

Case study commissioned by the Department for International Development, UK

A Contribution to WDR 2005 on Investment Climate, Growth and Poverty

Lessons from CBC Business Environment Surveys 1999, 2001, 2003

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Key Messages

1. Predictability and simplicity of regulation is a priority for investors.
2. Foreign investors would rather see a good business environment than elaborate incentives.
3. Major capacity constraints exist for developing country governments, and reforms have to be prioritised accordingly.
4. Addressing investor perceptions through better dialogue and communication is necessary.

The views and opinions expressed in this study are those of the author and do not necessarily correspond to the views or policies of the Department for International Development (DFID), UK.

INTRODUCTION

1. The Commonwealth Business Council (CBC) is engaged in ongoing work to help improve the business and investment climate in Commonwealth member countries through the expertise and direct involvement of its private sector members and partners from both developing and developed countries doing business across the Commonwealth. These partners are those same businesses that are making investment decisions regarding developing and emerging markets, and as such are the audience that policymakers need to convince about improvements in the investment climate.

2. CBC's work on the business environment highlights the importance of policymakers and businesspeople working together to overcome obstacles and foster successes. This work has consisted of identifying the constituent elements of a good business environment as well as the obstacles to investment or business activity, and evaluating the investment climate in individual Commonwealth countries taking these elements as criteria. The CBC then draws policy recommendations as a basis for policy dialogue with governments and embarks on programmes with individual countries to help implement these policy lessons.

3. The CBC has published a series of surveys of private sector views on the business climate across the Commonwealth in 1999, 2001 and 2003 (forthcoming), highlighting policy recommendations and imperatives for action by governments.

CBC Business Environment Surveys

4. CBC has conducted three full Business Environment Surveys since 1999 to canvass private sector opinions on the business environment, or investment climate, in Commonwealth countries. These surveys followed on from a number of more limited business surveys carried out in 1999 to identify obstacles to investment or business activity. Private sector opinion from the UK, on one hand, and from Commonwealth developing countries, on the other, ranked in order of severity different obstacles to business activity in developing countries. Prior consultation with an advisory group of CBC member companies had developed a list of potential

obstacles to business, which the survey then requested that respondents rank in order of importance. Results from both groups were unequivocal that corruption, lack of infrastructure and policy instability were the main obstacles to be overcome.

5. In the work CBC has done across the Commonwealth, it has been clear that some policy recommendations reflect more urgent priorities than others and are common to virtually all developing country economies. Apart from the obvious and general point about political and economic stability, the three above concerns are consistently identified as the most significant elements of a positive business environment.

6. These indicators have since been refined and used in the subsequent Business Environment Surveys, where a list of constituent elements of the local business environment are graded by respondents on a sliding scale to reflect their status as either an incentive to investment, an adequate or inadequate state of affairs, or a disincentive to investment. The survey provides a focused view of the investment climate in a wide range of Commonwealth countries, with an emphasis on those factors respondents considered to be most important. The latest Survey has included comparisons with the 2001 Survey results, to highlight changes in perception and to provide a means of evaluating countries' progress in improving the business environment.

Methodology

7. The Business Environment Surveys canvassed private sector opinion on the investment climate in Commonwealth countries in which they were active, on the following criteria:

OPENNESS AND ACCOUNTABILITY	BUSINESS ENABLERS AND OUTLOOK	POLICY FRAMEWORK
Government-Business Relations	Future Outlook	Environmental protection
Free Media	Corporate Governance	Corruption Reduction
Reliable Justice	Industrial Relations	Tax Policy
Efficient Administration	Human Resources	Competition Policy
Effective Government	Infrastructure	Consistent Policies
	Financial Framework	

8. Over the three Surveys, between 20 and 35 countries have been surveyed, with upwards of 1300 businesses contributing to the latest survey with detailed interviews conducted with a representative sample of companies. Respondents grade a country on a scale of one to four for each criteria, and can identify which criteria they consider to be of most importance. The marks for each criteria are then compiled and presented graphically to highlight the strong and weak points as regards a country's investment climate. The surveys have then been distributed to public and private stakeholders in the countries under review.

Results and Policy Lessons

9. At a practical level, the business environment surveys and CBC's other investment promotion work are producing results. An action plan for business and governments has been developed, business-government dialogue on the key issues is leading to increased confidence on both sides, and improved relationships and channels of communication have supported positive investment decisions being made. The following are some of the important lessons gleaned from the CBC's business environment surveys and other investment promotion work.

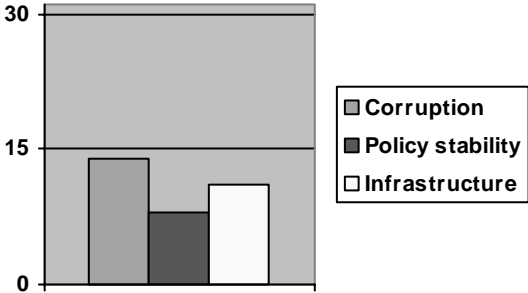
While circumstances vary across countries, private sector opinion is remarkably consistent about the key determinants of an investment climate. Corruption, policy consistency and infrastructure are central considerations.

The two 1999 surveys of private sector opinion in the UK and in Commonwealth developing countries identified corruption, policy stability and infrastructure as the most important obstacles to investment in developing countries. Throughout the three

business environment surveys that have followed, these three concerns have continued to feature permanently. It is only in those comparatively wealthier Commonwealth countries where these three obstacles have been generally overcome to greater or lesser degrees, that respondents identify other concerns as being key. In the vast majority of Commonwealth countries however, where corruption, infrastructure and policy stability, among others, continue to concern potential investors, it is these three that are regularly identified as the most important.

Figure 1

Out of 31 countries in the 2003 Survey, Corruption, Policy Stability and Infrastructure were identified as key priorities in 14, 8 and 11 countries, respectively.



The factors that constitute a good investment climate for foreign business are more or less the same factors that are important for domestic investment.

10. There are many considerations that go into making an investment decision, particularly a cross-border investment decision. For any potential investor, these considerations will include the national business climate and the international context (e.g. tariffs or currency valuation), and some that are particular to the terms of the deal being considered. Investment incentives are often seen as the easiest means of attracting foreign investors, apart from the fact that in the absence of other strategies, they do not automatically serve to attract many investors. This is supported by evidence from other recent surveys finding that resources put into incentive schemes could have been much better spent on, for example, improving local infrastructure.¹ In the words of investors themselves, it is much more important to see a stable business environment than to be offered tax or regulatory leniencies. The time and

place for such incentives is when the business environment is already reasonable, and the main criteria for potential investors have been satisfied. Incentives can only support, not replace, a good business environment.

Private Investors seek clear, consistent and stable policies.

11. A particular recommendation from the investment community to Commonwealth Heads of Government at the Commonwealth Business Forum in 1999 was that governments should simplify domestic tax arrangements, to make them clearer and more internationally compatible, rather than necessarily trying to make them more favourable.

12. The general point is that investors want to know as much as possible, and then to make their decision on terms that include a thorough risk assessment. Investors want to know exactly what the tax system involves, and to be able to make projections with confidence. As it is with the three main investment climate concerns spelled out in the point above, reliable information and predictability are crucial. A lack of infrastructure means a lack of predictability for considerations such as energy, communications, inventory and transportation. Corruption and policy inconsistency mean an uncertain investment climate: poor rule and enforcement of law, erratic economic management, political instability. These are obvious obstacles to predictability and greatly increase investment risk. Without these three concerns being met, it is hard for investors to even begin to make informed investment decisions.

Dialogue between the private sector and government is crucial to improving the business climate and attracting investment. The government learns what is of importance to investors, and investors are reassured by active interest and assurance about action taken by government in addressing the obstacles to investment.

13. It is often the case that investors' perception of the business environment is what counts, rather than the business environment, per se. For example, while there are indeed many excellent business opportunities in various parts of Africa, they are greatly under-subscribed because of the often negative associations which Africa has

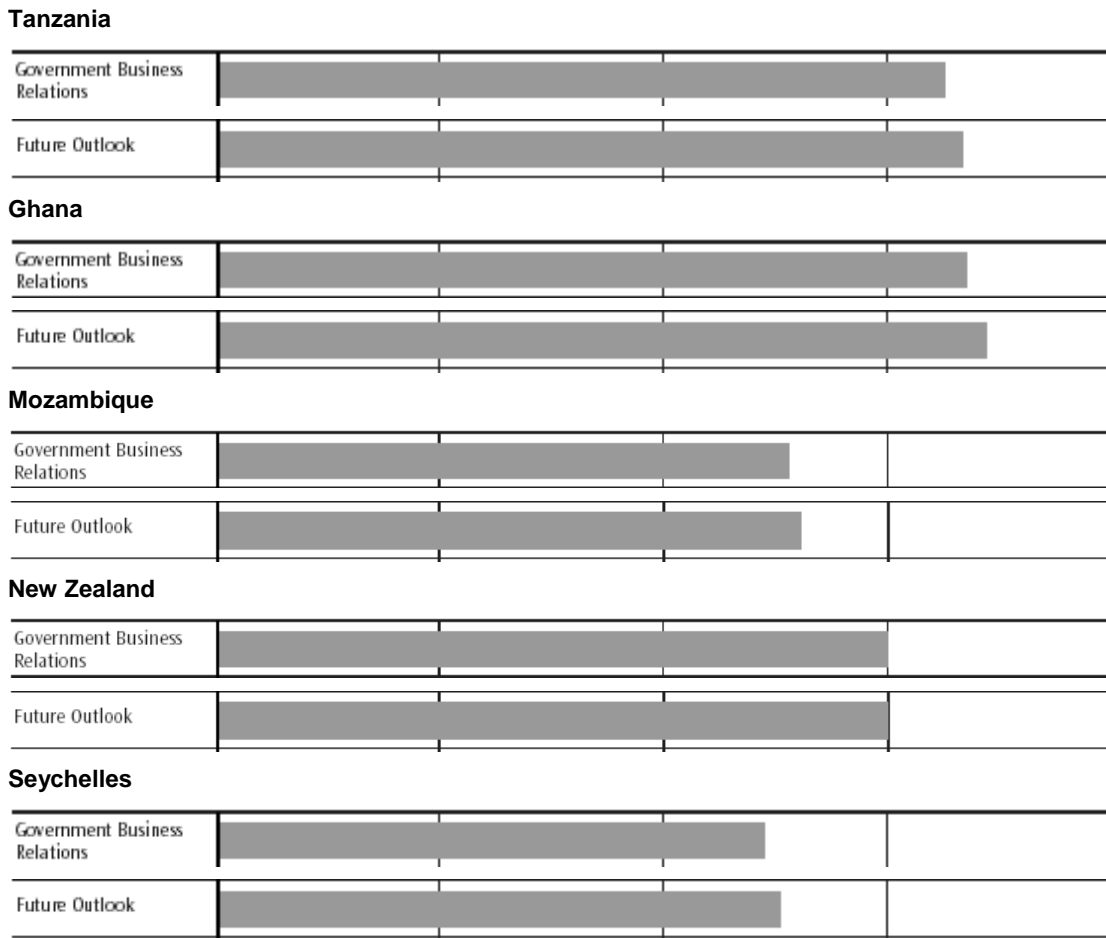
in the minds of many investors and the poor or negative media coverage it receives (Africa as a continent for example receives less business press coverage than Argentina). CBC's Friends of Africa Business Group (FABG), is actively publicizing examples of business success in Africa, to balance the overwhelming negative – in commercial terms – image of Africa. CBC investment events in these countries also help to publicise opportunities.

14. Dealing with perceptions, in simplified terms, involves addressing both justified and unjustified perceptions. Especially in the African context, the unjustified perceptions are vitally important to address. This was one of the themes of the inaugural session of the Zambian International Business Advisory Council (ZIBAC)² in September 2003. Only through balancing the negative image of Africa will there be any chance of taking the investment discussion onto a new plane; one which will engage investors in asking questions and demanding answers about precise conditions and opportunities.

15. The second of these two hurdles is that there has to be an exchange of information between the government and investors if the end result is to be increased investment or business activity. This is the main objective of the business environment survey and CBC's activity in the field of investment: to increase dialogue between governments and the private sector so conditions can be improved and increased investment ensue. Governments need to know what investors really want, and investors need to know what governments are really doing. And, the level of trust between the two needs to be increased. The Business Environment Surveys serve this purpose by showing the authorities very clearly which are the criteria that investors have themselves chosen by which to measure the quality of the business environment, while at the same time they provide uninformed potential investors (those not involved in the country or in the survey) with an independent account of the markets. The surveys also provide investors, over time, with a track of what the authorities are doing to change the investment climate.

Figure 2

Government Business Relations and Future Outlook are highly correlated.



Source: 2003 Business Environment Survey, Commonwealth Business Council

16. Two of the survey categories are particularly implicated in this question of perception, those of *future prospects and good government – business relations*. Investors grade the authorities on future prospects according to what they consider the government is doing, or will do, to improve the situation, reflecting directly the perceived commitment of the authorities to reform. (See Figure 2) The criteria of government – business relations is more indicative, in that where good such relations exist, overall perceptions of the investment climate tend to be strengthened. Both criteria then can be usefully seen as indicative of general perceptions, and in the case of the latter, this is a primary reason that CBC concentrates on trying to build good government – business relations in Commonwealth countries.

17. The primary benefit is that the government receives both a sense of the priorities of investors, and an account of investors' perceptions of the country. What comes next is to engage the authorities to respond to these priorities and change some of the perceptions. CBC's other investment activities aim to do just this, and draw on the surveys as an introduction to more thorough dialogue. To take the fight against corruption as an example of a short-term benefit linked to the survey, committed and well-communicated government campaigns against corruption, even before there is any sign of practical results, will have an impact on investors' perspectives. Investors have responded well to a strong government line against corruption, provided it is constant, because it reflects the fact that the authorities at least know what the important issues are. Judgement as to whether corruption was reduced by the announced governmental drive against it will be reserved until some time has passed, but making the right approaches already brings positive reaction.

Publicising information on the business environment across countries gives profile to some of these important issues, and gives governments an impartial picture of what other countries are doing to attract investment, what strategies are actually working, and builds confidence in the measures recommended.

18. The key points CBC raised about the business environment in the surveys may appear obvious, and widely accepted. This has not always been the case however, and the business environment surveys and CBC's other work has contributed, along with other organisations, to giving some of these issues the profile that they require to receive attention. Corruption is a case in point; obvious to all practitioners for many, many years, it is only recently that there has been a frank public debate on the subject and government and business leaders are committing themselves publicly to tackling corruption. The business environment surveys reinforce the importance of these issues, and provoke dialogue and action to address them.

19. There is strong competition between developing countries for investment resources. There are also a great number of conflicting opinions and recommendations as to what governments should be doing to attract these resources. By publicising the list of recommendations across countries, it is clear to

the governments that these criteria are generally accepted, and that the standards being applied to them are those being applied to others. It also gives governments a view of how other countries are faring in the competition between them, and to an extent reminds governments that they are in competition for the attention of investors. Governments will often be aware, and can easily inform themselves, about the reforms being carried out by other countries, and this gives all governments a sense of how these reforms are being seen in the investor community, and what success or otherwise different strategies appear to be having.

In the three countries highlighted (Ghana, Tanzania and Mozambique), the awareness-raising influence of the Business Environment Survey, combined with the work CBC has done in the countries to encourage and support government reform programmes, has helped to inform investors' perceptions.

20. The business environment surveys are only one part of the CBC's work on investment. For any significant improvement in perceptions and eventual increases in flows, more direct, detailed and prescriptive work needs to be done. The information garnered through the surveys, as well as the increased interest that has been generated, contribute to this more direct work. Discussions need to take place, between government officials and investors in which the priorities and limitations of each are made clear and confidence can be built between the parties. The CBC brokers and facilitates such dialogue, in several contexts.

21. In Ghana, one of the main issues arising from the Survey, is the hugely negative impact that excessive levels of government borrowing can have on the investment climate through crowding out. By driving up domestic interest rates, the private sector is cut off from the supply of capital. Further negative consequences are the disincentive that this creates for the informal sector to join the formal sector because the incentive to access credit is no longer there. This in turn keeps the corporate tax base small which in turn drives high government borrowing. This also leads to the stagnation of the financial sector, which simply recycles savers funds into government bonds and does not develop the capacity to lend to the private sector. The survey also highlighted the overly complex nature of land tenure and transfer processes, which also reduce the scope for raising capital to fund

investment. These were in addition to the issues of poor infrastructure and policy inconsistency already mentioned.

22. In Tanzania, the 2003 survey highlighted taxation reform and regulatory impacts and capacity as key action points for the authorities. In addition infrastructure and corruption, taxation policy simplification, availability of credit, and implementation of policy recommendations were highlighted as areas for reform. Problems of credit availability and cost reflected a big gap between the upper limits of credit offerings by micro-finance institutions and the threshold for commercial lenders. This gap greatly limits the development of an important segment of the economy. This was reported also as a problem in Ghana, and is generally a feature of developing country economies.

23. An important feature of this credit problem is that small and medium sized companies and entrepreneurs often do not have the capacity to meet the requirements of commercial lenders. It is a question of the transaction costs to those lenders relative to the size of and return from the loan. CBC is looking to address this issue with EU funding by helping to build the capacity of entrepreneurs to develop business plans that address the requirements of commercial lenders. Entrepreneurs demonstrating this capacity reduce the transactions costs to the lender, and this contributes to lowering the threshold for commercial lending to levels of credit appropriate to small enterprises.

Serious implementation capacity constraints exist in virtually all developing countries, and it is important that the authorities recognise the constraints, and plan reforms and strategies accordingly.

24. Getting the investment framework and policies right is a necessary but not sufficient criterion for improving the business environment. Policies have to be implemented before sustained increases in business activity will occur. Many of the governments concerned are operating under major capacity constraints, and have to prioritise their reform actions. This highlights the significance of ranking priority issues that our survey respondents have produced.

25. Implementation capacity constraints are also very evident in infrastructure development. While the private sector is increasingly looked to for funding and management, the capacity of governments to transact these complex private public partnership deals is limited. This is why CBC is developing initiatives to improve the capacity of Governments to transact PPPs.

26. The issue of poor business regulation was also raised in a number of the surveys. This represents a real cost to the private sector, with SMEs particularly vulnerable. The link between excessive red tape and corruption is obvious. With support from DfID, CBC is currently working on a campaign to raise awareness of the costs of poor business regulation and the existence of processes, such regulatory impact assessment, which can be used to improve the capacity of governments to enact better business regulation.

Conclusions

Pro-active strategies that engage the government and those actors actually taking investment decisions, and include concrete recommendations and implementation procedures, can make a real difference in investors' perception and consequently on FDI flows.

27. The CBC's activities to improve the investment climate in developing Commonwealth countries revolve around two main areas: a free flow of information through dialogue between the private sector and governments to improve perceptions and develop policy, and an action plan for implementing policy decisions. The Business Environment Surveys are an important element of this work, serving as a channel of communication between business and government, and helping to develop some policy recommendations. CBC's other work contributes concrete recommendations and implementation procedures, and the whole has supported improvements in investors' perceptions of business opportunities.

28. The key policy areas, headlined by corruption, policy consistency and infrastructure, are clear. What is more, the following conclusions can be drawn from the experience of the CBC Surveys:

- (i) While circumstances vary across countries, private sector opinion is remarkably consistent about the key determinants of an investment climate. Corruption, policy consistency and infrastructure are central considerations.
- (ii) The factors that constitute a good investment climate for foreign business are more or less the same factors that are important for domestic investment.
- (iii) Private Investors seek clear, consistent and stable policies.
- (iv) Dialogue between the private sector and government is crucial to improving the business climate and attracting investment. The government learns what is of importance to investors, and investors are reassured by active interest and assurance about action taken by government in addressing the obstacles to investment.
- (v) Publicising information on the business environment across countries gives profile to some of these important issues, and gives governments an impartial picture of what other countries are doing to attract investment, what strategies are actually working, and builds confidence in the measures recommended.
- (vi) In the three countries highlighted (Ghana, Tanzania and Mozambique), the awareness-raising influence of the Business Environment Survey, combined with the work CBC has done in the countries to encourage and support government reform programmes, has helped to inform investors' perceptions.
- (vii) Serious implementation capacity constraints exist in virtually all developing countries, and it is important that the authorities recognise the constraints, and plan reforms and strategies accordingly.

29. The issue now is to build further government – business dialogue and action to address priorities and develop mechanisms to remedy existing problems, as well further improving perceptions. The aim is that improved perceptions lead to increased flows and that policy implementation will produce tangible improvements in the business environment and lead to greater domestic and foreign business activity.

Notes

¹ Report by McKinsey as reported in Financial Times, Wednesday, 15 October 2003

² ZIBAC is a high level advisory group consisting of senior executives of international companies active in relevant sectors, formed to advise the President of Zambia on the investment climate. The council reports directly and confidentially to the President. The CBC is the secretariat for ZIBAC.