Legal Assistance for Economic Reform

Is there a causal link between investment climate and growth?

A review of the evidence

DFID Legal Assistance for Economic Reform Programme

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Introduction and summary

1. This paper reviews the evidence for the proposition that investment climate improvements, generate economic growth. Investment climate can be defined as the policies, rules, regulations and requirements that businesses must deal with to conduct business operations (DFID)[1], but it is also useful to consider broader implications of bureaucratic quality and rule of law, the *clarity, certainty and predictability of laws and their application*[2]. Between 2003 and 2012 some 180 economies have made it easier to do business by improving regulatory frameworks[3]. But is there a causal mechanism between this apparent progress and growth?

2. This paper looks at investment climate reform in a number of contexts and reviews the evidence base for a causal link. The conclusion is that the overall evidence base is currently weak. The practical problem for programming is that we have very little knowledge about which particular IC reforms to prioritize in different contexts (including in fragile and conflict affected states).

Overview of the different bodies of evidence linking IC reform to growth

3. An extensive body of literature interrogates the association between investment climate (IC) and growth. It includes literature reviews on specific IC topics commissioned by DFID[4]. The most recent are on contract enforcement[5] and property rights[6].

4. The contract enforcement paper identifies that only 19 studies from the period 1990-2010 that empirically address the question of a causal link between contract enforcement and investment. These include studies based on experimental and quasi-experimental methods. The mechanisms by which the causal linkage is said to operate include: reduced uncertainty, better access to formal institutions and increased expected returns. However, all these studies are statistical analyses of non-experimental data, and the results are neither statistically significant nor backed by a sufficiently strong theoretical base to conclusively demonstrate causality. The overall conclusion is that evidence on the impact of improvements in contract enforcement on levels of investment, as a proxy for economic growth, is limited, and emanates from a disjointed literature, which generally does not meet strong standards for causal inference. A further paper

[1] See DFID Investment Climate Core Brief – Internal document. London. DFID.
[2] Hogan Lovells (2015). Risk and Return – Foreign Direct Investment and the Rule of Law. *Hogan Lovells*
[3] World Bank (2012a). *Doing Business 2013 - Smarter Regulations for Small and Medium-Size Enterprises*. Washington DC: The World Bank. Retrieved from http://www.doingbusiness.org/reports/global-reports/doing-business-2013
[4] See for example Cox, M. (2008). *Security and justice: measuring the development returns – a review of knowledge*. London. Agulhas Development Consultants Ltd. This included a review of justice related IC issues such as dispute resolution. Roseveare, C. (2013). Rule of law and international development. This includes a review of the literature examining the relationship between domestic legal frameworks, commerce and economic growth, as well as the literature on rule of law and economic growth.
[5] Aboal, D., Noya, N., & Rius, A. (2014). Contract Enforcement and Investment: A Systematic Review of the Evidence. World Development, 64, 322-338. Retrieved from ScienceDirect.
[6] UK Department for International Development (2014). *Secure property rights and development: economic growth and household welfare. Property rights evidence paper.* Retrieved from https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/304551/Property-rights-evidence-paper.pdf

not included in this analysis[7] finds that judicial ability to enforce contracts is linked to increased firm size in Mexico.

5. The property rights paper (which in fact looks just at land rights and not at non-land private property or intangible property) concludes that there is better evidence for a linkage between land rights and growth, with a medium-sized body of high quality evidence that supports an association between secure rights to land and long-term economic growth. The mechanism by which this linkage operates is said to be through increased security, protecting income; increased efficiency, enhancing mobility of assets; facilitating transactions; and reduced costs of protecting property.

6. Looking at IC issues more broadly, relevant evidence comprises:

   i. theoretical studies with contested views on the role of institutions/ rule of law in economic development;

   ii. cross-country empirical studies, and cross-state empirical studies within a country, which generally fail to establish a causal link between IC reform and increased investment or growth;

   iii. empirical evidence of results at country level which tends to focus on outputs, and rely on 'before' and 'after' comparisons; and

   iv. rigorous impact evaluations of IC interventions which are just emerging and have not yet yielded strong results.

(i) Theoretical studies linking IC reform to growth

7. Academic literature reviews highlight the lack of consensus between investment climate *optimists* and *sceptics*[8] on whether there is a causal link between IC reform and economic development.

8. Optimists focus on the fact that in general better institutions are associated with higher levels of income and growth[9]. The theory is that a transparent regulatory framework, and low barriers, costs and risks of doing business give large and small firms alike the confidence to invest and expand[10]. It is suggested that a weak IC may have a disproportionate impact on small firms, less able than large ones to 'circumvent' inappropriate legal and regulatory regimes, often resulting in informality, and constraining growth[11].

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[7] Dougherty, S. M. (2014). Legal reform, contract enforcement and firm size in Mexico. *Review of International Economics*, 22(4), 825-844.
[8] Davis, K.E. and Trebilcock M.J. (2008). The relationship between law and development: optimists versus sceptics. *American Journal of Comparative Law*, 56(4), 895-946.
[9] See for example Acemoglu, D. & Robinson, J.A. (2012). *Why Nations Fail: The origins of power, prosperity and poverty*. London: Profile Books Ltd.
[10] See DFID Investment Climate Core Brief – Internal document. London. DFID.
[11] De Soto, H. (2000). *The Mystery of Capital: Why capitalism triumphs in the West and fails everywhere else*. New York: Basic Books; Beck, T. (2007, April). Financing constraints of SMEs in developing countries: Evidence, determinants and solutions; UNDP Commission on the Legal Empowerment of the Poor (2008), *Making the Law Work for Everyone*, Vol. 1.

9. Some studies see secure property rights and the ability to enforce contracts (seen by Fukuyama for example as a 'narrow' or 'economists'' definition of the rule of law[12]) as fundamental determinants of private sector development[13]. Other optimists emphasise the importance of broader rule of law issues[14] including democracy, separation of powers and freedom of the press because of their influence on government incentives to act in the public interest[15].

10. Surveys provide some evidence to back up the causal links propounded by optimists. According to the responses of more than 45,000 companies in 106 developing countries to the World Bank Enterprise Surveys[16] the top constraint they face is a poor investment climate, with the top IC constraints cited as ease of formalisation, corruption and tax regime. A 2014 survey of over 300 senior executives of multinational corporations[17] suggested that the rule of law[18] is among the top three considerations of multinationals making Foreign Direct Investment (FDI) decisions, together with 'ease of doing business' and 'stable political environment'.

11. However, IC sceptics question whether such causal links exists. Reasons for scepticism include the prevalent use of informal social norms as substitutes for formal law[19]; and the layers of historical, economic, political, cultural influences that control legal systems and limit the ability for their external control[20]. The DFID-commissioned study cited in paragraph 4 above on the linkage between contract enforcement and investment[21] highlights the lack of robust evidence for the 'basic story' that effective third-party enforcement enables more complex contracting, the limited testing that has been carried out to date of the plausible indirect causal channels, as well as the low number of robustness checks that have been undertaken to rule out alternative explanations. Research under the DFID funded Africa, Power and Politics Programme[22] has also thrown doubt on the efficacy of broad, donor-funded investment climate

[12] Fukuyama, F (2011) *The origins of Political Order: From Prehuman times to the French Revolution*. Profile Books Limited chapter 17.

[13] See discussion in Fukuyama, F. (2011); also Barzel, Y. (1989). Economic analysis of property rights. Cambridge University Press; North, D (1990) who asserted at p 54 that absence of a low-cost means of enforcing contracts is "the most important source of both historical stagnation and contemporary underdevelopment in the Third World";

[14] In the sense of 'sovereign rule of law' which puts limitations on the ability of the state to concentrate and use power. See Fukuyama, F (2011).

[15] For example Haggard, S., MacIntyre, A., & Tiede, L., (2008) The rule of law and economic development. *Annual Review of Political Science 11*; Keefer, P. (2004). A review of the political economy of governance: from property rights to voice. *World Bank policy research working paper* no. 3315; Kaufman, D., Kraay, A., & Mastruzzi, M. (2005). Governance matters IV: governance indicators for 1996-2004. *Policy Research Working Paper* no. 3630

[16] See DFID Investment Climate Core Brief – Internal document. London. DFID.

[17] Undertaken by the Economist Intelligence Unit on behalf of Hogan Lovells and the Bingham Centre for the Rule of Law and the Investment Treaty Forum of the not for profit research body the British Institute of International Comparative Law. Hogan Lovells (2015).

[18] "*Normative principles and practices such as freedom from expropriation, physical security of persons, respect for contracts, access to effective and efficient courts, and government adherence to agreements and dispute resolution procedures. Above all, the definition encompasses clarity, certainty and predictability of laws and their application*". Hogan Lovells (2015), page 5.

[19] See for example Ulen, T. S. (2010). The Role of Law in Economic Growth and Development. M. Faure and J. smits (Eds), Does Law Matter. *Bonn Law & Economics Workshop April 27, 2010.*

[20] See Institute of Development Studies (2010). An upside down view of governance. Brighton. Institute of Development Studies, University of Sussex. This paper emphasises the importance of informal rules of the game.

[21] Aboal, D., Noya, N., & Rius, A. (2014).

[22] Kelsall, T. (2013). *Business, politics, and the state in Africa: Challenging the orthodoxies on growth and transformation*. Zed Books.

reforms to bring about the economic transformation that leads to growth. A recent paper[23] has suggested that the traditional formulation of the 'right' institutions for growth is not supported by the evidence while a recent survey[24] of donor IC efforts in eight sub-Saharan countries[25] concluded that IC reforms reflected the priorities and dogmas of the aid community, were poorly implemented and insufficient to deliver growth.

(ii) Cross country and cross-state empirical studies

12. Cross-country and cross-state econometric research suggests a strong correlation between the strength of the investment climate and growth / investment, but causality is not established, although it is sometimes asserted. Various empirical studies conducted across countries or across states within a country suggest that factors such as institutional structures, property rights, and bureaucratic quality and political stability are associated with increased levels of private domestic and foreign direct investment / growth/ productivity, with positive relationships holding across many countries[26].

13. Examples of such correlations include:

- A Doing Business study of the World Bank that asserts that better business regulation and better infrastructure are associated with an increase of up to two percentage points of economic growth[27];
- A 2006 analysis of indicators in the World Bank Doing Business database for 135 countries against annual growth of GDP per capita finds that countries with better regulation grow faster, with an improvement from the worst to the best quartile for business regulations associated with a 2.3 percentage point increase in average annual growth[28];
- Jayasuriya (2011)[29] suggested that FDI inflows are higher for economies with a better score on the relevant indicators of the World Bank Doing Business series even when taking into account other factors relevant to FDI such that on average a difference of one percentage point in regulatory quality is associated with a difference in annual FDI inflows of $250 – 500 million;
- The most recent report of the World Bank's *Investing Across Borders* programme presents evidence that countries with poor regulations and inefficient processes for foreign companies receive less FDI, and that those that receive more FDI allow foreign

[23] Booth, D., Dietz, T., Golooba-Mutebi, F., Henley, D., Kelsall, T., Liliveld, A., & Kees van Donge, J. (2015). Initiating and sustaining developmental regimes in Africa. ODI. London.
[24] Page, J., (2014). Africa's Failure to Industrialize: Bad Luck or Bad Policy? Africa in Focus, Brookings Institute, November 20, 2014, retrieved from http://www.brookings.edu/blogs/africa-in-focus/posts/2014/11/19-africa-failure-industrialize-page
[25] Ethiopia, Ghana, Kenya, Mozambique, Nigeria, Senegal, Tanzania and Uganda
[26] Selected References: Banerjee, S.G., Oetzei, J.M. & Ranganathan, R. (2006). Private Provision of Infrastructure in Emerging Markets: Do Institutions Matter? *Development Policy Review*, 24(2,), 175-202; Busse, M., & Hefeker, C. (2007). Political risk, institutions and foreign direct investment. *European journal of political economy*, *23*(2), 397-415; Daude, C. and Stein, E. (2007). The Quality of Institutions and Foreign Direct Investment. *Economics and Politics*, 19(3), 317-344.
[27] World Bank (2005). *Doing Business in 2005 – Removing Obstacles to Growth*. Washington DC. The World Bank.
[28] Djankov, S., McLiesh, C., & Ramalho, R. M. (2006). Regulation and growth. *Economics Letters*, 92(3), 395-401.
[29] Jayasuriya, D. (2011). Improvements in the World Bank's ease of doing business rankings: do they translate into greater foreign direct investment inflows? *World Bank Policy Research Working Paper,* (5787).

ownership of companies, have strong laws protecting investor interests, and efficient and transparent systems for start-ups, land acquisition, and commercial arbitration procedures[30];

- In India net fixed investment is four times higher for firms in states with good business regulatory environments than for firms in states with poor environments[31];
- Cross-state analysis in Mexico[32] finds that firm size increases with state judicial quality and efficiency. Authors propose that the reduced risk increases demand for capital and labour, prompting less able entrepreneurs to join successful firms.
- A recent cross-country analysis by the World Bank found that a ten-day reduction in the time required to start a business was associated with a 0.3 percentage point increase in the investment rate and a 0.36% increase in the GDP growth rate in relatively poor and well governed economies[33];
- Significantly reducing the cost of starting a business is associated with a ten percent increase in the number of new firms[34]. Regulation critically affects individual decisions to start a new business[35].
- With improvements in property rights, loan amounts increase and maturities lengthen[36]. Cross country regression analysis suggests that secure property rights are associated with increases in credit, which in turn promote growth[37].

14. A recent World Bank study establishing a correlation between strong investment climates and FDI summarises the situation: *this correlation does not imply existence or direction of a causal relationship. Many other variables—such as market size, political stability, infrastructure quality, or level of economic development—are likely to better explain the relationship*[38]. And there is the possibility that the direction of causality in effect goes the other way: that growth brings with it, in the end, improvements in the investment climate.[39]

15. Taken together, the various studies do not provide guidance on which of the wide range of possible IC reforms are most strongly correlated with increased growth - even when narrowing the focus to rule of law. For example one empirical study suggests that, of the various dimensions of the rule of law, the basic control of violence has the strongest correlation with

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[30] World Bank (2010). *Investing Across Borders 2010 – Indicators of foreign direct investment regulation in 87 economies*. Washington DC. The World Bank.
[31] Dollar, D., Iarossi, G., & Mengistae, T. (2002). Investment climate and economic performance: Some firm level evidence from India. *Center for Research on Economic Development and Policy Reform*, Stanford University, Working Paper, (143).
[32] Dougherty, (2014).
[33] World Bank (2011a). *Doing Business in 2012 – Doing business in a more transparent world*. Washington DC. The World Bank, Washing DC.
[34] Klapper, L. F., & Love, I. (2010). The impact of business environment reforms on new firm registration. *World Bank Policy Research Working Paper*, (5493).
[35] Ardagna, S., & Lusardi, A. (2008). *Explaining international differences in entrepreneurship: The role of individual characteristics and regulatory constraints* (No. w14012). National Bureau of Economic Research.
[36] Bae, K. H., & Goyal, V. K. (2009). Creditor rights, enforcement, and bank loans. *The Journal of Finance*, 64(2), 823-860.
[37] Kerekes, C. B., & Williamson, C. R. (2008). Unveiling de Soto's mystery: property rights, capital formation, and development. *Journal of Institutional Economics*, 4(03), 299-325.
[38] World Bank (2010). Investing Across Borders 2010 *page 9.*
[39] See for example Khan, M (2006) Governance and Development, *workshop by World Bank and DFID.*

economic growth[40]. While a study which undertook cross-country regression analysis of the effects of constitutions and judicial independence on economic and political freedom asserts that *judicial independence matters most for economic freedom*[41].

(iii) Empirical evidence of results at country level

16. The major providers of IC advisory services collect and widely disseminate data on improved service delivery[42], providing strong evidence that particular IC reforms can deliver specific improvements in the IC environment in particular contexts. For example, we know from a wide range of countries, what has worked to reduce the time and expense of registering a business or resolving a commercial dispute (see table 1 below). Country-level reporting on IC results is strongly skewed towards outputs, with limited focus on impact. Where IC reforms are claimed to link to growth or job creation[43], the methodology tends not to be rigorous, typically using simple *before and after* comparisons, with no control for pre-existing trends or concurrent events in the economy[44] - as is the case for the examples cited in table 1 below. The World Bank's Doing Business in 2012 report[45] explicitly recognises that investment climate *reforms take time to translate into changes in the economy*. *Given the short term nature of many reform programmes and their focus on output- based indicators, credible findings in terms of impact remain elusive.*

Table 1. Examples of country-level reporting

CLJ topic	Country	Result	Source
Business entry	Bangladesh	Streamlining of the business registration process from 35 days to 1 day and launching it online has resulted in over 42,000 new businesses being registered.	RISE Annual Review May 2012.
	Liberia	Liberia reduced the time it takes to register a business from 99 days to 6 days. The number of businesses registered has increased by an average of 8% per year.	ICF Annual Review 2013.
	Burkina Faso	The one stop shop for starting a business in Burkina Faso costs $200,000. These costs are far outweighed by the estimated saving for businesses – estimated at $ 1.7 million a year.	Doing Business 2010.

40 Haggard, S. and Tiede, L. (2011). The Rule of Law and Economic Growth: where are we? World Development 39(5) 673-85

41 La Porta, R., Lopez-de-Silanes, F., Pop-Eleches, C., Shleifer, A (2004). Judicial checks and balances, Journal of Political Economy, 112(2), 445-470.

42 See for example IFC's Advisory Services in Sub-Saharan Africa Development Report 2012.
The World Bank Cost of Doing Business Indicators.
Indicators on the Investment Climate Facility for Africa's website http://www.icfafrica.org/.
IFC Advisory Services in Sub-Saharan Africa (2012).
Development Impact Report 2012: Making it happen. Washington DC. World Bank Group the Investment Climate Facility for Africa's webpage on 'impact' http://www.icfafrica.org/page/icf-impact and the World Bank Doing Business Reports.

43 IFC (2013). *Assessing Private Sector Contributions to Job Creation and Poverty Reduction - Jobs Study*. Washington DC: IFC/ The World Bank. Four evaluations conducted of IFC-supported investment climate reforms in Burkina Faso, Liberia, Rwanda and Sierra Leone estimated that about 50,000 jobs (about 0.3% of total labour force) were created in those four countries 2008 – 2010.

44 McKenzie, D. (2009). Impact Assessments in Finance and Private Sector Development: What have we learned and what should we learn? *The World Bank Research Observer*, lkp011.

45 World Bank (2011a).

CLJ topic	Country	Result	Source
	Mexico	A business entry simplification reform launched in 2002 was associated with a 2.8% increase in total employment (including self-employed workers) in the eligible industries in just one year[46].	World Bank Group 2010.
Contract enforcem ent	Bangladesh	In the last 24 months Bangladesh has streamlined 28 regulatory requirements, saving the private sector $21.8 million in compliance costs and facilitating savings of $4.6 million through an ADR mechanism.	RISE Annual Review May 2012.
	Ethiopia	Reduced average time to resolve a commercial dispute by 10%.	Doing Business 2010.
	Rwanda	The commercial courts that started operating in May 2008 had fully cleared the case backlog by the end of 2009.	Doing Business 2013
Licensing	Kenya	A $105.2 million - or 31% - reduction in the total licensing costs achieved since 2007, equivalent to 0.4% of Kenyan GDP.	Building a Reliable Investment Climate in Kenya DFID Business Case.
Tax	Burundi	The Burundi Revenue Authority has led to a revenue increase of 100% since 2010.	TMEA Results to Date Core Brief.
	India	A study in India estimates that tax reform can increase productivity by up to 60%.	Doing Business 2010.

17. An example of a study going beyond immediate impact comes from Pakistan where, in 2002, a reform to improve judicial efficiency was implemented, providing the judiciary with more training rather than additional material incentives[47]. The direct result of this was that judges disposed of a quarter more cases. The difference-in-difference analysis[48] shows an impact on entrepreneurship, with entry rates of new firms increasing by a factor of a half, translating into an estimated GDP increase of 0.5%.

18. A forthcoming LASER retrospective study of the Uganda Commercial Court[49] found evidence of a potential correlation between the formation of the Ugandan Commercial Court and economic growth, as reflected in a marked increase in bank lending to the private sector, a fall in the rate of non-performing loans and consistent growth in FDI. Investor perceptions of Ugandan commercial justice have improved significantly since the late 1990s, with a steady rise in Commercial Court caseload indicating increased trust in and use of its services. But while it was possible to present plausible arguments to help explain the net result of positive and negative developments, direct correlation or causality were impossible to prove or reject. One senior

[46] Bruhn, M. (2013). A Tale of Two Species, Revisiting the Effect of Registration Reform on Informal Business Owners in Mexico. *World Bank Group Policy Research Working Paper* no. 5971.
[47] Chemin, M. (2008). The impact of the judiciary on entrepreneurship: Evaluation of Pakistan's "Access to Justice Programme". *Journal of Public Economics*, 93(1), 114-125. The authors study the performance of Pakistan's 875 judges using a difference-in-difference analysis. Here two groups were studied over two time periods, with only one subject to intervention during only one time period.
[48] i.e. unaffected firms or sectors are used as the comparator group.
[49] Magson, J. (2015). *Retrospective study of the Ugandan Commercial Court*. LASER/DFID

executive was clear there had been a direct significant impact of the commercial court as it opened the way to forms of financing that did not require land title as security. Attempts to do this before the court had been established had been overturned by judges with limited commercial experience. As studies in other countries have shown, the provision of non land borrowing instruments is particularly important for women[50].

(iv) Rigorous impact evaluations

19. Assessments of the impact of IC reforms have until recently rarely involved rigorous baselines or comparator groups, especially in the context of developing countries. This is now beginning to change with more rigorous impact evaluations (RIEs) of IC issues being performed[51]. But the impacts of IC reforms have tended to be conceptualised in relation to direct beneficiaries (for example, benefits of regulatory compliance to informal businesses), rather than wider systemic change (for example, in terms of propensity for firms more generally to make investments). Typical findings in relation to impact on direct beneficiaries include:

Table 2. Examples of rigorous impact evaluations looking at direct beneficiaries

CLJ topic	Country	Result
Business entry – impact on formalisation	Sri Lanka and Brazil	Reducing the barriers to formalisation and the costs of regulatory compliance may not be sufficient to prompt firm formalisation. It may be necessary to complement such reforms with other incentive or enforcement mechanisms[52].
	Mexico	Reducing the barriers to business registration resulted in increased registrations[53], but a programme reducing registration delays by over half had only a temporary effect, with results concentrated in the first ten months of implementation[54].

[50] For a review of the evidence see Manuel, C. (2015). Levelling the legal playing field: What the law can and can't do to improve women's access to secured finance. In F. Dahan (Ed.), *Research Handbook on Secured Financing in Commercial Transactions* (pp.132-164). Cheltenham, UK: Edward Elgar Publishing.
[51] See for example IFC (Internal to DCED), (2014). *Findings from recent Impact Evaluations of Business Registration and Tax Simplification reforms*, Investment Climate Impact Program.
[52] See Bruhn, M. & McKenzie, D. (2013). Entry Regulation and Formalization of Microenterprises in Developing Countries, *World Bank Policy Research Working Paper* 6507;
De Mel, S., McKenzie, D., Woodruff, C. (2013): "The demand for, and consequences of, formalization among informal firms in Sri Lanka", *American Economic Journal: Applied Economics* 5(2): 122-50. This paper finds that the net benefit of formality is minimal for most firms;
Andrade, G. H., Bruhn, M., McKenzie, D. (2013): "A helping hand or the long arm of the law? Experimental evidence on what governments can do to formalize firms", *World Bank Policy Research Working Paper* no. 6435. This paper conducts a carrot-or-stick study on incentivizing firms to formalise in Brazil, finding that forms will not formalise unless forced to do so.
[53] Bruhn, M. (2008). Licence to Sell: The Effect of Business Registration Reform on Entrepreneurial Activity in Mexico. *World Bank Policy Research Working Paper* no. 4538.
[54] Kaplan, D.S., Piedra, E. and Seira, E. (2007). Entry Regulation and Business Start-Ups: Evidence from Mexico. *World Bank Policy Research Working Paper* no. 4322.

CLJ topic	Country	Result
	Mexico	Improved access to credit and improved formality was found to be related to an increased likelihood of firm survival, suggesting a greater capacity to cope with risk. These and other improvements in the business environment such as training and membership of business associations, led to increased formalisation, profits, survival rates and growth towards optimal firm size in microenterprises[55] using a control function approach[56].
Commercial dispute resolution	Liberia	Training in ADR of 15% of adults across 86 communities resulted in more settlement of land disputes and less violence than in 'non-treated' towns in the 246 communities studied[57].
Bankruptcy law reform	Colombia	Bankruptcy law reform improved the separation of firms filing for bankruptcy, reorganising economically viable firms and liquidating inefficient ones, thus increasing the efficiency of the bankruptcy system[58].

20. A few studies have attempted to look at the broader impact of IC reforms. Some examples are presented in table 3 below:

Table 3. Examples of rigorous impact evaluations looking at wider impact

CLJ topic	Country	Result
Business entry/ regulatory simplification/ formalisation	Mexico	Formalisation improved resource allocation across the economy; inducing high-ability entrepreneurs to formalise and a more appropriate allocation of workers to jobs[59].
	Brazil	Formalisation at start-up affects firm choices of location, production technology and product quality and consequently drives differences in firm performance[60].
	India	The progressive elimination of the Licence Raj system, a central control system for regulating entry and production activity in registered manufacturing, had the effect of boosting firm output, employment, entry and investment to different extents across states with different labour market regulations. It was found that firms in pro-employer labour environments grew more quickly than those in pro-worker environments[61] using difference-in-difference techniques[62].

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55 Fajnzylber, P., Maloney, W. & Rojas, G.M. (2006). Releasing Constraints to Growth or Pushing on a String? The Impact of Credit, Training, Business Associations and Taxes on the Performance of Mexican Micro-Firms. *World Bank Policy Research Working Paper* 3807.

56 To control for endogeneity, whereby an econometric model is employed that relates unobservable variables which affect the outcome of interest to variables that are observable, including the choice of participation in the policy or programme.

57 Blattman, C., Hartman, A., & Blair, R. (2014). How to promote order and property rights under weak rule of law? An experiment in changing dispute resolution behavior through community education. *American Political Science Review*, 108(1), 100-120.

58 Gine, X. & Love, I. (2006). Do Reorganization Costs Matter for Efficiency? Evidence from a Bankruptcy Reform in Colombia. *World Bank Policy Research Working Paper 3970.*

59 Bruhn, M., (2013).

60 Fajnzylber, P., Maloney, W. F., & Montes-Rojas, G. V. (2011). Does formality improve micro-firm performance? Evidence from the Brazilian SIMPLES program. *Journal of Development Economics*, 94(2), 262-276.

61 Aghion, P., Burgess, R., Redding, S.J. and Zilibotti, F. (2008). The Unequal Effects of Liberalization: Evidence from Dismantling the Licence Raj in India. American Economic Review, 98 (4), 1397-1412.

62 i.e. unaffected firms or sectors are used as the comparator group.

CLJ topic	Country	Result
Commercial dispute resolution	India	Introduction of the Code of Civil Procedure Amendment Act in 2002 led to fewer breaches of contract, encouraged investment and facilitated access to finance[63].

21. Taken as a whole we have few examples of rigorous studies that truly get to grips with the issues of causality. Overall, methodologically different processes and applications within and across countries can make it difficult to draw generalised conclusions from the RIEs[64], and they have not so far yielded strong results in determining empirical causality between IC and growth.

Prioritising and sequencing of IC reforms: what to do first, where and to benefit whom?

Prioritising and sequencing

22. In many cases a very wide range of IC problems can be identified. For example, a January 2015 scoping report completed by the Legal Assistance for Economic Growth programme (LASER) on proposed DFID support to IC reform in Bangladesh, revealed over 30 IC constraints identified by donors (in more than ten diagnostic reports and surveys) and by government in its national plan. The range of issues included for example electricity, access to land, access to finance and contract enforcement. While it may be relatively straightforward to draw up a long list of potential IC problems, it less clear where to focus efforts first. And there is increasing understanding that while it may be possible to develop diagnostic tools to identify 'binding constraints to growth'[65] the underlying political economy may make such constraints intractable and resistant to external assistance seeking to address them[66].

23. What seems clear is that growth drivers and constraints are highly context (country) specific, so reform priorities and possibilities will be context specific too[67]. Academic literature reviews[68] conclude that while there is empirical evidence that institutional reform can promote growth, it is less clear which reforms matter most, how to prioritise possible IC reforms, and what kinds of institutional frameworks and functions are needed. For example, it is unclear whether once a 'good enough' legal system[69] is in place, there is a need for further improvement given

[63] Chemin, M. (2007). Does Judicial Quality Shape Economic Activity? Evidence from a Judicial Reform in India. CIRPEE, Montreal; Chemin, M. (2010). Does Court Speed Shape Economic Activity? Evidence from a Court Reform in India. *The Journal of Law, Economics and Organizations*, 28 (3), 460-485. Both studies use difference-in-difference methods.

[64] Love, I. (2011). *Settling Out of Court: How Effective is Alternative Dispute Resolution?* World Bank / International Finance Corporation, Washington D.C.

[65] Dani Rodrik, with Hausmann & Velasco (see ref. 61). See also DFID's inclusive growth diagnostic tool.

[66] See for example Andrews, M. (2013). *Explaining positive deviance in public sector reforms in development*. CID Working paper no. 267. Andrews, Matt and the President and Fellows of Harvard College.

[67] See Hausmann, R., Rodrik, D., & Velasco, A. (2008). *Growth diagnostics*. The Washington consensus reconsidered: Towards a new global governance, 324-355.; Commission on Growth and Development (2008). *The Growth Report: Strategies for Sustained Growth and Inclusive Development*; World Bank (2012b). *World Development Report 2013: Jobs*. Washington DC. The World Bank.

[68] See especially Davis & Trebilcock (2008). Also Haggard & Tiede (2011).

[69] Good enough governance directs attention to consideration of minimal conditions of governance necessary to allow political and economic development to occur. See Grindle, M. S. (2004). Good enough governance: poverty reduction and

competing institutional development needs. This is particularly relevant for states emerging from conflict or a centrally planned economy. And the political economy is important too: for example Roland (2002) speculates that Russian liberalisation reforms may have been better received had the development of a small private industrial and service sector been prioritised first, as happened in post-communist Hungary.[70]

IC reforms for women's economic empowerment

24. Promoting women's economic empowerment (including through IC reforms such as enhancing women's property rights and access to dispute resolution mechanisms) is increasingly seen as an important driving force behind economic growth and the fight against poverty[71]. But there is very limited evidence on what IC reforms matter for female-headed businesses.

25. Attempts to quantify the impact of enhanced women's economic empowerment are focused on labour force participation. It is clear that increased participation of women in the labour force represents significant economic opportunity:

  - GDP per capita losses attributable to gender gaps in the labour market have been estimated at up to 27% in certain regions[72].
  - It has been suggested that raising the female labour force participation rate to country-specific male levels would, for instance, raise GDP in the United States by five percent, in Japan by nine percent, in the United Arab Emirates by 12%, and in Egypt by 34%[73].
  - If women's paid employment rates were raised to the same level as men's, in 15 major developing economies, per capita income would rise by 14% by 2020 and 20% by 2030[74].
  - A 2011 report from the International Labour Organization (ILO) and Asian Development Bank (ADB) reveals that a gender equality gap in employment rates for women as compared to men costs Asia $47 billion annually[75].

reform in developing countries. *Governance*, 17(4), 525-548; and Grindle, M. S. (2007), Good Enough Governance Revisited. *Development Policy Review*, 25: 533–574. See also Fukuyama, F. (2011).

70 Roland, G. (2002). The political economy of transition. *Journal of economic Perspectives*, 29-50.

71 Simavi, S., Manuel, C., & Blackden, M. (2010) Gender Dimensions of Investment Climate Reform. Washington DC. The World Bank.

72 Cuberes, D., & Teignier-Baqué, M. (2011), *Gender Inequality and Economic Growth*, World Development Report 2012 Background Paper.

73 IMF Women, Work and the Economy: Macroeconomic gains from gender equality.

74 Calculation comprises Bangladesh, Brazil, China, Egypt, India, Indonesia, Iran, Mexico, Nigeria, Pakistan, Philippines, Republic of Korea, Russia, Turkey and Viet Nam. Lawson, S. 2008, "Women Hold Up Half the Sky," Global Economics Paper 164, Goldman Sachs. - See more at: http://www.unwomen.org/en/what-we-do/economic-empowerment/facts-and-figures#notes.

75 International Labour Organization and Asian Development Bank (2011). *Women and labour markets in Asia: rebalancing towards gender equality in labour markets in Asia*. ILO Regional Office for Asia and the Pacific Asian Development Bank: Bangkok

- Where women's participation in the labour force has grown fastest, the economy has experienced the largest reduction in poverty[76].
- Globally, closing the gender labour market participation gap would increase gross domestic product by up to 5.4%[77].

26. Reforming property rights may also be a key area for enhancing women's economic empowerment, and thus growth[78], but the evidence base remains relatively thin. There are a number of studies that show that improving women's property rights is associated with benefits for women such as improved access to secured credit, or to bank accounts[79]. A recent RIE on the impact of reforming property rights for women in in Ethiopia[80] suggested that family law reforms resulted in an expansion of women's economic opportunities. But no studies have been found that directly link improved women's property rights with economic growth.

IC reforms in fragile and conflict affected situations

27. Economic recovery is vital in stopping a return to conflict. Developing stable economic foundations – generating employment and improving livelihoods – is one of the five Peacebuilding and Statebuilding Goals identified by the g7+ group of fragile states, and agreed as part of the New Deal in Busan[81]. Research[82] by Paul Collier (2011)[83] highlights the importance of focusing on the economy in fragile and conflict-affected states (FCAS), finding that the lower the income, the higher the risk of conflict reversion, and the slower the economic recovery, the higher the risk of a reversion to violence. The problem is that economic growth takes time to have an impact. Collier calculates that, if income can grow at seven percent a year (which he argues is possible in post-conflict situations), the level of income doubles in a decade and, by the end of the decade, the risks of conflict are substantially lower. He concludes that *economic recovery is to my mind the only genuine exit strategy for peacekeeping.* Alongside rebuilding infrastructure and developing a stable macro economy, Collier argues that generating jobs for

[76] International Center for Research on Women http://www.icrw.org/what-we-do/economic-empowerment. Consulted 23/04/15
[77] World Bank (2012a); Duflo, E. (2011). Women's empowerment and economic development (No. w17702). National Bureau of Economic Research; Kabeer, N. & L. Natali. 2013. "Gender Equality and Economic Growth: Is there a win-win?" *IDS Working Paper No. 417*. Brighton: Institute of Development Studies
[78] Hallward-Dreimeier, M. & Hasan, T., (2013). Empowering Women Legal Rights and Opportunities in Africa.' The World Bank.
[79] Almodóvar-Reteguis, N., Kushnir, K., & Meilland, T. (2013). *Mapping the Legal Gender Gap in Using Property and Building Credit*. Women, Business and the Law, World Bank; Demirgüç-Kunt, A., Klapper, L. F., & Singer, D. (2013). Financial inclusion and legal discrimination against women: evidence from developing countries. *World Bank Policy Research Working Paper*, no. 6416. See also Buvinic, M., Furst-Nichols, R., & Pryor, E. C. (2013). *A Roadmap for Promoting Women's Economic Empowerment*. United Nations Foundation and ExxonMobil Foundation. http://www.womeneconroadmap.org/sites/default/files/WEE_Roadmap_Report_Final.pdf.
[80] Hallward-Driemeier, M., & Gajigo, O. (2013). Strengthening economic rights and women's occupational choice: the impact of reforming Ethiopia's family law. *World Bank Policy Research Working Paper*, (6695). The finding was that women's economic opportunities expanded relatively more where the reform had been enacted, controlling for time and location effects. Women were more likely to work in occupations that require work out the home, in paid and full time jobs and in higher-paid occupations. The impact was particularly strong for young, unmarried women.
[81] OECD-DAC (2011). New Deal for engagement in fragile states. Paris. OECD-DAC
[82] Paul Collier conducts quantitative research, looking at household surveys, election results, etc, as well as cross-country statistical analysis. This research isn't without its critics, with some questioning the rigor of his analysis and suggesting that causality is not sufficiently established to justify his conclusions.
[83] Collier, P. (2011). *Wars, Guns and Votes; Democracy in Dangerous Places*. Random House

young men (especially via construction) looks to be critical in bringing down the risks of conflict, a point supported by the 2013 World Development Report (WDR) on jobs[84].

28. The 2011 WDR[85] also suggests that alleviating key bottlenecks identified by the private sector can help to restore confidence by signalling to entrepreneurs a more business-friendly environment generating economic revival and setting the stage for broader reform and points to an early emphasis on the simplification of business regulations, rather than expansion or refinement citing Bosnia and Herzegovina and Rwanda as examples.

29. Much has been written about how to improve developmental impact in FCAS. While many lessons have been documented, much of the information is anecdotal and focused on the types of reforms that should be considered (fiscal, monetary, business enabling environment, etc.), the sequencing of those reforms, and the need for external actors to continually pay attention to 'do no harm' and 'conflict sensitivity' principles. While this literature is useful in broad terms, there is a lack of empirical evidence and impact data to back up the lessons and the guidance. The end result is that *largely unjustified assumptions about the effectiveness of particular interventions often shape policy and programming decisions*[86] and there continues to be a need for an empirical evidence base to be established around what works in FCAS environments.

30. There are a few empirical studies that assess the impact that specific economic reforms or policies have had on growth in fragile contexts. Paul Collier stresses the devastating effects of conflict on national economies, with one of his most recognised statistics being that each year of conflict causes a 2.2% reduction in economic growth at the country level[87]. In a later study of 27 countries' in their first ten years post-conflict, Collier and co-author Anke Hoeffler found that the most critical policies in terms of delivering economic growth in post conflict environments were social policies—those proved to be more important than structural or macroeconomic policies[88].

31. An IMF empirical study looked at 146 cases of civil conflict in 94 countries around the world between 960 - 2010. This study found that while UN peacekeeping operations, foreign aid, and IMF-supported economic growth programmes did not directly impact growth trajectories in FCAS environments, FDI flows into countries and human capital improvements through educational attainments did have a direct and positive impact on economic growth figures[89]. In addition, the findings suggest that a post-conflict policy framework that focused on growth enhancing policies, reforming dysfunctional institutions and addressing urgent needs of the population would pave the way to sustainable growth in terms of GDP per capita improvements after the end of a conflict.

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[84] World Bank. (2012b)
[85] World Bank (2011b). *World Development Report 2011: Conflict, Security and Development.* Washington DC. The World Bank.
[86] Mallett, R., & Slater, R. (2012). Growth and livelihoods in Conflict affected situations: what do we know? *Secure Livelihoods Research Consortium, ODI Briefing paper.*
[87] Mallett, R., & Slater, R. (2012).
[88] Collier, P., & Hoeffler, A. (2002). *Aid, policy, and growth in post-conflict societies* (Vol. 2902). World Bank.
[89] Cevik, M. S., & Rahmati, M. M. (2013). *Breaking the Curse of Sisyphus: An Empirical Analysis of Post-Conflict Economic Transitions.* International Monetary Fund.

32. Another empirical study found that higher social cohesion in a country leads to high quality institutions which are more likely to act on behalf of the common good, which in turn leads to higher growth in the post-conflict period[90]. This puts the emphasis on rebuilding social cohesion—particularly across ethno-linguistic divisions - and in supporting strong formal institutions that will act as the arbiter between societal divisions as a way to deliver growth potential in FCAS environments.

33. One sectorally-focused study highlighted the successes that Rwanda and Colombia have had in delivering economic improvements at the grass-roots level, linking that success to the presence of a strong institutional agenda around national development, as well as effective coalitions that pushed the state to provide incentives for productive investments[91]. This study seems to indicate that it was the political environment and regulatory framework that existed within the two countries which transformed specific agricultural sectors into delivering results for the general population. While this means that there is some precedent for using IC frameworks to achieve pro-poor growth in select sectors, there still is not enough evidence to show how this might be replicated or adapted to other fragile environments.

34. A significant body of work has developed around extractive industries and their impact on conflict dynamics, but less research has been done on their potential to deliver transformative growth in FCAS contexts. A range of initiatives have been established to improve transparency around extractive industry operations, such as the Kimberley process and the Extractive Industries Transparency Initiative (EITI) - and these efforts have delivered improvements in good governance and in transparency and accountability between governments, multi-national companies, donors, and citizens[92]. However, the impact of these initiatives on growth is less clear.

35. DFID's How to Note on Results in FCAS[93] acknowledges that there is currently relatively little rigorous impact evidence of the effect of DFID's engagement in FCAS. The Note suggests that rigorous impact evaluation is possible in FCAS and gives examples of where it has been used successfully and where innovative approaches have been employed, for example, using mobile phone technology. The Note points to the unique opportunities that FCAS can offer for evaluating impact, because of the high and concentrated burden of need and the lesser fragmentation of services. The Note, however, identifies key challenges involved in measuring results in the case of FCAS. There is currently no experience of RIEs in IC reform in FCAS contexts. Although designing and conducting them would be challenging, the limited evidence base with regards to FCAS may be one that could be addressed with thoughtful RIEs.

[90] Easterly, W., Ritzen, J., & Woolcock, M. (2006). *Social cohesion, institutions, and growth. Economics & Politics*, 18(2), 103-120.
[91] Putzel, J., & Di John, J. (2012). *Meeting the challenges of crisis states*. The London School of Economics and Political Science.
[92] Caspary, G., & Seiler, V. (2011). *Extractive Industries Transparency Initiative: Combating the resource Curse in Fragile and Conflict-Affected Countries.* The World Bank
[93] See DFID (2012) Results in Fragile and Conflict-Affected States and Situations. London. DFID

Conclusion

36. Overall, the evidence base examining the causal link between investment climate reform and growth is currently weak, with a lack of endogeneity making it difficult to establish patterns in findings across studies. Theoretical studies only partly explore causal links. Although correlations are more readily evident in the body of cross-country empirical studies, causality is not always well substantiated. At a country level, reports of success in IC reforms rarely address impact.

37. As a way forward, future IC programming should have a strong focus on lesson learning. Where feasible, programmes should aim, as a matter of course, to integrate the delivery of IC reforms with the generation and dissemination of robust, rigorous evidence on the existence (or not) of a causal link between the reform programme and economic impact. A growing body of such evidence may enable broader lessons to be drawn about what works and what to prioritise in IC reform, including in fragile and post-conflict situations. Rigorous impact evaluations seem to offer potential for further enlightenment, and should be included in these efforts.

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