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Making Finance Work for Africa

Patrick Honohan and Thorsten Beck

African finance operates in an extreme environment in terms of scale, informality, governance, and shocks

Entrepreneurs in Africa mention access to and cost of finance as barriers to their firms' growth more often than do those in any other part of the world. If only for that reason, improving the situation of the financial sector should be a priority for African policymakers.

Indeed, as a new study by Honohan and Beck finds, conventional measures of financial depth and efficiency show African countries falling considerably behind those in other regions. For example, the mean net interest margin in African banks, at 800 basis points, is about 320 basis points higher than the world average. Interestingly, the authors find that the gap is even larger if they compare a matched sample of affiliates of the *same* foreign-owned banks in Africa and elsewhere.

To explain the wider margins in Africa, the authors take a close look at bank-level correlates of the margins, such as operating costs, profitability, and loan loss provisions. They find that all these elements contribute to the wider margins. The higher profitability may be associated with high perceived risks. But it is also likely to be explained in part by less competition, as documented by the much higher concentration in the typical African banking system. A deeper interpretation traces the wider margins to scale and to deficiencies in the information and legal infrastructure. The authors show that their analysis leaves only 60 of the 320 basis points of difference unexplained.

The authors' analysis shows that financial depth is lower in Africa than elsewhere not only in raw terms but also when controlling for other factors, such as inflation, per capita income, and other plausible explanatory variables. (For some African countries, such as Mauritius and the Seychelles, which score well on depth measures, conditional underperformance is only marginally significant.) One associated factor here is the higher recorded African deposits in international banks abroad.

Credit-based depth is further below international comparators than are deposit-based measures of depth. Consistent with this, the authors find that liquidity in African banking systems is high and growing. Interestingly, the shallowest banking systems in the region are the *most* liquid.

The authors suggest that this pattern is consistent with a correlation between the degree of confidence of depositors in the banks (or in macroeconomic stability) and that of the banks in their borrowers. They discuss policy measures that can aid economic agents in building confidence, including improvements in credit information and in the legal infrastructure for assuring contract enforcement.

Trends in recent financial sector data for Africa reveal a distinct turnaround since the mid-1990s. Private credit and other depth indicators have been increasing steadily as a

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Water in the Middle East: How to Manage Scarcity

Julia Bucknall and team

Improving public accountability can turn political opportunities into better water outcomes

The Middle East and North Africa region faces big and rapidly increasing water problems (figure 1). Per capita resources, only a sixth of the global average, are set to decline by half by 2050. Overpumping of groundwater causes net depletion of national assets valued at the equivalent of up to 2 percent of GDP every year.

The situation is set to get worse. Climate change models predict a decrease in rainfall of at least 20 percent. Environmental degradation of water already costs 1–2.5 percent of GDP every year, and population growth will increase the water quality challenge. The price for taxpayers is high—one in four dollars of capital budgets goes to water in some countries—and expected to increase. The problems result from institutional as well as resource constraints. Institutions in the region are not yet able to adapt to changing water supplies and changing demands from the population.

Who will be affected by this accelerating challenge? Urban residents will see increasingly frequent service outages. Even now water is delivered only twice a month in Amman, Jordan, and only once a month in Taiz, Republic of Yemen. Deteriorating water quality will have an impact on human health and ecosystems. But the greatest impact is likely to be in agriculture, which uses around 80 percent of the region's water. Transforming agricultural production systems while protecting the poor will be a key part of managing the water challenge.

Excellent national strategies exist to guide the region's water ministries toward more efficient courses of action. But can they be implemented politically? A new report by a World Bank team looks at ways to navigate through the region's changing political economy. Unlike earlier studies, the report treats water as a development challenge rather than a sectoral one, analyzing the impacts of nonwater policies on water.

An international index of the quality of policies and institutions for managing freshwater shows that the region does fairly well relative to a comparable set of developing countries. Yet many nonwater policies inadvertently distort use of this scarce resource. Energy subsidies depress the cost of water services and encourage wasteful use, and price supports for staple crops encourage irrigation of thirsty, low-value crops. Subsidized credit encourages drilling of wells. And the region's overwhelming unemployment problem leaves rural populations dependent on agriculture for livelihoods.

The water problem cannot be managed by water ministries alone. And water reformers can have an important impact if they also work on reforming policies in other sectors.

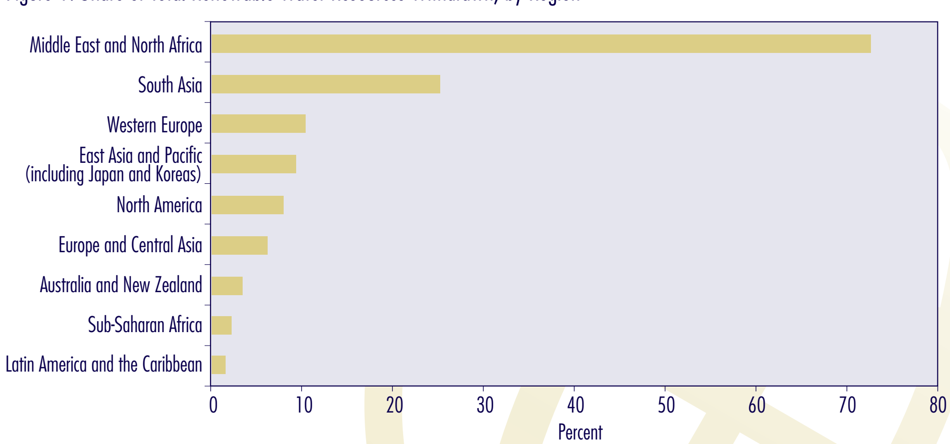
The report suggests that would-be water reformers analyze the changing dynamics of the political economy to seek opportunities for reform—and that changes in social, technical, environmental, and economic forces are indeed creating such opportunities. The region is experiencing, or on the cusp of, some major transformations—including rapid urbanization, growth of tourism, increasing education of girls, and potential transformation of agriculture. These will change interest group alliances. Educated women may lobby for more investment in sanitation. And a transformed agriculture changes both the ability of farmers to organize and lobby and the services they request. High-value farmers in the Arab Republic of Egypt and Morocco, for example, are lobbying for reliable rather than low-priced irrigation services.

The report also looks at public accountability, generally lower in the countries of the Middle East and North Africa than in other developing countries. Using an internationally comparable index of public accountability, it finds that countries in the region where authorities are more accountable provide better water services than those where authorities are less so. It concludes that measures to improve public accountability—such as releasing information about water services to the public, involving users in decision-making, and setting clear performance standards with consequences for failing to meet them—can turn potential political opportunities into actual improvements in water outcomes.

The report is optimistic that the region will meet its water challenges. But whether the changes can be made without massive cost, borne disproportionately by the poor, will depend on what reforms countries implement, in the water sector and elsewhere.

Julia Bucknall and team. 2007. Making the Most of Scarcity: Accountability for Better Water Management in the Middle East and North Africa. *Washington*, D.C.: *World Bank*.

Figure 1. Share of Total Renewable Water Resources Withdrawn, by Region



Source: Compiled from the Food and Agriculture Organization's AQUASTAT data for 1998–2002.
Note: The figure shows the sum of withdrawals across all countries in a region, divided by the sum of all the renewable water available in each country.

Fungibility and the "Flypaper Effect" of Aid

● *Dominique van de Walle and Ren Mu*

Some donor aid for a road project was diverted to recipients' own priorities—but it did stick to the road sector

The fungibility of aid—in which donor aid earmarked for a project substitutes for rather than supplements local spending intended for that purpose—has important implications for its effectiveness. And if aid ostensibly tied to a specific intervention simply displaces local resources, it becomes difficult to determine exactly what its development impact has been.

How much aid fungibility is there? There is little consensus. Most economists think that fungibility is the norm, while most aid donors behave as though there were none. The issue is routinely ignored in project work.

Aid fungibility has typically been examined using cross-country regressions on macro aggregates over time. In a new study van de Walle and Mu take a different approach, using impact evaluation methods to examine the issue in the context of project aid. They estimate the impact of a World Bank–financed rural road rehabilitation project in Vietnam on the kilometers of roads actually rehabilitated. The authors ask, did the aid for this project end up funding what the donor intended?

From a theoretical perspective the expected outcomes are ambiguous. Economic theory predicts that if project aid is less than or equal to what recipients intended to spend, they will spend as planned and treat the aid as general budget support. The aid will be fully fungible, and there will be no difference in impact between project areas and the nonproject areas used for comparison.

Against that is plentiful empirical evidence for "flypaper effects"—in which grants to local governments stimulate much higher local spending of the type intended than would an increase in community income, so that the money "sticks," like flies on flypaper. Theoretical contributions have shown how such effects can be generated. Others have argued that what appear to be flypaper effects are in fact due to biases in evaluation methods.

The Vietnam project stipulated that the work entail rehabilitating earth roads and not building new roads. Independent administrative data show that an average of 4.6 kilometers per commune were rehabilitated under the project. Supervision and other evidence confirm that the project was implemented as planned. Yet a casual look at the data suggests only half the expected difference between project and nonproject communes in increments of road rehabilitated during the project period. It also suggests that the project communes built significantly more new roads than the nonproject communes did.

> *Displacement occurred in that less rehabilitation took place than the aid had (ostensibly) financed. However, the aid stuck to the sector, with the donor getting more built roads*

Looking casually at data can be misleading. For example, if the project was implemented in communes with different characteristics than the nonproject comparators, simple mean differences will be wrong. Accurate impact assessments of rural roads have been rare because the necessary data are usually lacking. The authors' study is one of the first to use a panel data set of communes in project and nonproject areas before and after a project to rigorously examine road impact and fungibility.

The authors first ascertain that full fungibility is possible, since most of the project communes would have spent more on road rehabilitation without the project than they in fact received from the project. They then use a difference-in-difference estimator coupled with propensity score matching and weighting methods to determine the impact of the aid and rule out the alternative explanation that the results are due to model misspecification.

These impact evaluation methods confirm the conclusion drawn from a casual inspection of the data. The impact estimates, controlling for selective placement, suggest a *sectoral* flypaper effect: some of the project funds were diverted from rehabilitation to the building of new roads, but they did stay in the road sector. Diversion was less likely in communes that had been doing less rehabilitation before the project. Spending on rehabilitation plus building accords reasonably closely to the total project allocation.

Thus project communes ignored the donor's stipulation that they not build new roads. Instead, they imposed their own priorities and diverted some of the funding to priority road building. The authors also find that the quality of rehabilitated roads improved in the project communes. This again entailed a switch from the donor's preferred technology of rehabilitating earth roads.

Yet project aid did stick to the road sector. This is shown both by the estimated kilometers of rehabilitated and built roads and by supporting evidence that the project did not lead to the construction of other basic infrastructure.

Impact evaluations have become more sophisticated in recent years, worrying about selection, impact heterogeneity, and attrition bias. Yet evaluations still rarely establish that an intervention actually funded what it was intended to fund and was supplemental to local spending. One conclusion from the analysis is that ascertaining this should be a first step in evaluating the impacts of development projects.

Dominique van de Walle and Ren Mu. Forthcoming. "Fungibility and the Flypaper Effect of Project Aid: Micro Evidence for Vietnam." Journal of Development Economics.

Do Girls Gain from Migration-Induced Male Absence?

● *Ghazala Mansuri*

Girls have bigger health and education gains than boys in households with migrant males—except in those headed by women

Recent debates on "feasible globalization" have focused on the importance of opening up international labor markets to low-skilled guest workers from developing countries. Liberalizing labor markets in this way, it is argued, would lead to large gains in income and could help reduce inequalities of wealth and opportunity both within and across countries. Key to this is the expectation that remittances from migrants will fuel private investment in human capital in their communities of origin. Where gender gaps in human capital indicators are large, remittances are also expected to reduce gender inequalities.

Migration can affect household behavior through a number of competing channels, however, creating new constraints that could dampen this potential enhanced investment. Most significant are migration-induced changes in household structure. Children in migrant households often have less adult supervision and are required to spend more time on household production, the care of younger siblings, or other domestic chores.

Conversely, where migration is undertaken mainly by men, and there are important gender differences in preferences relating to child welfare, migration-induced "male absence" could change the balance of household preferences in a different direction. A substantial body of research has shown that investments in children tend to increase where mothers exercise greater control over the use of household resources. To the extent that girls gain more from such a change in preferences, male migration could well amplify gender differences in the gains from migration.

In two recent papers Mansuri examines the extent to which the expected gains from migration are borne out in rural Pakistan, where migration for work is substantial—with more than one in four families reporting at least one migrant—and migration is largely temporary and legal. The papers focus on household investments in child health and schooling, arguably the two most important contributors to inequalities of opportunity.

Work migration is undertaken exclusively by men, and female headship is almost exclusively a result of temporary migration-induced male absence. This makes the context particularly useful for examining gender differences in human capital investment not only between households with and without migrants, but also between migrant households, by female headship.

The key empirical problem in assessing the impact of migration on household behavior is that household characteristics that influence the decision to migrate are also likely to affect other household outcomes, including child schooling, labor market activity, early childhood growth, and any observed gender disparities in all of these.

The papers use two strategies to deal with this potential endogeneity problem: instrumenting for migration, and comparing siblings within migrant households by exploiting the fact that many schooling and health decisions are time sensitive. Finally, the analysis obtains the impact of female headship by comparing female-headed migrant households with male-headed ones.

Using two measures of early child growth (weight-for-age and height-for-age z-scores), instrumental variable estimates show significantly better growth outcomes among children in migrant households. Moreover, the effects are much larger for girls. And estimation on samples disaggregated by age indicate that this advantage is sustained as girls age, affirming the potential intergenerational benefits of averting nutritional and other health shocks in early childhood.

Migration also has a significant and positive effect on all schooling decisions and a strong dampening effect on child labor market activity. This suggests that the opportunity cost of time spent by children in school may be substantial, at least for some households.

Most important, migrant households make much larger investments in the schooling of girls, leading to a significant reduction in gender gaps in school enrollment, retention, and attainment. In contrast, there are no gender differences in labor market activity. Thus the smaller relative gains for boys do not appear to reflect higher labor demands.

A comparison of siblings corroborates these results.

Interestingly, though, while female headship has no impact on school enrollment for either boys or girls, adolescent girls in female-headed migrant households are much more likely to drop out of school and consequently have lower school attainment. The opposite is true for boys. They do significantly better in such households. Is this because female headship has a differential impact on the work burden of children? The data do not support this. While both boys and girls work substantially more in female-headed households, there are no gender differences in work burden. Nor does female headship have an impact on the woman's own labor supply.

This suggests that migration-induced female headship may create constraints that dampen at least some of the gains from migration. In particular, the evidence suggests greater restrictions on the mobility of adolescent girls, perhaps due to the greater social vulnerability of female-headed households.

Ghazala Mansuri. 2006. "Migration, School Attainment, and Child Labor: Evidence from Rural Pakistan." Policy Research Working Paper 3945. World Bank, Washington, D.C.

———. 2006. "Migration, Sex Bias, and Child Growth in Rural Pakistan." Policy Research Working Paper 3946. World Bank, Washington, D.C.

The Distributional Effects of WTO Agricultural Reforms in Rich and Poor Countries

Thomas Hertel, Roman Keeney, Maros Ivanic, and L. Alan Winters

The mix of high levels of support, specialization, and great wealth is toxic for agricultural reform

The modern apology for preserving rich countries' agricultural protection is that it supports poor farmers in the North and that liberalization would benefit only rich landowners in the South. Both assertions contain grains of the truth, but a new article by Hertel, Keeney, Ivanic, and Winters shows that the predominant effects are the very opposite.

The authors explore two liberalization scenarios: first, a prediction based on the WTO's Hong Kong Ministerial (December 2005) of what the Doha Round might bring in agriculture (75 percent cuts in tariffs, 60–75 percent cuts in domestic support, and the abolition of export subsidies), and second, complete liberalization. They translate these general rules into changes in policies on more than 5,000 products before reaggregating them into a manageable number of categories.

The authors convert the policy changes into resulting medium-run (three- to five-year) changes in prices, outputs, and factor rewards using a global simulation model (GTAP-AGR). The model contains detailed treatments of farm input and production decisions, labor and land markets, and consumption patterns.

Finally, the authors calculate the effects on farm incomes in developed countries and on poverty among all households in 15 developing countries on which they have good data on the sources of income. Among developed countries they give the United States special attention, identifying farm households specializing in four heavily supported sensitive crops—rice, sugar, cotton, and dairy—by their place in the wealth distribution.

For each developing country the authors distinguish seven strata of households by their main income source. They then calculate for each stratum the poverty elasticities at the poverty line ($1 or $2 a day), showing the sensitivity of the number of poor to changes in the prices of consumer goods, in taxes, and in each of 10 sources of income. The global model estimates how these prices and factor incomes change with liberalization, and from these two sets of information the authors calculate the poverty effects.

In developed countries the average farm household earns most of its income from nonfarm activities. Thus in Japan, for example, Doha liberalization might cut farm earnings by 16 percent but boost farmers' nonfarm earnings by 0.6 percent. The net effect is an income loss of just 1.4 percent, because agriculture provides only 12 percent of total earnings for Japanese farm households on average.

In the United States most farms earn little from farming, but large farms producing sensitive products are highly specialized, with the richest deriving up to 90 percent of their income from agriculture. Full agricultural trade liberalization would cut the total income of the wealthiest rice farmers by about 19 percent and that of cotton farmers by 13 percent. This combination of high levels of support, specialization, and great wealth is toxic for agricultural reform.

In the developing economies, rich-country agricultural trade liberalization boosts real returns in agriculture—for land and farm workers—and cuts them elsewhere. How this translates into national poverty depends on a range of factors. The effects, though varied, are generally rather small, even for the abolition of rich countries' agricultural trade barriers. Table 1 reports on four illustrative economies.

Brazil and Thailand are big gainers. The increased demand for their agricultural exports boosts rural incomes, and because agriculture is relatively important for unskilled workers, their wages also rise more generally. Because the poor are clustered around the poverty line, the income benefits shift substantial numbers above it.

Bangladesh and Zambia miss out, especially in the Doha scenario. Part of the reason is that Doha includes the abolition of rich countries' export subsidies—which does little or nothing for poverty in most developing countries because the poor either are isolated or are net purchasers of the commodities affected. In addition, Bangladesh loses because it is an importer of cotton, and Zambia because its farmers are so isolated that they receive relatively little increase in demand and so poor that what they do get is insufficient to pull them above $1 a day.

The authors also compare the "poverty friendliness" of different types of trade liberalization. Agricultural liberalization has larger poverty effects than nonagricultural liberalization. And developing countries' own agricultural liberalization always reduces poverty, in most cases more so than rich countries' reforms. It both reduces the prices of staple foods for the poor and creates market opportunities because developing countries trade a good deal with one another. That Doha requires very little trade liberalization by developing countries is a clear source of weakness in its poverty-reducing credentials.

Thomas Hertel, Roman Keeney, Maros Ivanic, and L. Alan Winters. Forthcoming. "Distributional Effects of WTO *Agricultural Reforms in Rich and Poor Countries."* Economic Policy.

Table 1. Effects of Rich-Country Liberalization of Agriculture on National Poverty

	Full liberalization		Doha liberalization	
Country	Percent	Thousands	Percent	Thousands
Bangladesh	–0.06*	–27*	0.00*	0*
Brazil	–1.88	–431	–0.73	–167
Thailand	–7.10	–84	–1.43	–17
Zambia	0.13	8	0.03	2

* Result cannot be distinguished from zero change at the 95 percent confidence level.

Note: The table shows percentage and absolute changes in the population below a poverty line of $1 a day, with a negative value indicating a reduction in poverty.

Clientelism, Credibility, and the Policy Choices of Young Democracies

Philip Keefer

When elected governments fail to promote broad social welfare, the solution may be reforms to increase political credibility

An important development puzzle is that among poor countries *elected* governments do not make dramatically different policy decisions than *unelected* governments. In a new article Keefer shows that in poor democracies measures of governance, schooling, infrastructure, government spending as a fraction of national income, and the business climate are generally about the same as or worse than those in poor nondemocracies.

This finding is inconsistent with the common assumption that competitive elections should make politicians notably *more* responsive to the concerns of the general public. Understanding why the assumption fails to hold—why policymakers in some democracies are not more sensitive to broad social welfare—is key to the design of successful development strategies in those countries.

Keefer presents new evidence showing that the cleavage in democratic performance also runs between young and old democracies. Countries with fewer continuous years of competitive elections are more reluctant to provide public goods (education, access to information, high-quality bureaucracies, the rule of law), more enthusiastic about private goods (jobs in the public sector, pork barrel infrastructure), and less restrained in the exercise of rent seeking and corruption. While there is a substantial overlap between young and poor democracies, the differences between younger and older democracies persist even when controlling for income per capita.

The best explanation for this particular pattern of policy performance is the inability of political competitors to make policy promises that are credible to all citizens. When citizens believe the broad policy promises of political competitors, electoral competition forces them to bid up the performance promises they make to voters. When promises are not credible, voters can rely only on past performance and clientelist promises (promises from political competitors that are credible to narrow groups, or individuals, in society). Neither provides a strong basis for electoral accountability.

Reliance on past performance can lead voters to retain even poorly performing incumbents, since voters cannot be sure that noncredible challengers will perform better. Reliance on credible clientelist promises, as Keefer and Vlaicu show in a 2005 paper, drives politicians to underprovide public goods and to overprovide targeted goods that benefit narrow constituencies that happen to believe the politicians' promises. This is the pattern of policy performance observed in young democracies: they are exceptionally accountable for private good provision, but exceptionally unaccountable for public good provision.

The association between democratic age and this pattern of policies is robust to many alternative explanations. In describing the political market imperfections that interfere with electoral accountability, Keefer and Khemani, in a 2005 article, also point to imperfectly informed voters and social polarization, which may particularly afflict young democracies. Young democracies may also exhibit systematically different political and electoral institutions or face greater exposure to political violence.

Theoretically, though, these competing explanations either are embedded in the credibility argument (information) or predict patterns of performance other than that observed among young democracies. Empirically, none of these variables affects the significant association of democratic age with lower public good provision, higher private good provision, and greater corruption. Nor does it appear that unobserved effects, unrelated to the credibility arguments, simultaneously determine government policy choices and democratic age.

These results point to the importance of reforms that increase political credibility. Credibility depends most on actions by politicians (such as investing in the programmatic reputation of their political parties); donors can do little to influence these. But it also requires that citizens have the information to verify whether politicians have fulfilled their promises. Policies to boost citizen information about policy outcomes, and a corresponding relaxation of government controls on information, are therefore key and already have a place in the donor toolkit.

The analysis also suggests reform strategies in the absence of political credibility. For example, reforms that are difficult for citizens to observe and are broad in their effects (such as civil service reform) are more likely to succeed if they are linked to specific outcomes that citizens can monitor (textbook delivery, road maintenance) and more strictly supervised.

Some reforms that appear to be economically inferior may also be preferable if they help to build credibility while satisfying the incentives of politicians to give targeted benefits (increasing capitation grants for students rather than increasing funding for schools generally; increasing redistributive grants to the poor rather than increasing the quality of services to the poor).

Demand-side interventions to accelerate reforms should focus on the civil society groups that have the most comprehensive strategies for bridging the credibility gap between politicians and citizens.

Philip Keefer. Forthcoming. "Clientelism, Credibility and the Policy Choices of Young Democracies." American Journal of Political Science.

Entry Regulation as a Barrier to Entrepreneurship

Leora Klapper, Luc Laeven, and Raghuram Rajan

Regulatory barriers against entrepreneurship hamper the creation of new firms, discourage the entry of small firms, and affect even older firms, which grow more slowly and to a smaller size

Entrepreneurship is important for the continued dynamism of the modern economy and contributes to economic growth. Yet many countries put in place regulations that make it more difficult to start a new firm. In a new paper Klapper, Laeven, and Rajan look at the cost of meeting the regulatory requirements for setting up a limited liability company and study the effect of such entry regulations on the creation of new firms, the average size of firms that finally are able to incorporate, and the dynamism of incumbent firms.

The authors start by investigating the cross-country picture of the incorporation of new firms, using a comprehensive database of corporations across a large number of developed and transition economies in Europe. Some facts are striking. Italy, for example, with its myriad small corporations, might be expected to have tremendous incorporation of new firms. In fact, new corporations (those that are one or two years old) represent only 3.8 percent of the total in Italy. In contrast, the average for France, Germany, and the United Kingdom is 13.5 percent.

To study whether entry costs affect the extent of incorporation, the authors examine whether the share of new corporations is lower in an industry with a higher "natural" propensity for entry when the country has higher costs of complying with bureaucratic requirements for incorporation. They find that the rate at which new corporations are created in "naturally high-entry" industries is relatively lower in countries with higher entry costs, suggesting that these costs matter. Interestingly, the costs matter most in richer countries and in countries that are not corrupt, where the regulations on the books are more likely to be enforced.

These findings suggest an explanation for the low level of incorporation in Italy: the average direct cost of complying with the bureaucratic regulations for registering a new corporation in Italy is 20 percent of per capita GNP—twice the average for other G-7 countries in Europe.

The authors next study the effect of bureaucratic entry regulations on the average size of entrant firms. Since the high entry costs are largely fixed, they should be reflected in a larger average size of entrants into high-entry industries in countries with high costs. The authors find that this is indeed the case. That means that such regulations not only discourage small firms from setting up, they also force others to grow without the protection of limited liability until they reach a scale at which they can afford the cost of incorporation.

If entry regulations indiscriminately screen out small young firms, constraints on their emergence should mute the disciplinary effects of competition, with older firms more likely to be lazy and less capable of enhancing productivity. Testing whether entry regulations affect the productivity growth of older incumbent firms, the authors find that value added per employee for older incumbents grows relatively more slowly in naturally high-entry industries in countries with costly bureaucratic barriers. Thus costly entry regulations are a form of protection that has the most deleterious effect on the performance of seasoned incumbents.

By hampering the creation of new firms, costly entry regulations serve as a form of protection. The absence of the disciplining effect of competition from new firms has real adverse effects

Here, a comparison between Italy, with high entry barriers, and the United Kingdom, with low ones, is particularly telling. Across all industries, firms start out larger when young in Italy, but then grow more slowly—so that by age 10, firms in the United Kingdom are about twice as large as those in Italy. This suggests that Italy has small firms not because there is too much entry but because there is too little.

To check whether entry regulations proxy for other aspects of the business environment that are likely to have an impact on entry—such as financial development, labor regulation, and protection of intellectual property—the authors include these environmental variables interacted with the characteristics of the industry they are most likely to influence. The results show that these aspects of the business environment do matter, but primarily for the rate of incorporation, not for the size of entrants or the productivity growth of incumbents. Particularly noteworthy is that the harmful effects of onerous entry regulations persist despite the inclusion of these other interactions.

Leora Klapper, Luc Laeven, and Raghuram Rajan. 2006. "*Entry Regulation as a Barrier to Entrepreneurship.*" Journal of Financial Economics 82 (3): 591–629.

(continued from page 1)

share of GDP—and the increase is broad. Indeed, four of every five countries for which data are available have had an increase in financial depth since 2000.

Similarly, organized securities markets have shown a sharp increase in capitalization and listings in the past few years. In the Lagos stock exchange alone about $3 billion in new capital was raised in 2006 to meet the new banking capital requirements. And listed bonds have increased in number and maturity.

The region's stock exchanges are still very small (except for Johannesburg's). But a comparison of their performance with that of other developing country exchanges using the World Bank's financial sector development indicators (*http://www.fsdi.org*) shows that African markets are close to the average in size (relative to the economy), access, and stability. Only in efficiency are African markets well behind the rest—a deficiency that again can be associated with gaps in the information infrastructure.

The shortcomings of African finance can be attributed largely to the fact that it operates in an environment that is extreme in four key dimensions: scale, informality, governance, and shocks. The authors examine alternative policy solutions that have been suggested to deal with these and distinguish between two approaches: *modernist* and *activist*.

Each approach has its advocates and its strengths, though each also can overreach. Modernist solutions sometimes overreach by unthinkingly attempting to transplant models from advanced economies into unprepared environments (an example is the advanced version of the Basel 2 capital accord for banks). Activism is surely necessary to help ensure direct access for all to the needed financial services, but weak governance is its Achilles' heel. The authors review how these tensions can be resolved in instances ranging from microfinance regulation to regional cooperation on currency unions.

Patrick Honohan and Thorsten Beck. 2007. Making Finance Work for Africa. *Washington*, D.C.: World Bank.

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