››› DEG economic analyses

The importance of the business environment for a thriving private sector

This report was produced in connection with DEG's economic analyses on the development of the private sector in its target markets.

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Last revised: February 2018

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1. Introduction

For the private sector to be able to contribute to the global sustainability agenda as agreed in Addis Ababa, a good investment climate is of fundamental importance. This is because only a robust investment climate provides incentives for companies – from micro-enterprises to multinational corporations – to invest and to create jobs. The term ‘investment climate’ describes the general political, legal and institutional conditions that influence the costs and risks associated with the establishment, running and closure of a company.[1]

Whereas a good investment climate reduces the costs and risks of corporate activity and thus facilitates the creation and implementation of investment projects, a poor investment climate discourages businesses from planning and making investments. Moreover, as investors tend to become involved for the long-term (for 10-20 years or even longer), it is important that the business environment improves not only temporarily but in a reliable manner.

Development finance institutions (DFIs) such as DEG have a mandate to provide financing and advisory services to private companies in developing and emerging-market countries. However, they also rely on customers (i.e. business owners) *requesting* these services. Whether or not businesses seek financing depends on whether and to what extent the general business environment opens up investment opportunities. The more favorable the investment climate, the more business opportunities are available to companies operating locally and the more successfully DFIs can fulfil their mandate: financing the investment projects of private businesses.

Promoting private investments through a sustainable improvement of the investment climate is also a goal of the “Compact with Africa” which was initiated by the G20. Given the relevance of this topic in the current debate, Section 2 of this paper provides an overview of the key elements of a good investment climate. By way of illustration, Section 3 contains two country case studies.

2. Four core elements of a good investment climate

When planning initiatives to improve the investment climate, it is important to keep business conditions for *all* companies in mind. In contrast, the selective support of certain firms or sectors, for example through tax breaks or barriers to market access, should be avoided.

First, the success of selective subsidy policies has not been proven conclusively, and even if measures have worked in one context, they cannot necessarily be replicated in other countries, or not with same result. Second, improving the fundamental business environment for all companies is preferable, since this generates a positive impact not just for com-

[1] Cf. World Development Report (2005) “A better investment climate – for everyone”.

panies but for society as a whole. Examples include ensuring macro-economic stability (low inflation, stable exchange rates), reducing corruption and enhancing infrastructure. The following four areas have a crucial influence on the investment climate:

1. **Stability and security**: By definition, investment decisions entail uncertainty, since they involve assumptions regarding the reactions of customers and competitors and in relation to technological developments. While these uncertainties are inextricably associated with business activity, political uncertainty, macro-economic instability (e.g. high or volatile inflation rates) and arbitrary regulations act as a deterrent to domestic and foreign investors. War and violence – as extreme cases of uncertainty – constitute the end of any productive investment. Consequently, a minimum level of political and macro-economic stability is a prerequisite for further reforms to be effective. It is therefore the responsibility of governments to ensure stable, predictable policies and a stable legal framework. In this regard, the protection of property rights is of vital importance. This includes the protection of land rights, the enforceability of contracts, the reduction of criminal activity and the avoidance of expropriations without financial compensation.

2. **Taxation, regulation and restraints on competition** have a significant impact on the costs of doing business.

   - **Taxation** generates the income necessary to finance public services (health, education, etc.). It is nonetheless important to structure corporate taxation in such a way that it does not undermine investment opportunities and incentives for firms. Key factors with scope for adjustment include not only the level of taxes but also the effort required for submitting tax returns, the transparency of taxes and the complexity of the tax system (overlapping tax rates, etc.).
   - Good **regulation** strikes a balance between the interests of companies and social or societal objectives. Excessive regulation and/or bureaucracy, however, increases costs, e.g. in the form of time needed to apply for a licence or to register a company or for customs clearance. As with taxation, it is important to find the right balance in regulation.
   - Although **restrictions of competition** benefit some (frequently state-owned) companies, they increase costs for other companies and hence also for consumers. Furthermore, they weaken the incentives for the protected companies to innovate and to increase their productivity. In developing countries, it is common for the majority of companies to be state-owned. In such circumstances, it is important that state companies are not afforded preferential treatment over private companies (for example through subsidised loans or preferential access to foreign currency), and that instead the same rules apply for state and privately-owned companies.

3. **Financing and infrastructure**: Well-functioning financial markets connect companies to lenders and investors. Sound infrastructure connects firms to their customers and suppliers. In many countries, however, there are major shortcomings in these areas.

- Financial markets are often hampered by state interventions, such as state banks, controlled or state-subsidised loans, and barriers to competition. In addition to reducing state intervention, reinforcing the rights of creditors and shareholders, establishing credit information mechanisms (similar to Schufa) and bank regulation can all contribute to more efficient financial markets.
- Infrastructure deficiencies differ greatly from country to country. From a private sector perspective, deficiencies in telecommunications, energy supply and transport (i.e. road construction, ports) have a particularly severe impact. In addition, inadequate infrastructure deters new companies from entering the market, meaning that existing unproductive and insufficiently innovative firms are shielded from competition. Expanding infrastructure thus plays a key role in several respects in terms of a good investment climate.

4. **Employee qualifications and labour markets:** For companies in developing and emerging-market countries, the often-inadequate skills of the workforce constitute a significant constraint. Improving education and training is thus a vital task for policymakers. A further issue is over-regulated labour markets, which are detrimental to both companies and the workforce since they tend to lead to an increase of informal employment. Adjustments to labour markets should be designed to take into account the varied interests of workers (i.e. those that are well and less-well qualified, the unemployed, and workers in the informal economy) and companies.

3. Identifying reforms to improve the investment climate – a practical approach

A government that wishes to improve the investment climate in its country needs to decide in which order to tackle the issues outlined above. In this regard, it is important to note that there is no standard ‘formula’ for improving the investment climate of a country. Firstly, the investment climate and its deficiencies vary from country to country and sometimes even from region to region within a country. Secondly, shortcomings in the investment climate differ for companies of different sizes (e.g. SMEs vs multinational companies).

In any event, the *starting point* for developing a reform agenda should be an analysis of the general economic conditions across the four core elements described and a fundamental understanding of the economic model of the country in question.

As a next step, it is important to *prioritize the reforms* to be implemented rather than attempting to address all areas at the same time. Ways to do this include…

- …determining the most significant obstacles from the perspective of companies, e.g. by conducting a company survey.
- …benchmarking, e.g. by comparing key indicators across different countries. The World Bank’s “Ease of doing business index”, for example, consists of various indicators that measure the quality of the investment climate. Additional indices can be used, such as the World Bank’s Worldwide Governance Indicators or the World Economic Forum’s Global Competitiveness Index. A given country can be

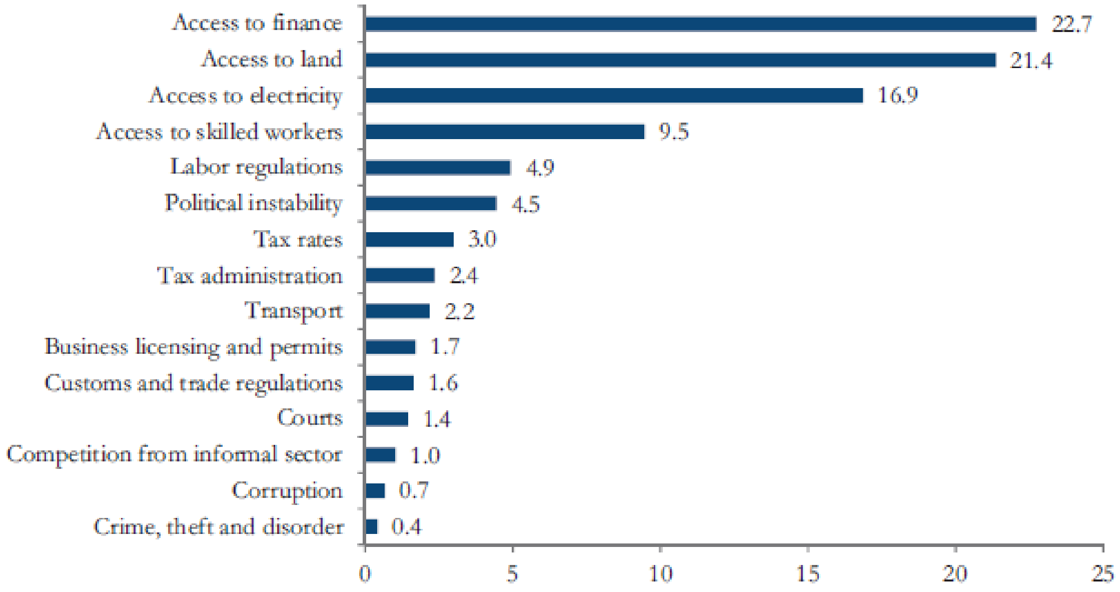
benchmarked by comparing it with its peers (e.g. with its neighbouring countries) or with the top-performing countries.

The section below illustrates potential approaches based on two country case studies.

A. Myanmar

In the context of investment climate work carried out on behalf of the Myanmar government, a total of 700 small, medium-sized and large companies was surveyed. The graph below shows the main obstacles that were cited. The four most significant obstacles from the perspective of businesses are inadequate access to finance, land, electricity and skilled workers.

Graph 1: Share of firms identifying the main obstacle (in %)



Source: World Bank (2015): Myanmar Investment Climate Assessment

- *Finance*: Since the financial sector is not adequately fulfilling its function as an intermediary, 92% of companies use their own resources to cover financing requirements. Only 1% of investment costs were financed by borrowing. Moreover, only 30% of the companies surveyed held a bank account. The situation described is the consequence of legal and regulatory restrictions, including the specification of an interest rate ceiling, limits to loan terms and onerous collateral requirements.
- *Land*: Access to land is considerably more difficult for micro-enterprises and SMEs than for large companies. The rules for obtaining, retaining and transferring land use rights are complicated, non-transparent and uncertain. These unclear land rights are jeopardising not only the sustainable growth of Myanmar but also its social cohesion.
- *Electricity:* The unreliable supply of electricity is especially problematic for medium-sized and large companies. As a result, most companies own their own generators, so that they can rely on them in the (frequent) event of a power failure.

- *Qualified workers:* 80% of respondents stated that the education system produces insufficiently qualified workers; 75% of respondents criticised the unsatisfactory work ethic of employees.

For a reform program to be successful, the role of the state needs to change. Instead of directly controlling the economy and promoting certain key sectors in particular, its role must be geared towards supporting all companies equally – regardless of whether they are state-owned or private companies and irrespective of personal relationships – and towards guaranteeing access to critical input factors.

B. Ethiopia

Ethiopia has been trying to establish itself as a location for foreign direct investment (FDI) for some years. An analysis of the economic environment focusing on the four core elements of a good investment climate establishes a basis for understanding which reforms are necessary. Additionally, a benchmarking exercise based on the World Bank's Doing Business report helps to identify the specific barriers to investment.

a. Economic environment

The government has recognized that the private sector and FDI are fundamental for economic growth and development and supports these parties with tax breaks and other measures. Nevertheless, the government has an ambivalent relationship with privately owned companies: its basic attitude towards the private sector is characterized by critical suspicion and mistrust. It is therefore pursuing conflicting objectives, on the one hand maintaining its strong influence on the private sector and on the other hand seeking to attract foreign investors. This results in a number of adverse effects for private companies:

1. Regulation

- The local currency is overvalued and not freely convertible. Tight foreign exchange controls regulate access to foreign exchange and even to self-generated foreign exchange. For companies that rely on the import of intermediate products, this constitutes a risk of production shutdowns.
- A paralysing bureaucracy and often poorly qualified civil servants prevent the efficient implementation of state regulation and generate high real costs that partially thwart other cost benefits.

2. Restraints on competition

- On the one hand, economic policy defines sectors that are closed to foreign direct investment (currently still more than 20), on the other hand, it specifically and selectively supports investors in sectors where Ethiopia has a comparative advantage.
- By means of state-owned companies, the state continues to be actively involved in a number of sectors it considers strategic, in some areas dominating the market. Although individual government stakes have been privatised elsewhere, new and sizeable state-owned companies have emerged, with current examples being in sugar production and

the metal industry. Thus, the government does not understand ‘privatisation’ as the state’s withdrawal from the economy but rather as portfolio management, whereby the objective is to divest of less important stakes while acquiring new holdings. The scope for investors lacking direct political support is thus small.

3. Financing and infrastructure

- The financial sector, which remains closed to foreign investment, does not provide companies based in Ethiopia with sufficient financing for investment and working capital. As a result, for the most part companies need to finance themselves from their own resources, while production capacity is frequently underutilised due to a lack of working capital finance.
- Despite some progress, weaknesses in the state-dominated energy and telecommunications sectors continue to create considerable problems, such as unstable, unreliable power supply and poorly functioning telecommunications.

4. Labour markets

- Most workers are low-skilled, with labour productivity being correspondingly low.

b. Specific barriers to investment

In the World Bank’s Doing Business 2016 report, Ethiopia ranks 146 out of 189 countries. Although this places Ethiopia slightly above the average for sub-Saharan Africa (143), it nonetheless ranks significantly lower than, for example, Botswana (72) or Ghana (114).

On the positive side, the legal framework for foreign investors has slowly but continuously improved since the 1990s. However, when it comes to *implementation,* there is enormous potential for improvement, e.g.:

- Despite tax exemptions for investors, taxation practice, especially retroactive taxation changes, is a massive risk for investors.
- The multitude of necessary authorisations for an investment and the lack of transparency on these regulations requires substantial effort.

If the Doing Business sub-indicators for Ethiopia are compared to other countries in sub-Saharan Africa (Kenya, Tanzania, Nigeria and South Africa), which attract significantly more investors than Ethiopia, the need for action becomes evident.

The areas where Ethiopia performs more poorly than its peer group constitute constraints not just for domestic investors but also for foreign investors. The most significant gaps between Ethiopia and the group average are those in relation to protecting minority investors, starting a business and getting credit.

Table 1: Comparison of Ethiopia with South Africa, Nigeria, Kenya and Tanzania

‘Doing business’ indicators	Ranking of Ethiopia	Group average	Gap between Ethiopia and the group
1. Security			
Enforcing contracts	84	102	-
Protecting minority investors	166	88	**78**
Registering property	141	134	7
2. Regulation			
Dealing with construction permits	73	123	-
Starting a business	176	143	**33**
Resolving insolvency	114	108	6
3. Financing and infrastructure			
Getting electricity	129	138	-
Getting credit	167	93	**74**

Source: World Bank Group Doing Business Report 2016

🟥	Worse than peer group
🟩	Better than peer group

However, in light of the obstacles for private businesses and FDI that are inherent to Ethiopia’s economic model, any breakthrough would require major reforms and hence adjustments to the economic model. Improvements to business-related regulation in accordance with the table above will not be sufficient on their own.

C. The experience of DEG in Ethiopia

The experience of DEG in Ethiopia confirms the importance of the named investment barriers. Especially companies in the manufacturing sector face a number of constraints, such as the difficulty of accessing foreign exchange (which is necessary to pay for imports), the lack of skilled personnel and time-consuming customs procedures. For DEG as a financing institution, risks exist mainly with regard to the introduction of capital controls, which would make it difficult to repatriate dividends and sales proceeds.