Chapter 3 Making progress

3.1 The challenges outlined in chapter 2 may seem daunting. But a growing number of countries are making significant improvements to their investment climates—and are being richly rewarded in faster growth and steeper poverty reductions. China, India, and Uganda, mentioned for their achievements in chapter 1, are hardly alone. Many countries have made progress in improving particular areas of their investment climates, from securing property rights and business regulation to infrastructure and labor markets. This experience provides lessons on the key ingredients of reform in particular areas of the investment climate. It also provides insights into how governments might manage a process of investment climate improvement to broaden and accelerate progress.

3.2 The chapter opens by looking at the implications of the breadth of the investment climate. The investment climate encompasses a wide range of government policies and behaviors, many of which are inter-related, and all of which can influence the opportunities and incentives facing firms. The good news is that perfection is not needed in even one area to ignite significant growth and poverty reduction. The key is to address binding constraints in a credible way—and to create a process for making ongoing improvements.

3.3 The chapter then looks at lessons of experience in each of the key elements involved in managing such a process. Identifying priorities. Catalyzing and managing changes in individual policy areas—including in the face of resistance from beneficiaries of the status quo. Maintaining momentum. And building government capabilities.

Grappling with the investment climate as a package

3.4 Government policies and behaviors shaping the investment climate play out over a broad domain, from contract enforcement, business regulation and taxation to finance, electricity supply, and labor markets. Governments typically administer each area in isolation, distributing responsibilities across a range of ministries and agencies. In contrast, firms tend to view particular investment opportunities as a package, and government policies and behaviors that influence the costs, risks, and barriers to competition are part of that package. Why might this matter?

3.5 First, the impact of any particular policy improvement will depend on the extent to which it addresses a constraint that is binding on firms. So improving access to credit will not have much impact on firms' investment decisions until more fundamental concerns about the security of their property rights have been addressed[1]—an effort described as "pushing on a string."[2] Special tax incentives may not be enough to compensate for other weaknesses in the investment climate in some situations—while in other situations they may be unnecessary.[3] And introducing a competition law may not have a big impact on an economy when the main obstacles to competition stem from trade restrictions, government monopolies, or regulatory barriers to entry and exit.

3.6 Second, different areas of investment climate policy can interact. Providing more secure title to land can be an important way to help expand firms' and households' access

to finance—but will not produce that result if complementary aspects of financial infrastructure are missing. The benefits from trade liberalization or other forms of product market reform may also be reduced if weak bankruptcy laws slow the exit of less efficient firms, or if labor market policies limit the ability of firms to adjust production processes to respond to a more competitive environment. And efforts to encourage local R&D can be limited by shortages of skilled workers, limited competition, or weak intellectual property rights.

3.7 These considerations highlight that investment climate improvements involve more than one-off, "stroke-of-the-pen" reforms. But they do not imply that simultaneous and comprehensive reform is necessary to show significant results. Indeed, efforts to tackle the full set of investment climate policies simultaneously, even if technically feasible, would likely generate so much uncertainty for firms that it would deter rather than encourage investment.[4] And deep and rapid institutional change can be disruptive for societies, possibly undermining public support and hence sustainability. So some degree of gradualism is not only necessary, but probably desirable. Experience shows that significant progress can be made by addressing key constraints in a credible way—and creating a process for making ongoing improvements to address other constraints as they become more binding.

3.8 Take China, the country enjoying the fastest growth and poverty reduction in the world in recent years. The reform that ignited growth was introduction of a rudimentary system of property rights, initially for town and village enterprises and then for individual farmers and entrepreneurs. Once official targets were met, additional production could be sold for personal gain. The improvements unleashed big changes because they of the size of the economy benefiting from the change, and because they were implemented in ways that gave people the confidence to invest (box 3.1). Subsequent improvements—including those attracting foreign direct investment and improving business regulation and infrastructure—addressed constraints that were less binding initially. A degree of autonomy between provinces also fostered experimentation and created incentives for lagging provinces to emulate the success of their faster moving counterparts.[5]

Box 3.1 Improving the investment climate, Chinese-style

Growth in China is officially reported at an average of 8 percent for the last 20 years—giving China the most impressive (if disputed) sustained growth performance in history. Declines in poverty have been equally dramatic—from 60 percent to 17 percent. Yet even today China's constitution does not give complete protection to private property rights, inefficient state-owned enterprises clutter the landscape, and the financial sector is heavily burdened with non-performing loans. How was such sustained progress possible?

Growth was ignited by introducing a rudimentary system of property rights that gave farmers and town and village enterprises incentives to take risks and invest. The response was magnified by the vast size of China's economy affected, aided by decades of suppressed entrepreneurialism. No less important, the reforms were interpreted by individuals and emerging enterprises as a decisive shift in government policy favoring private initiative, reinforced by a high level of policy stability, strengthening the confidence to invest. The initial signal was confirmed by subsequent reforms that improved the environment for private business. These included efforts to attract FDI, improvements to business regulation and infrastructure, accession to the WTO, and efforts to address corruption and improve transparency.

The Bank's investment climate surveys show that China has created an investment climate in its main industrial centers that would be the envy of many developing countries. And it's not just about wages or exchange rates. The surveys show that in five of the main industrial centers the costs of infrastructure disruptions, crime, bribes, regulation and contract enforcement difficulties average less than 14 percent of sales—well below the average in countries including Poland, Brazil and Pakistan, and less than half the average in Tanzania (see figure 1.2). China still has a long way to go—especially in extending similar improvements across the country—but its strong performance is less of a riddle when viewed in this light.

Source: Chen and Wang (2001), Qian (2003), Young (2003).

3.9 India's experience highlights the same basic point (box 3.2). Its current period of growth began with some trade, tax, and regulatory reforms in the 1980s. Firms responded because the reforms addressed important constraints and because they were seen as signaling a decisive policy shift toward private-sector-led growth. Subsequent reforms, including the dismantling of the licensing Raj and further trade liberalization in 1991, reduced costs more and increased competitive pressure in the economy—and also validated firms' perceptions. And just as in China, a degree of autonomy between state governments created room for leading states to innovate. Competition between states is now creating incentives for lagging states to follow suit, including in addressing long-standing problems in the power sector.

Box 3.2 India's path

In India much attention is paid to the liberalization efforts of 1991. But growth began picking up in the 1980s. The early reforms were less dramatic, more ad hoc. But they signaled an important shift in government policy toward the private sector.

In 1984 Rajiv Gandhi's government initiated reforms to encourage exports, facilitate foreign technology transfers, and rationalize the tax system. Quantitative controls on the imports of capital goods were eliminated. Tariffs were cut by 60 percent. Taxes on profits from exports were cut by half. And fewer industries were subject to licensing. The policies were a major shift in approach away from socialism and the primacy of redistribution over production.

In the early 1990s the reforms were more dramatic—the rupee became convertible, restrictions on foreign ownership were relaxed, additional quotas were abolished, and tariffs were reduced. Over the 1990s the pace of reform has slowed but it has continued in all areas. Licensing has been eliminated in all but seven industries. Private firms have been allowed to compete in an increasing list of sectors. A new competition law replaced the former Monopolies and Restrictive Trade Practices Act, which had required special approval for any large investment. Long-standing problems in infrastructure are being tackled. And anti-corruption efforts are being scaled up at the national and state levels.

The effects: Substantial. Growth increased from an average of 2.9 percent in the 1970s to 5.8 percent in the 1980s and to 6.7 percent in the mid-1990s, with growth in the industrial sector increasing from 4 percent to 7 percent. More of a puzzle is the effect on total factor productivity. The general pattern is that many firms have increased their productivity significantly but that the aggregate numbers have been slow to respond. In many sectors the dispersion of productivity has increased, with the more advanced firms realizing additional gains and the least productive falling behind. The expected pattern would have been to see greater competitive pressures reduce dispersion as less successful firms left the market. This gap highlights the effects of continuing bottlenecks surrounding exit procedures. According to the Bank's Doing Business database, it can take over 11 years to complete bankruptcy procedures in India. Firms may be taking advantage of stronger incentives to invest, but there clearly is scope for further improvement.

Source: Aghion and others (2003), Ahluwalia (2002), DeLong (2003), Rodrik and Subramanian (2004), Varshney (1999), Panagariya (2003).

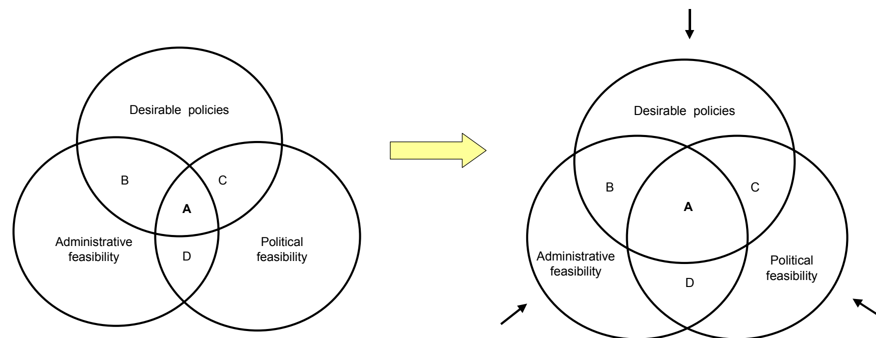
3.10 Even when a policy improvement addresses an important constraint, the extent of the benefits will often depend on addressing additional constraints that may have been less binding initially. For example, productivity improvement in India's manufacturing sector, while evident, has been limited by barriers to exit that slow the pace of industry restructuring. And labor market restrictions put a cap on the productivity improvements available from trade reforms in many countries in Latin America.[6] Investment climate policies also require regular review to take account of changes in the way business is conducted, changes in technology, and lessons of ongoing experience. Both considerations underline the critical role of processes to sustain ongoing policy improvements. Michael Porter has suggested that reforms in this area are a marathon, not a sprint[7]—but that may underestimate the nature of the task.

Setting priorities

3.11 At any point in time the set of reforms that are administratively and politically feasible may be limited. Over time, the goal is to expand the set of feasible options including by building government capabilities and building public support (box 3.3). But within the set of investment climate reforms judged to be feasible, priority setting requires an assessment of current conditions, the potential benefits from improvement (including possible spillovers), and the impact on different types of firms or activities.

Box 3.3 Expanding the zone of feasible and desirable policy improvements

As in other areas of policymaking, investment climate improvements must meet three tests. The proposed reform should be desirable, in the sense that it improves public welfare. It should be administratively feasible, in the sense that the government has the financial, technical and other resources to successfully implement the reform. And it must be politically feasible, in the sense that the government is able to secure sufficient support to overcome resistance from those who might prefer the status quo. At any point in time the menu of possible policy options that meet all three tests is limited—as shown in zone "A" in the figure. Options that fall in zone "D" are technically and politically feasible, but do not represent desirable policies—market restrictions or distortions of various kinds provide examples in the investment climate area. Options that fall in zones "B" or "C" would be sound policy, but are not feasible in the short-run.

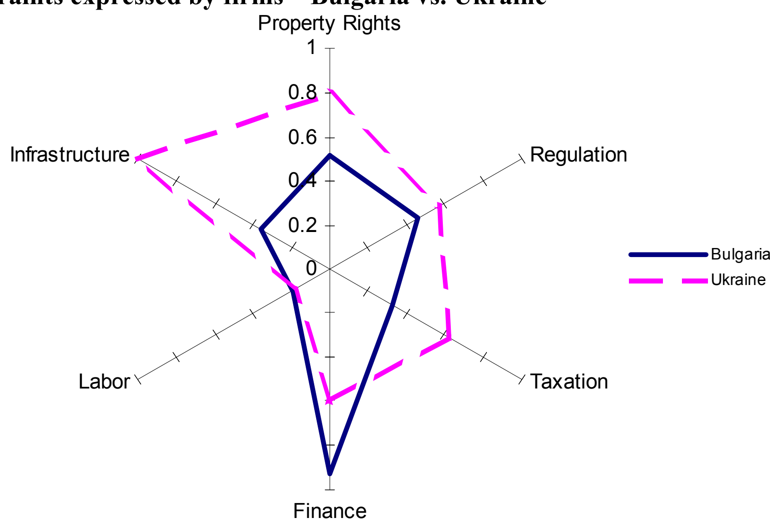


Over time, the goal is to expand the "sweet spot" by increasing the congruence between the three elements. The sphere of desirable policies can be expanded through policy innovation and learning. Administrative feasibility can be enhanced by mobilizing resources and expertise. And political feasibility can be enhanced through effective change management, including strategies for building public support.

Assessing current conditions

3.12 As chapter 1 highlighted, investment climates vary dramatically across and within countries. A major impediment in one country may be less important in another—as a simple comparison between Bulgaria and Ukraine illustrates (figure 3.1). Assessing the constraints on existing firms is relatively straightforward—firms can be asked directly, through dialogue with representatives of the business community or through surveys. These approaches have the additional benefit of enhancing a government's credibility with firms, and helping with possible implementation issues. But they have one obvious drawback: those firms cannot (or will not) speak on behalf of firms that have not yet entered the market, and so may tend to place less emphasis on barriers to competition. Regulatory barriers to entry (and exit) thus warrant particular scrutiny.

Figure 3.1 Constraints expressed by firms—Bulgaria vs. Ukraine



Note: The indices are based on surveys of formal sector firms. All values are normalized by regional maxima and minima for each indicator. Resulting indicators range from 0 (best) to 1 (worst).

Source: World Bank Investment Climate Surveys.

3.13 Comparing a country's performance in a given policy area with that of other countries can provide insights into the potential scope for improvement. For example, the World Bank's Doing Business database shows that the average time to close a business in India is over 11 years—while it can take less than 6 months in Ireland, suggesting significant scope for improvement. New sources of data make benchmarking feasible across a growing range of policy parameters.

Expected impact and potential spillovers

3.14 Constraints that affect a large share of economic activity will usually have a bigger impact than those affecting only a smaller group. Improving macroeconomic stability falls within this category, because until some stability is achieved the changes in other areas will have limited traction. Progress in addressing broader governance issues, particularly those affecting the government's credibility, will also tend to pay bigger dividends than reforms in any one policy area, because they can leverage the impact of

other policy improvements. This can be a special issue in weak or vulnerable states (box 3.4).

Box 3.4 Building credibility and legitimacy is a special issue in weak or vulnerable states

Countries emerging from conflict or whose institutions are particularly weak face special challenges in building investor confidence. Progress in improving particular areas of the investment climate will be more effective when extra attention goes to building the government's credibility and legitimacy.

Emphasizing consultative processes and transparency are important to heal the social wounds from conflict—or from distrust of whose interests are being served. Bosnia's Bulldozer initiative, with its emphasis on grassroots involvement and widespread media outreach and consultation strategy, illustrates one approach paving the way for broader investment climate improvements (see box 3.x). Uganda also placed special emphasis on ensuring the benefits from improvement were widely understood—and widely shared. Building credibility and confidence in expanding opportunities can be critical in stemming and even reversing the capital flight and brain drain in states under stress.

Nor should the emphasis on transparency be limited to local firms. Many vulnerable states are rich in natural resources (indeed, many conflicts arise from disputes over how this wealth is shared within society) and multinational enterprises are important investors. Enhancing the transparency of government-firm interactions in these areas can play an especially important role. For example, the Chad-Cameroon pipeline project involved special efforts to ensure that the proceeds from the project were appropriately accounted for, and directed to important social goals.

Source: World Bank (2003), Commonwealth Secretariat (2003).

3.15 When accelerating overall growth is the priority the share of GDP affected and the severity of the constraint will usually be important criteria. Targeting constraints that unlock opportunities and incentives for a large share of GDP—as China did with its rural sector—can have a big impact on aggregate growth. A key element in the calculation will be how the reforms affect people in the poorest strata of the population (box 3.5).

Box 3.5 Taking poverty reduction seriously

Improving the investment climate can have a direct impact on the situation of poor people in their many capacities: as workers; as entrepreneurs; as consumers; as users of public services; and as recipients of tax-funded services or transfers. The breadth of these impacts means that there is no one best way to make investment climate improvements more pro-poor. Certainly, poverty reduction alone does not justify an exclusive focus on small or informal firms. While the best way to target poor people will vary from country to country, four options include:

Focus on constraints in locations where poor people live. Rural poverty is a major challenge in many countries. Nonfarm employment can make an important contribution to incomes of the rural poor. Work in India suggests that manufacturing jobs contribute twice as much as agricultural productivity in raising non-farm income. Factories were located in rural areas to take advantage of lower wage costs and then transport the products to larger cities or even for export. To take advantage of these kinds of opportunities, transportation logistics and regulatory burdens are important.

Focus on constraints to activities likely to generate jobs for poor people. Given the potential for attacking poverty through job creation, improvements to investment climate conditions for firms likely to hire poor people can provide strong benefits for poverty reduction. This may imply focusing efforts on improving conditions for larger firms and foreign-owned firms, which may create more jobs directly and also create more opportunities for suppliers of a range of goods and services.

Focus on constraints facing microentrepreneurs. Efforts might focus on improving the investment climate faced by microentrepreneurs, such as by improving security of their property rights, reducing red-tape associated with business registration, and removing distortions that make access to finance more difficult. While the key constraints can vary by location, surveys for this Report show that corruption and access to land and finance were more likely to constrain informal enterprises than larger firms in Cambodia, Pakistan, and Tanzania. Because women's participation rates tend to be higher in the informal sector, such an emphasis may also help to address gender inequality. Sometimes the impact may not be fully anticipated: for example, liberalizing telecommunications in Bangladesh and Uganda created opportunities for microentrepreneurs to enter the market—helping the entrepreneurs and their broader communities.

Focus on constraints on firms that offer other potential benefits for poor people. Improving infrastructure can help improve living conditions where poor people live, whether they engage in entrepreneurial activities or not. Improving conditions for firms that produce or distribute goods and services consumed by poor people can also have a big impact on their living standards. Because larger firms are more likely to pay taxes, improving their conditions increases the potential for them to contribute to social objectives.

3.16 When considering the potential benefits from an improvement, it is also important to look at potential spillovers beyond the firms and activities most directly affected. Six are worth highlighting:

- *Spillovers to other firms.* Sometimes the benefits of an improvement spill over from the firms that immediately benefit from the reform—to others. For example, one of the attractions of increasing foreign direct investment is that technology and expertise may spill over to local suppliers, customers, and competitors.

- *Spillovers to other policy areas*. Improvements in some policy areas can make a positive contribution to others. For example, improving the security of land title can help firms gain access to finance (chapter 4).

- *Spillovers to government credibility.* The way governments approach policy improvements can help—or harm—their credibility and the resulting investor confidence. Efforts to engage firms and other stakeholders openly and transparently, with timely execution of reforms, can enhance business confidence and so elicit a stronger investment response. The corollary is that over-ambitious or poorly executed reforms can undermine credibility and confidence. This reinforces the importance of ensuring that goals are realistic. In some cases pilot projects can be used to try approaches and provide demonstration effects.

- *Spillovers to government capabilities.* Some investment climate improvements can help to improve a government's fiscal position—and so help to facilitate other improvements. For example, Uganda gave early priority to improving its revenue collection, which nearly doubled the ratio of tax revenue to GDP between 1991 and 1996. Privatizing state-owned enterprises can sometimes play a similar role.

- *Spillovers to broader social goals.* Many features of a good investment climate provide benefits that extend beyond firms. For example, secure title to land can empower people and free them to undertake more productive activities, while more effective courts can help to defend civil and political rights (chapter 4). And better

infrastructure and financial systems help all members of the community, whether engaged in entrepreneurial activities or not (chapter 6).

- *Spillovers to constituency building.* The choice of initial priorities can also influence the feasibility of later improvements in other ways. For example, reducing barriers to new business formation can increase the pool of firms with an interest in broad-based policy improvements.

3.17 The nature of investment climate improvements means that the extent of benefits from initial improvements may depend on addressing additional constraints that were less binding initially. For example, the benefits from trade reforms can be influenced by the extent to which governments address labor and product market distortions. In theory, one might develop a sophisticated strategy for sequencing investment climate improvements to reduce the risk of bottlenecks emerging. In practice, strategies for investment climate improvement are often influenced by pragmatic concerns about political feasibility. Trade reforms may be easier to implement than grappling with the detail of bankruptcy regimes or labor market institutions—and can unleash dynamic benefits. Creating pressure on a particular bottleneck can often be an important part of the process of building support for reform. Improving competition in product markets may also facilitate progress in addressing labor market distortions by reducing the rents available for the participants to contest.[8]

3.18 Some improvements can deliver fairly quick results—such as reducing barriers to entry. Others require a longer process of institutional development to deliver their full potential—such as reforms to courts and the development of new regulatory agencies. They promise large benefits but require patience and persistence. Of course, the sooner the longer term projects begin, the sooner the benefits arrive.

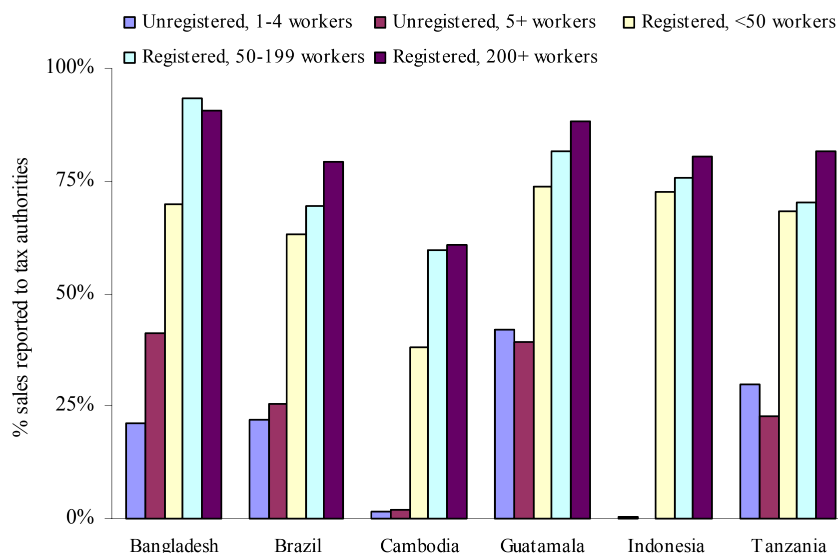
Link with national or regional strategies

3.19 Creating an environment where firms of all types and sizes can grow and contribute to poverty reduction has many advantages. It avoids the difficulty of governments trying to pick winners—where the track record has been discouraging (chapter 8). It creates opportunities for unforeseen success stories to emerge. It reduces concerns about rent-seeking. And ensuring opportunities for growth are shared widely in society helps build social cohesion and support for ongoing policy improvements.

3.20 But because investment climate improvements can affect different kinds of activities and firms differently, government strategies often focus efforts on removing constraints to a sub-set of the main things a good investment climate should do: reducing obstacles to growth faced not only by large or connected firms, but also firms in the informal economy, in rural areas, and smaller firms more generally; taking advantage of opportunities from international openness; and allowing firms to climb the technological ladder. The weight given to any of these goals will vary between countries given the nature of the constraints and the government's overall strategy.

3.21 *Integrating the informal sector.* Many developing countries have a "dual" structure, with a modern economy operating alongside a more traditional economy with high levels of informality. Estimates suggest that more than half the economy is informal in many developing countries (figure 1.18)—and that informality is growing.[9] There are also degrees of informality. One criterion is whether firms are registered with the government, another is compliance with regulations and taxes. What is striking is how few firms are completely "formal" by the second definition (figure 3.2).

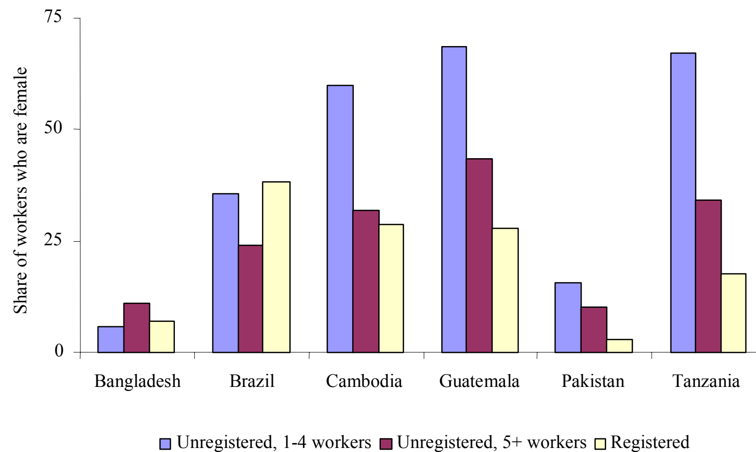
Figure 3.2 Informality is a matter of degree



Source: World Bank Investment Climate Surveys and WDR extensions to informal firms.

3.22 The informal economy covers people on the lowest rung of the economic ladder engaged in entrepreneurship out of necessity,[10] more affluent firms that find it feasible to evade tax and other obligations, and others in the middle. A large pool of individual workers also exists in the informal economy, sometimes working for formal firms "off the books," sometimes working for enterprises that are themselves informal. Women are disproportionately concentrated among the smallest of the informal microenterprises[11] (figure 3.3). The policy goals here are threefold. To ensure opportunities for the most vulnerable in society. To create opportunities for firms in the informal economy to expand. And to encourage those evading regulations and taxes to participate in the formal sector.

Figure 3.3 Women's participation is concentrated in the informal sector, among the smallest firms



Source: WDR surveys of the informal sector.

3.23 Insofar as particular regulations are intended to meet important social goals, the fact that a large proportion of the economy is not complying with them raises questions about the effectiveness of the regulatory strategy. Simply investing more effort in enforcing all existing regulations will often be counterproductive—and would reduce opportunities for poor people. A better approach would seek to streamline and simplify regulatory arrangements and to calibrate enforcement efforts by focusing on firms that clearly have the means to comply but choose not to. Similar considerations apply to taxation, where failure to collect taxes reduces resources for improving public services and other goals—and leads to a heavier-than-necessary burden on firms that do comply (chapter 5).

3.24 The constraints perceived by informal firms can differ from those of formal firms (chapter 2). They may face fewer taxes and official inspections, but many are harassed by officials, particularly if they are deemed to be in violation of some regulation. For some, the security of their business can be at risk. Particularly for entrepreneurs who do not have a fixed place of establishment, such as street vendors, there is a danger that they will be evicted from their sites and their goods confiscated (box 3.6).[12] Key policy areas will likely include strengthening property rights, such as clarifying land titles;[13] improving access to credit; lowering the barriers to registering firms;[14] and calibrating regulations and taxation with an eye to shifting the cost-benefit analysis towards making formalization more attractive.

Box 3.6 Street vendors in Africa

Street vending is one of the more visible forms of informal enterprise. Too often viewed as an underground activity that undermines the healthy functioning of the formal economy, the result has been conflict with urban authorities over licensing, taxation, site of operation, sanitation and working conditions, and representation in urban development policy discussions.

Permits and taxes. Street vendors in five African countries face a constant risk of confrontation with the authorities. Few urban authorities have consistent policies and regulations applying to vendors despite the

fact that most traders pay some form of tax or dues to enable them to operate. In both Kenya and Uganda, apart from interacting with authorities while processing a license or being allocated a trading site, harassment was seen as the main mode of interaction between street vendors and authorities. Vendors characterized the authorities as "gender insensitive," "inhuman," and "largely exploitative." Few saw any alternative to paying bribes, with many enforcement officers openly asking for them.

Infrastructure and service provision. Most street vendors operate in places that lack infrastructure and services. The urban authorities use the fact that the traders are not licensed as a justification for not providing services. Solutions do not have to be expensive. In Ghana a day care center is available in the Kumasi Market, making it possible for many more women to participate in trading there.

Disputes, crime, and security. In Johannesburg 10 percent of street traders had been assaulted, while 55 percent had been robbed. With police often viewed as indifferent, or even as collaborators, some traders have formed voluntary associations to fight crime. The insecurity in the streets is also used as an excuse to evict street traders. Both the Kenya and Uganda studies highlighted the view of urban authorities that the sites for street trade were dens for drugs and robbers.

Source: Mitullah, Background paper for the World Development Report 2005.

3.25 *Integrating the rural economy*. Many firms operating in rural areas also tend to be part of the informal economy, but rural location can itself be a separate source of disconnection from the modern economy. Seventy percent of people in low income countries live in rural areas, and improving their opportunities can make a direct contribution to poverty reduction (see box 3.5). Increasing the productivity of agriculture helps to expand opportunities in rural areas—not least because this increases the demand for services in the local area and provides an important means of diversifying risks.[15] But increasing rural nonfarm income is often identified as the most important way to combat rural poverty.[16]

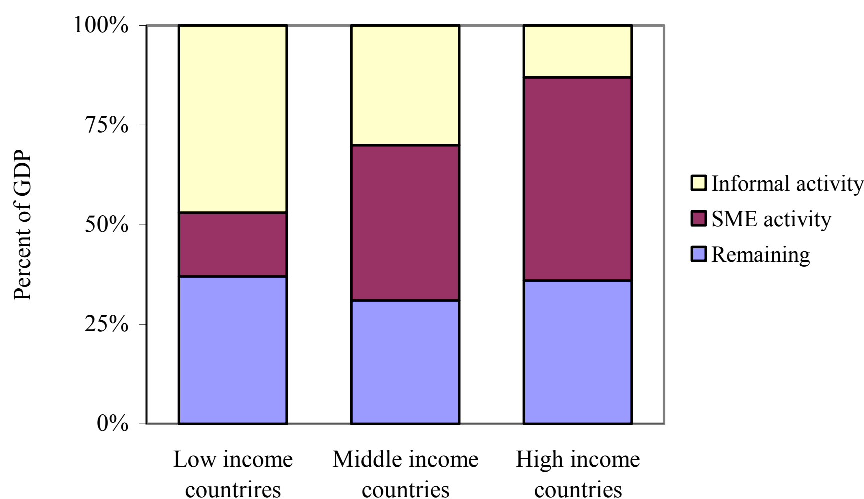
3.26 Nonagricultural activities account for up to 50 percent of rural employment and household income in many developing countries, with the figures highest in Africa, followed by Latin America, East Asia and lowest in South Asia.[17] Nonagricultural salaried employment is associated with the richest quintiles in rural areas, agricultural wages with the lowest, with self-employment in the middle.[18] Rural areas with lower agricultural productivity can make substantial contributions to incomes through manufacturing.[19] Labor and land costs are typically lower than in urban areas, leading some manufacturing companies in India to relocate to rural areas to serve urban markets and even to export.[20]

3.27 Distance and low population density add to the challenges of firms in rural areas. Lower concentration denies them the benefits of agglomeration economies that those in urban centers might enjoy. It also makes it more costly to supply modern infrastructure and provide other services valued by firms, including financial services and law and order. Subsidizing infrastructure and other services for rural communities is politically popular—but difficult to sustain. And in some cases the patronage threatens the viability of service provision across the economy (see box 6.10 on power supply in India). Resource-constrained governments face tradeoffs between subsidizing these services in rural areas or expecting users to cover the higher costs of service delivery and allowing urbanization to follow its natural course. Many governments are responding with more

pragmatic responses to the provision of infrastructure and other public services. One approach is to rely more on private firms rather than insisting on traditional state monopolies or dominant infrastructure utilities, such as the rural delivery of electricity in Cambodia and Yemen (chapter 6).

3.28 *Unleashing constraints to firm expansion.* The majority of productivity gains, new jobs and growth are realized by existing firms as they expand.[21] Constraining the ability of firms to realize such gains is of particular concern for small and medium enterprises (SMEs) which the most common form of formal firms in most countries and—together with informal microenterprises—account for the majority of GDP across income groups (figure 3.4). There is an ongoing debate over SMEs play a special role in economic development and so merit some kind of special policy privileges (box 3.7). Whatever weight is given to such claims, improving the investment climate faced by smaller firms can deliver significant benefits.

Figure 3.4 The contribution of SMEs to GDP does not vary too much by income—but the relative importance of informal and formal SMEs shifts dramatically



Source: Ayyagari, Beck, and Demirguc-Kunt (2003).

Box 3.7 Just how special are SMEs?

SMES are often targeted for special policy treatment in the belief that they play an especially powerful role in economic development. But these claims are difficult to substantiate.

Some believe that SMEs warrant special attention because of their high rate of job creation. It is typically true that SMEs as a group create more jobs than larger firms. But they also tend to shed more workers. They have a higher rate of "churning" and so do not always lead to greater net job creation. Large firms (with more than 100 employees) accounted for a greater share of net job creation in Ghana (56 percent), Kenya (74 percent) and Zimbabwe (76 percent) in the early 1990s than small firms did. Small firms outperformed the large only in Zambia—where there was a net overall job loss over this period. But in many countries small firms play a larger role in providing employment opportunities for low-skilled workers—and make a special contribution to poverty reduction in this way.

Some believe that SMEs are particularly innovative—adopting, designing and producing new technologies and new approaches to production. Smaller firms do tend to be more nimble than larger firms in responding to niche opportunities and changing market conditions. And there are many anecdotes about small firms pioneering particular technologies or ideas. But most R&D in developing countries is conducted by larger firms. SMEs also appear less likely to engage in activities that promote technology transfers. For example, small firms in Brazil, Cambodia, and Pakistan are less likely than larger firms to license technologies from abroad and less likely to have technical assistance contracts. And studies in Colombia, Indonesia, Malaysia, Mexico and Zimbabwe show that small firms are less likely to have formal training programs. Small firms in developing countries are also less likely to export than other firms.

	Micro (< 10)	Small (10–50)	Medium (50–150)	Large (> 150)
R&D expenditures (as % of sales)	0.5%	1.1%	1.4%	1.4%
Any R&D expenditures (% of enterprises)	7.1%	19.1%	29.3%	44.2%
Formal training program (% of enterprises)	38.9%	43.0%	53.6%	61.4%
Exports (as % of sales)	4.5%	11.3%	24.3%	37.3%
Any exports (% of enterprises)	12.1%	22.1%	40.4%	57.7%
Uses e-mail to communicate with suppliers and customers (% of enterprises)	36.0%	45.6%	62.2%	78.2%

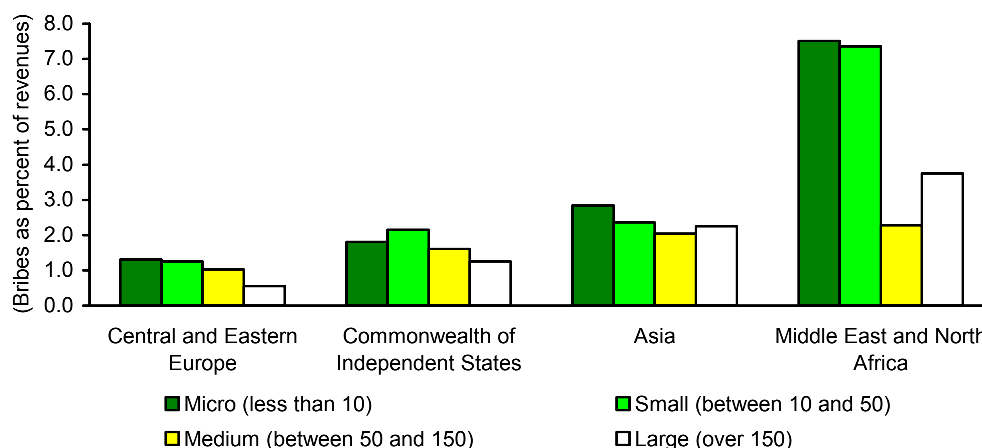
Source: World Bank Investment Climate Surveys.

Recent macroeconomic evidence also casts doubt on the claim that SMEs play an especially important role in growth and poverty alleviation. A cross-country study looking at the correlation between economic growth and SMEs' share of total employment found that although the SME sector is larger in countries where growth is faster, the size of the SME sector did not appear to cause faster growth. The study also found no correlation between poverty reduction and SME development. One interpretation is that policies that successfully promote growth—such as investment climate improvements—might also promote SME development, but that policies that promote SME development do not necessarily result in faster growth.

Source: Biggs, Ramachandran, and Shah (1998); Biggs (2003); Acs and Audretsch (2003); Biggs, Shah, and Srivastava (1995); Batra and Tan (1995); Beck, Demirgüç-Kunt, and Levine (2003).

3.29 Weaknesses in the investment climate tend to impose disproportionate burdens on smaller firms. Large enterprises can create their own infrastructure, integrate vertically to avoid problems related to weak enforcement of contracts, train or hire specialized staff in areas such as information technology, training and accountancy, and raise capital on foreign markets.[22] But SMEs depend heavily on domestic institutions for these services, such as public infrastructure, courts, and domestic financial institutions. Because many investment climate constraints represent a fixed cost, they also constitute a heavier burden on smaller firms. Small firms also tend to pay more in bribes (as a percent of the sales) than large enterprises do (figure 3.5).[23] And cumbersome regulations for entry, exit and sharing credit information hurt small businesses the most.[24]

Figure 3.5 Smaller firms pay a greater share of revenues in bribes than medium and large firms

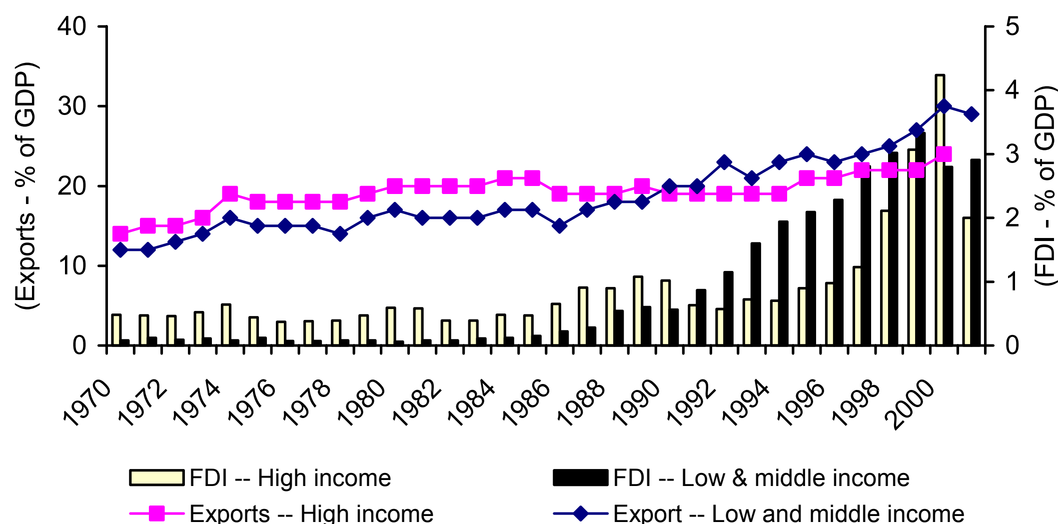


Source: World Bank Investment Climate Surveys.

3.30 Removing policy and regulatory distortions will usually be the most effective strategy to help unleash the growth potential of SMEs. If firms remain small because of policy-induced distortions or disproportionate burdens that inhibit their growth, removing those distortions is an important step.[25] Strengthening credit markets, establishing credit bureaus and registries of assets can help smaller firms obtain access to credit (chapter 6).[26]

3.31 *Taking advantage of international openness.* Few countries have grown without being open to trade.[27] Expanding markets and lowering barriers to new and better ways of doing things are creating new opportunities for developing countries to grow faster and catch up with richer countries. More developing countries are taking advantage of opportunities to connect to the international economy. Their exports increased from 12 percent of global GDP in 1970 to 29 percent in 2001, and FDI to low and middle income countries has increased from 0.1 percent of global GDP in 1970 to 3 percent in 2001 (figure 3.6). The challenge is to take advantage of these opportunities to accelerate growth and poverty reduction. While all economies can benefit, international integration is a special priority for smaller states (box 3.8).

Figure 3.6 Gross exports and FDI in developing economies jumped in the 1990s



Source: World Bank (2003f).

Box 3.8 International integration is especially important for small states

Forty-five developing countries that have populations under 1.5 million. The small size of their local markets and pools of skilled workers limit competition and the diversity of economic activities. For them, greater integration with the international market is a key priority. It involves providing adequate infrastructure to facilitate trade, emphasizing regional cooperation, and providing information on the opportunities available in the economy.

Regional integration enables enterprises to achieve economies of scale by expanding their market size. It can also facilitate the influx of investment on a larger scale by increasing the attractiveness of the region and reducing the risk of investing. Where regional integration entails a common currency, there can be substantial reductions in the transaction and administrative costs for firms. Regional integration can also reduce the cost of developing transport, telecommunications and energy infrastructure.

In the Caribbean two main organizations deal with economic integration. The Caribbean Community (CARICOM), with 15 members and a total population of 15 million, is discussing a Single Market and Economy to allow the free movement of goods, capital, and people. The Organization of Eastern Caribbean States, a smaller organization with nine member states and 500,000 inhabitants, has already instated a common central bank (the Eastern Caribbean Central Bank), a common currency (the Caribbean Dollar), and a common regulator for telecommunications. It is working on establishing an economic union.

The South Pacific Forum, a 16 member organization (including Australia and New Zealand) has adopted investment principles along the lines of those drawn up for the Asia Pacific Economic Cooperation countries. Concerned about the high costs of transportation in the region, the Forum's main priority is addressing shipping within the region.

Among the many African regional integration initiatives, the Southern African Development Community (SADC) is one of the more successful. It has enabled greater FDI from the more developed countries (South Africa and Mauritius) to the less developed countries, giving a new dynamism to the region.

Source: Commonwealth Secretariat and World Bank Joint Task Force on Small States (2004), Brautigam and Woolcock (2001); Commonwealth Secretariat (2003); Harsch (2002), Fairbairn and DeLisle (1995).

3.32 Unleashing exports expands access to foreign exchange and allows firms to better exploit economies of scale. The higher productivity of successful exporters can also result in spillovers to other firms in the local economy. Exporting firms can contribute to raising other firms' productivity through demonstration effects, labor turnover and helping connect local firms to overseas markets: firms in Mexico in locations where multinational exports are higher are more likely to export themselves.[28] If exporting helps firms to increase productivity (see box 3.9),[29] governments should consider ways to reduce regulatory and other policy-related barriers to exporting.

Box 3.9 Exporting and productivity—what is the link?

Economists suggest two possible explanations for exporters' higher productivity. One is that exporting directly improves the productivity of the firms that are doing it (the "learning-by-exporting" hypothesis). The discipline of competing in international markets might encourage firms to improve their productivity or might expose them to foreign technologies or modes of production. In addition, exporting might allow firms to achieve greater economies of scale by expanding their potential market.

The second explanation is that since firms have to be efficient to compete on international markets, only firms that are already efficient are able to export (the "self-selectivity" hypothesis). Although inefficient firms might be protected from international competition in domestic markets by natural barriers (high transportation costs) and policy barriers to trade (tariffs and quotas), they are unable to enter international markets. So only efficient firms end up exporting.

The two hypotheses are not mutually exclusive. Even if efficient firms are more likely to start exporting, this does not rule out the possibility that exporting will help them increase their productivity further.

The evidence appears to support both hypotheses to some degree. Several econometric studies have found that productivity improvements precede exporting, providing support for the self-selectivity hypothesis.[30] But case studies often support the "learning by exporting" hypothesis. Studies of exporters in Korea and Taiwan (China) found that export buyers were an important source for new technologies, which they provided in various forms including complete blueprints, information about manufacturing processes and quality control methods, technical advice and on-site plant inspections, and training for technical and production staff.[31] Some econometric studies also support the learning-by-exporting hypothesis.[32]

3.33 Reducing barriers to imported goods can be beneficial in three ways:

- *Reducing the costs of imported inputs*. Price markups are lower in countries where foreign competition is greater, however competition is measured (by import penetration, effective protection rates, or license coverage rates).[33] The cost that import restrictions impose on firms relying on inputs from the protected sector usually far outweigh the benefits to the protected firms.[34]

- *Facilitating the diffusion of modern technology*. Imported machinery is an important source for new technologies. Productivity growth is faster in developing countries that import more capital goods from developed economies. One study estimates that

if developing countries expanded their trade by 5 percent of GDP, their output would be about 6.5 percent greater in the long term.[35]

- *Enhancing incentives for local firms to innovate and improve their productivity*.[36] Firm-level studies have found that trade liberalization improves productivity among enterprises competing with imports.[37] For example, episodes of trade liberalization in Brazil between 1990 and 1995, in Chile in the 1970s and 1980s, in India in the early 1990s and in Colombia between 1977 and 1991 were all associated with higher firm productivity in import-competing sectors.[38] The effect of liberalization can be large (box 3.10). In Colombia, a 10 percent decline in tariffs was associated with as much as a 3 percent increase in productivity in firms.[39] The productivity gains reflect within-plant gains and the exit of inefficient firms.[40]

Box 3.10 Trade liberalization in India—recent evidence

Although India began reducing trade restrictions in the mid-1980s—eliminating quantitative restrictions on imports of industrial machinery and reducing tariffs on capital goods by 60 percent—its trade policies were still quite restrictive at the beginning of the 1990s.[41] In 1991 the average tariff rate was about 83 percent, and only 13 percent of goods were importable without a license. By 1998 average tariffs had been reduced to 30 percent, and the range of goods importable without any restrictions was increased to 57 percent.

Firm and industry studies that compare performance in the 1980s with performance in the 1990s find that productivity increased among firms exposed to competition from imports. The effect was large. Topalova (2003) found that a 10 percent decrease in tariffs resulted in a 0.5 percent increase in total factor productivity. Enterprises that were most efficient appear to have improved their performance the most. One study found that investment and productivity improved in industries close to the technological frontier, but failed to improve in less productive industries.[42]

Topalova (2003) notes that there were few firm exits following trade liberalization. Although this might suggest that most firms managed to cope with the additional pressures due to liberalization, it might also be because exit was very difficult for firms in India at that time. Although the government has recently taken steps that should strengthen the bankruptcy framework, bankruptcy procedures were very slow in India through recent times.[43] For example, in 2003, insolvency procedures took longer in India (11 years) than in any other country with comparable data.

Looking at a specific industry brings out the lessons clearly. From the 1950s until the early 1990s the machine tool industry was protected by tariffs of up to 100 percent and other restrictions. When tariffs were reduced to around 15 percent in 1992, local firms found themselves unable to compete with more efficient producers from Taiwan (China). After several difficult years, some of the local firms adapted to foreign competition by boosting their productivity. But the firm that led the recovery was not one of the firms that had enjoyed protection for 40 years—it was a fairly new producer that started operating only two years before the tariffs reduced.

Source: Aghion and Burgess (2003); De Long (2003); Rodrik and Subramanian (2004); Sutton (2000); Topalova (2003); ({World Bank, 2003 668 /id}).

3.34 Foreign investment can provide access to new investment capital, new technologies, management expertise, and export markets. The positive impact of foreign participation on productivity is demonstrated by studies from China and Venezuela to transition Europe.[44] There can also be productivity spillovers to local suppliers and customers. Foreign multinationals often help local suppliers by providing them with new technologies and advice on how to improve quality and productivity so that they can meet international standards. Studies in Indonesia and Latvia have found that foreign entry in

downstream industries boosts the productivity of local suppliers upstream.[45] Foreign firms also put competitive pressure on local firms. This can benefit firms that depend on inputs from the industry gaining FDI. In principle, the rival firms might also benefit from technological spillovers as well as sharpened incentives to innovate and improve their productivity. But the evidence of horizontal spillovers from foreign direct investment (to firms that compete with the foreign-owned firm) is more mixed than evidence for vertical spillovers (to firms that supply or use inputs produced by the foreign enterprise).[46] The potential volatility of short-term capital flows also raise broader issues (chapter 5).

Box 3.11 Foreign locals—the diaspora

The diaspora has been an important source of investment and contacts for export markets throughout history, with networks easing some investment climate constraints and building bridges between local and foreign investors.

Overseas Chinese contributed 70 percent of China's foreign direct investment over the past 15 years. By 1995, 59 percent of the accumulated foreign direct investment in China came from Hong Kong and Macao, a further 9 percent from Taiwan (China). Israel's software and biotech industries thrive on links with Jews in Europe and America. Korean Americans were the bridgeheads for the successful penetration into the U.S. market by Korean car, electronics, and white goods manufacturers. Studies in Canada show that a doubling of skilled immigrants from Asia led to a 74 percent increase in Asian imports.

In the mid-1990s, when India started to open up its economy, it began to attract its 20 million compatriots who live abroad. The Indian diaspora, second only to that of China, contributed 9 percent, or $4 billion, to the country's foreign direct investment in 2002. Some members of IndUS Entrepreneur, a networking group of Indian IT entrepreneurs and network professionals, are funneling funds into startups in India as well as hybrid companies and investment that operate in both India and the United States. This has boosted the confidence of overseas investors in India's potential. Several overseas Indians who had reached high management positions in western multinationals helped to convince their companies to set up operations in India, with Hewlett Packard a prime example.

Overseas Chinese and Egyptians played significant roles as investors in China and Egypt when multinational corporations considered these countries unattractive. Emigrant participation provided needed investment and improved others' perceptions of the investment climates in the two countries.

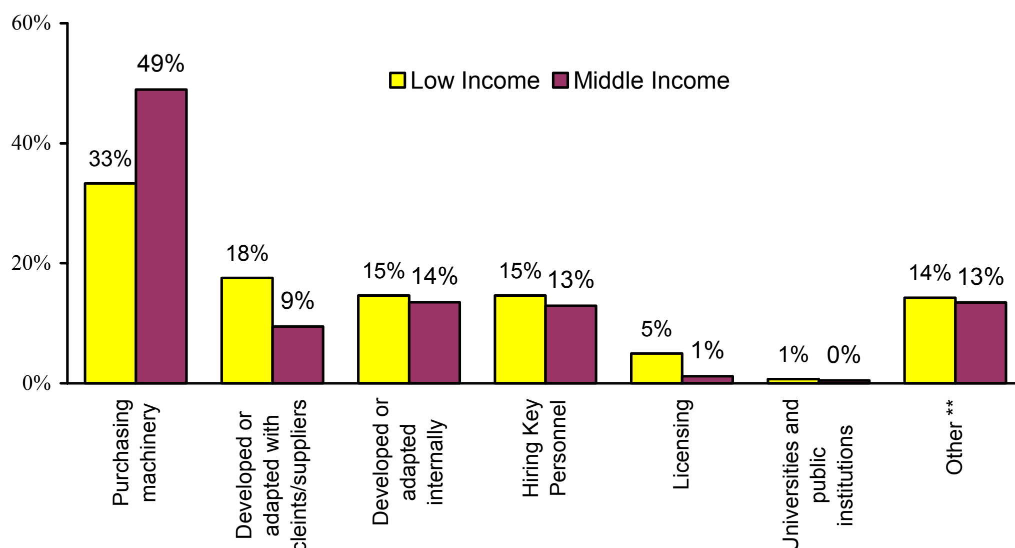
Source: Biers and Dhume (2000), The Economist (2003), The Economist (2001), Head and Reis (1998c), Gillespie and others (1999), Kapur (2001), Li and Li (1999), Rauch and Trindade (2002).

3.35 These benefits of international openness provide a strong rationale for giving priority to relevant constraints. The agenda includes improving customs administrations, liberalizing trade, streamlining foreign investment regimes (chapter 5), and improving ports and transport logistics (chapter 6). International rules and standards can also play a role (chapter 9).

3.36 *Climbing the technology ladder*. Technological progress is important for economic growth. But that does not mean that every country has to invent everything afresh—or that all technological improvements have to be cutting edge, pushing out the technological frontier. For most countries, adopting and adapting currently available technologies is more feasible and can still help improve productivity. Reducing barriers to trade and investment can help developing countries catch-up with industrial economies. And firm-level surveys confirm that enhancing competitive discipline can play a big role in encouraging firms to innovate (chapter 1).[47]

3.37 For firms a long way from the technological frontier, the most cost-effective strategy for technological upgrading is to tap technologies developed elsewhere through trade and licensing.[48] Several studies have highlighted the impact of machinery and equipment imports on productivity in developing countries.[49] Consistent with this, 33 percent of firms in low income countries and 49 percent of firms in middle income countries reported that knowledge embedded in new machinery was their most important source for technological innovations (figure 3.7).[50]

Figure 3.7 Gaining access to technological innovations—key sources



** Transfers from parent companies, trade fairs, study tours, consultants, and from business associations.

Source: World Bank Investment Climate Surveys.

3.38 Another way to climb the technology ladder is to conduct research and development. Firms in developing countries perform only about 26 percent of the R&D (as a share of GDP) of those in developed economies (table 3.1). This difference can be understood in part because high-income countries tend to have better intellectual property protection, deeper credit markets, higher quality research institutions, and more government capacity to mobilize public R&D expenditures.[51] As poor government institutions are negatively correlated with R&D expenditures,[52] strengthening those institutions can enhance a country's indigenous technological capabilities. Skill levels also play an important role, and have been found to hinder efforts to transition to more technology-intensive industries in East Asia[53] and Latin America[54](chapter 7).

Table 3.1 Who innovates?

	High income countries	*Developing countries*
Patents granted by the US Patent and Trademark Office [a]	0.35	0
Patents granted by the European Patent Office [a]	0.15	0
R&D personnel [a]	16.16	3.87
R&D expenditure	1.58	0.41
R&D financed by the productive sector [b]	0.74	0.13
R&D financed from abroad [b]	0.04	0.01
R&D performed by the productive sector [b]	0.96	0.25
R&D performed by high education [b]	0.34	0.12
R&D performed by the public sector [b]	0.28	0.22

[a] Per 10,000 in habitants; [b] As a percent of GDP
Source: Lederman and Saenz (2003).

Catalyzing and managing individual reforms

3.39 Trade liberalization obviously differs from land titling. And improving the courts differs from labor market reform. But a common issue across many of areas of the investment climate is dealing with resistance from those that benefit from the status quo, whether they be firms or other interest groups benefiting from market restrictions or other special privileges or officials benefiting from informal payments. Many people also exhibit a status quo bias due to uncertainty about what change will bring. Overcoming this resistance is a key part of managing investment climate improvements. What has been learned about the catalysts for change in these circumstances? And how might such changes be successfully managed?

Catalyzing change

3.40 Change tends to occur when something shifts the incentives for maintaining the status quo. International experience shows that there are many possible catalysts for investment climate reforms, including external shocks and crises, technological change, new opportunities, political change, and policy entrepreneurs (box 3.12). But access to new information highlighting a country's relative performance, especially when coupled with a degree of competition between jurisdictions, can play an especially important role in the investment climate area.

Box 3.12 When does change happen?

International experience reveals a diverse range of factors that can catalyze policy changes that face resistance from beneficiaries of the status quo. Common triggers include:

External shocks and crises. External shocks or crises can weaken the bargaining position of those who might normally oppose reform. They can also create opportunities for reformers to exploit rapidly changing economic or social conditions to justify or legitimize reform. In Korea limiting the cross-subsidies to chaebol subsidiaries, tried throughout the early 1990s without success, was implemented only after the 1997-98 currency collapse.[55] In Slovakia, a deteriorating fiscal situation combined with high unemployment led the government to pass a host of reforms in 2002 including collateral, tax, and labor reforms. Crises in a single sector can also prompt policy change. Power brownouts in Philippines in the 1980s led to efforts to engage private sector in power delivery. In the U.S. coal industry, labor restrictions were reformed only when movements in oil prices put the future of mines in question.[56]

But crises do not always transform the broader political-institutional apparatuses of policy making.[57] There are many cases where deep recessions or financial crises failed to spark reform. Indeed, crises have the potential to overwhelm policymakers' abilities to manage changes in the investment climate because of heightened social tensions.

Technological change and new opportunities. Advances in telecommunications created opportunities for introducing competition—and increased the costs of inertia for those beholden to national monopolies. Telecommunications reform thus spread rapidly around the world in the 1990s. New opportunities, such as access to new markets, can also catalyze change. The lure of EU accession has altered the reform agendas of East-Central European governments.[58] Joining NAFTA did the same for Mexico.

New information and institutional competition. New information can take the form of benchmarking performance against other jurisdictions, so that local prestige, and concerns over losing opportunities, can motivate policy change. Success in neighboring jurisdictions can have a tangible effect. Much as been written on the "diffusion" of privatization around the world, particularly in Eastern Europe and Latin America in the 1990s.[59] In China, competition between provinces for investment is spurring changes across a range of policy areas.[60] In India the success of reforming states, such as Andhra Pradesh, Karnataka, and Tamil Nadu, is encouraging other states to follow suit.

Political change. Marked shifts in policy approaches can occur on a grand scale—as with the collapse of central planning in the former Eastern bloc. It may also reflect a changing social consensus, as with the merchant class in England driving the protection of property rights, or the growing influence of urban middle classes elsewhere in supporting non-extractive, non-populist policies.[61] Political transitions, and changes of leadership, also provide reformers with a fresh mandate and an interest in differentiating their policies from those of their predecessors. In Colombia, a second round of labor reforms, after having been defeated in 2000, was passed in 2002 under a new government acting quickly to take advantage of political support. In India the coalition government that assumed office in 1996 issued guidelines for port reforms within six months of assuming office.

Policy entrepreneurs. Individuals play a key role in identifying and promoting policy changes.[62] They are often found in government, but also in places that have the government's ear. In Peru the effort to establish a uniform land titling system can be traced, in part, to the Institute for Liberty and Democracy's persuading the government of the value of reform and mobilizing citizens.

Communicating to build support

3.41 Effectively communicating the costs and benefits of alternative policy approaches is a central feature of successful reforms across most areas of the investment climate. Indeed, a study of senior officials and civil society representatives from 60 developing and transition economies cited the public's poor understanding of economic reform as a key obstacle to success.[63] Gathering and disseminating information that benchmarks a

country's performance or that analyzes the costs and benefits of reform—and the costs of not reforming—can build public awareness and understanding of reform. It can also help mobilize a broader range of support, including citizens, consumers and groups of smaller entrepreneurs who would benefit from change. Public awareness and support can also reduce opposition and hence the risks of policy reversal.

3.42 The most effective form of communication depends on the issue, the society, and the groups that need to be reached. In Tanzania a song highlighting the case for privatization became a popular favorite. In Uganda radio talk shows and plays in local dialects have been important. In Peru television commercials and public ceremonies of the delivery of land titles were the main channels. In Lesotho and Venezuela comic books are reaching a wide audience. In post-conflict Bosnia-Herzegovina, the "Bulldozer Initiative" (box 3.13), came up with a brand name and applied a range of communications mechanisms, including an open-door policy for the media, a public awareness campaign, and symbolic events.

Box 3.13 The "Bulldozer initiative" in Bosnia Herzegovina

Bosnia-Herzegovina launched the "Bulldozer Initiative" in 2002 at the initiative of the UN Office of the High Representative and with the support of bilateral donors. The initiative fosters the involvement and ownership of the key stakeholders in Bosnia's economic future—the private sector.

The reform coordination unit invited thirty local associations to help in proposing, evaluating, and finalizing reforms. Among them were regional business associations, municipal associations of entrepreneurs, the Employers' Confederation, the Women's Business Network, the Central Bank, the Foreign Investment Promotion Agency, the Micro-Credit Network, and the Association of Honey and Bee Production—all members of the Bulldozer Plenary Committee.

A group of lawyers and economists evaluated the proposals, developed solutions, and assessed the likely consequences for the economic environment. Each reform is subjected to a cost-benefit analysis, and industry experts are invited to comment on ideas before the reform is taken to the next stage. This way, the Bulldozer Committee ensured that no single firm could exploit the process to serve its own interests.

The proposed reforms are then submitted to the government, opening an intensive dialogue between the Bulldozer Committee and Council of Ministers and Regional Governments. Once the reform is designed, the Bulldozer Committee becomes an implementation watchdog. A biannual Bulldozer publication informs the public of progress, including scores for each reform.

The initiative significantly reduced the business costs of bureaucratic procedures. It halved the number of steps to register FDI, expedited customs clearance procedures, bridged the constituency gap by training and empowering local advocacy groups, and established mechanisms for civic participation in government. In June 2003 the Bulldozer Coordination Unit established Regional Bulldozer Committees, which are voluntary and self-financed.

Source: Herzberg (2004).

3.43 Apart from building awareness and support, communication campaigns can educate the public about the reforms, raise awareness of the consequences of reform, and help to change public behavior. Educating firms, consumers, and other groups about their rights and the measures to enforce them is part of the process. In reforming credit rating agencies in Mexico, for example, the financial authorities and the *Buro de Crédito* undertook a campaign to increase consumer awareness by placing the regulatory framework on their websites and listing the rights of consumers in a simple and

accessible way. In Georgia public opinion research revealed that most of the population was not aware of their judicial rights, nor did they trust the legal system. The "Ask for Justice" campaign was a comprehensive communications effort to educate the public about newly acquired rights, increase trust in the system, and help users navigate the courts (box 3.14).

Box 3.14 Ask for justice: communicating the benefits of judicial reform in Georgia

When Georgia started judicial reforms in 1997 it became evident that technical measures alone would not promote the rule of law. Reforms required a massive communications program to change the attitudes of judges, lawyers, and citizens. Early opinion research showed that Georgians had very little knowledge of their rights and no trust at all in the court system. Based on this research, a communications plan was developed and implemented. Rather than having the judiciary run the communication program, the Association for Legal Public Education, an independent entity comprising leading NGOs that had joined with the Council of Justice, became responsible for implementation, which started in 2000.

Understanding that public education requires a long-term approach, the Association is working on several fronts simultaneously. It produces educational weekly television programs for the public, publishes legal supplements in a leading newspaper, and has teamed up with Tbilisi's Faculty of Journalism to organize regular workshops for journalists on legal reporting. Its most important task is to make the judiciary a more "user-friendly" organization. The Association has also helped establish public information offices in the courts, disseminated the judicial code of ethics, and developed mechanisms for introducing transparency and accountability procedures in the organization's daily operations. Recent surveys show that that users of the judicial system have noticed an improvement in the functioning of the courts as well as in the overall attitude of employees towards the public.

Source: ALPE (2002); www.alpe.ge.

Engaging stakeholders

3.44 Early consultation with key stakeholders on proposed changes, including potential winners and losers, can help validate assumptions behind the proposed improvement. It can garner suggestions on how proposals might be fine-tuned to lead to better outcomes or easier implementation. It can also reduce the uncertainty firms face when dealing with changing policies and regulations—and thus elicit a faster and stronger investment response. And broad consultations can allay concerns that favored groups might exercise disproportionate influence in policy processes, thus enhancing the transparency and public acceptance of reforms.

3.45 In Vietnam consultations with private sector associations, domestic business groups, lawyers, the media, and members of the National Assembly built support for reforms to simplify business registration. In Pakistan business registration reforms were formulated and approved after a consultative process that involved the circulation and discussion of draft rules with various chambers of commerce and industry, professional bodies, and the public. In Peru's land reforms urban settlers were consulted through public assemblies to inform them about the method and schedule of land formalization programs and to elicit their views. In Latvia business associations and a wide range of inspectorates were involved in identifying reform priorities and designing an action plan for implementation. In a move toward greater stakeholder involvement and transparency,

Hangzhou municipality in China recently established a hearing system inviting stakeholders and the public to express their views on reform proposals.

3.46 Several reforms have engaged prospective losers—a group unlikely to remain silent in any event. But engaging them has its advantages, because they may also provide feedback on the detail of the proposed reform, and engaging them constructively may facilitate implementation. Particularly if some workers stand to be disadvantaged by a reform, early and constructive engagement can mitigate any negative social impacts (chapter 7). In South Africa the government provided funds and training programs to help trade unions become more effective interlocutors in the dialogue on privatization.

Compensating when appropriate

3.47 When state-owned enterprises are restructured or privatized, it is common practice to give some of the shares to employees, and to provide severance, pension, retraining, or other support to ease the adjustment to new employment (chapter 7). Special mitigation measures can also be adopted when particular industries are undergoing significant restructuring, particularly if effective economy-wide safety nets are not yet in place.

3.48 The case for compensating firms tends to be different. If a proposed reform would violate property or contractual rights, failing to compensate can chill the investment climate—as recent expropriations in Zimbabwe show (chapter 4). When no specific rights are affected, arguments for compensation involve more judgment. Firms tend to be compensated when they are a small group relative to society at large and the reform would disrupt what would be regarded as legitimate expectations. For example, investors in Singapore's privatized telecommunications company were compensated when the government shortened the promised period of exclusivity. And power utilities in the United States were compensated when the transition to a competitive market meant some of the assets built under a previous regulatory environment were "stranded." Compensation is less common when all or most firms in society are affected by a change seen as a normal risk of doing business—such as changes in tariffs or taxes or the introduction of a new competition law.

3.49 Compensation intended to reduce political resistance (as opposed to compensating for the violation of specific rights) need not always involve cash. In the United States, for example, compensation for utilities disadvantaged by changes in the regulatory environment came from an additional levy imposed on consumer tariffs. Some reform programs can be designed so that firms that might be disadvantaged by one reform (liberalizing trade) might benefit from another (improving business regulation).

3.50 Whenever compensation is proposed, a common concern is that governments might be held hostage by the affected group, who use their resistance to reform to extract larger compensation payments. Creating effective mechanisms for arbitrating possible disputes of this kind can reduce the incidence of strategic behavior, as can benchmarks or principles derived from experience in other countries.

Maintaining momentum

3.51 Investment climate improvements are a process, not an event. To help sustain a process of ongoing improvements, many governments are creating broader and more durable structures and processes to support reforms across the investment climate. Broader consultation structures. Policy coordination mechanisms. Policy review processes. And the institutionalization of reform champions. Do they work?

Consultation structures

3.52 Given the breadth of the agenda, the range of stakeholders involved, and the benefits of building consensus for change, many governments have established special structures to facilitate ongoing dialogues with stakeholders. To be effective, they should facilitate the free flow of information, build trust among participants, obtain feedback from affected parties, and assist in framing solutions. It is particularly important that they reflect that diversity and do not merely entrench elites. A high level of transparency in their operations—such as publishing their reports—can also contribute to a more transparent consultation between firms and governments—and so increase public support.

3.53 Some structures take an economywide perspective on economic policymaking while others focus on private sector issues. The scope of representation varies widely (table 3.2). Many have a specific mandate to identify bottlenecks, build consensus, recommend policy approaches, and monitor progress with reforms, as in Latvia and Turkey (box 3.15).

Table 3.2 Consultative forums dealing with investment climate issues—some illustrations

	Business	Unions	Legislators	Civil society	Donors
Economywide					
Latvia Tripartite Cooperation Council	√	√			
South Africa National Economic Development and Labor Council	√	√		√	
Papua New Guinea Consultative Implementation and Monitoring Council	√	√		√	√
Private sector issues					
Vietnam Private Sector Forum	√		√		√
Uganda Private Sector Foundation	√		√	√	
Pakistan Workers and Employers Bipartite Council	√	√			
Malaysia Business Council	√				
Singapore Competitiveness Council	√				

Box 3.15 Key features of consultation mechanisms in Latvia and Turkey

Latvia and Turkey illustrate some of the key features often reflected in dedicated structures for an ongoing dialogue with stakeholders on investment climate improvements.

In Latvia the Steering Committee for Improvement of the Business Environment first reported directly to the Prime Minister, then to the Minister of Economy. In Turkey the Coordination Council for the Improvement of the Investment Climate reports directly to the Undersecretariat of the Prime Ministry. The committees are served by a secretariat in charge of the daily work and monitoring of reforms—in Latvia the Business Environment Improvement Unit at the Latvian Development Agency, in Turkey the General Directorate for Foreign Investment in Treasury.

Both bodies have clearly defined objectives and mandates. Their tasks cover a broad spectrum of issues with a view to developing concrete proposals and strategies for ongoing reform. They are usually managed by technical committees. Turkey has nine, and Latvia started with four but the number and focus changed with the needs and concerns of business.

And both help design and implement reforms. Turkey’s council helped design laws on recruitment of foreign personnel, foreign direct investment, company registration, and labor, and it is engaged in reforms for customs, sectoral licensing, intellectual and industrial property rights, and land acquisition and site development. Latvia’s committee contributes to implementation of ongoing legislative and procedural reforms of inspections, registration, taxes, and customs, and land acquisition and construction.

Political will, ownership of the process by senior officials and technocrats, continual pressure by business associations, and adequate resources explain why investment climate reforms were sustained though four to five changes in the Latvian government between 1999 and 2002.

Policy coordination mechanisms

3.54 Formal policy responsibilities related to the investment climate are usually distributed among several government ministries and agencies, and their coordination can promote coherence, reflect the links across policy areas, and give impetus to reform efforts. Central leadership can also help overcome possible resistance from line ministries or agencies who may have a stake in maintaining the status quo.

3.55 High-level consultative forums that report to the president or prime minister can contribute to policy coherence. But mechanisms are often needed within government to facilitate coordination. Vietnam established an Inter-Ministerial Steering Group on Enterprise Law Implementation in 2000 to support the ongoing implementation of its reform program (box 3.16). Countries acceding to the European Union often created dedicated Ministries for Europe responsible for fostering coordination of individual reform initiatives across ministries and for managing negotiations with the EU. In Poland the Committee for European Integration became the main governmental body for coordinating policy changes relating to Poland's accession to the EU. In addition to coordination, the committee has been in charge of assessing the impact of new regulations.[64]

Box 3.16 Shepherding investment climate improvements in Vietnam

Vietnam began its transformation from a centrally planned to a more market-oriented economic system in late 1986. Despite many improvements, particularly in opening to foreign direct investment, there was a cumbersome, overlapping, and inconsistent regulatory environment for the domestic private sector. To improve it, government engaged the domestic private sector.

Technocrats worked with a broad-based business association (the Vietnam Chambers of Commerce and Industry) and a team in the Central Institute for Economic Management within the Ministry of Planning and Investment, the technical "champions" of the reform. In January 2000 a new Enterprise Law was passed. It was expected to facilitate the entry of new firms, protect businesses from bureaucratic interference in business operations, increase flexibility to expand business operations, and improve corporate governance.

Recognizing that passing the law was only the first step, the government established an Inter-Ministerial Steering Group on Enterprise Law Implementation, chaired by the Minister for Planning and Investment, who reports to the first Deputy Prime Minister. The Steering Group, continuing to improve interagency coordination at the center, recently exhorted state agencies to "change their management mindset and put themselves in the shoes of enterprises." Local authorities seem caught between regaining their discretionary powers over business registration (often for personal gain) and streamlining procedures to attract new businesses to locate within their geographical areas. A recent survey of enterprises noted a "return of troublesome and cumbersome unwritten procedures among various local authorities." Vietnam shows that continuing vigilance is needed to ensure that regulatory reforms take deep roots.

Source: Mallon, Background paper for the World Development Report 2005.

3.56 Fostering policy coordination among subnational governments raises special issues. As China and India show institutional competition between subnational governments can be a source of strength for the investment climate by fostering innovation and providing a check on more centralized governments (chapter 2). But

some coordination may be desirable to address spillovers across jurisdictional boundaries. Mexico is improving procedures for state and municipal governments to make some rules compatible and complementary so the nation as a whole can reap the benefits of regulatory reform, as in road freight and the environment.

Policy review processes

3.57 Some mechanisms review new policy proposals to ensure they do not introduce undesirable distortions in the investment climate. Others review existing laws and regulations more systematically. Both can work—but questions of institutional design are not trivial.

3.58 Most OECD countries now conduct impact assessments for new regulatory proposals, reviewing the costs and benefits of proposals and ensuring that the information is available to legislators or other policymakers. In the United States, which has the longest experience with these arrangements, the Office of Information and Regulatory Affairs can review rule-making and other policy proposals—and return regulatory proposals for reconsideration to sponsoring agencies if they are not supported by an adequate impact assessment. Some 60 percent of regulations are changed as a result of the Office's review. Variations of these arrangements are in place in 22 OECD countries and in some upper income countries in Eastern Europe and Asia.[65]

3.59 Efforts to transplant similar approaches to lower income countries have met with only mixed success, owing to low technical capacity and the challenges of institutional design. Low capacity can be addressed by drawing on the expertise of universities or other entities[66]—for example, Bulgaria's regulatory review processes benefited from collaboration with a not-for-profit think tank.[67]

3.60 Institutional design can be more difficult to address. There is a basic tension between creating an entity with the autonomy to take an objective view of regulations and creating a process that is adequately "nested" in the government's day-to-day policymaking and administrative processes. Under the best conditions policy reviews employ highly valid, reliable, and accurate instruments to help appraise proposed policy shifts. In reality, policy reviews cannot be implemented in an institutional vacuum—or mainstreamed into the routine business of government without the support of existing agencies. Independent central policy-review units are often seen as too intrusive on the prerogatives of line ministries. And they may not have the interagency cooperation or high-level political leadership to do their work.

3.61 Policy review programs can disintegrate when implemented without either strong political leadership or sufficient "buy-in" by existing agencies. In Sri Lanka they were initiated by regulatory commissions responsible for telecommunications and public utilities in 2001. The commissions were empowered to review all aspects of regulatory policy falling within their purview. Although the legislation supporting these reviews relied heavily on OECD best practices, the commissions did not receive support from the highest levels of government. Those performing the assessments often found their work

held up, unprotected from capture by public enterprises, or isolated. The regulatory review principles, rarely applied, were soon suspended.[68]

3.62 But when policy review processes have been too tightly bound into the fabric of the bureaucracy, the result can be vagueness in the instruments and excessive deference to the preferences of line ministries. In Ghana no ministry was really "in charge" of policy and regulatory reviews. Instead, each produced its own checklists, expressing different preferences in what were not much more than qualitative assessments.[69]

3.63 In Bulgaria a policy review mechanism dating from 1973 remains in force. But the law tended to be interpreted differently by various agencies, each performing different types of "long-term" cost evaluations, using different accounting methods, different benchmarks, and publicly releasing different amounts of information. Policy reviews did not have a perceptible impact on legislation until uniform review criteria and methods were devised.[70] Lithuania, by contrast, adopted a mandatory assessment for all draft legislation under the leadership of the presidency. Reviews are undertaken by the sponsor of legislation in consultation with those affected by the proposed policy changes. Summary assessments accompany all proposed draft legislation and are reviewed at interministerial, sectoral, and cabinet levels, any of which can return the legislation to the sponsor with a list of specific improvements.[71]

Institutionalizing reform champions

3.64 Some countries have established reform "champions" that act as advocates for ongoing policy improvement and support the review of existing regulatory and other constraints. In some cases, this role might be performed by secretariats to policy consultation or coordination bodies. For example, Thailand's National Competitiveness Committee and Singapore's Committee on Competitiveness—both established in the 1990s—have the specific purpose of studying constraints on competitiveness, reporting findings, and making specific recommendations. Thailand's committee is chaired by the prime minister, with the National Economic and Social Development Board as its secretariat. As with many such councils, it has undertaken competitiveness assessments of several sectors of the economy, including handicrafts, tourism, and software. And it has brought several sector-specific and economywide issues to the attention of the government: one-stop shopping for international investors, information about laws and regulations, and the skill levels of the workforce.[72] Competition and investment promotion agencies also often have a mandate to act as champions of reform in their particular areas (chapter 5).

3.65 Some OECD countries have established agencies that have proven influential in policy debates. Australia's Productivity Commission studies particular areas of policy reform. Its reputation for high quality and independent work, and effective consultation with stakeholders, has allowed it to exercise significant influence. In Japan a Regulatory Reform Committee, reporting to the Prime Minister, has responsibility for coordinating the implementation of a broad deregulation plan.[73] In Mexico a *Unidad de Desregulacion Economica* was created in 1988 to oversee improvements to business regulation. Among other reforms, it proposed dismantling price controls, deregulating

the transport sector, streamlining the standardization process. In 2000 it was transformed into the independent, non-governmental *Comisión Federal de Mejora Regulatoria* (COFEMER), maintaining broad formal oversight powers for the analysis of federal regulations and working with subnational governments to reduce red tape.

3.66 Experience with dedicated reform champions in lower income countries and post-conflict countries is mixed, again reflecting technical constraints and institutional design challenges. But there have been successes. For example, Senegal created a Growth and Competitiveness Review Group to identify policy and regulatory constraints to investment and competitiveness and to formulate and implement remedial measures (box 3.17).

Box 3.17 The evolution of a reform champion in Senegal

Senegal's Growth and Competitiveness Review Group was created by presidential decree in 1993 to identify policy and regulatory constraints to investment and competitiveness and to formulate and implement remedial measures.

Established as a coordinating body, the group also consults broadly with representatives of government, private sector organizations, labor unions, universities, and the media. It set up commissions to review domestic competition and antimonopoly issues; export and investment promotion; labor-management issues and labor regulation; and transportation costs. And it took the lead in facilitating substantial improvements to the business environment.

In 2000, the group's functions were integrated into a new Investment Promotion and Major Projects Agency (APIX), directly attached to the President's Office. APIX was directed to identify and support investors, facilitate the restructuring of the private sector, simplify administrative procedures, and implement strategies for the development of priority areas (tourism, cultural industries, building and civil engineering works and assembly industries). It established a one-stop shop processing all procedures for the registration of change of status of a business, reducing the amount of time required for the registration to operate under the investment code from 60 days to 14.

Source: Diop (2003). See also, www.apix.sn.

3.67 Mechanisms and processes of the kind discussed above can help, but ultimately depend for their success on high-levels of political commitment and establishing credibility with stakeholders. They also benefit from ongoing processes to build capabilities within government.

Building government capabilities

3.68 Investment climate improvements differ in their demands on resources, expertise and information. Many don't demand much from the budget—and improving economic growth can increase the tax revenues to governments. But all governments have to improve the quality of their civil services and the quality of the information available to guide and administer reforms.

Expertise

3.69 In some cases, it may be feasible to establish more autonomous administrative structures to make it easier to recruit and retain staff with expertise in core areas—as is common in tax and customs administrations (chapter 5). Central banks and specialist

regulatory agencies also tend to have greater freedom to hire staff with more specialized skills. There is also growing experience with contracting in expertise in particular areas to help design or manage reforms—common even in industrialized countries.

3.70 Investment climate improvements in some areas require the development expertise in specialist regulatory areas. And the credibility and effectiveness of the chosen approach can affect both the investment responses of firms and the sustainability of reforms. Reflecting this are efforts to complement traditional capacity-building strategies with new approaches, including international networks of regulatory professionals (box 3.18). A survey of regulatory agencies across the developing world showed that three-quarters of agencies engage external parties in regulatory tasks. In more than 90 percent of these cases, contracting out was also found to improve the organizational competence of the regulatory agency.[74] Contracting out has also been used effectively for infrastructure services (chapter 6) and customs administration (chapter 5).

Box 3.18 Networks of regulatory professionals in infrastructure

Beginning in the early 1990s governments worldwide began embracing a new model for delivering infrastructure services. It involved improving the government's capabilities as a regulator of services delivered primarily by private firms. As part of this process, more than 200 autonomous regulatory agencies for infrastructure have been set up in developing and transition economies.

The International Forum for Utility Regulation was established by the World Bank in 1996 as an umbrella structure for learning and networking initiatives. Its first major initiative was a two-week training program focusing on the needs of regulators in water, electricity, gas, and telecommunications. Since 1997 more than 1,000 regulators from 115 countries have attended the twice-a-year program. A complementary program for transport regulators, launched by the World Bank Institute in 1998, has reached more than 350 participants. Beyond formal training, these initiatives build direct networks of regulators to facilitate ongoing information sharing and mutual support.

Complementary regional initiatives have since been launched in South Asia and Africa. The South Asian Forum for Infrastructure Regulation, launched in 1999, offers training programs and other learning and knowledge-sharing support to regulators. The African Forum for Utility Regulation, launched in 2000, provides a mechanism for sharing experiences and information on particular regulatory issues, and regular meetings focus on specific themes, such as strategies for engaging consumers and other stakeholders.

Source: International Forum for Utility Regulation, South Asian Forum for Infrastructure Regulation, and African Forum for Utility Regulation websites.

Learning and information

3.71 The need to expand government capabilities extends beyond technical expertise. Governments need to improve their processes for ongoing learning—including from policy experiments abroad as well as within their own countries. Decentralization and institutional competition have been an important source of policy innovation and learning in China and India—states and provinces experiment with alternative policy approaches and successful approaches tend to be quickly emulated by other regions and in some cases by the central government. In Peru land reform pilot projects in the 1990s paved the way for a bolder national program. And in Uganda efforts to improve business registration processes are beginning with a demonstration project in Entebbe (chapter 5).

3.72 To take advantage of these experiments, and to track trends and monitor the supply response to particular policy changes, governments need reliable data on the operation of their private sectors. Consultation processes can be one source of information, but there is no substitute for more objective and consistent sources of data. Data on even basic measures, such as the level of private investment, are lacking or inadequate in many developing countries.

3.73 Similar deficiencies exist in data from official business registers in most developing and transition economies. Designed to meet various purposes—tax and social security collections—these data can provide powerful insights into the dynamism of firms. Greater standardization and proper updating of business registry data—as Eurostat is doing for EU countries—can help governments monitor the evolution of the private sector and alert them to emerging policy issues. Introducing or improving enterprise surveys—a standard tool in industrial countries—can also help governments and policy analysts. They provide information on investment, job creation and destruction, and productivity and output growth at fine levels of disaggregation. While many developing countries have enterprise surveys, there are opportunities to improve the representativeness of samples, the standardization of structures, and the regularity of conducting them.

Making it happen

3.74 Developing effective strategies and supporting mechanisms play a key role in guiding and implementing investment climate improvements. But practical improvements depend on grappling with the detail of policy design and implementation across a range of areas. Part II of the Report focuses on lessons of good practice in improving the "the basics"—the foundations of a sound investment climate ranging from security and stability (chapter 4), regulation and taxation (chapter 5), finance and infrastructure (chapter 6) and labor markets (chapter 7). Experience in each area highlights a host of opportunities for governments.

3.75 Part III of the Report looks at the role of measures that go "beyond the basics"—selective interventions (chapter 8) and the use of international rules and standards (chapter 9). These measures raise a number of special challenges, and can at best complement efforts to improve the basic foundations of the investment climate. Part IV concludes by looking at how the international community might help developing countries improve the investment climates of their societies.

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Endnotes

[1] Johnson, McMillan, and Woodruff (2002).
[2] Maloney (2002).
[3] Reid and Gatrell (2003).
[4] Rodrik (2004).
[5] Cao, Qian, and Weingast (1997).
[6] Saavedra (2003). See also Blanchard and Giavazzi (2003), Binesaree and Freund (2003), Klapper, Laeven, and Reynolds (2003).
7 Porter and others (2004).
[8] Blanchard (xxxx).
[9] International Labour Office (2002).
[10] Chen, Jhabvala, and Lund (2002).
[11] Some women can take advantage of more flexible hours to combine income generating work with taking care of families, but some are forced to work long hours for little pay to make ends meet. Discrimination against women in the formal sector can also be an issue in some countries. A trend that has been working to empower more women and is enabling them to undertake more entrepreneurial activities has been the expansion of microfinance institutions that lend primarily to women, expanding women's access to microloans for their small businesses and empowering them to undertake many more entrepreneurial opportunities (chapter 6). International Labour Office (2002), Ellis (2003).
[12] Mitullah, Background paper for the World Development Report 2005,Lund and Skinner, Background paper for the World Development Report 2005, Chen, Jhabvala, and Nanavaty (2003)
[13] Titling in the slum areas of Lima, Peru, was found to increase investments in homes and local businesses—and labor participation rate jumped 17 percent because family members no longer felt that they had to stay home to guard their plots. Field (2002). A study of microenterprises in 10 countries in Africa and Easter Europe found that establishing clear property rights was the key to reducing barriers to becoming formal. Bannock and others, Background paper for the World Development Report 2005
[14] Efforts to streamline procedures can make a difference. In Entebbe, Uganda, the costs of registering were lowered by 75 percent, and registrations quadrupled (chapter 5). Sander, Background paper for the World Development Report 2005, {World Bank, 2003 63 /id},Djankov and others (2002).
[15] Stern (2003).
[16] Lanjouw and Stern (1998).
[17] Reardon and others (1998).
[18] Lanjouw and Shariff (1999).
[19] Foster and Rosenzweig (2003).
[20] Foster and Rosenzweig (2003).
[21] Bartlesman and others, Background paper for the *World Development Report 2005*.
[22] For example, Messick (1999) notes that vertical integration is a response that enterprises use to avoid having to enter arms-length contracts with other enterprises in countries where the judicial system is too weak or politically dependent for firms to use to enforce contracts.
[23] Several studies have shown that this is the case in many developing countries. For example, using data from 20 countries in Eastern Europe and Central Asia, European Bank for Reconstruction and Development (1999), p. 125 shows that small enterprises pay higher bribes than medium or large enterprises. Using data from the World Business Environment Survey, Batra, Kaufmann, and Stone (2002) show that small enterprises are more likely to pay bribes than medium or large enterprises
[24] {World Bank, 2003 668 /id}.
[25] Christianson, Background paper for the World Development Report 2005.
[26] Despite the attention to this issue, credit is not always the binding constraint on SMEs. Studies in transition economies show that even SMEs with access to credit will not invest even their retained earnings if they face other obstacles, such as insecure property rights or corruption. McMillan and Woodruff (2002)
[27] Many studies have found that different measures of openness are correlated with economic growth (see, for example, Dollar and Kraay (2002), Frankel and Romer (1999)). However, other studies have criticized this cross-country literature for a number of reasons, including whether the measures of trade used in these studies are exogenous and whether they are reasonable proxies for trade policy (see, for example,

Rodriguez and Rodrik (2001)). Baldwin (2003) provides a recent survey of the literature. Despite the questions regarding both methodological issues and the magnitude of the effect that trade has on growth, there appears to be wide consensus that trade openness is both beneficial and associated with growth. For example, Rodrik (2000) concludes "No country has developed successfully by turning its back on international trade and long-term capital flows. Very few countries have growth over long periods of time without experiencing an increase in the share of foreign trade in their national product." (p. 28).

[28] Aitken, Hanson, and Harrison (1997).

[29] The large literature on this topic is summarized in Tybout (2003) and Keller (2003). Evidence from the Investment Climate Assessments provides support for this in many developing countries. See, for example, results for Bangladesh (World Bank (2003a)), Peru (World Bank (2003c)), Poland (World Bank (2003d)) and Tanzania (World Bank (2004)).

[30] Using data from Columbia, Mexico and Morocco from the 1980s and early 1990s, Clerides, Lach, and Tybout (1998) conclude that the evidence supports the self-selection hypothesis, while providing little support for the learning by exporting hypothesis. Similarly, using data from the United States for the mid-1980s through the early 1990s, Bernard and Jensen (1999) find similar results. Using data from Taiwan (China) for the electrical machinery and electronics industry, Liu, Tsou, and Hammitt (1999) reach similar conclusions. Finally, Aw, Chung, and J. (2000), using data from the 1980s and early 1990s, find some evidence to support the learning-by-exporting hypothesis for some industries in Taiwan (China) but no evidence to support it for Korea. Further, they find other evidence that is not consistent with the learning by exporting hypothesis in Taiwan (China) and conclude (p. 83): "the lack of strong evidence of learning by exporting is consistent with Clerides, Lach, and Tybout (1998) and Bernard and Jensen (1999)."

[31] Westphal (2002).

[32] For example, using data from four African countries, Bigsten and others (2000) find evidence consistent with both the learning-by-exporting hypothesis and the self-selectivity hypothesis. Similarly, using data from China, Kraay (1999) finds evidence or learning among Chinese enterprises. Finally, using data from Indonesia, the Philippines, Thailand, Malaysia and Korea, although Hallward-Driemeier, Iarossi, and Sokoloff (2002) find that exporters improve their productivity before entering export markets, they find evidence that firms that enter export markets take concrete steps to do so (e.g., training employees and using foreign technology) before entering export markets. They interpret this as suggesting that the firms are trying to pass the threshold to enter such markets.

[33] Hoekman, Kee, and Olarreaga (2001) conclude, based upon a cross-country analysis of 41 developed and developing countries, that average markups are lower in countries with greater import penetration and fewer barrier to entry for domestic firms. They find that the import penetration has a greater effect in smaller countries (in terms of GDP). Country-level studies also support the hypothesis that imports are a source of discipline. For example, based upon a series of studies looking at Chile between 1979 and 1986, Colombia between 1977 and 1985, Mexico between 1985 and 1990, Morocco between 1984 and 1989 and Turkey between 1976 and 1985, Roberts and Tybout (1996) conclude that foreign competition results in reduced price mark-ups in every country in their study. Similarly, Harrison (1994) and Levinsohn (1993) show that trade liberalization reduced markups in Côte d'Ivoire and Turkey respectively.

[34] For example, tariffs that the United States imposed on steel in 2002 increased costs to local steel users by nearly $600 million—well over twice the $240 million in benefits received by U.S. steel companies. See Hufbauer and Goodrich (2003a); Hufbauer and Goodrich (2003b).

[35] Coe, Helpman, and Hoffmaister (1997a) find that total factor productivity is higher in developing countries that import from R&D intensive industrial countries. They interpret this as showing developing countries can gain access to foreign technologies by importing intermediate goods and capital imported from developed economies that embody foreign knowledge. Based upon the estimates of spillovers from this paper, Bayoumi, Coe, and Helpman (1999) estimate that output would be about 6.5 percent greater after 80 years if trade were expanded by five percent of GDP. {World Bank, 2003 743 /id} summarizes other studies looking at the effect of trade on technology diffusion in developing countries.

[36] Chapter 3 of World Bank (2002a) and Tybout (2003) provide comprehensive surveys of this literature.

[37] For example, Djankov and Hoekman (2000) find that firm-level productivity increased for non-exporters (i.e., enterprises that were not already subject to the market discipline of operating in international markets) in Bulgaria as a result of trade liberalization and other changes that affected market discipline. See Tybout (2003) for a summary of many of these studies.

[38] See Fernandes (2003) for Colombia, Muendler (2002) for Brazil, and Pavcnik (2003) for Chile. Using industry-level data for India, Aghion and Burgess (2003) find similar results for India.
[39] See Fernandes (2003).
[40] Aghion and Burgess (2003) find that Indian firms that were close to technological frontier managed to improve their performance following liberalization, while less productive firms were not.
[41] Consistent with the notion that the 1980s reform was modest, trade did not increase significantly as a percent of GDP over this period. Trade was equal to about 15.74 percent of GDP in 1980, and only 15.71 percent of GDP in 1990 (World Development Indicators). In contrast, trade increased significantly during the 1990s, reaching 28.34 percent of GDP by 2000.
[42] Topalova (2003), however, did not find evidence of this.
[43] The recent enactment of Amendments to the Companies Act (January 2003) and repeal of the Sick Industries Company Act (December 2003) provide a new and enhanced framework for the liquidation of firms outside the court process, and this should help speed up bankruptcy proceedings.
[44] For example, foreign-owned textile and electronics firms in China in the late1990s have been more productive than domestic enterprises—a 10 percent increase in foreign ownership share increased total factor productivity by more than 4 percent in the electronics industry. Hu and Jefferson (2002)Foreign ownership also appears to have increased productivity in small manufacturing plants in Venezuela. Using panel data from Venezuela, Aitken and Harrison (1999) find that foreign ownership increases productivity in small, but not large, manufacturing plants, even after controlling for plant-specific effects. In contrast, Haddad and Harrison (1993) find that foreign-owned enterprises in Morocco were more productive than wholly domestically owned enterprises, but that their productivity grew more slowly.[44] Studies of privatization in the European transition economies found that the gains of privatizing to foreign owners were on average about three times greater than those of privatizing to insiders (workers and managers) and twice as great as those of privatizing to other outside investors. Djankov and Murrell (2002). The study draws upon 24 studies, but not all of these include foreign ownership as a separate ownership class.
[45] Blalock and Gertler (2003), Smarzynska (2002), Kugler (2001).
[46] See, for example, Haddad and Harrison (1993) in Morocco, Aitken and Harrison (1999) in Venezuela. In a meta-analysis of existing studies, Gõrg and Strobl (2001) conclude that the evidence concerning positive spillovers is mixed. Blomström and Kokko (1998) also review the. Hu and Jefferson (2002) for China and Aitken and Harrison (1999) for Venezuela found that productivity in local rivals fee. Other studies of firms in China have found evidence of positive spillovers, however. See, for example, Wei and Liu (2003).
[47] Parente and Prescott (2000). Baumol (2002).
[48] Evidence shows that for countries with low skill levels, the returns of acquiring foreign technology are higher. In India returns of technology purchase is 44 times higher than rate of return of domestic R&D, in scientific sectors rate of return for technology purchase is 166 %, but for domestic R&D is 1 %. Basant and Fikkert (1996).
[49] Using cross-country data, Coe and Helpman (1995) found that foreign R&D has significant impact on total factor productivity in developed countries, and the spillovers depend on the composition and level of imports. Coe, Helpman, and Hoffmaister (1997b) using a sample of 77 developing countries found this hypothesis econometrically valid with respect to imports of equipments and machinery and imports of all manufactured products. They estimate that in 1990 the total spillover effects from R&D in industrial countries may have increased output in the developing countries by US$22 billion.
[50] The level of absorption may depend on human capital and the stock of domestic R&D. Crespo, Martin, and Velazquez (2002) found positive contribution of technology spillovers from imports to growth on OECD countries. However, they also found that the absorption depends on human capital and the stock of domestic R&D stock. Similar results are found in Basant and Fikkert (1996) and Hohnson (1998), that firms in India and Brazil respectively benefit from spillovers from foreign R&D, but only to the extent that they conduct their own R&D.
[51] Lederman and Maloney (2003).
[52] Clarke (2001).
[53] UNCTAD (2003), World Bank Report on Malaysia (2003).
[54] de Ferranti and others (2003).
[55] Woo-Cumings (2001), Smith (2000).
[56] Parente and Prescott (2000).
[57] Krueger (2000); Tommasi (2002).

[58] Berglof and Roland (2000).
[59] Garrett and Brune (2001).
[60] Cao, Qian, and Weingast (1997), Yeung (2003).
[61] North and Weingast (1989).
[62] See Kingdon (1995).
[63] Cabanero-Vervosa and Mitchell (2003).
[64] Kostrzeva (2003).
[65] Argy and Johnson (2003).
[66] Kirkpatrick and Parker (2003). Lee (2002).
[67] In 1997, the Bulgarian Institute for Market Economics (IME) started producing its own regulatory impact assessments; between 1998 and 2003 IME performed cost-benefit analyses of approximately 150 proposes regulations, and submitted its findings to decision-makers and the media. See Stanchev (2003).
[68] Knight-John, Jayasinghe, and Perumal (2003).
[69] Regobeth and Ahortor (2003).
[70] Stanchev (2003).
[71] Zeroulis (2003), Vilpisauskas (2003).
[72] Wedel (2002).
[73] OECD (1999).
[74] Environmental Reources Management (2004).