

Research Summary 27: IDS Working Paper Series 307
Idealism, Realism and the Investment Climate in Developing Countries
By Mick Moore and Hubert Schmitz (2008) A Literature Review

This paper is published under the Centre for the Future State, based at the Institute of Development Studies. Below is a summary of research findings. Further details are available at:

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The orthodox view about what makes for a good investment climate includes legal protection of property rights and enforcement of contracts as central elements. While desirable in principle, such reforms are difficult to implement and may not lead to significant increases in investment and growth. Moreover some countries (notably China) have made dramatic progress without these institutions in place. The orthodox prescription, based on OECD 'best practice', may well represent a valid long-term goal. But it is ill suited to helping poor countries with weak institutions to increase investment in the short to medium-term.

Heterodoxy: the China Case. In China informal relations between investors and political power-holders gave investors confidence that they could retain their profits despite very weak legal protection of property rights or formal enforcement of contracts. The first new investors were small enterprises owned by local governments. They were reassured by a) high level political signals and b) incremental changes in existing institutional arrangements that allowed profit sharing between central and local governments and investors. Local governments were allowed to retain the surplus over and above targets set by central government, giving them incentives to foster local enterprise. Investors enjoyed political protection by virtue of their Party membership. These were interim measures, continually adapted to changing circumstances, and directed at solving immediate problems. China is of interest not because it provides a precise model for other countries to follow, but because it suggests that unorthodox approaches that provide investors with sufficient assurances can work.

Questioning Orthodoxy. The orthodox prescription for improving the investment climate does not match with the experience of many poor countries:

- i) It fails to distinguish between the 'business climate' (the relatively predictable costs of doing business), and the 'investment climate' (factors affecting investors' perceptions about their ability to profit in future from investment decisions made now). Reducing *uncertainty* concerning the latter is more significant for short-term policy.
- ii) It puts too much emphasis on changes to the legal system as the means to give adequate assurance to investors. Legal reform has proved very problematic.
- iii) It underplays the importance of informal relations between business people: these can substitute for many aspects of contract law, although they are less effective in safeguarding property rights. Governments do not need to do everything.
- iv) It reflects excessive distrust of governments: they can play useful coordinating roles. In sum, the standard investment climate advice emphasises large-scale reform of formal, legal institutions, and best practice. It neglects the importance of experimentation and informal, ad hoc measures that can be effective in the short term in very difficult contexts.

Relations between Public Authority and Private Capital. Relations between those who control political (and military) power and those who control capital are pivotal to economic and political development. Public authorities and private capital stand to benefit from co-operation, but also face risks in doing so. Public authority needs private capital to provide state revenue, finance political parties, and invest to create prosperity that supports political order. Private capital needs public authority to provide order and infrastructure. But there are obstacles and risks to cooperation. . Public authority faces standing temptations to predate on private capital; private capital has the capacity to convert its economic power into political power by 'buying up' government.

In OECD countries competition between public authority and private capital takes place within widely accepted formal rules, and relationships are relatively indirect (*'arms-length'*). Governments depend on general taxation for revenue and must therefore negotiate with private capital, which can use its 'structural power' to withhold or slow down investment if dissatisfied with government policy. Electoral democracy and high levels of welfare spending give governments legitimacy and capacity to bargain effectively with private capital. It is relatively easy to build political coalitions based on common interests between major economic and political actors, and to formulate pro-growth economic policies. In short, institutions of market capitalism, liberal democracy and welfare states are mutually reinforcing. But they are the product of a long history of political conflict and socioeconomic change, and cannot easily be replicated.

By contrast relationships between private investors and public authority in poorer countries are more likely to be highly personalised and informal (*'hand-in-hand'*). For complex historical reasons elites often see political power rather than capitalist enterprise as the route to wealth. Government access to external revenue sources (aid and natural resource exports) has further reduced incentives for cooperation with (weak, fragmented) private capital. It is difficult to formulate pro-growth economic policies that respond to a wide range of interests.

Hand-in-hand Relationships: problem or solution? If building best practice institutions in poor countries is not a short-term option, in what circumstances might hand-in-hand relationships lead to productive investment rather than crony capitalism? Experience from Mexico's history, where some sectors of the economy thrived despite years of political instability and civil war, shows the potential for productive cooperation between government and the private sector, based on common interests at the level of an economic sector or individual firm. Such hand-in-hand arrangements can provide the basis for transition to more rules based systems as those who have accumulated capital start to see their interests in more effective legal protection of property rights.

But hand-in-hand arrangements are not always positive. A major factor explaining different outcomes is the extent to which governments enjoy income from rents that free them from the need to nurture capital. Some rents are more damaging than others, and reflect the structure of the economy: mineral or fuel wealth invites looting. By contrast governments have an interest in cooperating with specialist export enterprises, with freedom to move elsewhere.

Future research needs to investigate: how have hand-in-hand arrangements emerged? Is there a transition from informal to formal arrangements? In what circumstances are hand-in-hand arrangements successful? Does a sub-national approach (focussing on local or regional levels) transform the possibilities of understanding and fostering private productive investment in developing countries?