world development report 2005

A Better Investment Climate for Everyone

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Overview

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Contents of the World Development Report 2005

Foreword

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

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

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

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

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

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

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

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

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

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

James D. Wolfensohn
President
The World Bank

Acknowledgments

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

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

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Overview
A better investment climate for everyone

Private firms are at the heart of the development process. Driven by the quest for profits, firms of all types—from farmers and microentrepreneurs to local manufacturing companies and multinational enterprises—invest in new ideas and new facilities that strengthen the foundation of economic growth and prosperity. They provide more than 90 percent of jobs—creating opportunities for people to apply their talents and improve their situations. They provide the goods and services needed to sustain life and improve living standards. They are also the main source of tax revenues, contributing to public funding for health, education, and other services. Firms are thus central actors in the quest for growth and poverty reduction.

What determines the contributions firms make to society? Mainly the investment climate—the location-specific factors that shape the opportunities and incentives for firms to invest productively, create jobs, and expand (box 1). Government policies and behaviors play a key role in shaping the investment climate. While governments have limited influence on such factors as geography, they have more decisive influence on the security of property rights, approaches to regulation and taxation (both at and within the border), the provision of infrastructure, the functioning of finance and labor markets, and broader governance features such as corruption.

Improving government policies and behaviors that shape the investment climate is fundamental to driving growth and reducing poverty. That makes progress especially critical for governments in the developing world—where 1.2 billion people barely survive on less than US$1 a day, where young people have more than double the average unemployment rate, and where demographic changes will add nearly 2 billion more people over the next 30 years. Expanding jobs and other opportunities for young people is essential to create a more inclusive, balanced, and peaceful world.

New data from the World Bank provide fresh insights into how investment climates vary around the world—and how they influence growth and poverty. These include Investment Climate Surveys, which cover more than 26,000 firms in 53 developing countries, and the Doing Business Project, which benchmarks regulatory regimes in more than 130 countries (box 2). *World Development Report 2005* draws on those data, other new evidence, and emerging lessons of international experience to show what governments at all levels can do to create a better investment climate—an investment climate that benefits society as a whole, not just firms, and one that embraces all firms, not just large or politically connected firms. In short, a better investment climate for everyone.

How investment climates vary

Government policies and behaviors shape the opportunities and incentives facing firms through their influence on costs, risks, and barriers to competition. All three matter for firms—and for growth and poverty.

Costs

Wages, raw materials, and the like are normal costs associated with any commercial activity. But many costs flow more directly from government policies and behaviors. Taxes are the most obvious example. But governments also have an important role in addressing market failures, providing public goods, and supporting the provision of infrastructure. Weaknesses in government performance in these roles can greatly

BOX 1 *What do we mean by the investment climate?*

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

Firms are the starting point of the framework. This Report uses the term "firms" to include the full range of private economic agents, from farmers and microentrepreneurs to domestic manufacturing establishments and multinational corporations, regardless of their size, activity, or formal legal status.

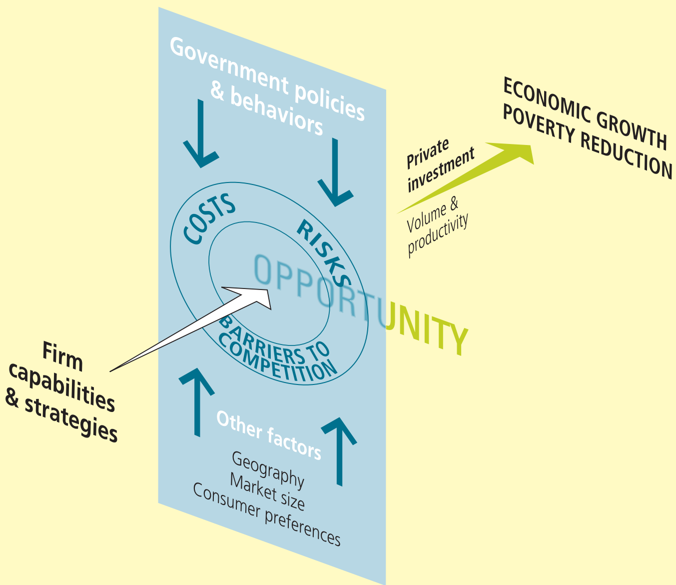
The horizontal plane in the figure below represents their investment decisions and activities. Firms decide whether to incur costs today to change or augment production in the future, such as investing in machinery, facilities, and research and development. Firms approach the decision with different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

A good investment climate is not just about generating profits for firms—if that were the goal, the focus could be narrowed to minimizing costs and risks. It is about improving outcomes for society as a whole. Many costs and risks are properly borne by firms. And reducing barriers to competition expands opportunities, spurs innovation, and ensures that the benefits of productivity improvements are shared with consumers and workers.

The vertical plane in the figure represents the investment climate. Some aspects of the investment climate, including geography and consumer preferences, are difficult for governments to change. But governments have more decisive influence over a range of other factors. The specific influences on costs, risks, and barriers addressed in the Report are policies closely tied to investment behavior. Thus the forward-looking nature of investment underlines the importance of stability and security, especially the security of property rights. Regulation and taxation qualify property rights and have first-order implications on costs, risks, and barriers to competition. Finance, infrastructure, and labor are key inputs to investment activities.

But firms do not respond to formal policies alone. They make judgments about how those policies will be implemented in practice. And firms (like other stakeholders) try to influence policies in ways favorable to them. Issues of government behavior and governance in the broadest sense—including corruption and credibility—are thus paramount. It is the interaction of formal policies and governance characteristics that firms assess when making investment decisions.

Improving the investment climate is the first pillar of the World Bank's overall development strategy. A critical complementary agenda, reflected in the second pillar of the Bank's strategy, is to invest in and empower people so that they can take advantage of these opportunities. The *World Development Report 2004: Making Services Work for Poor People* focused on key aspects of that second pillar.



increase the costs for firms and make many investment opportunities unprofitable. How greatly? The Bank's surveys show that the costs of unreliable infrastructure, contract enforcement difficulties, crime, corruption, and regulation can amount to over 25 percent of sales—or more than three times what firms typically pay in taxes. Both the level and the composition of these costs vary widely across countries (figure 1).

Costs also have a time dimension. The Bank's firm surveys highlight big variations in the time taken to get goods through customs and to obtain a telephone line as well as in the amount of time firms need to spend dealing with officials. The Bank's Doing Business Project shows that the time it takes to register a new business ranges from 2 days in Australia to more than 200 days in Haiti.

Risks

Because investment decisions are forward looking, firms' judgments about the future are critical. Many risks for firms, including uncertain responses by customers and competitors, are a normal part of investment, and firms should bear them. But governments have an important role to play in creating a stable and secure environment, including by protecting property rights. Policy uncertainty, macroeconomic instability, and arbitrary regulation can also cloud opportunities and chill incentives

BOX 2 *New sources of investment climate data from the World Bank*

Early efforts to understand how government policies and institutions influenced growth relied on aggregate indicators of a country's institutional framework, such as the rule of law and corruption. This work generated useful insights, the most important of which are that secure property rights and good governance are central in economic growth. But aggregate data provide limited insights into the heterogeneity of institutional arrangements across and within countries, or the impact of those arrangements on the investment decisions of different types of firms. They also make it hard to distinguish the effects of specific policy actions from broader background institutions. These limitations inspired a quest for more disaggregated evidence.

As a contribution to this effort, the World Bank recently launched two major initiatives to better understand how the quality of a location's investment climate influences the investment decisions and performance of firms and so contributes to growth and poverty reduction.

- *Investment Climate Surveys.* Large random samples of firms have been interviewed to collect assessments of constraints facing firms as well as objective quantitative data on measures of the investment climate and firm performance. This allows investment climate indicators to be linked with firm performance to better understand their impact on productivity, investment decisions, and employment decisions. In many cases subnational jurisdictions are included, capturing variations across locations within a country. The surveys were launched in 2001, with about 20 new surveys conducted each year since. This Report draws on early results from this work, covering more than 26,000 firms in 53 countries. The Investment Climate Surveys build on the World Business Environment Surveys, launched in 1999, which covered smaller samples of firms and relied more heavily on perception data.
- *Doing Business Project.* The project develops benchmark information on the operation of various regulatory regimes in more than 130 countries. It reports on the costs of doing business for a defined hypothetical firm and transaction based on the views of selected local experts (lawyers, accountants). The underlying information includes the time and costs of complying with various policy and regulatory frameworks—including business registration, contract enforcement, and labor regulation. A first report was published in 2003, with annual updates scheduled with additional topics.

To complement these initiatives the Report surveyed 3,250 microentrepreneurs in the informal economy in 11 countries recently completing Investment Climate Surveys.

Further details on the new data sources are provided in the Report and also available at: http://econ.worldbank.org/wdr/wdr2005.

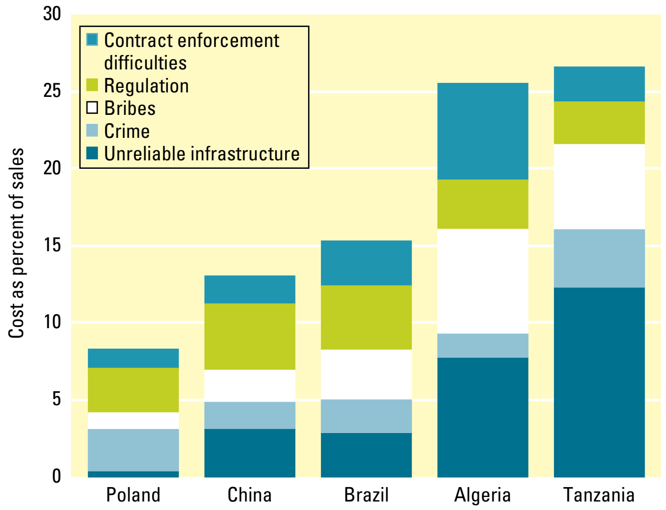
Source: Kaufmann, Kraay, and Mastruzzi (2003); Burgess and Venables (2003); Pritchett (2004).

to invest. The Bank's surveys show that policy-related risks dominate investment climate concerns across developing countries (figure 2). The surveys also highlight some of the variations across countries (figure 3).

Barriers to competition

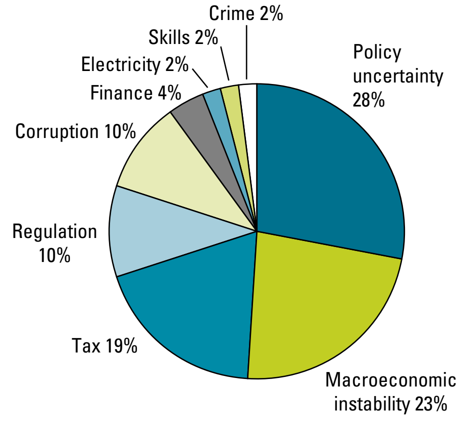
Firms prefer to face less competition, not more. But barriers to competition that benefit some firms deny opportunities and raise costs for other firms and for con-

Figure 1 Costs vary widely in level and composition



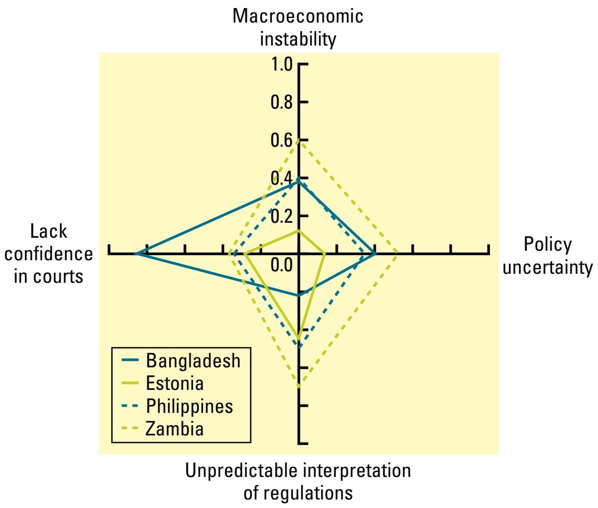
Note: The survey asked registered firms to report values either in monetary terms, directly as a share of sales, or in terms of time. "Contract enforcement difficulties" captures the share of inputs that are below agreed-upon quality (weighted by material inputs in total sales) and overdue payments (as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

Figure 2 Policy-related risks dominate the investment climate concerns of firms



Note: Share of countries where firms report issue as top constraint in surveys of 48 countries.
Source: World Bank Investment Climate Surveys.

Figure 3 Concerns about policy-related risks vary widely across countries



Note: Smaller numbers reflect less concern. Countries selected to illustrate range.
Source: World Bank Investment Climate Surveys.

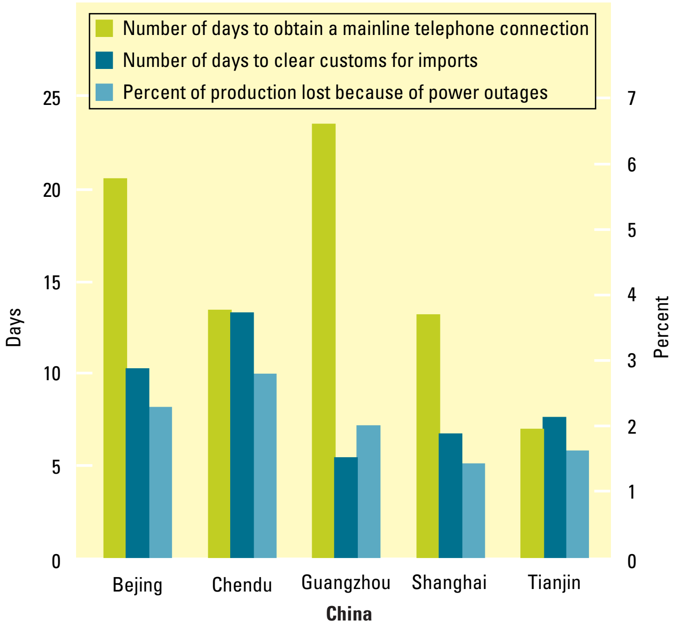
sumers. Barriers can also dull the incentives for protected firms to innovate and increase their productivity. Some barriers stem from natural features, such as distance and economies of scale associated with particular technologies. High costs and risks can act as barriers to entry. Governments also influence barriers more directly through their regulation of market entry and exit and their response to anticompetitive behavior by firms. While difficult to measure at the aggregate level, firm surveys show how the competitive pressure felt by firms can vary greatly across countries. For example, competitive pressure is reported to be significant for 90 percent of firms in Poland, but only 40 percent of firms in Georgia.

Variations within countries and across firms

Investment climates vary on these dimensions not only across countries, but also within them, as a comparison among locations in China makes clear (figure 4). Variations can stem from differences in the policies and behaviors of subnational governments, or from the way national policies are administered. Investment climates tend to be less hospitable in rural areas, reducing opportunities for farmers and nonagricultural firms alike.

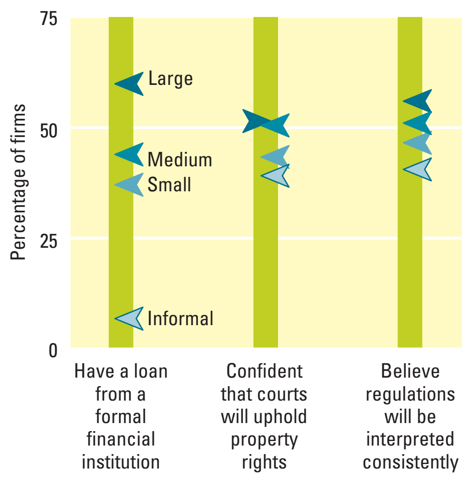
Even within a single location, the same conditions can affect firms differently. This can be true across activities—farmers, manufacturers, and hairdressers can each have different perspectives and priorities. Many aspects of a poor investment climate also hit small firms and those in the informal economy the hardest (figure 5).

Figure 4 Investment climate conditions vary within countries, as in China



Source: World Bank Investment Climate Surveys.

Figure 5 Small and informal firms are often hit hardest by investment climate constraints



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

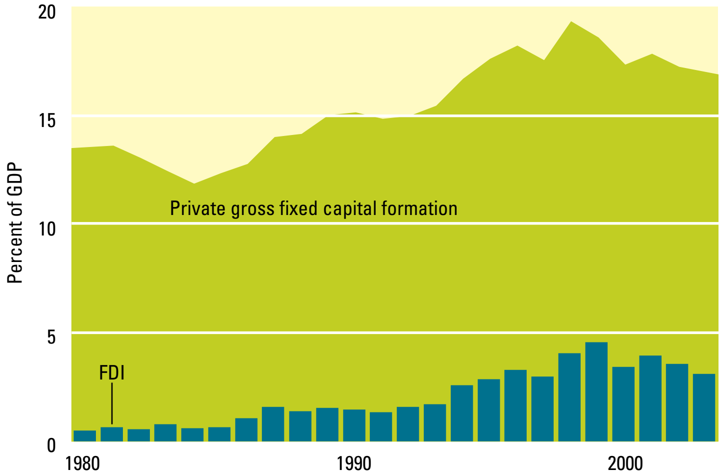
How the investment climate influences growth and poverty

Firms naturally care about the investment climate. So should societies. Improving the investment climate plays a central role in driving growth and reducing poverty. How?

Driving growth

As populations get larger, economic growth provides the only sustainable way of improving living standards. A good investment climate drives growth by encouraging investment and higher productivity. Investment underpins growth by bringing more inputs to the production process. Foreign investment is becoming more important in developing countries, but the bulk of private investment remains domestic (figure 6).

Figure 6 Domestic private investment dominates foreign direct investment



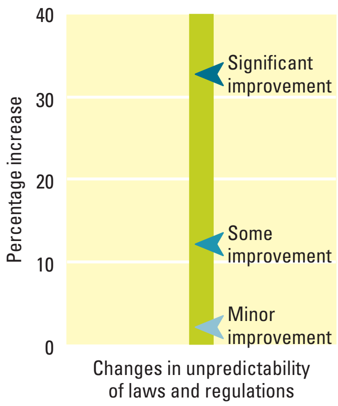
Note: Annual averages of 92 developing countries.
Source: World Bank (2004b).

A good investment climate encourages firms to invest by reducing unjustified costs, risks, and barriers to competition. As a result of investment climate reforms, private investment as a share of GDP nearly doubled in China and India; in Uganda it more than doubled. The same result is confirmed by more micro-level evidence. In Poland, Romania, Russia, Slovakia, and Ukraine, firms that believe their property rights are secure reinvest between 14 and 40 percent more of their profits in their businesses than those that don't.[1] Farmers in Thailand with more secure rights to land invested so much more in their land that their output was 14–25 percent higher than those working on untitled lands of the same quality.[2] Reducing barriers to competition in telecommunications in the 1990s unleashed a surge of new investment—including by microentrepreneurs in Bangladesh and Uganda. Firm-level data show that improving policy predictability can increase the likelihood of firms making new investments by more than 30 percent (figure 7).

But it is not just the volume of investment that matters for growth—it is the productivity gains that result.[3] Indeed, cross-country studies show that total factor productivity accounts for around the same share of growth in GDP as does capital accumulation (figure 8).

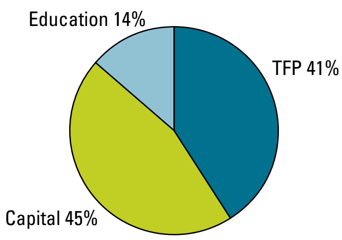
A good investment climate encourages higher productivity by providing opportunities and incentives for firms to develop, adapt, and adopt better ways of doing things—not just innovations of the kind that might merit a patent, but also better ways to organize a production process, distribute goods, and respond to consumers. What is required? Low barriers to the diffusion of new ideas, including barriers to importing modern equipment and adjusting the way work is organized, are essential. And an environment that fosters the competitive processes that Joseph Schumpeter called "creative destruction"[4]—an environment in which firms have opportunities and incentives to test their ideas, strive for success, and prosper or fail. A good investment climate makes it easier for firms to enter and exit markets in a process that contributes to higher productivity and faster growth. Net market entry can account for more than 30 percent of productivity growth. And firms reporting strong competitive pressure are at least 50 percent more likely to innovate than those reporting no such pressure (figure 9).

Figure 7 Improving policy predictability can increase the likelihood of new investment by over 30 percent



Note: Percentage increase is relative to firms reporting no improvement in predictability. Simulations based on firm responses to survey, with 80 countries, controlling for region, firm size, and sector.
Source: World Bank World Business Environment Survey.

Figure 8 Productivity accounts for a significant share of growth



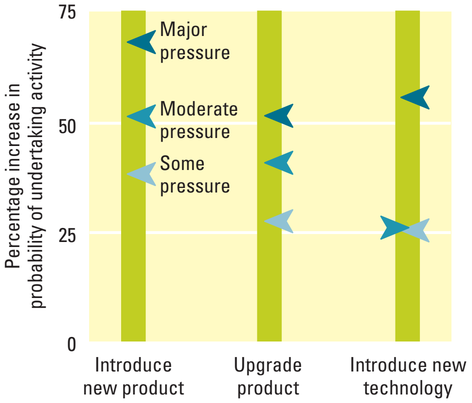
Note: Sources of growth for 84 countries from 1960–2000. "TFP" is total factor productivity.
Source: Bosworth and Collins (2003).

Reducing poverty

Improving the investment climate is critical in the fight against poverty. The contribution can be seen in two ways. First, at the aggregate level, economic growth is closely associated with reductions in poverty (figure 10).

Second, the contribution can be seen in the way a good investment climate enhances

Figure 9 More competitive pressure, more innovation

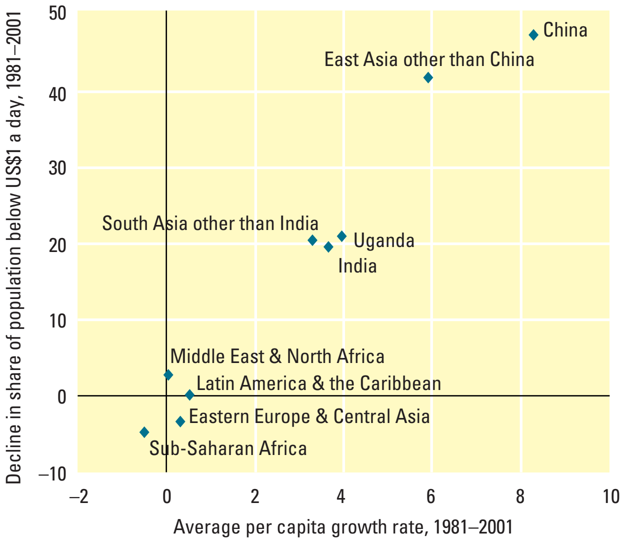


Note: Percentage increase is relative to firms' reporting no competitive pressure. Based on 27 countries in Eastern Europe and Central Asia.
Source: World Bank Investment Climate Surveys/BEEPS II.

the lives of people directly—in their many capacities.

As employees. The World Bank's *Voices of the Poor* study found that poor people identified getting a job—whether through self-employment or from wages—as their most promising path out of poverty (figure 11). Young people have more than double the average unemployment rate in all regions.[5] In many developing countries more than half the population work in the informal economy, where working conditions can be poor (figure 12). Expected population growth in developing countries reinforces the importance of accelerating the creation of more and better jobs in developing countries. Where will the jobs come from? Mostly from the private sector, which accounts for more than 90 percent of employment in most countries, and 95 percent in countries such as El Salvador and India.[6] Better employment opportunities also increase incentives for people to invest in their education and skills—thus complementing efforts to improve human development. More productive firms, nurtured by a good investment climate, can also pay better wages and invest more in training.[7]

Figure 10 Poverty reduction is closely associated with growth



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

As entrepreneurs. Hundreds of millions of poor people make their living as microentrepreneurs—as farmers, as street vendors, as homeworkers, and in a diverse range of other occupations—mostly in the informal economy. Surveys for this Report show that firms in the informal economy face many of the same constraints as other firms, including insecure property rights, corruption, policy unpredictability, and limited access to finance and public services. Relieving these constraints increases microentrepreneurs' incomes and allows them to expand their activities. A good investment climate also increases incentives to join the formal economy.

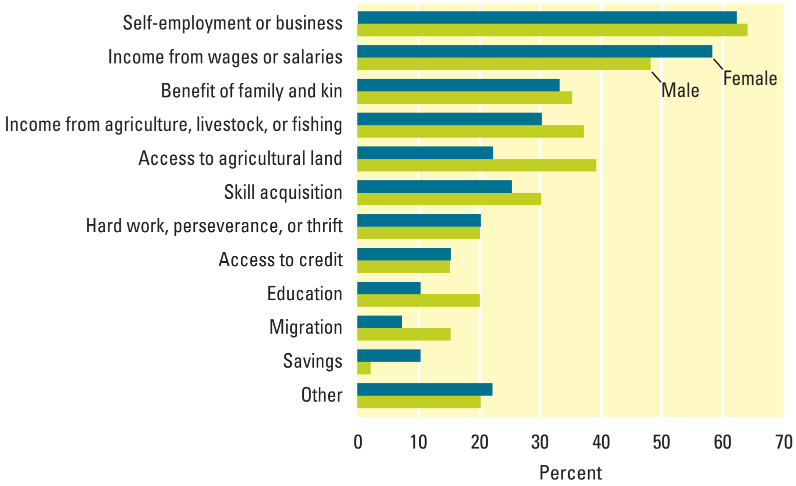
As consumers. A good investment climate expands the variety and reduces the costs of goods and services, including those consumed by poor people. For example, investment climate improvements lowered the price of food in countries including Ethiopia, Ghana, Kenya, Vietnam, and Zambia.[8] Lowering barriers to market entry by 10 percent has been estimated to reduce the average price markup by nearly 6 percent.[9]

As users of infrastructure, finance, and property. Improving infrastructure, finance and property rights can deliver broad benefits across the community. Constructing rural roads helps firms, and in Morocco also increased primary school enrollment from 28 percent to 68 percent.[10] Expanding access to finance helps firms develop their businesses, and also helps poor people weather family emergencies and educate their children. Providing more secure rights to land can encourage investment and ease access to finance, and in Peru was also found to enable urban slum dwellers to increase their incomes by working more hours outside the home.[11]

As recipients of tax-funded services or transfers. Firms and their activities are the principal source of tax revenues for governments, and growing economies generate more taxes. A good investment climate can thus expand the resources governments have available to fund the provision of public services (including health and education) and transfers to disadvantaged members of society.

Some investment climate improvements deliver broad benefits across society—such as better macroeconomic stability and less corruption. Others have a more focused impact on a particular location or activity, creating opportunities for governments to influence the distribution of benefits. Governments can design those investment climate improvements to be even more "pro-poor" by focusing on constraints where poor people live and on constraints to activities poor people benefit from, including in their capacities as employees, entrepreneurs, consumers, or users of infrastructure, finance, and property. This means that pro-poor approaches are not limited to efforts focusing on constraints that face smaller firms.

Figure 11 Self-employment and wage income are the ways out of poverty



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

Confronting the underlying challenges

More countries are improving their investment climates—and reaping the rewards of faster growth and less poverty. Despite the great rewards, progress is often slow and difficult. Why?

The basic tension

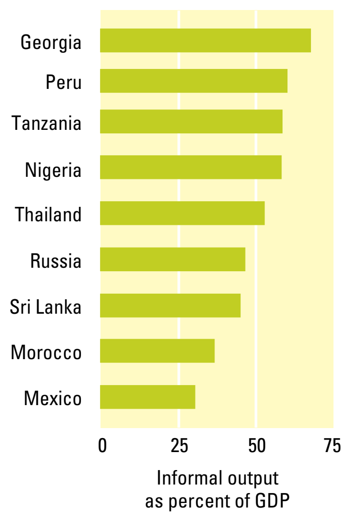
Societies benefit greatly from the activities of firms. But the preferences of firms don't fully match those of society—a tension most evident in taxation and regulation. Most firms complain about taxes, but taxes finance public services that benefit the investment climate and other social goals. Many firms would also prefer to comply with fewer regulations, but sound regulation addresses market failures and can therefore improve the investment climate and protect other social interests. Similar tensions can occur across most areas of investment climate policymaking.

Creating a good investment climate requires governments to balance these interests. Complicating this task are the differences in preferences and priorities between firms. Firms have common perspectives on many issues, but their views can diverge on others—whether on market restrictions, the structure of taxation, or the priority given to infrastructure improvements in different locations. There can also be differences in policy preferences within firms—between owners and managers on matters of corporate governance, or between owners and workers on labor market policies. All governments must arbitrate those differences in an environment in which firms, officials, and other stakeholders seek to tilt the outcome to their advantage.

Four resulting challenges

Responding to this tension requires governments to navigate four interrelated challenges that cut across all areas of investment climate policymaking. The way governments

Figure 12 The informal economy is substantial in many developing countries

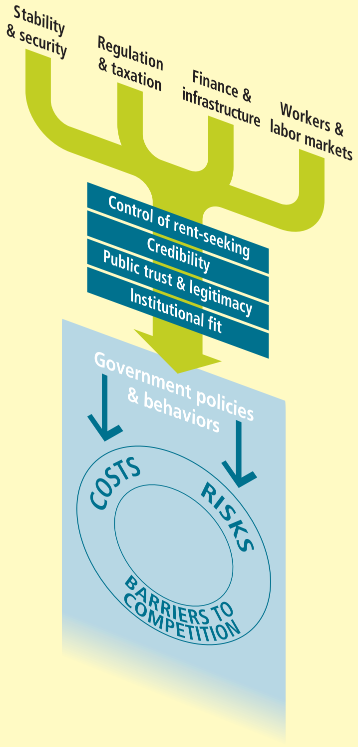


Source: Schneider (2002).

BOX 3 *Governance and the investment climate*

The opportunities and incentives that firms face to invest productively, create jobs, and expand are shaped by the costs, risks, and barriers to competition associated with particular investment opportunities. Governments influence those factors through a combination of their formal policies in particular areas—stability and security, regulation and taxation, finance and infrastructure, and workers and labor markets—and their behaviors and broader governance characteristics. The latter include control of rent-seeking, credibility, public trust and legitimacy, and the fit between the chosen policy response and local institutional conditions.

Formal policies interact with government behaviors and broader governance characteristics to shape the investment climate experienced by firms (see figure). Poor control of rent-seeking can influence both the content and the implementation of formal policies. Low credibility can undermine the impact of any policy. Concerns about public trust and legitimacy can impede the implementation of reforms and undermine the sustainability (and hence credibility) of policies. Policy interventions that are not well adapted to local conditions can have poor or even perverse results. Tackling these sources of potential policy failure is fundamental to efforts to create a better investment climate.



respond to those challenges has a big impact on investment climates and thus on growth and poverty (box 3). And each involves going beyond changes in formal policies to confront deeper sources of potential policy failure. The challenges: restraining rent-seeking, establishing credibility, fostering public trust and legitimacy, and ensuring that policy responses reflect a good institutional fit.

Restraining rent-seeking. Investment climate policies are an enticing target for rent-seeking by firms, officials, and other interest groups. Corruption can increase the costs of doing business—and when it extends to higher echelons of government, it can lead to deep distortions in policies. The Bank's surveys show that the majority of firms in developing countries expect to pay bribes when dealing with officials, and many rate corruption as the most severe constraint to their operations. Capture and patron-clientelism—reflecting unequal information and influence in policymaking—can also create large distortions, tilting policies in favor of some groups at the expense of others. Markets are restricted, the allocation of property rights skewed, financial markets distorted. Eliminating unjustified interventions in the economy, curbing discretion, and improving the accountability of governments, particularly through greater transparency, help to restrain rent-seeking.

Establishing credibility. Because investment is forward looking, uncertainty clouds all investment decisions. So the confidence of firms in the future—including the credibility of government policies—determines whether and how they invest. Policies that lack credibility will fail to elicit the intended investment response. What undermines the credibility of policy? A legacy of political or economic instability does not help. But all governments face temptations to compromise sound long-term policies to meet shorter-term or narrower goals, such as extracting rents for policymakers or currying favor with some voters. Building credibility requires mechanisms for governments to commit to sound policies, as well as discipline and persistence.

Fostering public trust and legitimacy. Firms and governments do not interact in a vacuum. Trust among market participants nurtures productive exchange and reduces the burden on regulation and contract enforcement. Social attitudes—including trust in markets and in firms—also influence the feasibility, sustainability (and hence credibility) of policy improvements. Good investment climates are thus nurtured by broad public support: by a consensus in favor of building a more productive society that can facilitate policy improvements, regardless of the political party or group in office. Open and participatory policymaking and efforts to ensure that the benefits of a better investment climate extend widely in society can help to build that support.

Ensuring that policy responses fit local conditions. To be effective, policy interventions need to take into account sources of potential government failure, as well as differences in local conditions. Failure to do so can lead to poor or even perverse results. Approaches that demand capacity beyond that available will not only fail to meet their intended objective, but also contribute to informality and corruption and undermine credibility. Approaches that involve high levels of discretion expose firms to considerable uncertainty and risk when effective safeguards against the misuse of that discretion have not yet been developed. Why do these problems come about? Too often, policy and regulatory approaches have been transplanted uncritically from one country to another. This phenomenon dates back to colonial eras, when developing countries inherited policy approaches that had little to do with local circumstances. Many of these museum pieces remain on the books today, many decades later. But the tendency persists. While approaches in today's rich countries can provide a valuable source of inspiration, care needs to be taken to adapt approaches to local conditions. In some cases this may involve the choice of simpler rules with less discretion and additional measures to restrain arbitrary behavior.

BOX 4 *Tackling a broad agenda: Lessons from China, India, and Uganda*

China, India, and Uganda illustrate some simple lessons about strategies for making investment climate improvements.

China and India have both grown impressively in recent years, greatly reducing poverty. China's growth is officially reported at an average of 8 percent a year for the past 20 years, and the share of its population living on less than US$1 a day fell from 64 percent in 1981 to less than 17 percent in 2001. India's growth has increased from an average of 2.9 percent a year in the 1970s to 6.7 percent by the mid-1990s, and the share of its population living on less than US$1 a day fell from 54 percent in 1980 to 35 percent in 2000.

Yet neither country has an ideal investment climate. China only recently gave constitutional recognition to private property, and its banking sector is dragged down by nonperforming loans. Problems in India's power sector are legendary. Both countries unleashed growth and reduced poverty through what appeared to be fairly modest initial reforms. China began with a rudimentary system of property rights that created new incentives for a substantial part of its economy. India began with early efforts to reduce trade barriers and other distortions that covered a significant part of its economy. In both cases the reforms addressed important constraints, and were implemented in ways that gave firms confidence to invest. And the initial reforms have been followed by ongoing improvements that addressed constraints that were less binding initially, and also reinforced confidence in the future path of government policy.

Such strategies are not limited to large countries. Uganda launched its program of investment climate improvements in the early 1990s after a period of civil conflict. Reforms covering many areas of the investment climate provided the basis for growing its economy by an average of more than 4 percent a year during 1993–2002 (or 8 times the average in Sub-Saharan Africa) and reducing the share of its population living below the poverty line from 56 percent in 1992 to 35 percent in 2000. The persistence of its reform efforts enhanced the government's credibility—giving firms the confidence to invest.

Source: China: Chen and Wang (2001), Qian (2003), and Young (2000); India: Aghion and others (2002), Ahluwalia (2002), De Long (2003), Rodrik and Subramanian (2004), Varshney (1998), and Panagariya (2003); Uganda: Holmgren and others (2001) and World Bank (2001).

Tackling a broad agenda

Government policies and behaviors shaping the investment climate play out over a wide field, from contract enforcement and business regulation to the provision of infrastructure and labor market policy. Policies and behaviors in each area can influence the opportunities and incentives for firms. And the policy areas often interact, with progress in one area possibly influenced by progress in others. This implies a broad agenda for government.

No country, however, has a perfect investment climate. Nor is perfection on even one dimension required for significant growth and poverty reduction. Experience shows that progress can be made by addressing important constraints in a way that gives firms the confidence to invest—and by sustaining a process of ongoing improvements (box 4).

Early rounds of economic reform were sometimes seen as one-off events. But investment climate improvements involve an ongoing process of policy adjustment and fine-tuning across a wide domain. This is as true in today's rich countries as it is in developing countries. Policies need regular review to reflect changes in the conduct of business and lessons from ongoing experience. Michael Porter has suggested that reforms in this area are a marathon, not a sprint,[12] but even that assessment may understate the task.

International experience provides insights into the essential elements of reform processes in this area: setting priorities; managing individual reforms; maintaining momentum; and strengthening government capabilities.

Setting priorities

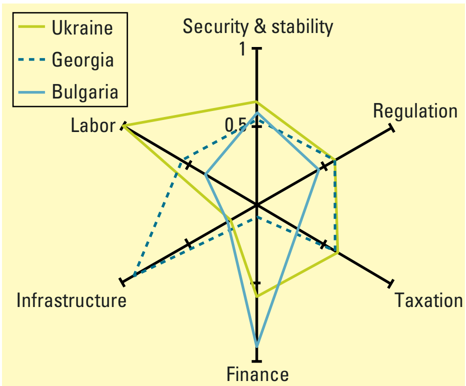
The goal is to identify important constraints that face firms. There are no standard formulas. Instead, it requires an assessment in each case of current conditions, the potential benefits from improvements, links with national or regional goals, and implementation constraints.

Current conditions. The most important constraint can differ widely across countries, even within a single region (figure 13). Governments can identify them by surveying and consulting with firms, with the caveat that existing firms will not always reflect the perspectives of future entrants. New sources of data also allow the benchmarking of current policy performance against international comparators in a growing number of areas—highlighting the scope for improvement.

Potential benefits. When the goal is to accelerate growth, an improvement that affects a large part of the economy will usually have a bigger impact than reforms that affect a smaller part. Progress in achieving a reasonable level of political and macroeconomic stability is thus fundamental—without it reforms in other areas will gain little traction. Enhancing policy credibility can also leverage the investment response to reforms in any particular policy area. A key consideration will be the impact of improvements on opportunities for poor people—including as employees, entrepreneurs, or consumers.

Governments should also consider benefits that may extend beyond the firms and activities affected most directly. These may include spillovers to other firms (for example, from foreign direct investment to local firms), to other policy areas (for example, from rights to land to access to finance), or to broader social goals (for example, infrastructure improvements benefiting the broader community, not just firms). There can also be spillovers to government capabilities, credibility, or constituency building.

Figure 13 Constraints reported by firms—comparing Bulgaria, Georgia, and Ukraine



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

Links with national or regional goals. Investment climate improvements can affect firms and activities differently. Because of this, priority-setting will often be influenced by the weight governments place on a subset of the goals a good investment climate can deliver: integrating the informal and rural economies; unleashing the growth potential of smaller firms; taking advantage of international openness; and enabling firms to climb the technology ladder.

- *Integrating informal firms.* The informal economy produces more than 50 percent of GDP in many developing countries. While less constrained by taxes and regulations, firms in the informal economy usually have less secure property rights and more difficulty getting public services and finance. Integrating them into the formal economy involves addressing the constraints they find most binding—and reducing obstacles to going formal.
- *Integrating rural firms.* Firms in rural areas usually face less hospitable investment climates than those in urban areas—due to lower population densities, greater distances to large markets, and fewer public services. Improving infrastructure can make a big difference, and deliver benefits to broader communities as well as firms.
- *Unleashing the growth potential of smaller firms.* Small firms tend to face disproportionate burdens in coping with poor investment climates due to the impact of fixed costs and greater difficulty obtaining financing. Addressing constraints that place a particularly heavy burden on small firms can help to unlock their growth potential.
- *Taking advantage of international openness.* Most countries have made a decisive

shift toward more open economies—and firm-level evidence confirms that they are reaping the benefits of higher productivity. Beyond reducing remaining trade and investment barriers, progress often requires tackling constraints in such areas as ports and customs administration.

- *Climbing the technology ladder.* Technological progress underpins productivity improvements and growth. But countries do not need to invent everything afresh. Firm surveys show that knowledge embedded in new machinery and equipment is the main source of technological innovation in developing countries. Reducing policy barriers to the adoption or adaptation of technologies developed elsewhere is thus a first step. Securing property rights and reducing barriers to competition provide the incentives for firms to pursue these opportunities.

Implementation constraints. At any point in time the range of potential policy improvements will usually be constrained by administrative and political feasibility. Well-designed strategies address these constraints through effective management of reforms and the ongoing strengthening of government capabilities.

Managing individual reforms

There is often resistance to investment climate reforms from those who benefit from the status quo. That resistance may come from firms or other interest groups benefiting from market distortions or other special privileges, officials benefiting from bribes or other perquisites of office, or even the wider community when the implications of reform are not certain. Experience shows that progress is possible when committed governments communicate to build public support, engage stakeholders constructively, and (when appropriate) provide some form of compensation to those disadvantaged by change. Special efforts to help vulnerable groups cope with change are also important, particularly when economywide safety nets are not yet in place.

Maintaining momentum

Because investment climate improvements are a process, rather than a one-off event, many countries are creating specialist institutions to help with specific tasks and to sustain progress even through changes in government. These institutions can perform one or a combination of several roles: consultation with stakeholders, policy coordination, and the more systematic review of existing investment climate constraints. Latvia, Senegal, Turkey, and Vietnam illustrate possible approaches. Governments are also creating mechanisms to review new policy and regulatory proposals more systematically to ensure that they do not introduce unwarranted distortions. Experience in countries such as Mexico and South Korea is encouraging, but political commitment and good institutional design are fundamental.

Strengthening government capabilities

Strengthening government capabilities is an essential part of any strategy to improve the investment climate. Strengthening capabilities in regulation is often a high priority. Traditional models for building capacity are being complemented by approaches that facilitate peer-to-peer learning. Local capacity is also being augmented by contracting-out some specialist functions—a common strategy even in developed countries. Governments also need to improve their ability to monitor the performance of their private sectors so that they can identify trends and emerging issues and evaluate the impact of their policies. Upgrading the quality of national statistical systems is an important part of these efforts.

Delivering the basics

Industrial development is usually a process of discovery, making it difficult to predict what a country or region will be good at producing. This underscores the importance of improving the basic foundations of the investment climate to benefit all firms and activities in the economy. International experience highlights promising approaches in each of the four core areas of the investment climate:

- Stability and security
- Regulation and taxation

- Finance and infrastructure
- Workers and labor markets.

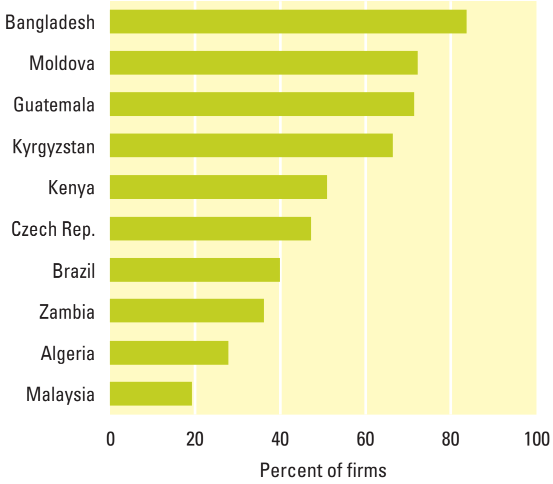
Stability and security

The outbreak of war or other widespread violence spells the end of almost all productive investment. But firms require more than peace to commit energy and resources to investing productively. A reasonable level of political and macroeconomic stability is the threshold requirement for a sound investment climate. Unstable or insecure environments have their most tangible effect on investment through their impact on property rights.

Secure property rights link effort with reward, assuring firms that they will be able to reap the fruits of their investments. The better protected these rights from government or third parties, the stronger the link between effort and reward, and thus the greater the incentives to open new businesses, to invest more in existing ones, and simply to work harder. Studies in many countries show that the more secure the rights, the faster the growth. Improving the security of property rights requires action in four main areas: verifying rights to land and other property; facilitating contract enforcement; reducing crime; and ending the uncompensated expropriation of property.

Verifying rights to land and other property. Providing more secure rights to land and other property encourages investment and eases access to finance. Experience in Peru, Thailand, and a growing number of other countries highlights the benefits of clarifying ownership of land and maintaining an effective registration system. Registries for equipment and other forms of moveable property also play an important role.

Figure 14 Firms in many countries lack confidence that the courts will uphold their property rights



Note: Countries selected to illustrate range.
Source: World Bank Investment Climate Surveys.

Facilitating contract enforcement. A secure contracting environment reduces the risks and costs associated with transactions and eases access to finance. In many developing countries more than half the firms surveyed lacked confidence in the courts to uphold their property rights (figure 14). According to the Bank's Doing Business Project, the time taken to enforce a simple contract can range from 48 days in the Netherlands and nearly 600 days in Bolivia to more than 1,400 days in Guatemala. Strengthening courts is thus a high priority. Complementary measures include facilitating the free flow of reputation information and removing unjustified impediments to the use of alternative dispute resolution mechanisms.

Reducing crime. Crime imposes large costs on societies—approximately a quarter of GDP in some countries in Latin America.[13] Firm surveys show that crime is also a severe constraint for many firms in all regions. Promising strategies involve efforts to prevent and deter crime, as well to improve enforcement. Community policing strategies along the lines of those applied in New York City are being pursued in many countries around the world.

Ending the uncompensated expropriation of property. All governments reserve the right to expropriate private property in some circumstances. But concerns about the arbitrary exercise of this power can chill incentives to invest. The key is to create credible restraints on expropriation without prompt, adequate, and effective compensation.

Regulation and taxation

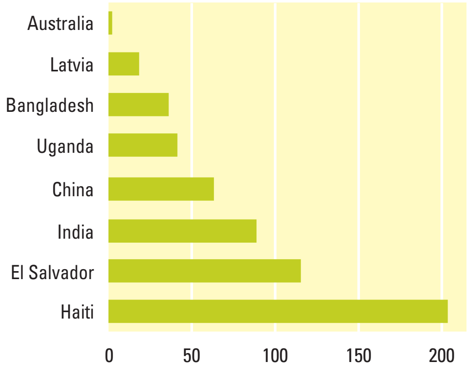
The way governments regulate and tax firms and transactions—domestically and at the border—plays a big role in shaping the investment climate. Sound regulation addresses market failures that inhibit productive investment and reconciles the interests of firms with wider social goals. Sound taxation generates the revenues to finance the delivery of public services that improve the investment climate and meet other social objectives. 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 expand. While there are tensions between firms' preferences and social goals in this area, there is huge scope to improve approaches in most developing countries without compromising broader social interests.

Improving domestic regulation. Too often, governments pursue regulatory approaches that fail to meet the intended social objectives, yet harm the investment climate by imposing unnecessary costs and delays (figure 15), inviting corruption, increasing uncertainty and risk, and creating unjustified barriers to competition. Why? Problems flow from two main sources. First, regulatory systems in all countries are vulnerable to rent-seeking by firms, officials, and other interests, often reflected in unjustified restrictions on competition or red tape. Second, many regulatory systems in developing countries have been uncritically transplanted from other countries without enough consideration of differences in local conditions.

The key is to strike a better balance between market failures and government failures, including by tailoring approaches to reflect local conditions and by enhancing transparency. Successful reforms reduce costs by removing unjustified burdens and streamlining procedures, as with reforms to business registration requirements in Bolivia, Uganda, and Vietnam. They reduce regulatory uncertainty and risk, by curbing unnecessary discretion and expanding consultation. And they remove unjustified barriers to competition by reducing regulatory barriers to entry and exit and by tackling anticompetitive behavior by firms.

Improving domestic taxation. Everyone complains about taxes, and firms in developing countries are no exception. Tax rates in developing countries are similar to those in developed countries. But a high level of

Figure 15 Number of days to register a new business —from 2 days in Australia to 203 days in Haiti



Note: Countries selected to illustrate range.
Source: World Bank (2004c).

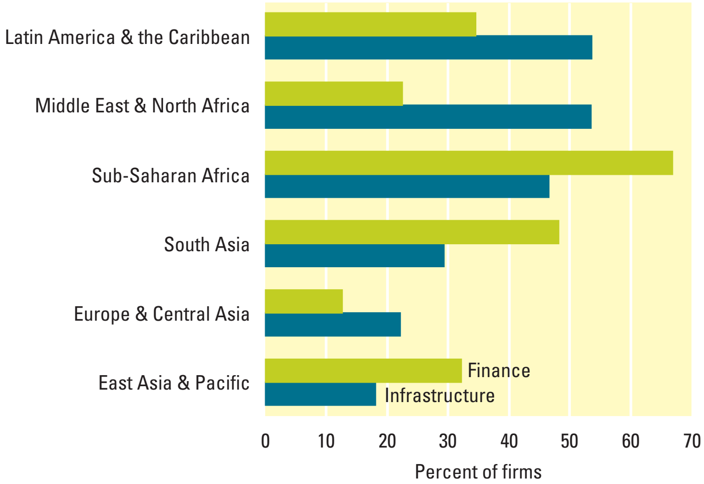
informality, coupled with poor administration and corruption, reduces revenue collections, puts a disproportionate burden on those who do comply, and distorts competition. Keeping the size of government in check and spending public money efficiently helps to ease the pressure on revenue collection. Beyond this, promising strategies involve efforts to broaden the tax base and simplify tax structures. Increasing the autonomy of tax agencies has also improved performance in Peru and many other countries.

Improving regulation and taxation at the border. Most countries have reduced barriers to international trade and investment in recent years, but many barriers remain. Improving customs administrations can also offer big benefits, with successful approaches exploiting new information technologies to reduce delays and corruption, as in Ghana, Morocco, and Singapore.

Finance and infrastructure

Financial markets, when functioning well, connect firms to lenders and investors willing to fund their ventures and share some of the risks. Good infrastructure connects firms to their customers and suppliers and helps them take advantage of modern production techniques. Conversely, inadequacies in finance and infrastructure create barriers to opportunities and increase costs for microentrepreneurs as well as multinationals. By impeding new entry into markets, inadequacies also limit the competitive discipline facing incumbent firms, dulling their incentives

Figure 16 The inadequacies of finance and infrastructure are severe in many developing countries



Note: Figure shows the share of firms that report access to finance, and any of electricity, telecommunications, or transportation as "major" or "severe" obstacles to their business.
Source: World Bank Investment Climate Surveys.

to innovate and improve their productivity. Such inadequacies can be severe in developing countries (figure 16).

Finance. The underlying challenge with finance flows from information problems, which are often exacerbated by insecure property rights. But too often government interventions make matters worse. Financial markets have been repressed and distorted by state ownership, barriers to competition, directed or subsidized credit, and other measures. The resulting problems usually hit smaller firms and those without political connections the hardest.

Governments are confronting these issues. New approaches recognize that financial markets are not only part of the investment climate for firms, but are also profoundly shaped by the investment climate facing providers of financial services. That is why more governments are reducing barriers to competition, strengthening creditor and shareholder rights, establishing credit bureaus and other mechanisms to address information problems, and improving bank regulation.

Infrastructure. The underlying challenge with infrastructure flows from market power associated with economies of scale. But responses focusing on provision by public sector monopolies have often made matters worse. Public ownership and regulation have often been used to pursue objectives unrelated to efficient service delivery—typically favoring some groups over broader interests and introducing new sources of inefficiency. Smaller firms and poor communities are usually hit the hardest by such approaches.

As with finance, the key is to create a better investment climate for providers of infrastructure services. Competition, improved regulation, and private participation have transformed telecommunications and are playing a bigger role in improving electricity supply and ports. For roads, many countries are getting better results by contracting out services and improving funding mechanisms. Governments are also working to improve management of public resources—to get more for their money when they finance or subsidize infrastructure services.

Workers and labor markets

One of the main motivations for pursuing investment climate improvements is to create more and better jobs. Government policies affecting the labor market play a critical role in the investment climate by helping to connect people to decent jobs. Improving policy performance requires action on three related fronts: fostering a skilled workforce, crafting labor market interventions to benefit all workers, and helping workers cope with change.

Fostering a skilled workforce. Improving the investment climate goes hand in hand with enhancing human capital. A skilled workforce is essential for firms to adopt new and more productive technologies, and a better investment climate raises the returns to investing in education. Government support for education and training affects the prospects for individuals—and the ability of firms to pursue new opportunities. Many firms in developing countries rate inadequate skills and education of workers as a major or severe obstacle to their operations (figure 17). Governments need to take the lead in making education more inclusive and relevant to the skill needs of firms, strengthening quality assurance mechanisms, and creating a sound investment climate for providers of education and training services.

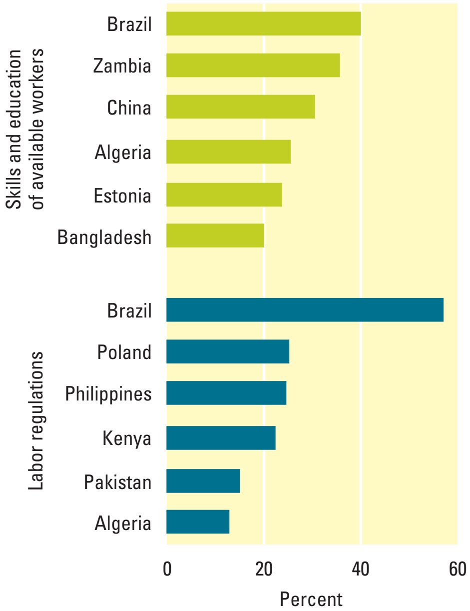
Crafting labor market interventions to benefit all workers. Regulation of labor markets is usually intended to help workers. But ill-considered approaches discourage firms from creating more jobs and contribute to a swelling of the informal workforce that lacks statutory protection. When this is the case, some workers may benefit, but the unemployed, the low-skilled, and those in the informal economy will not be among them. Policy interventions need to be crafted to reflect this wider range of interests. More countries are reviewing their labor market policies to encourage wage adaptability, to ensure workplace regulations reflect a good institutional fit, and to ensure a reasonable balance between workers' preference for employment stability and firms' need to adjust the workforce.

Helping workers cope with change. A good investment climate facilitates the allocation of labor to its most productive use while helping workers cope with labor mobility. Technological progress that leads to higher productivity and economic growth improves working conditions and wages, but it can also involve more rapid changes to firms and industries. In modern economies many firms are created and destroyed each year—about 20 percent in many countries—involving 10 to 20 percent of the workforce.[14] Inadequate mechanisms to help workers cope with change restrict entrepreneurship and the adaptability of workers. The inadequacies can also increase resistance to reforms that would benefit society as a whole. While a narrow tax base reduces the feasibility of creating comprehensive social safety nets in most developing countries, there are opportunities for improving the insurance component in income support schemes and the pooling of risks among individuals. Innovative programs can also reach out to poor and informal workers who cannot be covered by broader insurance schemes.

Going beyond the basics?

Many governments go beyond the basics just described by making selective interventions to benefit particular firms or activities, or by drawing on the growing body of international rules and standards dealing with investment climate issues. Both can play a role but involve additional challenges.

Figure 17 Firms often rate skill shortages and labor regulations as serious constraints



Note: Percentage of firms reporting that skills and education of available workers or labor regulations were a major or severe obstacle to the operation and growth of their business.
Source: World Bank Investment Climate Surveys.

Selective interventions

Broad improvements to the investment climate expand the pool of beneficiaries, reduce concerns about rent-seeking, and avoid new distortions. Given the breadth of that agenda, some firms or activities may benefit from improvements earlier than others—as with infrastructure in a particular location or regulatory reforms affecting a particular activity. But beyond the sequencing of reforms, some governments confer special policy privileges on targeted firms or activities. Those privileges take many forms: market restrictions, tax breaks, access to subsidized credit, and a range of other measures.

Some selective interventions have an economic rationale, such as the possible spillovers from foreign direct investment or research and development. Some may be regarded as a form of "second-best" response, given slow progress in addressing the basics. Yet others aim to accelerate growth by targeting particular industries.

Whatever the rationale, all such schemes must navigate the heterogeneous and self-interested requests of firms, rent-seeking pressures, and other sources of potential policy failure.

While governments have been experimenting with selective interventions for centuries, a review of international experience reveals no sure-fire strategies. Some countries in East Asia appear to have made selective interventions successfully, but recent work suggests that the contribution may have been relatively modest. Experience also shows how difficult it is to replicate similar approaches elsewhere and in what is now a very different international environment. Overall, experience with government efforts to "pick winners" is discouraging. Efforts to woo investors through tax holidays or other special incentives have also met with mixed success—even when investment expands in the targeted industry, it is difficult to know whether the inducements were necessary or cost effective. Indeed, there are many examples of selective interventions going spectacularly wrong—at best wasting public resources, but sometimes creating large distortions that harm the investment climate, and distracting attention from broader improvements.

Even in the best of circumstances many selective interventions seem to be a gamble. The more ambitious the goal and the weaker the governance, the longer the odds of success. This suggests that selective interventions should be approached with caution and not regarded as a substitute for broader investment climate improvements. The hazards of such strategies can be reduced by ensuring that schemes have a clear objective and rationale, focus on the sources of problems rather than the symptoms, match the instrument to the rationale, impose discipline on the beneficiaries, are administered transparently, and are reviewed regularly.

International rules and standards

The body of international rules and standards dealing with investment climate matters has grown exponentially in recent decades. There are now more than 2,200 bilateral investment treaties and more than 200 regional cooperation arrangements. There is also a plethora of new and proposed multilateral instruments on everything from trade, bribery, and corporate governance to taxation and environmental and labor regulation. International arrangements have a clear role to play in reducing barriers to international trade and investment. But they might also contribute to investment climate improvements in three broader ways: by enhancing credibility to reduce risks, by harmonizing rules and standards to reduce costs, and by addressing international spillovers. All three involve tradeoffs.

Enhancing credibility. By increasing the costs of policy reversal, entering into international obligations can reinforce the credibility of government policy, and so strengthen the investment responses of firms. But by design the tradeoff is forgone policy flexibility, which means that commitments need to be considered carefully. Strategies that involve the strongest form of commitment—allowing firms to enforce treaty commitments against government directly through binding international arbitration—can enhance credibility but would benefit from ongoing efforts to improve the transparency of the arbitration process. Strategies that rest more on the reputation concerns of governments can also contribute to policy credibility, but their impact will depend on whether participants in the arrangement insist on high levels of mutual compliance.

Harmonizing international rules and standards. To reduce costs in international transactions, many efforts focus on harmonizing particular rules or standards, with examples ranging from the harmonization of business laws in West Africa to the development of uniform accounting standards. These efforts can be beneficial for developing countries. But there can also be tradeoffs with adapting approaches to local conditions and with allowing a degree of competition between approaches. There are also tradeoffs among multilateral, regional, and bilateral approaches to harmonization.

Addressing international spillovers. Over the past two decades, concerted global action has been promoted for a growing number of matters where the effects of policy actions by one country may spill over onto others. Addressing international spillovers in the environmental area is important for sustainable development. When the suggested spillover is less tangible, or the benefits less evenly shared, cooperative action is more difficult. With taxation, for example, concerns have been expressed about the potential for competition between countries for investment to lead to a "race to the bottom" in tax collections, to the detriment of global public welfare. Similar concerns are sometimes expressed about other areas of investment climate policy, including environmental regulation. Experience so far suggests little evidence of the feared collapses in taxes or standards. But there are also practical issues of trying to find common ground. Proposals in these and other areas need to give due weight to the perspectives of developing countries.

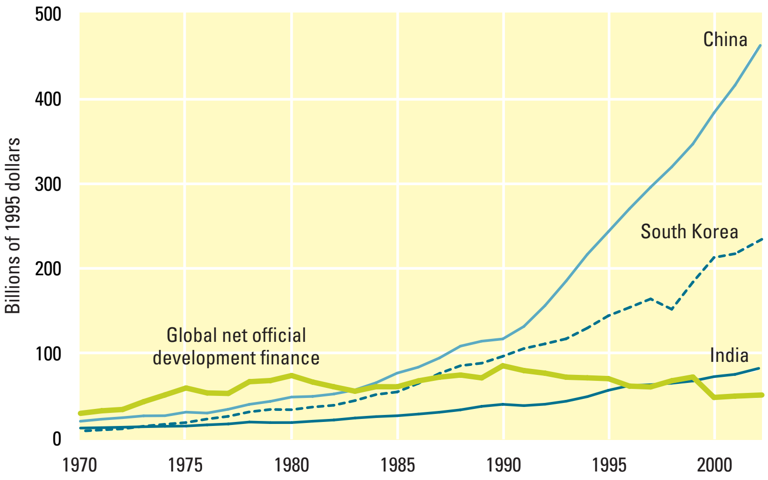
How the international community can help

Responsibility for improving their investment climates lies first and foremost with governments of developing countries, both national and subnational. But the international community can lend a hand. Helping to improve investment climate conditions can provide huge development dividends. The manufacturing value added unleashed by investment climate improvements in even a single country can far exceed the development assistance provided worldwide (figure 18). The international community can help developing countries reap these benefits in three main ways: by removing policy distortions in developed countries that harm the investment climates of developing countries; by providing more, and more effective, assistance; and by tackling the substantial knowledge agenda.

Removing distortions in developed countries

Developing countries are not alone in grappling with investment climate improvements. The trade and market distortions created by policies in developed countries impose large costs on their own economies. These distortions also undermine opportunities and incentives for firms to invest in developing countries. It has been estimated that removing trade protection and related distortions in developed countries could provide gains to developing countries of US$85 billion by 2015[15]—or more than four times the official development assistance currently provided for investment climate improvements.

Figure 18 Manufacturing value added in a single country can far exceed net global official development finance



Note: Data for China, India, and South Korea show manufacturing value added.
Source: OECD online database and World Bank (2004a).

Providing more, and more effective, assistance

The international community has long provided development assistance to support the design and implementation of investment climate improvements. Substantial support is also provided directly to firms. There is room to do better in both areas.

Development assistance for investment climate improvements. Around one quarter of official development assistance, or about US$21 billion per year, focuses on support to investment climate improvements, with the bulk of that directed to infrastructure development.[16] Technical assistance can be one of the most potent ways of helping governments improve their investment climates but accounts for just 13 percent of assistance in this area. There is room to provide more support of this kind and to deliver it more effectively. Improving effectiveness requires efforts to curb supply-driven approaches and greater efforts to ensure that recommended solutions reflect a good fit with local conditions. Multidonor technical assistance facilities are playing a growing role in several areas of investment climate policy and present opportunities to leverage resources and expertise in specialist areas and to improve the overall effectiveness of assistance.

Support provided directly to firms and transactions. Well-designed support of this kind can complement investment climate improvements. Development assistance to support small firms through credit lines and capacity building amounts to slightly more than the value of technical assistance for investment climate improvements. These measures have a mixed track record, however, and would benefit from the same guidelines suggested for selective interventions made by governments. Developed countries and international agencies also provide around US$26 billion per year in nonconcessional loans or guarantees to support specific transactions. While not a form of development assistance, increasing the emphasis on the contribution these transactions make to the creation of more transparent and competitive markets could expand the development impact of this support.

Tackling the substantial knowledge agenda

New sources of data of the kind drawn on in this Report add to our understanding of the foundations of growth and poverty reduction. But a long agenda lies ahead in broadening and deepening this understanding to provide guidance to policymakers. This includes expanding the development of objective indicators of the investment climate and the systematic analysis of country experiences to distill emerging lessons.

By working together on these themes, the international community can help create better investment climates in developing countries and so contribute to a more balanced, inclusive, and peaceful world.

BOX 5 *Main messages from World Development Report 2005*

The investment climate is central to growth and poverty reduction

Improving the opportunities and incentives for firms of all types to invest productively, create jobs, and expand should be a top priority for governments. It is not just about increasing the volume of investment but also spurring productivity improvements that are the key to sustainable growth.

- The goal is to create a better investment climate for everyone. A good investment climate benefits society as a whole, not just firms. And it embraces all firms, not just large or politically connected firms.
- Expanding opportunities for young people is a pressing concern for developing countries, where 53 percent of people live on less than US$2 a day, youths have more than double the average unemployment rate, and populations are growing rapidly.

Reducing unjustified costs is critical, but policy-related risks and barriers to competition also need to be tackled

All three matter for firms and thus for growth and poverty reduction.

- Costs associated with weak contract enforcement, inadequate infrastructure, crime, corruption, and regulation can amount to over 25 percent of sales—or more than three times what firms typically pay in taxes.
- Firms in developing countries rate policy uncertainty as their top concern. This and other sources of policy-related risk—such as insecure property rights, macroeconomic instability, and arbitrary regulation—chill incentives to invest. Improving policy predictability can increase the likelihood of new investment by over 30 percent.
- Barriers to competition benefit some firms but deny opportunities and increase costs to other firms and to consumers. They also weaken incentives for protected firms to innovate and improve their productivity. Increasing competitive pressure can increase the probability of firm innovation by more than 50 percent.

Progress requires more than changes to formal policies

Over 90 percent of firms claim gaps between formal rules and what happens in practice, and the informal economy accounts for more than half of output in many developing countries. Creating a better investment climate requires governments to bridge these gaps and to tackle deeper sources of policy failure that undermine a sound investment climate. This requires efforts to:

- Restrain corruption and other forms of rent-seeking that increase costs and distort policies;
- Build policy credibility to give firms the confidence to invest;
- Foster the public trust required to enable and sustain policy improvements; and
- Ensure policy responses are crafted to fit local conditions.

Investment climate improvements are a process, not an event

Government policies and behaviors influencing the investment climate cover a wide field. But everything does not have to be fixed at once, and perfection on even a single policy dimension is not required. Significant progress can be made by addressing important constraints facing firms in a way that gives them the confidence to invest—and by sustaining a process of ongoing improvements.

- Because constraints differ widely across and even within countries, priorities need to be assessed in each case. Reform processes benefit from effective public communication and other measures to build consensus and maintain momentum.

Endnotes

1. Johnson, McMillan, and Woodruff (2002).
2. Feder and others (1988).
3. Hall and Jones (1999); Parente and Prescott (2000); Easterly and Levine (2001); and Bosworth and Collins (2003).
4. Schumpeter (1942).
5. ILO (2004).
6. OECD (2002) and Carlson and Payne (2003).
7. Dollar, Hallward-Driemeier, and Mengistae (2003) and Hallward-Driemeier, Iarossi, and Sokoloff (2002).
8. Minot and Goletti (2000) and Winters, McCulloch, and McKay (2004).
9. Hoekman, Kee, and Olarreaga (2001).
10. World Bank (1996).
11. Field (2002).
12. World Economic Forum (2004).
13. Londoño and Guerrero (2000).
14. Bartelsman and others (2004).
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16. Migliorisi and Galmarini (2004).

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World Development Report 2005 looks at what governments can do to improve the investment climates of their societies to increase growth and reduce poverty. The Report identifies the opportunities and challenges governments face in making investment climate improvements and suggests practical strategies for accelerating progress. This Report offers practical insights for policymakers and their advisors as well as all those with an interest in growth and poverty reduction in developing countries.