Overview

Everyday, firms around the world face important decisions. A rural microentrepreneur considers whether to open a small business to complement her family's farm income. A local manufacturing company ponders whether to expand its production line and hire more workers. A multinational enterprise evaluates alternative locations for its next global production facility. Their decisions have important implications for growth and poverty in each location. And their decisions will depend largely on the way government policies and behaviors shape the investment climate in those locations.

A good investment climate provides opportunities and incentives for firms—from microenterprises to multinationals—to invest productively, create jobs, and expand. It thus plays a central role in growth and poverty reduction. Improving the investment climates of their societies is critical for governments in the developing world, where 1.2 billion people survive on less than $1 a day, where youths have more than double the average unemployment rate, and where populations are growing rapidly. 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.[1] *World Development Report 2005* draws on those data, other new evidence, and emerging lessons of international experience to look at 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.

The investment climate is central to growth and poverty reduction

Private firms—from farmers and microentrepreneurs to local manufacturing companies and multinational enterprises—are at the heart of the development process. Driven by the quest for profits, they 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 critical actors in the quest for growth and poverty reduction.

The contribution firms make to society is mainly determined by 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 factors such 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 drives growth and reduces poverty.

BOX 1 The investment climate perspective

The investment climate reflects the many location-specific factors that shape the opportunities and incentives for firms to invest productively, create jobs, and expand. A good investment climate is not just about generating profits for firms—if that were the goal, the focus could be limited to minimizing costs and risks. A good investment climate improves outcomes for society as a whole. That means that some costs and risks are properly borne by firms. And competition plays a key role in spurring innovation and productivity and ensuring that the benefits of productivity improvements are shared with workers and consumers.

Looking at growth and poverty reduction through an investment climate lens offers several insights:

- It puts firms—the actors making investment and hiring decisions—at the center of the discussion.
- It recognizes that firms assess investment opportunities and related government policies and behaviors as part of a package. This reinforces the importance of looking at property rights, regulation, taxes, finance, infrastructure, corruption, and other areas of government policy and behavior as part of an integrated whole, rather than in isolation.
- It highlights the forward-looking nature of investment activity. Investment is based on expectations about the future and not just on current conditions. This underlines the importance of governments fostering stability and credibility, which are critical elements of a sound investment climate.
- It treats as fundamental the need for policymakers to balance the goal of encouraging productive private investment with other social goals. Firms provide many benefits for society, but the interests of firms and society are not the same in all respects. Good public policy is not about giving firms everything they might ask for, but rather about balancing a range of social interests.

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

Source: Authors and Stern (2002).

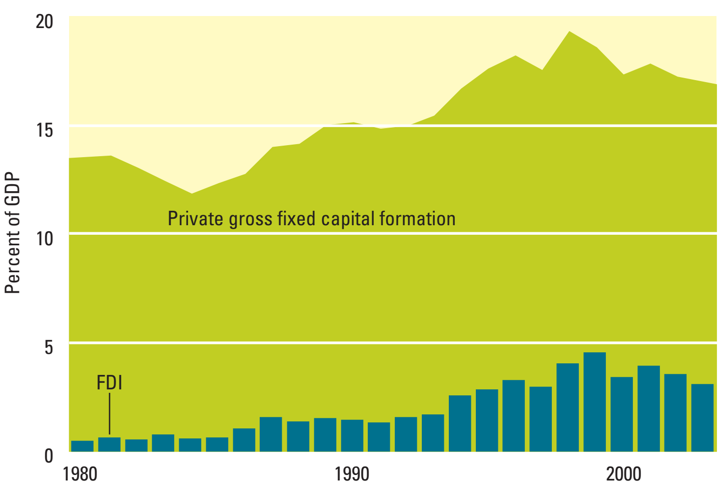
Driving growth

With rising populations, economic growth is the only sustainable mechanism for increasing a society's standard of living. A good investment climate drives growth by encouraging investment and higher productivity.

Investment underpins economic 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 1).

A good investment climate encourages firms to invest by removing unjustified costs, risks, and barriers to competition. As a result of investment climate improvements in the 1980s and 1990s, private investment as a share of GDP nearly doubled in China and India; in Uganda it more than doubled.[2] 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 who don't.[3] Improving policy predictability can increase the likelihood of new investment by more than 30 percent. Reducing barriers to competition in telecommunications in the 1990s unleashed a surge of new investment worldwide—including investment by microentrepreneurs in Bangladesh and Uganda.

Figure 1 Domestic private investment dominates foreign direct investment



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

But it is not just the volume of investment that matters for growth—it is the productivity gains that result (figure 2).[4] 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. And an environment that fosters the competitive processes that Joseph Schumpeter called "creative destruction"—an environment in which firms have opportunities and incentives to test their ideas, strive for success, and prosper or fail.[5] 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.[6] And firms facing strong competitive pressure are at least 50 percent more likely to innovate than those reporting no such pressure (figure 3).

Reducing poverty

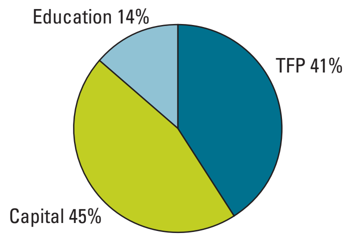
The critical role the investment climate plays in poverty reduction can be seen in two ways. First, at the aggregate level, economic growth is closely associated with reductions in poverty (figure 4). Indeed, investment climate improvements in China drove the most dramatic poverty reduction in history, lifting 400 million people out of poverty over 20 years. Second, the contribution can be seen in the way a good investment climate enhances 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 5). The private sector accounts for more than 90 percent of jobs in developing countries.[7] Better job opportunities also increase incentives for people to invest in their education and skills, thus complementing efforts to improve human development. Firms that are more productive can also pay better wages and invest more in training.[8]

As entrepreneurs. Hundreds of millions of poor people in developing countries make their living as microentrepreneurs—as farmers, as street vendors, as homeworkers, and in a range of other occupations. They often operate in the informal economy, which accounts for more than half of economic activity in many developing countries (figure 6). 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 incomes for entrepreneurs and allows them to expand their activities. A good investment climate also increases incentives to become part of the formal economy.

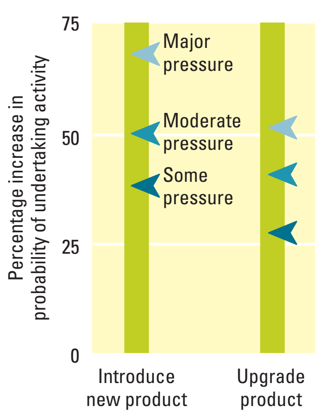
As consumers. A good investment climate expands the variety and reduces the costs of goods and services, including those consumed by poor people. Investment climate improvements lowered food prices in countries

Figure 2 Productivity accounts for a significant share of growth



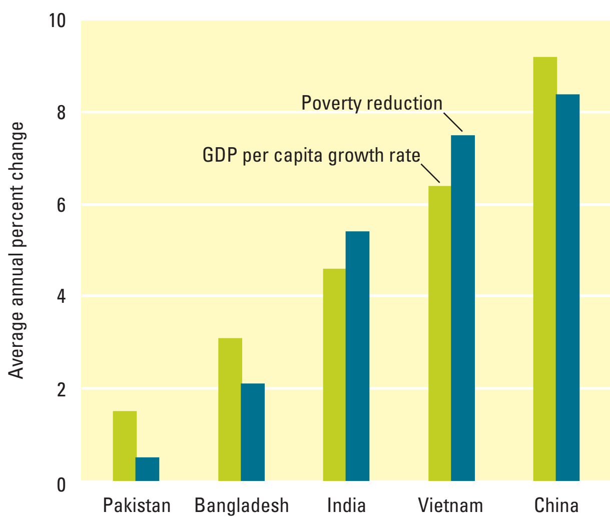
Note: Sources of growth for 84 countries from 1960–2000. "TFP" is total factor productivity.
Source: Bosworth and Collins (2003).

Figure 3 More competitive pressure, more innovation



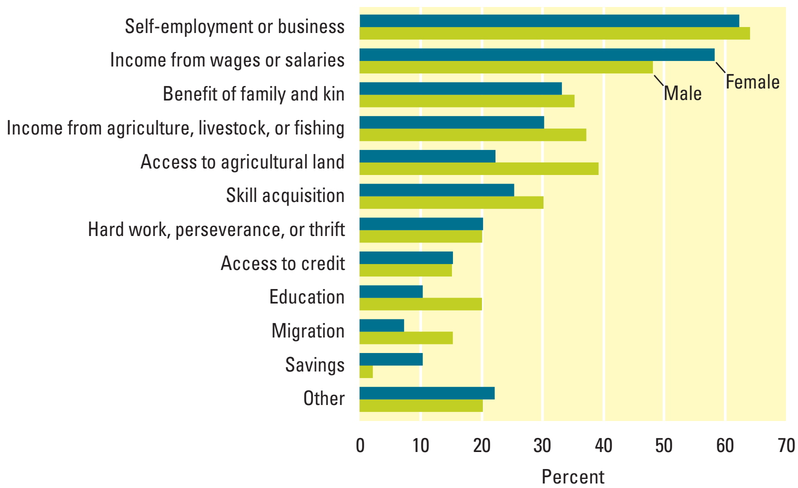
Note: Percentage increase is relative to firms reporting no competitive pressure.
Source: World Bank Investment Climate Surveys/BEEPS II in 27 countries in Eastern Europe and Central Asia.

Figure 4 Growth is closely associated with poverty reduction



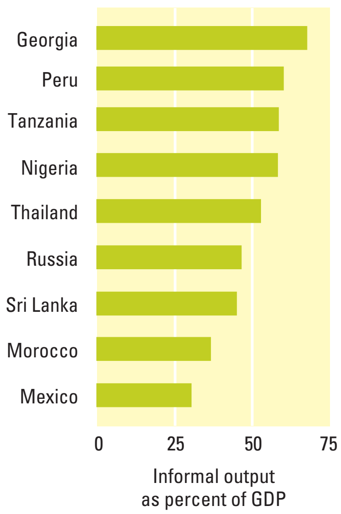
Note: All figures for 1992–98 except Bangladesh (1992–2000) and India (1993–99).
Source: World Bank (2002d).

Figure 5 How 60,000 poor people rated jobs and self-employment as paths out of poverty



Source: Narayan and others (2000).

Figure 6 The informal economy is substantial in many developing countries



Source: Schneider (2002).

including Ethiopia, Ghana, Kenya, Vietnam, and Zambia.[9] Lowering barriers to market entry by 10 percent has been estimated to reduce the average price markup by nearly 6 percent.[10]

As users of infrastructure, property, and finance. Improving infrastructure, property rights, and finance can deliver broad benefits across the community. Building rural roads helps firms get their goods to market, and in Morocco also increased primary school enrollment from 28 to 68 percent.[11] Providing more secure rights to land encourages farmers and other firms to invest and can ease their access to finance; in Peru more secure rights also allowed urban slum dwellers to increase their incomes by working more hours outside the home.[12] Improving the functioning of finance markets helps firms take advantage of promising investment opportunities, and also helps poor people weather family emergencies, educate their children, and improve their homes.

As recipients of tax-funded services or transfers. Firms and their activities are the principal sources of tax revenue for governments, and growing economies generate more taxes.[13] A good investment climate can thus expand the resources governments have available to fund 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 particular locations or activities, creating opportunities for governments to influence the distribution of benefits. Governments can design those investment climate improvements to be even more "pro-poor" by targeting constraints where poor people live and constraints to activities poor people benefit from, including in their capacities as employees, entrepreneurs, and consumers. This means that pro-poor approaches are not limited to efforts that focus on constraints that face small firms.

Tackling costs, risks, and barriers to competition

Governments influence the investment climate through the impact of their policies and behaviors on the costs, risks, and barriers to competition facing firms. Creating a better investment climate requires governments to tackle all three. Big variations in investment climates around the world highlight the potential for improvement.

Costs

Government policies and behaviors influence the costs of doing business and hence the range of investment opportunities that might be profitable. Taxes are the most obvious example. But governments also have important roles in providing public goods, supporting the provision of infrastructure, and addressing market failures. Weaknesses in government performance in these roles can greatly increase the costs for firms and make many potential opportunities unprofitable. How greatly? The costs of contract enforcement difficulties, 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. Both the level and the composition of these costs vary widely across countries (figure 7).

Costs also have a time dimension. There are big variations in the time taken to obtain a telephone line and to clear goods through customs, as well as in the time managers need to spend dealing with officials. The time it takes to register a new business ranges from 2 days in Australia to more than 200 days in Haiti.[14]

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 maintaining a stable and secure environment, including by protecting property rights. Policy uncertainty, macroeconomic instability, and arbitrary regulation can also cloud opportunities and chill incentives to invest. Indeed, policy-related risks are the main concern of firms in developing countries (box 2).

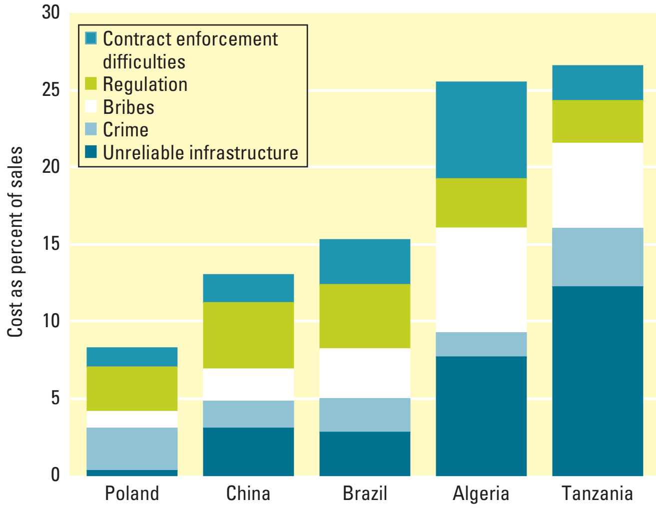
Barriers to competition

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 consumers. They can also dull the incentives for protected firms to innovate and increase their productivity. 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. Competitive pressure is reported to be significant by 90 percent of firms in Poland but only 40 percent of firms in Georgia.[15]

Variations within countries and across firms

Early efforts to assess investment climates focused on developing a single indicator for each country. But investment climates vary not only across countries but also within countries because of differences in the way national policies are administered and in the policies and behaviors of subnational governments. Even within a single location, the same conditions can affect firms differently depending on the activity they are engaged in and their size, often hitting small and informal firms the hardest (figure 8).

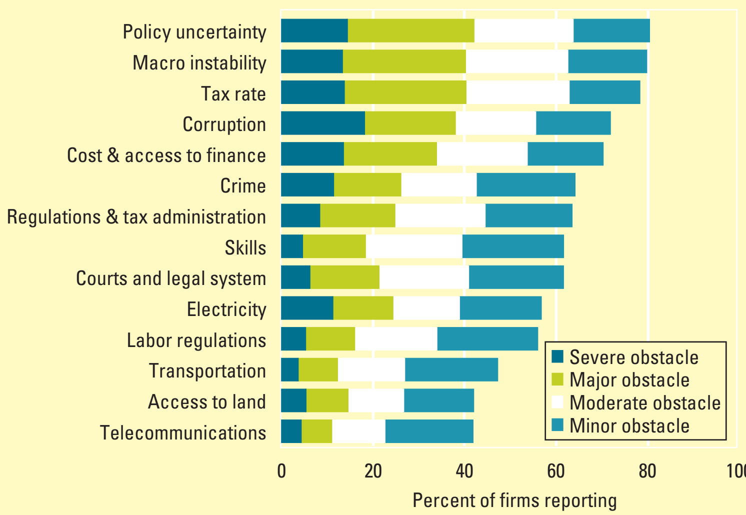
Figure 7 Costs vary widely in level and composition



Note: See figure 1.2 notes for methodology used.
Source: World Bank Investment Climate Surveys. Countries chosen to illustrate range.

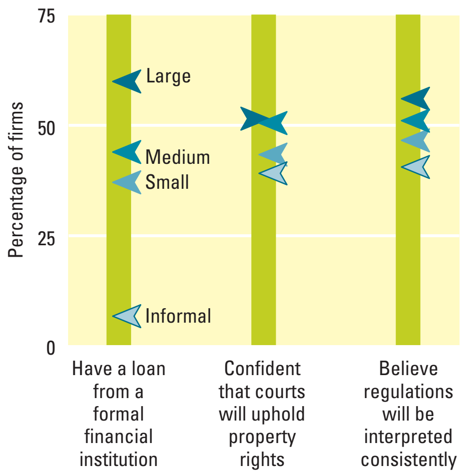
BOX 2 ***How do firms in developing countries rate various investment climate constraints?***

Early results of the World Bank's program of Investment Climate Surveys cover more than 26,000 firms in 53 countries. While priority constraints can vary widely across and even within countries, looking at the overall results highlights the importance of policy-related risks, including policy uncertainty and macroeconomic stability.



Note: Firms were asked to rank the list of issues as to whether they were an obstacle to the growth and operation of their business on a 5 point scale, from "no obstacle" to "severe obstacle." Additional information on the indicators is available at the back of the book, table A1.
Source: World Bank Investment Climate Surveys.

Figure 8 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.

Progress requires more than changes in formal policies

Many investment climate improvements require changes to laws and policies. But more is required. Over 90 percent of firms in developing countries report gaps between formal policies and what happens in practice. And the content as well as the implementation of policies are vulnerable to a deeper set of policy failures. At the heart of the problem lies a basic tension: Societies benefit greatly from the activities of firms, but the preferences of firms don't fully match those of society. This tension is 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 where 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 policy. The way governments respond to those challenges has a big impact on investment climates and thus on growth and poverty. And each involves going beyond changes in formal policies to confront deeper sources of policy failure.

Restraining rent-seeking. Investment climate policies are an enticing target for rent-seeking by firms, officials, and other 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. Surveys show that the majority of firms in developing countries expect to pay bribes when dealing with officials, but with big variations across countries.[16] 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. 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. The confidence firms have 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. Policy credibility can be undermined by many things, including the temptations governments face 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). Mechanisms that allow governments to commit to sound policies, discipline, and persistence all play a role.

Fostering public trust and legitimacy. Good investment climates are nurtured by broad public support: a consensus in favor of building a more productive society can facilitate policy improvements regardless of the political party or group in office. Absence of such support can make policy reform more difficult and undermine the sustainability (and hence the credibility) of reforms. 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 policy responses fit local conditions. To be effective, policy interventions need to take into account sources of potential government failure and differences in local conditions. Failure to do so can lead to poor or even perverse results. Approaches that demand enforcement 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 can expose firms to considerable uncertainty and risk when effective safeguards against the misuse of that discretion are not yet developed. While approaches in today's developed 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.

A process, not an event

Government policies and behaviors shaping the investment climate cover a wide field, from contract enforcement and 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.

But no country has a perfect investment climate, and perfection on even one policy dimension is not necessary for significant growth and poverty reduction. Experience shows that progress can be made by addressing important constraints in a way that gives firms confidence to invest, and by sustaining a process of ongoing improvements (box 3).

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 developed 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,[17] but even that assessment may understate the task. International experience provides insights about the essential elements of reform processes in this area: setting prior-

BOX 3 *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 $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 $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 per year during 1993—2002 (or eight 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 the government's reform efforts enhanced its credibility, giving firms the confidence to invest.

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

ities, managing individual reforms, maintaining momentum, and strengthening government capabilities.

Setting priorities

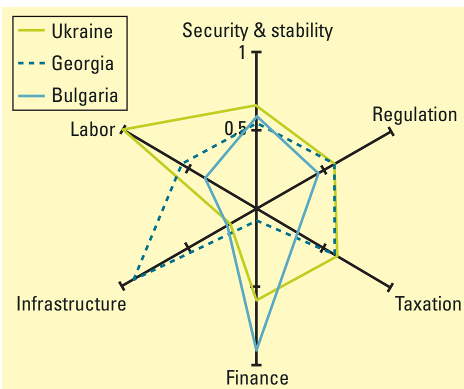
The goal is to identify important constraints that face firms. There are no standard formulas. Instead, it requires an assessment in each case of current conditions, the potential benefits from improvements, links with national or regional goals, and implementation constraints.

Current conditions. The most important constraints can differ widely across countries, even within a single region (figure 9). Governments can identify them by surveying and consulting with firms, but recognizing 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 in their capacities as employees, entrepreneurs, and consumers.

Governments also need to consider benefits that may spill over 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). There can also be spillovers to government capabilities, credibility, or constituency building.

Figure 9 Constraints reported by firms—comparing Bulgaria, Georgia, and Ukraine



Note: Indices based on surveys of formal sector firms. Values are normalized by regional maxima and minima for each indicator. Resulting indicators range from 0 (best) to 1 (worst). Countries chosen to highlight potential differences. See figure 3.1 notes for more details.
Source: World Bank Investment Climate Surveys and BEEPS II.

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. These often include integrating the informal or rural economies, unleashing the growth potential of smaller firms, taking advantage of international openness, or enabling firms to climb the technology ladder.

Implementation constraints. At any point 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 ongoing strengthening of government capabilities.

Managing individual reforms

There is often resistance to investment climate reforms from those who benefit from the status quo. This 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

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 so that they do not introduce unwarranted distortions.

Strengthening government capabilities

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 can also be augmented by contracting out some specialist functions—a common strategy even in developed countries. Governments 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.

Focus on 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 creating a good investment climate for all firms in the economy and so focusing on improving the "basics." International experience highlights promising approaches in each of the four core areas of a sound investment climate: stability and security, regulation and taxation, finance and infrastructure, and workers and labor markets.

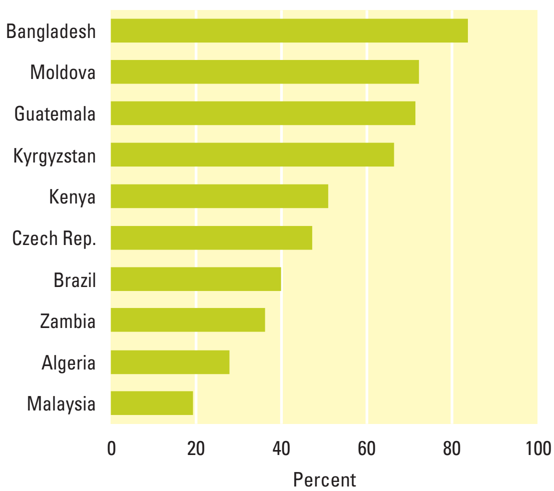
Stability and security

The outbreak of war or other widespread violence spells the end of almost all productive investment, and a reasonable level of political and macroeconomic stability is a threshold requirement for other policy improvements to gain much traction. Unstable or insecure environments have their most tangible affect on investment through their impact on property rights, which link effort with reward. 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 can ease access to finance. Experience in Peru, Thailand, and many 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.

Facilitating contract enforcement. In many developing countries, firms lack confidence in the courts to uphold their property rights (figure 10). Improving courts is thus a high

Figure 10 Firms in many developing countries lack confidence in the courts to uphold their property rights



Source: Investment Climate Surveys. Countries chosen to illustrate range.

priority. Facilitating the free flow of reputation information and removing unnecessary impediments to the use of alternative dispute resolution mechanisms can also help.

Reducing crime. Crime imposes large costs on societies—around a quarter of GDP in some countries in Latin America.[18] Surveys show that crime is also a serious constraint for many firms in all regions. Promising strategies involve efforts to prevent and deter crime, as well as to improve enforcement. Community policing strategies along the lines of those applied in New York City are being pursued by more countries around the world.

Ending the uncompensated expropriation of property. All governments reserve the right to expropriate private property in some circumstances. Reducing concerns about the arbitrary exercise of this power requires 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 can be tensions between firms' preferences and social goals in this area, there is huge scope for improving approaches in most developing countries without compromising broader social interests.

Improving domestic regulation. Too often, governments pursue regulatory approaches that fail to achieve the intended social objectives because of widespread informality, yet harm the investment climate by imposing unnecessary costs and delays, inviting corruption, increasing uncertainty and risk, and creating unjustified barriers to competition. The key is to strike a better balance between market failures and government failures, including by ensuring that approaches are adapted to local conditions and by enhancing transparency. Successful reforms remove unjustified burdens and streamline procedures. They reduce regulatory uncertainty and risk by curbing 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. Tax rates in developing countries are similar to those in developed countries. But a high level of informality, coupled with poor administration and corruption, reduces revenue collection, places a disproportionate burden on those who do comply, and distorts competition. Keeping the size of government in check and spending public money efficiently help ease the pressure on revenue collection. Beyond this, broadening the tax base and simplifying tax structures can help. 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 information technologies to reduce delays and corruption, as in Ghana, Morocco, and Singapore.[19]

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 and risks for microenterprises as well as multinationals. By impeding new entry into markets, inadequacies also limit the competitive discipline facing incumbent firms, dulling their incentives to innovate and improve their productivity. Such inadequacies are large in developing countries (figure 11).

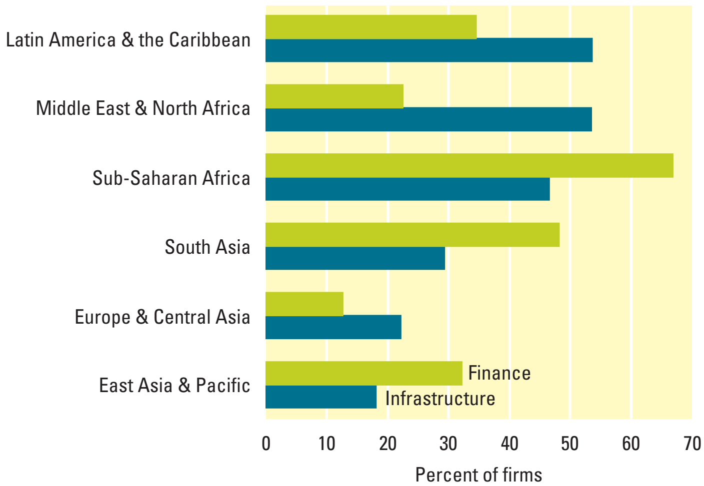
Improving finance. The underlying challenge with finance flows from information problems, which are often exacerbated by weak protection of property rights. Government intervention through state ownership, barriers to competition, directed or subsidized credit, and similar approaches can create deep distortions and retard financial market development. Better 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. More governments are thus reducing barriers to competition (including paving the way for nonbank financial intermediaries and commercial microfinance), strengthening creditor and shareholder rights, supporting the establishment of credit bureaus and other mechanisms to address information problems, and improving bank regulation.

Improving 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 produced poor results in many developing countries. Recognizing this, governments are now focusing on creating 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 electricity supply and ports. For roads, promising strategies include 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

Government intervention in labor markets should help connect people to decent jobs. Improving policy performance requires progress on three fronts: fostering a skilled workforce; crafting market interventions to benefit all workers; and helping workers cope with change.

Figure 11 The inadequacies of finance and infrastructure are severe for many developing countries

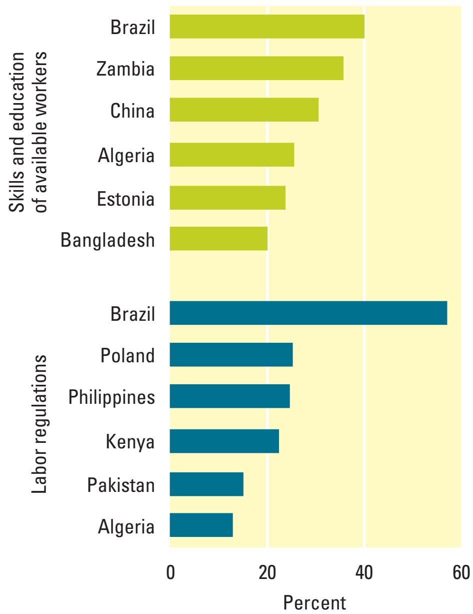


Note: Figure shows the share of firms that report access to finance, and any of electricity, telecommunications, or transportation, as "major" or "severe" obstacles to their business.
Source: World Bank Investment Climate Surveys.

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 of workers as a serious obstacle to their operations (figure 12). 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 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

Figure 12 Firms often rate skill shortage and labor regulations as serious obstacles



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.

unemployed, the low-skilled, and those in the informal economy will not be among them. Interventions need to be crafted to reflect this wider range of interests. More countries are reviewing 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 work force.

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 faster 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.[20] 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 involves additional challenges

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 that deal with investment climate issues. Both can play a role but involve additional challenges.

Selective interventions—approach with care

Broad improvements to the investment climate expand the pool of beneficiaries, reduce concerns about rent-seeking, and avoid new distortions. Given the breadth of the reform agenda, some firms or activities may benefit from improvements earlier than others—as with infrastructure in a particular location or with 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, 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 special inducements 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. Selective interventions should thus be approached with caution, and not viewed 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 their beneficiaries, are administered transparently, and are reviewed regularly.

International rules and standards—many tradeoffs

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, over 200 regional cooperation arrangements, and a plethora of new and proposed multilateral instruments covering most aspects of the investment climate. International arrangements have a clear role in reducing barriers to international trade and investment. But they might also contribute to investment climate improvements in three broader ways: by enhancing credibility, by harmonizing rules and standards, 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 policies and so strengthen the investment responses of firms. But by design the tradeoff is foregone 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 governments directly through binding international arbitration—can enhance credibility but would benefit from 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 insist on high levels of mutual compliance.

Harmonizing 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. There can be benefits 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. Proposals in these and other areas need to give due weight to the perspectives of developing countries.

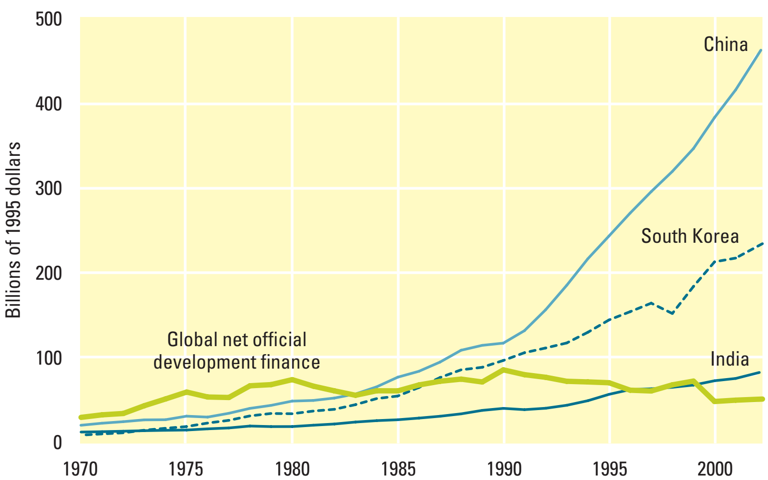
The international community can lend a hand

Helping to improve investment climate conditions in developing countries 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 13). The international community can help developing countries in three main ways: by removing 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 $85 billion by 2015[21]—or more than four times the development assistance currently provided for investment climate improvements.

Figure 13 Manufacturing value-added in a single country can far exceed net global official development finance



Source: OECD online database (www.oecd.org) and World Bank (2004k).

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 around $21 billion per year, currently focuses on support to investment climate improvements, with the bulk directed to infrastructure development.[22] Technical assistance plays an important role, but represents just 13 percent of assistance for the investment climate, and its effectiveness can suffer from supply-driven approaches and from inadequate attention to ensuring recommended solutions reflect a good fit with local conditions.

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 has a mixed track record, and would benefit from the same guidelines suggested for selective interventions made by governments. Developed countries and international agencies also provide around $26 billion per year in nonconcessional loans or guarantees to support specific transactions. Increasing the emphasis on the contribution these transactions make to the creation of more transparent and competitive markets would 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

BOX 4 *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 keys 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;
- to build policy credibility to give firms the confidence to invest;
- to foster the public trust required to enable and sustain policy improvements; and
- to 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.

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 do a lot to help create better investment climates in developing countries—and so contribute to a more balanced, inclusive, and peaceful world.