

Tackling a broad agenda

chapter 3

As chapter 2 highlighted, improving the investment climate requires governments to navigate four sources of potential policy failure that play out across a broad range of policy areas, from property rights and business regulation to infrastructure and labor markets. While the task may seem daunting, more countries are making significant improvements—and are being rewarded with faster growth and deeper poverty reductions. China, India, and Uganda, mentioned for their achievements in chapter 1, are hardly alone. Many countries have improved at least some areas of their investment climates. Their experience provides insights into possible strategies for broadening and accelerating progress.

This chapter opens by looking at the implications of the investment climate's breadth, encompassing a wide range of government policies and behaviors, many of them interrelated, and all possibly influencing the opportunities and incentives facing firms. The good news is that perfection is not needed in any given area to ignite significant growth and poverty reduction. The key is to address important constraints in a way that gives firms confidence to invest—and to sustain a process of ongoing improvements.

The chapter then looks at lessons of experience in each of the four key requirements for managing such a process:

- *Setting priorities.* The key is to reduce unjustified costs, risks, and barriers to competition. But there are no simple formulas for translating those principles to specific reform areas. Priorities need to be determined in each case based on an assessment of current conditions, the potential benefits from improvement, the links with national or regional goals, and implementation constraints.
- *Managing individual reforms.* Reforms often need to overcome resistance from those who benefit from the status quo. This can require a high level of political commitment, but also benefits from effective communication, consultation, and when appropriate, compensation.
- *Maintaining momentum.* Given the breadth of the agenda, and the need to review policies regularly, reforms in this area can be characterized as a marathon rather than a sprint. To help maintain momentum, many governments are creating specialized supporting institutions, including those that facilitate consultation, coordination, the review of existing constraints, and the review of new policy and regulatory proposals.
- *Strengthening government capabilities.* Improving government capabilities is an essential complement to any reform process. This means building not only more technical expertise, but also better and more reliable sources of information.

The investment climate as a package

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, with government policies and behaviors that influence the costs, risks, and barriers to competition as part of that package. Why might this matter?

First, the impact of any policy improvement will depend on how it addresses a

constraint that is actually binding on firms. So expanding access to credit will not have much impact on firms' investment decisions—an effort sometimes described as “pushing on a string”¹—until more fundamental concerns about the security of their property rights have been addressed.² Providing tax breaks may not be enough to compensate for other weaknesses in the investment climate in some situations—but may be unnecessary in others.³ Similarly, introducing a competition law may not have a big impact on the economy when the main barriers to competition stem from trade restrictions, government monopolies, or other regulatory barriers to entry and exit.

Second, different areas of the investment climate policy can interact. Clarifying rights to land can help ease access to credit by firms and households—but only when complementary aspects of financial infrastructure are in place. Reducing barriers to trade will not deliver its full potential 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. Similarly, efforts to encourage local R&D can be hobbled by shortages of skilled workers, limited competition, or weak intellectual property rights.

So investment climate improvements involve more than one-off, “stroke-of-the-pen” reforms. But this does not mean that

simultaneous and comprehensive reform is necessary for significant results. Indeed, efforts to tackle the full set of investment climate policies simultaneously, even if technically feasible, could generate so much uncertainty for firms that it might deter rather than encourage investment, at least temporarily.⁴ Deep and rapid institutional change can also be disruptive for society, possibly undermining public support and thus the sustainability of reform. So some sequencing of reforms is inevitable in a field as broad as the investment climate. Fortunately, experience shows that countries can reap significant benefits by addressing important constraints in a way that gives firms confidence to invest—and sustaining a process to address other constraints as they become more binding.

Take China, the country enjoying the world's fastest growth and poverty reduction in recent years. The reform that ignited growth was the introduction of a rudimentary system of property rights, initially for township 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 a strong response because of the size of the economy benefiting from the change, and because the changes were implemented in ways that gave people the confidence to invest (box 3.1). Subsequent improvements—including those attracting foreign direct investment (FDI) and improving

BOX 3.1 *Improving the investment climate, China's way*

Growth in China is officially reported at an average of 8 percent a year for the last 20 years—giving it the most impressive (if disputed) sustained growth performance in history. Declines in poverty have been equally dramatic—from 60 percent of the population to 17 percent. Yet China only recently gave constitutional protection to private property rights, inefficient state-owned enterprises still clutter the landscape, and the financial sector is dragged down with nonperforming loans. How was such sustained growth possible?

Growth was ignited by introducing a rudimentary system of property rights that gave farmers and township and village enterprises incentives to take risks and invest. The response was magnified

by the large size of the economy affected. 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 World Trade Organization (WTO), and efforts to tackle 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 is 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. This is well below the average in countries such as Brazil and Pakistan, and 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); and Young (2000).

BOX 3.2 *India's path*

In India much attention is paid to the liberalization efforts of 1991. Growth actually 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 import of capital goods were eliminated. Tariffs were cut by 60 percent. Taxes on profits from exports were cut by half. Fewer industries were subject to licensing. The policies were a major shift in approach away from socialism and the primacy of redistribution over growth in 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 further reduced. Over the 1990s the pace slowed but reform continued. Licensing has been eliminated in all but seven industries. Private firms have been allowed to compete in more and more 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. Anticorruption efforts are also being scaled up at the national and state levels.

The effects have been substantial. Private investment as a share of GDP grew from less than 9 percent in 1981 to more than 15 percent in 2000. Growth increased from an average of 2.9 percent a year in the 1970s to 5.8 percent in the 1980s, and to 6.7 percent in the mid-1990s.

More puzzling, however, has been the impact 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 firms falling behind. The expected pattern would have been to see greater competitive pressures reduce dispersion as less successful firms left the market. This highlights the significance of continuing barriers to exit. According to the Bank's Doing Business Project, it can take 10 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); De Long (2003); Rodrik and Subramanian (2004); Varshney (1998); and Panagariya (2003).

business regulation and infrastructure—addressed constraints initially less binding. A degree of autonomy between provinces has also fostered experimentation and created incentives for lagging provinces to emulate the success of their faster moving counterparts.⁵

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, did more to reduce costs and increased competitive pressure in the economy. Just as in China, a degree of autonomy between state governments created room for states to innovate. Competition between states is creating incentives for lagging states to follow the leaders, including by addressing long-standing problems in the power sector.

Even when a policy improvement addresses an important constraint, and is implemented in a credible way, the extent of the benefits often depends on going on to address constraints that may have been less binding initially. For example, productivity improvement in India's manufacturing sec-

tor, while evident, has been reduced by barriers to exit that slow the pace of industrial restructuring. Similarly, labor market restrictions have limited the productivity improvements from trade reforms in many countries in Latin America.⁶ Investment climate policies also require regular review to take into account changes in the conduct of business, and ongoing lessons of experience. Both considerations underline the importance of processes to support ongoing policy improvements. As Porter observed, reforms in this area are a marathon, not a sprint.⁷

Setting priorities

Improving the investment climate involves reducing unjustified costs, risks, and barriers to competition. In practice, costs, risks, and barriers are a function of government policies and behaviors that play out through a wide range of specific policy areas. Where should governments begin?

The diversity of investment climate conditions across and within countries, and the potential for reforms to impact on firms and activities differently, mean that there are no standard formulas. Governments need to determine priorities by assessing current conditions, the potential benefits from improvement, the links with broader national or regional goals, and implementation constraints.

Current conditions

As chapter 1 highlighted, investment climate conditions vary dramatically across and within countries. A major impediment in one country may be much less important in another—as a simple comparison between Bulgaria, Georgia, and Ukraine illustrates (figure 3.1).

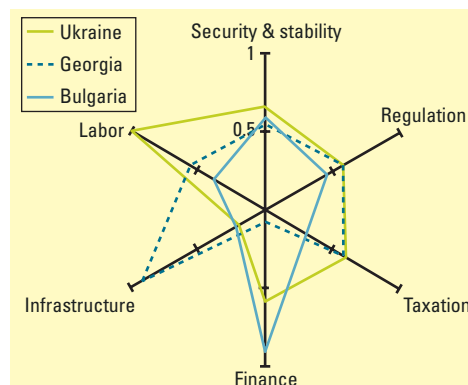
Assessing constraints on existing firms is fairly straightforward—firms can be asked directly through dialogues with representatives of the business community or through surveys. The World Bank’s Investment Climate Surveys collect not only subjective assessments of constraints, but also more objective data on the impact of those constraints. Engaging with firms has the additional benefit of enhancing a government’s credibility with firms, and also helping with possible implementation issues. But focusing on the views of existing firms has one obvious drawback: those firms cannot (or will not) speak on behalf of firms that have not yet entered the market, and so may place less emphasis on barriers to competition. Policy barriers to entry (and exit) thus warrant particular scrutiny.

Comparing a country’s performance in a given policy area with that of other countries also provides insights into the potential scope for improvement. For example, the Bank’s Doing Business Project shows that it takes more than 200 days to register a business in Haiti but less than 20 in Latvia and just 2 in Australia. Similarly, it takes 1,000 days to enforce a contract in Poland, but less than 50 days in the Netherlands and Tunisia.⁸ New sources of data make benchmarking of this kind feasible for a growing range of policy parameters.

Potential benefits

Addressing constraints that affect a large share of economic activity will usually have a bigger impact than those affecting only a smaller share. War and major episodes of political instability trump all other constraints on this criterion, and progress on these issues is fundamental to creating a decent investment climate (chapter 4). Improving macroeconomic stability also falls within this category, because without it changes in other areas will have limited traction.

Figure 3.1 Constraints reported by firms—comparing Bulgaria, Georgia, and Ukraine



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

Source: World Bank Investment Climate Surveys.

Progress in addressing broader governance issues, particularly those affecting the government’s credibility, also tend to pay bigger dividends than reforms in any one policy area, because they can leverage the impact of other policy improvements (chapter 2). Efforts to build credibility and legitimacy are usually especially important in weak or vulnerable states. In these cases emphasizing consultative processes and transparency can help to heal the social wounds from conflict—or from distrust about whose interests are being served. For example, Uganda placed special emphasis on ensuring that the benefits from improvement were widely understood—and widely shared. Similarly, the Bulldozer Initiative in Bosnia-Herzegovina emphasizes grassroots involvement and broad consultation (see box 3.9). Building credibility can be critical in stemming, and reversing, the capital flight and “brain drain” in states under stress.⁹

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 improve incentives for a large share of GDP—as China did with its rural sector—can have a big impact on aggregate growth.

Poverty impacts. When direct poverty reduction is given priority, the key will be to

understand how potential investment climate improvements impact the poorest members of society in their various capacities: as employees, as entrepreneurs, as consumers, as users of public services, and as recipients of tax-funded services or transfers (chapter 1). The breadth of these impacts means that there is no one best way to make investment climate improvements more pro-poor. Certainly, poverty reduction does not justify an exclusive focus on small or informal firms.

One approach is to focus on constraints in locations where poor people live, which can benefit poor people in all their various capacities. Rural poverty is a major challenge in many countries. Nonfarm employment can contribute much to the incomes of the rural poor, and research in India suggests that manufacturing jobs contribute twice as much as agricultural productivity in raising nonfarm income. There can also be opportunities to focus improvements on urban or peri-urban areas with high concentrations of poverty.

A second approach is to focus on constraints to particular activities that benefit poor people in their various capacities:

- *Constraints facing microentrepreneurs.* Hundreds of millions of poor people earn their livings as microentrepreneurs in the informal economy. Improving the investment climate they face can involve improving the security of their property rights, reducing red tape in business registration, and removing distortions that make access to financing more difficult. 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 them and their broader communities.
- *Constraints facing other firms likely to create jobs for poor people.* Improving investment climate conditions for firms likely to hire poor people can do much for poverty reduction. This may mean focusing on constraints faced by larger firms, which create jobs directly and also create more opportunities for suppliers of a range of goods and services.

- *Constraints facing firms that can deliver other benefits to poor people.* While self-employment and jobs have been identified by poor people themselves as the most promising pathways out of poverty, investment climate improvements can deliver additional benefits to poor people. Improving conditions for firms that produce or distribute goods and services consumed by poor people can have a big impact on their living standards. Improving infrastructure in a particular location can also enhance living conditions for poor people, whether or not they work or engage in entrepreneurial activities. Because larger firms are more likely to pay taxes, improving their conditions increases the potential for them to contribute to social objectives.

Potential spillovers. When considering the potential benefits from an improvement, it is also important to look at the possible 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 FDI 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, increasing the security of rights to land can help ease access to financing (chapter 4).
- *Spillovers to government credibility.* The way governments approach policy improvements can help—or harm—their credibility and resulting investor confidence. Efforts to engage firms and other stakeholders openly and transparently, with timely execution of reforms, can enhance firms' confidence and so elicit a stronger investment response. The corollary is that overly ambitious or poorly executed reforms can undermine credibility and confidence.

- *Spillovers to government capabilities.* Some investment climate improvements can strengthen a government's fiscal position—and so facilitate other improvements. For example, Uganda gave early priority to better revenue collection, nearly doubling 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 deliver benefits that extend beyond firms. For example, more effective courts can help defend civil and political rights, not just property rights (chapter 4). 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. For example, reducing barriers to new business formation can increase the pool of firms with an interest in broad-based policy improvements. Similarly, ensuring that improvements extend to firms across society—rather than just to large or connected firms—can contribute to the public support necessary to sustain progress.

Priority-setting may also be influenced by broader strategic considerations. For example, barriers to entry may be easier to address than labor market distortions—and may facilitate subsequent labor market reforms by reducing the rents available for the participants to contest.¹⁰

Some improvements—such as reducing barriers to entry—can deliver fairly quick results. 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 goals

Creating an investment climate that allows firms of all types to 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 that opportunities for growth are shared widely in society helps build social cohesion and support for ongoing policy improvements.

Investment climate improvements can affect firms and activities differently. Because of this, priority-setting may be influenced by the weight governments place on a subset of the goals a good investment climate can deliver:

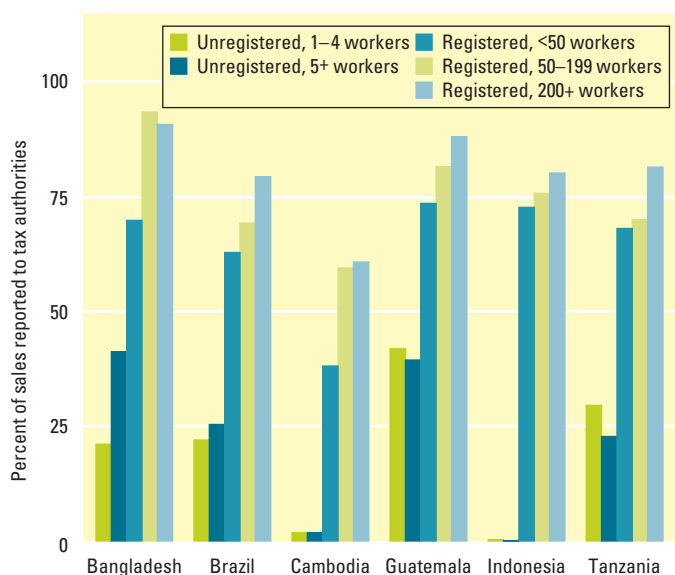
- Integrating firms in the informal and rural economies
- Unleashing the growth potential of smaller firms
- Taking advantage of opportunities from international openness
- Allowing firms to climb the technology ladder.

What are the implications for priority-setting?

Integrating firms in the informal economy.

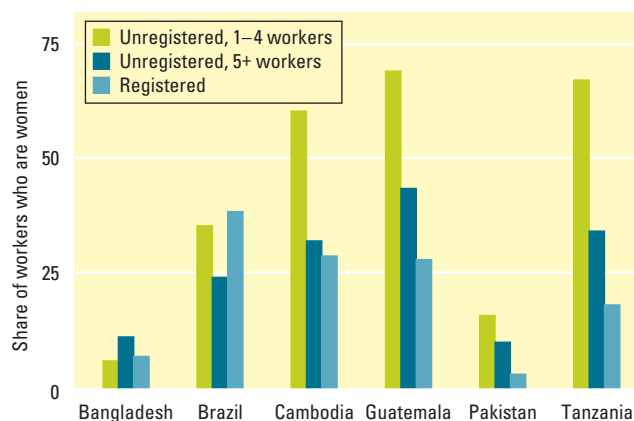
Most developing countries have a dual structure, with a modern economy operating alongside a more traditional economy with high levels of informality. Estimates suggest that more than half the economy is informal in many developing countries (figure 1.17)—and that informality is growing.¹¹ There are 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).

The informal economy is diverse, ranging from subsistence farmers and those engaging in entrepreneurship out of necessity,¹² to more affluent firms that find it feasible to evade tax and regulatory 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 (figure 3.3).¹³

Figure 3.2 Informality is a matter of degree

Source: World Bank Investment Climate Surveys and WDR Surveys of Micro and Informal Firms.

Governments have an interest in expanding the net of the formal economy to broaden the tax base, extend the reach of regulations intended to meet important social objectives, and remove distortions in competition between firms in the formal and informal economies. They also have an interest in reducing obstacles to growth faced by firms, and in expanding income-earning opportunities for those on the lowest rung of the economic ladder. Getting the balance right can be difficult. Simply enforcing existing regulations and taxes more strenuously may drive those on the

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

Source: World Bank Investment Climate Surveys and WDR Surveys of Micro and Informal Firms.

lowest rung of the ladder out of business and so exacerbate poverty. Recent work in Egypt suggests that society as a whole can be better off if this were to happen, but be better off if formalization were encouraged in an environment with reformed regulations.¹⁴ Experience in Vietnam and Uganda shows that reducing unjustified regulatory burdens, including the costs of going formal, can do much to encourage formality (chapter 5).

Beyond encouraging formality, governments can focus on addressing constraints faced by microentrepreneurs in the informal economy. The constraints they perceive can differ from those of formal firms.¹⁵ Informal firms can evade many regulatory and tax obligations, but face other obstacles, including less secure property rights and greater difficulty obtaining access to finance and public services. Entrepreneurs who do not have a fixed place of business, such as street vendors, are particularly vulnerable.¹⁶ While constraints need to be assessed in each context, surveys undertaken for this Report show that priority areas will often include strengthening property rights, such as clarifying rights to land (chapter 4);¹⁷ reforming regulations or taxes that encourage informality or contribute to harassment and corruption (chapter 5); and improving access to credit, including through microfinance schemes (chapter 6). Reforming labor market regulations can also encourage greater formality in employment relationships, and so extend the coverage of important protections for workers (chapter 7).

Integrating firms in the rural economy.

Many firms operating in rural areas also tend to be part of the informal economy, but rural location can 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 reducing poverty.

Increasing the productivity of agriculture expands opportunities in rural areas—not least because it increases the demand for local services and provides an important means of diversifying risks.¹⁸ Improving

security of rights to land has been shown to have a big impact on agricultural productivity (chapter 4), and breaking up agricultural monopolies can also expand opportunities for poor farmers (chapter 5). But increasing rural nonfarm income is often identified as the most important way to combat rural poverty.¹⁹

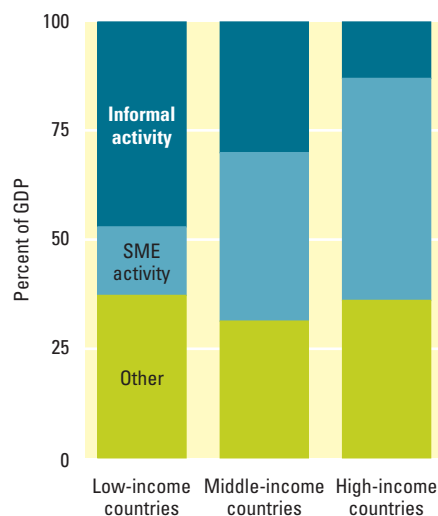
Nonagricultural activities account for up to 50 percent of rural employment and household income in many developing countries, with the figures highest in Africa, followed by Latin America and East Asia, and lowest in South Asia.²⁰ Nonagricultural salaried employment is associated with the richest quintiles in rural areas, agricultural wages with the lowest, and self-employment in the middle.²¹ Rural areas with lower agricultural productivity can make substantial contributions to incomes through manufacturing. 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.²²

Distance and low population density add to the challenges of firms in rural areas. Lower concentration denies them the benefits of agglomeration economies that firms in urban centers enjoy. It also makes it more costly to supply modern infrastructure and provide other services valued by firms. Subsidizing infrastructure and other services for rural communities is politically popular—but often poorly targeted and difficult to sustain. In some cases the patronage threatens the viability of service provision across the economy (see box 6.6 on India's power sector).

Many governments are responding with more pragmatic approaches to the provision of infrastructure and other services. Creating a better investment climate for small private providers, such as those delivering electricity in rural areas in Cambodia and Yemen, can play an important role (chapter 6).

Unleashing the growth potential of smaller firms. Small and medium firms (SMEs) account for the bulk of firms and employment in the formal economy and, together with informal microenterprises, account for

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



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

the majority of GDP across country groups (figure 3.4). There is ongoing debate about whether small firms play a special role in economic development and so might merit special policy privileges (box 3.3). But whatever the weight given to such claims, smaller firms do tend to face more burdens than larger firms in a weak investment climate.

Investment climate constraints that represent a fixed cost hit small firms harder—whether through regulatory compliance costs,²³ the costs of self-provision of electricity or security services, or bribes.²⁴ Limited assets to pledge as collateral and shorter credit histories can also make it more difficult for smaller firms to obtain access to finance. This means that improvements to the broader investment climate will tend to provide disproportionate benefits to smaller firms.

Removing policy and regulatory distortions will usually be the most effective strategy to help unleash the growth potential of small firms. 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 the protection of property rights and establishing credit bureaus and asset registries can also help small firms obtain access to finance (chapter 6).²⁶

BOX 3.3 Do small firms play a special role in economic growth?

Microenterprises in the informal economy often receive particular attention due to their role in poverty reduction. Small firms in the formal economy are also 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. True, SMEs as a group typically create more jobs than larger firms. But they also tend to shed more workers, with a higher rate of “churn,” so do not necessarily lead to greater net job creation. Large firms (more than 100 employees) were estimated to account 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 in the formal economy did. SMEs might, however, play a larger role in providing opportunities for low-skilled workers.

Some believe that SMEs are particularly innovative—adopting, designing, and producing new technologies and new approaches to

production. They do tend to be nimbler than large firms in responding to niche opportunities and changing market conditions. But while there are many anecdotes about small firms pioneering particular technologies or ideas, firms that fit that profile seem to be the exception rather than the rule. Indeed, most R&D in developing countries is undertaken by larger firms (see table). 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. 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 larger firms.

Others believe that expanding opportunities for SMEs can play a special role in helping to broaden public support for markets and in expanding domestic competition. These claims are

plausible, but imply that policy responses should aim to remove barriers facing all firms in the economy, rather than targeting a particular group for special treatment based solely on size.

Recent macroeconomic evidence also casts doubt on the claim that SMEs are especially important for growth and poverty reduction. 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 those to improve the investment climate—also promote SME development, but that policies that target SME development do not necessarily result in faster growth.

Source: Biggs, Ramachandran, and Shah (1998); Biggs (2003); Acs and Audretsch (1987); Biggs, Shah, and Srivastava (1995); Batra and Tan (1995); and Beck, Demirgüç-Kunt, and Levine (2003).

	Small (< 20)	Medium (20–49)	Large (50–249)	Very Large (250 and up)
R&D expenditures (% of sales)	0.9	1.4	1.5	1.4
Any R&D expenditures (% of firms)	6.7	13.6	20.4	24.9
Formal training program (% of firms)	27.2	41.6	56.7	63.4
Exports (% of sales)	5.7	10.1	21.0	34.0
Any exports (% of firms)	12.6	20.9	39.6	56.8
Uses e-mail to communicate with suppliers and customers (% of firms)	36.0	46.9	55.4	58.9

Source: World Bank Investment Climate Surveys.

Taking advantage of international openness. Few countries have grown without being open to trade.²⁷ Expanding markets and lowering barriers to new products and ideas creates 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 developing countries increased from 0.1 percent of global GDP in 1970 to 3 percent in 2001 (figure 3.5). While all economies can benefit, international integration is crucial for smaller states (box 3.4).

Exporting expands access to foreign exchange and allows firms to exploit

economies of scale. The higher productivity of successful exporters (box 3.5) 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 connections to overseas markets: firms in Mexico in locations where multinational firms exports are higher are more likely to export themselves.²⁸ Removing regulatory and other policy-related barriers to exporting is usually a top priority.²⁹

What then, about imports? Reducing barriers to imported goods can be beneficial in three ways:

- *Reducing the cost of imported inputs.* Price markups are lower in countries where foreign competition is greater, however

BOX 3.4 International integration is especially important for small states

Forty-five developing countries have fewer than 1.5 million people each. Their small local markets and small pools of workers limit domestic competition and the diversity of economic activities. For them, greater integration with international markets is crucial. It involves providing adequate infrastructure to facilitate trade and fostering regional cooperation.

Regional integration enables firms to achieve economies of scale by expanding market size. It can reduce transaction costs and investment risk, also encouraging more investment. Increased opportunities for competition also strengthen incentives for firms to innovate and improve their productivity. Where regional integration involves a common currency or common regulatory frameworks and agencies, there can be big reductions in the transaction and administrative costs for firms. Regional inte-

gration can also reduce the cost of 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 people, 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 established a common central bank, a common currency, and a common regulator for telecommunications. It is working on 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 Eco-

nommic Cooperation countries. Concerned about the high costs of transportation in the region, the Forum's main priority is shipping.

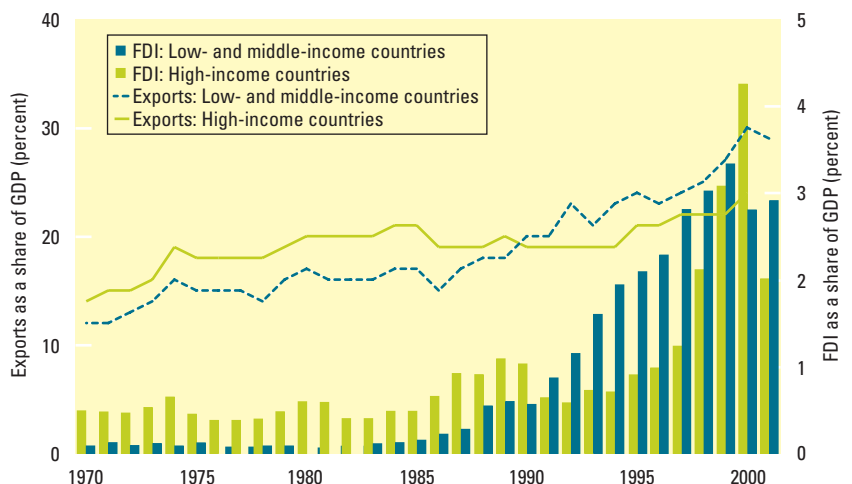
Among the many African regional integration initiatives, the Southern African Development Community (SADC) is one of the more successful. It has enabled greater FDI from the more developed countries (South Africa and Mauritius) to the less developed countries, giving a new dynamism to the region. French-speaking countries in West Africa have created a common central bank and have an active program for harmonizing business regulation (see box 9.5 on OHADA).

Source: Commonwealth Secretariat and World Bank Joint Task Force on Small States (2004), Brautigam and Woolcock (2001), Commonwealth Secretariat (2003), Harsch (2002), and Fairbairn and DeLisle (1996).

competition is measured (by import penetration, effective protection rates, or license coverage rates).³⁰ The costs that import restrictions impose on firms and consumers relying on inputs from the protected sector usually far outweigh the benefits to the protected firms.³¹

- *Facilitating the diffusion of knowledge and 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.³²

Figure 3.5 Gross exports and FDI in developing economies jumped in the 1990s



Note: Gross exports are of goods and services; FDI refers to net inflows in reporting economy.
Source: World Bank (2004b).

BOX 3.5 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 doing it (the learning-by-exporting hypothesis). The discipline of competing in international markets encourages firms to improve their productivity or exposes them to foreign technologies and modes of production. In addition, exporting allows firms to achieve greater economies of scale by expanding their potential market.

The second explanation is that because firms have to be efficient to compete in international markets, only firms that are already efficient can export (the self-selectivity hypothesis). Although inefficient firms might prosper in domestic mar-

kets when protected from international competition by natural barriers (high transportation costs) and policy barriers to trade (tariffs and quotas), they are unable to survive in international markets. Thus, 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 supports both hypotheses to some degree. Several econometric studies have found that productivity improvements precede exporting, providing support for the self-selectivity hypothesis. But case studies often support

the learning-by-exporting hypothesis. Studies of exporters in South Korea and Taiwan, China, found that export buyers were an important source for new technologies, which they provided in forms including blueprints, information about manufacturing processes and quality control methods, technical advice and on-site plant inspections, and training for technical and production staff. Some econometric studies also support the learning-by-exporting hypothesis.

Source: Aw, Chung, and Roberts (2000); Bernard and Jensen (1999); Clerides, Lach, and Tybout (1998); Hallward-Driemeier, Larossi, and Sokoloff (2002); Kraay (1999); Liu, Tsou, and Hammitt (1999); and Westphal (2002).

- *Strengthening incentives for local firms to innovate and improve their productivity.* Firm-level studies find that trade liberalization improves productivity among firms competing with imports.³³ Episodes of trade liberalization in Brazil between 1990 and 1995, Chile in the 1970s and 1980s, India in the early 1990s, and Colombia between 1977 and 1991, were all associated with higher firm productivity in import-competing sectors.³⁴ The effect of liberalization can be large (box 3.6). In Colombia a 10 percent decline in tariffs was associated with as much as a 3 percent increase in productivity in firms.³⁵ The productivity gains reflect within-plant gains and the exit of inefficient firms.³⁶

Foreign investment can also do much for productivity—by providing 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, the República Bolivariana de Venezuela, and transition Europe.³⁷ 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 found that foreign entry in downstream industries boosts the productivity of local suppliers upstream.³⁸

Foreign firms also put competitive pressure on local firms. This can benefit firms and other consumers that depend on inputs from the industry gaining FDI. In principle the rival firms might also benefit from technological spillovers as well as sharper incentives to innovate and improve their productivity. However, the evidence of horizontal spillovers from FDI (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 firm).³⁹

Trade and foreign investment are often facilitated by informal contacts through emigrants and diaspora (box 3.7). But the benefits from international openness provide a strong rationale for giving priority to easing relevant policy constraints. The agenda includes improving customs administration, liberalizing trade and foreign investment regimes (chapter 5), and improving transport infrastructure (chapter 6). Adoption of international rules and standards can also help improve the environment for international transactions (chapter 9).

Climbing the technology ladder. Technological progress is important for economic growth. That does not mean 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 available technologies is more fea-

BOX 3.6 Trade liberalization in India—recent evidence

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. But its trade policies remained quite restrictive at the beginning of the 1990s. 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 that in the 1990s find that productivity increased for firms exposed to competition from imports. The effect was large. Topalova found that a 10 percent decrease in tariffs resulted in a 0.5 percent

increase in total factor productivity. Firms that were most efficient appear to have improved their performance the most. Another study found that investment and productivity improved in industries close to the technological frontier, but failed to improve in less technologically advanced industries.

Few firms closed down following trade liberalization. This might suggest that most firms managed to cope with the additional competitive pressure, but it might also be because exit was very difficult for firms in India at that time. Although recent government reforms should speed up bankruptcy procedures, in 2003 they 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 Indian machine tool industry was protected by tariffs of up to 100 percent and by other restrictions. When tariffs were reduced to around 15 percent in 1992, local firms found themselves unable to compete with more efficient foreign producers. 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, Ace Designers, that started operating only two years before the tariffs were reduced.

Source: Aghion and others (2003); De Long (2003); Rodrik and Subramanian (2004); Sutton (2002); Topalova (2003); and World Bank (2004k).

BOX 3.7 Foreign locals—the role of emigrants and diaspora

Emigrants, or diaspora, have 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 firms.

Overseas Chinese contributed 70 percent of China's FDI over the past 15 years. By 1995, 59 percent of the accumulated FDI in China came from Hong Kong, China, and Macao, with a further 9 percent from Taiwan, China. Korean Americans were the bridgeheads for the successful penetration into the U.S. market by Korean car, electronics,

and white goods manufacturers. In Canada a doubling of skilled immigrants from Asia was accompanied by a 74 percent increase in Asian imports.

In the mid-1990s, when India started to open its economy, it began to attract its 20 million compatriots living abroad. The Indian diaspora, second only to China's, contributed 9 percent, or \$4 billion, to the country's FDI in 2002. Members of IndUS Entrepreneur, a networking group of Indian information technology entrepreneurs and professionals, are funneling funds into startups in India as well as hybrid companies that

operate in both India and the United States. This has boosted the confidence of overseas Indians who had reached high management positions in western multinationals helped to convince their firms to set up operations in India, with Hewlett-Packard a prime example.

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

sible and can still improve productivity. The Bank's Investment Climate Surveys confirm the important role of competitive discipline in encouraging firms to innovate (chapter 1).

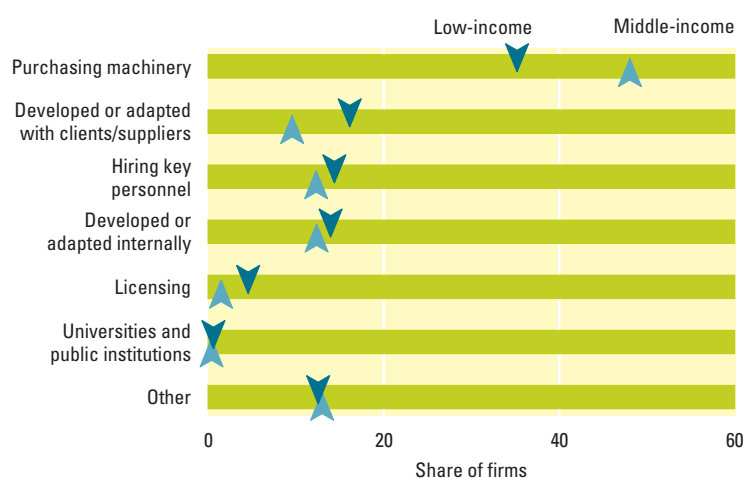
For firms a long way from the technological frontier, the most cost-effective strategy for technological upgrading is to tap technologies developed elsewhere, through trade and licensing.⁴⁰ Several studies highlight the impact of machinery and equipment imports on productivity in developing countries.⁴¹ 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 innovation (figure 3.6).⁴²

Another way to climb the technology ladder is to encourage local R&D. 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.⁴³ Low skill levels can also hinder moves to more technology-intensive industries (chapter 7).⁴⁴

Implementation constraints

The priority-setting process is also influenced by implementation constraints—both administrative and political (box 3.8). Strategies for strengthening government capabilities to relieve administrative con-

Figure 3.6 Gaining access to technological innovations—key sources



Note: "Other" includes transfers from parent companies, trade fairs, study tours, consultants, and business associations.

Source: World Bank Investment Climate Surveys.

Table 3.1 Who innovates?

	High-income countries	Developing countries
Patents granted by the U.S. 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 ^b	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 higher education ^b	0.34	0.12
R&D performed by the public sector ^b	0.28	0.22

a. Per 10,000 inhabitants.

b. As a percent of GDP.

Source: Lederman and Saenz (2003).

straints are discussed later in this chapter. Political constraints often require both a high level of commitment as well as effective strategies for managing change.

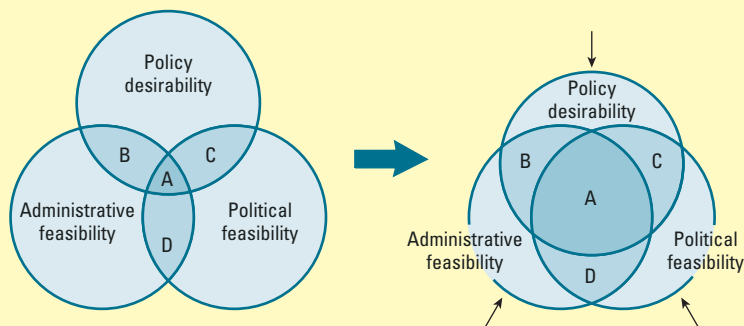
BOX 3.8 Expanding the zone of feasible and desirable policy improvements

Proposed improvements to investment climate policies must meet three tests. Clearly, 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 resources and technical expertise to 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 prefer the status quo.

At any point the menu of possible policy options that meet all three tests is limited—as shown in zone A in the figure. Options in zone D are technically and politically feasible but not desirable—

market restrictions or distortions of various kinds provide examples. Options in zones B or C would be sound policy but are not feasible in the short run, so reform efforts in these areas would either be unsuccessful or, if implemented, would lack credibility.

Over time the goal is to expand the “sweet spot” by increasing the congruence of 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. Political feasibility can be enhanced by effective change management, including strategies for building public support.



Source: Adapted from Lax and Sebenius (1986).

Managing individual reforms

Land titling obviously differs from trade liberalization, and improving the courts differs from labor market reform. But a common issue across most areas of investment climate reform is the need to deal with resistance from those who have incentives to maintain the status quo. Resistance may come from firms or other interest groups that benefit from market restrictions or other special privileges. It may come from officials who benefit from informal payments or other prerequisites of office. Even the broader community may have a bias toward the status quo when the implications of change are not certain,⁴⁵ or where there are other concerns about the reform process.

Overcoming this resistance is a key part of any strategy to broaden and accelerate investment climate improvements. What has been learned about the catalysts for

change? And how might such changes be successfully managed?

Catalyzing change

Change tends to occur when something shifts the incentives for maintaining the status quo. International experience illustrates how a diverse range of factors can trigger policy change even in the face of resistance by beneficiaries of the status quo. Those triggers can include external shocks and crises, technological change, new opportunities, new information and institutional competition, political change, and the initiative of policy entrepreneurs.

External shocks and crises. External shocks or crises can weaken the bargaining position of those who would normally oppose reform.⁴⁶

They can also create opportunities for reformers to exploit rapidly changing economic or social conditions to justify or legitimize reform. In Korea reducing cross-subsidies among *chaebol* subsidiaries, tried throughout the early 1990s without success, was implemented only after the 1997–98 financial crisis.⁴⁷ 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 the Philippines in the 1980s led to efforts to engage the 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.⁴⁸ But crises do not always have this effect, and indeed the heightened social tensions associated with large-scale crises can overwhelm policymakers.

Technological change. Technological change can threaten the interests of those committed to current technologies and provoke fierce resistance. Recall the Luddites in early 19th century England who rioted against technological progress in the textile industry. But technological progress can also alter the costs and benefits of policymakers maintaining current policies. For example, advances in telecommunications technology created new opportunities for introducing

competition, increased the costs of inertia for those beholden to national monopolies, and so sparked a wave of telecommunications reforms around the world in the 1990s.

New opportunities. New opportunities, such as access to new markets, can catalyze change. For example, the lure of EU accession altered the reform agendas of governments in Eastern and Central Europe,⁴⁹ and joining NAFTA did the same for Mexico. The prospect of joining the WTO also had wide-ranging effects on the reform agenda in China.

New information and institutional competition. New information can shake assumptions about the desirability of the status quo and highlight the costs of inertia. Information that benchmarks a jurisdiction's performance against other jurisdictions in terms of costs, productivity, or other measures can spur change through its impact on local prestige and concerns about future living standards. Success from policy reforms in neighboring jurisdictions can also have tangible effects. In China competition among provinces for investment is spurring changes across a range of policy areas,⁵⁰ and similar effects are evident in India.

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. They may also reflect a changing social consensus, as when the emergence of the merchant class in England drove the protection of property rights.⁵¹ A growing middle class can also create a constituency against confiscatory, populist policies.⁵² 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 implemented in 2002 under a new government acting quickly to take advantage of political support.

Policy entrepreneurs. Individuals identifying and promoting policy changes are often found within government—and in places that have the ear of the government or the

public.⁵³ In Peru the effort to reform land titles can be traced in part to the Institute for Liberty and Democracy's persuading the government and the wider community of the value of reform. Civil society groups are also playing an active role in promoting improvements in investment climate policies and behaviors. For example, Consumers International and its national chapters champion the benefits of greater competition, and Transparency International has emerged as an influential champion for greater transparency in government-firm dealings.⁵⁴

The level of resistance to any reform will be influenced by what the beneficiaries of the status quo have at stake, and by their alternatives. Firms benefiting from clientelistic relationships with governments, ineffective regulation, market restrictions, or other privileges that weaken the broader investment climate might be expected to fiercely resist change. But this is not always the case. Concerns about corporate reputations, about the long-term future of their businesses, or about the implications of more drastic government action can lead firms to take a more enlightened view of their self-interest. This is evident in moves by firms to burnish their reputations through corporate philanthropy, corporate social responsibility initiatives, and forms of self-regulation. Similar considerations can lead firms to moderate their resistance to reform and even to cooperate with reformers to develop workable solutions.

Communicating to build support

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.⁵⁵

Gathering and disseminating information that benchmarks a country's performance or that analyzes the costs and benefits of reform—including 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. Building public awareness and support can also reduce the risk of later policy reversal and thus enhance the credibility of the reform, increasing the likely investment response (chapter 2).

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 were important. In Peru television commercials and public ceremonies at the delivery of land titles were the main channels. In Lesotho and the República Bolivariana de Venezuela comic books reached a wide audience. In post-conflict Bosnia and Herzegovina, the Bulldozer Initiative came up with a brand name and used a range of communication devices, including the staging of symbolic events.

Apart from building support, communication campaigns can educate the public about the reforms and help change public behavior. Educating firms, consumers, and other groups about their rights and the measures to uphold them is part of the process. In reforming credit rating agencies in Mexico, the financial authorities and the

Buro de Crédito undertook a campaign to increase consumer awareness by placing the regulatory framework on their Web sites and listing the rights of consumers in a simple and accessible way. As part of its judicial reforms, Georgia launched a comprehensive communication effort to educate the public about newly acquired rights, increase trust in the system, and help users navigate the courts.⁵⁶

Engaging stakeholders

Early consultation with key stakeholders, including potential winners and losers, on proposed changes 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. Broad consultations can also allay concerns that favored groups might exercise disproportionate influence in policy-making processes, thus enhancing the transparency and public acceptance of reforms.

The form and structure of consultation can vary. In Vietnam reforms to simplify business registration involved consultations with private sector associations, domestic business groups, lawyers, the media, and members of the National Assembly. In Pakistan business registration reforms were designed and approved after a consultative process that involved circulating and discussing draft rules with various chambers of commerce, 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 reform priorities and an action plan were developed through consultations with business associations and a wide range of inspectorates. In China, Hangzhou municipality recently established a hearing system, inviting stakeholders and the public to express their views on reform proposals.⁵⁷ In Bosnia and Herzegovina, the Bulldozer initiative includes grassroots involvement in identifying, evaluating, and monitoring reforms (box 3.9).

BOX 3.9 *The Bulldozer initiative in Bosnia and Herzegovina*

Bosnia and Herzegovina launched the Bulldozer Initiative in 2002 to involve the private sector in reforms. A reform coordination unit invited 30 local associations to help in proposing, evaluating, and refining reforms. Among them were regional business associations, municipal associations of entrepreneurs, the Employers' Confederation, the Women's Business Network, 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 evaluates proposals. Each proposal is subjected to a cost-benefit analysis, and industry experts are invited to comment on ideas before taking the reform to the next stage. This way no single firm can exploit the process to serve its own interests.

The proposed reforms are then submitted to the government, opening an inten-

sive dialogue between the Bulldozer Committee and the Council of Ministers and Regional Governments. Once the reform is designed, the Committee becomes an implementation watchdog. A biannual publication informs the public of progress, including scores for each reform.

The initiative has helped to reduce significantly the burden of bureaucratic procedures on firms. 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 it established regional Bulldozer committees, all voluntary and self-financed.

Source: Herzberg (2004).

Engaging with prospective losers from reform—a group unlikely to remain silent in any event—is also important. They can provide feedback on the details 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

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

The case for compensating firms affected by policy changes 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 in society and the reform would disrupt their legitimate expectations. For example, investors in Singapore’s privatized telecommunications company were compensated when the government shortened the promised period of exclusivity.⁵⁸ Power utilities in the United States were compensated when the transition to a competitive market “stranded” some of the assets built under a previous regulatory regime.⁵⁹ 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 taxes or the introduction of a new competition law.

Compensation need not always involve cash. In the United States, for example,

compensation for utilities disadvantaged by changes in the regulatory environment came from a levy imposed on consumer tariffs. Reform programs can sometimes be designed so that firms disadvantaged by one reform (liberalizing trade) benefit from others (improving business regulation).

When 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 payments. Mechanisms for arbitrating disputes can reduce the incidence of strategic behavior, as can benchmarks or principles derived from experience in other countries.

Maintaining momentum

Investment climate improvements are a process, not an event. Given the breadth of the agenda, and the need to review policies regularly, many countries are creating supporting institutions to help with specific tasks and to sustain progress through changes in government. Those institutions take many forms, but perform one or a combination of four main functions:

- Facilitating consultation
- Facilitating coordination
- Reviewing existing laws and policies
- Reviewing new policy and regulatory proposals.

Facilitating consultation

Many governments have created special structures to facilitate ongoing dialogues with representatives of stakeholders. To be effective, these structures should encourage the free flow of information, build trust among participants, and assist in framing solutions. It is particularly important that they reflect the diversity of interests affected by investment climate reforms and not merely entrench elites. A high level of transparency in their operation—such as the regular publication of reports—can also increase public confidence in reform programs.

The scope of representation varies widely (table 3.2), as do their mandates. Some look at policymaking economywide while others focus more sharply on private sector issues. Many of the latter have a mandate that goes beyond dialogue and includes identifying

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

	Government	Business	Unions	Legislators	Civil society	Donors
Economywide focus						
<i>Latvia</i> —Tripartite Cooperation Council	✓	✓	✓			
<i>South Africa</i> —National Economic Development and Labor Council	✓	✓	✓		✓	
<i>Papua New Guinea</i> —Consultative Implementation and Monitoring Council	✓	✓	✓		✓	✓
Private sector issues						
<i>Vietnam</i> —Private Sector Forum	✓	✓		✓		✓
<i>Uganda</i> —Private Sector Foundation	✓	✓		✓	✓	
<i>Pakistan</i> —Workers and Employers Bilateral Council	✓	✓	✓			
<i>Singapore</i> —Competitiveness Council	✓	✓				

Source: World Bank staff.

bottlenecks, building consensus, recommending policy approaches, and monitoring progress of reforms. Latvia and Turkey illustrate common approaches (box 3.10).

Facilitating coordination

Responsibilities for investment climate policy issues are often distributed among several government ministries and agencies, and often across tiers of governments as well. Fostering coordination between relevant agencies can be important to deal effectively with issues of common interest and to promote policy coherence. Central leadership can also help give impetus to

reforms and help overcome resistance from agencies that may have a stake in maintaining the status quo.

Forums for consulting with external stakeholders can contribute to policy coherence when led by senior policymakers. But mechanisms are also often needed within the government. This may take the form of high-level cabinet committees or even the establishment of a dedicated ministry. For example, countries acceding to the EU often created ministries for Europe to foster coordination of individual reform initiatives across ministries. In Poland that task was given to a Committee for European Integration.⁶⁰

More day-to-day coordination may be undertaken by the technical secretariat to the consultative forum or the coordination committee. In 2000 Vietnam established an Inter-Ministerial Steering Group on Enterprise Law Implementation to support the ongoing implementation of its reform program (box 3.11).

Fostering policy coordination between national and subnational governments can be tricky politically, but also raises other issues. As China and India show, institutional competition between subnational governments can be a source of strength for the investment climate by fostering policy innovation and providing a check on arbitrary government behavior (chapter 2). But some coordination may be desirable to address spillovers across jurisdictional boundaries. In Mexico, for example, procedures for state and municipal governments to make regulations on road freight compatible and complementary are being improved.

BOX 3.10 *Consultative mechanisms in Latvia and Turkey*

Many countries have created dedicated structures to facilitate an ongoing dialogue with stakeholders on investment climate improvements. The approaches in Latvia and Turkey illustrate some of the key features.

In Latvia the Steering Committee for Improvement of the Business Environment reports to the Minister of Economy. In Turkey the Coordination Council for the Improvement of the Investment Climate reports to the Undersecretariat of the Prime Ministry. Both bodies comprise representatives from key ministries, as well as from associations of local firms, exporters, and foreign investors. In both countries the bodies are served by a secretariat responsible for the daily work and for monitoring reforms—in Latvia, the Business Environment Improvement Unit at the Latvian Development Agency; in Turkey, the General Directorate for Foreign Investment in the 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 committees, and Latvia started with four, but the number and focus change with the needs and concerns of business.

Both bodies help to design and implement reforms. Turkey's Council helped design laws on recruitment of foreign personnel, FDI, company registration, and labor. It is also engaged in reforms for customs, licensing, intellectual property rights, and land acquisition. Latvia's Committee contributes to implementing ongoing legislative and procedural reforms of inspections, registration, taxes, customs, land acquisition, and construction.

Source: Coolidge, Grava, and Putnina (2004) and www.yased.org.tr.

Reviewing existing laws and policies

Most distortions in the investment climate stem from existing laws and policies. To sustain an ongoing process of policy review and reform, many governments are creating institutions with a mandate to more systematically review such arrangements and recommend reforms.

This role may be given to the technical secretariats of consultative or coordinating bodies. For example, Thailand's National Competitiveness Committee and Singapore's Committee on Competitiveness have mandates to study constraints on competitiveness and to make specific recommendations. Thailand's committee is chaired by the prime minister, with the National Economic and Social Development Board as its secretariat. It has undertaken assessments of several sectors of the economy, including handicrafts, tourism, and software, and 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.⁶¹

Sometimes the body has a broader mandate. For example, Australia's Productivity Commission focuses on providing detailed analyses of particular areas of policy referred to it by the government. A strong reputation for rigorous and independent work, coupled with effective consultation with stakeholders, has allowed it to exercise significant influence. Japan's Regulatory Reform Committee, reporting to the prime minister, has responsibility for coordinating the implementation of a broad deregulation plan.⁶² In Mexico an Economic Deregulation Unit was created in 1988 to oversee improvements to business regulation. Among other reforms, it proposed dismantling price controls, deregulating the transport sector, and streamlining the standardization process. In 2000 it was transformed into the independent, nongovernmental Regulatory Improvement Commission (COFEMER), maintaining broad formal oversight powers for the analysis of federal regulations and working with subnational governments to reduce red tape. Competition and investment promotion agencies

BOX 3.11 *Shepherding investment climate improvements in Vietnam*

Vietnam began its transformation from a centrally planned to a more market-oriented economy in the late 1980s. Despite many improvements, particularly in opening to FDI, there was a cumbersome, overlapping, and inconsistent regulatory environment for the domestic private sector.

To advance the needed reforms, officials worked with a broadly 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 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 estab-

lished an Inter-Ministerial Steering Group on Enterprise Law Implementation, chaired by the Minister for Planning and Investment. 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 geographic areas.

A recent survey of firms noted a “return of troublesome and cumbersome unwritten procedures among various local authorities.” Vietnam thus shows that continuing vigilance is often needed to ensure that reforms take deep roots.

Source: Mallon (2004).

are also often given a mandate to act as champions of reform in their particular areas (chapter 5).

Experience with dedicated reform champions in low-income countries remains limited, 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 3.12).

Reviewing new policy and regulatory proposals

Governments also need to ensure that new policy or regulatory proposals do not undermine the investment climate by introducing unjustified burdens or other distortions. A common response in Organization for Economic Co-operation and Development (OECD) countries has been to establish processes for regulatory impact assessment. Proposed laws and regulations are subjected to a quantitative assessment of their costs and benefits, with the information made available to legislators and other policymakers. These processes help to ensure proposals reflect an economywide perspective. The additional scrutiny involved can also act as a check on rent-seeking.

In the United States some 60 percent of regulations are changed as a result of review by the Office of Information and Regulatory Affairs. Variations of these arrangements are in place in 22 OECD countries and in some upper-middle-income countries in Eastern Europe, Latin America, and Asia.⁶³ In Mexico the review process is supported by COFEMER, which reviewed almost 1,500 regulations between 2000 and early 2003.⁶⁴ In Korea a regulatory review committee reviewed nearly 3,000 regulations between 1998 and 2002, declining 387 draft regulations and returning 1,157 to sponsoring agencies for revision.⁶⁵ The question is whether such impact assessments can work in lower-income countries.

Strong political commitment is essential, and without it schemes can disintegrate in any country. Technical capacity can be more of a constraint in low-income countries, although drawing on the expertise of local universities or other entities can often augment this.⁶⁶ For example, Bulgaria's regulatory review processes benefited from collaboration with a not-for-profit think tank.⁶⁷

Questions of institutional design can be thornier. There is a tension between creating a central entity with the autonomy and expertise 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 structure. Independent central review units can help to leverage scarce technical exper-

tise and promote consistent assessments, but are often seen as too intrusive on the prerogatives of line ministries. Delegating responsibility to line ministries can help to get their buy-in to the process, but doing so without a clear framework can lead to disappointing results. In Ghana, for example, 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.⁶⁸

Bulgaria's review process had similar weaknesses until recently, with each agency performing different types of evaluations, using different accounting methods and different benchmarks, and publicly releasing different amounts of information. The reviews did not have a perceptible impact on legislation until uniform review criteria and methods were devised.⁶⁹ In Lithuania, by contrast, assessment for all draft legislation was mandated under the leadership of the presidency. Reviews are undertaken by the sponsor of the legislation in consultation with those affected by the proposed policy changes. Summary assessments accompany all draft legislation and are reviewed at inter-ministerial, sectoral, and cabinet levels, any of which can return the legislation to the sponsor with a list of requested improvements.⁷⁰

Mechanisms and processes of the kind discussed here can help to maintain momentum, but they depend for their success on high levels of political commitment and on being credible to stakeholders. They also benefit from ongoing processes to strengthen capabilities within government.

BOX 3.12 *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 committees to review domestic competition issues, export and investment promotion, labor-management relations and labor regulation, and transportation costs. It took the lead in facilitating substantial improvements to the investment climate.

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 sectors such as tourism and building and civil engineering works. It established a one-stop shop for 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.

Strengthening capabilities

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

Expertise

Creating a skilled, professional, and accountable civil service can benefit all areas of the

investment climate. In some areas of investment climate policy there is also a need to draw on more specialist expertise that remains scarce in many countries. Examples include areas of regulation and aspects of tax administration. The skills, credibility, and effectiveness of staff can have a big effect on the policy environment faced by firms.

To make it easier to recruit and retain staff with the requisite skills, many countries are establishing more autonomous administrative structures for these functions (chapter 5). There is also growing experience in contracting-in or contracting-out some specific functions to outside experts, even in developed countries. A recent survey of regulatory agencies for infrastructure across the developing world found that three-quarters of agencies engaged consultants or other external parties in regulatory tasks. In more than 90 percent of these cases, contracting-out was found to also improve the competence of the regulatory agency.⁷¹ When local capacity is weak, entire functions can be contracted out—such as customs administration in Mozambique (chapter 5). Capacity building strategies are also being adapted to the particular needs of specialist agencies, including the formation of international networks of regulatory professionals (box 3.13).

Learning and information

The need to expand government capabilities extends beyond technical expertise. Governments need to improve their processes for ongoing learning—including that from policy experiments abroad as well as within their own countries. Decentralization and institutional competition have been sources of policy innovation and learning in countries including 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. In Uganda efforts to improve business registration processes are beginning with a demonstration project in Entebbe (chapter 5).

To take advantage of these experiments, and to track trends and monitor the

response by firms to particular policy changes, governments need access to 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. Similar deficiencies exist in data from official business registers. 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 developed countries—can also help. The surveys 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.

BOX 3.13 *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 countries.

The International Forum for Utility Regulation, established by the World Bank in 1996, is 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, Africa, and East Asia. The South Asian Forum for Infrastructure Regulation, established 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 meetings focus on specific themes, such as strategies for engaging consumers and other stakeholders. A similar regional initiative for utility regulators in East Asia and Pacific was launched in 2003.

Source: World Bank staff.

Part I argued that improving government policies and behaviors shaping the investment climate is critical to spurring growth and reducing poverty—and so should be a top priority for governments.

Chapter 1 argued that the key is to improve the opportunities and incentives for firms of all types to invest productively, create jobs, and expand. This in turn requires efforts to reduce unjustified costs, risks, and barriers to competition. Chapter 2 focused on the basic tension that governments need to confront in investment climate policymaking: While firms play a key role in improving living standards in society, their policy preferences can diverge from those of society as a whole. Arbitrating these differences successfully requires governments to navigate four sources of potential policy failure: rent-seeking, credibility gaps, lack of public trust, and poor fits between policy responses and local conditions. It outlined lessons of experience in addressing those challenges, highlighting the powerful role of transparency. This chapter looked at practical strategies for tackling a broad agenda. It argued that the key to accelerating and broadening improvements is to address important constraints facing firms in a way that gives firms the confidence to invest—

and to sustain a process of ongoing improvements. It looked at issues associated with setting priorities, managing individual reforms, maintaining momentum, and strengthening government capabilities.

The remainder of the Report looks at more detailed issues associated with the design and implementation of effective strategies to create a better investment climate.

- Part II examines lessons of experience in delivering the basics—the foundations of a sound investment climate—stability and security (chapter 4), regulation and taxation (chapter 5), finance and infrastructure (chapter 6), and workers and labor markets (chapter 7). It reviews a rich body of international experience to highlight opportunities for policy improvement in all areas.
- Part III looks at the possible role of measures that go beyond the basics—selective interventions (chapter 8) and the use of international rules and standards (chapter 9). These measures can play a supporting role, but also raise special challenges that warrant careful attention.
- Part IV concludes by looking at how the international community might help developing countries improve the investment climates of their societies.