Constraints to Investment in Business in the Poorest Developing Countries
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Executive summary

Development finance institutions, such as CDC, were established to provide finance for private investment in the developing countries. Higher levels of private investment are associated with faster rates of economic growth and, in turn, growth is a critical factor in reducing poverty.

This literature review addresses four sets of questions: i) what constrains private investment in the poorest developing countries (particularly in Sub-Saharan Africa and South Asia) and how importance a constraint is access to finance; ii) the causes of lack of access to finance; iii)at what stages of their life cycle and what types of business are most affected by lack of access to finance and the consequences for wider economic development; iv) what policies are effective in addressing access to finance.

What constrains private Investment?

A good investment climate provides opportunities and incentives for firms to invest profitably, create jobs and expand output, thereby increasing private investment and growth. The literature shows that the better the investment climate the higher the levels of private investment are likely to be.

However, in the poorest developing countries, businesses frequently operate in investment climates that undermine their incentive to invest and grow. Businesses seek to maximise the risk adjusted rate of return to investment after tax. Investment climate constraints serve to depress the potential rate of return on investment, increase risk and/or prevent the entrepreneur from capturing the returns on offer.

The literature highlights seven investment climate constraints that affect the macro indicators of the rate of private investment and growth and the survival and growth of firms:

1. **Macro level stability:**Macro instability (economic, social and political) deters investment by making future rewards more uncertain or undermining the value of assets. Studies show that the greater the level of instability, the lower the rate of private investment and growth. Instability also increases the risk of firms going bankrupt, suffering slower growth or contracting if political conflict ensues. Fiscal and monetary policies that reduce inflation, polices that help to establish a competitive exchange rate and political and social stability are needed to sustain high rates of investment and growth.

2. **Crime and corruption** represent a substantial risk to earning attractive returns to investment and increase the cost of doing business, whether through the payment of bribes, the direct loss of goods or the costs of crime prevention. There is strong evidence that, at the macro level, these factors reduce the rate of private investment, job creation and growth. At the firm level, there is some evidence to show that these factors reduce the growth of output, investment and job creation. Greater transparency and accountability, simplification of administrative procedures and merit-based human resource management in public administration make it possible to curb corruption.

3. **Business regulation and licensing.** Whereas firms need to be regulated and licensed, if the costs they incur in complying with regulation are unnecessarily high, business entry and firm growth will be lower. The literature points to faster growth when countries improve their rank in the World Bank's Doing Business Index, especially if they move from being one of the worst performers to being amongst the best. There is some evidence also of poor licensing and regulation leading to low entry rates of new firms and lower productivity and growth of established firms. However,by itself, better business regulation may not result in faster economic growth.

4. **Institutions and the legal system.**There is strong cross country evidence in the literature that weak institutions, particularly forthe protection of property rights, and an ineffective judiciary that is unable to enforce contracts, reduce investment and growth. This is supported by firm level evidence which shows that secure property rights and better contract enforcement enable firms to grow: increasing their incentive to invest longer term, feel secure in trying out new suppliers, and enter into more complex contracts. Better systems of registering property, improved security of land tenure and reforms that reduce the cost of contract enforcement, such as promoting alternative dispute resolution, are policies that support better institutions and legal systems.

5. **Taxation.** Excessivelyhigh rates of tax exact a high cost in terms of lower private investment and growth. They reduce the incentive to invest because the after tax returns to investors are lower. In addition, the cost of compliance with the administration of taxes can be high. The literature shows that lower rates of tax can increase investment and growth. Higher rates of tax can decrease business entry and the growth of established firms, with the medium sized firms hit hardest, as the small can trade informally, and the large avoid taxes. As well as reducing tax rates, policies that broaden the tax base, simplify the tax structure, improve administration and give greater autonomy to tax agencies help to reduce this constraint.

6. **Financial Constraints.** Firms need to be able to access external finance to invest more. Moreover, the higher the cost of capital the lower the expected rate of return to the entrepreneur. There is a robust body of literature that shows that financial deepening, measured by the ratio of private credit to GDP, results in higher rates of growth and faster growth in the incomes of the poor, especially in the poorer countries with less well developed financial sectors. Studies show that firms able to access external finance are more likely to survive, invest and grow than those denied access.

7. **Infrastructure.** Access to infrastructure allows firms to become more productive (energy), reduce transaction (ICT)and transportation costs (roads, railways) and expand their businesses by reaching markets further afield. There is ample evidence to show that greater investment in infrastructure leads to faster growth. Studies also point to higher levels of investment, greater productivity and faster growth of firms that have better access to infrastructure, especially in the poorer countries where infrastructure is less developed. Greater investment in infrastructure, public and private, and higher expenditure on maintenance are needed to reduce this constraint.

Much of the literature focuses on correlating one or more of these seven investment climate factors to macro level impacts on investment and growth. Studies which trace the effect of these factors on the survival and growth of firms are much rarer, a gap that needs to be addressed.

In addition to these external factors, there are constraints internal to firms that prevent greater private investment. The literature points to access to technology, good quality management and access to business development services as important internal constraints.

How important is access to finance?

Evidence of which constraints matter comes from two main sources:

- Examining the World Bank's Enterprise Surveys to identify the factors that firms report to be the most severe constraints to their growth. In SSA, firms report tax rates to be the most severe constraint followed by access to finance, electricity, macro instability and corruption. In South Asia, where financial sectors are more developed, electricity, corruption, tax rates and policy uncertainty are reported as more severe constraints than access to finance.

- The binding constraints methodology was proposed by Rodrik and Hausmann to overcome the subjective nature of firms' perceptions reported in the Enterprise Surveys. Studies using this method find that access to finance is not a binding constraint to private investment in South Asia and the more developed countries of SSA (South Africa, Ghana) but it may be in the poorer countries such as Kenya and Sierra Leone.

At the firm level, though the evidence is more limited, it appears that access to finance is always a major factor in explaining the growth of firms. This finding appears to hold across the developing countries.

What causes lack of access to finance?

The level of development of the financial sector exerts a powerful influence over whether firms are likely to be able to access finance. This is influenced by the environment in which the sector operates. Macro stability, property rights, enforcement of contract, bankruptcy laws and whether the public sector borrows heavily to crowd out the private sector, influence the development of the financial sector.

The development of the financial sector is influenced also by conditions within the sector. The specific factors include bank regulation and supervision, the development of institutions that help to increase the level of information available to lenders, the transaction costs involved in lending, the extent of competition and hence pressure to improve efficiency, the investment financial institutions make to make their services more accessible, whether they have been able to raise long term savings for long term lending and the level of development of capital markets to provide exit routes for equity finance.

In addition, there is a set of factors that limit the opportunities for the financial sectorprofitably to lend to, or invest equity in, firms. These include poor business and financial management skills, and weaknesses in corporate governance that make firms unattractive to the financial sector because of the high risks they pose. In addition, attitudes of entrepreneurs towards risk or retaining complete control over their firms may make them unwilling to borrow or to allow third party equity into their businesses. In countries where the financial sector may have sufficient access to savings to increase lending, such demand side factors can represent a binding constraint to increasing access to finance.

Which types of firms are most affected by lack of access to finance?

The types of firms most severely affected by lack of access to finance are:

- **Start-ups and the newly established.** They may lack assets to be used as collateral and the track record of performance that banks need to mitigate risk. And the rate of failure amongst new businesses is high the world over, making the banks risk averse in lending to them. Studies show that financial constraints are greater for start-ups and younger firms than for older firms.

- **Small and medium firms**(SMEs) face more financial constraints than large firms. The literature shows a huge gap in serving the needs of such businesses and there is evidence thatfinancing constraints have a greater impact ontheir growth than on that of large firms. Studiesfind that small firms consistently report more financial constraints than medium-sized firms, which in turn report more constraints than large firms. Such firms are more likely to be unable to have assets to pledge as collateral, face greater information failures and the profitably in lending to them is likely to be lower for the banks because of risk and transaction costs.

- **Domestic firms.** Firms that have access to foreign capital markets are less financially constrained than those that have to resort solely to domestic capital markets. And it is ownership (domestic versus foreign) that seems to determine if firms have access to outside markets. Foreign-owned firms report significantly lower financing obstacles than domestically-owned firms as they may choose to borrow on either the domestic or foreign market depending on where terms are most favourable.

- ***Sector of operation*:**Agribusiness firms are particularly capital constrained as lenders and equity investors tend to perceive this sector as high risk. There is a history of patronage and subsidy from the public sector in lending to farmers that makes them less willing to repay loans provided by a commercial bank. Where access to long term finance is limited, firms wishing to undertake long-gestation projects in agriculture, mining, manufacturing, infrastructure and housing may face acute problems in raising finance. There is some evidence also that, in some industries, firms need equity because they lack tangible assets to serve as security or cash flows are unpredictable (ICT, Entertainment). Such firms are particularly constrained when equity markets are underdeveloped.

- ***Exporters.***There is some evidence that lack of development of export credit and trade finance can hold back exporters and have a wider impact on small firms as trade finance may play an even more important role in helping them access bank finance because of its strength in addressing information problems.

In general, themore underdeveloped the financial sector, the more likely that these types of firms will suffer lack of access to finance. The process of financial deepening tends to be accompanied by financial innovation that helps to serve progressively more of the needs of different types of business.

The effects on wider economic development

The overall effect of the lack of financial deepening on private investment and growth is well established in the literature. However, evidence on the consequences of the market failures that

result in some types of firms suffering more from lack of access to finance than others is much weaker:

- **Entry rates.** There is some evidence to show that rates of business formation have an impact on productivity and growth. Lower access to finance for start-ups and younger firms could hamper business formation and hence productivity and growth.
- **Size of firms.** Market failures in serving the needs of SMEs could amount to inefficient financial intermediation whereby finance is not allocated to its most productive use. However, the long-held view that increasing the proportion of output generated by SMEs is good for growth has been challenged by the evidence: countries have followed very varying patterns of the size structure of firms. The new literature suggests that it is not firm size that matters for growth but the market outcomes that businesses deliver in terms of investment, productivity, job creation and growth of output.
- **Ownership:** The better access to finance enjoyed by foreign firms helps them expand more quickly than their domestic rivals. However, in most countries, the majority of private investment and output continues to come from domestic sources. No doubt, if access to finance for domestic firms was increased, it would help to increase growth and investment and help to establish a more level playing field.
- **Sector of operation.** The failure to meet the financial needs of firms in particular sectors could lead to the economy failing to fulfil its potential growth trajectory and to develop inclusive broad based growth. However, the evidence that shows the link between breadth of financial sector lending for investment and the diversification of the economy is limited.
- **Exports.** There is good evidence that the level of trade openness of an economy is important for growth. The evidence that the lack of financial instruments hampers growth of exports is weaker, confined to smaller firms being disadvantaged compared to the large.

What policies have been followed to address access to finance?

The traditional focus of policy has been on improving policies and institutions. Assisted by the IMF and the World Bank, governments have focused on strengthening bank supervision, ensuring that banks comply with international standards for capital adequacy (e.g. Basel II) and financial liberalization, opening up the financial sector to domestic and foreign investors. Attention has been given also to establishing institutions such as credit bureaus to improve information on credit worthiness of borrowers and to increasing the efficiency of clearing systems.

Of late, there has been greater attention given to increasing financial innovation to meet the needs of underserved businesses such as SMEs (downscaling, partial credit guarantees), to promote product innovation (e.g. leasing, trade credit), to use technology to increase the outreach of the financial sector and to develop capital markets. Though there is a considerable body of literature showing why these are needed, the literature does not provide a definitive view of how well these are working. The fact that the efficiency of the banking system, as measured by the margins between rates at which banks borrow and lend (spreads), has not improved in many SSA countries, despite the entry of many new banks, and the huge proportion of businesses in the poorer countries that still report that their needs are not being served by the financial sector, show that there is a long way to go.