Berlin Workshop Series 2005

Investment Climate, Growth, and Poverty

inWent
Internationale Weiterbildung und Entwicklung gGmbH
Capacity Building International, Germany

THE WORLD BANK

Edited by
Gudrun Kochendörfer-Lucius
and Boris Pleskovic

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THE WORLD BANK
Washington, D.C.

1818 H Street, NW
Washington, DC 20433
Telephone 202-473-1000
Internet www.worldbank.org
E-mail feedback@worldbank.org

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Acknowledgments

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Introduction

GUDRUN KOCHENDÖRFER-LUCIUS AND BORIS PLESKOVIC

The articles in this volume were presented at the sixth annual Berlin Workshop, held September 3–5, 2003. The workshop was sponsored by InWEnt–Capacity Building International, Germany and the World Bank.

The workshop provides a forum for the European research community to contribute its perspectives to early discussions in preparation for the World Bank's annual *World Development Report*. The workshop exposes ideas from different constituencies and perspectives around the world. Participants in the 2003 workshop come from academia, government, nongovernmental organizations, private companies, and think tanks around the world, as well as from the World Bank and German development institutions and organizations.

The 2003 workshop examines what role the investment climate plays in influencing growth and poverty and explores approaches to development based on improving the investment climate. Participants explore how the institutional environment and social structure shape investment opportunities in developing countries.

The workshop is divided into seven sessions. Session I, on investment, productivity, and development, examines how private investment affects economic growth and poverty. The session identifies the determinants of investment in Sub-Saharan Africa: the investment climate, government policies and growth, internal finance, efficiency, exports, and learning. Private investment reduces poverty when investment rates are high and occur in sectors that intensively use factors owned by the poor. In Sub-Saharan Africa that means land and unskilled labor. Rapid growth of such sectors is linked to exports, because openness to international competition provides firms with opportunities for learning, higher productivity, and new products.

Session II, on investor perspectives, addresses the practical view of international companies investing in developing countries and what they see as the key elements

Gudrun Kochendörfer-Lucius is the managing director of InWEnt–Capacity Building International, Germany. Boris Pleskovic is Research Manager, Development Economics, at the World Bank.

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when they make investments. This session outlines a set of criteria for investment as part of the planning process for regional business strategies. A set of criteria has to be defined on the basis of strategic decisions about sales and production. For Siemens this strategic process is everyday business. The company is present in more than 200 countries around the world, including many developing countries. Siemens considers openness and regional integration, infrastructure, good governance, and human capital the most relevant factors for making investment decisions globally.

Session III, on securing property and contractual rights, examines corporate governance in transition economies and developing countries, the effects of judicial independence on the investment climate, and an empirical study on formalization in Egypt. The first paper shows that a range of private and public enforcement tools can help reduce the costs of corporate governance. The limited empirical evidence suggests that private tools are more effective than public forms of enforcement in the typical environment of developing countries. Public enforcement is still necessary, however, and private enforcement mechanisms often require public laws to function. The second paper shows that an independent judiciary is a key factor contributing to economic growth, because it induces investment by creating a favorable investment climate. The paper discusses two indicators of judicial independence: the legal foundation and the actual degree of independence. The third paper makes a compelling case for formalization in Egypt, showing that the estimated benefits of doing so—improved productivity, faster growth of firms, higher income tax collection—are high.

Session IV, on the role of financial markets in promoting the investment climate, addresses the links between the financial and real sectors. The financial sector is in many ways the mirror image of the corporate sector: without a solvent, efficient, and vibrant corporate sector, the financial sector is not viable. The financial sector provides essential inputs to production, such as risk-sharing services and the pooling of savings, in addition to the increasingly important functions of allocation and monitoring the production process. But finance can also be a source of distortions and risks, hindering real sector growth when resources are misallocated. To address the issues of developing a sound financial sector, two areas need to be examined further: the classification of countries' financial systems and financial sector and related reforms. The financial structure is often classified as bank versus market based, but can also be viewed as vertical versus horizontal. The two models have different implications for the role of the government and reforms. Research on the financial sector should include investigation of the political economy of financial sector reform and the links between reforms and ownership structures.

Session V, on regulation, governance, and corruption, discusses recent efforts by Transparency International (TI) to tackle corruption problems in the global market and examines the current policy consensus on a good investment climate. TI has adopted the coalition-building approach to find areas of common interest shared by government, the private sector, and civil societies. It has been in the forefront of efforts to implement the OECD Convention. The 35 signatories to the Convention account for more than 90 percent of foreign direct investment worldwide. Under the Convention, all major competitors in the world market are legally bound simultaneously

to stop bribing. TI has proved how constructive and helpful civil society organizations can be in shaping better governance in a globalized economy.

The session also examines whether the conditions of the current policy consensus are essential for ensuring rapid growth and sustained poverty reduction. Key policy goals are best attained by promoting a service delivery state—a state that protects property rights, is subject to the rule of law, and does not intervene in markets. But questions remain about whether the evidence validates the claims that these are necessary preconditions for growth; whether the theory behind the policy agenda has been sufficiently rigorous in identifying the critical preconditions of growth; and whether there may be more important institutional preconditions for high and sustained investment regimes in developing countries. The current focus on good governance and investment climate reforms does not address issues that historical observation tells us were critical in successful transformations. More research is needed to identify the institutional and political reforms that are most likely to enhance the state's transformation capacities, particularly in developing countries.

Session VI, on the role of more selective intervention, discusses the effects of competition policy on business investment. The presentation focuses on transition dynamics and the welfare effects of competition policy. It identifies two types of investment: physical and innovative investments. Physical investment increases productive capacity or replaces capital. Innovative investment improves firms' products or processes. These types of investment may respond in different ways to competition policy, and they generally interact with each other. For developing countries, government interventions that affect the nature of competition are policies concerning trade, small and medium-size enterprises, and multinational investments. The session examines the dynamic relationship between the intensity of product market competition and different types of investment, a relationship that captures some aspects of adjustment to the competitive environment after trade liberalization.

Session VII, on reforming the investment climate, discusses how to improve outcomes for society through government policies that reduce costs, risks, and barriers to competition. The emergence of connectivity and globalization has radically shifted factors that determine who would be successful in attracting investment. Why has the investment climate become so important in the past few years? Investment has always been one of the key variables determining economic growth, yet it is only recently that the attention of the economic development literature has focused on this issue. Determining why is crucial to understanding the factors that make for a good investment climate. A third question is how to reform the investment climate. An important aspect of a good investment climate is the capacity of government to make credible long-term commitments. Legal certainty and policy stability—key variables in the calculations of would-be investors—are impossible in the absence of such capacity. Achieving credibility is to a large extent a question of designing and enforcing suitable constraints on the discretion of policymakers. One significant source of the credibility problem is time inconsistency, which occurs in any area of discretionary policymaking in which long-run and short-run objectives are not aligned. Another is rooted in the very nature of the democratic process. To give a policy credibility, it is necessary to take some other action that makes reversing the policy costly.

A credible policy must thus contain two elements: the planned course of action and the commitment that makes the course credible. Political and legal institutions are important because they allow policymakers to make commitments that would not be credible in the absence of such institutions (delegating responsibility for monetary policy to an independent central bank, for example).

The workshop participants conclude by outlining issues that need to be addressed by the *World Development Report*. First, no unique set of rules on fostering the investment climate applies to all developing countries. Institutional and political reforms should therefore be tailored to local conditions. Second, firm-level research should be the starting point in the *World Development Report*. Firms make investment decisions based on costs, risks, and barriers to competition. As highlighted throughout the workshop, reducing these barriers is crucial to expanding investment opportunities, encouraging innovation, and improving productivity, so that the benefits of reforms are shared by every member of the society, including workers and consumers.

Opening Address

InWEnt's Commitment to Helping Improve the Investment Climate in Developing Countries

GUDRUN KOCHENDÖRFER-LUCIUS

It is increasingly clear that official development assistance alone will not be sufficient to ensure that all countries meet the Millennium Development Goals (MDGs). The central challenge in reaping greater benefits from globalization thus lies in improving the investment climate—the policy and institutional environment that fosters entrepreneurship and productive investment. In the context of a sound macroeconomic framework, a favorable investment climate requires, among other things, predictable laws, sound regulation of industries, good-quality infrastructure, low trade barriers, bureaucratic efficiency, and attempts to fight corruption. Productivity increases and effective investment are fundamental conditions for poverty reduction as well as for rapid growth. Fostering both requires improvement of the investment climate.

In addressing these problems, InWEnt can draw on many years' experience as an organizer of international policy dialogues. Although the organization has existed in its present form only since October 2002, it resulted from the merger of two institutions with long traditions of involvement in development cooperation in the personnel area: the Carl Duisberg Gesellschaft (CDG) and the German Foundation for International Development (DSE), previously home to the Development Policy Forum.

For more than 40 years these organizations have been concerned with international personnel development, training, and development policy dialogue. The program of international training and dialogue is directed toward decisionmakers from industry, politics, administration, and civil society from all over the world, as well as specialists and executives in developing countries. InWEnt is also active in transition economies and industrial countries.

InWEnt covers a wide area of topics, ranging from rural development, nutrition, and environmental concerns through sustainable economies and social development issues to international rules, good governance, and economic policy. It has established

Gudrun Kochendörfer-Lucius is managing director of InWEnt–Capacity Building International, Germany.

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development-related training and information programs in Germany, designed to promote greater understanding of the North-South context among the general public and improve acceptance of German development cooperation.

The organization has a staff of about 900 people, who work at the headquarters in Bonn and in 30 other locations within Germany and abroad. InWEnt has a budget of €130 million. Project financing reached €99.4 million in 2003, €62.4 million of which came from InWEnt's principal contractor, the Ministry for Economic Cooperation and Development. The German federal government is the chief shareholder.

InWEnt and the Development Policy Forum have been active in the field of investment policies:

- In cooperation with the United Nations Conference on Trade and Development (UNCTAD), the Development Policy Forum convened a high-level policy dialogue on "International Investment Policies: Which Strategies for Development Countries?" in January 2000. The meeting provided substantive input into the preparatory process for UNCTAD's 10th quadrennial conference. Many of the discussions focused on the determinants of foreign direct investment.

- In cooperation with the International Monetary Fund (IMF), InWEnt convened an international policy dialogue on "New Sovereign Debt Restructuring Mechanisms" in February 2003. The meeting contributed to the strategic policy discussion of a new framework for sovereign debt restructuring. These efforts are extremely important to enabling investment and preventing financial crises, particularly in emerging markets.

- In cooperation with the World Bank and the IMF, InWEnt convened an international policy dialogue on "Debt Sustainability in Low-Income Countries" in May 2003. There was widespread recognition at the meeting that unless low-income countries gain access to more concessional finance, including higher levels of grant funding, many are unlikely to achieve the MDGs without jeopardizing their debt sustainability; and that more focus on investment, domestic and foreign, is required. A forward-looking debt sustainability framework needs to be created to help low-income countries develop strategies for financing development and meeting the MDGs.

- In cooperation with UNCTAD, the Development Policy Forum organized a global policy dialogue in Geneva in May 2003. The *World Investment Report 2003*: *FDI Policies for Development: National and International Perspectives,* published by UNCTAD, benefited from the discussions at the meeting.

Early Thinking on the Scope and Approach of the 2005 *World Development Report*

WARRICK SMITH

The *World Development Report* is the World Bank's annual flagship publication. The 2005 report—the 27th in the series—will focus on what governments can do to improve the investment climates of their societies to spur growth and reduce poverty. This topic coincides with the first of the two pillars of the World Bank's overall development strategy. Important aspects of the second and complementary pillar—investing in and empowering people—were addressed in last year's *World Development Report*.

The investment climate is a vast topic, one of the broadest addressed by recent *World Development Report*s. Indeed, many constituent elements of the investment climate—such as infrastructure, finance, and labor markets—have been subjects of their own *World Development Report*s in the past. To set the scene for our discussions at this workshop, let me outline some of the team's early thinking on scope and approach.

Scope of the Investment Climate

At its broadest, the investment climate covers the full range of factors in a location that influence the opportunities and incentives for private firms to invest. Some of those factors, such as geography, resource endowments, and consumer preferences, are difficult for governments to address, at least over the medium term. Since our goal is to look at opportunities for making improvements, we plan to focus primarily on the role of government policies and behaviors in shaping the investment climate.

Warrick Smith is the director of the *World Development Report 2005*.

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The formal policy areas subsumed by the investment climate cover a broad field. They can be grouped into four main categories:

- Economic and political stability and the security of property rights, including rights to land and other property, contract enforcement, crime, and threats of government expropriation
- Regulation and taxation, including measures within and at a country's borders
- Finance and infrastructure, including how the scope and quality of services affect the investment climate for firms as well as the investment climate facing providers of financial and infrastructure services
- Workers and labor markets, including skills, labor market regulation, and measures to help workers cope with change

Of course, formal laws and policies are not the only way governments influence the investment climate. The quality of governance affects both the content of formal policies and the actual impact of policies on firms' investment decisions. These attributes might also be considered within four categories, which often interact:

- Rent-seeking, including not just corruption but also patron-clientelism and capture
- Policy credibility, or the extent to which firms feel confident about relying on a government's policy pronouncements or commitments
- Public trust and legitimacy, which are important in enabling and sustaining reform
- Government capacity, including resources and expertise, as well as the extent to which policy approaches take into account capacity constraints

Firms do not assess particular policies and behaviors in isolation when making investment decisions. Rather, they assess the full range of policies and behaviors as part of a package. An important challenge for the *World Development Report* will be to develop a framework to show how these factors interact to influence the costs, risks, and barriers to competition faced by firms—and hence their opportunities and incentives to contribute to growth and poverty reduction.

Investment plays an important role in growth processes. But the growth literature makes it clear that the goal is not merely factor accumulation—productivity plays a critical role. This means that the impact of policies and behaviors on competition and incentives to innovate plays an important role in the analysis. As we develop the *World Development Report,* we will also be looking at how alternative approaches may influence poverty reduction, including possible strategies for molding investment climate policies to enable more pro-poor growth.

Proposed Approach

We see our goal as taking stock of the current state of global knowledge in this field—and doing so in a way that provides practical insights for policymakers and

their advisors. Our proposed approach to this task is informed by a number of considerations.

New Sources of Micro-Level Data

Until recently, most of the work on the investment climate relied on aggregate indicators of a country's policy and institutional environment, such as rule of law, corruption, and trade openness. That work highlighted the central role of institutions. But aggregate indicators and cross-country regressions provide limited insights into the heterogeneity of institutional arrangements across and within countries or the impact of those arrangements on different types of firms. It is also difficult to distinguish the effects of specific policy actions from the broader background institutions that influence the content and impact of those actions.

To help address these shortcomings, the *World Development Report* will aim to deepen the analysis by drawing on new sources of disaggregated data. These sources include early results of the Bank's program of Investment Climate Surveys and Assessments—expected to cover some 50 developing countries—and the Bank's new Doing Business project.

Investment Climate for Whom?

Many studies in this area have focused on attracting foreign direct investment and hence looked at the investment climate from the perspectives of foreign firms. But while foreign investment in developing countries has grown strongly in recent years, the overwhelming bulk of private investment is domestic. We thus propose to look at the investment climate affecting both domestic and foreign firms. Since a substantial part of economic activity in developing countries occurs in the informal economy, we hope to understand the perspectives of informal firms as well. To do so, the team is commissioning surveys of firms in the informal economy to try to identify the extent to which the constraints they face are the same as those facing other firms.

Beyond the Basics

A focus on improving the investment climate will require the team to consider the general package of policies and behaviors that might apply to most firms in the economy. But it will also require us to consider the role of more selective interventions, from tax incentives and export processing zones to directed credit and market restrictions. In this context we expect to look at several broad categories of potential beneficiaries of selective intervention, including exporters, foreign investors, small firms, rural firms, and those engaged in research and development. Space limitations will prevent us from looking in detail at differences between industry sectors, such as mining, agriculture, and specific manufacturing and service sectors.

International rules and standards are also having a growing effect on most parts of the investment climate. It will be important for us to understand how those

instruments might help foster better investment climates and associated challenges for developing countries.

Managing Change

Early feedback from clients and others has urged us to address issues associated with implementing investment climate improvements. This will require us to reflect on two broad challenges. The first flows from the very breadth of the agenda, including issues of priority-setting and sequencing. The second flows from the political economy of reform in each area, including resistance from beneficiaries of the status quo. To help understand the ingredients of effective reform processes, the team is commissioning a series of case studies focusing on processes and outcomes.

As these brief observations suggest, this year's *World Development Report* team has set itself an ambitious task. We hope discussions at this workshop will help us navigate the road ahead.

Part I: Investment, Productivity, and Development: What Have We Learned?

How Do the RPED Surveys Inform the Debate on the Investment Climate?

FRANCIS TEAL

How do the Regional Programme on Enterprise Development (RPED) surveys of African firms inform the debate on how the investment climate affects growth and poverty reduction processes? Under this rather broad question are narrower questions that relate to how investment affects growth and poverty reduction and how government policies affect the investment climate.

What determines investment in Sub-Saharan Africa and how does private investment affect growth and poverty reduction? Private investment affects growth and poverty when investment rates are high and investment occurs in sectors that intensively use factors owned by the poor. In Sub-Saharan Africa that means land and unskilled labor. Rapid growth of such sectors is linked to exports.

One of the reasons why investment rates in African manufacturing firms have been very low may be that these firms have failed to grow through exporting. Whatever the reasons for the low level of investment, investment has been far too low to affect the demand for unskilled labor. It has therefore had only a minimal effect on poverty reduction.

What constrains investment? A poor investment climate, misguided government policies, lack of growth opportunities, reliance on internal finance, low efficiency, lack of exports, and low skill levels have all been suggested as explanations for Africa's low investment rates. One of the problems that confronts any attempt to assess which of these factors is most important in determining investment is that most firms in most African countries face all of them. The RPED surveys have informed the debate on the investment climate in Africa by drawing attention to the magnitude of the problems these firms face and the policy problem of reversing the current situation.

If the underlying problem that confronts investors in Africa is the poor investment climate, will improvement in that climate disproportionately benefit manufacturing

Francis Teal is deputy director of the Centre for the Study of African Economics, Department of Economics, University of Oxford, United Kingdom.

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firms? If so, which aspects of the investment climate will be most important? In terms of the impact on poverty, how important is it that the performance of manufacturing firms be improved? The RPED surveys can give us some insights into these questions.

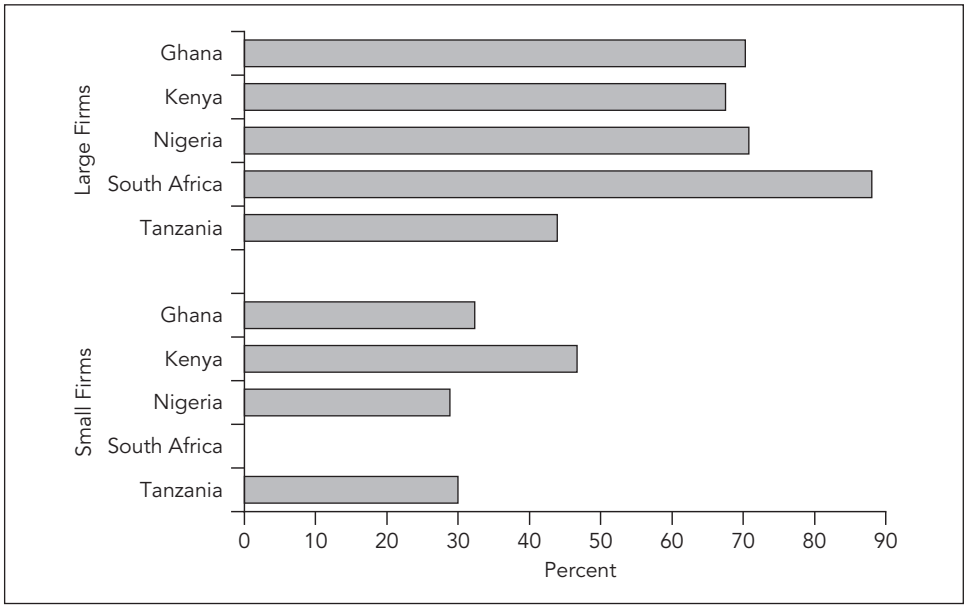
Investment in Sub-Saharan Africa

Data on the percentage of firms that invest in fixed capital in manufacturing firms were collected for five Sub-Saharan African countries: Ghana, Kenya, Nigeria, South Africa, and Tanzania (figure 1). (South Africa was not included in the RPED surveys; the data on South Africa come from other sources.) The data are presented separately for large firms (firms employing more than 100 people) and small firms (firms employing fewer than 20 people).

The percentage of firms investing differs greatly by size. In four of the five countries—Ghana, Kenya, Nigeria, and South Africa—70 percent of large firms invest in any particular year. (In Tanzania less than half of large firms invested.) In contrast, across all five countries, less than half of small firms invest. As most firms in all these countries except South Africa are small, these numbers imply that the percentage of firms investing any year is low, certainly less than 50 percent. Among firms that invest, the investment rate (the investment-to-capital ratio) tends to be higher for small firms than for large firms (figure 2).

The effect of these countervailing patterns differs across countries (figure 3). Large firms in Ghana have a substantially higher investment rate than small firms. In

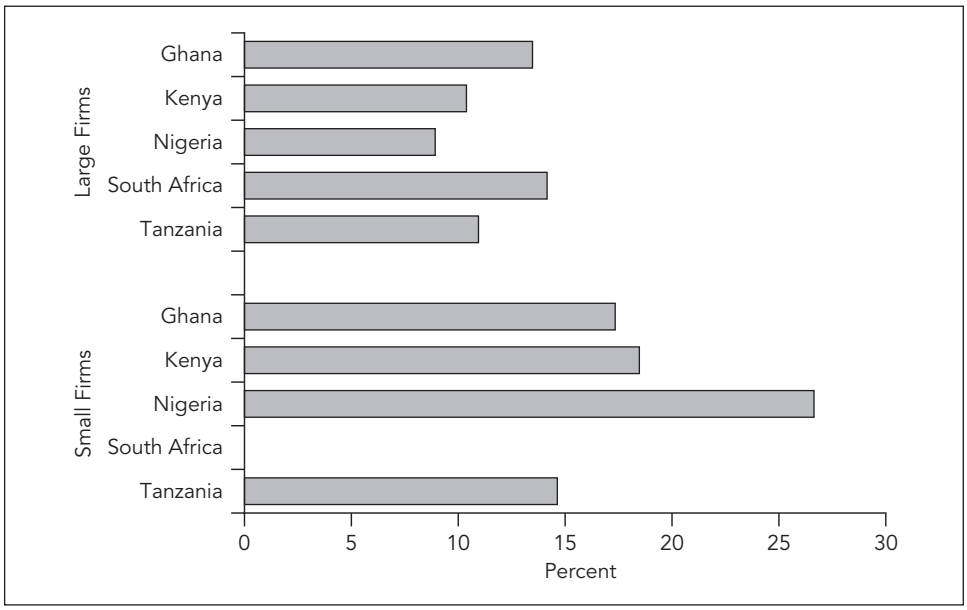
FIGURE 1. Percentage of Firms that Invest



Note: A small firm is one with less than 20 employees, a large firm has more than 100 employees. There are no small firms in the South African sample.

Source: RPED surveys, World Bank.

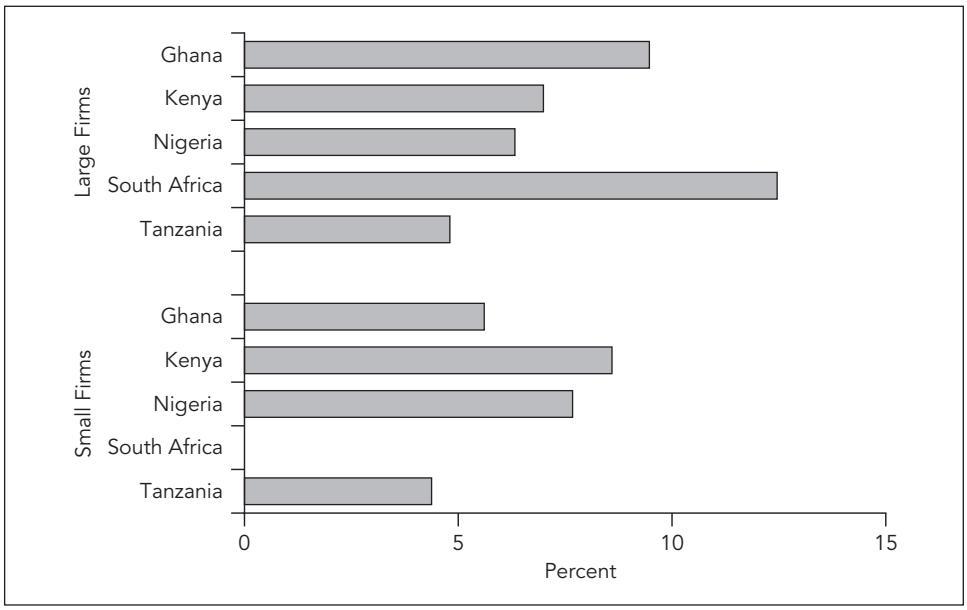
FIGURE 2. Investment as a Percentage of the Capital Stock: If Firm Invests



Note: A small firm is one with less than 20 employees, a large firm has more than 100 employees. There are no small firms in the South African sample.

Source: RPED surveys, World Bank.

FIGURE 3. Investment as a Percentage of the Capital Stock



Note: A small firm is one with less than 20 employees, a large firm has more than 100 employees. There are no small firms in the South African sample.

Source: RPED surveys, World Bank.

Kenya, Nigeria, and Tanzania, the investment rate is similar for large and small firms. For all four countries, the investment rate is low (below 15 percent). For Ghana and Tanzania, where the manufacturing sector is dominated by small firms, the investment rate is about 5 percent.

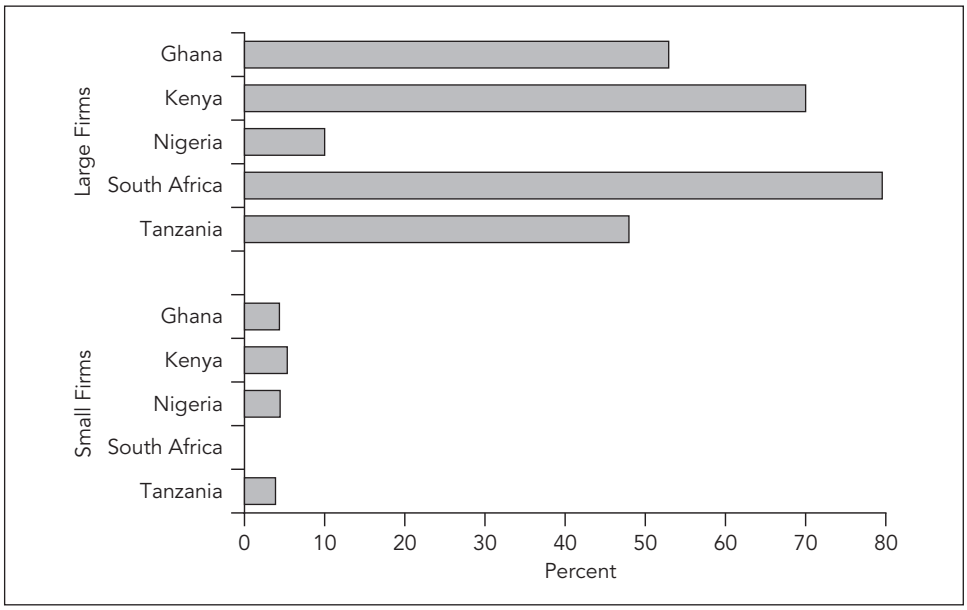
The RPED surveys provide strong evidence that the manufacturing sector in these countries was unable to generate substantial investment in the 1990s. Learning about the causes of rapid investment growth thus requires studying economies outside Sub-Saharan Africa.

Exports in Sub-Saharan Africa

Within Sub-Saharan Africa exporting appears to be confined to firms that are large by African standards (figure 4). In all of the countries studied (except South Africa, for which there were no data on small firms), a negligible number of small firms export. Among large firms, there are marked differences across countries. In Kenya and South Africa, at least 70 percent of large firms export. In contrast, only 10 percent of large firms in Nigeria do so. In Ghana and Tanzania, about 50 percent of large firms export. Since in all of these countries except South Africa, small firms are much more numerous than large ones, the implication is that very few firms export.

The RPED data show that exporting is related to the size distribution of firms. In fact, except in Nigeria, most large firms export. Why exports have not provided these countries with a basis for sustained growth remains unclear.

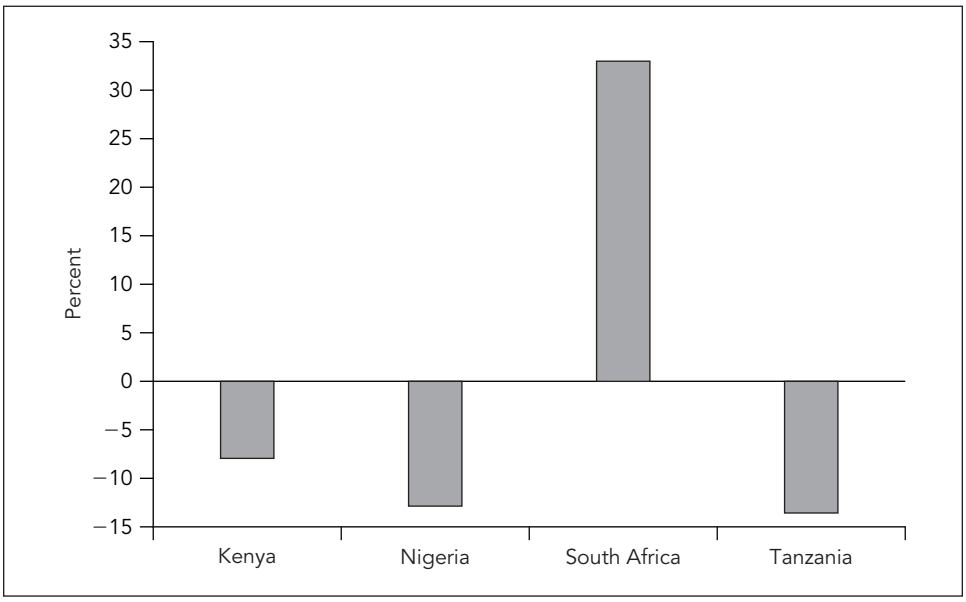
FIGURE 4. Percentage of Firms Exporting



Note: A small firm is one with less than 20 employees, a large firm has more than 100 employees. There are no small firms in the South African sample.

Source: RPED surveys, World Bank.

FIGURE 5. Relative Total Factor Productivity



Note: Measurement for each country is relative to Ghana.

Source: RPED surveys, World Bank.

There are compelling reasons to think that the productivity of a firm and its exports are linked. Exactly how they are linked is less clear. One view is that firms that are more efficient self-select into the export market. Another, not necessarily incompatible view, is that firms learn from being in the export market. This issue is being investigated with the RPED data.

Comparing total factor productivity across countries is problematic because comparable measures need to be used for inputs and outputs. Comparing the total factor productivity of firms in the manufacturing sector is less problematic than comparing aggregate GDP figures. Allowing for differences in inputs—which are much larger in South Africa than in Nigeria or Ghana—South Africa has the highest level of underlying productivity of the five countries (figure 5). The gap between South Africa, where firms have the highest levels of underlying efficiency, and Tanzania, where firms are least efficient, is about 50 percent. Nigeria's total factor productivity is very similar to Tanzania's. Surprisingly, Kenyan firms are less efficient than Ghanaian ones. Given the formidable problems of measurement involved in making this comparison, the differences across the four countries are not large, however.

The Investment Climate, Government Policies, and Investment

In recent years much ingenuity has gone into developing measures for assessing features of the investment climate. Measures of political and civil rights, of the openness of the economy, and of institutional quality have all appeared in growth regressions.

They have been less prominent in investment equations, partly because fewer comparative data have been available. The RPED surveys move us closer to being able to make these comparisons.

Macroeconomic data suggest that the extent to which an economy enters the international market affects its growth rate. Microeconomic data suggest that firm efficiency and exporting are linked. What is not clear is what constrains firms in Africa from entering the export market or what factors are most important in limiting their investment. It seems likely that exporting success and investment will be linked. Without much higher investment rates, theses firms will not be able to grow or provide new jobs. Without new jobs, there will be no impact on poverty.

Part II: Investor Perspectives on the Investment Climate

An Investor's Perspective on the Investment Climate in Developing Countries

BERND STECHER

The assessment of the investment climate in developing countries is part of the planning process for regional business strategies, and it is taking place in most large and all global companies. A set of criteria has to be defined, upon which strategic decisions on sales, investment, and production can be placed.

For Siemens this strategic process is everyday business. We are present in more than 190 countries around the world, including many developing countries. In the last fiscal year our turnover with customers from developing countries amounted to €14.4 billion, or 22 percent of our turnover abroad. Of the 250,000 employees who work for Siemens outside Germany, about 60,000 are located in developing countries, 99 percent of them local residents.

Siemens is present in developing countries producing any part of the value chain, including assembling, services, and production for the local, regional, and world market. We expect top-level world-market standards from any production location.

Our engagement in any country has a long-term orientation. We want to act as a good corporate citizen and stay in the country, even in difficult times. This long-term commitment is demonstrated by the fact that last year we celebrated 150 years of business activity in Russia and this year 100 years in China.

The global market environment is continuously changing. Markets are growing together due to globalization, the removal of market barriers, increasing speed, and revolutionary inventions in information and communication technologies. This dynamic framework is a constant challenge for the investment decisions of companies.

I want to address three questions with regard to a favorable investment climate: What will developing countries gain, what do they have to provide, and how can we support them?

Bernd Stecher is corporate vice president of Siemens AG, Munich, Germany.

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What Will Developing Countries Gain by Opening to Trade?

Opening up to trade means additional income from increasing exports and cheaper imports. It also attracts new resources for investment, helps increase productivity, and fosters new rounds of rising income. But the best way to speed up this process and to foster growth and development is to attract foreign direct investment (FDI). FDI not only supplies additional capital, which is necessary to speed productivity growth, but also imports best practice management expertise and technology that has already proven its excellence in other countries and other markets. Attracting FDI thus facilitates the structural changes required for growth and helps integrate countries into the international value chain.

Siemens' production locations around the world follow the principle of world market excellence. The worldwide demand for mobile phones, for example, is served by production locations in Germany, Brazil, and China. Production facilities in all of these locations have to provide the same top-quality standards for the world market. This means the same efficient production processes, the same high level of technology, management, and human capital.

Countries such as Ireland, Malaysia, Singapore, Thailand, and now—in a most impressive way—China have successfully followed the path of openness. They have attracted FDI and substantially increased their income per capita within a short period of time.

What Do Developing Countries Need to Provide?

Developing countries need to provide investors with openness and regional integration, infrastructure, good governance, and good human capital.

Openness and Regional Integration

Open borders and free entry and exit for goods, capital, and businesses are relevant factors for the investment decisions of companies as they define market size and the long-term allocation of their invested capital. These factors are especially important for small countries. As market size and market potential are primary driving factors for global FDI flows, large countries like Brazil, China, and India have a natural advantage over small countries. To compete, small countries need to tear down barriers to trade and factor mobility in order to foster regional—and global—integration. If they succeed in doing so, they can attract investment despite their small size—as the cases of Ireland and Portugal, which sucked in huge waves of FDI after they joined the European Union, demonstrate.

The need for further progress in openness and global integration makes the Doha Round particularly important. Regional integration models such as Mercosur and ASEAN also need to be further developed.

Infrastructure

Insufficient access to infrastructure services—telecommunication, energy, transport, and water—is often a severe constraint for firms. Production sites located in developing countries with poor infrastructure can hardly be integrated into international value chains—or only at substantial additional cost. This means that comparative advantages such as cheap labor can be realized only in part, if at all.

Good Governance

Good governance includes a broad range of public institutions and codes that jointly constitute a stable, transparent, and efficient framework for entrepreneurial activities. This means, of course, peace and stability. But good governance goes much further and includes the rule of law—a transparent and functioning legal and regulatory system combined with the necessary enforcement mechanisms. Good governance also means efficient and transparent public administration.

Even when new legal and administrative frameworks are established, they must be translated into action. Procedures that are bureaucratic, time-consuming, costly, and nontransparent lead to arbitrary results or provide room for large-scale corruption, which discourages foreign companies from investing.

Human Capital

In many developing countries the most important resource is cheap labor. But a minimum level of education as well as a functioning public health system are necessary to make efficient use of this important resource. Not only is the AIDS disaster in Sub-Saharan Africa a human catastrophe, it also dramatically reduces development prospects because of its effect on human capital.

What Can Foreign Companies and Industrial Countries Do to Support Developing Countries?

Foreign companies can transfer management skills and technological knowledge that can easily spread among local business communities. Confronted with the failure of public health, education, and other services, foreign companies often engage in projects that support their employees and local communities. Company-driven projects provide housing, teaching, and environmental and health services.

But it is the primary task of the government of any developing country to provide the framework of good governance. They can count on the help of international institutions like the World Bank or bilateral programs of many OECD countries. But they have to make the decisive steps and overcome basic deficiencies.

Beyond any facilitating support and development aid from industrial countries, which is clearly necessary, the best help industrial countries can provide is to open up their markets to agricultural and manufactured goods from the developing world. This is mainly what the Doha Round is all about.

The Investment Climate and a Strategy for Development

NICHOLAS STERN

The Berlin meetings have been landmarks in the development of the *World Development Report* over the years. They expose the writers of the report to serious criticism and ideas from constituencies and perspectives all around the world, and they force the team to clarify their approach. The very different perspectives represented at these meetings are of special importance for this particular *World Development Report,* which is devoted to taking forward an approach to development based on the investment climate, a key element in the strategy of the World Bank.

The approach to development based on the idea of investment climate is very different from the approaches we have seen before. While it embraces many familiar ideas, it looks deeper and provides an agenda that some of the earlier approaches did not provide. The investment climate approach looks at the institutional, governance, and economic environment in which people make decisions. It is referred to as the investment climate, but it actually includes the entire business environment.

The kinds of things we are talking about are not simply influences on investment projects in terms of risks and returns and what shapes the risks and the returns; we are talking about economic activity as a whole. Bureaucratic harassment affects what you can do now with what you have, not simply your possibilities for the future. The investment climate, in this sense, thus involves more than just investment.

To see just how different this approach is to earlier approaches, think back to the 1990 *World Development Report,* on poverty. That report spoke about investment in physical capital, investment in human capital, capital-labor ratios, and the importance of labor intensity in the growth process. All that is fine. But what we are talking about here is something that looks behind that, at what shapes investment, what shapes capital-labor ratios, what shapes investment in human as well as physical capital—namely, the institutional environment and the behavioral environment in

Sir Nicholas Stern is second permanent secretary and head of the Government Economic Service at Her Majesty's Treasury (U.K.). He was from 2000 to 2003 chief economist and senior vice president of the World Bank.

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which people make decisions. And that is why I think it is so fruitful. It is very much an Austrian view of the processes of growth, in the sense that it tries to look at what shapes markets and what shapes behavior within markets. It is looking at the deeper drivers of investment and pointing to policies that are more structural and institutional than policies that deal mainly with tax rates, investment credits in the tax system, and so on.

This is a fundamental change, and I think it reflects where the World Bank itself has been moving over the past 10 years or so in terms of taking much more careful account of the institutional and governance environment in which people and firms operate. Very roughly, the Bank began as a project-based organization. During the 1970s the Bank recognized that the macroeconomic policy environment was a fundamental determinant of whether or not projects were likely to succeed, and it focused on macroeconomic policies and structural adjustment. That was no bad thing, but it missed something important, which is that macroeconomic policies, trade policies, and so on function—or fail to function—in an institutional and governance environment. I think many of the mistakes of the structural adjustment story in the 1980s reflected the fact that that element was missed, that we did not look at the institutional environment and the social structures that were shaping those policies and their consequences.

During the 1990s the Bank came to understand that much better. The investment climate story makes those institutional and governance issues that can sound very abstract and airy—and for some economists "soft"—much more explicit and quantitative. The investment climate surveys go down to the firm level and ask businesspeople: What problems are you facing? How often are you visited by the local bureaucracy? How long does it take to get goods through customs? How often does the electricity go off (or in some countries, how often is the electricity on)? These kinds of questions reveal much about the functioning of an economy, and they lead directly to policy. They resonate so strongly and carry so much influence with policymakers because they are both very specific and accord with experience. Further, they allow policymakers to have a broad view of the problems facing enterprises. Most enterprises are not large enough to command an audience with an official from a finance or industry ministry to discuss general problems facing their sectors. Most large enterprises are usually capable of looking after themselves; when they do come to the ministry of finance or the ministry of industry, they are often seeking solutions to a specific problem—and thus favoring themselves—rather than trying to sort out the problems facing their industry as a whole. That is why these data are very powerful—they take the argument in the direction of conditions for all firms and farms and are based on an overall assessment.

This approach has been widely accepted in client countries and within the Bank. Investment climate issues are now central in about half of the Bank's portfolio. It is remarkable how quickly the idea and language of the investment climate have caught on at the Bank. Sometimes ideas and language and enthusiam run ahead of the theory and the empirical work. That is no bad thing; it just means that the theory and empirical work had better catch up and get back out in front. And that is what I see the *World Development Report* doing: getting back out in front of an idea that has already caught on in order to shape it, structure it, and give it a solid theoretical and empirical basis.

We know a great deal now about the relationship between investment climate and growth. We are not just saying, the investment climate is important for investment and investment is important for growth. What we are showing is the way in which the investment climate affects productivity, entrepreneurship, the willingness to innovate, and so on, right through the economy.

Look at the difference between Uttar Pradesh, one of the poorest and worst-governed states in India, and Maharashtra, one of the richest. Local authorities visit firms in Uttar Pradesh twice as often as they do in Maharashtra. They come not to discuss cricket or have a cup of tea but to leave better off than when they arrived. It is not surprising, then, that life is much more difficult for entrepreneurs in Uttar Pradesh than in Maharashtra. Electricity goes off much more often in Uttar Pradesh than in Maharashtra. The result is that 90 percent of firms surveyed in Uttar Pradesh have their own generator, while less than half of those in Maharashtra do. Partly as a result, the capital intensity of production in Uttar Pradesh, one of the poorest states in India, is higher than it is in Maharashtra. As a result, Uttar Pradesh has grown much more slowly than Maharashtra. We have many more examples from the data sets that Warrick Smith and his group and David Dollar and Michael Klein and their groups have been building at the World Bank.

My first message from the Report is that a good investment climate helps people get out of poverty—and not just by raising aggregate growth rates but by giving poor people opportunities. The weak investment climate is usually weak for large firms and small firms for the same reasons, and the problems faced by all firms are rather similar. If the ports do not work, everyone suffers; if customs officers are corrupt, they are usually corrupt for everyone; if the power system is down, it is usually down for many people. But I think we know—or are starting to see—that poor firms are hit harder than rich firms. Smaller firms usually pay a higher fraction of their turnover in bribes than richer firms; buying a generator represents a proportionally larger investment for a small firm than for a large firm. So when we talk about the investment climate, we are not just talking about the aggregate growth rate, we are talking also and in particular about the problems facing smaller firms. Poor people in developing countries do not work for the government or for large firms; those who are employed work in small firms or on farms. So getting the environment right for them yields growth, which is crucial, but it creates the kind of growth in which small firms—and poor people—can participate. That is a very powerful story.

The second important message is that the investment climate affects rural communities. Something like two-thirds of the poor people in the world live in rural areas; the most important small firm is the farm. Linking the investment climate to rural development is therefore extremely important. Rural development is about both farm and off-farm activities. Poor rural infrastructure—inadequate rural roads, electricity, water supply—hits both farm and off-farm activities. Farmers need relief from harassment by bureaucrats. They need reliable supplies of water and electricity. They need links to exports through rural roads in ways very similar to the need of someone trying to run a workshop in a small town. It would be very good if we could show the commonality of those problems and how the weak investment climate is

affecting rural areas just as strongly as—and in some ways more strongly than—urban areas.

My third message is on the prominence of institutions and behavior in the whole story. Often we use the language of government and government policies, as if there was one thing called the government. But we all know that the government is many things, many institutions, many people who behave in different ways and that much of the challenge of improving the investment climate is changing the nature of government and the way it operates. Transparency is a very powerful example of doing just that, and I think the centrality of transparency in the *World Development Report* is absolutely right. As Justice Louis Brandeis said, sunshine is a great disinfectant. But we have to be careful about describing transparency as simply one government policy, because what we are talking about is much more than policy, it is changing the nature and behavior of government. It can bring transformations in behavior and institutions, which are not only vital in themselves to participation of people in a society and an economy but also change the quality of governance in a way that has a powerful impact on growth.

Part III: Securing Property and Contractual Rights

Enforcing Corporate Governance

ERIK BERGLÖF AND STIJN CLAESSENS

Much effort has been devoted in recent years to the formulation of ever more elaborate and complete rules of corporate governance. Many countries have adopted their existing or established sophisticated and extensive new legal texts and regulations, often imported from developed market economies. More informal codes of conduct have also been adopted. International bodies, such as the Organisation for Economic Co-operation and Development (OECD), and other organizations have issued corporate governance principles; governments and groups have adopted more than 100 national corporate governance codes (Gregory 2000, 2001); and private companies have issued countless corporate governance pronouncements.

Whatever their source, these sets of rules are all remarkably similar. Yet corporate governance practices differ substantially across countries and companies (OECD 2003). And many concerns remain regarding the effectiveness of corporate governance rules in transition economies and developing countries, as well as in many industrial countries, where written rules are not adhered to and pronouncements of firms are not followed up by actions, in great part because rules and regulations are not enforced. Policymakers have come to realize that lack of enforcement more than regulations and laws-on-the-books is the key problem, at least in transition economies and developing countries.

While enforcement is a general problem of development, it particularly affects firms seeking external financing. Financial contracts, after all, involve the commitment of the firm to adhere to certain obligations, in particular to pay appropriate rates of return to the providers of external financing. A weak enforcement environment makes it harder for firms to commit to honor financial contracts and attract external financing. It is not only the laws but also their enforcement that affects the ability of firms to attract external financing and, consequently, the degree of

Erik Berglöf is the director of the Stockholm Institute of Transition Economics and East European Economies (SITE). Stijn Claessens is professor of international finance policy at the University of Amsterdam and senior advisor at the World Bank. The opinions do not necessarily represent those of the World Bank.

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financial development. Empirical evidence, for example, shows that it is not the presence of insider trading laws but rather actions taken against insider trading that help explain the development of securities markets (Bhattacharya and Daouk 2002).[1] A large international study finds that the level of enforcement is much more important than the quality of laws on the books in explaining the turnover of chief executive officers (Defond and Hung 2003).

We develop a rudimentary framework to help understand when corporate governance rules are enforced and what can be done to improve corporate governance mechanisms in a weak enforcement environment. The analysis of various options should help understand which reforms, including corporate governance rules, do most to improve corporate governance practices and mitigate social costs. The literature on how to improve poorly functioning enforcement environments is large and cannot be summarized here. Instead, we focus on enforcement issues that relate to corporate governance.

The Corporate Governance Problem in Developing Countries and Transition Economies

Any recommendations on national policies relating to corporate governance must start with a definition of the corporate governance problem facing a particular country, as these problems vary considerably across countries. This section focuses on the challenges facing developing countries and transition economies, with emphasis on how a weak general enforcement environment affects the functioning of the basic corporate governance mechanisms.[2] (For overviews of the corporate governance literature, see Shleifer and Vishny 1997 and Becht, Bolton, and Röell 2003). We begin with a simple conceptual model of the firm and how it can be financed by outside sources. We then discuss how various mechanisms can be used to deal with the principal agent problems that arise because of external financing.

Corporate governance is in great part about mitigating the following commitment problem: how can investors be ensured that management will choose the right projects, exert sufficient effort, adequately disclose relevant information, and ultimately repay investors? Investors can reduce the likelihood of being defrauded or deceived by monitoring and potentially punishing management. Firms can try to employ a variety of commitment mechanisms to overcome investors' concerns (table 1).

The preferred mechanisms will depend on the institutional development of the country, especially its contracting environment. A potentially important corporate governance mechanism may be hard to influence through policy, and mechanisms susceptible to policy intervention may not be very important. Policy recommendations should take both problems into account. The priorities for corporate governance reform must take into account both the relative importance of a particular mechanism in a particular environment and the scope for impact of policy intervention in that environment. For example, in some environments in which the court system functions

satisfactorily, formal protection of minority shareholders enforced through private litigation is an option for improving the functioning of the key mechanisms of large shareholder monitoring. In weaker enforcement environments, policy may have to focus on promoting private mechanisms and empowering shareholders by disseminating information (see table 1).

TABLE 1. Corporate Governance Mechanisms in Developing Countries and Transition Economies

Corporate governance mechanism	Relative importance in developing countries and transition economies	Scope for policy intervention
Large blockholders	Likely to be most important governance mechanism.	Strengthen rules protecting minority investors without removing incentives to hold controlling blocks.
Market for corporate control	Unlikely to be important when ownership is strongly concentrated; can still take place through debt contracts, but requires bankruptcy system.	Remove some managerial defenses; require disclosure of ownership and control; develop banking system.
Proxy fights	Unlikely to be effective when ownership is strongly concentrated.	Promote technological improvements for communicating with and among shareholders; require disclosure of ownership and control.
Board activity	Unlikely to be influential when controlling owner can hire and fire board members.	Introduce elements of independence of directors; train directors; require disclosure of voting; allow weighted voting (cumulative voting).
Executive compensation	Less important when controlling owner can hire and fire and has private benefits.	Require disclosure of compensation schemes, conflict of interest rules.
Bank monitoring	Important, but depends on health of banking system and the regulatory environment.	Strengthen banking regulation and institutions; encourage collection of information on credit histories; develop supporting credit bureaus and other information intermediaries.
Shareholder activism	Potentially important, particularly in large firms with dispersed shareholders.	Encourage interaction among shareholders; strengthen minority protection; enhance governance of institutional investors.
Employee monitoring	Potentially very important, particularly in smaller companies with highly skilled human capital in which threat of leaving is high.	Require disclosure of information to employees; possibly require board representation; ensure flexible labor markets.

(*Continues on next page*)

TABLE 1. (*Continued*)

Corporate governance mechanism	Relative importance in developing countries and transition economies	Scope for policy intervention
Litigation	Depends critically on quality of general enforcement environment, but can sometimes work.	Facilitate communication among shareholders; encourage class action suits (but include safeguards against excessive litigation).
Media and social control	Potentially important, but depends on competition among and independence of media.	Encourage competition in and diverse control of media; launch public campaigns to empower the public.
Reputation and self-enforcement	Important when general enforcement is weak.	Depend on growth opportunities and scope for rent seeking; encourage competition in factor markets.
Bilateral private enforcement mechanisms	Important, as they can be more specific, but do not benefit outsiders and can lock partners into long-term inefficient arrangements.	Establish functioning civil and commercial courts.
Arbitration, auditors, other multilateral mechanisms	Potentially important—often the origin of public law—but enforcement problem often remains. Audits sometimes abused; conflicts of interest can be a problem.	Facilitate formation of private third-party mechanisms, sometimes preventing public alternatives from emerging; deal with conflicts of interest; ensure competition.
Competition	Determines scope for potential mistreatment of factors of production, including financing.	Open up all factor markets to competition, including from abroad.

In industrial countries many firms are closely held, yet minority investors have some means to challenge insiders and ensure a reasonable rate of return on their investment. They are consequently willing to provide external financing. In transition economies and developing countries, these means may not be available.

Enforcement and Corporate Governance

Although enforcement is generally agreed to be critically important to economic performance and there is a vast literature on the subject, no simple framework for thinking about enforcement exists. The issues related to enforcement can be classified in several ways. One distinction is between private and public mechanisms. Private initiatives to enforce contracts are critical to the functioning of any economy and can be outside of the legal system. These initiatives can be unilateral, bilateral, or multilateral. Such private ordering among agents is different from private law enforcement. Law serves to standardize contracts and clarify liability. Laws can be enforced

privately (through litigation) or by the public sector. Under private law enforcement, private agents avail themselves of the framework defined by law or regulations to punish violations from contracts, using the courts to adjudicate and the state to enforce the final judgment. With public enforcement, the government provides only the final enforcement system and acts as the prosecutor. In the extreme case, the government has full control over all activities, there are no property rights of contracts to enforce, and laws are irrelevant.

An enforcement system thus consists of a continuum of overlapping mechanisms ranging from private arrangements, through private enforcement of laws and government-enforced regulation to full government control (Djankov, Glaeser, and others 2003). All mechanisms have their costs; tradeoffs between costs and benefits exist. Private and public initiatives are often complements rather than substitutes. The effectiveness of private enforcement mechanisms often depends on the effectiveness of public enforcement mechanisms. Public enforcement reduces the costs of private enforcement. But while more public intervention may mitigate market failure, it is more vulnerable to government failure and may not be the most efficient means of enforcement when private agents have better information, resources, and incentives. Private agents are particularly important when the general institutional environment is weak. A system of social control of business is necessary where both markets and government fail or cannot be expected to operate. More generally, it is necessary to support the functioning of markets.

Each country will choose a different mix of technologies. The optimal mix for many developing countries will differ from that observed in industrial countries. Public enforcement can play only a limited role in weak institutional environments, as powerful controlling owners and managers will most likely find their way around the system. Private enforcement of public laws and the power of litigation and court intervention vary greatly across countries, depending on how well public enforcement institutions function. Russian investors, for example, almost never go to courts, because when they do the likelihood of success is miniscule and even if they win, the judgment is often not enforced (Zhuravskaya and Zamulin 2003).

When courts are weak, other enforcement mechanisms may be used to enforce good corporate governance. Policies promoting bank lending and financial development may help enforce corporate governance. Yet even here relative costs are important. In China investors became increasingly active in taking their grievances to court, although court decisions were not always predictable or enforced (Pistor and Xu 2003).[3] They did so because other mechanisms were either unavailable or even more costly.

The choice among technologies depends largely on the overall environment. Political institutions are part of the general enforcement environment. They may function poorly, be dominated by an absolute ruler, or be captured by special interests. Legal standards and the level of enforcement can also interact. A benevolent government can trade off the benefits of stricter legal standards with the costs of their enforcement (Immordino and Pagano 2003). With a benevolent government, standards should be set lower, because the costs of enforcing them are higher. In other words, legal standards and enforcement are complements, and both can increase as countries

develop. Laws and regulations can be adopted not only to correct market failures, reduce transactions costs, and achieve social objectives but also to extract bribes. Djankov, La Porta, and others (2002) find some support for this so-called tollbooth view, especially in developing countries, suggesting that policymakers should err on the side of laxer laws in weaker environments.

Conclusions

Ultimately, the effectiveness of many enforcement mechanisms hinges on the commitment from the political sphere to enforce laws and regulations. Given the enormous potential gains from improvements in public enforcement, building support for reforming these institutions should be easy. Reforming enforcement institutions should be easier than changing basic investor rights, which often involves clear winners and losers. Many attempts to reform investor rights have failed because of powerful opposition, but changes to investor rights do occur, often following financial and other crises.

Review of the literature highlights some general lessons on improving enforcement, not necessarily limited to corporate governance:

- Private sector efforts to enhance enforcement are often more effective than government-led efforts, but the two forms of enforcement often complement one another. Experience from securities regulation in the United States suggests that private ordering can precede and serve as a basis for public laws and for private and public enforcement of those laws.
- The balance between private ordering and private enforcement of public law depends on the quality of public laws and the strength of enforcing institutions. When the general enforcement environment is weak, private ordering may be the only hope. The evidence suggests that private enforcement is very important (López-de-Silanes 2003). Improvements in enforcement are more often the result of bottom-up rather than top-down approaches. Capacity building is often important to support private initiatives, and it helps build constituencies for reform.
- Top-down efforts to improve the legal and enforcement environment are difficult and rarely successful. Transplanting elements of foreign legal systems has generally not worked well, but the experience of accession to the European Union suggests that outside anchors can play a positive role in encouraging the implementation of reforms.
- In designing strategies for improved enforcement of corporate governance, both the likely impact of a particular governance mechanism and the scope for improvement of the mechanism should be considered. A particular corporate governance reform may play a very important role in reducing agency costs but leave little room for improvement of enforcement.

Notes

1. This is not to say that laws are not important but rather that more than laws is needed. As López-de-Silanes notes, "The development of capital markets depends crucially on laws that facilitate enforcement and the improvement of court procedures that allow for a more efficient dispute resolution" (2003, p. 2).
2. For simplicity we do not distinguish between developing countries and transition economies, even though the problems they face are often different. For a discussion of the different corporate challenges facing the two types of economies, see Berglöf and von Thadden (2000).
3. After the onslaught of litigation, the Chinese Supreme Court basically froze the process by stating that it did not have the competence to adjudicate these cases. Litigation activity has recently surged again.

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The Economics of Formalization: Potential Winners and Losers from Formalization in Egypt

AHMED GALAL

Whether extralegal entities and activities should be formalized into the legal sector is a subject of debate. Arguments for leaving the informal sector alone rest on the belief that it would force entrepreneurs to move from a low-cost mode of operation most suited to small and microenterprises 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. The misperception that formalization is merely an effort at raising funds for the Treasury with little benefit to anyone else is widespread.

The case for formalization is compelling.[1] Formalization allows policymakers to make both marginalized entrepreneurs and society at large better off. It leads to better protection of property rights, which 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 equips and motivates entrepreneurs to expand their businesses, reorganize internally, and benefit from specialization and division of labor. These changes would increase economic growth (Barro and Sala-i-Martin 1995; Knack and Keefer 1995) and poverty reduction (Dollar and Kraay 2001).

But even if one accepts the merits of formalization in principle, three key questions remain unanswered: how large are the expected benefits from formalization in a given society, who are the likely winners and losers, and what does it take to achieve these gains? Without satisfactory answers to these questions, policymakers may not take the necessary actions to persuade entrepreneurs to voluntarily make the shift to the legal sector and stay there.

Policymakers face competing demands on their political capital; the case for paying attention to formalization over other reforms thus needs to be made. Since

Ahmed Galal is executive director and director of research at the Egyptian Center for Economic Studies (ECES). The author is grateful to Amal Refaat for handling the data analysis.

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policymakers do not necessarily attach equal weights to different groups in society, the potential winners and losers from formalization need to be identified. And policymakers need a reform package that can persuade entrepreneurs to formalize.[2]

This paper explains why some Egyptian entrepreneurs choose to remain informal under the current regulatory framework, estimates the welfare gains from formalization, and identifies the potential winners and losers from formalization reforms. The methodology used to estimate the magnitude and distribution of welfare follows a partial equilibrium model previously used to evaluate the welfare impact of privatization (Galal and others 1994). This methodology is in the tradition of applied welfare economics and project evaluation. The firm-level information and regulatory parameters used to assess the impact of formalization in Egypt are obtained from the extensive fieldwork carried out by the team from the Institute of Liberty and Democracy and the Egyptian Center for Economic Studies (ILD/ECES).

The expressions *extralegal* and *informal* are used interchangeably here to refer to entities or activities that do not comply with the legal rules governing entry, operation, or both. These activities do not include illegal activities, such as narcotics trafficking. The study covers not only small enterprises but also medium-size and large firms, which may be partially formal (possessing a license, for example, but not complying with social insurance rules). The analysis here is thus broader than and distinct from the literature on small and medium-size enterprises, which focuses on firm size rather than informality.

A Framework for Analyzing the Formalization Decision and Its Welfare Impact

Why do so many street vendors, bakeries, hairdressers, retailers, and artisans of all kinds opt to stay outside the formal economy? What does it take to convince them to shift to the formal sector and stay there? And what are the welfare implications of both decisions?

Intuitive Answers

From the perspective of entrepreneurs, the decision to stay informal is often mistakenly interpreted as a mere reflection of the high cost of entry into the legal sector. An alternative and equally mistaken view is that the choice of informality means that entrepreneurs find it too costly to abide by the formal rules and regulations governing taxation, labor, contract enforcement, securing inputs, and selling outputs to different buyers or that informality is due to costly procedures of exiting the formal sector.

A more comprehensive and convincing view of the phenomenon of informality is that entrepreneurs 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 extralegality (in the form of bribes, costly

finance, and lack of good protection) because it is more beneficial to remain informal. The only way to convince entrepreneurs to formalize is for the government to introduce reforms that reduce the costs and enhance the revenues for entrepreneurs to the point of tilting the balance in favor of formalization.

Implicit in this discussion is "the difference principle." That is, what matters for entrepreneurs is not whether the government reduces the cost of entry, operation, or exit or simply takes measures to enhance revenues through tax exemptions or subsidized credit. Rather, it is the difference in the net benefits under the two states of the world (formal versus informal) that makes a difference. Also implicit in this discussion is the notion that reforming the business environment facing the formal sector is key to attracting entrepreneurs to the sector.

From society's perspective, entrepreneurs are only one group among many. The government also cares about workers, consumers, and its own budget. Accordingly, the policymakers' decision to promote formalization hinges on its impact on all of these actors. Formalization could, of course, impact positively on certain groups and negatively on 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. Mechanisms could be found to make the winners compensate the losers. These mechanisms do not have to entail explicit transfer of funds but can be built into the reform package itself (through taxation, for example).

More Formal Answers

An entrepreneur chooses to be in the informal sector because:

$$Vp \text{ (informal)} > Vp \text{ (formal without reform)} \tag{1}$$

where Vp is the discounted stream of profits over the life of the firm, Vp (informal) is the private (as opposed to the social) value of the firm under continued informality, and Vp (formal without reform) is the private value of the same firm, also expressed in net present value, under the assumption that the firm is formalized into the existing legal and regulatory framework.

Three factors could make the private value of a firm higher under informality than under formality. The first is the high relative cost of entry (obtaining and renewing a license); operation (paying social insurance, corporate taxes, and value-added taxes and enduring inspections of factory and products); and exit (costly procedures of liquidation or bankruptcy) in the formal sector. The second is the expectation of low benefits from shifting to the formal sector under the current regulatory regime, especially with respect to obtaining credit from the financial sector at reasonable rates, gaining access to efficient infrastructure, and having contracts fairly and efficiently enforced. The third is that entrepreneurs in the informal sector are able to develop extralegal (albeit suboptimal) practices to protect their property rights, make informal contracts, and avoid payment of stiff penalties.

What would it take to make entrepreneurs change their mind and move to the formal sector? The answer depends on whether or not the government adopts sufficient

reforms to reverse the inequality in equation 1. More specifically, if the government adopts reforms such that:

$$Vp \text{ (formal with reform)} > Vp \text{ (informal)} \tag{2}$$

entrepreneurs in the informal sector would freely shift to the formal sector. Partial reforms of the regulatory regime governing entry, operation, or exit may not be sufficient to make it attractive for entrepreneurs to formalize. Partial reforms are desirable in their own right, but they will not be effective unless they collectively satisfy the inequality in equation 2.

So far the formalization decision has been discussed from the perspective of individual entrepreneurs. From society's perspective, the decision is more complicated. It depends on the likely impact of formalization on key economic agents, namely, entrepreneurs, workers, consumers, and the government. Reforms will be socially desirable if the social value of the firm in the formal sector is greater than that in the informal sector:

$$Vs \text{ (formal)} - Vs \text{ (informal)} > 0 \tag{3}$$

where Vs is the discounted stream of benefits (losses) to all economic agents affected by the operation of the firm.

The change in welfare (W) is the difference between the two values. This change in welfare, also expressed in net present value, can be decomposed into its major recipients as follows:

$$W = Vs \text{ (formal)} - Vs \text{ (informal)} = \Delta P + \Delta L + \Delta C \tag{4}$$

where the change in P, or profits, represents the shares of entrepreneurs and government in W (divided among them on the basis of the taxation regime); ΔL represents the change in the share of workers; and ΔC represents the change in the share of consumers.[3] Without formalization reforms, the change in welfare may not justify formalization socially, and the arguments for "leaving the informal sector alone" will hold. With appropriate reforms, the social value of the firm can be increased enough to justify formalization.

In principle, the two social values are not expected to be equal if a package of formalization reforms is adopted. On the one hand, formalization would lead to the expansion of firms, higher productivity, and a realignment of prices, including selling prices, interest rates, and wages. On the other hand, it would entail some expenditure of real resources to cover the costs of creating a new organization to handle the formalization process, maintaining books for tax purposes, and enforcing contracts. On balance, and without taking into account any general equilibrium effects, the net benefits from formalization are expected to outweigh the cost of carrying out the formalization process.[4]

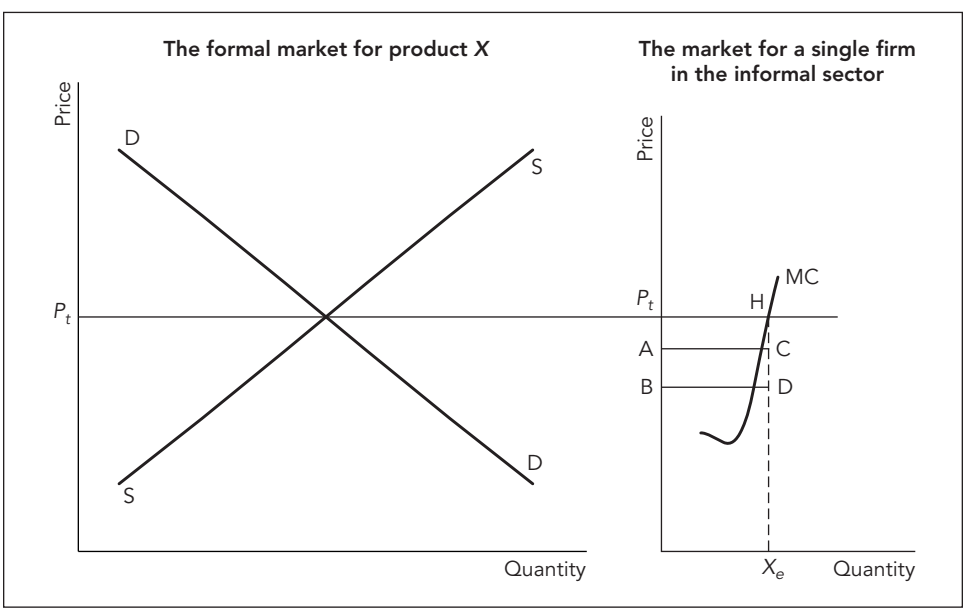
Formalization is expected to have different effects on different groups. Entrepreneurs and the government are likely to be better off. How the expected increase in profits will be divided between the two will depend on the taxation regime for newly formalized firms. Workers are also expected to gain from formalization, through

enrollment in social insurance, higher wages from improved productivity, and new employment opportunities due to expansion (these gains may be partially offset by lower take-home pay).[5]

The impact of formalization on consumers is uncertain. It depends on the price they paid for the product in the informal sector, the price they have to pay after formalization, and the incidence of the value-added tax (figure 1). Let P_t be the market-clearing price (inclusive of value-added tax) for a product in the formal sector. The price is determined competitively because of the multiplicity of producers and consumers. This price is the maximum a firm in the informal sector could charge, hence the demand curve it faces is perfectly elastic. Before formalization the firm is assumed to charge consumers a price equal to A, which includes half the value-added tax, even if that amount is not transferred to government. The quality of the product is assumed to be lower than that of a similar product produced in the formal sector, but consumers are willing to compromise on quality in return for lower prices. Following formalization, the informal firm maximizes profit by selling at P_t and producing at X_e. Quality is improved due to better surveillance and inspection. Entrepreneurs and consumers bear the value-added tax (area $P_t\,BDH$), and money is transferred to government. Consumers are worse off by the additional increase in price (area P_tACH), which they pay in return for improved product quality.

The distribution of the welfare gains is not even across groups. But the sum of the welfare gains (losses) originating from the improvement (deterioration) in firm performance should be equal to the sum of the benefits (losses) that accrued to (or are incurred by) different economic agents. Note that not all gains from formalization are pure gains to society. For example, while improved productivity is a real saving

FIGURE 1. Likely Impact of Formalization on Consumers



of scarce resources, payment of taxes is a mere transfer from entrepreneurs or consumers to the government. That is not to say that transfers are not important; they involve important redistribution among different actors in society. The point is that transfers are netted out in our calculation of the welfare impact of formalization.

Application of the Model in Egypt

Data for Egypt were available from fieldwork on the operation of a "typical firm" in the informal sector; a set of parameters related to the cost of extralegality and entry, operation, and exit under the current legal and regulatory regime; and a set of reform measures to make formalization worthwhile to entrepreneurs. A simulation exercise was carried out in five steps using these data. The first step involved estimating the value of the "typical" firm in the informal sector under the assumption that it would continue to operate extralegally.[6] To this end, projections were made of all revenues, costs (including extralegal costs), and profits. The information about the typical firm was compiled by the ILD/ECES research team from in-depth interviews with 100 firms in various sectors and locations where informality is known to be prevalent. Projections were needed because the benefits and costs of the investment or formalization decision occur over time and need to be discounted.

The second step involved estimating the value of the typical firm under the assumption that it would be formalized into the current legal and regulatory framework. Under this scenario the firm no longer bears the cost of extralegality but is obliged to pay the cost of entry, operation, and exit associated with being formal. The two sets of cost estimates were derived from a careful analysis of existing rules and regulations, interviews with firms in the formal and informal sectors, and interviews with lawyers and accountants familiar with the current business environment in Egypt. By comparing the values of a firm under continued informality and under formalization under the current regulatory regime, it is possible to explain why a firm operates informally.

The third step involved estimating a third value of the typical firm under the assumption that it would be formalized into a reformed regulatory environment. The reforms, spelled out in detail in the main study (ILD/ECES 2004), were translated into an increase or decrease in revenues, a reduction or increase in costs, or a redistribution of resources among different groups. A conservative approach was adopted to avoid inflating the impact of formalization. For example, it was assumed that the firm would expand by just 3 percent a year during the first five years, growing 5 percent a year thereafter. These growth rates do not involve large jumps and are in line with the potential growth rate of GDP in Egypt. Similarly, it was assumed that productivity would improve by just 1 percent a year. Given the severe constraints informal firms currently face, larger increases could be possible. It was also assumed that selling prices would be equal to those in the formal sector, although overall prices could decline because of increased supply. Finally, wages were assumed to rise 26 percent to cover social insurance, but workers were assumed to accept a 9 percent cut in take-home pay in return for new social benefits. These assumptions suggest that

the welfare impact of formalization, presented in the next section, represents a lower bound and that actual welfare gains could be larger.

The fourth step involved aggregating the firm-level data in order to estimate the welfare impact of formalization of the entire informal sector on the economy. This was done by multiplying the values obtained at the firm level by the number of firms in the informal sector and assuming that it would take five years to complete the formalization process. To simplify the exposition and normalize the results, all values are expressed in relation to GDP (adjusted by the value-added of formalized firms).

The fifth and final step was sensitivity analysis, performed under two sets of assumptions. Under the first (optimistic) scenario, more favorable assumptions were made about the rate at which formalized firms would expand, the rate at which productivity would improve, and the income tax rate at which revenue would be enhanced. Under the second (pessimistic) scenario, more conservative assumptions were made for all of these variables.

The Informal Sector in Egypt

By definition, entrepreneurs in the informal sector operate in the shadows and do not report their activities accurately or at all. Figures on the size of the informal economy are therefore hard to come by. Estimates suggest that the size of the sector in the developing world is large, however, accounting for 30–70 percent of GNP (Jagannathan 1987). The informal sector is smaller in Hong Kong (China) and Singapore and higher in Egypt, Morocco, Peru, and the Philippines. The level of development and the degree of informality appear to be negatively correlated. But even if the lower bound of 30 percent is taken as a benchmark, it is costly for these economies to have one-third of their economies operating suboptimally.

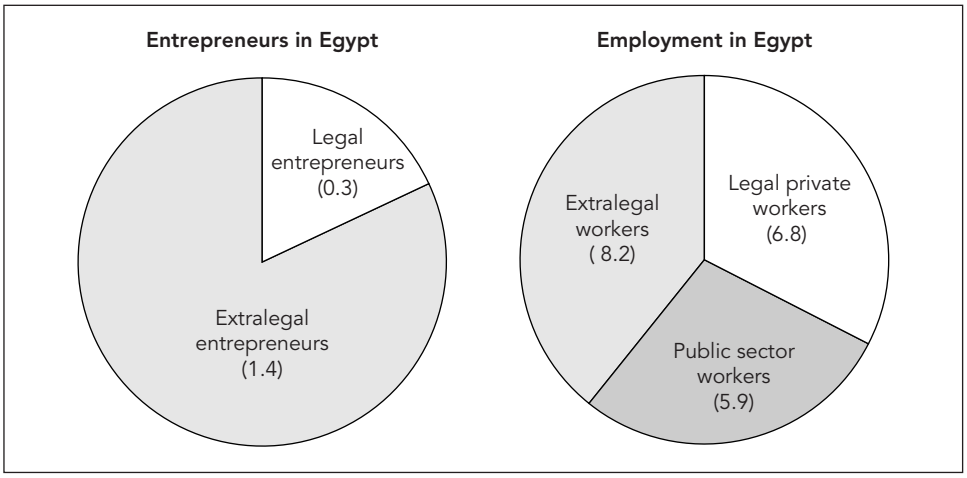
The Size of the Informal Sector in Egypt

Some 1.4 million entrepreneurs—82 percent of all entrepreneurs in Egypt—work in the informal sector (figure 2), according to 1996 government survey data (CAPMAS 1997) and the ILD/ECES team (ILD/ECES 2004). The sector employs about 8.2 million workers—more than either the formal private sector (6.8 million) or the government (5.9 million).

The characteristics of the informal sector in Egypt are similar to those observed elsewhere.[7] More than 90 percent of extralegal firms in Egypt are run as sole proprietorships. Most employ fewer than five workers, operate with limited capital, and provide services. The average lifetime of the firm is about 10 years, and the production techniques employed tend to be labor intensive.

The size of the informal sector and the fact that it operates suboptimally justify the formalization effort, which is expected to generate significant benefits to the Egyptian economy as well as to the underprivileged.

FIGURE 2. Extralegal Entrepreneurs and Workers in Egypt
(millions)



Source: ILD and ECES (2004).

The Rationale for Informality in Egypt

Comparing the estimated private value of the typical firm in the informal sector under continued informality (*Vp* informal) and the corresponding value of the same firm if it is formalized into the current regulatory framework (*Vp* formal without reform) reveals why informality exists in Egypt on a large scale. Under the prevailing regulatory framework, formalization would leave the typical entrepreneur worse off by as much as LE14,900 a year (table 1). Without reforms that make formalization profitable, informality will persist.

The results suggest that formalization under the current regulatory framework is not socially desirable. At the level of the individual firm, formalization would earn the government additional revenues of LE149,500 (primarily from value-added tax) and employees an extra LE11,400 (primarily in the form of social insurance) over 10 years. But the losses to the entrepreneur (LE148,800) and consumers (LE128,000) exceed the sum of these benefits, leading to a net loss to society of LE115,862, or LE11,586 a year per firm.

Aggregating the results across all firms in the informal sector confirms the conclusion that formalization is not beneficial. It also provides an order of magnitude of the potential benefits and losses at the level of the economy. Without reform formalization would lead to a loss of resources to society of LE6.5 billion, or 1 percent of GDP every year. The government would collect additional annual revenues of 2.4 percent of GDP and workers would earn an additional 0.3 percent of GDP, but entrepreneurs would lose 2.5 percent of GDP and consumers would lose 1.3 percent. Society would be worse off, validating the argument for leaving the informal sector alone.

Why does formalization under the current regulatory framework generate such negative results? An important part of the story lies in the cost of implementing the legal

TABLE 1. Welfare Impact of Formalization under No Reform
(in Egyptian pounds, unless specified otherwise)

Economic agents	Vs (informal) (1)	Vs (formal with reform) (2)	Firm-level change (Vs formal − Vs informal) (3) = (2) − (1)	Annual economy-level change (aggregate Vs formal − aggregate Vs informal) (4) = (3) * number of firms in the informal sector (LE billions)	Annual economy-level change (aggregate Vs formal − aggregate Vs informal)/GDP (5) = [(4)/GDP] * 100 (percent of GDP)
Entrepreneurs	356,426	207,664	(148,762)	(15.5)	(2.5)
Employees	207,897	219,276	11,378	1.9	0.3
Consumers	(127,980)	(255,960)	(127,980)	(8.2)	(1.3)
Government	27,195	176,698	149,502	15.2	2.4
Total	463,539	347,677	(115,862)	(6.5)	(1.0)

Source: Calculated from data obtained from the field survey.

and regulatory procedures in the formal sector regarding entry, operation, and exit. In-depth analysis of 10 cases shows that incorporating a single-person business could involve 91 steps and 43 entities and take 232 days (costs vary across neighborhoods)[8] and the process costs LE8,039—more than average per capita income in Egypt. Interviews with lawyers and accountants suggest that the cost of operating a business in the formal sector is even more significant, especially with respect to dealing with social insurance and tax administration. As for exit, the fieldwork suggests that bankruptcy procedures could involve as many as 53 steps, 14 entities, and 635 days, costing entrepreneurs about LE9,000 in cash and LE19,000 in opportunity cost.

To be sure, Egypt is not unique in the developing world in terms of how costly it is to enter and operate in the formal sector. Loayza (1996) surveyed studies assessing the cost of access to and operation in the formal sector in a large number of developing countries. Citing De Soto and his team (1989), he reports that it took 10 months to register a small firm in Peru. The cost of registering a business was $195 to obtain the license and $1,037 in waiting for utilities—costs that together represented 32 times the minimum monthly salary. In Bolivia, Brazil, and Guatemala, Tokman (1992) found that access to the formal sector took about 10 months and cost 10 percent of annual profits. Operating costs associated with formality cost a sample of 50 small Peruvian manufacturing firms about 348 percent of after-tax profit (De Soto 1989). For a sample of Latin American countries, the most important cost of staying formal was related to labor regulation, which increased labor costs an average of 20 percent (Tokman 1992).

All this does not mean that staying informal is not costly. It is, in Egypt and elsewhere, even if entrepreneurs are able to come up with extralegal practices to circumvent the constraints they face. In Egypt some entrepreneurs use licenses obtained for a particular business in a particular location to conduct other types of business in other locations. They sign checks to lenders to ensure repayment, risking imprisonment for 6–36 months if they fail to meet their obligations. The problem with such practices is that they do not permit entrepreneurs to take full advantage of market opportunities. Fearing detection, they tend to keep a low profile, resort to temporary closure of business, or make unofficial payments. For the same reason, they do not enjoy the full protection of the law. Extralegal practices enable entrepreneurs to survive, but they are poor substitutes for operating formally.

Potential Benefits from Formalization

What gains could Egypt expect if the government adopted a comprehensive reform 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; consolidating all relevant laws into a single law; and having all interaction between entrepreneurs and the government handled by a single agency? The reforms would reduce the cost of establishing and operating businesses by an estimated 90 percent, the cost of mortgages by 91 percent, and the cost of enforcing pledges by 77 percent.

Who would win and who would lose from formalization under this kind of reform? For a typical firm in the informal sector and for society as a whole, the potential net benefits are large (table 2). Under a reformed environment, formalization would increase the private value of the firm from LE356,423 to LE450,667, a net increase of 23 percent over 10 years. This is equivalent to an additional after-tax income of LE9,400 a year—about one and a half times per capita income in 2002. If entrepreneurs recognized the gains they would enjoy, formalization would take hold.

For society as a whole, the net present value of the gains from formalizing a single firm is LE66,000. These gains accrue in part to workers who would make LE46,100 more in wages and social security than they did before formalization. The government would earn additional revenues of LE93,000 from value-added and income taxes.[9] Consumers would enjoy improved product quality, but products would cost more because of value-added tax.[10]

Aggregating across all firms in the informal sector shows that formalization would increase GDP by LE8.6 billion, or 1.3 percent, a year. Entrepreneurs would gain 1 percent of GDP, workers would gain 0.7 percent, and the government would gain 1.3 percent, while consumers would be worse off by 1.7 percent of GDP. The cost of formalization to taxpayers is estimated at no more than 0.04 percent of GDP.

How sensitive are these results to alternative assumptions (table 3)? Under more favorable assumptions about firm growth rates (6 percent a year), productivity increases (2 percent a year), and higher income tax rates (3 percent of sales), the net annual gains to society could be as high as 3.7 percent of GDP a year. Entrepreneurs, workers, and the government would be much better off, while the cost to consumers would be greater than before. Under less favorable assumptions regarding firm

Table 2. Welfare Impact of Formalization under a Reformed Environment
(in Egyptian pounds, unless specified otherwise)

Economic agents	Vs (informal) (1)	Vs (formal with reform) (2)	Firm-level change (Vs formal − Vs informal) (3) = (2) − (1)	Annual economy-level change (aggregate Vs formal − aggregate Vs informal) (4) = (3) * number of firms in the informal sector (LE billions)	Annual economy-level change (aggregate Vs formal − aggregate Vs informal)/GDP (5) = [(4)/GDP]* 100 (percent of GDP)
Entrepreneurs	356,423	450,667	94,244	6.4	1.0
Employees	207,897	254,014	46,117	4.9	0.7
Consumers	(127,980)	(295,341)	(167,361)	(11.4)	(1.7)
Government	27,195	120,156	92,960	9.0	1.3
Citizens (cost of formalization)				(0.3)	(0.04)
Total	463,535	529.496	65,961	8.6	1.3

Source: Calculated from data obtained from field survey.

TABLE 3. Sensitivity Analysis: Annual Change in Welfare Relative under Alternative Scenarios
(percent of GDP)

Item	Base scenario	Optimistic scenario	Pessimistic scenario
Economic agents			
Entrepreneurs	1.0	2.2	0.6
Employees	0.7	1.1	0.7
Consumers	(1.7)	(2.1)	(1.7)
Government	1.3	2.5	0.8
Taxpayers	(0.04)	(0.04)	(0.04)
Total	1.3	3.7	0.4
Assumptions			
Productivity	1.0	2.0	0.5
Output growth rate	3% for first five years, 5% thereafter	6.0	3.0
Taxation (percent of sales)	1.0	3.0	0.0

Source: Author's estimates.

expansion (3 percent a year), productivity (0.5 percent a year), and income tax rates (zero percent), formalization still leaves the economy better off by close to 0.5 percent of GDP a year. The pattern of distribution of the gains and losses is not different from the other scenarios.

The simulation results indicate that formalization is likely to be beneficial to society even under more conservative assumptions than those assumed in the base case scenario. Perhaps equally important, because the exercise is carried out ex ante, the results could be altered by policymakers. One key instrument for changing the distribution of the gains is the taxation regime for formalized firms.

Concluding Remarks

The case for leaving the informal sector alone is justified only if the government takes no action to reduce the cost of entry, operation, and exit for firms in the informal sector and no steps are taken to expand opportunities for all entrepreneurs in Egypt. Holding this view and acting accordingly deprives the economy of the huge potential benefits from formalization.

The simulation results suggest that there are solid reasons for moving ahead with formalization reforms in Egypt. A coherent set of reforms would benefit entrepreneurs, workers, and government. While consumers are likely to pay higher prices, they would be ensured that the goods they consume are checked for quality. Economic growth would increase, and poverty would decline. Very few reform efforts would do as much to enhance development in Egypt as formalization.

The case for formalization may be even stronger than the simulations suggest. No attempt was made to account for the positive externalities resulting from an improved business environment for medium-size and large firms, the possible benefits of a more developed financial system, or the benefits from greater respect of law enforcement. In addition, the model does not take into account possible general equilibrium effects on prices, employment, and investment. Such indirect benefits are difficult to measure but cannot be ignored.

Partial reforms are not likely to be effective. All too often measures to promote small and medium-size enterprises or investment tend to focus on relaxing one constraint or another, with disappointing results. What is needed in the case of formalization—and in other areas of reform as well—is a coherent set of reforms that persuade economic agents to change their behavior in the direction of socially desirable outcomes. The package of reforms proposed has worked in other developing countries. There is no reason why Egypt could not take the lead on formalization in the Middle East.

Notes

1. De Soto (2000) makes the most persuasive case in favor of formalization.
2. For details regarding the proposed reform package, see ILD/ECES (2004).

3. For the sake of simplicity, no attempt is made here to attach different weights to different components of welfare. But that need not be the case. Different welfare components could carry different weights for the purpose of income redistribution. One dollar of profit may be worth more than $1 of consumption, and $1 in the hands of government may be worth more to society if, for example, it is used to reduce taxes, which would reduce the distortionary effects of taxation and deadweight loss.
4. Examples of possible general equilibrium effects include lower inflation, as a result of the increased supply of goods; higher wages, due to an increase in the demand for labor; and higher interest rates, due to increased demand for loans. Taking these effects into account requires a general equilibrium framework and more data than are available at the micro level.
5. Following Assaad (1996), take-home pay in the formal sector is assumed to be lower than take-home pay in the informal sector by about 9 percent.
6. Estimation of the welfare impact of formalization is not likely to be sensitive to how typical the "typical" firm is, because the same data were used to construct alternative values of the firm under different assumptions.
7. For an estimate of the informal sector in Egypt and its characteristics, see El Mahdi (2000) and Kamel (2003).
8. Given the limited size of the sample, these estimates cannot be used for "prediction" of the cost in all cases, but they are very useful for "prescription." In other words, the merit of the case study approach adopted here is that it helps identify all obstacles, thus making it possible to devise ways of dealing with them. The problem is that these results cannot be generalized to all cases, which is possible through econometric techniques.
9. Income taxes are calculated as 1 percent of total firm sales to reduce the cost of bookkeeping and make tax treatment simpler and less arbitrary.
10. It is difficult to model quality improvement in measuring consumer satisfaction, which is traditionally measured by the area under the demand curve.

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How Does Judicial Independence Affect the Investment Climate?

LARS FELD AND STEFAN VOIGT

A favorable investment climate requires secure private property rights, which in turn depend on a strong state. Yet the strength of the state can be its greatest weakness: if it is strong enough to secure private property rights, it may also be strong enough to attenuate them or expropriate investments. This can be called the dilemma of the strong state. A simple promise to honor private property rights in the future is not credible, because potential investors know that after they have invested, the state has an incentive not to keep its promises and to hold them up.

In such a setting an independent judiciary can make all actors better off: if it is able to make the representatives of the state stick to their promises, the economy can attract additional physical and human capital investment, which can lead to higher income and growth and higher tax receipts. It would thus seem that rational politicians would have introduced judicial independence long ago. But simply promising an independent judiciary may not be sufficient to induce additional investment: as long as potential investors do not believe that the judiciary will really be impartial, they may not change their investment behavior. Two kinds of judicial independence thus need to be distinguished, de jure and de facto judicial independence. De jure judicial independence is reflected in the law; de facto judicial independence captures the independence actually enjoyed by judges and justices (long term lengths, the degree to which judicial judgments affect government behavior, and so forth).

Judicial independence implies that judges can expect their decisions to be implemented regardless of whether they are in the (short-term) interest of other government branches upon which implementation depends. It also implies that judges do not have to expect negative consequences—being expelled, having their pay cut, losing influence—as the result of their decisions.

Lars Feld is professor of public finance at the University of Marburg, in Germany, and fellow at the Center for Research on Economics, Management and the Arts (CREMA) in Basel, Switzerland. Stefan Voigt is professor of economic policy at the University of Kassel, in Germany, and fellow at the International Centre for Economic Research (ICER), Turin, Italy.

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Three situations in which the independent judiciary plays a crucial role can be distinguished:

- *Conflicts between private parties*. Impartial dispute resolution can be important in cases in which one of the parties to a voluntary contract believes that the other has not lived up to the terms of the contract. As long as both sides expect the judiciary to be impartial and thus not subject to pressure from either of the contract partners or any other party, they can save on transactions costs while negotiating their contract. Lower transactions costs will translate into a more favorable investment climate.
- *Conflicts between citizens and the government*. In cases of conflict between citizens and the government, citizens need an organization that can adjudicate which party acted according to the law. The judiciary performs this task, both by determining whether newly passed legislation is within the confines of the constitution and by checking whether the representatives of the state have followed the procedural devices that safeguard the rule of law. The judiciary helps ensure that the government is under the rule of law.
- *Conflicts between government branches*. In the absence of an impartial arbiter, conflicts between government branches are most likely to develop into simple power games. An independent judiciary can keep them within the rules laid out in the constitution.

Reducing uncertainty is one of the most important functions of government. It does so, however, only if citizens can expect government representatives to respect the letter of the law. An independent judiciary can be thought of as a device for turning promises into credible commitments—to respect property rights and abstain from expropriation, for example. If it succeeds in doing so, citizens will develop a longer time horizon, which will lead to more investment in physical capital and to a higher degree of specialization (a different structure of human capital). Judicial independence is thus expected to be conducive to the investment climate and to economic growth.

This paper summarizes some of the results of two papers on the topic. Feld and Voigt (2003) introduce two indicators of judicial independence, a de jure indicator that focuses on the legal foundations of judicial independence and a de facto indicator that focuses on the factually ascertainable degree of judicial independence. Using a sample of 66 countries, they estimate an econometric model that explains real per capita GDP growth between 1980 and 1998 by judicial independence and standard controls. They show that de jure judicial independence has no impact on economic growth but that de facto judicial independence increases growth.

In a second paper, Feld and Voigt (forthcoming) replicate the results of the earlier work for a larger number of countries. They also estimate the economic effects of institutional arrangements that are not part of the judiciary and their interaction with judicial independence. The components of de jure judicial independence—the specification of the procedures, the accessibility and term length of the highest-ranking

judges—have a modestly significant positive impact on economic growth, while wide accessibility of the highest court and the highest court's power of constitutional review slow economic growth. With respect to de facto judicial independence, factors positively associated with growth are the absence of deviations from a "normal" average term length, few changes in the number of judges since 1960, and competitive incomes for judges. In terms of the effect on growth, no significant differences were found between courts organized as constitutional courts and supreme courts whose jurisdiction is not confined to constitutional issues. The positive impact of de facto judicial independence on economic growth is stronger in presidential than in parliamentary systems, and it is stronger in systems with a high level of checks and balances. De facto judicial independence appears to be effective independent of the age of a constitution. In fact, if a state is able to implement de facto judicial independence, the effect on growth is weaker in countries with older constitutions.

Data Description, Estimation Approach, and Results

To better understand the importance of judicial independence, Feld and Voigt (2003) introduce two new indicators, which measure the de jure and de facto independence of the highest court. In many countries the judiciary is made up of thousands of decisionmakers; radical simplification is necessary. The focus on the highest court seems warranted because even though judges are personally independent, the ultimate control of court decisions lies with the highest courts as they review—at the request of the parties involved—lower court decisions. The independence of the highest court thus seems crucial.

These indicators are objective indicators. A subjective indicator of judicial independence identifies survey respondents' perceptions of judicial independence. People's perceptions are surely an important element determining their own behavior. But as perceptions of what an ideal judiciary should look like differ greatly across countries, survey data are not easily comparable. The two new indicators are based on objective information.

The indicator measuring de jure judicial independence contains 16 variables, the indicator measuring de facto judicial independence 10. The de jure indicator includes variables such as the means of nominating or appointing highest judges, their term lengths, the possibility of reappointment, the procedure for removing judges from office, their pay and possible measures against reduction in their income, the accessibility of the court, the presence of a general rule allocating cases to particular judges, and publication requirements concerning the decisions of the court. The de facto indicator includes variables such as the effective average term length, the number of times judges have been removed from office since 1960, whether their income has remained at least constant in real terms since 1960, whether the size of the budget of the court has remained at least constant in real terms since 1960, the number of cases in which the relevant articles of the constitution were changed, and the number of times other government branches remained inactive when their action was

necessary in order to implement a court ruling. All variables can take on values between 0 and 1. The sum of the variables is then divided by the number of variables for which information is available. Data are available for about 80 countries.

The estimation approach is straightforward and follows the method used in modern empirical growth studies such as Haan and Sturm (2000). The following equation is estimated:

$$\Delta Y_i = \alpha M_i + \beta JI_i + \gamma Z_i + \varepsilon_i \tag{1}$$

where ΔY_i is average real per capita GDP growth in country i between 1980 and 1998; M_i is a vector of standard explanatory variables of country i; JI_i are the de jure and de facto indicators of judicial independence in country i; Z_i is a vector of additional explanatory variables in country i, introduced to check the robustness of the baseline model and consider the interaction with the constitutional, legal, and political environment of a country; and ε_i is an error term.

Average real per capita GDP growth data are obtained from the Penn World Tables Version 6.0 (Heston, Summers, and Aten 2001). The data pose particular problems with respect to Eastern European countries. Since the data for these countries in the 1990s are not comparable to data in the 1990s (or do not exist for the 1990s, when some countries did not exist), real per capita GDP growth had to be averaged for these countries depending on the first date for which GDP data were available instead of averaging it for 1980–98.[1] To ensure that the Eastern European countries do not drive the results, a dummy variable was introduced that takes on the value of 1 for transition economies and 0 otherwise. The vector M_i consists of three variables that are robustly linked to economic growth according to previous studies (Haan and Sturm 2000): the level of initial real GDP per capita; investment (as a percentage of GDP, averaged over the period 1980–98); and the percentage of the population 15 and older with a secondary school education. Data on the third variable are from the Barro and Lee data set (1996); the other data are from the Penn World Tables Version 6.0.

Other economic variables making up the vector Z_i are average government consumption, as a percentage of GDP 1980–98; openness, measured by the sum of exports and imports as a percentage of GDP; average population growth between 1980 and 1998; and the average inflation rate between 1980 and 1998, all from the Penn World Tables Version 6.0 data set. These variables were included because empirical growth studies suggest they may matter. Continent dummies are included to check for robustness of the estimation results. In addition to these standard additional variables, the data by La Porta and others (1999) on the legal origin of countries are used to test robustness of the growth impact of judicial independence to the legal and political environment. Finally, several additional constitutional, legal, and political variables are included, such as the age of the constitution; whether the court system contains a specific court that deals only with constitutional issues; the extent of checks and balances in the constitution; whether the country has a presidential or parliamentary system (based on the Database on Political Institutions [DPI], provided by Beck and others [2000]; a dummy variable on federalism [reported by Treisman 2000]; and an indicator of a free press [provided by Freedom House]).

First, the two judicial independence indicators are estimated. Second, the additional economic variables and continent dummies are included in the regression in order to check the robustness of the results. Third, the judicial independence indices are differentiated into their components (results are reported in Feld and Voigt forthcoming). Fourth, the additional constitutional, legal, and political variables are included in the regression and interacted with de facto judicial independence in order to investigate the differential effects. Several other variations of these regressions, not reported here, were also performed in order to check robustness. The cross-sectional analysis is performed using the ordinary least squares technique, while inference is based on *t*-statistics computed on the basis of White heteroscedasticity consistent standard errors.

Baseline Results

The three basic economic variables explain average real economic growth per capita well (column 1, table 1). This simple growth model explains about 50 percent of the variance of the real per capita growth rate.

The explanatory power is not improved if the de jure judicial independence indicator is introduced in the model (column 2). Introducing de facto judicial independence instead of de jure judicial independence (column 3) significantly changes the estimation results, however, increasing the explanatory power of the empirical model, measured by the adjusted R^2 from 51 to 64 percent.[2] Moreover, and as expected, de facto judicial independence has a positive impact on real economic growth per capita and is significantly different from 0 at the 1 percent significance level. The impact of de facto judicial independence is robust to the inclusion of continental dummies (column 5) and additional economic variables (column 6). In all specifications reported in table 1, the hypothesis of normal distribution of the residuals cannot be rejected at any conventional significance level (this is true for nearly all of the estimations). This result is important to keep in mind, since it indicates the absence of outliers.

Interaction of Judicial Independence with the Organizational, Constitutional, Legal, and Political Environment

Judicial independence may work differently in different environments. The organizational environment of the highest courts is described by three variables. The first is the legal origin of a country. La Porta and others (1999) distinguish between English, French, Scandinavian, German, and socialist legal origins.[3] The inclusion of the legal origin variables does not affect the estimation results of the two judicial independence variables. As before, de facto judicial independence is significant at the 1 percent level and has a positive impact on economic growth, while de jure judicial independence is not significant at any level. Of the legal origin variables, only the socialist origin variable has a significant positive impact, although the hypothesis that

TABLE 1. Baseline Specifications for OLS Regressions of per Capita GDP Growth on Judicial Independence and Controls, 1980–98

Variable	(1)	(2)	(3)	(4)	(5)	(6)
De jure judicial independence	—	0.635	—	−0.463	0.081	0.280
		(0.42)		(0.29)	(0.05)	(0.18)
De facto judicial independence	—	—	1.885**	1.914**	1.511*	1.673*
			(3.20)	(3.08)	(2.34)	(2.49)
Real per capita GDP in 1980 (thousands of dollars)	−0.177**	−0.180**	−0.200**	−0.200**	−0.205**	−0.264**
	(4.04)	(4.06)	(4.19)	(4.15)	(3.42)	(4.40)
Secondary school attainment in 1980 (percent)	0.047*	0.048*	0.037(*)	0.036(*)	0.032	0.037(*)
	(2.47)	(2.48)	(1.95)	(1.84)	(1.58)	(1.74)
Average Real Gross Domestic Investment (as percentage of GDP), 1980–98	0.170**	0.169**	0.178**	0.180**	0.159**	0.144**
	(5.63)	(5.61)	(6.81)	(7.04)	(5.43)	(3.63)
Dummy for transition economies	−1.805*	−1.798*	−1.085	−1.065	−1.549(*)	−2.202*
	(2.19)	(2.19)	(1.23)	(1.20)	(1.70)	(2.14)
Dummy for Africa	n.a	n.a	n.a	n.a	−0.890	n.a
					(1.30)	
Dummy for Asia	n.a	n.a	n.a	n.a	−0.060	n.a
					(0.10)	
Dummy for South America	n.a	n.a	n.a	n.a	−1.196*	n.a
					(2.38)	
Average population growth, 1980–98 (percent)	n.a	n.a	n.a	n.a	n.a	−0.821**
						(2.82)
Openness (percent of GDP)	n.a.	n.a.	n.a.	n.a.	n.a.	0.006
						(1.03)
Government consumption (percent of GDP)	n.a.	n.a.	n.a.	n.a.	n.a.	−0.011
						(0.45)
Inflation (percent)	n.a.	n.a.	n.a.	n.a.	n.a.	−0.020
						(1.10)
Constant	−1.352	−1.646	−2.136	−1.920	−1.004	−0.038
$\bar{R}^2$	0.508	0.503	0.641	0.636	0.476	0.657
Standard error of regression	1.800	1.808	1.571	1.582	1.565	1.537
Jarque-Bera-test of normality of the residuals	4.206	4.975	2.327	1.719	5.226	5.191
Number of observations	87	87	73	73	73	73

*Significant at the 10 percent level.

**Significant at the 5 percent level.

***Significant at the 1 percent level.

n.a. Not applicable.

Note: Numbers in parentheses are the absolute values of the estimated *t*-statistics, based on the White heteroscedasticity-consistent standard errors.

the legal origin variables have no impact on economic growth is rejected at the 1 percent significance level ($F = 17.811$).[4]

Second is the organizational environment, captured by the age of the constitution.[5] It could be argued that de facto judicial independence is higher in countries that have not had many changes in their constitutions in the past 40 years. This argument stems from the construction of the de facto index, which includes such components as changes in the number of judges since 1960 and the real income of and budget for judges since 1960. If the argument holds, countries with new constitutions would have a clear disadvantage by construction. Everything else equal, the older the constitution, the higher is economic growth. The impact of the age of the constitution is significant at the 5 percent significance level. The baseline model is not affected by the inclusion of judicial independence, however. In particular, the significant positive impact of de facto judicial independence remains robust. Interacting de facto judicial independence with the age of the constitution reveals an interesting result. While the basic impacts of de facto judicial independence and the age of the constitution remain robust and retain their significant positive impacts on economic growth, the interaction term is significantly negative. Given a high degree of de facto judicial independence, countries with old constitutions experience significantly lower real per capita GDP growth than countries with new constitutions; countries with new constitutions can be inferred to experience higher growth rates given a high degree of de facto judicial independence. The partial correlation coefficient between the age of the constitution and de facto judicial independence is -0.31, however, implying that the probability that a country with a young constitution manages to have a high degree of de facto judicial independence is low.

Third, and most important, the consequences of judicial independence may depend on the underlying court model. Constitutional review can be allocated to every court in a country, as in the United States; to a specialized constitutional court that deals with constitutional matters, as in Austria or Germany; or to a special body constrained to ex ante review, as in France. The constitutional court model may have an advantage over the other two because it provides the power for ex ante and ex post as well as abstract and concrete review. A dummy variable of 1 for a constitutional court according to the Austrian model and 0 otherwise was included in the estimated equation to capture this notion. Neither the constitutional court variable nor its interaction term with de facto judicial independence has any significant impact on economic growth, while the impact of de facto judicial independence remains robust and keeps the significant positive impact.[6]

In addition to the organizational environment, other constitutional provisions shape the impact of judicial independence on economic growth. The extent of checks and balances is included in the model by drawing on an ordinally scaled variable provided by Beck and others (2000). The higher the extent of checks and balances in a constitution, the higher are the values of that variable. The more checks and balances a constitution contains, the higher is economic growth. This variable is significant at the 5 percent significance level, but it leaves the significant positive impact of de facto judicial independence unaffected. The interaction of de facto judicial independence with the checks and balances variable does not yield clear-cut results.

Closely connected to the checks and balances discussion is the analysis of presidential versus parliamentary systems. In order to control for the differences in these systems, the model uses a variable by Beck and others (2000) that adopts values of 0 for direct elections of the president, 1 for a strong president elected by an assembly, and 2 for elections of the head of state by the parliament. The results indicate that parliamentary systems had significantly higher growth rates than presidential systems between 1980 and 1998. These results corroborate the findings by Persson and Tabellini (2003), who find that presidential systems have a lower labor productivity. While the significantly positive impact of de facto judicial independence remains robust in both equations, most interesting is the fact that the interaction term of de facto judicial independence and the parliamentary system variable has a significant negative impact, indicating that the growth-enhancing effect of de facto judicial independence exists in particular in presidential systems.[7]

Possible Policy Implications

Several policy implications can be drawn from these results. With regard to de jure judicial independence, the procedures and the powers of the court should be fixed in the constitution. With regard to de facto judicial independence, actual term lengths should not deviate from the lengths indicated by the law, and judges' salaries must not decline.

A few words of caution are in order. First, the model did not test for the effect of judicial independence on investment levels but on per capita GDP growth. Second, it is de facto judicial independence that is highly relevant for economic growth. Sadly, it is very difficult to substantially improve de facto judicial independence in the short run.

Notes

1. Average real per capita GDP growth is based on the following periods: Armenia and Estonia 1992–98, Azerbaijan and Kazakhstan 1994–98, Bulgaria and the Russian Federation 1991–98, Croatia 1995–98, the Czech Republic and Slovenia 1990–98, Georgia 1991–98, Lithuania 1993–98, the Slovak Republic 1987–98, and Ukraine 1989–98. The structural shift between growth data in the Federal Republic of Germany before and after unification is coped with by computing the average growth rate of GDP for 1980–90 for the Federal Republic of Germany, computing the average growth rate for unified Germany for 1990–98, and taking the mean of the two rates.
2. Information on de facto judicial independence is available for only 73 countries.
3. The dummy variables for socialist legal origin and transition economies are not identical, because the transition economies include only the former Soviet republics and the Eastern European countries, not Cambodia, China, Vietnam, and some former socialist countries in Sub-Saharan Africa.
4. That socialist legal origin has a significant positive impact should not be the source of worry, because Eastern European transition economies are controlled for by the dummy

for Eastern European countries, so that the socialist legal origin dummy controls mainly for Cambodia, China, Vietnam, and former socialist countries in Sub-Saharan Africa.

5. Including the age of the constitution reduces the number of observations by two, because it is difficult to assess the age of a constitution in countries, such as the United Kingdom, that do not possess a formal constitutional document.
6. The same equation was estimated by recoding the constitutional court variable so that the French model was not taken together with the American model. The results remain virtually the same. A more differentiated analysis must be left to future research.
7. Caution in the interpretation of this result is warranted. As earlier research has shown (Hayo and Voigt 2003), parliamentary systems are significantly more likely than presidential systems to realize high degrees of de facto judicial independence. It is possible that the few presidential systems that were able to realize high degrees of de facto judicial independence have been growing at faster rates than the large number of presidential systems that were not able to realize high levels of de facto judicial independence.

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Part IV: Financial Markets

How Important Are Financial Markets in Spurring Growth and Investment?

STIJN CLAESSENS

The quality of the overall business environment is an important determinant of a country's real economic growth. This article starts with the links between the financial sector and the business environment and reviews the evidence on how the financial sector facilitates economic growth. It analyzes the determinants of financial sector development, stressing the similarities between those factors that determine a country's business environment and those that drive financial sector development. It then reviews the issues on which there is less clarity, such as the tradeoffs between ensuring financial sector stability, financial sector efficiency, and broad access to finance. It ends by highlighting the many unknowns about how economic and political economy factors drive financial sector reform.

How Does Finance Affect Growth?

The financial and real sectors of the economy are linked in several important ways. The financial sector facilitates real sector growth by facilitating payments, sharing risk, pooling savings, allocating resources, and monitoring firms' activities. The financial sector also depends on the real sector: without a solvent, efficient, and vibrant real sector, a strong financial sector cannot exist. The financial sector is thus both an input to and an output of a country's real sector.

Many empirical studies have shown that finance contributes to growth—at the country, sector, and firm levels (for a review, see Levine forthcoming). Finance has been shown to be especially important for the growth of small firms and the emergence of new ones (see, for example, Beck, Demirgüç-Kunt, and Maksimovic forthcoming). Finance is thus critical to real sector growth.

Stijn Claessens was professor of international finance at the University of Amsterdam at the time of the conference. He is currently senior adviser, Financial Sector, Operations and Policy at the World Bank.

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Despite these studies, some doubts remain about the causal relation between finance and growth, partly because the measures of financial depth often used to establish the connection do not provide evidence of the channels through which finance works (see Zingales 2003 for a critique). Furthermore, finance can also be a source of distortions, risks, and misallocation of resources—as the recent corporate governance scandals revealed—thereby hindering growth. Finance can create volatility, even in well-developed financial markets, as it did when real sector shocks were exacerbated by weak banking systems during the "credit crunch" of the 1990s in the United States and other industrial countries or by the episodic exuberance and pessimism of financial markets in the early 2000s. In the extreme, distortions caused by the financial sector can lead to crises, as happened in the 1990s in East Asia and in many developing countries in Latin America and elsewhere.

Tailoring Financial Sector Reform

The depth of a financial system depends on macroeconomic and institutional fundamentals. Many of these aspects—not just legal origin, property and creditor rights, and the judicial system but also financial sector regulation and supervision—have been documented over the past decade, and their relationships with financial sector development and functioning have been shown empirically (see, for example, La Porta and others 1998; Barth, Caprio, and Levine 2003; Beck and Levine forthcoming).

Many questions nevertheless remain about financial development. How do the (newly) developed global standards fit in with the preferred model for financial sector development? Is the model being pursued for financial development the right one for all countries? Should different priorities be pursued at different phases of financial development? What do global and technological changes imply for the financial sector development strategies of developing countries?

Policymakers are pushing countries to adopt uniform, global standards, such as the 25 Core Principles for Effective Banking Supervision developed by the Basle Committee on Banking Supervision and the International Organization of Securities Commission (IOSCO) standards for securities markets. Such standards can be useful, but care must be taken that imposing them does not force countries to adopt policies that are ill suited to their initial conditions or particular circumstances. Barth, Caprio, and Levine (2003) show that low-paid supervisors in developing countries are unlikely to be able to resist the temptation of corruption, for example; reforms that depend too much on such supervisors or give them too much power may therefore not be realistic.

Other questions have to do with the type of financial system to develop. Is more concentration, which helps pool funds to finance large investments, desirable in countries with less developed financial sectors? In environments in which information is not transparent, close relationships between banks and borrowers that are less subject to competitive forces may help firms access financing. How should this access be weighed against the negative effect that reduced competition could have on

performance and on the political economy of reform? What is the best balance between competition, access to financing, and efficiency of a financial system?

Is there a life cycle in the dynamics of industrial structure that makes certain financial market structures more attractive at certain points? How does the balance between banks and markets change as countries develop? At what level of development is there scope and need to develop nonbank financial markets, such as bond and securities markets? Given the increased role of capital markets and nonbank financial institutions in financial systems around the world, do banks still play such a special role that they need the protection of a public safety net? Should prudential regulation be revisited?

These questions are particularly relevant today because of rapid changes in technology, globalization trends, and other changes in real economies and the global system that should affect the strategy for developing local financial sectors. Countries may be able to leapfrog by importing new financial sector approaches and techniques. Solutions that were not technically possible a decade ago may now be feasible. Examples include the use of the Internet to facilitate trade finance and remotely access the services of global stock exchanges, diminishing the need for local markets.

What Do We Know about the Political Economy of Financial Sector Reform?

Little is known about how countries can be encouraged to give financial sector development greater priority in their reforms. Much of the evidence on what drives financial sector development and the links between finance and growth is of a cross-country rather than a time-series nature. The fact that more new firms emerge in countries with better-developed financial sectors, for example, may reflect conditions other than access to finance. Better laws and regulations may reflect a higher level of social capital, which leads to better laws, more financial development, and higher growth. As Luigi Zingales (2003, pp. 47–48) notes:

> [T]here is a set of countries that seem to be doing "the right thing" in many dimensions: Their legal enforcement is better, their level of generalized trust higher, their judicial system more efficient and independent; they have less corruption, less regulation, more respect for property rights, and better-developed financial markets. Each institution taken individually has a positive effect on economic growth. Yet there are too many (highly correlated) variables and too few countries to be able to reliably identify the effect that one institution has compared with another. To make the problem worse, all these variables are measured with errors. Thus, a multiple regression may fail to identify which of these variables really matter. Finally, these characteristics seem to be very persistent.

Financial reform involves questions of political economy, to which finance is intrinsically linked. After all, the financial system allocates property rights and can be an important means by which incumbents block entry.

If, for political economy or other reasons, financial sector reform is difficult, are there other, less direct ways to achieve the desired outcomes? What other changes can

most usefully spur financial reform? Rajan and Zingales (2003a) have highlighted the importance of openness to capital flows and competition in the development of capital markets in Europe and the United States in the early 1900s. Changes in the real economy that over time lead to changes in cash flow and control rights can also affect the political economy, thereby affecting the desire to reform the financial sector. Rajan and Zingales (2003b) consequently stress the need for the middle class to push for reform, including financial sector reform. Wealth and income policies—such as privatization, which spreads ownership—can over time help create a constituency for financial sector reform.

The Need for Additional Research

Several questions require additional research:

What is the best way to view the structure of financial systems? The issue of financial structure has often been addressed in terms of a bank-based versus market-based structure. But it can also be viewed in terms of a vertical versus horizontal structure. In many countries, groups of financial institutions operate horizontally to allocate resources within the group. Elsewhere banks (as in Germany) or insurance companies (as in Japan) are at the apex of the ownership and control structure and operate vertically. The horizontal and vertical models have different implications for the role of the government and the reforms that need to be—and can be—pursued.

How do political economy issues affect financial sector reform? When do countries reform? When did the political economy in the United States allow changes such as the removal of intrastate banking restrictions or the repeal of the Glass-Steagall Act? Was it interindustry competition, technological progress, global competition between financial systems, or real sector changes that spurred politicians to remove barriers? Were changes in the political system responsible for reforms in the financial sector?

How have financial crises affected financial sector reform? Case studies could shed light on how financial crises have spurred countries to reform their financial systems. What measures were enacted? Which ones made a difference? If effective reforms follow crises, can these crises perhaps be viewed as blessings in disguise?

How are reforms and ownership structures tied? Is there a channel from ownership to reform? Does, for example, the degree of corporate sector ownership directly held by the public affect the public's incentives to push for reforms? If so, what does this imply for real sector reforms? What are the benefits of particular privatization strategies? In a country in which state ownership is widespread, are ownership reforms useful? What have been the effects of large-scale privatization and the wider distribution of equity ownership on financial sector reform in Eastern Europe? Did reforms go deep enough, or did insiders and incumbents hijack reforms?

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Part V: Regulations, Governance, and Corruption

Transparency International: The Fight against Corruption

PETER EIGEN

Breaking the Cycle of Corruption

Governments and businesses that engage in corruption are not only a part of the problem, but also the victims of a vicious circle. To break that circle, civil society organizations need to engage with one another—and with governments and the private sector—so that their voice is heard and taken seriously by policymakers at all levels. That is the key to the approach at Transparency International (TI).

This cooperative approach is essential in tackling an issue as complex as corruption in a global marketplace in which corruption has become almost the norm. Businesses find themselves in a prisoner's dilemma—those who refuse to bribe are at a competitive disadvantage because the bribes paid by their competitors secure lucrative contracts; to survive companies have to bribe. The coalition-building approach enables the government, the private sector, and civil society organizations to find areas of common interest. It allows them to establish responsible standards of behavior that no single government or company would unilaterally adopt.

Making the OECD Convention Work

The 1999 OECD Anti-Bribery Convention—whose 35 signatories account for more than 90 percent of foreign direct investment worldwide—is a striking example of the importance of this approach. The key to securing support for the convention was the support of large companies: 20 European companies signed a letter, drafted by TI, to their ministers encouraging them to sign the convention.

TI managed to bring business on its side by offering an escape route from the prisoner's dilemma. Under the OECD Convention all major competitors in the world

Peter Eigen is chairman of Transparency International, Berlin, Germany.

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market are legally bound simultaneously to stop bribing. French or German companies can now be charged under their home countries' laws for bribing African, Asian, or Latin American officials. Critical to success is the fact that each country feels confident that the other signatories will introduce appropriate legislation to implement and effectively enforce the convention.

A follow-up process is underway at the OECD to translate the Convention into law and practice. Civil society organizations, led by TI, are providing input to and monitoring the follow-up. In November 2002 TI chapters campaigned to ensure that governments made up the shortfall in the budget for monitoring enforcement of the Convention through a peer review process. The effort has met with success, but TI will have to continue to apply pressure to ensure that the monitoring process is adequately resourced.

The Bribe Payers Survey, a TI poll of 835 senior managers in 15 emerging market economies, was conducted between December 2001 and March 2002. It revealed that only one in five respondents knew something about the Convention. The results are damning evidence that OECD governments have failed to make businesses understand the new legislation.

Cracking Down on Corruption by Companies in Industrial Countries

The issue of bribing abroad hit the headlines in October 2002 when a Canadian engineering consultancy was convicted by the High Court of Lesotho. (The firm's appeal was rejected in 2003.) This case was just one of many: 14 Western companies face charges of bribing government officials to win contracts in the Lesotho Highlands Water Project, an $8 billion scheme to build dams to supply water to South Africa.

The significance of the case lies in the fact that for the first time a court in a developing country convicted an international company of paying bribes rather than just prosecuting a local official for taking bribes. If the industrial world does not start applying the OECD Convention to its own companies in its own courts, it will be hard to ask developing countries to demonstrate good governance and fight corruption.

The mood of both governments and the private sector is changing rapidly. Since the Enron, Global Crossing, and WorldCom scandals jolted shareholders and pension fund managers into reality, the public no longer has confidence that a corporation's books provide a fair and accurate statement of its finances. The implications for the efficient operation of capital markets are far-reaching.

Increasing Corporate Disclosure

Campaigns for greater corporate disclosure are beginning to make headway. On November 5, 2002, the world's main diamond producing and trading countries endorsed the United Nations–backed Kimberley process certification scheme, which traces rough diamonds from their point of origin. The new rules, put in place in

January 2003, make it illegal to import diamonds without a certificate of origin. The measures are designed to stop trade in diamonds from conflict zones, in particular Angola, the Democratic Republic of Congo, Liberia, and Sierra Leone, where they have been used to enrich military elites and entrench their interest in prolonging civil war.

Angola's oil industry has been the focus of a major campaign by Global Witness, TI, and more than 30 other NGOs. Almost 90 percent of the Angolan government's revenues come from the oil industry, but as much as 40 percent of GDP in some years has failed to reach the Treasury, instead being channelled into secret funds.

TI and Global Witness are urging financial regulators, such as the Securities and Exchange Commission in the United States, to require oil, gas, and mining companies to publish taxes, fees, royalties, and other payments made to host governments as a condition for being listed on international stock exchanges and financial markets. Relying on voluntary corporate disclosure has failed because companies fear discrimination by host countries if they breach confidentiality clauses. BP's decision to "publish what you pay" in Angola, for example, drew threats from the Angolan state oil company of terminating the concession.

With TI's input, the British government has pushed the case for disclosure forward with the Extractive Industries Transparency Initiative, which calls for a voluntary approach to disclosure in the oil industry. The move is a welcome start, but a mandatory approach is needed.

Working toward Adoption of a UN Convention against Corruption

Since 2001 TI has been working to pressure governments to agree on a UN Convention against Corruption. The drafting of the convention strengthens international cooperation on preventing and criminalizing corruption, particularly with the breakthroughs made on mutual legal assistance in the return of assets stolen by corrupt leaders.

Regrettably, the U.S. government blocked Article 10, on the financing of political parties, which would have made transparency of political party funding a legal requirement and enacted important conflict-of-interest laws. TI's Global Corruption Barometer—a survey of households in 47 countries—reveals that in three countries out of four, political parties are the institution from which citizens would most like to eliminate corruption; in the United States 4 out of 10 people single out political parties as the institution most in need of reform. People all over the world are sending a clear message to political leaders: rebuild the trust of ordinary people.

Establishing Business Principles for Countering Bribery

Companies must establish codes of conduct, including detailed rules designed to combat bribery at home and by subsidiaries abroad. Together with BP, Shell, Tata, General Electric, and other companies, TI has developed a set of business principles

for countering bribery. The proposals include training programs for all employees to help ensure that bribery—direct or indirect—does not take place.

The Unique Role of NGOs

TI has to focus on tasks that other players cannot credibly handle. Corruption is a clear example of an issue that governments and the private sector cannot tackle effectively alone. Governments lack the global reach; business is driven by the need to turn a profit. Civil society and its organizations and institutions thus have to become equal partners alongside governments and the private sector in order to form a "magic triangle." Civil society may be invited to fulfill this role, but it must also work itself into this position.

TI will continue to be a trailblazer. It will continue to strive to create a world free of corruption, and it will demonstrate how constructive and helpful civil society organizations can be in shaping better governance in a globalized economy. It will work to show that NGOs can help create an environment in which the poor and the weak have a fair chance to participate in a more prosperous world, one in which democracy is a vibrant tool for calling governments to account and where everyone has a full say, wherever he or she is born.

The OECD estimates that budgets for government purchases worldwide run up to $5 trillion a year. The scope for diverting large sums in bribes is frightening, as are the lost opportunities when public expenditure is diverted from basic needs, such as education, health care, and housing. Development is further undermined when import licenses can be obtained only by paying bribes and foreign investors have to negotiate entry regulations.

What Is a "Good Investment Climate"?

MUSHTAQ H. KHAN

To say that high levels of investment and efficient investment allocation require a good investment climate is a tautology. The policy question is to identify the precise conditions that make up a good investment climate. The current policy consensus is that a good investment climate is characterized by standard good governance requirements together with the adequate supply of certain types of infrastructure, such as electricity and telephone lines. Good governance in turn is measured by the stability of property rights and, according to some, the depth of democracy and public accountability. The theory is that stable property rights (measured by a number of factors, including a low risk of expropriation and a low level of corruption) induce high investment rates and ensure efficiency in investment allocation, while democracy signals that governments will not engage in ex post expropriation. These conditions, it is argued, are essential for ensuring rapid growth and sustained poverty reduction. These key policy goals, identified in the new consensus on investment climate, are best attained by policies that promote a service delivery state (Khan 2002). This is a state that protects property rights, is subject to the rule of law, does not intervene in markets, and provides key services, such as electricity and telephone lines.

The desirability of many of these institutional goals, particularly anticorruption and democracy, can hardly be questioned as ends in themselves. Nevertheless, several questions need to be addressed. First, does the evidence validate the claims that these are necessary, let alone sufficient, preconditions for growth? Second, has the theory behind the policy agenda been rigorous in identifying the critical preconditions of growth that need to be implemented in developing countries to accelerate their growth rates? And third—and most important—are there more important and vital institutional preconditions for high and sustained investment regimes in developing countries? If there are, we may be missing them by focusing on reforms that sound plausible and are clearly

Mushtaq H. Khan is senior lecturer in the Department of Economics at the School of Oriental and African Studies, University of London.

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desirable themselves but that may not be targeting the most critical obstacles to growth.

On the question of evidence, a substantial body of literature appears to show a correlation between standard good governance characteristics on the one hand and investment and growth performance in developing countries on the other (see Hall and Jones 1999; Kaufmann, Kraay, and Zoido-Lobatón 1999; Johnson, Kaufmann, and Zoido-Lobatón 1998; Clague and others 1997; World Bank 1997; Knack and Keefer 1995, 1997; Barro 1996; and Mauro 1995). But this evidence has to be treated carefully, for a variety of reasons (Khan 2002).

- *The indices measuring governance quality are subjective.* Respondents in well-performing countries are likely to give high rankings simply because things are working well. For instance, China scores higher than India on indices of the rule of law. But can we be sure that the higher ranking really reflects the better implementation of the rule of law in China? Or might the ranking simply reflect that the Chinese "legal system" works better to provide the things that investors want—and may be overriding the legal rights of other groups?

- *Available time series data are inadequate to test causality.* Most indices of governance quality begin in the mid-1980s; the more reliable data are available only for the 1990s. Longer time series are needed to determine if high-growth countries implemented good governance reforms or created good investment climates *before* their growth took off.

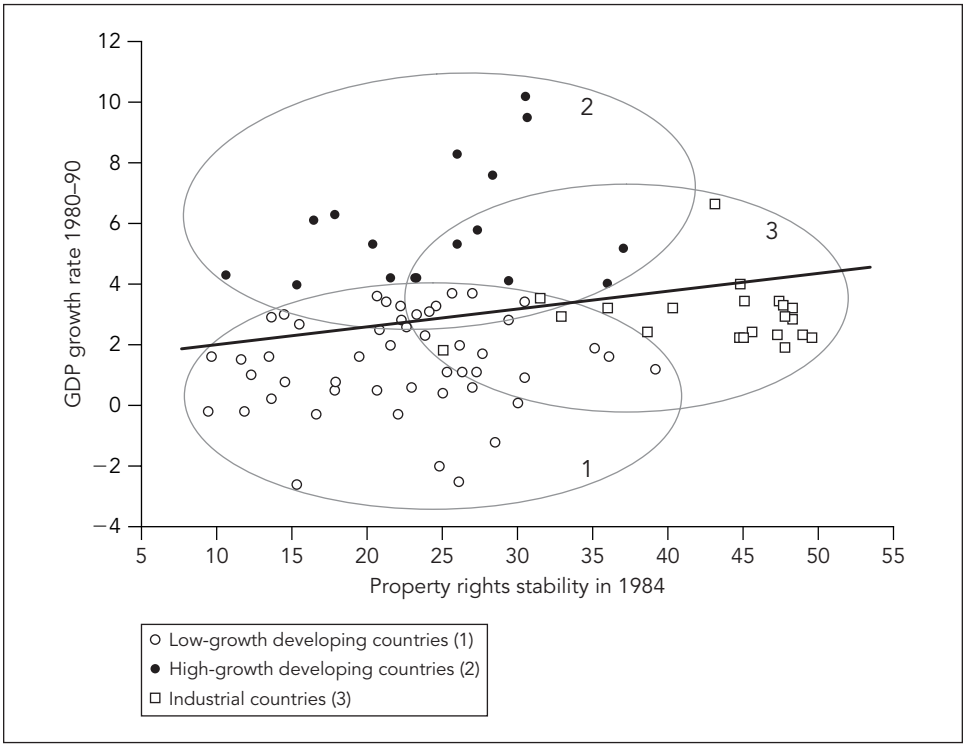
- *The number of high-growth countries is too small to generate satisfactory econometric results.* The high-growth developers are particularly important, because even though governance indices are not available for periods before their takeoffs, their governance indices remained poor for a considerable period even after growth took off. Even in the mid-1980s the Asian high-growth economies come out only a little better than many poorly performing countries in terms of the Knack and Keefer (1995) indices of institutional quality (based on quality of bureaucracy, rule of law, expropriation risk, and contract repudiation by government). Rodrik (1997) notes that while growth within East Asian countries was correlated with the index, only Japan, Singapore, and Taiwan (China) had high scores, and none was remotely poor by the mid-1980s. Indonesia scored the same as Ghana, Myanmar, and the Republic of Congo, while Malaysia, the Republic of Korea, and Thailand were at the same level as Côte d'Ivoire. Nor were most high-growth developers democratic when they began growing. Thus, while poorly performing developing countries did not have good governance characteristics, neither did many of the high-growth developing countries, well into their growth phases. If there were many of these high-growth countries in the regression exercises, the results may have changed; as it is, they simply drop out as outliers. But they should not be treated as outliers: they are the only cases of successful transitions in recent history.

- Most worrisome for the consensus, there are no historical examples of countries that first improved governance as defined in good governance theory and then began growing rapidly. Cross-sectional and even time series regression exercises

are misleading, because they do not allow sequential analysis of individual countries to be conducted to see which came first, better governance in the conventional sense or high growth driven by institutional changes that had little to do with good governance. No one would argue that Taiwan (China) in the 1950s, the Republic of Korea in the late 1950s and early 1960s, or China in the 1970s were introducing good governance, as it is defined today, and that their success in having done so explains their subsequent high rates of growth.

These issues are summarized in figure 1, which plots Knack and Keefer's Property Right Stability Index (incorporating corruption, rule of law, bureaucratic quality, government contract repudiation, and expropriation risk) for 1984, the earliest available year, against GDP growth rates for 1980–90. While the regression line has the expected positive slope (although the R^2 is only 0.03), the countries separate into three distinct groups. Most countries belong to either group 1 (low-growth developing countries, defined by a growth rate below the advanced country average) or group 3 (advanced industrial countries, defined by their per capita incomes). Group 1 has low growth (by definition) and poor governance characteristics, while group 3 has higher growth and the best governance characteristics. The most interesting group is group 2 (developing countries that are catching up by virtue of having higher growth rates than the advanced countries). Although the countries in this group are not

FIGURE 1. Relationship between GDP Growth and Property Rights Index



Source: Author's calculations.

numerous enough to affect the slope of the regression line, they are the only ones actually catching up. While their growth was significant, their property rights and other governance characteristics were not significantly different from the developing country average. This observation is particularly significant given that the data are already biased in some of the ways mentioned earlier (high-growth countries are likely to generate better subjective indices of governance). Moreover, because they have already grown for some time, their governance characteristics would be expected to be better as a result of growth.

This evidence raises a very important question for catching-up policies in developing countries: do group 1 countries try to reach group 3 by first emulating the governance characteristics of group 3 countries, or do they look at history and try to attain the governance characteristics of group 2 countries, the only countries actually catching up? The route to group 3 may be through group 2, in which case the relevant institutional and governance capacities for group 1 countries should be sought in group 2 rather than group 3 (Khan 2002). Whatever the critical institutional and governance characteristics that created a good investment climate in group 2 countries, they did not include stable property rights and other characteristics that good governance theory identifies.

These empirical observations raise serious questions about the adequacy of the theory underlying the current consensus on what constitutes a good investment climate. Underlying the good governance and investment climate approaches is a theory of capitalist development that has many weaknesses. These theories are based on observations of capitalist economies in industrial countries, but the theoretical mechanisms they assert may not be appropriate for identifying reform priorities in emerging capitalist economies going through developmental transitions. In particular, the focus on stable property rights and the creation of a well-functioning market needs to be questioned. While these are important characteristics of an advanced capitalist economy, creating a capitalist economy always requires substantial restructuring of property rights and incentives for emerging capitalists to rapidly acquire new technologies. During this transition, the condition of stable property rights is an odd one to aim for, particularly since the existing structure of rights and production systems is by definition of low productivity. The real question is whether the economic and social restructuring taking place is taking the country in the direction of a viable capitalist economy or not. The danger is that the good governance and investment climate approaches are bypassing the difficult questions about social transformation, instead focusing on reforms that may make an already existing capitalist market economy work better.

Recent historical experience suggests that developing countries that successfully transformed themselves into growth economies shared a number of important characteristics that were quite different from those identified in the investment climate and good governance approaches. These characteristics enabled their states to play a critical role in ensuring rapid structural changes (see Khan 2002). Two of the most important were the capacity to alter property rights and the capacity to manage growth-enhancing rents and destroy growth-reducing rents.

Far from guaranteeing not to intervene in property rights, dynamic transformation states actively engaged in property right transformations that transformed poorly performing precapitalist property rights into rights that were more appropriate for rapid productivity growth. These changes in the structure of rights were organized only partly through markets. Many important changes involved nonmarket transfers and interventions. These ranged from direct interventions in property rights (such as land reform) to indirect interventions that tilted the playing field to make it easier for some groups to acquire new rights (involving policies affecting relative prices, taxes, exchange rates, and land regulations) and even included state involvement in illegal transfers of rights (land grabs by individuals or groups connected to political power). It is not possible to generalize about the role of any of these processes in the capitalist transformation, since the type of intervention and its effect varied dramatically across countries, depending on initial technological and institutional conditions and internal political power structures. In most developing countries these processes led to plunder by unproductive classes, and growth and development suffered. In the few countries that did succeed, these processes led to the emergence of a dynamic capitalist class. All that can be said with some certainty is that capitalism did not emerge where states lacked the institutional and political capacity to carry out far-reaching changes in rights and or where states simply protected the sanctity of precapitalist property right structures.

Dynamic states also intervened in markets to create and manage rents to accelerate technology acquisition and to promote the competitiveness of emerging domestic capitalists. This, too, is very different from the good governance claim that competitive markets require that states should not intervene. There is a big difference between creating and maintaining international competitiveness and withdrawing all rents from the market and eliminating the capacity of the state to create any rents. Industrial countries maintain significant rents in their markets to promote technological innovation and stabilize their polities. In just the same way, developing countries have to acquire the capacity to create and manage rents to accelerate the adoption of new technologies and manage their polities. Dynamic transformation states had these capacities; less dynamic states often did not. Once again, the good governance and investment climate approaches divert attention from how to create these critical rent-management capacities in developing countries.

The types of changes in rights and the required rent-management capacities can—and do—differ significantly across countries. The task of policy-relevant research is to identify the conditions that determine which types of capacities and structural changes are most relevant in specific contexts (Khan 2000a, 2000b).

While this work needs to be extended, it is also important to point out that the current focus on good governance and investment climate reforms has serious weaknesses, because it does not address very important issues that historical observation suggests were critical in successful transformations. If nothing more, this should warn us against making exaggerated claims for the new policies.

We should be aware of at least two types of dangers. The first is that a focus on a policy that does not identify the critical state capacities essential for ensuring high

investment rates and efficient investment allocation may waste resources and divert policy attention from critical tasks that may be neglected. The political fallout is likely to be very damaging if developing countries following the advice of multilateral agencies are once again disappointed by the results. But an even more serious possibility is that a focus on a particular version of good governance and investment climate reforms could even weaken state capacities to carry out effective transformation interventions. This is not just a theoretical possibility: the service delivery conception of the state underlying the good governance and investment climate models argues that the state should restrict itself to a very limited number of service delivery tasks. If the state is trimmed down to a few key service delivery agencies and made to protect existing property rights to the best of its ability, the possibility of creating an effective transformation state in the future may be significantly reduced. If making a real difference in the investment climate requires creating a viable capitalist economy, investment climate reforms that reduce the state to service delivery tasks may paradoxically make it more difficult to achieve the investment climate that is desired.

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Part VI: What Role for More Selective Interventions?

Business Investment and Competition Policy

JAMES R. TYBOUT

Some of the effects of competition policy on business investment are familiar. Others concern aspects of firms' behavior that have not received much attention in the empirical literature. This paper attempts to fill in some missing pieces. Among other things, it examines transition dynamics and welfare effects. The story it tells is not the only plausible description of firms' responses to heightened competitive pressures. Rather, it represents informed speculation, constrained by the empirical facts and by the presumption that managers maximize the expected value of their firms in the face of uncertainty.

Two types of investment can be distinguished. Physical investment increases productive capacity or replaces capital that has worn out or been sold. Innovative investment, when successful, improves firms' products or productive processes. These types of investment may respond in different ways to competition policy, and they generally interact with each other.

The list of policies that affect the nature of competition is very long. For developing countries perhaps the most prominent government interventions are trade policies, policies that encourage small and medium-size enterprises, and policies concerning multinational investments. (Antitrust policies play only a minor role.) The focus here is on trade policy.

Openness Investment, and Welfare

Erdem and Tybout (2004) use a computable industrial evolution model to explore the effects of foreign competition on the behavior of firms in an import-competing industry.[1] They model the domestic product market as imperfectly competitive, with

James R. Tybout is professor of economics at Pennsylvania State University and research associate of the National Bureau of Economic Research (NBER).

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each firm producing a differentiated good and foreign firms supplying distinct varieties. They then simulate the dynamic effects of a permanent reduction in the price of imported varieties.

At the beginning of each period, each owner/manager takes stock of the industry structure and formulates beliefs about how his competitors will behave. He then decides whether to continue producing or to sell the firm's assets for scrap (negative capacity investment). If he decides to continue, he chooses the optimal price for his product and the optimal level of spending on product development (that is, innovative investment).[2] More spending increases the probability of an improvement in product quality. Simultaneously, potential entrants formulate their own beliefs about the behavior of economic agents and decide whether to pay the cost of creating a new firm (positive capacity investment). When the model has been solved numerically, each agent's beliefs are rational and the resulting characterization of behavior can be used to simulate industrial evolution patterns.

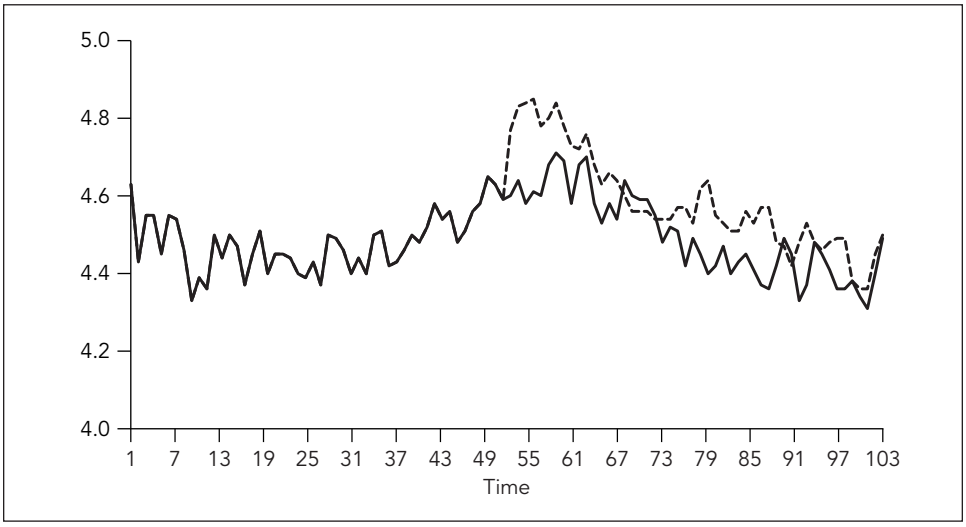
The simulation results of this model are summarized in figures 1–4. The first 49 periods in each figure correspond to the pre-reform era (a period can be thought of as roughly two to three years). An unanticipated reduction in trade protection occurs in period 50, after which firms operate under a "cheap imports" regime. (For comparison purposes, the darker line in each figure represents a counterfactual continuation of the trajectory that assumes no policy change.) Once the new regime is in place, all agents understand that cheap imports are there to stay and adjust their behavior accordingly.

When import competition intensifies, the average quality of domestically produced goods quickly improves relative to the quality of imported good (figure 1), as the lowest-quality domestic producers exit. Heightened import competition causes domestic firms to reduce their mark-ups (figure 2), driving down their profits. Those that were just getting by before the reforms—that is, some of the firms with the lowest-quality product varieties—decide to sell their facilities for scrap.

The squeezing of price-cost margins and the purging of low-quality firms are, in themselves, not news. They are consistent with numerous econometric studies of trade liberalization episodes in developing countries (Erdem and Tybout 2004 provide a survey).[3] The average quality gains from liberalization soon dissipate, however, because domestic innovative investment levels decline after 5–10 periods (10–30 years) in response to Schumpeterian forces (figure 3). More precisely, when foreign competition reduces domestic firms' market shares and mark-ups, the returns to product (or process) improvements are smaller and firms spend less on innovation. Econometric studies of trade liberalization episodes have not documented a similar deterioration in efficiency after the purging process is spent, but one would not expect them to, as data limitations have generally precluded econometric studies from including horizons this long.

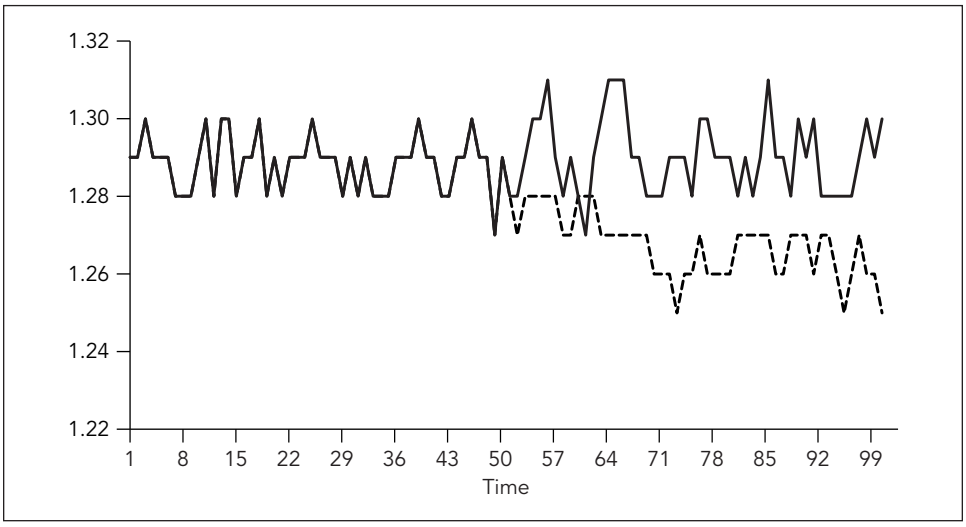
The simulations establish a link between the intensity of product market competition and investments in capacity. Heightened import competition crowds out some domestic production, so net exit generally occurs during the transition period (figures not reported). But more subtle forces are at work as well. When firms invest less in innovation, they fall behind their competitors relatively quickly. They lose value more

FIGURE 1. Mean Quality of Domestic Goods Relative to Imports



Source: Erdem and Tybout (2004).

FIGURE 2. Mean Price-Cost Margins of Domestic Firms



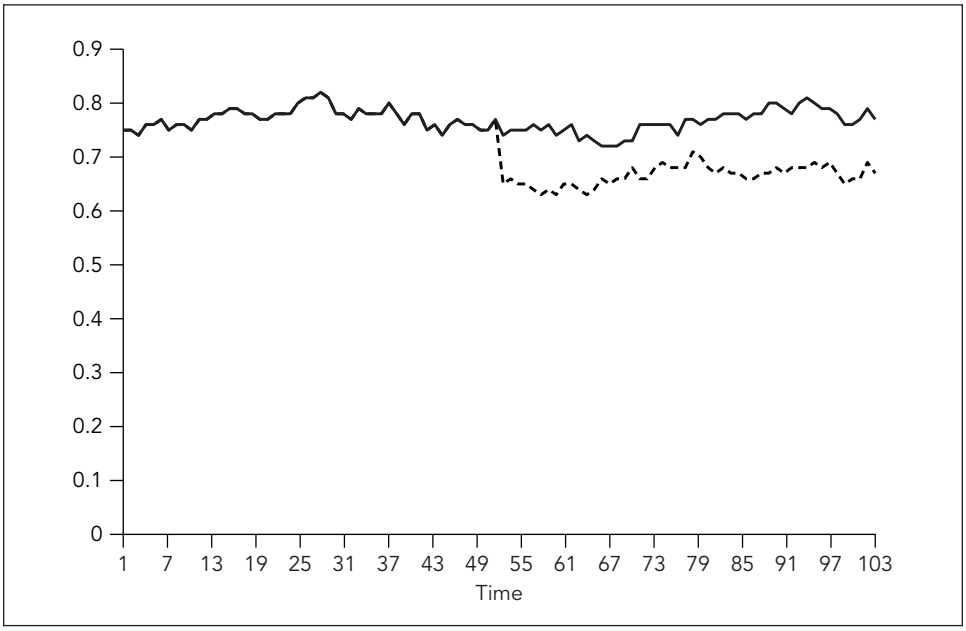
Source: Erdem and Tybout (2004).

rapidly and experience shorter life spans. They are replaced by new firms that, by assumption, are able to embody global best practice technologies in their production facilities and are therefore competitive upon entry.[4] Thus import competition creates more plant turnover and more opportunity for embodying new foreign technologies. At the same time, it accelerates the rate at which jobs are created and destroyed. This finding is not sufficiently common to call a stylized fact, but it is consistent with

evidence from several developing countries (Levinsohn 1999; Daveri, Manasse, and Serra 2003).

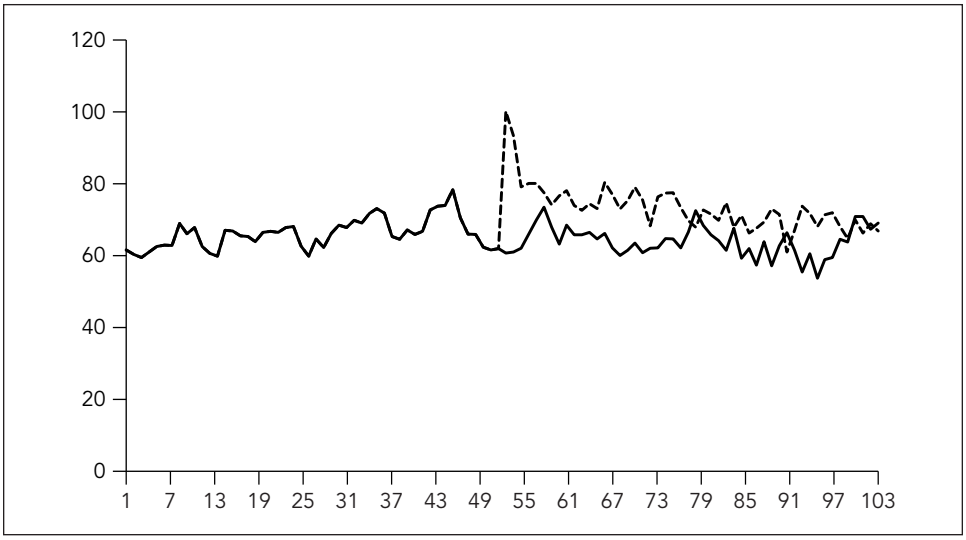
Workers in the import-competing industries are not likely to be happy about heightened import competition. Consumers feel differently, particularly in the immediate aftermath of the policy reform (figure 4). That is because all types of goods are

FIGURE 3. Mean Innovative Investment of Domestic Firms



Source: Erdem and Tybout (2004).

FIGURE 4. Consumer Surplus



Source: Erdem and Tybout (2004).

cheaper (figure 1), the goods that disappeared due to exit were not in much demand anyway, and the deterioration in the relative quality of domestic products has not yet become marked.

Import Competition and Investment

These simulations tell a coherent story about the dynamic relationship between the intensity of product market competition and different types of investment. They capture well-known aspects of adjustment to the competitive environment after trade liberalization, in which firms reduce their price cost mark-ups and the average quality of domestic firms rises as the worst performers are weeded out.

But the simulations also point to some possible features of the adjustment process that have not received much attention in the literature. Specifically, they suggest that over the medium to long term, firms' average quality may decline, because firms have less incentive to invest in innovation. Furthermore, with less investment in innovation, firms are likely to turn over more rapidly and workers become displaced more frequently. These effects emerge only gradually, so they are not easy to detect in empirical studies of liberalization episodes that span relatively short time periods.

The simulations show the effects of an import-competing industry in isolation. The effects would generally be reversed for an export-oriented industry: One would expect to see a short-run decline in the average quality of domestically produced goods in such an industry, because firms that would otherwise have shut down enjoy a boost in demand. One would also expect to see net entry. Over the longer term the export-oriented sector should show more investment in response to the greater profit potential associated with successful innovation.

Notes

1. The model is an open economy version of the framework developed by Ericson and Pakes (1995) and Pakes and McGuire (1994).
2. In this version of the model, there is no process innovation and all firms have the same marginal cost. Whether the focus is on process or product innovation matters little for what follows.
3. One can think of firms that shut down product lines as responding to the same forces, so intrafirm or intraplant gains may also reflect this type of competition-based purging effect.
4. This assumption reflects the fact that in small, poor countries, most of the machinery and equipment that manufacturers use is imported (Tybout 2000).

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Part VII: Reforming the Investment Climate

Reforming the Investment Climate

MANUEL HINDS

Why has the investment climate become so important in the past few years? What factors make for a good investment climate, and how can the investment climate be made more attractive? Investment has always been one of the key variables determining economic growth; creating a good environment within which growth could take place must also be important. But only recently has the economic development literature focused on this issue. The investment climate has become the most important determinant of progress. Finding out why is crucial to understanding what makes for a good investment climate.

Why Has the Investment Climate Become So Important?

The factors that determine the shape of a successful investment climate in developing countries have changed radically in the past two decades, so much so that many factors that were taken for granted as determinants of investment are no longer effective in eliciting it, while factors that were neglected in the past have become crucial. Just a few decades ago investment in developing countries was driven by one of two main motivations. Some companies invested in order to extract raw materials that were exported to industrial countries, where they were transformed into industrial goods. Others invested to gain access to domestic markets for finished products. Such access that could be gained only through investment in local productive facilities, because the markets were heavily protected against foreign competition. Attracting the first kind of investment was relatively simple for countries endowed with the right natural resources. Such countries—particularly those with reserves of natural gas and petroleum or scarce minerals, such as uranium or plutonium—attracted

Manuel Hinds is an international consultant and former finance minister of El Salvador. He is currently the Whitney H. Shepardson Fellow in international economics at the Maurice R. Greenberg Center for Geoeconomic Studies, Council on Foreign Relations, New York.

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investment even if their investment climate was awful. Even countries in war areas, with arbitrary regimes and significant crime rates, attracted investment to extract petroleum.

Attracting the second kind of investment was relatively simple as well. The tariff and nontariff protection afforded potential investors could be designed to compensate for the negative features of a country's investment climate. In those circumstances, investors could feel secure that their businesses would prosper independently of the problems they would find managing their enterprises in difficult environments. Investing in a country could be attractive even if the costs of production were twice as high as those in other countries, because local competitors faced the same costs and suffered from the same problems. Furthermore, if necessary companies could negotiate conditions that would grant them effective monopolies in domestic markets. With the market assured, even countries with small and heavily distorted economies could attract investments. Those investments were highly inefficient and in many cases resulted in negative value-added when measured at international prices, but investment was attracted.

Two revolutionary developments changed this scenario during the past two decades. First, burdened by its own inefficiencies, the inward-looking model of development collapsed in the 1980s and 1990s, leading to a worldwide wave of trade liberalization. In most cases the collapse took place because the growth of industry depended on the generation of foreign exchange by the export of primary products. Being protected, the domestic industry was inefficient and could not export to generate the dollars it needed to import its own inputs. To grow, industry needed ever-growing exports of primary products. Industrial growth hit this constraint in the 1970s and 1980s, as exports of primary products stagnated and the real prices of these products began a long-term decline that has continued through today. Many countries borrowed heavily in those years, expecting that such a decline would be temporary. When prices did not recover, those countries got into severe financial crises that forced them to abandon the model and liberalize their economies.

Second, the combination of computers, telecommunications, and rapid transportation allowed the coordination of complex tasks at a distance. This technological revolution is having crucial effects on the global economy. By multiplying the power of the mind, the marriage of computers and telecommunications is converting knowledge and the ability to coordinate complex tasks at a distance into the main source of wealth. As this happens, the prices of goods that embed knowledge are increasing relative to those that do not require it for their production. One of the manifestations of this trend is the long-term decline in the real prices of the goods that require the least knowledge of all—primary products—which accelerated the process of collapse of the old model of industrial development based on protection.

The ability to coordinate at a distance liberated companies from the need to have their production chains in the same place, allowing them to produce each component of their final product where it was cheaper to do it—even if such places were thousands of miles away. This brought about the current globalization that, contrary to what is commonly asserted, is not a phenomenon of international trade but one of production processes. Suddenly, all locations in the world began to compete for the investments that could be transferred from the industrial to the developing countries.

The truly innovative aspect of globalization—the geographical splitting of lines of production—could happen only as a result of the Connectivity Revolution.

The relocation of productive capacity allows for increases in productivity in all countries open to connectivity and globalization. It can increase in the most sophisticated economies when they export the least productive of their activities to other countries, allowing them to concentrate on more productive new activities. In developing countries the transferred activities are more productive than the ones they replace, so their transfer results in an increase in the productivity of the developing countries as well. Connectivity thus has the potential to increase the productivity of all countries in the world simultaneously simply by transferring activities from one place to another.

These events generated a structural transformation of the international economic relations that has changed the reasons why foreign companies invest in developing countries. The motivation to obtain raw materials remains in place. But the motivation to gain access to domestic markets has disappeared, because the trade liberalization of the 1990s opened most developing country markets. It is no longer necessary to produce in a country to sell in its markets. The motivation to produce for the domestic markets of huge countries such as China and Brazil remains in place. Producing locally for those markets is still cheaper than importing, even at the lower levels of protection now prevailing.

It would seem that globalization has reduced the incentive to invest in developing countries, because most have small economies and do not produce strategic materials. Yet the technological revolution has produced a third reason to invest in these countries: taking advantage of low costs of production to integrate local facilities into global chains of production and sell directly in international markets. This new motivation is changing the shape of the factors that result in a good investment climate.

Now that investment is geared to production for the entire world, competition may mean working in different places, where costs may be lower. Since there are alternatives, a country has to be better than others to attract investment. In such an environment, domestic protection against foreign competition is no longer a guarantee of success. On the contrary, since protection increases the prices of tradable goods that could be used as inputs for production, it reduces the competitiveness of potential investors. In fact, since tradables can be transported anywhere in the world, competitiveness depends on two major factors: the possibility of using tradable inputs at international prices and the availability of sophisticated and efficient nontradables—goods and services that cannot be transferred from one place to the other—that minimize the costs of processing the tradable goods. The most important of these nontradables is the investment climate.

What Kind of Investment Climate Attracts Investment?

While creating an investment climate that will attract investment depends on some explicitly economic factors, the *investment climate* actually refers to the quality of the ultimate nontradable that makes a location competitive: the shape of its social order.

Economic factors merit only a mention here, because they are discussed in detail elsewhere in this volume. They include the following:

- *Macroeconomic stability*. Macroeconomic stability remains crucial because the relative prices relevant for each investment must remain stable and predictable.
- *Openness to trade in tradable goods and services, particularly to inputs and intermediate goods*. An open trade regime is essential for integration in international chains of production.
- *Local managerial abilities*. Expatriate managers are expensive, so the availability of local managerial talent that can be trained to manage a proposed investment is a key element in the investment decision.
- *Initiative and education of the population*. In an international economy progressively driven by the knowledge contents of products, the possibility of training the local labor force to work in sophisticated processes is a key factor in the decision about the location of investments.
- *Low telecommunication costs*. Telecommunications costs remain high in many developing countries, largely because local monopolies are controlled by state-owned companies.
- *Low domestic and international transactions costs*. Transactions costs tend to be very high in most developing countries. Their magnitude was not a problem in the world of protected economies. Today, however, they impose costs on enterprises that do not represent value-added and therefore represent an obstacle to investment.
- *Access to social amenities and facilities for expatriate and local personnel and their families*. In the globalized world, people with skills useful for worldwide production are in global demand. Both to attract international companies that would import expatriates and to retain locals with global skills, countries must become attractive places to live in. Managers must have access to attractive residential areas with good educational, health, and recreational facilities for their families.

These economic features are important. Yet taking full advantage of the technological revolution to spur investment requires adapting society to the principles guiding the social order of the new world of connectivity and globalization.

Success in this new world is based on three different sets of skills: coordinating complex activities horizontally; using the technological possibilities created by modern computers, telecommunications, and transportation to expand the geographical span of such coordination; and taking full advantage of the networks created to generate value-added based on knowledge and logistics. Only when the three are combined is the success of a business ensured.

The ability to coordinate complex activities horizontally does not depend on the availability of computers and telecommunications. It can be exercised without any physical equipment. Conversely, the availability of computers and telecommunications does not guarantee that such ability is developed. This ability cannot be developed

within a vertical structure of social organization—that prevailing in countries in which social control is based on specific commands enforced by the strength of the regime.

The industrial countries had this kind of organization in preindustrial times, when feudal lords or national sovereigns dictated all the activities that could operate in their realms, the volume of production, prices, and the way each activity related to all others. Hierarchies were the mechanism that achieved control.

The complexity of industry changed all that, and people learned to control society through horizontal instruments and institutions. In this way, contracts between private parties, laws that apply equally to everyone, and a competitive market that everyone could access replaced the commands of the sovereign as the main instrument for controlling the relationships between people, activities, and enterprises. The determination of the national leader shifted from the vertical mechanisms of inheritance to the horizontal ones of democracy. This horizontal mechanism made countries stable. The key point in the development of all these mechanisms of social control is that all of them are based on the ability of the society to coordinate complex tasks in a horizontal way—that is, on its capacity to coordinate itself for the attainment of common goals.

This ability is crucial at the institutional level; the technological revolution is rendering it crucial at the enterprise level as well. With new technologies, companies are increasingly coordinating their worldwide operations not by creating local corporations in all countries but by establishing alliances with local partners. Within corporations many decisions that were traditionally made at the highest levels are being pushed downward to the lower levels of management as the only way to give proper attention to customers in the increasingly competitive world. Given the complexity of the tasks needed to gain and maintain profitable niches, work by teams of people with different abilities and without a clear hierarchy is becoming increasingly common.

The end product is a corporation in which decisions are not the result of vertical flows of information and commands but of horizontal communications and coordination by individuals. Companies with decisionmaking power closer to their customers have a clear advantage in both speed of response and creativity, the crucial features of successful enterprises in the new world. Many enterprises have not attained success in this new environment, producing chaos in their staffs rather than a better capacity of response. For this reason many people have come to think that the end of vertical hierarchies is a fad, bound to disappear. It is not: enterprises that succeed in this difficult art, combining it with the immense possibilities that modern computers, telecommunications, and transportation are creating, will win markets.

Most developing countries lack this strength. They tend to be vertically organized and able to accomplish objectives based only on hierarchies. Because of this, the rule of law is imperfect—meaning that the law may not be applied equally to everyone and contract violations are common. For the same reason, markets tend not to be fully competitive because of the existence of arbitrary privileges. At the core of these problems is people's lack of ability to coordinate themselves spontaneously in a horizontal way. This lack of coordination is evident even in minor activities, which tend to be performed less efficiently than in industrial countries.

The second and third elements of the Connectivity Revolution—the exercise of horizontal coordination at a distance and the use of this capability to engineer an increase in value-added per worker all over the world—can be achieved only if the first is attained. But attaining these conditions cannot be taken for granted. Both depend on the application of knowledge to economic activities, which means that education must be given top priority in economic development. That education generates progress is not a new discovery. But the Connectivity Revolution has accentuated its value. The problem is that the relation between education and economic success is not well established in many developing countries. Differing attitudes toward education are evident in the experiences of immigrants to the United States. Immigrants from societies that place a high value on education progress rapidly, while immigrants from countries that place less value on education tend to stagnate economically.

Development of the ability to acquire knowledge and coordinate horizontally within companies and with other enterprises is thus essential to attracting investment. The development of this ability in the social and political environments is even more important. What is needed is the creation of an institutional setting that ensures that the rule of law prevails and that reasonable laws are enacted so that investors feel secure that contracts will be enforced and their rights well established and not violated. Once this new institutional setting is created, it becomes much easier to meet the strictly economic conditions needed for a good investment climate.

Transforming the Investment Climate

For most developing countries, creating an investment climate means rebuilding the institutional setting. For many it means creating an institutional setting in a society that has been used to operating on the basis of arbitrary privilege, not institutions. The problem cannot be resolved by the executive action of an enlightened government that establishes the required institutions on paper. Many developing countries with progressive constitutions routinely violate them. To be effective, the shape of the institutions must be consistent with the values of the population and the popular conception of how society should be conducted.

The problem, then, is to elicit from the population the desire to be ruled under a horizontal and competitive institutional order. It is a formidable problem, because such a change can be accomplished only in the long term—and against substantial resistance from many sectors of society, particularly from people in positions of privilege. Resolving this problem may take generations. It cannot be resolved at all if the population does not understand the importance of the change. But people cannot understand the importance of the change unless they experience it. Countries may thus find themselves facing the chicken and the egg problem.

Is it possible to shortcut the process? Much can be learned from the Hanseatic League, a trade association created by the free cities of Northern Europe in the twelfth century. The League wanted to expand trade with its neighbors, but it faced problems similar to those that countries confront today regarding the investment

climate. Trade could not be sustainable if the rule of law did not prevail and if the institutions of the trade partners diverged too much from one another. To solve the problem, the League offered several services that made trade possible, including armed protection against pirates and legal protection against the arbitrariness of the cities that joined the League. Most important, the conditions of entry included the acceptance of free trade with all other members and the adoption of the laws and commercial procedures of Lübeck, the city in which the League was founded. Cities meeting some but not all of the conditions could still have access to some of the benefits of the League by participating as associate members. The League grew quickly, bringing rapid development to cities all over Northern Europe, from London to Novgorod. For centuries the members of the Hanseatic League—and leagues modeled on its success in Italy and southern Germany—were among the richest cities in Europe.

A similar arrangement, with standard conditions of participation, would advance the process of institutional creation in developing countries, providing a strong mechanism to motivate the population to reform their institutions and break resistance to change. It would create a credible prospect of growth associated with liberal institutions and policies—something that comes only with access to industrial country markets. All voters in developing countries (except those living in radicalized countries) understand the potential for growth associated with integrating their economies with those of the most advanced countries in the world. Achieving such integration can easily become a common purpose that would unite their societies, starting the process of social, political, and economic development that has been denied to them by their own fragmentation. Trading blocs like the Hanseatic League and the ones created in the twentieth century would facilitate such integration and could be the solution to the problem.

Regional trading blocs are inferior to a single global trade space, because they maintain trade protection against countries not included in the bloc, thereby forfeiting some of the gains of trade. There is no guarantee that regional blocs will eventually merge. Regional trading blocs have a crucial advantage, however: they are far easier to create than a global trade space. In practice, a combination of regional blocs and a longer-term effort to liberalize trade worldwide seems to be the best solution, as rapid global liberalization is not feasible. In the imperfect real world, forming increasingly large trading blocs—a process that has been occurring—may be the best way of achieving worldwide liberalization.

Because they are negotiated among smaller numbers of participants, trading blocs are more amenable to full economic integration than global treaties that just liberalize trade. The European Union and the North American Free Trade Agreement (NAFTA) have gone a long way toward creating integrated economic spaces, where not only trade rules but other economic regulations are approved. Countries become partners rather than just potential traders. For this reason trading blocs have proven to be effective vehicles for exporting the social order of the most developed partners.

Through regional integration with industrial countries, developing countries are experiencing the benefits of the rule of law and predictable institutional settings. Mexico, for example, is benefiting enormously from its participation in NAFTA, well beyond the gains it obtained from trade liberalization. True democracy started to

develop in Mexico only after it joined NAFTA. Macroeconomic instability, a long-term problem before NAFTA, was gradually turned into stability after the treaty was signed. Modernity is spreading rapidly across the country, factors of production are becoming more mobile, the enforcement of the rule of law has improved drastically, and even political processes are becoming more transparent and democratic.

The same phenomenon occurred in Portugal and Spain after they joined the European Union (EU). Their societies became more horizontal and multidimensional. The change benefited not only those societies but also their more advanced partners, which, in addition to a larger market, got more secure neighbors. The same is happening in the formerly communist countries of Eastern Europe. The prospect of joining the EU provided a strong motivation for institutional reforms that gave a horizontal shape to their societies. Participation in the EU is providing benefits that strengthen their determination to rule themselves in a modern, horizontal way.

Thus, like the Hanseatic League, today's trade blocs are opening the door for the rapid liberalization of the world's economy. Unlike the League, however, these blocs are not able to set modernization processes in motion in developing countries in general because they are not automatically open to new entrants. The entry of each potential partner depends on arbitrary decisions of the members of the blocs, and the terms and conditions are negotiated with each new potential entrant. This seriously retards the process of globalization, hindering adjustment to the new connected world. These procedures are different from those that countries follow to join the World Trade Organization (WTO), which is open to all entrants willing to comply with the institution's rules. If adopted by trading blocs, this kind of arrangement would greatly accelerate the dissemination of free trade. It would create strong incentives for modernization in developing countries if the conditions of access stipulated the adoption of liberal policies, modern commercial legislation, and transparent procedures in domestic markets. The certainty that meeting these requirements would automatically give them access to a trade bloc would motivate countries to dismantle the regulations that restrict the mobility of resources, enforce the rule of law, and become more democratic.

To use trading blocs as vehicles of modernization, it is essential that the rules be fixed and equally binding on all members, so that every potential member understands just what it needs to do to enter the bloc. There would be nothing to negotiate; joining would be just like joining the WTO. Member countries violating one of the fundamental covenants would automatically be suspended or expelled. Even the transition periods before integration could be fixed. In this way trading blocs could create the foundations for the new international order that must be created to replace the one that is now crumbling. Opening up these trading blocs would help export the most valuable of commodities—an efficient investment climate—from the industrial countries to the developing countries.

Of course, this does not mean that developing countries would have nothing to do except enter a trade bloc. The important aspect of such blocs is that they impose the rule of law and liberal institutions in trade—and through it in all economic activities. This, in turn, facilitates the organization of the other activities they have to carry out to spur economic growth.

Summary

The emergence of connectivity and globalization has radically changed the factors that determine which countries attract investment and develop. In the past countries could attract investment by simply protecting their domestic markets, forcing companies that wanted to sell in those markets to invest in local productive facilities. This strategy is no longer possible. Today countries must compete with one another to attract investment aimed at producing products to sell in international markets. The most important factor determining a country's competitiveness is its ability to organize itself through horizontal institutions under a rule of law that functions predictably, in the sense of protecting the rights of individuals. Transforming societies in this direction is a tall order, because it means changing the way they have operated for centuries and eliminating the privileges that have prevailed.

The possibility of joining industrial countries in trading blocs would create demand for this transformation. Partners in NAFTA and members of the EU have benefited not just from increased trade but also from new environments in which law and horizontal coordination prevail. Regional trading blocs must open their doors in a predictable way so that potential entrants know what they have to do to become members of the club. As the cases of Mexico, Portugal, Spain, and the former communist countries in Europe have shown, the possibility of joining the club serves as a powerful incentive to carry out all of the difficult tasks needed to create the right investment climate.

Credibility and Commitment

GIANDOMENICO MAJONE

A crucially important aspect of a good investment climate is the capacity of governments to make credible long-term commitments. Legal certainty and policy stability—key variables in the calculations of would-be investors—are impossible in the absence of such capacity. Achieving credibility is to a large extent a question of designing and enforcing suitable constraints on the discretion of policymakers. This paper reviews the most important "technologies of commitment."

From the Planning to the Strategic Model of Policymaking

"Normative policy analysis began by supposing that the policy was made by an omnipotent, omniscient, and benevolent dictator," writes Avinash Dixit (1996, p. 8). "The work on the second-best removed the omnipotence. That on information removed the omniscience. However, the assumptions of benevolence and dictatorship have remained unaffected by all these improvements in our understanding of the limits on instruments and information." Dixit suggests that even today many normative analysts continue to view policymaking as a purely technical exercise: once a policy that improves social welfare has been found and recommended, it will be implemented as designed and the desired effects will follow. Given such a view of policymaking, the issue of policy credibility does not even arise. What may be at stake, at most, is the credibility of the policy analyst.

Suppose, instead, that we think of a specific public policy not as a technical plan to be imposed on passive recipients but as a strategic course of action—usually resulting in the provision of goods or services, such as education, security, market regulation, or income redistribution. To say that a course of action is strategic means that

Giandomenico Majone is external professor at the Robert Schumann Centre of Advanced Studies of the European University Institute, in Florence, Italy.

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it is designed to alter the beliefs and actions of other agents in a direction favorable to the achievement of the policy objectives. As soon as we think of public policy as a strategic choice, we leave the realm of technical planning and welfare maximization to enter the domain of social interactions among rational players; in social-scientific terms, this is the domain of game theory. Instead of being a benevolent and wise—even if no longer omniscient and omnipotent—social planner, the policymaker is now a player who has to take into account the beliefs, incentives, and strategies of other players: other policymakers, voters, interest groups, courts, domestic and international investors, and so on.

Like all strategic games, public policies must confront the problem of credibility: why should player B believe the announcements, threats, or promises of player A, and how can A make his or her commitments credible in the eyes of B? The politician's promise to reduce taxes is not irreversible: once elected he or she can always find excuses for not acting. One significant source of the credibility problem is "time inconsistency." Time inconsistency occurs when a policy that appears optimal at time t no longer seems optimal at a later time $t + h$. Without a binding commitment holding them to the original plan, policymakers will use their discretion to switch to what now appears to be a better policy. But if people anticipate such a policy change, they will behave in ways that prevent policymakers from achieving their original objectives.

The phenomenon of time inconsistency appears in any area of discretionary policy making where long-run and short-run objectives are not aligned. Thus a policy of low inflation may be optimal over the long run, but at any time there can be short-run political gains from unanticipated inflation. If the policymaker has the possibility of revising the original, low-inflation policy to achieve such short-term gains, private actors will recognize this and change their behavior accordingly. In the language of game theory, a time-inconsistent policy cannot represent a subgame-perfect Nash equilibrium. The promise to pursue a time-inconsistent policy is not credible and hence not believed.

Another source of the credibility problem is rooted in the very nature of the democratic process. One of the defining characteristics of democracy is that it is a form of government *pro tempore* (Linz 1998). The time limit inherent in the requirement of elections at regular intervals implies that the policies of the current majority can always be subverted by a new majority with different and perhaps opposing interests. Because a legislature cannot bind a future legislature and a majority coalition cannot bind another, public policies are always vulnerable to reneging (Shepsle 1991). This is the reason why under international law states cannot invoke a national law as an excuse for failing to perform their treaty obligations toward other signatories.

The difficulties democracies experience in making credible long-term commitments have been known for a long time. The tendency of elected politicians to renege on their promises was already well known to Greek writers, such as Aristophanes and Thucydides. In the nineteenth century de Tocqueville viewed the democratic process as largely inimical to credible foreign policy commitments. Why, then, has policy credibility become an important criterion only recently? A paradigm shift was needed before the issue of policy credibility could even be formulated in analytically precise terms, but there are also pragmatic reasons why the issue has taken on new

importance. One is a new awareness of the advantages of policy credibility in a world in which national borders are increasingly porous. Growing economic and political interdependence among nations has the effect of weakening the impact of policy actions on the home country and increasing their impact on other countries. Thus domestic policy is increasingly projected beyond national boundaries, but it can achieve its intended objectives there only if it is credible. Even domestically the growing complexity of public policy continues to erode the effectiveness of the traditional command-and-control techniques of public administration. The single most important characteristic of programs at the cutting edge of policy development, such as the newer forms of economic and social regulation, is that their success depends on affecting the attitudes, incentives, and beliefs of millions of individuals and thousands of firms and units of local government. The tasks are difficult not only because they often deal with technologically complex matters, but even more because they aim ultimately at modifying expectations (Schultze 1977). In this new context of growing interdependence among nations and increasing complexity of governmental programs, credibility becomes an essential condition of policy effectiveness.

The Commitment Problem and Political Property Rights

To make a policy (or strategic move) credible, it is necessary to take some other supporting action that makes reversing the policy costly or impossible. Credible policy must thus contain two elements: the planned course of action and the commitment that makes the course credible. The commitment problem is not, of course, unique to the world of politics and public policy. Incentives to renege on agreements occur in many economic settings as well, but in such settings repeated interactions often provide incentives for individuals to honor agreements in order to maintain a flow of benefits over time. In the business world, reputation has long been one of the most important mechanisms for ensuring that contracts are honored. If the future is long enough, or important enough, short-run temptations to do what might be optimal today can be resisted.

This logic does not apply to politicians (although it may apply to political institutions), because political property rights—the right to exercise public authority—are ill defined. As above, in a democracy the policies of the current majority can be subverted, legitimately and without compensation, by a new majority with different and perhaps opposing interests. Because political property rights are ill defined—or, more precisely, attenuated—creating a situation of political uncertainty, electorally accountable policymakers lack the means of making long-term commitments.

Using Institutions to Make Policies Credible

Political and legal institutions are so important precisely because they allow policymakers to make commitments that would not be credible in the absence of such institutions. By delegating responsibility for monetary policy to an independent central

bank, for example, the government increases the credibility of its commitment to price stability, since the central banker does not have the incentive to deviate from the optimal long-run policy for short-run political considerations. The regulation of public utilities provides another example of the importance of policy credibility and the role of institutions in enhancing the credibility of regulatory commitments (Levy and Spiller 1996). For potential investors in privatized utilities, the credibility of regulatory commitments is essential. The assets of utility companies have few alternative uses, so that once the necessary investments have been made, politicians may be tempted to use regulation to set prices below long-run average costs, de facto expropriating the utilities' sunk costs. But without a credible commitment to allow a fair rate of return on capital, the companies will refuse to invest or they will not invest enough to satisfy future demand and develop technical innovations. In order to make its commitment credible, the government must limit its discretion. This is primarily a problem of institutional design.

The problem of regulatory commitment has been known for a long time in countries like the United States, where utilities have traditionally been privately owned. Throughout the nineteenth century public utilities in the United States were typically regulated at the municipal level. Between 1907 and 1922 nearly 30 states created independent utility commissions. According to some economic historians, the initial creation of such institutions at the state, rather than the municipal, level was related to the inability of city politicians to credibly commit themselves to stable regulatory regimes. In particular, gas companies found municipal regulation arbitrary and confiscatory. Werner Troesken (1996), who investigated the regulation of the Chicago gas industry between 1849 and 1924, identifies two main reasons why reputational forces were not sufficiently powerful to constrain the regulatory discretion of the Chicago City Council. First, the Council confronted an endgame problem: once the utilities neared completion of their networks, the Council's incentive to encourage future investment fell. Second, it was not easy to determine when municipal rate regulation was in fact confiscatory. When the gas companies sued for Fourteenth Amendment protection, the courts granted immediate injunctive relief only in cases in which the evidence clearly showed that city regulators had set confiscatory rates. In ambiguous cases the courts allowed the rates to go into effect. The inability of city politicians to credibly commit themselves to a stable and nondiscretionary regulatory regime, which would not use gas rates as a political device, eventually led to the creation of an independent regulatory body at the state level, the Illinois Public Utilities Commission.

Commitment through Delegation

Delegation to an agent with different time preferences or a different incentive structure than the principal is a well-known strategy for achieving credible commitment. For example, workers often delegate the task of negotiating a collective agreement to tough union leaders, who can be thought of as having a very low rate of time preference. Economists have developed formal models to show why delegation of monetary

policy to a central banker who is more "conservative" (that is, more averse to inflation) than the government can increase the credibility of the government's commitment to keeping inflation low. Put simply, a lower average level of inflation becomes credible because the delegate (the central banker) values inflation less than the political principals (Rogoff 1985).

The logic of the conservative central banker model may be extended to other areas of public policy, such as economic and social regulation. In most countries regulatory policymaking is now delegated to specialized agencies operating at arm's length from government. The point of insulating regulators from the political process is to enhance the credibility of policy commitments. Agency heads are usually chosen not only for their expertise but also for their pro-environment, pro-consumer, or pro-competition beliefs. They generally expect, and are expected by others, to have a well-defined agenda and to measure their success by how much of that agenda they accomplish. Regulators also know that courts can review their decisions and may overturn them if they seem to depart too widely from the language and aims of the enabling statute. Thus they have an added incentive to pursue the statutory objectives of the agency, even when those objectives no longer enjoy popular support (because of changed economic or political conditions, for example).

The Agency Model and Agency Costs

While agencies are certainly not a new feature of public administration, their importance has grown so much in recent years that they can no longer be treated as marginal additions to more traditional administrative structures. Rather, they should be seen as key elements of a new mode of governance that relies less on the power of taxing, spending, and direct state intervention in the economy and more on the power of making and enforcing rules—rules that are increasingly made by expert agencies operating at arm's length from government.

Some advocates of the agency model suggest that this model is unconditionally superior to more traditional methods of making and implementing public policy. This is not the case. Redistributive policies, or policies with significant redistributive implications, should remain under the direct control of electorally accountable policymakers (Majone 1996). The model of the independent agency is most relevant to areas such as economic and social regulation, where expertise, reputation, and credibility are the keys to success. As Gatsios and Seabright put it, "The delegation of regulatory powers to some agency distinct from the government itself is best understood as a means whereby governments can commit themselves to regulatory strategies that would not be credible in the absence of such delegation" (1989, p. 46).

Agencies can be single-headed (agencies in the narrow sense) or multiheaded (commissions, boards), more independent or less independent of the political process, with broader or narrower competencies, strong or weak enforcement powers, and so on. However varied their form, agencies—as the term indicates—are the agents established by political principals to carry out their single or joint purpose. An agency

problem arises because agents may pursue their own rather than the principals' objectives. This problem creates agency costs, that is, the costs incurred in the effort to induce agents to faithfully implement the principals' objectives and the losses principals sustain when they are not able to control their agents perfectly. Agency costs include the costs associated with selecting the executives of the agencies and monitoring their compliance; the cost of using corrective devices (rewards, sanctions, and legislative direction); and the cost of any residual noncompliance that produces a difference between the policy enacted and what is implemented.

Agency problems can be addressed in a variety of ways. The same level of compliance can be achieved with less monitoring if ex post rewards and sanctions align the agent's incentives with the principal's policy preferences; the importance of both monitoring and incentives declines dramatically if agents can be appointed who share the principal's objectives. The objective of institutional design is to identify the mix of selection, monitoring, and ex post incentive and correctional devices that reduce agency problems to the lowest cost to the principals.

The decision to delegate certain responsibilities to an agency does not depend only on agency costs but also on other transactions costs, such as the cost of decisionmaking per se. The two classes of costs are closely related. Broad delegation reduces decisionmaking costs, since the principal does not have to invest resources to work out the details of policy, but it increases the cost of controlling the agency's discretion. A high level of agency independence increases the credibility of policy commitments by reducing the influence of political considerations in agency decisionmaking, but it increases the risk that the agency will not comply with the preferences of the principals. In establishing a new agency, therefore, legislators and policymakers select, often implicitly rather than explicitly, particular values for a number of design variables. Their choices determine the governance structure of the agency.

An important conceptual distinction should be noted at this point. An agent is someone appointed to carry out certain tasks defined by the principal. In the case of a political principal and a bureaucratic agent, one important reason for delegating powers is to reduce the principal's decisionmaking costs—by taking advantage of executive branch expertise, for example. In such a situation, the main problem the principal faces is bureaucratic drift, that is, the ability of the agent to enact outcomes different from the policy outcomes preferred by the authority who originally delegated powers.

The situation is quite different when the main reason for delegating powers is not, or not only, to reduce decisionmaking costs but to enhance policy credibility. In this case the best strategy is often to choose a delegate whose policy preferences differ systematically from the preferences of the delegating principal—as in the case of the "conservative" central banker. An agent who simply carries out the principal's directives cannot enhance the principal's credibility. Hence when delegation is used as a technology of commitment, the delegate must be independent, although the level of independence may vary with the seriousness of the credibility problem. The highest level of independence occurs when the principals irrevocably transfer their political property rights in a given area to a separate institution whose independence is

constitutionally guaranteed—as in the case of the European Central Bank. Standard agency theory does not provide satisfactory models for analyzing relations between delegating authorities and independent delegates or for understanding the governance structure in which such relations are embedded. The first step toward better understanding the logic of delegation for credibility is to distinguish between agents and fiduciaries (or trustees)—a distinction well known to legal scholars but ignored by contemporary political science and economics (see Majone 2001a, 2001b).

Delegation and the Fiduciary Principle

Examples of institutional arrangements based on the fiduciary principle include relations between governments and independent central banks such as the European Central Bank or the U.S. Federal Reserve System, delegation of powers by the U.S. Congress to independent regulatory commissions in the United States, delegation of powers by the member states of the European Union to the European Commission, and relations between the European institutions and the member states when the member states implement EU policies. What characterizes such fiduciary institutions is a very broad delegation of powers and an open-ended commitment to general objectives such as "maintaining price stability," "ensuring the proper functioning and development of the European common market," or "regulating an industry in the public interest." Such commitments cannot be specified in sufficient detail to permit close monitoring, much less hierarchical controls. The fiduciary principle is an alternative to an elaborate specification of duties and extra monitoring. Bureaucratic agents have relatively fixed obligations under their employment contract. If their contract does not call for them to perform a particular function, they do not have to do so. By contrast, policy executives' "duty of care" is open-ended, as is, to a large extent, their duty of loyalty to their organization and their political principals. For this reason politically independent bodies are often subject to stricter procedural requirements than administrative agencies under direct political control (Majone 2001a, 2001b). Having recognized the conceptual distinction, it is important to keep in mind that in practice an agent may possess the elements of trust and confidence of a fiduciary relation, while a fiduciary is also an agent. In other words, all fiduciaries are agents, but not all agents are fiduciaries: a fiduciary is an agent and something more.

Independence and Accountability

Agency costs were defined as the costs incurred in the effort to induce agents to faithfully implement the principals' objectives, plus the cost of any residual noncompliance. When policy credibility is the main purpose of delegation, the situation is more complicated. Since the fiduciary is also an agent, some agency costs may still be relevant. However, the large amount of policy discretion granted to a nonelective

fiduciary raises serious issues of legitimacy in a democracy, where important policy decisions are supposed to be made by electorally accountable political leaders. Delegation can be thought of as a political exchange in which the principals give up some of their authority in order to enhance their credibility. Democratic principals can transfer policymaking powers, but they cannot transfer their own legitimacy. Hence this type of delegation may involve a cost that does not arise when the agent is under direct political control. By analogy with the concept of agency cost, this potential loss of legitimacy may be referred to as a fiduciary cost. Good institutional design is the key to minimizing both agency and fiduciary costs.

Whether political independence and democratic accountability can be reconciled depends crucially on how the relationships between elected principals, nonmajoritarian (politically independent) institutions, and the general public are structured. Elected leaders create such institutions; define their legal authority, objectives, and decisionmaking procedures; appoint key personnel; and in many cases exercise budgetary control. Such powers can, and should, be used in a systematic way to design institutional arrangements capable of ensuring transparency and public accountability over time.

The following variables appear to be crucial to the design of an effective structure of accountability (Horn 1995):

- the extent to which decisions are delegated to an agent or fiduciary rather than made by the principal
- the governance structure, which includes both the organizational form—single-headed agency, multiheaded commission, policymaking board, and so on—and the methods by which key personnel are appointed
- the rules that specify the procedures the institution must follow in decisionmaking (examples are reason-giving requirements and rules defining the rights of various groups to participate directly in the decisionmaking process)
- the procedures to be followed when the political principals wish to overrule agency decisions
- the allocation of resources, in particular the employment conditions of agents and fiduciaries, and the extent to which the institution is financed by the government or by the sale of its services
- the extent of ex post monitoring through ongoing legislative and executive oversight, the budgetary process, judicial review, citizens' complaints, and peer review

A judicious selection of the value assigned to each of these variables—more or less delegation, more or less independence, more or less stringent procedural requirements, and so on—in light of the nature of the policy problem and the relevant political and institutional setting will go a long way toward ensuring that independence and accountability are indeed complementary and mutually supporting rather than antithetical values. The simplest and most effective way of improving transparency and accountability, for example, is to require that policymakers, or their delegates,

give reasons for their decisions. This requirement activates at least four other mechanisms for controlling discretion and enhancing accountability: public participation and debate, peer review, complaint procedures, and judicial review. Similarly, clear procedures for overriding agency decisions are necessary to ensure transparency and the right allocation of political responsibility. In a democracy it is impossible to exclude the possibility that elected leaders may override the decisions of their agents or fiduciaries when they feel that those decisions are not in the public interest.

An important characteristic of expert institutions is the limited scope of their competencies. But the consequences of particular expert decisions cannot always be contained within the policy area assigned to a nonmajoritarian institution. Some environmental measures may have serious consequences for employment; the decision of the competition authority in a merger case could have important implications for industrial policy; the policy of the central bank may conflict with overriding political objectives of the government. When such spillovers are significant, value conflicts ensue that only electorally accountable policymakers should resolve. The political decision to override the conclusions of the agency must be made in a transparent way, following well-defined and generally known procedures. Overriding the agency's decision should be neither too easy nor too difficult. If interference with agency decisions entails only negligible political costs, the agency is not independent, and delegating powers to it cannot increase policy credibility. But if political intervention is too costly, there may be a serious loss of legitimacy.

Concluding Remarks: Enabling Constraints

Achieving policy credibility is to a large extent a question of designing and enforcing suitable constraints on the discretion of policymakers. The idea that constraints can be useful for certain purposes is widely accepted in engineering as well as in practical life. Friction, for example, is highly desirable in certain circumstances—without it the wheels of a car would skid, people would have to wear suction pads in order to cling to the floor, and knots would be ineffective. In politics, especially democratic politics, the importance of limitations on the freedom of choice of the current majority and of its political representatives is less obvious.

It has taken several centuries to recognize the weakness of unlimited power. Jean Bodin (1530–96) was perhaps the first political philosopher to argue that less power is more power and that the public realm becomes easier to govern if some issues are removed from the public agenda. According to Bodin, to achieve his objectives a king must cultivate a reputation for trustworthiness, which requires him to play by the rules. For example, by committing himself in advance to coins of fixed value, the king can successfully resist pressures to depreciate, cultivate the confidence of creditors, and retain better control of the economy in general (Holmes 1995).

Written constitutions, separation of powers, rule of law, federalism, and constitutional courts are all powerful constraints on the decisionmaking powers of the current majority, but it is precisely because of these constraints that our representative democracies can achieve results that would be beyond the capacity of the direct

democracies of antiquity. The relation between constitutionalism and democracy can be significantly clarified by an analysis of the way constraints can not only protect freedom and individual rights but also enhance the credibility and effectiveness of public policy. Such analysis should be an important part of any institution-building exercise.

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Closing Remarks

WARRICK SMITH

We have had a very rich set of discussions, covering new research, new arguments, and new insights. Let me highlight just three of the many lessons I and the team will be reflecting on as we set to work preparing the *World Development Report*.

First, it is clear that while there have been many advances in the literature, there remains no shortage of controversies and debates in this area. Our discussions at this workshop have helped sharpen and clarify many of those debates, which will be very useful as we begin to assemble the evidence, including the new micro-level data.

Second, our discussions have reinforced the importance of looking at the investment climate from the perspective of a broad range of firms, including those in the informal economy. This is another area in which we hope new sources of data will allow us to broaden and deepen the analysis.

Third, the workshop has confirmed the importance of incorporating political economy considerations into the analysis. This has important implications not only for the research we pursue but also for the structure of the report.

Let me close by thanking all of you for your contributions and suggestions. The report should be much stronger as a result.

And last but not least, let me extend a very warm thank you to our hosts, InWEnt and the German Ministry for Economic Cooperation. We enjoyed a very effective partnership in organizing this event, and I think we would all agree that the arrangements here in Berlin were world class. We also benefited from superb German hospitality and from a glimpse at a city that has itself been transforming its investment climate.

Warrick Smith is the director of the *World Development Report 2005*.

Berlin Workshop Series 2005

Appendix 1: Program

International Bank for Reconstruction and Development
The World Bank

Development Policy Forum

InWEnt—Capacity Building International, Germany*

Workshop

INVESTMENT CLIMATE, GROWTH & POVERTY

in preparation for the

WORLD DEVELOPMENT REPORT 2005

Grand Hyatt Hotel, Berlin

03 to 05 September 2003

PROGRAMME

In cooperation with the German Federal Ministry for Economic Cooperation and Development (BMZ)

*InWEnt (Capacity Building International) was established in 2002 through a merger of the German Foundation for International Development and Carl Duisberg Gesellschaft.

Wednesday, 3 September 2003

06:30 P.M. **Welcome and Opening**

Speakers: **Gudrun Kochendörfer-Lucius,** Managing Director, InWEnt Capacity Building International, Germany

David Dollar, Director, Development Policy in the Development Economics Vice Presidency (DEC), The World Bank

Dinner at the Restaurant "Kaisersaal"

Thursday, 4 September 2003

09:00 A.M. **Current Thinking on Scope and Approach of WDR 2005**

Warrick Smith, Director, *World Development Report 2005,* The World Bank

09:30 A.M. **I: Investment, Productivity & Development: What Have We Learned?**

Chair: **David Dollar,** Director, Development Policy in the Development Economics Vice Presidency (DEC), The World Bank

Speakers: **John Haltiwanger,** Professor, University of Maryland, USA

Francis Teal, Professor, Oxford University, United Kingdom

11:30 A.M. **II: Investor Perspectives on the Investment Climate**

Chair: **Boris Pleskovic,** Research Manager, The World Bank

Speakers: **William Kalema,** Member of the Advisory Committee, Uganda Chamber of Manufacturers, Uganda

Reema Nanavaty, General Secretary, Self Employed Women's Association (SEWA), India

Bernd Stecher, Corporate Vice President, Siemens, Germany

01:00 P.M. *Lunch Speech:* **Nick Stern,** Senior Vice President and Chief Economist, Development Economics, The World Bank

02:30 P.M. **III: Securing Property & Contractual Rights**

Chair: **Jürgen Zattler,** Head of Division, Federal Ministry for Economic Co-operation and Development (BMZ), Germany

Speakers: **Erik Berglöf,** Director, Stockholm Institute of Transition Economics (SITE) at the Stockholm School of Economics, Sweden

Ahmed Galal, Executive Director and Director of Research, The Egyptian Center for Economic Studies (ECES), Egypt

Stefan Voigt, Professor, Kassel University, Germany

04:30 P.M. **IV: Finance Markets**

Chair: **Heinrich Siegmann,** Director of Department, InWEnt Capacity Building International, Germany

Speakers: **Stijn Claessens,** Professor, University of Amsterdam, The Netherlands

James Mwangi, Finance Director, Equity Building Society, Kenya

06:30 P.M. *Departure for dinner and sightseeing—boat cruise on the river Spree*

10:00 P.M. *Return by bus to the hotel*

Friday, 5 September 2003

09:00 A.M. **V: Regulation, Governance & Corruption**

Chair: **Mary Hallward-Driemeier,** World Development Report 2005, The World Bank

Speakers: **Peter Eigen,** Chairman, Transparency International, Germany

Mushtaq Khan, Senior Lecturer, University of London, UK

Joaquim Oliveira Martins, Principal Economist, Economics Department, Organisation for Economic Cooperation and Development (OECD), Paris

11:00 A.M. **VI: What Role for More Selective Interventions?**

Chair: **Warrick Smith,** Director, World Development Report 2005, The World Bank

Frederic Richard, Director, Industrial Policies and Research Branch, United Nations Industrial Development Organisation (UNIDO), Vienna

James Tybout, Professor, Pennsylvania State University, USA

12:30 P.M. *Lunch*

02:00 P.M. **VII: Reforming the Investment Climate**

Chair: **Michael Hofmann,** Director General, Federal Ministry for Economic Co-operation and Development (BMZ), Germany

Speakers: **Marek Belka,** Ambassador and Professor of Economics, Polish Academy of Sciences, Warsaw; Chairman, Council of International Coordination, Coalition Provisional Authority, Baghdad; former Deputy Prime Minister and Minister of Finance, Poland

Manuel Hinds, former Minister of Finance, Business and Government Consultant, El Salvador

Giandomenico Majone, External Professor, European University Florence, Italy, Visiting Distinguished Professor, EU Center and Graduate School of Public and International Affairs, University of Pittsburgh, USA

04:00 P.M. **Wrap-up discussion & implications for WDR 2005**

Chair: Warrick Smith, Director, World Development Report 2005, The World Bank

05:00 P.M. *Closing reception*

Appendix 2: Participants

Final List—September 2003

Marek Belka
Ambassador and Professor of Economics
Polish Academy of Sciences, Warsaw
Ciechocinska 17
93-459 Lodz
Poland
Phone: +48 22 520 5100
Email: marekbelka@poczta.com

Erik Berglöf
Director
Stockholm Institute of Transition Economics (SITE)
Stockholm School of Economics
Sveavägen 65
113 83 Stockholm
Sweden
Phone: +46 8 736 9676
Fax: +46 8 31 64 22
Email: Erik.Berglof@hhs.se

Stijn Claessens
Professor of International Finance
Faculty of Economics and Econometrics
University of Amsterdam
Roeterstaat 11
1018 WB Amsterdam
The Netherlands
Phone: +31 20 525 6020
Fax: +31 20 525 5285
Email: stijn@fee.uva.nl

David Dollar
Director, Development Policy
Development Economics (DEC)
The World Bank
1818 H Street, N.W.
20433 Washington, D.C.
USA
Phone: +1 202 473 7458
Fax: +1 202 522 0306
Email: DDollar@worldbank.org

Peter Eigen
Chairman of the Board
Transparency International (TI)
Otto-Suhr-Allee 97/99
10585 Berlin
Germany
Phone: +49 30 343 8200
Fax: +49 30 3470 3912
Email: pe_ti@transparency.org

Ahmed Galal
Executive Director and Director of Research
The Egyptian Center for Economic Studies
1191 Corniche El-Nil, WTC 14th Floor Boulaq
11221 Cairo
Egypt
Phone: +202 578 1202
Fax: +202 578 1205
Email: agalal@eces.org.eg

Mary Hallward-Driemeier
Senior Economist, Development Research Group
The World Bank
1818 H Street, N.W.
20433 Washington, D.C.
USA
Phone: +1 202 473 9120
Fax: +1 202 522 3518
Email: mhallward@worldbank.org

John Haltiwanger
Professor of Economics
University of Maryland
College Park
20742-7211 Maryland
USA
Phone: +1 301 405 3504
Fax: +1 301 405 3542
Email: haltiwan@eco.umd.edu

Manuel Hinds
Business and Government Consultant
Quinta Las Piletas; km 13,5 a La Libertad
San Salvador
El Salvador
Phone: +503 288 7681
Fax: +503 228 5627
Email: Mehinds@Attglobal.Net

Michael Hofmann
Director General, Global and Sectoral Tasks; European and Multilateral Development Co-operation
Federal Ministry for Economic Co-operation and Development (BMZ)
Friedrich-Ebert-Allee 40
53113 Bonn
Germany
Phone: +49 228 535 3801
Fax: +49 228 535 3804
Email: hofmann@bmz.bund.de

William Kalema
Member, Advisory Committee
Uganda Manufacturers Association (UMA)
Lugogo Show Grounds
P.O. Box 6966
Kampala
Uganda
Phone: +256 41 220 831
Fax: +256 41 220 285
Email: wskalema@utlonline.co.ug

Mushtaq Khan
Senior Lecturer
Department of Economics
School of Oriental and African Studies (SOAS)
Thornhaugh Street, Russell Square
WC1H 0XG London
United Kingdom
Phone: +44 20 7898 4546
Email: mk17@soas.ac.uk

Gudrun Kochendörfer-Lucius
Managing Director
InWEnt—Capacity Building International, Germany
Hallerstr. 3
10587 Berlin
Germany
Phone: +49 30 439 96 338
Fax: +49 30 439 96 220
Email:
gudrun.kochendoerfer@inwent.org

Giandomenico Majone
External Professor
Robert Schumann Centre of Advanced Studies
European University Institute, Florence
26, Via Lappeggi
50015 Grassina (Firenze)
Italy
Phone: +39 055 647 027
Fax: +39 055 468 52 01
Email: gian.majone@tin.it

Joaquim Oliveira Martins
Principal Economist
Economics Department
Organisation for Economic Co-operation and Development (OECD)
2, rue André Pascal
75775 Paris Cedex 16
France
Phone: +33 1 4524 8853
Fax: +33 1 4524 9175
Email: Joaquim.OLIVEIRA@oecd.org

James Mwangi
Finance Director
Equity Building Society
Fourway Towers, Muindi Mbingu
75104 Nairobi
Kenya
Phone: +254 2 330 433
Fax: +254 2 252 575
Email: Ebs@Nbnet.Co.Ke

Reema Nanavaty
General Secretary
Self Employed Women's Association (SEWA)
Opp. Victoria Garden
380 001 Bhadra, Ahmedabad
India
Phone: +91 79 550 64 77
Fax: +91 79 550 64 46
Email: bdmsa@icenet.net

Boris Pleskovic
Research Manager
The World Bank
1818 H Street, N.W.
20433 Washington, D.C.
USA
Phone: +1 202 473 1062
Fax: +1 202 522 0304
Email: bpleskovic@worldbank.org

Heinrich Siegmann
Director of Department
International Regulatory Framework, Good Governance, Economic Policy
InWEnt—Capacity Building International, Germany
Hallerstr. 3
10587 Berlin
Germany
Phone: +49 30 439 96 325
Fax: +49 30 439 96 336
Email:
heinrich.siegmann@inwent.org

Warrick Smith
Director, *WDR 2005*
The World Bank
1818 H Street, N.W.
20433 Washington, D.C.
USA
Phone: +1 202 473 0965
Fax: +1 202 522 0308
Email: wsmith3@worldbank.org

Bernd Stecher
Corporate Vice President
Siemens AG
Wittelsbacherplatz 2
80333 Munich
Germany
Phone: +49 89 636 33800
Fax: +49 89 636 32420
Email: bernd.stecher@siemens.com

Nicholas Stern
Senior Vice President and Chief Economist, Development Economics
The World Bank
1818 H Street, N.W.
20433 Washington, D.C.
USA
Phone: +1 202 473 37 74
Fax: +1 202 522 09 06
Email: nstern@worldbank.org

Francis Teal
Deputy Director of the Centre for the Study of African Economics
Department of Economics
University of Oxford
Manor Road
OX1 3UQ Oxford
United Kingdom
Phone: +44 1865 271 077
Fax: +44 1865 281 447
Email: Francis.teal@economics.ox.ac.uk

James Tybout
Professor of Economics
Pennsylvania State University
517 Kern Graduate Building
16802 University Park, PA
USA
Phone: +1 814 865 4259
Fax: +1 814 863 4775
Email: jtybout@psu.edu

Stefan Voigt
Professor for Economic Policy
University of Kassel
Nora-Platiel-Str. 4
34109 Kassel
Germany
Phone: +49 561 804 3089
Fax: +49 561 804 2818
Email: voigt@wirtschaft.uni-kassel.doc

Jürgen Zattler
Head of Division
World Bank, IMF
Federal Ministry for Economic Co-operation and Development (BMZ)
Friedrich-Ebert-Allee 40
53113 Bonn
Germany
Phone: +49 30 2503 2709
Fax: +49 30 2503 2632
Email: zattler@bmz.bund.de

Observers

Raj M. Desai
The World Bank
1818 H Street, N.W.
20433 Washington, D.C.
USA
Phone: +1 202 458 5288
Fax: +1 202 522 3518
Email: rdesai@worldbank.org

Paul Garaycochea
Federal Ministry for Economic Co-operation and Development (BMZ)
Stresemannstr. 94
10963 Berlin
Germany
Phone: +49 30 2503 2520
Fax: +49 30 2503 2632
Email: pgarayco@bmz.bund.de

Tim Irwin
Senior Economist, Infrastucture
The World Bank
1818 H Street, N.W.
20433 Washington, D.C.
USA
Phone: +1 202 473 7143
Fax: +1 202 522 3481
Email: tirwin@worldbank.org

Sonja Kurz
Project Manager
Economic Development and Employment
German Technical Co-operation (GTZ)
Dag-Hammerskjöld-Weg 1-5,
PO Box 5180
65726 Eschborn
Germany
Phone: +49 6196 791 213
Fax: +49 6196 796 157
Email: sonja.kurz@gtz.de

Rick Messick
Senior Public Sector Specialist
Public Sector Group
The World Bank
1818 H Street, N.W.
20433 Washington, D.C.
USA
Phone: +1 202 458 7942
Fax: +1 202 522 7132
Email: Rmessick@worldbank.org

Deena Philage
Senior Partnerships Officer
The World Bank
1818 H Street, N.W.
20433 Washington, D.C.
USA
Phone: +1 202 473 6971
Fax: +1 202 522 0304
Email: dphilage@worldbank.org

Stephano Scarpetta
Labour Market Advisor
Human Development
The World Bank
1818 H Street, N.W.
20433 Washington, D.C.
USA
Phone: +1 202 458 1119
Email: Sscarpetta@worldbank.org

Gaiv Tata
Lead Financial Analyst
Private Sector Development
Africa Region
The World Bank
1818 H Street, N.W.
20433 Washington, D.C.
USA
Phone: +1 202 473 2175
Fax: +1 202 614 0798
Email: gtata@worldbank.org

Katia Vostroknutova
Young Professional
World Development Report
The World Bank
1818 H Street, N.W.
20433 Washington, D.C.
USA
Phone: +1 202 473 5411
Email: evostroknutova@worldbank.org

Programme Coordination Team

InWEnt—Capacity Building International, Germany
Development Policy Forum
Hallerstr. 3
10587 Berlin
Germany
Phone: +49 30 43 996 341
Fax: +49 30 43 996 250
Email: ef@inwent.org
http://www.dse.de/ef/ef-e.htm

Joachim Müller
Senior Project Manager
Development Policy Forum
Phone: +49 30 43 996 361
Email: joachim.mueller@inwent.org

Klaus Krüger
Senior Project Manager
Development Policy Forum
Phone: +49 30 43 996 359
Email: klaus.krueger@inwent.org

Judith Klemmer
Project Manager
Development Policy Forum
Phone: +49 30 43 996 213
Email: judith.klemmer@inwent.org

Marianne Donda
Project Manager
Development Policy Forum
Phone: +49 30 43 996 342
Email: marianne.donda@inwent.org

Deena Philage
Senior Partnerships Officer
Phone: +1 202 473 6971
Fax: +1 202 522 0304
Email: dphilage@worldbank.org

Yasmin D'Souza
Conference Coordinator
Email: Ydsouza@worldbank.org

Conference Service

Ute Weber
Free University Berlin

Silvio Köhler
Free University Berlin

Axel Rückemann
Junior Project Manager

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This volume present papers from Berlin Workshop sessions on investment perspectives; securing property and contractual rights; the role of financial markets in spurring investment; regulation, governance, and corruption; selective interventions; and reforming the investment climate.

IN THIS VOLUME:

Introductory remarks by Gudrun Kochendörfer-Lucius and Boris Pleskovic; opening addresses by Gudrun Kochendörfer-Lucius and Warrick Smith; papers by Francis Teal, Bernd Stecher, Nicholas Stern, Erik Berglöf and Stijn Claessens, Ahmed Galal, Lars Feld and Stefan Voigt, Stijn Claessens, Peter Eigen, Mushtaq H. Khan, James R. Tybout, Manuel Hinds, and Giandomenico Majone; closing remarks by Warrick Smith.

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