

# Confronting the underlying challenges

## chapter 2

An investment climate that enhances the opportunities and incentives for firms of all types to invest productively, create jobs, and expand is the key to unleashing growth and reducing poverty. That was the message of chapter 1—a message now understood by more governments around the world. But if a sound investment climate is so beneficial, and understood to be so by governments, why are there such large variations in investment climates across and within countries? Why is progress often slow and difficult?

The government's role in shaping the investment climate is traditionally explained by market failures—or the failure of *laissez-faire* conditions to achieve efficient social outcomes. This is the textbook rationale for most government interventions in the economy—to provide public goods such as law and order, to support the provision of infrastructure, and to regulate firms and transactions to address information asymmetries, externalities, and monopoly power. But governments often fail to mitigate market failures—and too often intervene in ways that make matters even worse. Why?

Clearly, failure to create a sound investment climate is not merely due to lack of money. Many investment climate improvements place few demands on government budgets, and the growth unleashed by reforms contributes to greater tax revenues. Indeed, considerable oil and mineral wealth is often associated with a worse rather than a better investment climate. Nor are poor investment climates simply a result of a lack of technical expertise. While the design of some reforms can require the expertise of specialists, administering the resulting policies typically demands far less. And the bookshelves of ministries in most developing countries are lined with reports con-

taining detailed recommendations on how policies might be improved.

Slow progress in improving the investment climate is better explained by the challenges that arise when governments deal with a basic tension. Firms are the primary creators of wealth, and a good investment climate must respond to their needs. But a sound investment climate serves society as a whole, not just firms, and the preferences of the two can diverge. There can also be differences in the policy preferences and priorities between and even within firms. Responding to the resulting tension creates four practical challenges, and the way governments respond to those challenges has a big impact on investment climates and thus on growth and poverty:

- *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 can lead to deep distortions in policies. Capture, patronage, and clientelism can also create large distortions, tilting policies toward some groups at the expense of others.
- *Establishing credibility.* Uncertainty about the future affects whether and how firms choose to invest. Governments need to provide clear rules of the game, but approaches that lack credibility will fail to elicit the intended investment response, no matter how well crafted the rule or how sincere the policy pronouncement.
- *Fostering public trust and legitimacy.* Firms and governments do not interact in a vacuum. Trust between market participants nurtures productive exchange and reduces

the burden on regulation and contract enforcement. Public trust and confidence in markets and firms affect not only the feasibility of reforms, but, through their impact on policy sustainability, and hence credibility, also influence the response of firms.

- *Ensuring policy responses reflect a good institutional fit.* The design of investment climate policies needs to take into account sources of government failure and differences in local conditions. Inadequate consideration of questions of institutional fit can lead to poor or even perverse results.

These challenges cut across all areas of investment climate policymaking, from contract enforcement and business regulation to infrastructure provision and labor markets, and directly impact on the costs, risks, and barriers to competition faced by firms (box 2.1). This chapter looks at the implications for creating a better investment climate and practical strategies for moving forward. The main message: Improvements are certainly possible. But accelerating and broadening progress requires governments to go beyond formal policies and tackle deeper sources of policy failure.

**The basic tension:  
Firm preferences or the  
public interest?**

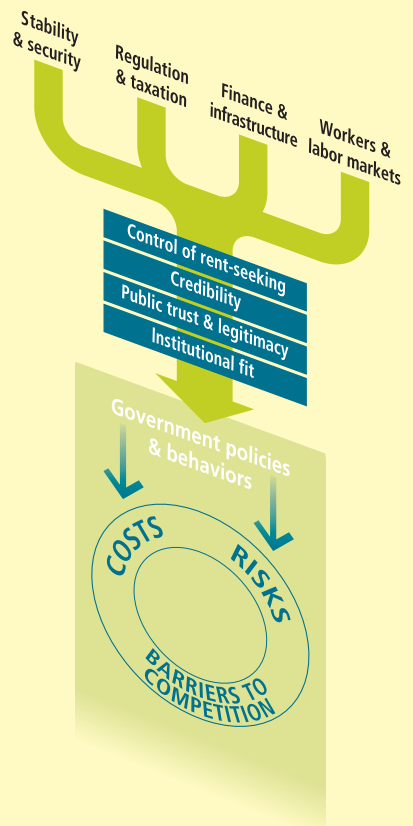
A half-century ago Charles “Engine Charlie” Wilson was famously misquoted as claiming, “What’s good for General Motors is good for the country.”<sup>1</sup> Wilson may have provided grist for a commonly held view of the firm ever since: as an entity that conflates the public interest with its own, and only looks at the public interest—if at all—through a narrow, self-serving lens. It may be a caricature, but it also highlights the fundamental tension that governments must confront in creating a better investment climate.

Firms are the generators of wealth and jobs in society, and an investment climate that is hostile to firms cannot expect to promote economic growth or reduce poverty.

**BOX 2.1 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 (chapter 1). 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 broader governance features. The latter include control of rent-seeking, credibility, public trust and legitimacy, and institutional fit.

Formal policies and broader governance features interact 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. Weak credibility can undermine the impact of any formal 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 also have poor or even perverse results. Tackling these four broader sources of policy failure is fundamental to efforts to create a better investment climate.



So creating a favorable investment climate must begin with understanding the perspectives and preferences of firms. Firms exist to make profits for their owners—something they’ve done for thousands of years (box 2.2)—and their policy preferences are guided by that objective. In contrast, government policies need to balance the preferences of firms with broader social objectives. Governments thus have to understand where the interests of firms may diverge from those of the wider society, and must deal with the implications of differences in preferences between and within firms.

Stable macroeconomic policy, secure property rights, reliable infrastructure, and efficient financial markets benefit firms and society. But there is potential for great divergence in some areas. Obviously, most firms

### BOX 2.2 *Firms in history*

Since ancient times people have been striving to increase their opportunities by moving from subsistence to exchange and investment. As far back as 3000 BCE, business arrangements in Mesopotamia went beyond simple barter. Sumerian families who traded along the Euphrates and Tigris rivers developed contracts that tried to rationalize property ownership. A thousand years later the Assyrians developed an early version of a venture capital fund.

Early predecessors of companies appeared in Rome by the second Punic War (218–202 BCE). For much of the Middle Ages guilds were the most important form of business organization. In the 16th and 17th centuries governments and merchants combined to create chartered companies to exploit the riches of the New World. While the mid-20th century saw widespread experiments with public enterprise, the sub-

sequent disenchantment led to a strong renaissance of private enterprise. Today the private sector accounts for the bulk of investment and the overwhelming majority of jobs in developing countries.

Private trade and investment are not only ancient—they are extremely hard to suppress. Some private investment continues even in Somalia's war zones, and there is recent acknowledgment of private enterprise even in North Korea. In the meantime private activities are becoming more global: Trade as a share of global GDP rose from 25 percent in 1960 to 57 percent in 2001, and world flows of foreign direct investment reached \$1.4 trillion in 2000.

*Source:* Micklethwait and Wooldridge (2003); IMF (2004); Bates (2001); Bernstein (1996); Yergin and Stanislaw (2002); World Bank (1996b); McMillan (2002); *The Economist* (2003a); Chinoy (1998); World Bank (2004k); and UNCTAD (2003i).

would prefer to pay less in taxes—including taxes required to sustain the public services they benefit from and to fund other social objectives. Many firms would prefer to comply with fewer regulations—including those to safeguard the environment and promote other important social interests. Most firms would also welcome access to subsidized credit—whatever the policy justification or implications for financial sector development. And most firms would welcome monopolies or other restrictions on competition to increase their profits and reduce the

pressure to innovate and perform efficiently—whatever the consequences for consumers and broader society. Similar tensions can arise in most areas of investment climate policy.

This is not to suggest that firms are rogues or bandits. Most individuals would also prefer to pay less in taxes and welcome subsidized loans. Many firms also voluntarily accept obligations well beyond those required by law, whether through a sense of philanthropy, as a form of brand differentiation, to protect their reputation, or to earn the support of their workers and surrounding communities (box 2.3). International economic integration is increasing pressures on firms to build and maintain good reputations, but it is not a new phenomenon: even the infamous United Fruit Company provided its workers in Guatemala with schools and hospitals.<sup>2</sup>

Nor are there always tradeoffs between the preferences of firms and other social goals, even in matters of regulation and taxation. Improving the design and administration of regulatory or tax systems can reduce the burdens on firms, but can also contribute to better regulatory compliance and higher tax revenues. When regulatory regimes have not been reviewed in decades, are only partially enforced, and are used more to extract bribes than to protect broader social interests—all too common in many countries—the opportunities for solutions that benefit both firms and broader society can be huge (chapter 5).

### BOX 2.3 *Firms and social responsibility*

The debate on firms' responsibility to social concerns has a long history. Part of it stems from different conceptions of the objectives of firms. The Anglo-American model focuses primarily on maximizing shareholder value, though corporate philanthropy has long been important. European and Japanese models put more weight on other stakeholders, especially workers. While there has been some convergence between models, there are still debates about the extent to which firms can—or should—worry about matters other than wealth creation.

Social obligations are imposed on firms through taxation and regulation. Some firms voluntarily accept broader obligations. For example, multinational firms operating in developing countries often exceed minimal local reg-

ulatory requirements—one study shows that affiliates of U.S. multinationals pay a wage premium of 40 percent in high-income countries and 100 to 200 percent of the local average wage in low-income countries.

It can be hard to distinguish the motives for these behaviors. At one level it might be perceived to be in the best interests of the firm, taking a broad view of reputation and risk. Firms may do it to protect their interests in a healthy workforce, as with firms in Africa that are providing HIV/AIDS drugs to their workers. Others may consider it part of a brand differentiation strategy, as with dolphin-free tuna, no animal testing for The Body Shop, or socially conscious mutual funds.

Still other firms are responding to concerns about reputation. Nike and Disney have worked

to improve working conditions in their plants in Asia, following criticisms and protests from civil society. More firms are also adopting codes of conduct on matters of corporate social responsibility, often based on international norms promoted by civil society groups or international agencies (chapter 9). For example, about 20 banks worldwide have adopted the Equator Principles, a voluntary set of guidelines for managing social and environmental issues related to financing development projects, based on the policies and guidelines of the World Bank and International Finance Corporation.

*Source:* Graham (2000); *The Economist* (1999, 2002a); and the Equator Principles Web site ([www.equator-principles.com](http://www.equator-principles.com)).

The task of balancing the preferences of firms and broader social interests is complicated by differences in preferences and priorities between and within firms. Firms share common perspectives on many issues, but their interests may diverge on specific policy questions. This is most apparent when considering proposals to reduce barriers to competition. Proposals to lower barriers will typically be resisted by protected firms, but would benefit firms (and others) that rely on products from the protected sector as inputs. For example, it has been estimated that restrictions on steel imports into the United States in 2002 cost

firms relying on steel as an input two-and-a-half times the benefits to local steel producers.<sup>3</sup> Similarly, proposals to develop a bond market may be resisted by banks that prefer less competition in debt markets, but be welcomed by industrial firms.<sup>4</sup> Conflicts can also arise over the structure of taxation, the detailed design of particular regulatory regimes, or the priority given to infrastructure development in different locations. Even when engaged in the same activity in the same location, firms of different types can face different constraints, leading to different policy preferences and priorities (box 2.4).

**BOX 2.4 How do firm differences affect their policy preferences and priorities?**

Investment climate policymaking is complicated by differences in the preferences and priorities of firms. Those differences can be seen along multiple dimensions: the extent to which the firm's activity is labor- or capital-intensive; the extent to which the firm serves local or export markets, or is otherwise exposed to international competition; the firm's specific location within a country; and a range of other factors particular to each industry or firm. Preferences and priorities can also differ along four broader dimensions.

*Foreign and local firms.* Foreign firms still face many regulatory barriers intended to protect local firms, and foreign firms may be more vulnerable to expropriation. Foreign firms tend to be less constrained in their access to financing than local firms, may be able to relocate more easily in response to adverse changes in the investment climate, and may have more

options for dispute resolution. Foreign firms also often place more priority on infrastructure—in part reflecting more sophisticated production methods and a greater propensity to export.

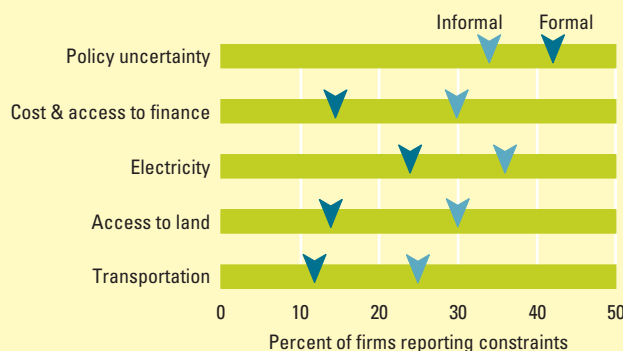
*Large and small firms.* Fixed costs tend to impose a disproportionate burden on smaller firms, as with license or permit fees and even bribes. Evidence from the Investment Climate Surveys indicates that bribe payments as a share of sales are 50 percent larger for small firms. Large firms may make higher payments, but the burden on them may be smaller. When unreliable power supply requires firms to have their own generators, this cost can also be greater for smaller firms. This means that smaller firms stand to benefit more from broadly based investment climate improvements than larger firms. Smaller firms also tend to have greater difficulty getting finance than larger firms and

tend to pay higher interest rates—survey data show that small firms are 50 percent more likely to see this as a major or severe constraint. Larger firms are more likely to have a bank loan, reflecting the advantages of having a track record and holding more assets that can be pledged as collateral. So improving the operation of financial markets will often be a higher priority for small firms.

*Formal and informal firms.* Informal activities account for more than half of economic activity in many developing countries. Although firms in the informal economy operate free of many tax and regulatory requirements, they have less secure property rights and more difficulty getting public services and obtaining financing at reasonable cost (see figure). In Peru the nominal borrowing rate for informal firms was found to be more than four times that of formal firms of similar size. Noncompliance with taxes and regulations can also make them easy targets for bribes or bureaucratic harassment.

*Rural and urban firms.* Remoteness and lower population densities increase the cost of providing infrastructure and other public services in rural areas. Access to finance is also often more of a constraint. Informal firms in rural areas can face even more constraints than their peers in urban areas. For example, in Cambodia informal rural firms reported greater concerns about infrastructure and finance than informal urban firms. They also had greater concerns about corruption, crime, and policy uncertainty.

**Formal and informal firms have different perspectives**



Note: Share of firms reporting issue as a major or severe constraint.  
 Source: World Bank Investment Climate Surveys, WDR Surveys of Micro and Informal Firms.

Source: World Bank Investment Climate Surveys; WDR Surveys of Micro and Informal Firms; Hallward-Driemeier and Stone (2004); Hallward-Driemeier and Stewart (2004); Schneider (2002); and de Soto (2000).

Within firms, owners, managers, and employees share some common interests but conflict on others. Recent scandals involving Enron and Parmalat highlight the potential for conflicts between the interests of management and other shareholders (chapter 6). There are also tensions between owners and workers over wages, benefits, and employment protection. For owners, lower labor costs and greater flexibility in hiring and firing workers have many benefits. Workers, of course, prefer higher wages and more job protection. While regulations that make it harder to fire workers are often seen as favoring workers over employers, the cost of meeting those regulations is often passed on to existing workers (through lower wages) and to the unemployed. Some workers may benefit, but there are often subgroups with different interests (chapter 7).

These differences mean that there is no single vision of an ideal investment climate. Governments need to arbitrate between rival claims. Like other interest groups, firms are not passive in this process and are often prepared to devote resources to obtain favorable policy treatment. Lobbying is an ancient art, and regulated firms have a long history of trying to win favorable treatment from their regulators.<sup>5</sup>

Managing the tension that can arise between firm preferences and broader social interests gives rise to four practical challenges for investment climate improvement:

- Restraining rent-seeking
- Establishing credibility
- Fostering public trust and legitimacy
- Ensuring that policy responses reflect a good institutional fit.

## Restraining rent-seeking

When asked why he robbed banks, Willie Sutton was reported to have replied, “That’s where the money is.”<sup>6</sup> In a similar way, investment climate policymaking can act as a magnet for rent-seeking by firms, officials, and other interests.

Firms, officials, and other groups have incentives to manipulate the design or implementation of investment climate policies to advance their private interests. Corruption and outright predation are the most glaring examples, but rent-seeking can also include more subtle forms that do not involve the breaking of laws or the exchange of cash. Capture and patron-clientelism can also undermine the development of a sound investment climate.

## Corruption and predation

Corruption—the exploitation of public office for private gain—can harm the investment climate in several ways.<sup>7</sup> When it infects the highest levels of government, it can distort policymaking on a grand scale and undermine the credibility of government. Even when played out through officials at lower echelons of government, corruption can be a tax on entrepreneurial activity, divert resources from the public coffers, and create a constituency for erecting or maintaining unnecessary red tape. The Investment Climate Surveys show that the majority of firms in developing countries expect to pay bribes. They also show how corruption can vary by firm size and by region (table 2.1), and how the main locus of bribe-taking can vary between countries (figure 2.1).

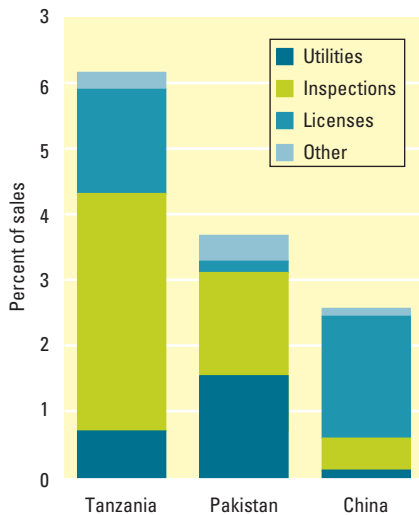
Corruption manifests itself as a public sector phenomenon. Typically, firms, consumers, or other groups make payments to politicians or public officials in return for favorable decisions—whether a high-level policy decision or a more mundane matter, such as getting a connection to utilities, clearing goods through customs, or registering a business. Unlike most production, corrup-

**Table 2.1** Bribes vary by firm size, sector, and region

	Firms reporting bribes %	Bribes as share of sales %
Formal sector firms	55.5	3.9
Micro (<10 employees)	49.9	4.4
Small (10–19)	56.7	4.8
Medium (20–49)	57.6	4.0
Large (50–249)	58.5	3.4
Very large (250+)	55.7	3.0
Informal sector firms	27.4	8.6
Small (<10 employees)	25.5	8.5
Large (10+)	49.1	9.3
Central and Eastern Europe	43.1	2.8
Sub-Saharan Africa	50.0	5.2
Commonwealth of Independent States	51.0	3.4
East Asia and Pacific	59.1	4.2
Latin America and the Caribbean	68.8	7.0
South Asia	74.2	3.2

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

**Figure 2.1** The main locus of bribe-taking can vary



Note: Countries selected to illustrate variations. "Other" includes construction permits and government contracts.  
Source: World Bank Investment Climate Surveys.

tion is subject to increasing returns: an increase in rent-seeking activity may make corruption more attractive, not less.<sup>8</sup> So high levels of corruption can be sustainable, and divert energy from more productive activity. No country can claim to be immune from the problem. In the extreme, a "predatory" state consumes the surpluses of the economy, as government offices come to be treated as income-generating property (box 2.5).

Rent-seeking behavior can be especially pronounced in countries that have a high-level of dependence on exports of minerals, oil, or other natural resources. While many of today's successful economies—including Australia, Chile, and Norway—prospered in part through natural resource endowments, dependence on natural resources has been more of a curse than a blessing for many developing countries (box 2.6).

Corruption can be traced to a combination of three basic factors: monopoly power, discretionary authority, and inadequate accountability for the exercise of that authority. As Klitgaard put it

[C]orruption is a crime of calculation, not passion. True, there are saints who resist all temptations, and honest officials who resist most. But when the size of the bribe is large, the chance of being caught small, and the penalty if caught meager, many officials will succumb.<sup>9</sup>

**BOX 2.5** *The predation of Gécamines in Mobutu's Zaïre*

At independence the Democratic Republic of Congo's main asset was nothing less than a horn of plenty—a 300-kilometer-long, 70-kilometer-wide mining complex (Union Minière du Haut Katanga), renamed Gécamines after its nationalization in 1966. The Belgians had left behind a supporting network of refineries, hydroelectric installations, employee housing, schools, and hospitals. The company provided 70 percent of the country's export receipts.

The war in Katanga (formerly Shaba) province contributed to an initial collapse of output, but by the late 1960s Gécamines had recovered. So important was the mine to the nation's economy that then-President Mobutu had a power line connected from the mine to electricity generators 1,800 kilometers to the north in Kinshasa as a way of forever tying the mines to the capital. The Inga-Shaba line bypassed thousands of electricity-starved villages, as well as local dams that might have supplied power to the mine more easily.

In the early 1970s the complex was producing between 400,000 and 700,000 metric tons of copper and between 10,000 and 18,000 metric tons of cobalt a year, securing annual revenues between \$700 million and \$900 million. For Mobutu, Gécamines was a

source of ready cash. Supported by a coterie of foreign bankers, he used diverse schemes to strip the company, ranging from diverting foreign exchange receipts to presidential accounts, to forward selling of minerals with the proceeds going to the presidency. Not all the proceeds went solely to the president's personal account. Gécamines also guaranteed state debts and covered personal expenses of top executives and their families. According to one outside audit, officials were stealing around \$240 million a year, often listed in corporate reports under the category *redressement exceptionnel déficitaire*—"exceptional deficit recovery."

These practices starved the company of any earnings, led to the deterioration of its fixed assets, and when copper prices collapsed in 1974, sped the company's demise. By 1990 Zaïrean copper cost twice as much to produce as its foreign equivalent. In 1994 production dropped to 30,600 metric tons of copper and 3,000 metric tons of cobalt a year, with zero revenues. According to some estimates, in order to restore annual production to 300,000 metric tons a new investor would need to inject around \$3 billion, including \$2 billion just to absorb the company's debts.

Source: Wrong (2001).

**BOX 2.6** *Natural resource endowments: Blessing or curse?*

In principle an abundance of natural resources such as minerals or oil should be a valuable asset in creating a modern, prosperous economy. Certainly many of today's successful economies have been able to leverage these assets to their advantage. But in many developing countries substantial endowments of natural resources often seem more like a curse than a blessing.

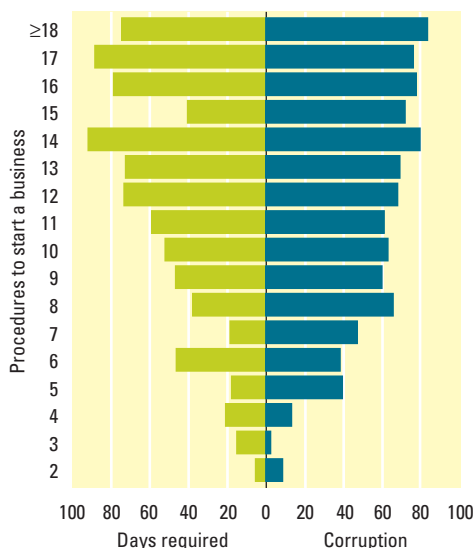
A wealth of natural resources can have several adverse consequences. When the discovery of natural resources attracts significant capital inflows, the value of the national currency can appreciate, making non-resource exports less competitive—the so-called "Dutch disease." Heavy reliance on resource exports can also expose an economy to the vicissitudes of international commodity price movements. But the impact on governance can be far more harmful. The potential to exploit natural resources can prompt more intense rent-seeking behavior by politicians and others, diverting attention from more productive activities. In the extreme, competition over access to the rents from natural resources can lead to, or perpetuate, civil war. When governments

rely heavily on revenues from such resources there are also weak incentives to develop a broad tax base or consistent and non-arbitrary tax policies. Far from being a benefit to the state, relief from needing effective local tax laws and administration can lead to unaccountable, inefficient, and uninformed government.

How have some countries been able to capitalize on resource endowments without succumbing to the resource curse? Historical and contemporary evidence suggests several possibilities. It helps if natural resources do not dominate the local economy, and if resource extraction is not dominated by monopolies. It also helps if governments are held accountable for their behavior through political competition and an informed population. Efforts to create a better investment climate for firms outside the resource sector can also play an important role by helping to diversify the economy and so reduce dependence on natural resources.

Source: Stijns (2000); Tornell and Lane (1999); Levi (1988); Sachs and Warner (2001); Leite and Weidmann (1999); Ross (2001); Chaudhry (1997); and Moore (1998).

**Figure 2.2 More business start-up procedures increase both delays and corruption**



Note: 133 countries are grouped by average number of procedures needed to start a business in each country. Number of days required to start a business and level of corruption are then averaged according to the number of procedures needed to start a business across those groups of countries. Corruption is a weighted average of multiple indicators of corruption, taken from Kaufmann, Kraay, and Mastruzzi (2003), and normalized by sample maximum and minimum.  
Source: World Bank (2004b) and Kaufmann, Kraay, and Mastruzzi (2003).

Strategies for tackling corruption focus on the same three points. The scope of monopoly power can be reduced in several ways. Competition can be facilitated wherever possible, and government interventions that lack a compelling policy justification can be eliminated. Firm surveys

confirm that bribe payments are higher when dealings with officials cannot be avoided.<sup>10</sup> Evidence suggests that countries with more interventionist approaches to business regulation also tend to have more corruption (figure 2.2).

Where intervention is justified, the scope for bureaucratic discretion can be limited by reducing unnecessary ambiguity or vagueness in government policies and regulations, by promptly publishing implementing regulations, and by promoting adherence to precedent by publishing administrative decisions and rulings (chapter 5).

The third and complementary strategy is to enhance accountability for the exercise of public authority. Political competition can play an important role in holding governments responsible for their results and for their behaviors. But experience shows that more is required. Enhancing the transparency of government-firm transactions is one of the most promising strategies, and has become an increasing focus of efforts to address corruption worldwide. A free press also plays a critical role in monitoring governments and informing citizens, helping to keep potential abuses in check.<sup>11</sup> A growing number of countries are also creating specialist bodies to investigate and prosecute corruption and lead broader prevention strategies (box 2.7).

Developing clear standards of public conduct and conflict-of-interest laws for the civil service can constrain discretion and influence social norms within an agency. Providing protections to whistleblowers can reinforce those norms and complement other monitoring mechanisms.<sup>12</sup> Low salaries in the civil service are often believed to contribute to corruption, but the relationship can be complex. Certainly civil service salaries are less likely to influence large-scale corruption at higher echelons of government, which can be particularly destructive to the investment climate and to society generally. And while studies suggest that increasing salaries for lower-level officials might reduce the incidence of smaller-scale corruption, this will not always be a feasible or cost-effective strategy.<sup>13</sup> So, while improving civil service wages and conditions can be an important part of improv-

### BOX 2.7 Combating corruption in Botswana and Lithuania

In 1974 Hong Kong established a three-pronged anticorruption strategy focused on investigation, prevention, and education, implemented by the autonomous Commission against Corruption. Drawing inspiration from its success, similar initiatives have been adopted in countries as diverse as Botswana and Lithuania.

**Botswana.** Following a series of high-level corruption scandals, Botswana created a Directorate of Corruption and Economic Crime in 1994 with powers to investigate and prosecute suspects, prevent corruption, and educate the public. The directorate is an autonomous agency under the Office of the President. In its first two years of operation, it launched 828 investigations, bringing 141

persons before the court and recovering approximately \$1 million in fines, forfeitures, seizures, and taxes. It has sustained an active publicity campaign through seminars, poster campaigns, displays at trade exhibitions, and cartoon strips, as part of the moral education of the young.

**Lithuania.** In 1997 Lithuania established a Special Investigation Service that reports to the president and the parliament. The number of prosecutions for bribe-taking increased sevenfold between 1997 and 2002 (from 10 a year to 73), and the cases of prosecution for abuse of office, from 2 in 1997 to 19 in 2002.

Source: Open Society Institute (2002); Fombad (1999); and Doig and Riley (1998).

ing the quality and professionalism of the civil service, merely increasing salaries does not substitute for broader efforts to limit monopoly power, curb discretion, and enhance accountability.

### *Capture and patron-clientelism*

Investment climate policies can be distorted by rent-seeking in forms that do not involve breaking laws or direct exchanges of cash. Industrial-financial elites, workers, consumers, and other groups influence policy-making to very different degrees in different settings. When one group has disproportionate influence, the design or implementation of policies can be skewed in their favor at the expense of society as a whole in ways that establish long-lasting privileges for that group. There are two related phenomena: capture and patron-clientelism.

**Capture.** Firms and other groups can skew policies in their favor by formal or informal lobbying, controlling access to information, or a variety of other strategies. It has long been recognized that regulatory agencies are vulnerable to becoming “captured” by the industries they are charged with regulating, and so promote the interests of the industry rather than those of the broader public.<sup>14</sup> The concept of “state capture” has more recently been used to describe how firms and other groups can shape the formation of laws and policies (as opposed to their implementation) through informal and opaque channels of influence—by controlling the policy agenda or by changing the basic nature of representation and constitutional design.<sup>15</sup> Firms or other groups most directly affected by particular laws or policies will have stronger incentives to invest in influencing policy than consumers and other groups, and usually also face fewer logistical difficulties in framing a coordinated view. These groups often also have superior access to information and technical expertise than legislators, regulators, or others affected by the policy decision.

**Patron-clientelism.** Under conditions of capture, it is usually the private interest group that derives benefits. But politicians and officials also have incentives to exploit

relationships with private interests. In societies with democratic forms of government, elected representatives make policy in the interests of their constituents in exchange for political support. This is a necessary part of ensuring the accountability and responsiveness of policymakers to their citizens. But representative government can devolve into patron-clientelism when policymakers distribute policy privileges to particular groups on the basis of ethnic or cultural solidarity or political support, often at the expense of society as a whole. The problems can be even worse in dictatorships, where leaders still need to curry favor with particular groups, but are subject to fewer constraints.<sup>16</sup>

Investment climate policymaking presents myriad opportunities for granting benefits to, and redistributing resources toward, favored groups. Policies that would benefit the investment climate may not be implemented because they cannot reward loyalty and strengthen ties between patrons and clients.<sup>17</sup> The result: property rights, tax, and regulatory regimes are designed with specific constituencies in mind. Governments suppress competition by conferring monopolies, devising market restrictions, or tolerating cartels. Tax systems become riddled with special exemptions—or are enforced selectively. Financial markets are underdeveloped because governments help middlemen maintain their stranglehold on the allocation of funds. Public investment in infrastructure and related tariff policies are designed to reward favored groups.<sup>18</sup>

Patron-clientelism can be exacerbated in polarized and fragmented societies, where politicians use their authority to benefit their particular constituencies. Governments with low credibility in the eyes of the public as a whole may also resort more to clientelistic approaches to buy support from particular groups.<sup>19</sup> Unequal access to information can have an even more pervasive impact on clientelism. Citizens may want leaders who will implement policies that benefit society as a whole rather than favor particular groups, but they cannot always tell the difference—particularly when governments use less transparent forms of intervention (box 2.8). Uninformed voters are more likely to



### BOX 2.8 *The form of intervention: How many cheers for transparency?*

Governments wishing to confer benefits on a particular group can choose between two main strategies. They can make an explicit budgetary transfer, or they can create a market restriction or provide other forms of less transparent support.

From an economic standpoint, the first approach is more efficient. The costs are borne by taxpayers in general. And when the tax system is reasonably efficient, those costs are usually of the same order of magnitude as the benefit. Market restrictions, by contrast, impose the costs on a subcategory of society (typically con-

sumers), and those costs usually far exceed the benefits received. For example, restrictions on the import of steel in the United States in 2002 were estimated to deliver benefits to the protected industry of \$240 million, but impose costs on U.S. steel-using industries of nearly \$600 million. Market restrictions also create additional costs for society by dulling the incentives of the protected group to innovate and improve productivity.

Why do governments so frequently choose the less efficient option? One possible explanation is that they lack the budget resources to

make direct transfers. This is not always the case, however, and an explicit tax rebate could often achieve similar results. A more common explanation is that the less efficient approach is more appealing politically. The transfer is not transparent. It is usually not exposed to the same level of scrutiny as a budgeted item. And consumers or others are often not in a position to evaluate the magnitude of the costs being imposed on them.

Source: Tullock (1983); Acemoglu, Johnson, and Robinson (2001); Hufbauer and Goodrich (2003b).

support or oppose policies based on crude, visible criteria—for example, whether the economy seems to be prospering or whether new highways are being built.<sup>20</sup> In many countries—rich and poor—public invest-

ment projects and targeted tax breaks tend to proliferate as elections approach.<sup>21</sup>

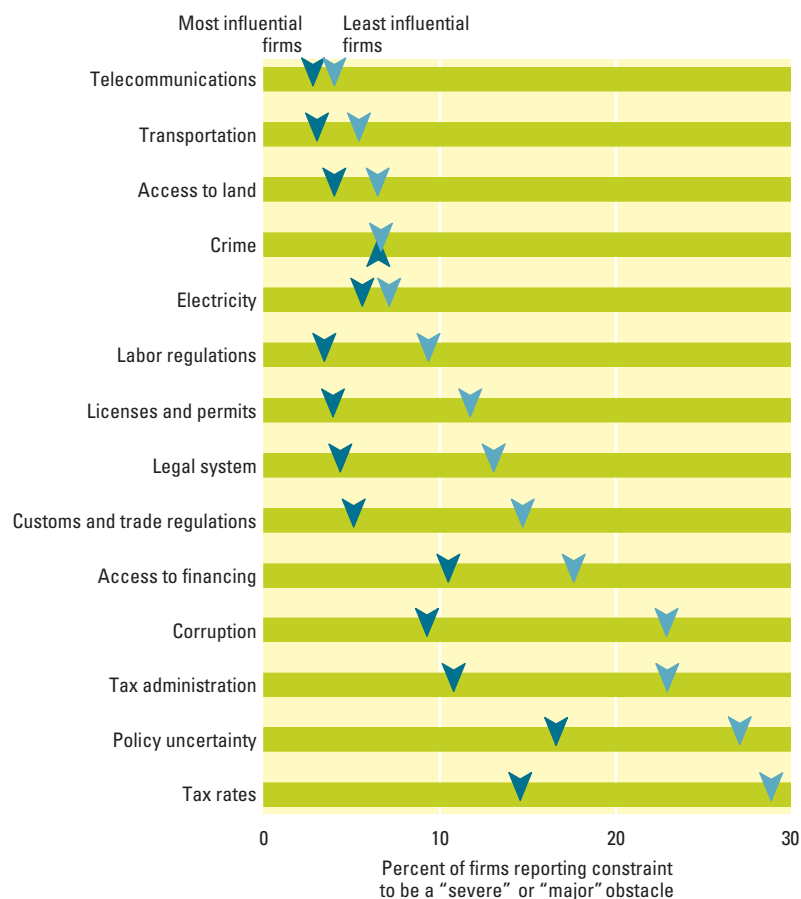
There is some evidence to suggest that the more widespread the direct personal connections between owners of firms and politicians, the poorer the quality of a country's investment climate.<sup>22</sup> These connections can yield substantial benefits to firms and politicians alike, creating incentives for both parties to invest in such relationships. It has been estimated that as much as a quarter of the share value of Indonesian firms before 1998 could be attributed to dependence on the Suharto family.<sup>23</sup>

The Bank's surveys confirm that firms that are part of the favored circle tend to face a more attractive policy environment than other firms (figure 2.3). The evidence also suggests that more influential firms are likely to innovate less (figure 2.4).<sup>24</sup> One interpretation is that a more challenging environment is more conducive to innovation. More likely, perhaps, the favored firms are more concerned with maintaining their influence and enjoying the resulting benefits than focusing on improving their productivity.

Every society faces the challenge of creating governance arrangements that can accommodate a spectrum of interests while preventing the formation of undue or illicit influence by any particular group to the detriment of others. Three complementary strategies can help:

- *Enhancing the transparency of government-firm relations.* Regulatory arrangements can be designed and administered in ways that facilitate public scrutiny,

**Figure 2.3 More influential firms face fewer constraints**



Note: Percentages based on simulations controlling for country, firm size, and sector. "Influence" is measured as the difference, as perceived by firms, between their own ability to influence national policies and legislation and the ability of other domestic firms to do so. Figure shows responses for those firms regarding themselves as most and least influential. Source: Desai (2004), drawing on World Bank Investment Climate Surveys.

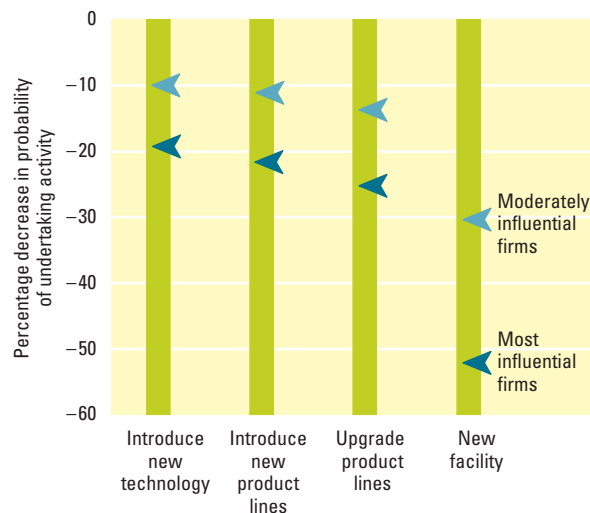
including through use of regulatory impact assessments (chapter 3). The disclosure of budgetary or quasi-budgetary support provided to firms or industries can be mandated. Government procurement practices can be made open and competitive. “Sunshine laws” can require certain government decisions to be preceded by opportunities for public comment and for public access to certain records. No less important, the disclosure of funding for political parties can be mandated.<sup>25</sup>

- *Broadening policy dialogues.* Investment climate policymaking affects a broad range of interests—not just those of large or influential firms. Creating an investment climate that benefits everyone requires processes to ensure this fuller set of interests is heard, including representatives of consumers and smaller firms. Business associations can sometimes give smaller firms more of a voice in policymaking (box 2.9). Many governments are also establishing dedicated consultative mechanisms to broaden the dialogue on investment climate issues (chapter 3).
- *Strengthening accountability mechanisms.* Strong and competitive legislatures can permit disenfranchised groups to challenge the authority and privilege of incumbents, and make it more difficult for executive branch officials to deliver clientelistic policies (figure 2.5).<sup>26</sup> Expanding legislative authority over budgetary matters and strengthening oversight of regulators reduces the preferentialism in taxation and the prevalence of regulatory capture.<sup>27</sup> A free and independent media can make the public aware of the costs of clientelistic practices and reinforce accountability through the ballot box.

### Establishing credibility

Firms do not make decisions based on the formal content of laws, regulations, or policy statements alone. Because investment decisions are forward looking, firms need to assess the likelihood of those policies actually being implemented and sustained over

**Figure 2.4 More influential firms innovate less**



*Note:* Percentage decrease is relative to firms’ regarding themselves as least influential. The findings are based on simulations controlling for country, firm size, and sector. “Influence” is measured as the difference, as perceived by firms, between their own ability to influence national policies and legislation and the ability of other domestic firms to do so.  
*Source:* Desai (2004), drawing on World Bank Investment Climate Surveys.

the life of their proposed investment. Addressing firms’ concerns about uncertainty, and building policy credibility, are fundamental to creating a better investment climate.

### The central role of uncertainty

Uncertainty plays a central role in investment decisions. Because those decisions are forward looking, with the bulk of costs

#### BOX 2.9 Business associations and the investment climate

Business associations can lower the costs of information and help firms seek opportunities and make transactions in new markets. They can be economywide, or “peak” associations, such as confederations of industry, manufacturers’ associations, and entrepreneurs’ associations. They can also be sectoral lobbies.

In some cases business associations consolidate the influence of already powerful groups. The Thai Bankers’ Association, for example, represents 13 banks, four of which control more than two-thirds of Thailand’s banking assets. But business associations can also help to broaden the dialogue on investment climate policy issues, giving voice to firms that might not otherwise be heard. In India, for example, the Self-Employed Women’s

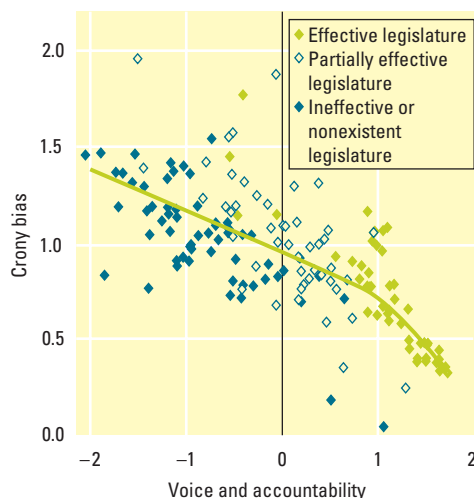
Association represents the policy concerns of more than 300,000 members working in the informal economy.

Experience suggests that business associations are more likely to contribute to a sound investment climate when:

- They are free of state influence and not reliant on governments for resources, capital, or personnel.
- They are unaffected by endemic sectarian divisions.
- They have a broad constituency.
- They exercise their influence through formal, transparent channels.

*Source:* Maxfield and Schneider (1997), and Recanatini and Ryterman (2001).

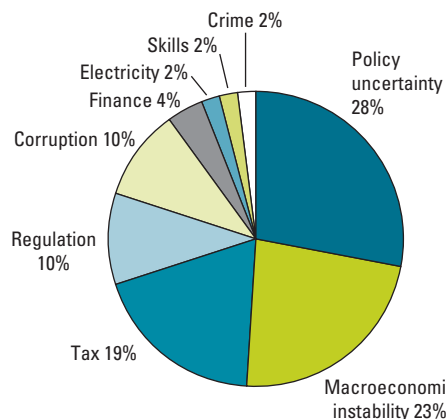
**Figure 2.5 Cronyism is reduced by greater accountability—and legislatures play an especially important role**



Notes: “Crony bias” (vertical axis) is the difference between perceived influence of firms with political ties and influence of business associations, based on WEF Executive Opinion Surveys. “Voice and accountability” (horizontal axis) reflects various mechanisms to hold governments accountable, based on Kaufmann, Kraay, and Mastruzzi (2003). Measures of legislative effectiveness are based on Banks (2001). Crony bias based on predicted values. Source: Kaufmann (2003); Banks (2001).

borne upfront and the potential benefits spread over time, there is always uncertainty about what the benefits will actually be—because of uncertainties about the way consumers or competitors will respond, about the broader economic outlook, and about how government policies may evolve. The Investment Climate Surveys show that firms in developing countries rate policy

**Figure 2.6 Policy uncertainty dominates 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.

uncertainty as their dominant concern among investment climate constraints (figure 2.6).

Concerns about policy uncertainty can stem from vagueness or ambiguity in current policies and laws. But no matter how well-defined current policies may be on paper, there may still be concerns about how they will be implemented in practice or evolve over time. The latter concerns reflect on the credibility of governments and their policies, including the ability of governments to deliver what is promised.

The impact of policy uncertainty on investment decisions varies along several dimensions. The nature of the investment obviously matters. While all investments involve up-front costs, some can be reversed more easily than others. The less reversible an investment, and the greater the firm’s vulnerability to uncertain future changes, the greater the value in waiting to see if the uncertainty is resolved before investing.<sup>28</sup> For example, firms in Ghana and Uganda were more likely to increase their hurdle rate of return as uncertainty increased, and uncertainty had a more negative effect on firms with less reversible investments.<sup>29</sup> Uncertainty and irreversible investments imply that reductions in uncertainty, rather than changes in interest rates, may be more effective in influencing investment (box 2.10).

Beyond issues of reversibility, some investments are more sensitive to policy changes than others. Investments in heavily

### BOX 2.10 Reducing policy uncertainty to stimulate investment

Lowering interest rates is often proposed as the best way to spur investment. Interest rates affect investment decisions because they are a measure of the opportunity cost of the resources dedicated to the project—that is, the return these resources could otherwise have earned. They affect the cost of borrowing by firms and the returns that equity investors look for. As interest rates fall, investment should rise because the expected benefits now need to clear a lower value.

But many empirical studies have failed to find a significant relationship between interest rates and investment rates. Real options theory helps explain why. With uncertainty and irreversible costs, the importance of interest rates in investment

diminishes. True, lower interest rates give greater weight to the future and thus the expected stream of benefits, but they also increase the value of waiting. The overall effect is thus weak or even ambiguous. Research finds that reducing the sources of uncertainty about future profits—or about the likely future path of interest rates—has more important effects on investment than does the current level of interest rates. Reducing unnecessary uncertainty, including that about government policy, is thus likely to be the better approach to stimulating investment.

Source: Blanchard (1986); Caballero (1999); and Dixit and Pindyck (1994).

regulated sectors such as infrastructure can be especially sensitive to policy uncertainty because the profitability of the venture is often determined directly by government regulation. For example, Hungary’s initial attempt to involve private investment in its energy sector—before defining the policy and regulatory framework—attracted few bids and the tender was aborted in 1993. Two years later, with a clearer regulatory framework in place, it attracted bids of nearly \$2 billion.<sup>30</sup>

Firms also differ in their ability to cope with risks. Larger firms will typically have more opportunities to diversify risk than smaller firms, and multinational firms can diversify country-specific risks across several countries. While firms in the informal economy are usually less constrained by regulation than their counterparts in the formal economy—and so may be less concerned about the risk of policy changes—they usually also have fewer opportunities to diversify or manage such risks. Reflecting this, the Bank’s surveys show that policy uncertainty is still a significant concern to firms in the informal economy (figure 2.7).

Access to information influences how firms respond to uncertainty. Constrained access to information can lead firms to herd—basing decisions on how other firms are seen to be responding. Enhancing the transparency of government policies has also been found to increase the level of international investment.<sup>31</sup>

Uncertainty, credibility, and information go a long way toward explaining some of the apparent mysteries of firm behavior—what Keynes referred to as “animal spirits.”<sup>32</sup> But firm responses can also be conditioned by other factors. Ultimately, the way firms respond to uncertainty is shaped by their confidence in the future, and some firms will be more optimistic than others. Attitudes toward risk can also vary depending on the entrepreneurial characteristics of individuals and the firms they own and manage—and possibly across societies as well (box 2.11). Recent work in behavioral economics and psychology provides some additional insights, suggesting that people are not as rational as traditional theories assumed. For example, people tend to be loss-averse—will-

**Figure 2.7 Policy uncertainty is a concern for informal firms as well**



Note: Based on responses in 11 countries where surveys of informal firms were undertaken. Source: World Bank Investment Climate Survey and WDR Surveys of Micro and Informal Firms.

ing to accept more risk to avoid a loss than to realize a gain of the same size. There can also be an endowment effect—placing greater value on something already owned just because it is owned. Anchoring can also interfere with judgment—people place disproportionate weight on recent experiences, particularly their own, rather than on longer historical trends. Conservatism can have the same effect—slowing the response to changes in trends.<sup>33</sup> These phenomena influence the

**BOX 2.11 Entrepreneurship and uncertainty**

Entrepreneurship—or attitudes toward innovation, pro-activity, and risk-taking—influences the way individuals and firms respond to uncertainty, including policy uncertainty, when assessing investment opportunities.

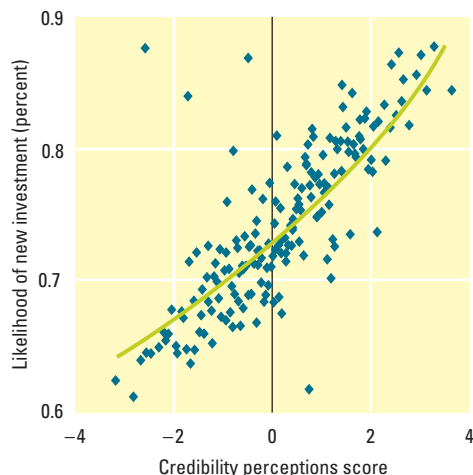
Despite difficulties in measurement, it is generally accepted that the personal characteristics that make up entrepreneurship are not distributed equally in any given society—some individuals and firms are less daunted by risk and uncertainty than others. There may also be differences between societies. Studies exploring this question often focus on the incidence of new business registration or self-employment, which may not be reliable indicators when applied to developing countries with significant informal economies and fewer alternatives to self-employment. But several

authors have argued that some countries in Africa may exhibit relatively low levels of entrepreneurship.

If this is true, and has adverse implications for investment and growth, the question is whether such attributes are deeply ingrained or are responsive to government policies that shape the investment climate. The evidence supports the second view, indicating that the incentives provided by government policies and behaviors can have a big impact on observed levels of entrepreneurship in any society.

Source: Covin and Slevin (1989); Etounga-Manguelle (2000); Hart (2003); Hofstede (1984); Iyigun and Rodrik (2003); Lee and Peterson (2000); Lumpkin and Dess (1996); McGrath, MacMillan, and Scheinberg (1992); Miller (1983); Miller and Friesen (1982); Porter (2000); Reynolds and others (2004); and Wild (1997).

**Figure 2.8 Firms are more likely to invest when the policies are perceived to be credible**



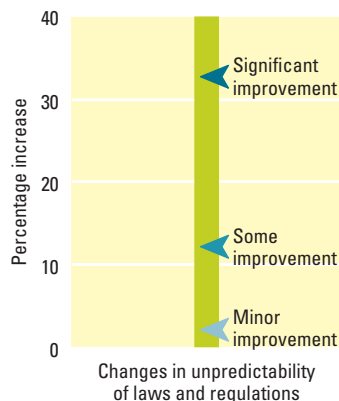
*Note:* The figure plots firms' predicted probabilities that they have increased investment in the past year against a measure of credibility. Credibility perceptions score is derived from principal components analysis of firm responses to questions of policy predictability, consistency, and enforcement, with higher scores meaning greater credibility. Data points represent average probabilities for each credibility score. Probability of new investment is based on predicted probabilities generated from a logistic regression controlling for firm size, industry, and region.  
*Source:* World Bank: World Business Environment Survey database.

way firms respond to government policies, but do not undermine the fundamental roles of uncertainty, credibility, and information.

Uncertainty, including that stemming from credibility concerns, can impact investment decisions in various ways. Firms may demand higher rates of return to compensate for the extra risk involved—resulting in less investment at higher prices. They may shorten their planning horizon, thus influencing the level and form of investment, the choice of technology, and the willingness to train workers. They may pursue various risk management strategies, from buying insurance to cultivating personal relations with political leaders. They may use an initial limited investment to elicit more information—about the opportunity, or about the reliability of government policies—before committing to a larger or less reversible investment.<sup>34</sup> Or firms may simply refuse to invest at all.

Firm-level surveys confirm that firms are more likely to invest when policies are regarded as credible (figure 2.8). The surveys also show that improving policy predictability can increase the probability of making new investments by more than 30

**Figure 2.9 Improving policy predictability can increase the probability 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.

percent (figure 2.9). The impact of uncertainty can increase more than proportionately, so large sources of uncertainty can be especially damaging.<sup>35</sup>

### *The quest for policy credibility*

Improving the clarity of existing policies and regulations, and managing changes to those policies and regulations in ways that minimize unnecessary uncertainty for firms, are relatively straightforward (chapter 5). Addressing concerns about how policies will be implemented or will evolve over time can have an even bigger impact (box 2.12)—but is also more challenging. The credibility of investment climate policies can be undermined by many factors. A recent track record of political or macroeconomic instability does not help—creating a special burden for governments seeking to rehabilitate the reputations of their countries.<sup>36</sup> The credibility of a government's policies may also be in doubt if there are questions about its willingness or ability to enforce its stated policies, or to sustain them over time.

To some degree the ability of government to achieve greater policy credibility is bounded by the broader polity and social consensus. Normal, constitutionally based turnover in government does not preclude a government from making credible commitments. Indeed, even frequent changes in government may not undermine policy credibility when there is a broad consensus for a particular policy direction. For example, Estonia and Latvia have each aggressively pursued investment climate improvements since independence in the early 1990s, notwithstanding having each had 12 changes in governments during that time. Replacing policymakers can even improve credibility when the new leaders are considered more likely to honor policy commitments. But instability manifested through frequent shifts in policy direction can demolish credibility.

All governments face the challenge of committing today to policy actions in the future, particularly when it is understood that circumstances and incentives can change. Some policy flexibility is essential to adjust to changing circumstances. But unrestrained governments too often succumb to the appeal of short-run political goals that

**BOX 2.12** *The power of credibility*

Policy credibility plays a powerful role in the investment climate, influencing the level of firms' response to any given set of policies.

One can think of the main dimensions of the investment climate influenced by government policies and behaviors—costs, risks, and barriers to competition—as ranging from zero to very high levels. At zero, costs and risks are minimal and firms face no barriers to competi-

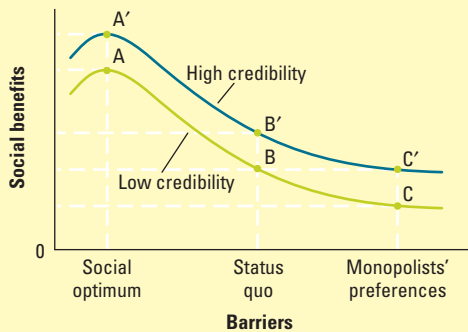
tion. At extremely high levels the distortions are such that there are no incentives for private investment.

This view of an "optimal" investment climate is captured in the figure. It shows social benefits of the investment climate—higher productivity of investment or growth—as a function of barriers to competition (and could be similarly applied to costs and risks). The socially optimal position is not zero—some barriers might be justified as part of a regulatory strategy for dealing with pollution or other social concerns, just as some costs may be justified through taxation, or some risks (and uncertainty) can be justified to preserve a degree of policy flexibility. In the figure the status quo is to the right of the optimum, indicating the presence of undesirable barriers to competition.

Current policies may fall short of their optimum for several reasons. Rent-seeking by firms looking for more

restrictive barriers (point C in the figure) can pull policies in their preferred direction. Public concerns about the role of firms or markets may lead to lack of public support for more desirable policy approaches. Or the chosen policy design may represent a poor fit with local conditions for other reasons. Restraining rent-seeking, building consensus, and improving institutional fit can lead to policy outcomes that increase social welfare (a move from point B to point A in the figure).

Improving the content of policies can make a big difference. But enhancing the credibility of those policies provides additional benefits by increasing the level of firms' investment responses to any given set of policies. In the figure, enhancing credibility shifts the frontier of the curve outward (the status quo for a more credible government would be at B' rather than B). Improving both the content of investment climate policies and the credibility of those policies (the shift from B to A') thus results in the largest gain in social welfare.



leave society as a whole worse off. Examples abound, from printing money to finance profligate public spending to reneging on specific commitments to investors and creditors. To address these concerns, governments need mechanisms to commit credibly to sound long-term policies.<sup>37</sup> Just as the triumph of the English Parliament over the Crown in 1689, for example, limited the ability of the monarchy to confiscate wealth, restraining the arbitrary behavior of government is considered a watershed in the creation of modern capital markets in developed and developing economies.<sup>38</sup>

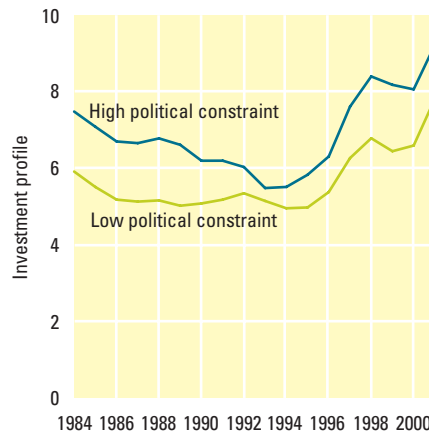
Governments can draw on a variety of mechanisms and strategies to enhance their credibility. The main formal mechanisms involve constitutions, institutions, contracts, and international agreements:

- *Establishing effective veto points on decisionmaking and providing other guarantees through national constitutions.* This can include formal checks and balances among different branches of government, autonomous subnational governments, and constitutional prohibitions on the expropriation of property, coupled with independent judiciaries able to enforce those rules.<sup>39</sup> Political con-

straints are associated with lower perceptions of investment risk (figure 2.10).

- *Entrusting discretion on sensitive subjects to more autonomous agencies.* Examples include independent central banks and specialist regulatory agencies for infrastructure—areas where the temptation to renege on commitments is particularly acute (chapter 6).<sup>40</sup>

**Figure 2.10** The power of restraint: governments with less discretion present lower investment risk



Note: The Henisz index of political constants measures restrictions on policymakers' ability to make discretionary policy changes. The ICRG investment profile is an indicator of risk to investment. Source: Henisz (2000) and International Country Risk Guide.

- *Providing specific contractual commitments on particularly sensitive matters.* While clearly not feasible for all firms or topics, this is a common strategy for major natural resource and infrastructure projects, and increasingly common on matters of taxation for a broader range of activities (chapter 5). The credibility of contractual commitments can be further enhanced by making them subject to international arbitration (chapter 4).
- *Entering international agreements that commit governments to sound policies.* International agreements cover a growing range of investment climate policy areas. They can enhance credibility by increasing the costs of renegeing on relevant policy commitments, whether through reputation effects or by the threat of more tangible sanctions (chapter 9).

Formal mechanisms of these kinds are not the whole story. For example, privatization programs in sensitive areas often allocate at least some of the shares in the privatized enterprise to a wide range of local people to raise the political costs of a policy reversal. In the transition economies, this

was one rationale for mass privatization programs. In Bolivia and Chile similar effects were obtained by including pension funds among the investors in privatized utilities. Improving the ability of firms and consumers to monitor and evaluate policy actions can also enhance credibility,<sup>41</sup> and so can create structures to sustain an ongoing process of reforms, including effective consultation and policy review mechanisms (chapter 3).

Establishing credibility can be particularly challenging for governments building on a legacy of political and economic instability. But Uganda's experience in the 1990s shows how persistence can pay off (box 2.13).

Firms and governments can also come to other arrangements that may allow investment to proceed but that involve longer-term costs for society. For example, in the aftermath of the Mexican revolution of 1910–20 one might have expected private investment to collapse as revolutions, civil wars, and coups took their toll. Yet investment was not disrupted. One explanation is that revolution-era Mexican governments offered credible protection to existing investors by incorporating them into ruling coalitions.<sup>42</sup> The phenomenon of “crony capitalism” in Indonesia and other countries in more recent history can be explained through the same lens: forging close ties between selected firms and politicians allowed investment to proceed in an environment with few formal checks on government.<sup>43</sup> But these arrangements can ossify to the detriment of the broader investment climate—and to the detriment of more innovative entrepreneurs, smaller firms, and consumers. This underscores the importance of drawing on commitment mechanisms that embrace broader segments of society—not merely elites or the largest firms, but smaller firms and other groups as well.

### Fostering public trust and legitimacy

Governments and firms do not interact in a vacuum. The broader social context can influence the investment climate in two main ways: in the level of social cohesion

#### BOX 2.13 *Building credibility through persistence in Uganda*

Many economies in Africa have stagnated or shrunk in recent decades, largely reflecting poor investment climates. Yet Uganda climbed out of civil conflict and chaos in the late 1980s and severe macroeconomic instability in the early 1990s to more than double the share of private investment in GDP between 1990 and 2000, and boosted its per capita GDP by over 4 percent a year from 1993 to 2002—or 8 times the average in Sub-Saharan Africa. How?

Beginning in 1991–92 the government launched reforms that eventually encompassed most aspects of the investment climate. Macroeconomic stability was achieved, and the independence of the central bank was strengthened. Monopolies in coffee, cotton, and tea were dismantled, and trade barriers were reduced. A new investment code providing protection against expropriation was introduced, and the return of property expropriated by an earlier government was accelerated. An autonomous tax agency was created. Public enterprises were privatized. A new commer-

cial court was established in 1996. The telecommunications sector was modernized through competition and private sector participation, including the privatization of Uganda Telecom Limited in 2002. The power sector was opened to private participation, and in 2002 a 20-year concession was awarded for the country's main generating station. Efforts are under way to improve business regulation.

Each reform had some impact on the opportunities and incentives for firms. Just as important, the determination of policymakers to stick with reforms—including dealing with setbacks along the way—enhanced the credibility of the government's commitment to create a more productive society. For example, the privatization of Uganda Telecom succeeded only on the third attempt. The Uganda Commercial Bank was privatized only in 2002, after an earlier unsuccessful attempt.

Source: Holmgren and others (2001) and World Bank (2001d).

and trust between market participants, and in the level of trust and confidence citizens have in firms and markets. Governments influence, and are influenced by, both.

**Social cohesion and trust**

Social cohesion and trust can reduce the costs of regulation and contract enforcement—a plus for the investment climate. Trust and shared values and expectations (social capital) facilitate cooperative relationships and can encourage firms to lengthen their planning horizons as they think about investing.<sup>44</sup> Richer networks of trust also make it easier for participants to exchange reliable information about each other, and to monitor the actions of policy-makers.

The potential positive economic effects of social capital have been documented since Alexis de Tocqueville’s travels in the United States in the early 19th century. But social capital can also have negative effects given its tendency to foster closed, insular relations among individuals of similar backgrounds, to encourage conformity, and to ostracize innovators and individualists.<sup>45</sup> Cronyism and corruption may also be tolerated more in communities characterized by high levels of social capital.<sup>46</sup>

At the other extreme, societies that are highly fragmented along ethnic or linguistic lines can experience social conflict that undermines the investment climate. Cross-country studies show that ethnic and linguistic fractionalization is negatively associated with economic growth.<sup>47</sup> The negative effects on the investment climate may range from open conflict and political instability to clientelist distortions in policymaking. Creating a society that bridges these divides can take generations. Ensuring that the benefits of a better investment climate extend to all members of society can help build those bridges.

**Trust and confidence in firms and markets**

Public attitudes toward firms and markets can affect the feasibility of policy improvements. They can also affect the sustainability of reforms and hence the credibility of government policies. The investment cli-

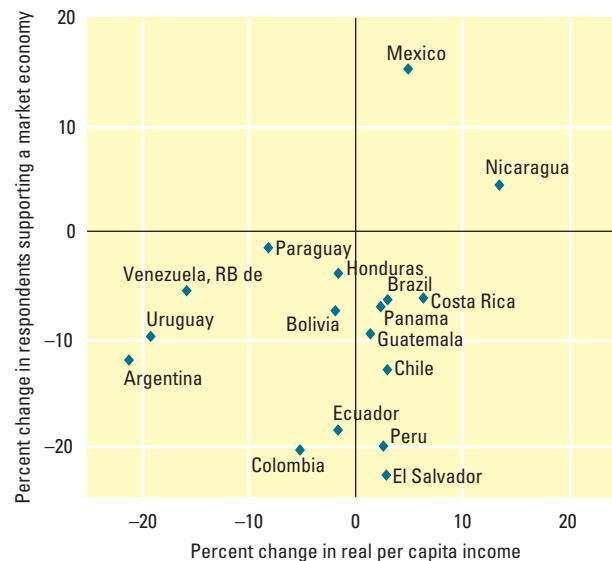
mate thus benefits from a social consensus in favor of creating a more productive society—and from widely held perceptions that processes and outcomes are legitimate in the sense that they are consistent with social norms, values, and beliefs.<sup>48</sup>

Public attitudes toward firms and markets can be deeply rooted in history, but also reflect more contemporary experience. They can also be complicated, not least because even a single individual often needs to reconcile divergent perspectives, including as a consumer, a worker, a taxpayer, and often also as an investor.<sup>49</sup> To further complicate matters, support for markets does not always track economic growth<sup>50</sup> (figure 2.11).

Recent opinion surveys suggest that attitudes toward international economic integration and firms vary considerably around the world, but tend to be favorable. For example, for more than 85 percent of countries surveyed, between 77 percent and 98 percent of respondents believed international trade and business were positive forces for their country (figure 2.12).<sup>51</sup>

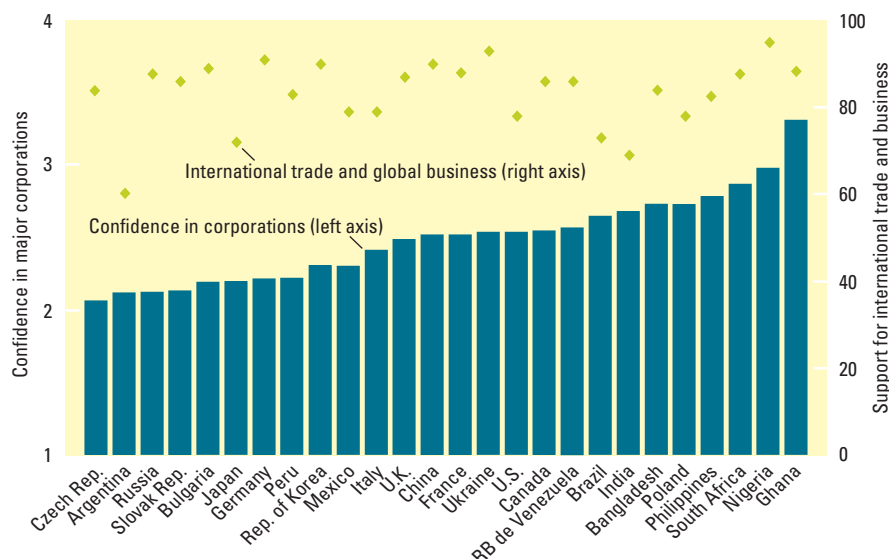
Similar surveys often find that confidence in major corporations is somewhat less positive. Ambivalence toward markets

**Figure 2.11 Support for markets does not always track economic growth—as in Latin America**



Note: Change in support measured as change in those responding, “strongly agree” or “agree” to the statement “In general, a market economy is best for our country.” Responses cover years 1998–2002. Source: www.latinobarometro.org.



**Figure 2.12 Strong support for international trade and business—but less confidence in corporations**

Note: Survey questions were (right axis) “Are international trade and business ties good for your country?” (percent responding yes); (left axis) “How much confidence do you have in major corporations?” (1 = none, 4 = a great deal).  
 Source: The Pew Global Attitudes Project (2003) and Inglehart and others (2000).

and firms, particularly toward “big business,” has a long pedigree.<sup>52</sup> Historically these concerns have been heightened by corporate or corruption scandals, leading to public backlashes against firms and markets and to demands for more intrusive regulation or even nationalization.<sup>53</sup> These concerns also reflect responses to the way governments manage conflicts and protect their citizens.

Multinational firms have long aroused suspicion due to concerns about their loyalties and their possible economic power.<sup>54</sup> This has recently led to mutual efforts to promote corporate social responsibility through the elaboration of various codes of conduct (see box 2.2). Other concerns about government–firm relationships, including those about corruption and other forms of rent-seeking, are also creating

### BOX 2.14 *Shining the light on government–firm dealings in natural resources and infrastructure*

Proposals to enhance the transparency of government–firm dealings are often seen as mainly addressing corruption or other forms of rent-seeking. But reducing concerns about inappropriate behavior can also contribute to broader public support for firms and markets, and so facilitate ongoing investment climate improvements.

Two recent global initiatives focus on improving the transparency of revenue arrangements between international investors and host governments in the natural resources sector. The Publish What You Pay campaign, supported by a coalition of more than 200 nongovernmental organizations (NGOs), proposes legislation requiring publicly listed oil and mining companies to disclose information about payments to government as a condition of stock exchange listing. The Extractive Industries Transparency Initiative, launched at the World Summit on Sustainable Development in 2002, encourages governments; international organizations; NGOs;

publicly traded, private, and state-owned extractive enterprises; and others with an interest in the sector to work together to develop a framework for reconciling payments by firms to governments and account for any missing amounts.

Nigeria took an initial lead in enhancing revenue transparency. In 2003 the Nigerian government agreed to publish budgets and records of oil revenue collection, as well as applicable statutes and rules. It also encouraged oil companies doing business in the country to make full disclosure of their revenues and costs of operation. The accounts are then to be examined by an “aggregator”—an independent auditor—to assess any discrepancies.

Under the Extractive Industries Transparency Initiative a commission was also established in Azerbaijan to publish revenues of the State Oil Fund. In a similar vein the Chad-Cameroon Petroleum Development and Pipeline project, supported by the World Bank, established a

framework for revenue management from the pipeline, earmarking revenues for poverty reduction, and requiring private operators to conduct business only with firms that comply with transparency and disclosure rules.

The impetus for enhanced transparency is also extending to private infrastructure arrangements. Traditionally many countries treated concession contracts and licenses like commercial agreements, not publicly disclosed. Growing recognition of the public character of these arrangements, and of the importance of fostering broad public support for reforms, has led Argentina, Brazil, Panama, and Peru to publish these contracts by placing them on a public Web site. Together, they have published more than 120 contracts covering a range of infrastructure sectors.

Source: World Bank (2000b); World Bank (2001e); and World Bank staff.

impetus to enhance the transparency of dealings between governments and firms, particularly in areas where relationships can be especially troublesome (box 2.14).

Because public support for markets does not necessarily track economic growth, and because the growth response from reforms is not always immediate, governments often need to actively foster public support for investment climate improvements. Building a consensus in favor of a more productive society not only enhances the feasibility of reform, but through its impact on sustainability and hence credibility can also have a big influence on the size of the investment response. There are no simple formulas in this area, but experience underlines the importance of four key elements:

- Ensuring the benefits of a better investment climate are not confined to particular categories of firms, but extend widely across society
- Promoting broad public understanding of the benefits of reform
- Enhancing the transparency of government-firm dealings to reduce concerns about rent-seeking
- Protecting vulnerable groups that may be disadvantaged during the transition.

### Ensuring policy responses reflect a good institutional fit

Market failure is the textbook rationale for most government interventions intended to improve the investment climate. But those interventions can fail to achieve their intended result for myriad reasons, including inadequate information, expertise, or resources—or from rent-seeking, credibility gaps, and lack of public support. The success of any policy intervention ultimately depends on the extent to which the chosen approach reflects a good fit with local institutional conditions.

Market failures may be more prevalent in developing countries than in developed countries.<sup>55</sup> But government failures can also be more severe in countries with limited resources and expertise and less developed checks on government behavior. Policy interventions make sense only when the expected benefits exceed the likely costs.

This means governments need to weigh carefully the costs and benefits of alternative approaches and take local conditions into account when designing particular policy responses. Failure to give sufficient weight to local conditions can leave important market failures unchecked—or make matters worse. For example, approaches that demand enforcement capacity beyond that available may not only fail to meet the intended social objective but can also contribute to informality and corruption and undermine government credibility. Similarly, in the absence of effective safeguards, approaches that involve significant discretion may be misused to obtain bribes or expose firms to unnecessary uncertainty and risk (box 5.2).

The challenge of ensuring that policy responses fit with local institutional conditions has implications for policy design across the investment climate. It plays an especially important role in the design of regulatory strategies but is also relevant to the distribution of responsibilities between tiers of government (box 2.15).

Because conditions vary across countries, transplanting approaches uncritically from one country to another often leads to

#### BOX 2.15 *Decentralization and the investment climate*

Decentralization has been a theme in constitutional design since at least the foundation of the Swiss Confederation in 1291, and remains a major theme to this day. How does decentralization affect the investment climate?

Decentralization can contribute to a sound investment climate in several ways. Decentralization of regulatory responsibilities can help locales adapt approaches to their conditions and preferences and facilitate the involvement of stakeholders. Fiscal decentralization can assure local authorities that taxes raised locally will not be appropriated by the central government, giving local authorities incentives to develop their local tax base. Decentralization also permits a degree of institutional competition between centers of authority that can stimulate policy innovation and reduce the risk that governments will expropriate wealth.

But there are tradeoffs. Subnational authorities are not well placed to deal with issues that involve spillovers between juris-

dictions. They may also face more severe capacity constraints and be unable to exploit economies of scale associated with particular functions. And subnational governments are not immune from governance problems—and in some contexts may be more vulnerable to them than national authorities.

Reflecting these tradeoffs, the optimal location of particular policy and administrative responsibilities will depend on the country and policy issue concerned. Small countries present fewer opportunities for decentralization than larger ones. But even in large countries, some matters will be best handled centrally, some subnationally, and others may require some form of shared responsibility. A clear delineation of responsibility between tiers of governments reduces uncertainty and risk for firms and improves accountability.

Source: Brueckner (2000); Treisman (2000); Tanzi (1995); and Weingast (1995).

poor results. Historically, many regulatory systems in developing countries were transplanted from colonial or occupying powers with little regard to how they might operate in a very different environment. Because they were less relevant to local circumstances, they were often ignored or enforced selectively to solicit bribes. While the laws in the source country went through a continuing process of modernizing and upgrading, the regimes left behind often did not. For example, company law regulating business entry dates back to 1884 in the Dominican Republic and to 1901 in Angola, while laws dealing with insolvency date back to 1916 in Nicaragua. One result is a high level of informality, with regulations ostensibly aimed at mitigating market failures or promoting other social objectives often complied with by less than half the economy—yet placing a disproportionate burden on firms that do comply.

A tendency to transplant approaches uncritically from one country to another continues to this day. Policy approaches in today's rich countries can provide a useful source of inspiration. They may also reduce

the information costs faced by foreign investors and help signal the application of high standards to local stakeholders. But failure to adapt approaches to local realities can lead to outcomes as poor as their more ancient forebears.

Strategies for tailoring approaches to local conditions vary according to the area of policy intervention. They may involve developing simpler rules with less discretion; relying more heavily on transparency, competition, and market monitoring; and reinforcing local institutional safeguards, including through the use of appropriate international arrangements. These strategies need to be complemented by efforts to strengthen government capabilities (chapter 3).

Advances in information technology are also creating opportunities to reduce demands on government capabilities, while enhancing transparency and easing the burden on firms.<sup>56</sup> These approaches have been applied to a wide range of investment climate areas, including business regulation and land titles (box 2.16) as well as tax and customs administration (chapter 5).

### BOX 2.16 *E-government and the investment climate*

Advances in information technology, including the Internet, are paving the way for investment climate improvements that reduce demands on public administration, enhance transparency, and ease compliance burdens on firms. Approaches to business regulation in Singapore and land titling in India's Karnataka state illustrate the potential.

The e-government initiative launched by Singapore in 2000 included business registration and licensing procedures. It provides an online application system for business registration and licensing and a one-stop online application system for certain special licenses (for example, building and construction permits) that previously required separate submissions to as many as 12 regulatory authorities. The integrated approach reduced the cost of incorporating a new company from anywhere between S\$1,200 and S\$35,000 (around \$700 to \$20,000) (depending on the capital of the company) to a flat fee of S\$300 (\$175). What used to require two days now requires less than two hours. Streamlining the submission process for construction permits saves applicants more than S\$450 (\$260).

India's Karnataka state introduced an electronic land-titling system, Bhoomi, in the late 1990s. The online system is delivered through kiosks installed in all land offices of Karnataka. These kiosks provide copies of a Record of Rights, Tenancy, and Crops (RTC). Obtaining an RTC once required up to 30 days, and typically a bribe of as much as Rs. 2,000 (about \$43). Land records could be deliberately "blurred" for fees of Rs. 10,000 (\$220). These records were not open to the public, and it sometimes took two years for the records to be updated under the manual accounting system maintained by 9,000 "village" accountants—state employees responsible for three to four villages each. Today an RTC can be obtained for a fixed fee of Rs. 15 (\$0.32) in 5 to 30 minutes. The records are open for public scrutiny. Citizens can now request that land titles be updated quickly through the kiosks, a process that has increased the number of annual applications for updates by 50 percent.

Source: Tan (2004); Bhatnagar and Chawla (2004); and Lobo and Balakrishnan (2002).

### Making progress

These four separate but related challenges can produce vicious circles of worsening governance and stagnating investment climates. Weak control over rent-seeking not only directly leads to poor economic outcomes, but also undermines government credibility and can create or exacerbate fissures in society, and erode public trust in firms and markets. Low government credibility can contribute to rent-seeking and a lack of public trust in firms and markets. Lack of public confidence in firms and markets can undermine the credibility of policy reforms. Policy interventions that are poorly adapted to local conditions can leave important market failures unchecked, encourage informality and rent-seeking, undermine credibility, and also weaken public trust in firms and markets. Conversely, the circles can be virtuous—with progress in one area contributing to that in others.

A common strategy for addressing all four challenges is to enhance the transparency of government-firm dealings. This

can play a critical role in restraining rent-seeking, in contributing to policy credibility, and in helping to build public support for reforms. It can also be part of a strategy for complementing government capabilities and thus helping to ensure policy interventions reflect a good institutional fit. Governments in both rich and poor countries have a long history of resisting calls for more openness, and some firms benefit from the resulting secrecy.<sup>57</sup> But more governments are opening their policy processes to public scrutiny and improving public access to information. Stakeholders are being consulted on regulation in Bolivia and Ghana. Infrastructure contracts are being placed on public Web sites in Argentina and Peru. Freedom of information legislation is being introduced in China and Mexico. While care needs to be

taken not to encumber weak administrations with some of the more elaborate procedures adopted in some developed countries, more pragmatic approaches, including those that exploit the potential of new information technologies, create opportunities to transform governments—and the investment climates they produce.

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Improving the investment climate requires governments to address these challenges in the context of specific policy areas affecting stability and security, regulation and taxation, finance and infrastructure, and workers and labor markets. The agenda is broad and demanding. Chapter 3 looks at what has been learned about successful strategies for tackling such a broad agenda.