

Regulation and taxation

chapter 5

The way governments regulate and tax firms and transactions—both within and at their borders—plays a big role in shaping the investment climate. Sound regulation addresses market failures that inhibit productive investment and reconciles the interests of firms with those of society. Sound taxation generates the revenues to finance public services that improve the investment climate and meet other social goals. The challenge all governments struggle with is how to meet these objectives without undermining the opportunities and incentives for firms to invest productively, create jobs, and thereby contribute to growth and poverty reduction.

There is huge scope in most countries for improving regulation and taxation without compromising broader social interests. Too often, governments pursue approaches that fail to meet the intended social objective, yet harm the investment climate. How? By imposing unnecessary costs, by increasing uncertainty and risks, and by erecting unjustified barriers to competition.

Examples of regulatory problems abound. Regulations to promote social goals are often enforced only partially—as is evident in the huge informal sectors in most developing countries. Yet they can impose significant burdens on firms that do comply—whether through the extraordinary requirements to set up a new business or the long delays in getting goods through customs. The interpretation and application of regulations can be unpredictable—creating uncertainty and risk for firms and inviting corruption. Regulations also create monopolies or cartels for favored groups—imposing costs on consumers and other firms, and stifling incentives for the pro-

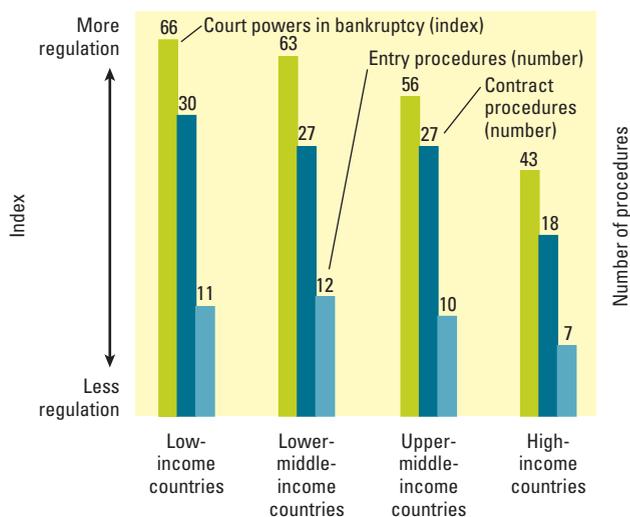
ted firms to innovate and boost their productivity.

Tax systems are plagued by similar problems. Tax structures often benefit favored groups, distorting competition and foisting higher taxes on others. And tax administration can be burdensome, increasing compliance costs, reducing revenues, and opening the way to corruption.

That such problems exist is hardly news. But new sources of evidence underline the extent of the problems and their impact on productivity and growth. While the underlying problems do not always have simple solutions, a growing body of international experience points to some practical steps that governments can take to improve these areas of their investment climates. This chapter takes a broad view and considers regulation and taxation behind and at a country's borders. It shows that there is great scope for improving performance. Later chapters look at specific challenges in regulating the financial system and infrastructure (chapter 6), regulating labor markets (chapter 7), as well as issues associated with selective interventions (chapter 8) and the use of international rules and standards (chapter 9).

Regulating firms

Governments regulate firms in many ways—for many reasons. They regulate to restrict who may participate in a market, where firms may locate, the production process used, the quality or other parameters of the goods and services produced, and the way products are marketed and distributed. Indeed, it is hard to find any aspect of a firm's business and investment decisions that is not affected in some way by regulation. While it is difficult to find a

Figure 5.1 Low-income countries tend to regulate more

Note: Data from World Bank Doing Business Project.
Source: World Bank (2004b).

single indicator that captures the many dimensions of regulation and the variations in its intensity, recent work suggests that developing countries tend to regulate more than richer countries in many areas (figure 5.1).

How, then, can governments make progress? The key is to strike a better balance between market failures and government failures, and to ensure a good fit with local conditions. This requires efforts to address regulatory costs and informality, to reduce regulatory uncertainty and risk, and to tackle barriers to competition.

Balancing market and government failures and achieving a good institutional fit

Regulation improves social welfare—and the investment climate—when it responds to a market failure cost effectively. This requires an assessment of market failures and government failures, and the extent to which the proposed regulatory strategy reflects a good fit with local conditions.

Market failures. The usual rationale for regulation is market failure, the three most common of which are externalities, information problems, and monopoly.

- *Externalities* arise when producing or consuming a product imposes costs (negative externalities) or confers benefits

(positive externalities) on others. Pollution is a classic negative externality: a firm that releases pollution into a river can impose costs on its neighbors farther downstream. If the firm fails to take account of the effect of its pollution on others, it will generate more than is socially optimal. Governments can reconcile the firm's incentives with those of the wider community by restricting pollution. They may do this through traditional command-and-control regulation, such as prohibiting certain activities or establishing standards for acceptable effluent levels, or they might fully assign property rights or tax the product that causes the negative externality.¹

- *Information problems* arise when contracting parties have unequal access to information about the good or service in question. For example, consumers may lack reliable information about the quality or safety of a product, or the qualifications of a service provider. Regulation may address these concerns in several ways. Over and above prohibiting fraudulent conduct, governments may require firms to disclose certain information about their products (as through product labeling), require the safety of products to be independently verified (as with drugs in many countries), or simply ban the sale of hazardous products.
- *Monopoly* arises when a firm (or group of firms acting in concert) has enough market power to raise prices above the competitive level and thereby extract higher profits at the expense of consumers and economic efficiency. In assessing market power, competitive pressure is not limited to direct head-to-head competition between existing firms offering identical products. It can also come from the threat of entry by new firms, as well as from products that may be effective substitutes (rice might compete with beans for some uses). Governments can address monopoly by removing unjustified regulatory barriers to competition, by dealing with anticompetitive behavior by firms through competition law, or in extreme cases by regulating the price and quality of the goods or services provided. Some

BOX 5.1 *Public ownership, regulation, and the investment climate*

Modern notions of regulation involve a set of explicit rules that define acceptable conduct that are administered and enforced by an entity operating at arm's length from regulated firms. Some governments have also experimented with public ownership as a form of regulation.

Combining production and regulatory roles involves an inherent conflict of interest. Experience shows that this conflict—coupled with political interference, protection from competition, and weak accountability—often leads public enterprises to have dismal productivity. The dramatic improvements unleashed through privatization have highlighted how significant the costs can be.

No less important, public enterprises in developing countries have a poor record in meeting regulatory requirements. For example, state-owned enterprises in Indonesia were found to emit more than five times as much pollution as similar private firms. State-owned pulp and paper plants in Bangladesh, India, Indonesia, and Thailand also controlled pollution less well than similar private firms.

Several factors seem to be at work. First, diffuse objectives, political interference, and weak accountability can conspire against good performance. Second, even when regulation is entrusted to a separate regulatory body, public

enterprises have weaker incentives to comply with regulations than private firms. While the threat of being fined can motivate private firms, governments have only weak incentives to prosecute enterprises that they own, for both political and fiscal reasons. Third, public enterprises that depend on budget support, or whose prices are regulated with political criteria in mind, often lack the resources to meet environmental or other regulatory standards.

Overall, public ownership has the potential to weaken the investment climate in three main ways:

- When public enterprises are responsible for providing inputs relied on by private firms (such as power, telecommunications, or finance), weaknesses in their productivity and incentives can contribute to higher costs and less reliable service, to the detriment of firms (and other consumers) dependent on those inputs (chapter 6).
- Public ownership can increase demands for corrupt payments, because public managers usually have weaker incentives to reduce leakage and graft. For example, firms in transition economies are more likely to have to pay bribes to get telecommunications and electricity services when they are provided by public enterprises. Employees of state-owned power

companies in South Asia have developed a highly organized system to extract bribe payments from customers. The result can be higher costs for firms and reduced revenues for the public enterprise, reducing public investment or increasing the burden on taxpayers.

- When public enterprises are granted a monopoly, opportunities are denied to other firms. Even when competition is permitted between public enterprises and private firms, it is notoriously difficult to create a level playing field. The problems are especially acute when the public enterprise has a regulatory role, because it will face incentives to use that role to advance its interests over those of competitors—a phenomenon common in telecommunications. Even when such obvious conflicts of interest have been addressed by moving regulatory responsibility to a more independent body, pressures to favor the interests of public enterprises can continue. Public enterprises often also enjoy a range of exemptions (by law or by practice) from taxes and other regulations that can also distort competition.

Source: Clarke and Xu (2004); Djankov and Murrell (2002); Hettige and others (1995); Lovei and McKechnie (2000); Megginson and Netter (2001); Shirley and Walsh (2000); Wheeler (2001); and World Bank (1995a).

countries have also used public ownership as a form of regulation, typically with poor results (box 5.1).

Government failure. Regulation that addresses a market failure can benefit society and the investment climate. However, even when a market failure exists, it makes sense to intervene only when the expected benefits exceed the likely costs. This involves balancing market failures with potential government failures. There are three common sources of government failure:

- *Information and capacity problems.* In designing and implementing interventions, governments often face severe information problems. Governments will never have as much information as firms about the impact of interventions on their costs or incentives. This is a particular challenge in utility regulation, but can arise in other areas as well. And the implementation of some kinds of regulation demands a reasonable level of

technical expertise, the absence of which can undermine effectiveness.

- *Rent-seeking.* Regulation may be distorted by rent-seeking in its many forms (chapter 2). Firms or other groups may seek regulation to protect them from competition. Officials may use regulation to extract bribes in return for favorable interpretations, quick decisions, or selective enforcement, and regulated firms have incentives to try to “capture” their regulators through a range of strategies.
- *Rigidity.* Regulation tends to be rigid, making it hard to keep up with changes in technology or the way business is conducted. Indeed, many regulations in developing countries have not been reviewed for many decades or longer. Part of the problem lies in inertia, but firms, officials, or other interest groups that benefit from particular regulations can have strong incentives to resist reform, no matter how beneficial it may be to society.

The challenge of “institutional fit.” As discussed in chapter 2, interventions that work well in one country may lead to very different results in others. This means the costs and benefits of intervention, and the choice of regulatory strategy, need to take account of local conditions. While there is ample scope to learn from regulatory experience in other countries, too often regulatory systems have been transplanted uncritically to developing countries from elsewhere.

Many developing countries inherited their regulatory systems from former colonial powers. Particularly when the colonizing power had little interest in establishing long-term settlements, there was little incentive to adapt approaches to the needs of the broader community.² Being largely irrelevant to conditions in the host society, the regulations were often ignored, or used mainly as a lever for officials or others to extract rents.³ Those benefiting from the status quo have incentives to resist reform, no matter how dysfunctional the regulations may be for the investment climate. So the same laws and regulations often remain unchanged for decades, even as laws in the source country evolve. For example, Chile established a restrictive corporate law in 1854, based upon Spanish and French law from that time. The restrictive law was maintained until 1981, when the code underwent a major revision. As a result, Chile did not adopt the principle

of free incorporation until a century after France and Spain did so.⁴ In some cases the transplanted laws remain in place today. For example, the law regulating business entry in the Dominican Republic dates back to 1884.

The tendency to transplant laws and regulatory systems from other countries continues to this day.⁵ Regulatory systems in rich countries can seem a convenient way to modernize regulation by offering a proven system that is familiar to foreign investors, or foreign experts advising on these matters may simply be more familiar with the approach in their home country. But in many cases adaptation to local conditions is required, and without it transplanted approaches can lead to poor results.⁶ Regulatory standards may be set at unrealistic levels relative to local circumstances, contributing to compliance problems, informality, and unjustified costs. Approaches may not fit easily with related parts of the policy and regulatory framework, generating additional uncertainty and risk. Or regulatory systems may involve high levels of discretion relative to the effectiveness of local institutional safeguards. Experience in Jamaica’s telecommunications sector illustrates the hazards of the last phenomenon (box 5.2).

Government failures and poor institutional fits combine to create many distortions in regulatory approaches that harm the investment climate in developing countries.

BOX 5.2 *Regulating in Jamaica—from transplants to better institutional fit*

Regulatory systems for utilities need to reconcile the investor’s need to receive a reasonable rate of return on an investment with the concern that a firm with monopoly power can misuse it to the detriment of consumers (chapter 6). A variety of approaches to reconcile these interests have developed around the world. In the United States the system involves giving substantial discretion to an independent regulatory agency, with legislative guidance on tariffs often defined only as “fair” or “just.” Discretion of this breadth on an issue as politically sensitive as tariffs is a source of considerable risk to investors in capital-intensive sectors with immobile assets. Those risks have been mitigated in the United States, however, by a series of Supreme Court decisions, dating from the 1890s, that have interpreted the Constitution in ways that create safeguards for investors in regulated industries.

In 1965 Jamaica adopted a regulatory system modeled closely on those in the United States. The Jamaica Public Utilities Commission was authorized to determine a “fair” rate of return but lacked the complementary institutional safeguards that developed over decades in the United States. The commission became politicized, and despite increased inflation and the need to expand services, the private phone company was not granted a single rate increase between 1962 and 1971. The company’s profits fell and after 1970 failed to cover the real depreciation of its assets. Service deteriorated and disputes developed, leading to the company’s nationalization in 1974.

With poor service and a shortage of funds for investment under public ownership, the government reintroduced private participation in the telephone company in 1985. This time, to compensate for the lack of broader institutional

safeguards, the discretion of the regulatory agency was reduced considerably. The license guaranteed the private operator a fixed rate of return based on shareholder equity and allowed for arbitration when the government and the investor could not agree on rates. In 1995 Jamaica undertook more wide-ranging changes to its regulatory system for utilities, replacing the Public Utilities Commission with a new Office of Utility Regulation. While the new agency has some discretion, the new law retained a mechanism for providing specific pricing and other commitments to investors through contracts, thus helping to mitigate the risks of a traditional U.S.-style agency operating in a country with less developed institutional safeguards.

Source: Spiller and Sampson (1996); Phillips (1993); and Jamaica Office of Utility Regulation Act.

Tackling those problems requires a three-pronged approach:

- Addressing regulatory costs and informality
- Reducing regulatory uncertainty and risk
- Removing unjustified barriers to competition.

Addressing regulatory costs and informality

All regulations can impose costs on firms, whether in the need to adapt business processes to meet regulatory requirements, to pay licensing fees, to await delays in obtaining regulatory approval, or to spend management time dealing with officials. A good investment climate does not seek to eliminate those costs—instead, it seeks to ensure they are no higher than necessary to meet social interests (box 5.3). The goal is thus better regulation, not no regulation. Too often the costs are unnecessarily high as a result of rent-seeking, inefficient administration, poor institutional

fit, or a combination of these. Regulation that imposes costs beyond the expected social benefits is usually regarded as red tape.

A growing body of evidence highlights the toll of outdated or ill-considered regulations on the investment climate. Recent studies looking at the effect of regulation in Organisation for Economic Co-operation and Development (OECD) economies show that both investment and the productivity of that investment are lower in countries where the regulatory burden is greater.⁷ The effect can be large. For example, it has been estimated that reducing the burden of transport regulation in Italy to the level in the U.S. could increase the investment rate in that sector by 2.6 percentage points.⁸

Recent work focusing on objective measures of the compliance costs for particular regulations highlights the wide variations across countries. For example, the World Bank's Doing Business Project shows that the time to set up a new business ranges from 2 days in Australia and 9 days in Turkey to more than 200 days in Haiti.⁹ The overall

BOX 5.3 *Environmental regulation and global integration*

As it became easier for goods and investments to flow across borders in the 1990s, concern arose that a race to the bottom in environmental regulation might follow. For goods that can be transported between countries, firms might choose to produce in locations with low environmental standards and then export to countries with higher standards. The concern is that countries with high standards would find themselves at a disadvantage and, as capital left their economy, would feel under pressure to relax their own standards to stem the outflow. Countries with already low standards might reduce them further to vie for footloose investment. So far, however, there is little evidence to support such concerns. There seem to be three main explanations.

Environmental regulation is only one part of the investment decision

The cost of complying with environmental regulation can influence firms' investment decisions, but it is only one of many factors, and the weight given to it will vary by firm, by industry, and by location. Polluting industries tend to be capital intensive, which means investors tend to place a high premium on the broader policy environment, particularly political and regulatory risk. Costs associated with environmental regulation might carry more weight in invest-

ment decisions between two locations that are otherwise highly comparable, such as states in the United States or countries in Europe.

But developing countries tend to face disadvantages relative to developed countries on this broader set of criteria, so differences in environmental regulation tend to carry less weight. Indeed, a recent study of foreign direct investment (FDI) in developing countries found no evidence that environmental standards significantly affected investment decisions.

Society's preferences for higher standards rise with income

As societies prosper, the value they place on higher environmental standards tends to increase. Environmental quality appears to have improved, rather than deteriorated, in many countries over the past decade. For example, air pollution in industrial areas fell in the 1990s in Brazil, China, and Mexico—three developing countries that have received significant FDI. As countries improve their broader investment climates and experience faster economic growth, there is likely to be pressure for more environmental regulation, not less. The preferences of citizens in high income countries for high standards of environmental protection also show no signs of abating, further reducing the risk of a collapse in standards. Indeed, the race, if there is

one, may be to the top rather than the bottom as countries become more prosperous.

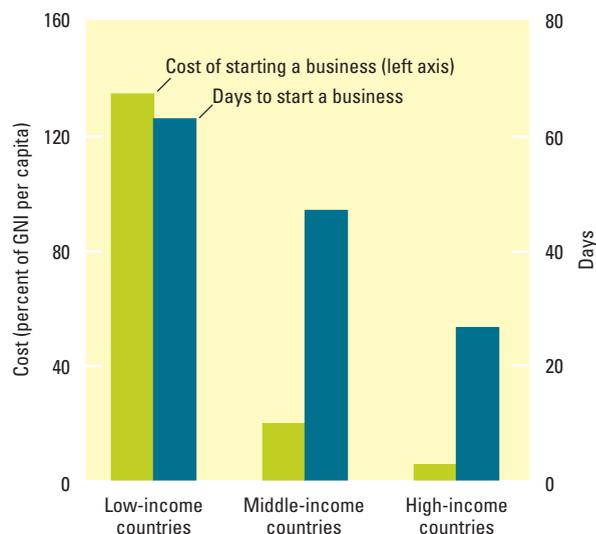
Incentives to comply with higher standards are already strong

Multinational firms often have stronger incentives to comply with higher environmental standards than local regulations require, both because of advantages in adopting common technologies and standards across the countries in which they operate, and also to protect their corporate reputations. Indeed, the evidence suggests that multinational firms tend to exceed local regulatory requirements in many areas.

Concerns about a possible race to the bottom need to be distinguished from the possibility of low environmental standards in one country reducing the environmental quality of other countries by producing effluents that flow across national boundaries. The international community has been addressing these concerns in recent decades, including through a host of new international rules and standards (chapter 9).

Source: Copeland and Taylor (2004); Wheeler (2001); Becker and Henderson (2000); Dowell, Hart, and Yeung (2000); Frankel (2003); Greenstone (2002); Jaffe and others (1995); Keller and Levinson (2002); Klein and Hadjimichael (2003); and List and others (2003).

Figure 5.2 Starting a new business takes longer and is more costly in developing countries

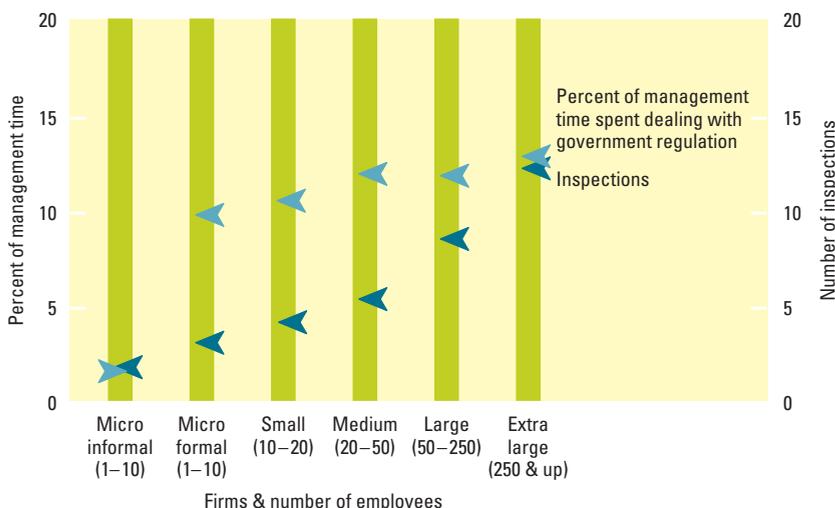


Note: Based on median cost as percent of gross national income (GNI) per capita and median days reported in the World Bank Doing Business Project. Source: World Bank (2004b).

pattern is that delays are greater and costs higher in low-income countries (figure 5.2).

When compliance costs are the same for firms of different sizes, they impose a disproportionate burden on smaller firms. In Tanzania small formal firms, on average, pay an amount equal to about 0.4 percent of their sales for an operating license—large enterprises pay only about 0.01 percent.¹⁰ Other regulations can also be a greater burden for small firms because it is (relatively)

Figure 5.3 Larger firms spend more time dealing with regulations and are inspected more often



Note: Data covering firms in Bangladesh, Brazil, Cambodia, Guatemala, India, Indonesia, Kenya, Pakistan, Tanzania, and Uganda. Source: World Bank Investment Climate Surveys and WDR Surveys of Micro and Informal firms.

more costly for them to hire professionals to help them complete bureaucratic procedures. Large firms in Peru are almost three times as likely as small firms to hire lawyers to help them complete application procedures for licenses and permits.¹¹ Other costs are greater for large firms: managers of large firms spend more time dealing with government regulations, and large firms are also more likely to be inspected than small firms (figure 5.3).

When it is costly to comply with regulation, firms have an incentive to evade these costs through informality. By staying informal, firms can reduce—but not completely eliminate—compliance costs (figure 5.3). Informality is widespread in many developing countries, often accounting for more than half of GDP.¹² The fact that most of the economy is not complying with regulations raises fundamental questions about the effectiveness of the chosen regulatory strategy.

The answer is not simply to apply greater efforts to enforce all existing regulations. Unless the regulations themselves are well considered, this may just put a disproportionate burden on poor entrepreneurs in the informal economy and lead to perverse results. Efforts are required to first see if the regulation is necessary to meet an important social objective and, if so, whether the expected social benefits outweigh the likely costs. A growing number of countries are now focusing on reducing requirements for business registration in this light, with positive results. For example, when the municipal government of La Paz, Bolivia, reduced the number of procedures required to register a business, the number of registered businesses increased by 20 percent.¹³ Even larger gains have been observed in Vietnam and Uganda (box 5.4).

Governments are also making efforts to streamline other regulatory approval processes. This may involve using information technology that allows on-line processing of regulatory approvals as in the case of Singapore (box 2.15) or the creation of “one-stop shops” (box 5.5). To encourage agencies to act upon approvals quickly, more countries are also adopting “silence as consent” rules for some licenses and per-

BOX 5.4 Easing business registration requirements in Vietnam and Uganda

The high cost of business registration discourages new firms from entering the formal economy. Vietnam and Uganda illustrate successful strategies for reducing these costs.

Vietnam

Before a new Enterprise Law was enacted in January 2000, business registration and licensing requirements were extremely burdensome in Vietnam. Entrepreneurs were required to submit detailed business plans, curricula vitae, character references, medical certificates, and other documents along with their applications for registration. On average, registering a business took about three months, and required visits to 10 different agencies and submissions of about 20 different documents with official seals.

Additional licenses were often required before firms could start operating. Some of these licenses did not appear to serve vital public interests (such as those to operate photocopy-

ing machines). It took 6 to 12 months to fulfill the legal requirements to establish a business at a cost of \$700 to \$1,400.

The new law reduced the costs of establishing a new business. The time to establish a new business came down to about two months—with business registration taking only 15 days—and total start-up costs were reduced to about \$350. Vietnamese entrepreneurs responded. Fewer than 6,000 new businesses had registered in 1999, but the number shot up to more than 14,000 in 2000 and to more than 21,000 in both 2001 and 2002.

Uganda

A recent pilot program in Entebbe reduced the time and monetary costs to register a business. By streamlining licensing processes and reducing the number of previously required approvals and assessments, the time to register a business was reduced from two days to about

30 minutes. This reduced the cost of registering a business by 75 percent. Although business registration is only one of several steps to start a new business in Uganda (businesses have to register for tax purposes and many need additional licenses), the cost can be significant because registration needs to be repeated annually for most businesses.

The pilot program increased business registrations, with an estimated four times as many businesses registering in Entebbe the year after the pilot. Despite the lower fees, the higher number of registrations meant that revenue collections increased by 40 percent. With administrative savings of 25 percent in staff time and 10 percent in financial resources, the program also benefited the municipal authority.

Source: Vietnam: Mallon (2004); and Uganda: Sander (2004).

BOX 5.5 One-stop shops—or one-more-stop shops?

In many countries firms have to receive approvals from a range of different agencies before they can start operating: one to register the business, another to register for taxes, another to get environmental approvals, another for health and safety clearances, and so on. To reduce this burden some governments have established “one-stop shops” where firms can find all the information and complete all the regulatory procedures that they need to start operating a business in a given jurisdiction.

One approach would be to give a single agency the power to grant all licenses, permits, approvals, and clearances necessary for a new firm to start operating. In practice this is difficult. Existing ministries and agencies often resist surrendering their powers to a new agency. Moreover, to the extent that approvals are a response to a valid policy concern, the one-stop shop would need to duplicate expertise and facilities elsewhere in the government. Of course, if the approvals do not meet valid policy objectives, the procedures could simply be eliminated.

Because of these considerations, most one-stop shops have narrower mandates, with

authority to grant some approvals and provide assistance on others. For approvals that remain the responsibility of other agencies, the one-stop shops may house staff from the relevant agencies or simply pass the applications on to them. Even when the staff from other agencies that are housed at the one-stop shop are unable to approve the application themselves, they can often facilitate the approval process.

The Tanzania Investment Center houses nine senior officials from other ministries, and normally manages to turn around applications within a few days. The rapid turnaround is due in part to a “no objection” provision written into the investment code—unless a ministry objects within 14 days, the Center is entitled to approve the application.

This approach has been less successful when the lines of authority are not clearly drawn. After being set up in 1987, the One-Stop Action Center in the Philippines housed representatives from seven agencies who were responsible for providing information to applicants and acting on some applications. Lack of effective agency representatives—and the non-reporting of some representatives to the Center

led to poor results, requiring the government to reorganize the center in the late 1990s.

When agencies lack authority to grant all necessary approvals, it is important that they still add value to the process and do not just constitute an additional regulatory burden. In Thailand the Investment Services Center could issue establishment licenses for nonpolluting activities, but factories still had to get permission from the Ministry of Industry before production could actually start. To avoid delays later in the process, many firms preferred to obtain the necessary licenses directly from the ministry from the outset.

One-stop shops with narrower mandates have sometimes accelerated the process of gaining specific approvals. For example, by shifting from a pre-auditing to a post-verification system, the One-Stop Service Center for Visas and Work Permits in Thailand reduced the time it took foreign firms to get visas for foreign workers from about 45 days to just 3 hours.

Source: Bannock Consulting (2001); Brimble (2002); Miralles (2002); and Sader (2003).

mits.¹⁴ If the licensing office does not respond within a set period of time, the license is issued automatically. The Bank’s Doing Business Project shows that business registration takes an average of 28 days less when a time limit is combined with a silent consent rule.¹⁵

Reducing regulatory uncertainty and risk

Regulations can increase the risks firms face when the regulations change frequently, are vaguely drafted, or are interpreted or enforced inconsistently. The result in each case is greater uncertainty, which makes it

hard for firms to make long-term decisions about entering markets, choosing production technologies, or hiring and training workers. Uncertainty can also reduce the response to otherwise beneficial reforms. Evidence from firm-level surveys shows that improving the predictability of regulation can increase the probability of making a new investment by more than 30 percent (chapter 2).

Managing regulatory change. Of course, concerns about regulatory uncertainty do not mean that regulations should never change. Indeed, there is a huge agenda for change in most developing countries, and effective regulation requires regular review and fine-tuning to ensure it keeps up to date with changes in the way business is conducted and lessons from experience. The key is to minimize the adverse impact of uncertainty on firms. The best way to do this is to consult firms and other stakeholders early in the process about proposed changes that are likely to affect them. This can reduce the concerns of firms, elicit useful suggestions, and facilitate later implementation. Yet firm surveys show that the majority of firms in developing countries are seldom or never consulted on proposed changes. More countries are now improving consultation, however, including by placing draft proposals on the Internet.

In some cases it may be appropriate to provide a transition period before the new

regulations take effect to enable firms to adjust to the new requirements. When the regulatory change could have a big impact on major investments made on the basis of earlier regulations, it may also be appropriate to grandfather those investments, or provide a longer transition period.

Promoting certainty in the interpretation and application of existing regulations.

Uncertainty about how existing rules will be interpreted or applied can also be a significant source of risk, and can be especially burdensome for firms in capital-intensive and heavily regulated industries.

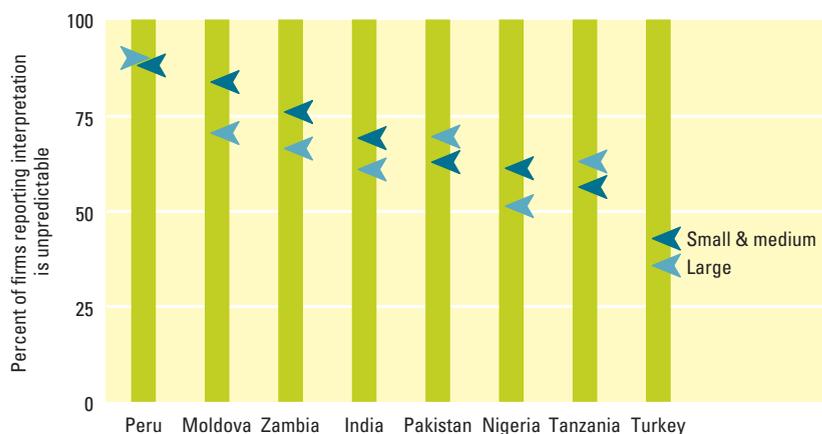
Firm-level surveys confirm that concerns about the predictability of regulation loom large for firms in developing countries. In many countries the majority of firms report that officials' interpretations were unpredictable (figure 5.4). In most countries, small and medium firms were more likely than larger firms to report that interpretations were unpredictable.

The simplest strategy for improving predictability is to ensure laws and regulations are drafted with as much clarity and precision as possible. While there are tradeoffs between specificity and discretion (box 5.6), it is often far from clear that the degree of discretion reserved to officials meets any socially useful purpose. Indeed, in some cases discretion appears to be used more to expand opportunities for officials to collect informal payments.

Some uncertainty is inherent in any new law or regulation, but governments can reduce uncertainty by quickly promulgating more detailed regulations or implementation guidelines. The timely publication of regulatory and administrative decisions can also help build a body of precedents that can curb administrative discretion and foster predictability. Improving the transparency of regulatory decisionmaking can also do much to promote consistency—and reduce concerns that discretion will be misused.

On complex or sensitive matters, an advisory opinion or preclearance process might be instituted—common for competition laws in many countries and a growing practice with complex tax issues. In some

Figure 5.4 Firms of all sizes report that officials' interpretations of regulations are unpredictable



Note: Firms designated as small or medium if they have fewer than 50 employees; and large if they have 50 employees or more.

Source: World Bank Investment Climate Surveys.

cases it may be feasible to promote certainty by entering specific contractual commitments on particular issues of interpretation (box 5.7).

Removing barriers to competition

Regulation also affects the investment climate through its impact on competition. While individual firms typically prefer less competition, not more, competition plays a critical role in the investment climate by creating opportunities for new firms and providing incentives for existing firms to innovate and improve their productivity.

Much early evidence on the benefits of competition came from experience in OECD countries. For example, a study of the impact of pro-competitive regulatory reform in several industries in the United States found that annual welfare gains in the part of GDP affected by reform were more than 7 percent, with 90 percent of the benefits flowing to consumers.¹⁶ New work in developing countries shows significant gains as well.¹⁷ For example, the benefits of greater competition from trade reform have been documented in countries such as Brazil, Chile, Colombia, and India.¹⁸ Firm surveys also show that competition plays a much larger role in encouraging firms to be efficient than do customers, shareholders, or regulators. The surveys also show that firms reporting strong competitive pressure are at least 50 percent more likely to innovate than those feeling no such pressure (chapter 1).

BOX 5.6 *Balancing the tradeoffs between specificity and discretion in regulation*

Firms have a strong interest in regulatory certainty. Without such certainty—both for the stability and interpretation of rules—there can be concerns about the extent of their regulatory obligations and thus the potential returns from an investment opportunity.

Providing firms with appropriate assurances on the stability of the regulatory regime can reduce their risks and thus encourage investment. Reducing discretion can also reduce concerns about corruption. But there can be tradeoffs. Highly specified regulatory regimes reduce the flexibility to fine-tune applications to particular cases, and to accommodate changing circumstances.

The optimal balance between specificity and discretion will vary according to the issue, sector, and country. For example, highly discretionary regimes can have a chilling effect on private investment in infrastructure—where investments are large, long-lived, and immobile; where regulation has a significant impact on the

returns from the investment; and where political economy problems can create incentives for governments to renege on commitments (chapter 6). Regulatory discretion may have a less deleterious effect on investments that are more easily reversed, where regulation plays a minor role in influencing expected returns, and where there are no special political sensitivities about regulation. But regulatory discretion can still create uncertainty for firms and be used as a source of bribes by officials in any sector.

Concerns about regulatory discretion can also vary by country. In the United States, legislative guidance on the regulation of infrastructure involves considerable discretion—but broader institutional safeguards help provide assurance to investors. Countries that have not yet established credible safeguards for investor interests need to provide more specific regulatory assurances—or expect reduced investment at higher cost to reflect the risks (see box 5.2).

Regulation has a pervasive impact on competition. Regulatory approaches that increase costs or risks faced by firms can deter firm entry and thus dull competitive pressure. But regulation can also influence competition more directly, including by creating barriers to market entry or exit, and by addressing anticompetitive behavior by firms.

Regulatory barriers to market entry. Regulatory barriers to entry can take many forms

BOX 5.7 *Contracting for certainty*

One strategy governments can adopt to promote regulatory certainty is to enter specific contractual commitments with firms. While it is obviously not feasible to do this with every firm in the economy, this approach can be useful in dealing with risks associated with major investments.

During the first wave of foreign investment after World War II, many firms entered contracts with host governments that included “stabilization clauses.” Covering everything from tax rates, to the duties payable on capital goods imported to develop a project, to the rules governing foreign exchange and profit repatriation, these clauses sought to freeze in place those host government policies that could affect the return on the investment. These approaches have been

applied to major resource projects and extended to private infrastructure projects (where they often include specific commitments on tariff regulation) and to other major investments.

Besides such global efforts to deal with policy certainty, firms often seek advance rulings and other forms of before-the-fact signals on how government will interpret various laws and regulations. One example is the transfer pricing agreements that developing and developed countries often sign with domestic and foreign firms.

A major factor in determining a multinational firm’s income tax is whether national tax authorities in the countries where it operates will agree with the prices it uses to transfer goods and services among its corporate

affiliates. Because these transfer prices can be manipulated to shift tax liability from one country to another, tax agencies usually reserve the right to determine whether the prices reflect market conditions. The methods for making these determinations involve a good deal of judgment, thus introducing much uncertainty into the calculation of the taxes due. To make firms’ tax bills more predictable, governments have entered advance agreements on the appropriate level of transfer prices. China, Colombia, and Mexico have entered into hundreds of such agreements. India and Thailand are considering similar programs.

Source: Waelde and Ndi (1996) and Tropin (2003).

and have many rationales. Requirements to set up a new business are one obvious form of entry barrier, but can be designed in ways that are not especially burdensome. But unnecessarily high registration costs can still have a negative impact on competition. For example, estimates for a group of developing countries—none of them the worst offenders—suggest that reducing the cost of registration procedures to the level in the United States (0.6 percent of per capita income) could increase the number of new entrants by more than 20 percent.¹⁹

Governments often erect more substantial regulatory barriers to entry in particular industries. Some of these may be part of a strategy to address a market failure but are vulnerable to being made more onerous than necessary through rent-seeking by the protected groups. Other restrictions lack any clear economic rationale. Public enterprises also often benefit from legislated monopolies.

In India the manufacture of certain products is reserved for small firms, reducing opportunities for other firms to participate—and reducing incentives for small firms to grow (box 8.5). Agricultural markets in many countries have been heavily regulated, with parastatals granted monopolies over marketing or processing of export crops, and traders who purchase goods from farmers required to be licensed. Recent efforts to liberalize agricultural markets have, for the most part, benefited poor rural producers of export crops by increasing producer prices relative to border prices.²⁰ While supply responses have sometimes been slower than expected, this seems to reflect continuing impediments in other parts of the investment climate (including insecure property rights and poor infrastructure)²¹ or concerns about the credibility of the government's commitment to liberalization.²²

Removing unjustified regulatory barriers to entry can have a big impact not only on competition but also on opportunities for individual entrepreneurs. For example, reducing regulatory barriers to competition in telecommunications has created opportunities for microentrepreneurs to enter the market and provide services in rural areas,

helping their communities while improving their own livelihoods (chapter 6). When Bangladesh introduced competition in cellular phone services, one of the new entrants encouraged female entrepreneurs to set up and run phone shops in rural areas. By 2004 these shops provided service to about 5,000 villages and an estimated 12.5 million people who previously had no access to this service.²³ Barriers have been lifted even more in Uganda, opening new opportunities for small entrepreneurs across the country and expanding service in rural areas.

Regulatory barriers to market exit. Competition is also affected by barriers to firms leaving the market. The most pervasive barrier to exit is bankruptcy regulation. When those procedures are long and costly, distressed firms and their creditors are less willing to use them, and markets become cluttered with failed firms that block opportunities for new entrants. Firms will also be less likely to risk entering new markets, and lenders will be less willing to lend to firms they do not already have a relationship with, further reducing competition.²⁴ As a result, long and costly bankruptcy procedures have a negative impact on productivity—over 20 percent of productivity gains can be attributed to the least productive firms exiting (chapter 1).

Bankruptcy procedures tend to be longer and more expensive in developing countries than in developed countries. A standard bankruptcy procedure takes an extraordinarily long time in some countries. According to the Bank's Doing Business Project, a procedure that takes only five months in the fastest country (Ireland) would take 10 years in Brazil, India, and Chad. The costs can also consume a large share of the estate. While taking only about 1 percent of the estate value in several countries (Colombia, the Netherlands, Norway, and Singapore), they take up to 76 percent in Chad and Lao PDR. Bankruptcy procedures also appear less likely to result in efficient outcomes (rehabilitating viable businesses and liquidating unviable businesses) in developing countries. A growing number of developing countries are recognizing the importance of reform in this area, with recent examples including Bulgaria, India, and Poland.²⁵

Addressing anticompetitive behavior by firms.

Regulation is not the only source of barriers to competition. Firms can curb competition by colluding or forming cartels, by entering restrictive agreements with suppliers or customers, by misusing their market power, or simply by merging with competitors.

To address these concerns, a growing number of countries have introduced competition (or antitrust) law.²⁶ While the details vary, most competition laws include provisions to do the following:²⁷

- Prevent firms from colluding or forming cartels to limit competition. Prohibited actions typically include agreements to fix prices, restrict output, allocate markets and customers, and rig bids or tenders.
- Prevent dominant firms from abusing their market positions by engaging in predatory pricing, forcing firms that buy particular goods or services to also buy other goods or services, foreclosing markets for inputs or distribution, or setting discriminatory prices or terms of service.
- Require proposed mergers to be reviewed by a specialist agency to ensure that any resulting reduction in competition has offsetting public benefits.

Competition laws are usually enforced by specialist agencies. In addition to their roles in enforcing competition law, the agencies often act as advocates for competition by commenting on policy proposals by other government agencies and performing studies to make policy recommendations on competition-related issues (chapter 3). According to a recent survey, 65 percent of 43 responding agencies participate early in the regulatory review and decision process, while 28 percent were consulted throughout the process or at any stage.²⁸ Indeed, some argue that competition advocacy should be the first priority of competition agencies—particularly in economies with a legacy of heavy-handed government interventions.²⁹

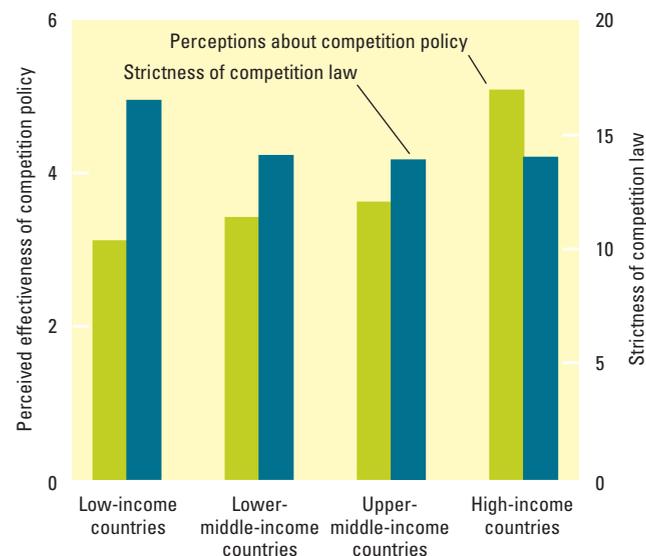
Competition laws are relatively new in developing countries and early results present a mixed picture. A recent study that looked at price markups in a number of developed and developing countries found

that markups were no different in countries with and without competition laws.³⁰ While agencies in countries such as Brazil, Chile, Korea, and Mexico have achieved some standing, implementation in many other countries has so far been less impressive. Recent work suggests that while competition laws in developing countries tend to be no weaker than in developed countries, competition policy is perceived to be much less effective (figure 5.5). Why? Limited resources and slow and inefficient courts are part of the story. Perhaps more important, however, are other policies that reduce competition (such as regulatory barriers to entry and exit) and the politics of prosecuting firms that have close ties to the government, such as state-owned enterprises and firms owned by influential people (box 5.8).

Toward better regulation for the investment climate

The challenge of regulatory improvement is large and ongoing. It requires continuing efforts to review and modernize approaches in line with changes in the way business is conducted and lessons of experience, but doing so in ways that provide as much predictability as possible for firms. This is true in all countries, but it is

Figure 5.5 Despite strong laws, competition policy is seen to be less effective in low-income countries



Note: For competition policy data, higher values mean more effective policy; for competition law, the higher values mean stricter laws.

Source: World Economic Forum (2002) and Nicholson (2003).

BOX 5.8 *Competition laws in developing countries*

Given the importance of competition to a sound investment climate, competition laws and agencies could be expected to play a key role. However, experience in developing countries remains mixed. There are several possible explanations.

First, competition laws do not usually address barriers to competition flowing from government policy in other areas—including trade barriers, mandated monopolies, licensing regimes, and other regulatory barriers to entry and exit. When those barriers are pervasive—still the case in many countries—competition laws and agencies will not be enough to unleash a competitive and productive economy. The primary lever for governments is to address the policy barriers directly.

Second, competition laws are not always enforced vigorously in developing countries. Although agencies in some countries appear to be quite active, others appear to be less so (see table). Why is enforcement often weak?

One explanation might be constrained resources. For example, the competition agency in Tanzania had only two economists and no lawyers in 2000, while the authority in Zambia had four economists and one lawyer. A second explanation is that enforcement often depends on effective courts. Unless the competition agency can rely upon the judiciary to support its decisions and protect it from political interference, the agency will find it difficult to enforce its rulings.

A third explanation is that it can be difficult to prosecute politically connected firms, even when the competition agency is independent, unless the law and the agency command a high level of public support. For example, when the independent Monopoly Control Authority in Pakistan tried to take action to reduce cartelization in the cement market in 1998–99, the government intervened, fixing prices at a “mutually acceptable” level. Similarly, when the competi-

tion agency in Tanzania forbade a local brewer from barring independent agents and mini-wholesalers from stocking competitors’ products, the firm, with support of government officials, contravened the agency’s orders. When officials intervene against agency decisions on behalf of influential firms, competition agencies will be hesitant to move against them in the first place.

The main message? Well-designed competition laws can be an important tool to improve the investment climate. But they need to be seen as part of a broader strategy that includes reducing regulatory barriers to competition, and helping to promote a more pro-competition culture. And as elsewhere, a high level of political commitment is key.

Source: CUTS Center for Competition (2003) and Economic and Social Research Foundation (2002).

In some developing countries competition agencies deal with very few cases

	India (1999)	Kenya (1996–2000)	Pakistan (1996–2000)	South Africa (1999)	Sri Lanka (1996–2000)	Zambia (1998–2000)
Total cases disposed of annually	206	30	166	273	6	50
Mergers and acquisitions	0	22	16	236	1	22
Anticompetitive practices	206	8	149	37	6	28
Cases per professional	9.0	1.3	33	7.4	0.9	24.8

Source: CUTS Center for Competition (2003).

especially important in developing countries where the existing body of regulation too often bears little relationship to contemporary circumstances, is only partially enforced, and if enforced more vigorously could lead to even more perverse results. As highlighted in chapter 3, tackling the regulatory reform agenda requires efforts to systematically review existing regulations, as well as assessing new regulatory proposals more carefully. Strengthening the skills and expertise of regulators and those on the front line of government-firm relations also plays an important role.

Taxing firms

Governments need revenue to cover the costs of providing public services—including those that improve the investment climate—and of meeting other social goals. Yet taxes represent a cost to firms and so reduce their incentives to invest and create

jobs. All societies struggle with how best to strike the balance in an efficient, equitable, and sustainable way. This section reviews the nature of the challenge and highlights some promising areas for improvement.

Taxes and the investment climate

Throughout history, governments have raised revenues in many ways. They have seized the assets of their enemies—and their subjects. They have created monopolies to sell to the highest bidder. They have taxed land, production, transactions, income, and consumption—and in most cases still do. Indeed, income taxes are fairly recent. The first income tax, levied by the Dutch Batavian Republic, dates from 1797,³¹ but the United States did not have a corporate income tax until 1909 or an individual income tax until 1913.³² The value added tax (VAT) is even more recent—the first was levied in France in 1948, and it did not become common until the 1970s and 1980s.³³

For as long as governments have levied taxes, those who pay them have complained. Firms in developing countries are no exception, and cite tax rates as a major constraint on their operations (table 5.1). Taxes affect the incentives for firms to invest productively by weakening the link between effort and reward, and by increasing the cost of inputs used in the production process. Tax rates and compliance costs both matter. When levied or applied unevenly, taxes can also distort competition.

Tax rates. Tax rates are a function of the size of government and the way the burden is allocated among alternative sources. While views on the appropriate size of government differ, government's share of GDP in many developing countries is much larger than in today's developed countries when they were at similar stages of development.³⁴ The share of the tax burden carried by firms can be influenced by efficiency and equity considerations, as well as by more pragmatic concerns about collecting revenue.³⁵ Narrow tax bases and weak tax administrations lead governments in developing countries to collect a larger share of their revenues from firms and from commercial transactions than is the case in developed countries. Indeed, corporate taxes, direct taxes on goods and services, and trade taxes account for over 70 percent of government revenues in low-income countries.³⁶

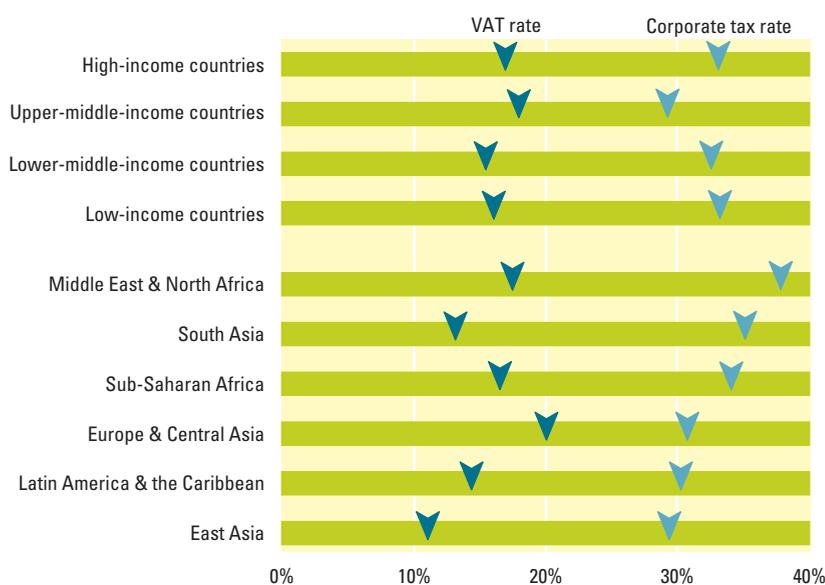
While tax rates and structures differ across countries, corporate tax rates and value-added tax rates are broadly similar in developing and developed countries (figure 5.6). Despite similar rates, revenues collected from corporate taxes tend to be lower in developing countries than in developed countries due to the narrowness of the tax base and problems of tax administration (figure 5.7). Corporate tax revenues either increased slightly or remained stable during the 1990s in all developing regions except Europe and Central Asia, where revenues fell due to privatization and a general contraction in the size of the state.³⁷ This is contrary to some of the dire predictions of those concerned about the impact of tax competition between countries as a result of increasing global integration (box 5.9).

Table 5.1 Firms report that tax rates are one of their top concerns

	Share of countries where firms report tax rates as key obstacle		
	Biggest obstacle	Among top three obstacles	Among top five obstacles
All countries	18	56	82
Upper-middle-income	40	90	100
Lower-middle-income	12	35	71
Lower-income	11	56	83
Eastern Europe & Central Asia	14	62	86
Sub-Saharan Africa	33	67	83
Asia	14	29	71
Latin America	50	50	50

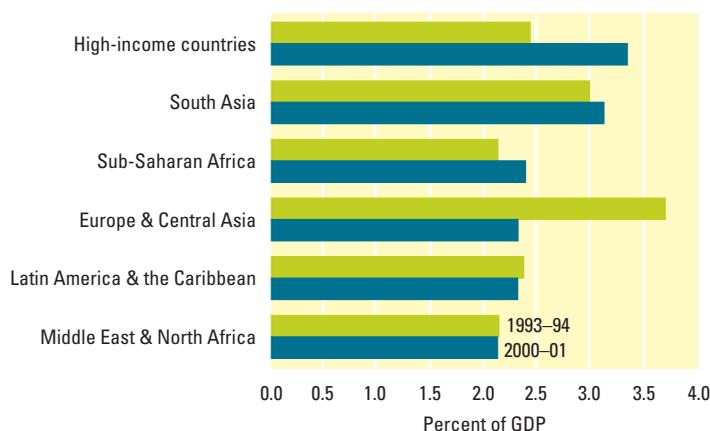
Note: Reports share of countries where firms rank tax rates as a top constraint in a list of 18 possible obstacles. Source: World Bank Investment Climate Surveys.

Figure 5.6 Corporate tax and VAT rates are similar in high-income and developing countries



Note: Data are for 1999–2000. Source: World Bank (2004k), and Ebrill and others (2001).

Figure 5.7 Corporate tax revenues remained stable or increased during the 1990s, except in ECA



Note: Averages are for 81 countries for which comparable data was available for both periods. Source: IMF (2003); OECD (2002d); Dobrinsky (2002).

BOX 5.9 *Taxation and global integration: A race to the bottom?*

Concern is often expressed about whether competition for investment between countries is leading to a race to the bottom in corporate tax rates. Competition might pressure governments to cut corporate taxes to attract new investment or retain existing investment. The concern is greatest for investment by firms that are the most footloose, such as multinational firms producing tradable goods.

Do tax rates affect where firms invest?

The answer seems to be yes, but like other aspects of the investment climate, the weight will likely vary between firms, industries, and locations. A meta-analysis of 25 studies that looked at the effect of tax rates on FDI (mostly using data on FDI into the United States or FDI by U.S. firms) concluded that a one percentage point increase in tax rates reduces FDI by about 3.3 percent. Other surveys and evidence support a similar conclusion.

Is tax competition harmful?

Because corporate taxes affect the decisions of investors, countries might try to use tax rates to compete for foreign investment. International tax competition can have both positive and negative effects on welfare and efficiency, and it is not immediately clear that it will make countries worse off. Allowing countries or regions to set taxes and expenditures based on local preferences for and costs of providing local public goods (ones that affect people only in that jurisdiction) is generally more efficient than requiring that governments mandate uniform taxes and expenditures across regions. Many commentators also argue that a degree of competition between governments on taxes and other policies can be a good thing, because it disciplines governments and prevents them

from wasting public resources or becoming overly intrusive.

Other theoretical models suggest that tax competition might have some adverse consequences. One concern is fiscal externalities. When a government cuts its tax rates on capital—and does not cut expenditures that owners of capital care about (if it cuts only expenditures that benefit immobile workers)—it might attract capital from neighboring jurisdictions. If it does not take into account the effect of this on taxes (and thus expenditures) in the neighboring jurisdictions, it can set tax rates lower than are globally optimal. A second concern is that tax competition might have an undesirable impact on the distribution of taxes. In particular, if capital is mobile but workers are not, a greater part of the burden of corporate taxes will fall on workers rather than on capital.

A host of other factors—such as other tax instruments available to the government—also affect whether tax competition improves, or reduces, public welfare in theoretical models of the economy. The broader point, however, is that tax competition is not necessarily harmful.

Have corporate taxes fallen as international economic integration increased?

If tax competition was resulting in significant fiscal externalities and thus a race to the bottom, corporate taxes should have fallen in the 1990s as international integration increased. Although marginal corporate tax rates have fallen over the past decade, bases have often been broadened. As a result, corporate tax revenues have increased or remained steady on average, except in the European transition economies, where the decrease in revenues was more from privatization than economic integra-

tion (figure 5.7). Further, whether the decrease in marginal rates is a result of tax competition or other factors is not clear—governments might reduce rates in an attempt to stimulate private investment by local firms.

The dire predictions of some commentators may not be bearing out for two reasons:

- Tax rates are not the only factor influencing investment decisions. Infrastructure, law and order, and the education of the workforce can be even more influential, and it is hard for governments to sustain those services with a shrinking tax base. Location decisions are also influenced by agglomeration economies. Together, these factors mean that investment is not as responsive to changing tax rates as some fear.
- Corporate tax rates also affect the taxes paid by domestic firms and firms producing non-tradable goods, and investment by these firms is likely to be far less responsive to differences in tax rates than investment by foreign firms, especially those producing traded goods. This means that across-the-board cuts in corporate tax rates would be a costly way to attract foreign investment. Rather than cutting taxes across the board, governments tend to offer tax incentives—or other advantages—targeted specifically to firms thought to be the most responsive (chapter 8).

Source: Baldwin and Krugman (2004); Brennan and Buchanan (1980); De Mooij and Ederveen (2001); De Mooij and Ederveen (2002); Devereux, Griffith, and Klemm (2002); Glaeser, Johnson, and Shleifer (2001); Gordon and Hines (2002); Haufler (2001); Hines (1999); Mitra and Stern (2003); Oates (2001); Rodrik (1997); Tiebout (1956); Wilson (1999); and Wunder (2001a).

BOX 5.10 *Who pays taxes levied on firms?*

When governments levy taxes on firms, firms will often pass the costs of the tax on to others. For example, if government levies a payroll tax on firms, increasing the cost of hiring workers, firms will hire fewer workers. As unemployment increases, real wages will fall (or increase more slowly than they would have otherwise), passing the cost of the tax on to workers. So workers ultimately bear some of the tax burden in the form of lower wages, even though the tax is levied on the firm. Part of the burden might also be passed on to consumers through higher prices.

Incidence has been especially controversial for corporate taxes. Although the corporate income tax is often seen as a tax on capital, and the popular press often sug-

gests that raising corporate taxes is necessary to make firms “pay their fair share,” labor bears a large part of the burden of corporate tax in the United States. Because labor’s share of the corporate tax burden is higher when capital is more mobile, labor may bear a greater part of the burden in developing countries than it does in the United States. As capital becomes more mobile—and multinational firms become more sophisticated in their tax minimization strategies—the share of the corporate income tax falling on labor will likely increase.

Source: Fuchs, Krueger, and Poterba (1998); Mulligan (2002); and Rosen (1995).

The burden that taxes impose on firms can vary along several dimensions. First, because firms can partially pass the costs of taxation on to consumers or workers, the actual burden can differ from the statutory burden (box 5.10). Second, many firms and activities benefit from special tax exemptions or privileges, whether as a result of government deliberately trying to promote some kinds of activity—as is often the case with foreign investment and research and development (chapter 8)—or as a reward to favored constituencies. Third, a large proportion of firms in many developing countries are in the informal economy, where they typically do not pay taxes. This includes microentrepreneurs, but weak

enforcement capacity means that even larger firms evade at least some taxes. Corruption in tax administration contributes to informality, resulting in less revenue for government and a higher burden on those that do pay.

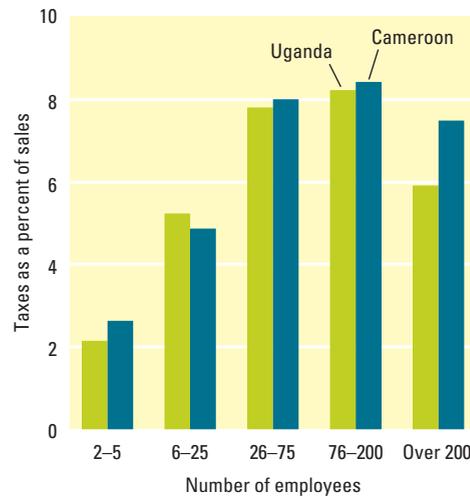
Small firms can often reduce their tax burden through informality and evasion. Large firms can also reduce taxes because of their ability to negotiate various tax privileges and to avoid taxes through sophisticated legal means (hiring accountants to search for existing loopholes in the tax system). This can lead to a disproportionate burden for medium firms. For example, they pay a greater share of their revenues in taxes than either small or large firms in Cameroon and Uganda (figure 5.8).³⁸

Tax administration. Firms rate tax administration as a separate and additional obstacle from tax levels. In countries including Bangladesh, Brazil, and Ethiopia, more than 50 percent of firms said that tax administration was a very severe or major problem (figure 5.9). Red tape and corruption in tax administrations are common, and weaken the incentives to comply with taxes and contribute to leakages.

Taxes and competition. Taxes can also affect the level of competition between firms in two main ways. First, many developing countries have traditionally relied heavily on trade taxes (tariffs and export taxes), in part because of the ease of collection, which has reduced competitive pressure on local firms. To take advantage of global integration, governments have been reducing trade taxes with a positive impact on the competitive discipline facing local firms—and reducing costs for firms and consumers. They have typically made up for the lost revenues by introducing or increasing VAT.³⁹

The second way taxes influence competition is through differential treatment of local firms in the same market. As noted above, medium firms may be disadvantaged relative to smaller and larger firms. Firms in the informal sector can have advantages over those in the formal sector. In Argentina, for example, it has been suggested that although labor productivity at large meat processors is

Figure 5.8 Caught in the middle: taxing firms in Uganda and Cameroon



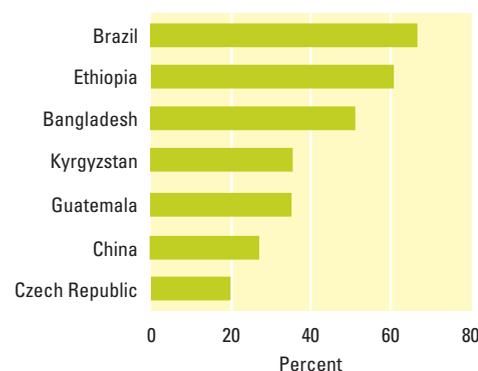
Source: Gauthier and Reinikka (2001) and Gauthier and Gersovitz (1997).

almost twice as high as in smaller firms, small informal processors can undercut the prices of the large firms by evading taxes and not complying with all regulations.⁴⁰

Better taxes for the investment climate

Crafting better tax policies for the investment climate requires governments to recognize the tradeoffs between efficiency, equity, and pragmatic implementation concerns, and the impact of tax policies have on the incentives of firms to invest productively, create jobs, and so contribute to a

Figure 5.9 Many firms rate tax administration as a serious obstacle



Note: Percentage of firms reporting tax administration as a "major" or "severe" obstacle to the operation and growth of their establishment.

Source: World Bank Investment Climate Surveys.

growing tax base over time. A first step is to ensure the tax burden is no higher than necessary, including by keeping the size of the state in check and striving for more efficiency in public spending. For example, *World Development Report 2004* identified many opportunities for governments to better leverage public funding for public services. Beyond this, the most promising strategies involve broadening the tax base (including by addressing informality), simplifying tax structures, and improving tax administration in its various dimensions.

Broadening the tax base. Reducing impediments to the emergence of new firms that contribute to growth expands the tax base and creates the potential to reduce the tax burden on other firms. Addressing informality of existing firms can require a more nuanced approach. For larger firms that evade tax obligations, more vigorous enforcement action is justified, but compliance can also be encouraged by simplifying tax structures and tax administration. Several countries in Eastern Europe are also experimenting with flat corporate and personal taxes to encourage tax compliance, reduce distortions, and simplify administration. Reducing impediments to firms joining the formal economy—including by simplifying business registration requirements and relieving other unjustified regulatory burdens—can also play a role.

Confronting informality. Microenterprises in the informal economy raise more difficult and sensitive issues (chapter 3). Some small firms may not be viable if they have to comply with all taxes and regulations.⁴¹ Forcing them to comply might simply result in them closing down, with an adverse impact on poverty. And even a big increase in formality among microenterprises may not lead to a significant increase in revenues but would greatly increase the cost of collecting taxes.⁴²

Governments are experimenting with novel schemes to improve tax morality. In China, to encourage businesses to issue official receipts, some local governments have experimented with a scheme that allows official receipts to double as lottery tickets, to encourage customers to demand receipts

from businesses (box 5.11). In Mongolia some local governments issue awards, including consumer goods, cash, and plaques to firms nominated as the best taxpayers.

Simplifying tax structures. Simplifying complicated tax systems can be beneficial for three main reasons. First, tax systems riddled with exemptions are not transparent and can act as magnets for rent-seeking behavior by firms and other groups. While this benefits the favored groups, it reduces revenues and puts a greater burden on others. Second, such systems can provide significant opportunities for corruption.⁴³ Third, complicated systems increase the cost of administration. Large firms can devote resources to reducing their total tax burden. This in turn increases the burden of administration for the agencies responsible for administering taxes and auditing returns. Simplifying the tax system is especially useful in countries where administrative capacity is limited or control of corruption is weak.

Increasing the autonomy of tax agencies. A common strategy for improving revenue collection and reducing compliance costs is to give tax agencies more autonomy. Since autonomous tax agencies were introduced in Bolivia and Ghana in the 1980s, more than 15 countries have set them up.⁴⁴ Autonomous tax agencies promise better performance than traditional ministries. They can bypass restrictive civil service rules and pay better salaries to attract and retain well-qualified professionals.⁴⁵ They are also better protected from political interference.⁴⁶

Autonomy usually improves the performance of revenue agencies.⁴⁷ A recent study of agencies in Latin America and Africa concluded that the agencies granted the most autonomy were the most successful in boosting revenue collection and efficiency, increasing compliance, and improving service quality.⁴⁸ After the reform of the Kenya Revenue Agency in 1995, revenue efficiency and compliance improved and, despite an across-the-board reduction in tax rates, revenues declined by less than had been forecast.⁴⁹ But sustaining autonomy requires a high level of political commitment.⁵⁰

BOX 5.11 Tax receipts as lottery tickets?

Shop owners sometimes have problems with employees who pocket the customer's cash rather than putting it into the register. To discourage employees from doing this, some stores and fast food restaurants offer customers a small amount if the checker fails to issue them a receipt. By giving the customer an incentive to report employees who fail to enter sales into the register, the owners effectively enlist the customer in their attempts to prevent employee theft.

In 2002, to boost tax collections, the city government of Beijing, China, instituted a similar program to encourage enterprises to issue proper receipts. Under this program, a small scratch box was added to official receipts. When the customers scratch the box, they can win small prizes ranging between 100 and 5,000 Yuan. To discourage forgery, a second scratch box with a code number allows customers to check over the Internet whether the business gave them a valid receipt. In a pilot program outside Beijing a small town increased tax revenues by \$732,000 while giving out \$17,100 in prizes.

Source: *The Economist* (2002b).

Autonomy also has to be balanced with accountability. Although an autonomous agency needs to have control over its day-to-day operations (deciding whom to hire and whom to audit), it is important that it remains accountable for its overall performance, including its relationship with taxpayers. In Mexico the autonomous agency has to present a report on its performance to the legislature three times a year. In Kenya the head of the tax authority is required to present quarterly audit reports, conducted by the internal audit unit, to the agency's board, the minister of finance, and the auditor general. The agency head is also required to present the agency's financial statements, performance indicators, and annual report to both the board and the minister of finance. The auditor general also conducts an annual audit, which the minister of finance presents along with the annual report, to the National Assembly.⁵¹

Tackling corruption in tax administrations.

Corruption in the tax authority undermines collection efforts. Corruption can be a persistent challenge because the problems are rarely unique to tax administration. But governments can take several practical steps.⁵² One general principle is to minimize direct contact between tax officials and taxpayers—by automating and computerizing procedures, increasing the use of third-party data for assessments, and relying on tax withholding.⁵³ A second useful step is to organize the tax agency along functional lines (such as auditing, taxpayer assistance, and processing tax returns) rather than by tax type, because this makes it harder for officials to develop relationships with taxpayers. Broader strategies for addressing corruption in civil service organizations can also help, such as allowing independent internal and external audits, protecting whistleblowers, and giving citizens a way of complaining about harassment (chapter 2).

In some cases corruption also appears to have been reduced when agencies have become autonomous. In Peru, 85 percent of taxpayers surveyed believed that there was substantially less or much less corruption in SUNAT, the Peruvian tax agency,

after it became autonomous.⁵⁴ But autonomy is not a universal salve: for example, corruption remained a serious problem in Tanzania after the reform of its revenue agency.⁵⁵

Improving compliance through computerization. Increasing computerization in revenue administration agencies can sometimes help.⁵⁶ Singapore reduced tax arrears and staff turnover, while public satisfaction with the tax service improved.⁵⁷ But experience suggests that increased computerization is likely to be successful only when part of an overall strategy that takes into account civil service wage structures and human capital constraints.⁵⁸ Computerization projects tend to be more successful when implemented with other reforms to improve tax administration.⁵⁹ Using off-the-shelf software and hardware can also reduce the risks of having to develop proprietary technologies.⁶⁰

Regulating and taxing at the border

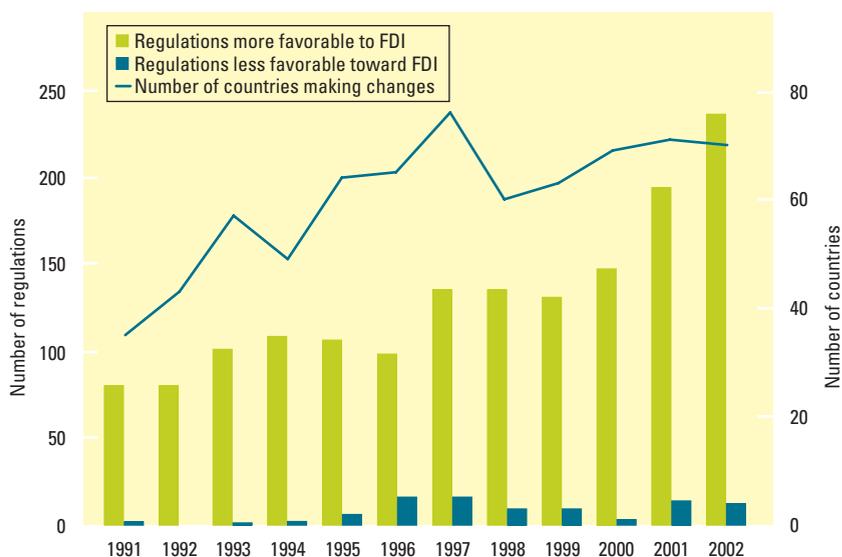
In addition to regulating and taxing firms within their borders, governments regulate and tax goods at the border and impose additional regulations and restrictions on foreign-owned firms.

Although the regulation of domestic transactions can often be justified on efficiency grounds, such as addressing a market failure, similar arguments rarely apply to restrictions on trade or FDI. Apart from revenue goals for import tariffs, policies in this area are often driven by the preferences of local firms to face less competitive pressure. A growing appreciation of the benefits of openness has resulted in both developed and developing countries significantly reducing barriers to trade and investment in recent years (chapter 3). However, many barriers that weaken the investment climate remain.

Regulatory barriers to foreign investment

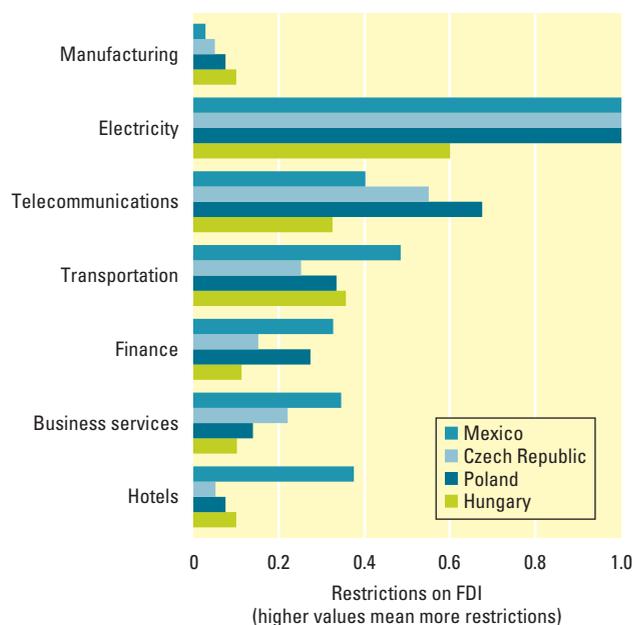
Since 1995 at least 60 countries have made regulatory changes affecting foreign investment every year, with the vast majority reducing restrictions (figure 5.10).

Figure 5.10 Most changes in national regulations governing FDI reduced restrictions



Source: UNCTAD (2003e).

Figure 5.11 Restrictions on FDI have fallen in manufacturing, but persist in other sectors



Source: Golub (2003).

Restrictions that discriminate against foreign investors usually have one of three objectives. First are those that seek to encourage FDI but also to promote spillovers to the local economy by imposing requirements to enter joint ventures with local firms or to meet other requirements. Experience with the effectiveness

of such arrangements is mixed at best (chapter 8).

Second are those that seek to exclude or otherwise more tightly control foreign participation in sectors perceived to be especially “sensitive”—such as infrastructure and media services. For example, the United States restricts foreign ownership of radio licenses and prevents majority foreign-owned companies from operating domestic air services.⁶¹ Although many middle-income countries maintain few restrictions on foreign ownership in manufacturing, they often impose greater restrictions on foreign ownership in electricity, telecommunications, transportation, and financial services (figure 5.11). Given the benefits of foreign ownership in improving productivity, and the fact that many domestic firms rely on the services from the restricted sectors, restrictions can weaken the investment climate.

A third objective may be to control the potentially destabilizing effects of large, short-term capital flows—with the emphasis on short-term portfolio investment rather than FDI (box 5.12).

Regulatory barriers to foreign trade

Tariff and nontariff barriers to trade have been reduced over the past decade, but the remaining restrictions and weaknesses in customs administration still have a big impact on the investment climate.

Trade protection. Average tariff rates remain moderately high in developing countries (13 percent).⁶² It has been estimated that if developing countries reduced their average tariffs to 10 percent on agricultural products and to 5 percent on manufacturing products, their gains would exceed \$100 billion by 2015. This is greater than the gains developing countries would get from developed countries reducing the tariffs and other restrictions they impose on goods from developing countries (chapter 10).⁶³

Improving customs administration. When customs are administered poorly, significant costs can be imposed on firms engaged in importing or exporting—and indirectly on firms that supply exporters

BOX 5.12 Dealing with short-term international capital flows

Although most countries now actively court FDI, there is more debate about the merits of capital account liberalization, particularly for short-term capital flows. Recent crises in Asia, Latin America, and Russia have contributed to the debate, with many observers questioning whether it is wise to allow short-term investment to flow freely in and out of developing countries.

Most of the debate has focused on short-term portfolio investment. FDI—especially greenfield investment—is difficult to reverse. Portfolio flows, in contrast, can change direction very quickly, putting pressure on exchange rates and fragile banking sectors and sometimes causing currency or banking crises. What can governments do to insulate themselves from these reversals without deterring all foreign investment? Several proposals have been put forward, some more controversial than others.

Avoid overspending and overborrowing during periods of rapid inflows. Although several recent crises have been the result of private borrowing (Asia in 1997), governments often contribute to crises by overborrowing from international capital markets as foreign investment

flows into their economy. Governments in many developing countries, including those in Latin America, have run procyclical fiscal policies, contributing to cycles of booms and busts. Avoiding overspending and overborrowing during booms is thus important.

Strengthen oversight of the financial system. One way to reduce problems associated with capital inflows is to improve management of financial sector risk. In addition to ensuring that banks are adequately capitalized and have appropriate levels of provisioning for bad loans, it is important to ensure they do not develop portfolio mismatches in currencies or terms. Banks might also have to be discouraged from lending foreign currency to firms with earnings primarily in domestic currency (those operating in nontraded sectors). Removing implicit or explicit government deposit insurance might also be valuable.

Capital controls. Regulations aimed at preventing sudden outflows of investment or discouraging short-term inflows are more controversial. Several countries have experimented with capital controls. In 1991 Chile imposed a requirement that foreign investors make a 20

percent reserve deposit in an unremunerated account for up to a year for all portfolio inflows from abroad. It also required that FDI stay in the country for at least three years—a restriction reduced to one year in 1992.

Evidence on the effectiveness of capital controls is mixed. Some studies have found that capital controls have altered the composition of capital inflows, increasing the share of FDI and decreasing the share of short-term and portfolio investment. Other studies found that capital controls can have harmful side effects. Because they impose costs on foreign investors whether they restrict inflows or outflows, controls generally increase the cost of borrowing in the country. Further, because controls can often be circumvented, especially in countries where corruption is a problem, it is unclear whether they are an effective way of deterring crises.

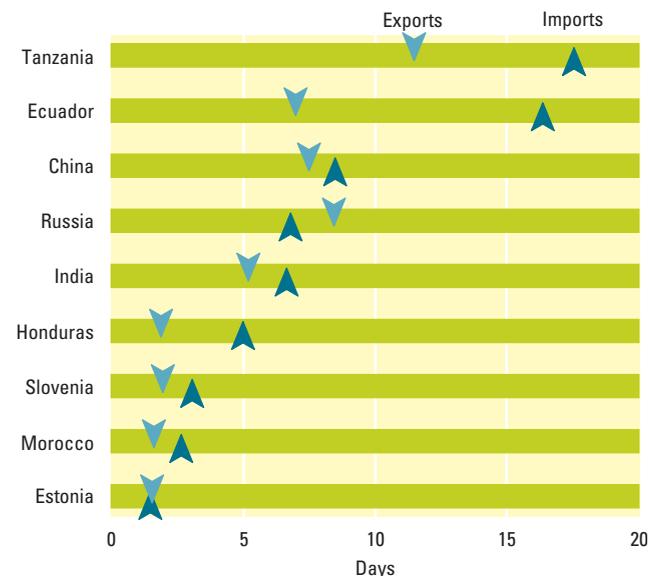
Source: Schmukler (2003); World Bank (2002d); Ariyoshi and others (2000); de Ferranti and others (2000); Edwards (1999); Kaminsky, Reinhart, and Végh (2003); Montiel and Reinhart (1999); and World Bank (2001f).

or depend on imported goods. Delays in imports can also prevent firms from adopting production processes that rely on just-in-time deliveries and mean that firms have to hold larger inventories than they would otherwise. Firms in Estonia reported that, on average, imports cleared customs in less than 2 days. By contrast, the average for firms in Tanzania was 18 days and in Ecuador, 16 days (figure 5.12). These delays can impose real costs on workers and firms in developing countries: on average firms in the garment industry grew more slowly, in both output and employment, and wages were lower in countries where customs clearance took longer.⁶⁴

Corruption can also be a major problem in customs administration. Officials can impose large costs on importers—especially for importers of perishable goods—by delaying the processing of imports. In Eastern Europe and Central Asia more than 20 percent of firms that directly imported some inputs reported that bribes were needed to deal with customs and imports. Although import licenses are not needed in

many areas in most countries, bribes were common for firms that reported applying for licenses. Around 10 percent of firms that applied for import licenses reported that bribes were requested or expected when

Figure 5.12 Clearing customs for imports—from under 2 days to 18



Source: World Bank Investment Climate Surveys.

BOX 5.13 *Reducing customs delays in Singapore and Ghana*

Firms in developing countries often face long delays when importing and exporting goods. In recent years computerization has demonstrated the potential to dramatically speed up parts of the process. One initiative uses software and procedures based on a program called TradeNet. Rather than submit multiple unique forms to multiple agencies, a trader can electronically submit a single document that contains all the information required by the different agencies. TradeNet then submits the information to the relevant agencies, which can then respond with the necessary permits or request additional information. By eliminating overlapping requirements and multiple forms, the process reduces transaction costs for firms and minimizes direct contact between public officials and the trader, reducing opportunities for side payments.

Singapore used these methods in 1989 to reduce processing time from two to four days to a few minutes, and the number of required documents from between 3 and 35 to a single document. Freight forwarders estimate that the program has reduced their cost of handling trade documentation by between 20 and 35 percent.

Singapore's success, and a similar program in Mauritius, inspired the government of Ghana to adopt a similar program as part of its strategy to become a more attractive location for exporters. Before the program, importers estimated that the fastest clearance time at seaports was four days, with an average clearance time of several weeks. After implementing the program, about 14 percent of clearances took less than a day at Tema port and only 11 percent took more than five days. At the airport, average clearance times fell from three days to four hours, with 18 percent of clearances taking less than two hours.

Although computerization can reduce delays, it will not succeed unless procedures are modified to fully exploit its benefits. Before implementing TradeNet, the Ghanaian customs administration was already using a standard software package to help process imports, but procedures were not designed to take advantage of the package, so the technology was underused. For example, customs declarations had to be manually entered into the database, a process that took up to 24 hours, rather than being submitted electronically.

Source: De Wulf (2004), and World Bank (1998b).

applying for them, with the median payments exceeding \$100 in several countries.

Improving customs administration promises large gains. Increasing the use of information technology can help accelerate customs processing (box 5.13).⁶⁵ Computerization is becoming less costly and less demanding of human capital than before because of standardized software packages. In addition to reducing delays, computerization can increase transparency and so reduce corruption.⁶⁶ Importers in Morocco now find out in real time the progress of customs operations and the status of their imports under special import regimes, monitoring payments of duties and taxes, and even monitoring clearance times.⁶⁷ Customs can also be improved by contracting out functions to private firms as in Mozambique (box 5.14).

Government approaches to regulation and taxation are not limited in their impact on product markets. They also play a big part in the quality of a country's financial system and its infrastructure—the subject of chapter 6.

BOX 5.14 *Contracting out customs in Mozambique*

Before 1995 customs administration had been a serious problem in Mozambique. There was no reliable system for detecting and punishing corrupt officials. More than three-quarters of staff lacked a high school education. There was little use of information technology, and all goods were physically inspected after arriving in the country. So revenue collection was poor. The inspection process was slow. Corruption was serious, with importers and customs officials frequently colluding to undervalue and misclassify imports.

In 1995 the government initiated an ambitious program to improve customs operations. The program included the following:

- Issuing a new customs code to update the previous law, which dated from the colonial period
- Replacing many workers with better-educated personnel, while boosting employment by 20 percent

- Introducing a new salary scale and compensation package that was higher than for other civil servants and that compared well with private sector salaries
- Adopting a new software package and new computer hardware
- Reducing the agency's reliance on physical inspections
- Adopting anticorruption measures.

In addition the government, with support from the U.K. Department for International Development (DFID), entered a contract with Crown Agents, a private company, which took over the management of customs in 1996.

Even with a reduction in nominal tariff rates, better administration and reduced exemptions increased the ratio of customs revenue to imports between 1996 and 2000 (there was a

slight decline in 2001). The reform also helped the investment climate. By 2002 the median number of days for imported goods to clear customs was significantly lower in Mozambique than in Tanzania or Kenya and similar to the number in China.

Some questions remain. It is not clear whether the improvements can be sustained after Crown Agents leaves. In 1999 Crown Agents' three-year contract was extended until 2003 and then extended again until 2005. Crown Agents' responsibilities and number of staff have declined since the first contract, but a review by DFID and the Mozambique government concluded that the improvements were not yet sustainable in mid-2003.

Source: Mwangi (2003).