

Governing the Investment Climate

BY RAJ M. DESAI AND SANJAY PRADHAN

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

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

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



Bribes: one of many distortions

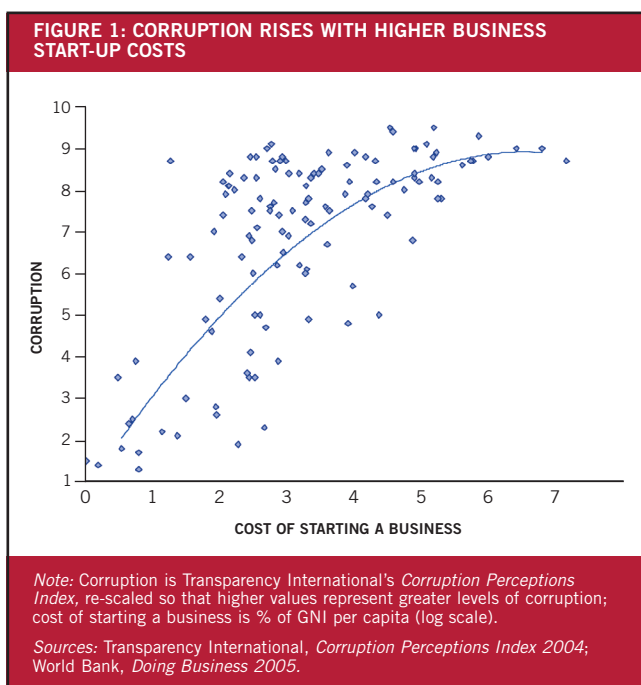
FOR VALID REASONS, efforts to improve governance in the investment climate have often focused on reducing the bribe tax paid by firms to public officials. High levels of corruption can last for a long time, all the while diverting resources from more productive activities. In the most extreme cases,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

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

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

The cost of patron-clientelism and state capture

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



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

When one group of individuals has disproportionate political influence, the design or implementation of policies can be skewed in their favor at the expense of society as a whole in ways that establish long-lasting privileges for these groups. For instance, during the simultaneous economic and political transition in Eastern Europe and the former Soviet Union, powerful firms and individuals (“oligarchs”) bought off politicians and bureaucrats to shape legal, policy, and regulatory environments in their own interests. Today several countries are beset with the problem of “state capture” whereby powerful economic interests in the public and private sectors influence the formation of laws, regulations, and policies to their own advantage—at the expense of the general public—through illicit and non-transparent provision of private benefits to public officials.

Consequently, policies that are inimical to the investment climate persist because they reward the narrow, personal interests of rulers and elites. The result: property rights, tax, and regulatory regimes are designed with specific constituencies in mind. Governments suppress competition by conferring monopolies, devising market restrictions, or tolerating cartels. These distortions, once in place, are notoriously difficult to dismantle.

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

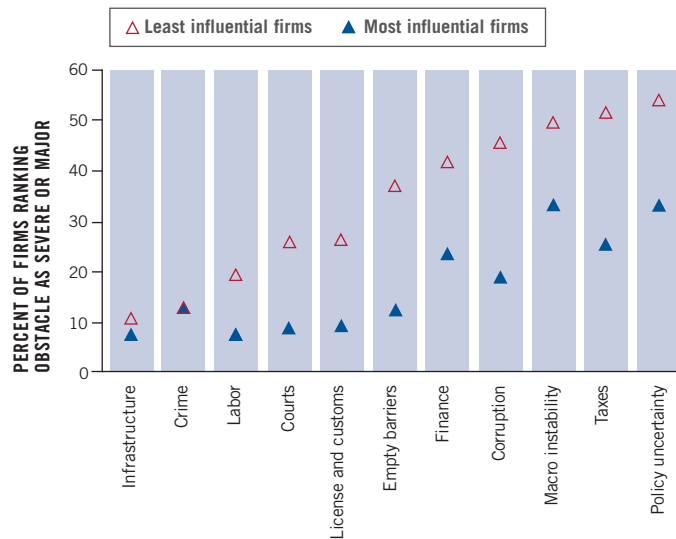
As Figure 2 shows, in example after example, influential, well-connected firms face fewer investment climate problems. Now all these relative benefits would not necessarily be a bad thing if the most influential firms were also the most dynamic—the firms that opened new plants or introduced new products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

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

The way forward

HOW CAN ECONOMIES BREAK OUT of these cycles of bad

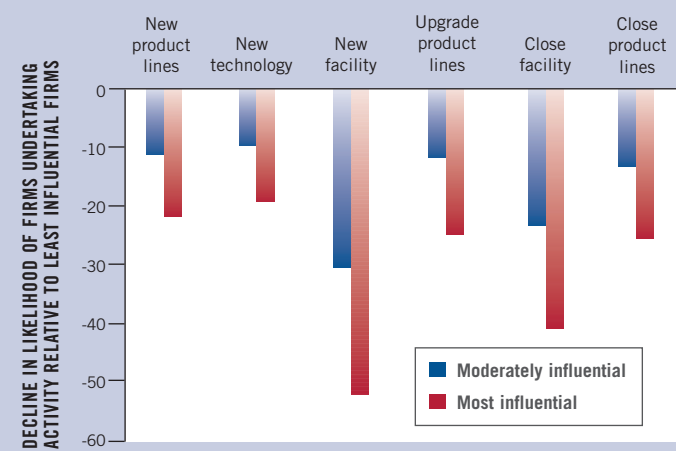
FIGURE 2: LIFE IS EASIER FOR INFLUENTIAL FIRMS...



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

Source: World Bank, *Investment Climate Surveys*.

FIGURE 3: ... BUT INFLUENTIAL FIRMS INNOVATE LESS



Source: World Bank, *Investment Climate Surveys*.

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

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

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

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

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