

Improving the Investment Climate

PART I THE REPORT ARGUES THAT THE INVESTMENT CLIMATE plays a central role in growth and poverty reduction. This part shows why improving the investment climates of their societies should be a top priority for governments, and looks at how the necessary improvements can be made.

Chapter 1—*The investment climate, growth, and poverty* shows how governments influence the investment climate and how improving the investment climate drives growth and reduces poverty.

Chapter 2—*Confronting the underlying challenges* looks at why improving the investment climate can be difficult, and the sources of potential policy failure that governments must face.

Chapter 3—*Tackling a broad agenda* reviews international experience in making investment climate improvements and suggests practical strategies for accelerating and broadening progress.

The investment climate, growth, and poverty

chapter 1

A good investment climate fosters productive private investment—the engine for growth and poverty reduction. It creates opportunities and jobs for people. It expands the variety of goods and services available and reduces their cost, to the benefit of consumers. It supports a sustainable source of tax revenues to fund other important social goals. And many features of a good investment climate—including efficient infrastructure, courts, and finance markets—improve the lives of people directly, whether they work or engage in entrepreneurial activities or not.

Improving the investment climate—the opportunities and incentives for firms to invest productively, create jobs, and expand—is the key to sustainable progress in attacking poverty and improving living standards (box 1.1). Varying enormously around the world, both across and within countries, the investment climate influences the decisions of firms of all types: the decision of the farmer to sow more seed; the decision of the microentrepreneur to start a business; the decision of the local manufacturing company to expand its production line and hire more workers; the decision of the multinational to locate its next global production facility.

This chapter looks at how improving government policies and behaviors that shape the investment climate matters not only for firms—it also drives growth and improves opportunities for everyone. The chapter opens by looking at what we know about the investment climate. Some of the many factors influencing the decisions of firms to invest productively, create jobs, and expand are specific to each firm—its ideas, its capabilities, and its strategies. Many

more are specific to each location, to the investment climate in its broadest sense. Governments may have limited influence over such factors as geography. But they have much more influence over the security of property rights, the approaches to regulation and taxation (both at and within the border), the adequacy of infrastructure, the functioning of finance and labor markets, and broader features of governance such as corruption.

Earlier work looking at differences in incomes across countries highlighted the role of “institutions”—the broad organizational framework governing market transactions. New sources of data drawn on in this Report allow us to go further and provide fresh insights into how the details of institutional arrangements vary across and within countries and influence the level and productivity of private investment.

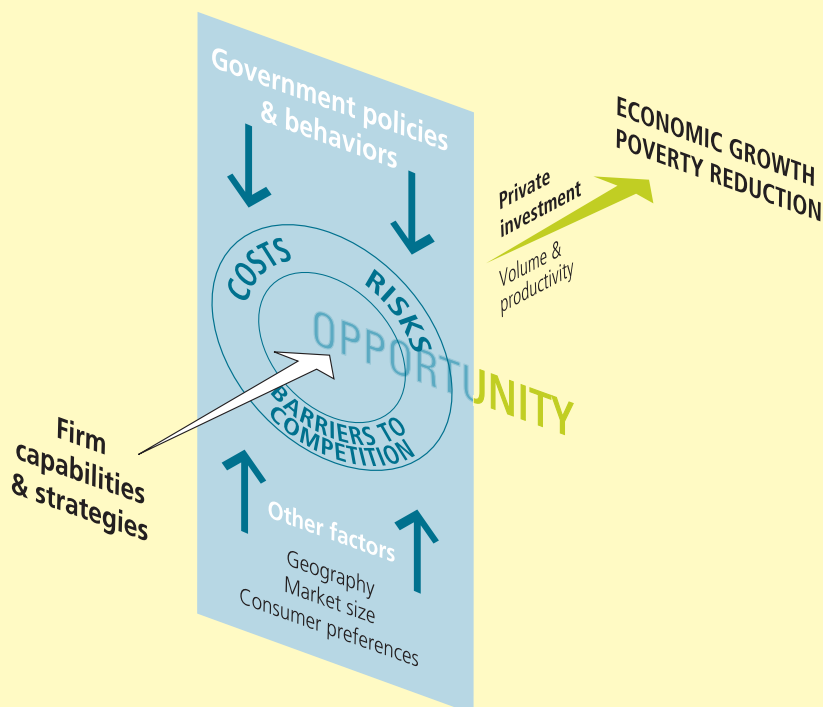
The chapter then looks at how variations in government policies and behaviors affect the investment climate—and thus growth and poverty. The key is to remove unjustified costs, risks, and barriers to competition faced by firms of all types. An investment climate that encourages growth creates sustainable jobs and opportunities for microentrepreneurs—the key pathways out of poverty for poor people, pathways that will become more crowded with coming demographic changes. A good investment climate also helps to reduce the costs of goods consumed by poor people, and improves the living conditions of poor people directly. It also contributes to an expanding tax base that allows governments to invest in the health, education, and welfare of its people.

The key message: for governments at all levels, a top priority should be to improve the investment climates of their societies. To do so, they need to understand how their policies and behaviors shape the opportunities and incentives facing firms of all types, domestic and foreign, formal and informal, small and large, urban and rural. The agenda is broad and challenging, but delivering on it is the key to reducing poverty, improving living standards, and creating a more inclusive, balanced, and stable world.

Understanding the investment climate

Firms invest to make profits. Their investment decisions are affected by their own ideas, capabilities, and strategies, and by their assessment of the opportunities and incentives in particular locations. Early efforts to understand how governments influence these location-specific factors focused on broad indicators of country risk, often based on surveys of international experts and usually

BOX 1.1 What do we mean by the investment climate?



The investment climate is the set of location-specific factors shaping the opportunities and incentives for firms to invest productively, create jobs, and expand. Government policies and behaviors exert a strong influence through their impact on costs, risks, and barriers to competition—and are the focus of this Report.

Firms are the starting point of the framework. This Report uses that term to include the full range of economic agents ranging from individual farmers and microentrepreneurs to domestic manufacturing establishments and multinationals, regardless of their size, activity, or formal legal status.

The horizontal plane in the diagram above represents their investment decisions. Firms decide whether to incur costs today to change or augment production in the future, such as investing in machinery, facilities, and research and development. Firms come to the decision with different capabilities and strategies. Their decision is motivated by the quest for profits—and profitability is influenced by the costs, risks, and barriers to competition associated with the opportunity. The volume and productivity of the resulting investment contribute to growth and poverty reduction.

A good investment climate is not just about generating profits for firms—if that were the

goal, the focus could be narrowed to minimizing costs and risks. It is about improving outcomes for society. Many costs and risks are properly borne by firms. And reducing barriers to competition expands opportunities, spurs innovation, and ensures that the benefits of productivity improvements are shared with workers and consumers. A good investment climate is one that benefits everyone in two dimensions. First, it serves society as a whole, rather than just firms, including through its impact on job creation, lower prices, and broadening the tax base. Second, it embraces all firms, not just large or influential firms.

The vertical plane in the figure represents the investment climate. Some aspects of the investment climate, including geography and market size, are difficult for governments to change. But governments have more decisive influence over a range of other factors. The specific influences addressed in the Report are policies closely tied to investment behavior. Thus, the forward-looking nature of investment points to the importance of stability and security, especially the security of property rights (chapter 4). Regulations and taxes qualify property rights and have first-order implications for costs, risks, and barriers to competition (chapter 5). Finance, infrastructure, and labor are the key inputs to investment activities (chapters 6 and 7).

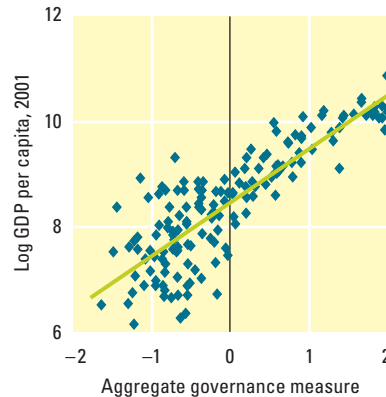
But firms do not respond to formal policies alone. They make judgments about how those policies will be implemented in practice. And firms (like other stakeholders) will try to influence policies in ways favorable to them. Thus, issues of government behavior and governance, in the broadest sense, are paramount (chapter 2). It is the interaction of formal policies and governance that firms assess in making investment decisions. This has important implications for strategies to improve the investment climate (chapter 3).

resulting in a single score for each country.¹ Many studies focused on the narrower question of the constraints facing foreign firms. The last 20 years have seen a broadening and deepening of efforts to understand how various location-specific factors influence differences in incomes across countries.

Researchers began by looking at various aggregate indicators of a country's institutional and policy environment, such as the rule of law, corruption, openness to trade, legal origins, and financial sector depth.² Their work generated useful insights—the most important is that secure property rights and good governance are central to economic growth (figure 1.1).³ However, relying on aggregate indicators and cross-country regressions provides limited insights into the heterogeneity of institutional arrangements across and within countries—or the impact of those arrangements on the investment decisions of different types of firms.⁴ It is also difficult to distinguish the effects of specific policy actions from the broader background institutions that influence the content and impact of those actions.⁵

These limits inspired the search for more disaggregated evidence on the quality of a location's investment climate and for ways to trace the impact of that climate on the investment decisions and performance of firms. The World Bank is contributing to this work in several ways, including Investment Climate Surveys and the Doing Business Project (box 1.2). These and other new sources of data provide fresh insights about how investment climates vary across and

Figure 1.1 Institutions, broadly measured, clearly matter for growth



Note: The horizontal axis represents the average of “rule of law,” “government effectiveness,” “regulatory quality,” and “control of corruption” as defined by Kaufmann, Kraay, and Mastruzzi (2003). The variables are normalized so that the average is at 0, and the standard deviation equals 1.

Source: Kaufman, Kraay, and Mastruzzi (2003).

within countries—and impact on firm performance, growth, and poverty.

The opportunities and incentives firms have to invest productively, create jobs, and expand can be traced through their impact on expected profitability. And profitability is influenced by the costs, risks, and barriers to competition associated with particular opportunities. Each factor matters independently, and all three are interrelated. Some risks can be mitigated by incurring greater costs. High costs or risks can be barriers to competition. Barriers to competition can reduce risks for some firms but deny opportunities and increase costs for others.

Many factors shape the costs, risks, and barriers to competition in a particular location. Factors like geography are difficult

BOX 1.2 New sources of investment climate data from the World Bank

The World Bank recently launched two major initiatives to understand more about the determinants of growth and productivity.

- *Investment Climate Surveys.* Large random samples of firms have been interviewed to collect assessments of constraints facing firms including governance, regulation, taxation, finance, infrastructure, and labor. The surveys also collect objective data, which allow investment climate indicators to be linked with firm performance to understand their impact on productivity, investment decisions, and employment decisions. The surveys were

launched in 2001, with about 20 new surveys conducted each year since. This Report draws on early results from this work, which covers more than 26,000 firms in 53 countries, and together employ some 4.8 million people. The Investment Climate Surveys build on the World Business Environment Surveys, launched in 1999, which covered smaller samples of firms and relied more heavily on perception data.

- *Doing Business Project.* Covering over 130 countries, this project reports on the costs of doing business for a defined hypothetical firm and transaction based on the views of

selected experts (lawyers, accountants).

Underlying information includes the time and costs of complying with various areas of regulation—including business registration, contract enforcement, and labor regulation. A first report was published in 2003, with annual updates scheduled with additional topics.

Selected data from these sources appear at the back of this Report.

This Report complemented these initiatives by surveying 3,250 entrepreneurs in the informal sector in 11 countries recently completing Investment Climate Surveys.

BOX 1.3 *Geography matters, but it is not destiny*

Some aspects of the investment climate are more difficult for governments to change than others. The most important of them is geography, which can have direct and indirect effects on the investment climate.

Countries with large domestic markets, or near larger markets, may be more attractive to investors than smaller or more remote markets, though moves toward more open trade and advances in transportation and communications are reducing the gap. Within countries, low population densities and distances from markets can also affect the attractiveness of rural areas, though investments in infrastructure can reduce that gap as well.

Climatic variables can also influence the feasibility of some types of activity, such as

agriculture and tourism. And countries in malaria-affected regions face special disadvantages.

Large endowments of natural resources were once thought to be a big advantage. But such concentrations of wealth have consumed some societies in rent-seeking, raising the question of whether such endowments are always a blessing (chapter 2).

Whatever the weight of geography, it is clear that efforts to improve aspects of the investment climate more amenable to government influence can provide large payoffs. Such efforts help a society make the most of its innate resources—physical and human.

Source: Easterly and Levine (2003) and Gallup, Sachs, and Mellinger (1999).

to influence (box 1.3). Governments have more decisive influence over many other aspects of the investment climate, such as the security of property rights, approaches to regulation and taxation, the adequacy of infrastructure, and the functioning of finance and labor markets (table 1.1). Government policies on these subjects interact—for example, secure rights to land can ease access to finance. Moreover, the content and impact of formal policies in these areas are determined by broader features of the governance environment, including corruption and credibility (chapter 2). Firms assess

how government policies and behaviors interact as part of a package to influence the costs, risks, and barriers to competition associated with particular opportunities.

The new data show how costs, risks, and barriers to competition can affect firms' investment behavior—and how they vary around the world.

Costs

The costs of producing and distributing products influences the range of opportunities that may be profitable. Many costs to firms are a normal function of commercial activity, while others flow directly or indirectly from government policies and behaviors. The most obvious direct cost is taxation. But governments have important roles in providing public goods, supporting the provision of infrastructure, and mitigating other market failures. The ways they do this can have a big impact on the costs that firms face. For example, the costs associated with crime, corruption, regulation, unreliable infrastructure, and poor contract enforcement can amount to over 25 percent of sales—or more than three times what is typically paid in taxes. The level and composition of these costs vary widely (figure 1.2). The time costs of complying with particular regulatory requirements also vary widely. For example, registering a new business can take 2 days in Australia, but over 200 days in Haiti.⁶

Table 1.1 Government policies and behaviors and investment decisions—some examples

	Factors that shape opportunities and incentives for firms to invest	
	Government has strong influence	Government has less influence
Costs	<ul style="list-style-type: none"> • Corruption (chapter 2) • Taxes (chapter 5) • Regulatory burdens, red tape (chapter 5) • Infrastructure and finance costs (chapter 6) • Labor market regulation (chapter 7) 	<ul style="list-style-type: none"> • Market-determined prices of inputs • Distance to input and output markets • Economies of scale and scope associated with particular technologies
Risks	<ul style="list-style-type: none"> • Policy predictability and credibility (chapter 2) • Macroeconomic stability (chapter 4) • Rights to property (chapter 4) • Contract enforcement (chapter 4) • Expropriation (chapter 4) 	<ul style="list-style-type: none"> • Consumer and competitor responses • External shocks • Natural disasters • Supplier reliability
Barriers to competition	<ul style="list-style-type: none"> • Regulatory barriers to entry and exit (chapter 5) • Competition law and policy (chapter 5) • Functioning finance markets (chapter 6) • Infrastructure (chapter 6) 	<ul style="list-style-type: none"> • Market size and distance to input and output markets • Economies of scale and scope in particular activities

Risks

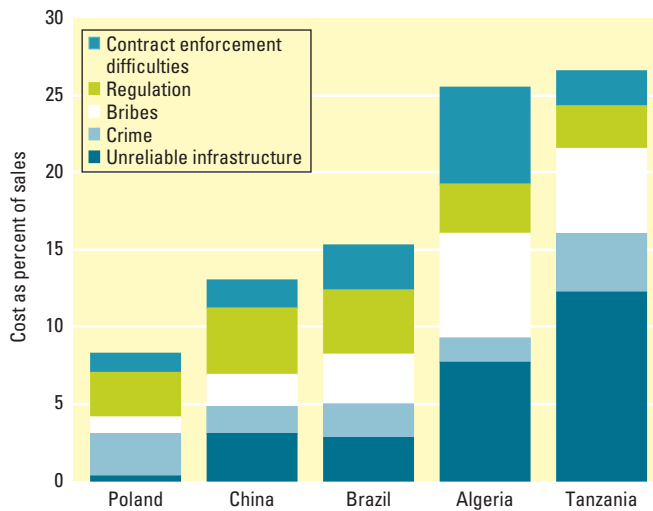
Investment decisions are forward looking, allocating resources today in the hope of future rewards. Many investment risks, like costs, are a normal function of commercial ventures, including uncertain responses from consumers and competitors, so firms should bear them. Governments, however, have an important role in helping firms cope with risks associated with the security of their property rights. Governments can also increase the risks and uncertainties that firms face directly—policy uncertainty and macroeconomic instability rank consistently as the leading investment climate concerns of firms (chapter 2). Unpredictability in the interpretation of regulations is often a big concern (figure 1.3). And almost 95 percent of firms report a gap between formal policies and their implementation.

Assessing the impact of risks is complicated by the different ways firms respond—demanding higher returns, adopting shorter planning horizons, or not investing at all. Firms operating in some high-risk countries require more than twice the rate of return they would in lower-risk countries to compensate for the extra risks.⁷ Firm-level surveys show that improving policy predictability can increase the probability of new investment by more than 30 percent (chapter 2).⁸

Barriers to competition

Firms naturally prefer less competition rather than more. But a barrier to competition benefiting one firm denies opportunities and increases costs for other firms and to consumers. And competitive pressure drives firms to innovate, to improve productivity, and to share the benefits of productivity gains with consumers and workers. Many factors, including economies of scale and market size, can influence the level of competition in a market. Governments also influence competitive pressure through their regulation of market entry and exit—and their responses to anticompetitive behavior by firms. Competition is difficult to measure at the aggregate level, but firm-level evidence shows how much competitive pressure can vary between countries (figure 1.4).

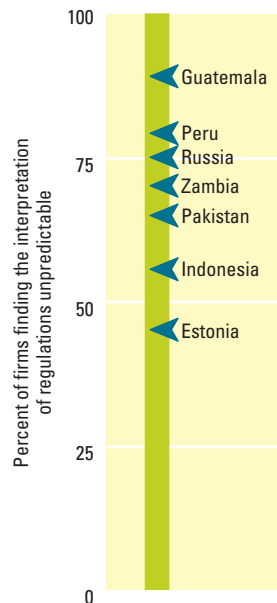
Figure 1.2 Costs vary widely in level and composition



Note: The survey asked registered firms to report values either in monetary terms, directly as a share of sales, or in terms of time. “Contract enforcement difficulties” captures the share of inputs that are below agreed-upon quality (weighted by material inputs in total sales) and overdue payments (as a share of total payments, using an interest rate of 10 percent for the average length of overdue payments). “Regulation” captures management time spent dealing with officials (weighted by the cost of management compensation to total sales), and the gap in actual employment relative to desired levels due to regulatory costs associated with hiring and firing workers (weighted by total labor costs in sales). “Bribes” are the total costs of bribes as a share of sales. “Crime” is the sum of losses due to theft, security costs, and protection payments (as a share of sales). “Unreliable infrastructure” includes sales lost due to interruptions in power and telecommunications and due to the loss or damage of goods in transit. Countries selected to illustrate range.

Source: World Bank Investment Climate Surveys.

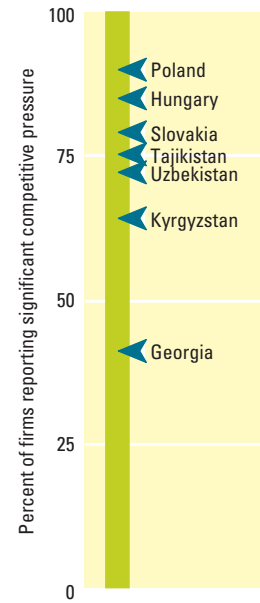
Figure 1.3 Regulatory unpredictability is a big concern for firms



Note: Countries selected to illustrate the range of responses.

Source: World Bank Investment Climate Surveys.

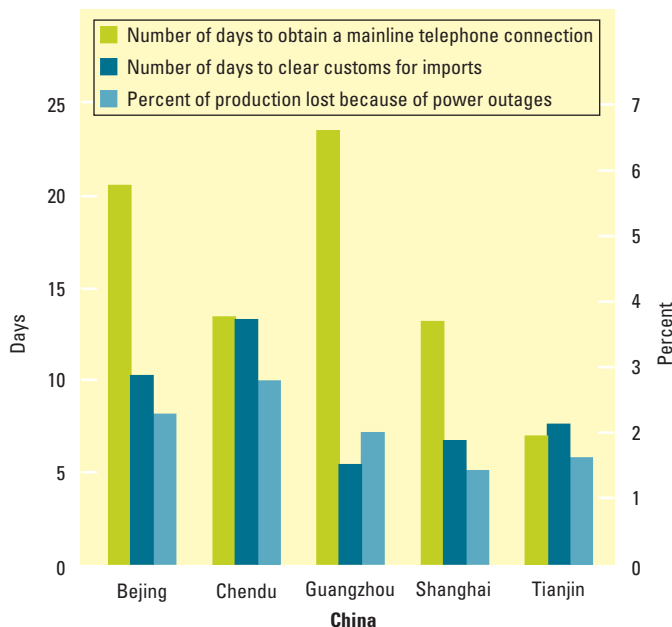
Figure 1.4 Competitive pressure can vary significantly between countries



Note: Countries selected to illustrate range of responses; data limited to Europe and Central Asia.

Source: World Bank Investment Climate Surveys/BEEPS II.

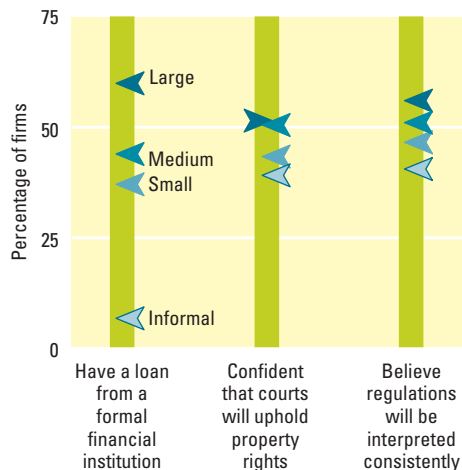
Figure 1.5 Investment climate conditions vary within countries



Source: World Bank Investment Climate Surveys.

Improving the investment climate is not about reducing *all* costs, *all* risks, and *all* barriers. Taxes and regulation support a sound investment climate and protect broader social interests. Managing the tension between creating a favorable investment climate for firms and achieving other social goals is a major challenge for governments—and a key theme of this Report.

Figure 1.6 Investment climate conditions can affect firms differently



Note: Uses 10 countries for which formal and informal surveys were conducted, controlling for industry, country, ownership, and firm age.
 Source: World Bank Investment Climate Surveys and WDR Surveys of Micro and Informal Firms.

The new evidence shows large variations in investment climate conditions not only between countries, but also within countries, as illustrated by China (figure 1.5). This will often be the case with infrastructure provision or when subnational governments determine policies. But even a single national law may be applied differently within a country: for example, the time to transfer property title in Brazil varies from 15 days in Brasilia to 65 days in Salvador.⁹

Even within a single location, the same conditions can affect firms differently. This can be true across activities—farmers, manufacturers, and barbers each have different perspectives. But a poor investment climate often hits smaller and informal firms the hardest (figure 1.6).

How investment climate improvements drive growth and reduce poverty

With rising populations, economic growth is the only sustainable mechanism for increasing a society’s standard of living. Growth is associated not just with higher incomes, but with better indicators of human development, such as lower infant mortality, broader education, and longer life expectancy. It provides opportunities for firms of all types, creating jobs and expanding the tax base available to fund public services. Households as well as firms benefit from better property rights, financial markets, and infrastructure services. It is also now widely understood that growth must be sustainable, safeguarding the value of national assets—including environmental assets—and the potential for future growth (box 1.4). A growing body of research shows how investment climate policies contribute to economic growth, and how policy approaches might be tailored to better target the needs of poor people. What has been learned?

Significant economic growth is a modern phenomenon, not shared by all

Some early economists were concerned that the potential for rising incomes was inherently limited, while mercantilists believed that growth was a zero-sum game, with gains by some countries coming only at the expense of others. For centuries the average

BOX 1.4 The environment matters for well-being and productivity: Main messages from WDR 2003

Growth in income and productivity is required to eliminate poverty in developing countries, but it needs to be environmentally sustainable. The immediate gains of depleting or degrading environmental assets can be outweighed by the costs in productivity and lost options. Over the longer run, economic growth is unlikely to be sustained unless attention is paid to assets such as fresh water and fish stocks.

Even in the short to medium run, addressing the objectives for growth and the preservation or restoration of environmental assets can be critical to raising production and incomes. Consider Madagascar, where the conversion of biodiversity-rich forests to mostly unsustainable low-yield agriculture has been costly. With three-quarters of the country's people in rural areas and three-quarters of them poor, productivity growth in agriculture is critical to reducing

poverty, but agricultural productivity has been stagnant over the past four decades. Much of the cropland is degraded, and hillside erosion clogs downslope waterways. The country's per capita GDP slid from \$383 (in 1995 dollars) in 1960 to \$246 in 2002.

Environmental conditions will only worsen if present trends continue. People in hundreds of developing-country cities live with unhealthy air, which causes premature deaths, preventable at a modest cost. Nearly 23 percent of all cropland, pasture, forest, and woodland worldwide has been degraded since the 1950s. Local conflicts over water and the loss of freshwater ecosystems loom in some regions. Two-thirds of all fisheries are exploited at or beyond their sustainable limits. Every decade another 5 percent of tropical forest is cleared.

Why are environmental assets particularly threatened and underprovided? Because of spillovers. The actions of one person may impose environmental costs, such as pollution, on other people—costs that the responsible party does not bear. Addressing these environmental problems requires governments to take a long-term view and manage a broad portfolio of assets that includes not only human and physical capital but also environmental assets. Policies that have proved successful in solving these problems are those that align individual incentives with social incentives—including those for property rights, regulation, taxes, and subsidies. Such measures form an important part of a sound investment climate.

Source: World Bank (2003o).

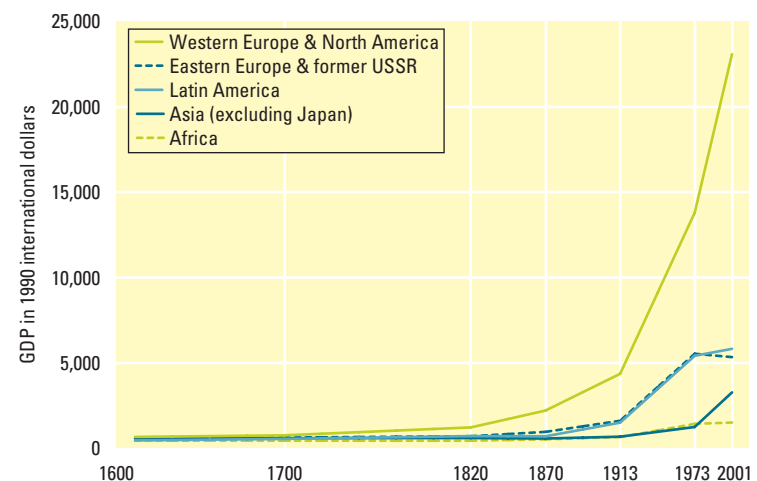
level of income did not change. This led to Malthus' observation in 1798 that any rise in income was quickly offset by a rise in population, leaving per capita incomes constant.¹⁰ Over the next hundred years, however, the leading countries doubled their per capita incomes, with the speed accelerating over the 20th century (figure 1.7). The time to double incomes fell from a millennium, to centuries, to just 20 to 30 years.

Today the world's per capita GDP is estimated to be at least five times what it was at the beginning of the 19th century,¹¹ and the comparison actually underestimates the growth achieved. It is a matter of looking not just at real incomes to judge whether more goods can be purchased now—because the goods available have changed dramatically. Inventions in medicine (penicillin, vaccinations), transportation (cars, airplanes), and communications (mobile phones, e-mail) are just some examples of new products greatly enhancing the quality, and even the length, of life. Using exchange rates that equalize the purchasing power of different currencies, about two-thirds of the world's people now live in a country with an average income more than that of the United States a century ago. Taking into account new products, the average material prosperity in Thailand or Tunisia in 2000 was three times that of the United States in

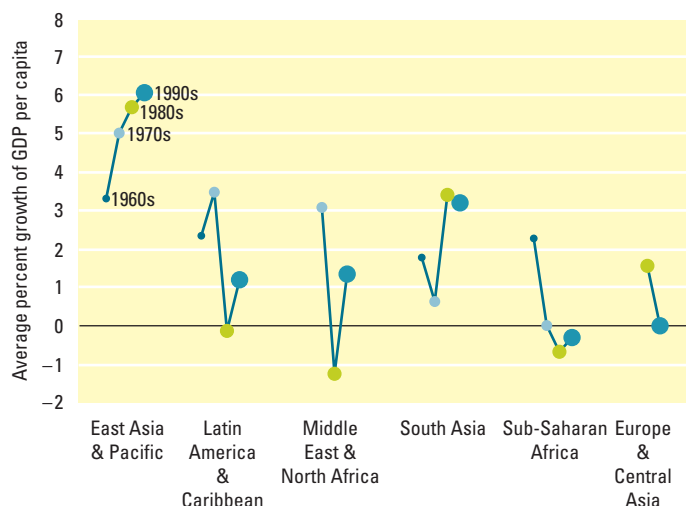
1900—and that in Botswana, Mexico, and Uruguay was five times greater.¹²

Some countries have experienced tremendous success, sustaining high growth rates over many years and achieving significant reductions in poverty. China is the most striking recent example. India is another. Among regions, East Asia has had the fastest sustained growth, with Latin America more disappointing in recent years and Africa suffering from stagnant and declining growth (figure 1.8). Many countries in Eastern Europe and Central Asia, after sharp declines in the early 1990s, are recovering their growth. While some

Figure 1.7 Significant economic growth is a modern phenomenon



Source: Maddison (2003).

Figure 1.8 Fast sustained growth in East Asia—declines in Sub-Saharan Africa

Note: Data for the Europe and Central Asia Region begin in the 1980s.
Source: World Bank (2004k).

developing countries have converged on the income levels of the richest countries, limited progress by the poorest countries means that incomes between the richest and poorest have diverged.¹³ Too prevalent are the periods of short-lived growth—and of continued decline. Igniting a growth spurt is clearly possible. The challenge is to sustain it.¹⁴

The search for a magic formula that would guarantee faster economic growth has been a long-standing but elusive quest.¹⁵ Recent research, however, provides important insights on how investment and

productivity contribute to growth—and how the investment climate determines the size of both contributions.

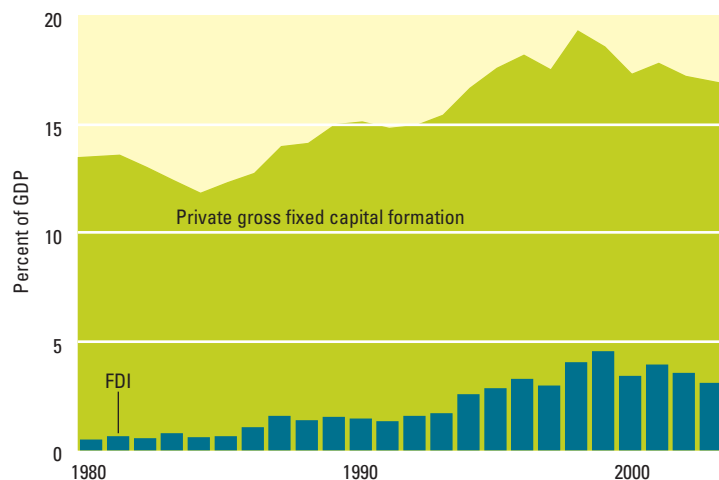
Investment and productivity

The role of private investment has grown in the last 20 years. Foreign direct investment has increased significantly, but the bulk of investment is by domestic firms, reinforcing the importance of looking at the full spectrum of firms in analyzing the investment climate and its contribution to growth and poverty reduction (figure 1.9).

The investment climate has an obvious role in influencing the level of private investment. The evidence confirms that improving the opportunities and incentives for firms to invest by reducing unjustified costs, risks, or barriers has the predicted effect. For example, farmers in Thailand with secure rights invested so much more in their land that their output was 14–25 percent higher than those working untitled land of the same quality (chapter 4). Dismantling monopolies in telecommunications around the world unleashed a dramatic rise in investment in the sector, including that by microentrepreneurs in Bangladesh (chapter 6). At the aggregate level, improvements in the investment climates in countries as diverse as China, India, and Uganda have been marked by strong growth in private investment (box 1.5). Cross-country evidence using broad proxies for investment climate quality confirm the link between the investment climate and private investment (figure 1.10).

Investment rates by themselves are not the main driver of growth. Capital accumulation brings more inputs to the production process, but there is a limit to how much this process can sustain growth because of the decreasing marginal impact of additional capital. So, the measure of success of an investment climate is not the quantity of investment—it is the *quality* of investment, and quality is also influenced by the investment climate.

Indeed, experience provides many examples of investment projects that yielded few or no benefits. This is most obvious with “white elephant” projects in the public sector, such as the Tanzanian shoe factory that pro-

Figure 1.9 The contribution of private investment to GDP has grown

Note: Annual averages of 92 developing countries.
Source: World Bank (2004k).

BOX 1.5 Improving the investment climate and growth: the cases of China, India, and Uganda

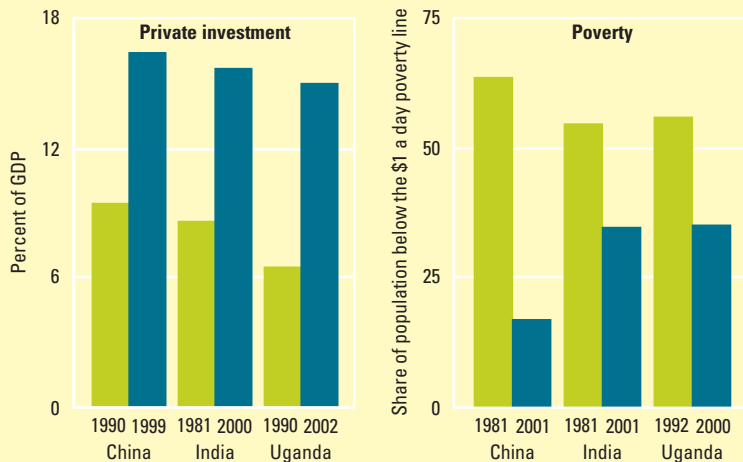
China and India have grown impressively in recent years, greatly reducing poverty. In both cases the roots can be found in improving the investment climate. Beginning in the early 1980s China introduced rudimentary systems of property rights and private enterprise, liberalized trade and investment, and embraced a broad program of improvements across the investment climate. India introduced reforms to reduce tariffs and loosen licensing requirements in the mid-1980s, followed in the early 1990s

with more extensive trade liberalization and a further dismantling of the so-called licensing Raj.

The results? Private investment as a share of GDP nearly doubled in both countries. Per capita GDP in China rose tenfold from \$440 in 1980 to \$4,475 in 2002 (in international prices), and India's almost quadrupled from \$670 in 1980 to \$2,570 in 2002. Both experienced dramatic reductions in poverty (see figure)—each on distinctive paths, but both sustaining efforts

to improve the opportunities and incentives for firms to invest productively.

The benefits of a better investment climate are not limited to large countries. Take Uganda. Many countries in Africa have experienced limited or negative growth, with investment climates often clouded by historical legacies, political instability, excess government interference, and other factors that stifle opportunities and incentives for firms to invest productively. Beginning in the early 1990s, however, Uganda embarked on a program to improve its investment climate. Macroeconomic stability was achieved. Expropriations by a previous government were reversed. Trade barriers were reduced. Tax and court systems were reformed. Private sector participation and competition were introduced in telecommunications. Now efforts are under way to improve business regulation. While many challenges remain, these efforts are reaping rewards. The share of private investment in GDP more than doubled between 1990 and 2000. Per capita GDP grew by over 4 percent from 1993 to 2002 (8 times the average in Sub-Saharan Africa). The percentage of the population living below the poverty line fell from 56 percent in 1992 to 35 percent in 2000.



Note: Dates reflect the timing of significant reform efforts and, particularly for China, the availability of data. Poverty data for Uganda based on national poverty line.

Source: Ahluwalia (2002); Chen and Ravallion (2004); De Long (2003); Chen and Wang (2001); Qian (2003); Rodrik and Subramanian (2004); Young (2003); Young (2000); Holmgren and others (2001); World Bank (2002d); World Bank (2001d); and IMF and IDA (2003); World Bank (2004k); IMF (2004).

duced few shoes, the nuclear power plant in the Philippines that was never commissioned, and the numerous roads to nowhere.¹⁶ The former Soviet Union also had very high investment rates in the 1950s, but too often in projects that provided little economic or social return.

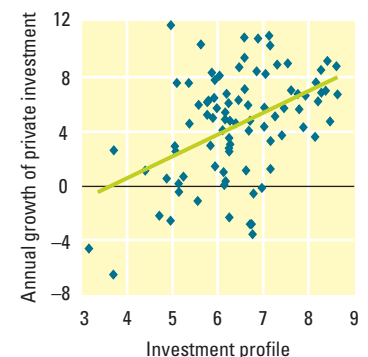
Reflecting this, cross-country studies find little correlation between aggregate investment and growth, particularly if no distinction is made between public and private investment.¹⁷ This highlights the importance of ensuring that investment is undertaken with some discipline to improve the likelihood of it being productive. That discipline will most likely be forthcoming when private firms put their own money at risk to invest in a competitive business environment, so that they bear the consequences of their investment decisions.

The critical role of productivity is underscored by studies of aggregate growth perfor-

mance across countries. Over 1960–2000 the bulk of the differences in growth between countries (45–90 percent) is accounted for not by the accumulation of physical capital, or of human capital, but by total factor productivity (TFP)—the productivity contributions above those made by physical and human capital (figure 1.11 and box 1.6).¹⁸ As Krugman said, “Productivity isn’t everything, but in the long run it’s almost everything.”¹⁹

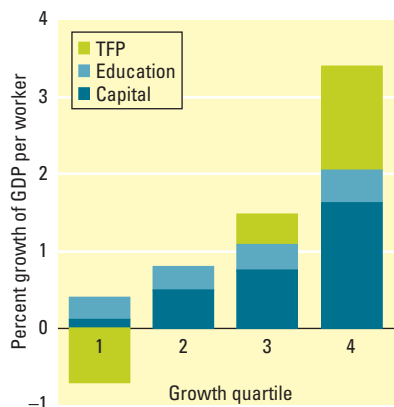
Aggregate-level studies differ in the weight they attach to TFP and factor accumulation in explaining economic growth.²⁰ The debate is important because it has implications for the sustainability of growth. If growth is due to factor accumulation, the diminishing marginal contribution of capital implies that high growth rates, such as those achieved in East Asia, will not be sustainable. However, the same limitation is not true for gains in TFP. In practice the distinction between invest-

Figure 1.10 Private investment has grown faster in countries with better investment climates



Note: Data presented are averages for 1984–2000. ICRG’s index of “investment profile” is based on measures of contract enforceability, expropriation, profit repatriation, and payment delays. Higher numbers are associated with less risk and stronger investment climates. Source: World Bank (2004k) and International Country Risk Guide.

Figure 1.11 Differences in TFP account for the largest share of differences in GDP growth per worker.



Note: Decomposition of sources of growth per worker; 1960–2000 for 62 developing countries.
Source: Data from Bosworth and Collins (2003).

ment and TFP is not always straightforward. For example, technological improvements can encourage investment, and investment can help to improve technology. And investment climate improvements can spur both.

BOX 1.6 Measuring productivity

Productivity is the key to growth—for individuals, for firms, and for the economy as a whole. Increasing productivity means producing more with the same amount of inputs. Two common measures are labor productivity and TFP.

Labor productivity is the value-added produced by each unit of labor. Increases in labor productivity simply mean that an individual is able to produce more. How? Take the example of a worker in the informal economy producing garments from home. One possibility is that she has access to more machinery—such as greater access to a shared sewing machine. A second is that she has more skills or training in sewing. A third is that she has access to new technology—such as a newer sewing machine. A fourth is that she works in an environment that enables and provides stronger incentives to work efficiently—such as fewer difficulties accessing raw materials, fewer distractions dealing with bureaucratic harassment and demands for bribes, or less exposure to theft. Progress in any area allows her to increase the number (and quality) of garments she produces—and thus boosts her income. Her improved productivity is a contribution to economic growth ultimately reflected in macroeconomic statistics.

Total factor productivity (TFP) attempts to measure contributions to output beyond

those made by the number of workers, their skill level, and the machinery they use. In the above example it would capture the third and fourth sources of growth in labor productivity. In the macroeconomic literature, studies initially emphasized differences in technology. More recent work has expanded this to reflect differences in institutional setting (often proxied with measures of property rights security) or “social infrastructure” that influence the opportunities and incentives to adopt new technologies and operate efficiently. The latter measures are largely synonymous with what this Report refers to as the investment climate.

Rather than being measured directly, TFP is the residual that is not explained by differences in factor inputs. Calculations of TFP often generate debate because of difficulties in measuring capital stocks, questions of how to attribute changes in the quality of factor inputs, and the assumptions needed to estimate the necessary coefficients. Despite challenges in measurement, it is not disputed that TFP makes a critical contribution to growth.

Source: Acemoglu (2001); Barro and Sala-i-Martin (2003); Bosworth and Collins (2003); Easterly and Levine (2001); Hall and Jones (1999); Parente and Prescott (2000); Klenow and Rodríguez-Clare (1997); Young (1995).

This provides encouraging news for developing countries—improving investment climate conditions can directly improve efficiency, encourage the adoption of better technology, and strengthen incentives for investment in physical and human capital.

Early growth research emphasized technological progress in explaining TFP, suggesting that differences in growth rates were driven by differences in the technologies adopted.²¹ The dramatic acceleration in income levels among the fast growing countries over the last 200 years can be understood by improvements in technology. “Technology” in this sense, however, is not limited to scientific breakthroughs of the kind that might merit a patent. It can also include more modest advances, as well as new and better ways to organize production processes, interact with consumers, or distribute goods.

Importantly, firms and countries do not have to invent everything afresh. Even in countries that make some of the biggest contributions to innovation, the ratio of adaptation to innovation is extremely high—Jovanovic estimates it at 20 or 30 to 1 in the United States.²² This highlights the huge potential for developing countries to catch up with richer countries by creating an environment that facilitates the diffusion of ideas developed elsewhere, as well as the development of new ones. The potential for catching up is real. It took some of the first industrializing countries 40 to 60 years to double their incomes in real terms, but others have done this much faster—Costa Rica in 19 years starting in 1961, Jordan in 15 years starting in 1965, Taiwan, China, in 10 years starting in 1965.²³

Recent research has emphasized that TFP can also be understood to encompass more than just differences in technology.²⁴ The broader environment in which firms operate matters too, whether this is understood in terms of property rights, institutions, or the investment climate. A better investment climate can directly improve productivity by reducing unjustified costs and risks flowing from government policies and behaviors. By making it more attractive to develop and adopt new and better ways of doing things, a better investment climate will help productivity through its impact on technology as well. Thus, at least as

important as reducing costs and risks is eliminating unjustified barriers to the development, adoption, or adaptation of new processes—and fostering competition to encourage firms to take up those opportunities (box 1.7).

Productivity and competition

Firms do not innovate or improve their productivity from any sense of philanthropy, because the processes can be demanding and disruptive. Most firms would prefer the “quiet life”—which Hicks noted was the best of all monopoly profits.²⁵ Instead, firms adopt and develop new and better ways of doing business in response to the pressures they face to survive and prosper in a competitive marketplace.²⁶ A sound investment climate supports the dynamic processes that Schumpeter called “creative destruction.”²⁷ It encourages firms to experiment and learn, it rewards success, and it punishes failure (box 1.8). The firm-level surveys confirm the importance of competitive pressure for incentives to innovate (figure 1.12) and increase productivity.²⁸

Healthy market economies exhibit fairly high rates of opening and closing firms (box 1.9). In Organisation for Economic Co-operation and Development (OECD) countries, 5–20 percent of firms enter and exit the market every year.²⁹ Firms that leave the market are the least productive, and their departures contribute more than 20 percent of the productivity gains. New firms are more productive—though it can sometimes take them several years before their productivity reaches that of incumbents.³⁰ The combined effect of net entry is substantial, particularly in countries with fewer barriers to entry (figure 1.13).

The contribution of new entrants to productivity is particularly strong in higher technology sectors. There is also evidence that sectors with many new entrants push incumbents to increase their productivity. Why might entry rates be strongly correlated with productivity growth by incumbents? Perhaps because new entrants are attracted to productive sectors, or because the new entrants stimulate incumbents to

BOX 1.7 Growth with a poor investment climate—possible, but unlikely to be sustained

Growth with a poor investment climate is possible, but unlikely to be sustained. For example, in the 1960s and 1970s Brazil experienced strong growth while closing domestic markets to international competition and pursuing heavy public investment through state-owned enterprises. The initial results were impressive, but the growth proved unsustainable. Protected firms lacked the incentives to improve their productivity and fell further behind international best practices. Other firms had less access to new technologies and had to pay higher prices for inputs supplied by

protected sectors. Public investment to sustain growth led to severe debt problems—and ultimately to a macroeconomic crisis.

Subsequent efforts to improve the investment climate initially met with cautious responses from firms. Many attribute this to questions about the credibility of the government’s commitment to reforms, particularly in the wake of repeated episodes of macroeconomic instability.

Source: Castelar Pinheiro and others (2001) and Schor (forthcoming).

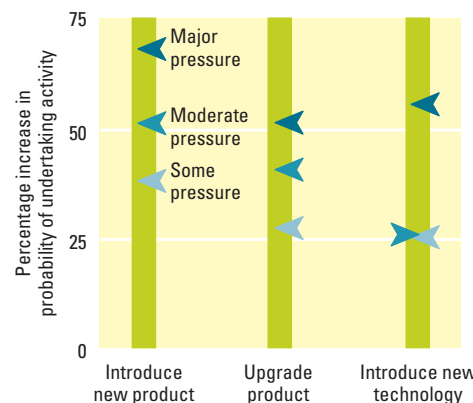
BOX 1.8 Developing a product is a learning process—as Hyundai shows

Hyundai’s efforts to produce a car began in the 1960s. It purchased foreign equipment, hired expatriate consultants, and signed licensing agreements with foreign firms. But the process was not a simple matter of adopting the technology. Despite the training and consulting services of a foreign consultant and three experts, Hyundai engineers repeated trials and errors for 14 months before creating the first prototype. The engine block broke into pieces at its first test. New prototype engines appeared almost every week, only to break in testing. No one on the team could figure out why the prototypes kept breaking down—casting serious doubts, even among Hyundai management, on the company’s ability to develop a competitive engine.

The team had to scrap eleven more broken prototypes before one survived the test. There were 288 engine design changes, 156 in 1986 alone. Ninety-seven test engines were made before Hyundai refined its natural aspiration and turbocharger engines, 53 more engines were produced for durability improvement, 88 more for developing a car, 26 more for developing its transmission, and 6 more for other tests, totaling 324 test engines. In addition, more than 200 transmissions and 150 test vehicles were created before Hyundai perfected them in 1992. In 2003, Hyundai sold close to 2 million vehicles around the world.

Source: Kim (1997).

Figure 1.12 More competitive pressure, more innovation



Note: Surveys cover 27 countries in Eastern Europe and Central Asia. Source: World Bank Investment Climate Surveys/BEEPS II.

BOX 1.9 Firm dynamics

The private sector is not static, nor are individual firms. There is a large and ongoing reallocation of output and jobs across firms. Such dynamism is a sign of a vibrant economy, and accounts for a significant share of productivity growth. This is true across OECD countries and in developing countries. Firms are forced to compete in their search for profits. There are enticements, such as the lure of larger profits, even if they are short lived. And firms dare not be left behind. This is the secret to a market economy's success and what Schumpeter called "the essential fact of capitalism."

The role of entry and exit. Every year between 5 and 20 percent of firms enter or exit an economy. Many of the entrants are small. Most of them will remain small. Some will grow, with a few becoming the large firms of the future. Firms also contract and some will go out of business. This entry and exit of firms is an inherent part of a market economy and an important source of innovation. Reducing barriers to entry is important because new entrants—and even the threat of new entry—spur existing firms to improve their productivity. Entering firms also tend to use newer technologies and production methods. It is not that they are all more productive from their beginning—not even in comparison to exiting firms. Experience in the marketplace will determine which firms will be successful. The highest exit rates are among small and young firms. If firms have survived the first five years, however, they are much more likely to remain in business and to contribute to productivity growth.

While trade theory predicts that much of the adjustment to greater openness would lead

to reallocation across sectors, in fact, much of the reallocation of resources is from low- to high-productivity firms within the same sector. There are large differentials in the levels and rates of growth of productivity across firms within a sector, and low productivity helps predict exit.

The evidence underscores the importance of the process of creative destruction to the growth process. Barriers to exit need to be addressed to free up resources that can be used more productively in other activities. Barriers to entry can be particularly harmful, not just by stifling the pressure to innovate and leading to more "technological sclerosis," but by forestalling the creation of new jobs. However, the churning process can be disruptive, and the government has a role in helping workers cope with change (chapter 7). Improving the investment climate is central to ensuring the process of creative destruction works well—to the benefit of workers and society as a whole.

Implications of firm size. Beyond entry and exit, these same pressures impact on firm size and growth. Large firms do not grow as fast as small ones, but they are more likely to survive. Large firms tend to be more productive, pay higher wages, and offer greater job security. The causation, however, runs from productivity to size; firms that are more productive are the ones that are likely to grow.

The interactions between firms can have important implications for how they develop. It is not always cutthroat. Firms at the top of a supply chain tend to be large. They provide oppor-

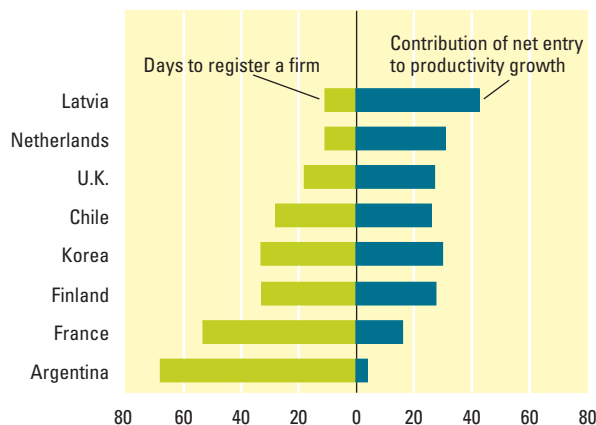
tunities to smaller firms as suppliers—often accompanied by technical assistance and access to credit. Particularly when financial markets are less developed, large firms can be an important source of credit to smaller suppliers.

Economies of scale specific to particular technologies help define the minimum efficient size of a firm, but in practice there is a large range of firm sizes within the same sector. Some of this can be due to concerns about contracting, with some finding it optimal to keep activities in-house. The inability to access credit or other investment climate constraints can keep firms small. Large firms can face challenges in organization and can be less agile in responding to change.

It is not that countries should aim to have a particular size distribution of firms. Rather, what is important is allowing the selection mechanism to work free of political interference that favors influential firms. Large firms often have more political influence and try to use this to manipulate policies to their advantage—often at the expense of smaller firms. A good investment climate facilitates the allocation of resources, fosters innovation, and encourages the selection of firms that increase productivity and so contribute to growth and higher living standards.

Source: Bartelsman and others (2004); Klein and Hadjimichael (2003); Haltiwanger (2000); Roberts and Tybout (1996); Schumpeter (1942); Caballero and Hammour (2000); Baumol (2002).

Figure 1.13 The contribution of net entry to productivity is higher when barriers to entry are lower



Note: Data cover manufacturing firms from 1988–2000, using census data.

Source: Bartelsman and others (2004) drawing on World Bank Doing Business Project.

increase their productivity to maintain their market shares. Census data from developing countries confirm the importance of the second explanation.³¹

The greater microeconomic flexibility associated with a good investment climate helps firms take advantage of internal opportunities. It also helps the economy weather external shocks. Countries in Latin America and East Asia with more microeconomic flexibility experienced less dramatic declines in output and recovered faster than those with less flexible economies.³²

Showing the potential returns of investment climate improvements

Research showing the links between investment climate improvements and improved firm performance typically focuses on a single dimension of the investment climate,

such as aspects of property rights security or regulatory reform. The Bank's Investment Climate Surveys make it possible to see how broader packages of policy improvements can influence firm performance by use of counterfactual comparisons (box 1.10). For example, firms in states in India and provinces in China with better investment climates show much stronger growth and productivity than their peers in states or provinces with less favorable investment climates. The effects are large—improving the investment climate could account for up to 80 percent of the differences in productivity among these locations.

Sharpening the focus on poverty reduction

The investment climate clearly matters for growth. Even more important is understanding how investment climate improvements can enhance the situation of the nearly half the world's people living on less than \$2 a day, especially the 1.2 billion people who barely survive on less than \$1 a day.

The relationship between the investment climate and poverty reduction can be seen in two ways: by looking at the links between growth and poverty reduction at the aggregate level, and by looking at the ways investment climate improvements affect the lives of people directly.

The links with economic growth

There are almost no examples of countries experiencing significant growth without reducing poverty.³³ Growth in average incomes associated with broadly based growth has been found to account for up to 90 percent of the reductions in poverty (figure 1.14).³⁴

Investment climate improvements in China and India have driven the greatest reductions in poverty the world has ever seen, and in China alone lifted 400 million people out of poverty (box 1.5).³⁵ The increases in income were also matched by gains in health outcomes. In China, life expectancy rose by four years, from 66.8 to 70.7 years from 1980 to 2002, and infant mortality fell from 49 to 32 per 1,000 live births. In India, life expectancy increased

BOX 1.10 Showing potential returns to investment climate improvements

The Bank's Investment Climate Surveys link firm performance to objective measures of costs and risks affected by policy. This makes it possible to simulate how changes in investment climate conditions might contribute to improved productivity, sales, and wages:

- In India, firms in states with poor investment climates have 40 percent lower productivity than those in states with good investment climates.
- If Tianjin, a large port city east of Beijing, could achieve the same investment climate as Shanghai, firm-level productivity

would increase by 15 percent and sales growth by 20 percent.

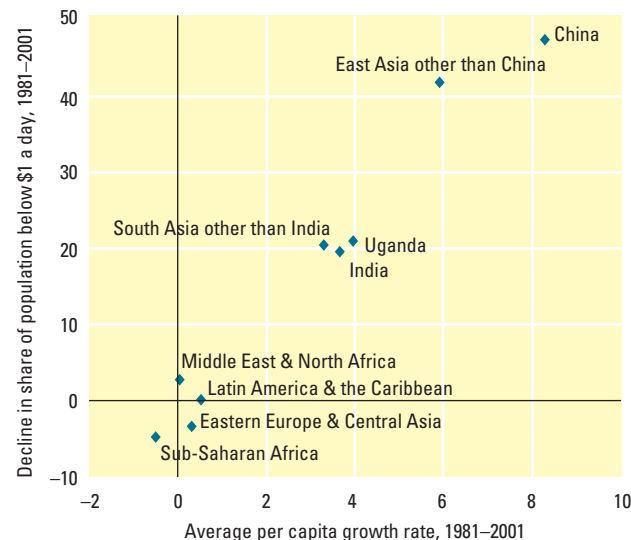
- If the investment climate for firms in Dhaka, Bangladesh, matched that of Shanghai, Dhaka would reduce its productivity gap by 40 percent, and wages could rise by 18 percent. For Calcutta the effect is even larger: 80 percent of the productivity gap could be closed, and wages could rise by 38 percent.

Source: Dollar, Hallward-Driemeier, and Mengistae (2003b); Hallward-Driemeier, Xu, and Wallsten (2003); and Dollar and others (2004).

from 54 to 63 years, infant mortality fell 40 percent, and evidence of malnutrition dropped, too.

The incomes of poor people can increase in two basic ways—if average incomes rise and the distribution of income stays the same, or if the distribution of income shifts to become more pro-poor. Clearly the biggest impact is if growth is combined with a shift to a more equal distribution of income. If the feedback from greater equality reinforces growth processes, the dynamic can significantly reduce poverty over time.³⁶

Figure 1.14 Poverty reduction is closely associated with growth



Note: Data for Uganda are from 1992–2000 and uses its national poverty level due to data availability. Source: Chen and Ravallion (2004); World Bank (2004k).

With income distribution relatively stable, growth is often said to be good for the poor because the share of income going to the poor rises in tandem with average incomes.³⁷ But there is evidence that the level of inequality in a society affects the way growth translates into rising incomes for the poor (box 1.11). It is not just that poor people's share of income is relatively smaller in a more unequal society—it also rises by less than one-for-one with average incomes.³⁸

Inequality can be of concern for other reasons too. Greater inequality is associated

with less social cohesion, less secure property rights, and greater risk of significant political upheaval.³⁹ So inequality can have important implications for the likelihood and nature of investment climate improvements, the credibility of policy changes, and thus the impact on decisions of firms. This reinforces the importance of governments being sensitive to the distribution of gains from growth.

The investment climate and the lives of poor people

Governments committed to attacking poverty aggressively need to look beyond aggregate numbers and understand how investment climate improvements can enhance the lives of poor people directly. In this context it is useful to distinguish the impacts on poor people in their various capacities: as employees; as entrepreneurs; as consumers; as users of infrastructure, finance, and property; and as potential recipients of tax-funded transfers or services.

As employees. Studies looking at households that have escaped poverty find that in more than 80 percent of cases the decisive factor was the head of household's getting a new job.⁴⁰ The World Bank's "Voices of the Poor" study of more than 60,000 poor men and women in 60 countries identified getting a job and self-employment as the best way to escape poverty (figure 1.15).

Private enterprise is the engine for sustainable job creation and the dominant source of jobs worldwide. In 2003 the private sector employed more than 90 percent of people in developing countries and 95 percent of people in countries such as El Salvador, India, and Mexico.⁴¹ Growing economies create more jobs, particularly in developing countries (figure 1.16). The impact of investment climate improvements on employment growth can also be seen by looking at experiences in individual countries. For example, investment climate improvements in China, India, and Uganda contributed to employment growth of more than 2 percent a year between 1985 and 2000. The garment sector in Cambodia also illustrates the potential impact of a thriving private sector: exports grew from \$20 million in 1995 to more than \$1 billion in 2002, employing an additional 200,000

BOX 1.11 *How growth translates to rising incomes for poor people*

The extent of inequality in a society affects how much average growth is shared by poor people. Concerns about whether growth is "pro-poor" raise a debate about whether absolute or relative rates of growth for poor people are what matters. The figure compares overall growth rates and the growth rates for the poor to illustrate these points.

Clearly, there is a strong relationship between rising average incomes and the incomes of poor people as illustrated by a selection of country experiences spanning the mid-1980s to the end of the 1990s (see the figure). But countries above the 45 degree line in the figure are the ones where the growth in incomes of the poor is higher than average: in those cases, growth resulted not only in stronger absolute growth in the incomes of poor people, but also stronger growth relative to the average. Under the relative definition of pro-poor growth, inequality must fall. The absolute definition, by contrast, looks only at the income growth of poor people, whether inequality changes or not.

Inequality declined in both Ghana and Zambia: in Zambia the poor suffered smaller declines in income than the average, but were

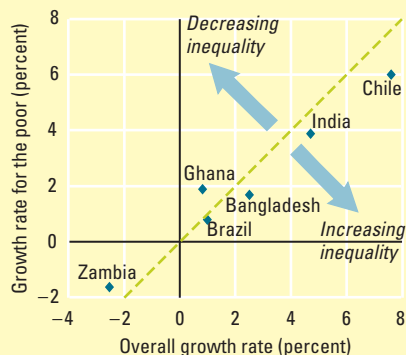
still worse off in an absolute sense; in Ghana, declining inequality and growth combined to boost the incomes for poor people.

Brazil and Ghana had roughly equal overall growth rates. But the incomes of poor people grew by 1.8 percent in Ghana and only 0.7 percent in Brazil. Indeed, the growth rate for the poor in Ghana is even slightly higher than that in Bangladesh, whose overall growth rate was triple that of Ghana.

Using the relative definition of pro-poor growth, Ghana's performance is better than India's—even though in India the absolute income of the poor grew by 3.9 percent, twice that of Ghana. While Ghana's inequality was falling, its slower overall growth translated into less poverty reduction than in India, with its slight increase in inequality but faster growth.

Aggregate numbers of this kind mask changes in which households are poor. Income mobility can be considerable. In Indonesia, among those who were in the poorest quintile in 1993, 59 percent moved up at least one quintile in the income distribution by 1997, with 4 percent moving all the way to the richest quintile. In South Africa, 62 percent of those who were in the poorest quintile in 1993 had moved up at least one quintile by 1998, with 10 percent making it to the richest quintile. In Russia, 60 percent of the poorest quintile households moved up between 1995 and 1998, with 9 percent attaining the highest income quintile. In Peru 55 percent moved up, with 5 percent making it to the top quintile between 1991 and 2000.

Source: United Kingdom—DFID (2004); Pritchett (2003); Graham and Pettinato (2001); Fields and Pfeffermann (2003); and López (2003).



workers, many of them women and many previously poor.⁴²

A vibrant private sector also contributes to higher wages. More productive firms, nurtured by a good investment climate, can pay higher wages and invest more in training their workers.⁴³ The expansion of firms can also have knock-on effects, raising the wages of those in smaller firms as the pool of available workers tightens. Similar patterns are found in rural areas, with rising nonfarm employment lifting agricultural wages—with significant impacts on poverty reduction.⁴⁴

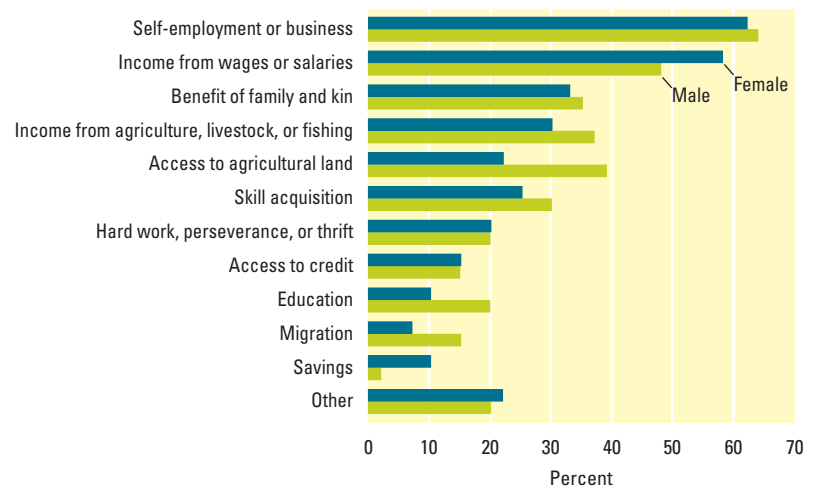
Improving the investment climate does more than create jobs and improve living standards today. It also encourages people to invest more in their own education and skills to take advantage of better jobs in the future. There is thus a two-way link between skills and jobs, with an improved investment climate complementing efforts to improve human development (chapter 7).

Demographic trends underline the imperative to create more and better jobs in developing countries. Nearly 3 billion people are under the age of 25 today, 1.5 billion under 15. In the next 30 years the population in developing countries is expected to increase by nearly 2 billion people, and 7 out of 8 billion of the world's people will live in developing countries. The population of Sub-Saharan Africa, the region with the most poor people, will double by that time, even with today's incidence of HIV/AIDS.⁴⁵

As entrepreneurs. Hundreds of millions of poor people in developing countries make their living as microentrepreneurs—as farmers, street vendors, and homeworkers, and in a range of other occupations, a large share of them women (box 1.12).⁴⁶ They are a big part of the informal economy, which is substantial in many developing countries (figure 1.17).⁴⁷

Individual entrepreneurs and microenterprises can benefit from the same measures that improve the opportunities and incentives for larger firms. They benefit from lower costs of doing business (including less red tape and corruption), and from lower risks (including more secure property rights and less policy uncertainty). Reducing barriers to competition also benefits them by expanding

Figure 1.15 Self-employment and wage income are the ways out of poverty



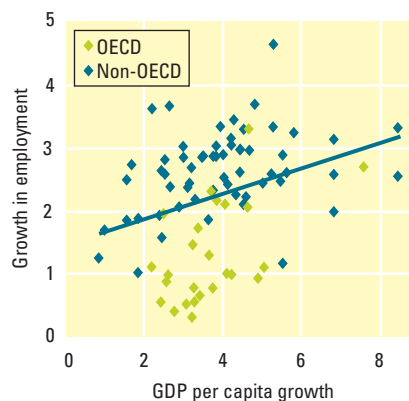
Note: Reports views of 60,000 poor people on how they saw their best prospects of escaping poverty. Source: Narayan and others (2000).

their opportunities and reducing the costs of inputs they transform. The way microentrepreneurs have benefited from telecommunications liberalization in Bangladesh and Uganda shows how (chapter 6).

As consumers. Improving the investment climate reduces the costs of producing and distributing goods, and stronger competition helps to ensure these benefits flow on to consumers. Poor people benefit from lower prices for the goods they consume, including staples.

In Vietnam, where up to 80 percent of the poor's caloric intake comes from rice, lifting

Figure 1.16 Growing economies generate more jobs—particularly in developing countries



Note: Data are average annualized rates for 1960–2000. Source: World Bank (2004k).

BOX 1.12 Women and the investment climate

During the 1990s, women's share of the formal labor force increased almost everywhere—to close to 40 percent worldwide and to at least a third in all regions except the Middle East and North Africa and Europe and Central Asia. It has been estimated that women own between a quarter and a third of firms. Women run many multimillion dollar firms that employ thousands of staff.

But women predominate in the informal economy, particularly in microenterprises or as homeworkers. Some of this reflects discrimination and the difficulties women can face obtaining a formal job. But it can also reflect how children and other family obligations can make the flexibility of jobs in the informal economy more attractive. More than 95 percent of the female nonagricultural labor force work in the informal sector in Benin, Chad, and Mali—and more than 80 percent in Guinea, Kenya, India, and Indonesia.

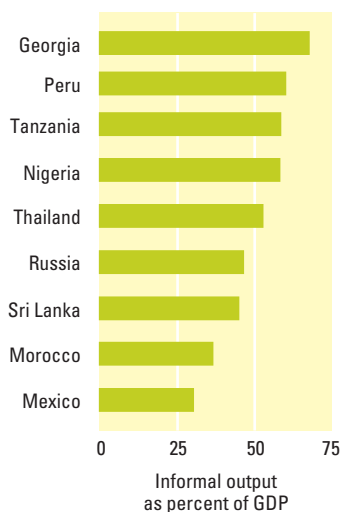
Higher female labor force participation tends to result in significantly faster growth in incomes. For example, it has been

estimated that higher female participation rates in the Middle East and North Africa in the 1990s increased per capita GDP growth rates by 0.7 percentage points.

Investment climate improvements can deliver many tangible benefits for women. In Burkina Faso, where women have more secure land rights than in many other African countries, female farmers' productivity is significantly higher. Providing secure rights to land in Peru allowed more women to work outside the home. Removing barriers to competition expands opportunities for women and other groups that have traditionally suffered from discrimination. A more competitive economy can also reduce discrimination in the workplace by increasing the costs to firms of discriminating on noneconomic grounds.

Source: Black (1999); Ellis (2003); Field (2002); Grameen Bank website: www.grameen-info.org; Kabeer (2003); Klasen (1999); Klasen and Lamanna (2003); Maloney (2004); Narayan and others (2000); Rama (2002); United Nations (2000); World Bank (2001g); and World Bank (2004f).

Figure 1.17 The informal economy is substantial in many developing countries



Source: Schneider (2002).

fees, taxes, registration permits, and police checkpoints on internal trade lowered the price of rice considerably.⁴⁸ Studies in Ethiopia, Ghana, Kenya, Mali, South Africa, and Zambia found that liberalizing food markets lowered the real prices of food, with benefits extending to the poor in both urban and rural areas in these countries.⁴⁹ Reducing restrictions on secondhand clothing markets, which account for 80 percent of garment purchases in countries such as Uganda, can also broaden access to affordable clothing for poorer members of society.⁵⁰ While food and clothing represent the vast majority of poor people's expenditures, the phenomenon is applicable more broadly. Lowering barriers to entry by 10 percent has been estimated to reduce the average price markup by 5.8 percent.⁵¹

As users of infrastructure, finance, and property. Many features of a better investment climate raise the living standards of people directly, whether they work or engage in entrepreneurial activities or not. Lowering consumer prices is one example. But improving infrastructure, finance, and property

rights can deliver broad benefits across the community:

- Improving access to electricity helps firms—but it also reduces the burden on women collecting firewood, reduces the health concerns associated with burning dung, and helps children study at night. In the Philippines members of electrified households attain about two years more formal education than do members of unelectrified households. That translates into higher wage earnings of between \$37 and \$47 a month for households with electricity.⁵²
- Improving roads helps firms get their goods to market—but it also helps poor people obtain access to health, education, and other services, and connects them to other communities (chapter 6). In Morocco the construction of rural roads was associated with an increase in primary school enrollment from 28 percent to 68 percent (see box 6.14).
- Improving the functioning of finance markets helps firms—but it also allows poor people to weather family emergencies, improve their homes, and educate their children (chapter 6).
- Improving security of land rights helps firms—but it also empowers people and delivers more tangible benefits. In Peru granting land titles to city slum dwellers boosted labor participation rates outside the home. No longer needing to have someone stay to guard the home gave family members additional choices. Better security of title also increased investments in improving housing quality by 17 percent.⁵³

As potential recipients of tax-funded services or transfers. Attacking poverty involves more than just improving the investment climate. It also involves efforts to invest in and empower people, including public investment in education, health, and other services. But these services need to be paid for, and the expansion in economic activity from a better investment climate permits increases in the tax revenues to fund those services and make transfers to the disadvantaged in society. About 80 per-

cent of taxes in developing countries are collected from firms as value added taxes, corporate taxes, and labor taxes.⁵⁴ There is a close relationship between per capita growth and tax revenues (figure 1.18).

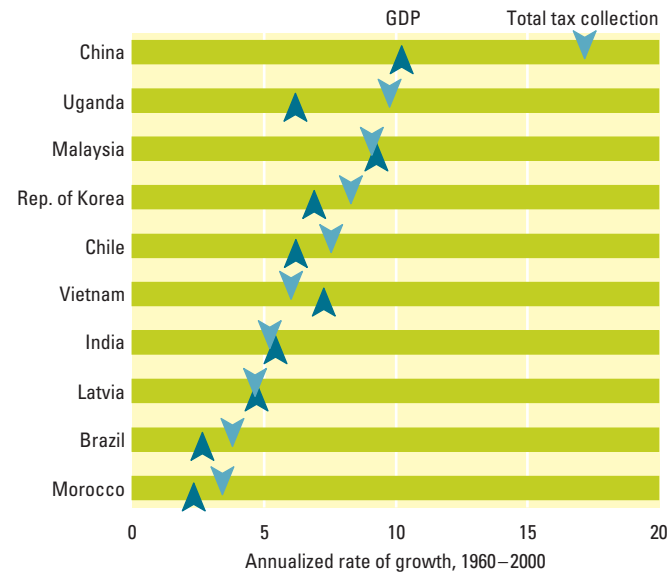
Of course, there are tradeoffs between raising tax revenues and providing incentives for firms to invest, create jobs, and expand. Widening the tax base, rather than increasing rates, minimizes the tradeoffs (chapter 5). The extent to which the public spending from a stronger tax base is directed to services for the poor will depend on the government and its ability to spend resources wisely.⁵⁵ But economic growth remains the only way to sustainably increase the public resources to fund such services and transfers.

Can investment climate improvements be made more pro-poor?

Improving the investment climate promises huge benefits for a society, including the poor. But can governments fashion their investment climate improvements in ways that deliver even deeper reductions in poverty? Much depends on the part of the investment climate that is improved. Some improvements—such as improving macroeconomic stability, reducing corruption, and dismantling distortionary barriers to growth—deliver broad benefits across society. Other measures are more focused—such as addressing regulatory constraints affecting particular activities or improving infrastructure in particular locations. In the latter case governments can influence the distribution of benefits.

As discussed in chapter 3, there are several options for making investment climate improvements more pro-poor. One approach is to focus on improving the investment climate where poor people live, which can deliver benefits to poor people in that location in all of the capacities discussed above. A second approach is to focus on removing constraints to activities that poor people benefit from—including as employees, entrepreneurs, or consumers.

Figure 1.18 Rising GDP is associated with rising tax revenues—expanding the opportunities to fund services for the poor



Source: World Bank (2004k).

The two approaches can also be combined by focusing on particular activities in particular locations. While the choice of strategy can vary from country to country, the key point is that pro-poor approaches need not focus exclusively on addressing the needs of the smallest firms—they can encompass a much broader set of firms.

Creating a better investment climate for everyone

This chapter showed how investment climate improvements are the driving force for growth and poverty reduction. A good investment climate is one that is better for everyone in two dimensions. It benefits society as a whole, not just firms. And it expands opportunities for all firms, not just large or influential firms.

The rest of the Report looks at how governments can create a better investment climate. The next chapter begins by looking at the important question of why progress in making investment climate improvements is often slow and difficult.