WORKING PAPER **307**

Idealism, Realism and the Investment Climate in Developing Countries

Mick Moore and Hubert Schmitz

June 2008

Institute of Development Studies

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Institute of Development Studies at the University of Sussex Brighton BN1 9RE UK

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Summary

The question which drives this paper is how, in the political and institutional environments typical of poor countries, public action can bring about substantial increases in productive private investment. ‘Improve the investment climate!’ is the dominant policy advice. This paper reviews what is meant by the investment climate and then concentrates on the institutional dimension of investment climate reform. The standard advice in such reform is that governance through informal relationships should be replaced with governance through formal rules. This means above all the legal protection of property rights and the legal enforceability of contracts.

This paper agrees with this view as a long term goal, but it disagrees with the big push for the introduction of formal rules – which is at the heart of much investment climate reform. It suggests that this big push is idealistic: it is very difficult to achieve and may not produce the expected increases in investment. The paper therefore draws on cases in which substantial increases in investment occurred even though property and contracts were not legally protected. In these cases, informal relationships between those who hold political power and those who decide on investment seem to have been critical to stepping up investment and economic growth. The paper zooms in on such hand-in-hand arrangements between politicians and investors, suggesting that they may offer a more realistic way forward in poor countries with weak public institutions. However, it is also stresses that such arrangements can be, and indeed have been, abused. The challenge therefore is to specify the circumstances in which hand-in-hand arrangements have the desired effect. Where these arrangements are transitional and raise productive investment, they are likely to strengthen the demand for formal rules. The central issue is thus one of sequence and dynamics: do investors follow or lead institutional reform? The paper ends with suggestions for research which is comparative and investigates changes over time.

Keywords: economic growth; investment, investment climates; politics; government-business relations; business climate.

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Concepts, terminology and distinctions

Here are some of the more important conceptual distinctions that we make in this paper:

- *Investment climate* (risk-reducing) versus *business climate* (cost-reducing).
- *Experimental, incrementalist* versus *blueprint* approaches to reform.
- Relationships between government/politics and private business that are *rule-based, arms-length, universalistic* versus those that are *relationship-based, hand-in-hand, particularistic.*
- *Hand-in-hand* relationships between government and business versus *crony capitalism.*
- The notion that government/politicians are principally (a) a potential *threat* to investors that needs to be restrained or (b) a *source of support* that needs to be nurtured.
- The state/politics as a *single-level source of monolithic power* versus a *multi-level source of pluralism.*
- The need for investors to have politicians' *assurances* about their property and other rights versus the *formal legal system* as a potential source of assurance.
- Provision of assurances about property and other rights through *state* versus *private* institutions.
- The generic incentives that public authorities and private capital face to both *cooperate* and *compete* with one another.

1 Introduction

Imagine that a poor country, suffering from low economic growth and bad governance, has elected a new government. The new Prime Minister and her team are convinced that poverty reduction requires faster economic growth, and that this in turn requires stepping up private investment. They turn to a group of honest consultants with extensive international experience who are committed to *evidence-based advice*. The advisers would find it:

- Easy to provide the policymakers with a list of things to do, for example, strengthen the legal protection of property, make commercial contracts legally enforceable, reduce 'red tape', improve transport and communication infrastructure.
- Difficult to say how actually to implement some of these reforms within the typical five-year lifespan of a government.
- Impossible to guarantee that, even if the government somehow implemented the reforms, substantial increases in investment and growth would follow.
- Appropriate to admit that some regions in the world have had high levels of investment and economic growth without having the desirable institutions in place.

This in a nutshell is the state of the art on the investment climate. Those who disagree probably do so because they have particular elements of the investment climate in mind for which the above summary assessment applies less. This is indeed a big problem in discussing the reform of the investment climate: it often includes many different things. We address this problem in this paper but then concentrate on what most would consider the heart of a good investment climate: *reliance on formal rules rather than informal relationships*. This means concentrating on institutional reform, in particular the advice to prioritise the legal protection of property rights and the legal enforceability of commercial contracts.

In this paper we suggest that that there is an orthodox view about how institutional reform should proceed and that this view is not trustworthy. Our disagreement is not over goals but the methods and processes of reaching goals. The orthodox view may provide both guidance about the general direction of desirable policy reform and bits of practical advice. But governments cannot assume that this conventional advice can be translated into a set of policies that will actually generate more private investment. In particular, they should be aware that in practice it is often very difficult actually to implement the recommended reforms. Desirable as they may appear in principle, they may not in practice be within the grasp of a government with a time horizon of around five years.

We offer in this paper a more practical way of thinking about some of the key investment climate issues. We believe our approach is particularly relevant in places where, according to conventional understandings, the quality of public institutions[1] is weak, i.e. where governments themselves are in varying degrees fragile, arbitrary, representative only of narrow interests and thus lack credibility; legal institutions are neither impartial nor influential; and politics tend to be unstable or deeply conflictual. The paper is organised in three main components:

a) Unorthodox and successful. We begin, in Section 2, with an inspiring case of successful unconventional policies. China has been enjoying unprecedently high rates of economic growth largely driven by very high levels of profit-seeking domestic investment. This experience is at odds with orthodox notions about the investment climate in one central respect: investors in China, who are dominantly Chinese and increasingly 'private' actors in the conventional sense of the term, have enjoyed very little protection through law. This was especially true of the period on which we focus, the 1980s. Investors had few formal 'property rights'. Not only was there little rule of law in China, but there was no rule through law – the state itself is not law-bound. Why were potential investors not deterred through fear that they could not enforce their contracts, collect their debts in the courts and, more important, protect their assets against thieves, predatory politicians, or the greed of a one-party government that allowed no political opposition and recognised very few restraints on its own power? We show that Chinese authorities worked out a series of compromise arrangements that worked well enough for limited periods of time. Strategically, these arrangements were characterised by an *experimental and incremental* approach to institutional reform. Emphasis was placed on solving immediate problems through manipulating existing institutions rather than (a) reconstructing them according to some long term design or (b) assuming that particular purposes could be achieved only by creating new institutions dedicated to particular purposes. Substantively, the basic societal mechanisms employed to encourage investment were more *relationship-based* than *rule-based*: relationships between investors and those who held political power played a greater role than did formal rules or laws. Why do we set out the China case so early in the paper? It is not to identify a model that others can or should follow, but rather to illustrate that there are feasible alternatives to the orthodox investment climate advice.

b) Problems with orthodoxy. Our critique of conventional advice on the investment climate in Section 3 does not focus on the empirical evidence that it is an unreliable way of generating productive investment. To the extent that one can prove that argument, other researchers have already have done so.[2] We rather deconstruct the ideas that underlie the orthodox view, to better understand its biases, weaknesses, and strengths. It reflects a confluence of four different sets of concerns:

- *Reducing cost:* The belief that governments can and should play an important role in reducing the costs of doing business by being efficient at providing – or

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1 What is an 'institution'? The term is widely – and often very loosely – used in the literature we are dealing with here. Many economists, in particular, employ Douglass North's notion of institutions as (formal or informal) authoritative *rules*, which structure any 'game' (consistent series of interactions). That is however conceptually and practically deeply problematic. Rules do not enforce themselves. They cannot be the ultimate arbiters of any game. Who sets them? How are they enforced? (Toye 2008; Woodruff 2000). We employ the older and more intuitive concept of institutions, defined by Grief as 'a system of connected rules, beliefs and organisations that guides, enables and motivates regularity in behaviour' (Helpman 2004: 115).

2 See for example, (Altenburg and von Drachenfels 2006, 2007; Hobday and Perini 2006; Keefer 2007; Khan 2005a; Rodrik 2005; Sayeed and Memon 2007).

regulating the private provision of – physical infrastructure (e.g. electricity, transport, telecommunications), efficiently supplying other services like tax collection and effectively regulating financial and labour markets.

- *Reducing uncertainty:* The understanding that government can play a role in reducing many of the uncertainties that business faces, including those, like policy uncertainty, that can be caused by government itself.
- *Legal formalism:* A set of inter-related concerns about the importance of protecting property rights, and the need to do so through formal, independent courts and other legal institutions, all embedded in a strong emphasis on the positive value of formal institutions.
- *State minimalism:* A deep suspicion of the motives of governments and politicians in relation to economic activity, and a consequent preference for limiting or minimising their direct engagement in economic decisions.

The first two objectives in this list are not controversial in themselves. They are however conflated in the investment climate debate and, as we explain in Section 3.1, this leads to practical problems. There would be more clear thinking if we had a consistent terminology to distinguish (a) policies designed to help reduce business costs (*business climate*) from (b) policies designed to help reduce the unpredictability that businesses face, above all the degree of uncertainty that investors face about their ability to profit in the future from investment decisions made now (*investment climate*).

We explain in Section 3.2 why a strong policy emphasis on the last two items in the list above – *legal formalism* and *state minimalism* – might in practice do little to encourage private investment. There are five main reasons, most of them inter-related:

- Investors need to be assured that they will not be prevented from reaping and retaining the profits of their enterprise. *Legal formalism* is an important means of doing this. It is not necessarily the best or the only means; governments have other tools to achieve the same ends.
- Experience shows that it is very difficult to bring about effective, rapid reform of weak legal institutions. In adopting relatively ambitious standardised reform programmes, governments may be trying to do too much too quickly.
- Conversely, recent experience and research illustrates the scope for a more politically strategic approach to reform, with an emphasis on small steps that will help mobilise private interests that in turn are likely to support further reform.
- Some of the apparent deficiencies of formal public institutions may not be significant obstacles to competitive market enterprise, because the private sector itself provides, through private and non-formal mechanisms, much of the assurance that investors need. Some institutional reforms merit a low priority.
- The standard investment climate advice embodies an excessive distrust of governments insofar as they have any direct role in undertaking or shaping

economic activity. The emphasis is on reducing any such involvement. This is too narrow and often impractical. Not only can governments play useful roles in coordinating investment, but they often need to do so. Investors' needs extend beyond assurances that governments will not molest them, or allow others to do so. Investors may also need assurances that governments will come to their aid in times of trouble and otherwise use their authority in a supportive way.

c) Business and politics: interdependence. In Section 4 we suggest a way of thinking about the relationships between government and business that is both more accurate and more useful than the assumptions that underlie the conventional approach to the investment climate. The core conceptual problem with orthodoxy is that government and political power are viewed primarily as persistent threats to capital, investment and economic growth. From that perspective, the policy mission is to curtail the influence of political power through formal rules, laws and institutions. If that mission fails, politicians are expected at least to maltreat the private economy, and possibly to loot it, and thus undercut economic growth.[3] The alternative view starts from the understanding that the relationship between politics and business is always actually or potentially one of *interdependence*. Politics and business need one another. Business needs the support of government to make profits; governments and politicians need to share in these profits to finance government and politics. Sometimes these mutual needs can be reconciled within an institutional configuration marked by: relatively transparent *arms-length relationships* between government and business that are regulated through formal political and legal institutions; competitive, democratic politics that empower the majority of the population who are not significant owners of capital; and political coalitions that reconcile the potentially competing interests of investors, politicians, consumers and employees by promoting both economic growth and popular welfare. That institutional configuration is most consistently – albeit far from completely – found within the OECD ('advanced capitalist') countries. It is very difficult to create such an institutional configuration within countries characterised by weak institutions. But neither is that necessary in the short term. For it is not a matter of making a choice between (a) an OECD-type

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3 This attitude is exemplified in the following extract from an editorial in *The Economist* (26 April 2008) on what it terms Vietnam's economic miracle:

> Vietnam began to be a success only after its ruling Communists accepted that capitalism, free markets and free trade were the surest route to riches. They began in 1986 with a liberalisation programme called *doi moi* (renewal), though real reform began in fits and starts over the following 20 years. Collectivisation was scrapped, farmers were given their own land to till and agricultural prices were freed. In 2000, private business – until then strictly curbed – was legalised and a stockmarket created. Trade barriers were lowered, exports and imports soared, and Vietnam is now among the world's most open economies. There can probably be no going back: any attempt to reapply the dead hand of government will ensure that Vietnam's dream of riches by 2020 remains just a dream.

The suggestion that moves toward 'capitalism, free markets and free trade' underlay this exemplary economic performance are not very controversial. But the more doctrinaire insinuation that the government can only touch the economy with a 'dead hand' simply does not square with the facts that the Vietnamese economy grew very fast for a long period of time when dominated by enterprises that were either directly state-run or joint ventures between foreign investors and state agencies.

good (but very hard to achieve) investment climate and (b) some far inferior alternative arrangement, of the kind evoked by the term ‘crony capitalism’: highly politicised, corrupt, inefficient, and economically sluggish. Even where institutions generally are weak, politicians and business have strong incentives to seek mutually beneficial arrangements that will give investors the confidence to invest and politicians some assurance that they will be able to share in the fruits of this investment, through some combination of legal taxes and other less legal transfers. These arrangements can take a variety of forms. We do not understand them very well, in part because we have tended to dismiss them for not meeting what we believe to be the right standards of transparency, legality and fairness. We need more research to enable us to understand, in particular, the circumstances in which different *hand-in-hand* relations between politicians and business, that do not meet the highest standards of fairness, transparency or legality (a) help promote investment and (b) do so with limited risk that they will deteriorate into ‘crony capitalism’.

2 Unorthodox and successful: the China case [4]

In the late 1970s, the leadership of China’s ruling Communist Party began strongly to signal that it would like farmers and other producers, especially those controlled by local governments, to pay less attention to the framework of central planning that had been dominating their economic lives. Were they to begin to produce for other markets, to innovate, to trade with one another, and to invest, then the government would look on their activities favourably, would not expropriate their additional earnings, and would not punish them for doing things that had until recently been treated as crimes. That signal initiated a virtuous circle: the expansion of markets outside the central planning framework, greatly increased investment, accelerated economic growth (around 9 per cent annually over a period of 30 years), and the emergence of a recognisably capitalist economy. Fortunately, for the purposes of this paper we do not need to explain everything about this massive, ongoing transformation of China and, consequently, of the world economy. The element that interests us is the rate of investment. This has been high and climbing over most of the period. China is in this respect typical of most economies in the world: the economic variable that best predicts or explains changes in rates of economic growth is changes in investment levels, especially levels of profit-seeking investment. It is this high level

4 The understanding of China that we put forward in this section derives from a variety of sources. The original inspiration was the much-cited chapter by Qian (2003). Other important general interpretations include (Keefer 2007; Oi 1999; Rodrik 2005). In an important new piece of research, Fang and Smith (2008) use provincial level data to confirm major aspects of Qian’s work, notably his explanation of why Township and Village Enterprises (TVEs) played such a major role in the economic expansion of the 1980s. Fang and Smith find that TVEs had institutional advantages over private sector enterprises until 1988. Once the institutions of the market economy were better established, the TVEs lost their advantage, and declined. Kung and Lin (2007) make a similar argument.

of investment that we need to explain. But we need not explain all causes of it. We can be sure that, in China as in the rest of the world, levels of investment are driven dominantly by expectations about profitability. There are many reasons why actual and expected profits have been so high in China. We are interested only in understanding why this long investment boom took place despite apparently serious institutional deficiencies. Investors in China have enjoyed slight protection from the law in the formal sense. There has been very little commercial law, and few courts to enforce it. Rights to land and other property, as conventionally understood, have been weak. Indeed it was as late as 1982, *after* the move to the market got underway, that a long process of paring down individual property rights culminated in the assertion, in a new constitution, of the state ownership of all urban land.[5] The Communist Party has retained a monopoly of power, and has rarely been bound by law or constitution in the exercise of that power.

Why have potential investors not been deterred through fear that they could not realise their potential profits because of an inability to enforce their contracts and collect their debts in the courts and, more important, to protect their assets against thieves, predatory politicians, or the greed of a one-party government that allows no political opposition, and practices little overt accountability? As the economy has become more successful, and the Chinese variant of capitalism more deeply embedded, fears of a wholesale policy reversal have naturally subsided. We are interested more in the earlier period, especially the 1980s, when it was less obvious that the capitalist road was going to offer so many material benefits so quickly, the political opposition was greater, and investors' profits seemed more vulnerable to expropriation and sudden policy reversals.

Why were Chinese people in particular willing to invest in China in this early period?[6] There will never be consensus on this issue, because it touches upon two matters about which informed observers are likely to have biases. The first is specific to China; any suggestion that public policy was somehow right, or good enough, implies a political judgement on the Communist Party, and on one party rule. The second is the generic issue of attitudes to government and market respectively. Some people are very willing to believe that governments can play positive roles in promoting economic growth. Others tend to assume that governments are so inept or self-interested that, whatever they do, rates of economic growth would always have been higher if government had done less. We are neutral on both issues, but impressed by research suggesting that the Chinese authorities were able to provide adequate assurances to investors by exploiting and manipulating the existing, highly statist, political and institutional environment:[7]

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5 Private ownership of land was the norm before 1947, and many of these rights were guaranteed in the 1954 constitution. The establishment of People's Communes in 1958 led to the first of a series of laws that converted all land into either state or collective property.

6 Since the 1980s, foreign and domestic investors have subject to different legislation and laws. Firms (partly or wholly) funded from foreign sources have enjoyed more rights and legal protection. Indigenous Chinese investors have been taking the highest political risks (Huang 2007).

1) In the late 1970s and early 1980s, the reformist political leaders led by Deng Xiaoping put a great deal of effort into travelling around the country, repeating the message about the virtues of the 'socialist market economy', and trying to ensure that the Party and state apparatuses would cooperate. This high degree of commitment was in part an effort to overcome continuing top level political opposition. It had the effect of signalling that, if the reformist leadership remained in power, the switch to pro-market policies was likely to last. It was important to broadcast that political signal widely because most early profit-seeking investors were not large state-owned enterprises, which were only released slowly from the framework of central planning,[8] but small local enterprises owned by local governments. The reassuring message had to diffuse widely and deeply. Unlike in India at the same time (Section 4.6), in China it was not a matter of sending 'private' signals to a small number of large private conglomerates.

2) Competitive markets were introduced only gradually, through formally creating a non-plan sphere of economic exchange alongside the dominant plan sphere. New production and new economic activities were encouraged by channelling them into the more lucrative non-plan sphere.

3) The first new investors in the non-plan sphere were dominantly enterprises belonging to local governments, especially at township level and below – the famous TVEs (Township and Village Enterprises). Local governments already controlled production units engaged in agro-processing, manufacturing and other activities. It required little institutional change for the people in command to treat these units as sources of potential profit and to establish new ones more directly oriented to profitability. 'TVE-capitalism' provided political assurance to investors through two distinct sets of mechanisms. The first operated essentially at the ideological and symbolic level. The fact that TVEs were formally 'collectives',[9] and not private enterprises, helped validate them in terms of orthodox Communist policy positions. This made it relatively easy for individuals and groups in authority gradually to emerge as individual capitalists while remaining within the Communist Party. The second set of mechanisms were more structural: the ownership of new enterprises by local governments, and thus by local Communist Party units, provided considerable protection against potential predators: local thieves; other competing enterprises; and, above all, higher levels of government itself. Local thieves would have been reluctant to steal from what were effectively local political-cum-administrative-cum-economic establishments. The fact that the political authority of these local establishments had clear territorial limits reduced the scope to use it to suppress economic competition from enterprises based in other local administrative units. Concretely, it is not easy for one county government to suppress competition from the economic enterprises controlled by

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7 We are not here discussing the broader political conditions that made possible the transition from state socialism to capitalism in China. These included, for example, the use of foreign direct investment to put competitive pressure on state-owned enterprises and to introduce industrial new labour practices without generating large scale labour resistance (Gallagher 2005).

8 Much of the Chinese economy remains in the hands of large scale public enterprise.

9 Chinese formal distinction between state and collective.

the government of an adjacent county. It made more sense to compete economically. This is what local governments did.[10] However, the bigger potential predators were higher levels of government (and Party), which had the authority to extract revenue from those below them, and thus potentially to kill the geese that laid the golden eggs. To obviate this threat, existing institutions were adapted to encourage the potential predators to focus instead on the scope for extracting surpluses from lower levels in institutionalised ways that continued to reward profit-making. Taxation and budgetary systems were modified to encourage higher levels of government to share in profits, and to assure them that they were indeed able to do so. The accounts of local enterprises were relatively accessible to higher levels of government. An existing distinction between budgetary and extra-budgetary funds and revenues was exploited. Higher levels of government set fixed targets for the delivery of extra-budgetary revenue from lower levels, but in turn allowed lower level governments to keep most or the entire surplus they earned over and above those targets. The lower levels thus had incentives to exceed their targets by fostering and profiting from local enterprise. As a result, Chinese fiscal accounts were unreliable and opaque to outsiders, but provided useful incentives to insiders. As we mentioned above, much of the suspicion of the role of government in relation to private enterprise is implicitly based on an image of a single, powerful central state unconstrained by alternative domestic accumulations of political power. Once one admits into the picture powerful sub-national governments with real capacity to bargain with higher levels, then the political game becomes more complex, and simple assumptions more suspect.

4) For a time, household bank accounts were anonymous: individuals could open and operate accounts without having to prove their personal identity or use their real names. The ratio of the value of household bank accounts to GDP increased from 6 per cent in 1978 to 65 per cent in 1998. In a country ruled by a Communist Party that had recently reviled capitalism and private profit, banking secrecy provided incipient private entrepreneurs with some assurance that they were not totally vulnerable to a change of state policy, a sudden decision to tax the rich or political extortion. Government was not depriving itself of vital economic information, because most economic activity was still in the public sector. And, since government owned all the banks, it was able to help itself to substantial revenue by paying a low rate of interest on these deposits.

5) In respect of enterprise development the Chinese authorities followed what is for them a fairly standard procedure of encouraging different sub-national levels of government to experiment with different methods of achieving some broadly defined policy goals, and then carefully evaluating the results and promoting the more successful models (Huang 2007).

A crude but useful way of summarising the points made above would be to say that means were found effectively to assure members of the Communist Party that, were they to become investors, their assets would be politically protected. Since Party members and their families account for around 5 per cent of the

10 This competition has been institutionalised in Vietnam. Since 2005, a separate Provincial Competitiveness Index (PCI) has been produced for most of Vietnam's 64 provinces.

population of China, that amounts to quite a lot of *de facto* property rights (Keefer 2007). Party members comprise the core of the new capitalist class. The continuing, albeit weakening, capacity of the Party to recruit talented people and to oversee and monitor government and private economic activity has helped limit the extent of 'crony capitalism', i.e. the biased use of political influence to advantage some investors over others. It is not that some kind of happy equilibrium has been achieved. To the contrary, institutional and political arrangements are continually in flux. Especially since China's accession to the World Trade Organisation in 2001, the government has been introducing reforms that will establish more of a *rule-based* relationship between the state and private business, and make Chinese institutions more like those of the OECD countries. Private enterprise was only officially allowed in 1988, but with no legal protection for private property rights. The first formal grant of significant private property rights was made in the new 2004 constitution. This has been followed by legislation in 2007, with more under consideration. Following a series of measures to improve accounting standards, in 2007 the companies listed on the Shenzhen and Shanghai stockmarkets were required to adopt norms close to the International Financial Reporting Standards. China has not found *the* solution for itself.[11] The processes that we have interpreted in terms of successful adaptation to continually changing circumstances are viewed by many other observers as, at best, a process of 'muddling through'. But 'muddling through' can be good enough.[12]

Why have we talked first about China? It is not because China, or the similar experiences of contemporary Vietnam, provides precise policy guidance to other countries with different political institutions.[13] Rather, these two important success cases help us reframe the investment climate debate in productive ways, both at the general and the more specific levels:

- At the general level, China and Vietnam matter because they provide vivid, contemporary example of a series of successful investment policies that bear little resemblance – and in some respects seem almost contrary to – those promoted through most international institutions. The recognition that unorthodox policies can be so successful in generating investment gives rise

11 There are major concerns in China about levels of official corruption, which tend to be concentrated around infrastructure projects, land rights, government procurement and financial services. This is partly because a large proportion of the economy remains in private hands. In this as in other respects in China, the central political leadership often has limited influence at more local levels (Pei 2007). Since the early stages of the market reforms, the central leadership has been making major efforts to enhance discipline over lower levels cadres and reduce the extent to which they use their influence over the economy for personal gain (Edin 2003; Keefer 2007).

12 One could tell much the same story about Vietnam, that has the same core elements: one party Communist rule; the gradual opening up the market and private enterprise in ways that assure political insiders a near-monopoly of opportunities for entrepreneurship; the persistent lagging of formal and legal changes behind changes in economic practice; substantial decentralisation of power to sub-national (provincial) governments; and a major role for sub-national governments as drivers of economic change.

13 For example, efforts in the late 1980s in the Soviet Union to emulate aspects of China's economic reforms did not succeed (Rodrik 2005: 994).

to new questions: are there other cases – perhaps less spectacular – that have been overlooked? How do we need to reframe the debate in order to make analysis and advice more relevant?

- At the more specific level, these cases illustrate the limits of conventional ideas about the investment climate premised on the notion that government, as a single, coherent centre of power, poses major threats to investors, and needs above all to be restrained. A great deal of the investment climate orthodoxy focuses on ways of restraining the power of 'the state'. But the China and Vietnam stories demonstrate that, given genuine multi-level government – i.e. some independent authority and bargaining power for sub-national governments – policymakers can exploit and shape relations between these different levels to make 'the state' a far less fearsome creature.

3 Problems with orthodoxy

Our central question is how, in the political and institutional environments typical of poor countries, public action can bring about substantial increases in productive private investment. 'Improve the investment climate!' is the dominant policy advice. This section reviews what is meant by the investment climate and then concentrates on the institutional dimension of investment climate reform, setting out the standard advice and explaining why it is misleading.

3.1 What is an 'investment climate'?

One of the most authoritative recent statements on the investment climate is the World Bank's *World Development Report 2005 (A Better Investment Climate for Everyone).* How does the World Bank define the 'investment climate'? They offer: 'location-specific factors that shape the opportunities and incentives for firms to invest productively, create jobs and expand' (World Bank 2005: 1). In other words, the investment climate comprises the things that affect investment. That seems like a rather unhelpful tautology. It is however understandable that the World Bank was unable to come up with a coherent, brief and substantive definition. That reflects the nature of the field. We can learn more about what the World Bank means by 'investment climate' through looking at the components listed in the *World Development Report 2005*. In fact, the Overview contains two different lists of the kinds of things that governments might do to promote investment. The first, labelled 'focusing on delivering the basics' (pp. 9–12), is conventional. It is summarised here using the headings and sub-headings in the original:

- Stability and security
  - Verifying rights to land and other property
  - Facilitating contract enforcement
  - Reducing crime
  - Ending the uncompensated expropriation of property

- Regulation and taxation
  - Improving domestic regulation
  - Improving domestic taxation
  - Improving regulation and taxation at the border
- Finance and infrastructure
  - Improving finance
  - Improving infrastructure
- Workers and labour markets
  - Fostering a skilled workforce
  - Crafting market interventions to benefit all workers
  - Helping workers cope with change

That list is however preceded by another setting out the higher-level, longer term, political and strategic actions that government should be taking to promote investment (pp. 6–7):

- Restraining rent-seeking
- Establishing credibility (of government policies)
- Fostering public trust and legitimacy (in public policy)
- Ensuring policy responses fit local conditions

The *World Development Report 2005* has been criticised for being wishy-washy in not declaring exactly what makes a good investment climate. We are more sympathetic, because this ambiguity represents an advance on the more doctrinaire certainties criticised for example by Qian a couple of years earlier:[14]

> To these (new institutional – authors) economists, a set of institutions is critical for sustained growth, including secure private property rights, protected by the rule of law, impartial enforcement of contracts through an independent judiciary, appropriate government regulations to foster market competition, effective corporate governance, transparent financial systems, and so on. The fact that all of them can be readily found in the developed economies, especially in the United States, implies that they are 'best practice' institutions.
>
> Economists then use these institutions as a benchmark to judge transition and developing economies, and often find huge institutional gaps. These findings then serve three purposes. First, they generate a diagnosis of deficiency of institutions in developing and transition economies. Second, they are used to explain why these economies perform poorly, confirming the central hypothesis that institutions matter. Third, they lead to recommendations for institution building: If the economy has weak property rights, clarify them. A weak financial system? Strengthen it. A bad law? Change it. A corrupt legal system? Clean it up.
>
> (Qian 2003: 302–3)

14 Qian was criticising a range of authors and material. A good example of his target – certainty that new institutional economic analysis provides the right diagnosis and the right policy prescriptions for poor countries – is to be found in the collection of papers by World Bank authors edited by Burki and Perry (1998).

It is better to admit to genuine uncertainty than to assert ill-founded 'truths'. We would rather the *World Development Report 2005* had been more open about where the uncertainties lie, including uncertainties about the very scope of the term 'investment climate'. In this paper, we are more explicit about definitions in two main ways. First, we adopt a relatively broad definition of what we call 'the orthodox view', to include the *World Development Report 2005*. We understand this orthodoxy to have three main components:

- Substantively, policymakers are expected to give greater protection to property rights; provide more effective legal and institutional support to the enforcement of commercial contracts; reform credit and capital markets; enhance the rule of law; maintain monetary and fiscal stability, low inflation, and policy stability; improve the efficiency of import and export procedures; and reduce the amount of 'red tape' that businesspeople face when dealing with public agencies.
- Strategically, policymakers are expected to rely on the instruments of law and formal government procedure in implementing these policies, and move the polity toward more rule-based governance.
- Procedurally, overseas experience and support, especially from the OECD countries, is to play a major role in defining objectives and modalities.

Second, we try to draw a clear distinction between two terms that are used interchangeably by specialists: *investment climate* and *business climate*. Both expressions refer to factors external to individual enterprises that affect their economic performance. Both are practitioners' terms. Both are tools used to encourage governments to introduce policies likely to promote market exchange, competition, private investment and enterprise growth, by signalling that specific reform proposals are backed by a widely-accepted body of technical and professional knowledge. There is such a body of knowledge, and some parts are growing fast. We have an increasing number of international data series, often backed by extensive efforts at surveying businesses, that compare and score countries according to their investment/business climates, and related concepts like 'competitiveness'.[15] We can now access data comparing, for Argentina and Zambia, the average number of person-days consumed in tax matters in the typical small enterprise, or the number of bureaucratic steps required and typical time taken to register a new business. Such indicators can be useful for drawing attention to specific problems. We agree with those who criticise their abuse for more ambitious purposes such as drawing general policy lessons or ranking the economic performance of countries (Altenburg and von Drachenfels 2007; Hobday and Perini 2006). We focus here on a different problem: the indiscriminate, interchangeable use of the terms 'investment climate' and 'business climate'.[16]

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15 For example, www.doingbusiness.org; www.investmentclimate.org; www.enterprisesurveys.org; www.weforum.org; www.businessenvironment.org; http://www.heritage.org/research/features/index/ (accessed 22 May 2007). DFID has created a database of investment and business climate indicators (Silva-Leander 2005).

16 Also 'competitiveness', but we will keep it simple.

The interchangeable use of these two terms is not a problem for the uncritical devotee of laisser-faire economic doctrines. From that perspective, the essential tasks of government are to get off the back of business, and support the provision of efficient and accessible legal systems and infrastructure. That strategy should help generate profits, and thus new investment and growth. But that is not a sensible policy position for governments of poor countries. First, as we explain in Section 3.2.2, the implied institutional and political reforms may not be achievable within a reasonable time span. Second, if the objective is to generate new investment and growth, it is important to focus on what make a difference to investors. Policies that are good for business are not necessarily and proportionately good for investment and growth. Our argument is summarised in Table 3.1. Governments can try to do two different kinds of things to improve the environment for business and investment:

- First, they can help to *reduce the costs of doing business*: the availability, reliability and cost of public infrastructure (transport, water, telecomm-unications, sewerage etc.); the availability of skilled labour; the implications for business of the procedures for registering companies, employing labour, taking legal action, paying taxes, importing and exporting, meeting environmental standards; tax rates; and the typical, predictable level of bribes that a company might have to pay to get its business done and protect itself against political interference.[17]
- Second, they can reduce *the degree of uncertainty that investors face about their ability to profit in the future from investment decisions made now*. Uncertainty is inevitable and ubiquitous in a market economy, in particular uncertainty arising from changes in demand, in interest and exchange rates or input costs. In many poor countries, however, there is a particular problem of uncertainty due to the poor governance. One set of causes is widely cited in the investment climate literature: large arbitrary changes in tax rates; inability to enforce contracts and debt obligations with suppliers or customers; the unwillingness of the police to take action against large scale theft of goods in transit; or the sudden word from the Minister of Industries that, unless his son is able to purchase a large slice of the equity cheaply, a company will face repeated closures on grounds of violations of labour, environmental, safety and tax regulations?[18] Another set of causes of uncertainty are acknowledged less frequently: the inability or unwillingness of governments to act positively in, for example, giving private investors in a new industrial sector confidence that the government will make the promised infrastructural investment on which the viability of the investment depends, intervene sensibly to help resolve conflicts that may arise between them, or provide additional loan guarantees should that prove necessary?

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17 If a company has to pay a regular bribe to the Minister of Industry to stay in business, but knows what the amount is, and can count on the Minister to ensure that no one else demands big bribes, then bribery is just a cost of doing business (Hewko 2002: 9).

18 The data from the World Bank's Investment Climate Surveys summarised in the *World Development Report 2005* (World Bank 2005: 43) indicate that 'policy uncertainty' was rated as the most severe single constraint by firms in developing countries.

Table 3.1 Distinguishing the investment climate from the business climate

	Business climate	Investment climate
Underlying question:	How easy or difficult is it for enterprises to operate profitably?	How easy or difficult is it for enterprise owners to retain their profits?
Focus on:	The costs of doing business	The degree of uncertainty that investors face about their ability to profit from their investment decisions
Degree to which indicators can be quantified:	Mainly high	Mainly low

In this paper, we employ the distinction made in Table 3.1. The *business climate* is about cost-reduction, and the *investment climate* is about risk reduction. Relative to the business climate, the investment climate (a) is less about measurable costs and more about intangibles – confidence, uncertainty, how (potential) investors *feel* about prospects of a good return on their investment; and (b) derives more directly from the reality and perceptions of the relationships between business and those who exercise political power. What largely makes the investment climate is the extent to which different groups of actual and potential investors perceive that those who hold political power are on ‘their’ side. Holders of political power are likely to be in national governments, although the extent of policy coherence among different elements of national government can vary widely. In some contexts, power holders in provincial or district governments may be important. In countries with severe governance problems, investors may have to pay attention to power holders located in the military, in armed opposition groups, or in foreign embassies. Our concerns about the investment climate are defined as *the ways in which those who hold political power affect the degree of uncertainty that investors face about their ability to profit in the future from investment decisions made now.* If reducing this uncertainty is critical for triggering investment in countries with weak institutions, the question is whether the orthodox investment climate advice helps to resolve it. We focus on this issue in the remainder of Section 3.

3.2 Biases in orthodoxy

There are five main reasons for fearing that the investment climate orthodoxy might mislead policymakers:

3.2.1 Legal formalism versus predictability [19]

Orthodox approaches to the investment climate are very much shaped by a set of ideas that we label *legal formalism*: concerns about the importance of protecting property rights, and the need to do so through legislation and formal, independent courts and other legal institutions, all embedded in a strong emphasis on the positive value of formal institutions. The general approach is often validated by appeal to the notion of 'strengthening the rule of law'.[20] The resultant policy prescriptions – re-writing legislation, reforming courts, training judges and lawyers, introducing new accounting standards and practices, changing land registration practices – constitute much of the core business of investment climate specialists. There is a particularly militant and influential variant of legal formalism, associated with Hernando de Soto, that we discuss separately in Annex 1 under the label of 'property rights fundamentalism'. The core ideas are that poor people in particular lack effective legal rights to the property that they use and control and that, if governments could issue them with formal property titles, a great deal of capital and enterprise that is now locked away would be unleashed. We explain in Annex 1 that the evidence is not very supportive. Property rights fundamentalism illustrates, in a graphic form, the conceptual and the practical weaknesses of legal formalism generally.

The insistence on 'strengthening the rule of law' is at first sight very plausible. It is however neither a new idea nor an untested idea:

> To the extent that the new agenda includes legal reforms it is premised on the notion that legal institutions play an independent and significant role in development. Ironically, just over 25 years ago this notion was discredited and renounced by scholars who had once been its most ardent proponents.
>
> (Davis and Trebilcock 2001: 21)

The same critiques of legal formalism therefore recur. One of the most fundamental, for our purposes, is that the rule of law is a means, not an end. It is a means to provide investors with what they need: assurance that their property rights will not be violated, whether by government itself or other predators (Clarke 2003).[21] Legal formalism is neither the sole nor necessarily the best way for governments to provide investors with the assurances they need. We explain in the next sub-section that the experience of trying to bring about wide-ranging legal and institutional reform in developing countries has been disappointing. Conversely, we have explained in Section 2 how, in China in the 1980s, public authorities were able to provide investors with adequate predictability and

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19 The main general sources for this section are (Carothers 2006; Clarke 2003; Davis and Trebilcock 2001; Frye 2004; Golub 2003; Schafer and Raja 2006).

20 Phraseology shapes perceptions. To talk of the 'rule of law' is to evoke positive images. It would be equally accurate to talk of invoking 'the coercive power of the state in support of one's personal interests' (Clarke 2003: 93), but the resonance is very different.

21 Some scholars suggest that governments should give priority to the re-allocation of property rights to investors who will use them productively, although that inevitably generates uncertainty. We express scepticism in Annex 1.

assurances by employing non-formal and unorthodox political and institutional instruments. Those instruments were, in the jargon we have adopted, more relationship-based than rule-based. Government effectively took it upon itself to assure organisations and individuals well connected to the ruling party and the state apparatus that, were they to invest and become rich, the state would not appropriate their wealth. But China is not the only case. For example, the 'rule of law', as conventionally understood, was actually weak in Japan during the decades of its rapid economic growth in the decades after World War Two, and in South Korea while it was one of the 'miracle economies' of the world (Kang 2002: 198–200).[22] Conversely, although the US typically is seen as the exemplar of the rule of law, it is often argued that the major role played there by the law and the judiciary in regulating public life is actually an obstacle to economic growth, because of the costs it imposes on many economic transactions (Kleinfeld 2006; Upham 2006, 2002). The law and legal processes can be costly in more than the financial sense, by causing delays and generating uncertainty for those caught up in them. Despite its rhetorical appeal, 'extending the rule of law' can represent a threat to business if the legal system is not working well.

3.2.2 Obstacles to legal and institutional reform

Plans to change legislation and to reform courts and legal systems more widely – and especially to bring them more in line with one of the variety of national legal systems found in OECD countries – play a major role in most orthodox programmes to improve the investment climate. However, a great deal of experience, including two major waves of programmes to transfer legal systems from richer to poorer countries in recent decades, tells us that these systems are much less 'reformable' (within limited timescales) than enthusiasts have expected. There are at least three reasons:

1) The notion of the 'rule of law' can be quite ambiguous in practice, and imply conflicting rather than congruent objectives (Kleinfeld 2006; Upham 2006, 2002). The concept has been employed to justify five distinct goals: 'making the state abide by law, ensuring equality before the law, supplying law and order, providing efficient and impartial justice, and upholding human rights' (Kleinfeld 2006: 35). All good things do not always go together. These goals may clash with one another, especially in contexts where the rule of law is relatively weak. For example, improving access to courts that are already overloaded may slow down the pace at which issues actually are resolved, generate uncertainty, and even encourage opportunistic recourse to courts to harass business competitors or extract money from them. Similarly, badly drafted legislation or unclear court procedures may generate court cases and business uncertainty. Granting 'independence' to the judiciary implies insulating judges from political pressures. This may make it more rather than less difficult to achieve other goals (Kleinfeld 2006).

2) The range of organisations and institutions that impact on the rule of law – and which may therefore need to be reformed to improve it – is actually wide:

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22 For a review of the role of law in East Asian economic development, see Ginsburg (2000).

> Modern rule-of-law practitioners still define the rule of law as a state that contains these three primary institutions:
> - *Laws* themselves, which are publicly known and relatively settled;
> - A *judiciary* schooled in legal reasoning, knowledgeable about the law, reasonably efficient, and independent of political manipulation and corruption; and
> - A *force able to enforce laws,* execute judgements, and maintain public peace and safety: usually police, bailiffs, and other law enforcement bodies.
>
> As practitioners have tried to reform these primary institutions however, they have found that they rely on the proper functioning of a large and ever growing array of essential supporting institutions. Laws are supported by institutions ranging from legislatures and land cadastres to notary publics. The judiciary is reliant on magistrates' schools, law schools, bar associations, clerk and administrative workers, and other supporting groups. Police require prisons, intelligence services, bail systems, and cooperative agreements with border guards and other law enforcement bodies, among other institutions. As new supporting institutions are discovered and deemed to be essential, they are added to the areas in need of reform.
>
> (Kleinfeld 2006: 47–8)

3) Just as the reform agenda has appeared wider than expected, the scope for foreign agencies to promote reform has often appeared more limited than anticipated, for reasons that are often highly political. If they are to have an impact, aid organisations and other external agents may need to invest a great deal, be very patient, to desist from promoting particular 'models' from developed countries (which are often quite diverse), and be ready to seize opportunities (Hammergren 2002; Spence 2005). Berkowitz *et al.* (2003) found that countries that adapted imported legal codes to local condition, rather than simply transplanting them, ended up with better law.

3.2.3 Reform strategies: planning versus seeking [23]

The default mode of planning legal reform is (a) to decide what reforms are needed, according to some kind of benchmark of 'good practice' (which is often set by prevailing practices in OECD countries) and then (b) to promote a range of measures aimed at moving the system closer to good practice. This planners' approach is likely to run up against the major obstacles to reform sketched in the previous sub-section. The seekers' approach is to look for leads and support from non-state agents with an interest in reform. Hewko's study of the connections between direct foreign investment and attempts to reform the rule of law in the countries of the former Soviet Bloc provides a good example. He found that the initial decision by foreigners to invest in the region typically was not based on a detailed understanding of the condition of the legal system – or indeed any other specific set of institutions – but on a 'visceral perception', derived from business

23 We have borrowed the language of planners versus seekers from (Easterly 2006).

contacts and media, of the business opportunities and the overall condition of the host country (Hewko 2002: 4).[24] The weakness of the legal system had different implications for different types of potential foreign investors. It posed the greatest disincentive for 'mid-sized investors or foreign investors with little international experience' (p4). It was less of a problem for (a) individual entrepreneurs, who were often returning émigrés with good personal connections for whom 'unclear legislation and a weak, opaque, unpredictable and corrupt system were at times highly desirable' (p10); and (b) large multinational companies, who did not actively seek out such weak-law environments, but knew how to operate effectively in them. Once established locally, these same multinationals often became active reformers, and were better placed than visiting consultants to identify the minimum changes in law or legal procedure needed to improve the investment climate. Most of them found that poor local standards and practices of accounting were a bigger obstacle to business than deficiencies in the legal system.

If new investors are themselves potential agents for positive legal (or other formal institutional) change, then does it not make sense to focus initially on the minimum reforms needed to attract more private investors in order to strengthen the active constituency for reform?[25] A paper from the International Monetary Fund (IMF) goes a long way down this road, arguing that foreign investors make a greater contribution to economic growth in host countries in their role as agents for institutional reform than in their role as suppliers of capital (Kose *et al.* 2006). It is not easy to test this claim in a rigorous fashion. The fact that it is being advanced from within the IMF illustrates the extent of current questioning of the 'old orthodoxy' that reform of formal institutions is (more or less) a precondition for investment – foreign or domestic. Researchers at least are now more likely to talk of mutual causation.[26] In the words of a distinguished legal specialist working on Eastern Europe:

> Progress in the development of a functioning system of entitlements, (to 'property' – authors) especially with respect to the more complex types of assets in the economy, cannot be expected to come primarily from the perfection of the legal system. Instead, contrary to the common economists' assumption that a system of property rights is a precondition of a market economy, the development of market institutions is often a prerequisite for a viable private property regime. Property rights, like other goods, are produced in response to market demand. Although the state may satisfy a portion of this

24 He also found that, in 'countries such as Russia, the onerous tax regime and inadequate accounting standards and practices served as a much greater source of investment disincentive than did the lack of an ideal legal system' (p8 fn).

25 We cannot assume that all investors are potential reformers. Some will have privileges that they can better protect in an environment of weak, unstable and unpredictable institutions.

26 That indeed is the dominant conclusion from cross-country statistical analysis of the relations between institutions and economic growth: better quality institutions seem to lead to higher growth in the long term, but economic growth and structural change also seem to improve the quality of institutions (Glaeser *et al.* 2004).

> demand, market responses often come first and provide more effective solutions. Indeed, the legal responses are often only effective against a background of self-enforcing market mechanisms.
>
> (Rapaczynski 1996: 102)[27]

We look at these 'self-enforcing market mechanisms' in the next section.

3.2.4 Informal institutions

The planners' approach to improving the investment climate, summarised in the section above, may also, in its focus on formal institutions, mislead policymakers by failing to recognise the existence of informal institutions that do an adequate job.

Governments have no monopoly in providing the kinds of social coordination needed to make possible large-scale, complex, long-distance commercial transactions between business people who may rarely or never meet face to face. The private sector does not depend only on government to find ways of regulating and arbitrating its commercial disputes, enforcing its debt repayments, assuring effective control of its physical assets, punishing its fraudsters and thieves, or providing information on the creditworthiness of its component enterprises. In some contexts, government has been a relatively minor provider of these services, and the private sector has depended in large degree on self-service. There is now a large literature describing and analysing these self-service alternatives, notably private arbitration systems and various modes of conveying information about the business behaviour, credit-worthiness, honesty and economic standing of individuals through more or less formal networks, some of them networks of kin, ethnicity, locality, religious group, caste, school or profession. Such common background can provide a basis for trust. When people from different backgrounds do business, a history of good experience becomes more critical. Good experience enhances reputations, bad experience ruins them. The fear of losing reputation is generally an effective sanction. Correspondingly, large amounts of business are conducted without formal contracts, or with contracts that are incomplete and leave many of the details of transactions to be negotiated informally. This is now well established in the literature (Davis and Trebilcock 2001; Humphrey and Schmitz 1998; Moore 1994; Nadvi 1999a; Platteau 1994; Zucker 1986).

Why then is any kind of formal law required at all? There are several aspects to the answer. One is that some private business enterprises are too powerful to be disciplined through self-regulation mechanisms, and need to be controlled by even more powerful states. A second is that informal self-regulation mechanisms may not have sufficient global 'reach'. Another is that the existence of alternative formal legal mechanisms might help to discipline and improve the performance of informal, non-state regulation systems (Ginsburg 2000: 841). Perhaps the most important part of the answer for policy purposes is that non-state mechanisms are

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27 See also Hendley (1999) on the importance of a demand for the rule of law, in addition to the supply.

intrinsically better at providing the equivalent of contract law than the equivalent of property law.[28] The bite behind non-state mechanisms lies in their ability widely to broadcast information about the status and behaviour of individual business-people, and thus create and sustain reputations. In some places, business financing depends on active secondary markets in post-dated cheques. If Jane is still trading when she is effectively bankrupt, some of the people with whom she does business are likely to have at least some inkling of the truth. When asked to purchase a post-dated cheque from Jane, they will do so only for an unusually high discount on the face value. The word will get around that Jane's cheques are being traded at a high discount, and people will think carefully about the conditions under which they do business with her. Equally, if Jane starts to cheat, by failing to pay her suppliers or by providing sub-standard goods to her customers, then that information is likely to percolate around the networks in which she is enmeshed: the business associations and clubs; caste, kinship, ethnic and language groups; or the cadres of the government and the ruling Party in countries like China and Vietnam. The sanction mechanism is the likely refusal of others to do business – or to do it only on special terms – with people whose reputation is in some way tarnished or suspect. The sanctions are motivated by simple self-interest. They are applied spontaneously, and require no organised collective action. All enterprise depends on a continuous flow of transactions with other businesses, for supplies, inputs, credit, and outputs. Even in the absence of courts of any kind, businesspeople who commit malfeasance may find themselves quickly punished, through informal institutions that serve many of the functions of contract law. By contrast, there is less scope for effective self-regulation of property rights. If Julie simply moves in, and forcibly appropriates Jane's property (whether land, buildings, equipment, stocks, supplies, credits, investments, or bank accounts), Jane's business associates might be actively altruistic and band together to support her. But, as individuals, they have no obvious or pressing self-interested reason to do. Julie may never be sanctioned, and others may be tempted to follow her example. It is quite logical that, insofar as it has been introducing law into the realm of realm of domestic business, the government of China has been more concerned with regulating property rights than contract rights. The latter are more likely to look after themselves. Private market exchange may thrive under predatory rule, but investment will wither (MacGaffey 1987).

There are three broad implications for policy. The first is that, particularly where the capacity of government to provide authoritative and effective regulation and coordination of business activities is limited, it makes sense to depend as far as possible on the many self-regulation systems that exist – and not to take measures that might undermine these self-regulation mechanisms without putting something better in their place. The second is that effective self-regulation is more likely in relation to contracting issues than in relation to property rights. The third is that, because many regulation systems are a hybrid of state and non-state mechanisms,[29] changes to public policy might have complex or unintended consequences.

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28 The issues around protecting (a) property rights and (b) contract rights are often, and wrongly, conflated (Clarke 2003). For an example, see the *World Development Report 2005* (p9).

3.2.5 A coordinating role for government?

Orthodox ideas on the investment climate are ideologically biased. The emphasis is on minimising the influence of government organisations over economic decisions. To the extent that government agencies have any economic influence, their hands should be tied through constitutional and institutional devices that leave them as little discretion as possible.[30] This way of thinking causes collateral intellectual damage: denial of the possibility that investors might actually need and want politicians to have discretion to help them in times of trouble, or to encourage coordination among private sector enterprises. Governments can play major constructive roles in promoting investment by using their resources, authority and convening power to help businesses, collectively or individually, to overcome what are sometimes termed market failures and coordination failures. Large, complex, inter-related investments sometimes require active state support. That support can come in many forms, including loan guarantees for firms undertaking very risky investments, subsidies for pioneering research, active diplomatic support for nationally-based companies trying to break into export markets, or a convincing assurance from the provincial government that a large new airport investment will not be hampered by delays on the part of local governments and publicly-owned utilities in extending highways, electricity and sewerage infrastructure to the new site. It is easy to imagine circumstances in which the knowledge that government is unable to come to the rescue of firms and projects facing unforeseen problems effectively adds to the uncertainties that investors face. Political support can reduce uncertainty, as well as increase it. Discretion for government does not translate directly into uncertainty for investors. The question of how and how far governments can play these more activist roles in promoting economic growth is the subject of a massive literature and continuing

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29 In Ho Chi Minh City, Vietnam, urban property markets are very active and property prices are lower than one might expect, despite the fact that most rights holders do not possess the standard Building Ownership and Land Use Certificate, 'which combines homeownership with the land use rights into one legal document' (Kim 2007: 281). Why? Kim explains how another 'Communist' (and 'traditional') practice – the wide ranging authority of residential block and ward committees – combines with substantial devolution of authority to local officials to produce a workable solution to the problem of assuring property rights. These committees deal authoritatively with a wide variety issues: 'Outsiders are often surprised by the extent to which neighbours in Vietnam can weigh in on what would be deemed private household affairs in other contexts' (Kim 2007: 281). Most property and land disputes are settled locally. Block and ward committees represent and commit neighbours and local officials, and in most cases provide prospective purchasers with the effective assurances they need to buy property without full legal documentation. If Hoa has sold a piece of land to Huyen, the block committee will know and will in effect guarantee Huyen's rights, including her right to sell it on to someone else.

30 The *World Development Report 2005* (pp48–50) provides a good example of these biases. The mechanisms listed to increase the credibility of government in relation to investors all involve reducing the scope for government to make decisions: increasing the number of 'veto points' on government decisions through constitutional or other means; devolving more authority to autonomous public agencies; and entering into more contracts and international agreements. This is followed by a paragraph acknowledging that what we term hand-in-hand arrangements have been associated with good economic performance in some cases. The point is then dismissed with one phrase: 'But these arrangements *can* [emphasis added by authors] ossify to the detriment of the broader investment climate ...' (p50).

wide disagreement.[31] The sceptics become nervous at suggestions that governments might have direct, special dealings with individual enterprises, or groups of them, rather than simply pursuing policies that apply equally across the board, and are as arms-length as possible. We have sympathies with these concerns about the potential for bias, corruption, and the misuse of public resources for private gain, but believe it would be foolish for governments to refuse to employ the considerable powers they have to support and encourage particular private investments. We explain in Section 4 that an appreciation of the extent to which governments and investors are interdependent helps us think more realistically. In some environments, the completely arms-length, rule-bound relations between political power and business that are so dear to the heart of free market ideologists may either be impossible or may actually discourage investment.

Finally, note the irony implicit in our critique of the investment climate orthodoxy. The orthodoxy tends consistently to reflect both:

- A low level of trust in the capacity of governments either (a) to make or directly influence economic decisions or (b) to determine what kinds of institutional reform are appropriate to specific contexts; and
- A high level of trust in the capacity of those same governments rapidly to implement the institutional reform menus presented to them.

Reality is more mundane. Most governments are neither quite so predatory nor so bad at making policy choices; but neither are they so capable of effecting large scale institutional reform. Above all, they are very diverse in their capacities and in the problems they face. The investment climate orthodoxy tends toward what Peter Evans (2004) termed 'institutional monoculture', in environments where institutional variety is preferable.

3.3 The investment climate and the debate on institutional reform

The orthodox ideas about what makes a good investment climate have diverse roots. Some lie in practical experience. The underlying general confidence in the superiority of private over public enterprise and competitive markets over market restrictions or monopolies is not very controversial in a world in which many economies have recently been organised in highly planned or statist fashions. The concerns with the costs of doing business and with uncertainty reflect genuine unease that, for example, governments often are not good at helping to provide reliable electricity or efficient port services, can be predatory at the points where licences are issued, taxes collected or goods imported, and can impose high levels of uncertainty on business because their policies are unclear or unstable. The other main roots of the investment climate orthodoxy – *legal formalism* and the *state minimalism* treated in the previous section – are more ideological in character. They are standard components of the set of principles of 'good

31 For clear recent expositions of the anti- and pro-activist views see respectively (Pack and Saggi 2006; Rodrik 2007).

government' that have been adopted and promoted by most international development institutions – and many OECD governments and their aid agencies – over the past two decades. These principles reflect deeply embedded Western (mainly Weberian) ideas about how the public realm should be organised and a rather self-congratulatory impression of how the OECD polities work in practice. Our assessment of the practical usefulness of this bundle of ideas for investment policy purposes closely parallels – and in many respects has been inspired by – the work of other scholars critiquing the general notion that the economic institutions characteristic of contemporary OECD countries could and should be emulated extensively in contemporary poor countries. Two economists have been particularly influential. One is Dani Rodrik.[32] We summarise below the main arguments of his paper on the investment climate (Rodrik 2005):

- Cross-national comparisons indicate that there is no empirical basis for the old conventional wisdom on the investment climate: poorer countries that have performed well economically in recent decades typically have not adopted that policy package.
- The core intellectual problem is that the new institutional economists typically have confused two very separate things about institutions: their *forms* and their *functions*. For example, property protection does not necessarily require a legal system that takes a familiar form (typically that of one of the OECD countries); and introducing such a legal system in new contexts might not secure property effectively. Particular purposes, such as securing property rights or providing market-based incentives, can be achieved using different institutional forms.[33]
- Processes of experimentation, search and discovery are central to real improvements in the investment climate. These processes may be gradual or rapid. They will often result in 'an unconventional mix of standard and non-standard policies well attuned to the reality on the ground' (Rodrik 2005: 989). 'Successful reforms are those that package sound economic principles around local capabilities, constraints and opportunities' (p996).
- The fact that poor countries typically are endowed with weak public institutions is not a basis for arguing that they should abandon any attempt to search institutional arrangements appropriate to local conditions, and rely on standard international principles. The evidence is scarce and mixed, but in some cases at least it seems clear that standard remedies are impractical, because they are institutionally highly demanding.

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32 Sections 2 and 3 of this paper are very consistent with Rodrik's work. We differ in the political analysis, in Section 4. Rodrik places a great deal of faith in the existence of institutions for conflict resolution as means of dealing with basic issues of political order. We believe that the task of creating and sustaining adequate political order to encourage investment is more fundamental problem (Bates 2008).

33 This is confirmed by Stephan Haggard's (2004) research on institutional roots to the fast economic growth in East Asian Countries. He concluded that institutions were indeed important to growth, but that it was not possible to identify any particular set of institutions that had underpinned growth in these countries.

- Institutional innovations often do not travel well, and, after transfer, fail to have the expected effects (pp994–6).
- In the real world, changes in rates of national economic growth are not as gradual as they would be if significantly shaped by changes in the kinds of institutions on which the old conventional wisdom focuses. They are much more 'jerky'. Spurts of national economic growth, lasting only a few years, are surprisingly widespread. We should think more about the difference between the things – including the public policies – that might initiate economic growth spurts and those that might sustain them.

Ha-Joon Chang (2002) makes many similar arguments.[34] He criticises the tendency of contemporary advocates of planned institutional reform not only to confuse *form* with *function* (see above), but also to assign unique functions to individual institutions – when functional multiplicity is the norm in the real world (Chang 2007: 5). We can conclude that there is a powerful and relatively coherent set of critiques of both the ideas underlying conventional approaches to improving the investment climate and the reform tactics that are implied. We end this section with a stylised summary, in Table 3.2, of the two contrasting approaches to reform. The one is not always better than the other. Nor is *experimental* necessarily *gradual*, or vice versa (Rodrik 2005). What ultimately matters is finding strategies that work.

Then, in Section 4, we stand back from immediate policy concerns to look at a set of issues that underlie actual investment climates: variations in the political relationships between the people who control capital and those who have political power.

34 Chang is particularly well-known for his book graphically titled *Kicking Away the Ladder* (2003), where he argues passionately that contemporary richer countries are using their influence to try to persuade or coerce poorer countries into adopting economic institutions and laws that (a) were not actually in force in those same richer countries at earlier points in history when they were poor and (b) will tend to impede economic and industrial growth in poorer countries. While this historical contrast serves to raise useful questions, it leaves open the validity of his point (b), and the policy implications. How far are the global norms and rules that Chang dislikes (a) actually imposed on poor countries and contrary to their interests or (b) a more or less necessary – and even desirable – set of responses to the underlying globalisation of economic and other activities? The answer is probably: some of both.

Table 3.2 Two approaches to improving the investment climate

	Orthodoxy	Experimental and incremental
Source of ideas for policy change	International best practice	Adaptation of existing local practice
Mode of operation in policy reform	Formal, transparent and legal	Be willing to use informal and extra-legal channels
Future perspective	Establish relatively permanent 'good practice' institutions	Be willing to use temporary expedients
Desirable speed of reform	Faster	More gradual
Desirable scope of reform	Wider	Selective
Political drivers of reform	Government, technocrats, international institutions	Also those sectors of business likely to support reform
Political strategy in relation to business	Find ways of overcoming potential resistance to reform	Find ways of recruiting potential supporters of reform

4 Business and politics

This section introduces an approach which is more political and focuses on the relationship between politicians and investors. In dissecting this relationship it stresses the need for realism: there is conflict (as stressed in the orthodox investment climate approach) but there is also cooperation. Exploring to what extent, where and how the two sides need each other opens up a way forward which is both more analytical and pragmatic. The aim is to explore the consequences for policy of adopting a more political and realistic understanding how investors and politicians relate to one another.

4.1 Towards a new approach

> Political development occurs when people domesticate violence, transforming coercion from a means of predation into a productive resource. Coercion becomes productive when it is employed not to seize or to destroy wealth, but rather to safeguard and promote its creation.
>
> The roots of political development productively join with the economic when specialists in violence realize that they can best survive and prevail by promoting the prosperity of their economic base. Under such circumstances, owners of capital will believe their promises to refrain from predation. Knowing that predation will be politically unproductive, they will be willing to invest. In

> such circumstances, those with power will also be willing to delegate authority to those with resources and skills, enabling them to combine and to organize and, literally to govern economic organizations. When their ability to survive, politically, depends upon the capacity of others to produce, economically, then specialists in violence will vest their power in those who will invest in capital.
>
> (Bates 2001: 100–1)

This quotation is an assertion of the central importance to investment and economic growth of the relationship between those who control capital and those who control political power (and military force). The importance of that relationship is not controversial. Proponents of the orthodox approach to the investment climate would agree. We – along with Robert Bates and other researchers – differ from them not in the degree of importance we attach to the business-politics relationship, but in how we understand that relationship. As explained above, the orthodox approach to the investment climate is founded upon a conception of government and politicians as potential predators on the private sector. Left unrestrained, government and politicians cannot be trusted. The policy prescriptions are packages to 'tie the hands' of government: to assure investors that government will not violate their property rights and will avoid creating high levels of policy uncertainty.

Underlying this policy prescription is a one-sided view of the relationship between politicians and investors. This view ignores that they often have an interest in cooperating. Investors are not simply the helpless victims of the raging beast of the state, which will attack them unless kept chained. Investors also have teeth. They are interdependent with politicians. Investors and politicians need one another, and are able to bargain with one another to their mutual benefit. It follows that various hand-in-hand relationships between business and politicians may, in varying combinations and in different circumstances, be beneficial or even inevitable if investment is to take place. While concerns about monopoly, privilege and corruption implicit in the term 'crony capitalism' are quite valid, it is simply not helpful to slap that label on every relationship between government and business that has a strong particularistic element.

The purpose of this section is to provide a framework for a more realistic general understanding of the relationships between investors and politicians. This framework is necessarily simple. It provides us with a way to begin to think usefully about government and business in particular contexts, starting from a few broad concepts and propositions. It does not provide us with a map of how government and business currently relate in, say, Mexico, or how this compares with Mali or Malaysia. Neither do we review all the more conceptual and theoretical literature relating to this issue. It has been one of the core themes in social science from its birth, central to Marxist scholarship, prominent in other schools of thought, and the subject of a continuous flow of research findings concerned with government-business relations.[35] We simply present a few basic analytical tools relevant to our policy concerns.

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35 See, for example, the review articles of Moore (1997) and Schneider (1998).

Let us begin with a simple model of the world. It comprises a set of countries that do not interact much with each other. War or large-scale conflict are background threats rather than a part of daily reality. Within each country there is a set of organisations – a state, a government – that we will generically term the *politicians* (sometimes *public authority* or *holders of political power*). Politicians control few material resources, but represent concentrations of political power, in all its forms: coercive, organisational, ideological etc. Material resources are concentrated in the hands of the people who control private capital. We term them *investors* (or *private investors, private capital* or simply *capital*). We assume, for purposes of theoretical discussion, that public authorities and private capital are distinct categories, which do not overlap with one another.

Our core propositions are:

- Both investors and politicians simultaneously stand to benefit from cooperation with one another and have incentives to compete – to enlarge their authority and domains at the expense of the other.
- The extent and nature of these incentives to cooperate or compete varies according to context.
- In the OECD ('advanced capitalist') nations, competition between investors and politicians is marginal rather than fundamental. It takes place within a relatively stable, encompassing institutionalised framework. Bargains between the two are embodied in formal and legal rules and principles. Relationships are relatively indirect (*arms-length*), and the rewards for cooperation are relatively diffuse.
- This OECD model of indirect, rule-mediated relationships between investors and politicians forms the (unspoken) basis of the investment climate orthodoxy.
- Significantly mediated by electoral democracy, this OECD model provides considerable scope and pressure to adopt pro-growth economic policies that appear to address the immediate interests of most major economic and political actors: government, power-seekers, business, employees and consumers.
- For a range of reasons, OECD-type (broad, institutionalised, formal) relations between investors and politicians are less common and more difficult to achieve in poorer countries.
- In poorer countries, relationships between investors and politicians are more likely (on average, with wide variations) to be particularistic, informal, and 'political' in the narrow sense of the term (*hand-in-hand*). Politicians are more likely to cooperate with smaller than with larger segments of business, and to expect direct, tangible rewards in the relatively short-term, rather than through sharing the more diffuse benefits of broad cooperation in the longer term. It is more difficult than in the OECD cases to formulate pro-growth economic policies that appear to respond to the immediate interests of a wide range of social actors.

The remainder of this section develops these points more fully. We look first at the main bases for cooperation and conflict between investors and politicians.[36]

4.2 Cooperation and conflict

Investors and politicians are engaged in continual interaction and bargaining, explicit or implicit. The bargaining may range from (a) direct and explicit haggling and agreement ('I'll show you mine if you'll show me yours') to (b) indirect strategic interaction and mutual behaviour adjustment without direct negotiation. The relationships between investors and politicians are complex and variable.[37] Cooperation is essential if private capital is to take the risk of investing, and especially the risk of investing in fixed (identifiable, vulnerable) assets. But cooperation is not guaranteed. Investors and politicians simultaneously (a) need one another and (b) pose threats to one another (Table 4.1).

Let us look first at their mutual needs. Politicians need the support and cooperation of investors for two main reasons, which might to some extent substitute for one another:

1) The political process and the governance of the country are not free goods. They need to be fuelled by material resources, for which private capital is often the sole or primary source. This 'fuel' can be provided in a variety of ways for a range of specific political purposes. We can identify three main types, beginning with the most open and identifiable:

- Governments need tax revenues to pay for the costs of government and for its programmes. Private capital is a major source of tax revenue.
- In virtually all contemporary polities, politicians and political parties require or extract from the economy resources to sustain and reward themselves. Political activity must be financed in one way or another. Private sector provision of these resources can range from more or less open and legal donations to political parties to covert, illegal bribes paid to politically-influential people for specific favourable decisions or as general protection money.

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36 Our emphasis on the importance of politician-business relationships in shaping economic outcomes relates to a parallel debate about the 'developmental state'. The scholars who have promoted the concept of a developmental state have tended to focus on the state itself, i.e. on how and whether 'developmentalism' reflected the state's bureaucratic and political capabilities and the internal and external (geo-political) political incentives it faced (Doner 1991). Without dismissing these factors, we agree with Chibber (1999) on the importance of government business relationship and alliances to 'developmentalism'.

37 Researchers aware that some kind of 'balance of power' and cooperation between government and business can help promote economic growth have long been (a) seeking to understand what patterns of government-business relationships actually generate positive results and (b) putting labels on those patterns. Unfortunately, the labels and the underlying concepts used to capture this 'balance' – 'reciprocity' (Amsden 1989), and 'embeddedness' (Evans 1995) – have not been easy to define or measure. It has therefore not been possible to test the validity of the propositions (Schneider 1998).

Table 4.1 The bases for cooperation and conflict between public authority and private capital

Bases for cooperation
Public authority needs private capital 1. To 'fuel' the polity via: • Providing revenue to the state • Directly financing politics and politicians • Indirectly supporting the status quo 2. To invest actively, to create prosperity and thus support the political order. *Private capital needs public authority to do any or all of:* 1. Provide law, order and protection 2. Supply physical infrastructure efficiently 3. Help ensure reliable, efficient supplies of finance and labour 4. Tax and regulate in predictable, non-extractive ways 5. Behave in a stable and predictable fashion 6. Help obtain access to scarce land or natural resources 7. Generally provide support in times of trouble 8. Actively support and promote investment by helping the private sector to overcome its collective action problems.
Bases for conflict
Public authority and private capital may each be internally divided. *Public authority and private capital face incentives to predate on the other.* *Public authority may have alternative sources of funding, and not need private capital.*

- Private capital often supports and subsidises the instruments – notably the mass media – that help create a favourable image of, and thus general public support for, either (a) the specific group of people that happen to hold governmental power today (the Reds rather than the Blues) or (b) the political-economic system in a broader sense.

2) Politicians need private capital to invest eagerly and efficiently within their own jurisdictions, rather than (a) keeping capital locked up in less productive, more secure activities (e.g. property, bank accounts and speculation in commodities) or (b) expatriating the capital and investing it in some other political jurisdiction.

Domestic investment is needed to maintain or increase the rate of economic activity, and thereby (a) enlarge the tax base (b) increase national wealth and thus the geo-political and military power of the state and (c) keep most of the population relatively satisfied, and thereby increase the chances that the incumbent government will win the next election and/or will face less public dissent or resistance to its rule. The higher the proportion of the population whose livelihoods come from direct engagement in the capitalist market economy, the greater this indirect dependence of governments on private investors for political popularity. The capacity of investors to withhold this investment is conventionally termed its *structural power* (Winters 1996).[38]

Similarly, investors need the active support and cooperation of politicians for a wide range of purposes, as listed in Table 4.1. Profitable private trading enterprise is possible even where government is actively predatory and hostile, but investment will be minimal (MacGaffey 1987). Capital investment requires political support of some kind.

In practice, cooperation between investors and politicians is rarely smooth, and there is often conflict, rivalry and 'zero-sum behaviour'. Why? There are three major reasons, which interact closely in practice, but are best presented separately:

1) At any level, effective cooperation is more likely if both *public authority* and *private capital* are both relatively coherent, unified political actors that can deal and bargain with each other. At national level, the private sector is more likely to trust the government if, for example, provincial governments, the President, the ruling party, the Minister of Industry and the Ministry of Finance are not following radically different policies, and are not locked in intense conflict with one another. Similarly, the government is more likely to respond to the needs of business sectors not divided by intense conflicts and rivalries. The two may not be coherent groups, because there are always latent or overt differences of interest within each category, that might, depending on the broader political circumstances, dominate behaviour. Individual ministers, members of the legislature, local councillors, political party organisers, government bureaux or public servants are likely to have their distinct interests and concerns. Equally, small businesses providing office-cleaning services may see the world very differently from large scale food importers or from transnational enterprises producing electronic goods for export, and be more focused on their sectional concerns than the general interest of capital.

2) Although investors and politicians stand to gain from cooperation, their relationship is also potentially antagonistic. In some circumstances, one party can gain at the expense of the other, and therefore faces temptations to seek to dominate. Most obviously, politicians face a standing temptation to predate on private capital: legally to tax its profits very heavily or take its assets into public ownership; and illegally to extract bribes, protection money, jobs for the political

38 For a discussion of the range of interpretations of the concept of the structural power of capital, see Hay (1997).

supporters, or ownership shares through the threat of using the many instruments of coercion and control available to public agencies and officials. Equally, investors may have the capacity and the incentive to convert their economic power directly into political power, by 'buying' up government in one way or another: through bribery, funding political parties, or using influence over the political content of the mass media. In particular, there is a persistent possibility that sections of private capital want to take over government in their own interests, to establish monopolies and restrictions on competition to the extent that they might severely undermine the normal dynamics of capitalist development – a situation that is often labelled 'state capture'.

3) Politicians might not need to cooperate with and support investors because they have alternative ways of obtaining state revenue, financing politics, and funding the institutions that support the political status quo. These alternatives comprise some combination of: a profitable and sizeable state-owned economic sector; large foreign aid inflows; or substantial revenues from the export of natural resources (oil, gas, diamonds, bauxite and other minerals).[39]

In practice, these potential conflicts between investors and politicians are managed or resolved in a wide variety of ways. But one solution tends to dominate our collective imaginations. This is the 'model' underlying the orthodox approach to the investment climate: a configuration of institutions that we believe to be characteristic of advanced capitalist (approximately, OECD) countries.

4.3 The model: arms-length and rule-based [40]

This model is not a complete or accurate description of the relationship between politicians and investors in OECD countries. It is rather an institutional configuration that is found there more evidently and consistently than elsewhere in the world. It is marked in particular by: relatively transparent *arms-length relationships* between government and business that are regulated through formal political and legal institutions (*rule-based*); competitive, democratic politics that empower the majority of the population who are not significant owners of capital;

39 We are not suggesting that these alternative sources of state income have adverse effects in all circumstances. One can plausibly argue that some of them, including a state owned economic sector, can give governments a useful degree of autonomy from the private sector, that may be used – wisely or badly – to promote structural economic change. Magnitudes matter a great deal.

40 The points made here are expressed in a wide variety of ways in diverse literatures. One recent example, couched in terms of the problematic of the 'autonomy of the capitalist state', is as follows: 'It is by far no accident that the institutional separation between state and society, i.e. between political authority and social rule, took place with the transition to capitalist development. The latter required the guarantee of private property, clear market rules, the dissolution of traditional bondages, in short a society organised in accordance with a rule of law that only can be ensured by the state as an autonomous political arena. On the other hand, the autonomy of the state is by far not absolute, but only relative. Indeed, the state is structurally dependent on the dynamics of capitalist (re-)production … For instance, since the state, by and large, is excluded from the process of capitalist production and therefore unable to organise production for its own ends, it has to rely on extracting its own resources – mainly in the form of tax revenues – out of the capital circuit' (Bieling 2007: 7).

and political coalitions that reconcile the potentially competing interests of investors, politicians, consumers and employees by promoting both economic growth and popular welfare. In more detail, its most important features are:

1) Business and politics are relatively distinct spheres of activity, notably in terms of personnel: leading business people are not normally active in electoral politics or in the public bureaucracy, and vice versa.

2) Governments receive no significant overseas aid, and few revenues from natural resource extraction.[41] Consequently, they are almost entirely dependent on general taxation for their financial resources. They therefore find it hard to evade the structural power of capital: the willingness of controllers of capital to slow down the rate of investment if dissatisfied with government policy, and thereby generate trouble for the government (see above).

3) Investors exercise political influence through relatively indirect, non-visible means. The most reliable channel is the exercise of structural power (see above). This mode of exercising power mimics the operations of markets, and does not require the private sector to organise itself to coordinate collective action. If government is not paying adequate attention to investors' needs, the latter will tend, individually and automatically, to respond by considering the options of reducing investment or expatriating capital. Behaviour that is politically very consequential is understood and represented in terms of 'normal' economic and financial rationality (Winters 1996). Conversely, more instrumental modes of exercising business influence – funding particular politicians or activities, bribes, placing reliable individuals in the public service – tend to be less common, and are likely to be considered illegitimate.[42]

4) Because of the prevalence of electoral democracy, and associated high levels of 'welfare state' spending, governments tend to enjoy – and need continuously to seek – high levels of popular legitimacy and support. Consequently, they have some autonomy and incentives to negotiate with investors, and not simply to accept the brute logic of the structural power of capital. Levels of compliance with tax obligations are high, and a relatively large proportion of national income is collected in tax to fund public welfare spending.

5) The tensions and conflicts between politicians and investors are to a large degree resolved through representative electoral politics. Competing interests invest heavily in trying to influence the outcomes at various levels of the

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41 Norway is the main contemporary exception, but even in this case, oil and gas are not a dominant source of revenue.

42 One can usefully think of business as employing three different types of political power: *structural, instrumental,* and *discursive.* The latter refers to the capacity of business to shape norms and ideas. Social scientists often disagree widely about the extent to which business employs *discursive* power (Fuchs and Lederer 2007). The balance between (a) the power of (elected) governments over capital and (b) the power of capital over the polity is a subject of continual debate. Generally speaking, earlier concerns that democracy would empower the masses to exploit and despoil private capital – e.g. by excessive taxation – have been replaced by concerns that wealthy individuals and companies exercise too much influence over the democratic process.

policymaking process, especially at the electoral level.[43] The private sector is a major source of political funding, especially via political parties.

6) It is relatively easy to create political coalitions that negotiate workable compromises between government support for pro-growth economic policies and ‘welfareist’ concerns for mitigating the inequalities and uncertainties generated through primary dependence on market mechanisms of resource allocation.

7) These national ‘political settlements’ are congruent with broad support for formal institutional arrangements (rules) that protect property rights, limit the capacity of politicians and investors to engage in bargaining behind closed doors, reduce the direct influence of private capital on the political process, and generally try to keep public authority and private capital at arms-length from one another.

We are emphatically not suggesting that arms-length relationships between politics and business are the absolute rule or even the statistical norm in OECD countries. There are plenty of more hand-in-hand connections.[44] The point is that rule-bound, arms-length relationships are more common, and are the basis of a widely accepted image. Why is this image so often taken as the normative starting point for public policy elsewhere? It certainly has a strong claim to constitute the best set of arrangements extant for reconciling productive capitalism with electoral democracy and open, accountable government. By contrast, it is not evidently superior to other systems in terms of economic performance.[45] Its main strength in the market for policy ideas stems perhaps from its roots in richer countries that dominate in the research and consultancy business.

4.4 The reality: hand-in-hand and relationship-based

There is much more economic and political diversity within the ‘rest of the world’ (i.e. mainly the poorer countries, plus a few small wealthy petro-states) than among the OECD countries. Any statement about the ‘rest of the world’ therefore

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43 It has often argued that while in advanced capitalist countries public policy is actually made at the formal policymaking stages of governments (elections, policy debates, legislation and broad policy decisions), in developing countries actual policy decisions are more likely to be made in the course of what we normally term ‘implementation’, often through illegitimate means.

44 Among the more long-standing members of the OECD, these more *hand-in-hand* (particularistic, corrupt) relationships seem to have been most prevalent in Italy and Japan. They are also found more frequently in particular sectors, including arms manufacturing and public sector civil engineering projects.

45 Prevalent ideas about the ‘best’ economic models tend to change regularly. In the 1970s and 1980s, one response to relatively slow economic growth in the more economically liberal (and mainly Anglophone) OECD countries was to look for inspiration to the more state-directed economies, especially those of East Asia (Japan, South Korea, Taiwan). This enthusiasm waned after Japan’s economy stagnated in the 1980s while America’s boomed, the Soviet Bloc collapsed in 1989, and the ‘Asian economic crisis’ struck in 1996. For a while, the ‘liberal’ (and Anglophone) economic model seemed to be in the ascendant. But recent comparative patterns of national economic growth, characterised by very fast growth in China and some other Asian economies, and the (temporary?) booms enjoyed by natural resource exporters, and relatively slow growth in most of the OECD, seem to challenge all previous generalisations.

represents a very broad generalisation. On average, exchanges between investors and politicians are likely to be hand-in-hand, informal, shaped by personal or small-group relationships rather than general rules or principles, and to involve relatively direct bartering of one favour for another. In the jargon of social science they are *particularistic*. Why are such relationships more common in poorer countries? There are three main parts to the answer that apply variably to different countries:

1) First, the stage of capitalist development seems to matter. The processes generating domestic political support for arms-length, rules-based governance are largely the result of successful capitalist development. Those who accumulate capital through political channels tend, especially in later life, to favour the establishment or strengthening of the kinds of formal institutions advocated by conventional investment climate specialists. They are aware of the fragility of their own political connections, and the risks that they or their heirs will be stripped of their assets following a change in political fortunes. The effective legal protection of property rights, regulated share and bond markets and robust, reliable and independent banking systems all become attractive. The kind of 'frontier' capitalism that Marxists have often labelled 'primitive accumulation' eventually generates internal pressures to become more rule-bounded (McVey 1992). These dynamics are under-researched in today's poor countries, but we know that in OECD countries the institutionalised political settlements that provide ways of negotiating government-business relationships emerged through long historical processes of political conflict associated with the construction of advanced market capitalism, liberal democracy, and welfare states. Politically-stable capitalism does not naturally take strong root everywhere. Advanced market capitalism, liberal democracy, and welfare states are in most respects mutually reinforcing institutions. High income levels contribute to stable democracy. A thriving market economy reduces the incentives to use the political process as a primary route to wealth.

2) Second, there is a set of structural reasons, all stemming from the ways in which contemporary smaller poor countries engage with global economic and political forces, that put obstacles in the way of broad-based, open negotiation and bargaining between governments and relatively encompassing organisations representing investors:

- When most of the OECD countries emerged as advanced capitalist powers in the nineteenth and early twentieth centuries, they had, through colonialism and global trading systems, major impacts on the rest of the world – the parts we here label 'poorer countries'. In particular, they often created states with relatively powerful central executive authorities ('over-developed states'), in situations where local capitalism was relatively weak and markets were not very powerful mechanisms for resource allocation. For a century or more, and especially in the period after the big decolonisation movement of the mid-twentieth century, the political economies of much of the poorer world provided consistent temptations for aspirant or actual elites to seek political power, rather than trading or capitalist enterprise, as the primary route to wealth. Those holding political power have been especially tempted to dominate rather than to negotiate with (weak) private capital.[46]

- This tendency has been exacerbated since the 1970s in particular by the big growth in two new sources of public revenue in poor countries that have reduced the incentives for governments to cooperate with private capital. These two new income sources – development aid and large revenues from natural resource exports following the oil price increases of the 1970s – have affected two categories of countries that overlap to some degree.[47] Aid has been increasingly concentrated on the poorest (and generally, in per capita terms, on the smallest countries), especially in sub-Saharan Africa, but also in pockets of poverty in Central America, the Andes and the mountainous regions of West, Central Asia and Southeast Asia. Natural resource revenues – mainly from oil and natural gas, but also from diamonds and scarce minerals – have been dispersed more widely. Governments that have large assured incomes from aid or natural resource exports do not have strong self-interest incentives to cooperate with the private sector to promote economic growth (and thus higher tax incomes). Worse, they have weak incentives to desist from exploiting the private sector or subjecting it to a great deal of policy uncertainty.[48]
- Most of the poorer countries are relatively small in size and open to a range of international economic and political influences – including those mentioned in the previous paragraph. Their economies are typically characterised by a 'missing middle': high number of very small enterprises and a few large firms, many of them foreign or state-owned. Their governments are very open to transnational influences. In these circumstances, the prospects for national-level cooperation between governments and capital-in-general are reduced, because both sides tend to be relatively diverse or fragmented, and the most influential components are highly oriented to external interests and net works.[49] Conversely, relatively small combinations of political and business actors may contend to take control of the state and run it in their immediate interests.[50]

3) Third, and most immediately relevant to the investment climate debate, in situations of conflict or very weak governance, hand-in-hand relationships may be

46 Robert Bates' interpretation of the causes of state failure in contemporary Africa places particular emphasis on this kind of naked domination (Bates 2008).

47 The international narcotics trade has also become larger over the same time period, and, in poorer countries, become the focus of much business enterprise and political energy.

48 There is now a large literature on the governance effects of oil and aid on the one hand and of tax revenue on the other (Brautigam *et al.* 2008).

49 For a theoretical treatment of the proposition that the economies of many developing countries grow slowly because they face major problems of political coordination, see Wydick (2008).

50 Size matters. For example, India, which has unusually high levels of institutionalised electoral democracy for such a poor country, shares many institutions with OECD countries. So does Brazil. India, like China, also enjoys the historical advantage of having been the home of large, sophisticated transnational trading groups and networks before European colonial enterprise began to dominate Asian economies. These networks were never destroyed, and have re-emerged very powerfully in recent decades. In the Chinese case, they have largely been re-imported from the Chinese business diasporas of Southeast Asia.

essential if investment is to take place at all. This claim makes sense only if we transcend the strong anti-politics bias in the conventional investment climate approach. From the conventional perspective, political activity is represented mainly as a problem to be avoided or overcome. Politics is about power holders seeking to predate on the private sector or subjecting it to arbitrary, unpredictable policymaking. A good investment climate protects investors from politics as far as possible. If they are not protected, a few 'crony capitalists' may thrive, but at the expense of corruption, rent-taking, a general reluctance to invest, and low rates of economic growth. That corresponds closely to the ways in which businesspeople and their organisations tend publicly to talk about politics. But their behaviour is often very different. What happens if we go beyond the image of business as the passive victim of predatory, irresponsible politics and posit (a) rational politicians to some degree interested in tomorrow as well as today; and (b) rational investors willing to find out what politicians want, and to cut deals that are mutually beneficial? Thanks in part to recent research on the economic history of Mexico, scholars' views on these issues have become more sophisticated.

Haber, Razo and Maurer (2003) undertook detailed research to discover why some sectors of the Mexican economy thrived during a long period of political instability and civil war, from 1876–1929. Robert Bates neatly explains the significance of that work for our purposes:

> Both common sense and economic reasoning give rise to the expectation that political instability should undermine economic growth. Political instability leads to uncertainty, most relevantly with regard to property rights … Why then do Haber et al., like … (a number of other researchers) … find economic reality at variance with expectations? The key, Haber et al. argue, is that property rights are private, not public, goods. In the midst of political chaos – indeed, in response to political chaos – political entrepreneurs will strive to provide property rights. In doing so, they target particular people, firms, or industries, not the entire economy. They do so in order to reward their friends, to build and consolidate a constituency, and to generate financing for their political machines. In the midst of chaos, then, investors will find political patrons eager to protect them, in exchange for political and economic support. …
>
> In doing so, Haber et al. formulate a theory of 'vertical political integration'. By this they mean not only the alliance of politicians with investors, but also the alignment of incentives. Insofar as politicians succeed in attracting investment to particular enterprises, and insofar as they supply conditions that generate non-competitive rents and artificially high rates of return, then the temptation to engage in predation grows. Investors being rational, recognize the incentives at play. In order to provide them assurances, politicians must render themselves hostage to the performance of the firm. In particular, they must attach their political future to its economic performance, thus signalling that even when political times are hard and the future therefore uncertain, they will not opportunistically defect from their commitments.
>
> (Bates 2004: 496–7)

In sum, not only (a) are politicians able to pursue common interests and work hand-in-hand with investors by providing credible assurances even when the overall institutional environment seems unfavourable, but (b) where there is little established political order, this kind of cooperation may be essential if there is to be any investment at all. The challenge is to distinguish benign hand-in-hand relationships from the malign relationships conventionally labelled 'crony capitalism'.

4.5 Hand-in-hand relationships versus 'crony capitalism'

Crony capitalism is a widely used, value-laden, yet ill-defined term.[51] There are two possible ways of defining it. First, it can be defined in terms of the relationships between politicians and investors. The problem then is that it is easy to fall into the trap of labelling any kind of hand-in-hand relationship as crony capitalist, regardless of its effects on investment and economic growth. Second, it can be defined in terms of consequences: crony capitalism constitutes hand-in-hand relationships that entrench privilege and rent-taking, and stifle competition, investment, innovation and economic growth.[52] The problem with that definition is that the consequences of crony capitalism may only be evident after some period of time, and the applicability of the label to any specific case will inevitably be much contested. It would serve no useful purpose for us to delve further into these issues here. The main point is that the term 'crony capitalism' has no clear meaning, and is frequently used in a doctrinaire way to de-legitimise any relationship between politicians and investors that does not appear to be fully arms-length.

The key analytical and policy question is whether any particular set of hand-in-hand arrangements are meant to be temporary or long-lasting. We have argued that hand-in-hand arrangements need to be considered without prejudice, because they can be very effective in generating investment and growth at a particular *stage* of economic and political development. Whether they succeed in unleashing a new dynamic and moving the economy/region/sector to a new stage is a matter for empirical research. Several scenarios are possible. They include:

- The hand-in-hand arrangements are so lucrative for both sides that they cling on to them and try to limit the spread of benefits to others.
- The arrangements strengthen the 'chosen' investors so much that they can capture the state.
- The investments generated by the hand-in-hand arrangements have economic knock-on effects, giving rise to new investors and diluting the original selective arrangements.

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51 There is a very large literature on crony capitalism in poor countries. Perhaps the classic study of the classic case is Hutchcroft (1998) on the Philippines.

52 One of the clearest and most widely cited examples is the relationship between Ferdinand Marcos, President of the Phillipines from 1965–1986, and a few leading business cronies.

- The investors benefiting from the hand-in-hand arrangements (directly and indirectly) find that the most promising way of protecting their wealth in their old age or for future generations is to support institutional reform, including legal protection of property rights and legal enforceability of contracts.[53]

Other scenarios (and combinations) are possible.[54] The key point is to shift the policy debate to the question of dynamics and not get stuck in the static question of whether a particular arrangement is corrupt or crony-capitalist. For researchers the key question is in what circumstances the hand-in-hand arrangements are a useful transitional device for generating investment and growth. The emphasis is on 'transitional', just as the arrangements which helped to transform China were transitional (see Section 2).

This is very difficult territory for policymakers in poor countries and for aid agencies which seek to help them to promote economic growth. There is very little evidence-based advice that researchers can give to steer them through this political minefield. Both policymakers and researchers would probably benefit from distinguishing between different stages of development (as implied above) and between different types of hand-in-arrangements, which are discussed in the next section.

4.6 Variations in hand-in-hand relationships

What types of hand-in-hand relationships exist between investors and politicians? In what circumstances do they emerge? Some existing research helps throw light on these questions. We summarise some of it here, not to provide an inventory but to suggest some useful ways of thinking about the design of future research. Three distinctions seem to be particularly helpful:

- *Interests* versus *institutions*: In trying to explain hand-in-hand relationships between investors and politicians, how far do researchers focus on (a) the interests of the different parties in cooperating or (b) the extent to which the institutional environment – the organisation of the private sector and of government agencies – affects the likelihood of cooperation?
- *Structure* versus *construction:* How far is the degree and type of cooperation (a) determined by relatively invariant structures inherited from the past or (b) constructable through conscious efforts to reshape relationships in the shorter term?

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53 Those who accumulate capital through political channels tend, especially in later life, to favour the establishment or strengthening of the kinds of formal institutions advocated by conventional investment climate specialists. They are aware of the fragility of their own political connections, and the risks that they or their heirs will be stripped of their assets following a change in political fortunes. The effective legal protection of property rights, regulated share and bond markets, and robust, reliable and independent banking systems all become attractive (McVey 1992).

54 Particularly interesting is the question of whether the politicians can make the continuation of the arrangement conditional on performance. See Schneider (1998: 105–8) on the difficulties on imposing such conditions and of assessing whether they have been met.

- *National* versus *sub-national:* At what level should we be expecting to find effective hand-in-hand cooperation between investors and politicians?

4.6.1 Interests

We know from Section 4.2 that there is a range of factors that give business and government interests in cooperating with one another – or barely cooperating at all. What factors are especially likely to bring about variation, in practice, in poorer countries? The most visible factor has already been mentioned in Section 4.2: the extent to which governments enjoy incomes from rents, mainly from natural resource exports or foreign aid, which in turn free them from the need to nurture investors in order to find financial resources. However, rents come in various forms. Not all are as large or represent such a free gift to government as do generous oil and gas reserves. We can better understand the implications of different types of rents by using Wedemann's (1997) useful conceptual distinction between three modes through which holders of political power might extract resources from private business in the context of what we have termed hand-in-hand relationships:

- *Looting:* those who control the state basically rob as much money as they can and hide abroad the cash that they don't need to keep themselves in power. This is seriously bad news for potential investors. The exemplary case was Zaire under President Mobutu.
- *Rent-scraping:* those who control the state set up rules and institutions that create opportunities for them and their associates to skim various kinds of rents off the private sector. This is bad news for potential investors, but not necessarily disastrous. Investors can get by, and those with the right connections do rather well. If the rent-scrappers re-invest locally, the economy might fairly well. The exemplary case was the Philippines under President Marcos, where individual cronies were given control of entire state-regulated sectors of the economy, such as sugar and pineapple production and exporting.
- *Dividend-collecting:* those who control the state establish institutional arrangements that permit them personally to benefit, on a continuous basis, from the profit of private enterprise. They may ask for regular political donations, take ownership stakes in private firms, or go into business themselves, sometimes via companies owned by the ruling party or the military. But the basic point is that they will tend to benefit from the general prosperity of the private sector, and may easily find themselves re-investing locally. This can be a growth-promoting scenario. The exemplary cases were the classic developmental states – Korea and Taiwan – and also Indonesia in some respects.

How do we explain the choice between the *looting, rent-scraping* and *dividend-collecting* strategies? Wedeman (1997) does not explore this question in any detail. Underlying material factors, notably the structure of the economy, are likely to provide an important part of the answer:

- Mineral or fuel wealth invites *looting.* First, the levels of appropriable surplus tend to be very high and the resource is immobile. The enterprises that pump the oil or mine the cobalt will continue to produce, despite a high level of looting, provided that the state provides adequate security and infrastructure in the very confined geographical areas in which these resources are extracted and transported. Second, the looting of these sectors finances a military apparatus that is adequate to maintain the regime in power with little concern for its legitimacy in the eyes of the bulk of the population. This tends to liberate much of the state apparatus to prey on the economy generally.[55]
- The kind of sugar and coconut export industries found in the Philippines in the 1970s provided enough of an appropriable surplus to finance cronyist *rent-scraping,* but would be likely to respond to more extreme *looting* by production cuts. Further, the production and export of these commodities requires the state to perform its basic tasks of providing order and infra-structure over large populations and territorial extents. In these circumstances, it is not sustainable in the long run to allow the state apparatus an unrestricted licence to loot.[56]
- If one is trying to build up an industry exporting electronic equipment to competitive international markets, then *dividend-collecting* is the only sustainable way of getting some share of the surplus. More direct appropriation – and the uncertainty it implies – is likely quickly to kill the goose that lays the golden eggs. Those who exercise political authority require some relatively direct incentive to give the industry the support and protection it needs to thrive in a difficult political environment, but it is in their interests to tie the level of rent-taking to the profitability of the enterprise.

Where governments have large rent incomes from the types of resources that invite looting, they have little interest in supporting and cooperating with an independent private sector.[57] Conversely, governments have more interest in cooperating with relatively footloose enterprises with high levels of embodied specialist knowledge, i.e. enterprises that will be welcomed in another political jurisdiction and cannot easily be replaced.

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55 For an extreme example of the consequences of high-level looting of mineral resources in the Democratic Republic of Congo, *World Development Report 2005* (p41).

56 Judith Tendler (2002) provides an analogous example of relatively unproductive rent-taking at another level: if a cluster of small informal businesses pays off local government officials to ensure they remain off the records of tax collectors and labour standards inspectors, then their economy may continue to tick over, but it is unlikely that the public agencies tasked with supporting and promoting small business will come to their assistance; the political pressures on both sides are to minimise that kind of potentially-productive engagement.

57 This proposition applies particularly to poor countries. The effects of very large rent incomes in very small countries now seem less dire than when the general theory of 'rentier states' was formulated, to apply mainly to the oil-rich rulers of the Middle East, in the 1970s. Some super-rich rulers, notably in Dubai and, to a lesser extent, Qatar and Saudi Arabia, have themselves become entrepreneurial. Like the ruling Communist Party of Vietnam, they have also shown a willingness to encourage and engage in joint ventures with foreign capital in particular, and thereby avoided promoting the development of an independent local capitalist class that might threaten their own rule.

4.6.2 Institutions

But the interests of government or business may not always be read off so easily from features of the general environment, like economic structure. In some cases, interests are partly shaped by, and in turn shape institutions – broadly, the ways in which the parties are organised. This is illustrated by Kang's work on the South Korean developmental state (Kang 2002). He argues that government-business cooperation was effective in South Korea until the late 1980s mainly because economic and political power was concentrated in the hands of a sufficiently small number of centralised sets of institutions that bargains could be made and monitored relatively easily. Government was centralised and underpinned by a strong military and a powerful central public bureaucracy. The private sector was dominated by a small number of large national conglomerates – the *chaebol* – that each had a wide, encompassing interest in national economic success and a great deal of political influence. That institutional configuration in turn shaped the interests of the different parties. Kang focuses explicitly on the question of why the evident widespread corruption did not undermine growth-promoting policies. His general answer is:

> Money politics remained constrained because Korean elites existed in a mutual hostage situation where neither political elites nor economic elites could take excessive advantage of the other. This balance of power allowed them to pursue corrupt activities, but it also limited the chances for excessive advantage. Government intervention was subject to political influence in a number of ways that reduced both rent-seeking by entrepreneurs and transaction costs for the politicians and bureaucrats involved in monitoring the policy process.
>
> (Kang 2002: 191)

Chibber (2003) sets out very interesting hypotheses about why South Korean-type, developmental state arrangements did not work in India at the national level in the 1950s and 1960s, despite strong political commitments to rapid industrialisation, the existence of large Indian conglomerate firms similar to the South Korean *chaebol*, and much political support for the general notion of close collaboration between the state and domestic enterprise. He argues the importance of a set of institutional issues that reflect a difference in economic structure between South Korea and India. The South Korean economy was relatively small, and always dependent on exports for growth. The government was able to use its capacity to monitor the export performance of individual firms as a means of disciplining them: government support, notably in the form of generous bank credit, was tied to firm performance, especially as measured by exports. By contrast, the Indian economy was much larger, and faced higher barriers to penetrating export markets than did Korea. An export-led strategy was more difficult for India, and the large domestic market was relatively more attractive. The large Indian business houses therefore had little incentive to go along with the national planners' injunctions that they should upgrade technologically and export. And the national planning authorities did not have the organisational tools to monitor the degree to which the business houses were performing as government wished in return for the privileges they were granted by the planners in the allocation of scarce resources.[58] National planning therefore developed in a

formalistic and bureaucratic direction: government and big business were not cooperating with one another in a strategic way, and the corruption that can attend any hand-in-hand arrangements came to dominate perceptions of the system.

We have more research on how the organisation of the private sector affects interactions with government than we have work on the other side of the relationship, i.e. how the organisation of government affects the way in which it interacts with the private sector.[59] Much of the research on the organisation of business focuses explicitly on business associations, and how they represent their members to government (Brautigam *et al.* 2002; Haggard *et al.* 1997; Maxfield and Schneider 1997; Moore and Hamalai 1993; Schneider 1998). Some of the more interesting research deals with the ways in which the internal structure of firms and of sectors affects organisational capacity and motivation and capacity to interact with government and politicians. Ken Shadlen (2002) provides a stimulating explanation of why, within a liberal polity, small business finds it particularly difficult to engage in effective collective action – organisational or electoral – in relation to the state at national level, and tends to be out-competed politically by big business and, often, by organised labour. The implication is that, if small business is to organise itself effectively in this kind of polity, it is more likely to do so at local level.

The prime point of reference for ideas on how the structure of firms and sectors affects government-business relationships is Michael Shafer's *Winners and Losers. How Sectors Shape the Developmental Prospects of States* (Shafer 1994). He argues that the scope for governments to shape private economic activity at the level of the sector is shaped by the existing structure of the economy, above all the structure of the 'leading sector' through which it is tied to the international economy. Four factors that vary among economic sectors – capital intensity, economies of scale, production flexibility and asset/factor flexibility – shape the politics of government-business interaction, affecting such things as the autonomy of the state to make policy, its capacity to do so intelligently, and the extent to which sections of business might cooperate with or successfully resist government's policy initiatives. A listing of his original sectoral case studies provides some of the flavour of his analysis: mining in Zambia; light manufacturing in Korea; industrial-style plantation production in Sri Lanka; and peasant cash crop production in Costa Rica. This type of analysis can be very fruitful (see also Thorp and Durand 1997).

4.6.3 Structure and construction

There is however the danger that the influence of economic *structure* is understood in too mechanistic or deterministic a fashion. When researchers look for the effects of economic structure on government-business relations, they

58 Most vividly, larger firms were obliged to obtain permission from government to expand their production capacities.

59 For an example of a study of the influence of government and public policies on the structure of business representation, see Sinha (2005).

normally find them. But that rarely gives the complete picture, and is inevitably somewhat backward-looking. For policy purposes in particular, it is useful also to look for evidence of more short term processes of *reconstruction* of the relationship between investors and government, through interaction and experiential learning. Evidence of this kind is not always very visible.

It was highly visible in China in the 1980s (Section 2). The national government took the initiative and openly declared and propagated a major policy shift, that was widely felt and understood because a major component was the removal of many long-standing prohibitions on market exchange and profit making. The policy changes made by the Indian political leadership at the same time (late 1970s, early 1980s) were similar in some respects: they were national in scope and centred around reducing specific barriers to market exchange and profit making and giving broader assurances to private investors that government was on their side. These changes were '*pro-business* rather than *pro-market*' (Rodrik and Subramanian 2004: 2). They have attracted far less attention than those in China, because they were far less visible. Indeed, they so lack a clear profile that scholars continue to disagree about what actually happened. There was no declared policy change; that came a decade later, with the explicit adoption of policies of economic liberalisation in 1991. However, it seems clear that something occurred in the late 1970s to trigger a marked upturn in private investment, in total factor productivity in manufacturing, and in various other economic indicators (Rodrik and Subramanian 2004). The weight of evidence suggests that there was an attitudinal shift on the part of the Indian political leadership adequate to generate a positive response from the private sector. Some researchers believe that this quiet change in attitudes and relationships, which was associated with some minor liberalising economic reforms in the 1980s, had a bigger impact than the 1990s reforms (DeLong 2003; Kohli 2005).[60] However, in the absence of any formal policy change, it is not surprising that researchers continue to dispute what happened, and to question the interpretation we have put forward here.[61] The Indian political leadership did not need to make public its attitudinal change. Unlike the Chinese leadership at the time (Section 2), the Indian government did not want or need to by-pass the existing large scale enterprises with whom it had close – if often corrupt – relationships through the planning system. The private Indian business houses were sufficiently few in number, large in size and competent to read the positive message, respond to it quickly and increase investment levels economy-wide. There was no need for the government to

60 One indirect sign of this change in attitudes is the measure of the quality of contract enforcement in India produced by Business Environment Risk Intelligence. This improved from 1.15 to 1.93, on a four point scale, between 1979 and 1980 (Keefer 2007: 202). This measure reflects the impressions of key informants in the private sector, and is probably a good indicator of their understanding of government attitudes to the private sector in general.

61 Sen (2007) questions both the statistics on changing economic performance put forward by Rodrik and Subramanian (2004) and the political analysis put forward by Kohli (2005). Keefer suggests that part of the reason for the higher level of business confidence in the late 1970s was that the defeat of Indira Gandhi's Congress Party in the 1977 general elections terminated definitively the arbitrary, personalistic and anti-business political strategy pursued under the leadership of Indira Gandhi in the early and mid-1970s (Keefer 2007: 201–3).

broadcast widely the 'enrich yourselves' message. Indeed, in the face of an electorate reared on anti-capitalist, anti-market rhetoric, it was sensible not to do so.

The Indian political system is relatively open. The persistence of disagreements about interpreting a policy change, that took place at the national level and does not appear to have involved any significant increase in corruption, illustrates how difficult it is to research the process and the consequences of less institutionalised, smaller-scale direct inter-personal interactions between investors and politicians: the contemporary equivalents of the kinds of 'deals' made during civil war in Mexico about which Haber *et al.* (2003) wrote. Investors and politicians may learn to trust one another, and to build wider activities on the basis of that trust, through a gradual process of familiarisation and exchange of favours. If I really do deliver on my promise to generate some jobs in your electorate, you may be willing to use your influence to ensure that the 'normal' harassment of exporters at Customs is suspended. If you ensure the electricity and water utility companies perform according to schedule, then I will mobilise enough investors to make credible your new high profile technology park, and you will be able to assure your restless cabinet colleagues that you really can be trusted with the Commerce Minister's post. If you ensure that tariffs on our imported machinery are substantially reduced and that our inputs are not held up in customs, we will really step up our investment. Schneider's (1998) review of research on government-business relations in Asia and Latin America underlines the importance of such reciprocal interactions for industrial growth and transformation but he also draws attention to the difficulty of obtaining solid evidence. Indeed the research process is very challenging. Participants in these interactions may not be very willing to give honest explanations of events. Two other kinds of narrative are much more likely to get a public airing: suggestions that all hand-in-hand relationships are motivated by corruption; and the businessmen's normal representations of themselves as victims of oppressive, extractive or incompetent states.

4.6.4 Levels: national, regional, local

Most literature of the investment climate and on government-business relations is focused on the national level. There is a good reason for this: the legal and policy framework is often defined by the central state.[62] By contrast, the literature on industrial organisation and innovation has increasingly moved to the sub-national level. An important theme in the literature on industrial clusters and local innovation systems is that the density and quality of relationships – among enterprises and between enterprises and government agencies – is an important determinant of growth and competitiveness.[63] However, the analysis has rarely dealt with the

62 Ideas also play a role: thinking about economic development in poorer countries typically is suffused with strong elements of nationalism, and a desire to build strong institutions at the national level.

63 For example, (Cassiolato and Lastres 2000; Humphrey and Schmitz 1996; Nadvi 1999b; Oyelaran-Oyeyinka and McCormick 2007; Tendler and Amorim 1996).

politics of these relationships and has given little explicit emphasis to investment levels. There is implicit evidence in some of this literature that the government-business relationships matter for investment, especially at turning points in the developments of these clusters (Schmitz and Nadvi 1999).[64]

There are two reasons for examining explicitly the politics of investment and growth at the sub-national level. First, there are wide intra-national variations in government-business relations and these differences seem to matter for investment and growth.[65] For the case of India in the 1980s, Kohli (2005: 6) concludes that *states* with more growth-oriented governments, adopting a pro-business approach tended to have faster economic growth. '… identifying variations in … the institutionalised relationship of the state to the private sector is the key to the understanding the relative effectiveness of state interventions in the economy' (p.9). In the case of China, the *local* level seems particularly important. Hsing (1998: 132–3) quotes a Taiwanese investor who proclaimed 'No favourable investment policies issued by Beijing could be as favourable as the special deals I made with the local officials'. The significance of differences between local authorities in China comes out clearly from a comparative study by Hampton (2006). She sought to understand why one locality was so much more successful in attracting foreign investment than a neighbouring one. She found that, in the successful case, officials had been able to build strong relationships with targeted investors and these relationships were central to explaining the high levels of investment. The revenue gains for the locality were substantial. She also explained why the investment promotion agency in the successful locality was able to do this whereas the other was not. The explanation was found in intra-government relationships. The officials in the successful locality had connections to central government giving them greater influence and better access to resources. The alignment of interests extended from local government to central government.

Second, the importance of sub-national variations increases with the trend towards decentralisation. Since the mid-1990s, decentralisation of administrative and political power to sub-national jurisdictions has become a dominant trend in the developing world. As a result, we have two new phenomena in the decentralising countries: (a) the scope for public entrepreneurship has multiplied; and (b) some of these public entrepreneurs compete to attract private investors (where taxation is essential for increasing public revenue). The results are hard to predict. They can range from fiscal wars, to more hand-in-hand arrangements to institutional transformation or combinations therefore. It could well be that some

64 There is a sizeable and growing number of practitioners in RED (regional economic development) and LED (local economic development), often funded by donor agencies, that seek to foster such public-private relationships (in the name of pro-poor growth or competitiveness). PACA (participatory appraisal of competitive advantage) is a method for bringing together public and private actors, so that together they explore problems, discuss specific ways forward and then work hand-in-hand and step-by-step on new initiatives www.mesopartner.com. One of the main problems in RED or LED initiatives is that they are often unable to involve those politicians and investors that matter most.

65 Using conventional measures of the quality of the investment climate (Dollar *et al.* 2005) found wide variations across cities within Bangladesh, China, India and Pakistan.

institutional transformation accelerates with decentralisation. Christian Von Luebke (2007) shows that, in the case of Indonesia, some political leaders at the district level used the space, created by decentralisation, to forge reform coalitions to improve the local enabling environment for private investors. Provincial-level research by Edmund Malesky (2008) on the politics of economic reform in Vietnam goes further. He shows how a coalition of provincial officials and foreign investors induced far-reaching economic reforms by the Vietnamese central government.

In sum, by opening up the state apparatus and including its regional and local levels, we are likely to improve our understanding of the dynamics of change. Understanding the alignments of interests between business and local/regional politicians seems critical. Equally critical is to then extend the enquiry and identify arrangements (or conflicts) between different levels of government. There is relatively little research on this, and the value-added to new research is likely to be high.

5 Conclusion

In reviewing the investment climate debate, we have

- Argued for greater recognition of heterodox ways forward
- Suggested a political approach which concentrates on the relationships between investors and policymakers
- Emphasised the need to understand dynamics: sequences and stages matter.

The investment climate debate reflects general thinking in the governance field about the way in which advanced economies have developed and the path that less advanced economies should follow: less governance through informal relationships and more governance through formal rules. There is no disagreement over the long term destination: governance through formal rules. Views differ however on how best to get there. Put in a nutshell: do investors follow or lead institutional reform? The orthodox position assumes the first, we think that the second might reflect better real processes.

The intention, however, is not to replace one position with another. This is a field which has been characterised for too long by lots of advice and little serious research. The ambition is to open up rather than close down, to analyse rather than prescribe. In this final section of our paper we seek to bring together some of the key issues that future research needs address and briefly indicate ways of conducting such research.

5.1 Dynamics

The central issue is sequence and dynamics. Does ‘getting the institutions right’ come first? Or does investment and growth lead to demand for institutional transformation? Or is there an iterative connection between private investment

and political support for institutional reform? Investigating such questions requires adopting a process approach, investigating changes over time and distinguishing between different stages.

There are two promising ways into such research. One is to take a country or region which has a poor investment climate but registered substantial increases in investment. The questions that then arise are: Did hand-in-hand arrangements play a role in bringing about this investment? How did these arrangements emerge, what stages did they go through, what were the key factors that made them effective? In her research on Egypt, Abdel-Latif (2007) follows this route. She hypothesises that productive government-business relations start informally and then become institutionalised. She also suggests that the organisational capacity of entrepreneurs is critical for making the hand-in-hand arrangements succeed.

The second way forward would be to examine places where the investment climate has improved substantially and then reconstruct the process which led to the reform, asking which forces drove the reforms forward and whether they included investors. This route is particularly promising where investment climate assessments have been carried out at the sub-national level over several years. Vietnam, for example, has such assessments based on surveying the perceptions of national investors (www.pcivietnam.org – accessed 12 May 2008). This makes it possible to compare provinces with fast and slow progress in reforming the investment climate and explore the reasons for these differences. In the case of fast progressing provinces one can then ask which are the economic/political forces driving this process and whether and how investors contribute.

5.2 The quality of investment

This paper has been concerned primarily with poorer countries where governments are unwilling or incapable of protecting private accumulation and might themselves become predators. In many countries of the developing world this is not the key problem, but accelerating investment and growth remains a key concern. And these countries are not just concerned with the level of investment but the quality of investment. Quality here refers to investment in sectors and in capabilities to which they attach high priority. Do particularistic relationships matter in this context? We cannot discuss this issue at length in this paper but suggest that even in these contexts hand-in-hand arrangements matter more than the investment climate literature or industrial policy literature recognises. Politicians keen to step up investment and economic growth realise that offering a ‘good investment climate’, characterised by transparent, universalistic relationships between state and business, is not sufficient and therefore seek particularistic relationships with specific groups of investors. In order to examine the effectiveness of this strategy one would need to compare regions in which politicians engage in this practice with others in which they do not.

5.3 The attribution problem

Investment and growth result from a combination of many different factors. How can we even begin to establish causal relationships? The attribution problem can be overwhelming. The first thing to be clear about is that the governance issues discussed in this paper have only a limited influence. Business people do not invest in country X because it has a good investment climate or because they trust those in power. They invest because they see a promising business opportunity. The governance variables come into play when investors make choices between good business opportunities, for example whether to invest in region A, B or C and whether to invest now or postpone the decision.[66] To examine the impact of governance variables, it is important to be able to hold at least some contextual factors constant. This is why intra-country comparisons are a promising route. The advantage of intra-country (as opposed to inter-country) comparisons is that they make it possible to hold in particular the general legal and policy framework constant. This does not solve the attribution problem but reduces the number of intervening variables considerably. Intra-country comparisons of regions or localities with high and low investments, comparisons of successful and unsuccessful sectors, and inter-temporal comparisons of high and low investment are likely to generate significant new insights.

Whether such intra-country comparisons will lead to generalisable findings and identify transferable practices is hard to predict. One of the main lessons from China and other East Asian countries is that each country found its own way of generating investment and growth. However, the construction of common interests between public authorities and private investors seems to have been a critical ingredient in all of them.

66 This is not to suggest that the business opportunity is entirely exogenous. The profitability can depend to some extent on the special connection to key politicians.

Annex 1 Property rights fundamentalism

The most prominent extant variant of what we term property-rights fundamentalism is the long campaign under the leadership of Hernando de Soto (2000) and his Institute of Liberty and Democracy in Lima to persuade governments of poor countries to make a major effort to issue formal titles to the numerous property assets 'owned' or controlled by poor people: the houses, shops, farms and businesses that lack any formal title because they are on land that has been occupied illegally or extra-legally, or because the actual cost of gaining legal title is too high. De Soto argues that, lacking formal property rights, poor people in poor countries are in effect sitting on large amounts of capital that they are unable to mobilise for developmental purposes. If they had formal titles, both to farmland and urban property, they would be able to borrow by using property as collateral, and would be motivated to invest in their property because their access to the fruits of that investment would be secure. The Institute of Liberty and Democracy have been contracted to manage a major programme to put their ideas into practice in Tanzania. The outcome of that experiment will be very important. In the meantime, there are a number of reasons to believe that the idea has been considerably overhyped:[67]

1) The property titling process itself is costly and can create insecurity, conflict and corruption.

2) What are conventionally labelled 'property rights' are actually a bundle of rights and obligations among people. Property is a social relationship. The more rights that some people (e.g. 'owners') have to use resources ('property'), to control who else uses those resources, to transmit those rights to others (by sale, lease, gift, legacy etc.), or to control how others may transmit their rights in the same property, then the less rights some other people have (Van den Brink *et al.* 2006: 3–4). Stronger formal rights may lead to exclusion, especially of poorer, weaker people.

3) If formal land titles are to be effective, corresponding (costly) changes may be required in related areas, such as judicial systems, bankruptcy codes and financial market regulations.

4) An effective property rights regime for ordinary people is dependent on the existence of a good system of identity registration. Poor people may be able to contest and protect their property in the courts only if they have acceptable evidence of their own identity, based on some system of registration of births, deaths, marriages etc. In many poorer countries, identity registration systems have very incomplete coverage (Szreter 2007).

5) The lack of formal title may not rule out active land markets. Effective informal or quasi-formal institutions may guarantee land market transactions, as for

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67 In addition to specific sources cited for specific points, this critique derives in particular from Nyamu Musembi (2007) and Woodruff (2001).

example in contemporary urban Vietnam (Kim 2007) and rural Kenya (Nyamu Musembi 2007: 1468).

6) Previous land titling programmes similar to those that de Soto is promoting have not had very positive results (Davis and Trebilcock 2001: 27; Woodruff 2001: 1218–9).

7) The figures which de Soto uses to estimate the returns to land titling are very questionable (Woodruff 2001: 1220–22; Altenburg and von Drachenfels 2006).

Our interim judgement on property-titling fundamentalism is much the same as on the old investment climate orthodoxy generally: it may not be a bad idea, and is likely to produce some positive results, but is based on some heroic simplifications about the world, and has been much overhyped. It is far from clear that this is a cost-effective way of unleashing the growth potential of micro-enterprises.

Annex 2 Is there a case for weak property rights?

There is some fundamental professional dissent from the assertion that stronger property rights will tend to induce investment and promote economic growth. Some people argue that, to the contrary, giving secure property rights to owners of (some) assets could result in a reduced rate of investment, on the grounds that many potentially productive assets would be better used if they were in other hands. Aggressive profit-seeking capitalists might within a few years produce more for society from a hundred acres of peri-urban ricefields, and the labour of the 250 people who currently work on them, than do the 150 small farm families who currently have rights to that land. Economic development might be accelerated through the *weak* protection of some people's property rights so that productive capitalists can acquire that property for their own use – or be given it by the government (Khan 2005b). There is a long tradition, going back at least to the work of Karl Marx, of asserting that investment may be accelerated if some people are permitted to get control of assets that are underused by the people who currently control them. But does that observation have policy implications? One could only advocate the weak protection of property rights if satisfactory answers can be given to two questions. First, is there a mechanism to ensure that the right assets will be appropriated by – or handed to – the people likely to make more productive use of them, rather than by thieves and thugs who will simply accumulate them? Second, can we be reasonably sure that the likely adverse external effects of weak property protection, such as the general disincentive to invest in visible assets, will not outweigh the benefits? At a number of points in history, the answer to both those questions has been positive, and has justified the redistribution of land from large landowners/landlords to smaller scale cultivators. Where a fixed, scarce resource like land is concentrated in the hands of wealthy people who (a) make less efficient use of it than small farmers and (b) use it to reinforce their socio-political dominance, land reform can be justified on economic, political and social grounds. But that kind of land is a special kind of

property. Further, it is relatively easy to justify land reform to other property owners and to assure them that it is not a prelude to a weakening of property rights generally.

We agree with the dissidents in questioning the view that ‘the more property rights, the better’. It is not clear that this is either a good thing or that the concept always has a clear empirical meaning (Section 3.2.2). Allocating scarce resources to improving the formal legal protection of property rights might not always be justified. However, it is not clear that there are many circumstances in which it would be sensible for governments to do things which would actively weaken property rights, whether through formal or informal mechanisms.

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