Understanding the Investment Climate

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New data sources about firms provide insights into helping economies grow

Photo: A car production line at a Ford factory in southern India.

ONE OF the new frontiers of economics is the analysis of growth from a microeconomic perspective. This puts the focus on the firm as the lever of growth, instead of the broad aggregate numbers that are the stuff of macroeconomics. Examining the investment climate and how firms thrive and create jobs gives economists a new perspective on the dynamics of development and poverty reduction. After all, firms create over 90 percent of jobs, supply most of the goods and services necessary to improve living standards, and provide the bulk of the tax base needed to fund public services.

Early efforts to understand the investment climate—that is, the set of location-specific factors shaping the opportunities and incentives for firms to invest productively, create jobs, and expand—focused on broad indicators of country risk, often based on surveys of international experts and usually resulting in a single score for each country. Many studies focused on the narrower question of the constraints facing only foreign investors. Researchers looked at various aggregate indicators of a country's institutional and policy environment, such as the rule of law, corruption, openness to trade, legal origins, and financial sector depth. Their work underscored the importance of secure property rights and good governance to economic growth. But relying on aggregate indicators and cross-country regressions provided limited insights into the wide range of institutional arrangements across and within countries—and the impact of those arrangements on the investment decisions of different types of firms. It was also difficult to distinguish the effects of specific policy actions from the broader background institutions that influenced the content and impact of those actions.

In an effort to break through these limits, researchers began a few years ago to search for micro-level evidence on the quality of a location's investment climate and for ways to trace the climate's impact on the investment decisions and performance of firms—after all, higher productivity holds the key to boosting growth in the developing world. The *World Development Report 2005* (*WDR*) is the first to bring together insights from two World Bank initiatives—the Investment Climate Surveys and the Doing Business Project (see Box 1). It also draws on its own surveys of 3,000 entrepreneurs in the informal sector in 11 countries that recently completed Investment Climate Surveys, along with data from census records and business

Box 1

New sources of investment climate data

The World Bank recently launched two major initiatives to understand more about the determinants of growth and productivity (see *www.worldbank.org/wdr2005* for links to data).

Investment Climate Surveys. These surveys, which were launched in 2001, now cover more than 26,000 formal firms in 53 developing countries. They collect assessments of constraints facing firms, including corruption, finance, regulation, taxation, infrastructure, and labor. They also collect objective quantitative data, which allow investment climate indicators to be linked with firm performance to understand their impact on productivity, and investment and employment decisions.

For example, in India, firms in states with poor investment climates have 40 percent lower productivity than those in states with good ones. Within China, if Tianjin could achieve the same investment climate as Shanghai, firm-level productivity would increase by 15 percent and sales growth by 20 percent. If countries could achieve the same investment climates as the best-performing location in developing countries, firms in Dhaka would reduce 40 percent of their productivity gap, and those in Calcutta, 80 percent. In Dhaka, wages would rise by 18 percent, and in Calcutta, by 38 percent.

Doing Business Project. This project, which covers more than 140 countries, reports on the costs of doing business for a hypothetical firm and transaction based on the views of selected experts (lawyers, accountants). Underlying information includes the time and costs of complying with various areas of regulations—including business registration, contract enforcement, and labor regulation. A first report was published in 2003; annual updates, which include additional topics, are scheduled.

registries on the dynamics of starting and closing businesses for a range of countries.

Spurring growth and poverty reduction

Growing evidence demonstrates the fundamental role that an improved investment climate has in encouraging growth and poverty reduction—which is how China lifted 400 million people out of poverty, India doubled its growth rate, and Uganda grew at eight times the average of other sub-Saharan African countries (see Box 2). While the scope of policy areas covered by the investment climate is broad, the new sources of micro-level data provide useful insights. Firms assess the package of policies and behaviors as a whole, and through the lens of costs, risks, and barriers to competition. Addressing the most pressing of these concerns can spark a tremendous response from the private sector.

Risks. The surveys find that policy-related risks dominate the concerns of firms in developing countries. Uncertainty about the content and implementation of government policies is the number one concern, followed by macroeconomic instability, arbitrary regulation, and weak protection of property rights. Together they cloud opportunities and chill incentives to invest productively and create jobs (see Box 3). Nearly 90 percent of firms in Guatemala, and more than 70 percent of firms in Belarus and Zambia, find the interpretation of regulations unpredictable. More than 80 percent of firms in Bangladesh, and over 70 percent of firms in Ecuador and Moldova, lack confidence in the courts to uphold their property rights. Improving policy predictability alone can increase the likelihood of new investment by more than 30 percent.

Costs. The policy-related costs shouldered by firms can be substantial and make many potential investment opportunities unprofitable. The Doing Business indicators highlight the heavy burden imposed by outmoded or ill-conceived regulation. But regulation is part of a larger problem. Costs associated with unreliable electricity supply and other infrastructure, crime, and corruption can impose costs that are more than double those of regulation. Together with weak contract enforcement and onerous regulation, these costs can amount to over 25 percent of sales—or more than three times what firms typically pay in taxes (see Chart 1). The costs associated with unreliable electricity supply alone amount to over 10 percent of sales in Eritrea, India, and Kenya, while the costs of crime exceed 10 percent of sales in Armenia, Azerbaijan, and Peru. Bribes average more than 6 percent of sales in Algeria, Cambodia, and Nicaragua.

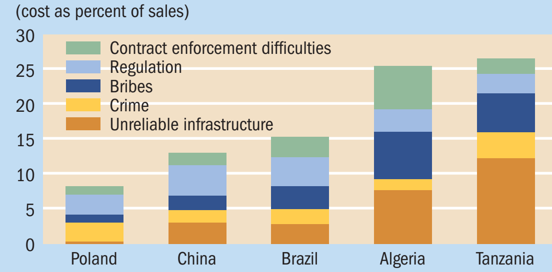
Barriers to competition. Firms naturally prefer less competition than more, but a barrier to competition benefiting one firm denies opportunities for others. Competitive pressure drives firms to innovate, improve productivity, and share the benefits of productivity gains with consumers and workers. In fact, the *WDR* found stronger competitive pressure can increase the probability of innovation by more than 50 percent. Many factors, including economies of scale and market size, can influence the level of competition in a market. But governments also influence competitive pressure by regulating market entry and exit and by responding to anti-competitive behavior. Openness to trade can be one of the more effective means of increasing competition. At the aggregate level, competition is difficult to measure, but firm-level evidence shows how much competitive pressure can vary among countries. Nearly 90 percent of firms in Poland

Chart 1

Troubling costs

Costs vary widely in level and composition.

(cost as percent of sales)



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

report strong competitive pressure, more than twice the share of firms in Georgia.

Pushing back the boundaries

Of course, improving the investment climate is not about reducing *all* costs, *all* risks, and *all* barriers. Taxes and regulations support a sound investment climate and protect broader social interests. Managing the tension between creating a favorable investment climate for firms and achieving other social goals is a major challenge for governments at all levels.

Moreover, the data show that researchers and governments working on reform agendas need to grapple with three additional sources of variation. First, there are large variations not only across countries but also within countries (see Chart 2). There can even be variations in how a national law is applied across locations. For example, the time to transfer a property title in Brazil varies from 15 days in Brasilia to 35 days in Rio de Janeiro to 65 days in Salvador. Second, investment climate conditions can also vary by type of firm—often hitting smaller firms the hardest (see Chart 3). Third, as reported by more than 90 percent of firms, there can be a significant gap between formal requirements and how they are actually enforced.

Box 2

Lessons from China, India, and Uganda

China has reported growth of about 8 percent a year for the past 20 years, with the share of its population living on less than $1 a day falling from 64 percent in 1981 to less than 17 percent in 2001. India's growth has increased from an average of 2.9 percent a year in the 1970s to 6.7 percent by the mid-1990s, with the share of its poor falling from 54 percent in 1980 to 35 percent in 2000. Yet neither country has an ideal investment climate. China only recently gave constitutional recognition to private property, and nonperforming loans hamper its banking sector. India's problems in the power sector are legendary.

So how have these countries managed to unleash growth and reduce poverty? The answer lies in their commitment to making pragmatic improvements in the investment climate. China began with a rudimentary system of property rights that created new incentives for a substantial part of its economy. India began with early efforts to reduce trade barriers and other distortions that covered a significant part of its economy. These initial reforms were followed by a series of improvements that chipped away at other barriers.

Less big countries have also benefited from taking this route. Uganda, which launched a major investment climate reform in the early 1990s—after a period of civil conflict and macroeconomic instability—saw private investment as a share of GDP more than double, from just over 6 percent in 1990 to 15 percent in 2002. Growth averaged 4 percent per year during 1993–2002 (or eight times the average in sub-Saharan Africa) and the share of its population living below the poverty line fell from 56 percent in 1992 to 35 percent in 2000.

Together, the Doing Business database and the Investment Climate Surveys can help policymakers identify priorities for reform and monitor progress. The former provides benchmarks of the formal costs of regulatory compliance. The latter captures how the implementation of regulations is experienced on the ground and the actual costs to firms of a weak investment climate.

Tackling the knowledge agenda

Progress in measuring the investment climate is an important first step in identifying specific areas for reform. Rather than a measure of "property rights," there are now numbers that report on the percentage of firms that believe courts will uphold their property rights, the percentage of firms that use the courts, the time and costs it takes to enforce a contract, the time and costs to resolve a bankruptcy, the percentage of firms reporting crimes and the cost of these crimes, and the predictability of interpretations of regulations. Similarly disaggregated information is available for other investment climate areas, too. With substantial differences in income across countries as well as within them, understanding how to unleash the potential in firms of all sizes is central to the development challenge.

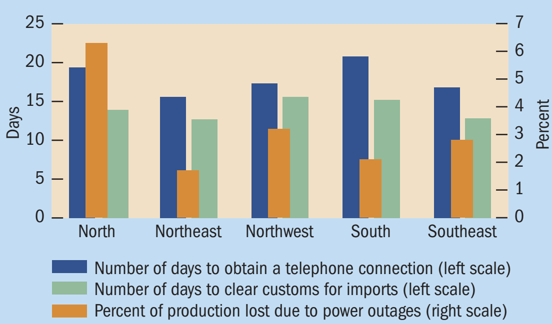
While early results on the firm-level investment climate work are encouraging, a huge research agenda still lies ahead. Part of this involves continued efforts to improve data collection. In particular, substantial efforts are required to improve national statistical systems. Work on strengthening statistical agencies in developing countries has increased in recent years, including multipartner initiatives such as the Partnership in Statistics for Development in the 21st Century (PARIS21). Such efforts can help governments monitor the performance of private sectors, identify emerging trends and problems, and evaluate the impact of alternative policy approaches.

The international community is well placed to develop more standardized measures of the investment climate to make cross-country comparisons. The World Bank's Investment Climate Surveys and the Doing Business Project are important contributions in this direction. Besides

Chart 2

Irksome delays

Variations within Brazil can be considerable.



Source: World Bank Investment Climate Surveys.

informing analysis, they provide a useful tool for governments to benchmark performance and monitor progress. And they can act as catalysts for reform.

Over time, as a consistent body of data is built up, policymakers can gain insights into the critical links between policy changes and growth. The ability to test more rigorously the impact of different policy approaches is particularly promising. Being able to better evaluate the impact of policies should encourage more experimentation and competition between approaches. Evaluations of pilot programs can identify the ones that are successful and should be scaled up.

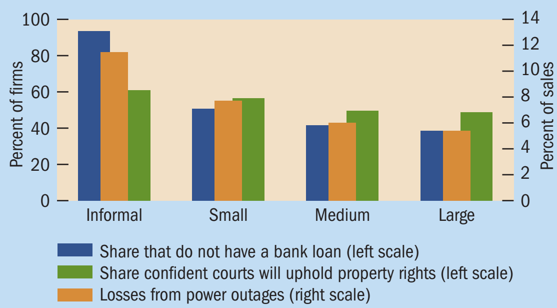
Tracking the data over time and possibly linking it with other sources such as census data will further our understanding of firms and growth. The processes and patterns by which firms are created and evolve, including creative destruction, are based mostly on industrial country experiences. Early research provides insights into how similar processes play out in developing countries. But there is a need to deepen and broaden understanding of these dynamics, including the important role of firms in the informal and rural economies, and the impact of international economic integration.

The role of the investment climate also needs to be linked to flows of people—not just capital. The links between the quality of a location's investment climate and migration warrants further study, whether that be movement from rural areas to urban, from one city to another, or from one country to another. Today, the world's migrants from developing countries total nearly 175 million. The $90 billion in remittances they send to their families every year is the second largest source of private capital (after foreign direct investment) for poor countries and poor people. Understanding the links between investment climate conditions and migration flows will become more important as the world deals with major demographic shifts over the next 25 years. ■

Chart 3

Size matters

Informal and small firms are often hit the hardest by investment climate constraints.

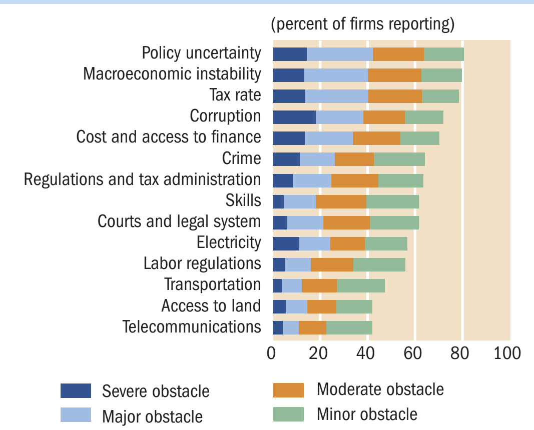


Source: World Bank Investment Climate Surveys.
Note: Uses 10 countries for which formal and informal surveys were conducted, controlling for industry, country, ownership, and firm age.

Box 3

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

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



Source: World Bank Investment Climate Surveys.
Note: Firms were asked to rank the list of issues according to whether they were an obstacle to the growth and operation of their business on a 5-point scale, from "no obstacle" to "severe obstacle."

Warrick Smith was Director and Mary Hallward-Driemeier Deputy Director of the World Bank's World Development Report 2005: A Better Investment Climate for Everyone.

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