APPENDIX 1: LITERATURE REVIEW

A. Quality of Institutions and Private Sector Development

1. In its 2005 World Development Report, the World Bank used research based mainly on cross-country data sets to conclude that countries that undertake legal and regulatory reforms affecting what it calls “Doing Business indicators” can significantly increase growth and employment and lower the share of the informal sector as a percentage of gross domestic product (GDP). However, other research found no statistically relevant relationship between Doing Business indicators and economic growth rates or aggregate investment and employment levels, and few significant relationships with intermediate outcomes. This might have been due to the narrow time frame of available datasets used by these studies, which did not allow for attainment of macro-level impacts and the lack of meaningful intermediate outcome data. A more recent study utilizing a five-year panel of data on regulations and procedures from the World Bank’s Doing Business project finds some evidence of positive impacts of regulatory reforms in countries that are relatively poor (conditional on governance) and relatively well-governed (conditional on income). Relatively poor countries grow about 0.4 percentage points faster in the year immediately following one or more reforms, and relatively well-governed countries grow about 0.2 percentage points. In both subsets of countries, investment rates accelerate by about 0.6 percentage points in the subsequent year. Moreover, some of the regulatory and property rights reforms (e.g., business entry reforms) mainly benefit a larger number of small enterprises, which will unlikely influence macroeconomic aggregates significantly in DMCs where small and medium enterprises (SMEs) account for a comparatively small share of GDP and investment, although such reforms will likely be important for making growth more inclusive. An increasing body of research shows linkages between the quality of countries’ institutions and prospects for private sector development, although causality has been difficult to prove.

2. Empirical research generally confirmed a relationship between the implementation of business entry reforms and increases in private investment, productivity, economic growth, or employment. Cross-country studies show that a 10-day reduction in the time to start a business is associated with a 0.3 percentage point increase in the investment rate and a 0.36% increase in the GDP growth rate (footnote 3). However, it is noteworthy that causality has usually been difficult to prove, as other factors also affect results. Nevertheless, it would appear that economies with efficient business registration and good governance have a higher entry rate for new firms as well as greater business density.

3. Enterprises that need to import or export goods often fall victim to inefficient and corrupt customs regimes in which the costs of clearing, paperwork, and delays increase the barriers to engaging in international trade. It is estimated that each additional day in transport delays costs 0.5% of the cargo value for goods transported by ship or rail. Red tape is assessed to cost more than 10% of the value of exports in developing countries. Inefficient customs and trade transport mean that

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1. Doing Business indicators include the following areas: starting a business, dealing with construction permits, registering property, getting credit, protecting investors, paying taxes, enforcing contracts, and closing a business.


businesses must hold larger inventories at their warehouses, adding 4%–6% to production costs.\(^6\) A recent study using newly collected data on the days it takes to move standard cargo from the factory gate to the ship in 98 countries finds that each additional day that a product is delayed prior to being shipped reduces trade by more than 1%, or put differently, each day is equivalent to a country distancing itself from its trade partners by about 70 kilometers on average.\(^7\)

4. An analysis of panel data from the Doing Business dataset found positive economic responses to changes in business registration, contract enforcement, property registration, and import and export procedures to be limited to countries that are relatively poor but well governed.\(^8\) This indicates that business reforms are not implemented in a vacuum and that their successful implementation is dependent on an overall conducive governance environment.

5. A 2003 analysis of World Business Environment Survey data suggested a link between corruption, taxation, and financing on the one hand, and growth and investment on the other.\(^9\) An analysis of enterprise survey data for the garment industry found that business climate matters for the level of productivity, wages, profit rates, and the growth rates of output, employment, and capital stock at the firm level.\(^10\) Recent micro studies by the World Bank in the People’s Republic of China (PRC) and Uganda found corruption to have a greater negative impact on enterprise performance than taxation.\(^11\) The study based on the experience of Ugandan firms finds that both the rate of taxation and bribery are negatively correlated with firm growth. A 1 percentage point increase in the bribery rate is associated with a reduction in firm growth of 3 percentage points, an effect that is about three times greater than that of taxation.\(^12\) An analysis of firm-level data from Guatemala, Honduras, and Nicaragua concluded that the three categories that most impact business climate variables on productivity growth are red tape, corruption and crime, and infrastructure.\(^13\) Corruption has been found to have a negative impact on foreign and domestic private investment.\(^14,15\) Foreign direct investment inflows and private investment are higher in countries with good governance.\(^16\) Recent research concludes that some indicators of governance matter more than others. Effective government, including a competent and independent civil service and credible governmental policies, is positively associated with private investment. Fair and predictable rules of the game that determine the extent to which property rights are protected also facilitate private investment.\(^17\)

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6. Strong rule of law can improve formal firm growth. Also, research on transition countries indicates that entrepreneurs are more likely to reinvest their profits in the business if their property rights are protected. In particular, there is some evidence that enhancement of tenure security through land registration can lead to higher levels of investment and productivity and reduce the need to defend land rights. For example, research in the PRC, where more than 40% of farmers lack written documentation to confirm their land rights, shows that in areas where land registration reforms were implemented, farmers have been more likely to invest in and benefit from their land as they are less vulnerable to local governments taking away or selling off their land rights. Land registration has also been shown to increase activity in land rental markets, leading to higher efficiency overall. The ability to use land as collateral in credit markets has facilitated investment in the rural non-farm economy. However, evidence with regard to improved access to credit has been mixed. While some studies indicate a positive impact, others conclude that there has been little impact of land titling on increasing demand or supply for finance. The issue is whether tenants and other stakeholders, including potential creditors, perceive the security of land tenure to be irreversible, which might not be the case for politically motivated mass titration programs. Moreover, the issue depends on whether lack of security of title has really been the binding constraint to investing and obtaining credit. While land registration reforms seem to be largely beneficial for entrepreneurs, a review of existing research concludes that formalization of land rights should not be viewed as a panacea for poverty reduction efforts and that interventions should be decided only after a careful diagnosis of the policy, social, and governance environment (footnote 10). Particularly where customary land is involved, the introduction of formal land registration may have unpredictable effects, with the efficiency and marketization of existing forms of land tenure underestimated, the costs of formal registration underestimated, and the security of formal land title overestimated.

B. Access to Finance and Private Sector Development

7. The link between financial sector development and private sector development is fairly robust. A 10 percentage point increase in the ratio of broad money to GDP is associated with an acceleration in GDP growth of 0.25 percentage points per year. Subsequent work has refined these findings and has shown that the positive impact is channeled mainly through productivity gains rather than through capital accumulation. Research shows that higher levels of access to finance contribute to productivity increases and growth at the individual firm level.

8. Financial sector development, in particular private sector access to finance, depends on the overall investment and business environment. There is evidence that legal rights of borrowers and

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23 A recent impact evaluation of land titling reforms in Brazil found that land title increases the access to credit for about 60% or beneficiaries. See: Caio Pize and Mauricio José Serpa Barros de Mour. 2011. How Does Land Title Affect Access to Credit? Empirical Evidence from an Emerging Economy. Working Paper. Department of Economics, University of Sussex.
lenders are positively associated with private credit, gross private capital flows, and net foreign direct investments. An effective legal environment facilitates firms' access to finance. Although all firms are more likely to have loans from financial institutions in countries with stronger legal rights, the relationship is larger and more significant for small firms. A good court system that facilitates enforcement of collateral induces banks to lend more. Also, research from India concluded that the introduction of debt recovery courts significantly reduced loan repayment problems, which contributed to a reduction in interest rates.

9. Bank lending is higher, defaults are lower, and systemic risk monitoring is better in countries where lenders share credit information. A 2007 World Bank review found that information sharing is more important in low-income countries, while creditor rights matter more in high-income countries.

C. Infrastructure and Private Sector Development

10. Adequate physical infrastructure provision is a condition for investment and economic growth. World Bank research using enterprise survey data from Bangladesh, the PRC, Ethiopia, and Pakistan found that, even after controlling for firm characteristics and region- or country-level effects, power losses have a significantly negative effect on total factor productivity. The relationship between power generation and GDP growth is well established. The lack of a reliable power supply is often identified as one of the major problems affecting production, particularly by larger firms and exporters, and policies that improve the access and reliability of electricity supply have an important impact on business development. By comparison, transport is usually perceived as less of a business constraint, although research on African countries shows that deficient transport systems can add to production costs and significantly reduce the competitiveness of firms. Other analysis using data from the PRC, however, did not find a significant link between infrastructure and firm performance, which is likely due to decreasing marginal productivity of infrastructure given good infrastructure provision in the PRC study regions. This would indicate that the effects of infrastructure investments on firm productivity and performance are larger in countries or regions with poor infrastructure stock.

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39 M. Hallward-Driemeier, S. Wallsten and L.C. Xu. 2006. Ownership, investment climate and firm performance. Economics of Transition. 14. pp. 629-647. The study also found that by comparison, government regulatory burden, and corruption were significant factors.