

DEVELOPMENT

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PUTTING KNOWLEDGE TO WORK FOR DEVELOPMENT  MARCH 2005

A Better Investment Climate FOR EVERYONE

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ABOUT THIS ISSUE

The *World Development Report 2005* that was released last fall drew attention to the importance of improving the investment climate—especially in the developing world, where 1.2 billion people barely survive on less than \$1 a day. It argued that improving the investment climate of their societies should be a top priority for governments, because firms and entrepreneurs of all types can play a key role in growth and poverty reduction.

Development OUTREACH has asked the leaders of the *WDR 2005* team Warrick P. Smith and Mary C. Hallward-Driemeier, to put together the special report featured in this issue in order to provide comments by world-renowned specialists on the issues raised in the *WDR 2005* and expand the discussion beyond its parameters.

The articles included in the Special Report, while reinforcing the idea that private firms—from micro-enterprises to multinationals—provide the foundation for growth and prosperity, also emphasize the need for governments to make the investment climate beneficial to everyone. For example, Raj M. Desai and Sanjay Pradhan argue that “an investment climate must be judged not by how much it helps corporations, but by the tangible benefits it brings to citizens.” Too often, they maintain, rules designed to empower the private sector result in high levels of corruption, which is ultimately destructive to the country’s economy. Dani Kaufmann, too, focuses on the governance issues that may impair an investment climate.

On the other hand, using specific country examples and emerging lessons, other authors show how government interventions benefiting SMEs and informal firms can have a positive impact on society by increasing employment and providing services. Overall, the message of this special report confirms the findings of the *WDR 2005*, namely that a well managed investment climate must include a two-pronged strategy: reform policies that remove constraints impairing the performance of both small and large firms, and measures that ensure opportunities for all citizens.



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PHOTO CREDITS

Cover: James Endicott, Images.com; Page 3: The World Bank; Page 7: Stephen Shaver, AFP; Page 11: The World Bank; Page 13: Gent Shkullaku, AFP; Pages 19, 21, 25, 26: The World Bank; Page 27: Hoang Dinh Nam, AFP; Page 29: The World Bank; Page 31: FeatureChina/Duwei, FCH; Pages 35-36: The World Bank.

This magazine is printed on recycled paper, with soy-based inks. 

ISSN 1020-797X © 2005 The World Bank Institute

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THE WORLD BANK

DEVELOPMENT Outreach

VOLUME SEVEN, NUMBER ONE MARCH 2005

PAGE 2

PAGE 21

PAGE 28

SPECIAL REPORT A BETTER INVESTMENT CLIMATE FOR EVERYONE

2 A Better Investment Climate for Everyone

Guest Editorial

WARRICK P. SMITH AND MARY C. HALLWARD-DRIEMEIER

Based on the *WDR 2005*, this editorial discusses how progress can be achieved in improving the investment climate and creating favorable conditions for everyone.

7 Initiating a Growth Boom

RICARDO HAUSMANN, LANT PRITCHETT, AND DANI RODRIK

This article illustrates the shifting towards rapid growth strategy that selectively attacks the key binding constraints to growth.

10 Public-Private Sector Dialogue in Uganda's Reform Process

WILLIAM KALEMA

Uganda's wide-ranging reforms have resulted in a radical improvement in its economic fundamentals and provided a strong platform for sustained economic growth.

13 Governing the Investment Climate

RAJ M. DESAI AND SANJAY PRADHAM

This article argues that an investment climate must be judged not by how much it helps corporations, but by the tangible benefits it brings to citizens.

16 Click Refresh Button: Investment Climate Reconsidered

DANIEL KAUFMANN

A new set of survey instruments beyond conventional measures proved effective in assessing corruption issues that would impair the investment climate.

19 Entitled to Work: Informal Enterprise in Urban Peru

ERICA FIELD

Growth and sustainability of small business enterprises in Peru depends on security of tenure and formalization of residential property.

21 Local Government Innovations for the Informal Economy: Creating a Positive Investment Climate

FRANCES LUND AND CAROLINE SKINNER

The focus of this article is on South Africa and the role of the government in creating a favorable investment climate for the informal economy.

24 Wither SME Policies?

QIMIAO FAN, ALBERTO CRISCUOLO, AND IVA ILIEVA-HAMEL

While improving the investment climate will help all firms, the same policies will have different impacts on small and medium enterprises due to their size.

28 Potential Winners and Losers from Formalization

AHMED GALAL

As a study of Egypt's informal sector shows, formalization could generate significant benefits to the economy and most economic agents if reforms were adopted.

31 Getting the Best out of Creative Destruction: Productivity Growth and Job Creation

STEFANO SCARPETTA

A more flexible investment climate that permits entry and exit is associated with greater productivity growth and job creation, but reform initiatives should be designed to assist those adversely affected.

35 VOICES FROM THE FIELD

37 KNOWLEDGE RESOURCES

38 BOOKSHELF

40 CALENDAR OF EVENTS

Aoetier

Guest Editorial

**BY MARY C. HALLWARD-DRIEMEIER
AND WARRICK P. SMITH**

IMPROVING THE INVESTMENT CLIMATE is key to sustainable growth and poverty reduction. Investment climate reforms help to explain China's achievement in lifting 400 million people out of poverty, India's success in doubling its growth rate and Uganda's ability to grow at 8 times the average of other Sub-Saharan countries over the last decade (see Box 1). The policy agenda is to address those government policies and behaviors that affect the incentives and opportunities facing firms to invest productively, create jobs and expand. The focus on firm decisions is well placed as firms create over 90 percent of jobs, supply the goods and services necessary to increase livelihoods, and provide the bulk of the tax base needed to fund public services. The goal is not to raise profits per se, but to understand the constraints facing firms of all sizes to prioritize reforms that will benefit society more generally. Nor is the aim simply to increase the level of investment—the real driver of long-term growth is productivity improvement. A good investment climate needs to encourage both.

The cross-country evidence shows that aggregate growth and the growth of the poor are very highly correlated. And, at a more disaggregated level, investment climate improvements have a direct impact on poor people through four channels.

First, through job creation and self-employment, the top priorities identified by 60,000 poor people interviewed in the "Voices of Poor Study." Second, through more and cheaper consumer goods, including goods that are consumed by the poor such as food and clothing. Third, as users of property, finance, and infrastructure whose improvements benefit poor people in their private lives whether they work or engage in entrepreneurial activities or not. And fourth, the poor benefit as the recipients of tax-funded services. A growing private sector is the only sustainable source of raising taxes for public health, education, and other important social services.

Reducing risks, costs and barriers to competition

GOVERNMENT POLICIES AND BEHAVIORS that shape the investment climate cover a truly broad terrain: stability and security (including macroeconomic stability, securing property rights, curbing crime); regulation and taxation both at and within the border; finance and infrastructure; and workers and labor markets (including worker skills and measures to help workers cope with change). But firms do not evaluate policies in each area in isolation: they look at them as part of a package. To evaluate them from a firm's perspective, new data allows policies to be measured according to their impact on three key fac-

CHINA, INDIA, AND RWANDA

ILLUSTRATING THE IMPACT OF POLICY UNCERTAINTY TO INVESTMENT

China and India have experienced waves of foreign direct investment (FDI) inflows that have heralded growth. China's FDI inflows helped spur growth and doubled its GDP in 2004. India's FDI inflows spurred its economic growth and investment. Rwanda is facing the growth challenge.

The benefits of FDI are multiplied when countries have improved macroeconomic and investment environments.

China's macroeconomic and investment environment improved by a policy uncertainty index score of 3.0 in 2004, up from 2.0 in 1992. India's score was 2.5 in 2004, up from 1.5 in 1992. Rwanda's score was 1.0 in 2004, up from 0.5 in 1992.

China's GDP growth rate was 9.7 percent in 2004, up from 7.7 percent in 1992. India's GDP growth rate was 9.3 percent in 2004, up from 7.3 percent in 1992. Rwanda's GDP growth rate was 7.3 percent in 2004, up from 5.3 percent in 1992.



tors influencing opportunities and incentives for firms: risks, costs and barriers to competition (see Box 2).

Risks—Because investment is forward-looking, uncertainty and risk chill incentives to invest. Indeed policy-related risks dominate concerns of firms in developing countries. As Figure 1 shows, policy uncertainty and macroeconomic instability are the 2 top-rated concerns across countries (also true across firms). The share of firms reporting that the interpretation of regulations are unpredictable as a major constraint is 34 percent in China, 56 percent in Indonesia 56 percent and



BOX 2

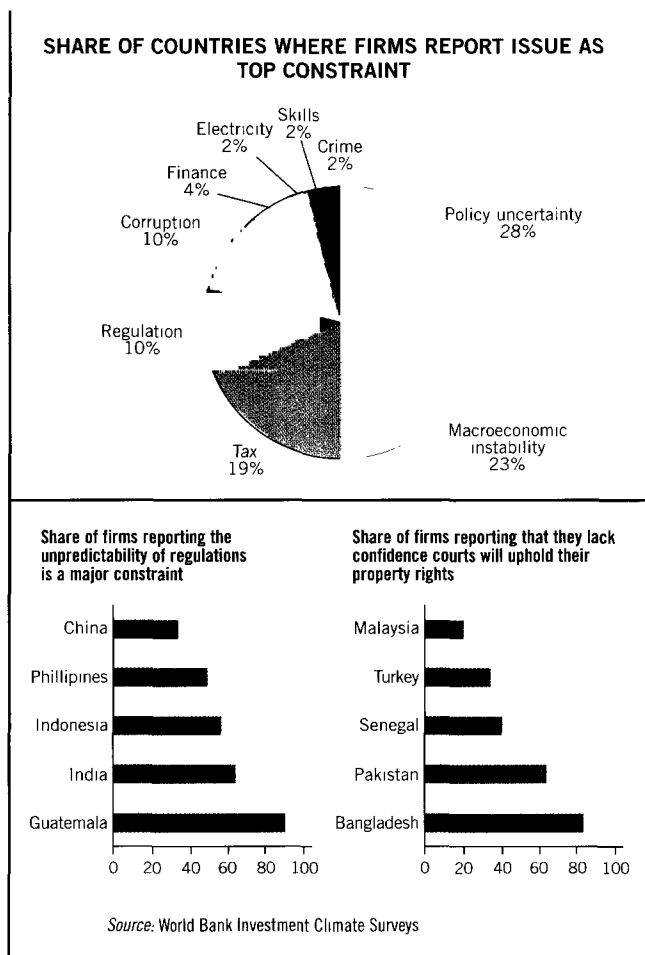
NEW DATA MEASURING THE INVESTMENT CLIMATE

Earlier efforts to measure the investment climate have focused on a score for each country. But more detailed analysis shows that the score can be misleading. The World Bank investment climate surveys cover mostly local firms in 53 countries. With surveys of 3,000 micro and information, the WBI team completed both perceived and objective cost dimensions of the investment climate. The microdata clearly shows that there are big variations with local governance matters. The impact across different types of firms, with a new source of data is provided by the Business. It provides official costs associated with fully accessing these data sources, visit: worldbank.org/wdr2005

89 percent in Guatemala. The share of firms that lack confidence in courts to uphold their property rights ranges from 19 percent in Malaysia to 83 percent in Bangladesh. *The World Development Report 2005* shows that improving policy predictability alone can increase the probability of new investment by over 30 percent.

Costs—Policy related costs directly influence the range of opportunities that might be profitable, and hence the incentives to invest. Firms everywhere complain about taxes. But the other costs associated with a weak investment climate can

FIGURE 1: POLICY-RELATED RISKS DOMINATE THE CONCERNS OF FIRMS ACROSS COUNTRIES



be more than 3 times what firms typically pay in taxes (Figure 2). In Tanzania, poor infrastructure, weak contract enforcement, corruption, crime, and burdensome regulation amount to nearly 30 percent of sales. And these are actually a bigger constraint than taxes, because unlike taxes, firms bear these costs whether or not they make a profit. As Figure 2 shows, there are big variations both in the level and the composition of costs within countries. Costs also have a time dimension. In many developing countries managers spend more than 15 percent of time dealing with officials, rather than concentrating on making better products or improving their productivity. To start a new business takes 2 days in Australia but 203 in Haiti. To enforce a simple contract takes 48 days in the Netherlands, 69 days in Singapore and 730 in Nigeria.

Barriers to competition—Barriers deny opportunities to some firms, increase costs for firms depending on inputs from protected sectors, and reduce incentives for protected firms to innovate and increase productivity. High risks and costs themselves act as barriers to entry. But governments also influence the extent of barriers through regulations of entry and exit and approaches to controlling anti-competitive behavior by firms. Firms facing strong competitive pressure are at least 50 percent more likely to innovate.

FIGURE 2: COSTS VARY BY LEVEL AND COMPOSITION

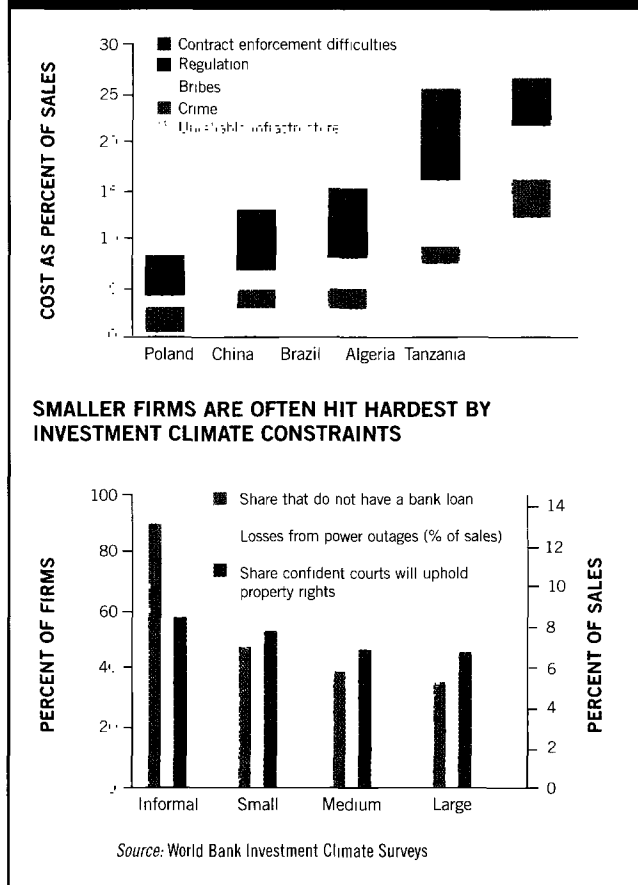


FIGURE 3: COSTS HAVE A TIME DIMENSION TOO



Addressing priorities persistently rather than seeking perfection

THE POTENTIAL AGENDA IS LARGE, but it does not need to be daunting. No country has a perfect investment climate. But if perfection is not necessary, persistence does matter. Experience shows that even modest initial improvements can unleash a strong response when they target important constraints and are implemented in ways that give firms the confidence to invest.

The impact of enhancing property rights in China, and trade and regulatory reforms in India, are only two such examples.

Setting priorities is key. Because the most important constraints vary widely across (and within) countries, these need to be assessed in each case. Simply reforming will not have much impact unless these efforts tackle binding constraints.

In setting priorities, the private sector is an important partner in the process. Private sector-public sector dialogue can help identify constraints and build a constituency for reform. The process also helps foster credibility and increases the likelihood of a strong private sector response to reforms.

Reform is not just about changing formal policies

IF A GOOD INVESTMENT CLIMATE offers so many benefits, why is progress often slow and difficult? The answer is that the agenda goes beyond simply changing formal policies. Adequate resources can be a constraint, but often it is not about a lack of money—many investment climate improvements demand little from the budget, and the growth unleashed can increase tax revenues.

Rather, there are four deeper sources of policy failure that need to be navigated:

- **Restraining rent-seeking:** It is not just about corruption, but also the disproportionate influence exercised by connected firms that lead to deep distortions.
- **Building credibility:** It is not enough to pass a new law if firms lack confidence that it will be implemented and sustained. This is a big issue with some reforms implemented to meet conditionality requirements.
- **Building public trust:** It is not just about firms and governments. Governments need to nurture broader public support to enable and to sustain reforms. The extent of public trust can have a direct impact on credibility and hence investment response.
- **Ensuring policy responses match local conditions.** Too often, laws are transplanted uncritically from other countries, and can lead to poor or perverse results.

A Better Investment Climate For *Everyone*

"FOR EVERYONE" should be interpreted in two ways. First, the goal is to improve outcomes for society as a whole, not just for firms. Thus, for example, regulations and taxes should be evaluated by their contributions to social welfare and not just by their popularity with firms. Second, the goal should be to embrace firms of all types—from farmers and microentrepre-

neurs to local manufacturing companies and multinationals. All have important and complementary roles to play in improving living standards and reducing poverty. As much of the literature and attention on the private sector focuses on large and multinational firms, this magazine turns the spotlight to the contributions made by smaller firms—and the challenges they face.

Small firms are hurt disproportionately by a weak investment climate and so will benefit from improvements. But there is also a further debate as to whether there are "pro-poor" investment climate improvements. One strategy is to focus reforms to improve the investment climate where poor people live. For some countries this is in rural areas, but it is also in peri-urban or urban slum areas. Clearly all levels of government, from national to municipal, can affect the investment climate agenda.

A second strategy is to improve the investment climate for activities poor people are concentrated in, whether as workers, entrepreneurs, or consumers. One approach that is politically popular is to implement targeted interventions that favor SMEs. However, such programs are very often ineffective and costly. They can also introduce deeper distortions and distract attention from broader-based measures and so need to be evaluated carefully. Rather, broader reforms often stand to benefit SMEs more than proportionately by reducing constraints that hit them hardest. It should also be noted that pro-poor strategies should not be limited to those benefiting smallest firms. Large firms are also important providers of employment and training, purchasers of supplies and sources of tax revenue.

Challenges with the transition to a better investment climate

A BETTER INVESTMENT CLIMATE can expand opportunities, but policy makers should recognize that the process is not always smooth. There are winners and losers, particularly in the transition. Where possible, reforms should build in a means of compensating them and ensure safety nets are in place. This reinforces the need to complement the strategy of improving the

investment climate to create opportunities for people to improve their situations, with policies to invest in and empower people so they can take advantage of those opportunities. These efforts have clear benefits to affected individuals, but also enhance the political environment for reform by assisting with building constituents for change.

PRIVATE SECTOR-
PUBLIC SECTOR
DIALOGUE CAN HELP
IDENTIFY
CONSTRAINTS
AND BUILD A
CONSTITUENCY
FOR REFORM.
THE PROCESS ALSO
HELPS FOSTER
CREDIBILITY AND
INCREASES
LIKELIHOOD FOR
PRIVATE SECTOR
RESPONSE
TO REFORMS.

What's in this issue

THIS ISSUE OF DEVELOPMENT OUTREACH provides country examples and lessons illustrating how progress can be achieved in improving the investment climate. The emphasis is on improving conditions for everyone—for society as a whole and for firms of all sizes—to maximize the impact on growth and poverty reduction.

The first article by Ricardo Hausman, Lant Pritchett, and Dani Rodrik discusses the experiences of initiating growth booms, finding that reforms per se are not sufficient in this process. Rather, what is critical is tackling binding constraints in generating growth. In setting these priorities for investment climate reforms that can initiate growth, fostering private sector-public sector dialogue can be key. William Kalema demonstrates the significant role such a dialogue played in Uganda's recent success.

Raj Desai and Sanjay Pradhan discuss the deeper governance agenda that underlies the challenges of reform. They provide evidence of the costs of corruption and the distortions stemming from the undue influence of connected firms: firms with greater political ties enjoy a better investment climate, but actually innovate less. Dani Kaufmann also stresses the need to broaden the discussion of governance to go beyond notions of predatory states and bribe-taking to tackle the deeper problems associated with the capture of policymakers by certain firms.

The above two articles address some of the challenges inherent in ensuring 'everyone' in society benefits from investment climate policies, not just certain privileged firms. The next set of articles addresses 'everyone' in the second sense, that reform priorities need to address the constraints of firms of all types. Here we focus on smaller and informal firms; firms that too often are denied much voice in policy setting. Erica Fields highlights the important role that securing title to land can have in urban areas of Peru, increasing investment and employment participation of poor households. Frances Lund and Caroline Skinner look at reforms in Durban, South Africa, aimed at better integrating informal firms and the benefits stemming from them. Qimiao Fan, Alberto Criscuolo and Iva Ilieva-Hamel address the broad justifications of policies specifically targeted to benefit SMEs.

The process of improving the investment climate is a dynamic one. Ahmed Galal, in analyzing initiatives to increase formalization of businesses in Egypt, identifies broad groups of winners and losers, demonstrating that the former outweigh the latter. Stefano Scarpetta provides new evidence on the extent to which firms enter and leave the market. Linking this to a country's investment climate shows that a degree of turnover is an inherent part of a healthy economy and can lead to productivity gains and net job creation. While the overall gains are positive, individual firms and workers can have difficulty adjusting. Where possible, reforms should build in means of compensating them and ensure safety nets are in place.

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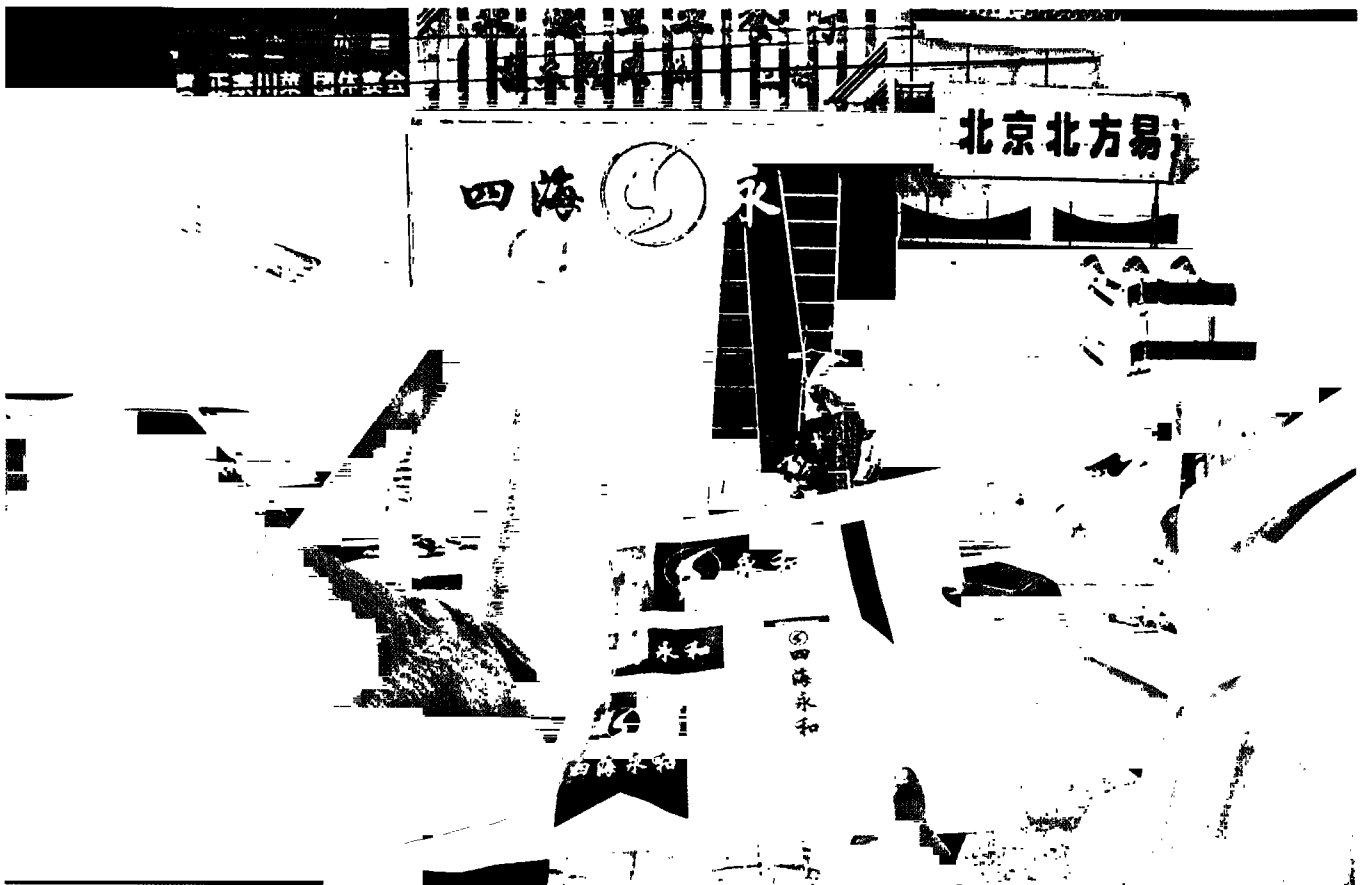
Initiating A GROWTH BOOM

BY RICARDO HAUSMANN,
LANT PRITCHETT, AND DANI RODRIK

ACCELERATING ECONOMIC growth is perhaps the most important policy issue in economics. Increases in income not only lead directly to reductions in income poverty but also improvements in well-being nearly across the board—from improved health, better nutrition, increased education, reduced child labor. Attention is shifting towards a focus on initiating an episode of rapid growth through a country specific growth strategy that selectively attacks the key binding constraints to growth.

Why an emphasis on episodes of rapid growth?

ADAM SMITH LAUNCHED MODERN ECONOMICS with *An Inquiry into the Nature and Causes of the Wealth of Nations*. The topic has never been off the economist's agenda since. In the 1990s there was a resurgence of interest in empirical work examining the correlates of growth rates and levels of income across countries. Literally thousands of papers have been written examining the association of growth rates across countries and an enormous array of country geographic, poli-



cy, and institutional characteristics. In addition, researchers have examined the determinants of countries' current level of income (as a proxy for very long-run growth rates) in order to understand the large and diverging levels of income between the richest and poorest countries.

While this literature has reconfirmed the importance of many of the fundamental economic principles it does have an enormous empirical weakness, which limits its usefulness to policy makers. The empirical weakness is that the growth rates of individual countries tend to be enormously unstable and volatile while nearly all of the empirical determinants of growth tend to be quite stable.

An empirical example illustrates the magnitude of the changes in growth rates over time. The average growth rate in per capita GDP (using the standard purchasing power adjust-

ment) over the 1960 to 2000 period across all countries in the world is about 1.8 percent per annum. The bottom quarter of countries grew less than .5 percent per year, while the fastest quarter of countries grew at about 2.6 percent per year. So if a country's growth changed by 2 percent per annum this is a big change, as it would take them from quite poor growth performance to good growth compared with other countries. But the actual change in growth in individual countries over time is enormously larger than this. If one compares countries highest to lowest growth decade over the four decades from 1960 to 1990 one finds that the difference in growth rates for the same country was, on average, a truly astounding 4.4 percent per annum—this implies the income was 50 percent higher at the end of a high growth decade than what it would have been in a low growth decade. Examples of large shifts in

growth rates, both accelerations and decelerations are easy to find: Indonesia accelerated by 4.5 percent per annum (from 1.0 to 5.5) from the 1960s to 1970s. China accelerated by 3.0 percent (from 2.4 to 5.4) from the 1970s to 1980s, the Dominican Republic accelerated by 4.7 percent (from .8 to 5.5) from the 1980s to the 1990s, Brazil's growth decelerated by 4.5 percent (from 5.3 to .8) from the 1970s to 1980s, Mexico decelerated by 4.2 percent (from 3.1 to -1.1) from the 1970s to the 1980s.

While growth rates are very volatile the usual correlates of growth tend to be very stable. This implies that existing empirical models do very badly in identifying the "turning points"—the timing of growth accelerations and decelerations. Our approach is to focus on these turning points in growth experiences. By doing so we also come significantly closer to answering the questions that most preoccupy policy makers. Policy makers are rightly much more concerned with the question "what is it that I can do to accelerate growth rates in *my* country, *today*?" than with the question "what on average across all countries are the correlates of growth rates over long periods?"

New facts about growth accelerations

OUR RESEARCH BEGINS by defining an *episode of acceleration to rapid growth* as a period of at least seven years which met three criteria: (a) growth *accelerated* by at least 2 percentage points over the previous growth rate, (b) the post-

TABLE 1: EPISODES OF RAPID GROWTH CLASSIFIED BY GROWTH RATE BEFORE AND AFTER THE EPISODE (identified by three letter country acronym and year of acceleration to rapid growth)

GROWTH RATE IN THE TEN YEARS FROM SEVEN YEARS AFTER THE INITIATION OF THE GROWTH EPISODE (T+7 TO T+17) (with at least 7 years of data—no episodes after 1986)

GROWTH RATE IN THE SEVEN YEARS BEFORE THE INITIATION OF THE EPISODE OF RAPID GROWTH (T, T-7)			
	Negative before (<0) (15/69)	Slow before (>=0 & <2) (32/69)	Above average before (>=2) (22/69)
Negative <0 (after) (16/69)	Ghana 65 Guinea-Bissau 69 Jordan 73 Nigeria 67 Chad 73 <i>Slow to growth episode back to slow</i>	Ecuador 70 Mali 72 Malawi 70 Rwanda 75 <i>Slow to growth episode back to slow</i>	Congo, Rep. 78 Algeria 75 Indonesia 87 Panama 75 Romania 79 Syria 74 <i>(fast to growth episode to slow growth)</i>
Slow after (>=1 & <2) (16/69)	Dominican Republic 69 Pakistan 62 Uganda 77	Argentina 63 Australia 61 Colombia 67 Lesotho 71 New Zealand 57 Nicaragua 60 U.K. 82 Uruguay 74 Zimbabwe 64	Brazil 67 Israel 67 Paraguay 74 Thailand 86
Above average after (>=2) (37/69)	Chile 86 Cameroon 72 Egypt 76 Indonesia 67 Morocco 58 Mauritius 71 Thailand 57 <i>Slow to growth episode and stays rapid</i>	Canada 62 China 78 Congo, Rep. 69 Denmark 57 India 82 Ireland 58 Ireland 85 Korea 62 Mauritius 83 Nigeria 57 Pakistan 79 Panama 59 Peru 59 Portugal 85 Spain 84 Sri Lanka 79 Syria 69 USA 61	Belgium 59 Botswana 69 Finland 58 Finland 67 Israel 57 Japan 58 Korea 84 Malaysia 70 Singapore 69 Spain 59 Taiwan 61 Tunisia 68 <i>(fast to growth episode (even faster) to fast)</i>

acceleration growth rate was *rapid*—at least 3.5 percent per annum and (c) the level of income was higher at the end of the episode than its previous all-time peak (to distinguish growth from mere “recovery” episodes).

FACT 1: GROWTH ACCELERATIONS ARE COMMON

The first finding is that even by these quite stringent standards for an episode of rapid growth, they are quite frequent. While the method identifies and plausibly dates all of the obvious episodes—e.g. China after 1978, Indonesia in 1967, Chile in 1986, Korea in 1962—the method also finds there are 83 total episodes of growth acceleration in the period 1957 to 1992 (the limitations imposed by data availability and the use of a seven year period). This frequency implies that, as a baseline, a country has a 1 in 4 chance of experiencing an episode of rapid growth in any given decade. The accelerations were spread across decades and across regions—even in “low performing” regions there have been a substantial number of growth accelerations—18 in Sub-Saharan Africa, 17 in Latin America.

FACT 2: EPISODES OF GROWTH BEGIN AND END VERY DIFFERENTLY

While initiating an episode of rapid growth is of interest, clearly what happens after the episode is critical—does growth stay high, return to trend, or collapse? We examined growth before the episode and ten years after the episode. For instance, Indonesia initiated a rapid growth episode in 1967, so this procedure would compare growth 1960-1967 (before), 1967-1974 (the seven years of the episode), and 1974-1984 (ten years after). Table 1 classifies the 69 possible episodes (by whether growth was negative, slow, or above 2 percent per annum) before and after. This exercise distinguishes those episodes that were and were not sustained into the longer term. Of the 69 growth episodes for which this calculation can be undertaken, 16 had *negative* growth for the ten years after the end of the episode (busts followed booms), 16 had slow growth (between 0 and 2) and 37 continued growth above 2 percent per annum. This exercise also examines the conditions at the initiation of the episodes, 15 of these 69 episodes of rapid growth were preceded by falling output, 22 of 69 were initiated from slow growth and 32 of 69 from above average growth.

FACT 3: GROWTH ACCELERATIONS ARE (MOSTLY) UNPREDICTABLE.

Our research also examined the correlates of the beginning of rapid growth. While there were some factors that predicted growth acceleration, most growth accelerations are not preceded or accompanied by major changes in economic policies, institutional arrangements, political circumstances, or external conditions. The standard growth regression determinants have some statistical leverage over the timing of accelerations. But on the whole those determinants do a very poor job of predicting the turning points. It would appear that growth accelerations are caused predominantly by small-scale, idiosyncratic changes. The search for the common elements in these idiosyncratic determinants—to the extent that there are any—is an obvious area for future research.

Implications for growth strategies

WHILE ANY CONCLUSIONS ARE TENTATIVE, there are some preliminary implications of the focus on episodes of acceleration to rapid growth.

Success does not require getting everything right. Both the frequency of the episodes and the examination of the conditions in which individual episodes began shows that rapid growth does not require the elimination of corruption, nor a completely open trade environment (India 1982), nor the complete control of inflation (Brazil 1967), nor even a stable regime of private property rights (China 1978). The “policy pessimism” that attributes slow growth in spite of policy reforms to the fact that the payoffs require getting (nearly) everything right because of reform synergies cannot be generally true.

Success requires getting the right things right. The unpredictability of initiation of reforms does not imply that “nothing matters”—a number of the growth episodes can be easily identified with well-known reform efforts (e.g. Chile 1986, Indonesia 1967, China 1978, Korea 1962, Mauritius 1971, Argentina 1990, Dominican Republic 1992). But these findings reinforce the emerging view that initiating growth cannot be associated with a standard “one size fits all” package of the “usual” policy actions, but rather that “growth strategies” (Rodrik) should focus on attacking the “binding constraints” (Rodrik, Hausmann and Velasco) as outlined in the recent World Bank report on the “Lessons of the 1990s” and the *World Development Report 2005*.

Sustaining a boom requires continuous action. While the good news is that growth comes, the bad news is that growth goes—almost half of the periods of rapid growth were followed by slow or negative growth. Complacency with high growth is a recipe for slow growth. Just as creating a boom requires getting the right thing right, sustaining growth requires attacking the binding constraints in turn, hopefully before the bind bites. ♣

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Public-private Sector Dialogue

in Uganda's Reform Process

BY WILLIAM KALEMA

UGANDA'S IMPRESSIVE TRACK RECORD as a fast reformer has been well documented and widely acclaimed (R. Reinikka and P. Collier, 2001). The country recorded robust economic growth averaging 6.8 percent in the period 1990–2003 (World Bank, 2004), thanks to political stability and to prudent macro economic reforms that have imposed fiscal discipline, restructured public expenditure, and liberalized the economy. The reforms were implemented following a period of civil conflict (the 1970s and early 1980s) that saw Uganda's economy spiral out of control.

Key reforms successfully implemented have included the enactment of an Investment Code offering opportunities, incentives and protections to both domestic and foreign investors, an independent role for Bank of Uganda, the central bank, enhancing its capacity to manage the strengthened financial sector; overhaul of the trade regime and abolition of state commodity marketing monopolies; and privatization of public enterprises. Today, Uganda has one of the better

investment climates and the most liberal trade regime in the region. Much still remains to be done, but there is a commitment to lowering investment risks and reducing the costs of doing business, by implementing efficiency-enhancing reforms, strengthening key institutions, and providing better physical infrastructure.

The wide-ranging reforms have resulted in a radical improvement in Uganda's main economic fundamentals and provided a strong platform for sustained economic growth. The rapid recovery of Uganda's small but important industrial sector sharply illustrates this point (Figure 1).

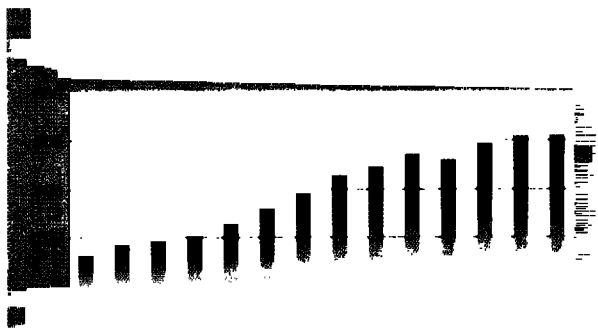
Public-private sector consultation

PUBLIC-PRIVATE SECTOR CONSULTATION has been a major factor driving Uganda's reform process. Indeed, the evolution of a strong public-private partnership presents interesting lessons for countries aiming to structure a successful consultative dialogue in a post conflict or emerging economy context.

Towards the end of the 1980s, the Ugandan economy was lacking in the most basic commodities, the inflation rate was over 90 percent, and a sudden collapse in the price of coffee, the country's only export commodity at the time, had precipitated a currency crisis. At the beginning of the 1990's, both the Government of Uganda and other key stakeholders in the economy had recognized that they needed to pull together to face the serious challenges of economic recovery. A major outcome of this realization was the launch of Uganda National Forum in 1992.

Key to the effectiveness of the Forum was the support of the President of Uganda, who made clear his commitment to private sector-led growth. The Uganda Manufacturers Association, the strongest and most credible business support organization in Uganda at the time, and the Presidential Economic Council (PEC), sponsored the Forum, with financial support from USAID.

FIGURE 1



Source: Statistical Abstract 2001, Uganda Bureau of Statistics & Background to the Budget 2004/05, Ministry of Finance Planning & Economic Development

The Forum, conceived by a small but influential group of reform minded public servants and visionary private sector leaders, was seen as a way to stimulate private sector investment and promote export development. The initial core group effectively steered a larger partnership including opinion leaders, catalysts, believers, skeptics, and others. The Forum had a well-defined organizational structure, with clear mandates for its working committees. It held a high level annual conference, attracting world-class speakers to provoke new thinking, with a strong mandate to conclusively define the country's reform agenda.

The Forum ran for 5 years, and while it lasted it provided a dynamic platform for key economic stakeholders to articulate business-friendly and growth-promoting policies, working on such initiatives such as the liberalization of interest rates, improved tax policy and administration, an export strategy, privatization, and public utility reform, among others. Starting from a background where government bureaucrats were more familiar with a command and control approach to policy-making, the forum worked hard to eliminate the high level of mistrust that had existed between the public and private sectors and to consolidate an emerging culture of participation. Participation of high-level leaders from business, government, and academia provided a deep reservoir of power and knowledge to exert influence in the public policy arena.

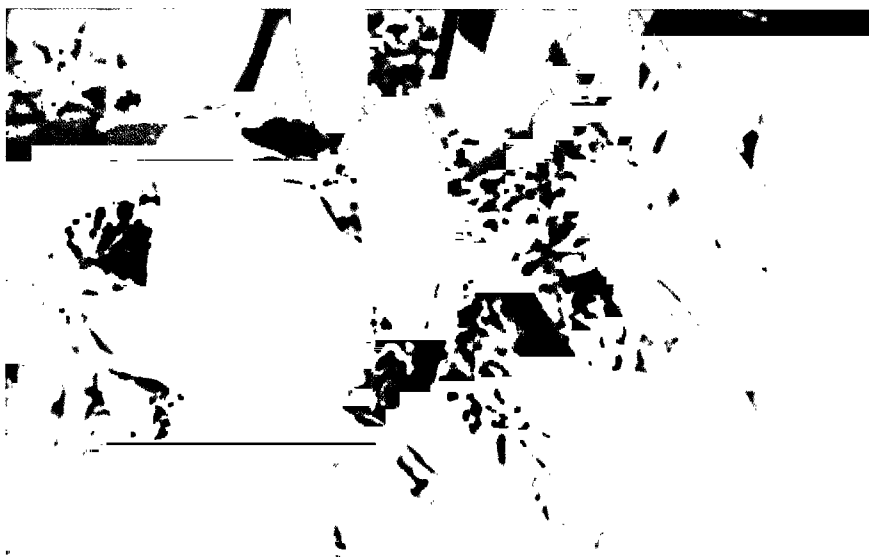
The Private Sector Foundation Uganda (PSFU)

THE SUCCESS of the National Forum was a major factor in the creation of strong sub-sector business organizations with the Private Sector Foundation Uganda (PSFU) at the apex. Formed in 1995, the PSFU now has a membership of 66 business associations and corporate bodies.

The PSFU broadly represents all sub-sectors of the economy and is at the heart of structured consultations between the public and private sectors. The Foundation has benefited from strong support and patronage of the many individuals from business, government and academia that were instrumental to the success of the National Forum. Strength in consensus building has enhanced the Foundation's profile as an effective platform for greater transparency among

private sector associations thereby mitigating/limiting tilt of policies in support of narrow special interests.

The Foundation enjoys growing recognition and is now Government's main partner in the implementation of the country's main framework for the development of the private sector—the Uganda's Medium Term Competitive Strategy (MTCS, www.psfuganda.org/docs/Content-MTCS.doc). The fact that the Foundation is not directly dependent on Government funding, conducts its business via transparent channels and is broadly representative of different sub-sectors has been its source of strength. Most importantly, the



SWEET TASTE OF VANILLA

THIS WAS POSSIBLE IN PART THANKS TO THE INITIATIVES OF MANY SMALL ENTREPRENEURS SUCH AS MARGRET NAMPALA

IN THE 1980S MARGRET NAMPALA WAS FARMING COFFEE AND RARELY SURVIVING ON UNDER \$1 A DAY BY 2003 SHE AND HER FAMILY WERE EARNING MORE THAN 10 THOUSAND DOLLARS A YEAR, MAINLY FROM FARMING A NEW CROP, VANILLA

MARGRET'S STORY SHOWS HOW AND HOW TO MAKE THE SUCCESSFUL OUTCOME SUSTAINABLE. SHE KNOWS SHE CAN NOT RELY ON VANILLA - ITS PRICE IS NEVER GUARANTEED - SO SHE IS INTO OTHER CROPS SUCH AS BANANAS, ORANGES, AND AVOCADOS AND SHE IS PLANNING FOR THE FUTURE "WE HAVE YET FOUND A NEW PLANT - COCOA"

THE EVOLUTION OF A STRONG PUBLIC-PRIVATE PARTNERSHIP PRESENTS INTERESTING LESSONS FOR COUNTRIES... IN A POST CONFLICT OR EMERGING ECONOMY CONTEXT.

leadership of the PSFU is widely respected, not only by its private sector constituency but also by the government and by Uganda's development partners.

The Foundation successfully managed a US\$20 million World Bank funded Private Sector Competitiveness Project (PSCPI) on behalf of the Government and now is poised to manage a successor project valued at US\$70 million. PSFU has managed other private sector programs sponsored by the EU and the USAID.


The successful record of the PSFU has inspired the formation of similar private sector apex organizations in Tanzania and in Rwanda, and the Foundation has played a pivotal role in the evolution of the East African Business Council [EABC], the apex business organization at the East African Community level.

Like any other new organization, the Foundation has had its share of challenges. For example, the disproportionate strength of some of its member associations, such as the Uganda Manufacturers Association, leads them on occasion to ignore PSFU consultative channels and take their case directly to government. The challenge of meeting the ever-rising expectations of both members and the Government has resulted in added pressure for PSFU to deliver on its mandate and has stretched the Foundation's internal capacity.

Other initiatives

OTHER PARALLEL, but no less important, initiatives have positively impacted on the quality of Uganda's public private dialogue. Government's launch of a Regulatory Best Practice initiative (RBP, www.goodregulation.or.ug) in 2000 is a case in point. The RBP program, working with both public and private sector partners, is enhancing public – private sector consultative channels thereby contributing to a more structured and efficient dialogue. Institutionalization of regulatory best practices in Government coupled with capacity building in Regulatory Impact Assessment (RIA) among private and public sectors, has provided a strong foundation for quality policy and law making in Uganda. Under this initiative, capacity in evidence based policy advocacy has been enhanced among private sector organizations, enabling them to dialogue with Government more effectively.

The drive to further improve the quality of Uganda's investment climate will increasingly depend on the skill with which the private sector associations, with the PSFU at the apex, work with government to identify new reform priorities and deliver solutions that progressively reduce both the risks and costs of doing businesses in Uganda. Following the quick, high-impact policy reforms of the type pursued with such success in the early 1990s, Uganda's major economic stakeholders

now have to grapple with the challenges of implementing institutional reforms and building their capacity to respond strategically to the demands of an increasingly competitive world. 

William Kalema is Chairman of the Board of the Uganda Investment Authority

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Information on the Government of Uganda's Medium Term Competitive Strategy (MTCS) is available at the Private Sector Foundation Uganda (PSFU) website: www.psfuganda.org/docs/Content-MTCS.doc.

Information on the Government of Uganda's Regulatory Best Practice (RBP) Initiative is available on the website: www.goodregulation.or.ug

Joint World Bank Institute/Private Sector Development **Investment Climate Program**

The World Bank's overall development strategy emphasizes two pillars for long-term growth and poverty reduction: improving the investment climate and empowering and investing in people. Investment climate has been identified as one of the seven corporate priorities at the 2003 Implementation Forum. The **Joint WBI/PSD Capacity Building Program in Investment Climate** was started this year and is designed to support the implementation of this corporate priority.

The program's objectives are:

- To familiarize clients with the importance of investment climate to growth and poverty reduction.
- To promote new thinking, share knowledge and disseminate best practices on how to incorporate investment climate issues in policy formulation.
- To enhance clients' capacity in assessing and improving investment climate.
- To train local trainers and researchers to build capacity for policy research and training in investment climate.

The target audience for the program includes: policy makers, practitioners and stakeholders in client countries, trainers and local partners, representatives from the international donor community, and Bank staff.

For more information, please email icprogram@worldbank.org.

www.investmentclimate.org

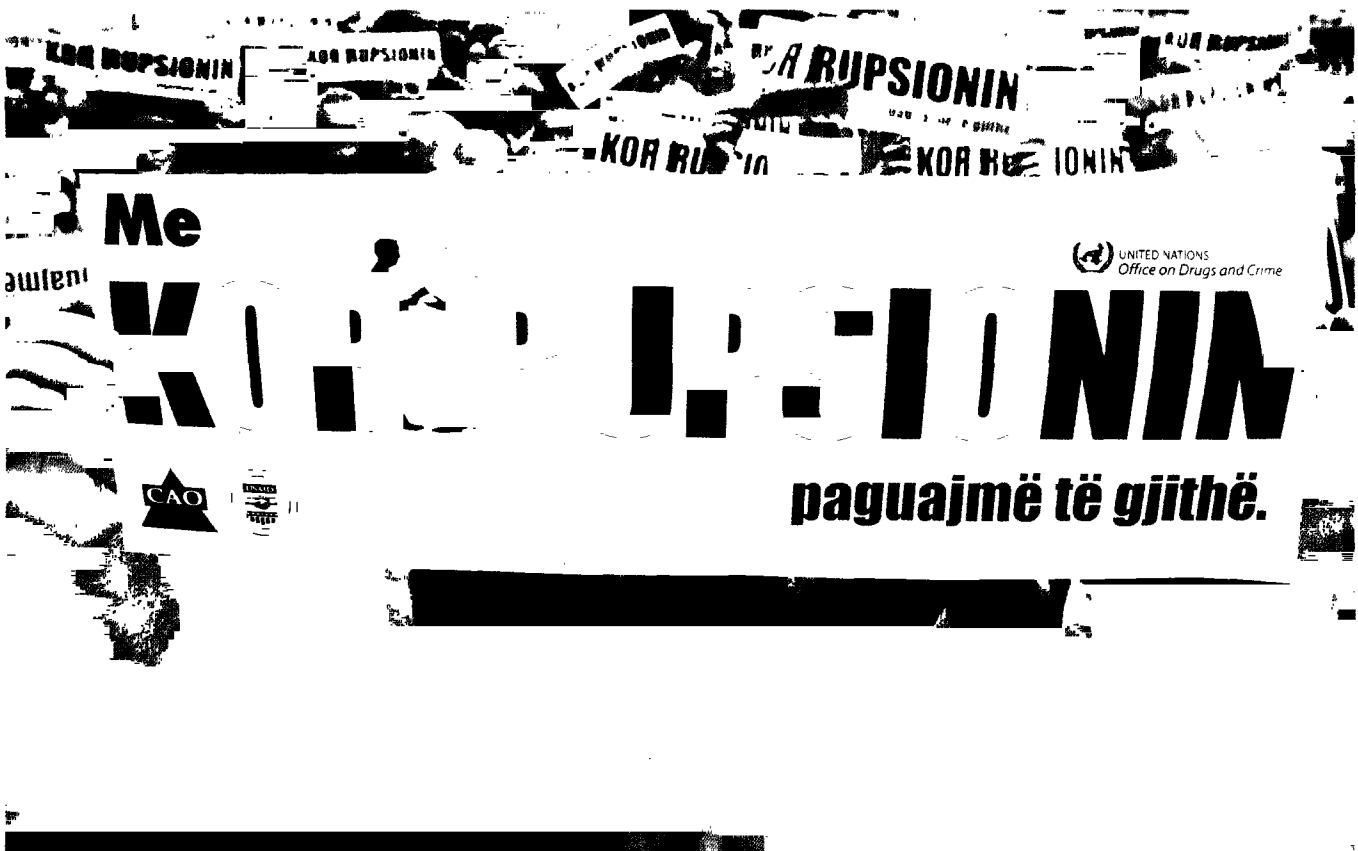
Governing the Investment Climate

BY RAJ M. DESAI AND SANJAY PRADHAN

IN MANY NATIONS around the world investment climates suffer from a crisis of governance. Because firms are the principal engines of job growth, a favorable investment climate cannot be hostile to firms. Yet an investment climate must be judged not by how much it helps corporations, but by the tangible benefits it brings to citizens. And so policymakers may face a dilemma: they can make and enforce rules that benefit companies, or they can legislate in favor of the public interest. Sometimes they can do both, but often—too often in many countries—the choice is made to devise rules of the game that

systematically benefit particular, privileged companies at the expense of the rest of society. As the *World Development Report 2005* argues, these are precisely the types of policies that thwart entrepreneurship and competition, and that stifle innovation and productivity.

In short, bad investment climates don't just happen, they are made—not because public officials lack the knowledge or expertise to govern well, but because there are deeper imbalances in the ways policies are designed and implemented. Why does this happen? How does it affect the economy? And most importantly, what can be done to resolve these problems?



Bribes: one of many distortions

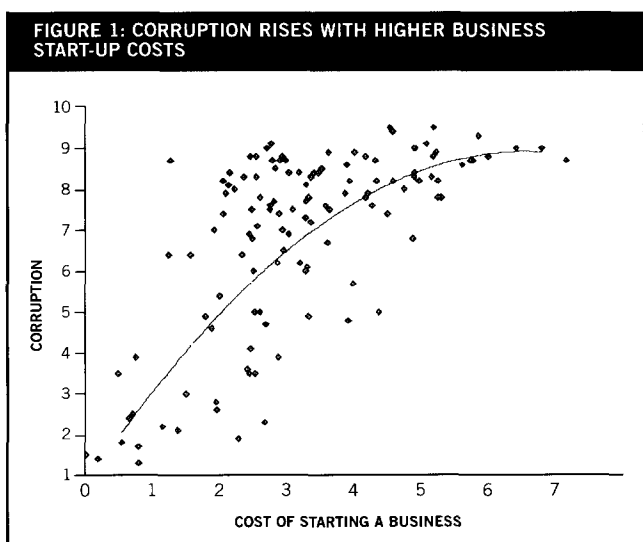
FOR VALID REASONS, efforts to improve governance in the investment climate have often focused on reducing the bribe tax paid by firms to public officials. High levels of corruption can last for a long time, all the while diverting resources from more productive activities. In the most extreme cases, corruption becomes "predation" and public officials treat their offices as a means of amassing vast personal fortunes. Mobutu's regime, for example, systematically plundered the Zairean copper-mining industry over the course of 30 years, leaving what was once a productive sector stripped of its wealth and highly inefficient by the late 1990s—the classic case of a predatory state. Mobutu is listed by Transparency International among the top-ten most corrupt leaders on record.

Yet, there would be no "grabbing hand" were it not for the often high levels of discretion that public officials have in implementing investment climate policies. For this reason, corruption is typically a more severe problem in countries with greater state intervention in the economy. Countries where the administrative costs of starting a business are higher also experience higher levels of corruption (see Figure 1).

No country is immune from these problems. But while reducing the bribe-tax on firms is a laudable goal, bribes may represent only one of many distortions that hamper an investment climate.

The cost of patron-clientelism and state capture

IN OPEN AND COMPETITIVE GOVERNMENT, representatives make policy in the interests of their constituents in exchange for their support. This is a normal part of democratic politics, and a necessary part of ensuring the accountability and



Note: Corruption is Transparency International's *Corruption Perceptions Index*, re scaled so that higher values represent greater levels of corruption; cost of starting a business is % of GNI per capita (log scale)

Sources: Transparency International, *Corruption Perceptions Index 2004*; World Bank, *Doing Business 2005*

responsiveness of policymakers to their citizens. But representative government in which the public is ill informed, or which lacks transparency can quickly devolve into patron-clientelism, where policymakers distribute privileges to particular groups on the basis of loyalty, ethnic or cultural solidarity, or other political criteria at the expense of the broader public. The problems can be worse in dictatorships, where the basic elements of transparency are missing.

When one group of individuals has disproportionate political 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 these groups. For instance, during the simultaneous economic and political transition in Eastern Europe and the former Soviet Union, powerful firms and individuals ("oligarchs") bought off politicians and bureaucrats to shape legal, policy, and regulatory environments in their own interests. Today several countries are beset with the problem of "state capture" whereby powerful economic interests in the public and private sectors influence the formation of laws, regulations, and policies to their own advantage—at the expense of the general public—through illicit and non-transparent provision of private benefits to public officials.

Consequently, policies that are inimical to the investment climate persist because they reward the narrow, personal interests of rulers and elites. 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. These distortions, once in place, are notoriously difficult to dismantle.

The *World Development Report 2005* provides evidence that the more widespread the direct personal connections between enterprise owners and politicians, the poorer the quality of a country's investment climate. These political connections may yield substantial benefits to firms that enjoy special relationships with political leaders, but they often come at the expense of other firms. More importantly, patron-clientelism creates a strong incentive for firms to invest in relationships of influence with politicians, rather than in their own production processes.

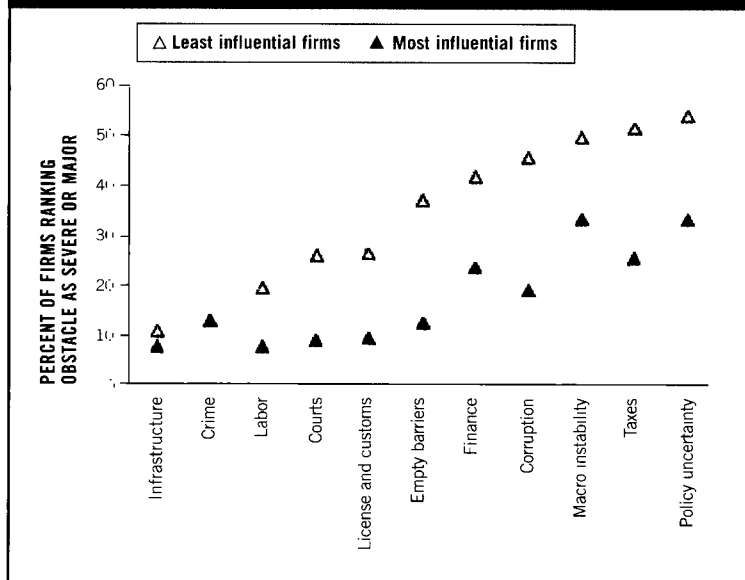
As Figure 2 shows, in example after example, influential, well-connected firms face fewer investment climate problems. Now all these relative benefits would not necessarily be a bad thing if the most influential firms were also the most dynamic—the firms that opened new plants or introduced new products and new production technologies. But the evidence from the *Investment Climate Surveys* shows exactly the opposite. As depicted in Figure 3, the most influential firms are actually the least innovative.

What this suggests is that the preferential treatment of particular firms at the expense of other (usually smaller) firms constitutes a major drain on the economy, and carries large social costs.

The way forward

HOW CAN ECONOMIES BREAK OUT of these cycles of bad

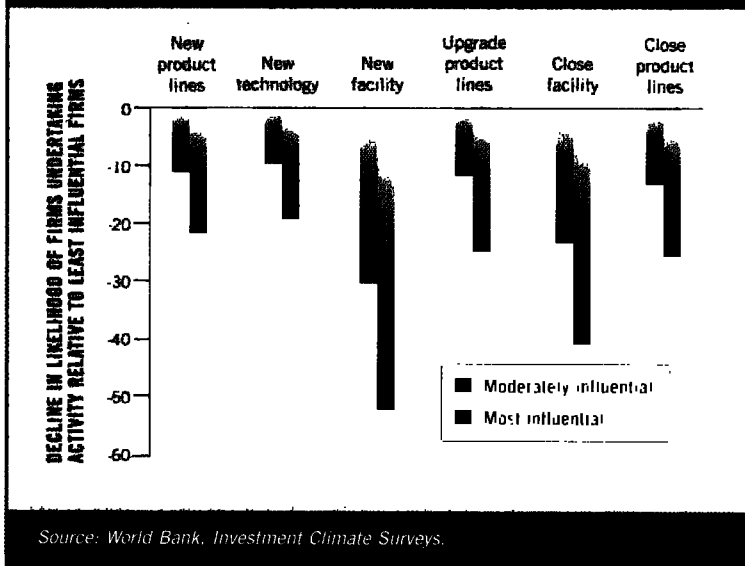
FIGURE 2: LIFE IS EASIER FOR INFLUENTIAL FIRMS...



Note: "Influence" is measured as the perceived gap between the ability of the responding firm and the ability of other domestic firms to affect national economic policy. Percentages are based on simulations controlling for country, sector, and firm size.

Source: World Bank, *Investment Climate Surveys*.

FIGURE 3: ... BUT INFLUENTIAL FIRMS INNOVATE LESS



Source: World Bank, *Investment Climate Surveys*.

governance, bad policy, and poverty? Around the globe countries as diverse as India, Uganda, and Brazil have shown how a combination of domestic will, political openness, and well-crafted reform efforts can improve how the investment climate is governed, and do so in ways that enhance both confidence among investors and legitimacy in the eyes of their citizens. Among the lessons:

- *Capitalize on windows of opportunity for reform.* Patron-clientelism creates powerful resistance to reform. Economic crisis, an external threat or the arrival of a new

government with fewer vested interests in the old system, may provide the impetus for reform. Political leadership is vital. Reform-oriented leaders can speed reforms by articulating a compelling longer-term vision of societal gain from an inclusive investment climate, and by building coalitions that give greater voice to often-silent beneficiaries.

- *Give all investment climate participants a voice.* Broadening policy dialogues to include representatives of a wider range of interests, including consumers, taxpayers, and owners and employees of smaller businesses will enfranchise previously excluded groups in policymaking. Business associations can sometimes play a role in helping to empower smaller firms vis-à-vis traditional elites.
- *Strengthen accountability and restraint.* Competitive legislatures permit disenfranchised groups to challenge the authority of incumbents. Strong legislatures also make it more difficult for executive-branch policymakers to deliver clientelist policies without legislative approval. Clientelism can be checked by increasing the transparency of decisions made by public officials and through political competition that provides broad constituencies with vehicles, such as mass-based political parties, for expressing their collective demands. A free and independent media can make the public aware of the costs of clientelist practices and reinforce accountability through the ballot box. Finally, embodying formal rules and processes in national constitutions that create effective "veto" points in decision making—such as checks and balances between different branches or levels of government—can constrain arbitrariness and clientelism.
- *Create a competitive private sector.* The concentration of economic power in a few firms or industries is both a consequence of clientelism and a cause of state capture. Concentration of economic power can be tackled by deepening price and trade liberalization, increasing transparency in the ownership structure of firms, introducing greater competition by lowering barriers to entry, and competitive restructuring.
- *Ensure that benefits are widely enjoyed.* Growing gaps between the privileged few and the rest of the population has often fueled populist backlashes against markets. By contrast, efforts to ensure that benefits of the investment climate extend widely across society—and to protect those disadvantaged by change—can improve social attitudes towards firms and markets, and improve the political feasibility and sustainability of policy improvements.

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Click Refresh Button

Investment Climate Reconsidered

BY DANIEL KAUFMANN

"Have dinner menus here always been the same?," asked Menem's aide to the chef at the Argentinian presidential residence. 'The menus change, the presidents change. What never changes are the dinner guests', retorted the presidential chef, referring to the cadre of businessmen who frequented the residence."

—In *El Octavo Círculo* by G.Cerrutti y S.Ciancaglini, 1992

THIS ANECDOTE by no means pointed to a challenge circumscribed within one country or region of the world. Years later, John Lloyd would write in *The Financial Times*: "The oligarchs were so called because they had real power, state power. They wrote laws. They appointed ministers, often entire cabinets, and made sure that their interests were served. They corrupted the new governing, legislative and bureaucratic class of Russia, in the centre, in the regions and abroad."

Indeed, by the late nineties, with Joel Hellman, we embarked on a joint research project to go beyond conventional measures of the investment climate and of corruption. Inter alia it aimed at measuring capture of the state by powerful private interests, and the extent of undue influence by elites. A new set of survey instruments was put forth, which was first applied to thousands of enterprises throughout transition economies, and subsequently extended to other regions. As a result, by the year 2000, in writing the results from the initial phase of this project, we were challenging orthodoxy:

"Corruption is conventionally defined as 'the abuse of public office for private gain.' Behind this definition lies an image of a predatory state seen as a large 'grabbing hand,' extorting firms for the benefit of politicians, high officials and bureaucrats...[Here] we shift the focus to the role of firms. The new evidence suggests that many firms in practice...collude with politicians for their mutual benefit.... We conclude with rather different implications for action."

Mixed results: The traditional approach to investment climate still prevails

HALF A DECADE HAS ELAPSED since then. Nowadays discussion on state capture or undue influence is not as infrequent;

further the indicators of capture and influence that emerged from the research have helped in evaluating these forms of misgovernance. The data generated also did help in providing insights on the causes and consequences of capture of the state. For instance, our findings suggested that not only were more competitive and liberal economic policies associated with a lower degree of state capture in an economy, but, more fundamentally, that the extent of civil liberties and political contestability in the country was inversely related to the extent of state capture and unequal distribution of influence. The evidence on the political content of manifestations of grand corruption such as state capture could therefore no longer be ignored. These findings have enjoyed some exposure and discussion in the policy world, such as parliamentary debate (Russia), or the publication of a full-fledged diagnostic book (on the Colombia's presidency website). Furthermore, some subsequent analytical work is gradually accounting for challenges of capture and influence, such as in the Bank reports on *Anti-Corruption in Transition*, and in the recently launched *World Development Report 2005*.

However, concrete progress in terms of country strategies and actions on the ground has been modest. Furthermore, popular notions and myths continue to persist. In fact, the international—and multilateral—community has not fully faced the strategic and policy implications of the reality of capture of the state and unequal influence. This, in turn, has perpetuated an obsolete approach to investment climate analysis and policies.

Indeed, the extent to which state capture and the unequal distribution of influence by the corporate sector affect the investment climate field of inquiry forces one to metaphorically propose applying the 'refresh button click' to the whole theme. Abbreviating from the recent *WDR* definition, investment climate is generally seen as 'the set of factors for firms to productively invest, employ, and expand.' In practice, however, the focus has been on a rather narrow and traditional set of factors comprising the investment climate, often focusing largely on economic, financial, and legal regulations by fiat—and divorced from the political dimensions of governance. A simple web-search is illustrative of the biases in how the investment climate is viewed and analyzed: of the almost 10,000 articles on investment climate since 1996 that result from a search in the Factiva search engine, over 50 percent address issues related to economics or policy, 30 percent address monetary or financial fac-

tors, almost 20 percent address issues related to law or legal matters, yet less than 10 percent bring up issues related to corruption or governance.

As a result of the traditional approach to the investment climate, ill-advised policies continue to be put forth. Examples abound: adopting yet another myriad of regulations, or officially decreeing that a firm should be able to register its operation within a certain time frame, or drafting new anti-corruption laws, or creating yet another investment promotion agency or anticorruption commission. It is thus warranted to put forth salient unresolved issues at the core of the governance-investment climate nexus.

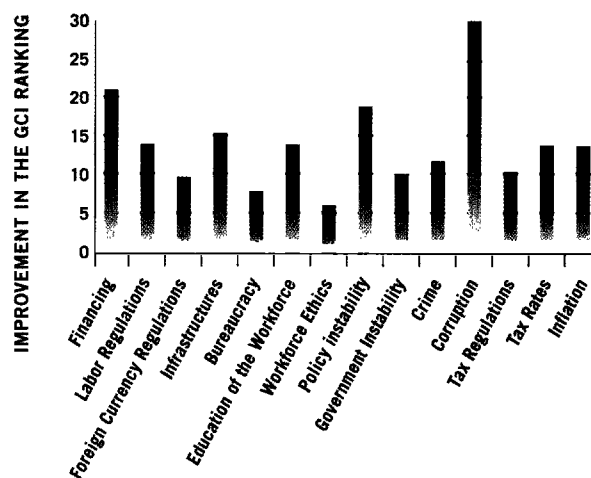
Governance and corruption impact on competitiveness and the investment climate.

THE RESEARCH CARRIED OUT with the data collected in 1999 on transition economies already gave a clear sense of the cost of state capture: countries in transition that fell into the trap of a high degree of state capture were experiencing an overall growth rate for firms of only one-half the rate of those that had embarked on a path towards a competitive market economy. Yet the 'captor' firms in the highly captured economies did benefit privately—explaining why capture is likely to persist—at the expense of the rest of the enterprise sector, and thus at a very large socio-economic cost.

More recently, thanks to the enterprise surveys carried out by the World Economic Forum (WEF) for the *Global Competitiveness Report (GCR)*, we have analyzed the extent to which governance and corruption constitute one of the most important constraints to business development and to competitiveness. In particular, we probed into the views of the firm about the main constraints they face. The results indicate that the most acute constraints for emerging countries were corruption, bureaucracy, policy instability and financing, while for the wealthy countries of the OECD they were labor regulations, bureaucracy, and taxation. In terms of broader clusters, the governance cluster, comprising corruption and bureaucracy, emerges as the most binding constraint, on average, worldwide, named as one of the top three constraints by firms in 79 out of the 105 countries surveyed in 2004.

We also asked the question of what constraints to business, as seen by the firm itself, appear to matter in particular for the country's competitiveness. For this, we related the firm answers to the business constraints questions mentioned above with the WEF's *Growth Competitiveness Index (GCI)*, which rated the relative competitiveness of all the surveyed countries. The results, which control for other factors, shown in Figure 1, are telling regarding the importance of tackling corruption in order to improve a country's competitiveness. A country that manages to reduce the extent of corruption as an obstacle to business by one standard deviation can expect on average, to move up about 30 rank positions in its global competitiveness standing (among 105), dominating the payoff of alleviation of any other obstacle to business operations.

FIGURE 1: GAINS IN THE COMPETITIVENESS RANKING BY TACKLING THE BUSINESS CONSTRAINTS



Source: Constraints to Business data based on EOS 2004 (Question "From the following list, please select the five most problematic factors for doing business in your country, and rank them from 1 to 5"). GCI based on GCR calculations for 2004/2005. GDP per capita from World Bank. Gains in competitiveness based on regression estimates of the impact on the GCI of an improvement in the constraint by one standard deviation.

Unbundling corruption matters

AS SUGGESTED, the undue focus until not long ago on "pettier" forms of administrative bribery ought to give way to the need to address explicitly the costly challenges of "grander" forms of corruption, such as the tendency by elite firms and conglomerates to shape illicitly the formation of the state laws, policies, and regulations, which we have referred to as *state capture*. Until recently, however, these more political and "grander" forms of corruption were not regarded as subject to measurement. Through surveys we pointed to the extent of state capture by some elite firms (including some with foreign interests) and to their substantial socioeconomic costs and consequences. More recently, based on the WEF survey, Figure 2 below suggests that nowadays it is possible to unbundled the various measures of corruption and related misgovernance components. From this evidence it is clear that there are many countries in most parts of the world where the challenges of state capture as well as undue influence (proxied in this case through political financing influence), are dominant.

Who shapes the business policy environment?: Investment climate 'takers' and 'makers'

A FALLACY THAT STILL PERSISTS TODAY is the presumption that the state is almighty in shaping the investment climate—and thus seen as the investment climate "maker"—while the atomic and powerless enterprise sector is viewed as the passive investment climate "taker." In reality, powerful corporations often exert enormous influence over public policy, public institutions and officials, and particularly so in weak states. Even in

strong states, such as those in rich OECD countries, powerful conglomerates can have significant influence in shaping regulatory policy, for instance.

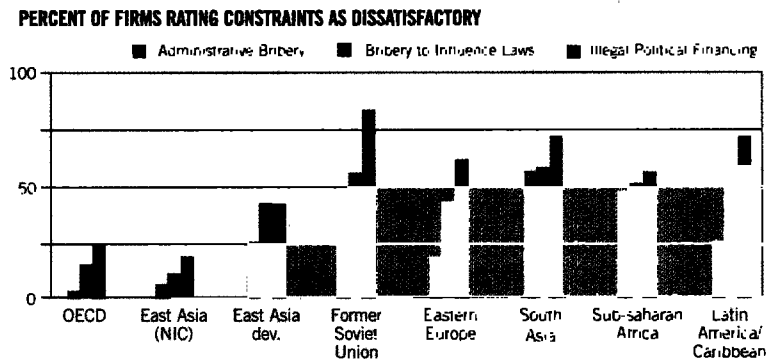
Consequently, it is paramount to revisit the traditional notions of the investment climate. The current *WDR* has made an important contribution inter alia by aptly placing center stage the private sector as a potentially key contributor to economic development. While it argues that the size of the enterprise sector contribution largely depends on how government policies and behaviors shape the investment climate, it does at least recognize the role played by segments of the corporate sector in shaping the investment climate as well, often in collusion with segments of the political elite, or in more extreme cases, by capture of key institutions. However, this perspective needs to be deepened and shared throughout the investment climate literature.

Policy Implications: Away from traditional public sector management

THE IMPLICATION OF THIS NEW APPROACH is that much more focus is needed on strategies encompassing effective external accountability, transparency, and prevention in order to mitigate capture and undue influence, and thus to improve the investment climate. Particular measures, increasing the cost of bribery and capture by the private sector are also needed. In particular, the following areas deserve concrete emphasis in the next stage:

- *Transparency is crucial*—with the support of rigorous data gathering and monitoring, and improved disclosure and access for financial and budgetary data, scaling up in the adoption of e-governance tools (such as e-procurement), as well as transparent disclosure of parliamentary votes and public officials' assets. More transparency is also needed in publicly disclosing the debarred firms from international bidding due to corruption, as the World Bank has done.
- Accounting for the *political* forces affecting the particular forms of capture and undue influence in a country, which among others imply modernization and competition of party politics, and transparent political and campaign financing.
- Rethink orthodoxy on *legal and judiciary* reforms. Where the forces of capture have penetrated the judiciary it is warranted to abandon altogether traditional programs of technical assistance, such as caseload management or superficial study tours. Fundamental reforms focusing inter alia on political and economic independence of the judiciary are instead needed.
- Explicit recognition of who are the *shapers of the investment climate*, pointing also to the importance of corporate responsibility and having a clear set of incentives for enhancing corporate ethic standards by domestic and multinational firms. Given space limitations, this is a rather partial list and

FIGURE 2: UNBUNDLING GOVERNANCE—SELECTED COMPONENTS: VIEW OF THE FIRM, 102 COUNTRIES



Source: EOS 2003, GCR of WBI, authors' calculations. Each region has the following number of countries: OECD: 23; East Asia (Developing): 6; East Asia (NIC): 4; Eastern Europe: 14; Former Soviet Union: 2 (Russia and Ukraine); South Asia: 4; Sub-Saharan Africa: 21; Latin America and Caribbean: 21.

treatment of this complex topic. Continuing questioning of orthodoxy, and thus departure from the narrow confines of the traditional interpretations of corruption and investment climate, may enable a further broadening of the framework for measurement, research, analysis, and effective policies in these areas. ↻

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Entitled to Work

Informal Enterprise in Urban Peru

BY ERICA FIELD

GIVEN THE PREVALENCE of micro-enterprise in urban areas of developing countries and continuing urbanization in much of the developing world, strategies for economic growth cannot afford to ignore the investment climate for small, informal businesses. In most cities of the developing world, a large fraction of the poorest residents are engaged in some form of small business enterprise. In a 2000 nationwide survey of neighborhoods in urban Peru, 61 percent of households reported one or more self-employed workers, and a quarter of such workers operated micro-enterprises out of their homes (COFOPRI, 2000). Most of those who worked at home ran small shops or repair workshops. As in much of the developing world, micro-enterprise in urban Peru is characterized by high turnover and

low growth. The mean size of entrepreneurial activities was 2.1 employees, and only a small fraction employed workers outside the family. More importantly, over half of these micro-enterprises earned monthly revenues of less than US\$100 and the majority had been in operation for less than five years despite the fact that residential mobility in these settings was extremely low.

Data from Peru further suggest that the growth and sustainability of these investments depends critically on security of tenure and the formalization of residential property. Prior to a nationwide property titling program, the majority of the country's urban residents did not have legal title to the land on which they resided and operated small businesses. This figure mirrors the situation of urban residents throughout the developing world. In the absence of legal claims to residential



property, a large fraction of small business owners cope daily with fear of eviction by the government or expropriation by residents with competing property claims. Indeed, more than half of untitled households in urban slums of Peru reported fear of losing property.

Tenure insecurity affects growth

RESIDENTIAL TENURE INSECURITY directly impacts small-scale entrepreneurial investments through several channels. Individual entrepreneurs have lower incentives to invest in their property. In urban Peru, untitled households invested in home construction at roughly one-third the rate of residents with secure property rights. Second, the growth and sustainability of micro-enterprises depends on the availability of community infrastructure such as public utilities. For the same reasons that weak property rights discourage individuals from investing in residential property, community-level tenure insecurity may inhibit communities from providing public goods such as infrastructure for water and electricity services that can help create and sustain local business ventures. Furthermore, in many settings, both private and public provision of water and electricity depend directly on land regularization.

An array of evidence also indicates that tenure insecurity among urban residents gives rise to distortions in the location of entrepreneurial investments. For instance, 45 percent of untitled entrepreneurs in Peruvian cities reported a desire to move businesses away from their homes, suggesting that business ventures were not optimally located to maximize profitability and growth. A strong force that appears to inhibit self-employed workers from relocating market work outside of the residence is the need to provide informal property protection. Presumably, in-home work increases tenure security either by directly protecting the residence or by facilitating participation in community groups, thereby distorting the investment decisions of small-scale entrepreneurs. In Peru, untitled households engaged in market work at home reported both lower than average tenure security and were significantly more likely to keep a person at home to protect property. In comparison, home businesses with legal title to land were far less burdened by the need to keep watch over the residence and reported higher than average security.

Finally, entrepreneurs without legal title to property are generally unable to use their residences as collateral for loans. More than two-thirds of small business owners in this setting report inability to borrow from formal sources to finance business activities or residential construction. Only 25 percent of micro-enterprises were financed by loans, and the

majority of loans were obtained through informal channels.

This set of facts suggests that self-employed workers are considerably constrained by fear of eviction in settings characterized by weak property institutions. Because their investments are not protected by the legal system and government police services, micro-enterprises are unable to optimally locate and expand their business investments. The effect of insecurity on the success of small businesses is evident from a comparison between titled and untitled residents of mean entrepreneurial revenues: in Peru, the income from home business ventures is 40 percent lower for untitled households than for households with security of tenure.

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Impact of residential formalization

TO IMPROVE THE INVESTMENT CLIMATE for small, informal enterprises in developing countries, it is critical to reduce tenure insecurity plaguing the urban poor. Property titling programs and legal reforms aimed at regularizing informal neighborhoods have made important gains in this direction in several parts of the world. The nationwide urban titling program in Peru is one of the largest of such programs to date. Between 1996 and 2001, over 1.2 million property titles were distributed to urban residents throughout the country under the auspices of the public agency, COFOPRI. According to survey data collected three years after the program began, urban land titling had a large effect on residents' feelings of tenure security: two-thirds of households that obtained a nationally registered property title reported a significant improvement in tenure security.

Correspondingly, greater tenure security among these residents appears to have substantially improved the investment climate for small businesses in urban communities. Formal property ownership was associated with

a significant reduction in the amount of time household members spend inside the home, including a 48 percent decrease in the fraction of entrepreneurs that locate micro-enterprises inside the home and a 36 percent reduction in the fraction of households that report keeping individuals at home to protect property.

Urban land titling was also associated with a greater number of both labor and leisure hours spent outside the home. Newly titled households worked an average of 17 percent more hours than squatter households, and were also 38 percent

ENTITLED TO WORK
continued on page 34

Local Government INNOVATIONS for the Informal Economy

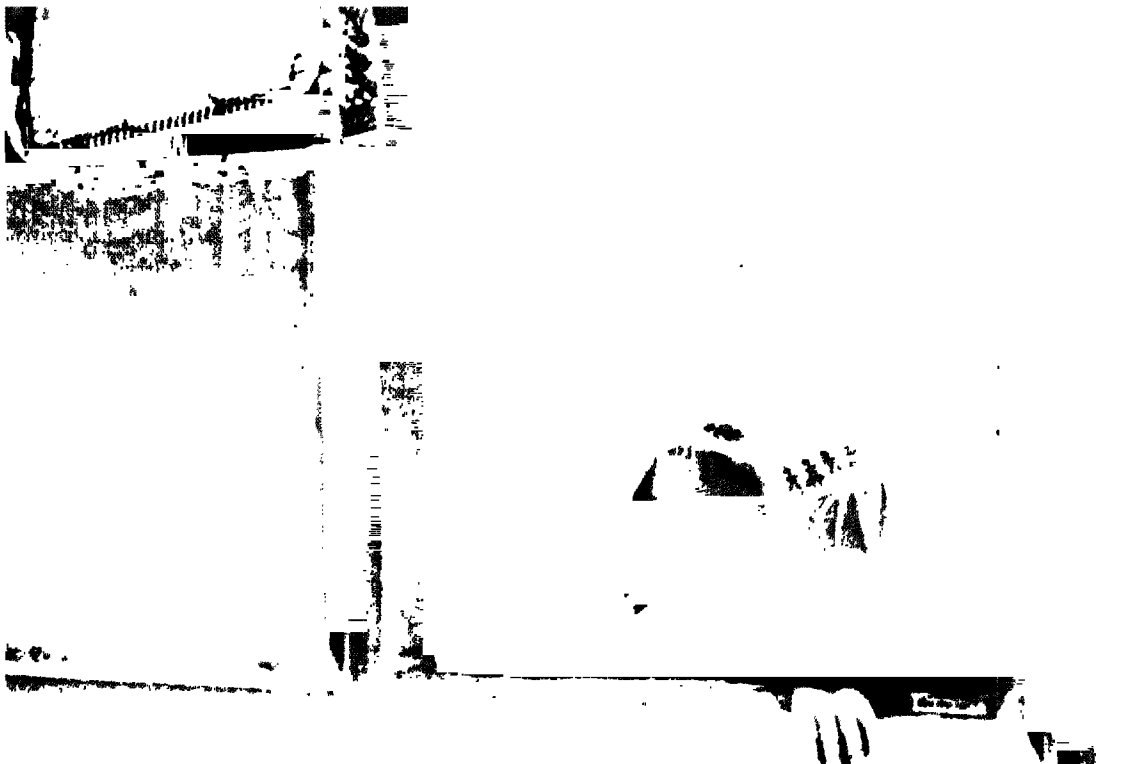
Creating a Positive Investment Climate

**BY FRANCES LUND
AND CAROLINE SKINNER**

THE WDR 2005 CALL to create “a better investment climate for everyone” (World Bank, 2004) rightly includes a consideration of both informal enterprises and informal workers. Informal work has become the dominant form of work in developing countries: “Informal employment comprises one half to three quarters of non-agricultural employment in developing countries: specifically 48 percent in North Africa, 51 percent in

Latin America, 65 percent in Asia and 72 percent in sub-Saharan Africa” (ILO, 2002:7). Non-standard or atypical work is a growing phenomenon in developed countries as well.

A wide range of policies affect the investment climate for the informal economy, among them macro-economic policies, labor policies, laws and standards, and social protection policies (Chen et al, 2002). In this article, we focus on South Africa and address the particular role that local government has to play. National statistics show that between 25 percent and 30 percent of the South African labor force work in the



Industrial Companies Act, which prevented bankrupt firms from being liquidated, reducing the time to go through bankruptcy by 15 percent.

Lowering the costs of financial institutions in providing financial services. SMEs are usually more credit-constrained than larger firms. The World Development Report 2005 indicates that small firms obtain only 19 percent of their financing from external sources while large firms meet up to 44 percent of their financing needs through external sources. This is largely due to higher costs of collecting and analyzing information concerning SMEs, high unit transactions costs associated with SME lending because of the relatively small loan sizes, exacerbated by weak or underdeveloped financial markets and policy-induced distortions. Here, the role of public policy is not to provide subsidies or directed credits to SMEs; rather it should create conditions that will lower the costs of SME lending to financial institutions and increase their reach in providing services to SMEs.

In this regard, governments need to first remove policies, including state ownership of financial institutions,



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directed and subsidized credits to large firms in specific sectors, that favor large, state-owned enterprises and crowd out lending to SMEs. Governments are sometimes tempted to mandate below-market interest rates for SMEs, but this usually causes more problems than it solves. Low rates make lenders less willing to lend to SMEs due to their intrinsically risky nature. The removal of interest rate controls in Indonesia in 1983 allowed banks to experiment with new financial products, which enabled them to expand their outreach and meet the demand of many SME clients.

More actively, governments should foster the creation of credit reporting systems that lower the costs of credit and other relevant information collection for financial institutions. The establishment of credit bureaus in a number of countries has shown to decrease the cost of lending to SMEs by providing creditors with information on clients' loan repayment histories. In the World Bank's survey, more than half of the credit bureaus interviewed indicated that credit history information reduced the processing time, costs and default rates in their country by more than 25 percent.



Furthermore, governments should put in place policies that encourage competition among financial institutions and promote innovations that lower the costs to financial institutions providing credit to SMEs. In India, for instance, the innovative use of Kisan Credit Cards enabled financial institutions to provide credits to SMEs in the agriculture sector. Since its introduction 31.6 million cards have been issued which have made it easier to get credit and renew loans for small farmers.

The public sector can also play a catalytic role in providing training and capacity building to financial institutions that offer services to SMEs. In the case of the Kazakhstan Small Business Development Fund, the government provided targeted technical assistance to banks, which enabled them to train loan officers in evaluating the creditworthiness of SMEs and on how to provide cash flow-based credit. This improved the banks' client outreach and led to an annual growth of their SME portfolio of nearly 100 percent.

Finally, governments can strengthen property rights and allow the use of new forms of collateral by borrowers. In Romania, for instance, the government removed impediments that restricted the use of movable collateral and established a movable collateral registry, thus expanding the basis for obtaining credit in the market place, which particularly benefited SMEs as the majority of their assets are in movable assets.

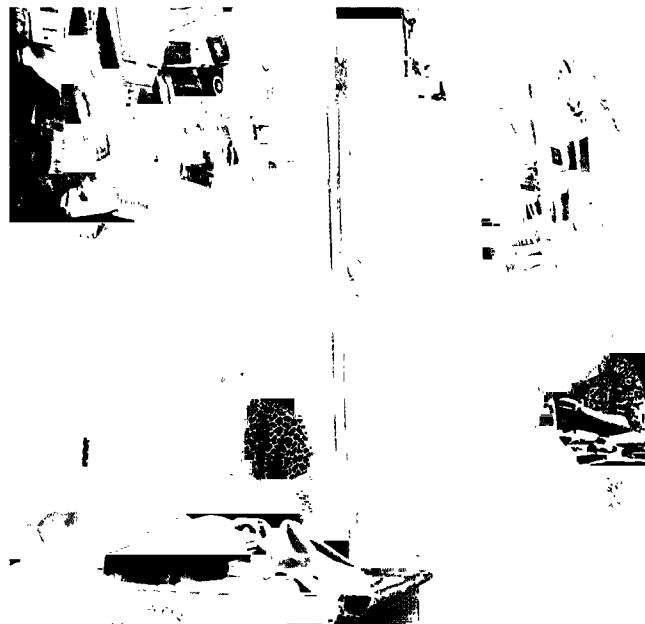
Facilitating the transfer of technology and knowledge and upgrading of SME capabilities. Public policies also have a role to play in promoting market mechanisms that facilitate the transfer of technology, knowledge, and upgrading SME capabilities—services that are undersupplied due to externalities and the lack of economies of scale. The public sector can help SMEs integrate more fully and competitively into global production processes through: 1) providing investment and trade information, 2) establishment and enforcement of product, process, and quality standards that are consistent with global practices and training SMEs on such standards, 3) facilitating and encouraging the development of market-based business development services (BDS) that help SMEs access global production networks, and 4) facilitating the training and capacity building of SMEs.

Conclusions

IMPROVING THE OVERALL investment climate is necessary and essential for promoting growth—and SMEs stand to realize proportionately larger gains as too often they suffer most from a weak investment climate. However, SMEs also face specific constraints that call for additional measures. Such policies would not provide special preferences or subsidies to SMEs, rather they would help level the playing field for firms of all sizes by addressing the specific market and institutional failures facing SMEs.

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POTENTIAL WINNERS LOSERS FROM BUSINESS FORMALIZATION

BY AHMED GALAL

It is extremely difficult to estimate the size of the informal sector accurately. However, there is consensus that the sector of small entrepreneurs and employees in the formal sector in developing countries operate extra-legally. Available evidence suggests that the size of the formal sector ranges between 35 and 70 percent of GDP. If one were to accept the conventional view, this means that at least one third of these economies is trapped in activities characterized by low productivity, limited capacity to expand, and inability to create as many decent jobs as possible. Exacerbating this problem is that most of these entrepreneurs and workers are often marginalized and poor. Thus, informality represents a missed opportunity for faster economic growth and better income distribution, let alone functioning markets and rule of law.

If the problem of informality is that reported, it is legitimate to ask such questions as, "why do so many small entrepreneurs, such as street vendors, bakers, handicrafters, retailers, and artisans of all kinds opt to stay outside the formal economy? What would it take to convince them to shift to the formal sec-

tor and stay there? And what are the welfare implications of formalization? This article attempts to answer these questions, with an application to Egypt.

The formalization decision

FROM THE PERSPECTIVE of entrepreneurs, it is safe to assume that the decision to operate informally is rational. They decide to stay informal because the total costs of entry, operation, and exit associated with joining the formal sector are greater than the potential benefits from being formal. They are willing to forgo the benefits of better protection of property rights and to bear the cost of extra-legality (in the form of bribes, costly finance, etc.) because it is more beneficial to remain informal. To convince them to become formal, it is therefore necessary to adopt sufficient reforms to tilt the balance of the net benefits in favor of formalization. Less important is whether these reforms are related to measures to simplify entry, operation in the formal sector, or exit.

From society's perspective, entrepreneurs are only one group among many. Policymakers should also care

about workers, consumers, and government budget. Accordingly, their decision to promote formalization should be derived from its impact on all of these actors. Formalization could, of course, positively impact certain groups and negatively impact others, just like other policy reforms. However, as long as the net benefits to society are positive, the decision to encourage formalization is socially desirable. Meanwhile, mechanisms could be found to make the winners compensate the losers.

Despite the simplicity of the above framework, formalization is sometimes interpreted as a mere reflection of the high cost of entry into the legal sector. At other times, it is seen as a rational choice by entrepreneurs to avoid the cost of abiding by the formal rules and regulations governing taxation, labor, contract enforcement, securing inputs, and selling outputs to different buyers. A third partial view of informality is that it is the result of costly procedures of exiting the formal sector. These interpretations could lead to ill-fated policy reforms. Relaxing one constraint or another may not make it sufficiently rewarding for entrepreneurs to shift to the formal sector. The potential benefits from formal-



ization will not materialize, despite good intentions.

Potential winners and losers from formalization in Egypt

APPLYING THE ABOVE FRAMEWORK to identify the potential winners and losers from formalization is demanding. It requires detailed firm level information about the costs and benefits associated with operation in the informal sector and similar information about operation in the formal sector, with and without reform. This kind of information is not readily available. Compiling it takes careful investigation of the rules and regulations governing the life cycle of a firm, and, more importantly, an exploration of how these rules are enforced in practice.

Luckily, a detailed investigation of this kind has been undertaken in Egypt by a team from ILD and ECES over a peri-

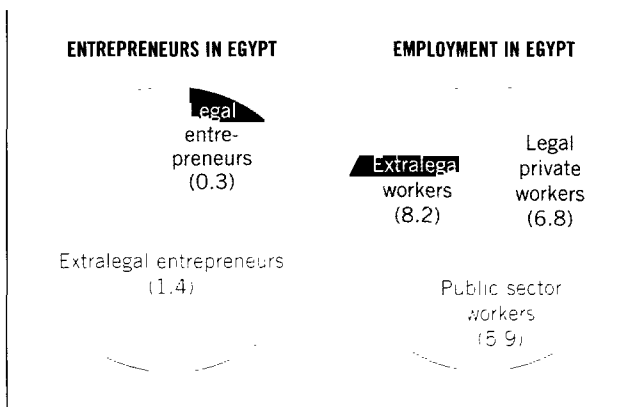
od of two years. On the basis of collected information, it was possible to estimate the potential gains from formalization in Egypt, as well as the distribution of these gains, with or without reform. The results were significant, as reported below, thanks in part to the large size of the informal sector.

Informality of business in Egypt

According to 1996 government survey data, some 1.4 million entrepreneurs-82 percent of all entrepreneurs in Egypt-worked in the informal sector (see Figure 1). The sector employed 8.2 million workers-more than employment in the formal private sector (6.8 million) or the government (5.9 million). The characteristics of the sector in Egypt were found to be similar to those observed elsewhere. More than 90 percent of extralegal firms in Egypt were run as sole proprietorships, employing fewer than five workers and operating mostly in the service sector. The average lifetime of the firm was

about 10 years, and the production techniques employed tended to be labor intensive.

FIGURE 1: EXTRALEGAL ENTREPRENEURS AND WORKERS IN EGYPT (in millions)



Source: The Institute of Liberty and Democracy and the Egyptian Center for Economic Studies, 2004. Proposals to Integrate the Extralegal Sector into Mainstream Economic Activity in Egypt. Cairo, Egypt: The Egyptian Center for Economic Studies.

Although entrepreneurs in the informal sector in Egypt were found to face many problems with local authorities, and had limited access to finance, infrastructure, technology and markets, they perceived the constraints of the formal sector to be more costly and binding at their scale of operation. The constraints were not only related to the conditions of entering the formal sector, but also regarding the rules governing operation and exit if that becomes necessary. No wonder, they remained in the informal sector at such a massive scale.

The welfare impact of formalization in Egypt

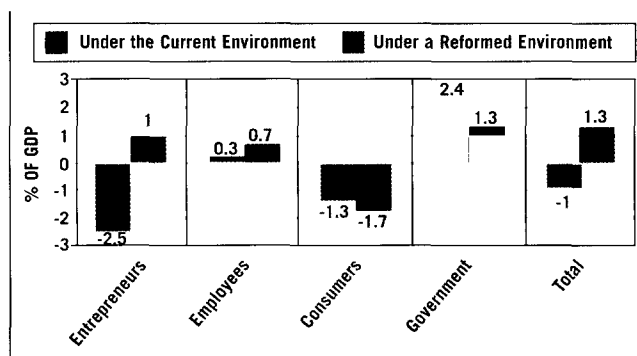
In an attempt to change their fortune, the team proposed to the government a comprehensive reform program that included simplifying all rules and procedures regarding entry, operation, expansion, and exit of firms; creating an independent organization to carry out the formalization process and consolidating all relevant laws into a single law. These reforms were expected to reduce the cost of establishing and operating businesses by 90 percent, the cost of mortgages by 91 percent, and the cost of enforcing pledges by 77 percent.

Based on the proposed reform package and firm level information, it was possible to estimate the impact of the formalization of a typical firm on entrepreneurs. The net benefits were large. Under a reformed environment, formalization would increase the private value of the firm by 23 percent annually. This gain is equal to one and a half times per capita income, measured in 2002. These gains are sufficiently large to persuade entrepreneurs to formalize. Understandably, it was found that the value of the firm would deteriorate if formalization were to be carried out under the current formal environment. And this explains why firms currently chose to stay informal.

For the Egyptian economy as a whole, the gains from formalization were also large. The analysis started with an assessment of the likely impact of formalization of a typical firm on entrepreneurs, workers, consumers and the Treasury. The results were then aggregated for all firms. Under the

assumption of reform, the results shown in Figure 2 indicate that formalization would increase GDP by 1.3 percent every year. Entrepreneurs would gain one percent of GDP, and workers 0.7 percent of GDP, thanks to productivity improvement and expansion. The Treasury would gain 1.3 percent of GDP, as firm profits go up. Consumers are the only group that are expected to be worse off by 1.7 percent of GDP, because they now have to pay value added taxes. In return, they would be assured a better quality of products, because firms would then be subject to inspection. In contrast, all actors, except workers, are expected to lose if formalization were to be carried out without any reforms.

FIGURE 2: WINNERS AND LOSERS FROM FORMALIZATION WITH AND WITHOUT REFORM



Source: The Institute of Liberty and Democracy and the Egyptian Center for Economic Studies, 2004. Proposals to Integrate the Extralegal Sector into Mainstream Economic Activity in Egypt. Cairo, Egypt: The Egyptian Center for Economic Studies.

Conclusion

SOME ARGUE IN FAVOR OF leaving the informal sector alone. They point out that formalization would force entrepreneurs to move from a low-cost mode of operation most suited to small and micro-enterprises to a restrictive and costly formal environment, deprive the economy of an absorber of shocks in times of difficulty, and negatively affect those who cannot afford to be unemployed, leaving the Treasury as the only winner.

The analysis of the Egyptian case suggests otherwise. Formalization could generate significant benefits to the economy and most economic agents if reforms were adopted. This is because these reforms would lead to better protection of property rights, which would enable entrepreneurs to secure inputs at lower costs, increase access to infrastructure services and credit, take advantage of expanded markets, and avoid coping with unofficial payments to stay informal. It would equip and motivate entrepreneurs to expand their businesses, reorganize internally, and benefit from specialization and division of labor. These changes would increase economic growth and poverty reduction. The likelihood is high that the results obtained in Egypt could be obtained elsewhere.

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This article is based on a complete study accessible at: www.eces.org.eg, Working Paper Series, no.95.

Getting the Best out of Creative Destruction

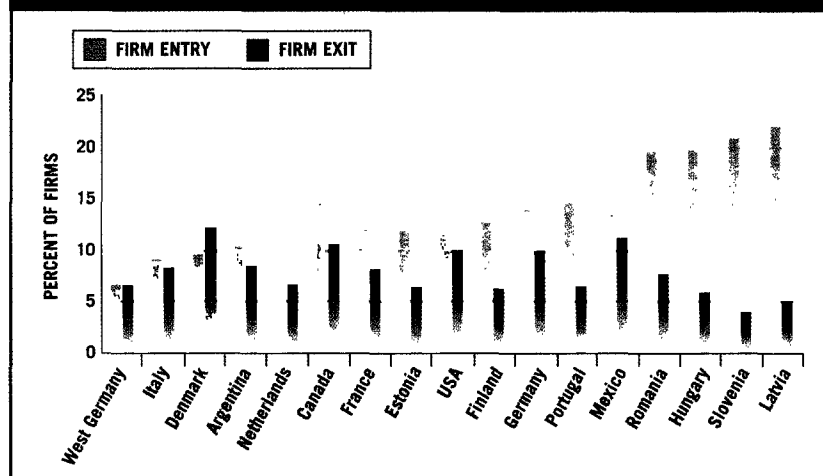
Productivity Growth and Job Creation



BY STEFANO SCARPETTA

JOSEPH SCHUMPETER WAS RIGHT! Micro evidence for a number of industrial and developing countries suggests that they are affected by "a perennial gale of creative destruction" (Schumpeter, 1975). Many new firms enter the market each year, creating new jobs and opportunities and often introducing new products and adopting new technologies. But such creation has implications for existing firms that may be less efficient, leading to firm closures. And chances of survival for the many tiny and the few large firms change over time, while those that survive make continuous efforts to improve their efficiency. This process of creative destruction, albeit widespread, is not painless for all those involved: workers lose their jobs and have to search for a new one, and entrepreneurs face losses when their firm fails and great risks when they decide to launch a new venture. So the natural question is: how important is creative destruction for promoting growth and job creation? This article sheds some light on this question summarizing a study of enterprise data conducted in the context of the *World Development Report 2005: "A Better Investment Climate—for Everyone"* (Bartelsman, Haltiwanger, and Scarpetta, 2004). It shows that a more flexible investment climate that permits entry and exit is indeed associated with greater productivity growth and net job creation.

FIGURE 1: FIRM TURNOVER IN INDUSTRIAL AND EMERGING ECONOMIES



Note: Entry and exit rates are calculated as a share of the total number of firms. Data refer to the total business sector over the period 1989-2000. All firms with at least one employee are included in the sample.

Source: Bartelsman, Haltiwanger, and Scarpetta (2004).

But assisting those individuals adversely affected during the transition remains a critical challenge for policy makers designing reform initiatives.

How sizeable is the process of creative destruction?

THE WORLD BANK FIRM-LEVEL PROJECT extends the analysis previously conducted at the OECD by adding to the original 10 OECD countries evidence from 14 developing and emerging economies of Latin America, Central and Eastern Europe, and East Asia. It draws from censuses of firms, business registers and enterprise surveys in these countries to dress a comprehensive picture of the creative destruction process and its impact on firms' and aggregate performance.

Just by its size, the process of creative destruction is large: in most countries one-fifth to one-fourth of all firms enter or exit the market each year (Figure 1). The high firm turnover rates (entry rate plus exit rate) involve a proportionally lower number of workers because both entrants and exiting firms are generally smaller than incumbents. For most countries, new firms are only 20 to 60 percent the average size of existing firms.

While entry and exit rates are fairly similar across industrial countries, post entry performance of successful new firms differs markedly. In the U.S., new firms expand rapidly in the early years of life, while in most Continental Europe even successful firms do not grow significantly. This is a potential indication of the importance of barriers to firm growth as opposed to barriers to entry. Transition economies show an even more impressive process of creative destruction, with many firms entering markets that were largely under-populated during the central plan period. In Latin

America, Mexico shows large firm dynamics with many new firms entering the battle and expanding, if successful; but it also shows many failing rapidly. Argentina resembles more Continental Europe with smaller flows and less impressive post-entry growth of successful firms.

Are resources reallocated towards more productive uses?

ONE WAY TO ADDRESS THIS QUESTION is by comparing the productivity level of entering firms with that of existing units or those that are forced out of the market. The entry of firms and failure of obsolete ones jointly account for a significant share of total productivity growth. There are, however, large differences across countries with the contribution of firm turnover to productivity growth, ranging from only 5 percent in Argentina to more than 40 percent in Estonia and Latvia.

Firm exits always involve low productivity units and thus contribute to promote aggregate productivity by freeing resources for other activities. By contrast, new firms in industrial countries tend to be less productive on average than existing firms (especially in the U.S.). It is only after a period of *learning by doing* and adaptation that they climb the productivity ladder, often above most of their older competitors.

Interestingly, the story is different in the transition economies. In these countries, new firms are since the beginning more efficient than the incumbents. They often adopt new and more efficient technologies, which makes them perform better than existing firms.

There is also an important sectoral dimension to the process of creative destruction. The contribution of new firms to productivity growth is generally modest in low-technology industries. But new firms make a strong positive contribution in technologically more advanced industries. This suggests an important role for new firms in promoting the adoption of new technologies. While existing firms often find it difficult to adjust the work organization and infrastructure to the requirements of new technologies, entering firms do not have to face the legacies of old modes of production and are often better at harnessing new technologies. The strong contribution of new firms in advanced sectors is particularly evident in some emerging economies, including Argentina, Taiwan (China), and Korea as well as in transition economies.

The creative destruction process not only allows redeploying resources from obsolete to more productive firms but also pushes incumbent firms toward efficiency-enhancing investment. There is indeed a strong relationship between firm turnover (entry and exit rates) and the productivity growth of incumbent firms across countries and industries. Hence, pro-

moting the entry of firms directly contributed to make the market more contestable and forces incumbents to upgrade technology, or change work organization to promote efficiency.

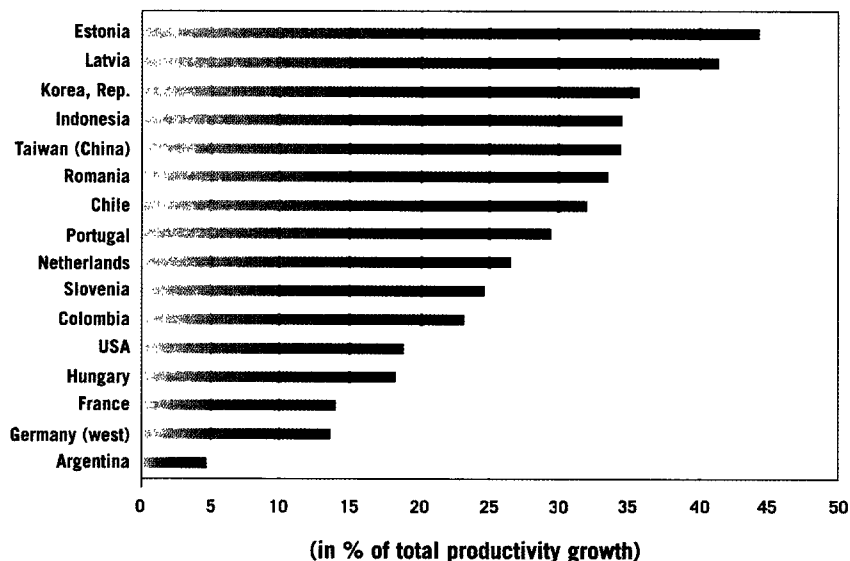
How many workers are affected by creative destruction

THE PROCESS OF CREATIVE DESTRUCTION involves many workers. In industrial countries, 10-15 percent of jobs are generally created and destroyed every year, and the share goes up to 30 percent in some emerging economies. This is particularly true in transition economies where labor had to be reallocated massively across firms, sectors and locations, but also in Brazil, Mexico, and Chile where more than 20 percent of jobs are created or destroyed every year. Many jobs are created and destroyed by firms entering and exiting the market, but incumbent firms also continuously adjust their workforce to the evolution of demand.

How to get the best out of creative destruction: the policy challenges

THE PROCESS OF CREATIVE DESTRUCTION seems to be a natural feature of market economies and has the potential to promote a better utilization of resources, including labor, in the economy. Most of the policy issues highlighted in the *World Development Report 2005* influence the process of creative destruction. Not necessarily its overall magnitude, but most likely its role of promoting productivity growth and the creation of rewarding jobs. For example, regulations that unduly raise entry costs may not necessarily reduce the number of new ventures, but influence their decision to register in the formal market or stay informal. In turn, this decision may affect their willingness to expand, access modern technologies, and hire more workers. Similarly, lack of access to credit, corruption or weak infrastructure may preclude the ability of firms to expand once they have entered the market. And providing special treatments to well established businesses may shelter them from competitive pressure from new firms and weaken their incentives to invest efficiently. Likewise, very onerous labor regulations may fail to protect many workers in countries where firms can opt for the un-regulated economy. Labor regulations in many developing countries tend to be

FIGURE 2: THE EFFECT OF CREATIVE DESTRUCTION ON LABOR PRODUCTIVITY GROWTH
(the contribution of entry and exit of firms to total labor productivity growth)



Note: Data show the sum of the contributions from new entrant firms and exiting firms to total labor productivity growth in manufacturing. Data cover different periods for the countries. For all but three countries, the contributions are calculated on the basis of five-year rolling windows. For Hungary, Indonesia, and Romania, the data refer to three-year rolling windows and tend to under-estimate the contribution of new firms to total labor productivity growth.

Source: Bartelsman, Haltiwanger, and Scarpetta (2004).

more restrictive—on paper—that those of industrial countries and cover only some workers. But even for formal workers the prospect of job loss is grim; the lack of safety nets (such as unemployment benefits or other cash transfers) implies that they have to rush and accept any available job, often with a lower pay in the informal sector. Creating a comprehensive social safety nets is difficult in many developing countries, but there are opportunities for improving the protection of workers affected by labor mobility that could help them searching for new jobs and reduce their resistance to changes.

Stefano Scarpetta is Lead Economist, Social Protection Team (HDNSP), The World Bank

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ENTITLED TO WORK

continued from page 20

more likely to participate in organized activities outside the home. All of these results indicate that increasing household tenure security via land titling programs has the potential to reduce the level of human resources households and communities devote to informal property protection. Relaxing households' time constraint in this manner not only enables business owners to move income-generating activities to more profitable locations, but frees up local labor markets for all workers in the community. In settings characterized by a large amount of residential informality, distortions resulting from informal urban property protection may constitute an important obstacle to labor market adjustment.

Finally, distributing property titles to urban residents appears to have a strong impact on the demand for both entrepreneurial and housing credit. Empirical results indicate that the rate of loan applications in urban communities increased by 20 percent as a result of improvements in tenure security. Meanwhile, data on loan approval rates of titled and untitled households provide no indication that property titles immedi-

ately improve access to entrepreneurial loans. Given that collateralizable wealth is an important determinant of small business formation, the growth implications of strengthening property institutions rely heavily on facilitating legal transactions governing banks' use of titled property as collateral for loans. ■

Erica Field, Assistant Professor, Department of Economics, Harvard University

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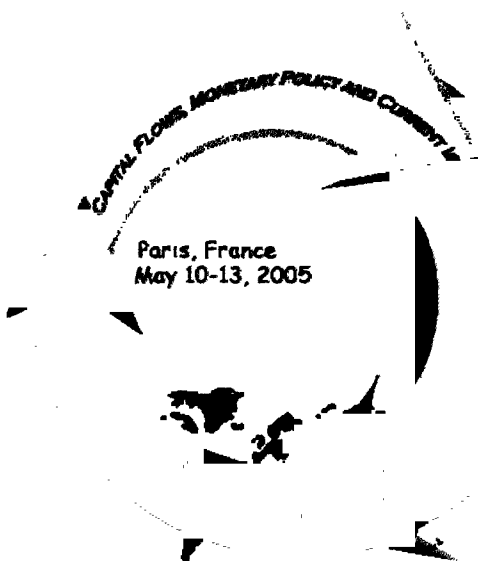
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Capital Flows, Monetary Policy and Current Issues in International Finance

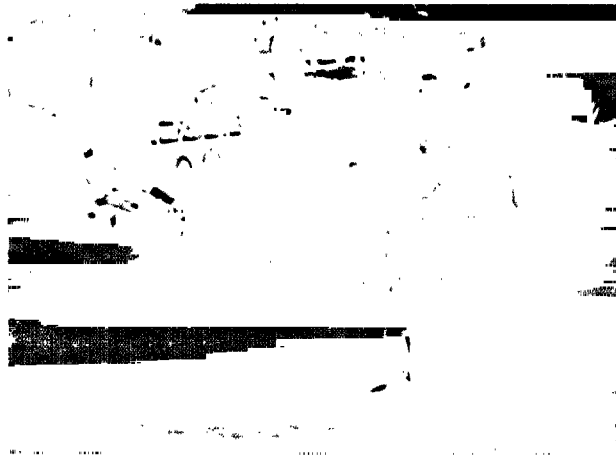
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The Day My Country Cried



BY MOHAMAD AL-ARIEF

THE EARLY MORNING OF DECEMBER 26 started like a normal Jakarta Sunday. The festive mood of the holiday was still in the air. I was exchanging belated SMS text messages containing holiday greetings to friends. Sundays are usually the best day of the week, a chance to spend some quality time with my 7-month-old daughter and her mother.

I was staying at my in-laws that day. My father-in-law, a health ministry official who spent his first 11 years as a doctor in Aceh, left home in the wee hours of that morning to attend a major gathering of the Acehnese community in Jakarta. Suddenly in the midst of the event, cell phones started to ring one by one. The sound began to dominate the whole room. The calls turned out to be a cry for help from family members 1,700 kms away in Aceh. People in the room were shocked by the news. Aceh reported major jolts, and a large tidal wave washed away homes and the people in them.

A frenzy of panic interrupted the Jakarta gathering. The event just stopped as people ran outside and tried frantically to call other relatives. Others headed home, some went directly to the airport. My father-in-law called home telling us to watch the news closely on TV and update him. Nearing mid-day,

the horrifying pictures from the ground started to trickle in. By this time all telecommunication lines to Aceh—cellular and fixed line—were totally cut-off. The country could only sit by and watch the events unfolding on the continuous news bulletins on TV. Images of men, women, and children running to higher ground dominated the screen, but at that point, we still did not have a clue about the extent of the disaster.

It was not until we watched CNN and BBC that we understood the sheer scale of it all. The quake off the coast of Aceh had unleashed tsunami tidal waves that affected places as far flung as Thailand, Malaysia, Sri Lanka, India, Maldives, and Somalia. It was totally unprecedented. Nobody could believe their eyes. Commentators on TV called it the worst natural disaster in recorded history. Many have heard stories about the devastation of Krakatoa back in 1883, but even that could never prepare us for anything like this. The grim pictures beamed from Aceh were very much in front of us.

Trying to get information

MY FIRST INSTINCT was to call my Acehnese friends in Jakarta and try to find out the condition of their family members. All of them were worried and stressed by the fact that information was not flowing in. As we watched the death tolls rising, the feeling of helplessness started to prevail. When I woke up the next morning, I was shocked by the stream of SMS message from my Acehnese friends. "I have only heard news from my mother and older sister. My other family members are still missing; most likely they did not make it," said one friend. That friend packed his bags, his satellite phone, and flew to Aceh on the earliest flight he could get.

I was even more saddened by the news from him upon arriving in Aceh. "Aceh is dead. Unburied bodies everywhere. Refugees are plagued with hunger and disease. Please help us," he said. I looked at that SMS message for a couple of minutes and felt helpless. I could not bear the idea of sitting behind a desk while my best friend is scouring for the bodies of his loved ones.

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When I called another friend, he was close to total desperation. Realizing that his parents lived very close to the coastline in Banda Aceh, he did not have much hope of them surviving. The death of his mother and brothers were later confirmed that same day by a relative. I was at a loss for words.

A friend of my wife from her younger days in Aceh had not received one single word from her entire family in Aceh. They, too, lived near the coastline. The last time she saw her parents and three sisters was during the Eid celebration last month. She came back to Pekanbaru where she lives with her husband right after that, not knowing that would be the last time she saw them. An entire family, gone.

Three other friends from Aceh lost distant relatives and friends in the tragedy, including their young cousins and nephews. I did not have one single Acehnese friend who was not in deep sorrow. The waves did not discriminate.

Devastation in Aceh province

FIFTY PERCENT OF BANDA ACEH, the province's capital and population center, was wiped out. In Aceh's western coastline which is closest to the epicenter, the devastation was even larger. Meulaboh, the largest town on the west coast, close to 80 percent of its people were just gone. By the following day, the death toll reached a staggering 48,000 lives and still counting, making Indonesia the hardest-hit country. Much of Aceh's west coast is still impenetrable, posing a challenge to relief workers. The military was deployed to open up links to the west and use Meulaboh as a staging post to distribute relief. According to the government's initial estimate, the cost of rebuilding Aceh would be at least US\$1.5 billion.

The outpouring of support from the Indonesian public and the international community also reached an unprece-



ented level. Scores of people lined up to volunteer and provided support to the relief effort. Cash and in-kind donations bound for Aceh came in from across the country. Parliamentarians gave their salary to the cause. Pedicab drivers donated their daily wages. TV stations staged impromptu telethons to raise donations. Employees gave a portion of their annual bonus. Doctors and engineers lent their talents. NGOs united and mobilized volunteers. Corporations gave out cash and in-kind contributions. Airlines provided free cargo space for transporting relief. Donors lobbied their headquarters for additional resources. Governments around the globe pledged generous support to the cause. The list goes on. Sympathy and a sense of solidarity also did not discriminate. People from all walks of life rapidly rose to the occasion to lend a helping hand. Region wide, the UN has called it the largest relief effort ever.

Aceh holds a special place in the hearts of all Indonesians. During the fight for independence, the people of Aceh contributed money to purchase Indonesia's first passenger plane. The airplane was used to transport Indonesia's leaders overseas for their diplomatic rounds which resulted in the recognition of Indonesia's independence. Indonesians realize that Aceh has now called us in their time of need. The tragedy in Aceh has brought us closer as a nation.

December 26 is the day when my country and the whole world cried. When Aceh drowned, the whole nation was drowning in tears. May God speed the recovery process in Aceh and other affected countries. And may God grant solace to those who lost their loved ones.

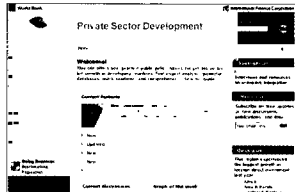
Mohamad Al-Arief, Communications Officer in the Bank Group's Jakarta office.

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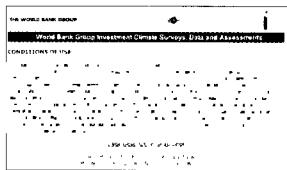


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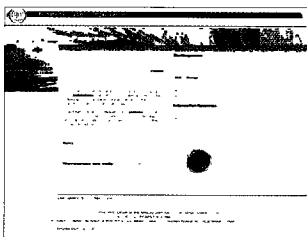


INVESTMENT CLIMATE SURVEYS, DATA, AND ASSESSMENTS

This database covers 54 countries, 9 of which have had two rounds of surveys. Thus there are a total of 63

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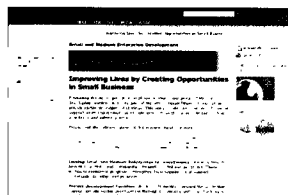


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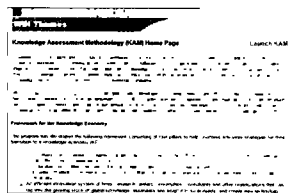


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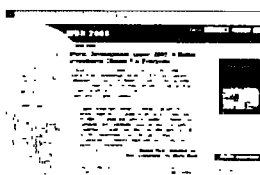


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WORLD DEVELOPMENT REPORT 2005

The *WDR 2005* was launched on September 28, 2004. The Report focuses on what governments can do to improve the investment climates of their societies to increase growth and reduce poverty.

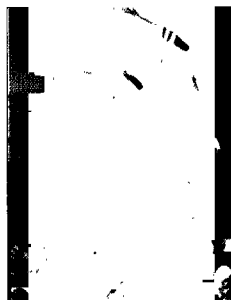
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WORLD DEVELOPMENT REPORT 2005: A BETTER INVESTMENT CLIMATE FOR EVERYONE, *World Bank, 2004.*

Firms and entrepreneurs of all types—from microenterprises to multinationals—play a central role in growth and poverty reduction. Their investment decisions drive job creation, the availability and affordability of

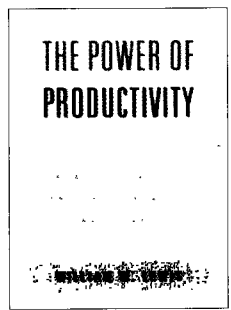
goods and services for consumers, and the tax revenues governments can draw on to fund health, education, and other services. The *World Development Report 2005* argues that improving the investment climates of their societies should be a top priority for governments. Drawing on surveys of nearly 30,000 firms in 53 developing countries, country case studies, and other new research. In addition, the Report contains selected data from the World Bank's new program of Investment Climate Surveys, the Bank's Doing Business Project, and *World Development Indicators 2004*—an appendix of economic and social data for over 200 countries.



AGRICULTURE INVESTMENT SOURCEBOOK, *World Bank, 2005.*

This Sourcebook addresses how to implement the rural strategy, by sharing information on investment options and identifying innovative approaches that will aid the design of future lending programs for agriculture. It provides generic good practices

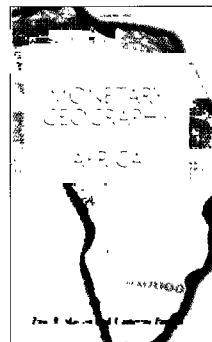
and many examples that demonstrate investment in agriculture can provide rewarding and sustainable returns to development efforts. The book draws on a wide range of experience from donor agencies, governments, institutions, and other groups active in agricultural development.



THE POWER OF PRODUCTIVITY: WEALTH, POVERTY, AND THE THREAT TO GLOBAL STABILITY, *by William W. Lewis. University of Chicago Press, 2004.*

Drawing on an extensive microeconomic study of 13 nations over 12 years, Lewis' book counters most of the prevailing wisdom about the best method to ameliorate

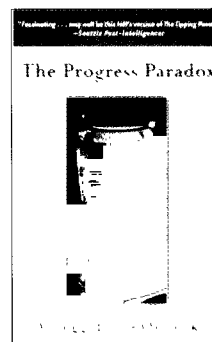
economic disparity. He argues that providing more capital to poor nations is not the primary way to help them out of the poverty trap, nor is improving levels of education, exchange rate flexibility, or government solvency. Rather, the key to improving economic conditions in poor countries, argues Lewis, is increasing productivity through intense, fair competition and protecting consumer rights. Policies must be enacted in developing nations that reflect a consumer rather than a producer mindset and an attendant sense of consumer rights.



THE MONETARY GEOGRAPHY OF AFRICA, *by Paul R. Masson and Catherine Pattillo. Brookings Institution Press, 2004.*

The authors examine the current economic situation and for the first time review the history of monetary arrangements in Africa. They contend that economic realities suggest that plans for African monetary unions are unlikely to be successful. They anticipate a range

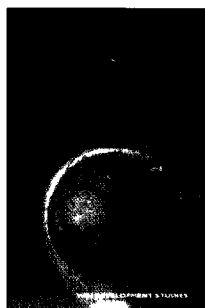
of monetary regimes and currencies developing in Africa over the next few decades, rather than the dominance of a regional continental currency. Masson and Pattillo believe that Africa's economic wellbeing will be better served in the short term by addressing the more fundamental problems of corruption and governance facing the continent.



THE PROGRESS PARADOX: HOW LIFE GETS BETTER WHILE PEOPLE FEEL WORSE, *by Gregg Easterbrook, Random House, 2004.*

Gregg Easterbrook draws upon three decades of wide-ranging research and thinking to make the persuasive assertion that almost all aspects of Western life have vastly improved in the past century—and yet today, most men and women feel less happy than in previous

generations. Why this is so and what we should do about it is the subject of this book. Detailing the emerging science of "positive psychology," which seeks to understand what causes a person's sense of wellbeing, Easterbrook offers an alternative to our culture of crisis and complaint. He argues that optimism, gratitude, and acts of forgiveness not only make modern life more fulfilling but are actually in our self-interest.



BUILDING STATE CAPACITY IN AFRICA: NEW APPROACHES, EMERGING LESSONS,

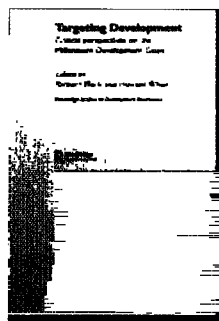
by Brian Levy and Sahr Kpundeh, eds. World Bank, 2004. December 2004.

The book's core message is that if Africa is to have a well-functioning public sector there needs to be a paradigm shift in how to analyze and build state capacity.

Specifically, African governments

and their partners should move from a narrow focus on organizational, technocratic, and public management approaches to a broader perspective that incorporates both the political dynamics and the institutional rules of the game within which public organizations operate.

The book draws from the experience of a new generation of initiatives started in 1990s in more than a dozen countries after decades of failed efforts. It provides pointers on how to align a capacity building strategy with country-specific realities, recognizing that although building effective and accountable states is a centuries-long process, small beginnings can set in motion progressively more profound consequences.

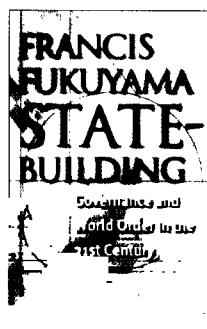


TARGETING DEVELOPMENT,

by Richard Black and Howard White, eds. Routledge, 2003.

The aim of this book is to provide a critical appraisal of the Millennium Development Goals, and the progress so far towards meeting them. The 'International Development Targets' were first adopted by the OECD in 1996, and have been succeeded by the

yet more widely endorsed 'Millennium Development Goals' following from the UN Millennium Summit in September 2000. This book consists of six introductory chapters on how and why the International Development Targets and the MDGs have become incorporated into development policy, and what their overall value is. Each chapter in the second part analyzes whether current trends suggest the target can be reached. Contributors assess the main constraints that exist to achieving each of these targets and the resulting implications for policy. The book includes index and references.



STATE-BUILDING: GOVERNANCE AND WORLD ORDER IN THE 21ST CENTURY,

by Francis Fukuyama. Cornell University Press, 2004.

The end of history was never an automatic procedure. Fukuyama argues, and the well-governed polity was always its necessary precondition. "Weak or failed states are the source of many of the world's

most serious problems," he believes. He traces what we know—and more often don't know—about how to transfer functioning public institutions to developing countries in ways that will leave something of permanent benefit to the citizens of the countries concerned. These are important lessons, especially as the United States wrestles with its responsibilities in Afghanistan, Iraq, and beyond.

Fukuyama begins *State-Building* with an account of the broad importance of "stateness." He rejects the notion that there can be a science of public administration, and discusses the causes of contemporary state weakness. He ends the book with a discussion of the consequences of weak states for international order, and the grounds on which the international community may legitimately intervene to prop them up.



DOING BUSINESS IN 2005: REMOVING OBSTACLES TO GROWTH, by World Bank. Oxford University Press, 2004.

This is the second in a series of annual reports investigating the scope and manner of regulations that enhance business activity and those that constrain it. New quantitative indicators on

business regulations and their enforcement can be compared across 145 countries—from Albania to Zimbabwe—and over time.

The previous report, *Doing Business in 2004: Understanding Regulation*, presented indicators in five main topics: starting a business, hiring and firing workers, enforcing contracts, getting credit and closing a business. *Doing Business in 2005* updates these measures and adds another two sets: registering property and protecting investors. The indicators are used to analyze economic and social outcomes, such as productivity, investment, informality, corruption, unemployment, and poverty, and identify what reforms have worked, where and why.

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7-8 Designing and Implementing Rural
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16-17 World Bank/IMF Spring Meetings
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MAY 2005

2-3 OECD Forum 2005: Fueling the Future:
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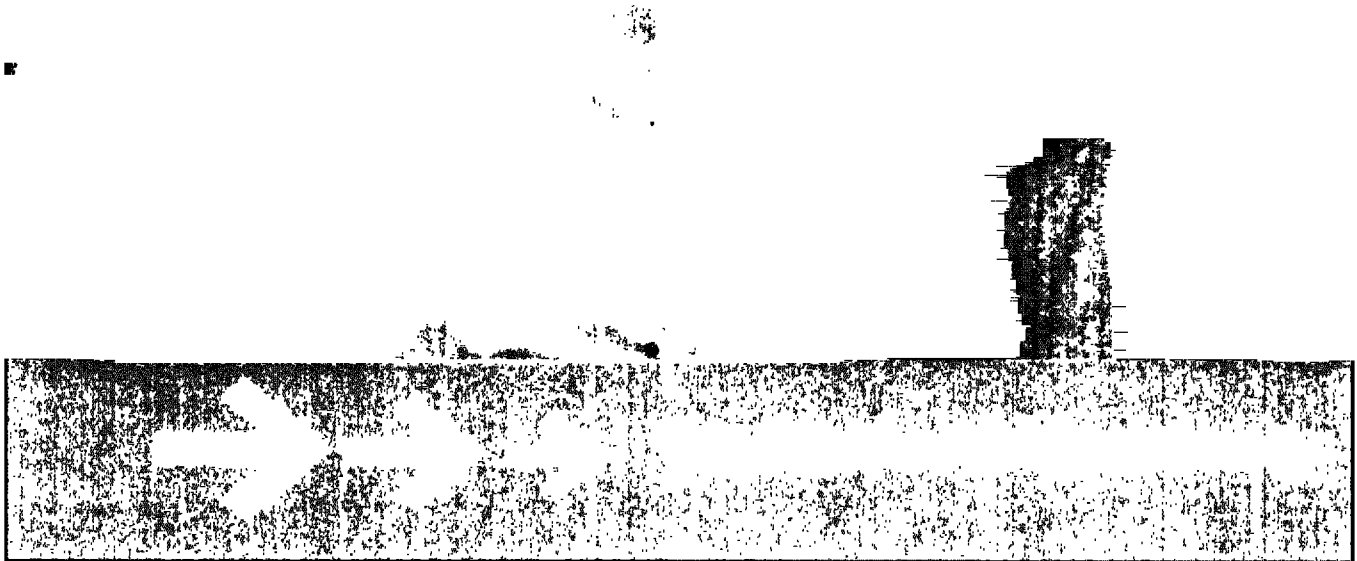
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World Development Report 2005

A Better Investment Climate for Everyone

Every day, firms and entrepreneurs around the world face important choices:

- A rural micro-entrepreneur ponders whether she should start a small business.
- A local manufacturing firm considers whether it should expand its production line and hire more workers.
- A multinational enterprise debates whether it should establish a new plant in one of several alternative locations around the globe.

Their decisions affect not only those directly involved, but also play a key role in economic growth and poverty reduction. And they will depend in large part on government policies and behaviors that shape the investment climate in each location.

World Development Report 2005 looks at what governments can do to improve the investment climates of their societies to help spur growth and reduce poverty. The Report identifies the opportunities and challenges governments face in making investment climate improvements, and suggests practical strategies for accelerating progress. In doing so, the Report draws on new sources of evidence – including surveys of nearly 30,000 firms in 53 countries, country case studies, and other new research.

This Report offers practical insights for policymakers and their advisors, executives, and all those with an interest in economic development.

PLUS: *World Development Report 2005: A Better Investment Climate for Everyone* includes selected data from *World Development Indicators*.

A copublication of the World Bank and Oxford University Press.

Paperback: September 2004. Stock No. A15682 (ISBN 0-8213-5682-8). Price US\$26.

Hardcover: September 2004. Stock No. A15721 (ISBN 0-8213-5721-7). Price US\$51.

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