Assessing the Investment Climate for Rural Enterprises

BY GUNNAR LARSON, JOHN LAMB, AND CORNELIS VAN DER MEER

Recognition of the cardinal significance of the investment climate to economic growth and poverty reduction led the World Bank to devote its 2005 World Development Report to the topic – A Better Investment Climate for Everyone. While acknowledging the great prominence of the informal sector in many developing societies, the analysis presented in the Report focused on formal manufacturing enterprises in mainly urban settings. Business environments in rural settings are quite different. Rural enterprises operate in more informal environments in which small, often household-based business enterprises are very prevalent, and where seasonality is generally a far more prominent factor than it is in urban spaces. Business start-up in rural areas is more likely to be financed by the owner’s own savings, which is very often accumulated from agriculture-based income, and far less likely to be borrowed from a formal credit source. The differing investment climates in rural and urban areas lead to quite different perspectives of risks, incentives, and possibilities among rural and urban entrepreneurs.

The 2008 World Development Report Agriculture for Development identified two fundamental elements of a dynamic rural nonfarm economy: rapid agricultural growth and a sound rural investment climate. The great distances and lack of infrastructure characteristic of rural space often impose transport and other transaction and logistical costs that are so high in relation to the value of many locally-produced goods and services that they are rendered non-tradable, that is relegated to a narrowly local exchange or to the producer’s own consumption. Such costs are likely to determine which activities are potentially profitable for rural producers. The costs heavily influence the risks and incentives facing prospective entrepreneurs as they decide whether to establish businesses, and existing businesses as they decide whether to make productive investments. The same factors often make the costs of inputs and goods from other markets prohibitive in many rural areas (World Bank 2006).

The 2008 World Development Report identifies competition as an important variable of the rural investment climate. Competition triggers innovation and the productivity gains that drive economic growth, and with it the creation of jobs. Employment is generally the principal pathway that people have out of poverty. Fostering such competitive environments entails inducing the entry of local, mainly small-and-medium enterprises as well as the development of agribusinesses that enable small farmers, entrepreneurs, and investors to participate in expanding markets.

The barriers to entry confronting prospective small rural enterprises include all the risks and costs and market failures characteristic of many rural economies, in addition to poor access to financial and public services, weak business skills, and extremely
limited or non-existent information about what demand consists of in the non-local markets they hope to sell to.

Improving the opportunities and incentives for rural firms to invest productively, expand, and bring on new workers should be a policy priority for governments, particularly given the prominence of policy, regulations, and enforcement in rural investors’ perception of risk. Providing a sound, enabling policy environment is a vital role of the government and public sector and includes setting food quality and safety grades and standards and reliable contract enforcement. Such stable policy environments go very far in relieving investors’ uncertainty over what governments will do next, what policies will be formulated, and how policies and regulations will be interpreted and enforced. This is a pressing concern among investors. Making policy formulation and enforcement more predictable can dramatically encourage investment (World Bank 2005). The policy environment is the first of four principal components of the rural investment climate identified in the 2008 World Development Report.

The second component of the rural investment climate is the extent and quality of public goods. Transport, communications, and power infrastructure have direct implications for the costs and risks of operating privately in rural areas. The state of rural infrastructure can be instrumental in influencing prospective entrepreneurs as they decide whether or not to set up a business, and in influencing established business owners as they decide whether or not to make productive investments in their existing businesses. Demand constraints and the lack of roads and reliable electricity were the principal concerns listed by small and micro enterprises in Kabupaten in Indonesia, in stark contrast to the concerns listed by large formal enterprises—macroeconomic instability, policy uncertainty, corruption, and taxation issues (World Bank 2006a).

Increasing public revenue by expanding the tax base is often the principal means by which local governments can obtain the financial resources necessary to provide the public goods that farm and rural nonfarm enterprises need to become more productive and more competitive. Expanding the tax base entails enabling and encouraging people and firms to leave the informal economy and to enter the formal economy, and this, therefore, becomes a practical priority for most governments. In the formal sector, businesses are more likely to gain access to enforceable property rights as well as to credit and other financial services. On the other hand, the income they earn is more likely to be taxed, which provides a disincentive for many rural entrepreneurs to become formal, and an incentive for some formal sector entrepreneurs to become informal again. For workers already employed in the formal sector, labor market regulations such as a minimum wage or high severance payments provide a number of safeguards. Yet such regulations can also depress the overall demand for labor in the formal sector, undercutting job expansion. RIC surveys and analysis can help clarify and quantity these tradeoffs.

While physical infrastructure is the type of public good most often cited as a bottleneck to rural integration, investments in schooling and human capital—investments that transform unskilled to skilled labor—are vital in enabling workers to capitalize on expanding opportunities or to migrate to where such opportunities exist. “For those who cannot” the World Development Report warns, “only social protection can ease their poverty” (World Bank 2007).

The state of the legal and regulatory framework is presented as the third component of the rural investment climate in Agriculture for Development. A framework that fosters competition, business integrity, and fair practices makes for an investment climate in which firms have confidence that their property rights will be upheld and that the contracts they enter into will be legally binding. They do not have
to fear that larger, more powerful and politically-connected interests may expropriate what they own—a source of anxiety which the 2005 World Development Report *A Better Investment Climate for Everyone* identified as particularly inimical to the stability and security characteristic of sound investment climates.

Access to financial services, risk-sharing institutions, and business development services is the fourth component of the rural investment climate. Surveys carried out in Indonesia, Nicaragua, Sri Lanka, and Tanzania indicated that—in addition to insufficient infrastructure—the lack of rural finance, and business and public services is particularly binding. The World Development Report therefore sets out business services and market intelligence as important entry points for public policy intended to encourage market entry by small-and-medium enterprises.

*Small rural nonfarm enterprises* in particular are a focus of World Bank rural investment climate assessments. The assessments are a modification of the investment climate survey instrument that is adapted for specifically rural contexts. Beginning in 2003 a series of six pilot rural investment climate surveys were carried out in Benin, Ethiopia, Indonesia, Nicaragua, Sri Lanka, and Tanzania. Earlier surveys had revealed rural nonfarm enterprises to be mostly household-based, informal (or “unregistered”), and to operate mainly in the service sector. These enterprises provide between 30 and 45 percent of rural income in developing countries, and a still higher proportion among the rural poor—for whom they are an important source of employment. They link farmers to markets, providing them with inputs like seed and fertilizer, as well as with services like post-harvest storage, transportation, and sales to distance markets. The development of such agribusinesses is therefore crucial to agricultural development and to the diversification and integration of rural economies (World Bank 2005). Cultivating investment climates in which such rural enterprises can flourish and grow and come together into clusters of local firms that can coordinate to effectively and competitively participate in servicing expanding markets will be instrumental in making the 2008 World Development Report operational. The Report itself cites well-documented cases of such ‘agro-based clusters’ for nontraditional exports in Brazil’s San Francisco Valley and for dairy production in Ecuador and Peru.

A sound investment climate and rapid agricultural growth are inextricably inter-related. Income from agricultural production is very often the source of funds for rural microenterprises to begin operations or to expand investment into new activities. Agricultural growth can stimulate demand for goods and services from other sectors, and significant rural integration can take place as a result of consumption and production links between sectors. The existence of a favorable investment climate enables non-agricultural sectors to respond to increased demand for agricultural inputs and services by farmers, and encourages people to mobilize rural savings into investment capital. The development of a functioning local economy with limited market fragmentation and market failures can over time attract the notice of investors from other localities and cities.

**IMPLICATIONS FOR THE RURAL AGENDA**

Given the importance of the rural investment climate for raising rural incomes and reducing rural poverty, identifying the principal determinants of the investment climate and especially those that can be improved are pressing concerns in World Bank operations. The need to work out a reform agenda that promotes and accommodates a better investment climate is a particular imperative, and this was a principal reason behind undertaking the pilot RIC assessments in six countries. Additional RIC assessments are now underway or in advanced planning.
in Bangladesh, Cameroon, Ghana, Mozambique, Nigeria, Pakistan, and Zambia. In 2007 the World Bank’s Agriculture and Rural Development Department developed a Rural Investment Climate Assessment Implementation Manual, which together with a number of prototype questionnaires is now being used by Bank task teams throughout the regions (see reference World Bank 2007a for a link to the Manual). Their use is an encouraging indication of strong demand among the Bank’s Regional Vice Presidencies, where the need for favorable reform agendas is widely recognized. (More information is available at ricsurveys@worldbank.org.)

The RIC assessments have employed a new and truly promising series of methodologies that continue to be refined based on the experience gained and lessons learned from earlier assessments. New analytical and survey tools are likewise being developed and the next round of assessments is intended to refine the methodologies used in conducting surveys and interpreting results. The ongoing modifications are also designed for the purpose of standardizing data, facilitating the comparison of results across countries. Expanding the number of completed RIC assessments will make the sum of all results more useful in informing policy planning, and encourage the analysis of RIC data sets as they become available – both inside and outside of the World Bank itself. The World Bank, therefore, recommended in late 2007 that at least six additional RIC assessments be commissioned over the next four years. Funding for the next round of RIC work is being sought from two trust funds.

Mainstreaming improved RIC surveys and assessments into World Bank operations and into rural development programs more generally will ultimately lead to a more informed policy dialogue, one that is based on rigorous supporting analysis. The results of this analysis will also be available to private sector actors, providing them with improved information on which to base investment decisions. In fact, the increased confidence that comes from better information is in itself an important element of the rural investment climate. For the World Bank, the information the assessments provide will inform the design and monitoring of operations that support rural enterprise development. It will also improve our understanding of the structure and functions of the rural economy generally, beyond the parameters of individual economies. In this way they will provide a source of insight into agricultural and rural economics and their place in the global economy.

SOURCES


