

EXECUTIVE SUMMARY

1. This report provides an up-to-date assessment of the investment climate of Thailand. As the socio-economic framework in which enterprises operate—including infrastructure, policies and regulations—improving the investment climate is helpful for productivity and economic growth. The report is based mainly on the results of the second round of the Thailand Productivity and Investment Climate Surveys (PICS) carried out in 2007 and on a comparison with results from the first round (conducted between March 2004 and February 2005). Some 1043 establishments from nine manufacturing sectors (food processing, textiles, garments, automobile parts, electronic parts, electrical appliances, rubber/plastics, furniture/wood, and machinery) in six regions (North, Central, metropolitan Bangkok, East, Northeast, and South) were surveyed. This report aims to present policymakers with detailed information on key business climate indicators and their relationship to Thai economic performance.

Main Findings

2. Thailand has achieved great economic and social successes. It ranks in 15th place out of 178 economies in terms of ease of doing business, in the 2008 Doing Business report, and outranks Malaysia, Indonesia and the Philippines. Among East Asian nations, only Singapore is better placed. In comparison with similar middle-income countries including Brazil, China, India and Turkey, Thailand is relatively well placed in terms of infrastructure, regulations and other objective investment climate measures. But Thailand's traditional labor cost advantage is being eroded by fast growing countries and skill shortages are worrisome given the need for Thailand to move toward a more skill- and knowledge-based economy.

3. Thailand's investment climate seems to have worsened between 2004 and 2007 judging by the opinions of firm managers which have deteriorated significantly. However, judging by the changes in objective investment climate indicators, which were generally small in magnitude, the investment climate in Thailand is reasonably stable though a few areas require the attention of policymakers.

4. This worsening of subjective perceptions is probably related to the political uncertainty and the changes in global macroeconomic environment. "Political instability" was ranked second among the top constraints to doing business in 2007 while in 2004 it was not even among the top 10 concerns of enterprises. Moreover, while each one of the 18 investment climate indicators was ranked as a 'major' or 'severe' obstacle by a higher percentage of firms in 2007 than 2004, but political instability more so than any other indicator.

5. Apart from political instability, however, the ordinal ranking of the investment climate indicators was similar in both survey rounds. In other words, firms tended to worry about the same obstacles in 2007 as in 2004, only more so given the background of political crisis. What firm managers view as the four main constraints (which are analyzed in chapters 3, 4, 5 and 6) are:

- Constraints related to the macroeconomic environment and policy (taxation; foreign exchange regulations; etc) and access to finance
- The shortage of skilled labor
- Taxes and the regulatory framework
- The quality, price and reliability of infrastructure

6. Measures to improve Thailand's investment climate should of course take into account the fact that constraints vary across regions, industries and types of firms. These variations, described in details in Annex 1, may have policy implications. For instance, tax reforms need to address the special concerns of small firms; efforts should meet the needs of the industries most affected by skill shortages; etc.

- *Regions:* Particular regions face specific challenges. For instance, concerns about infrastructure supply and utility prices were especially marked in the Northeast. More generally, the investment climate of some regions is perceived as superior to that of others. Bangkok and vicinity, the Central and the Eastern region are viewed most favorably; the South, the North and the Northeast most negatively.
- *Industries:* The extent to which firms are constrained by particular obstacles differs across industries. For instance, the perception of skilled labor shortages did not vary much across regions, but a lot across industries. It was viewed as particularly severe in the garments, wood and furniture, machinery and auto-parts industries.
- *Firm characteristics:* Different firm characteristics often imply different concerns: smaller firms were much more concerned about inadequate access to credit than larger firms. They also appeared more constrained by high and complicated tax regimes. Exporters naturally worried more about foreign currency regulations than other firms.

7. Thailand has much to build on, but decisive action is required as the country moves forward. Improving the investment climate by removing key constraints would help enterprises reduce costly inefficiencies and would give a boost to productivity and growth in Thailand.

Investment Climate and Enterprise Productivity

8. Thailand's rapid growth and transition to middle-income country status in the past two decades was mainly the result of the rapid increase in employment and capital goods. Productivity growth has been relatively low. Out of the six percent annual growth rate in 1985-2005, only one-sixth of that was attributable to total factor productivity and less than one-tenth to human capital improvements.

9. High growth rate may not be sustainable in the long run if it depends solely on factor accumulation due to the diminishing marginal contribution of capital. Not only the quantity but the quality of growth is essential. Given the ongoing decline of Thailand's labor cost advantages in several industries by international competitors and the appreciation of the Thai Baht, much of Thailand's success in the global marketplace will depend on its ability to achieve fast and continuous productivity improvements. This can be accomplished *within each industry*, not only by advancing technological frontiers through innovations, but also by catching up with global best practice through the adoption and adaptation of existing products, processes and methods. Productivity gains can also be attained *between industries* by providing incentives to reallocate resources to more productive industries and by moving up the technology ladder. Enhancing the investment climate helps realizing both types of gains by providing firms with a better environment, fewer unjustified risks and less unnecessary regulations and costs.

10. Chapter 2 of the report provides details about the relationships between investment climate indicators and productivity, both at the national level and across industries, using three different measures (labor productivity, TFP and sales growth). The data from both PICS rounds are not sufficient to make causal statements about these relationships. More research on the links between the diverse elements of the business climate and firm productivity would be required before making pronouncements. In policy terms, it is clear that political stability and stable macroeconomic and trade policies would have positive payoffs in terms of economic growth and productivity. What is less clear is whether improvements in the investment climate, which would certainly provide favorable incentives for increased investment, would also lead to significant productivity gains by firms.

11. The PICS results suggest that firm performance is higher in areas where the investment climate is better, skilled labor supply abundant, regulations and bureaucratic procedures less burdensome, infrastructure services reliable and financial service accessible. An improvement of investment climate over time is associated with an increase in firm performance. This is a self-reinforcing process as high economic returns encourage capital accumulation and growth virtuously. Since development is path-dependent and agglomeration effects play an important role in the growth process, this can perpetuate existing differences in investment climates if they are not addressed appropriately. The urgency to eliminate investment climate constraints is reinforced by the pressure of international competition. Policymakers cannot wait since other countries are catching up and the window to reap the benefits of reforms can close quickly.

Key Investment Climate Constraints

12. The uncertain political situation since 2006 has negatively affected the Thai economy. The PICS 2007 was fielded at a time of great political instability and policy uncertainty. This is clearly reflected in the subjective assessments of enterprise managers. Instability and economic policy uncertainty became major issues – firms that perceived it a major or severe obstacle doubled from one-third in 2004 to two-thirds in 2007. Forty percent of firms ranked political instability as one of their three biggest obstacles in 2007 compared to less than 10 percent in 2004. The negative changes in the investment climate were to some extent magnified by this somber entrepreneurial mood while the improvements often went unnoticed. The pessimistic business sentiment resulted in a sharp decline of private investment growth, from 10.6 percent in 2005 to 3.7 percent in 2006 and 0.5 percent in 2007. Gross foreign direct investment (FDI), which had been the main source of investment growth in 2005 and 2006, declined by US\$10 billion in 2007.

13. Inadequate financial service negatively affected firms' investment decisions. Limited access to finance contributed to sluggish private investment growth. An increasing share of firms had to forgo commercial loans and finance their working capital and new investments through internal funds or retained earnings. In PICS 2007, 23 percent of firms reported access to domestic credit as a major or severe obstacle—a sharp increase from the 14 percent of PICS 2004. Some 35 percent of firms reported the high cost of financing to be a major constraint to business in 2007, compared to 15 percent in 2004. Although more than half of the firms reported that fluctuations in the exchange rate and volatility in commodity prices adversely affected their investment decisions, less than one-fifth of firms used financial hedging instruments.

14. Shortages and mismatches of skilled labor and inadequacies in the technological innovation system limited the ability of Thai firms to increase productivity. Employees with college degree or above represented only ten percent of total employment in the PICS 2007 enterprises, and it takes them more than seven weeks to fill vacancies for professionals. Many job vacancies arise because applicants lack both basic and technical skills required by firms; and there is high staff turnover due to intense competition among firms for qualified labor. Two-fifths of firms responded that shortage of skilled labor was one of their three biggest constraints. The insufficient supply of qualified staff in Thai enterprises has dire consequences: not only does it immediately lower their productivity; it also limits their capacity and willingness to invest in training in the long run, which tends to perpetuate the vicious circle. The growth model of Thailand is still largely based on “learning by exporting” and advanced technology or high skill intensity play a limited role in productivity growth. Thai firms adopt new technologies, often by acquiring them from a parent company; introduce new production processes; and develop new product lines but technological innovations are very limited. PICS 2007 indicates that less than one-fourth of Thai firms have R&D staff and they only spend 0.3 percent of total sales on R&D. A weak collaboration between research institutes and industrial sectors also negatively affects innovation and technology transfer.

15. There are some indications that the regulatory framework was burdensome for some enterprises and unnecessarily increased the cost of doing business. One-third of

firms perceived tax administrations as major or severe obstacles to doing business—and one-fourth, customs and trade regulations. Tax administration was perceived by one-fifth of firms as one of their top three constraints (out of 22 investment climate indicators) in 2007—immediately following skilled labor shortage and political instability. The regulatory issues perceived by firms to be the most burdensome were tax administration, followed by customs and trade regulations, labor regulations, and time wasted in obtaining business permits and registration. The higher burden from tax administration was reflected in the greater number of days and larger uncertainty for firms interacting with the tax authorities—in particular with the Revenue Department. Although export customs clearance remains speedy, import customs clearance takes longer than before and has become more uncertain. Inefficient tax refunds, ambiguous goods categorization, cumbersome certification procedures, frequent inspection from multiple agencies, and policy uncertainties on regulations are most often mentioned as key constraints by managers in in-depth interviews.

16. No large public infrastructure investments have been undertaken since the financial crisis in the late 1990s, and the poor quality of infrastructure facilities (and/or lack of maintenance) raised the logistic costs of enterprises. The percentage of firms that reported that inadequate and unreliable public infrastructure services in transport, electricity, water, and telephone were a major obstacle for business is higher in 2007 than in 2004. Production loss due to power outages represents more than 50 percent of the total indirect costs of doing business in Thailand. Infrastructure services were the most adequate and reliable in Bangkok and vicinity and were the least satisfactory in the Northeast, South, and North. Food processing firms, which represent a large share of manufacturing production in those three regions, have the highest transport and logistics costs (eight percent of their export earnings). One-third of firms in this sector owned at least one generator since food quality is sensitive to power interruptions. They often relied on their own generators to supplement the unreliable public electricity supply. There is a pent-up demand for infrastructure in inland container depot (ICD), electricity and piped water (since the government has raised user charges for groundwater significantly).

The Policy Agenda

17. The Royal Thai Government has given priority to improving competitiveness and productivity—the key topics of the 9th and 10th National Economic and Social Development Plans which focus on education and on the development of a knowledge economy. The current government has also announced the continuation of the public infrastructure projects with an emphasis on the mass transit system in Bangkok. Efforts to improve public services and streamline bureaucratic processes are also visible and ongoing.

18. However, many programs need to be expanded and many others remain declarations or plans and still need to be translated into action. The government needs to continue to restrain rent-seeking, establish credibility and foster public trust and legitimacy. Improving the investment climate in the various areas discussed in this report would certainly be helpful. The removal of binding constraints that limit firm

performance will give firms the confidence to invest and expand, and will stimulate economic growth. An improvement in the overall investment climate does not require all constraints to be removed at the same time and the government has the possibility of sequencing reforms and public investments, depending on its policy priorities.

19. First and foremost is the key importance of political stability and economic policy certainty, which are a prerequisite for other investment climate reforms to have a positive effect. Political tensions continue to prevail in Thailand following this election, and are having a deleterious effect on the investment climate.

20. Developing financial markets is also important for business expansion, but making needed improvements in the business environment and making them known are important to boost sentiments to invest.

21. Investing in human capital and ensuring that education is more in line with the skill needs of enterprises is critical. The main challenge will be in the higher education sector, where Thailand's government has been successful in designing and passing the regulations required to modernize and make more efficient its higher education system. It now needs to focus on implementing these policies and on educating the public, and the academic community, about the advantages of a more decentralized and autonomous system. These advantages include having the potential to engage in fruitful collaborations with industry, encouraging entrepreneurial endeavors from faculty to attract external funding, and promoting cross-institutional, cross-border, and interdisciplinary partnerships for maximizing outputs.

22. Promoting a wider use of engineering, design, and IT services, improving and targeting fiscal incentives to promote enterprise innovations, having a more coordinated science and technology policy, and strengthening cooperation between research institutes and firms are also important starting steps to employ more effectively existing technology and knowledge and to help build up the capacity to innovate of the private sector.

23. Providing a stable and conducive regulatory framework is important for firms to make informed decision of investment and concentrate resources to improve productivity. Promoting a greater use of information and communication technology (ICT) services, which have become more available and affordable in recent years, would help to reduce the cost and time spent by firms dealing with regulations. This requires relatively limited budget support and implementation can begin without lengthy preparation. The government is currently making efforts to improve public services and streamline bureaucratic processes. The establishment of the Single Window at the Department of Export Promotion is an excellent example on how better coordination among government agencies can help streamline bureaucratic processes and alleviate the regulatory burden of firms. The establishment of one-stop service centers in each ministry and the greater use of information technology have also been effective in reducing the number of steps, days, and face-to-face interaction with government officials.

24. Improving infrastructure has now become a priority. It would greatly reduce the operational and logistical costs of enterprises. Increasing public investment in projects

with high expected rates of returns is expected to have large impact by alleviating bottlenecks, increasing the availability of infrastructure services and reducing logistic cost, stimulating private investment through public-private partnerships, and through positive externalities for property developers and other businesses. Given the reasonably good budget situation and the fact that new public investments would not pose significant fiscal risks, this is within the fiscal capacity of the government.