International Conference: "Reforming the Business Environment", Cairo, 29 November – 1 December 2005

Conference Theme 1: Assessing the business environment for small enterprise development

MAKING SENSE OF INVESTMENT CLIMATE SURVEYS

Presenter: Katja Silva-Leander
Investment, Competition & Enabling Environment Team, DFID

October 2005

CONTENTS

1. Summary

A good investment climate is central to private sector led growth and investment, which in turn is essential for employment generation, income growth and poverty reduction. Effective policies to improve the investment climate require the development of a sound evidence base on the problems and constraints to private sector investment. In recent years a wide array of assessment techniques and tools have been designed to measure key components of the investment climate. Yet many challenges remain. There is no single approach that can be said to be superior to all others, nor does it seem feasible to develop an all-embracing methodology that can generate all the information needed for investment climate policy analysis. The appropriate measurement and analytical technique depends on the purpose of the investment climate study, whether, for example, the research focus is on the economy as a whole, a particular sector, or a particular feature of the investment climate such as regulation, corruption or infrastructure. This paper discusses some of the key survey approaches being used to diagnose the investment climate.

In view of the bewildering variety of survey approaches being used to measure various features of the investment climate, DFID has recently developed an in house database search tool aimed at rapidly identifying and summarising the key features of the various survey approaches and enabling practitioners to find out quickly which types of survey have been conducted in which countries. Section 6 of this paper describes the investment survey approach database tool developed by DFID This database is a work in progress and needs to be updated periodically, but it is felt that it is sufficiently developed to be useful to a wider audience outside DFID concerned with business environment diagnostics. DFID intends to update and expand the database following the Cairo conference and produce it in CD form for wider dissemination.

An important question that arises in any study of investment climate diagnostics is how to improve the relevance and usefulness of investment climate assessment studies for policy formulation, and how to move more effectively from investment climate diagnostics to policy implementation. This question is beyond the scope of the present paper but will undoubtedly be a focus of much discussion at the Cairo conference. However, donors have an important role to play in helping build the bridge between survey reports and action, particularly through support for public private dialogue processes and capacity building to governments.

2. Introduction

There is now almost universal consensus that a sound investment climate is critical for private sector led economic growth. A good investment climate provides opportunities and incentives for firms – from micro enterprises to multinationals – to invest productively and create jobs. The investment climate shapes the costs and risks of doing business, as well as barriers to competition, all of which strongly influence the role and impact of the private sector in social and economic development, economic growth and poverty reduction. The investment climate in recent years has become a key issue in international policy discussions on promoting private sector development.

The investment climate is a broad concept and on the widest definition can comprise all factors external to firms, including the policy, legal and regulatory framework; external trade policy; governance and institutions; physical security; the social and cultural context of business; macroeconomic policies; access of firms to financial and business services; and the availability of physical and social infrastructure services. The breadth and complexity of the investment climate, and different views on what it should comprise, poses inherent difficulties in attempts at measurement, or to compare the quality of investment climates between different countries.

Over the past decade, improved data collection methodologies have contributed to an increased understanding of what elements constitute a good investment climate and how these elements vary in relative importance. The first comprehensive study was the World Bank sponsored Regional Programme on Enterprise Development (RPED), which carried out a number of surveys in various countries between 1992 and 1995. The surveys covered approximately 200 firms over a period of three years, thereby producing panel data[1]. In the late 1990s, the World Bank established Investment Climate Surveys (ICS) and the World Business Environment Survey (WBES), which were oriented towards investment climate issues and concentrated on cross-section data.

Over time, many other surveys or assessments have been created by a number of institutions. Generally speaking, investment climate assessments help identify the aspects of the investment climate that matter most for productivity, private sector development and income growth. They also help in tracking changes of these aspects over time and in facilitating the comparison of data between countries, regions, sectors etc.

3. What different investment climate approaches exist?

There is a vast range of different approaches to measuring and analysing the investment climate. This indeed has almost become an industry in itself. Some of the more common approaches are discussed in the following sections.

3.1 Comprehensive studies

Many early studies were of a comprehensive nature and focused on numerous aspects of the investment climate in individual countries. The thorough and in-depth analysis of these comprehensive studies make them ideal for facilitating dialogue between governments, the private sector and civil society.

3.1.1 Aggregate indices

Some of these comprehensive assessments aggregate the various components of the investment climate to create a single index, such as the World Economic Forum's Global Competitiveness Index and the International Institute for Management

[1] Cross-section data (comparing countries, regions, sectors etc.) over a period of time

Development's (IMD) World Competitiveness Scoreboard. The former aims to measure the growth prospects and different elements of economic competitiveness in countries. In 2003, Finland ranked highest in this Index and Haiti lowest. The World Competitiveness Scoreboard ranks countries in terms of "how a nation's environment creates and sustains the competitiveness of enterprises". In 2004, the USA ranked highest, and Venezuela lowest.

3.1.2 Disaggregate indices

Micro-level data generated through studies such as the Commonwealth Business Council's Business Environment Surveys (BES) and the World Bank's Investment Climate Surveys (ICS) indicate that country-level aggregate indicators can sometimes be misleading. Microdata shows that there are big variations within countries and across different types of firms. The ICSs cover over 30,000, mostly local, firms in 53 countries. The World Bank's World Development Report (WDR) 2005 complemented this work with surveys of 3,000 micro and informal firms in 11 countries. The surveys cover both perceived and objective costs of many dimensions of the investment climate, based on the actual experience of firms.

3.1.3 Other indices

Other comprehensive studies are carried out by the United Nations Conference for Trade and Development (UNCTAD) and United Nations Industrial Development Organisation (UNIDO). The UNCTAD Foreign Direct Investment Potential Index (2003) looks at characteristics that make a country attractive to foreign investors. It provides a snapshot of some dimensions of the overall investment climate including skill levels, infrastructure, communications, and country risk. But, 'FDI Potential' is not a perfect proxy for the investment climate, as it focuses too heavily on the potential for and preferences of foreign investors, who may be interested in very specific sectors (such as natural resources and export goods). And FDI is only a small part of total domestic investment.

Additionally, a number of surveys and indices are produced by private entities, focusing on different investment climate aspects, for example the Economist Intelligence Unit, Euromoney and PricewaterhouseCoopers, or on sectors, for example IHS Energy for country rankings of petroleum exploration attractiveness. Moody's and Standard and Poor's credit rating agencies compile Sovereign Rating Listings, which rank countries according to their willingness and ability to repay debt.

3.2 Studies of specific investment climate features

Some investment climate assessments attempt to benchmark specific features of a country's investment climate against those of other countries. This allows explicit comparisons between countries and can provide strong incentives to governments to implement policy reform in order to climb up the country 'league table'.

3.2.1 Regulation

The World Bank's Doing Business series ranks countries according to various aspects of the regulatory environment, such as the time taken and costs associated with starting or closing a business, getting credit, or enforcing a contract. For example, it shows that bankruptcy procedures are fastest in Ireland and slowest in India, cheapest in Singapore and most expensive in Macedonia.

3.2.2 Corruption

Transparency International's Corruption Perception Index ranks 133 countries according to perceived levels of corruption. In 2003, Finland topped this index as the country with the least corruption, whilst Bangladesh was perceived as the worst country in this regard. Botswana was the best African country in 30th position and India was 83rd.

3.2.3 Freedom

Several indices measure levels of freedom, such as economic freedom (The Heritage Foundation's Index of Economic Freedom) and political and civil liberties (Freedom House's Freedom in the World Index).

3.2.4 Others

Other specific features include: competitiveness (The World Competitiveness Yearbook, which benchmarks specific aspects of industrial competitiveness), governance (The World Bank's Governance Indicators), legal issues (the European Bank for Reconstruction and Development's Legal Indicator Survey), human development (UNDP's Human Development Index), the environment (the World Economic Forum's Environmental Sustainability Index) and transparency (Transparency International Index).

3.2.3 Other studies

Other studies focus on sub-national areas within a country or on specific sectors or firm sizes. They can stimulate policy reforms and are useful for pinpointing the areas where reform is needed most, and indeed where progress has taken place over time.

3.3.1 Sub-national

Some surveys provide rankings of sub-national areas such as cities or states within a country. The World Bank Investment Climate Assessments (ICA) of India and China, which draw upon the results of the Investment Climate Surveys (ICS), are examples. These assessments rank different Chinese cities and Indian states, respectively, on various factors such as labour market flexibility, infrastructure, research and development, and staff quality. This approach typically reveals considerable variations in the investment climate within countries.

3.3.2 Sectors or firm sizes

Other surveys provide rankings for specific sectors or firm sizes, such as the Multilateral Investment Guarantee Agency's (MIGA) "Benchmarking Foreign Direct Investment Competitiveness in Asia". This survey focuses on East Asia and the services and electronics sectors in particular. This approach enables more detailed analysis of the specific obstacles faced by firms in a particular industrial sector.

One area that has been relatively neglected in the coverage of investment climate survey tools is the informal economy. However, the World Bank and FIAS (Foreign Investment Advisory Service) have recently made efforts to narrow this gap. As part of the 2005 World Development Report (WDR) on the investment climate, the World Bank WDR team carried out eleven background surveys on the informal sector, mainly in Africa, using a modified Investment Climate Survey instrument. FIAS is piloting a policy-oriented survey instrument in Rwanda and Sierra Leone, with the objective of producing policy recommendations to shift economic activity from the informal to the formal sector.[2]

4. What are the challenges in assessing the investment climate?

Assessing the investment climate encounters a number of challenges as discussed in the following sections.

4.1 Aggregate versus disaggregate data

Aggregate indicators are useful for identifying key dimensions of the investment climate at the country level. They can be used to analyse the causes and consequences of the quality of the business environment and to compare them across countries. The Doing Business database uses this method by collecting data from law and regulation experts rather than individual firms. This allows it to identify various aspects of the regulatory environment facing firms in a large number of countries.

However, aggregate scores can hide enormous variations between different components of the investment climate. A country can score high on macroeconomic environment and poorly on infrastructure, but the total score will not show these variations.

Aggregate studies fail to highlight differences within countries. The investment climate can vary substantially between different locations within a country. This is particularly the case in large countries where, for example, geographic conditions may lead to differences in infrastructure facilities. It is also the case in federal countries, where sub-national governments may adopt different local policies and regulations.

Aggregate data also fails to show differences across firms or sectors. Different features of the investment climate affect firms in different ways, depending on their size, activity, location etc. For example, smaller firms may be disproportionately affected by certain fixed costs, such as lump sum taxes. Similarly, the same policy can sometimes affect firms in directly opposite ways, benefiting some at the expense of others. As such, state monopolies may benefit some firms while preventing others to enter the market or raising prices for products sold to them.

[2] FIAS Concept Paper for a Conference on Informality (circulated at annual FIAS donors meeting October 2005)

Furthermore, there is a multidimensional aspect to the investment climate that cannot be identified through aggregate indices. Various dimensions interact with each other and have causal links that only appear in a more disaggregated analysis. For instance, lack of access to finance is not necessarily only linked to deficiencies in the financial sector, but could also be due to poor infrastructure or lack of secure property rights.

The result is that aggregate indices may not be sufficiently effective tools to identify priorities for reform in a country. In many cases, a more disaggregated analysis is necessary to identify variations in criteria, within countries and across firms, and allows a causal interpretation of the results. There is also a methodological advantage, as the size of samples available is usually larger than for aggregate studies making the statistical results more robust. Firm-level surveys collect data from a large number of firms, whereas samples for aggregate indices are limited to the number of countries in the world.

4.2 Objective versus subjective data

Some investment climate assessments are based on objective data, such as actual number of power shortages in a year, whereas others are based on subjective data, such as perception-based surveys investigating firms' subjective opinions.

While objective measures allow a more precise benchmarking of conditions and facilitate comparisons between countries, not all investment climate dimensions can be measured objectively. Some dimensions are difficult to quantify and measure consistently across countries. Policy risk and competition, two of the critical elements of an overall investment climate, are examples of such dimensions. Others are of a sensitive nature and may not be reported adequately. For example, issues related to corruption may be underreported and may be difficult to uncover merely through statistical analysis.

Furthermore, there are methodological weaknesses linked to objective measures. In many countries, data can be difficult to find, due to weaknesses in collecting and reporting data or due to political or economic disruption. Available data can be unreliable due to limited statistical systems of many developing economies. Statistical methods and definitions differ between countries making cross-country comparisons sometimes unreliable.

Subjective indicators are necessary to reflect differences in perception across types of firms or locations, as perceptions are fundamental to investment decisions and behaviour. Furthermore, perception-based surveys are efficient for identifying whether written laws and regulations are actually being implemented in practice. The realities on the ground can sometimes be very different from policies on paper. Also as indicated above, the same policy or investment climate dimension can be perceived in different, sometimes opposite, ways by different types of firms.

However, perceptions may not be comparable across countries. What may be perceived as cumbersome regulatory practices in one country may be perceived as normal practice in another due to different cultural attitudes. In addition, it is difficult to make historical comparisons of perceptions, as the survey base most often changes over time.

The reality is that both objective and subjective indicators can contribute something to the analysis and an investment climate assessment is most complete if it contains both types of data.

5. How do we move from assessment to implementation?

A vast number of studies of the investment climate have been undertaken over the past decade. Indeed, many would argue that developing countries have been over-surveyed and it is now time to move from diagnostics to solution design and implementation of policy reforms. This final section looks at the continuing role of investment climate assessments and considers the issues in moving from survey findings to practical business environment reforms.

5.1 What are the benefits of investment climate assessments?

The findings of investment climate surveys can be used by many stakeholders. They can help governments and policymakers identify which dimensions of their investment climate need improving and what action needs to be taken for this. They help investors assess the business environment they are operating in, or plan to operate in. And they can form the basis for public-private dialogue between government and business on how to improve the investment climate. Finally, survey results help the donor community identify country-specific issues in order to develop targeted private sector development programmes.

Investment Climate surveys help raise awareness amongst stakeholders of those dimensions of the investment climate that may require attention. They raise the profile of issues that may constrain the effective functioning of the private sector and that may need correcting, such as corruption, or excessive regulatory and administrative burdens.

Assessments also highlight how the country performs in comparison with other countries and facilitate the identification of best practices in investment climate policy. They inform governments how the investor community perceives other countries' reforms. This can give policymakers an incentive to address issues that other countries may be dealing with better.

The increased awareness of the dimensions and importance of the investment climate by government, businesses, civil society and the public in general, stimulates debate in the country and provokes dialogue between relevant stakeholders. As such, business environment surveys can be seen as a channel of communication, particularly between the government and the private sector, and form the basis for public-private dialogue. The dialogue established will put pressure on relevant parties to take action to address the issues at stake.

Investment climate surveys also provide the tools and analytical framework to help governments identify reform priorities in their country and the steps to take in order to improve conditions.

5.2 Are diagnostic tools sufficient for implementing reform?

Although investment climate assessments are necessary to develop a sound evidence base for the identification of good investment policy frameworks, they are not sufficient by themselves for improving the business environment. It is not enough to know how a country is ranked or be aware of the problems and issues that constrain private sector growth. A government needs to understand why there are constraints and what reforms will be needed to correct the failures and impediments in the system. Benchmarking with other countries can help governments identify best practices in other countries.

However, once best practices have been identified, policies need to be implemented to stimulate business activity. Implementation of reforms is crucial for any sustained improvement in the business environment. However, many governments face major capacity constraints and are unable to design or execute the identified reforms. Even when the private sector steps in to fund and manage certain projects, which is often the case in infrastructure, the government lacks the capacity to manage the public-private partnership, particularly when it is large and complex.

5.3 How do we move from assessment to implementation and what role can donors play?

The donor community can play a crucial role in building the necessary capacity within governments to implement reform. As such, donors should move beyond the mere provision of diagnostics and engage in long-term partnerships with governments. They should develop comprehensive investment climate programmes that include everything from assessments of the investment climate to technical assistance for implementing reforms, as well as monitoring and impact assessments over a number of years.

Once the relevant information has been gathered through investment climate assessments, effective dissemination of the findings is crucial. This will help raise awareness of the issues amongst relevant stakeholders and help stimulate debate and dialogue.

While standardised diagnostics are valuable for benchmarking, they are not sufficient for identifying country-specific needs. The findings of standardised diagnostics should therefore be used to develop more tailored and prescriptive solutions that can be applied to specific circumstances. Priorities should be ranked and the most important issues selected to provide the basis for a focused approach to reform. A more focused approach tailored to local circumstances will help shape country-specific reform recommendations.

It is also important to engage stakeholders at an early stage of the investment climate assessment process. Early stakeholder engagement will help create ownership of the results and increase the government's accountability for reform implementation. It will also contribute to identifying the issues at stake and priorities for reform, as well as designing appropriate solutions.

Once the reforms have been implemented, it will be important to monitor progress over time. Impact assessments of the implemented reforms should be performed as this will generate data on how and to what extent particular investment climate indicators have been influenced and what remains to be done. DFID work has recently developed an integrated framework to assess the impact of reform interventions on key investment climate indicators.

6. Investment Climate Surveys Database

This database in the attached Excel file has been compiled by DFID's Investment, Competition and Enabling Environment (ICEE) Team, to assist DFID staff who require information about the investment climate of individual countries. It includes 30 investment climate surveys and rankings available on the web. The entries contain:

- **information on the institution that produces the survey,**
- **frequency of the survey**
- **the exact nature of what the survey is intended to measure,**
- **the indicators and methods used to do so,**
- **all the countries which the survey covers,**
- **a few results or conclusions drawn by the most recent survey,**
- **a hyperlink that will take you to the survey website itself.**

The Excel file attached to this report gives a complete listing of all the surveys in the database, displayed in alphabetical order.

If readers are looking for studies that consider **many aspects** of the investment climate, and then aggregate them to create a **single index**, then the World Economic Forum's Global Competitiveness Report and the International Institute for Management Development's (IMD) World Competitiveness Scoreboard are the ones to consult.

For **country** investment climate (IC) surveys, the ICEE Team recommends The World Bank's Investment Climate Surveys**.** Their comprehensive and in-depth analysis makes them ideal for facilitating dialogue between governments, the private sector and civil society. For a lighter comparative approach we suggest the Commonwealth Business Council's Business Environment Surveys (BES)**.** Both the ICAs and BESs are repeated at 4-yearly and 2-yearly intervals respectively, thereby helping to shed light on how investment climates are changing over time

Other investment climate surveys attempt to benchmark specific features of a country's investment climate against those of other countries. For example:

- **business regulations** (see the World Bank's 'Doing Business' series),

- the **degree of corruption** (see Transparency International's Corruption Perception Index),

- the **quality of governance** (see The World Bank's Governance Indicators)**, economic freedom (**The Heritage Foundation's Index of Economic Freedom) **and political and civil liberties (**Freedom House's Freedom in the World Index)**.**

Also, some surveys assess **sub-national areas** such as cities or states within a country, such as The World Bank Investment climate Assessments of India and China.

Still others, such as the Multilateral Investment Guarantee Agency's (MIGA), "Benchmarking Foreign Direct Investment Competitiveness in Asia"**,** provide rankings for **specific sectors or firm sizes.**

In assessing the quality and value of each survey for a particular purpose, users should consider the sources of the data (primary or secondary), the nature of the data used (quantitative or qualitative), whether it focuses on either domestic or international investment, the credibility of the institution that produces it (the World Bank leads here) and who its main audience is intended to be.

Electronic search function (To be used with the attached Excel file)
(Click **'Yes'** when asked to enable macros).

Either read through the entire table or simply select your country/continent and/or the nature of the survey and/or the type of data (qualitative, i.e. survey based or quantitative) you want the survey to consider from the drop-down section boxes below, and the search engine will pull up details of all investment climate surveys that deal with that country and/or consider that specific aspect of the investment climate.

Select country/continent:	
Nature of survey:	
Quantitative or qualitative data:	

Disclaimer: To the ICEE Team's knowledge, the information contained within this database is correct at the time of posting, and any views expressed do not necessarily reflect official DFID policy.

Who to contact: K-Silva Leander@dfid.gov.uk

Date: 4th November 2004