" has been around for a long time. Industrial-financial elites, workers, and consumers influence policymaking to very different degrees in different settings. There are two related phenomenon: capture and patron-clientelism.

2.23 *Capture*. Firms and interest groups can seek to skew policies in their favor by formal or informal lobbying—and by otherwise cajoling legislators and officials. Over time, "captured" regulatory agencies can become dominated by the industries they regulate. The concept of "state capture" has recently been used to describe how firms and other groups can shape the formation (as opposed to the implementation) of laws and policies through informal and non-transparent channels of influence, by controlling the policy agenda, or by changing the basic nature of representation and constitutional design.[15] Whether through regulatory or state capture, groups seek to acquire special privileges that establish ongoing sources of rents.

2.24 Unequal access to information between firms and consumers creates conditions ripe for capture. Firms most directly affected by laws or regulations have stronger incentives than consumers to be informed about the costs and benefits of those regimes. This information advantage can expand their relative influence in policy discussions, and create opportunities for firms to manipulate information to advance their own interests.

2.25 *Patron-clientelism.* Under conditions of capture, it is usually the private interest group that derives and extracts benefits from public officials. But officials can also have incentives to exploit relationships with these groups. In open and competitive government, representatives make policy in the interests of their constituents in exchange for their support. This is a normal part of democratic politics, and a necessary part of ensuring the accountability and responsiveness of policymakers to their citizens. But representative government can devolve into patron-clientelism when policymakers distribute policy privileges exclusively to particular groups on the basis of ethnic or cultural solidarity or other criteria unrelated to broader public interests in exchange for support or loyalty.

2.26 Investment climate policies present myriad opportunities for granting benefits to and redistributing resources towards favored groups. Policies that would benefit the investment climate may not be implemented because they cannot be used to reward loyalty or strengthen personal ties between patrons and clients.[16] The result: property rights, tax, and regulatory regimes that are designed with specific constituencies in mind. Governments suppress competition by conferring monopolies, devising market restrictions, or tolerating cartels. Tax systems become riddled with special exemptions—or are enforced selectively. Financial markets are underdeveloped because middlemen prefer to maintain their stranglehold on the allocation of funds. Public investment in infrastructure, and related tariff policies, reward favored groups.[17]

2.27 The *World Development Report 2004* highlighted three inter-related explanations for patron-clientelism: social polarization, lack of credibility among political leaders, and lack of information among citizens. In socially polarized and fragmented societies, politicians are more likely to resort to clientelistic approaches to policymaking that benefit their constituencies. When political promises are only be "credible" to particular groups, not to society at large, politicians are also more likely to parcel benefits to their clients in exchange for support.[18]

2.28 Unequal access to information is particularly important in explaining the incidence of clientelism in the investment climate. Citizens may want political leaders who will implement policies that broadly improve investment climates rather than favor particular groups, but they cannot always tell the difference—particularly when governments use less transparent forms of intervention (box 2.7). Uninformed voters are more likely to support or oppose policies based on crude "visible" criteria—for example, whether the economy seems to be prospering, whether employment levels are stable, or whether new highways are being built.[19] In many countries—rich and poor—public investment projects and targeted tax breaks tend to proliferate as elections approach.[20]

Box 2.7 The form of intervention: How many cheers for transparency?

Governments wishing to confer benefits on a particular group can choose from two main strategies. They can make an explicit budgetary transfer. Or they can create a market restriction or other distortion benefiting the favored group.

From an economic standpoint, the first approach is far more efficient. The costs are borne by taxpayers in general. And when the tax system is reasonably efficient those costs are usually of the same order of magnitude as the benefit. In contrast, market restrictions impose the costs on a subcategory of society (typically consumers), and the efficiency loss associated with the restriction means the costs exceed the benefits received. For example, restrictions on the import of steel in the United States in 2003 were estimated to deliver benefits the protected industry of $240 million, but impose costs on U.S. steel-using industries of nearly $600 million. Market restrictions also dull the incentives of the protected group to improve productivity.

Why do governments so frequently choose the less efficient option? One possible explanation is that they lack the budget resources to make direct transfers. But this is not always the case, and a tax rebate could often achieve similar results. A more likely explanation is that the latter approach is more appealing politically. The transfer is not transparent. It is not exposed to the same scrutiny as a budgeted item. And consumers or others who bear the cost are often not in a position to evaluate the costs.

Source: Tullock (1983); Acemoglu, Johnson, and Robinson (2001).

2.29 There is some evidence to suggest that the more widespread the direct personal connections between enterprise owners and politicians, the poorer the quality of a country's investment climate.[21] These political connections yield substantial benefits to firms and politicians alike, creating incentives for firms and politicians to invest in these relationships. It has been estimated that as much as a quarter of the share value of Indonesian firms before 1998, for example, could be attributed to "dependence" on the Suharto family.[22]

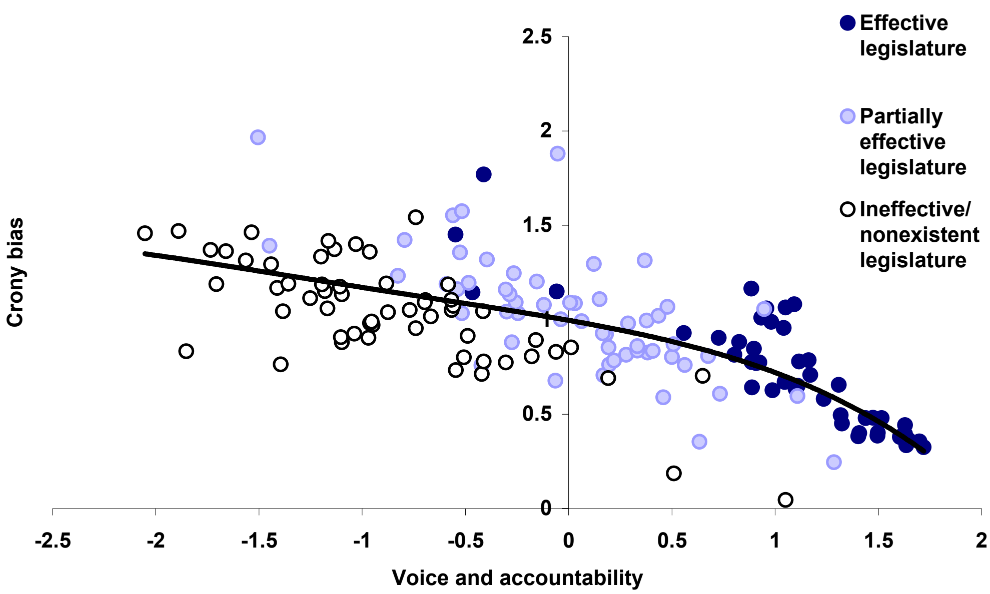
2.30 Like corruption, keeping capture and patron-clientelism in check involves efforts to broaden access to information and enhancing the accountability of policymakers. This can involve three complementary strategies:

- *Enhancing the transparency of government-firm relations*, including the design of policy interventions as well as the financing of political parties.[23]

- *Broadening policy dialogues* to include representatives of a wider range of interests, including consumers, taxpayers, and owners and employees of smaller businesses. Business associations can sometimes play a role in helping to empower smaller firms vis-à-vis traditional elites (box 2.8).

- *Strengthening accountability mechanisms*. Competitive legislatures permit disenfranchised groups to challenge the authority and privilege of incumbents (figure 2.3).[24] Strong legislatures also make it more difficult for executive-branch policymakers to deliver clientelist policies without legislative approval.[25] Expanding legislative authority over budgetary matters and strengthening oversight of regulators has reduced both the "preferentialism" in taxation and the prevalence of regulatory capture.[26] A free and independent media can help by making the public aware of the costs of clientelistic practices, and reinforce accountability through the ballot box.

Figure 2.3 Cronyism is reduced by greater accountability—and legislatures play an especially important role



Notes: "Crony bias" (vertical axis) is the difference between perceived influence of firms with political ties and influence of business associations, based on WEF *Executive Opinion Surveys*. Voice and accountability (horizontal axis) reflects various mechanisms to ho hold governments accountable, based on Kaufmann, Kraay, and Mastruzzi (2003). Measures of legislative effectiveness are based on Banks (2001). *Source*: IMF (2003), calculated in Kaufmann (2003), and Banks (2001).

Box 2.8 Business associations and the investment climate

Business associations can be economywide or "peak" associations, such as confederations of industry, manufacturers' associations, and entrepreneurs' associations. Or they can be sectoral lobbies. Formal business associations can lower the costs of information and help firms seek opportunities and make transactions in new markets.

Business groups can consolidate the influence of already powerful groups—or give voice to the interests of firms that might not otherwise be heard. In India the Self-Employed Women's Association elevates the policy concerns of more than 300,000 members working in the informal economy. The influence that groups wield is a function of their size, the commonality of group interest, and the ability to overcome collective action problems.

Businesses and other groups are more likely to support a sound investment climate when:

- They are free of state influence and are not reliant on governments for resources, capital, or personnel.
- They are unaffected by endemic sectarian divisions.
- They have a broad and stable constituency.
- They exercise their influence through formal, transparent channels of access and representation.

Source: Maxfield and Schneider (1997).

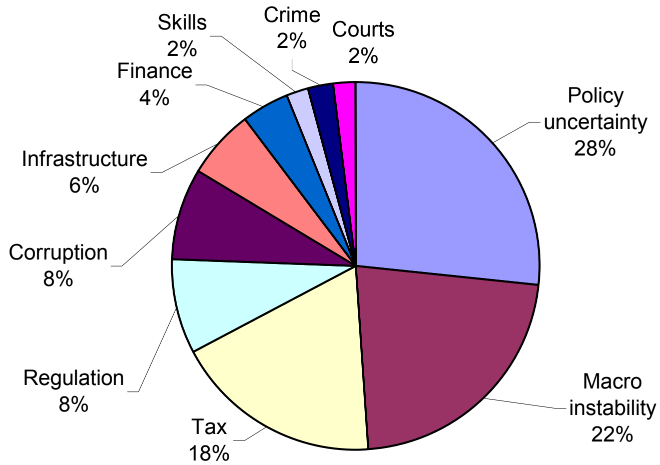
Establishing credibility

2.31 Firms do not make investment decisions based on the formal content of laws or regulations. Because investment is forward-looking, they need to make an assessment of the likelihood of those policies being implemented, and being sustained over-time. Addressing firms' concerns over uncertainty, and building policy credibility, are fundamental challenges to creating a stronger investment climate.

Firms and uncertainty

2.32 Uncertainty plays a central role in investment decisions. Those decisions are forward looking, with the bulk of costs borne upfront and the potential benefits spread out over time. There is always uncertainty about what the benefits will actually be—because of uncertainties about responses by consumers or competitors and about changes in the policy environment. There is also a question of how much weight to give to the future and to the present. The greater the uncertainty about the future, the less weight firms will place on possible future returns, and thus the less likely they will be to invest. The Bank's Investment Climate Surveys show that firms in developing countries rate policy uncertainty as their dominant concern among investment climate constraints (figure 2.4).

Figure 2.4 Policy uncertainty rates as firms' top investment climate concern



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

2.33 All investments involve upfront costs, but some investments can be reversed more easily than others. The less reversible an investment and the greater the firm's vulnerability to uncertain future changes, the greater the value in waiting to see if the uncertainty is resolved before investing.[27] That is why firms in Ghana and Uganda were more likely to increase the hurdle rate of return as uncertainty increased, and uncertainty had a more negative effect on firms with more irreversible investments.[28] Uncertainty and irreversible investments imply that reductions in uncertainty rather than changes in interest rates may be more effective in influencing investment (box 2.9).

Box 2.9 Reducing policy uncertainty to stimulate investment

Lowering interest rates is often proposed as the best way to spur investment. Interest rates affect investment decisions because they are a measure of the opportunity cost of the resources dedicated to the project, that is, the return these resources could otherwise have earned. They affect the cost of borrowing by firms and the returns that equity investors look for. As interest rates fall, investment should rise as the expected benefits now need to clear a lower value.

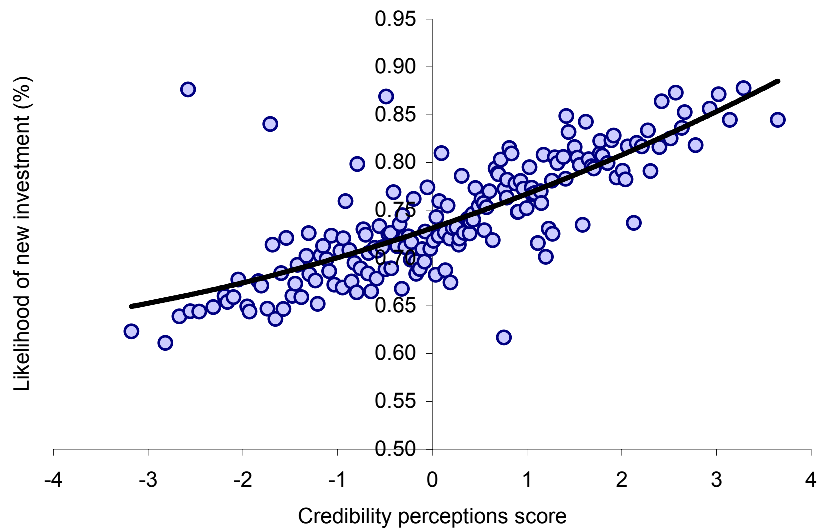
But many empirical studies have failed to find a significant impact of interest rates on investment rates. Real options theory helps explain why. With uncertainty and irreversible costs, the importance of interest rates in investment diminishes. True, lower rates give greater weight to the future and thus the expected stream of benefits, but they also increase the value of waiting. The overall effect is thus weak or even ambiguous. Research finds that reducing the sources of uncertainty about future profits—or about the likely future path of interest rates—have more important effects on investment than does the current level of interest rates. So, reducing unnecessary uncertainty, including that about government policy, is likely to be the better approach to stimulating investment.

Source: Blanchard (1986), Caballero (1999), Dixit, Avinash, and Pindyck (1994).

2.34 Uncertainty puts a premium on information, which can be costly for firms to obtain. Information constraints can lead firms to adopt herd behavior—basing decisions on how other firms are seen to be responding. Firms may also use an initial limited investment to elicit more information—about the opportunity or about the reliability of government policies—before committing to a larger or less reversible investment. For example, a study of investment patterns by Japanese firms in 49 countries shows how their market entry strategies varied according to perceptions of policy uncertainty.[29]

2.35 Concerns about the credibility of government policy commitments are one manifestation of uncertainty.[30] Reforms to cashew marketing arrangements in Mozambique in the early 1990s attracted a weak supply response from farmers: cashew trees take 3–5 years to bear fruit and involve considerable sunk costs, and farmers were wary about making this investment when the government's commitment to the reform was in doubt.[31] Firm-level surveys confirm that firms are more likely to invest when policies are regarded as credible (figure 2.5). They also suggest that reducing policy uncertainty can increase the probability of making new investments by more than 30 percent (figures 2.6). The impact of uncertainty can increase more than proportionately, so large sources of uncertainty can be especially damaging.[32]

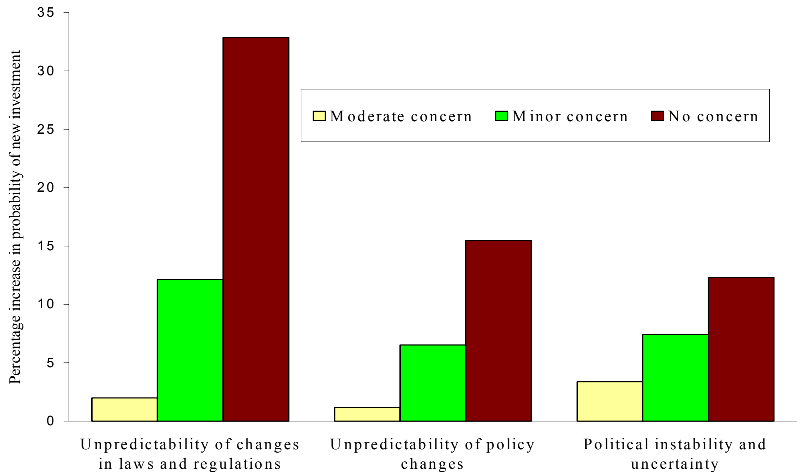
Figure 2.5 Firms are more likely to invest when the policies are perceived to be credible



Notes: Graph plots firms' predicted probabilities that they have increases investment in the past year against a measure of credibility. Credibility perceptions score is derived from principal components analysis of firm responses to questions of policy predictability, consistency, and enforcement, with higher scores meaning greater credibility. Data points represent average probabilities for each credibility score. Probability of new investment is based on predicted probabilities generated from a logistic regression controlling for firm size, industry, and region.

Source: World Bank, *World Business Environment Survey Database*.

Figure 2.6 Reducing policy uncertainty can increase the probability of new investment by over 30 percent



Source: Simulations bases on World Business Environment Survey, based on 80 countries.

2.36 In confronting uncertainty, individuals and firms vary in their appetite for risk. Larger firms typically have more opportunities to diversify risk than smaller firms, and multinational firms can diversify country-specific risks across several countries. Attitudes towards risk can also vary depending on the "entrepreneurship" of individuals and the firms they own and manage—and possibly across societies as well (box 2.10).

Box 2.10 Entrepreneurship and responses to policies

Notions of "entrepreneurship"—or attitudes toward innovation, pro-activity, and risk-taking—can influence the way individuals and the firms respond to investment opportunities.

While few dispute the role of this factor, there are problems of measurement. None of the proxies used in the literature is free of difficulty, particularly when applied to developing countries. For example, the incidence of new business registration can be influenced by the considerable impediments to registration in many countries (chapter 5). And the incidence of self-employment may reflect a lack of alternative opportunities rather than entrepreneurial spirit.

Despite measurement difficulties, it is generally accepted that these personal characteristics are not distributed equally in any given society—some individuals and firms will be more entrepreneurial than others. A growing body of work also suggests that there can be differences in entrepreneurship between societies. For example, Wild (1997) and Etounga-Manguelle (2000) have argued that some countries in Africa may exhibit low levels of entrepreneurship, with explanations ranging from broad cultural attitudes to the role of various social institutions in undermining incentives for productivity.

To the extent this is true, and has adverse implications for investment and growth, the question is whether such attributes are immutable or are responsive to government policy. The evidence supports the second view, indicating that the incentives provided by government policies and institutions can have a big impact on observed levels of entrepreneurship in any society.

Sources: Covin and Slevin (1989); Etounga-Manguelle (2000); Hart (2003); Hofstede (1980); Iyigun and Rodrik (2003); Lee and Peterson (2000); Lumpkin and Dess (1996); McGrath, MacMillan, and Scheinberg (1992); Miller (1983); Miller and Friesen (1982); Porter (2000); Reynolds and others (2004); Wild (1997).

2.37 The way firms respond to uncertainty and to policy pronouncements is also a function of their confidence and expectations about the future. Expectations can be self-fulfilling. If firms are confident about the future and invest, growth can indeed increase, realizing what firms had forecast. Equally, pessimistic forecasts can be self-realizing if firms curb investment.

2.38 Uncertainty, information, policy credibility, and investor confidence go a long way to explaining some of the apparent mysteries of firm behavior—what Keynes referred to as "animal spirits."[33] But recent work in behavioral economics and psychology suggests that people may not always be as rational as traditional theories predict. For example, people tend to be loss-averse—willing to accept more risk to avoid a loss than to realize the same size gain. There can also be an endowment effect—placing greater value on something already owned than on the current price to acquire it. And anchoring can interfere with people's judgements—people can place disproportionate weight on recent experiences, particularly their own, rather than on longer historical trends. So can conservatism—slowing the response to changes in trends.[34] While these phenomena may influence the way firms interpret and respond to government policies, they do not undermine the fundamental roles of uncertainty, information, and credibility.

The quest for policy credibility

2.39 Many things can undermine the credibility of a government's investment climate policies. A recent track record of political instability or poor economic management does not help—creating a special burden for governments seeking to rehabilitate the reputations of their countries.[35] But the credibility of a government's policies may also be in doubt if there are questions about its competence, its ability to enforce its policies, its willingness to stay the course of reform, or its ability to stay in office.

2.40 All governments also face the specter of time, and the challenge of committing today to actions in the future, particularly if it is understood that incentives may change. Some policy flexibility is essential to adjust to changing circumstances. But unrestrained governments too often succumb to the appeal of short-run political incentives that leave society as a whole worse off. Examples abound, from printing money to finance profligate public spending—to reneging on specific commitments to investors and creditors. To address these concerns, governments need mechanisms to credibly commit to sound long-run policies—in Douglass North's phrase, to be bound "to agreements across space and time."[36] Credibility comes from reducing the scope for government to manipulate rules to its own advantage. Indeed, restraining the arbitrary behavior of government was the turning point for the creation of modern capital markets in developed economies.[37]

2.41 Governments can draw on a variety of mechanisms and strategies to enhance their credibility. The main formal mechanisms involve constitutions, institutions, contracts, and treaties:

- Embodying formal rules and processes in national constitutions that create effective "veto" points in decisionmaking. This can include formal checks and balances between different branches of government, autonomous subnational governments, and constitutional prohibitions on the expropriation of property, coupled with independent judiciaries able to enforce those rules (chapter 4).[38]

- Entrusting discretion on sensitive subjects to more autonomous agencies. Examples include central banks and specialist regulatory agencies for infrastructure—areas where time inconsistency problems can be particularly acute (chapter 6).[39]

- Providing specific contractual commitments to investors in especially sensitive areas, and enhancing the credibility of those commitments by making them subject to international arbitration—a common strategy in the resources and infrastructure sectors, but also increasingly in taxation (chapter 4).

- Entering international treaties that commit governments to sound policies—whether for trade, investment protection, or for a range of other areas (chapter 9).

2.42 But formal mechanisms are not the whole story. For example, privatization programs in sensitive areas often allocate at least some of the shares in the privatized company to a wide range of local people to raise the stakes of a policy reversal. In the transition economies this was one of the rationales for mass privatization programs. In Chile and Bolivia, similar effects were obtained by involving pension funds among the investors in privatized utilities. Improving the ability of firms and consumers to verify, monitor, and evaluate policy actions can also enhance credibility.[40] Creating structures to sustain an ongoing process of reforms can also enhance credibility.

2.43 Establishing credibility can be particularly challenging for governments building on a legacy of political and economic instability. But Uganda shows how persistence can pay off (box 2.11). In the late 1980s and early 1990s the country was in a shambles. Infrastructure had been destroyed during an armed conflict. Budgetary discipline was weak. And inflation had soared to an annualized 230 percent in 1992. But beginning in 1991–92 the government implemented reforms that began to transform the investment climate. Macroeconomic stability was achieved. Monopolies were dismantled. Trade barriers were reduced. The security of land tenure was improved. Taxes were reformed. Telecommunications were modernized. And problems in the power sector and courts are being addressed. Each reform had some impact on the opportunities and incentives for firms. But the determination of policymakers to stick with reforms—including dealing with setbacks along the way—served to enhance the credibility of the government's commitment to the creation of a more productive society.

Box 2.11 Building credibility through persistence in Uganda

Many countries in Africa have experienced stagnant or negative growth in recent decades, reflecting in large part poor investment climates. Yet Uganda climbed out of civil conflict and chaos in the late 1980s and severe macroeconomic instability in the early 1990s to boost its per capita GDP by 3 percent a year from 1990 to 2000, with the share of people below the poverty line falling from 56 percent in 1992 to 35 percent in 2000. How?

Beginning in 1991-92 the government launched reforms that eventually encompassed most aspects of the investment climate. A new investment code providing protection against expropriation was introduced, as was an autonomous tax agency. The independence of the central bank was strengthened in 1993. Monopolies in the coffee, cotton, and tea sectors were dismantled. The return of property expropriated by an earlier government was accelerated. Public enterprises were privatized. A new commercial court was established in 1996. The telecommunication sector was modernized through competition and private sector participation, including the privatization of Uganda Telecom Limited in 2002. The power sector was opened to private sector participation, and in 2002 a 20-year concession was awarded for the country's main generating station.

While the list of achievements is impressive, they did not all proceed smoothly. For example, the privatization of Uganda Telecom succeeded only on the third attempt. And the Uganda Commercial Bank was privatized only in 2002, after an earlier unsuccessful attempt. But the overall story is one of persistence, which enhanced the credibility of the government's commitment to reform.

Sources: Holmgren and others (2001); World Bank (2002c).

2.44 Firms and governments can also come to other arrangements that may allow investment to proceed but involve longer term costs. For example, in the aftermath of the Mexican revolution of 1910-20 one might have expected private investment to collapse as revolutions, civil wars, and coups took their toll. Yet investment was not disrupted. One explanation: revolution-era Mexican governments offered credible protection to existing investors by incorporating them into ruling coalitions.[41] The phenomenon of "crony capitalism" in Indonesia and other countries in more recent history can be explained through the same lens: forging close personal ties between selected firms and politicians allowed investment to proceed in an environment with few formal checks on government. But over time personalistic ties tend to ossify to the detriment of the broader investment climate—and to more innovative entrepreneurs, small businesses, and consumers. This underscores the importance of drawing on commitment mechanisms that embrace broader segments of society—not merely elites or the largest firms, but smaller firms and entrepreneurs as well.

Fostering trust and legitimacy

2.45 Governments and firms do not interact in a vacuum.[42] The broader social context can influence the investment climate in two main ways: in the level of social cohesion and trust between market participants, and in the level of trust and confidence citizens have in firms and markets. Governments influence, and are influenced by, both.

Social cohesion and trust

2.46 Social cohesion and trust can reduce the costs of regulation and contract enforcement—a plus for the investment climate. Trust and shared values and expectations ("social capital") facilitate cooperative relationships, and can encourage firms to lengthen their planning horizons as they think about investing.[43]

2.47 The positive economic effects of social capital have been documented since de Tocqueville's travels in United States in the early nineteenth century. But social capital can also have negative effects given its potential to foster closed ties among individuals of similar backgrounds, to force conformity, and to ostracize innovators and individualists, particularly in the face of change.[44] Cartels, for example, can develop social capital in their efforts to exert control over an industry.[45] And cronyism and corruption may also be tolerated more in communities characterized by high levels of social capital.[46] Even so, social capital is important for collective endeavors. In an investment climate characterized by richer networks of trust, participants are better able to exchange reliable information about each other, while monitoring the actions of policymakers.

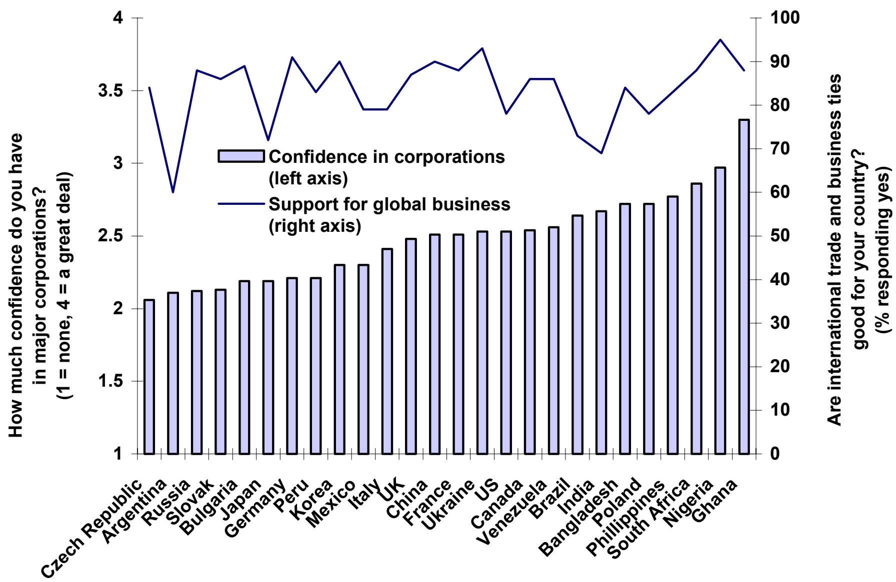
2.48 Countries with a high degree of ethno-linguistic fractionalization have often had discordant relationships between groups. Recent cross-country studies suggest that ethnic and linguistic fractionalization is negatively associated with economic growth.[47] From an investment climate standpoint, high levels of fractionalization can have negative effects when it results in open conflict, political instability, or clientelistic distortions in policymaking. Building a society that bridges social divides can take generations. It typically requires governments to create more open and inclusive processes and to ensure that opportunities for economic success are shared equitably in society.

Trust and confidence in firms and markets

2.49 Social attitudes towards firms and markets can affect the political feasibility of policy improvements and their sustainability. And because of their impact on sustainability, they can also influence the credibility of government policy pronouncements and hence the investment response of firms. So the investment climate benefits from a social consensus in favor of creating a more productive society—and from widely held perceptions that processes and outcomes are "legitimate" in the sense that they are consistent with prevailing norms, values, and beliefs.[48]

2.50 Public attitudes towards firms and markets can be deeply rooted in history, but also reflect more contemporary experience. Recent opinion surveys suggest that attitudes toward firms, markets, and international economic integration vary considerably around the world—but are generally favorable. For example, for more than 85 percent of countries surveyed, between 77 percent and 98 percent of respondents believe global trade and business to be positive forces for their country (figure 2.7).[49]

Figure 2.7 Strong support for international trade and business—but less confidence in corporations



Source: The Pew Global Attitudes Project (2003); Inglehart and others (2000).

2.51 Confidence in corporations was also found to be positive, if more moderate. Ambivalence toward markets and firms, particularly "big business," has a long pedigree.[50] Historically these concerns have been heightened by corporate or corruption scandals, leading to public backlashes against firms and markets and to demands for more intrusive regulation or even nationalization.[51] But they also reflect responses to the way governments manage conflicts and protect their citizens.

2.52 Multinational corporations have long aroused particular suspicion due to concerns over their loyalties to particular communities and their possible economic power.[52] This has recently led to mutual efforts to promote "corporate social responsibility" through the elaboration of and compliance with various codes of conduct (see box 2.2). But there are also other concerns about the nature of government-firm relationships, including concerns about corruption, capture and patron-clientelism. In response to these concerns, there is a growing impetus to improve the transparency of government-firm dealings, particularly in areas where relationships are perceived to be potentially troublesome (box 2.12).

Box 2.12 Transparency of firm-government dealings in natural resources and infrastructure

Proposals to enhance the transparency of government-firm dealings are often seen as being mainly about addressing corruption. But they can also play a broader role. They can act as a check on clientelist government policies that might otherwise distort the investment climate. And by reducing possible concerns about inappropriate behavior, they can contribute to broader public support for firms and markets and so facilitate ongoing efforts to improve the investment climate.

Two recent global initiatives focus on improving the transparency of revenue arrangements between international investors and host governments in the resources sector. The “Publish-What-You-Pay” campaign, supported by a coalition of more than 200 NGOs, proposes legislation requiring publicly listed oil and mining companies to disclose information about payments to government, as a condition of stock exchange listing. Relevant payments to be disclosed include tax payments, royalty and license fees, revenue sharing and payments-in-kind, forward sales of future revenues, and commercial transactions with government and public sector entities.

The Extractive Industries Transparency Initiative (EITI), launched at the World Summit on Sustainable Development in 2002, encourages governments, publicly traded, private and state-owned extractive companies, international organizations, NGOs and others with an interest in the resource sector to work together to develop a framework to reconcile payments and revenues to account for any missing amounts.

Nigeria has taken an initial lead in enhancing revenue transparency. In 2003 the Nigerian government agreed to publish budgets, records of oil revenue collection, as well as applicable statutes and rules. It also encouraged oil companies doing business in the country to make full disclosure of revenue and cost of operation. The accounts are then to be examined by an “aggregator”—an independent auditor—for assessment of any discrepancies.

Under the EITI, a commission was also established in Azerbaijan to publish revenues of the State Oil Fund. In similar vein, the Chad-Cameroon Petroleum Development and Pipeline project, supported by the World Bank, established a framework for revenue management from the pipeline, earmarking revenues for poverty reduction, and requiring private pipeline oil-field operators to conduct businesses only with companies that comply with transparency and disclosure rules.

The impetus for enhanced transparency is also extending to private infrastructure arrangements. Traditionally, many countries treated concession contracts and licenses as akin to commercial agreements and not publicly disclosed. The growing recognition of the "public" character of these arrangements has led countries including Argentina, Brazil, Panama, and Peru to publish these contracts by, *inter alia*, placing them on a public website. Together, they have published more than 120 contracts covering a range of infrastructure sectors.

Sources: World Bank (2000b), World Bank (2001).

2.53 Governments can take several concrete steps to help build broad public support for investment climate improvements, and so enhance the feasibility, sustainability and impact of those improvements. They can:

- Ensure the benefits of a better investment climate are not confined to particular categories of firms—but extend widely across society, including to firms in the informal economy.

- Be sensitive to the distributional outcomes of their policy arrangements—and take special care to protect those disadvantaged by change.

- Enhance the transparency of government-firm dealings and foster competition wherever feasible.

- Promote a broad public understanding of the benefits of investment climate improvements.

Ensuring a good institutional fit

2.54 The existence of a "market failure" is the textbook rationale for most government interventions to create a better investment climate. But as the above discussion made clear government interventions can fail for myriad reasons. They include problems stemming from inadequate information, expertise, or resources. And political-economy problems associated with rent-seeking, credibility gaps, and lack of public support.

2.55 Market failures may be more prevalent in developing countries than in industrial countries.[53] But government failures can also be more severe in countries with more limited expertise and resources and less-developed checks on government behavior. Policy interventions only make sense when the expected benefits exceed the likely costs. This means that governments need to weigh the costs and benefits of proposed interventions and take this into account when framing their responses. Poorly designed interventions can leave important market failures unchecked—or make matters worse.

2.56 Ensuring that interventions reflect a good institutional fit is a challenge for all governments. But considerations of government capacity are resources can also influence the optimal allocation of responsibilities between tiers of government (box 2.13).

Box 2.13 Decentralization to subnational governments—a plus for the investment climate?

Decentralization has remained a theme in constitutional design since at least the foundation of the Swiss confederation in 1291. For Madison and Montesquieu, the separation of powers—not merely between branches of government but between levels of government—provided a constitutional check on the capacity of central authorities to expropriate local wealth.

Decentralization can contribute to a sound investment climate in several ways. Fiscal decentralization assures local authorities that taxes raised locally will not be appropriated by the national government, giving local authorities incentives to protect their local tax base. Decentralization of regulatory responsibilities can help locales adapt approaches to their conditions and preferences, facilitating the involvement of stakeholders. Above all, decentralization permits some institutional competition between centers of authority and provides that subnational governments will not unduly restrict markets (as long as labor and capital are mobile).

But there are tradeoffs. Smaller countries, or countries with resources concentrated in single areas, are less likely to reap the benefits of decentralization. Subnational authorities are not well-placed to deal with spillovers between jurisdictions. Subnational governments may face more severe capacity constraints and in some cases lack sufficient scale. Nor are local governments immune from governance problems—and some local governments may be more vulnerable to them than national governments.

Reflecting these tradeoffs, the best location of a responsibility can vary, with some matters best handled at centrally, some subnationally, and others where there is shared responsibility. Whatever the approach, experience underlines the importance of clearly delineating the responsibilities of each tier of government to avoid creating unnecessary uncertainty for firms. Successful decentralization also requires a parallel division of accountability. Too often, expenditure responsibilities are transferred to subnational governments but crucial decisions are kept in the hands of central governments, diluting the accountability of central authorities.

Effective decentralization—both market-preserving and welfare-enhancing—requires:

- A hierarchy of government with constitutionally delineated authorities.
- A national government capable of providing national public goods and policing the common market to ensure the mobility of goods and factors across subnational jurisdictions.
- Hard budget constraints at all levels of government.
- No major sources of interregional inequalities, such as natural resources.

Sources: Brueckner (2000), Treisman (2000), Tanzi (1995), and Weingast (1995).

2.57 Because capacities, conditions and priorities can vary between countries, uncritically transplanting approaches from other countries often leads to poor results. This problem has a long history in many developing countries. Many regulatory systems in developing countries were transplanted from colonial powers with little regard to how they might operate in a very different environment. And because they were less relevant to local circumstances, they were often ignored or enforced selectively to solicit bribes. While the laws in the colonial power went through a continuous process of modernizing and upgrading, the regimes they left behind often did not. For example, company law regulating business entry dates back to 1884 in the Dominican Republic, to 1901 in Angola, and to 1916 in Burkino Faso. And laws dealing with insolvency date back to 1916 in Nicaragua, to 1944 in Haiti, and to 1948 in Kenya.[54] One result: a high level of informality, with regulations ostensibly aimed at promoting important social objectives often complied with by less than half of the economy—yet placing a disproportionate burden on firms that do comply.

2.58 This has two important implications for investment climate improvements. First, there is often an existing body of laws and regulations dealing with investment climate issues that is not well-adapted to local conditions or to contemporary circumstances, and which can create unnecessary burdens on the investment climate. Governments often face a large agenda in reviewing and modernizing relevant arrangements. Moreover, policies and regulations need to be subject to ongoing review to ensure they take account of changes in the way business is conducted, advances in technology, and lessons from ongoing experience. Indeed, a growing number of countries are exploiting advances in information technology to make a big difference in the ways investment climate policies are administered (box 2.14).

Box 2.14 E-government and the investment climate

Advances in information technology, including the internet, are paving the way for investment climate improvements in a range of areas. These approaches can reduce demands on public administration, reduce compliance costs on firms, and enhance transparency.

Business registration and licensing procedures were featured in the e-government initiative launched by Singapore in 2000. It provides an online application system for business registration and licensing and a "one-stop" online application system for certain special licenses (for example, building and construction permits) that previously required separate submissions to as many as 12 different regulatory authorities. The integrated approach has reduced the cost of incorporating a new company from anywhere between S$1,200 to S$35,000 (depending on the capital of the company) to a flat fee of S$300. What used to require two days now requires less than two hours. Streamlining the submission process for construction permits saves applicants more than S$450.

Land titling and registration are also benefiting from well-crafted e-government programs. An electronic land-titling system, *Bhoomi*, has been in operation in Karnataka state in India since the late 1990s. It is an online land-titling system delivered through kiosks installed in all land offices of Karnataka, which provide copies of a Record of Rights, Tenancy, and Crops (RTC). Obtaining an RTC once required up to 30 days to execute a request, and a typical bribe of as much as Rs. 2,000—land records could be deliberately "blurred" for fees of Rs. 10,000. These records were not open to the public, and it sometimes took two years for the records to be updated under the manual accounting system maintained by 9,000 "village" accountants—state employees responsible for three to four villages each. Today an RTC can be obtained for a fixed fee of Rs. 15, and takes between five and thirty minutes. The records are open for public scrutiny. Citizens can now request that land titles be updated quickly through the kiosks, a process that has increased the number of annual applications for updates by 50 percent.

Customs administrations are also benefiting from e-government approaches in countries as diverse as Singapore, Mauritius and Ghana (chapter 5).

Sources: Tan (2004); Bhatnagar and Chawla (2004); Lobo and Balakrishnan (2002).

2.59 Second, when undertaking policy improvements, governments need to ensure that the chosen intervention strategy is well adapted to local circumstances. Approaches applied in other countries can serve as inspiration, but sound approaches require adaptation to local circumstances to ensure a good institutional fit. The special challenges this creates for the design of regulatory systems is discussed in chapter 5.

Responding to the challenges

2.60 Each of these challenges is inter-related—and can contribute to vicious or virtuous circles. Unrestrained rent-seeking distorts policymaking, contributing to poorer economic outcomes. It undermines government credibility, dulling investor responses. It can create or exacerbate fissures in society, reduce social cohesion, weaken public trust in firms and markets, and so reduce public support for pro-market reforms. Regulatory strategies that are poorly adapted to local capacities, conditions and priorities can encourage informality and corruption, undermine policy credibility, leave market failures unchecked, and weaken public trust in firms and markets. Or the circles can be virtuous—contributing to stronger growth and poverty reduction.

2.61 Responding to these challenges implies a substantial agenda for governments. Possible trategies for making progress are the subject of the next chapter.

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Endnotes

1 Appearing before the US Senate Armed Services committee during confirmation hearings as Eisenhower's nominee for Secretary of Defense in 1953, Wilson—a former president of GM—was asked whether in his new capacity he would be able to make decisions that adversely affected his former company. He answered in the affirmative, but went on to say that he couldn't conceive of such a situation because, "[F]or years I have thought that what was good for our country was good for General Motors and *vice versa*."
2 Litvin (2003) at 132.
3 Hufbauer and Goodrich (2003)—see Chapter 5.
4 Rajan and Zingales (2002) cite examples in Mexico, Brazil and Japan.
5 The Anti-Corn-League, a group founded in 1839 to lobby for the repeal of England's Corn Laws which kept prices of grain artificially high, was one of the most prominent and well-organized lobby groups of the modern age. The group pressed their views on influential members of both Houses of Parliament, formed local associations, subscribed funds, made speeches, drew cartoons, wrote editorials and above all, organized petitions and demonstrations. The League achieved its objective in 1846.
6 Stigler (1971), Peltzman (1976).
7 Sutton (1976).
8 World Bank (1997).
9 Murphy, Shleifer, and Vishny (1993).
10 Klitgaard (1998).
11 Klitgaard (2000).
12 Reinikka and Svensson (1999); TI, Report on Bangladesh, 1997.
13 See Klitgaard (1998).
14 Adserà, Boix, and Payne (2003).
15 Hellman and Kaufmann (2003).
16 Robinson and Verdier (2002); Robinson (1998); Herbst (2000); Bates (1981).
17 On poorly-defined property rights, see Barzel (2002), on red tape, see de Soto (2000); on labor markets, see Golden (1997); on finance, see Rajan and Zingales (2003); on infrastructure see World Bank (2004).
18 Patronage and clientelism are often associated with "personal voting," whereby promises made by policymakers may only be credible to groups with whom they have personal relationships. See Keefer (2002).
19 See, e.g., Morris and Shepsle (1990); Keefer and Khemani (2003).
20 Khemani (2004); Desai and Olofsgärd (forthcoming).
21 Faccio (2003).
22 Fisman (2001).
23 For a review of the effects of political finance on state capture, see Kaufmann (2002). For evidence of efforts to reform campaign-finance laws in transition economies, see World Bank (2000c).
24 Messick (2002).
25 Keefer (2002), Keefer (2003).
26 Mukherjee (2002), World Bank (2000a).
27 Dixit, Avinash, and Pindyck (1994). The option theory of investment highlights how uncertainty raises the threshold value a project must meet before firms will be willing to commit due to the loss of the option of waiting. However, it should be noted that uncertainty does not necessarily have to decrease investment. Uncertainty that raises the probability of a bad outcome will lower the expected benefits. However, if increased uncertainty rises with the marginal revenue product of the investment, then the expected profitability can increase. In practice, Caballero has shown that imperfect competition or decreasing returns to scale lead the threshold effect to dominate. Many empirical studies bear this out. See Serven (1977), Caballero (1991).
28 Pattillo (1998), Darku (2000).
29 Henisz and Delios (2003).
30 Rodrik (1991).
31 McMillan, Rodrikand Welch (2002).
32 Hnatkovsk and Loayza (2004), Ramey and Ramey (1995).

33 Keynes (1936).
34 Thaler (1993), Thaler (2000), Rabin (1998), Kagel and Roth (1995), Camerer, Loewenstein, and Rabin (2003), Kahneman and Tversky (2000).
35 Paunovic (2000). See also Rodrik (1991).
36 North (1993).
37 North and Weingast (1989).
38 See, e.g., Henisz (2000); Stasavage (2002); Falaschetti (2003).
39 Levy and Spiller (1994); Gomez-Ibanez (2003).
40 Olofsgård (2003). Also see McCubbins and Lupia (1998).
41 Haber, Razo, and Maurer (2003).
42 For example, see Fukuyama (2001); Muller (2002); Rajan and Zingales (2003); Kay (2003); Henisz and Delios (2003).
43 On the various definitions of trust and social capital, see Fukuyama (2001); Coleman (1988); Putnam, Leonardi, and Nanetti (1993).
44 Indeed, it is not inevitable that communal, family-or kinship-based relationships always instill trust and create the basis for richer civic-associational life. Numerous studies of immediate post-war southern Italy found that citizens were unwilling to coordinate in establishing businesses, schools, hospitals, or other voluntary organizations. Organized life tended to depend on the initiative of centralized, distant authority: the church and the state. See, e.g., Banfield (1958), Piore and Sabel (1984). See also Fukuyama (1995).
45 See Ostrom, in Dasgupta and Serageldin (2000).
46 In parts of Sub-Saharan Africa, the giving of kola or "little gifts" for services rendered has long been considered customary, and has been transformed into something under which many practices of "petty" corruption are tolerated, Olivier de Sardan (1999). The business system produced by family and other personal ties in East Asia also used social capital to do business in countries and regions where contracts were not often enforced. Mafiosi and street gangs have also built their organizations with social capital.
47 Alesina and others (2003).
48 Henisz and Zellner (forthcoming).
49 The Pew Global Attitudes Project (2003).
50 Muller (2002).
51 Examples include proposals to abolish joint-stock companies in England after bankruptcies of 1860s and to nationalize large parts of corporate American by the New Dealers: see Micklethwait and Wooldridge (2003a).
52 See Micklethwait and Wooldridge (2003a) at 161-179.
53 Stiglitz (1989).
54 World Bank Doing Business database.