world development report 2005

A Better Investment Climate for Everyone

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1818 H Street, NW
Washington, DC 20433
Telephone: 202-473-1000
Internet: www.worldbank.org
E-mail: feedback@worldbank.org

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Foreword

This *World Development Report* is about creating opportunities for people to escape from poverty and improve their living standards. It is about creating a climate in which firms and entrepreneurs of all types—from farmers and microenterprises to local manufacturing concerns and multinationals—have opportunities and incentives to invest productively, create jobs, and expand, and thereby contribute to growth and poverty reduction. The Report thus deals with one of the central challenges of development.

Expanding opportunities for people in developing countries is a pressing concern for governments and for the global community. Nearly half the world's population lives on less than $2 a day, and 1.1 billion barely survive on less than $1 a day. Young people have more than double the average unemployment rate in all regions, and population growth will add nearly 2 billion more people to developing countries over the next 30 years. Improving the climate for investment in developing countries is essential to provide jobs and opportunities for young people and to build a more inclusive, balanced, and peaceful world.

There is good news. More governments are recognizing that their policies and behaviors play a critical role in shaping the investment climates of their societies, and they are making changes. China and India provide compelling examples: investment climate improvements in these countries have driven growth and the most dramatic reductions in poverty in history. Many other governments are also taking on the agenda, but progress remains slow and uneven. Governments still saddle firms and entrepreneurs with unnecessary costs, create substantial uncertainty and risk, and erect unjustified barriers to competition.

This year's *World Development Report,* the 27th in the World Bank's flagship series, looks at what governments can do to create better investment climates for their societies. Drawing on new research, including surveys of nearly 30,000 firms in 53 developing countries, other new data, and country case studies, it makes four main points.

First, the Report emphasizes that the goal should be to create an investment climate that is better for everyone—in two dimensions. The investment climate should benefit society as a whole, not only firms. Well-designed regulation and taxation are thus an important part of a good investment climate. And the investment climate should embrace firms of all types, not just large or influential firms. Small and large firms, local and foreign firms, and low-tech and high-tech firms each have important and complementary contributions to make to growth and poverty reduction.

Second, the Report argues that efforts to improve the investment climate need to go beyond just reducing business costs. Those costs can indeed be extraordinary in many countries, amounting to several times what firms pay in taxes. But policy-related risks dominate firms' concerns in developing countries and can cripple incentives to invest. And barriers to competition remain pervasive, dulling incentives for firms to innovate and increase productivity. Governments need to address all three aspects of a good investment climate.

Third, the Report underscores that progress requires more than changes in formal policies. The gaps between policies and their implementation can be huge, with the vast informal economies in many developing countries providing the most palpable evidence. Governments need to bridge these gaps and address deeper sources of policy failure that can undermine a sound investment climate. Governments need to tackle corruption and other forms of rent-seeking, to build credibility with firms, to foster public trust and legitimacy, and to ensure their policy interventions are crafted to fit local conditions.

Finally, the Report reviews strategies for tackling such a broad agenda. It emphasizes that perfection is not required and that everything does not have to be done at once. But progress requires governments to address important constraints in ways that give firms the confidence to invest—and to sustain a process of ongoing improvements. Persistence pays off.

These findings are supported by detailed analysis and the many examples discussed throughout the Report, which should provide practical insights for policymakers and for others concerned with growth and poverty reduction in developing countries.

Improving the investment climate is the first pillar of the World Bank's overall development strategy. The *World Development Report 2005* complements last year's WDR, which addressed key aspects of the second pillar of that strategy: investing in and empowering people to take advantage of opportunities. Together, these two Reports offer sound advice and research that will help the World Bank and our partners realize our common dream—a world free of poverty.

James D. Wolfensohn
President
The World Bank

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The team undertook a wide range of consultations for this Report, which included workshops in Berlin, Dar-es-Salaam, London, New Delhi, Shanghai, and Washington, D.C.; videoconferences with sites in Brazil, Egypt, Guatemala, Honduras, Japan, Lebanon, Nicaragua, Russia, and Serbia and Montenegro; and an on-line discussion of the draft report. Participants in these workshops, videoconferences, and discussions included researchers, government officials, and staff of nongovernmental and private-sector organizations.

Rebecca Sugui served as executive assistant to the team, Ofelia Valladolid as program assistant, and Madhur Arora and Jason Victor as team assistants. Evangeline Santo Domingo served as resource management assistant.

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Abbreviations and Data Notes

Abbreviations

APEC	Asia-Pacific Economic Cooperation
BEEPS II	Business Environment and Enterprise Performance Survey II
BITs	Bilateral investment treaties
DFIs	Development finance institutions
EPZs	Export processing zones
EU	European Union
FDI	Foreign direct investment
GATT	General Agreement on Tariffs and Trade
GDP	Gross domestic product
GNI	Gross national income
HIV/AIDs	Human immunodeficiency virus/ acquired immunodeficiency syndrome
ICRG	International Country Risk Guide
ICS	Investment Climate Surveys
ICSID	International Centre for Settlement of Investment Disputes
ILO	International Labour Organisation
IMF	International Monetary Fund
MERCOSUR	Common Market of the South
NAFTA	North American Free Trade Agreement
NEPAD	New Partnership for Africa's Development
NGOs	Nongovernmental organizations
OECD	Organisation for Economic Co-operation and Development
PPP	Purchasing power parity
R&D	Research and development
SMEs	Small and medium enterprises
TFP	Total factor productivity
U.N.	United Nations
UNCITRAL	United Nations Commission on International Trade Law
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
USAID	U.S. Agency for International Development
VAT	Value added tax
WEF	World Economic Forum
WTO	World Trade Organization

Data Notes

The countries included in regional and income groupings in this Report are listed in the Classification of Economies table at the beginning of the Selected World Development Indicators. Income classifications are based on GNP per capita; thresholds for income classifications in this edition may be found in the Introduction to Selected World Development Indicators. Group averages reported in the figures and tables are unweighted averages of the countries in the group unless noted to the contrary.

The use of the word *countries* to refer to economies implies no judgment by the World Bank about the legal or other status of a territory. The term *developing countries* includes low- and middle-income economies and thus may include economies in transition from central planning, as a matter of convenience. The term *developed countries* is used to denote the high-income economies.

Dollar figures are current U.S. dollars, unless otherwise specified. *Billion* means 1,000 million; *trillion* means 1,000 billion.