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UNITED NATIONS
ECONOMIC COMMISSION FOR EUROPE

Review of the implementation of OSCE commitments in the economic and environmental dimension

Investment climate: A UNECE report

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Prague, Czech Republic
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Table of contents:

This presentation describes and reviews key features of investment climate:

- FDI
- The size of informal economies
- Macroeconomic stability
- Institutions
- Physical infrastructure
- A benchmarking exercise where countries are compared in terms of various factors that affect investment decisions
- Focus on decisions to invest in physical capital by individual entrepreneurs and companies (human capital not discussed)

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OSCE commitments:

- There are explicit and implicit references to investment climate as an OSCE commitment:
- "The participating States wish to create favourable conditions for a harmonious development" and "they therefore agree to improve business conditions" (The Bonn Document, paragraph A.1).
- "The participating States are prepared, insofar as the appropriate conditions exist, to foster a favourable climate for investment" (paragraph A.6).
- "Economic dimension [will] receive appropriate attention" with a view "to ensure the rule of law and the development of a transparent and stable legal system in the economic sphere" (The Charter for European Security, paragraph 31).
- Participating States "will step up exchange of information and experience on the best means of attracting investment, in particular foreign direct investment, and removing the obstacles to it" (The OSCE Strategy Document, paragraph 2.1.13).

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Investment climate:

- Difficult to define
- Characterizations such as "conduciveness of private investment and enterprise growth" or "the state of enabling environment for private enterprise" have been used
- In general, a sound investment climate could be described as the conditions that make up the enabling environment in which private enterprises thrive by investing and producing

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Two aggregate measures:

Foreign direct investment

- Foreigners – given their global perspective and choice - can be expected to invest only in the countries that meet their investment criteria

Informal economy

- Domestic entrepreneurs often escape what they perceive as an unfavourable investment climate by hiding their activities from governments

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Foreign direct investment:

- Foreign investors select a specific location based on the expected profitability and on the type of investment
- The rationale is determined by the specific characteristics of the preferred location: market size, availability of cheap and skilled labour, presence of natural resources, proximity to the home country or access to good financial and physical infrastructure
- Depending on their interest, foreign investors will place varying emphasis on particular elements
- High level of protectionism, barriers to foreign investment, restrictions to banking and finance and generally weak protection of property rights discourage foreign investors

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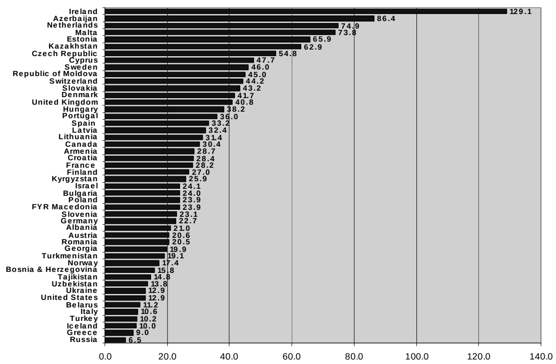
Figure 1
Inward FDI stocks as a percentage of gross domestic product, 1980-2002



Source : World Investment Report 2003, UNCTAD.

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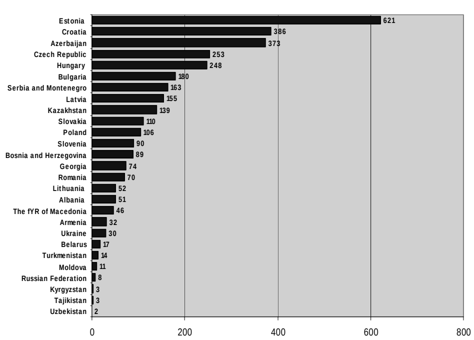
Figure 2
FDI Inflow per capita, 2003
(in US dollars)



Source : UNECE Database and national statistics

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Informal economy:

- The overall investment climate can also be gauged by the size of informal markets
- Informal markets are the direct result of government intervention in the marketplace (through taxation, regulation or outright prohibition)
- Some have argued that it is not higher taxes or regulation per se but the ineffective and discretionary application of the tax rules and government regulations

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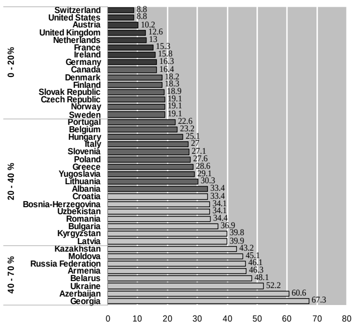
Figure 4
Informal Economy as a percentage of GNP 1999/2000



Source : Friedrich Schneider : Size and Measurement of the Informal Economy in 110 Countries around the World, July 2002, available at http://rru.worldbank.org.

Investment climate depends on a large number of factors that can be grouped into three broad clusters:

- Macroeconomic stability
- Institutions
- Physical infrastructure

Macroeconomic conditions:

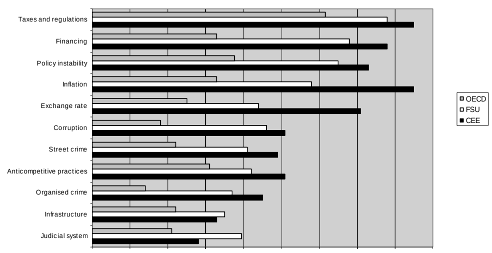
- Prudent macroeconomic policies are those policies that result in low inflation and fiscally responsible actions
- A number of factors that significantly affect macroeconomic stability include, but are not limited to, the growth in GDP, price stability, financial stability, fiscal and current account balances
- Recent economic developments in the UNECE region show promising impacts of greater economic stability and growth

Institutions:

- Institutions are necessary to support markets
- They range from formal rules such as laws and informal customs that govern behaviour to mechanisms such as organizations or reputation that enforce these rules
- Institutional framework conducive to productive investment centres on:
  - the legal and regulatory system that promotes competition
  - good governance
  - it improves access to financial services
- Governments – as elected representatives of societies - play the key role in the design and implementation of formal institutions

- The most comprehensive survey of investment climate to-date has confirmed the primary role governments play in shaping the investment climate
- Regulations, taxes, financing, political instability and inflation have been identified as key concerns for businesses around the world (Figure 5)

Figure 5
Constraints on Firms, 2000
(in per cent)



Source: G. Batra, D. Kaufmann and A. Stone, *Investment Climate Around the World*, the World Bank, Washington D.C., 2003, pp. 30-33.

Note (1): "OECD" denotes Canada, France, Germany, Italy, Portugal, Spain, Sweden, United Kingdom and United States;
"CEE" denotes Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Hungary, Poland, Romania, Slovak Republic, Slovenia and Turkey;
"FSU" denotes the countries in the former Soviet Union: Armenia, Azerbaijan, Belarus, Estonia, Georgia, Kazakhstan, Kyrgyz Republic, Lithuania, Moldova, Russia, Ukraine and Uzbekistan.

Note (2): Percentage of firms identifying these factors as "problematic for their operations and growth."

Financial sector:

- High interest rates, limited access to credit, unreasonable collateral requirements and lack of credit information about customers are business impediments
- Figure 6 provides a ranking of 38 countries based on conditions in their domestic credit markets

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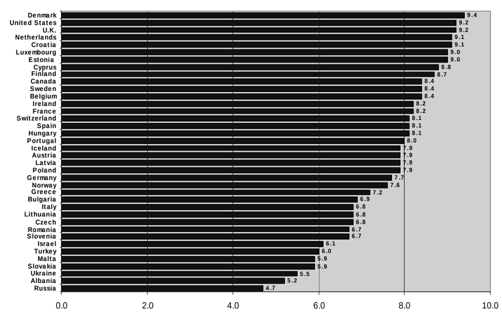
Figure 6
Credit Market Regulations, 2001



Source : Economic Freedom of the World : 2003 Annual Report, http://www.fraserinstitute.ca.

Note : Scale from 0 (in principle, a state-owned banking sector allocates credit to state-owned enterprises) to 10 (a private banking system allocates credit to private sector). The rating consists of the following sub-components: percentage of deposits held in private banks, presence of foreign banks, percentage of credit extended to private sector and interest rate controls

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Property rights:

- Secure property rights are the foundation of incentives for individuals and firms to invest
- Market based transactions may be meaningless unless they are accompanied by secure property rights, the effective enforcement of contracts and just settlement of disputes
- Protection of persons and property is the most important function of the government

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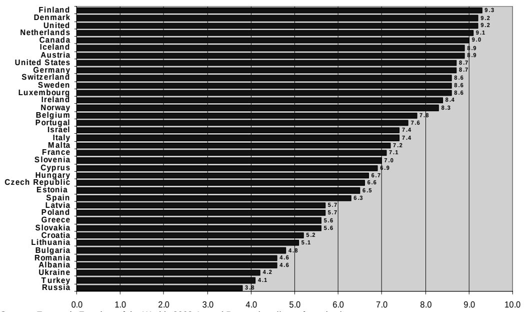
Figure 7
Legal structure and security of property rights, 2001



Source : Economic Freedom of the World : 2003 Annual Report, http://www.fraserinstitute.ca

Note : Scale from 0 to 10. The higher the rating, the greater the security of property rights. Figure 7 measures how well the protective function of government is performed, The ranking is a combination of independent and impartial courts, protection of intellectual property, military interference in the political process and integrity of the legal system.

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Government regulation of business:

- Regulation consists of governmental actions to control price, sale and production decisions of firms in order to achieve some public benefit
- Regulations are effectively a form of taxation and are often necessary
- Typically, regulation aims to address market failures, to create and sustain competitive markets, to compensate for inadequate information, to ensure consumer safety or to meet some other social objective

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Government regulation of business:

- Figure 8 presents a ranking illustrating the extent of business regulations. The ranking is made up of price controls, administrative procedures, estimated time spent with bureaucracy, the ease of starting a new business and the necessity of paying bribes

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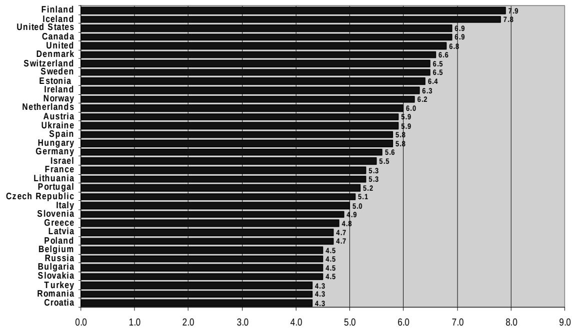
Figure 8
Business Regulations, 2001



Source : Economic Freedom of the World : 2003 Annual Report, http://www.fraserinstitute.ca.
Note : Scale from 0 to 10. The higher the rating, the lesser the regulatory burden on business.

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Government regulation of business:

- Regulations make it more difficult for entrepreneurs to start and maintain a business
- If regulations are unnecessary or designed and/or implemented inappropriately, they may limit a company's ability to compete, distort its business decisions or deter investment entirely

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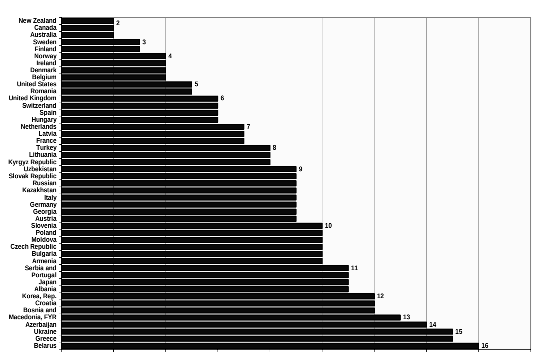
Number of procedures required to register a firm:



Source: http:rru.worldbank.org based on Simeon Djankov, Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer The Regulation of Entry, *Quarterly Journal of Economics*, 117, 1-37, Feb. 2002

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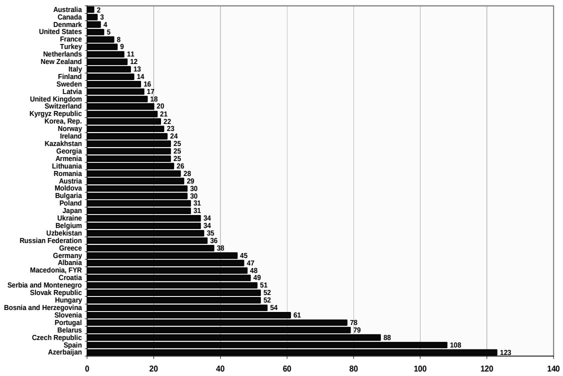
Number of days required to register a firm:



Source: http:rru.worldbank.org based on Simeon Djankov, Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer The Regulation of Entry, *Quarterly Journal of Economics*, 117, 1-37, Feb. 2002

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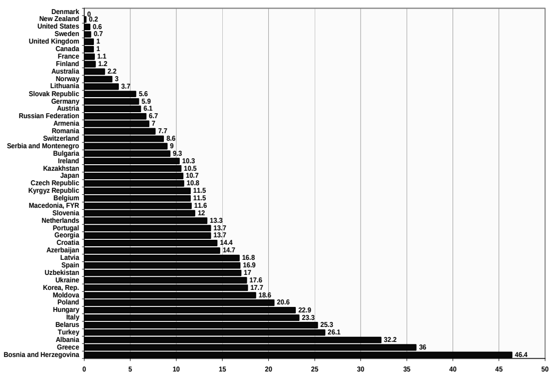
Cost of registering a firm as a % of Gross National Income:



Source: http:rru.worldbank.org based on Simeon Djankov, Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer The Regulation of Entry, *Quarterly Journal of Economics*, 117, 1-37, Feb. 2002

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Physical infrastructure

- The quality and availability of physical infrastructure such as electricity supply, road network and telecommunication links can have a significant impact on the incentives to invest
- In many countries access to quality infrastructure services is insufficient and significant financial resources are required to develop and/or enhance it
- Many countries are unable to accumulate the needed resources for the purpose of investing and upgrading physical infrastructure due to fiscal constraints
- Private investment in infrastructure faces a challenging regulatory and institutional environment in many countries, particularly in the former centrally planned economies

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Conclusions:

- Entrepreneurship exists everywhere
- Governments are largely responsible for creating and maintaining favourable investment climate
- Three building blocks: macroeconomic stability, institutions and physical infrastructure.
- Investment climate depends crucially on setting up institutions that are necessary to support economic growth and structural change

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