What Is a "Good Investment Climate"?

MUSHTAQ H. KHAN

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

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

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

Berlin Workshop Series 2005

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

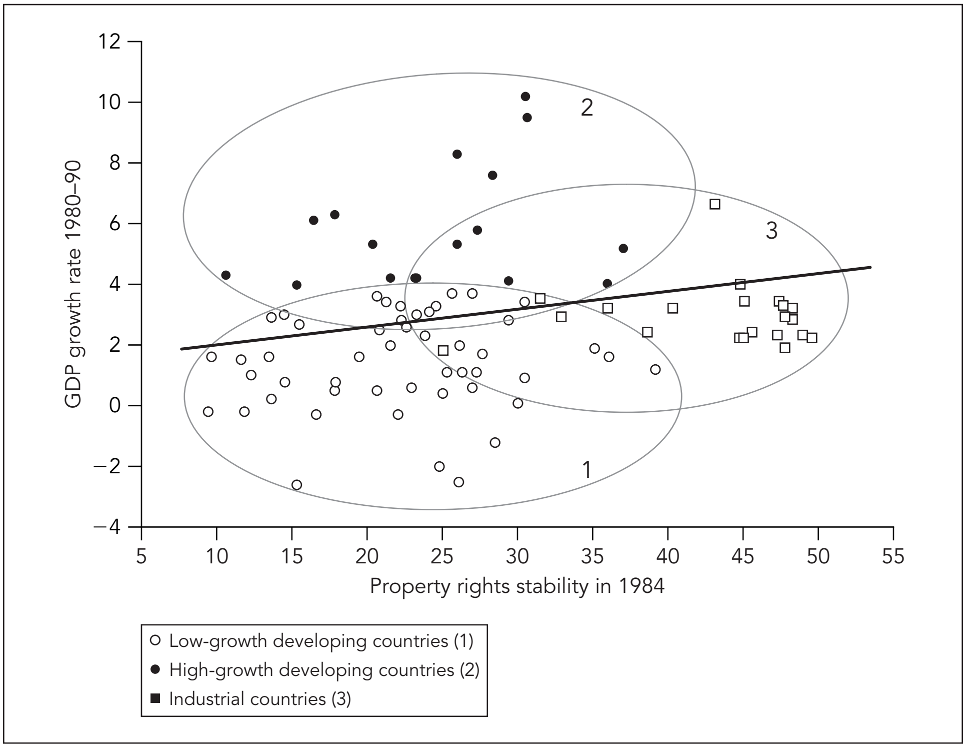
On the question of evidence, a substantial body of literature appears to show a correlation between standard good governance characteristics on the one hand and investment and growth performance in developing countries on the other (see Hall and Jones 1999; Kauffman, Kraay, and Zoido-Lobatón 1999; Johnson,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

- *The indices measuring governance quality are subjective.* Respondents in well-performing countries are likely to give high rankings simply because things are working well. For instance, China scores higher than India on indices of the rule of law. But can we be sure that the higher ranking really reflects the better implementation of the rule of law in China? Or might the ranking simply reflect that the Chinese "legal system" works better to provide the things that investors want—and may be overriding the legal rights of other groups?
- *Available time series data are inadequate to test causality.* Most indices of governance quality begin in the mid-1980s; the more reliable data are available only for the 1990s. Longer time series are needed to determine if high-growth countries implemented good governance reforms or created good investment climates *before* their growth took off.
- *The number of high-growth countries is too small to generate satisfactory econometric results.* The high-growth developers are particularly important, because even though governance indices are not available for periods before their takeoffs, their governance indices remained poor for a considerable period even after growth took off. Even in the mid-1980s the Asian high-growth economies come out only a little better than many poorly performing countries in terms of the Knack and Keefer (1995) indices of institutional quality (based on quality of bureaucracy, rule of law, expropriation risk and contract repudiation by government). Rodrik (1997) notes that while growth within East Asian countries was correlated with the index, only Japan, Singapore, and Taiwan (China) had high scores, and none was remotely poor by the mid-1980s. Indonesia scored the same as Ghana, Myanmar, and the Republic of Congo, while Malaysia, the Republic of Korea, and Thailand were at the same level as Côte d'Ivoire. Nor were most high-growth developers democratic when they began growing. Thus while poorly performing developing countries did not have good governance characteristics, neither did many of the high-growth developing countries, well into their growth phases. If there were many of these high-growth countries in the regression exercises, the results may have changed; as it is, they simply drop out as outliers. But they should not be treated as outliers: they are the only cases of successful transitions in recent history.
- Most worrisome for the consensus, there are no historical examples of countries that first improved governance as defined in good governance theory and then began growing rapidly. Cross-sectional and even time series regression exercises

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

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

FIGURE 1. Relationship between GDP Growth and Property Rights Index



Source: Author's calculations.

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

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

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

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

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

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

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

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

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

References

Barro, Robert. 1996. "Democracy and Growth." Journal of Economic Growth 1(1): 1–27.

Clague, Christopher, Philip Keefer, Stephen Knack, and Mancur Olson. 1997. "Democracy, Autocracy, and the Institutions Supportive of Economic Growth." In *Institutions and Economic Development: Growth and Governance in Less-Developed and Post-Socialist Countries,* ed. Christopher Clague, pp. 91–120. Baltimore: Johns Hopkins University Press.

Hall, Robert, and Charles Jones. 1999. "Why Do Some Countries Produce So Much More Output per Worker than Others?" *Quarterly Journal of Economics* 114(1): 83–116.

Johnson, Simon, Daniel Kaufmann, and Pablo Zoido-Lobatón. 1998. "Regulatory Discretion and the Unofficial Economy." *American Economic Review* 88(2): 387–392.

Kauffman, Daniel, Aart Kraay, and Pablo Zoido-Lobatón. 1999. "Governance Matters." World Bank Policy Working Paper No. 2196, Washington, DC.

Khan, Mushtaq H. 2000a. "Rents, Efficiency and Growth." In *Rents, Rent-Seeking and Economic Development: Theory and Evidence in Asia*, Mushtaq H. Khan and K.S. Jomo, eds., pp. 21–69. Cambridge: Cambridge University Press.

______. 2000b. "Rent-Seeking as Process." In *Rents, Rent-Seeking and Economic Development: Theory and Evidence in Asia*, Mushtaq H. Khan and K.S. Jomo, eds., pp. 70–144. Cambridge: Cambridge University Press.

Khan, Mushtaq H. 2002. "State Failure in Developing Countries and Strategies of Institutional Reform." In *Toward Pro-Poor Policies: Aid Institutions and Globalization. Proceedings of the Annual Bank Conference on Development Economics,* Bertil Tungodden, Nicholas Stern, and Ivar Kolstad, eds. pp. 155–186. Oxford: Oxford University Press and World Bank 2004. Available at http://www-wds.worldbank.org/servlet/WDS_IBank_Servlet?pcont=details&eid=000160016_20040518162841.

Knack, Stephen, and Philip Keefer. 1995. "Institutions and Economic Performance: Cross-Country Tests Using Alternative Institutional Measures." *Economics and Politic*s 7(3): 207–227.

———. 1997. "Why Don't Poor Countries Catch Up? A Cross-National Test of an Institutional Explanation." *Economic Inquiry* 35(3): 590–602.

Mauro, Paolo. 1995. "Corruption and Growth." *Quarterly Journal of Economics* 110(3): 681–712.

Rodrik, Dani. 1997. "TFPG Controversies, Institutions, and Economic Performance in East Asia." NBER Research Working Paper 5914, National Bureau of Economic Research, New York.

World Bank. 1997. *World Development Report 1997: The State in a Changing World*. Washington DC.