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Governance Issues and Investment Climate

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ABSTRACT

This paper reports findings on the perception of business leaders on investment climate. We met captains of industry. In-depth interviews revealed that governance factors are highly significant to investors. Business leaders find the government unfriendly. They see political instability and unstable policy as major barriers. They dislike the rampant corruption. They face unduly slow and complex bureaucracy. They want immediate action to reform governance. They want simpler rules. They prefer deregulation. They seek transparency. They want an investment council to serve as a bridge between the government and the investor community. They want the government to consult the business community to discover ways to improve the investment climate.

Keywords: Investor Perceptions, Governance Reform, Investment Council, Investment Climate

INTRODUCTION

Governance affects investment decisions. Investors attach a high degree of importance to governance factors. They seek immediate attention to the issues. They want proper reform to improve governance.

This paper reports findings from a field survey of prominent captains of industry and influential leaders of the business community. They identified the nature and severity of problems affecting their investment decisions. They suggested potential general and specific solutions of these problems.

Our research team used structured and unstructured questionnaires. The unstructured questionnaire gave the respondent the freedom to identify problems and suggest solutions. The structured questionnaire gave them a list of preidentified problems and asked them to assign a numerical value of importance.

We conducted in-depth in-person interviews with business leaders and captains of industry. We tried to reach several hundred business leaders in metropolitan Dhaka. However, there was a time limitation. The perennial traffic

jams in Dhaka made it very difficult to interview all the potential respondents. The number of respondents who ultimately were able to give us completely filled in questionnaires was 46. There were scores more whose responses were incomplete. We also talked to many respondents over the phone, but these were not included in filled-in questionnaires.

The output of the research was the list of factors identified as important and their relative magnitude of importance.

The respondents identified 48 different factors affecting investment decisions. These were put in a few clusters for analysis. The most important problems were as follows:

- Unfriendly governance, especially corruption and unstable policy environment;
- Inadequate physical infrastructure, especially power supply; and
- Lack of a bridge between investors and the government.

The key suggestions were as follows:

- Improve physical infrastructure;
- Improve governance; and
- Create confidence through a friendly working relation.

LITERATURE REVIEW

Investment climate is an emerging subfield of study. It does not have much of a theoretical literature. For theoretical insights, researchers usually fall back on studies of investment behavior (Jorgenson, 1967; Gould & Waud, 1973). Recently some authors have offered newer types of analytical model based on the emerging field of behavioral economics (Jensen, 1998; Katay & Wolf, 2004). They want to develop cognitive models of the investor and a description of the investment environment. In the modeling tradition of cognitive science and intelligent systems, the investor is seen as a learning, adapting, and evolving entity that perceives the environment, processes information, acts upon it, and updates its internal states.

The classic themes of economic theory regarding investment emphasize the significance of rates of return, rates of interest, access to finance, and tax rates. However, from our sample, we found that return on investment seemed significant

only to 2.27% of respondents, tax rates mattered only to 27.27%, while interest rate was important to 63.64 %. In contrast, power shortages was a major concern for 81.82%, port bottlenecks dismayed 54.55 % and government policy towards investment affected 52.27% of the investors we met.

The above suggests that empirical studies of investment climate can hardly follow classic theoretical literature. The trouble with using macro data to understand investment behavior has been succinctly stated by Katay and Wolf (2004). According to them, models using aggregate data have been rather unsuccessful. The ambiguity of results and the failure to detect significant linkages between variables can be attributed to a number of reasons. First, aggregation itself obscures effects that could otherwise be important at the firm level. Hence significant parameter estimates are rarely derived from macro data. Second, the endogeneity of aggregate investment and the user cost of capital cause simple OLS parameter estimates to be inconsistent and good instruments are difficult to find at the aggregate level. Third, financial market imperfections are not explicitly taken into account in aggregate models of investments, yet their role is widely accepted in the literature.

Hardnosed researchers carry on investment climate studies through a mix of eclectic models, indeed often without clear analytical models. The last decade saw several studies on assessments of investment climate. (Kurz & Fröde, 2005; Business Advocacy Fund, 2008; Dollar et al., 2003; Veeramani & Goldar, 2004; Ballotta, 2004; Asian Development Bank, 2005; Escribano, et al., 2008).

Despite this, there is no previous study on Bangladesh investment climate according to any of the behavioral models. In Bangladesh, certain bits of information on investor perceptions are available from the reports on the first and second investment climate studies. For example, the second investment climate study (World Bank, 2008) noted that the shortage of electrical power was a major barrier to investment. The study noted various problems associated with infrastructural inadequacy and governance bottlenecks. It noted problems with land registration and other administrative red tapes. It noted scarcity of long term industrial finance and the lack of high-level skills of workers. Though not derived from investor interviews, these would pretty much give a sense of matters of grave importance to investor.

The recent most relevant examples of studies on investor perceptions relate to three East African nations (Irwin Grayson Associates & Steadman Group, 2008). These studies were sponsored by the World Bank Group. The present study is partly modeled on the East African studies. The structured questionnaire used a list of factors identified by the East African studies.

In the absence of benchmarking data, we ended up with an exploratory study. It is partly modeled on three country studies carried out in East Africa, as sponsored by the World Bank.

METHODOLOGY

Research Methods

This is an exploratory research. Its goal is to identify the factors that affect investment decisions of business leaders. The principal method of research is to conduct in-depth interview with a sample of investors, with a preference to include captains of industry and leading opinion-makers with leadership roles in the investor community. The key emphasis was on investors who have built physical projects.

Both structured and unstructured questionnaires were used. The structured questionnaires involved a list of factors identified by researchers as key factors of the investment climate. The unstructured questions and open discussions allowed the respondents to offer reflections, suggestions, and criticisms of policies and practices.

Sample

In view of the limitations of time and resource budget, and the fact that we were targeting extremely busy business leaders to respond to our questionnaires, we did not pretend to find a representative sample.

We first gathered printed directories of industrialists and business leaders. Then we downloaded available directories from the internet. We listed 469 potential respondents, all from Dhaka. Then we emailed 393 potential respondents on the ground that the directories listed their email addresses. No more than 5 responses came. We learned that email is not a viable method of

getting responses or even making an appointment. About 37% of the addresse were no longer valid, so we found them bouncing back. The others generally di not check emails or may be did not check the junk folders or choose not to reply.

The next task was to call them over the phone. We called 288 potentia respondents to make appointments and to send them the printed questionnaires. 9 of them eventually agreed to sit for interviews. We ultimately got 46 filled-i questionnaires. If we had more time, we could get full responses from some 6 leaders.

A major problem we faced was the perennial traffic congestion, especiall around the areas where most of our respondents worked, namely, Motijheel Karwan Bazaar, and Mahakhali areas. Sometimes we could not reach their office on time, and more frequently they were caught in traffic or were otherwise unabl to sit for the interviews.

Though there is no pretense of representative sampling, the importance of th sample is that it is deliberately a set of highly influential business leaders whos opinions do reflect a base of consensus and which influence others. So this coul be taken quite seriously.

We deliberately choose big bosses with intimate exposure to the investmen climate, being the kind of people deeply engaged in the investment scene. We me high level bankers for their professional judgment on investment related issues We met bosses of conglomerates who could give us views based on their depth an breadth of perceptions.

Analysis of data

We gathered data on identification of important problems and on their relativ importance. These basically imply a list of factors with relative ranking.

The nature of the data does not permit application of standard statistica techniques. Nor could we embark on econometric analysis.

Our data neither have a time sequence nor have a cross section. It is akin to a snapshot of a dynamic process of perceptions at a given point of time. Durin June-November 2010, the respondents had certain ideas and opinions. If the sam set of respondents could be asked the same questions at different intervals, w could have studied the evolution of their perceptions. If we could mee

respondents in other locations outside Dhaka, we could get a cross section. We do have a cross section potential based on sectors of respondents, but the sample size is too small to give us much confidence about significant differences for the different sections of the sample.

Despite the small size of the sample, we have noted some difference in the relative importance assigned to various factors by exporters versus others.

We do not have a database to categorize the respondents into various groups to check how the subgroups differ, because we do not have the groundwork to understand such a category, since there is no available list of investors according to various categories.

Consequently, all we could do is basically make a list of problems and their suggested solutions. The most important contribution of this study is the list of suggestions, which includes surprising elements.

EMPIRICAL FINDINGS ON GOVERNANCE FACTORS

We grouped the problem factors identified by the investors in the following categories: Governance, Infrastructure, Tax/fiscal policy; Finance/Monetary policy, Labor and Employment Policy, and Enterprise. This grouping will help us consider the issues raised by the investors in a framework of close-knit policy units.

Governance Related Problems

Table I: List of Governance Related Factors and the Number of Respondents (#=number of respondents; %=percentage of respondents out of 46)

Factor	#	%
Government policy	23	52.27
Corruption	19	43.18
Dealing with Line Ministry	18	40.91
Political stability	14	31.82
Environmental law	10	22.73
Rule of law	36.82	
Bureaucratic delay	24.55	

Government subsidy	24.55
Approval process	12.27
Government support	12.27
Procedure	12.27

Table II: Importance Score of Governance Related Factors

Factor	**Score**
Government Policy	6.83
Dealing with Line Ministry	6.65
Licensing	6.36
Environmental Law	6.25
Land registration	5.38
Contracts	5.37

The governance related issues are of grave importance to the investor community. The investors are highly skeptical of the stability or continuity of government policy, as they see that a change in political power leads to different partisan policies. Many business leaders think that there should be an institutional framework for development of policies affecting businesses. They believe that continuity and stability of policy without the fear of abrupt change is a necessary precondition for faith in the investment climate.

Investors are worried about the continued plague of corruption in nearly every sphere of government with investor linkage. And in general, they are dissatisfied with the bureaucratic hassles of administrative red tape, undue complexity, and unfriendly legal structures.

Business leaders have a feeling that the law books may have sound and sensible laws but the administrative apparatus of the government is not well equipped to execute the rule of law.

In candid admissions, they opined that some businessmen themselves search for loopholes and try to evade or violate laws. A strong legal structure with powers of strict enforcement might go a long way to shield the investors against unfair competition an unjust barriers erected by violators.

Here again, the investors felt the need to set up an investment council to serve as an apparatus of the investment community both for the purpose of self-regulation as well as for assisting and guiding the government with respect to reforming the laws and policies.

Table III: Nature of Problem and Type of Solution Regarding Political Stability

Main problem	#	Solution
political party cancel decision anytime	1	All political parties should co-ordinate for
political discord	1	the national issue
frequently changing decision	1	continuity of policy
instability	3	political continuity approval by the
unstable policy	1	parliament
lack of commitment	1	non reflection of administration rather
transfer of bureaucrat slows the project	1	parties
chaos	1	no turbulences
instable government	1	democratization in the party politics
no bold policies to move ahead		
poor execution	1	
lack of consensus on national issues	1	
lack of customer between the opposition		
and government	1	

INTERPRETATION

Nature of Problem

a) Unstable political decision

b) Transference of bureaucrats makes a project slow

c) No consensus even in the national issues between the political parties

The respondents perceived lack of continuity of policy, beleaguered by abrupt shifts. This was thought to come from the bitter rivalry between the two major parties with very dissimilar loyalties to constituencies of investors.

The lack of professional working relation between different political parties, born in an atmosphere of hostility and confrontation appeared as the underlying problem of unstable policy.

In administrative matters concerning public private partnership in particular and in implementing government sponsored projects in general, the business leaders saw frequent change of executives as major reason for abrupt discontinuity and sloth of work.

Types of Solutions

a) Democratic environment

b) Continuity of policy

c) Coordinated decision making

The leaders emphasize the need for political parties to learn the basic rule of civilized democracy: learn to share the country and serve it through cooperation. For this, politicians ought to learn about the key goals of the people. This however is under challenge owing to the lack of respect for democratic values. A climate of cordial and civilized discourse is required. This could ensure the emergence of policy continuity.

Table IV: Nature of Problem and Type of Solution Regarding Political Stability

Main problem	# Solution
political party cancel decision	1 All political parties should co-ordinate for the
political discord	1 national issue
frequently changing decision	1 continuity of policy
instability /unstable policy	4 political continuity approval by the parliament
lack of commitment	1 non reflection of administration rather partics
transfer of bureaucrat slows project	1 no turbulences
chaos / unstable government	1 democratization in the party politics
no bold policies to move ahead	2
poor execution	1
no consensus on national issues	1
no mediation between opposition and	1
government	1

INTERPRETATION

Nature of Problem

a) Unstable political decision

b) Transference of bureaucrats makes a project slow

c) No consensus even in the national issues between the political parties

The respondents perceived lack of continuity of policy, as beleaguered by abrupt shifts. This was thought to come from the bitter rivalry between the two major parties with very dissimilar loyalties to constituencies of investors.

The lack of professional working relation between different political parties, born in an atmosphere of confrontation, appeared as the underlying cause of unstable policy.

In administrative matters concerning public private partnership in particular and in implementing government sponsored projects in general, the business leaders saw frequent change of executives as major reason for abrupt discontinuity and slowdown of work.

Types of Solutions

a) Democratic environment

b) Continuity of policy

c) Coordinated decision making

The leaders emphasize the need for political parties to learn the basic rule of civilized democracy: learn to share the country and serve it through cooperation. For this, politicians ought to learn about the key aspirations of the people. This however is under challenge owing to the lack of respect for democratic values. A climate of cordial and civilized discourse is required. This could ensure the emergence of policy continuity. This would be based on institutional arrangements for coordinated decision-making through dialogues to sort out points of agreement and points of dispute.

Table V: Nature of Problem and Type of Solution Regarding Corruption and Bureaucracy

Main problem	# Solution
government is corrupted	1 need to decrease
high/ tremendous	3 should be mitigated
bribery	2 automation
increase the cost	1 digitization
rent seeking	1
unfriendly system of working	1
no control of government	1
No coordination among government agencies	2
red tapism	2

INTERPRETATION

Nature of Problem

a) Widespread corruption

b) Lack of monitoring and control

c) Bureaucratic red tape

The perception of system-wide embedded corruption and bureaucratic hassles needs attention. The corruption is embedded in the labyrinthine rules that make it next to impossible for any forthright bureaucrat to make prompt and lawful decisions. The bureaucratic red tape creates the major barrier towards a properly functioning government system. While the rulebooks are full of ideas and methods of honest administration, the lack of monitoring and enforcement leaves the corrupt practices in place.

Types of Solutions

a) Reforms to curb corruption

b) Automation and standardization of paperwork

c) Digitization and rapid access to recordkeeping

People desperately want an end to corruption. They ask the policymakers to undertake all the necessary reforms to rebuild the system. However, the suggestion on how exactly to tackle this national problem based on practices of a very large number of people does not seem to offer concrete solutions. Investors think that there should be something like a 'paperwork reduction act' to lessen the burden of paperwork associated with government approval of investment projects and business actions. They believe that most of the routine work of the bureaucracy can be automated with digitization and modern electronic communication. This would significantly reduce the delay in processing the paperworks.

Investors are hopeful that the launching of 'Digital Bangladesh' may bring some good results to improve the governance. A digital framework of routing paperwork processing through many different agencies may make paperwork simpler.

Table VI: Nature of Problem and Type of Solution Regarding Tax Administration

Main problem	# Solution
Full of corruption	1 Need regular monitor
complexity	4 reform
lacks in implementation	1 strict monitoring
Impose several time	2 offering tax holiday for a certain period
high tax	2 one material should have one tax / vat

INTERPRETATION

Nature of Problem

a) Complexity of tax laws

b) High tax rates

c) Corruption

The key areas of concern with the tax system is the complexity of the tax laws, the embedded corruption and corruptibility of the tax loopholes, and the perception of high tax rates for honest tax payers. The complexity of the tax code seems to increase as the government tries to change taxes. The tax systems are not harmonized and the differential tax rates create incentives for misclassification and opens doors for corrupt mislabeling.

The paperwork burden for compliance with tax filing is a major source of frustration for investors.

Type of Solution

a) Reform

b) Monitoring

c) Tax reduction, tax holidays

Investors make sensible propositions that the tax system must be fully overhauled and rationalized, with institutional reform in every sphere of tax administration. One of the key goals of the reform is to simplify the tax structure and make compliance easier. It also requires embedding rules for ensuring transparency in tax filings, with procedures for verification and monitoring.

They put high emphasis on developing a monitoring system for the honest performance of the tax administration as well as transparency to ensure better compliance with the tax laws. The rapacious corruption in the tax administration is the hardest barrier to investment. The perception of an uncaring government becomes palpable when the complexity of tax regulations seems to have been designed to facilitate and even institutionalize corruption.

In addition, they of course always want lower tax rates and tax holidays in less attractive projects.

CONCLUDING COMMENTS

Better governance will improve the investment climate. The government needs to show that it is serious about promoting investment. This requires believable actions to show the government's commitment. It requires a pattern of conduct to build a friendly and supportive working relation. The creation of an Investment Council may help the government build the required trust and inspire the confidence so investors can undertake greater investments.

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