An Evaluation of World Bank Investment Climate Activities

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Operations Evaluation Department

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Abbreviations and Acronyms

AFR   Africa region
CAE   Country Assistance Evaluation
CAS   Country Assistance Strategy
CEM   Country Economic Memorandum
CICIC Investment Climate Unit of the Investment Climate Department
CPIA  Country Performance and Institutional Assessment
EAP   East Asia Pacific region
ECA   Europe and Central Asia region
ESW   economic and sector work
EU    European Union
FDI   foreign direct investment
FIAS  Foreign Investment Advisory Service
FSAC  Financial Sector Adjustment Credit
FY    fiscal year
GDP   gross domestic product
IBRD  International Bank for Reconstruction and Development
IC    investment climate
ICRG  International Country Risk Guide
IDA   International Development Association
IFC   International Finance Corporation
LAC   Latin America and Caribbean region
MIGA  Multilateral Investment Guarantee Agency
MNA   Middle East and North Africa region
OED   Operations Evaluation Department
OEG   Operations Evaluation Group
OEU   Operations Evaluation Unit
OPCS  Operations Policy and Country Services
PIBL  Private Sector Institution Building Loan
PREM  Poverty Reduction and Economic Management
PSA   Private Sector Assessment
PSAL  Private Sector Adjustment Loan
PSD   private sector development
SAS   South Asia region
SME   small- and medium-scale enterprise
WBES  World Business Environment Survey
WBG   World Bank Group

Director-General, Operations Evaluation : Mr. Gregory K. Ingram
Director, Operations Evaluation Department : Mr. Ajay Chhibber
Manager, Sector and Thematic Evaluation : Mr. Alain Barbu
Task Manager : Ms. Kristin Hallberg
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Preface

The Investment Climate Study is a joint evaluation of the Operations Evaluation Department (covering the activities of IBRD/IDA), the Operations Evaluation Group (covering IFC), and the Operations Evaluation Unit (covering MIGA). The combined findings are summarized in a separate Overview report. This report presents OED’s evaluation of Bank activities.

The OED report reviews the Bank’s investment climate lending and non-lending activities during fiscal years 1993 through 2002-03 (the methodology is outlined in the Approach Paper of November 26, 2002). The report presents the collected findings of several evaluative exercises: a literature review; an analysis of investment climate themes in country assistance strategies and sector strategies; an analysis of lending operations as well as economic and sector work including survey-based diagnostic assessments; discussions with groups of international investors as well as with Bank staff; and client consultations and country case studies for five countries – Indonesia, Romania, India, Mozambique, and Peru. Separate reports on the literature review, the country case studies, and discussion groups are available upon request.

Special thanks are due to the members of the advisory panel for the study, who provided unique perspectives and advice:

- Roger Leeds, Professor at the School of Advanced International Studies of the Johns Hopkins University, and Director of the School’s Center for International Business and Public Policy.
- Beatriz Boza, former head of the regulatory body for competition policy in Peru (INDECOPI) as well as its investment promotion agency (PromPeru), and founding director of Ciudadanos al Dia, a non-profit organization that promotes transparency and good governance.
- Herbert Oberhaensli, Chief Economist and Head of Economic and International Relations, Nestle Corporation.
- John McMillan, Professor of Economics at the Stanford University Graduate School of Business, and Senior Fellow at the Stanford Institute of Policy Research.

The report benefited immensely from the insights of international investors who participated in discussion groups in Washington, Tokyo, Brussels, and London. The authors also are grateful to the staff members from the Bank, IFC, and MIGA who shared their experience in discussion groups in headquarters. Helpful guidance was provided by the internal peer reviewers for the report, Harry Broadman and John Nellis.

The OED report was written by Kris Hallberg and Ramachandra Jammi with assistance from Danuta Danilova. Background papers were prepared by Tyler Biggs (literature review and Mozambique case study), Eric Oldsman (India case study), Paul Holden (Romania and Peru

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1. The portfolio analysis covers fiscal years 1993 through 2003; the remaining components of the evaluation, which were prepared earlier, cover fiscal years 1993 through 2002. It should be noted that the World Bank Group is currently attempting to improve the focus and effectiveness of its investment climate activities as part of the re-emphasis on the growth agenda. Where relevant, these recent activities are noted but not evaluated.
case studies), Ashok Khanna (Indonesia case study), Benjamin Rowland (international investor discussion groups), and Ramachandra Jammi (staff discussion groups). William Hurlbut edited the report, and Helen Phillip provided administrative assistance.
Summary

A country’s “investment climate” is its environment for private sector activity. The quality of the investment climate is determined by the risks and transaction costs of investing in and operating a business, which in turn are primarily determined by the legal and regulatory framework, barriers to entry and exit, and conditions in markets for labor, finance, information, infrastructure services, and other productive inputs. Governments influence the quality of their countries’ investment climates through policies, institutions, and their relationship with the private sector. The quality of the investment climate is linked to poverty reduction by the impact of better investment climates on private sector activity, and thus on economic growth and employment.

Trends in the Investment Climate

As shown in OED’s Annual Review of Development Effectiveness 2003, the investment climates of developing and transition economies have improved modestly in recent years. Broad indicators of the policy and institutional environment – such as the Country Policy and Institutional Assessment (CPIA) rating compiled by the Bank – improved over the past five years in all regions, but particularly in the transition economies. However, looking at the components of the CPIA, it is noticeable that indicators of macroeconomic conditions (macroeconomic management, financial stability, and revenue stability) are higher than for some institutional areas (property rights, public administration, transparency, and rules-based governance). This suggests that institutional issues need attention.

The Bank’s Strategic Focus

Under different names, the investment climate was a part of Bank private sector development (PSD) strategies throughout the 1990s. Recently, however, the subject has risen to become one of the two pillars of the World Bank Group’s (WBG’s) corporate strategy for reducing poverty, and occupies center stage in the 2002 Private Sector Development Strategy of the World Bank Group. The increased prominence of the investment climate at the corporate level is mirrored in the shift in Country Assistance Strategies (CASs) over the past decade from first-generation to second-generation reforms. This “macro first, micro second” sequencing was not so much a planned strategy as the result of the disappointing supply response to first-generation reforms. Increasingly, the Bank has become aware of the importance of institutional reform to sustain growth. This shift in focus was appropriate, and is well supported by the literature.

CASs in all regions show a trend toward greater emphasis on the investment climate. However, the priorities given to different investment climate topics vary by region. For example, in East Asia, the emphasis has been on corporate governance, corporate restructuring, and financial sector reform. In Latin America and the Caribbean, there has been more attention to regulatory issues and competitiveness. To some extent, these differences reflect the macroeconomic environment, such as in East Asia following the financial crisis. They also reflect the fact that different investment climate constraints matter to different firms, because firms are diverse.
Non-Lending Services

The Bank’s economic and sector work (ESW) has helped motivate many governments to adopt investment climate reforms. Nevertheless, there are areas where more work needs to be done to provide guidance to clients as well as to Bank staff designing investment climate interventions. Not enough is known about good practice in institutional design, or about the dynamic process of changing institutions. It would be useful to have a typology of country situations and institutional designs that would provide guidance on which types of arrangements work where, how the change process happens, and how it can be supported and sustained. The Bank’s ESW and research have not yet provided enough of this knowledge of institutional design and the process of reform.

Diagnostic work on the investment climate has evolved toward greater use of enterprise surveys to provide information on the constraints to private sector development as perceived by firms. The most recent survey instruments do a good job of benchmarking indicators of the quality of a country’s investment climate in a way that allows cross-country comparisons as well as monitoring changes in individual countries over time. However, some clients have complained that surveys and assessments duplicate earlier work. This duplication is perhaps an inevitable consequence of the Bank’s objective of building a global investment climate database, but the Bank may need to clarify that objective to clients in order to manage expectations.

Other problems with investment climate diagnostics carried out during the review period have been (i) a lack of prioritization of problems and their proposed solutions, and (ii) an excessive focus on the manufacturing sector, urban areas, and formal sector firms as opposed to rural areas and the informal sector. These problems are beginning to be addressed in the most recent Investment Climate Assessments. Finally, it should be kept in mind that enterprise surveys provide valuable information on the perspectives of the private sector, but are an insufficient basis for policy recommendations. The views of business on public policies need to be balanced with other economic and social perspectives.

Lending Operations

A review of lending operations over the past ten years shows that investment climate lending, broadly defined, accounts for a large share of the Bank’s portfolio. In other words, supporting improvements in the investment climate is a large part of what the Bank has always done. At the same time, the investment climate share of the Bank’s total lending shows no observable trend over the past ten years, although it has varied. Thus, the Bank’s increased strategic focus on improving investment climates has not yet translated into a greater share of the loan portfolio being devoted to this objective.

The composition of investment climate lending also has remained relatively stable over fiscal 1993-2003. Of the five Core investment climate themes, regulation and competition policy has been and remains by far the dominant theme. Other areas – judicial reform, property rights, and corporate governance – received less emphasis, both in the early and later years of the period. Across Non-Core investment climate themes, infrastructure and financial sector operations are dominant.
Over the entire fiscal 1993-2003 period, Core investment climate projects performed better than the Bank average. Outcome ratings improved only slightly over the period, in contrast to a more significant improvement in the Bank-wide portfolio. Thus, the performance of Core investment climate projects is falling relative to the Bank average. An analysis of OED’s reviews of Implementation Completion Reports suggests that more recent investment climate projects were more heavily focused on longer-term institutional reforms that were more vulnerable to the political economy of reform, implementation and enforcement, and the capacity of public sector agencies.

From different angles, the various components of OED’s evaluation come to the same conclusion: institutions are key to the quality of the investment climate, and supporting institutional reform is a critical challenge for the Bank. The literature review provides evidence that cross-country differences in the quality of institutions explain a large share of the differences in growth, and may even “trump” other growth determinants. The case studies confirm this view by providing examples of countries where the Bank paid insufficient attention to institutional weaknesses, and as a result had little impact on the investment climate. And the slower than average improvement in the investment climate loan portfolio is explained by the increased concentration of investment climate projects on complex, politically-sensitive institutional reforms that take time to achieve results.

Organizational Issues

The investment climate is a broad topic, and this is reflected in the wide-ranging “ownership” of the Bank’s investment climate portfolio across networks and sector boards. In fact, more investment climate projects are assigned to non-PSD networks than to PSD. In a sense, this is a good thing: it shows that investment climate issues have been mainstreamed in the Bank. But it also means that coordination and teamwork across sector units is needed in order to design integrated strategies and to balance private sector perspectives with broader economic and social goals.

Coordination across the WBG on investment climate issues was weak during the period of the evaluation, both between the Bank and IFC and across sector units within the Bank. Competition for the investment climate agenda between PSD and the Poverty Reduction and Economic Management (PREM) units was common and led in some cases to a lack of coordination and information sharing. The burden of integrating different sector perspectives and setting priorities lay with the country departments — but some country departments were more actively involved in managing this integration than others.

The Bank needs to have an organizational structure that facilitates integration across sectors and collaboration among staff. Recently, the joint World Bank-IFC Private Sector Development Vice-Presidency has undertaken to improve coordination and reap synergies in investment climate work across the World Bank Group, for example by holding WBG-wide country review meetings and conducting WBG-wide training in the field. The Vice President of the Bank-IFC PSD vice presidential unit is also Chief Economist of the IFC.
Recommendations

The OED evaluation concludes with the following recommendations to improve Bank support for investment climate reforms:

- Pay more attention to institutions and the political economy of reform.
- Improve the focus and use of survey-based diagnostics.
- Do a better job of prioritizing and packaging investment climate reforms in lending operations.
- Find organizational solutions that help integrate microeconomic and macroeconomic reform agendas.
1. **Introduction**

1.1 A country’s “investment climate” (IC) is its environment for private sector activity. The quality of the investment climate is determined by the risks and transaction costs of investing in and operating a business, which in turn are primarily determined by the legal and regulatory framework, barriers to entry and exit, and conditions in markets for labor, finance, information, infrastructure services, and other productive inputs. Governments influence the quality of their countries’ investment climates through policies, institutions, and their relationship with the private sector. The quality of the investment climate is linked to poverty reduction by the impact of better investment climates on private sector activity, and thus on economic growth and employment.

1.2 Improving the investment climate of client countries is one of the two pillars of the World Bank Group’s (WBG’s) approach to development effectiveness and is central to the 2002 Private Sector Development Strategy. Despite the centrality of the topic, the PSD Strategy notes that “no rigorous effort has yet been made to analyze the relationship between the Bank’s PSD work in different countries and improvements in the countries’ investment climate…” OED has touched on some investment climate issues in earlier sector and corporate evaluations — of Bank support for policy reform (*2003 Annual Review of Development Effectiveness*), Bank assistance to the transition economies (2004), private sector development in the electric power sector (2003), private sector development in IDA countries (2001), as well as private sector development issues in specific sectors (e.g., extractive industries (2003), water supply and sanitation (2003)). In 1998, OEG and OED conducted an evaluation of the Foreign Investment Advisory Service. This broader and more comprehensive evaluation of the Bank Group’s IC work builds on the findings of previous selective evaluations.

1.3 The Investment Climate Study is a joint evaluation of the Operations Evaluation Department (covering the activities of IBRD/IDA), the Operations Evaluation Group (covering IFC), and the Operations Evaluation Unit (covering MIGA). The combined findings are summarized in a separate Overview report. This paper presents OED’s evaluation of IBRD/IDA activities.

**Evaluation Scope and Design**

1.4 The intended chain of causality from World Bank investment climate activities to economic performance outcomes has three parts:

- the link between Bank activities and the adoption of policy and institutional reforms
- the link between reforms and actual changes in the investment climate
- the link between changes in the investment climate and performance outcomes (firm-level productivity and profitability, and economy-wide productivity, investment, income, and employment).

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2. The “World Bank Group” refers to IBRD/IDA, the IFC, and MIGA; the “World Bank” or “Bank” refers to IBRD/IDA only.

1.5 The OED evaluation focuses on the first two links of the chain — from Bank activities to policy and institutional reforms, and for the country case studies, on the relationship between reforms and actual changes in the investment climate. The evaluation relies on a review of the literature to provide evidence on the relationship between improved investment climates and final economic outcomes.

1.6 The evaluation addresses the following questions:

- **Relevance of Bank assistance:** What relative priority did the Bank attach to addressing investment climate issues among its total interventions? Were the policy and institutional areas emphasized in Bank operations consistent with current empirical research linking investment climate indicators with performance outcomes, and with the obstacles to investment as perceived by potential investors? Do the survey-based diagnostics used by the Bank provide good information about the quality of the investment climate, and do they lead to sound policy advice?

- **Effectiveness of Bank assistance:** Are Bank activities helping to get investment climate reforms implemented? Was the Bank effective in motivating client governments to undertake reforms, beyond what they would have done in the absence of Bank intervention? Was conditionality in lending operations helpful in supporting reform? What were the outcomes of Bank interventions, in terms of the quality of the investment climate and in terms of investment and growth?

- **Sustainability:** What is required for investment climate improvements to be sustained? How should reforms be sequenced?

- **Organizational issues:** Does the Bank’s organizational structure support good investment climate work?

1.7 This report summarizes the findings of the following evaluation components, some of which appear in complete form as background papers (Annex 1 describes the tools and methods used):

- a review of the literature on the drivers of investment and growth, and of the microeconomic factors that determine investment behavior.
- a review of investment climate issues in Bank strategy documents — institution-wide PSD strategies, Country Assistance Strategies (CASs), and Poverty Reduction strategy Papers (PRSPs).
- a description and analysis of the portfolio of IBRD/IDA lending operations that support improvements in the investment climate.
- a description and analysis of IBRD/IDA non-lending services including economic and sector work and survey-based diagnostic assessments.
- results of structured discussions with Bank staff and international investors.

4. The evaluation does not cover small- and medium-scale enterprises (SME) or financial sector issues in depth as these are being addressed in other ongoing OED evaluations.

5. Available as a background paper for this report.


7. The results of international investor meetings are available as a background paper for this report.
• client consultations and country case studies for Indonesia, Romania, India, Mozambique, and Peru.\(^8\)

**A Review of Global Trends in the Investment Climate**

1.8 OED’s *Annual Review of Development Effectiveness (ARDE) 2003* evaluates the effectiveness of Bank support for policy and institutional reform in borrower countries. The indicators of policy and institutional performance presented in the ARDE can be interpreted as very broad indicators of the quality of the investment climate. The indicators compiled by four organizations — the World Bank’s Country Policy and Institutional Assessment (CPIA), the Heritage Foundation Index of Economic Freedom, the International Country Risk Guide (ICRG), and the Economist Intelligence Unit (EIU) Country Risk Service — agree that developing countries’ policies have, on average, improved modestly.\(^9\) Improvement is seen at both low- and middle-income levels (shown as IDA and IBRD country groups in Figure 1.1). Although there are some distinctive regional patterns, average ratings for the CPIA have also improved for every one of the Bank’s regions (Figure 1.2).

1.9 Improvements in the investment climate, measured very broadly by the CPIA, were greatest in transition economies — which started the reform effort from a lower base than the average — including some that joined the European Union on May 1, 2004 and those that aspire to EU accession. Countries whose investment climates deteriorated were more diverse. Five of the 10 countries showing deterioration between 1999 and 2003 were in Latin America and the Caribbean, which suffered macroeconomic crises during the period. Significant reform occurred in environments that were conducive to change, driven either by crisis (macroeconomic crisis or transition from planned to market economies) or opportunity (e.g., EU accession, the chance to join regional agreements, a new regime).

1.10 Looking at the components of the CPIA (Figure 1.3), it is evident that current ratings are highest in some of the macroeconomic areas that were the target of “first-generation” policy reforms supported by the Bank: macroeconomic management, trade and foreign exchange regimes, and public debt management. Ratings are lowest in some institutional areas — property rights and governance, transparency, and the quality of public administration — that are commonly termed “second-generation” reforms. This suggests that the Bank needs to focus its assistance on these institutional issues, which are among the core investment climate themes that are the subject of this evaluation.

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8. The country case studies are available as background papers and are summarized in Annex 4. The case study countries were chosen to achieve a diversity of regions, income levels, and economic systems, along with a significant volume of World Bank investment climate activity. The case study methodology is described in Annex 1.

9. OED (2004a), p. 6. The CPIA assesses borrower countries’ policy and institutional frameworks annually with regard to their capacity to foster poverty reduction, sustainable growth and the effective use of development assistance. The CPIA is currently being redesigned to better differentiate sub-themes such as the “business environment.” The Heritage Foundation Index measures developed and developing countries’ performance with respect to 50 policy dimensions. The ICRG Risk Rating System is a proprietary service that rates the risks faced by investors in a country based on political instability, economic vulnerability, and ability to meet financial obligations. The Economist Intelligence Unit Country Risk Service is a proprietary service that rates risks faced by investors in a country, designed for commercial bankers, institutional investors, and corporate executives who invest in emerging markets.
Figure 1.1: Investment Climate Indicators in Developing and Transition Economies (all rated IBRD/IDA countries)

Source: OED (2004a)

Figure 1.2: CPIA by Region, 1999 and 2003

Source: World Bank data
1.11 Country risk indicators provide a broad measure of policy and institutional performance. They provide a useful reminder that a lot remains to be done to improve the investment climate in many developing countries. Until recently there has been a lack of microeconomic data that could be used to compare the quality of the investment climate, at a detailed level, across countries. To fill this gap, the Bank’s Doing Business Project (discussed in Chapter 3) has just started collecting data on the cost of doing business in more than 130 countries (to be increased to 145 countries in 2005). The indicators will be updated annually to provide time series data on progress with reform. The project’s first publication on regulation allows cross-country comparisons of the cost of starting a business, hiring and firing workers, enforcing contracts, getting credit, and closing a business.

1.12 *Doing Business 2004: Understanding Regulation* shows that regulation varies widely around the world, but that rich countries regulate business in a more consistent manner than do poor countries. For example, it takes two days to start a business in Australia, but 203 days in Haiti and 215 days in the Democratic Republic of Congo. It costs more than five times per capita income in Cambodia to start a new business, and over thirteen times in Sierra Leone. Across all sets of indicators included in the 2004 surveys, Bolivia, Burkina Faso, Chad, Costa Rica, Guatemala, Mali, Mozambique, Paraguay, the Philippines, and

10. The Investment Climate Surveys and Assessments represent another effort to improve on cross-country indicators of the quality of the investment climate.

Venezuela regulate the most. Australia, Canada, Denmark, Hong Kong (China), Jamaica, the Netherlands, New Zealand, Singapore, Sweden, and the United Kingdom regulate the least.

1.13 Doing Business 2004 also shows that heavier regulation is associated with more inefficiency in public institutions and poor enforcement, as well as with worse economic outcomes. The costs of starting a business, going through bankruptcy proceedings, hiring and firing workers, and enforcing commercial contracts are associated with lower enterprise productivity and investment as well as with greater informality. Rigid employment laws are associated with fewer job opportunities for women, and regulatory restrictions on sharing credit information restrict access to credit particularly for small enterprises. The report recognizes the legitimate need for regulation to deal with market failures. Two examples are credit rights — the legal rights of lenders to recover their investment if the borrower defaults — and the efficiency of enforcing property rights through the courts. Countries that protect such rights achieve better social and economic outcomes.12

1.14 The real issue is not “more” or “less” regulation, but the effectiveness of regulation (although some argue that, in some areas, “less” is a good proxy for “effective”). Overregulation in developing countries comes from two sources: (a) a hangover of the past when the prevailing ethos was that the private sector was exploitative and had to be controlled, and (b) the wholesale adoption of regulatory systems from developed country models without any assessment of whether it was the right institutional model or whether the country had the institutional capacity to implement them. For example, Jamaica imported the British regulatory system in the 1980s with disastrous results, and has now shifted to much simpler rules-based regulation with arbitration provided by external courts.13

The Big Picture: Determinants of Investment and Growth

1.15 OED’s Annual Review of Development Effectiveness 2003 shows that policies and institutions matter a great deal in determining outcomes of the growth of per capita income and of social indicators. Countries with good policies and institutions, as measured by the CPIA, have the highest per capita income growth rates. In order to dig deeper into the relative importance of policies and institutions, this evaluation tried to unbundle the determinants of growth. A review of the literature shows that, at the highest level of aggregation, investment and growth are driven by accumulation and innovation, which in turn are determined by three broad variables — geography, policies, and institutions:

- **geography** includes exogenous factors such as endowments of natural resources, distance from important markets, and climate that help determine relative prices, transportation costs, and market structure.
- **policies** (sometimes called “integration”) include macroeconomic, trade, and sectoral policies that determine the integration of markets across regional and national boundaries and, hence, also help determine relative prices.
- **institutions** influence investment decisions by structuring the environment within which transactions occur, thus determining transactions costs and risk of production.

12. Ibid., pp. xv-xvi.
7

Box 1.1: Institutions and Organizations

_Institutions_ — often referred to as “the rules of the game” in institutional economics literature — are the humanly-devised constraints that shape human interaction. They may be formal (statute law, common law, and contracts between individuals) or informal (conventions, codes of conduct, and norms of behavior). They may be created (a nation’s constitution) or simply evolve over time (common law). Taken together, formal and informal rules, as well as the type and effectiveness of their enforcement, determine “how the game is played” — including how markets function.

_Organizations_ are groups of individuals that implement and enforce the rules of the game. They are influenced by institutions, and in turn influence how institutions evolve. Organizations include political bodies (such as regulatory agencies) as well as social and educational bodies.

Institutions affect the performance of the economy by their effect on the costs of exchange and production. Together with the technology employed, they determine the transaction and transformation (production) costs that make up total costs. Economies with underdeveloped institutional frameworks tend to favor activities that promote redistributive rather than productive activity, create monopolies rather than competitive conditions, and restrict opportunities rather than expanding them.

In practice, however, the distinction between “institutions” and “policies” is not always clear. The Bank’s operational notion of policy reforms – for example, Central Bank independence – sometimes overlaps with this broad definition of institutions.

_Source: North (1990), pp. 3-5._

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and exchange. Institutions include the legal and regulatory framework, administrative procedures, property rights, contract enforcement, corporate governance, etc. (Box 1.1).

1.16 Recent studies have tried to sort out the importance of these three broad investment climate variables in explaining economic performance at the country level. Most find that institutions “trump” geography and policies in explaining cross-country differences in income. Macroeconomic and structural reforms are necessary conditions for growth, and can stimulate an initial growth spurt even in the absence of a sound institutional framework, but modern institutions are needed to sustain growth. Principal among these institutional factors are the security of property rights, the rule of law, and absence of expropriation risk; political factors (political stability, civil liberty, and democracy); and the absence of corruption and graft.\(^{14}\)

1.17 It is clear that institutions matter a great deal for growth, but less is known about what constitutes “best practice” in institutional design. Different institutional arrangements seem to work in different countries, so it appears that there is no “one size fits all” institutional design. For example, the system of private property rights and Anglo-American corporate governance is not the only institutional arrangement that enforces the principle of protecting property rights. China, with its hybrid system of property rights and a legal regime that is far from the Anglo-American system, has supported a tremendous amount of investment and entrepreneurial activity.\(^{15}\) The literature on the country-specificity of institutions comes to

\(^{14}\) See, for example, Knack and Keefer (1995, 1997), Sachs and Warner (1995), Hall and Jones (1999), Acemoglu, Johnson, and Robinson (2001), Mauro (1995), and Kaufmann, Kraay, and Zoido-Lobatón (1999), and others cited in the literature review for this evaluation.

two conclusions. First, certain best-practice principles are applicable to all institutional arrangements, such as transparency, accountability, competition, the rule of law, and the protection of property rights. Second, the mechanisms to implement these principles vary from country to country, but are not completely unique to each. Between the two extremes of “one size fits all” and “uniqueness” in institutional design, macroeconomic management seems to be closer to a single, well-established model; education, health services, and social protection the most unique; and legal, regulatory, and financial sector models lie somewhere in the middle.16

The Determinants of Investment Behavior: Micro-Empirical Evidence

1.18 At a microeconomic level, many different factors determine the investment behavior of firms. A more nuanced picture emerges, with considerable difficulty in pinning down a common set of factors influencing the investment climate. Econometric evidence suggests that business fixed investment is influenced by tax policy and fiscal incentives,17 product market regulations,18 and high barriers to entry.19 Results from the World Business Environment Survey (WBES) show that taxes and regulations, financing, policy instability and uncertainty, and inflation matter most for company growth and investment.20 There are important differences across regions: in South Asia, street crime imposes the leading constraint, but in Africa infrastructure is identified as the second-leading problem after financing. In Central and Eastern Europe, inflation ties with taxes and regulations as the leading constraint.

1.19 Some overarching issues (e.g., regulatory uncertainty) matter to most firms, but more specific constraints may be ranked differently by different firms, because firms are diverse. The relative priority of various constraints seems to depend on the size, age, input mix, and mobility of the firm and the industry in which it operates. Foreign investors care about different constraints than domestic investors do because of their greater mobility. Foreign direct investment (FDI) decisions are more heavily influenced by macroeconomic and political risk than are domestic investment decisions. Compared with domestic investment, FDI is more positively associated with privatization, a competitive environment, the level of technological development, and lower regulation; it is less influenced by the availability of domestic credit.21 Even within countries, firms may be relatively immobile. In India, for example, private sector representatives interviewed for this evaluation indicated that, while streamlining regulations and procedures may facilitate investment in a particular state, differences in regulatory regimes among states would not induce domestic companies to

21. Batra and Mody (2003). It should be noted, however, that FDI may fluctuate in a country for reasons that have nothing to do with its investment climate — for example, economic cycles in source countries (particularly for investments in emerging market economies) and commodity prices (particularly for investments in Africa).
invest in one state over another. Local companies tend to remain where they first began operations, typically in the home town of the owner, and few firms have the capability to operate in multiple states.

1.20 The WBES finds that, for most categories of obstacles, small and medium enterprises identify themselves as more constrained than larger firms. Firms that are private, smaller, newer, devoid of FDI, and that cater to the domestic market generally tend to report more acute business constraints than do firms that are older, larger, that export, that have FDI, or that are state-owned. In facing some obstacles to doing business, medium-size firms identify themselves as equally or even more constrained than do small firms.

1.21 As part of this evaluation, interviews were conducted with a small number of multinational corporations headquartered in the United States, Europe, and Japan. Participants were asked to discuss the importance of investment climate considerations in their investment location decisions worldwide. The interviews confirmed the diversity in the relative importance assigned to these considerations stemming from the diverse needs of the firms (Box 1.2). For some, investment climate conditions take second place to factors such as cheap labor and large markets. Other investors cited physical security, rule of law, and currency convertibility as critical factors determining their investment locations. The cost and time required to register a business were viewed as relatively unimportant by most of these international investors.

Conclusions

1.22 Indicators of country-level policy and institutional performance show that the investment climates of developing and transition economies have improved modestly in recent years. Improvement is seen in both low- and middle-income countries, and across all Bank regions. The largest improvements were in transition economies — which started from a lower base — including countries that aspire to EU accession. Performance ratings are higher for macroeconomic conditions (macroeconomic management, financial stability, and revenue stability) than for some institutional areas (property rights, public administration, transparency, and rules-based governance), suggesting that these areas deserve attention.

1.23 The literature review conducted for this study provides evidence on the factors most important for investment and growth. At a broad level, policies and institutions determine growth outcomes. Macroeconomic and structural reforms are necessary conditions for growth, and can stimulate an initial growth spurt even in the absence of institutional reforms, but modern institutions are needed for sustained growth. Certain best-practice principles are applicable to all institutional arrangements, such as transparency, accountability, competition, the rule of law, and the protection of property rights. However, the institutional arrangements needed to implement these principles are somewhat country-specific. An institutional arrangement that is successful in one country doesn’t necessarily transfer well to another country without modifications, and unorthodox arrangements often work.

23. Summarized in a background paper for this report. Annex 1 contains information on these interviews and their participants.
Evidence from the literature and from interviews with international investors conducted for this evaluation indicate that different factors determine the investment behavior of individual firms, because firms are diverse. For foreign investors, investment climate conditions in host countries matter, but there are also firm-specific global strategic factors that influence investment decisions, such as the size of the internal market, low wages, and the actions of competing firms. Enterprise surveys show that firms that are private, newer, smaller, devoid of FDI, and that cater to the domestic market report more acute business constraints than do firms that are older, larger, that export, that have FDI, or that are state-owned.

**Box 1.2: Diverse Factors Influence Foreign Investment Decisions Because Firms are Diverse**

Interviews with multinational corporations conducted for this evaluation illustrate the diversity of factors that determined each company’s decision to locate or expand an overseas investment. For some firms, the exigencies of doing business — including access to large markets, cheap labor, natural resources, quotas, and sometimes incentives — dominated institutional factors, whether the latter were viewed positively or negatively. For other companies, institutional factors were decisive. Firm needs differed across manufacturing and service specialties, and between manufacturing and services. Some quotations from participants:

“Other things being equal, we are drawn first in our investment decisions to large markets that are under-served and have growth potential. But we can operate in smaller markets as well. For example, the Dominican Republic, though a small market, has been a successful investment for us. The critical factors are that we can set a fair tariff and take money out when we want.” *(U.S. telecom company)*

“We are constantly weighing risk against reward in a search for new business opportunities, and the factors that enter into these calculations, as well as the weight we assign to them, can vary a lot from one setting to the next. There is no formula. For example, we don’t like labor conditions or the treatment of intellectual property in China, but there is no question we have to produce there. We also produce in some smaller countries — for example, Singapore and Ireland — either because we have confidence in their political and macroeconomic stability or because the advantages of factors such as lower labor costs and investment incentives outweigh our perception of risks.” *(U.S. computer and information technology company)*

“Strictly speaking, I can’t tell you the principles we use for choosing an investment location because we’ve been shrinking our operations for the past few years, but maybe something is said by how we have consolidated. Our remaining operations tend to be located where labor is cheap and where there is a large internal market. Regrettably, we had to close our production facility in Ireland, even though it had a superior investment climate.” *(Japanese information technology company)*

“We are the epitome of a “reputation-sensitive” company. We market our products to final customers and we need to be responsive to their mounting concerns, particularly in the areas of environmental and labor conditions. Above all, we have to protect our brand. These are the ‘investment climate’ issues that affect us most directly.” *(U.S. footwear and apparel designer and distributor)*

“Investment climate conditions do not dictate where we work, but are an important factor when we get there and can affect the time and costs and profitability of individual projects — for example, the time and costs of obtaining licenses and permits; local corruption; quality, availability, and employment conditions of the local labor force.” *(U.S. construction and engineering company)*

“Investment climate issues are of course important in selecting overseas locations. One of our largest overseas investments is in Singapore, started as a joint venture with the Singapore government as partner. Singapore doesn’t have the cheapest labor or a very large internal market, but labor is competent and reliable, and the government and its policies are stable.” *(Japanese chemical company)*
2. The Bank’s Strategic Focus

From First-Generation to Second-Generation Reforms

2.1 Although the term “investment climate” came into use fairly recently, the topic — under such names as “business environment” or “enabling environment” — has been a part of private sector development strategy documents throughout the 1990s. The 1989 Private Sector Development Action Plan identified four priority areas for Bank support to promote PSD: (i) improving the business environment; (ii) public sector restructuring and privatization of enterprises, infrastructure, and services; (iii) financial sector development and transfer of resources; and (iv) research and policy work to establish a basis for future Bank operations. Bank assistance to improve the business environment was to take the form of adjustment operations to support policies, regulations, and legal reforms. The strategy also called for an expansion of the Bank Group’s Foreign Investment Advisory Service (FIAS).

2.2 Two years after the PSD Action Plan was adopted, the Bank took stock.24 Efforts to improve the business environment through adjustment operations was the area in which the Bank responded most promptly in terms of its PSD emphasis: three-quarters of the Bank’s adjustment operations in 1989-90 supported this objective. Components for dismantling barriers to market entry and exit were included in 60 percent of adjustment operations. There was also a large increase in the proportion of investment operations designed to enlarge the range of economic activities open to private agents. Country economic and sector work increasingly gave priority to identifying constraints to PSD and to developing programs to overcome them.25

2.3 In the early 1990s, at least as much attention was paid to other PSD topics as was paid to the investment climate.26 State-owned enterprise restructuring and privatization was at the core of Bank assistance to the transition economies. The PSD strategy for IDA countries issued in 1995 emphasized the drain of dysfunctional state-owned enterprises on poor economies and advocated privatization in IDA countries.27 The expansion of private investment in infrastructure during the mid- and late-1990s was supported in many countries by Bank operations. Financial sector reform predominated following Mexico’s devaluation in 1994 and the Thai devaluation in 1997. Although directed credit lines were largely abandoned by the 1990s, other forms of direct assistance to firms — particularly in non-financial services — continued throughout the decade.

2.4 In the second half of the 1990s, the Bank began to shift its focus from “first-generation” reforms — macroeconomic stability and trade integration — to “second-generation” reforms involving improvements in the administrative, legal, and regulatory functions of the State. Greater emphasis was placed on institutional development as well as

25. ibid., p. 9.
26. For a review of WBG PSD activities in the 1990s, see World Bank (2001a).
to addressing the social costs of PSD interventions, such as privatization-related labor retrenchment. Issues of transparency and corporate governance also were highlighted, especially after the East Asia crisis.  

2.5 The shift from first-generation to second-generation reforms — or the “macro first, micro second” sequencing — was not so much a planned strategy as a result of the disappointing supply response to first-generation reforms. Macroeconomic stability, financial sector reform, privatization, and trade liberalization were recognized as necessary but not sufficient conditions for sustained growth. Increasingly, the Bank became aware of the importance of institutional reforms, sometimes referred to as the “microeconomic foundations of growth.”

The Investment Climate Takes Center Stage

2.6 The past several years have witnessed a shift in emphasis in the Bank’s PSD strategy toward a clearer and more central role for the investment climate. In part this is due to the declining activity in both privatization and private investment in infrastructure. It also reflects the Bank’s broader corporate agenda: improving the investment climate is one of two pillars of the WBG’s approach to development effectiveness, and one of the “focal points” in the WBG’s corporate agenda.

2.7 The emphasis on the investment climate is especially noticeable in the 2002 Private Sector Development Strategy for the World Bank Group. The strategy cited several studies that suggest that the development impact of PSD activities in the Bank depends on the overall quality of the investment climate. Also cited is a recent OED review of PSD in IDA countries, which concluded that Bank operations “focused too narrowly on projects and did not tackle such fundamental constraints to PSD as the appropriate role of the State, financial sector reforms; institutional, legal, and regulatory bottlenecks, and the policy environment.”

The Strategy suggested that the relative neglect of investment climate reforms was due partly to opposition by vested interests in the countries concerned, and partly because the Bank continued to lend for direct support to firms.

2.8 The 2002 PSD Strategy placed special emphasis on improving the investment climate to extend the effective reach of markets. The Strategy called for country-level assessments of the quality of the investment climate, undertaken in consultation with the private sector. Enterprise surveys were to be used to identify constraints from the perspective of firms, and to link the policy and institutional environment to the performance of firms. Regular, standardized surveys would allow inter-country comparisons as well as the ability to track the implementation and results of reform over time. Investment Climate Assessments were to be integrated into other economic and sector work (ESW) products such as Country Economic Memoranda (CEMs) and Development Policy Reviews, and would underpin

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29. World Bank (2002a) and (2003a).
Country Assistance Strategies (CASs), Comprehensive Development Framework (CDF) exercises, and Poverty Reduction Strategy Papers (PRSPs). Building on these assessments, the Strategy expected that policy-based lending would be a major vehicle for advancing investment climate reform efforts, complemented by technical assistance operations and free-standing advisory services.

2.9 More recently, the Rural Development Strategy devoted considerable attention to investment climate issues in the rural sector, outlining necessary policy and institutional reforms such as more secure property rights, market access and free entry, market information, financial services, and rural transport, communication, and power infrastructure. The Agriculture Investment Sourcebook (2004), which provided practical guidance for the implementation of the strategy, also dealt with rural investment climate issues.

Investment Climate Strategies at the Country Level

2.10 Investment climate issues have received increasing attention in CASs over the fiscal 1993-2002 period. The most critical investment climate issues, and the Bank’s strategic response, vary significantly by region. Table 2.1 highlights the investment climate issues that received the most attention in CASs as well as the issues that were addressed, de facto, in investment climate-related lending in the region. The table shows the following regional patterns:

- **Africa (AFR):** The CASs emphasized the need to improve the enabling environment for business and make progress on privatization. Projects focus on achieving macroeconomic stability and building investor confidence (changing business perceptions regarding the risk of investing in the region), addressing institutional constraints, and improving the adaptation of private firms to competitiveness challenges.

- **East Asia and the Pacific (EAP):** Beginning with the Asian financial crisis, both the CASs and investment climate lending focused on corporate restructuring and corporate governance issues. Investment climate lending also supported financial sector reform.

- **Middle East and North Africa (MNA):** CASs focused on the need to improve competition policy. The lending program targeted macroeconomic stability as a means of reducing uncertainty, and addressed the problem of public monopolies.

- **South Asia (SAS):** CASs emphasize constraints in the business environment and the need for further privatization. Investment climate lending operations target the problem of pervasive government involvement in the economy.

- **Latin America and the Caribbean (LAC):** Major issues identified in the CASs include the lack of global competitiveness and the need for regulatory and judicial reform. Investment climate projects also focus on corporate governance and agricultural sector reform.

- **Europe and Central Asia (ECA):** CASs focus on the legal and regulatory framework, labor legislation, and privatization; investment climate lending covers judicial reform, property rights and land markets, corporate governance, access to finance, and bankruptcy law.

Table 2.1: Investment Climate Issues in Country Assistance Strategies, FY 1993-2002

<table>
<thead>
<tr>
<th>Issues addressed in CASs and Core IC projects</th>
<th>AFR</th>
<th>EAP</th>
<th>MNA</th>
<th>SAS</th>
<th>LAC</th>
<th>ECA</th>
</tr>
</thead>
<tbody>
<tr>
<td>24 countries/33 CASs</td>
<td>10 countries/14 CASs</td>
<td>5 countries/6 CASs</td>
<td>6 countries/9 CASs</td>
<td>18 countries/22 CASs</td>
<td>24 countries/36 CASs</td>
<td></td>
</tr>
<tr>
<td>Investor confidence</td>
<td>Corporate governance</td>
<td>Public monopolies</td>
<td>Pervasive government involvement</td>
<td>Corporate governance</td>
<td>Judicial system reform</td>
<td></td>
</tr>
<tr>
<td>Macro stability</td>
<td>Corporate restructuring</td>
<td>Lack of stability/uncertainty</td>
<td>Uncertain environment</td>
<td>Agricultural sector reform</td>
<td>Access to finance</td>
<td></td>
</tr>
<tr>
<td>Slow firm adaptation</td>
<td>Financial sector reform</td>
<td></td>
<td></td>
<td></td>
<td>Property rights</td>
<td></td>
</tr>
<tr>
<td>Enabling business environment/ Small and medium enterprises (SMEs)</td>
<td>Competition policy</td>
<td>Privatization</td>
<td>Regulatory/judicial reform</td>
<td>Enabling business environment (incl. legal)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment climate reform</td>
<td>Legal &amp; regulatory reform</td>
<td>Business environment</td>
<td>Deregulation/monopolization</td>
<td>Privatization</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Privatization / vs credit to PS</td>
<td>Transparency</td>
<td></td>
<td></td>
<td>Global competitiveness</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other issues emphasized in CASs*</td>
<td>Legal and regulatory reform</td>
<td>Public/private partnerships</td>
<td>SME Competitiveness</td>
<td>Difficulty attracting investment</td>
<td>Deregulate investment regime</td>
<td>High barriers to SME entry &amp; growth</td>
</tr>
<tr>
<td>Role of government/bureaucracy/arrears</td>
<td>Competition policy</td>
<td>Slow pace of privatization</td>
<td>Improve incentives for SMEs</td>
<td>Low FDI</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Need for private investment</td>
<td>Access to credit</td>
<td>Regulatory system</td>
<td>Attract foreign investment</td>
<td>Administrative corruption</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dialogue w/ private sector</td>
<td>Macro environment</td>
<td>Enforceability of contracts</td>
<td>Completing privatization</td>
<td>Poorly functioning markets; ease of entry and exit</td>
<td></td>
<td></td>
</tr>
<tr>
<td>High interest rates</td>
<td>Competitiveness</td>
<td>Land tenure</td>
<td>Strengthening investment climate</td>
<td>Communication infrastructure</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Institutional constraints</td>
<td>Private corporate debt</td>
<td>High cost of capital</td>
<td>Liquidity problems/bankruptcies</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Infrastructure</td>
<td>Enabling environment</td>
<td>Weaknesses in manufacturing export</td>
<td>Government interference and over-regulation of private sector activities</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dominance of conglomerates</td>
<td>Conglomerates</td>
<td>Fostering potential industries</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unemployment/land constraints</td>
<td>Uneven playing field w/ state-owned enterprises</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* Issues that were included in the development priorities matrix at the end of the CAS.
2.11 OED’s Country Assistance Evaluations (CAEs) assess the fit between country priorities and the Bank’s assistance strategy. A review of the 42 CAEs completed between 1997 and 2003, which evaluated progress against the latest corresponding CASs, shows that one or more investment climate issues were of high country priority in 28 countries; the Bank assigned high priority to the same issues for 23 of these countries. The most frequent obstacles to achieving better investment climate outcomes were a lack of government ownership and capacity (e.g., Lithuania) and the hesitancy in completing reforms because of political sensitivities (e.g., Mongolia). Reform efforts were sometimes hindered by a lack of role models to support entrepreneurship (e.g., Mongolia), and participation and partnership of more domestic and donor stakeholders (e.g., Uganda). The Bank was criticized in some CAEs for not giving enough weight to governance issues, weak institutions, and civil service reform (e.g., Ghana, Bolivia). In many cases, the CAEs argue that the Bank’s ideas and policy advice have often been more useful than lending. The Bank’s ESW, policy dialogue, and aid coordination were assessed in several cases to be timely, of good quality, and appreciated by governments (Guatemala, Sri Lanka, Ukraine).

2.12 OED’s recent evaluation of Bank assistance to transition economies33 shows that Bank assistance programs initially reflected the view that privatization must take place quickly, taking advantage of limited reform “windows,” to prevent the possibility of reversals. The hope was that new private owners would lobby for further liberalizing reforms and supporting institutions. Few Bank PSD projects in these countries contained specific institutional components, and the majority of regulatory reform and competition policy projects were initiated after privatization in most transition economies, especially in the Commonwealth of Independent States. In hindsight, it is apparent that the Bank, along with other donors, should have tried harder to promote the improvement of the institutional framework for business and investment, as well as, and in parallel with, privatization.34

2.13 The country case studies conducted for this evaluation provide examples of CASs that have been moving from first-generation to second-generation reforms (Box 2.1). Exceptions were found for those countries that experienced macroeconomic crises, where the CASs necessarily focused on restoring macroeconomic stability (for example, Indonesia in the late 1990s).

2.14 The country case studies and focus group discussions conducted for this evaluation suggested that the Bank is (or is perceived to be) more focused on promoting foreign investment than domestic investment. In Mozambique, for example, Bank activities were reasonably successful in developing Mozambique’s investment promotion capacity, and this has helped bring foreign investment into the country. However, most of these investments were large “mega-projects” that came in under special negotiated conditions and circumvented many of the administrative barriers faced by local investors. While this strategy did some good by helping Mozambique establish itself as open to business, small domestic investors still face administrative barriers to doing business, and the degree of linkages between foreign investors and local firms is a matter of debate.

33. OED (2004b).
34. ibid., pp. 18-19.
Box 2.1: The Increasing Focus on the Investment Climate in Country Assistance Strategies: Evidence from Country Case Studies

The Bank’s Mozambique strategy stressed the investment climate from the beginning. However, the particular aspect of the investment climate emphasized changed as the country’s political conditions improved and the transition progressed from plan to market. Bank activities focused on securing first-generation and second-generation reforms have been timed and sequenced well — based on strategic necessity, sound economic principles, and prevailing social and political conditions. In the war years, when conditions were difficult, adjustment lending supported incremental steps toward price and trade reforms, privatization, and improved public expenditure management, which were critical in laying the foundation for recovery and growth once peace was established. In the recovery and growth years after 1995, macro reforms continued, at the same time, microeconomic reforms of administrative and regulatory barriers and legal institutions featured more prominently in the Bank’s program. This sequencing of investment climate reforms was necessary in Mozambique because of the urgency of problems as seen by investors, and the feasibility of changes. Removing administrative and regulatory barriers to investment was bound to be a complex and long-term process, particularly given Mozambique’s economic and political history. Moreover, microeconomic reforms such as these would not have had much impact on investment in the face of poor macroeconomic incentives.

The Bank’s strategy for Romania during 1992-98, contained in a 1991 CEM, focused on macroeconomic stabilization, price liberalization, and transformation of the command economy to a market-oriented system. The report said little about the institutional foundation of markets and lacked an extensive treatment of financial markets. The late 1990s witnessed much stronger government dedication to promoting the private sector, as well as stronger commitment to reform. The 2001 CAS emphasized strengthening institutions for a market economy — governance, anti-corruption, and the business environment. Recent projects have focused on institutional reforms critical for private sector development, including the reform of the legal environment for business, the reduction of regulatory burdens, and secured transactions reform to facilitate collateralization of assets for loans.

The 1997 CAS for Indonesia was presented to the Board in June of that year, a few weeks before the crisis erupted in Thailand. It acknowledged the progress made during the 1980s and early 1990s on the trade regime, investment licensing, financial intermediation, privatization, and private participation in infrastructure. It identified a number of remaining weaknesses, including the undeveloped legal and regulatory framework (land use and bankruptcy), the lack of transparency in the enforcement of regulations, a shortage of technical and managerial skills, excessive regulation, tariff and non-tariff barriers in agricultural markets, outdated laws and regulations covering financial intermediaries, and weak bank supervision. After the crisis, the 2001 CAS shifted focus to macroeconomic stabilization and to helping the financial and corporate sectors resolve the overhang of corporate debt and enable the resumption of financial flows for investment and working capital. Economic reports focused on assessing the impact of the crisis on banks and corporations, and on designing an approach to restructuring them to expedite recovery and resume growth. This focus on macroeconomic stabilization and bank and corporate restructuring was appropriate under the circumstances.

2.15 Discussions with Bank staff suggested that some topics have received little attention. Investment climate issues in rural areas, in particular the constraints to non-farm income-earning activities, have received little coverage because of the mainly urban, manufacturing-sector focus of survey-based diagnostic assessments. Other issues that have received limited coverage are labor laws; competition policy; the informal sector; and land and property rights (particularly in AFR and ECA), though it was acknowledged that these are politically
difficult. In general, staff felt that investment climate issues that involve genuine market failure should receive more attention.\footnote{More recently, the PSD Network has been piloting rural Investment Climate Assessments in collaboration with the Agriculture and Rural Development Network. Labor and property rights issues are to be covered in Doing Business 2005, and informal sector studies were commissioned by the 2005 World Development Report. In addition, it should be noted that land and property rights issues have been dealt with in research by the Development Economics and Environmental and Socially Sustainable Development departments, and competition policy in the LAC Region.}

**Translating the Strategy into Operations**

2.16 Comparing the Bank’s increased strategic focus on second-generation issues in CASs with the trend in the share of investment climate projects in the portfolio, it appears that the strategic shift toward investment climate issues has not been implemented in the Bank-wide lending program. Using either a broad or narrow definition of the investment climate portfolio (described in Chapter 4), the share of investment climate projects in the Bank’s portfolio shows no observable trend over the FY93-03 period, although it has varied (see Chapter 4, Figure 4.3).

2.17 Interviews and case studies conducted for this evaluation indicate that several issues may explain why the share of investment climate lending has not increased. One problem has been the lack of data on the quality of different aspects of the investment climate, which has made it difficult to identify priority problems, draw comparisons across countries, and monitor progress. This issue is now being addressed primarily through the preparation of investment climate diagnostics based on standardized enterprise surveys (discussed in Chapter 3).

2.18 Second, while it is clear that the Bank needs to increase its focus on building and reforming institutions, less is known about “best practice” in institutional design (an issue raised in the preceding chapter). The basic principles of good investment climates are well recognized (for example, a high degree of competition, protection of property rights, contract enforcement), but the institutional arrangements for applying these principles seem to be highly country-specific. Strategies for improving the investment climate in individual countries have suffered from a lack of knowledge about what types of institutional arrangements will succeed in different environments, and about the dynamic process of change that is needed.

**Conclusions**

2.19 Under different names, the investment climate has been a theme in Bank PSD strategies and CASs throughout the 1990s. More recently, the subject has become prominent in the Bank’s corporate strategy and in the 2002 World Bank Group PSD Strategy. Greater emphasis has been placed on collecting and monitoring comparable data on the quality of the investment climate at the country level, and measuring country performance against these indicators.

2.20 The increased prominence of the investment climate in sector strategy papers and CASs mirrors the Bank’s shift in emphasis from first-generation to second-generation
reforms. This “macro first, micro second” sequencing was not so much a planned strategy as the result of the disappointing supply response to first-generation reforms. Increasingly, the Bank has become aware of the importance of institutional reform to sustain growth, and this recognition is noticeable in the CASs during the period. This shift in focus was appropriate, and is well supported by the literature.

2.21 The Bank’s increased strategic focus on improving investment climates has not yet translated into a greater share of the loan portfolio being devoted to this objective. Except for an increase in fiscal 2002, the investment climate share of the loan portfolio, using either a broad or narrow definition of the investment climate, shows no observable trend over the past 10 years.
3. Non-Lending Services

3.1 The Bank is involved in a wide range of analytical and advisory activities on investment climate issues. Principal among these are ESW on various investment climate topics and survey-based diagnostics of the constraints of doing business. This chapter briefly describes relevant ESW and then looks in more detail at recent diagnostic work.

Economic and Sector Work

3.2 Over the past decade the Bank has produced a large number of reports on investment climate issues. Analysis of investment climate topics is frequently part of economic reports (CEMs, Development Policy Reviews) and sector reports (for example, on industrial development, competitiveness, export development, governance, and small and medium enterprise development). In addition to these formal vehicles of non-lending assistance, advice is also provided informally to governments and the private sector through discussions, sharing of information, and in-country seminars.

3.3 A keyword search identified more than 2,800 reports and working papers produced since fiscal 1990 that at least touched upon investment climate issues. A much smaller number were primarily directed toward core investment climate themes: 307 reports were directed toward one or more core investment climate themes during FY93-03, with a larger number in the second half of the decade (Table 3.1). About 45 percent of these reports were policy research working papers rather than formal ESW. The topics that have received the most attention were those in the legal area (judicial and other dispute resolution mechanisms, legal institutions for a market economy) followed by regulation and competition policy. Of the regionally focused reports, almost 40 percent were in the ECA region; the lowest numbers were in the MNA and SAS regions. In ECA, corporate governance was the most important topic; in LAC, regulation and competition policy received the most attention. In ECA and East Asia, property rights were also important.

Table 3.1: Bank Reports on Investment Climate Issues, FY93-03

<table>
<thead>
<tr>
<th>Core IC Theme</th>
<th>FY90-96</th>
<th>F 97-03</th>
<th>Total</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment climate/business environment</td>
<td>44</td>
<td>49</td>
<td>93</td>
<td>30%</td>
</tr>
<tr>
<td>Regulation and competition policy</td>
<td>31</td>
<td>44</td>
<td>75</td>
<td>24%</td>
</tr>
<tr>
<td>Property rights</td>
<td>25</td>
<td>30</td>
<td>55</td>
<td>18%</td>
</tr>
<tr>
<td>Corporate governance</td>
<td>27</td>
<td>18</td>
<td>45</td>
<td>15%</td>
</tr>
<tr>
<td>Legal institutions for a market economy</td>
<td>8</td>
<td>13</td>
<td>21</td>
<td>7%</td>
</tr>
<tr>
<td>Judicial and other dispute resolution mechanisms</td>
<td>7</td>
<td>11</td>
<td>18</td>
<td>6%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>142</strong></td>
<td><strong>165</strong></td>
<td><strong>307</strong></td>
<td><strong>100%</strong></td>
</tr>
</tbody>
</table>

(Unique documents) 262

3.4 A recent OED review of the treatment of PSD in 15 Country Assistance Evaluations (CAEs) found that, in general, the Bank’s economic and sector work (ESW) and related
advisory services in PSD had generally been effective. The CAEs remarked that the Bank has a comparative advantage in ESW and that good ESW is important to both the clients and donors and has a bearing on the quality of the Bank’s lending. However, the OED review also identified several cases of insufficient ESW, which lowered the quality of the Bank’s strategy and lending work. They also identified cases of inadequate participation by clients and poor in-country dissemination of the findings, which reduced the effectiveness of many good ESW pieces.

3.5 Evidence from the country case studies conducted for this evaluation indicates that the Bank’s ESW on investment climate issues has helped define the reform agenda and has been appreciated by clients — in fact, they encouraged the Bank to do more (Box 3.1). However, some of the officials interviewed suggested that recent reports have presented the same policy recommendations as earlier reports. While recommendations that were not adopted may bear repeating, this feedback suggests that the Bank may need to be more selective and focused in its choice of ESW.

3.6 What is striking is that, despite the quantity and quality of investment climate ESW that has been produced by the Bank over the past 10 years, many have observed that “we really don’t know very much” about good practice in institutional design, nor about the dynamics of reforms to improve the investment climate. While basic economic principles are well accepted (for example, the benefits of competition), there is less knowledge about the institutional arrangements to apply these principles (for example, laws governing competition and the organizations that implement them). These institutional arrangements are neither “one size fits all” nor completely country-specific. It would be useful for the Bank to develop (perhaps building on the taxonomy used in Chapter 5 of this report) a typology of country situations and institutional designs that would provide guidance on which types of arrangements work where, how the change process happens, how it can be supported and sustained, etc. — in other words, an understanding of what types of institutional arrangements are transferable in different country contexts. The Bank’s research and ESW have not yet provided enough of this knowledge of institutional design and the process of reform.

Survey-Based Diagnostics

3.7 Over the past decade, the Bank has employed several diagnostic tools to assess the quality of a country’s investment climate and the constraints facing private enterprises:

- Private Sector Assessments (PSAs), many of which were based on enterprise surveys to determine perceived constraints in the business environment.
- The World Business Environment Survey (WBES) and the Firm Analysis and Competitiveness Survey (FACS).

36. OED (2001a). Note that there have been few Quality Assurance Group evaluations of investment climate-related ESW, particularly of survey-based diagnostic instruments such as Private Sector Assessments.

37. Based on the literature review as well as input from the external advisory panel for this evaluation.

38. The findings of the WBES surveys are summarized in Batra, Kaufmann, and Stone (2003).
Box 3.1: Relevance of the Bank’s Analytical Work: Evidence from Country Case Studies

Evidence from the country case studies confirms the important contribution that high-quality, well-focused, and strategically timed ESW can make to the quality of the Bank’s lending operations and their impact on the investment climate. There were cases where this has worked well (Romania), others where important topics were missed (Indonesia), and other cases of repetition and redundancy (Peru), detailed below.

The Bank’s analytical work in Mozambique beginning in 1996 made relevant contributions to the process of removing microeconomic constraints to investment. Among these were the FIAS Administrative Barriers to Investment studies (1996, 2001) and Investment Climate Assessments (1997, 2002) that helped to identify the reform agenda. To facilitate a continuing dialogue between government and business concerning investment climate reforms, the Bank supported an annual private sector conference. Studies that focused on government red tape, such as the FIAS studies, detailed long lists of problems. Business leaders interviewed for this evaluation asserted that the recommendations were not sufficiently prioritized. They felt that there was not enough focus on selected priority issues, action plans for organizing to implement the reforms, monitoring arrangements, and mechanisms for accountability for success or failure.

In pre-crisis Indonesia, Bank reports consistently pointed out several structural weaknesses that could impede future private sector-led growth. Although these analyses were appropriate for Indonesia at the time, they lacked depth in one crucial respect. While weaknesses in the financial sector were well analyzed, the obvious connection to weaknesses in the corporate sector was not explored. It was well known that insider lending, stemming from joint ownership of banks and corporations, caused some of these bad loans. Borrowing was collateralized by inflated asset values and facilitated by weak accounting practices, which were not investigated. Thus, a comprehensive framework for Bank Group assistance to the financial and corporate sector was missing.

In Romania, the successful investment climate activities of the past few years appear to have been based on more intensive ESW. Among the reports produced were a 1999 FIAS report that identified the most important obstacles to business growth, which were incorporated in the conditionality of the First and Second Private Sector Adjustment Loans (PSALs I and II); Romania’s Evolving Legal Framework for Private Sector Development (2002), which addressed property rights, rules for entry and exit of productive activity, and rules for market exchange; and Financial Markets, Credit Constraints, and Investment in Rural Romania (2001) that provided the basis for the financial market components of PSAL I and PSAL II. Several of those interviewed for this evaluation indicated that the priority given to the investment climate by the government has been a result of the Bank’s enterprise surveys and analysis.

In Peru, the Bank engaged in a substantial amount of ESW on investment climate issues during the past 10 years, including a 1993 reports on measures needed to establish a competitive market economy; a 1994 Private Sector Assessment; a secured transactions analysis in 1997; and a 2003 Investment Climate Assessment. While the reports were of high quality, many of the recommendations contained in the later reports were similar to those in earlier sector work.

- The Regional Program for Enterprise Development (RPED) in the Africa Region, which combined enterprise survey data with productivity analysis and sector studies.
- FIAS studies of the administrative barriers to doing business.39

39. FIAS was the subject of a 1998 evaluation by OEG, and is covered in the OEG part of the present evaluation.
3.8 Private Sector Assessments (PSAs) were developed in 1991 to strengthen the private sector perspective in the Bank, to provide the basis for Bank Group assistance strategies for PSD, and to encourage stronger World Bank Group collaboration on these issues. The Board mandated the involvement of the IFC, as it was considered to be in closer touch with the private sector, and private sector consultations and surveys were recommended to capture the views of a broad cross-section of the private sector. PSAs were to be country-specific and flexible in coverage, but each was to include a description and analysis of the private sector and its role in the economy as well as constraints to private sector development. About 30 PSAs were prepared, most in the early 1990s.

3.9 A 2001 OED review of PSD in IDA countries contained a brief evaluation of PSAs. The evaluation found that, at their best, PSAs deepened Bank staff and government policymaker understanding of PSD issues and enhanced the dialogue between business and government. They also contributed to country strategy and led to follow-up through projects or policy conditionality. However, PSAs varied widely in scope, methodology, and quality. Some staff argued that some PSAs failed to provide substantially new insights into the problems of the private sector or to identify strategic priorities and actionable recommendations for promoting PSD. As market-oriented perspectives on economic development became more mainstream, the cost-effectiveness of PSAs as separate exercises was increasingly questioned. Task managers increasingly preferred more focused analysis on specific issues.

3.10 A number of elements of PSAs became incorporated in subsequent work including the WBES surveys, which used a uniform core questionnaire to measure and compare business environment conditions and constraints in 80 countries and in the West Bank and Gaza. The WBES was launched through the World Bank Group’s Innovation Marketplace in 1998 and reflected collaboration across units of the Bank Group (Development Economics, FIAS, IFC, Poverty Reduction and Economic Management [PREM], PSD, and World Bank Institute) as well as with external organizations (the European Bank for Reconstruction and Development, the InterAmerican Development Bank, and Harvard University). The WBES attempted to standardize the types of analysis carried out by the earlier PSAs to assess conditions for private investment in developing and transition countries, as shaped by local economic policy; governance; regulatory, infrastructure, and financial impediments; and services to businesses. At least 100 firms were surveyed in each country. The WBES were seen as potentially more cost-effective than PSAs, and thus more attractive to operational staff.

3.11 Although the WBES has not been evaluated independently by OED, a number of observations in the Bank’s own summary of WBES results are consistent with OED’s findings on Private Sector Assessments (PSAs) and more recent survey-based diagnostic instruments. The summary cited, first, the need for better coordination, comparability, and uniformity of the core survey and implementation between partner institutions. Second, it is important to account for inherent biases and measurement errors in any survey of this type.

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40. OED (2001b).
41. The findings of the WBES surveys are summarized in Batra, Kaufmann, and Stone (2003).
This necessitates care in interpretation and the use of control variables, and suggests that survey results should be complemented with other data in order to assess the investment climate. Even though perceptions matter significantly for firm behavior and decision-making, they are only imperfectly related to underlying physical and cost conditions. This underscores the desirability of complementing questions of perception with more quantitative evaluations of a firm’s experience of costs associated with various constraints. Finally, larger and more representative samples, particularly for economy-wide surveys and for core questions, would be desirable.42

3.12 More recently, the PSD Vice-Presidency has developed two new diagnostic tools: Investment Climate Assessments (ICAs, described in Box 3.2) and the Doing Business project (Box 3.3). These two instruments are at the core of the Bank’s current analytical work

<table>
<thead>
<tr>
<th>Box 3.2: Investment Climate Surveys and Assessments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment Climate Assessments (ICAs) are designed to systematically analyze conditions for private investment and enterprise growth. Underpinning all ICAs is a standard core investment climate survey instrument (the Investment Climate Survey, or ICS), which allows the comparison of existing conditions and the benchmarking of conditions to monitor changes over time. The survey is administered to managers of firms and consists of a core set of questions as well as several modules that can be used to explore in greater depth specific aspects of the country’s investment climate and links to firm-level productivity. The core survey has 11 sections:</td>
</tr>
<tr>
<td>• General information about the firm: ownership, activities, location.</td>
</tr>
<tr>
<td>• Sales and supplies: imports and exports, supply and demand conditions, competition.</td>
</tr>
<tr>
<td>• Investment climate constraints: evaluation of general obstacles.</td>
</tr>
<tr>
<td>• Infrastructure and services: power, water, transport, computers, and business services.</td>
</tr>
<tr>
<td>• Finance: sources of finance, terms of finance, financial services, auditing, land ownership.</td>
</tr>
<tr>
<td>• Labor relations: worker skills, status and training, skill availability, over-employment, unionization and strikes.</td>
</tr>
<tr>
<td>• Business-government relations: quality of public services, consistency of policy and administration, customs processing, regulatory compliance costs (management time, delays, bribes), informality, capture.</td>
</tr>
<tr>
<td>• Conflict resolution/legal environment: confidence in legal system, resolution of credit disputes.</td>
</tr>
<tr>
<td>• Crime: security costs, cost of crimes, use and performance of police services.</td>
</tr>
<tr>
<td>• Capacity, innovation, and learning: utilization, new products, planning horizon, sources of technology, worker and management education, experience.</td>
</tr>
<tr>
<td>• Productivity information: employment level, balance sheet information (including income, main costs and assets).</td>
</tr>
</tbody>
</table>

To date, 8 ICAs have been posted on the ICA website. Most are conducted at the national level, although the India ICA focused on the state level. The number of firms in the sample has varied widely, in part due to the different size of the countries: from 1,032 in India to 659 in Bolivia, 576 in Peru, 223 in Nepal, 193 in Mozambique, and 98 in Bhutan.

More recently (since 2003), Rural Investment Climate Surveys have been piloted in Sri Lanka, Tanzania, and Nicaragua.

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on the investment climate, and in particular are providing the means of tracking the performance of IDA countries on achieving PSD targets. The ICAs and Doing Business have tried to address these issues by providing standardized instruments with better quality control by the PSD Sector Board. Measuring the same variables in a consistent way allows benchmarking — comparisons across countries at a particular point in time, and tracking changes over time in a particular country. Objective and quantitative measures of the policy environment demonstrate to policymakers that change is possible, and give credibility to reform efforts.

**Box 3.3: The “Doing Business” Project**

The Doing Business Project investigates regulations that enhance business activity and those that constrain it. Quantitative indicators on business regulations and their enforcement are being gathered that will allow comparisons across more than 145 countries, and over time. The indicators are based on assessments of laws and regulations, with input from and verification by local experts.

In contrast to the Investment Climate Surveys, information is gathered from surveys of experts rather than firms. The questionnaire is administered to local professionals experienced in their fields, such as incorporation lawyers and consultants for business entry, or litigation lawyers and judges for contract enforcement.

The Doing Business methodology aims for comparability across countries, so that most indicators are structured around a hypothetical firm: a limited-liability company that operates in the country’s most populous city; is domestically owned; has start-up capital of 10 times income per capita, paid in cash; performs general industrial or commercial activities; leases the commercial plant and offices; does not quality for investment incentives or any special benefits; has up to 50 employees, all of them nationals; has turnover of at least 100 times income per capita; and has a company deed 10 pages long.

The Doing Business project is publishing a series of annual reports, each covering several topics. The first report, *Doing Business in 2004: Understanding Regulation*, focuses on starting a business, hiring and firing workers, enforcing contracts, getting credit, and closing a business. *Doing Business in 2005* will discuss three topics: registering property, dealing with government licenses and inspections, and protecting investors. *Doing Business in 2006* will cover paying taxes, trading across borders, and improving law and order. The Doing Business project has received high marks from external audiences as well as Bank staff for providing, for the first time, objective indicators of the costs of regulation and administrative procedures. At the same time, when using the survey results, some of the limitations of this approach must be recognized. As countries and industries differ in optimal firm size and structure, estimating the time required to set up a straw firm provides comparability but at the expense of some bias against countries with heavier reliance on the informal sector.

3.13 The design and methodology of ICAs and the underlying Investment Climate Surveys are better than those of the earlier surveys and assessments. However, there are some issues of relevance, and of the use of the information gathered in the ICSs. Interviews and discussions conducted for this evaluation — in the country case studies, international investor interviews, and focus groups of Bank staff — identified the following issues:

- **Duplication of existing work:** In some countries, the nature of investment climate constraints, and the actions required to solve them, are already known. Often, similar surveys have been conducted by the government, local universities or think tanks, the
Bank, or other donors. The benefit of an additional survey may be limited to that of providing comparable data for cross-country comparisons.

*In the Indian states of Andhra Pradesh and Karnataka, the nature of investment climate problems, and the actions required to solve them, were already known. Both state governments had a significant appreciation of the challenges faced by their states in restoring fiscal discipline, improving governance, and addressing constraints to private investment, particularly in the regulatory area. Many potential remedies had been identified, for example, the concept of a single window for license clearances.*

One of the Peruvian reviewers of the ICA who was interviewed for this evaluation said, “We have known these things for 10 years — why do we need another report to say the same thing? The World Bank has ignored earlier reports on what needs to be done for the private sector. Why were the issues that had been identified not incorporated into policies?”

- **Survey fatigue:** Related to the issue above, firms sometimes complain that they are repeatedly asked to participate in similar surveys by different organizations. This is particularly a problem in smaller countries with a relatively small private sector.
- **Geographic focus:** Investment climate conditions can vary significantly by geographic area — across states, across municipalities, and even within municipalities. While ICSs routinely show variations in investment climate indicators across geographic regions, there may be a need to focus ICAs at the sub-national level, particularly in large countries.43
- **Sector or industry focus:** Similarly, investment climate conditions may vary significantly by industry (for example, telecommunications versus agro-industry), and these differences may not be captured in ICAs. In some countries the main constraints to private sector development may lay outside the scope of ICAs – for example, labor skills.
- **Unprioritized recommendations:** Earlier surveys and assessments often produced long lists of problems and proposed solutions, without a clear set of priorities. This problem is beginning to be addressed in ICAs, which use firms’ rankings or impacts on productivity to set priorities. Nevertheless, feedback from clients suggests that more effort is needed to identify priorities and sequencing:

  *Business leaders in Mozambique who were interviewed for this evaluation said, “The list was presented to government as the things that needed to be fixed. But the list was far too long — government can’t fix everything. There was no credible effort made to prioritize what needed to be fixed first and what needed to be worked on in the longer run.”*

3.14 The more fundamental problem with ICAs lies in how survey information is used to derive policy recommendations. Investment climate indicators tell the analyst, from the perspective of firms, “what hurts,” or even “what hurts the most, relatively speaking,” but not “what to do about it.” In other words, they provide “description” rather than “prescription.”

43. The recent state-level Investment Climate Assessments in India are an example of recent efforts to do this.
Examples of constraints typically identified by firms include high taxes, high interest rates, and the high cost of regulatory compliance. This does not necessarily suggest that taxes, interest rates, or regulations should be reduced. Economic and social objectives — fiscal stability, monetary management, environmental protection, labor protection — are the “benefit” side of the cost-benefit analysis that needs to be done to determine the optimal policy stance (see the example in Box 3.4). Survey-based instruments are not able to capture both sides of the analysis. In addition, they do not provide an understanding of the root cause of problems such as market failures.

Box 3.4: The Costs and Benefits of Reforming Labor Legislation in India

The India case study provides an example of an issue that is of concern to firms, but also has broader economic and social implications: labor regulations. Existing labor laws emanate from various acts, including the India Trade Union Act of 1926, Industrial Disputes Act of 1947, Minimum Wages Act of 1948, Companies Act of 1956, and Sick Industries Companies Act of 1985. The 1976 amendment to the Industrial Disputes Act makes layoffs, retrenchment, and closure illegal for industrial concerns with 100 or more employees except with the prior permission of the state government, which is rarely provided. The typical Indian firm reported having 17 percent more workers than it desired and that labor laws and regulations were the main reason why it could not adjust to the preferred level.

While Bank analytical work has identified labor regulations as an important constraint to private sector development and asserts that changing labor legislation will have significant economic benefits, it does not present an assessment of the likely impact of reforms on labor or the broader social costs that may arise as a result of worker displacement. Industry favors the use of contract labor to avoid regulations and lower costs, but such workers are generally not afforded the same level of job security, benefits, worker safety, and other protections as those covered by labor laws. As such, greater reliance on contract labor entails social costs. The point of this example is not to question the need for labor reform, but to suggest that further analysis is needed to assess the costs and benefits — both economic and social — of policy reform.

3.15 A further implication of the difficulty of drawing policy recommendations from enterprise survey information may be that the reforms that are proposed are relatively straightforward ones, such as reducing administrative barriers (licenses, inspections, etc.). For these types of regulations it is often true that less is better, since the beneficiaries of the barriers — for example, corrupt bureaucrats or incumbent firms — are not perceived to be worthy of continuing to receive benefits. In other words, the solution to the cost-benefit question is relatively straightforward. Again using India as an example, the Bank’s work on PSD issues in Karnataka and Andhra Pradesh has focused primarily on reducing transactions costs associated with regulations and administrative procedures. None of the Bank’s adjustment loans have directly addressed rigidities in labor markets, despite the widespread view — shared by the Bank — that labor regulations impose greater costs on companies.

Conclusions

3.16 The Bank’s diagnostic work on the investment climate has evolved toward greater use of enterprise surveys to provide information on the constraints to private sector development as perceived by firms. The most recent version of a standardized diagnostic tool, the Investment Climate Assessment, does a good job of benchmarking indicators of the quality
of a country’s investment climate in a way that allows cross-country comparisons as well as monitoring changes in individual countries over time.

3.17 The Bank’s economic and sector work has helped motivate many governments to adopt integrated reform strategies. Nevertheless, there are areas where more work needs to be done to provide guidance to clients as well as to Bank staff designing investment climate interventions. Not enough is known about good practice in institutional design, or about the dynamic process of changing institutions. It would be useful to have a typology of country situations and institutional designs that would provide guidance on which types of arrangements work where, how the change process happens, how it can be supported and sustained, etc. — in other words, an understanding of what types of institutional arrangements can be “exported” from one country to another. The Bank’s ESW has not yet provided enough of this knowledge of institutional design and the process of reform.

3.18 Feedback from clients collected for country case studies suggest that the Bank has not been focused enough or selective enough in its ESW and diagnostic work on the investment climate. Reports sometimes duplicate earlier work, and firm surveys are sometimes very similar to existing surveys conducted by governments, think tanks, or other donors. Investment climate diagnostics sometimes do not take into account the heterogeneity of investment climate conditions across geographic areas (states and municipalities) and across industries. In some cases, the Bank has not focused ESW sufficiently on the highest-priority types of investment (for example, domestic versus foreign) or highest-priority constraints (for example, labor issues). Investment climate diagnostics often produce long lists of problems and proposed solutions, without a clear set of priorities.

3.19 Enterprise surveys provide valuable information on the perspectives of the private sector, but are an insufficient basis for policy recommendations. The views of business on public policies need to be balanced with other economic and social objectives.
4. The Investment Climate Loan Portfolio

Definition

4.1 The definition of the investment climate used in this report to compile the Bank’s loan portfolio is driven by the Bank’s sector and thematic coding system. The Bank’s Operations Policy and Country Services department (OPCS) assigns five themes to each project in the Bank’s Business Warehouse database. Each of these themes is coded as a primary or secondary objective of the project. The system allows one to five primary themes and up to four secondary themes to be assigned to each project.

4.2 OPCS and the PSD Board have defined a set of five “core” and five “non-core” investment climate themes as shown in Table 4.1. The numbers in the table are the theme codes used in the OPCS sector/theme coding system. Detailed descriptions of the themes are contained in Annex 2.

4.3 To identify the investment climate portfolio, this report defines three types of projects:

- **“Core IC” projects** contain at least one Core IC theme that is a primary objective.
- **“Non-Core IC” projects** are not Core IC, but contain at least one Non-Core IC theme that is a primary objective of the project.
- **“Secondary IC” projects** are defined similarly: at least one Core IC theme or Non-Core IC theme is a secondary objective of the project.

Composition

4.4 Table 4.2 and Figure 4.1 show that a large share of the Bank’s portfolio is investment climate lending, broadly defined. Of the 2,891 closed and active Bank projects approved during FY1993-2003, 1,291 (45 percent) had investment climate objectives related to Core or Non-Core themes. The value of IC projects was nearly $123 billion, representing 52 percent of the Bank portfolio. Core IC projects (those having one or more Core theme as a primary objective of the project) amount to 14 percent of the Bank’s portfolio (in terms of the number of projects), and Non-Core IC projects another 19 percent.

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Table 4.1: Thematic Definition of Investment Climate

<table>
<thead>
<tr>
<th>Code</th>
<th>Theme</th>
</tr>
</thead>
<tbody>
<tr>
<td>32</td>
<td>Judicial and other dispute resolution mechanisms</td>
</tr>
<tr>
<td>34</td>
<td>Legal institutions for a market economy</td>
</tr>
<tr>
<td>36</td>
<td>Personal and property rights</td>
</tr>
<tr>
<td>38</td>
<td>Corporate governance</td>
</tr>
<tr>
<td>40</td>
<td>Regulation and competition policy</td>
</tr>
<tr>
<td>28</td>
<td>Tax policy and administration</td>
</tr>
<tr>
<td>39</td>
<td>Infrastructure services for PSD</td>
</tr>
<tr>
<td>44</td>
<td>Other financial and private sector development</td>
</tr>
<tr>
<td>45</td>
<td>Export development and competitiveness</td>
</tr>
<tr>
<td>49</td>
<td>Trade facilitation and market access</td>
</tr>
</tbody>
</table>

---

44. However, it should be noted that the assignment of themes to projects in the portfolio under the current Bank coding system is somewhat arbitrary and may not be 100 percent accurate. Sample checks carried out by OED showed that the potential for mis-classification is greatest for Non-Core IC projects.
4.5 Investment climate components are often included in larger projects (e.g., regulatory reforms in macroeconomic adjustment loans), so the significance of IC lending is smaller than overall lending volumes suggest. The value of IC components (weighted by the importance of objectives using OPCS methodology) was about $55 billion, or 45 percent of the total value of the IC portfolio, and 23 percent of the overall Bank portfolio, over the fiscal 1993-2003 period.

Table 4.2: Investment Climate Lending, FY 1993-2003

<table>
<thead>
<tr>
<th>Category</th>
<th>No. Projects</th>
<th>% of Total Projects</th>
<th>Total Loan Value ($m)</th>
<th>IC Loan Value as % of Bank Portfolio Value</th>
<th>IC Component Value ($m)</th>
<th>IC Component Value as % of IC Loan Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>IC</td>
<td>1,291</td>
<td>45%</td>
<td>122,868</td>
<td>52%</td>
<td>55,441</td>
<td>45%</td>
</tr>
<tr>
<td>Core IC</td>
<td>418</td>
<td>14%</td>
<td>49,767</td>
<td>21%</td>
<td>25,002</td>
<td>50%</td>
</tr>
<tr>
<td>Non-Core IC(^a)</td>
<td>563</td>
<td>19%</td>
<td>48,641</td>
<td>21%</td>
<td>25,227</td>
<td>52%</td>
</tr>
<tr>
<td>Secondary IC(^b)</td>
<td>310</td>
<td>11%</td>
<td>24,460</td>
<td>10%</td>
<td>5,212</td>
<td>21%</td>
</tr>
<tr>
<td>Non-IC</td>
<td>1,600</td>
<td>55%</td>
<td>112,834</td>
<td>48%</td>
<td>5,355</td>
<td>5%</td>
</tr>
<tr>
<td>Other PSD(^c)</td>
<td>231</td>
<td>8%</td>
<td>16,613</td>
<td>7%</td>
<td>5,355</td>
<td>32%</td>
</tr>
<tr>
<td>Other</td>
<td>1,369</td>
<td>47%</td>
<td>96,221</td>
<td>41%</td>
<td>0</td>
<td>0%</td>
</tr>
<tr>
<td>TOTAL(^d)</td>
<td>2,891</td>
<td>100%</td>
<td>235,702</td>
<td>100%</td>
<td>60,796</td>
<td>26%</td>
</tr>
</tbody>
</table>

\(^a\) Excludes Core projects that contain Non-Core themes.

\(^b\) Consists of projects not included in the first three categories, but containing Core, Non-Core, or Other PSD themes of secondary priority.

\(^c\) Excludes Core and Non-Core projects that contain “other PSD” themes: SME support, standards and financial reporting, state enterprise and bank restructuring and privatization, technology diffusion, and rural non-farm income generation.

\(^d\) Includes amounts committed to all IC themes in the project, whether Core, Non-Core, or Other PSD.

Figure 4.1: Number of IC and Non-IC Projects, FY 1993-2003

4.6 The total value of all IC lending (Core IC, Non-Core IC, and Secondary IC) in the Bank’s portfolio experienced a significant increase in 1998-99 along with the Asian financial crisis (Figure 4.2). Since then, IC lending has fallen below the levels of the early- and mid-1990s except for a spike in fiscal 2002. As a proportion of overall Bank lending, the value of IC lending has been fairly stable except for FY98-99 and FY02 (Figure 4.3). These trends are similar for all IC as well as Core IC projects. Within IC lending, the share of Non-Core IC projects declined significantly (from 25 percent of the Bank’s lending in fiscal 1994-98 to 14 percent in fiscal 1999-2003) as the shares of Core IC and Secondary IC projects increased.
Figure 4.2: Investment Climate Lending, FY93-03 (Number and Value of Loans)

![Graph showing investment climate lending, FY93-03](image)

Figure 4.3: Investment Climate Lending as a Share of the Bank’s Portfolio, FY93-03

![Graph showing investment climate lending as a share of the bank's portfolio, FY93-03](image)

Figure 4.4: Core IC Themes in the IC Portfolio

![Graph showing core IC themes in the IC portfolio](image)

Data represent the number of occurrences of Core IC themes in Core IC, Non-Core IC, and Secondary IC projects.
4.7 The dominant Core theme in the IC portfolio is regulation and competition policy, which includes activities aimed at the elimination of monopolies, simplification of business licensing and registration requirements, reduction of barriers to FDI, developing regulatory frameworks, enactment of competition policy (Figure 4.4). However, the relative importance of this theme has declined slightly with an increase in projects aimed at other Core IC themes (judicial and other dispute resolution mechanisms, legal institutions for a market economy, and corporate governance). Among Non-Core themes, the most important are “other financial and private sector development” and “infrastructure for private sector development” (Figure 4.5). The former covers measures to strengthen institutions that support the private sector (investment and export promotion agencies, public-private consultative mechanisms); support restructuring or private enterprises, including corporate restructuring; and promote financial sector development. The latter are infrastructure projects that include components to improve sector regulation.

**Figure 4.5: Non-Core Themes in the IC Portfolio**

![Graph showing Non-Core Themes in the IC Portfolio](image)

Data represent the number of occurrences of Non-Core IC themes in Core IC, Non-Core IC, and Secondary IC projects.

4.8 Increasingly, investment climate objectives are included as components in adjustment loans. Adjustment loans increased from 32 percent of Core IC projects in fiscal 1994-98 to 38 percent in fiscal 1999-2003, compared to an average of 17 percent for all Bank projects over the entire period.

4.9 Regionally, Core IC projects are concentrated in ECA, AFR, and LAC, with the smallest numbers in MNA and SAS. Compared to the regional distribution of all Bank lending, Core IC projects are more heavily concentrated in ECA than in other regions, mainly reflecting post-transition assistance in legal and regulatory reform (Figure 4.6). By income group, Core IC projects are increasingly concentrated in low-income countries, more so than for all Bank projects (Figure 4.7). Although Core IC projects are somewhat more concentrated in countries with poor investment climates as measured by the Country Performance Institutional Assessment (CPIA), it is to a degree similar to all Bank projects.
Performance

4.10 OED rates project performance against stated objectives, and assigns ratings to the project’s outcome, institutional development impact, and sustainability. Table 4.3 shows ratings for Core IC projects, averaged over fiscal 1993-2003, compared to Bank-wide averages. Over the entire fiscal 1993-2003 period, outcome ratings for Core IC projects were better than the Bank average: 81 percent of Core IC projects were moderately satisfactory or

45. OED assigns ratings according to the following criteria. Outcome measures the extent to which the project’s major relevant objectives were achieved, or are expected to be achieved, efficiently. Institutional development impact measures the extent to which a project improves the ability of a country or region to make more efficient, equitable and sustainable use of its human, financial, and natural resources through: (a) better definition, stability, transparency, enforceability, and predictability of institutional arrangements and/or (b) better alignment of the mission and capacity of an organization with its mandate, which derives from these institutional arrangements. Institutional development impact includes both intended and unintended effects of a project. Sustainability measures the resilience to risk of net benefits flows over time. Note that OED Outcome ratings measure the degree of achievement of project objectives due to the project as well as to factors external to the project — in other words, outcomes are not necessarily attributable to the project alone.
better, compared to 77 percent for all Bank projects, and the difference is statistically significant at the 5 percent level. There was a marginal improvement in the outcome ratings over the 10-year period: 81 percent of Core IC project outcomes were moderately satisfactory or better during fiscal 1994-98, and 82 percent during fiscal 1999-2003. In contrast, the performance of the overall Bank portfolio improved significantly from 78 percent in fiscal 1994-98 to 83 percent in fiscal 1999-2003. Thus, the performance of the IC portfolio is declining relative to that of the Bank portfolio. The institutional development impact and sustainability of Core IC projects were slightly better than the Bank average, but these differences are not statistically significant. Institutional development impact and sustainability remained nearly constant over the period. Projects targeting personal/property rights and corporate governance had somewhat higher outcome ratings than projects covering other themes, but sample sizes are small. Sustainability is rated higher in projects directed at legal institutions for a market economy, and corporate governance, than in the other Core IC themes. Outcome ratings were lower in low-income countries than in middle-income countries (79 percent moderately satisfactory or better in low-income countries, compared to 83 percent in middle-income countries).

### Table 4.3: OED Ratings for Core IC Projects, FY 1993-2003

<table>
<thead>
<tr>
<th></th>
<th>Outcome (Mod. Sat. or better)</th>
<th>Inst. Dev. Impact (Substantial or better)</th>
<th>Sustainability (Likely or better)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>% No. Rated Projects</td>
<td>% No. Rated Projects</td>
<td>% No. Rated Projects</td>
</tr>
<tr>
<td>Core IC</td>
<td>81% 210</td>
<td>54% 209</td>
<td>70% 210</td>
</tr>
<tr>
<td>Judicial/other dispute resolution</td>
<td>79% 14</td>
<td>50% 14</td>
<td>54% 13</td>
</tr>
<tr>
<td>Legal inst. For market economy</td>
<td>88% 58</td>
<td>62% 58</td>
<td>76% 58</td>
</tr>
<tr>
<td>Personal/property rights</td>
<td>91% 11</td>
<td>55% 11</td>
<td>64% 11</td>
</tr>
<tr>
<td>Corporate governance</td>
<td>80% 10</td>
<td>50% 10</td>
<td>70% 10</td>
</tr>
<tr>
<td>Regulation &amp; competition policy</td>
<td>81% 185</td>
<td>54% 184</td>
<td>71% 185</td>
</tr>
<tr>
<td>Overall Bank Portfolio</td>
<td>77% 1366</td>
<td>49% 1355</td>
<td>65% 1369</td>
</tr>
</tbody>
</table>

Note: The number of rated projects is not the sum of projects listed by theme, since a project can have more than one theme. For this reason the average ratings for Core IC projects is not a weighted sum of ratings for individual themes.

4.11 There were also differences in project outcomes according the quality of the country’s macroeconomic environment (measured by the economic policy performance rating in the latest CAS) and the performance of the financial sector (measured by the financial sector performance rating in the latest CAS). This suggests that the outcomes of investment climate operations are more likely to be successful in countries that have better macroeconomic and financial sector performance — although there is no evidence to suggest the direction of causality. Projects performed better in countries with good investment climates, as defined by a 2002 CPIA over 3.5: 85 percent had outcome ratings of Moderately Satisfactory or higher compared to 69 percent for poor investment climate countries, and the difference is statistically significant at the 5 percent level.

4.12 OED outcome ratings are assigned to the project as a whole, so that the outcomes of individual project components may differ from the overall rating. To check this, OED
evaluations were analyzed for 86 completed Core IC projects with significant and correctly-coded IC components. The outcomes of the IC components of these projects were examined to determine whether their performance was relatively the same, better, or worse than the overall project. For 80 percent of the projects, the performance of the IC component was the same as the overall project. For the 20 percent that differed, most (15 out of 17) performed worse than the overall project.

4.13 Various factors are associated with the worse performance of IC components:

- **IC components form a small part of the project:** IC components seem to perform worse than the overall project primarily when these components do not constitute the main objective of the project, and/or account for a relatively small percentage of project costs. In adjustment operations, IC components are often overwhelmed by macroeconomic adjustment objectives and conditionality; similarly, in investment operations, IC components are often a minor part of the project. Outcomes were more likely to be poor when IC components were not linked with the rest of the project. In Indonesia’s Land Administration Project, there was little interaction between the component involving land management policies and the rest of the project, limiting the component’s success.

- **Insufficient supervision:** Related to the above, in some cases the IC components received less attention during supervision than other larger components of the project. In Hungary’s Product Market Development Project (P008482), Bank supervision inputs were much less than planned and the skills mix of missions was inadequate to oversee the objectives of reducing distribution costs and increasing competitiveness, which may have contributed to their partial attainment and marginal impact.

- **Lack of government ownership and commitment:** In Madagascar’s First Sector Adjustment Credit (SAC I; P001582), lack of government ownership contributed to the slow implementation of reforms for promoting competition in the petroleum and telecommunications sectors. Progress in the land management policies component of Indonesia’s Land Administration Project (P003984) was limited by the failure of the government to remain substantially engaged. In Romania’s Private Sector Adjustment Loan (P064853), the government amended the law for bankruptcy reform, but follow-up action remained pending at the end of the project. In Russia’s Privatization Project (P008810), significant outcomes included institutional strengthening of the Anti-Monopoly Committee and Bankruptcy Agency, and adoption of a new bankruptcy law, but weak enforcement, poor incentives, and remaining legal loopholes continue to undermine their impacts. In the China Telecom Project (P003633), the government did not sufficiently address the legal and institutional environment that impeded private sector involvement in the sector.

- **Complex or ambitious project design** seems to make it more likely for IC components to under-perform, even if the complexity does not pertain to the IC components themselves. Under Uganda’s Financial Sector Adjustment Credit (FSAC; P002962), a new law related to capital markets was passed, but institutional reforms proved more difficult during appraisal, partly due to an ambitious project design. At the close of Thailand’s Second Economic and Financial Adjustment Loan (EFAL II; P058536), the cabinet of ministers had not approved the framework for accounting
and auditing standards and the draft legislation to improve competitiveness in the economy. The government considered the reform program as extremely complex, detracting from clarity and overburdening its capacity.

- **Underestimating political and social readiness:** A lack of broad political and social support has inhibited the performance of IC components. In Malawi’s Second Fiscal Restructuring and Development Program (FRDP II; P045030), the privatization of agricultural marketing was on hold and little progress was seen in developing land markets due to complex underlying social and political factors. A turbulent social and political situation made consensus difficult in Indonesia’s Land Administration Project (P003984). In Indonesia’s Second Public Sector Reform Loan (PSRL II; P060258), political interference and allegations of corruption contributed to slow implementation of commercial court and bankruptcy law intended to improve governance and transparency. Moldova’s Rural Finance Project (P035781) did not succeed in establishing an efficient and sustainable financial system, and in the absence of any significant savings mobilization — due to low beneficiary participation — the system has evolved into a group lending operation rather than a savings and credit system. Under Uganda’s FSAC (P002962), institutional reforms following the passage of a new law relating to capital markets proved difficult due to resistance to reform.

- **Overestimating institutional capacity:** IC components were adversely affected by a lack of broad institutional capacity. In Romania’s Program Adjustment Loan (PAL; P064853), weak institutional capacity in the audit field undermined efforts to bring accounting standards in line with international accounting standards. Computerization of the customs department and installation of public sector information systems failed in Georgia’s Institution-Building Project (P008413), mainly because the broader institutional and cultural environment was not conducive. In Guyana’s Financial Sector and Business Environment Project (P034605), the new private sector investment promotion agency was not very effective in simplifying the numerous government rules and regulations that severely limited investment, and was remiss in providing critical information on its services to investors.

### Conclusions

4.14 Projects with investment climate objectives account for a large share of the Bank’s lending portfolio. Projects that have Core and Non-Core IC themes as primary or secondary objectives account for 45 percent of all Bank projects over fiscal 1993-2003, and 52 percent of project value. Core IC projects (those that have one or more of the five Core IC themes as a primary objective of the project) account for 14 percent of all Bank projects. However, the value of IC components is usually less than the total loan amount, averaging 50 percent of value for the Core IC portfolio.

4.15 With the exception of the expansion in lending during the fiscal 1998-99 Asian financial crisis, the Bank’s lending for investment climate reforms declined slightly until fiscal 2000 and has increased since then, with a significant spike in fiscal 2002. As a proportion of total Bank lending, however, IC lending has remained fairly stable. Within the IC portfolio, Core IC topics have increased relative to Non-Core topics; within Core topics,
various regulations and competition policy are the most common objectives. Of Non-Core themes, infrastructure for PSD and other PSD and finance sector projects are most common.

4.16 Regionally, the Core IC portfolio is concentrated in ECA, LAC, and AFR; 87 percent are in low or lower-middle income countries. Increasingly, adjustment loans are the instrument of choice, rising from 23 percent of Core IC projects in fiscal 1993 to 31 percent in fiscal 2002. Although Core IC projects are somewhat more concentrated in countries with poor investment climates as measured by the CPIA, it is to a degree similar to all Bank projects.

4.17 Over the entire FY93-03 period, Core IC projects performed better than the Bank average: 81 percent of Core IC project outcomes were moderately satisfactory or better, compared to 77 percent for all Bank projects. Although this performance improved slightly over the period, the improvement was less than for the Bank-wide portfolio. Thus, the performance of the IC portfolio is declining relative to the Bank-wide average. Moreover, when the outcomes of IC components differ from overall project outcomes, they are often worse. A number of factors contribute to disappointing outcomes: apparent lack of attention and supervision when IC objectives are a minor part of larger projects; lack of government ownership and commitment; complex or overly ambitious project design; lack of overall institutional capacity; and political or social factors that were underestimated at project appraisal.
5. Implementation and Outcomes at the Country Level

5.1 Five country case studies were conducted for this evaluation— for Indonesia, Romania, India, Mozambique, and Peru— covering Bank lending and non-lending activities over the fiscal 1993-2002 period. Annex 5 contains brief summaries of the case studies and Annex 1 describes the evaluation protocol. This chapter presents the main findings and lessons derived from these case studies with respect to the implementation, outcomes, and sustainability of investment climate reforms. It summarizes what worked, and what didn’t; the factors that led to success and failure; and lessons that can be generalized to the Bank’s investment climate activities. The chapter begins with a brief characterization of each of the countries and the investment climate strategy pursued by the Bank.

Typology of Countries

Indonesia: Crisis Drives the Investment Climate Agenda

5.2 The 1990s were divided into two periods by the East Asia financial crisis, which began in July 1997 with the devaluation of the Thai bhat. In less than two months, Indonesia’s currency depreciated 75 percent against the dollar; GDP fell by 13 percent in 1998. The proximate causes of the crisis were the rapid increase of unhedged short-term private external debt before 1997, and shortcomings in the banking system. The country’s chronically weak institutions, endemic corruption, and political instability amplified the financial crisis because no credible arrangement to deal with the crisis decisively and fairly was offered to restore investors’ confidence. An enterprise survey conducted in 2000 suggested that macroeconomic and policy instability and uncertainty were the leading concerns of Indonesian firms.

5.3 Before the crisis, Bank assistance on the investment climate dealt with protecting property rights, facilitating an efficient land market, and developing the accountancy profession. Analytical work emphasized trade and domestic regulations, improving governance, reforming the legal system, privatization, and land administration. After the crisis, the focus of the Bank’s lending operations shifted to macroeconomic stabilization and bank and corporate restructuring.

Mozambique: A Poor Country with Little Local Capacity

5.4 Despite fast growth during the 1990s, Mozambique remains one of the poorest countries in the world. Per capita income was only $200 in 2001, about 40 percent of the average for Sub-Saharan Africa. Adult literacy is only 56 percent, and there is an acute shortage of highly educated workers.

5.5 Beginning in the late 1980s and accelerating after the 1992 peace agreement, extensive policy reforms improved macroeconomic management; liberalized prices, exchange rates, and trade; privatized public enterprises; promoted financial deepening; and improved public investment. Even with the progress on first-generation reforms, Mozambique began the decade of the 1990s with an extremely poor investment climate.
Incentives, institutional arrangements, governance stability, and physical infrastructure had to be either fashioned from whole cloth or rehabilitated. Added to this, a transition from plan to market had to be engineered in the context of the post-conflict recovery.

5.6 The Bank’s strategy during the 1990s moved from a first-generation set of macroeconomic reforms to second-generation reforms aimed at removing microeconomic barriers to investment stemming from antiquated laws and regulations, inefficient administrative capacity, and corruption.

**Romania: Investment Climate Reforms Motivated by Opportunity**

5.7 In the early years of transition, a flurry of reform activity was undertaken to promote a more open market economy. But most of the 1990s was characterized by economic and political instability; half-hearted reforms undertaken by successive governments resulted in a weak supply response from the economy. Both domestic and foreign investment were weak, there was little growth, and the incidence of poverty continued to rise.

5.8 The end of the 1990s was a watershed for Romania. Low growth and macroeconomic instability brought governments to office that were committed to reform. Government commitment was “pulled” by opportunity: the prospects of NATO membership and integration with the European Union (EU).

5.9 The Bank’s assistance during 1999-2002 showed a stronger focus on the investment climate. Recent projects focused on institutional reforms critical for private sector development, including the reform of the legal environment for business, the reduction of regulatory burdens, and secured transactions reform to facilitate collateralization of assets for loans.

**India: Investment Climate Constraints at the State Level**

5.10 India’s economic reforms in the 1990s raised GDP growth to almost 6 percent per year between 1993 and 2003, fueled in part by external debt. Living standards improved markedly, and the number of people living below the national poverty line declined from 45 percent in the 1980s to 25 percent in 2002. Foreign direct investments and portfolio investments responded strongly to the first wave of reforms, and have fluctuated around $6 billion per year. While progress was substantial, economic performance has fallen below the target set by the central government in the years after liberalization — partly due to persistent and growing fiscal deficits, inadequate infrastructure (particularly power), and institutional constraints on private investment. The most important investment climate constraints are bureaucratic red tape and administrative procedures, inflexible labor markets, persistent trade protection, and lack of access to financing.

5.11 Investment climate conditions vary significantly across different states and even within states. The Bank’s recent Investment Climate Assessment for India shows that Maharashtra and Gujarat are perceived by firms to be the “best climate” states; Tamil Nadu, Karnataka, and Andhra Pradesh are “good climate states,” Delhi and Punjab are “medium,”
and Kerala, West Bengal, and Uttar Pradesh are “poor climate states.” That entrepreneurs actually act on these perceptions can be seen in the investment rates for these states.

5.12 Beginning in the mid-1990s, the Bank began to focus greater attention on working with states that were strongly committed to reform. The Bank’s activities have supported broad packages of state-level reform efforts as well as sector-specific programs in power, water, transport, health, and education.

Peru: Progress in Some Areas, Reversals in Others

5.13 When President Fujimori was elected in 1990, Peru was verging on total disintegration. Hyperinflation, multiple exchange rates, the nationalization of the banking system, and a vicious terrorist movement had resulted in economic collapse. The government embarked on a comprehensive economic reform program that introduced market mechanisms into every sector of the economy. The response to these reforms was a surge in growth over 1993-97, a decline in inflation, buoyant foreign investment, and a fall in poverty.

5.14 During Fujimori’s second term, however, conditions deteriorated. External shocks, the El Niño effect, and reversals in the reform program all served to weaken the economy, increase uncertainty, and damage the investment climate. A new government was elected in 2001, promising to improve the economy and eradicate government corruption. However, confidence in the new government began to erode almost immediately, and the government has changed its stance on several important issues in response to public opinion. Attitude surveys indicate that the business community does not have confidence in the government, which it views as unstable and anxious to appease populist sentiment at the expense of continuing reform. The result has been a sharp decline in investment.

5.15 The Bank has undertaken a series of private sector assessments since the mid-1990s, but CASs during the 1990s did not focus on investment climate issues. This changed with the 2002 CAS, which increases the stress on institutional projects, particularly to continue property rights efforts and to modernize the judicial system.

Lessons Learned

Investment climate reform is often driven by crisis or by opportunity

5.16 Decisions by policymakers to take measures necessary to improve the investment climate are often motivated by urgency: on the negative side by crisis (macroeconomic, financial, political) or on the positive side by opportunity (the prospect of joining regional trade agreements, taking advantage of new technologies). The Bank has been successful in supporting reforms in both of these situations.

5.17 In Indonesia, the motivation was a negative one: the Asian financial crisis that began in 1997. Before the crisis, Bank reports consistently pointed out several structural weaknesses that could impede future private sector-led growth. To overcome these weaknesses, the Bank recommended good macroeconomic management, strengthening the
financial sector, reducing international and domestic trade barriers, facilitating private investment, improving governance and reforming the legal system, improving land administration, and reducing excessive state ownership of productive assets. However, when Indonesia was perceived to be performing well and not in need of Bank resources, the Bank lacked leverage with the government to move it toward implementing structural reforms. The Bank’s usually strong influence with government “technocrats,” who had a voice in policy formulation and implementation, was muted during this period, perhaps because the reforms were politically difficult and did not seem critical for Indonesia’s growth.

5.18 During the crisis, the Bank had substantial leverage and influence despite frequent changes in governments. The Bank supported macroeconomic stabilization, bank and corporate debt resolution, and structural reforms including competition policy and governance and justice system reforms. Many of the structural reforms recommended by the Bank before the crisis became required policy actions in adjustment loans immediately following the crisis.

5.19 Political stability began to recover after the election of President Sukarnoputri. In the new political arrangement, the Soeharto-era “technocrats,” with direct access to the President for decisions, have been replaced by inexperienced politicians with diverse interests and without clear decision rules or hierarchy. Decentralization has further complicated the decision process and created complications for the investment climate. With so many new players and diverse interests vying for decision authority, the Bank’s ability to influence policy has been reduced. While the investment climate has not improved very much, the Bank’s activities have probably prevented it from deteriorating. Eventually, these reforms are likely to improve Indonesia’s investment climate, especially for foreign investment but also for domestic investment. For the future, because the Bank has less leverage and influence with the government than during the crisis, it will have to adopt a strategy that appropriate to the new political landscape and persevere for a longer period to achieve its objectives.

5.20 The Indonesia case study offers lessons for Bank strategy and activities in countries where it has less leverage — in large countries where the economy is stable and growing, in democratic countries governed by a coalition of parties in which the decision process is diffuse and complicated, and/or when formerly central government decisions are devolved to regional and local authorities. In these countries, stakeholders determined to improve the country’s investment climate play a critical role. The Bank should be prepared to pursue investment climate reforms directly with several layers of government and indirectly through stakeholders. The Bank should be prepared to exercise patience and persist for long periods to achieve its policy reform objectives.

5.21 The Bank’s investment climate strategy in Romania during the 1990s can be divided into two periods. The early years (1992-98) focused on the movement away from a planned economy to one in which markets determined resource allocation and investment. Macroeconomic imbalances were a major concern. The second period, which had its genesis in a major economic crisis in 1999, was characterized by a much stronger dedication by the government to promoting the private sector as well as a rededication to the reform effort in general. The new government that came into power in mid-2000 adopted an economic program for 2001-04 with the goals of stimulating economic growth, reducing poverty and
unemployment, combating corruption, and speeding up EU integration and NATO membership.

5.22 The Bank’s 2001 CAS evidenced the evolution of the Bank’s approach to investment climate reform from one that was based on macroeconomic conditions to one that was institutionally oriented. Recent projects have focused on the reform of the legal environment for business, the reduction of regulatory burdens, and secured transactions reform to facilitate collateralization of assets for loans. Successive private sector adjustment loans (PSALs) and public and private institution-building loans (PIBLs) supported these reforms.

5.23 The first PSAL was an ambitious attempt to support enterprise and financial sector reforms that could substantially reduce the pressure on the government’s finances. There were two major factors that motivated the government to undertake these reforms. First, in 1997-98 GDP contracted by more than 11 percent and the budget deficit increased for the fifth consecutive year to 5.5 percent of GDP. These factors, along with an unstable current account balance and mounting external repayment obligations, increased pressure on the government, which moved in late 1998 to initiate an ambitious reform program. A second major factor was (and is) the prospect of accession to the EU in 2007. PSAL conditions were well coordinated with the milestones set out by the EU, and the government — along with a broad segment of society — supported the effort to “join Europe.” This was reinforced by NATO’s decision in November 2002 to invite Romania to join the alliance. Once the government understood the severity of the macroeconomic situation and wished to proceed with reforms, the Bank moved quickly to prepare the project.

5.24 Preparation of the PSAL provided an example of how high-quality analytical work and good collaboration among Bank Group units along with other donors can lead to high-quality lending operations. FIAS prepared an Administrative Barriers to Investment report with recommendations encompassing regulatory reform, corruption, company and tax registration, foreign exchange, property rights, standardization, employment, land and site development, and customs and international trade. Based on these recommendations, the government approved an action plan in September 2001 that is now being used to improve the investment climate. The government established an implementation group with broad representation from the Chamber of Deputies, the Chamber of Commerce, nongovernmental organizations, the business community, importers and exporters, and other members of civil society. The Bank worked closely with other donors (International Monetary Fund, EU, European Bank for Reconstruction and Development, and bilateral donors), which resulted in the transmission of a consistent message to the government.

5.25 The combination of the “push” of macroeconomic crisis, the “pull” of EU accession, the coordinated support of donors, and efforts to build broad support seem to be having a positive, though gradual, effect on the investment climate in Romania. One area of achievement has been increased access to credit as a result of secured transactions reform (Box 5.1).
Box 5.1: Romania: Secured Transactions Reform

In 1999 the Bank approved two private sector development loans for Romania: the first Private Sector Adjustment Loan (PSAL) and an accompanying technical assistance loan, the Private Sector Institution Building Loan (PIBL). One of the most important components of the PIBL was secured transactions reform. The first phase of the project supported the implementation of a Law of Secured Transactions, which was drafted with the support of the Bank. The law incorporated provisions that permitted movable property, both tangible and intangible, to serve as collateral for loans. The second phase of the project involved setting up the filing archive to permit the law to operate by recording pledges of property and establishing priority regarding which creditors have the first rights to repossess and sell the collateral in the event of default. The secured transactions framework had several innovations:

- The law abrogated all existing legislation affecting debt, so that there was no danger of ambiguity regarding the validity of pledges.
- The filing archive in which pledges are recorded is run by an association of lenders, so that the public sector is not involved. It is electronic and priority is determined electronically by the time when pledges are recorded.
- No documents are necessary to file a security interest. This allows internet-based filing, currently the only filing archive in the world to have this feature. The effect is to broaden coverage, especially in the rural areas, and to reduce costs.
- No notaries are involved in the process.
- Repossession takes place outside the court system. If repossession is not disputed, the creditor can simply collect the pledged property. In the event of a dispute, upon evidence of the validity of the debt, an officer of the court can seize the pledge property without the necessity of a court hearing. Very harsh penalties for wrongful repossession discourage creditors from abusing the system.

The impact of the law on lending has been dramatic. In the 18 months since the reform was implemented, there have been more than 400,000 loans against which security interests have been registered. Over 100 banks have registered security interests in the filing archive. Since there are only 38 licensed banks in Romania, the implication is that scores of non-Romania banks have been lending in the country against collateral and registering their security interests.

Of the security interests that have been registered and are current, nearly 20 percent represent non-bank secured loans. This is especially beneficial in rural areas that do not have bank offices. In addition, the geographic coverage has been extensive: there have been filings of security interests in 42 of Romania’s 43 counties. In rural areas, credit has been granted against diverse assets including cows and tractors.

The Bank’s analytical and advisory work has been key to motivating reform

5.26 Successful Bank interventions usually have started with high-quality analytical work that provided the policy framework for lending operations. The Bank’s analytical work has often helped to accelerate the process of reform.

5.27 In Romania, a comprehensive set of policy recommendations emerged from the FIAS administrative barriers study and other ESW. Based on these recommendations, the government approved an action plan that is now being used as a roadmap for measures to improve the investment climate. Several of those interviewed indicated that the priority given
to the investment climate by the government has been a result of the Bank’s enterprise surveys and analysis. Businessmen and representatives of business groups report that the investment climate is considerably better than it was a few years ago — for example, in the effort required to register a business — and that the involvement of the Bank contributed to this outcome.

5.28 In India, the Bank made an important contribution by focusing attention on specific issues, while placing them within a broader context. According to government officials involved in the reform process, the Bank helped sensitize the government to the gravity of the problem. The Bank drew attention to the significant cost of not reforming in terms of the ability of the government to address social needs within the states. Those interviewed highlighted the ability of the Bank to present recommendations in terms of an integrated strategy that reflected the significant interactions among different issues faced by the states. Government officials in Karnataka acknowledge that, while the need for regulatory and administrative reforms was broadly recognized within the government, efforts to implement them were sporadic and uncoordinated before the Bank’s analytical work and adjustment operations.

5.29 Interviews conducted in several of the country case studies suggest that clients would appreciate even greater emphasis on analytical and advisory work. In Peru, government officials indicated that they would like more sector work and technical assistance on investment climate and financial market issues: “The international financial institutions are becoming more like commercial banks. We ask for advice and they give us money,” one senior government official complained.

IC conditionality has been important in strengthening the hand of reformers

5.30 It is important to recognize that a country’s government is not monolithic. At any time, there are individuals within the government — top political leaders, senior government bureaucrats, party officials, and various formal and informal advisors — that will support certain reforms and others that will oppose them. The Bank’s loan conditionality played an important role in the political economy of reform in several case study countries by strengthening the hand of reform-minded policymakers and other stakeholders against those opposed to reform.

5.31 In Romania, many of those interviewed for this evaluation felt that the Bank’s conditionality has been important in assisting reformers in getting their programs adopted, particularly during the latter part of the 1990s and early 2000s. Conditionality and the need for Bank financing helped prevent backsliding on reforms.

5.32 In India, the Bank supported investment climate reforms in the states of Karnataka and Andhra Pradesh with state-level adjustment loans. All of these loans contained up-front triggers requiring the state government to take specific actions before loan approval and effectiveness. The adoption of triggers helped ensure the achievement of agreed actions. In Karnataka, the adoption of triggers related to deregulation contributed to the reform effort. The triggers were developed after extensive discussions between Bank staff and government officials. Once in place, they helped ensure that actions were taken by the government even if
some groups were opposed to particular reforms, recognizing that the loan might be jeopardized by failure to make adequate progress.

**Local champions often initiate reforms, but broad support is needed to sustain them**

5.33 It is important to have the backing of key politicians to spur reform. However, while much attention is paid to the role of senior political leaders, other stakeholders — professional civil servants, business groups, and the general public — are critical to sustaining reforms.

5.34 In Karnataka and Andhra Pradesh (India), political leaders were elected on a reform agenda and took steps upon assuming office to institute policy and institutional reforms. The Bank elected to work with these states precisely because officials demonstrated that they were willing to tackle pressing fiscal, governance, and administrative problems. Government officials and business leaders interviewed spoke of their concern over whether reform efforts could be sustained in the event of changes in political leadership. Lacking a strong institutional basis and grass-roots support, the reform agenda is in danger of facing difficulties in the event of electoral shifts. Many people pointed to the need to build support for reforms outside of government. It was suggested that there is a need for strong business associates at the state level with the capability for careful, objective analysis and the ability to voice concerns in the corridors of government and the court of public opinion.

5.35 The Mozambique case study indicates that the Bank did not work vigorously enough to build commitment in the government to manage and implement the reform process. The 1997 Action Plan for reform of administrative barriers was not thoroughly discussed by all the relevant ministries and agencies, nor did the government formally endorse it. The lack of ownership, support, and participation by the respective stakeholders resulted in poor implementation.

**Institutional issues are key**

5.36 The literature review for this evaluation provides evidence that cross-country differences in the quality of institutions explain a large share of the differences in growth, and may even “trump” other growth determinants. The case studies provide examples of countries where the Bank paid insufficient attention to institutional weaknesses, and as a result had little impact on the investment climate.

5.37 Although the Bank has done much to improve the financial sector in Mozambique, little has been done to address institutional weaknesses that continue to hamper lending to the private sector and investment in equities. Interviews called attention to three important areas where business leaders say the Bank should have been more involved in financial sector reform during the decade: improving financial information, improving contract enforcement mechanisms, and improving the land law and movable assets law to increase the private sector’s collateralizable asset base. It was argued that the Bank’s lack of attention to the underpinnings of financial markets — for example, accounting standards and skills — is one of the reasons for continued high interest rates and lack of access to credit. Bank activities
have supported programs in the legal area, but enforcement problems continue to cause banks to require more than 100 percent collateral for most loans.

5.38 During the second half of the 1990s, Bank activities in Romania strongly supported efforts to strengthen the country’s nascent institutions in order to improve the investment climate. Many of these efforts have been successful (for example, secured transactions reform) but others have been less successful due to institutional factors. By contrast to moveable property, the legal status of fixed property (land and buildings) remains unsatisfactory, and the problems are especially difficult in rural areas. The focus of the General Cadastre and Land Registration Project was on technical mapping — rather than ensuring that property owners receive a registered title — and has resulted in little change in the land market. Both domestic and foreign investors continue to complain that uncertainty over land ownership has caused delays and cost increases in investment projects. In some cases, planned investments have been cancelled. The Bank supported changes in the legal framework for business under the PSAL and PIBL, but there was insufficient focus on the institutions necessary to enforce the laws. As a result, the legal system remains weak, and governance is poor.

5.39 In Peru, contract enforcement remains lengthy and costly. Businesses still view the legal system as almost irrelevant — they usually confine transactions to those they know well. In surveys of Peruvian businesses, the overwhelming majority claimed that the court system did not adjudicate disputes impartially, delays were long, and judges were untrained in commercial law and open to influence.

5.40 OED’s recent Project Performance Assessment Report on three PSD projects in Guyana provides an illustration of Bank efforts to improve the investment climate in a low-income country. The assessment concluded that the Bank did not have a realistic understanding of the structure of institutional dynamics and incentives, the governance context (including a recognition of the implications of the ethnic divide between citizens of African and Indian descent), and management capabilities. As a result, all three projects failed to anticipate the risks of weak ownership, rent seeking, and poor management, which severely constrained the effectiveness of the projects.

The implementation of reforms can get bogged down at lower levels of bureaucracy if incentives haven’t changed

5.41 Professional civil servants are key to the success of reform efforts. The responsibility for the implementation of regulatory and administrative reforms often runs across a large number of government agencies and departments. Senior civil servants must understand, support, and assume ownership of reforms.

5.42 Bank investment climate activities in Mozambique beginning in 1996 made relevant contributions to the process of removing microeconomic impediments to investment. FIAS Administrative Barriers to Investment studies (1996, 2001) and Investment Climate Assessments (1997, 2002) helped to identify the reform agenda. To improve private sector capacity to analyze and lobby for reforms, the Bank supported the formation and early operation of the Confederation of Mozambique Business Associations. To improve
government capacity to analyze and implement reforms, the Bank provided assistance to establish a private sector development unit in the Ministry of Industry and Commerce, and provided technical assistance to the unit to work with the private sector on administrative and regulatory changes. To facilitate a continuing dialogue between government and business concerning investment climate reforms, the Banks supported an annual private sector conference.

5.43 These efforts, though modest in financial terms, helped the government make some improvements in administrative procedures and laws and regulations governing investment. But business leaders interviewed for this evaluation stated that the reforms undertaken to date are far from sufficient to ease the prevailing administrative and regulatory constraints to investment. Reforms require more than rewriting legal and regulatory frameworks. They must be coupled with capacity building to address weaknesses of executing agencies, and efforts to build political consensus and commitment by government leaders to adopt and implement required reforms. And even when there was a desire at the highest levels of government to reform administrative barriers to investment, this desire was not manifested into a shared vision or commitment adopted by all political parties, responsible ministries, and executing agencies. Reform implementation problems partly stemmed from the overlapping structure of government institutions and lack of clarity on responsibilities and accountability. But there also existed a widespread “passive resistance” from unmotivated executing agencies and officials, and corruption at all operational levels. These problems could not have been solved by reforming investment procedures alone — they required complementary civil service reform.

5.44 Indonesia’s legal and judicial system has been viewed for decades as unreliable for enforcing rights or resolving disputes. The government initiated a series of reforms since the Asian financial crisis, but follow-through has been disappointing and pessimism has grown about the pace of reforms. A recent assessment by the UN Special Rapporteur suggested that progress was poor. Political will to push through the reforms is lacking, and corruption in the institutions that enforce the laws has not been tackled. Indonesia’s political and economic elite benefit from the existing corrupt system and are not eager to change it. Without a powerful constituency, legal and judicial reforms have had limited impact.

5.45 The India case study concluded that legal and regulatory reforms should have been supported by efforts to build the capacity of relevant institutions. Most of those interviewed voiced concern about the extent to which reforms had been institutionalized. The concern related less to the particulars of laws and regulations, but more with the mindset and capabilities of government agencies and departments. In particular, people cited problems with lower-level officials and cited the need for training.

5.46 Finally, in Romania, the General Cadastre and Land Registration Project was designed to address the lack of an effective land market that have been identified as an issue throughout the 1990s. The project was intended to support a unified system of land registration in the country, establish a cadastre system to provide up-to-date and unambiguous definitions of existing real estate parcels for land registration, institute a low-cost and reliable method for land transactions, and facilitate collateralization of this more fundamental and widespread asset. However, the outcome of the loan has been disappointing,
in part because judges handling land issues were underpaid, many were unmotivated, and there was evidence of corruption in the system.\textsuperscript{46}

\textit{Modest, piecemeal efforts are less successful than a “big push” of reforms}

5.47 Bank activities in Mozambique have made relevant contributions to the process of removing microeconomic impediments to investment. But business leaders interviewed for this evaluation state that reforms undertaken to date are far from sufficient to ease prevailing administrative and regulatory constraints to investment. They felt that the Bank’s support has been too modest, too piecemeal, and too inconsistent to get the job done. They stressed that, if the Bank were really serious about increasing the pace and scope of these types of reforms, it should have developed a program with the government to make a “big push” to get the necessary changes, as in its adjustment lending for macroeconomic reforms, rather than the “partial program” it put together.

5.48 The Bank’s early focus on investment climate issues in Peru was apparent in a series of high-quality analytical reports throughout the 1990s. In fact, many of the later reports identified issues that had been raised in earlier reports: regulation, policy uncertainty, infrastructure, a weak judiciary, underdeveloped financial markets, and poorly protected property rights. Despite successive CASs that established private sector development as a priority, a comprehensive strategy for doing this was not prepared. Although critical constraints to PSD had been identified in ESW, they were not pulled together into a cohesive investment climate action plan. Partly as a result, there has been progress on some investment climate issues but little or no progress in others.

\textbf{Conclusions}

5.49 The country case studies conducted for this evaluation show that investment climate reforms are usually motivated by factors external to the Bank — either by economic or political crisis, or by the prospect of joining regional agreements — but that the Bank has helped governments push reform primarily through its intellectual contributions. Lending conditionality has also helped the process of reform by strengthening the hand of reformers and preventing backsliding. Even in poor, low-capacity countries, the Bank can make progress if the government is committed to reform.

5.50 Where results have been disappointing, they have mainly resulted from a lack of implementation of the laws and regulations adopted under Bank-supported reform efforts. Often the Bank has not understood or paid sufficient attention to institutional issues, for example, the skills and incentives that determine the behavior of authorities charged with implementing the reforms. The process of changing institutions takes time, and getting institutions right is highly country-specific.

\textsuperscript{46} The Bank and the Government of Romania have agreed to and begun implementation of the restructuring the General Cadastre and Land Registration Project to ensure its meeting the development objectives. The restructuring includes the integration of land registration and cadastral tasks into one function in one new agency and a re-design of the capacity building component of the project.
5.51 Local champions often drive reforms, but broad support is needed to sustain them. The Bank has been more effective when it used its convening and coordinating role to build support among various segments of society, and engaged in a continuing dialogue with both the public and the private sectors.

5.52 In some countries, the Bank’s support has been too modest and piecemeal to make a significant difference in the quality of the investment climate. When the critical constraints to private sector development are pulled together into a cohesive action plan, investment climate outcomes have been better.
6. **Organizational Issues**

6.1 Responsibility for the Bank’s investment climate operations is spread across the institution. Investment climate lending operations in the Regions are primarily managed by Finance and Private Sector Development, Poverty Reduction and Economic Management (PREM), and Infrastructure units. The sector units in the Regions are organized somewhat differently across Regions: in some, Infrastructure is combined with Finance and Private Sector Development (FPSD), and in others Infrastructure is separate; in the East Asia Region, financial sector and private sector development is part of PREM, but in the other regions it is outside of PREM.

6.2 The central “Anchor” for the investment climate is the Investment Climate Department of the joint World Bank-IFC Private Sector Development Vice-Presidency. In this department are three joint Bank-IFC units: the Foreign Investment Advisory Service (FIAS); the Monitoring, Analysis, and Policy Unit in charge of the Doing Business projects; and the Investment Climate Unit (CICIC), in charge of network responsibilities and the Investment Climate Assessment (ICA) initiative. The PSD Vice-Presidency is led by a Bank-IFC Vice President who is also the Chief Economist of the IFC.

6.3 Since its creation in 2002, CICIC has focused on the development of standardized investment climate diagnostic instruments — Investment Climate Assessments and the Doing Business Project. The ICAs have been implemented by the Regions with budget and technical support from CICIC. Planning and quality control of the ICA program is under the management of the PSD Sector Board.

6.4 The wide-ranging “ownership” of the Bank’s IC portfolio is apparent in the assignment of projects to individual networks and sector boards. In fact, more Core IC projects are assigned to non-PSD networks (particularly Infrastructure, PREM, and Financial Sector) than to PSD. Only 17 percent of Core IC projects were managed by the PSD Sector Board over fiscal 1998-2003 (Table 6.1). The PREM share of Core IC projects has increased over the past 10 years. The PSD Board manages even fewer of the Non-Core IC projects, since most of the “infrastructure services for PSD” projects are handled by the Infrastructure network, “tax policy and administration” by PREM, and “other financial and private sector development” by the Financial Sector network. ESW on investment climate issues is similarly spread across a wide range of networks.

6.5 Discussions with clients and staff conducted as part of this evaluation identified a number of specific organizational issues that have affected the quality of the Bank Group’s work on the investment climate. They concern the division of labor across sector units within Regions; the respective roles of the Regions versus central units; and the roles of the Bank and IFC.
Table 6.1: Network Assignment of Core IC Projects

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<tbody>
<tr>
<td></td>
<td>No. Projects</td>
<td>% of Total</td>
<td>No. Projects</td>
<td>% of Total</td>
</tr>
<tr>
<td>Infrastructure (INF)</td>
<td>65</td>
<td>34%</td>
<td>45</td>
<td>23%</td>
</tr>
<tr>
<td>Poverty Reduction and Economic Management (PREM)</td>
<td>51</td>
<td>26%</td>
<td>60</td>
<td>31%</td>
</tr>
<tr>
<td>Financial Sector (FSE)</td>
<td>40</td>
<td>21%</td>
<td>37</td>
<td>19%</td>
</tr>
<tr>
<td><strong>Private Sector Development (PSD)</strong></td>
<td><strong>23</strong></td>
<td><strong>12%</strong></td>
<td><strong>33</strong></td>
<td><strong>17%</strong></td>
</tr>
<tr>
<td>Environmentally and Socially Sustainable Development (ESSD)</td>
<td>13</td>
<td>7%</td>
<td>19</td>
<td>10%</td>
</tr>
<tr>
<td>Human Development (HDN)</td>
<td>2</td>
<td>1%</td>
<td>2</td>
<td>1%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>194</strong></td>
<td><strong>100%</strong></td>
<td><strong>196</strong></td>
<td><strong>100%</strong></td>
</tr>
</tbody>
</table>

6.6 Within Regions, linkages among sector units on investment climate issues have been weak. With the exception of the East Asia Region, PSD and PREM are separate departments that compete to some degree for the PSD agenda. In many regions (for example, ECA and increasingly LAC), first-generation reforms are no longer the focus of country assistance strategies, either because macroeconomic stability has been restored or because the solutions to macroeconomic problems are well known. Along with the shift toward second-generation reforms in CASs, PREM has taken more responsibility for covering microeconomic and institutional topics and including them in adjustment loans, which are often managed by PREM staff. It is not surprising that the competition between PSD and PREM units has become pervasive, and has led in some cases to a lack of coordination and information sharing.

6.7 The lack of coordination between PSD and PREM on investment climate operations has been a problem because of the need to integrate macroeconomic and microeconomic concerns. The burden of integrating different sector perspective and setting priorities now lies with the Country Departments — but some country departments have been more actively involved in managing this integration than others.

6.8 The broad nature of the investment climate topic — and the need to balance private sector interests with broader economic and social goals — requires the Bank to have an organizational structure that facilitates integration across sectors and collaboration among staff. Recently, the joint World Bank-IFC Private Sector Development Vice-Presidency has undertaken to improve coordination and reap synergies in investment climate work across the World Bank Group, for example by holding WBG-wide country review meetings and conducting WBG-wide training in the field.

6.9 A second issue has been the role of central units compared to the Regional units. Currently, CICIC is mainly involved in designing and supporting the implementation of investment climate diagnostics — the task of collecting descriptive information on the investment climate. As mentioned in previous chapters, the Bank’s knowledge in some areas — “best-practice” institutions, the political economy of reform, and how to facilitate
indigenous reform processes — seems to have been lacking. This suggests that the Anchor could take a larger role in building and disseminating knowledge in these areas.47

6.10 The third issue deals with the respective roles and comparative advantages of the Bank and IFC (and to a lesser degree MIGA) on investment climate activities. This issue is discussed in the combined OED/OEG/OEU overview report.

47. Work conducted in FY04 and planned for FY05 includes country case studies of investment climate reforms; using lessons and research from the FIAS program to compile best practice in policies and institutions; and a focus on reform episodes in the next Doing Business report.
7. Recommendations

1. Pay more attention to institutions and the political economy of reform.
   a. Do more analytical work on institutional arrangements and the political economy of reform, involving local organizations. This could include (i) a guidance note with a typology showing what types of institutional arrangements work in different country circumstances; (ii) assessments of a country’s institutional capacity constraints, incentives, barriers to changing behaviors, and training needs, to help design IC assistance and monitor progress; (iii) country case studies of IC reform successes and failures to gain a better understanding of how reform processes are motivated and sustained, and the role of different stakeholder groups.
   b. Be less timid in dealing with vested interests and in building a balanced constituency for reform. Make better use of the Bank’s convening power to bring the government together with the business community, as well as with consumer and labor groups, and local think tanks.
   c. Be more proactive in disseminating information — on investment climate constraints, the country’s reform agenda, the implementation of laws and the achievement of specific targets, and lessons from the reform experience of other countries. The Bank could facilitate research by academics by ensuring better access to investment climate data and research results.
   d. Make a stronger push for transparency and openness – to help create political will where it is weak, to enlist local oversight of potential government inefficiencies and abuses, and to improve the investment climate itself.
   e. Ensure that Bank staff develop a deep understanding of and sensitivity to country-specific political and business cultures, as well as key features that define the relationships between business and government.

2. Improve the focus and use of survey-based diagnostics.
   a. Focus Investment Climate Assessments on specific country needs. Make greater use of existing material and collaborate with other donors doing similar things to avoid duplication of effort.
   b. Take into account the heterogeneity of investment climate conditions by targeting diagnostic assessments on sub-national geographic areas or individual industries.
   c. Recognize that enterprise surveys represent only the views of the business community. Use survey-based diagnostics only as an input to making policy recommendations in order to balance business perspectives with broader economic and social concerns.
3. **Do a better job of prioritizing and packaging IC reforms in lending operations.**
   
a. Give high priority to reforms that will build political and civil society commitment to continue the reform process — by focusing on problems that, if fixed, would have immediate positive impacts.

b. Consider packaging a critical mass of microeconomic reforms and components (including civil service reform and training of public officials) into IC-focused adjustment loans, rather than piggy-backing small investment climate components to macroeconomic adjustment operations.

c. Choose lending instruments appropriate to support the process of institutional change over a long period of time (e.g., programmatic adjustment loans). This will help ensure that changes in laws and regulations are actually implemented, and are sustained.

4. **Find organizational solutions that help integrate microeconomic and macroeconomic reform agendas.**
   
a. Maintain the responsibility for integration with the country departments, but provide better support from the sector and anchor units, IFC, and MIGA. Clearly define the roles of the sector units in the Regions ( prinipally PSD and PREM) to improve coordination and reduce potential conflicts.

b. Improve the integration of sectoral issues in proposed reform strategies. Possible options to accomplish this would be to continue and expand the recent practice of holding country-level PSD reviews (for individual countries, country departments, or regions), bringing together staff across sector units (particularly PSD and PREM) as well as the IFC and MIGA; and/or to nominate investment climate “coordinators.”
References


Hubbard, Glen; Anil Kashyap; and Toni Whited (1994). “Internal Finance and Firm Investment” Journal of Money, Credit and Banking.


Annex 1: Evaluation Methodology

Evaluation Framework

1. The chain of causality from World Bank investment climate activities to economic performance outcomes, illustrated below, has three main parts:

   (1) Between Bank activities and the adoption of policy and institutional reforms.
   (2) between reforms and actual changes in the investment climate.
   (3) between changes in the investment climate and performance outcomes (firm-level productivity and profitability, and economy-wide productivity, investment, income, and employment).

Figure A.1: Logic Model for World Bank Investment Climate Activities

2. The Investment Climate Study focuses on the first parts of the chain — from Bank activities to investment climate outcomes — relying on a review of the literature to provide evidence on the relationship (3) between improved investment climates and final economic outcomes.

3. The evaluation addresses the following questions:

   - **Relevance of Bank assistance:** What relative priority did the Bank attach to addressing investment climate issues among its total interventions? Were the policy and institutional areas emphasized in Bank operations consistent with current empirical research linking investment climate indicators with performance outcomes, and with the obstacles to investment as perceived by potential investors? Do the survey-based diagnostics used by the Bank provide good information about the quality of the investment climate, and do they lead to sound policy advice?

   - **Effectiveness of Bank assistance:** Are Bank activities helping to get investment climate reforms implemented? Was the Bank effective in motivating client governments to undertake reforms, beyond what they would have done in the absence of Bank intervention? Was conditionality in lending operations helpful in supporting reform? What were the outcomes of Bank interventions, in terms of the quality of the investment climate and in terms of investment and growth?

   - **Sustainability:** What is required for investment climate improvements to be sustained? How should reforms be sequenced?

   - **Organizational issues:** Does the Bank’s organizational structure support good investment climate work?
4. The evaluation comprises the following components:

- A review of the literature on the drivers of investment and growth, and of the microeconomic factors that determine investment behavior.
- A review of investment climate issues in Bank strategy documents — institution-wide PSD strategies, Country Assistance Strategies (CASs), and Poverty Reduction Strategy Papers (PRSPs).
- A description and analysis of the portfolio of IBRD/IDA lending operations that support improvements in the investment climate.
- A description and analysis of IBRD/IDA non-lending services including economic and sector work and survey-based diagnostic assessments.
- Results of discussions with Bank staff and international investors.
- Client consultations and country case studies for India, Indonesia, Mozambique, Peru, and Romania.

Literature Review

5. A literature review was prepared in order to provide a conceptual framework for the Investment Climate Study. Theoretical and empirical literature on the investment climate, produced both inside and outside the Bank, was reviewed. Specifically, the literature review focused on the following topics:

- The relationship between economic growth and poverty reduction.
- The relationship between the quality of the investment climate and investment flows, both domestic and foreign.
- Aspects of the investment climate that make the most difference to investors, both domestic and foreign.
- The importance of the investment climate as a determinant of investment, relative to other factors (e.g., macroeconomic and political risk, labor costs, global investment strategies).
- Policy and institutional reform strategies that have had the most success in improving the investment climate.

6. The review was prepared in November 2003 by Tyler Biggs (consultant) and is available as a background paper for this report.

International Investor Interviews

7. Interviews with large multinational investors were held in Washington D.C., Tokyo, London, and Brussels between early November 2003 and mid-January 2004. The interviews were conducted by Benjamin Rowland (consultant). The participants were chosen by the consultant and several others, including Thomas Niles and Steven Canner of the U.S. Council for International Business (USCIB); Gilles Garcia, private sector outreach officer in the World Bank’s Paris office, Jonas Moberg and Gina May of the Prince of Wales International Business Leaders’ Forum (IBFL) in London, Carlos Gonzales-Finat of the Union of Industrial and Employers’ Confederations (UNICE) in Brussels; and Y. Yoshimura and K.
Omori of the World Bank’s Tokyo office, with additional help from the staff of the leading Japanese industry association, Nippon Keidanren. USCIB, IBLF, and UNICE kindly provided the use of their facilities for the meetings.

8. The main criteria for the selection of participants were: headquarters-based executives with a good knowledge of the overseas investment strategies and procedures in their respective companies; a willingness to be open and candid; and the ability to participate fully in meetings conducted in English. Although detailed prior knowledge of the World Bank and its programs was not intended to be a requirement for participation, familiarity with the Bank and its goals proved to be fairly strong. For example, two of the corporate respondents, one in Washington and one in Tokyo, were former World Bank Group staff members, and at least four others, one in Washington, two in Tokyo and one in Europe, had negotiated or done business with the Bank in areas such as finance, procurement, and partnering.

9. To establish a common threshold level of knowledge about the Bank’s investment climate programs and the design and aims of the OED evaluation, all participants received briefing materials about 10 days before the meetings. These materials included (1) a discussion of the scope and definition of the OED evaluation, together with an attempt to place the evaluation subject matter in the context of the broader range of activities undertaken by the Bank Group in the name of “private sector development”; (2) a summary statistical analysis of the Bank’s “investment climate” loan portfolio; (3) examples of the two new diagnostic instruments (the “Investment Climate Assessments” and the annual “Doing Business” survey) developed to carry out the Bank’s recently initiated Private Sector Development Strategy; and (4) several questions to help guide the discussions.

10. A summary description of the corporate and industry-association participants is provided in Table A.1. Aggregate revenues for the corporate participants are approximately $735 billion. Total employment is approximately 1.4 million. Nine of the 17 participating companies are included in the 2003 World Investment Report (produced by the United Nations Conference on Trade & Development) list of the 100 largest non-financial transnational corporations.
Table A.1: Participants in International Investor Interviews

<table>
<thead>
<tr>
<th>Sector and Co.</th>
<th>Home Country</th>
<th>Revenues (US$bil)</th>
<th>Employees (000s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Computer and information technology</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Leading computer co.</td>
<td>US</td>
<td>90</td>
<td>315</td>
</tr>
<tr>
<td>Leading computer co.</td>
<td>Japan</td>
<td>38</td>
<td>118</td>
</tr>
<tr>
<td>Infrastructure</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gas</td>
<td>UK</td>
<td>5.3</td>
<td>4.6</td>
</tr>
<tr>
<td>Water and sewer</td>
<td>France</td>
<td>13.3</td>
<td>77</td>
</tr>
<tr>
<td>Water and sewer</td>
<td>UK</td>
<td>2.3</td>
<td>14</td>
</tr>
<tr>
<td>Telecom</td>
<td>US</td>
<td>68</td>
<td>230</td>
</tr>
<tr>
<td>Telecom</td>
<td>UK</td>
<td>50</td>
<td>53</td>
</tr>
<tr>
<td>Investment Fund</td>
<td>US</td>
<td>na</td>
<td>na</td>
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<td>Extractive</td>
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<td></td>
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<tr>
<td>Integrated oil co</td>
<td>Europe</td>
<td>202</td>
<td>116</td>
</tr>
<tr>
<td>Mining</td>
<td>UK</td>
<td>20.5</td>
<td>177</td>
</tr>
<tr>
<td>Mining</td>
<td>UK</td>
<td>10.8</td>
<td>36</td>
</tr>
<tr>
<td>Const. / Engineering</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Industrial const.</td>
<td>US</td>
<td>4.5</td>
<td>15</td>
</tr>
<tr>
<td>Shipbuilding</td>
<td>Neth.</td>
<td>10</td>
<td>30</td>
</tr>
<tr>
<td>Pharmaceutical</td>
<td>UK</td>
<td>34</td>
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<tr>
<td>Apparel / Footwear</td>
<td>US</td>
<td>10</td>
<td>22</td>
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<tr>
<td>Chemical</td>
<td>Japan</td>
<td>10</td>
<td>2.2</td>
</tr>
<tr>
<td>Trading Co.</td>
<td>Japan</td>
<td>168</td>
<td>35</td>
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<tr>
<td>Industry Associations</td>
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<tr>
<td>Nippon Keidanren</td>
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<td>Prince of Wales International Business Leaders’ Forum</td>
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<td>UNICE</td>
<td>Belgium</td>
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<td>European Services Forum</td>
<td>Belgium</td>
<td></td>
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<tr>
<td>European International Contractors</td>
<td>Germany</td>
<td></td>
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<tr>
<td>U.S. Council for International Business</td>
<td>US</td>
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</table>

11. Participants were asked the following discussion questions:

- Which country-level factors do you consider when making international investment decisions?
- How important are “investment climate” considerations in your investment decisions?
- Which investment climate considerations (if any) do you include in screening for investment locations? How much weight do you give to them?
- Are the investment climate activities that are the focus of World Bank Group lending and advisory services the most important ones, from the vantage point of your company’s location decisions?
• Can you provide examples of how investment climate improvements have affected the costs and risks in the developing countries where you invest? Do the improvements affect your company’s bottom line?
• Is the quality of existing firm-level and country investment climate data (from private or other multilateral institution sources) a deterrent to making good investment decisions in developing countries for your company? Do the new World Bank instruments, i.e., the Investment Climate Assessments and the annual “Doing Business” survey fill a gap?
• Were you aware of World Bank Group activities in the area of investment climate reform? Would more information about these activities (e.g., activity details, participating countries) affect your investment location decisions?
• Is the PSD investment climate strategy, with its emphasis on generating internationally comparable survey data, and a common assessment methodology for the Bank’s operating regions, the best use of Bank Group resources to “lower the transaction costs and risks of investing in and operating a company”? (alternatives might include a stronger emphasis on implementing the Bank Group’s policy advice, measures to improve (increase) direct lending to and risktaking on behalf of the private sector, etc.).
• Has the presence of IFC as a direct investor taking private sector risk in specific companies and sectors served as a demonstration effect or influenced your company’s perception of investing in a particular country?
• Are you familiar with MIGA’s instruments that target improving the investment climate?
• Have you ever used, or considered using, MIGA products or services (e.g., political risk insurance or information services for potential foreign investors such as IPAnet and FDI Xchange)? If so, have you found these products or services effective and useful?
• How would you rate these MIGA products and services compared with similar products from other providers (e.g., political risk insurance from national or private investment insurers, information services from commercial providers, or other international organizations)?
• When considering or undertaking an investment in a developing country, have you used the services of investment promotion agencies? If so, have you found these agencies’ assistance to be effective and useful?
• Other topics?

Bank Group Staff Discussion Groups

12. OED, OEG, and OEU held joint discussion groups with Bank staff to get their feedback on World Bank Group investment climate activities. Invited staff were task managers of private sector development (PSD) projects, PSD specialists, country economists, and IFC investment officers. Two discussion groups were held: one on February 3, 2004, for the AFR, EAP, and LAC regions; and one on February 10, 2004, for the ECA, MNA, and SAS regions. The results of the discussions are summarized in a background paper by Ramachandra Jammi (OED).
13. Participants were provided with background materials in advance of the meeting, which included (a) the objective and components of the evaluation, (b) the working definition of the investment climate, (c) a description of the investment climate portfolio, (d) project descriptions from OED evaluation summaries, and (e) findings from OED country assistance evaluations.

14. Participants were:

<table>
<thead>
<tr>
<th>Name</th>
<th>Office</th>
</tr>
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<tbody>
<tr>
<td>Magdi Amin</td>
<td>EASFP</td>
</tr>
<tr>
<td>Bernard Drum</td>
<td>EASFP</td>
</tr>
<tr>
<td>Charles Feinstein</td>
<td>LCSFP</td>
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<tr>
<td>Arvind Gupta</td>
<td>EASPS</td>
</tr>
<tr>
<td>Gaiv Tata</td>
<td>DECWB</td>
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<tr>
<td>Albert Zeufack</td>
<td>EASPR</td>
</tr>
<tr>
<td>Ahmad Ahsan</td>
<td>SASPR</td>
</tr>
<tr>
<td>Irina Astrakhan</td>
<td>ECSPF</td>
</tr>
<tr>
<td>Harry Broadman</td>
<td>ECSPE</td>
</tr>
<tr>
<td>Kutlay Ebiri</td>
<td>CEUST</td>
</tr>
<tr>
<td>Jim Emery</td>
<td>CASFC</td>
</tr>
<tr>
<td>Neil Gregory</td>
<td>CSASC</td>
</tr>
<tr>
<td>Peggy Henderson</td>
<td>CMEDR</td>
</tr>
<tr>
<td>Gregory Jedrzejczak</td>
<td>ECSPF</td>
</tr>
<tr>
<td>Arthur Karlin</td>
<td>COSDR</td>
</tr>
<tr>
<td>Mihaly Kopany</td>
<td>TUDRU</td>
</tr>
<tr>
<td>Melanie Mbuyi</td>
<td>AFTPS</td>
</tr>
<tr>
<td>Mohua Mukherjee</td>
<td>AFTOS</td>
</tr>
<tr>
<td>Vijaya Ramachandran</td>
<td>AFTPS</td>
</tr>
</tbody>
</table>

15. The discussion questions were:

**Relevance:**
- Have investment climate (IC) issues been given enough priority — relative to macroeconomic, rural, social, and human development issues — in the countries you are familiar with?
- Have the IC issues chosen for emphasis in Bank country strategies reflected the most important constraints to investment and enterprise performance?

**Instruments:**
- Have the instruments of Bank assistance (adjustment loans, technical assistance, diagnostic studies, etc.) been appropriate to country needs?
- Should IC constraints be tackled in stand-alone projects, as opposed to being components of larger structural adjustment loans?

**Diagnostics:**
- Did the Bank’s diagnostic work (Private Sector Assessments, Investment Climate Assessments, and other economic and sector work) provide a sound basis for policy dialogue and operations?
- How might these instruments be improved?

Outcomes:
- What factors seem to have led to good outcomes, or poor outcomes, in Bank IC projects?
- Can we expect good IC outcomes in countries with poor macroeconomic conditions?

Organizational structure:
- Are the mandates of the various Bank Group units dealing with the investment climate clearly defined in theory and in practice?
- Are there overlaps or gaps in responsibility?
- Do the Bank, IFC, and MIGA operate in areas of their comparative advantage, and are synergies being utilized?
- Has Bank-IFC coordination on PSD strategies in CASs worked well?
- Have there been areas of conflicting objectives between the Bank and IFC in policy or regulatory issues?

Human resources:
- What kinds of expertise are needed in the Bank to design and implement high-quality assistance on IC issues?
- Are these resources available?

Country Case Study Protocol

Activities to be Included

16. The set of World Bank activities to be included in the evaluation, covering the period fiscal 1993 through fiscal 2002, will be taken from the previously constructed databases of lending operations and non-lending services. The set of activities will include individual lending operations (closed as well as ongoing projects), surveys/assessments, ESW, advisory services, training and knowledge dissemination, and partnerships. The review will also include activities undertaken by the Bank/IFC SME Department. Other IFC and MIGA activities will not be specifically evaluated in the case study, but issues of coordination between the Bank and IFC/MIGA will be covered.

Unit of Analysis

17. The unit of analysis was the country. However, it proved useful to focus on particular organizations (e.g., a foreign investment promotion institution) or policy (e.g., commercial transactions law) as an embedded unit of analysis. This was appropriate when the institution or policy received sustained attention from the Bank over a period of time.
External Sources of Information

18. Prior to the mission, the following information will be collected:

- **Strategic documents**: the CASs covering the period, as well as any relevant policy notes (e.g., dealing with private sector development).

- **Project documentation**: For each lending operation, the Memorandum of the President and the Appraisal Report.

- **Existing evaluation material**: Quality Assurance Group reviews and Project Supervision Reports (PSRs); for completed projects, the Implementation Completion Report (ICR) and Evaluation Summary (ES) and, where applicable, the Project Performance Assessment Report (PPAR); Country Assistance Evaluations (CAEs).

- **ESW and surveys/assessments**: surveys/assessments produced during the period (Private Sector Assessments, Firm Analysis and Competitiveness Surveys, World Business Environment Survey, Investment Climate Surveys, Investment Climate Assessments); relevant economic and sector work (e.g., reports on private sector development, or PSD chapters in Country Economic Memoranda).

- **Investment climate indicators**: Existing data on the constraints to private sector development, the cost of doing business, and country risk indicators.

- **Economic outcome indicators**: annual data on domestic and foreign investment, the share of private sector activity in GDP, private sector employment, productivity growth (if available), exports, GDP growth, and poverty indicators, from 1990 through the most recent year available.

Persons to be Interviewed

19. In headquarters, relevant staff and managers were interviewed to gain their perspectives on the objectives and targets of activities, how activities were implemented, and the results of the interventions.

20. In the field, persons interviewed included relevant government officials (policymakers and management in institutions receiving assistance) as well as representatives of the private sector to gain their perspectives on constraints to private sector development during the past 10 years, the relevance of policy and institutional reforms undertaken by the government, the effects of those reforms, and the remaining reform agenda.

Evaluation Questions and Methodology

21. The questions addressed in the case study, and sources of information used to form conclusions, are shown in the table below. Note that “outcome” refers to the efficacy of Bank strategy and activities, and includes Institutional Development Impact. Bank Group performance should cover the effectiveness of the institution’s organization, knowledge sharing, etc. in contributing to intended outcomes.
### Evaluation Questions and Methods

<table>
<thead>
<tr>
<th>Relevance</th>
<th>Sources of Information</th>
</tr>
</thead>
</table>
| Did the investment climate themes chosen for emphasis in Bank strategy reflect the most important constraints to investment, employment, and growth of the private sector? | • Literature review  
• CASs, Sector Strategies  
• IC indicators  
• Surveys/assessments, ESW  
• Project documentation  
• Evaluation material  
• Headquarters and field interviews |
| Did Bank diagnostic work lead to the choice of relevant objectives for lending operations? |
| Were the instruments chosen appropriate to country needs at the time? |

<table>
<thead>
<tr>
<th>Outcome (including Institutional Development Impact)</th>
<th>Sources of Information</th>
</tr>
</thead>
</table>
| Were changes in the quality of the investment climate associated with changes in economic outcomes (foreign and domestic investment, productivity growth, sectoral and GDP growth)? | • Literature review  
• CASs, Sector Strategies  
• IC indicators  
• Surveys/assessments, ESW  
• Project documentation  
• Evaluation material  
• Headquarters and field interviews |
| Were the policy and institutional reforms adopted associated with changes in transactions costs and risks? Were private sector perceptions of risk improved? |
| Were the adopted reforms actually implemented and sustained? Were necessary complementary actions taken? |
| Did the Bank have an influence on the government’s decisions to adopt policy and institutional reforms? |
| Were there other plausible explanations for outcomes, apart from Bank activities? |
Sustainability

What was the degree of government commitment to reform, and did the Bank correctly assess this commitment?

Was there sufficient government ownership of reforms?

Were the concerns of civil society (particularly the private sector) recognized and taken into account?

Have the policy and institutional reforms been sustained? Do the relevant institutions have enough capacity to continue their work?

Were temporary subsidies reduced or eliminated?

Were implicit budget subsidies (e.g., to newly privatized firms) reduced or eliminated?

Bank Group Performance

Was relevant information about constraints to private sector development shared among the various WBG units involved in improving the investment climate?

Were activities undertaken by various units well coordinated?

Did the various units undertake activities that were in their comparative advantage?

Borrower Performance

Did the Government own the process of reform and take a leadership role in the preparation, implementation, and evaluation of the project?

Were counterpart funds provided as required?

Did the Government sustain the necessary policy and institutional framework required to sustain the impact of the project?

Outline of the Case Study

I. Country Context

A. Trends in Investment, Employment, and Growth
B. Trends in the Quality of the Investment Climate

II. Bank Activities to Improve the Investment Climate
   A. Strategic focus
   B. Lending operations
   C. Non-lending services

III. Relevance of Bank Activities

IV. Outcome of Bank Activities

V. Sustainability

VI. WBG Performance

VII. Borrower Performance

VIII. Lessons for the Future
Annex 2: Investment Climate Theme Definitions

Core IC Themes

32 Judicial and other Dispute Resolution Mechanisms

Includes activities aimed at:

- Improving the efficiency of the courts, simplifying court procedures, improving capacity of court personnel, and modernizing case management and court administration.
- Supporting the rehabilitation of courts and the provision of information technology.
- Strengthening institutions responsible for budget, planning, human resources, and court facilities; and those involved in rendering, publishing, and enforcing judgments.
- Improving the independence and accountability of the judiciary.
- Improving compensation, appointment, promotion, discipline, and removal procedures.
- Strengthening judicial and court personnel training programs/institutes.
- Publication of court decisions and statistics.
- Support for watchdog civil society organizations (CSO).
- Building legal framework for complimentary resolution of disputes.
- Supporting alternative dispute resolution (ADR).
- Supporting arbitration, mediation, conciliation, mini-trials, small claims courts, and other dispute resolution mechanisms.
- Supporting indigenous customary and traditional methods of dispute resolution.

34 Legal Institutions for a Market Economy

Includes activities aimed at:

- Identifying vulnerabilities in existing frameworks having a negative impact on economic growth.
- Assessment of prevailing legal and regulatory frameworks.
- Establishing and strengthening of the legal and regulatory frameworks and legislative process related to economic and commercial activities so as to promote private sector development and economic growth in a fair and competitive economy.
- Assistance with formulation of appropriate policies.
- Assistance with study, formulation and revision of laws related to such matters as banking, insolvency, contracts, property, commercial transactions, competition, trade and the private provision of public infrastructure services, including telecommunications, water supply, electrical power, and transportation.
- Assistance with the application and implementation of relevant legislation.
- Improving capacity of institutions responsible for the regulation of private sector activities, including commercial banks, secured transactions, capital markets, and the private provision of infrastructure services.
- Assistance with regulatory frameworks for the above and related matters.
- Research and dissemination of results thereof regarding policy directions.
• Training of staff, externally and internally.

Includes activities aimed at:
• Clarifying and strengthening personal and property rights, including gender based, children’s, indigenous peoples’ and other human rights, social protection, labor, health, civil rights, and criminal law.
• Supporting with land titling, family and succession laws, other property laws.
• Creating and maintaining land, personal property security and intellectual property registers.
• Supporting institutions responsible for clarifying and strengthening such rights.
• Landlord-tenant courts and alternative disorder resolution (ADR).

Excludes business related laws which would be coded under Legal Institutions for a Market Economy

38 Corporate Governance

Includes activities that focus on:
• Rights of shareholders.
• Equitable treatment of shareholders.
• Treatment of stakeholders.
• Disclosure and transparency.
• Duties of the board.
• Assessment of corporate governance institutional frameworks and practices through the preparation of country assessments.

Excludes activities related to corporate social responsibility issues.

40 Regulation and Competition Policy

Activities that promote deregulation and enhancement of competition and improve the legal and regulatory framework for financial and private sector development

Includes activities aimed at:
• Elimination or weakening of state monopolies in various sectors.
• Simplification of business licensing and registration requirements.
• Removal or reduction of barriers to foreign direct investment.
• Enactment or refinement of competition policy, including its legal basis.
• Development of regulatory framework, including legislation and regulatory capabilities, for private provision of infrastructure.
• Strengthening the supervision and regulation of financial institutions and markets.
• Regulating the provision of electronic financial services (e-finance).
• Regulation of microfinance institutions.
Non-Core IC Themes

28 Tax Policy and Administration

Includes activities aimed at improving the effectiveness, efficiency, and fairness of public revenue systems, including tax policies and tax and customs administration at national and subnational levels of government. This category includes activities related both to the economic analysis of tax policies and to the design and functioning of institutions related to tax and customs administration (as well as the links between policies and institutions, and between tax and customs).

Excludes activities related to the economic analysis of individual tariff policies (which falls under Trade and Integration) or activities that involve minor changes in tax rates or coverage, or changes in revenue administration that are not intended to affect or address systemic issues of revenue policy or administration.

39 Infrastructure Services for Private Sector Development

Includes activities aimed at:
- Development of infrastructural services such as transport, information technology and communications, energy and water, where the objective is to improve the conditions in which private businesses operate, e.g., a rural electrification program that aims to facilitate the growth of rural enterprises.
- Improving logistics and distribution systems.
- Supply chain infrastructure.
- Customs facilities and procedures.

Excludes infrastructure projects that have objectives other than private sector development, such as a rural electrification program whose main goal is to improve living conditions for the rural population, not facilitate growth of rural enterprises.

44 Other Financial and Private Sector Development

Includes activities that:
- Help establish or strengthen institutions that provide support to the private sector (e.g., establishment or strengthening of investment promotion agencies, export promotion agencies or technology development institutions, capacity building of private sector collective bodies and development of public-private consultative mechanisms).
- Support development of nongovernmental service delivery mechanisms, such as output-based aid schemes involving private provision.
- Small-scale contracting to private providers and nongovernmental organizations (e.g., under social funds, may be included if the development of private sector or nongovernmental organization provision is an explicit objective. If there is a strong SME development objective, it may be classified under Small and Medium Enterprise Support.
- Support restructuring of private enterprises, such as corporate restructuring.
• Address multiple sub-themes in promoting financial sector development (e.g., for work in diversifying financial systems, developing domestic debt markets, advising governments with small financial systems, designing new financial instruments for managing risk, and systemic restructuring policy advice).

45 Export Development and Competitiveness

Activities that focus on the determinants of export growth and external competitiveness in developing economies.

Includes activities aimed at:
• Trade liberalization (e.g., benefits of unilateral tariff reform, pattern of Effective Rates of Protection and impact on foreign direct investment).
• Promoting nontraditional exports.
• Countering anti-export bias.
• Export promotion and marketing activities.
• Market liberalization and access in services.
• Diagnostic country trade studies.
• Aspects of “new” trade agenda at the national level, such as competition policy, product standards, and the linkage between exports and labor or environmental issues.
• Implementation challenges (e.g., timetable for phasing in tariff reductions, handling of sensitive industries, dealing with fiscal impact of tariff reduction).
• Business facilitation.

Excludes regional trade agreements/integration, global liberalization.

49 Trade Facilitation

Activities that focus on increasing the volume of international trade by reducing the costs and increasing the efficiency of transporting traded goods to consumers.

Includes activities with the following as either primary or secondary objectives:
• Modernizing and/or reforming customs operations and administration.
• Streamlining and modernizing border-crossing procedures and documentation requirements.
• Regional (cross-border) programs that strengthen mechanisms of interaction and cooperation among border agencies (and between border agencies and the trading community) in order to increase the efficiency of border operations.
• Reducing corruption and smuggling and enhancing security at border crossings.
• Enhanced transport and supply chain security.
• Improving trade and transit logistics (i.e., port, maritime, air, and multi-modal transportation).
• Expanding access to transportation modes (air, land, and sea) for firms and other business entities whose primary goal is to engage in external trade.
• Expanding access in landlocked countries to ports and other border posts.
• Increasing the quality and efficiency of transportation infrastructure — roads, railroads, ports, and airports — with a direct impact on lowering the costs of transporting goods to/from borders.
• Support for information technology infrastructure to enhance e-commerce usage within the trading community.
• Regulatory and administrative reform and harmonization to expand trade.
## Annex 3: The Investment Climate in Sector Strategy Papers

<table>
<thead>
<tr>
<th>Report Title and Date</th>
<th>Investment Climate Messages</th>
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<tbody>
<tr>
<td><strong>PSD STRATEGY PAPERS</strong></td>
<td></td>
</tr>
<tr>
<td>“Private Sector Development Action Plan” (1989) and “Progress Report on the Private Sector Development Action Plan” (1990)</td>
<td>Improving the business environment is one of four priority areas identified for promoting PSD. Bank assistance will take the form of adjustment operations to support policies, regulations, and legal reforms; FIAS to be expanded. Financial sector development, a related area, is also given priority.</td>
</tr>
<tr>
<td>“Private Sector Development Strategy: Directions for the World Bank Group” (April 2002) and “World Bank Group Private Sector Development Strategy: Implementation Progress Report (May 2003)</td>
<td>The current sector strategy highlights the fundamental importance of the investment climate. The strategy suggests that IC issues be part of systematic and regular analysis in preparation of country strategies; and that policy-based lending operations and capacity-building efforts, particularly to reduce unjustified obstacles to private business and to establish secure property rights for poor people, be continued.</td>
</tr>
<tr>
<td><strong>SECTOR STRATEGY PAPERS</strong></td>
<td></td>
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<tr>
<td>Energy: 1993 Policy Paper (title?)</td>
<td>Regulatory processes must be established that are transparent and clearly independent, and that avoid government interference in the day-to-day operations of power firms.</td>
</tr>
<tr>
<td>Energy: “Renewing Our Energy Business: Draft Strategy for Discussion” (January 2001)</td>
<td>Promoting PSD in the energy sector requires the creation of objective, transparent, non-discriminatory regulatory mechanisms, expanding competition and cross-border trade, and catalyzing private investment. Bank assistance will be in the form of loans and non-lending services in support of on-going reform programs.</td>
</tr>
<tr>
<td>Social Sectors: “Sector Strategy: Health, Nutrition, and Population” (1997)</td>
<td>To promote private participation in health services, the paper recognizes that weak institutional capacity to deal with regulatory problems often causes governments to become excessively involved in the direct production of health services.</td>
</tr>
<tr>
<td>Rural Development: “From Vision to Action” (1997) and “From Vision to Action: Update” (July 2000)</td>
<td>Facilitating PSD in rural areas is key to improving well-being in rural areas, and considers that the creation of a regulatory framework which allows for the development of a competitive private sector and efficient markets as a mandatory first step in private sector development. Emphasizes the business environment in rural areas, public infrastructure, and public services.</td>
</tr>
<tr>
<td>SMEs: SME Department “Strategy, Business Plan, and Budget” (May 2000)</td>
<td>Establishing the business environment conducive to SME development is listed as one of the four pillars of the WBG strategy. It is crucial to tackle those factors that discriminate against small firms as well as the broader issues that affect all firms.</td>
</tr>
<tr>
<td>Urban Development: “Cities in Transition: A Strategic View of Urban and Local Government Issues” (March 2000)</td>
<td>To foster competitive firms of all sizes, the paper emphasizes the importance of the enabling and institutional framework, including a legal and regulatory framework that establishes business incentives and imposes minimal transactions costs: land, real estate, and transport planning; and the rule of law and property rights protection.</td>
</tr>
<tr>
<td><strong>OTHER PSD PAPERS</strong></td>
<td></td>
</tr>
<tr>
<td>“Private Sector Development in Low-Income Countries” (1995)</td>
<td>Identifies four key areas for improving the business environment: strengthening the legal and judicial system, reducing the barriers to competition and improving regulation; supporting entrepreneurial development; and promoting global integration through foreign direct investment and regional integration to complement trade reform.</td>
</tr>
<tr>
<td>“Private Sector Development Strategy: Issues and Options” (May 2001)</td>
<td>The paper is the outcome of a discussion process within the WBG dating back to mid-2000 culminating in a discussion with the Executive Directors of the World Bank Group on May 23, 2001. The paper is focused on six major themes, including the creation of an investment climate that promotes growth and provides opportunity for the poor.</td>
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# Annex 4: Findings from OED Country Assistance Evaluations

<table>
<thead>
<tr>
<th>Country (CAE Year)</th>
<th>CAE Findings</th>
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</thead>
<tbody>
<tr>
<td>AFR</td>
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<tr>
<td>Burkina Faso (2000)</td>
<td>Adjustment lending addressed public sector reform and the environment for growth and private sector development. Slow but significant progress has been made in privatizing public enterprises, but the program has not been adequately supported by the promotion of new private sector activities or by the removal of economic, institutional, legal, and regulatory bottlenecks to domestic and foreign investment. Trade reform was undermined by the proliferation of tax and tariff exemptions, but is now proceeding swiftly with the introduction of the sub-regional WAEMU free trade and the common external tariff.</td>
</tr>
<tr>
<td>Cameroon (2001)</td>
<td>The Bank and IFC contributed to improve the environment of the private sector. They played an important role in promoting privatization and insuring that the process was conducted in a reasonably transparent manner. The government recognizes that this is probably the major impediment to increased private investment, and is preparing to deal effectively with the problem. The Bank played a role in bringing corruption to the forefront and contributed to reducing one of the main sources of corruption, by promoting privatization and ensuring that the privatization process is conducted with sufficient transparency.</td>
</tr>
<tr>
<td>Cote d’Ivoire (1999)</td>
<td>Improving the competitive position of the Ivorian economy and improving the private-sector environment was the focus of Bank lending during the 1994-96 period, with almost half of Bank commitments going to macroeconomic adjustment credits. Lending has been particularly successful in the series of recent adjustments loans and credits aimed at restoring Cote d’Ivoire’s competitive position: FSAL for restoring the health of the financial sector, PASCO for simplifying and rationalizing the regulatory framework, ERC for supporting the recovery of the private sector and PSD for creating a more friendly private sector environment. The success of these operations was predicated on a consistent strategy that was supported by sequences of credits and non-lending activities. The Bank has to assist the government in creating an attractive environment for domestic and foreign private investors by simplifying and rationalizing the system of taxes and regulations, by reducing corruption, improving the functioning of the judiciary system and by pursuing the privatization drive.</td>
</tr>
<tr>
<td>Eritrea (2002)</td>
<td>A major restructuring of Eritrea’s external regime is required, in an atmosphere in which both foreign and domestic investor confidence has been severely shaken. The government’s privatization and PSD efforts have slowed, investors have shied away from Eritrea, and many local entrepreneurs who had invested before the conflict suffered substantial losses and faced difficulties in resuming production and export activities. Enabling legislation in a number of important areas has also been delayed by the government’s preoccupation with the war. The Bank should assist the authorities develop a time-bound concrete program of critical investments and policy adjustments to be pursued over the coming three years which recognize the constraints to development associated with war devastation, geographical factors, social fragmentation, governance challenges and policy weakness.</td>
</tr>
<tr>
<td>Ethiopia (2000)</td>
<td>As defined in the policy matrix of the last CAS in 1997, private sector development should be conceived broadly to include regulatory reforms, relaxation (if not the abolition) of the investment code, development of private markets for land leases of both short and long duration, trade liberalization, elimination of controls on foreign exchange transactions, and financial sector liberalization. The progress benchmarks listed in that CAS for these items have not been fully met in many cases. The frustrations of the private sector color its perception of the usefulness of the Bank. The client survey of</td>
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48. In many cases, the assessments made by the CAEs have been overtaken by subsequent developments, especially since the Bank’s IC related activity has been more intense in recent years. Significant developments have been highlighted (in italics) wherever applicable.
<table>
<thead>
<tr>
<th>Country</th>
<th>CAE Findings</th>
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</thead>
<tbody>
<tr>
<td><strong>Ghana</strong></td>
<td>1997 indicated that 88 percent of the private sector group did not think the Bank was adequately supporting private sector development, and no one in that group responded favorably when asked if he/she was satisfied with the Bank (56 percent reacted unfavorably, and the rest were noncommittal). There remains much to be done in bringing about a competitive economy, and the critical success indicators of private investments—whether domestic or foreign—are not showing improvements. There has been insufficient progress in removing fundamental institutional and policy constraints. The Bank should now focus on a strategy for removing the remaining impediments to private sector development, including faster liberalization of the financial sector.</td>
</tr>
<tr>
<td><strong>Kenya</strong></td>
<td>While private sector investment increased from extremely low levels, it is still inadequate, constrained by incomplete implementation of reforms to improve governance and redefine the role of the state, and by continuing episodes of macroeconomic instability. Emphasizing private sector-led growth was appropriate, given the failures of public sector-led growth in the first two decades after independence. Improvements in public sector capability and better governance were expected to facilitate private sector growth and poverty alleviation, but governance issues were not treated with enough weight to make an important difference. Improved private sector investment will depend substantially on the government’s ability to improve fiscal discipline through the 2000 election period and on its even-handed application of laws and regulations.</td>
</tr>
<tr>
<td><strong>Lesotho</strong></td>
<td>An improved environment for growth and private sector development depends on enhanced political stability, better governance, and deeper parastatal reform of the state sector. Prospects for all of these improvements are uncertain. The Bank would probably have contributed more to the emergence of an efficient private sector had its assistance been preceded or accompanied by the array of interlocking legislative, regulatory, and institutional and financial measures critical to the creation of more congenial environment for private sector investment as well as improved water supply and electricity services. Lesotho. In the years following the CAE, a well-functioning government has displayed committed to improving governance (e.g., the successful prosecution of powerful international firms on bribery charges related to the Lesotho Highlands Water Project). Also, in the last 4 years, Lesotho has been able to take advantage of the U.S. Africa Growth and Opportunity Act initiative, as a result of which there have been significant investments in the garment industry. Lesotho has created more employment than any other African country in this area. Much of this investment was possible because of previous PSD projects that were supported by the Bank and a continuing dialogue on issues affecting investment, particularly utilities. The Bank has also completed an Integrated Framework study (with other donors and technical assistance is forthcoming) and more recently, a PSD strategy was prepared to address some of the legislative, regulatory and institutional issues affecting the investment climate.</td>
</tr>
<tr>
<td><strong>Malawi</strong></td>
<td>With Bank support, price and regulatory obstacles to agricultural production were removed, and further improvements were made in the environment for production and exports. However, due to external shocks and periodic fiscal indiscipline, macroeconomic stability was not sustained, resulting in crowding out of credit to the private sector and inflation. Bank assistance for infrastructure development had limited results, efficiency in the financial sector was not increased, the poor competitive environment was not improved, and most capacity-building measures had limited long-term impact.</td>
</tr>
<tr>
<td><strong>Mozambique</strong></td>
<td>The Bank should remain the lead agency in assisting the Government as it continues to develop the policies and capacities for economic governance, trade policies, and financial sector reform and development. The Bank has demonstrated comparative advantage in economic governance assistance and in policy-based adjustment lending. However, the Bank’s development effectiveness has been limited by</td>
</tr>
<tr>
<td>Country (CAE Year)</td>
<td>CAE Findings</td>
</tr>
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<td>--------------------</td>
<td>--------------</td>
</tr>
<tr>
<td>Tanzania (2000)</td>
<td>Among the more obvious constraints in PSD was a complex and burdensome administrative and regulatory structure. Of the four countries where “Roadmap” exercises were carried out — Ghana, Namibia, Tanzania, and Uganda — Tanzania had the most extensive and time-consuming and least transparent regulatory framework. In 1996, the Warioba Commission documented incidences of corrupt practices in the judiciary, civil service, customs service, and issuance of licenses and permits for all types of business operations. It concluded that the spread of corruption was not due to the absence of appropriate policies, institutions, rules, regulations and procedures, but rather to the non-observance of established rules and the ineffectiveness of the established institutions. Rationalizing taxes and regulations, and infrastructure development are key for private sector development. Support for the indigenous private sector will create a broader constituency for reform. Bank efforts in these areas should be closely coordinated with IFC and MIGA, and private sector development should be made an integral part of the CAS.</td>
</tr>
<tr>
<td>Togo (2000)</td>
<td>Restructuring and privatizing the banking system without further delay would remove an obstacle to the expansion of the private sector. Financial restructuring should be supported by a radical reform of the judiciary system, which is in a crisis stage.</td>
</tr>
<tr>
<td>Uganda (2001)</td>
<td>By FY95, when the government’s ability to maintain macroeconomic stability was no longer seriously questioned, policymakers turned to issues that they had addressed in a primarily macroeconomic context in the past — institutional development in all areas of public sector management, and the creation of a favorable environment for PSD. The agenda in each of these areas is still largely unfinished. To promote PSD, the government is attempting to complete its privatization program, promote transparency, free public resources for services, enforce financial sector reforms, reduce intermediation costs, improve access to financial and infrastructure services, and promote corporate governance. Reforms in these areas are more sectoral, microeconomic, and complex; they require time, tailoring to specific contexts, a holistic approach, and careful sequencing. Moreover, unlike past macroeconomic reform, which created relatively few losers (given the post-war Ugandan context), they require the participation and partnership of many more domestic and donor stakeholders, who do not necessarily have uniform views on reform.</td>
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<td>Zambia (2002)</td>
<td>The country made substantial progress in creating an enabling environment for private investment through legal and regulatory reform and reduction of state intervention in various factor and product markets. The Bank played a critical role in this progress. By end-1999, nearly all non-mining commercial and manufacturing entities had been privatized—unquestionably a fundamental change in the institutional structure of the economy. However, the economic impact of this has been small, and less than it could have been had the country moved swiftly to privatize the copper mines, which was the most critical reform to restore short-term, export-led growth in the 1990s. Simultaneously, to benefit all privatized and new private entities, and provide an environment more conducive to diversification, the Bank would have needed to take a more intensive approach to improving the investment climate. In June 2004, an Investment Climate Assessment for Zambia was completed, and has already started to inform PSD operations in the country. The IC questionnaire was modified to explore key sectors like tourism and mining, so that it would be more relevant to country operational support.</td>
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<td>Country (CAE Year)</td>
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<td>Zimbabwe (2003)</td>
<td>Relative to the CAS and other relevant objectives, the outcomes of Bank assistance are rated unsatisfactory, and institutional development as negligible. While the Bank's program helped to liberalize trade, reform agricultural marketing arrangements, deregulate domestic investment, and establish a fund to mitigate the social impact of adjustment, the assistance did not support macroeconomic stability. Given the current political situation, a resumption of normal Bank lending should be conditional on credible and upfront measures to achieve macro stability, fundamental governance reforms etc.</td>
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<td>Cambodia (2000)</td>
<td>A Technical Assistance Credit (TAC) for US$17 million approved in November 1994 aimed to enhance the government’s economic management capacity, re-establish legal institutions and promote private sector development. The government viewed TAC as a complex project with too many components. Implementation of the legal reform and private sector development component was delayed for two years by coalition government politics. IDA could also provide assistance for small-scale enterprise development, particularly for exports. Finally, IDA could assist the government in creating a business environment hospitable for investment, especially by expatriate Khmers and other foreign investors. Because of the prolonged trauma experienced by Cambodia’s population, the level of insecurity is high. Although many measures are needed for several years to quell insecurity, IDA can assist by rehabilitating legal institutions and promoting legal reforms.</td>
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<td>Mongolia (2002)</td>
<td>The Bank made a positive contribution to progress in the 1990s including an easier transition, improved macroeconomic management, and an improved legal and regulatory framework. At the same time, efforts to help remove some key policy and institutional impediments to sustain growth met with less success; key elements of the enabling environment for private sector investment are still lacking. Factors inhibiting a greater Bank contribution include (in general) limited linkage between the lending program and recommendations from ESW; and political sensitivity and anticipated adverse short-term consequences, which caused hesitancy to complete some reforms.</td>
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<td>Papua New Guinea (2000)</td>
<td>The outcome of Bank assistance to PNG over the past decade is assessed as unsatisfactory, institutional development impact modest, and sustainability uncertain. To assist PNG in the future, the Bank should (i) sustain its non-lending services and establish a field presence, even though minimal lending is expected; (ii) collaborate with the government and other donors to help develop a long-term strategy to support capacity-building and the consistent implementation of key reforms; and (iii) assist in public dissemination of country assistance objectives to broaden consensus and build ownership of reforms. Subsequent to the CAE, the Bank’s field presence has been strengthened through the appointment of a country manager in Port Moresby. The Bank has also sustained non-lending services and collaboration with donors has strengthened across a number of fronts.</td>
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<td>Philippines (1998)</td>
<td>As economic recovery and structural adjustment unfolded in the 1990s, Bank strategy became more balanced. The Bank lifted its sights to long-term growth issues such as capital market development. It sought to improve the enabling environment for the private sector with similar instruments through advice on, and lending for reforms in the incentive framework for foreign investment, the regulatory framework for private sector activity, export development and diversification, ongoing deregulation (especially in transport and industry), basic infrastructure investment, and ongoing financial sector reform, particularly to develop the market for long-term finance. In 1994, under the Private Sector Infrastructure Initiative, the Bank began assistance to address comprehensively a series of issues (including legal, regulatory, promotion, competition, risk unbundling and mitigation issues) emerging from increasing private sector participation in infrastructure. The EIL extended and deepened the sequence of economic reforms, as in the process of tariff reform and import liberalization that had been included in earlier Bank operations-Structural Adjustment Loans I and II, the Agriculture Sector/Inputs Loan, and the Economic Recovery Loan (ERL, which supported a major tax reform as well).</td>
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<td>Country (CAE Year)</td>
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<td>Thailand (2000)</td>
<td>The East Asian financial crisis opened a window of opportunity for reforms, which would not have been politically feasible during the boom years. The Bank could take advantage of this opening to assist the authorities in improving governance and legal provisions. The Bank should be selective and focus its interventions in areas where there is a strong support for reforms. Reducing red tape and corruption in customs services would improve Thailand's competitiveness. Barriers that have now disappeared may, however, reappear when the crisis is over.</td>
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<td>Vietnam (2001)</td>
<td>Until recently, the climate has not been conducive for PSD — administrative bottlenecks, delays, and overlapping responsibilities, poor regulatory environment, unclear legal framework and absence of enforcement, high transaction costs, for example, in telecommunications and shipping, unequal playing field with state owned enterprises, a weak financial sector, and perceptions of corruption have discouraged potential investors. The passage of a new Enterprise Law in 2000 has improved the climate, but official attitudes toward PSD have been ambivalent. Establishing a sound legal and regulatory framework is underway, but still not in place. Many obstacles to improving labor productivity in rural areas relate to policy issues. Areas for future focus might be policies that promote land markets, greater freedom of crop selection, and a level playing field for private rural enterprises. Most Bank reports emphasized policies to address existing constraints: land use rights and title registration; mortgage rights; accelerating reforms of state-owned enterprises; banking sector reforms; import tariff and other trade reforms; private provision of infrastructure. The Bank has also helped to provide substantial technical assistance, often financed through grants (UNDP, PHRD, IDF, ASEM), for: improving the legal environment, such as the new Enterprise Law. Initiated by the Bank and IFC in 1998, the Business Forum has become an important vehicle for on-going dialogue between the Government and the private sector; it is now managed by the IFC. Initially comprised of foreign investors, the Forum gradually drew in domestic entrepreneurs. In the years following this CAE, the situation has been changing very fast in Vietnam. Over the last few years, FDI as a share of GDP in Vietnam has been on par with China, and total investment in the economy is a blistering 36 percent. Official attitudes towards PSD have been changing. High-level policy-maker support for PSD has improved the momentum of pro-PSD reforms. The Constitution was changed in 2002 to formally recognize the private sector as an important pillar of the economy. Also in 2002, the Party declared openly that the private sector is an important contributor to economic growth, and party members were at the same time allowed to own private businesses. World Trade Organization accession is now the major energizing force for reform in Vietnam. Also, from the perspective of Vietnam, IC is about business development including state owned enterprises and not just private sector development or privatization. Vietnam, like China, has chosen to retain a large number of enterprises in the state sector. Developing effective approaches to improve corporate governance, harden the budget constraint and monitor the performance of state-owned enterprises have to be important aspects of IC analysis. Another focus important for Vietnam is non-farm activities in rural areas.</td>
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<td>Ecuador (2001)</td>
<td>Faster growth will require improvements in the investment climate through privatization, deregulation, and transparent rules for competition. Corruption has also hampered the climate for growth, distorting incentives, depriving the Government of badly needed revenues, and undermining public security. A modern legal framework for the development of capital markets and new kinds of financial institutions was passed, but remains largely on paper. Formal labor markets remain highly regulated, and private investors remain uninterested in increasing their commitment, so long as the macroeconomic and political climates remain uncertain.</td>
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<td>El Salvador (2002)</td>
<td>Over the last decade, the Bank supported the Government's efforts in competitiveness to promote private sector development, agricultural reform and land titling. ESW was relevant to the country assistance strategy. It provided a coherent framework to establish priorities, and to guide lending and economic policy advice. One discussed short-term measures for dealing with the liberalization of markets. Bank assistance promoted stability and growth, a more effective public sector,</td>
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<td>competition and PSD. While the risks associated with exchange rate policy have fallen sharply after the Legislative Assembly passed the law of monetary integration, insecurity and high crime rates persist, thereby discouraging domestic and foreign investment. Bank assistance helped reshape economic institutions and organizations and supported good policy management and better use of private and public resources. Freer markets and fewer regulations have increased transparency, have reduced opportunities for graft, and have increased competition. Low import tariffs and the absence of non-tariff barriers reduced graft and eased the reforms in customs administration. A good legal and regulatory framework for the electricity and telecommunications sector contributed to the successful privatization of the electricity distribution system and to competitive markets in telecommunications.</td>
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<td>Guatemala (2002)</td>
<td>The environment for PSD has deteriorated. Political divisions within the party in government, weak financial institutions, fiscal deficits, and changing business rules, have dented business and investor confidence. Political tensions and weak economic fundamentals reduce investment and constitute the major constraints to private sector activities. Several publicized governance issues have exacerbated the perception of high regulatory risks and instability of private contracts. Guatemala needs to strengthen its institutions for the country to achieve and sustain high growth rates. Property rights continue to be weak, and excessive regulation of domestic commerce and foreign trade burdens private enterprises, which then seek to avoid the burden by paying bribes to civil servants. Crime rates (kidnappings, robberies) are high compared with other countries in Central America (except El Salvador). Bank ideas and policy advice have sometimes contributed more to the country’s development than the money lent. The Economic Modernization Loan helped shape the liberalization of trade, the sale of state-owned companies, and the management of taxes, budget, and treasury. The liberalization of trade reduced the discrimination against agriculture, forced the industrial sector to be more efficient, and reduced the incentives in customs to engage in corrupt activities.</td>
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<td>Argentina (2000)</td>
<td>The Bank’s ESW on Argentina has been of very high quality. It could be argued that much of this work is somewhat superfluous in that local research institutions can and do produce reports of the same quality. In view of the sophistication of Argentina’s policymakers and research establishment, ESW should increasingly be in the form of short policy notes to assist in deliberations with the authorities and engage the broader society in dialogue and in a process of “learning together.” Specific technical assistance and specialized advice also are likely to be of high value.</td>
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<td>Bolivia (2000)</td>
<td>The key to PSD in Bolivia is to formulate and implement a comprehensive strategy to improve the transparency and legitimacy of the legal and regulatory environment, overhaul the judicial system, radically restructure the civil service, and to improve tax compliance. The Bank’s diagnosis correctly emphasized the excessive role of the state and its lack of effectiveness, and the poor environment for private investment as the main structural explanation for low domestic savings, investment, and growth. Although Bank’s ESW had correctly diagnosed that weak institutions and excessive productive capacity in the hands of the public sector were the main constraints to growth and poverty alleviation, the Bank’s assistance did not immediately address these constraints. This reduced the relevance and efficacy of the Bank’s early lending and non-lending strategy. The Bank’s own diagnosis had suggested that privatization was essential, but obtaining Government commitment to this was not achieved at this time. The Bank must help Bolivia remove its remaining governance and institutional constraints against private-sector development and continue to develop its capital market. High quality ESW lost efficacy because sound policy analyses did not translate into policies adopted by the Government or into project design and conditionality agreed with the Bank. The clear need for macroeconomic stability and to restore balance of payments viability led to efforts being initially directed at highly inefficient state enterprises. This meant that creating a suitable environment for private sector development did not proceed as expeditiously as possible. The CAE recommends that the Bank should (a) give higher priority to promoting private sector development by developing the financial sector and helping the Government accelerate reforms of the judicial system and of the civil service; (b) in partnership with the Government, place a high priority on improving the</td>
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<td>Country (CAE Year)</td>
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<td>Brazil (2003)</td>
<td>The Bank can still play a relevant role in a middle-income country such as Brazil. The Bank is most relevant as a source of knowledge and technical assistance. There is also scope for improving Bank support to PSD. The Bank might consider assistance to judicial reform, as the judiciary has been identified as a bottleneck in PSD strategies produced by the Bank and domestically. The Bank is already providing some initial assistance through ESW. More assistance to regulatory agencies is also needed, especially at the level of states, in order to reduce the lingering uncertainties and encourage public sector investment.</td>
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<td>Chile (2002)</td>
<td>The Bank played a key supportive role, with money and advice, in helping Chile out of the mid-1980s crisis and in the economic transformation that followed. The institutional change that the assistance supported promoted private sector development and better governance, financial accountability and financial management. While Chile now has good access to international capital markets, systemic shocks could reduce that access, encumbering Chile's ability to achieve its development objectives. Consequently, it may be beneficial to maintain an active Bank program in Chile. Some lessons stand out from the Bank's experience in Chile: the Bank can be more effective in promoting development if it supports programs and projects in countries committed to stable macroeconomic policies; when the Bank lacks sufficient information about the consequences of legislative and regulatory reforms, it should promote and support pilot tests and small demonstrations of the proposed reforms; good results from pilot tests become a powerful tool to convince stakeholders of the benefits of reforms. In a country with sophisticated economic management, the Bank should abstain from insisting on reforming policies if ownership for reforms is weak.</td>
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<td>Costa Rica (2000)</td>
<td>The Government of Costa Rica has continued to implement its reform program—at its own pace, without much financial assistance from the Bank. It has continued to make progress in opening-up trade and diversifying exports while maintaining political stability. Foreign investors complain of excessive bureaucracy, expensive labor costs, and too much government involvement in the economy. In spite of this, foreign private investment continues to expand due to Costa Rica's relative political stability, commitment to economic openness, excellent educational system, market access, and high quality of its labor force. The government, however, has dealt decisively with the problem of corruption and Transparency International has ranked Costa Rica second (i.e. low perception of corruption) among all Latin American countries and 27th in the world.</td>
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<td>Dominican Republic (2003)</td>
<td>During the past 10 years the Bank has had little contact with the Central Bank, the country's central policy-making body. More recently, it has tried to step up that contact, but it is yet to establish a continuous dialogue with the authorities in areas where the Bank can offer expertise. As a result of this, the Bank has missed the chance to provide advice at times when the country embarked on important reforms such as the privatization of public enterprises. The Bank should help the country broaden its structural reform agenda to encompass agriculture, including trade, land, water and price reform, and to remove barriers to entry and competition in domestic activities.</td>
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<td>Mexico (2001)</td>
<td>Overall, the policies and programs with which the Bank has been associated in Mexico over the decade are likely to be sustainable. The open, market-oriented economic policies pursued since FY89 have helped to generate rapid recovery from the disastrous 1994/95 crisis. The banking system is regaining strength, in part due to the participation of foreign management and equity, a better legal framework, and more effective supervision. Mexican government officials indicated that engagements with Bank staff during the design and implementation of a project sometimes have had value added in these ways: providing direct technical assistance and useful policy advice; providing an objective, outsider's perspective on problems; communicating the lessons from international experience; using the Bank's &quot;convening power&quot; to bring about more productive dialogues among Mexican stakeholders; inducing greater coordination among units of government which normally do not communicate well with each other; insisting on technical norms for resources allocations that might otherwise...</td>
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<td>Country (CAE Year)</td>
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<td>Mexico (2000)</td>
<td>The ongoing political uncertainty is exacerbating Paraguay’s underlying governance problems. Policy-making is not always transparent. The country’s legal and institutional framework is weak, leading to evasion and selective enforcement of laws and regulations. The Bank is only the fourth largest official lender in Paraguay. Over the past few years, the Bank has consistently urged reform of the state, especially privatization of state enterprises and improved governance. These recommendations have been generally ignored by government, but are frequently referred to in the press.</td>
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<td>Peru (2002)</td>
<td>The reforms of the early 90s, in which the Bank played a significant role, totally altered the environment for private sector development and set off rapid private investment growth. As the decade progressed, two primary obstacles to private investment, the unpredictability of the judiciary and tax instability, became more pronounced and, together with growing political tension, put a damper on private investment after 1997.</td>
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<td>Uruguay (2000)</td>
<td>The authorities have moved toward increasing private sector participation in activities traditionally provided by the public sector. They have opened markets to competition by the private sector and eliminated monopolistic privileges enjoyed by public enterprises in those cases where this can be done within the existing legal framework. They are also preparing legislation to open the markets to competition in cases where changing the existing legislation is needed.</td>
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**ECA**

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<th>Country (CAE Year)</th>
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<td>Albania (2000)</td>
<td>IDA saw rapid privatization of small and medium scale firms and the creation of a “private sector friendly” legal and regulatory environment as simultaneous processes. Entrepreneurial dynamism is very strong in Albania, but the need for a regulatory environment that is transparent and uniformly applied has now become acute. Vibrant private sector initiative is a powerful development ingredient, but in the absence of some basic “ground rules” transactions costs escalate rapidly and anarchy ensues. The balance in the lending program has been good, and the adjustment operation supported a complete liberalization of the agricultural price and incentive framework. Adjustment credit also supported revised land legislation that authorized the leasing and sale of agricultural land. Full development of a land transfer system is still pending however as the land titling and registration system is only about 10 percent completed. Land fragmentation and the division of family farms into many parcels will present a future obstacle in trying to raise farm incomes and operational efficiency. Land holdings are small and fragmented. This will be a constraint to the transition from the current, largely subsistence farming to a market oriented, commercial agriculture. An active land market needs to develop to facilitate consolidation.</td>
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<td>Azerbaijan (2000)</td>
<td>Complex regulations, corruption and lack of access to finance have hampered private business development. In economic and sector work, greater emphasis on private sector development through an analysis of the business environment would have been a useful addition. Progress in governance reform and private sector development was slow. Nonetheless, a policy dialogue with the government was established and the groundwork prepared for future reforms. IDA could also do more to improve the environment for private sector development and to strengthen the social safety net for those expected to be made redundant as the public sector is restructured and privatized.</td>
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<td>Bulgaria (2002)</td>
<td>A number of reports point out in some detail the administrative obstacles to doing business and weak enforcement of laws and regulations. Bulgaria lagged most other EU candidate countries in a number of areas related to the business climate. The Ministry of Finance would like Bank’s help to improve the investment climate for the</td>
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### Country (CAE Year) | CAE Findings
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**private sector rather than support for public investment by line ministries. Between 1991-97, with Bank assistance, a basis for privatization was laid, a new commercial banking law was promulgated, and the Central Bank made efforts to improve supervision. Between 1998-00, laws and regulations for private sector activity, legal and institutional basis for health insurance and social protection reform and foundations for more efficient labor markets have been established. The newly privatized banks operating in the absence of an adequate judicial and legal framework are not yet engaging in lending to the private sector. The development of private capital markets is lagging, complicating policy for pension fund investment. In December 1998, FIAS initiated a major study on administrative barriers to investment in Bulgaria, upon a request from the Bulgarian Foreign Investment Agency. Though the FIAS study made a number of important recommendations, the follow-up and implementation have been hampered by changes in the Bulgarian counterparts behind the study.**

**Croatia (2001)** | The main objectives of the CAS were to redefine the role of the state, reform public finance, encourage private sector-led growth (including privatization and bank reform), and upgrade infrastructure. The proposed program was largely relevant and well designed. With hindsight, a notable weakness was the absence of focus on governance. This was understandable given that at that time governance was not the priority it is now in the Bank. A Private Sector Assessment would have been useful to formulate reforms of the enabling environment for private enterprises, as has been done in other transforming economies. The main strategic objectives of the new CAS are appropriate: to reduce the size of the public sector and increase efficiency, improve governance, create the conditions for competitive sector real development, and contain poverty.

**Kazakhstan (2001)** | The Bank’s early private sector strategy consisted of macroeconomic stabilization and structural reforms (price and trade liberalization, privatization, enterprise restructuring, passage of laws and regulations for private sector activity, financial sector reform) to develop competitive markets. The IBRD strategy was relevant, but in hindsight, the relevance would have been greater if more attention had been devoted to privatization procedures and to strengthening of the judicial framework early in the transition. Following the second CAS (FY98), the legal and judicial framework were priorities in the Legal Reform Project (FY99). A new and unique feature of the CAS was the formation of a joint IBRD/IFC/MIGA Rapid Response Team to provide quick turnaround advice on urgent policy issues for the promotion of an enabling climate for the private sector. The CAS should link WBG support to progress on improving the enabling environment for the development of the private sector, in particular with regard to the clarity in the legal and regulatory framework, judicial reform, transparency in privatization, and a reduction in the arbitrary enforcement of tax laws.

**Kyrgyz Republic (2001)** | IDA appropriately focused its assistance from the outset on stabilization, liberalization, privatization, and institutional reform geared to moving the country from a command to market economy. The Privatization and Enterprise Adjustment Credit (PESAC) (whose main objectives were to increase the speed and improve the quality of privatization of small, medium, and large scale enterprises, and to support substantial trade and price liberalization measures to improve PSD) was considered only marginally satisfactory because the objective of attracting strategic investors was not realized, serious corporate governance issues were not addressed, negligible enterprise restructuring followed privatization, and many of the large loss-making enterprises intended to be liquidated or restructured continue to be a drag on the economy. The Kyrgyz Republic came to be regarded by IDA as a star performer in policy reform relative to other FSU countries. OED has found, however, that satisfactory covenant compliance in Kyrgyz has not always meant satisfactory development outcomes. Some progress was made in tax reform and in establishing a new legal framework for private enterprise, including foreign investment. A new legal framework and system of rural finance for private agriculture was put in place and private ownership of land is now permitted. All of these reforms were supported by IDA operations.
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<th>Country (CAE Year)</th>
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<td>Lithuania (2003)</td>
<td>Apart from supporting the macroeconomic framework, the Bank’s adjustment lending (especially SAL II) supported voluntary compliance in tax administration, implementing new auditing and accounting laws to improve corporate governance, a revised bankruptcy law, removing bottlenecks in land markets and sale of goods, and removing barriers to the functioning of land markets. While most key conditions in this regard were met, their implementation was challenging, and the record suggests that broad-based government ownership and capacity to implement parts of the package were lacking. After Lithuania’s planned accession to the EU in May 2004, improving the business environment is an area of comparative advantage for the Bank, should the country seek the Bank’s assistance.</td>
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<td>Russia (2002)</td>
<td>In the key reform areas of private sector development (PSD), the 1990 joint study recommended clarification and legal protection of property rights as a necessary first step. De-monopolization and the enforcement of hard budget constraints were noted as crucial measures for the restructuring of existing enterprises, the transfer of underutilized assets to new enterprises, and increased competition. An effective legislative and judicial basis, institutional capacity, and political commitment for the rule of law, corporate governance, and competition policy were also viewed as urgent. The study’s priorities reflected the broad consensus on these fundamental issues among government reformers, the academic community, and IFI officials. The study, however, gave insufficient emphasis to public governance and bureaucratic harassment issues, which proved central to the investment climate and the entry and growth of new enterprises. Bank assistance for improving the enabling environment had limited results through 1998, with little progress in establishing a conducive policy and institutional framework for enterprise restructuring, corporate governance, competition, new entry, and private investment. On the other hand, the Bank helped prepare legislation and establish institutions conducive to PSD (e.g., the Anti-monopoly Commission, the Federal Energy Commission).</td>
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<td>Ukraine (2000)</td>
<td>From a development outcome perspective the efficacy of the Bank’s country assistance efforts has been unsatisfactory. Recognizing the difficult political environment, the Bank’s strategy was a graduated assistance program, increasing with the intensity of the perceived reform effort. The “graduated response” approach was probably the best option, given the lack of full government commitment to reform across all sectors. But despite Bank efforts to create a shared vision of the path to follow, the principles of a market economy are not yet accepted enough by policymakers and civil servants. All country strategies continually refer to the need to strengthen public administration institutions and reform laws and legal procedures. Nevertheless no comprehensive legal reform agenda was mapped-out by the World Bank although certain laws were identified as necessary to support the development of a market economy, (progress in this was sought under a variety of sector adjustment operations). A new civil code, a bankruptcy law, banking regulations, secured transactions, contracts and company law were all identified as crucial. Yet it was becoming increasingly apparent that excessive regulation, bureaucratic intervention and corruption were perverting the desired outcomes from the liberalization agenda. The Bank in conjunction with the authorities, did attempt to create a more comprehensive legal reform agenda in the context of a legal reform project. Progress was thwarted by waning support from the Ministry of Justice, and elements have now been subsumed into a proposed larger technical assistance project. The Bank recognized that while privatization was a necessary condition for vigorous private sector development it was not a sufficient condition. Substantial changes in the environment for private sector development would be necessary, including regulatory reform, tax reform, legal reform, and capital market development. But once macroeconomic stabilization was in progress, the Bank pressed forward with privatization, and decontrol of domestic and international trade; the Bank would deal with other liberalization issues later. Part of the reasoning for this strategic approach was that while the reforms were important, they would not be forthcoming until a constituency largely consisting of the new owners of privatized enterprises was developed. Progress has been made in putting in place the laws necessary for a market-based economy. But many anomalies and omissions remain. Progress has</td>
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<td>been most extensive in banking and securities law. Basic facilitation laws such as bankruptcy and collateral laws and a uniform civil code have not fully emerged as yet. Many donors have been involved in this process that has created problems of consistency between laws enacted. Even with good laws, application and enforcement in Ukraine are highly deficient. However, the key part of the Bank’s intervention is not the resource transfers, but the policy dialogue, underpinned by ESW, and the Bank coordination of donor efforts to effect change and policy reform. If the Bank had not been engaged, policy reform in certain key areas would have been much slower. Privatization in particular would not have proceeded as swiftly, and the progress achieved in trade and price liberalization might not have occurred. While much remains to be done in agriculture, what has been achieved has created a foundation for further reform, and Bank efforts in this sector have created results.</td>
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<td>MNA</td>
<td>Egypt (2000)</td>
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<td>According to the 1992 Country Strategy Paper (CSP), the Bank hoped to make a number of policy-based loans in support of privatization and removing barriers to the private sector. The 1994 Country Strategy recognized Egypt’s reticence to borrow from IBRD, but still hoped to provide support to the now slowed reform program. The focus was similar to the previous strategy, but with more modest goals for lending and greater emphasis on non-lending support and IDF grants. For example, in two focus areas, export-led growth and private sector development, operations did not materialize. More recently, as the momentum for reform has increased, the Bank has not been involved in areas where it might have had some impact: private sector development, financial sector reform, targeted poverty alleviation. Although some Government officials expressed the view that no support from IBRD is necessary in this area, other officials disagreed and suggested that they would welcome such support.</td>
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<td>Morocco (2001)</td>
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<td>In the area of private sector development, a Private Sector Assessment Update (1999) noted that after a decade of efforts at stabilization, liberalization, and deregulation and the launching of the privatization program, the response of the private sector has fallen short of the high expectations generated by the achievements of the 1980s. It concluded that further reforms are needed, of both policies and institutions. One of the suggested reforms, to improve the judicial system, is included in a Legal and Judicial Development Loan (FY00). FIAS has been discussing with the government three possible advisory projects designed to improve the FDI investment environment in the country: the development of a strategy and possible establishment of an investment promotion agency; a feasibility study for the establishment of an export processing zone; and a review of the investment incentives system. The slow rate of privatization more broadly calls for particular efforts, whether through AAA or lending, to improve the environment for PSD; Any future adjustment loans should be smaller in size and conditioned on substantive and irreversible progress on a focused set of key reforms.</td>
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<td>West Bank and Gaza (2002)</td>
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<td>As private investments failed to materialize, the Bank placed greater emphasis on creating an enabling environment. A wide range of projects was approved to provide financing and remove regulatory obstacles to the private sector, including: housing finance, micro-enterprise finance, an industrial estate in Gaza, and finance for PA’s contribution to the MIGA guarantee fund. The Bank provided support to institutional development, broadly defined, including improvements to the legal framework, financing qualified Palestinian expatriates to improve public sector management, and strengthening the nongovernmental organization sector in service delivery. A third major theme of the Bank’s strategy was support for private sector development. In this regard, the Bank (as well as IFC and FIAS) and other donors have provided assistance on a wide variety of measures, including legal and regulatory changes, risk insurance funds, guarantees, development of an industrial zone, improvements in housing finance, support for microfinance, as well as support for basic infrastructure and laying the groundwork for future participation by the private sector in the provision of water and energy. Much remained to be done even to harmonize the legal and regulatory environment.</td>
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<tr>
<td>Country (CAE Year)</td>
<td>CAE Findings</td>
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<td>Yemen (2001)</td>
<td>Apart from the petroleum sector, private foreign direct investment has been negligible. A 1997 report by the Foreign Investment Advisory Service (FIAS) noted that impediments to private investors related to governance issues. Following unpleasant experiences, IFC and other international banks were reluctant to do business in Yemen; between 1987 and 1997, IFC had no new investments or lending commitments there. Private businessmen also report problems of doing business common in other countries. IDA has given too little attention to identifying and assisting the Government to remove constraints to private investment and growth; sector work and lending assistance have shown inconsistencies.</td>
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<td>SAS</td>
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<td>Bangladesh (1998)</td>
<td>Despite over fifteen years of policy dialogue, the enabling environment for PSD is still deficient. The pace of reform of the policy environment has been slow, and the successes that have occurred (ready-made garments) cannot be attributed to Government or IDA. The quality and depth of the ESW undertaken by the Bank certainly diagnosed the problems and constraints. However there was a chronic over-estimation of Government ownership of the reform process, given strong and highly politicized labor movements, a central bureaucracy seeking to maintain centralized control and a complex array of policy distortions and regulations. Throughout much of the eighties, genuine Government commitment to, and a vision of, an industrial sector driven by market forces was absent. By and large the relevance, timing and quality of sector work has been good. Undoubtedly the situation has got better in the nineties, with more aggressive trade policy reform following good IDA ESW and more intense policy dialogue on trade liberalization issues. IDA’s move to SECALs with broad sector reform agendas has been appropriate, and while not fully successful has generated a momentum for more economy-wide liberalization and created a growing constituency for this wider reform. As has been manifested in the nineties, a stronger focus on key sector and sub-sector policy reforms and actions is a more effective way of using IDA resources in the sector.</td>
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<td>Maldives (2000)</td>
<td>None of the two Country Economic Memoranda of the 1980s identified PSD as a priority. None of the Bank's projects contained components aimed at improving the competitive environment or liberalizing markets. In particular, as discussed above, despite a significant involvement in fisheries, the Bank did not press for greater competition or for phasing out the direct public sector role. In retrospect, a more appropriate strategy is likely to have been to enable competition and market forces as far as possible, while strengthening Government’s regulatory and oversight capacity and targeting direct safety net transfers to the most vulnerable.</td>
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<td>Nepal (1999)</td>
<td>In retrospect, in the 1990s, the Bank focused too much on implementing its investment projects in infrastructure, agriculture, and power in a very difficult environment and not enough on helping ensure the presence of a conducive policy environment to support both sustainable public investment as well as much greater private sector activity. The critical obstacle to agricultural growth and diversification represented by lack of rural roads was also not fully integrated into the Bank’s agriculture strategy. Until road access improves, access to markets and inputs, linkages with agro-industry, and the inflow of food will remain limited. Strong commitment by the government between 1991 and 1994 resulted in significant progress in liberalizing the trade and price regime and removing regulatory barriers to investment. An emphasis should be placed on defining and realizing a conducive policy environment for increased private sector activity and improved access to social services. ESW should support reform in the financial sector, an improved competitive environment through privatization of key enterprises, and intra-sectoral reorientation of public expenditures toward basic social services.</td>
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<td>Sri Lanka (2001)</td>
<td>The Bank rightly operated on the belief that, even with the conflict lingering on, there was nonetheless room for reforms to strengthen macroeconomic management, openness, financial institutions, private sector development, safety nets and the civil service. It constantly reminded the Government of the reform agenda in its ESW, policy dialogue, and aid coordination activities, which have been timely, of good quality, and appreciated by successive governments.</td>
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Annex 5: Country Case Study Summaries

Mozambique

Background

After gaining independence from Portugal in 1975, Mozambique entered a period of post-independence conflict. By the time the peace agreement was signed in 1992, real per capita GDP had declined by half compared with pre-independence levels, much of the country’s human and physical infrastructure had been destroyed, and five million people had been displaced. The country began a period of transition to democracy and a market-based economy, supported by substantial aid from the Bank and other donors. Extensive policy reforms, beginning in the late 1980s, improved economic management; liberalized prices, exchange rates, and trade; privatized public enterprises; promoted financial deepening; improved public investment; and increased foreign direct investment (FDI). Growth and investment increased significantly, though much of this growth was due to several foreign “mega-investments” in the capital city and southern provinces that are expected to provide relatively few jobs.

The government has made considerable progress in improving various aspects of the investment climate in the past decade, particularly considering where the country started. The advent of peace and two successful elections have significantly reduced political uncertainty. Economic reforms have increased macroeconomic stability and improved the business environment. Institution-building efforts have helped to strengthen public administration and promote FDI. Infrastructure investments in roads, ports, and telecommunications have begun to lower business costs. And some inroads have been made in developing technical capacity in government and in firms.

Despite this progress, however, Mozambique still has much to do to create the investment climate conditions necessary for broad-based economic growth and poverty reduction. Significant political risk remains, and geographic dualism is a potential threat to political stability. Despite progress in reforming administrative barriers to investment, the country is still one of the most difficult places to do business in the world. The leading constraints are entry procedures for new firms, constraints to hiring and firing workers, high real interest rates and limited access to credit, and impediments to labor-intensive FDI.

Bank Strategy and Activities

The Bank’s strategy for Mozambique stressed the investment climate from the beginning. The emphasis on particular aspects of the investment climate changed, however, as the country’s political conditions changed and the transition progressed from plan to market. The Bank’s strategy during the past decade has been to move from a first-generation set of macroeconomic reforms to second-generation reforms aimed at removing microeconomic barriers to investment, stemming from antiquated laws and regulations, inefficient administrative capacity, and corruption.

The Bank’s investment climate lending program since 1992 included a series of Economic Recovery Credits (FY92, FY94, FY97) that supported financial sector reform, foreign
exchange liberalization, privatization, the removal of remaining price controls, bank privatization, and trade reform. The Economic Management Reform Credit (FY98) supported improved tax and trade policies and administration. An FY94 Financial Sector Capacity Building Project concentrated on privatizing state-owned banks as well as training central and commercial bank staff. The FY00 Enterprise Development Project provided direct support to firms in the form of cost-sharing grants for training as well as SME financing. In addition, there were several infrastructure projects (Roads and Coastal Shipping I and II, Maputo Corridor Revitalization Technical Assistance, and Railway and Port Restructuring Project).

Non-lending services included private sector conferences and competitiveness advice; ESW on land policy, legal and judicial reform, financial sector development, regional trade and energy issues, and constraints to private sector development; an enterprise survey by the Regional Program for Economic Development (RPED); and assistance in building statistics capacity. FIAS “Administrative Barriers to Investment” studies (1996, 2001) were followed by two “Investment Climate Assessments” (1997, 2002).

Broadly, Bank activities focused on securing “first-generation” and “second-generation” reforms have been timed and sequenced well — based on strategic necessity, sound economic principles, and prevailing social and political conditions. This prioritization of investment climate reforms was necessary in Mozambique, as it is in most countries, because of the urgency of problems as seen by investors and because of the feasibility of changes. Macro price, trade, and financial sector reforms, and privatization were crucial to economic stability and efficiency of aggregate resource allocation, and thus had to be the first priority. Second-generation reforms, such as removing administrative and regulatory barriers to investment, were bound to be a complex and long-term process, particularly in light of Mozambique’s economic and political history. Moreover, microeconomic reforms such as these would not have much impact on investment in the face of poor macroeconomic incentives.

It is likely that economic recovery and growth might have been stronger had the pace of reform been faster. However, the pace was mostly set by the government, reflecting its judgment about political feasibility and its caution as it made the transition to a market economy where economic management was different. Gradualism contributed to a stronger sense of Mozambican ownership of the reform process, despite the government’s need to rely on external advice and technical assistance. Greater ownership has enabled government to be persistent in the transition over the decade.

**Outcomes**

Bank lending and non-lending activities have been quite important in improving many aspects of the investment climate in Mozambique. Bank support has been at the center of all of Mozambique’s first-generation reforms, which, among other things, have improved macroeconomic stability, increased economic integration with world markets, improved operation of financial markets, reduced state involvement in production, strengthened FDI promotion and facilitation, and improved infrastructure. Just about all observers would agree
that these reforms are permanent: Mozambique has successfully made the transition to a point where reforms will be sustained in the long run.

Despite successful progress in improving important aspects of the investment climate, an objective assessment of the outcome of these activities by most of the people interviewed for this evaluation is that it has been less robust than expected. A large part of the growth and poverty reduction that did take place during the decade can be attributed to post-war bounce-back and large aid inflows. Bank activities to reform the investment climate surely have spurred growth, but, thus far, it looks like they have had their primary effect on foreign “mega” investors, which have provided the majority of investment capital, outpacing local investors by four to one.

Mozambique still has inadequate infrastructure and capability problems in public administration and private business. Institutional weaknesses have received some attention, but the Bank’s efforts have been too modest, too piecemeal in the legal area, and insufficient in the area of reforming administrative barriers to secure much change. Business leaders interviewed for this evaluation stressed that, if the Bank were really serious about increasing the pace and scope of these types of reforms, it should have developed a program with the government to make a “big push” to get the necessary changes, as in its adjustment lending for macroeconomic reforms, rather than the “partial program” it put together.

Studies that focused on government red tape — such as FIAS’s “Administrative Barriers to Investment” in 1996, the “Manufacturing Survey” in 1997, and others — detailed a long list of problems. Business leaders say “this list was presented to government as the things that needed to be fixed. But the list was far too long — government can’t fix everything. There was no credible effort made to prioritize what needed to be fixed first and what needed to be worked on in the longer-run.” Similar comments were received about the Bank’s annual private sector conference, begun in 1996: local observers noted that there was not enough focus at the time on selected priority reform issues, action plans for organizing to implementing these reforms, monitoring arrangements, and mechanisms of accountability for success or failure.

In all procedural areas examined by the review, the investment process was hindered by fundamental weaknesses of the current civil service system. Reform implementation problems partly stemmed from the overlapping structure of government institutions and lack of clarity on responsibilities and accountability. But there also existed a widespread “passive resistance” from unmotivated executing agencies and officials, and corruption at all operational levels. These problems cannot simply be resolved by reforming investment procedures alone. They require a complementary civil service reform.

Although Bank activities have done much to improve the financial sector, including assistance to set up a stock market, little has been done to address institutional weaknesses that continue to hamper lending to the private sector and investment in equities. Interviews in Mozambique called attention to three important areas where business leaders say the Bank should have been more involved in financial sector reform during the decade: improving financial information, improving contract enforcement mechanisms and improving the land law and movable assets law to increase the private sector’s collateralizable asset base.
Lessons

- Even under difficult conditions — such as in Mozambique, where poor economic, social, and political conditions influenced what the Bank was able to do — Bank activities can make important intellectual and financial contributions to improving the investment climate, if the government is committed to reform and economic development. The Bank’s non-lending intellectual and coordinating contributions can be as important as its financial contributions.

- Successful “first-generation” macro reforms are necessary but not sufficient for sustained private sector led growth. Institutional weaknesses in the form of administrative and regulatory barriers and poor property rights, as well as inadequate infrastructure and capability problems in public administration and private business, can continue to constrain growth.

- Removing administrative and regulatory barriers is a complex and long-term undertaking. Administrative procedures and regulations are tied up with a country’s social, political, and economic systems. Hence, reform requires more than rewriting legal and regulatory frameworks. Reform efforts must be coupled with a convincing analysis of the costs and benefits of reform, together with an exercise to set reform priorities, capacity building to address weaknesses of executing agencies, and efforts on the ground to achieve political consensus and commitment by government leaders to adopt and implement required reforms.

- “Second-generation” reform programs may need a “big push” to get the necessary changes, just as was the case for first-generation macroeconomic reforms. Partial programs may fall well short of achieving their objectives.

- In cases where comprehensive reform programs are politically impossible, greater effort may be needed to prioritize what needs to be fixed first and what needs to be worked on in the longer run. There may need to be more focus on a few problems that, if fixed, could have immediate positive effects, in order to build political support for further reforms.

- Reform efforts need people on the ground to help build required political commitment. There may be “passive resistance” from unmotivated executing agencies and officials, and corruption at all operational levels. These problems cannot simply be resolved by reforming investment procedures alone. They may require a complementary civil service reform, which must be part of the whole institutional reform effort.

- Free markets work best, but they often need a little tweaking. This is especially true in the areas of technology transfer and training where unfettered markets fail to provide socially optimum levels of investment. There may be a need for interventions to assist firms in these areas by way of vocational and in-firm training and cost-sharing subsidies for technology transfer to increase the possibilities for a growth response to investment climate reforms. To be a successful public investment effort, cost-sharing
grants must go to projects that generate broad economic benefits, not simply private benefits.

Indonesia

Background

The 1990s were divided by the East Asia financial crisis that began with the devaluation of the Thai bhat in July 1997. In less than two months between the end of November 1997 and the end of January 1998, the Indonesian rupiah depreciated by 75 percent against the dollar, far exceeding the exchange rate depreciations in Thailand and Korea. Indonesia’s GDP fell by 13 percent in 1998, and inflation peaked at 80 percent in 1998-99. The proximate causes of the crisis were the rapid increase of unhedged short-term private external debt before 1997, and existing recognized shortcomings in Indonesia’s banking system. The country was also hit by the worst drought of the century, a collapse in regional demand, and the lowest international oil prices in decades. The country’s critically weak institutions, endemic corruption, and political instability amplified the financial crisis because no credible arrangement to deal with the crisis decisively and fairly was offered to restore investors’ confidence.

Economic growth rebounded earlier than expected and inflation came down rapidly. GDP growth increased to between 3 and 5 percent per year between 2000 and 2002. Indonesia is, however, the only crisis country that has not yet reached pre-crisis levels of GDP, which remain about 10 percent below the 1997 level.

Poor governance in the public sector has had serious consequences for Indonesia’s private sector. Extensive corruption has raised the cost of doing business, from approvals and investment clearances to customs, taxation, and purchase of public services. Many smaller businesses, unable to pay the cost of corruption, have remained in the informal sector.

The crisis had a profound effect on the banking system. Many insolvent banks were closed or nationalized, and as a result, state-owned banks control about 70 percent of bank deposits. Banks have hesitantly begun to lend again, although mainly for consumer finance.

The widespread international impression is that Indonesia’s investment climate is deteriorating and now ranks among the worst in the world. The country continues to face fundamental problems such as inefficiency, corruption, bureaucratic delays, uncertain labor relations, violence and crime, a weak legal and judicial system, and excessive taxation by some local governments. An enterprise survey conducted in the year 2000 suggested that macroeconomic and policy instability and uncertainty are the leading concerns of Indonesian firms.

Bank Strategy and Activities

Before the crisis, Bank reports consistently pointed out several structural weaknesses that could impede future private sector-led growth. To overcome these weaknesses, the Bank recommended maintaining good macroeconomic management, strengthening the financial
sector, reducing international and domestic trade barriers, facilitating private investment, improving governance and reforming the legal system, improving land administration, and reducing excessive state ownership of productive assets. Two projects dealt with protecting property rights, facilitating an efficient land market, and developing the accountancy profession.

Although these analyses were appropriate for Indonesia at the time, they lacked depth in one crucial respect. Weaknesses in the financial sector were well analyzed, but the obvious connection to weaknesses in the corporate sector was not explored. It was well known that insider lending, stemming from joint ownership of banks and corporations, caused some of these bad loans. Borrowing was collateralized by inflated asset values and facilitated by weak accounting practices, which were not investigated. Thus, a comprehensive framework for Bank Group assistance to the financial and corporate sectors was missing. In addition, the Bank’s analyses did not establish reform priorities and were not backed by project lending for core investment climate issues, except for property rights. Although important, land registration and accounting profession reforms were not as critical as financial and corporate sector, trade, and competition policy reforms, for example. In addition, since Indonesia’s growth relied more on domestic investment than foreign investment, the Bank’s assistance strategy should have focused more on issues relevant to reviving domestic investment.

This situation changed dramatically during the crisis period, 1998-99, when the Bank enjoyed substantial leverage. The Bank’s assistance strategy focused on macroeconomic stabilization and bank and corporate restructuring, as was appropriate under the circumstances. The strategy was put into operation with balance of payments support and technical assistance loans. The Bank’s pre-crisis analysis of the financial sector was used to design laws, regulations, and institutions to resolve the banking and corporate debt crisis. Many of the structural reforms recommended by the Bank before the crisis became required policy actions in adjustment loans immediately following the crisis.

**Outcomes**

Before the crisis, Indonesia’s macroeconomic management and growth performance were perceived as excellent, despite many problems with its investment climate. After the crisis, macroeconomic stability has been restored, although risks of deterioration remain. This achievement has assisted the evolution of democracy and devolution of authority to regional governments, which are moving toward a stable polity. The banking crisis has been stabilized, but not yet resolved. Resolving corporate debt has made more progress, but important issues remain. Important trade and regulatory reforms were implemented during the crisis period, although some have recently been reversed. Insufficient progress has been made in governance and legal and justice sector reforms. Also, there is little progress in privatization or private participation in infrastructure.

Assessing the impact of these changes on Indonesia’s investment climate is difficult. Domestic and foreign investment have remained low since the crisis and several investment climate surveys show a deterioration. However, this outcome can be explained by Indonesia’s macroeconomic and political instability from 1997 through 2001, which affects both sources of investment. Moreover, foreign investment has also been affected by poor
economic performance in source countries. With better macroeconomic management and political stability for the past two years, some observers believe that 2003 will prove to be a turning point in business confidence in Indonesia. They see signs of increasing domestic and foreign investment. Thus, the timing of surveys to gauge investment climate is important. Moreover, surveys measure corruption and regulatory impediments, which may not be the most important determinants of investment climate, especially for domestic investment.

Have the Bank’s analytical and advisory activities and lending services had any impact on Indonesia’s investment climate? Before the crisis, when Indonesia was perceived to be performing well and not in need of Bank resources, the Bank lacked leverage with the government to move it toward implementing structural reforms. The Bank’s usually strong influence with government “technocrats,” who had a voice in policy formulation and implementation, was muted during this period, perhaps because the reforms were politically difficult and did not seem critical for Indonesia’s growth. Nevertheless, the Bank’s method of influencing policy through dialogue with government technocrats was well established. In turn, these technocrats were subject directly to presidential decisions.

During the crisis, the Bank had substantial leverage and influence despite frequent changes in governments. In the new political arrangement, the Soeharto era technocrats, with direct access to the President for decisions, have been replaced by inexperienced politicians with diverse interests and without clear decision rules or hierarchy. Decentralization has further complicated the decision process and created complications for the investment climate. With so many new players and diverse interests vying for decision authority, the Bank’s ability to influence policy has been reduced.

According to the President of the International Chamber of Commerce, nothing the Bank has done has affected their interests. At best, the Bank’s activities have prevented deterioration in the investment climate. This judgment is harsh for two reasons. First, the Bank has contributed to macroeconomic stabilization, which has facilitated political stabilization, perhaps the two most important determinants of investment climate. Second, it may be too early to assess the impact of the Bank’s activities. The reforms it is supporting will be implemented over a long period, especially as its leverage and influence has declined. Eventually, these reforms are likely to improve Indonesia’s investment climate, especially for foreign investment but also for domestic investment.

The sustainability of Indonesia’s investment climate reforms depends on the government’s commitment, other stakeholders’ lobbying efforts, and donor community influence. While many reforms were implemented during the crisis period, the reformist zeal has cooled after achieving macroeconomic and political stability. In fact, the government has back-tracked on some earlier reforms. With elections due in the near future, it is not possible to judge whether the new government will support investment climate reforms. Because the Bank Group has less leverage and influence with the government than during the crisis, it will have to adopt a strategy that is more effective in the new political landscape and persevere for a longer period to achieve its objectives.
Lessons

The Bank’s leverage tends to decrease in large countries where the economy is stable and growing. Moreover, the Bank’s influence also decreases when democratic countries are governed by a coalition of several parties because the decision process becomes diffuse and complicated. These complications multiply if some former central government decisions are devolved to regional and local authorities. In these circumstances, stakeholders in improving the country’s investment climate play a critical role. The Bank’s strategy and services should focus on one or two of the most critical constraints to investment. In addition, the Bank should be prepared to pursue those structural reforms directly with several layers of government and indirectly through stakeholders. The Bank should be prepared to exercise patience and persist for long periods to achieve its policy reform objectives.

There are many components of investment climate. Some are more important than others in facilitating private investment and some can be reformed more quickly than others. In addition, these components can affect domestic and foreign investment differently. The Bank’s assistance strategy should focus the investment climate components that influence the kind of investment that is most critical to attain sustained growth. For example, if domestic investment is critical for the next five years, then the Bank should emphasize investment climate components that influence that kind of investment the most. The Bank should not get distracted and expend resources on components that have long-term ethical value, but do not affect investment.

Romania

Background

Romania’s transition to a market economy began in 1989 with the overthrow of the Ceausescu dictatorship. As a result of the policies that Ceausescu had followed during the 1980s, the country was largely autarkic with imports comprising less than 10 percent of GDP. In addition, extensive centrally planned investment in heavy industry, the output of which amounted to nearly 50 percent of GDP, provided a legacy of large plants with outdated and inefficient capital stock. Agriculture had been collectivized into vast state farms and was similarly inefficient.

In the early years of transition, a flurry of reform activity sought to promote a more open market economy. But most of the 1990s were characterized by economic and political instability. The half-hearted reform activities of successive governments resulted in a weak response from the economy. GDP growth over the 1990s was mostly low or negative, and highly variable.

The investment climate at the outset of transition was therefore difficult and one that was relatively hostile to business. Macroeconomic and political instability created substantial uncertainty, the state remained heavily involved in the economy, and the financial system was not able to finance new investment. Prices were decontrolled only slowly and there were severe restrictions on foreign investment. Combined with high rates of inflation, the private sector faced especially distorted price signals. As a result, both domestic and foreign direct
investment were weak. For most of the decade, there was very little growth and the incidence of poverty continued to rise.

**Bank Strategy and Activities**

The Bank’s investment climate strategy and activities can be divided into two periods: 1992-1998, and 1999 onwards. The early years were characterized by projects that focused on support for the movement away from a centrally planned economy, where most decisions related to economic issues were the purview of the state, to one in which markets determined resource allocation and investment. Investment climate lending focused on structural adjustment and financial market development. The Bank also undertook a number of transportation projects during the FY92-98 period that amounted to more than $700 million.

The initial focus of Bank strategy — achieving macroeconomic stability, freeing up prices, and encouraging privatization — was appropriate. In hindsight, the Bank’s strategy overestimated the commitment of successive governments to reform and underestimated the difficulties of attaining some degree of macroeconomic stability.

The period around the end of the 1990s was a watershed for Romania. Economic crisis resulting from low growth and macroeconomic instability brought governments that were finally committed to reform. The new government that came to power in mid-2000 adopted an economic program for the 2001-2004 period whose major goals were stimulating economic growth, reducing poverty and unemployment, combating corruption, and speeding up EU integration and NATO membership. Encouraging the private sector became a focus of policy, and the Bank was asked for help to implement reform.

The Bank responded strongly with a high lending strategy scenario that was embodied in the 2001 CAS. The strategy evidenced further evolution of the approach toward investment climate reform from one that was based on macroeconomic conditions to one that was institutionally oriented. The Bank’s investment climate strategy focused on governance, anti-corruption, and the business environment. Successive private sector adjustment loans (PSALs) and private sector institution building loans (PIBLs) supported the government in its efforts to reorient policies toward promoting the private sector.

An important component of the first PSAL was the secured transactions reform that attempted to improve access to credit by the poor by lowering interest rates, increasing the size of loans, and lengthening the terms of repayment. The first phase of the project was the implementation of a Law of Secured Transactions. The law was drafted with the support of the Bank, and incorporated provisions that permitted movable property, both tangible and intangible, to serve as collateral for loans. The second step involved setting up the filing archive to permit the law to operate by recording pledges of property and establishing priority regarding which creditors have the first rights to repossess and sell the collateral in the event of default.

More recent investment climate loans, not yet closed, include:
• The 2001 Rural Finance Loan ($80 million) to provide financial services to a previously underserved section of the economy.

• The 2001 Second Private Sector Adjustment Loan ($300 million) that continues the PSAL I efforts to support enterprise, utilities, and financial sector privatization, along with improvements in the business environment by reducing administration barriers and other regulatory burdens, and ensuring the appropriate social protection and poverty reduction measures are in place.

• The 2001 Second Private Sector Institution Building Loan ($18.6 million). Like the PIBL I, the loan provides technical assistance to ensure a competitive financial sector, privatization of state-owned enterprises, a more efficient energy sector, creation of a business environment conducive to private sector growth, institutional and governance reform, and the necessary measures to ensure social protection.

Non-lending services for the investment climate during the FY98-02 period included a 1999 FIAS report that identified the most important obstacles to business growth (incorporated in the conditionality of PSAL I and PSAL II), a 2002 report on the legal framework for PSD, and a 2001 report on credit constraints that formed the basis for the financial market components of PSAL I and PIBL I.

Outcomes

Infrastructure. Despite the emphasis on infrastructure in Bank lending, according to private sector representatives interviewed for this evaluation, in the end these projects did not have a noticeable impact on the quality of Romania’s infrastructure. They complained about the high costs that poor infrastructure created for their businesses and said that they had seen little improvement over the past eight or nine years. Infrastructure data show little improvement over the decade, although it is possible that improvements were made at the margin and do not show up in the data.

Privatization. Compared to the situation at the start of transition, when the State dominated the economy, substantial progress has been made in privatizing state-owned enterprises (SOEs). However, the most important SOEs have remained in State hands for a large portion of the decade. Some of the privatization projects financed by the Bank — the 1994 FESAL and many of the infrastructure projects with privatization components — did not achieve their privatization goals.

Trade policy. Romania made initial strides in liberalizing its trade regime and removing the distortionary instruments of the previous regime. The 1994 FESAL made an important contribution in assisting the government in the trade area, although many of its other components were not successful. In the latter half of the decade, the country has focused on making the changes necessary to harmonize its trade system with the EU, and significant progress has been achieved.

Secured transactions. The introduction of secured transactions reform in 2001 had a dramatic impact on lending. In the 18 months since the reform was implemented, there have
been over 400,000 loans against which security interests have been registered. Of these, nearly 20 percent represent non-bank secured loans. This is especially beneficial in rural areas that do not have bank offices. In addition, the geographic coverage has been extensive: there have been filings of security interests in 42 or the country’s 43 counties. Over 100 banks have registered security interests in the filing archive. Since there are 38 licensed banks in the country, the implication is that scores of non-Romanian banks have been lending against collateral and registering their security interests.

By contrast with moveable property, the legal status of fixed property (land and buildings) is unsatisfactory, and the problems are especially difficult in rural areas. The focus has been on technical mapping — rather than insuring property owners receive registered title — and has resulted in little change in the land market. Both domestic and foreign investors continue to complain that uncertainties over land ownership have delayed and increased the costs of projects. In some cases, planned investments have been cancelled.

**Legal and regulatory framework.** PSAL I assisted rationalizing taxation and improving the capacity of bankruptcy-related institutions as well as other regulatory impediments to business. All of these actions were relevant and important. There has been follow-up of these efforts in the new PIBL, which has assisted the government in formulating an action plan in which major impediments to business have been identified, and for which a timetable for corrective measures has been established. Substantial progress has been made in completing the action plan. However, businesses complain that the government is exacerbating uncertainty by continually issuing decrees, many of which are contradictory.

While many changes were made to the legal framework for business, there was insufficient focus on the institutions necessary to enforce the new laws. The legal system remains weak, and governance is poor. Corruption continues to be seen as a major obstacle by firms.

**Financial sector.** Many Bank projects during the 1990s had components that dealt with the banking sector, its privatization, supervision, and regulation. These efforts were, however, severely limited by the government’s reluctance to privatize the large state banks as well as restructure their debt. Even with secured transactions reform, the ratio of private sector credit to GDP is still very low.

**Lessons**

**Institutional issues.** In the early part of the 1990s, Bank investment climate activities in Romania paid little attention to the institutional issues that are now considered to be central elements of the business environment. Institutional reform has come into focus in Bank lending, and there have been significant achievements under PSAL and PIBL, which are likely to be continued under PSAL II and PIBL II.

**Conditionality.** Conditionality has been important in assisting reformers in implementing their programs. The latter part of the period stands in marked contrast to the first part in this regard. Many of the investment climate loans of the first 8 years of the period had weak conditionality or the conditionality was not enforced — for example, macroeconomic stability was a condition of many of the loans and yet Romania has only recently started to
attain stability. Whether this would have influenced the ultimate outcome is uncertain, but the Bank continued to lend for investment climate activities in spite of little progress being made in many areas.

**Economic and sector work.** The successful investment climate activities in the past few years appear to have been based on more intensive economic and sector work. The quality of this work has been high, and this has contributed to recent operations (the PSAL and PIBL) and persuaded the government of the need to focus on investment climate reforms. Several of those interviewed indicated that the priority given to the investment climate by the government has been a result of the Bank’s enterprise surveys and analysis.

**Information.** The Bank is now devoting substantial resources to collecting and publishing information on the investment climate. In the case of Romania, evidence of inaccuracies was found. Given the importance of this data, better coordination between the teams collecting the data and the Romania country team would be helpful.

**India**

**Background**

In the wake of a severe balance of payment crisis, India embarked on a process of economic reforms in 1991. Reform efforts were marked by a reduction in the role of government in the economy and greater emphasis on the private sector, relying on market forces as a means for ensuring economic efficiency and growth. The Government of India took steps to dismantle many industrial controls, privatize public sector enterprises, encourage foreign direct investment, liberalize trade policy, and strengthen the banking system.

These and other reforms seem to have met with some success. Between 1992-93 and 2002-03, GDP grew at an average annual rate of 5.9 percent — slightly higher than the 5.8 percent rate of growth recorded in the 1980s that was fueled, in part, by significant external debt. Growth was particularly high in the service sector where the annual average growth rate reached 7.6 percent between 1992-93 and 2002-03. Inflation has also fallen from the double digits in the mid-1990s to an average of 5.8 percent in the past three years.

Foreign direct investments and portfolio investments responded strongly to the first wave of reforms in the early 1990s. Since then, annual investments have fluctuated around $6 billion with the exception of 1998-99 when portfolio investments suffered a net reduction.

While progress has been substantial, economic performance has fallen below the target set by the Government in the years after liberalization. Part of the reason may be attributed to the slowdown in worldwide economic growth and drought conditions in certain parts of the country that limited agricultural output. However, some critics have pointed to trade liberalization as a major culprit, highlighting the impact of imports on domestic industries.

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49. For 2003/04, economic growth is estimated to reach a record high of over 7 percent, largely because of a good monsoon.
Others, including the Bank, have pointed to the slow pace of reforms and difficulties in implementing certain policy changes. The remaining concerns stand out:

- Government debt continues to accumulate and servicing that debt puts upward pressure on interest rates.
- While reforms in telecommunications have met with success, access to reliable power at reasonable costs remains a prime concern.
- Institutional constraints on private investment inhibit small firms from investing beyond the stipulated limits, expanding their operations, and taking advantage of efficiencies arising from economies of scale.
- Existing bankruptcy laws make it very hard for companies to restructure their business.
- While the central government has reduced licensing requirements, state governments still require numerous licenses, permits, and other clearances before allowing businesses to start operations. In addition, companies must deal with various state officials on an ongoing basis with respect to applications, inspections, and reporting requirements.
- Labor legislation limits the actions of companies and imposes certain rigidities in labor markets. According to the Bank’s Investment Climate Survey, hiring and firing of workers were named as one of the biggest constraints in doing business in India.
- Import licensing has been abolished and some import tariffs were reduced in the early 1990s, but on average, tariffs on imports remain high relative to other countries.

- While capital markets have been the subject of substantial reforms, small businesses are still constrained by the lack of commercial credit.

**Bank Strategy and Activities**

The Bank has been a consistent advocate for greater economic liberalization in India. In the late 1980s, the Bank issued a number of reports calling for deregulation of industry and substantial trade reform in order to increase economic efficiency and boost economic growth. While noting that sound macroeconomic policy was essential, the Bank also argued that significant improvements in economic performance could not be achieved without substantial changes in policies, laws, and regulations that limited the development of the private sector.

Beginning in the mid-1990s, the Bank began to focus greater attention on working with states that were strongly committed to reform. This was first made explicit in the 1997 CAS and further reinforced in the 2001 CAS. The strategy centered on supporting fiscal and governance reforms, promoting private-sector led growth, and addressing the critical need for education, health and improved infrastructure. The Bank’s strategy was to work with selected state governments on deregulation and improvement of the investment climate, while continuing to engage the central government through policy dialogue and advice on reforms that fall within its purview.

In keeping with strategic principles of selectivity, pragmatism, and reliance on partnerships, the CAS indicated that the Bank would work primarily with those states that had chosen to embark on a comprehensive program of reforms, expressed interest in entering into a
partnership with the Bank, and had relatively high poverty rates. Uttar Pradesh, Andhra Pradesh, and Karnataka were the first three states designated as “focus” states by the Bank. Bank support was provided for broad packages of government reforms as well as sector-specific programs targeted to power, water, transport, health, and education. As of November 2003, one adjustment loan had been extended to Andhra Pradesh and two had been provided to Karnataka.

The reforms that the Bank has supported in the two states are related to improving the climate for private investment to the extent that reforms lead to an increase in the level of resources and/or a more efficient use of resources devoted to the development of social and physical infrastructure. Interviews with government officials and members of the business community highlighted the critical importance of improving roads, port facilities, water systems, and power supplies to the private sector. The Bank’s support for efforts of the states to minimize regulations and streamline procedures is consistent with the expressed interests of government and business. Numerous studies have called attention to the need to dismantle the complex system of licensing, reduce ongoing reporting requirements, and deal with burdensome inspections from multiple government agencies.

The Bank’s work on private sector development issues in Karnataka and Andhra Pradesh has focused primarily on reducing transactions costs associated with regulations and administrative procedures. However, there are other regulatory barriers that impose greater costs on companies, particularly those that deal with labor. None of the adjustment loans have directly addressed rigidities in labor markets, despite the widespread view — shared by the Bank — that labor regulations pose a significant constraint to private investment.

Many of those interviewed in Karnataka and Andhra Pradesh noted the absence of attention paid to the agricultural sector in adjustment operations. Approximately 70 percent of the workforce in the two states is employed in the agricultural sector. People pointed out that reforms concerning agricultural markets and land tenure are critical and likely to have much more of an impact on living standards than those dealing with industry in the near term. While reforms in the agricultural sector have been the subject of Bank reports, adjustment operations in the two states have not yet taken on these issues.

**Outcomes**

Implementation of various components has not always proceeded as smoothly or as rapidly as envisioned. Both state governments have taken significant steps forward on regulatory and administrative reforms. However, questions remain as to whether reforms have led to changes in actual behavior and are sustainable. Many of those interviewed suggested that reforms had not percolated down to lower level officers where changes in behavior are likely be harder to effect. People expressed concern with the capacity of institutions to undertake needed changes and alter the “mindset” of officials.

Government officials and business leaders also spoke of their concern over whether reform efforts could be sustained in the event of changes in political leadership, particularly in Andhra Pradesh where the agenda is seen as being driven primarily by top political leaders.
Lacking a strong institutional basis and grass-roots support, the reform agenda may face difficulties in the event of electoral shifts.

Moreover, the impact on private investment is uncertain. Discussions with representatives of the business community suggested that type of regulatory and administrative reforms that have been adopted so far would do little to affect the level and pattern of investment. The decision to start or expand a company is driven foremost by conditions in end-use and factor markets, rather than the number of days that it takes to obtain clearances or the effort required to comply with inspections. Moreover, managers stated that while streamlining regulations and procedures may facilitate investment in a particular state, differences in regulatory regimes among states would not induce companies to invest in one state over another. Those interviewed suggested that relatively few firms have the capability to operate in multiple states — companies tend to stay put wherever they first began operations, which is typically in the home town of the owner. Larger firms that consider investment outside of their home states seek financial incentives offered by state governments.

The Bank played an important role in focusing governments’ attention on specific issues, while placing them within a broader context. Officials in Karnataka acknowledged that while sought after changes were broadly recognized within the government, efforts to implement reforms were “sporadic and uncoordinated” before the adjustment operations. The Bank sensitized governments to the gravity of the problem, especially with respect to fiscal matters and power sector reform, and drew attention to the significant cost of not reforming in terms of the ability of governments to address social needs within the states. In addition to the “intellectual clout” of the Bank, the adoption of triggers related to deregulation in Karnataka contributed to the reform effort.

Lessons

- Champions are needed to initiate and drive reform, but broad support is needed for success. Senior civil servants must understand, support, and assume ownership for reforms.
- The success of reforms is dependent on the ability of agencies and department to implement them. It would be useful to include an analysis of the institutional capacities within government to effect change to identify potential barriers to proposed reforms and plan accordingly (e.g., training).
- Some of the regulatory changes advocated by the Bank, particularly those dealing with labor, are more politically sensitive because they are not costless. It would be useful to develop a more compelling argument for these types of reforms based on an objective analysis of the social benefits and costs of proposed regulatory changes.
- While industry surveys are clearly important, the views of industry should be only one of the inputs used in the calculus of whether particular policies are merited. The investment climate is not just what is good for industry from industry’s perspective — it needs to reflect broader concerns.
- The investment climate varies significantly by industry. Those interviewed would like to see more in-depth industry studies that lead to a specific and actionable policy agenda.
• The Investment Climate Assessment instrument could be improved. Those interviewed would prefer hard data on actual cost differentials rather than subjective perceptions of firms. In addition, they indicated that it was difficult to determine which policies were most effective in terms of actually increasing the flow of investment in states.

• Changes within government are necessary, but not sufficient to ensure sustainability. It is important to create public demand for change to sustain reform process and ensure implementation. Strong business associations can play an important role in advocating for reforms and monitor progress. The Bank could do a better job of interacting with industry representatives.

• Conditionality provides a basis for ongoing dialogue with senior government officials and can serve to secure the support of individuals within agencies and departments that may be reluctant to implement required changes. Triggers should shift over time from focusing on the institution of reforms to the achievement of desired performance improvements such as the reduction in the length of time required to obtain clearances, the frequency of inspections, and the cost of regulatory compliance.

Peru

Background

When President Fujimori was elected in 1990, the country was verging on total disintegration. Hyperinflation, multiple exchange rates, the nationalization of the banking system and a vicious terrorist movement had resulted in economic collapse. The impact on the private sector was catastrophic: anti-business legislation and endemic corruption caused a collapse of business activity. Sharp increases in poverty pushed many into the informal sector, which employed over 50 percent of the economically active population in low-productivity and low-wage occupations.

The new government embarked on the most comprehensive economic reform program in the country’s history. Market mechanisms were introduced in every sector of the economy. Macroeconomic policies were directed at stabilizing prices in the face of rampant inflation, large-scale privatizations were announced, negotiations with foreign creditors were opened, and the exchange rate was unified. Labor market rules were changed, foreign investment restrictions were liberalized, intellectual property rights were strengthened, government spending was cut, and attempts were made to increase tax revenues. The result was a retreat from hyperinflation as price stability began to be restored. Foreign capital returned to participate in the privatization program.

During Fujimori’s second term, however, conditions deteriorated. External shocks, the El Niño effect, and reversals in the reform program all served to weaken the economy, increase uncertainty and damage the investment climate. The government’s privatization program came to a virtual halt as the government increasingly bowed to public pressure.

President Toledo came to power in April 2001 promising to improve the economy and eradicate government corruption. However, the moribund state of the economy made the task especially difficult and confidence in the government began to erode almost immediately. In
particular, policy reversals have added to uncertainty. Attitude surveys indicate that the business community does not have confidence in the government, which it views as unstable and anxious to appease populist sentiment at the expense of continuing reform. The result has been a sharp decline in investment.

**Bank Strategy and Activities**

The 1994 Country Assistance Strategy laid the foundation for lending and non-lending services over the 1995-97 period. The CAS focused on the objective of poverty reduction through private sector-driven, environmentally sustainable growth as well as investments in public goods such as infrastructure, education, and health. The Bank aimed to assist the government in decentralizing, increasing its capacity, and reducing its role in the economy. Improving government efficiency was central to this effort. The Bank would cooperate with the International Monetary Fund in assisting Peru in maintaining macroeconomic stability.

The 1997 CAS evaluated earlier Bank interventions and concluded that they had been successful with the exception of activities related to building institutions. The CAS pointed out that these efforts had been less successful because strengthening institutions requires a much longer time horizon and is intertwined with political issues. Although the CAS stated that private sector development was important, it did not have an investment climate focus. In contrast, the 2002 CAS shifted attention to the investment climate with an institutional focus, proposing continued property rights efforts as well as actions to modernize the judicial system.

Bank activities during the FY93-02 period included:

- The $22.5 million Judicial Reform project in 1997 to reform the judiciary. The project’s overall aim was to improve the execution of justice and create an environment for conflict resolution. But due to political maneuvering surrounding the efforts by Fujimori to secure the right to run for a third term in office, the project did not proceed.
- The 1999 Financial Sector Adjustment Loan ($300 million), intended to strengthen the government’s capacity to manage the impact of future economic shocks on the financial system, promote the longer-term development and resiliency of the system, and enhance its contribution to the overall growth and stability of the economy.
- The Urban Property Rights Project, a $38 million loan approved in 1998 and still active, aimed to formalize transfer of land in urban areas on which the poor had built dwellings.

The Bank engaged in a substantial amount of ESW on investment climate issues during the period under review. In 1993, a report on measures needed to establish a competitive market economy was published. In 1994, a Private Sector Assessment was completed, outlining issues pertaining to the investment climate and containing policy recommendations designed to deal with some of the problems faced by the private sector. A secured transactions analysis in 1997 made recommendations on ways to improve the functioning of Peru’s underdeveloped financial markets. In 2003, an Investment Climate Assessment was
published which analyzed problems faced by the private sector based on a standardized enterprise survey.

**Outcomes**

Many of the “contextual” investment climate variables improved in Peru over the course of the period under review: macroeconomic stability was restored, impressive progress was made in privatization and infrastructure, and the trade environment was drastically improved. Among the core investment climate variables, there has been progress in some areas and little or none in others.

- **Legal System, governance, and property rights.** The attempt to improve Peru’s legal system through the Judicial Reform project failed, at least partly because of the judicial instability associated with President Fujimori’s attempt to secure a third term in office. The Urban Property Rights project appears to have been successful and has made an important contribution to poverty alleviation through the wealth and labor market effects that it engendered. However, financial market reform to allow mortgages of the newly titled property has yet to occur.

- **The financial sector.** Access to credit for many businesses is still limited. The ratio of private sector credit to GDP in Peru lags behind that of many other countries and is lower than that of many poorer countries in other parts of the world. Experience in Peru contrasts markedly with Bank efforts in Romania, where a successful secured transactions reform has resulted in a large increase in access to credit for the private sector.

- **Foreign investment** also remains at chronically low levels. Peru initially saw an encouraging increase in FDI levels in the mid-1990s but the external shocks of El Niño and the Asian and Russian crises scared off investors, and protracted political issues have kept foreign investors away.

- **Regulation.** Labor regulations reduce flexibility and encourage informality. It is estimated that the regulation imposes a tax on employers of 50 percent of wages. Business registration has improved but it still takes a long time to register (83 days, down from 289). Bankruptcy still takes too long at two to three years to resolve cases.

- **Contract enforcement** remains length and costly. Businesses still seem to view the legal structure as almost irrelevant — they usually confine transactions to those with whom they know well. In surveys of Peruvian businesses, the overwhelming majority claimed that the court system would not adjudicate disputes impartially, delays were long, and judges were untrained in commercial law and open to influence.

**Lessons**

Unlike in many other countries, the Bank’s early focus on microeconomic investment climate issues was apparent in a series of high-quality analytical reports throughout the 1990s. In fact, many of the later reports identified issues that had been raised in earlier reports: regulation, policy uncertainty, infrastructure, a weak judiciary, underdeveloped financial markets, and poorly-protected property rights. This suggests that either there was some repetition in this work, or that the priority investment climate issues had not been addressed.
Despite successive Bank CASs that established private sector development as a priority, a comprehensive strategy for doing this was not prepared. Although critical constraints to PSD had been identified in ESW, they were not pulled together into a cohesive investment climate action plan that could be reviewed and updated on a regular basis.

Evidence from interviews conducted for this evaluation suggests that the Bank is not communicating sufficiently with either the public or the private sector. The private sector does not see the Bank as considering their view important in terms of project efforts and complained of rarely being consulted.