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Executive Summary

The unexploited competitiveness potential of the EESC region

The Eastern Europe and Southern Caucasus (EESC) is one of the fastest-growing regions in the world. The six countries in the region are Armenia, Azerbaijan, Belarus, Georgia, the Republic of Moldova and Ukraine. Following the post-Soviet transition and particularly between 2002 and 2008 it reached double-digit growth – a rapid expansion that was driven by high capital inflows, rising domestic consumption and expansionary fiscal and monetary policies. However, this expansion came to an abrupt end in late 2008 with the onset of the global financial crisis. The EESC economies have now embarked on a recovery, although expansion in 2011-15 is likely to be weaker than in the preceding period. The World Bank 2010-13 forecast expects real GDP growth to be lower than in other developing countries: between 2.9% and 5.7%.

To return to their previous growth rates, the EESC countries will have to raise their long-term economic growth potential by improving the overall competitiveness of their economies. To do so, they will need to address some important policy weaknesses and structural faultlines that were exposed by the crisis, but had been masked during the brisk economic expansion of the recent past. Thanks to their geopolitical context and their natural endowments, the EESC countries are well positioned to benefit from the rising global demand for food, energy, goods and services.

The EESC region has many advantages: it is well located to trade with neighbours both east and west on two vast continents. It has significant resources – ranging from the black soil in Ukraine that produces some of the best wheat in the world, to energy reserves in Azerbaijan, and the less fully explored resources of water. The area has great potential to seize new opportunities in food production, investment in land and moving up the value chain. However, in spite of recent growth, productivity (in terms of output per capita) for the region was still 77% below world average in absolute terms in 2008.

There is a need to improve the quantity and quality of foreign direct investment (FDI) in the EESC region. Between 2002 and 2008 the boom in FDI inflows was mainly produced by mergers and acquisitions and privatisations. Much FDI was directed at the extractive industries. Now that the first wave of privatisations is completed, a political strategy is required to attract investors to greenfield investments. A favourable investment environment and a business climate that encourages productive use of long-term investments can help support sustainable development.

The competitiveness of the six EESC countries has been analysed using the global Competitiveness Index (GCI) developed by the World Economic Forum. As a group, the

major competitive advantage of the EESC countries is their labour market efficiency. However, the GCI has pinpointed the poor quality of education, a business environment that is not sufficiently supportive of entrepreneurship, problems in access to finance and a need to stabilise the banking system as particular weaknesses that need to be addressed.

The private sector is under-developed in many of the countries

The private sector is generally the part of the economy which is most flexible and receptive to market needs and hence vital for providing adequate employment and economic growth. Across the EESC region there is a need for a less restrictive regulatory environment with fewer obstacles to starting a business and, importantly, a need for greater efforts in the fight against corruption. A commitment to addressing corruption is exemplified by the participation by four of the six EESC countries in the Istanbul Action Plan. Tax payment processes are also marred by complex regulations and non-transparent procedures. This also affects trade across borders and rules governing subsidies. For example, the large number of state-owned enterprises in Belarus negatively affects the competitiveness potential of private sector firms in that country.

Developing the private sector also remains hampered by poor access to finance across the region. This has a particularly negative effect on small and medium sized enterprises (SMEs) which, as a result, tend to innovate less than larger companies (or compared with their peers in other regions) and cannot expand. The informal economy also remains significant. Although the informal economy dominates labour intensive sectors such as agriculture and construction, it has negative economic ramifications for the rest of the economy: state budgets suffer from unpaid taxes, and registered enterprises have additional burdens due to anti-competitive practices. It thus remains vital to create incentives for SMEs to move out of informality by making the business climate more conducive to their activities.

Education standards need to be improved and supported

Although literacy rates are generally high across the region, education must be supported by improving overall quality. EESC countries have below-average educational outcomes for both PISA and TIMSS results. In 2007, EESC governments spent on average 14.1% of their state budgets on education, although only two of the countries allocated more public funds to education than the OECD average of 4.8% of GDP. Most educational institutions in the EESC region are overstaffed and underfunded; many qualified teachers have left the profession for the private sector, and teaching methods are based more on knowledge accumulation than on skills development. Those who obtain an education are often caught up in the brain drain from the region which has resulted in a chronic shortage of engineering and science specialists. The still-high poverty rates across the region (around 50% in the EESC; 20% in Ukraine) reduce opportunities for children to attend higher education and lead them into low-skilled jobs.

Policy priorities for the region

Human capital development

Against a backdrop of dwindling productivity levels, and working with the OECD Eurasia Competitiveness programme, the governments of the region have identified three

policy areas particularly crucial to improving their competitiveness: human capital development, access to finance and investment policy and promotion. The OECD Secretariat's Policies for Competitiveness Assessment Framework, a self-assessment tool for both public and private sector representatives, assesses existing policy and reform against international best practice, gives guidance and creates a process to enhance the quality of policy development. The Policy Assessment Framework indicates that there is broad agreement across both governments and the private sector in the EESC that existing skills mismatches between educational outputs and labour requirements must be tackled. The assessment notes that there is no national strategy for the development of workforce skills that align job-market requirements with the curricula; there is no public-private consultation between educationalists and employers to help bridge the skills gap; vocational and job-related training is not aligned with labour market needs; and there is no national strategy for teacher recruitment and retention. This issue is addressed in Chapter 3 where specific policy recommendations are made to tackle some of these shortfalls. It is recommended that all the countries participate in international educational surveys, involve employers in decision making on higher education and VET, devote more resources to the less advantaged and excluded pupils and improve both the quality of teachers and teaching and the quality of business and management schools.

Access to finance

Companies can only grow and expand if they have adequate access to finance. SMEs in particular suffer from high administrative costs attached to the small-scale lending of banks, the perception of the high risk associated with lending to small businesses, and the presence of asymmetric information. Furthermore, SMEs often lack the collateral to secure affordable loans, giving banks and financial institutions few incentives to provide them with credit. Start-ups with no suppliers or low working capital to sustain them are especially exposed to the lack of adequate funding. Improving access to funding for businesses, including SMEs, would have a beneficial impact on the economy as a whole. The OECD assessment identifies the need to improve the regulatory and legal framework, including a strengthening of creditor rights and ensuring central bank independence, as a key priority for the improvement of access to finance in general and SMEs in particular. Another priority is to reduce the asymmetry of information between SMEs and credit providers through the development of credit history bureaus and improving the standards of financial reporting of enterprises.

In the short term, microfinancing institutions are effective tools to expand credit to micro-enterprises and individual entrepreneurs. However, their dependence on external loans and grants should be reduced. Government policies should also focus on diversifying the sources of financing for SMEs to include other financial tools apart from bank credit, such as leasing, factoring, and, in case of high-growth potential firms, a specialised stock market for low-capitalised firms could be considered. Collateral requirements could be eased through extensive guarantee schemes; however, more needs to be done to refine credit analysis and project evaluation in order to avoid moral hazard. A better financial education and the development of entrepreneurial skills through adequate training can further facilitate access to finance for SMEs. Credit institutions are more willing to put up funds when the borrower displays the necessary skills and knowledge through submitting workable business plans.

Investment policy and promotion

To unlock the full potential of foreign direct investment (FDI) as a source of improved competitiveness and economic growth, further policy reforms are needed to improve the existing investment framework. Key areas to address include better law enforcement mechanisms such as ensuring transparent and non-discriminatory legal proceedings, diversifying the sectors receiving FDI and expanding investment promotion and facilitation. Investment promotion activities should be integrated with ongoing investment policy reform and industrial policy objectives. They should also be developed so as to better support regional development. The OECD assessment indicated that legislation on FDI generally provides for national treatment in all EESC countries, although there are few coherent review mechanisms to benchmark the scope of restrictions relative to practices in other countries. There also is a need to further improve land titling and cadastre systems and to strengthen protection against expropriation.

Specific investment promotion activities are carried out in all countries of the region and facilitation services to investors are delivered through investment promotion agencies (IPAs). Knowing how to position a country strategically among its global and regional competitors to capitalise on foreign investor presence for the development of local SMEs is essential. An outcome of the assessment is that IPAs do not yet use FDI-SME linkage programmes actively to support the development of SMEs. Schemes that can specifically help SMEs to benefit from the presence of foreign investors can include mechanisms such as conducting strategic audits of SME capacity to participate in specific linkage programmes, defining a development plan, promotional campaigns and a database of SMEs for potential foreign investors. Making such linkages can lead to the creation of sustainable business networks, invaluable to both foreign investors and domestic companies alike.

Developing a public-private dialogue

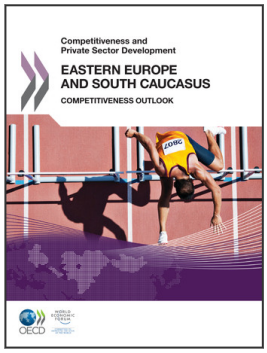
For effective policy making, the participation of stakeholders such as business intermediaries, employers, and civil society in the consultation process is crucial for improving the transparency and effectiveness of policies. The perception of the reform efforts being undertaken often differs among stakeholders; this is particularly marked between the private and public sectors. A large perception gap concerning the reform being pursued in investment policy and access to finance emphasises the need to strengthen public-private dialogue between government officials and foreign investors. This misalignment may be the result of a lack of communication, difficulties of implementation or bottlenecks in enforcement. The OECD Secretariat is working with the EESC countries to further develop this dialogue through policy working groups in these three key policy areas for competitiveness. The public sector is also encouraged to engage in more regular dialogue with other sectors and to adjust policies according to need. In two measures already carried out, the OECD assessment of the level of reform and the GCI are both perceived to be lower than OECD and non-OECD best practice. Thus, there is still room for improvement in both reform and its implementation.

To raise their competitiveness potential, the EESC countries must tap into their vast endowments and further build their capabilities in human capital, access to finance and investment policy and promotion. Education must provide the skills required by the market and must be defined by a joint policy dialogue; SMEs, essential for growth and job

creation, must have easier access to finance through improvement of the regulatory and legal framework affecting credit provision, a reduction of information asymmetry, and the development of sustainable micro-credit institutions; the overall investment climate must be enhanced by targeted investment policy and promotion reforms and must address the needs and requirements of the private investor, including areas such as national treatment, transparency and accountability. These three areas for greater competitiveness are assessed in this report which points to the policies that must be addressed as a priority, what is the most effective method of implementation and how public-private dialogue can be enhanced.

The case of Ukraine – an example of making reforms happen

A programme to enhance the competitiveness of a number of economic sectors in Ukraine is currently being undertaken by the OECD. Between 2000 and 2008 Ukraine had one of the fastest growing economies in Europe, but the subsequent financial crisis caused it to seek financing from the IMF. Today, it is returning to positive growth but key challenges remain: a limited stock of FDI per capita as compared to its neighbours; an unfavourable business climate with export quotas, continuing problems with VAT refunds and government monopolies; a high level of external debt; inadequate implementation of laws; and seemingly no long-term strategy for investment policy and promotion. The case study in the report addresses problems with the newly-adopted Tax Code, the need for directed, sector-specific FDI with higher competitiveness potential and for a sector-specific investment and promotion strategy to optimise FDI. The case study specifically addresses the grain and dairy sectors, energy production based on biomass and the civil aircraft manufacturing sector. Policy recommendations for these selected sectors include differentiation of markets and investment, identifying sector-specific reforms, promoting sectors and implementing and monitoring reform.



From:

Competitiveness and Private Sector Development: Eastern Europe and South Caucasus 2011

Competitiveness Outlook

Access the complete publication at:

https://doi.org/10.1787/9789264112322-en

Please cite this chapter as:

OECD/The World Economic Forum (2011), "Executive Summary", in *Competitiveness and Private Sector Development: Eastern Europe and South Caucasus 2011: Competitiveness Outlook*, OECD Publishing, Paris.

DOI: https://doi.org/10.1787/9789264112322-4-en

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