

CHAPTER 5

Attracting Private Investment

Introduction

Earlier analysis in this report has indicated that sustained growth demands significant improvements in export performance in most SEE countries. Export patterns are inimical to sustained export growth and in many cases are vulnerable to competition from lower-wage countries. FDI remains low, despite recent increases in inflows. Deeper integration between SEE countries—such as complete implementation of CEFTA 2006, the reduction of border frictions, effective implementation of rules of origin within CEFTA 2006 countries, and the expansion of SEE participation in pan-European-Mediterranean Cumulation of Origin arrangements (an ongoing process)—would contribute to market contestability and the development of a larger market, and thereby help attract FDI. Deeper integration between CEFTA countries in services could also contribute significantly to improving service quality and thereby enhance overall productivity of the SEE economies.

FDI could be considered the centerpiece of efforts to sustain and improve export growth and thereby GDP growth. FDI would be attracted by a larger, single economic space, but FDI (such as in services) would itself contribute to the creation of such a space. Creating a single economic space requires some coordinated policy action at the regional level, as

discussed earlier. It would also need each country to implement its own policies in support of the regional agenda (such as improving customs to allow cumulation of rules of origin with the EU).

By itself, however, policies to create a single economic space will not be enough to attract FDI; otherwise all large, middle-income countries would be receiving significant FDI. In addition to these policies, attracting FDI would require the improvement of selected aspects of the investment climate; an agenda that is particular to each country. Given the problem of low capital investment in most SEE countries (see chapter 1), investment climate improvement should also help attract not only more FDI but also more (and better quality) domestic private investment.

Investment climate analysis is subject to the pitfall that it ends up with a laundry list of “priority reforms” that are demanded by business. To overcome this, the next section of this chapter adopts an eclectic approach, which relies, in the first instance, on distance of constraints from the comparator country, the Slovak Republic. It then differentiates responses from different types of firms, and points out that high-performance firms face multiple constraints. The third section discusses some case studies of firms in different environments. The fourth section discusses possible priorities for investment-climate reform. The fifth section examines the regional institutional dimension for investment-climate policy coordination, and the final section offers concluding remarks.

The central theme of the chapter is that SEE countries need to improve the quality and quantity of human skills (echoing one of the findings of previous chapters) in order to prepare for faster and more export-oriented growth and for the demands of increasingly privatized economies. This is urgent, given the long lags in human capital formation and the below-par quality of education outcomes in many countries. Failure to do so would also leave countries vulnerable to low-wage competition in their increasingly open export and domestic markets. Another priority includes improving the quality of telecommunications, given high costs (and therefore large potential payoffs) despite improved penetration of mobile telephones. Besides enhancing economic productivity in general, this would also help improve logistics and enhance regional integration. A third priority involves preemptive action to prevent possible future shortages in power availability. This agenda does not mean that the most important current constraints, which include tax rates, anticompetitive practices of others, access to finance, the judicial system, and so on, should be neglected. However, this chapter suggests that there are other areas which have not received the attention they deserve, and that government priorities may need some

reordering to accommodate human capital, telecoms, and power as likely future and possibly binding constraints to *future and faster growth in SEE*. It is important to remember that the italicized part of the last sentence implies that as the easier, post-transition phase of growth winds down, future growth will increasingly be led by the private sector, and be based, among other things, on stronger export performance and improved labor skills.

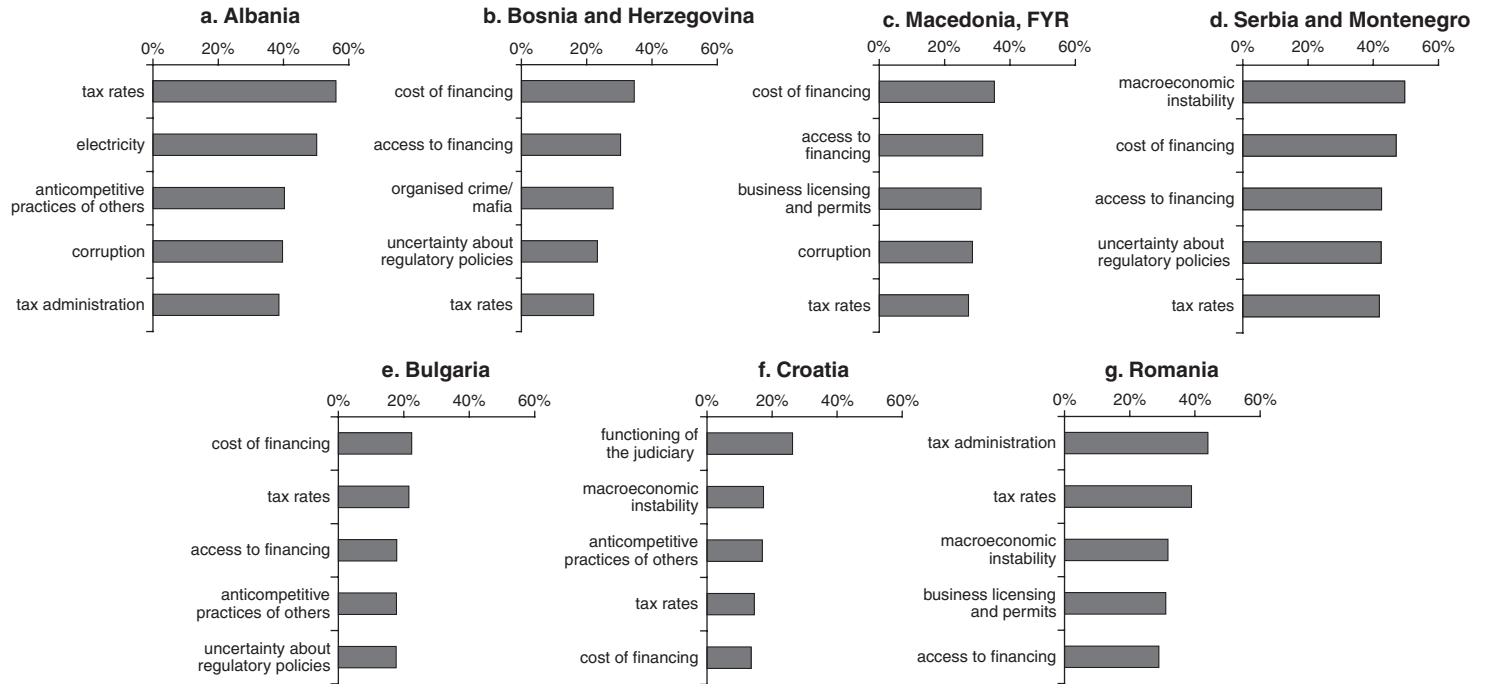
Reordering priorities does not necessarily mean reordering government expenditures, and certainly not to the same relative degree as would be suggested by changes in priorities. In different countries, improved human capital formation could mean more expenditures, but, recognizing that expenditure and outcomes are very loosely related, perhaps more attention could be paid to improving the quality of education.¹ In telecom, the private sector could take care of most investment needs, but more competition and stronger regulators would be needed to further reduce costs of telecommunications. In power, too, more effort at attracting private sector investment within a sound regulatory framework and furthering regional energy cooperation could help alleviate current and future energy shortages.

Business Perceptions

Figure 5.1 presents a variant of the usual business perceptions survey. It shows the top five gaps (as opposed to absolute values) in perceptions of constraints between SEE countries and the reference country, the Slovak Republic, using BEEPS data.² In 2005, firms in Albania and Serbia and Montenegro reported significant gaps (in excess of 40 percentage points) in perceptions of constraints: tax rates for both countries; electricity, anticompetitive practices of others, and corruption in Albania; and macroeconomic instability, cost of financing, access to financing, and regulatory policy uncertainty for Serbia and Montenegro. For FYR Macedonia and Bosnia and Herzegovina, the gaps are not as large, but are still in excess of 30 percentage points in the case of cost of finance and access to finance.

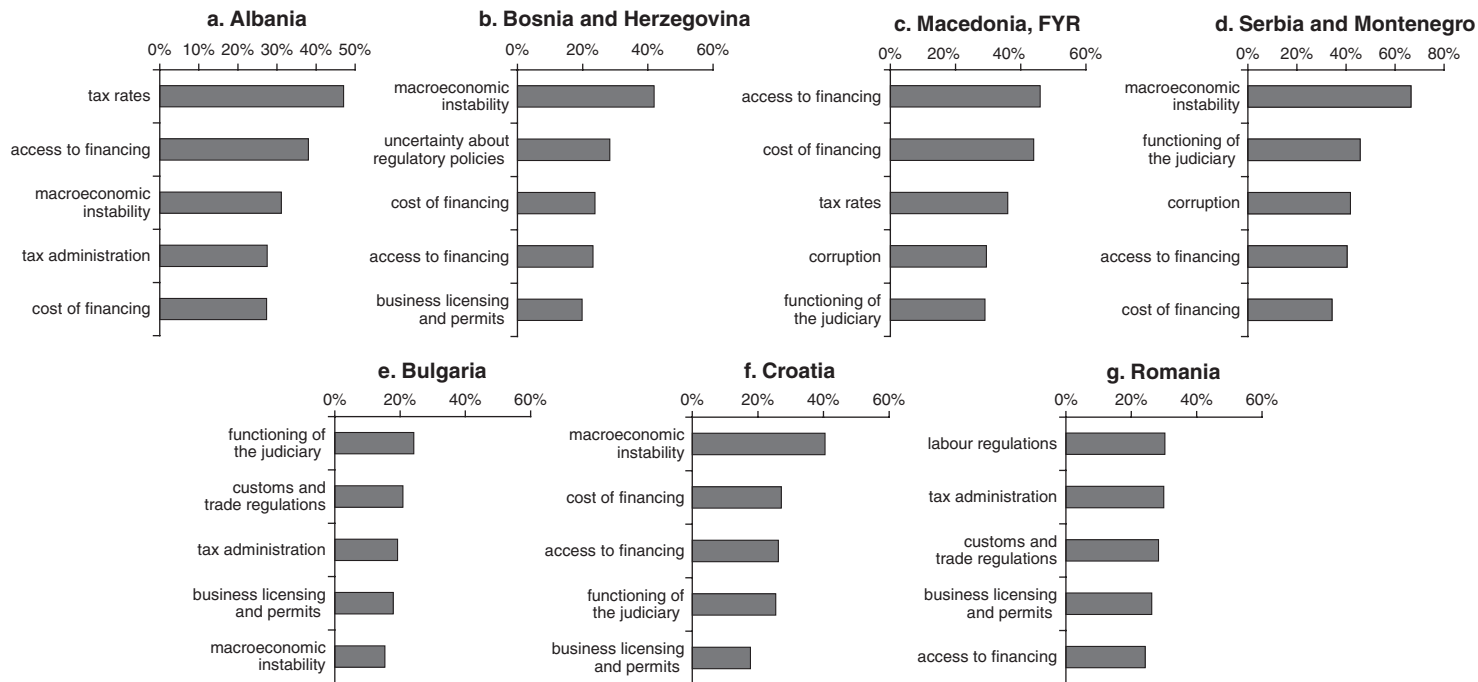
Perhaps a more interesting story is the increase in the gaps over time. Figure 5.2 shows the difference in key perceptions between a SEE country in 2005 minus the same difference in 2002, again presenting the five cases where the difference has been the highest. In general, given that the SEE5 countries are at an earlier stage of reforms and have EU aspirations, one would expect the gaps with the Slovak Republic, an EU member country since 2004, to close over time.³ However, the reverse has happened

Figure 5.1. SEE Countries: Key Gaps in Perceptions of Business Constraints Compared with the Slovak Republic, 2005



Source: BEEPS 2005.

Figure 5.2. SEE Countries: Key Changes in Perceptions of Business Constraints Compared with the Slovak Republic, 2005



Source: BEEPS 2005.

(figure 5.2 shows the changes between 2002 and 2005). In 2002, the overall gaps between perceptions in SEE5 and the Slovak Republic were much lower for all countries, and for FYR Macedonia the overall gap⁴ was actually in favor of FYR Macedonia. Areas where the gaps are now significantly higher for SEE5 include access to and cost of financing in all cases. Macroeconomic instability is another area, as well as tax rates and corruption. This is largely because the Slovak Republic improved substantially between 2002 and 2005 in several dimensions in terms of perceived constraints, especially in the areas of access to and cost of financing, tax rates, and macroeconomic instability. Perceptions deteriorated markedly in Serbia and Montenegro with respect to macroeconomic instability (coinciding with a surge in inflation), judiciary functioning, and corruption. Deterioration was also significant in several dimensions in FYR Macedonia: access to and cost of financing, contract violations, and, significantly, telecommunications.

For BCR, the overall picture is similar. The gaps increase between 2002 and 2005 (see figure 5.2). For Croatia, like FYR Macedonia, the overall business perceptions gap appeared to be in its favor in 2002, but the story changed in 2005 because of improved perceptions in the Slovak Republic. For BCR, there is some overall improvement in their business perceptions between 2002 and 2005, but the Slovak Republic reformed faster, at least as perceived by business. Thus, significant gaps emerge in 2005 in perceptions of constraints for tax administration and tax rates, macroeconomic instability, business licensing and permits (Romania), functioning of the judiciary (Croatia), and cost of financing (Bulgaria) (see figure 5.1).

These are average pictures for the countries as a whole, based on the perceptions of all firms as a whole, which imply the view of the median firm. However, firms that perform better, export more, or grow faster usually face different constraints. Also, newly entering firms can be expected to face more hurdles. This is borne out by the data.

For example, new firms (most of whom are small) perceive the business environment to be more constraining than do state-owned and privatized firms (World Bank 2007a). For SEE as a whole, newer firms find taxation, regulation (land titling and leasing, customs and trade regulations, business licensing, and permits), the judicial system, and crime and corruption to be major deterrents, more than do state-owned and privatized firms. Assuming the superior performance of small firms (along the dimensions of labor productivity, technology, subsidies and arrears),⁵ a case can be made for attending to the constraints faced by

small firms (which governments often tend to ignore, at least in practice, as their attention is often taken up by large FDI projects).

Similarly, exporting firms in SEE find that customs and trade regulations, as well as macro instability, pose a greater constraint than do nonexporting firms. On the other hand, corruption appears to constrain both exporters and nonexporters equally. Again, given the superior performance of exporting firms,⁶ their concerns should matter to policy makers.

Thus, high-performance firms face multiple constraints. This is to be expected. For example, if a firm grows fast, it is likely to face a shortage of labor even if the average firm does not. Goldberg et al. (2005), in their global sample of 15,051 firms, find that firms that are growing and investing, and that have characteristics (such as export orientation and private/foreign ownership) that can be associated with good performance are more likely to face all kinds of significant investment climate constraints. The one exception is finance, about which poorer performing firms complain more (high performance firms can generate profits and/or find it easier to borrow). This finding is echoed in their analysis of firms in Serbia: privatized firms faced greater skill shortages and bigger constraints from business licensing; new private firms found licensing to be a significant constraint; foreign-owned firms perceived greater constraints than domestically-owned firms across the board (except for finance and taxation); and exporters faced excessive customs and trade regulations.

In general, high performance firms are held back by the overall investment climate. This means that the performance of such firms could have been even better, and that the share of firms in the overall distribution of firms that exceed a benchmark performance indicator could have been higher. Although a better investment climate helps to create more of such high performance firms in the first place, their fast growth can quickly bring them face-to-face with multiple constraints.

The precise goal of policy is to create conditions for better performance. For example, a lower share of state-owned firms in Serbia would help overall productivity and growth. Currently, the private sector generates only 55 percent of GDP in Serbia, which is far lower than the 75 percent in Albania. A more active privatization agenda would help. Another way of increasing the share of the private sector is to encourage entry of new firms and exit of failed firms. Here, Serbia does better in entry (*Doing Business 2007* rank for starting a business is 60) than in exit (rank for closing a business is 103). The general point is that an investment climate should aim to create a wider mass of more productive firms. The fact that developed economies are able to do this better can

be seen, for example, in the larger share of small (new) firms in their GDP (Beck et al., 2005).

The analysis of gaps in constraints compared with the Slovak Republic could be a starting point for further analysis in each country.⁷ If the Slovak Republic is accepted as a reasonable comparator, and there are many reasons why that should be so, individual SEE countries have some clear-cut signals from figures 5.1 and 5.2. Although business perceptions should not be the sole basis for policy action, they are a valuable tool for helping guide further analysis, such as benchmarking and quantitative analysis of the impact of policies. Countries such as Albania have already embraced much of the agenda (although much remains to be done) that is implicit in figure 5.1, as they reduce labor and corporate taxation, strive to improve the electricity situation, try to reduce anticompetitive practices by targeting the informal sector, and embark on a wide-ranging program to reduce the opportunities for corruption. To sum up, countries should pay close attention to what firms say (if they have been surveyed systematically and without biases, as in the BEEPS), and even closer attention to high-performing firms, because they reveal the constraints in an (future) economy that is likely to be moving closer to its potential.

Case Studies

There are many stories of firms overcoming investment climate constraints. The following section brings up a selection of such case studies.

Firms can buck general economy-wide trends and grow even as the rest of the sector declines. Although this may seem obvious, it has important lessons. Box 5.1 shows how a Romanian company has gradually expanded its output in textiles and clothing in a sector that employed 393,000 in 2002 but dropped to 326,000 in 2005. Success factors for the company include foreign ownership, which has helped in terms of access to export markets, and availability of skills to enable its upgrading to higher-quality output. Here, the lesson for government is at least not to discriminate against what it might perceive as a declining industry, and also to try to ensure that skills keep pace with the demand for higher quality outputs.

EU entry for Bulgaria and Romania can mean significantly lower transactions costs. The recent EU accession of Bulgaria and Romania gives them the benefit of rules of origin cumulation (see chapter 3). This reduces their transaction costs (such as paperwork) if they are importing fabrics from EU countries like Greece or Italy. It also reduces border controls, so that their shipments can reach Europe faster. These factors

Box 5.1**Higher Quality Helped This Romanian Firm to Expand Clothing Output**

This company demonstrates the possibilities as well as challenges that lie ahead for an industry that is still important in Romania. At the end of 2005, the contribution of textiles and clothing to total industrial production in Romania was 5.4 percent, down from a peak of 6.6 percent in 2003.

The company is probably the largest clothing firm in Romania, employing about 8,000 people in several factories scattered across Romania. It produces a whole range of clothing products, including approximately 125,000 pieces of suits, 180,000 trousers, and 30,000 blouses per month. The company was privatized through a management-employee buyout in the early 1990s, similar to most of the textile factories in Romania, and subsequently was taken over by a foreign investor. In general, the management staff is Romanian, with long-standing careers in textiles. About 95 percent of production is exported, mostly to Germany, Italy, France, the United Kingdom, Sweden, Denmark, the Netherlands, Greece and, increasingly, Russia. Most of the orders are placed by large European retail chains and fashion houses, who predominantly sell the production through outlets in Western Europe.

The company does not seem to be overly concerned about competition from China. In spite of worsening conditions for the industry, it has succeeded in maintaining its employment and even gradually expanding output. The elimination of the Agreement on Textiles and Clothing in January 2005 led to temporary declines in orders, but these have fully recovered since. The explanation provided by the managers was that the distributors' initial expectations of cost reductions from China were belied. Company management tends to believe that, for items of similar quality, Romanian labor costs are comparable with China (average gross wages in the industry are about 960 RON or \$286 per month). In addition, the company enjoys a huge advantage in transportation costs to Europe. In any case, the company strategy to cope with emerging competition has been to move toward higher value-added, better-quality products that, in management's perception, face less competition from China, India, and other Asian countries. To do this, and to cope with the rapidly changing trends in fashion, the company has acquired increasingly complex machines.

Immediate concerns relate to the rising utility tariffs (electricity, gas, water, and steam), which, management believes, are lower in neighboring countries, such as

(continued)

Moldova and Ukraine. Although wage levels do not seem to be a concern so far, the managers do complain however about the collective-bargaining system, through which wage agreements that are negotiated at higher levels (national and branch) are imposed upon them without their participation in the process.

The export model followed by the company, namely, its dependency on orders from major retail chains and fashion houses, is quite common in the clothing industry. It ensures a steady flow of orders, hence a steady income stream to the company. Design and development is provided by the buyer. The risks are relatively low and are matched by low profit margins (average of 4-6 percent in the industry). Expensive attempts to diversify this model and develop the company's own brand have not yet succeeded.

Source: World Bank staff interviews.

mean that Bulgarian and Romanian companies now have a preferential edge in access to the EU relative to the rest of SEE.⁸

Lack of privatization and delays in signing an SAA agreement have held back the textile industry in Serbia. Between 1990 and 2004, Serbian textiles and clothing exports stagnated at about \$209 million, whereas those of FYR Macedonia rose from \$89 million to \$541 million.⁹ Box 5.2 shows the contrasting fortunes of Leskovac (Serbia) and Stip (FYR Macedonia). According to ESI (2006), three factors explain the superior performance of Stip. One, privatization and liquidation were completed by 2001 in Stip in contrast to Leskovac. Two, FYR Macedonia continued steadily on the EU path, signed the SAA in 2001, and was granted candidate status in 2005. Three, companies in Stip never cut off contacts with EU partners to the extent that those in Leskovac did.

Key Bottlenecks: Human Development, Quality of Telecommunications, and Power Availability

Labor shortages have appeared as key bottlenecks in several case studies across countries. Box 5.3 shows that Bulgarian and Albanian firms producing textiles and footwear have encountered shortages of skilled labor. All these firms face these constraints as output expands. On the other hand, another Romanian firm that is not growing as fast as these firms complains about labor costs rather than skill shortages, which is what one would expect. Evidence in chapter 2 also shows that labor shortages can appear rather quickly, and this has been experienced by many investors in Eastern Europe.¹⁰

Box 5.2**Privatization and EU Prospects Have Seen Contrasting Fortunes of Leskovac (Serbia) and Stip (FYR Macedonia)**

A major textile cluster in the town of Leskovac is symptomatic of the decline of the Serbian textile and garments industry. Leskovac has all the institutions and traditions for a textile cluster—a textile school since 1947, an Association of Textile Engineers, a textile fair, and a textile magazine. In 1990, it had 17 socially-owned textile and clothing companies, which employed 11,000 workers. In 2006, these companies employed less than 900 workers, and the privatization process had barely begun. Of these 17 companies, only two are now privatized and active; four are bankrupt; one was recently liquidated; and ten await privatization, although four of these are now inactive. The private sector has been unable to make up for the job losses of the socialist enterprises, and the eleven largest textile companies now create less than 500 jobs.

In contrast, the town of Stip in FYR Macedonia has successfully transformed itself. Stip, in Eastern FYR Macedonia, also saw a decline in the 1990s in its textile output and employment. But unlike Leskovac, it completed its privatization program in 2001 and, in the same year, signed the SAA with the EU. Employment in Stip's textiles rose from roughly 4,000 in 2002 to 7,000 in 2006. There are many signs of further foreign investor interest, including from Greece, Turkey, Germany, and Switzerland. Foreign firms have also opened up four logistic centers.

Interestingly, many of the managers in Stip's companies were educated and trained in Leskovac.

Source: ESI (2006).

The BEEPS data provides an interesting validation of the above anecdotal evidence. Figure 5.3 shows that in 2005, countries with a higher private share in GDP had a larger percentage of firms citing skills and education as a business constraint. This is as true for SEE countries as for other ECA countries. The partial correlation coefficient between the two variables is as high as 0.80 for SEE. Again, this is not surprising, given the evidence (see previous section) that private sector firms in ECA countries are more dynamic and productive than socially-owned enterprises and are seeking to expand much more than their public sector counterparts. Hence, countries with more private firms, on average, find skill availability to be a greater constraint.

The Slovak Republic demonstrates the importance of human capital for achieving high export-orientation and attracting FDI. It appears to

Box 5.3**Availability and Cost of Labor is Manifesting Itself Differently in Different Countries**

Rodina Popovo, one of the largest textile firms in Bulgaria, has a workforce of over 900. This firm, privatized in 1996, creates its own designs and does not have a problem financing its operations. It exports all of its output. Its major problem is finding skilled labor, especially quality controllers, designers, and supervisors. To overcome this, the company gives serious attention to training and professional development.

Another Bulgarian company, also exporting all of its production, has a similar problem. It is medium-sized and has a work force of over 300. It reinvests all of its profits, faces no financial difficulties, and can also finance its own labels. To overcome labor shortages, it has started a cooperation arrangement with the vocational schools in Bulgaria and invests in training; it is also located in a region where the population is dominated by women, which gives access to a wider pool of potential workers.

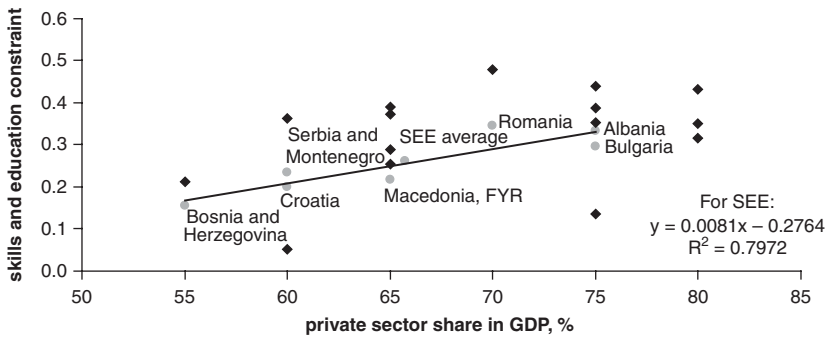
Emka Plc., a leading Croatian company producing women's wear, exports about two-thirds of its output under subcontracting arrangements and the rest is sold domestically (29 percent of output) and to Bosnia and Herzegovina (3.5 percent) under its own brand name. Production has been fluctuating. There was an increase in output in 2006 following declines during 2002–05. Employment has stagnated since 2000. Not surprisingly, the company sees productivity-adjusted wages as too high, with Turkey and China key competitors. According to the firm, Croatia's textile industry faces serious problems of high labor costs (see also chapter 2, final section),^a competition from imports and from the informal sector, and a liquidity problem.

On the other hand, another Croatian firm, JGL, which produces pharmaceuticals and cosmetics, has been growing at over 30 percent per year for the last eight years. JGL is a fully private company, invests significantly in R&D, and has been exporting an increasing share of its output, with exports now at 50 percent of total sales. This firm has been able to create value and high productivity to sustain Croatia's high wages.

Several Albanian firms in footwear and garments encountered shortages of skilled labor. One firm pointed out that it was not the cost of skilled workers but their availability that was the issue. Migration of skilled labor may be a key reason for the problem.

Source: Field interviews by World Bank staff.

a. Our field interviews showed that overall wages in the Croatian textile firm were 2.3 times as high (in euro terms) as in the large Bulgarian firm.

Figure 5.3. Private Sector Share in GDP (%) vs. Skills and Education Constraint, 2005

have had the benefit of both quality and quantity of skills. Average years of schooling of its population aged 15 and over were 9.27 in 2000 (Barro-Lee data set), higher than in Singapore (7.05), Taiwan (8.76), and Hungary (9.12), and somewhat lower than in high-performing and innovating economies such as Ireland (9.35) and Finland (9.99). Similarly, 80 percent of the 25 to 64 age population had achieved at least upper-secondary education by 1998, which exceeds most countries in the EU.¹¹ This increased further to 89 percent by 2006. A recent study cites abundance of skilled labor as a key factor in attracting FDI in the automobile industry in the Slovak Republic (Jakubiak, et al. 2007). In a comparative study by MIGA, wages in the Slovak Republic have been found to be cheaper, for example, than in Poland or Croatia, despite the Slovak Republic's higher average income per head.¹² This skill endowment has also enabled the Slovak Republic to increase the share of skilled labor-intensive exports in its total basket from 35 percent in 1996 to 48 percent in 2005 (see chapter 2), and is likely to be a key element in its path toward sustained export growth.

Human capital is a significantly greater constraint than physical capital in the BEEPS data. Table 5.1 shows that between human and physical capital, a significantly larger percentage of SEE firms reported that finding skilled and educated workers was more of a constraint than those who reported that they suffered from constraints of transport, telecoms, electricity, or land (BEEPS 2005). This also extends to labor regulations. The only exception was electricity in the case of Albania.

In the future, human capital constraints will only become bigger. As the private sector contributes an increasingly larger share of GDP, its

Table 5.1. Share of Firms Reporting Constraints in Infrastructure, Human Development, and Land Markets

<i>BEEPS</i> 2005	<i>Infrastructure</i>			<i>Human development</i>		<i>Land</i>	
	<i>Telecom</i>	<i>Electricity</i>	<i>Transport</i>	<i>Skills and education</i>	<i>Labor regulations</i>	<i>Access to land</i>	<i>Title or leasing of land</i>
SEE	0.152	0.212	0.167	0.261	0.256	0.153	0.165
ECA	0.114	0.159	0.141	0.298	0.252	0.193	0.218
Albania	0.238	0.574	0.256	0.333	0.267	0.253	0.247
Bosnia and Herzegovina	0.170	0.241	0.247	0.156	0.185	0.123	0.142
Bulgaria	0.094	0.124	0.094	0.295	0.172	0.088	0.127
Croatia	0.043	0.043	0.077	0.200	0.085	0.066	0.088
Macedonia, FYR	0.240	0.239	0.187	0.218	0.270	0.166	0.156
Romania	0.142	0.176	0.190	0.345	0.403	0.206	0.197
Serbia and Montenegro	0.182	0.191	0.159	0.234	0.352	0.175	0.197
Slovak Republic	0.055	0.073	0.068	0.196	0.142	0.125	0.136

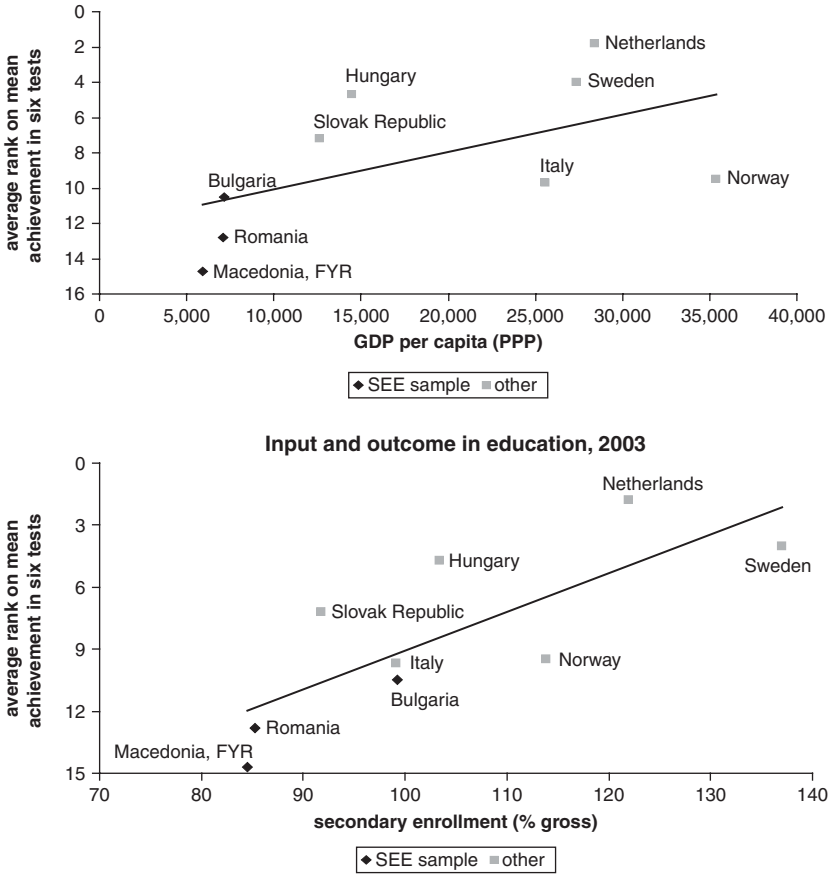
Source: BEEPS 2005.

greater dynamism will lead to increased demand for labor and skills. This could happen even faster in economies like Serbia and Bosnia and Herzegovina, where the private sector shares of GDP are only 55 percent (EBRD Annual Transition Report). Experience in fast-growing economies including those that receive sustained FDI further suggests that demand for skills can increase very rapidly.

Against this, education outcomes in many SEE countries are well below expectations. For example, the actual average ranks of FYR Macedonia and Romania (represented as MKD and ROM, respectively) across six international tests (PISA, TIMSS, PIRLS, mostly 2002–03) are well below their expected values, represented by the fitted regression line in figure 5.4, given their stage of development (GDP per capita in PPP terms). Similarly, the second part of the figure shows that the ranks are also lower than would be predicted by looking at enrollment ratios (which are often taken as an indicator of government's education performance). In other words, the issue is not one of inputs but of efficiency, namely, translating the inputs into acceptable outputs. The OECD's Investment Reform Index (see next section) corroborates these results on a more general SEE basis.

Improved skill formation appears to be an unambiguous necessity in most if not all SEE countries. The process of human capital formation is

Figure 5.4. Average Rank on Mean Achievement in Six Tests vs. GDP per Capita, 2003 and Gross Secondary Enrollment Ratios



Sources: World Development Indicators database, World Bank; EdStats database, World Bank; OECD/PISA website (<http://www.pisa.oecd.org>).

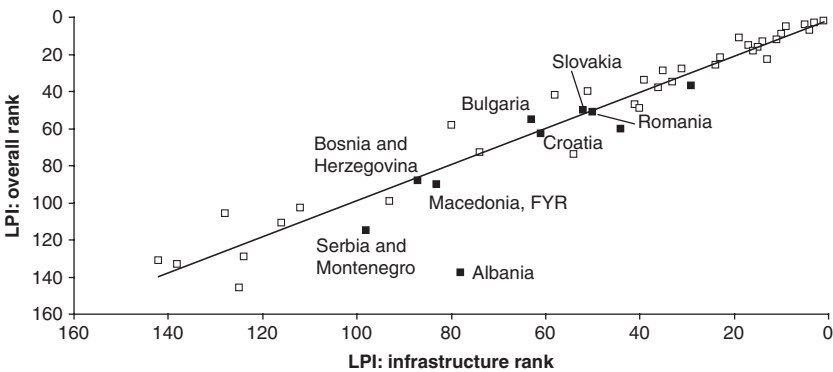
the longest-gestation element in the list of factors that make up the investment climate. Urgent action is therefore needed to improve both the quality as well as quantity of skills available in order to prepare for faster and more export-oriented growth, and to attract more FDI. To reiterate, this is because:

- Education outcomes are poor.
- Demand for skills is likely to increase.

- Given wage levels, export sustainability demands a much higher share of skill- and capital-intensive products in total merchandise exports.
- Education and health are not part of the *acquis* and so are not given a push by the EC as part of the preaccession process; thus, if important, require focused and prioritized attention by national authorities.

Does the low weight to infrastructure constraints mean that these are not a problem? In the short-term (based on the immediate past), this is indeed what business perceived. However, we know that infrastructure can have high rates of return in many different situations (see, for example, Easterly and Serven 2003). In the BEEPS survey, it is possible that business perceptions reflect improved infrastructure performance. Indeed, this has been the case over the last few years and is encapsulated, for example, in the EBRD index of infrastructure reform (see table 4.1). Another indicator is the Logistics Perception Index (LPI), which is a combination of perceptions of infrastructure, customs, ease of shipment, timeliness, logistics services, ease of tracking, and internal logistic costs. Here, FYR Macedonia, Albania, and Serbia perform much worse on the overall LPI than they do on indicators of infrastructure (see figure 5.5), which implies that the “softer” elements in the LPI require more attention. Compared with physical infrastructure, on the other hand, human-capital formation takes longer, which means skills are more likely to continue to be a problem for business.

Figure 5.5. Logistics Perceptions Index 2006: Overall Rank vs. Infrastructure Rank

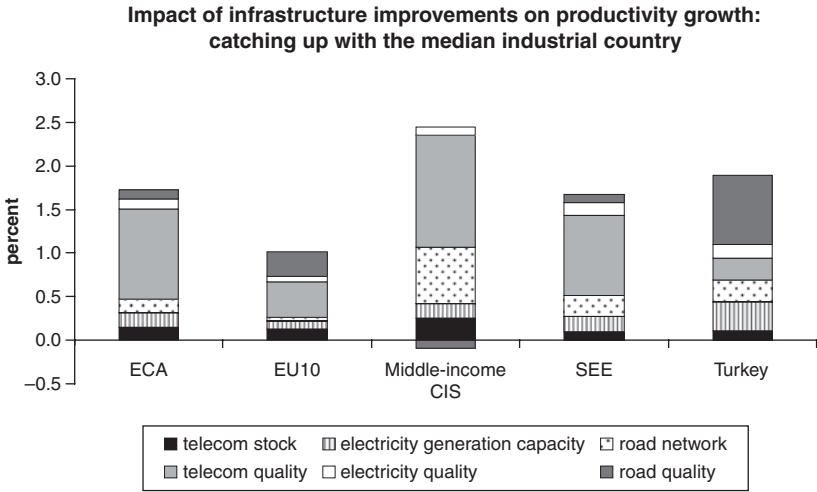


Source: Global Facilitation Partnership for Transportation and Trade Website (<http://www.gfptt.org>).
 Note: Trendline in the above chart excludes Albania since it is an outlier; infrastructure rank is scaled down by a factor of 10.

In the future, constraints will of course change. Past constraints are based on a situation in which there may have been slack capacity in the countries, and where reallocation of resources provided most of the impetus for TFP growth and GDP growth. In the future, as capacities become more fully used, demand for labor will increase, and constraints not perceived in the past may emerge.

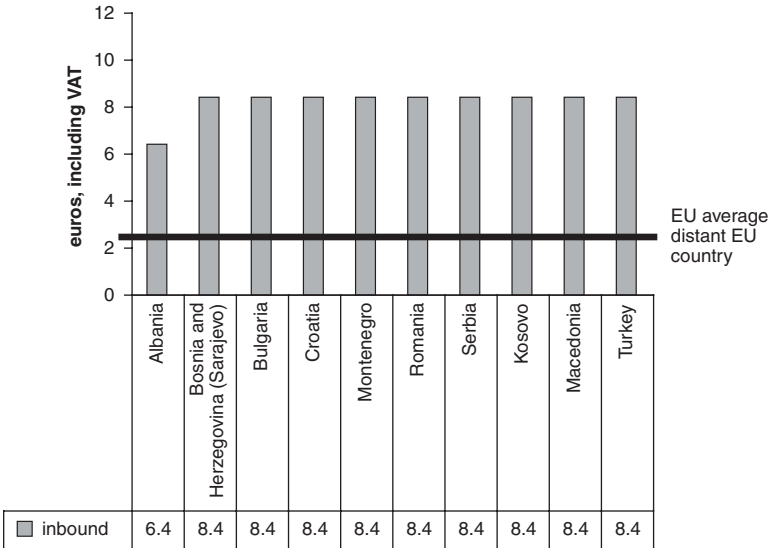
Telecommunications could merit further attention, given potentially large payoffs to its further development. Several pieces of evidence point in this direction. First, a recent study for ECA (Calderon, 2007) finds a positive and robust relationship between aggregate indexes of infrastructure stock and quality and growth in real output per worker, when comparing 2001–05 with 1991–95 for 18 ECA countries.¹³ It also calculates the potential payoff of different aspects of infrastructure improvement for productivity growth. It finds that achieving the infrastructure levels of the ECA leader would improve productivity growth in the average of 18 ECA countries by 1.8 percent per year, and the highest contributions would arise from improvements in telecom quality. The results for the three SEE countries (Serbia, Bulgaria, and Croatia) are very similar, and telecom quality improvement contributes to over half of the 1.8 percent improvement in productivity growth (see figure 5.6). Second, the gap in telecom costs between many SEE countries and the EU is quite high. This is particularly true when comparing the prices of incoming calls. For example, for a 10-minute incoming call from the United Kingdom, prices for all countries of SEE are two to three times as high as the EU average price (figure 5.7), and in most cases incoming calls are more expensive than outgoing. This implies that the accounting rates demanded by incumbent operators are still not subject to competitive pressures or strict regulatory requirements (Cullen International, 2007, p. 148 and figures 47 and 49). This gap in telecom costs is also reflected in Skype call costs to a fixed line, especially for calls to FYR Macedonia, Bosnia and Herzegovina, and Albania (see table 5.2). The Calderon (2007) results suggest that the potential payoffs from the reduction in such costs could be high. Third, the potential impact of telecom improvement is widespread, because it is an input into virtually every aspect of the economy (see World Bank 2007c), and can also help in the process of deepening integration within SEE. Efficient telecommunications can also help smaller countries overcome at least some of the diseconomies of small size by making distance irrelevant for provision of some services and allowing some leveling of the playing field between large and small firms (World Bank 2005a, chapter 5; and World Bank 2007b, chapter 2).

Figure 5.6. High Payoffs to Telecom Quality Improvement



Source: Calderon (2007).

Figure 5.7. Cost of a Ten-minute Call from the United Kingdom



Source: Cullen International (2007).

Table 5.2. Telecom Indicators in SEE and Comparators

<i>Country</i>	<i>Mobile phone penetration rate (% population) 2006</i>	<i>Skype rate per min to landline, 2007</i>	<i>EBRD telecom reform transition indicator, 2006</i>
Albania	52.0	\$0.169	3.00
Bosnia and Herzegovina	44.0	\$0.203	2.33
Bulgaria	90.0	\$0.068	3.33
Croatia	90.7	\$0.068	3.67
Macedonia, FYR	65.5	\$0.217	3.00
Montenegro	98.5	\$0.115	3.00
Romania	61.8	\$0.124	3.33
Serbia	73.5	\$0.115	2.33
Spain	95.2	\$0.021	—
Switzerland	92.1	\$0.021	—
United Kingdom	108.8	\$0.021	—
Ireland	101.2	\$0.021	—
Slovak Republic	84.3	\$0.068	3.67
Slovenia	87.9	\$0.064	3.00
Tunisia	56.6	\$0.250	—

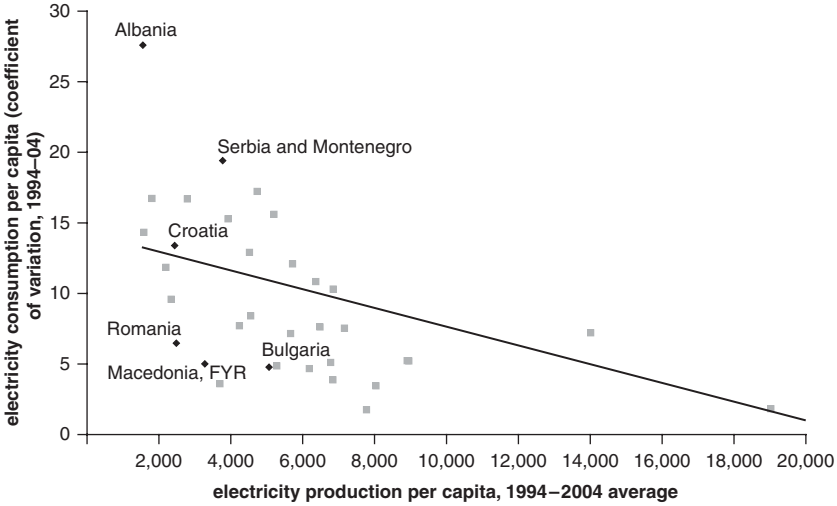
Sources: Cullen International (2007); Skype.com; and EBRD.

Note: — = not available.

Power is the other element of infrastructure that could prove problematic in the future. If power is in short supply, it can become a binding constraint, and can reduce economic growth, as it did in Albania in 2005¹⁴ (see also BEEPS 2005). FYR Macedonia's similar experience in 2006, arising from regional shortages including the shut down of a nuclear power plant in Bulgaria, illustrates that the problem can extend to a wider area. In general, energy problems can affect the quantity of FDI and domestic investment, as well as influence the pattern of investment.

Figure 5.8 shows the inverse relationship between the volatility of electricity consumption per capita over 1994–2004 in a sample of 37 countries (each data points represents a country) and the electricity production per capita in that country. Volatility is clearly a concern to business, because it makes planning more unpredictable. An effective policy response should involve investment in the regional energy market, which would help substitute regional production for domestic production, and thus aid consumption smoothing (see chapter 3). A regional power market is of interest to both net importers as well as net exporters of energy, because it allows better returns to the latter and smoother consumption to both.

Figure 5.8. Electricity Consumption Per Capita (Coefficient of Variation, 1994–2004) vs. Electricity Production Per Capita, 1994–2004 Average



Source: Calculated from World Bank World Development Indicators database.

Taken together, the evidence suggests that SEE governments should prepare for higher firm performance by relieving the constraints to human capital, telecommunications cost effectiveness, and power availability. As seen earlier, the process of faster, private-sector-driven growth can come up against a variety of investment climate constraints. This paper argues that to be prepared for faster and more export-oriented firm growth, and to attract more FDI, relative priority should be accorded to human development, telecommunications cost effectiveness, and power-shortage-prevention policies. This does not mean that the agenda identified in figure 5.1 should be neglected (this is based on currently perceived constraints), but that government priorities may need some reordering to accommodate human capital, telecoms and power as likely future and possibly binding constraints to faster growth in SEE.

The Regional Institutional Dimension

In seeking a regional economic space, SEE countries will need a forum to evaluate, compare, and where necessary, harmonize their investment climate policies. A natural forum to do this is the Investment Compact for South East Europe (ICSEE). The ICSEE provides a framework for

assessments and peer reviews on investment-related policies as well as technical assistance for related reforms. Some relevant highlights from the 2006 assessment are presented below.

The OECD and SEE government teams (along with local stakeholders) have collaborated to produce the 2006 Investment Reform Index (IRI) (see OECD 2006).¹⁵ This index is produced on seven dimensions, including investment policy, investment promotion and facilitation, tax policy, anticorruption and business integrity, trade policy, regulatory reforms, and human capital. In addition, competition policy is discussed qualitatively. It is scored from 1 to 5 (weaker to stronger), and level 5 is illustrated by good practices with other countries, especially those in CEE.

Broadly speaking, the IRI shows that investment, trade, and tax policies are relatively more advanced in SEE countries (which include Moldova); whereas the other dimensions are relatively less advanced. For example, the IRI finds that most countries' human capital (education and training) is at very low levels, especially in Bosnia and Herzegovina and Albania, with indexes of 1.75 and 2.5 respectively (see table 5.3). As can be expected, there are wide variations within countries. Bulgaria is above average on all indicators, and Romania (and to a lesser extent Croatia) is above average on most indicators.

This paper suggests that SEE governments should take the ICSEE beyond its initial mandate, and use it as a forum to attempt to harmonize policies (including on taxes, state aid, and so on) and avoid, for example, a damaging, race-to-the-bottom tax competition, or excessive aid, or other incentives to attract FDI. The countries of SEE are at different stages of implementing EU policies on state aid and responsible tax-incentive policies, broadly corresponding to their stage of EU accession (OECD 2006, chapters 5 and 7). Given the potential for maneuver in such policies for many countries, and the potential damage from excessive and non-transparent incentives, the coordination role of the ICSEE could be a valuable one. In addition, the forum can also be used for regional investment promotion (in collaboration with MIGA's EIOP) and jointly promote SEE as an investment destination to complement other efforts to convert it into a single economic space (see chapters 3 and 4).

The IRI methodology does not enable prioritization across different dimensions of the investment climate, as acknowledged by the report (OECD 2006). Such prioritization needs to be done by each country government, based on its objectives, business consultations and perceptions, and economic analysis. However, the merit of the IRI and the ICSEE lies in the country-to-country peer evaluations, the comparison

Table 5.3. Investment Reform Index (IRI) Scores for Education and Training of Workforce

	<i>Albania</i>	<i>Bosnia and Herzegovina</i>	<i>Bulgaria</i>	<i>Croatia</i>	<i>Macedonia, FYR</i>	<i>Moldova</i>	<i>Montenegro</i>	<i>Romania</i>	<i>Serbia</i>
Human capital (education and training of workforce)	—	—	—	—	—	—	—	—	—
Education strategy and workforce skills development	2	1.5	2.5	4	3.5	3.5	3.5	3.5	2.5
Vocational training	2.5	2	3	2.5	3	2	3	4	2.5
Adult learning	1.5	1.5	2	3	2	1.5	3	4	2.5
Civil servant training	3.5	2	4	4	3.5	2	2.5	4	3
Weighted average	2.5	1.75	3	3.5	3.25	2.5	3	4	2.75

Source: OECD (2006).

Note: — = not available.

with CEE, and the dialogue between SEE and CEE countries. Also, as mentioned earlier, its possible role in regional coordination could benefit the region.

Conclusions

A large market size is a major attraction for FDI, especially for the kind of FDI that seeks to exploit the domestic market. To the extent that the regional agenda succeeds in creating a more integrated market within SEE countries, more FDI should flow into the region. This has been discussed in the previous chapters.

Key actions will be needed at the country level, both to implement the regional agenda and to improve the investment climate (the latter to be based on individual country assessments).

Ultimately, individual countries will need to decide a priority list of reforms based on their analysis of what they consider as the binding constraints. In other words, what three to four key policy actions would have the largest impact on productivity improvements or attracting FDI? To answer this question, countries will need to go beyond business perceptions and also consider tools such as benchmarking (as in the IRI) and economic analysis that allows a judgment on the possible quantitative impact of different policies.

This chapter has tried to provide broad indications of policy directions, based on business perceptions, supplemented by case studies, and some international evidence. This can provide the basis for further drill-down analysis at the country level. Policies to improve the investment climate in each country will of course be different for each country and tailored to its own requirements and objectives.¹⁶

Subject to the caveats above, this chapter suggests that SEE countries, especially the SEE5, need to work on selected aspects of their investment climate. These areas perhaps have not received their due share of attention in policy priorities. SEE5 countries need to improve both the quality and quantity of labor skills (the Slovak Republic is a possible model), in order to enable faster, sustained growth, attract FDI, and improve the skill content of exports. Given long gestation lags in training workers (because training starts with primary education), it is suggested that this priority be translated into quick action. Although telecommunications penetration has improved, costs are still high, and could lead to major development payoffs if reduced. Finally, power was not cited as a constraint (in BEEPS 2005) except in Albania, but given warnings of power shortages in

Europe, the region would do well to invest heavily in this sector, focusing especially on the SEE regional energy market and relying on enhanced public-private partnerships where possible.

The above policies may not have significant implications for government expenditures. In different countries, improving human capital could mean higher expenditures, but, recognizing that expenditures and outcomes are very loosely related, greater attention to improving quality of education may be needed.¹⁷ In telecom, the private sector could take care of most investment needs, but more competition and stronger regulators would help further reduce costs of telecommunications. In power, too, more effort at attracting private sector investment within a sound regulatory framework and furthering regional energy cooperation could help alleviate current and future energy shortages. However, governments need to ensure that public-private partnerships are undertaken in an open, transparent, and competitive setting with transparent (if any) government guarantees.

Notes

1. This chapter does not examine health issues and the relationship between health and productivity, but these are undoubtedly important. In this case, companion regional pieces are being done by World Bank teams.
2. The gap refers to the difference between the percentage of firms in a SEE country that perceives a particular factor as a constraint minus the percentage of firms in the Slovak Republic that perceive the same factor as a constraint. Among the Western Balkans, BEEPS in 2005 includes Serbia and Montenegro, Albania, FYR Macedonia, Bosnia and Herzegovina, and Croatia.
3. One could argue that reforms in the Slovak Republic would have accelerated in the run-up to accession in 2004. However, the survey was done in 2005, a year after accession, when this momentum often falters. The argument about SEE lagging further behind in reforms still holds. In any case, the increasing gap also shows the distances that should be closed.
4. Obtained by summing up the gaps in perceptions on all dimensions.
5. Small firms in transition economies have higher labor productivity (World Bank 2002); newer firms (most of whom can be expected to be small) bring in new technology and thus contribute significantly to labor productivity. In addition, in SEE as in the rest of ECA, new firms receive much less in subsidies from government, and have much lower arrears than do the state-owned and privatized firms (World Bank 2007a). This is echoed in Goldberg et al. (2005), who find that new private firms in Serbia in 2002–03 have TFP levels 85 percent higher than the benchmark of socially-owned firms; for

- a 44 country sample, the positive impact of new private firms on TFP is 38 percent.
6. See, for example, Goldberg et al. (2005), where in a sample of over 15,000 firms in 44 countries, a TFP regression found that export-orientation added 22 percent to the TFP of manufacturing firms.
 7. A question may be raised as to why the Slovak Republic is the chosen benchmark. This report has shown that the Slovak Republic has set many of its economic and social policies wisely and, as of the end of 2007, has been proceeding strongly toward its goals with a much stronger track record on macroeconomic stability than many of its neighboring countries. It is of course true that there is no unique path to growth and development, but the Slovak Republic seems to be as good a role model as any in the immediate neighborhood of the Western Balkans. In any case, the gap analysis should only be a starting point for further analysis at the country level. What this section of the report illustrates is that SEE5 countries have a long way to go on many dimensions of reform.
 8. See case study of ModaTim, an apparel firm in Timisoara, Romania, in BBC News, January 2, 2007, which expects to enjoy easier border controls and reduced paperwork, <http://news.bbc.co.uk/1/hi/business/6225145.stm>.
 9. ESI (2006) includes a detailed case study of the town of Leskovac in Serbia. The period 1990–2004 is admittedly an unfavorable one for Serbia and Montenegro.
 10. See also World Bank (2007f) for a report on emergence of skill shortages in the EU10.
 11. This ratio was exceeded only by the Czech Republic, Estonia, Lithuania, and Latvia (Eurostat).
 12. Poland–Slovak Republic comparison in Jakubiak and Kolesar (2007) and Croatia–Slovak Republic in MIGA (2006).
 13. The same study did not find a strong impact in the case of education: catching up with the ECA leader in education yields only a 0.2 percent productivity improvement for SEE versus a 1.3 percent improvement in the case of aggregate infrastructure quality improvement. The likely reason is that the study uses gross secondary enrollment as the education indicator, which does not reflect outcomes in education (see figure 5.3), and is thus an indicator for which the gaps between SEE and the ECA leader are not as large as in infrastructure.
 14. See IMF (2006) for the impact of the electricity crisis on growth in Albania. In other countries/regions where power is a problem (such as in South Asia), Dollar et al. (2005), in a sample of over 5,000 firms in Bangladesh, China, India, and Pakistan, find power outages (as well as customs delays) to be the most serious constraints for firm productivity and profitability.

15. The IRI is available at <http://www.investmentcompact.org/dataoecd/41/0/37686316.pdf>.
16. Within BEEPS-type surveys, it is possible to drill down further into aspects of the major constraints. If finance is a constraint, for example, high interest rates appear to be a bigger problem in the 2005 comparison between SEE5 and the Slovak Republic, as are burdensome application procedures for finance in the case of BCR and the Slovak Republic. BEEPS also facilitates differentiation in the responses of different types of firms. This chapter has sought to do this at a broad level.
17. See Gray et al. (2007) for more details on the key expenditure and quality issues in education.