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BUSINESS CLIMATE IN TRANSITIONAL ECONOMIES

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Foreword

The Northern Dimension Research Centre (NORDI) is a research institute run by Lappeenranta University of Technology (LUT). NORDI was established in the spring of 2003 in order to co-ordinate research into Russia.

NORDI publications have paid permanent attention to investment climate in transitional economies (TEs): several studies of the Research Centre deal with foreign direct investment (FDI) in post-communist societies. Western investors have strongly influenced the economic development in national economies which used to be guided by central planning.

Investment decisions by international companies are made on the basis of careful assessment of business environment in different national economies. Investment climates are dissimilar in the global economy.

This short research report deals with 12 TEs, which all try to attract outside investors to their respective territories. The countries under review are assessed by using a multitude of indices. The results of the study show that there is a positive correlation between the investment climate and the actual FDI results in countries under review.

Lappeenranta, February 2008

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1 Introduction

Almost two decades have passed after anti-communist revolutions in Eastern part of Europe and in the former Soviet Union. Transformation from central planning towards market orientation has caused fundamental institutional changes. This historical process caused economic decline and high inflation in the early period of the systemic resuffle.

The second decade of the post-communist period has started very well. Russia with her enormous natural resources has profited from high raw material prices on the global market. Thus, the country has experienced a strong boom in the early years of the 21st century. Eight transitional economies (TEs) were accepted into the EU in 2004, and two more in 2007. This participation on economic integration process of ten TEs has enhanced the attractiveness of them as a location of foreign direct investment. TE-economies have developed very positively in quantitative terms (for details, see Tiusanen: Transitional Economies and International Competitiveness, Lappeenranta 2006. NORDI publication no. 31.).

Amid globalisation, the number of qualitative indicators has increased substantially. These indicators are compiled on the basis of surveys (opinion polls), and help to make investment decisions in international business. Also various composite indeces containing both quantitative as well as qualitative components are published frequently.

Thus, assessing overall economic development in various parts of the globe has become much easier than before. Selection of target markets and new locations for production or service activities calls for risk analyses. Qualitative indicators help to estimate relative risks in international business.

This short research report deals with some qualitative indeces, as well as with some composite ones. The main aim here is to help international companies to assess investment climate in European post-communist countries.

2 Corruption

It is often maintained that in the post-communist world the market is the most important guiding force in the global economy. It is assumed that “the invisible hand” of the market will harmonize all parts of the world economy. National differences are supposed to disappear. All economic institutions will be similar everywhere.

This harmonization process obviously takes plenty of time. There are plenty of development differentials between countries which can be measured with quantitative indicators. There are also essential dissimilarities in cultures and institutional frameworks in the globe. Honest and dishonest economic activity takes place in every national economy.

There is plenty of empirical evidence that democracy correlates positively with wealth. Democratic societies have more transparency in economic policy than autocracies. Thus, corruption is said to be a bigger problem in emerging markets than in mature market economies.

In the communist-dominated countries all productive assets were in the possession of the public sector. Enterprise profits were said to be used to exploit workers. Therefore, profit motive as a guide-line for economic activity was dismantled in communist societies. Enterprise success was measured by gross production indicator. State-owned companies were supposed to fulfill planned production targets given in quantities (e.g. in tons of steel, number of tractors, etc).

In all centrally planned economies with one-party rule a special ruling class called nomenklatura emerged. This communist elite had a monopoly power concerning all economic policy-making. The ideological aim of this system was to establish complete economic equality among all members of the society. Very early on it became clear that communist elites started allocating special favours for themselves, most in kind, comprising special housing, cars linked with profession, special shops with extra supplies, etc. In centrally planned economies money played a passive role only, but also monetary income was determined by importance in the economic and political pyramid.

In “the economies of shortage” (as the famous Hungarian economist, Janos Kornai, called communist societies) demand permanently exceeded supply. Prices were fixed administratively, and thus, mostly remained on an artificially low level. Therefore, it was only

natural that unofficial markets with free prices emerged everywhere in the Communist Bloc. Demand and supply were brought into equilibrium in the extensive black market.

By definition, a big bulk of services was free of charge in communist societies, including health care and education. As demand also in these spheres exceeded supply, were services allocated unofficially, on the basis of corruption. Special favours normally were given in non-monetary form, e.g. service against counter-service, of favours in kind. Corruption in one form or another was one of the most decisive features of the communist society.

Alexandr Yakovlev, a member of the party elite and a close associate of the last Soviet president, Mikhail Gorbachev, compares in his memoirs the Soviet society with feudalism. In both cases the leading elite is called “rent-seeking” group. This term is rather clear in feudal environment, in which lords with landed property exploited their vassals. Rent linked with income from land was the main source of non-work income. After industrial revolution profit became the main source of capital income, while rent (leasing landed property) decreased in relative importance as a form of non-labour income.

Presently, rent-seeking is used in economic texts without necessarily hinting on feudal times. Individual bureaucrats can practice rent-seeking by offering their public decisions for sale to private persons or companies. This “sale” contains accepting bribes. From the point of view of the corrupt civil servant rent-seeking means enriching him – or herself via non-labour income. Profit made by business transaction is said to involve risk-taking, and profit is said to be a reward of taking a risk. Rent-seeking is an extra income without a market-oriented risk.

Thus, rent-seeking is mainly connected with dishonest work done by public sector employees who regulate business scene. However, rent-seeking can also be linked to private bidders, who look for public sector projects. It may happen that an enterprise attempts to avoid risks by bribing officials. In an optimal case this enterprise may clinch a deal without any real competition and achieve an extra profit (bribing helps to secure the project with an unusually high bidding price). Therefore, regulators and regulated may live in a similar symbiotic (mutually dependent) relationship of rent-seeking (risk avoidance).

Quite obviously, this symbiotic relationship is not free of risks. An individual civil servant may be caught out by state inspectors and will become unemployed. Corrupt politicians may be voted out of office. Dishonest enterprises may be excluded from publicly financed biddings. Thus, rent-seeking in its modern meaning involves risks, but not in the same sense as normal business risks.

In the first decade of the 21st century, TE-region can be divided in two categories: TEs within and TEs without EU. The former comprises 10 countries: Estonia, Latvia, Lithuania, Poland, Czech Republic, Slovakia, Hungary, Slovenia (admitted in 2004), Bulgaria and Romania (joined EU in 2007). In the membership negotiations these countries were told to root out corruption. The EU entry of Bulgaria and Romania was postponed because of too high corruption level and too much organised crime.

In this historical pan-European integration process, EU membership requirements were as follows:

- that the candidate country has achieved stability of institutions guaranteeing democracy, the rule of law, human rights, and protection of minorities,
- the existence of a functioning market economy, as well as the capacity to cope with competitive pressure and market forces within the Union;
- the ability to take on the obligations of membership, including adherence to the aims of political, economic, and monetary union.

It is not the aim of this report to cover all details of the Eastern enlargement of EU. It suffices to state here that those 10 TEs mentioned above had external pressure to modernise their economies and improve their institutions in order to be able to join the Union. This pressure is not present in Russia. Ukraine, a country with almost 50 M inhabitants, has expressed her wish to become EU-member in the future. However, this scheme is a long-term one. Russia and Ukraine are discussed below, together with 10 TEs (so called NMSs = new member states) mentioned above. Other TEs are not covered systematically in this report.

The World Bank (IBRD or International Bank of Reconstruction and Development) has paid plenty of attention to anti-corruption activities lately. The Bank publishes World Development Report annually. Material below is gathered from WDR of 2004 and from WDR of 2005.

In the World Bank definition, corruption is exploitation of public office for private gain. When it infects the highest levels of government, it can distort policy-making on a grand scale and undermine the credibility of government. Even when played out through officials at lower

echelons of government, corruption can be a tax on entrepreneurial activity, divert resources from the public coffers, and create a constituency for erecting or maintaining unnecessary red tape. Typically, firms, consumers, or other groups make payments to politicians or public officials in return for favourable decisions – whether a high-level policy decision or a more mundane matter, such as getting a connection to utilities, clearing goods through customs, or registering a business. Unlike most production, corruption is subject to increasing returns: an increase in rent-seeking activity makes corruption more attractive, not less. No country can claim to be immune from the problem. In the extreme, a state consumes the surpluses of the economy, as government offices come to be treated as income – generating property.

The World Bank gathers internationally information on corruption, including qualitative indicators (based on surveys). The table below is from WDR, 2005.

Table 1. Bribes vary by firm size, sector and region

	Firms reporting bribes	Bribes as share of sales
	%	%
Formal sector firms	55,5	3,9
Micro (< 10 employees)	49,9	4,4
Small (10-19)	56,7	4,8
Medium (20-49)	57,6	4,0
Large (50-249)	58,5	3,4
Very large (250+)	55,7	3,0
Informal sector firms	27,4	8,6
Small (< 10 employees)	25,5	8,5
Large (10+)	49,1	9,3
Central and Eastern Europe	43,1	2,8
Sub-Saharan Africa	50,0	5,2
Commonwealth of Independent States	51,0	3,4
East Asia and Pacific	59,1	4,2
Latin America and the Caribbean	68,8	7,0
South Asia	74,2	3,2

Source: World Bank

Commonwealth of Independent States (CIS) in the above table is the former Soviet Union without Estonia, Latvia and Lithuania. This group comprises 12 TEs including Russia and Ukraine. More than half (51%) of firms active in this area report bribes. The equivalent figure in Central and Eastern Europe (the other group of TEs) is about 43%. In the latter, bribes make up 2,8% of sales revenue, while in the former the figure is higher, 3,4%. Thus, it can be

stated that firms active in TE-region pay “inofficial taxes” (in the form of bribes) in the range of about 3% of their earned income.

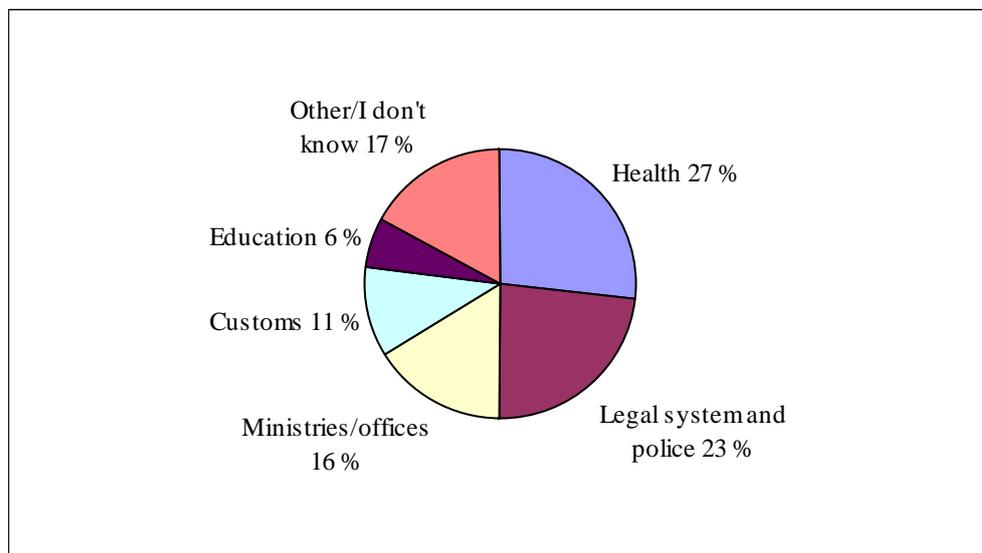
In comparison to Latin America (including Caribbean) this figure is rather modest. Latin America extracts no less than 7% of company sector income as bribes. Also East Asia and Sub-Saharan Africa are in this respect worse than post-communist countries.

Global bribery hurts small and medium sized enterprises (SMEs) more than big ones. Formal firms are not as badly hurt by corruption as informal ones.

Figure one published by the World Bank deals with sectoral corruption in Eastern Europe. Not all TEs are involved in this survey.

Figure 1. Bribery in Eastern Europe

Surveys in nine transition countries of Eastern and Central Europe* asked: “In your opinion, in what area is bribery most common, widespread?” Health systems rank highest overall, but with answers ranging from 11 percent in Bulgaria to 48 percent in Slovakia. Since there has been an overall contraction in public services with that in economic activity, the most likely reason is that these services are naturally easy to charge for and difficult to maintain without infusions of funds from patients.



*Bulgaria, Croatia, Czech Republic, Hungary, Poland, Romania, Slovakia, Slovenia and Ukraine. The diagram summarizes results averaged over these countries (weighted by population).

Source: IBRD

Health care in TEs has suffered fundamental changes in the post-communist period. This sector is clearly underpaid, and thus, personnel attempts to improve its position by taking

inofficial income. In the perception of local citizens, health care poses the most important corruption problem, followed by legal system and police. Ministries and other offices also cash in considerably from locals. Customs officials in TEs have hardly a reputation of being honest. Also in the educational sector corruption is not an unknown factor.

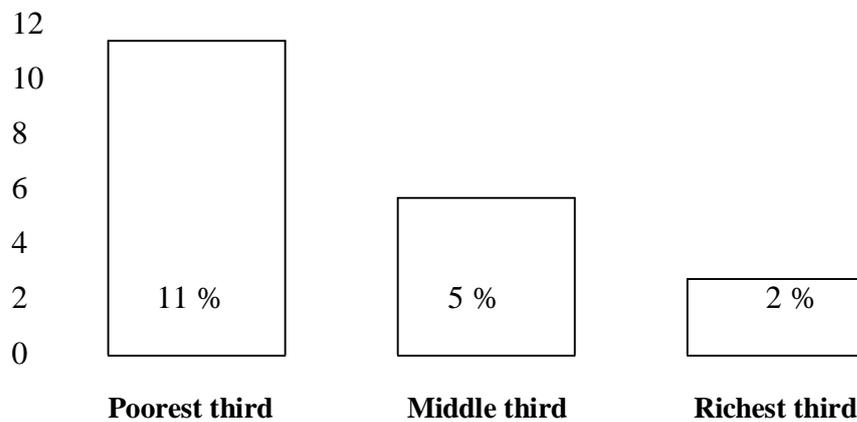
According to the World Bank, corruption hurts the poor more than the rich. In this context, Romania is used as an example.

Figure 2. Bribery hurts the poor

In Romania, the poor pay substantially higher fractions of income in bribes.

Romania: Percent of income paid in bribes (of those paying bribes)

Percent



Source: IBRD

In Romania, the poorest third pays about 11% of its income in bribes, while the equivalent figure among the best earning third is only 2%. Thus, corruption is enhancing income inequality in a rather poor country, Romania. According to The World Bank, governments can draw on a variety of mechanisms to enhance their credibility:

- Establishing effective veto points on decision-making and providing other guarantees through national constitutions. This can include formal checks and balances among different branches of government, autonomous subnational governments, and constitutional prohibitions on the expropriation of property, coupled with independent judiciaries able to enforce those rules.

- Providing specific contractual commitments on particularly sensitive matters. While clearly not feasible for all firms or topics, this is a common strategy for major natural resource and infrastructure projects, and increasingly common on matters of taxation for a broader range of activities. The credibility of contractual commitments can be further enhanced by making them subject to international arbitration.
- Entrusting discretion on sensitive subjects to more autonomous agencies. Examples include independent central banks and specialist regulatory agencies for infrastructure – areas where the temptation to renege on commitments is particularly acute.
- Entering international agreements that commit governments to sound policies. International agreements cover a growing range of matters linked with international business. They can enhance credibility by increasing the costs of renegeing on relevant policy commitments, whether through reputation effects or by the threat of more tangible sanctions.

Obviously, in every corruption case there are at least two (maybe more) parties involved: the bribe-taker and the bribe-provider. It is maintained that the environment in emerging markets is more corrupt than in developed countries. There is very little accurate information on Western companies' involvement in bribery when they are doing business in emerging markets. Siemens, the biggest employer in Western Europe in the manufacturing branch, got a penalty of EUR 200 million in the court of Munich in 2007 for corrupting potential clients. This international enterprise has been involved in power station business for more than 100 years with extensive links in the global business. It is impossible to estimate how many transnational companies have been using and probably still use dishonest means to advance their international business.

It is a well-known fact that many big companies use middlemen in their international deals. The big company pay a commission (for an agency) or a fee (for a consultant), say USD 1,5 million. This sum is paid on the basis of an official bill. The middleman pays, say, USD 1 million from that sum as a bribe for the client, and keeps the rest for himself. Thus, it is difficult or even impossible to trace corruption.

Transparency International (TI) is a non-profit organisation with headquarters in Berlin. TI has its international network through which it compiles its Corruption Perception Index (CPI) annually. This typically qualitative index is widely quoted in the international financial press when the yearly results are published.

The 2007 Corruption Perception Index looks at perceptions of public sector corruption in 180 countries (163 countries in 2006) and is a composite index that draws on 14 expert opinion surveys. It scores countries on a scale from zero to ten, with zero indicating high levels of perceived corruption and ten indicating low levels of perceived corruption.

For several years, CPI figures have shown a strong correlation between corruption and poverty. In 2007 index, 40% of those scoring below three, indicating that corruption is perceived as rampant, are classified by the World Bank as low income countries. Somalia and Myanmar (Burma) share the lowest score of 1,4, while the Nordic countries (Finland, Denmark, Sweden, Norway and Iceland) are permanently within the top ten countries. Singapore is a non-European country scoring very well in the CPI ranking.

According to TI, the poorest countries suffer most under the yoke of corruption. It is ultimately their responsibility to tackle the problem. Low scores in the CPI indicate that public institutions are heavily compromised. The first order of business is to improve transparency in financial management, from revenue collection to expenditure, as well as strengthening oversight and putting an end to the impunity of corrupt officials. An independent and professional judicial system is critical to ending impunity and enforcing the impartial rule of law, to promoting public, donor and investor confidence. If courts cannot be relied upon to pursue corrupt officials or to assist in tracing and returning illicit wealth, progress against corruption is unlikely.

Many countries are unable to shoulder the burden of reform alone. In countries where public sector institutions were historically based on patronage and nepotism rather than merit, reform takes time and can require a substantial investment of resources, as well as technical assistance. As significant development assistance donors, top scoring countries play a special role in supporting greater accountability and institutional integrity in countries plagued by the highest levels of public sector corruption. Technical assistance is a key requirement of the landmark United Nations Convention against Corruption (UNCAC).

Transparency International remarks that corruption by high-level public officials in poor countries has an international dimension that implicates the CPI's top scorers. Bribe money often stems from multinationals based in the world's richest countries. It can no longer be acceptable for these companies to regard bribery in export markets as a legitimate business strategy.

In addition, global financial centres play a pivotal role in allowing corrupt officials to move, hide and invest their illicitly gained wealth. According to TI, criticism by rich countries of corruption in poor ones has little credibility, while their financial institutions sit on wealth stolen from the world's poorest people. In many cases, asset tracing and recovery are hindered by the laundering of funds through offshore banks in jurisdictions where banking secrecy remains the norm. Through the UNCAC, priority should be given to improving international cooperation and mutual legal assistance, expediting action to recover assets, and developing legal and technical expertise in nations requesting the return of looted assets.

Transparency International gives its list of remedies to beat corruption:

- Developing countries should use aid money to strengthen their governance institutions, guided by national assessments and development strategies, and to incorporate strengthened integrity and corruption prevention as an integral part of poverty reduction programmes.
- Judicial independence, integrity and accountability must be enhanced to improve the credibility of justice systems in poorer countries. Not only must judicial proceedings be freed of political influence, judges themselves must subject to disciplinary rules, limited immunity and a code of judicial conduct to help ensure that justice is served. A clean and capable judiciary is essential if developing countries are to manage requests for assistance in the recovery of stolen assets from abroad.
- Governments must introduce anti-money laundering measures to eradicate safe havens for stolen assets, as prescribed by the UNCAC. Leading banking centres should explore the development of uniform expedited procedures for the identification, freezing and repatriation

of the proceeds of corruption. Clear escrow provisions for disputed funds are essential.

- Wealthy countries must regulate their financial centres more strictly. Focusing on the roles of trusts, demanding knowledge of beneficial ownership and strengthening anti-money laundering provisions are just a few of the ways that rich governments can tackle the facilitators of corruption.
- The world's wealthiest governments must strictly enforce the OECD Anti-Bribery Convention, which criminalises the bribery of foreign public officials. Lack of compliance with the convention's provisions continues to hinder corruption investigations and prosecutions.
- The boards of multinational companies must not only introduce but implement effective anti-bribery codes, and ensure that they are adhered to by subsidiaries and foreign offices.

TI is well aware that it is difficult to assess the overall levels of corruption in different countries based on hard empirical data, e.g. by comparing the amount of bribes or the number of prosecutions of court cases. In the latter case, such comparative data does not reflect actual levels of corruption; rather it highlights the quality of prosecutors, courts and/or the media in exposing corruption across countries. One strong method of compiling cross-country data is therefore to draw on the experience and perceptions of those who are most directly confronted with the realities of corruption in a country. The expertise reflected in the CPI scores draws on an understanding of corrupt practices held by those based in both the industrialised and developing world. Surveys are carried out among business people and country analysts, and use two types of samples, both non-resident and resident. It is important to note that residents' viewpoints correlate well with those of non-resident experts.

Table 2. Corruption Perceptions Index 2006 – 2007

Country Rank		Country	CPI Score	
2007	2006		2007	2006
1	1	Finland	9,4	9,6
1	1	New Zealand	9,4	9,6
1	4	Denmark	9,4	9,5
4	5	Singapore	9,3	9,4
4	6	Sweden	9,3	9,2
6	1	Iceland	9,2	9,6
7	7	Switzerland	9,0	9,1
7	9	Netherlands	9,0	8,7
9	8	Norway	8,7	8,8
10	9	Australia	8,6	8,7
27	28	Slovenia	6,6	6,4
28	24	Estonia	6,5	6,7
39	41	Hungary	5,3	5,2
41	46	Czech Republic	5,2	4,8
49	49	Slovakia	4,9	4,7
51	46	Lithuania	4,8	4,8
51	49	Latvia	4,8	4,7
61	61	Poland	4,2	3,7
64	57	Bulgaria	4,1	4,0
69	84	Romania	3,7	3,1
118	99	Ukraine	2,7	2,8
143	121	Russia	2,3	2,5

Source: Transparency International

The upper part of the CPI has changed rather little since its first publication in 1995. The number of countries involved has increased considerably.

The table above contains top ten countries in 2006 – 2007 plus TEs under review in this report. The best eight countries in the 2007 list score 9 points, or more. Thus, the top performers of the list are regarded as very honest ones.

The best-scoring TE in CP-index, Slovenia, is far the richest TE (for details, see Tiisanen: Transitional Economies and International Competitiveness, Lappeenranta 2006. NORDI publication no. 31). Slovenia's rank is 27th out of 180 countries. Her score in 2007 table is 6,6, or almost three points lower than at the top of the list. Estonia comes just after Slovenia (rank 28 with 6,5 points). Estonia is the most successful TE in attracting FDI (foreign direct investment). Obviously, international investors have appreciated Estonia's investment climate, in which corruption is rather well under control.

Hungary with 39th rank and 5,3 score is the next TE in the above table. Her score is clearly more modest than Slovenia's and Estonia's. However, Hungary is permanently able to attract

FDIs into her territory. Czech Republic is almost on the same level with Hungary in the CPI comparison and also in attracting foreign investors.

Slovakia, Lithuania and Latvia are very close together in the 2007 corruption comparison. All these three countries score less than 5 points. Slovakia has improved her relative position lately in CPI and also in FDI competition.

Poland is far the largest country among the new member states of EU (NMSs). Her rank in the CPI table with 61st position is rather modest, but she has improved her score by 0,5 points between 2006 and 2007. This improvement is impressive, even if the latest score of 4,2 is still modest.

Romania and Bulgaria were relegated in the EU enlargement of 2004. Both countries were told to improve their respective business environments, which were hampered by corruption and organised crime. Both were able to enter the Union in 2007 (for details, see Tiisanen: Romania and Bulgaria – Two New EU Members, Lappeenranta 2007. NORDI publication no. 44). In Romania, CPI score has improved considerably in 2007. The equivalent advancement in Bulgaria was rather modest, but Bulgaria ranks higher than Romania in the above table. These two EU-newcomers are substantially behind the top scores within TE-region in the CPI scoreboard. Corruption in Bulgaria and Romania must be paid attention to in the immediate future.

Ukraine and Russia, two TEs without EU membership but under review here, are at the bottom of the above list with very modest scores and ranks. In both countries CPI points declined modestly in 2007. Russia is clearly better off than Ukraine in living standard comparison. The oil price boom of the present decade has improved living conditions in Russia substantially. However, this improvement of living standard seems to correlate negatively with corruption development, which has negative tendency.

In the CPI comparison Ukraine and Russia are really far behind the top TEs, Slovenia and Estonia. Seven states from the CIS (Commonwealth of Independent States) are below Russia in the CP-index: Kazakhstan (2,1 score), Belarus (2,1), Tajikistan (2,1), Azerbaijan (2,1), Kyrgyzstan (2,1), Turkmenistan (2,0) and Uzbekistan (1,7). All these former Soviet republics are within the 30 most corrupt countries in the world. Uzbekistan is very close to the bottom of the complete CPI-list. Many of these countries (with exceptions of Belarus, Kyrgyzstan and Tajikistan) have considerable natural resources, and thus, potentially attractive for foreign

investors. Obviously, rampant corruption is hampering foreign operations in this group of countries.

Transparency International attempts to shed light on the other side of the corruption coin by publishing Bribe Payers Index (BPI), which is not as extensive as the CPI, and not as precise. However, the BPI contains some valuable information, even though TEs are not included in the same manner as in the CPI.

The CPI ranks 30 of the leading exporting countries, whose combined global exports represent 82% of the world total. In this index, higher scores reveal a lower propensity of companies from a country to offer bribes or undocumented extra payments when doing business abroad. The index is based on the responses of 11,232 business executives from companies in 125 countries. Respondents are asked to answer on a scale of 1 (bribes are common) to 7 (bribes never occur). In calculating the BPI, the answers are converted to a score between 0 and 10. The index figure reflects the average score.

Table 3. The BPI 2006

Rank	Country / territory	Average score (scale 0-10)
1	Switzerland	7,81
2	Sweden	7,62
3	Australia	7,59
4	Austria	7,50
5	Canada	7,46
6	UK	7,39
7	Germany	7,34
8	Netherlands	7,28
9	Belgium	7,22
	USA	7,22
11	Japan	7,10
12	Singapore	6,78
13	Spain	6,63
14	UAE	6,62
15	France	6,50
16	Portugal	6,47
17	Mexico	6,45
18	Hong Kong	6,01
	Israel	6,01
20	Italy	5,94
21	South Korea	5,83
22	Saudi Arabia	5,75
23	Brazil	5,65
24	South Africa	5,61
25	Malaysia	5,59
26	Taiwan	5,41
27	Turkey	5,23
28	Russia	5,16
29	China	4,94
30	India	4,62

Source: Transparency International

The top 10 countries in table above are Western industrialised countries (members of OECD). At the bottom of the scale are Taiwan, Turkey, Russia, China and India.

According to TI, there is a high correlation between the results of BPI and CPI, even if these two indicators are different in magnitude (CPI has much more countries than BPI). In commenting the BPI results, Transparency International remarks that many foreign companies do not resort to bribery while operating in the developed world, where institutions are strong and there is a significant threat of legal retribution for illegal activities. However, in emerging markets, many of which are characterised by poor governance and inefficient legal systems for dealing with corruption, it appears that many companies resort to corrupt

practices. The result is that the countries least equipped to deal with corruption are hardest hit, with their anti-corruption initiatives undermined. This helps trap many of world's most disadvantaged people in chronic poverty. The tendency for companies to let standards slip when working in countries with less stringent regulations than their home countries is alarming, and underlines the need for governments to take responsibility for the way their companies do business abroad as well as at home.

3 Composite indices

3.1 Business rankings model by EIU

The Economist Intelligence Unit (EIU) is a specialist publisher serving companies establishing and managing operations across national borders. The firm is a member of The Economist Group. EIU has a long tradition of publishing country reports of over 80 countries covering information on business developments, economic and political trends, government regulations and corporate practice. In addition, EIU has developed a business rankings model including a forecast over a 5-year period. This model is based on quantitative and qualitative components.

The business rankings model measures the quality or attractiveness of the business environment in the 82 countries covered by Country Forecasts using a standard analytical framework. It is designed to reflect the main criteria used by companies to formulate their global business strategies, and is based not only on historical conditions but also on expectations about conditions prevailing over the next five years. This allows the Economist Intelligence Unit to utilise the regularity, depth and detail of its forecasting work to generate a unique set of forward-looking business environment rankings on a regional and global basis.

The business rankings model examines ten separate criteria or categories, covering the political environment, the macroeconomic environment, market opportunities, policy towards free enterprise and competition, policy towards foreign investment, foreign trade and exchange controls, taxes, financing, the labour market and infrastructure. Each category contains a number of indicators that are assessed by the Economist Intelligence Unit for the last five years and the next five years. The number of indicators in each category varies from five (foreign trade and exchange regimes) to 16 (infrastructure), and there are 91 indicators in total.

Almost half of the indicators are based on quantitative data (eg, GDP growth), and are mostly drawn from national and international statistical sources for the historical period (2002-2006) and from Economist Intelligence Unit assessments for the forecast period (2007-2011). The other indicators are qualitative in nature (eg, quality of the financial regulatory system), and are drawn from a range of data sources and business surveys adjusted by the Economist Intelligence Unit, for 2002-2006. All forecasts for the qualitative indicators covering 2007-2011 are based on Economist Intelligence Unit assessments.

The rankings are calculated in several stages. First, each of the 91 indicators is scored on a scale from 1 (very bad for business) to 5 (very good for business). The aggregate category scores are derived on the basis of simple or weighted averages of the indicator scores within a given category. These are then adjusted, on the basis of a linear transformation, to produce index values on a 1-10 scale. An arithmetic average of the ten category index values is then calculated to yield the aggregate business environment score for each country, again on a 1-10 scale.

The use of equal weights for the categories to derive the overall score reflects in part the theoretical uncertainty about the relative importance of the primary determinants of investment. Surveys of foreign direct investors' intentions yield widely differing results on the relative importance of different factors. Weighted scores for individual categories based on correlation coefficients of recent foreign direct investment inflows do not in any case produce overall results that are significantly different to those derived from a system based on equal weights.

For most quantitative indicators the data are arrayed in ascending or descending order and split into five bands (quintiles). The countries falling in the first quintile are assigned score of 5, those falling in the second quintile score 4 and so on. The cut-off points between bands are based on the average of the raw indicator values for the top and bottom countries in adjacent quintiles. The 2002-2006 ranges are then used to derive 2007-2011 scores. This allows for intertemporal as well as cross-country comparisons of the indicator and category scores.

The indices and rankings attempt to measure the average quality of the business environment over the entire historical or forecast period, not simply at the start or at the end of the period. Thus in the forecast we assign an average grade to elements of the business environment over 2007-2011, not to the likely situation in 2011 only.

The scores based on quantitative data are usually calculated on the basis of the numeric average for an indicator over the period. In some cases, the "average" is represented, as an approximation, by the recorded value at the mid-point of the period (2004 or 2009). In only a few cases is the relevant variable appropriately measured by the value at the start of the period (eg, educational attainments). For one indicator (the natural resources endowment), the score remains constant for both the historical and forecast periods.

EIU's latest business environment index contains all TEs under review. The forecast period covers 2007-2011. Most of the 12 TEs on the table below have improved the scores in comparison to the previous period (2002-2006).

Table 4. Business environment rankings

	2002-2006 Global rank ^b	2007-2011 Total score ^a	2007-2011 Global rank ^b	Change in total score	Change in rank
Bulgaria	49	6,77	44	0,93	5
Czech Republic	28	7,55	26	-0,17	2
Estonia	20	7,87	21	1,08	-1
Hungary	32	7,12	35	2,02	-3
Latvia	39	7,06	37	0,44	2
Lithuania	40	7,03	38	0,30	2
Poland	35	7,17	34	1,39	1
Romania	51	6,58	48	1,13	3
Russia	59	6,07	63	1,09	-4
Slovakia	31	7,44	29	0,69	2
Slovenia	34	7,41	32	2,97	2
Ukraine	76	5,45	70	-1,09	6
World average		6,87		0,46	

^aOut of 10. ^bOut of 82 countries. Source: EIU

Estonia is the best scoring country in the EIU assessment. Its rank is 21st (out of 82 countries). Her score has improved by 1,1 points in comparison to the previous assessment.

Estonia's economic performance has been permanently strong, with foreign investors taking advantage of Estonia's favourable location, low labour costs, exemplary system of business regulation and favourable tax system. Estonia's entry to NATO and the EU has dispelled most concerns about regional stability.

Estonia is set to continue to attract FDI, although rapid economic growth will gradually reduce the appeal of low wages. The sectoral composition of FDI is set to shift away from financial intermediation towards business services, more sophisticated manufacturing activities and ICT services.

The Czech Republic is the second best in the EIU list with 26th rank. Her score has diminished by about 0,2 points.

As early reformer, the Czech Republic led the way in the early 1990s in adopting far-reaching stabilisation, liberalisation and privatisation programmes. The implementation of EU rules and regulations has also helped to improve the business environment.

However, foreign investors have cited problems, such as the overbearing bureaucracy, as well as high taxes. The overall tax burden is one of the highest in Europe. With an advantageous geographical location, the country remains attractive to foreign investors, even if her neighbouring Slovakia is a strong rival with cheaper labour costs and more advantageous taxes.

Slovakia's political and economic climate in the 1990s was unstable, and thus, FDI inflow was modest. In the early years of the 21st century institutional reforms improved business climate substantially, and FDI inflow, especially in car manufacturing, recovered rapidly. In the EIU assessment Slovakia's score improved by 0,7 points in comparison to 2002-2006. A new populist government, which took office in 2006, has placed some doubt on the continuation of the business-friendly atmosphere.

In the early period of transition, Slovenia was reluctant to let foreign investors have a strong role in the privatisation process combined with a burdensome regulatory system that was perceived as unfriendly by foreign firms. In addition, Slovenia is far the richest country under review, and thus, has very high wage level in TE-comparison. As a result, FDI plays a rather modest role in the Slovenian economy.

In the EIU assessment, Slovenia has improved her score more substantially than any other TE in the list, by almost 3 points. A new programme for the stimulation of FDI has been created. However, these positive features in the business environment are not necessarily causing a strong inflow of FDI, because labour costs in this small national economy of 2 million people remain comparatively high.

Hungary is the fifth most attractive TE in the above list. Her score shows also a considerable improvement of more than two points.

In the early transitional period, Hungary carried out economic reforms rapidly. The sale of state assets to foreign investors formed the cornerstone of Hungary's privatisation. Special tax incentive schemes were developed to attract FDI, which flowed in rather massively.

In the early years of the 21st century, special tax incentives for FDIs have been phased out or changed to comply with EU regulations. In the meantime, Hungary has become a location of relatively high labour costs. As a result, massive FDI inflow can not be expected to continue in the same manner as in the 1990s. However, a big part of FDI profits is obviously reinvested in Hungary.

Poland's global rank is 35th in the EIU list with score improvement of about 1,3. In the early period of transition Poland was perceived by potential foreign investors as politically unstable and economically underdeveloped. In the second half of the 1990s, the country started to receive FDI in increasing magnitude attracted by the size of the internal market.

In the first years of the 21st century, the FDI stock in Poland has increased steadily, but in per capita terms it is substantially lower than in Estonia, Hungary, Czech Republic and Slovakia.

Latvia is scoring moderately worse than Poland in the EIU score-board. In the latest assessment her score improved by about 0,4 points.

In the early period of transition, Latvia restricted FDI inflow radically. This is one the most important reasons why Latvia was the poorest EU newcomer in the Eastern enlargement of 2004.

In the early years of the 21st century, Latvia has enjoyed a very rapid economic growth. This economic dynamism has attracted rather nicely FDIs. One of the most important background factors is the rather modest wage level which is clearly more advantageous than in Estonia.

Lithuania scores somewhat less points than her northern neighbour, Latvia. Also the growth in scoring is bit less, about 0,3 points.

Lithuania's economic history in the transitional era resembles that of Latvia in many respects. Foreign investors had rather modest interest in the country in the 1990s. With rapid economic growth lately, FDI inflow has become more dynamic. In TE-comparison, labour costs are relatively modest.

Bulgaria's EU entry (together with Romania) was postponed in 2004. Therefore, it is understandable that Bulgaria's global rank (44th) in the EIU assessment is below those 8 countries described above. Her score shows an improvement of 0,9 points.

In the early years of post-communism, Bulgaria suffered of extremely severe economic and political instability. The macro-economic management of the country was taken over by IMF officials in the late 1990s. After that, stability was re-established and economic growth resumed. Thus, in recent years foreign investors have started to have confidence on Bulgaria's economic prospects.

Bulgaria is able to offer the most attractive wage level in the present-day EU. This is obviously going to keep FDI inflow on a dynamic path.

Romania is somewhat behind Bulgaria in EIU scoreboard with a reasonable growth of 1,1 points. As in Bulgaria, also in Romania the second decade of transition is essentially better than the first one.

Romania is more expensive in terms of labour costs than Bulgaria. However, Romania is in this respect much cheaper than those TEs in Central Eastern Europe, which were able to enter EU in 2004. With improving institutional framework and reasonable economic growth it is highly likely that Romania will benefit of increasing FDI inflow in the near future.

Russia's global rank in the EIU table is 63rd with 1,1 increase in scoring. Thus, Russia is far behind those 10 TEs covered so far above.

However, Russian economy has in the early years of the new century profited from the oil price boom. The overall living standard of over 140 million Russians has increased very rapidly. Thus, foreign investors have a strong motive to establish themselves in the large Russian market. Inadequate protection of property rights, corruption, problems with customs and a weak banking sector are still seen as barriers to investment.

It is likely that oil and natural gas prices remain on a high level. Therefore, Russian economic boom will continue which increases her attraction in the eyes of foreign investors. They will be confronted with still high risks and potentially high profits.

Ukraine is at the bottom of the list with low and decreasing score. Political and economic uncertainty has continued during the whole transitional period. Therefore, FDI stock has remained on a very low level.

In Ukraine, local currency is permanently grossly undervalued, while the real exchange rate of Russian rouble appreciates amid the oil price boom. Thus, there is an attraction to invest in

Ukraine and export goods from there to Russia. In terms of costs and prices this option may offer beneficial prospects in certain sectors.

In the EIU assessment, there are two TEs with declining score in comparison to the previous assessment, which means that the business environment has deteriorated. In the Czech case, the decline is rather moderate (-0,17), while the Ukrainian equivalent figure (-1,09) is relatively high.

In two cases, there are considerable improvements visible. In Slovenia, the score has increased almost by 3 (+2,97) points. In Hungary the equivalent increase is over 2 (2,02).

The average score in EIU-index is 6,87 (of 82 countries involved). Four TEs in the list (Ukraine, Russia, Romania and Bulgaria) score less than the average. All eight TEs, which joined the EU in 2004, score above the “world average”. Estonia is the best TE in EIU’s business environment ranking.

3.2 The World Competitive Index by IMD

IMD, International Institute for Management Development, in Lausanne, Switzerland, is one of the world leaders in executive education. This Swiss Institute publishes annually since 1989 “World Competitiveness Yearbook” (WCY) which is cited widely in financial press.

In the World Competitiveness Scoreboard 2007 there are 55 countries involved. Lithuania and Ukraine are newcomers in the list, which excludes Latvia, one of the countries under review here.

The WCY keeps pace with structural changes in national environments and the rapidly changing technological revolution. Based on analysis made by leading scholars, the methodology of the WCY divides the national environment into four main Competitiveness Factors: Economic Performance, Government Efficiency, Business Efficiency Performance and Infrastructure. Each of these four factors has been broken down into five sub-factors, each highlighting different facets of competitiveness.

The WCY uses different types of data to measure quantifiable and qualitative issues separately. Statistical indicators are acquired from international, national and regional organizations, private institutions and 50 Partner Institutes worldwide. These statistics are referred to in the WCY as Hard data and include 127 criteria used to determine the overall rankings and 77 criteria presented as valuable background information but not used in the

calculation of the rankings. The 127 Hard criteria represent a weight of approximately two-thirds in the overall ranking. An additional 119 criteria are drawn from our annual Executive Opinion Survey and are referred to in the WCY as Survey data.

Whereas the Hard data shows how competitiveness is measured over a specific period of time, the Survey data measures competitiveness as it is perceived. The survey was designed to quantify issues that are not easily measured, for example: management practices, labor relations, corruption, environmental concerns or quality of life. The survey responses reflect perceptions of competitiveness and indications for the future by business executives who are dealing with international business situations.

IMD underlines that its competitiveness assessment focuses primarily on hard data (quantitative indicators), which make up two-thirds of the composite index, while survey data makes up the rest (1/3). In the final calculation, the most competitive country is marked with 100. The other 54 countries deviate in the index from this “optimal” or highest possible score. Country-wise deviations are remarkable.

The WCY index below comprises the 20 best countries in the world in the competitiveness ranking and includes also the scoreboard. After that, eleven TEs are listed with global rank and score.

Table 5. WCY 2007 Index

Rank	Country	Score
1	USA	100,0
2	Singapore	99,1
3	Hong Kong	93,5
4	Luxembourg	92,2
5	Denmark	91,9
6	Switzerland	90,4
7	Iceland	88,7
8	Netherlands	85,9
9	Sweden	84,1
10	Canada	83,8
11	Austria	83,2
12	Australia	82,4
13	Norway	82,0
14	Ireland	81,9
15	China Mainland	79,5
16	Germany	78,0
17	Finland	77,3
18	Taiwan	76,0
19	New Zealand	75,5
20	United Kingdom	75,45
22	Estonia	74,3
31	Lithuania	61,7
32	Czech Republic	59,6
34	Slovak Republic	57,7
35	Hungary	57,63
40	Slovenia	55,2
41	Bulgaria	48,7
43	Russia	47,3
44	Romania	47,3
46	Ukraine	45,5
52	Poland	42,7

Source: IMD WCY database

Estonia is the best TE in the IMD list with 22nd rank with a relatively high score of 74,3, which is very close to United Kingdom on the 20th place. Lithuania (rank 31) and Czech Republic (32) are the next most competitive TEs with clearly lower score than Estonia. Slovakia and Hungary are not far away with 34th and 35th rank.

Slovenia, the richest TE, and the relatively poor TE, Bulgaria, are in the next category with 40th and 41st rank. Russia (43) and Romania (44) are not far away. Ukraine (46) and Poland (52) are the most moderately ranked TEs in IMD's composite index.

Estonia is the best TE in the light of IMD, as well as in EIU composite index. Also Czech Republic does well in these two assessments. In the world competitiveness measurement of IMD, Poland is scoring very modest results, and is with her 52nd rank very close to the bottom of the list (of 55 countries). Poland's position below Russia, Romania and even Ukraine is rather surprising.

Both composite assessments described above (IMD, EIU) contain quantitative as well as qualitative elements. This fact is obviously the most important feature in differences in ranking. Qualitative parts of any index reflect survey results (opinions), and thus, can never deliver exact results of various issues connected with business climate. It is worth noticing that survey methods used in assessments under review here deviate from each other.

3.3 Services Location Index of A.T. Kearney

One of the most dynamic spheres during the last two decades has been the offshoring of services. The most common remote functions include IT services and support, contact centers and back-office support. The fast growth of remote services business is based on huge cost differentials in the global economy. Companies in the rich part of the world have started to outsource services to the emerging markets. Transitional economies in Europe offer high level of education combined with moderate wage/salary level, and thus, potentially attractive opportunities in offshoring services.

A.T. Kearney (a consultancy) has compiled data on leading offshore destinations for several years. Its Global Services Location Index has been published annually since 2004. The latest Index (2007) includes eleven TEs under review here. Slovenia with high living standard and high pay level is excluded.

The Index analyzes and ranks the top 50 locations worldwide in the remote function business. Each country score is composed of a weighted combination of relative scores on 43 measurements, which are grouped into three categories: financial attractiveness, people and skill availability, and business environment. Index materials were determined from responses to Kearney and other industry surveys, and knowledge obtained in client engagements. As cost advantage is the most important determinant in the location selection, financial factors constitute 40% of total weight in the overall index. The two remaining categories – people and skill availability, and business environment – each constitute 30% of the total weight. In the final Index high score indicates high attractiveness.

Table 6. Services Location Index 2007

Rank	Country	Financial attractiveness	People and skills availability	Business environment	Total score
1	India	3,22	2,34	1,44	7,00
2	China	2,93	2,25	1,38	6,56
3	Malaysia	2,84	1,26	2,02	6,12
4	Thailand	3,19	1,21	1,62	6,02
5	Brazil	2,64	1,78	1,47	5,89
6	Indonesia	3,29	1,47	1,06	5,82
7	Chile	2,65	1,18	1,93	5,76
8	Philippines	3,26	1,23	1,26	5,75
9	Bulgaria	3,16	1,04	1,56	5,75
10	Mexico	2,63	1,49	1,61	5,73
12	Slovakia	2,79	1,04	1,56	5,75
15	Estonia	2,44	0,96	2,20	5,60
16	Czech Republic	2,43	1,10	2,05	5,57
17	Latvia	2,64	0,91	2,00	5,56
18	Poland	2,59	1,17	1,79	5,54
24	Hungary	2,54	0,95	1,98	5,47
28	Lithuania	2,60	0,83	1,98	5,42
33	Romania	2,88	0,87	1,53	5,28
37	Russia	2,61	1,38	1,16	5,14
47	Ukraine	2,76	0,98	1,09	4,83

Note: The weight distribution for the three categories is 40:30:30. Financial attractiveness is rated on a scale of 0 to 4, and the categories for people and skills availability, and business environment are on a scale of 0 to 3.

Source: A.T. Kearney

It is not surprising that India is at the top of the list in the above table with 7 points (out of ten), followed relatively closely by China. Malaysia, Thailand, Indonesia and Philippines are further Asian countries within the top ten in the index ranking.

Bulgaria is the only European country among the most attractive locations in offshore services. Bulgaria scores excellently in the financial attractiveness, but the overall score is affected negatively by the rather modest score in the skill availability category.

Slovakia is on the second place in TE-competition and occupies the 12th place globally. She cannot offer as low pay level as Bulgaria, but provides a better business climate. In offering human resources, Bulgaria and Slovakia are both scoring modestly.

There are four more TEs within the best 20 in the Service Location Index, Estonia (15th), Czech Republic (16th), Latvia (17th) and Poland (18th). Estonia scores very well in the business environment component of the index, but is relatively expensive country in costs. Also Czech Republic and Latvia score rather well in business climate part of the index. In this group of

four TEs, Poland has the highest score in the human resource sub-index, but the lowest in the overall marking.

Hungary (24th) and Lithuania (28th) are relatively close to each others in total scoring (5,47 and 5,42, respectively). Both score rather modestly in the availability of people and skill.

Romania, which is on the 33rd place, offers rather convenient financial incentives, but lacks human resources and nice business climate. Russia offers even worse climate to do business, but has relatively good people and skills base. In overall ranking, Russia is, however, only in the 37th place.

Ukraine is very close to the bottom of the list, on 47th rank (out of 50). Her business climate score is the second worst in the whole index (only Senegal has lower score). Ukraine's financial attractiveness in the above index is almost on the same level with Romania. Thus, improving political and economic stability in Ukraine would enhance her attractiveness as a location of offshore services essentially.

Obviously, relative costs in remote service functions change rather rapidly. A.T. Kearney warns, that in certain TEs, especially in the Czech Republic and Hungary, wage level increases are hurting business prospects in offshore services.

3.4 Global Competitiveness Index (GCI) by the World Economic Forum (WEF)

The World Economic Forum has been studying the competitiveness of nations for nearly three decades. Since 1979, annual Global Competitiveness Reports have examined the factors enabling national economies to achieve sustained economic growth and long-term prosperity.

The methodology used to assess national competitiveness has necessarily evolved over time. In 2004 the World Economic Forum introduced the Global Competitiveness Index (GCI), a highly comprehensive index for measuring national competitiveness, taking into account the microeconomic and macroeconomic foundations of national competitiveness.

WEF defines competitiveness as the set of institutions, policies and factors that determine the level of productivity of a country. The level of productivity, in turn, sets the sustainable level of prosperity that can be earned by an economy. In other words, more competitive economies tend to be able to produce higher levels of income for their citizens. The productivity level

also determines the rates of return obtained by investments in an economy. Because the rates of return are the fundamental determinants of the growth rates of the economy, a more competitive economy is one that is likely to grow faster over the medium to long run.

The concepts of competitiveness thus involves static and dynamic components: although the productivity of a country clearly determines its ability to sustain a high level of income, it is also one of the central determinants of the returns to investment, which is one of the central factors explaining an economy's growth potential.

The global competitiveness index provides a weighted average of many different components, each of which reflects one aspect of the complex reality that is called competitiveness. The GCI comprises altogether 12 pillars, which are organized into three subindexes, The Index contains the following elements:

Basic requirements

- Institutions
- Infrastructure
- Macroeconomic stability
- Health and primary education

Efficiency enhancers

- Higher education and training
- Goods market efficiency
- Labor market efficiency
- Financial market sophistication
- Technological readiness
- Market size

Innovation and sophistication factors

- Business sophistication
- Innovation

The composite index includes both quantitative and qualitative (survey-based) elements. The overall index is calculated from the 12 components, each of which affects the final score. In the index scoreboard a scale of one to seven is used. In the GCI of 2007 - 2008, the total number of countries is 131.

Table 7. Global Competitiveness Index

GCI 2007 - 2008		
Country/ Economy	Rank	Score
USA	1	5,67
Switzerland	2	5,62
Denmark	3	5,55
Sweden	4	5,54
Germany	5	5,51
Finland	6	5,49
Singapore	7	5,45
Japan	8	5,43
UK	9	5,41
Netherlands	10	5,40
Estonia	27	4,74
Czech Republic	33	4,58
Lithuania	38	4,49
Slovenia	39	4,48
Slovak Republic	41	4,45
Latvia	45	4,41
Hungary	47	4,35
Poland	51	4,28
Russia	58	4,19
Ukraine	73	3,98
Romania	74	3,97
Bulgaria	79	3,93

Source: The Global Competitiveness Report 2007 – 2008, World Economic Forum

In the GCI list of 2007 – 2008 USA, Switzerland, Denmark, Sweden, Germany, Finland, Singapore, Japan, UK and Netherlands are the top ten countries with scores from 5,67 (USA) to 5,40 (Netherlands). The UK dropped from the second rank in 2006 to 9th place. Hong Kong was 10th in 2006, but in the 12th place 2007 – 2008.

Estonia (ranked 27th) is, by a significant margin, the most competitive economy among the 12 countries under review. According to WEF, the efficiency of her government institutions, her excellent management of public finances and her aggressiveness in adopting new technologies outperform many “old” EU-members. This stands in contrast with Poland (on the 51st place), which continues to slip in the ranking (from 45th in 2006) with poor marks for its institutional environment and low public trust in politicians, against the backdrop of weak and deteriorating public finances.

The Global Competitiveness Report 2007 – 2008 pays verbal attention to Russia, which is ranked 58th. Despite the country’s large market size and improving macroeconomic

management, Russia places below the other large European countries, mainly attributable to weaknesses in its institutional environment and business standards. Of major concern is a perceived lack of government efficiency (subindex rank 118th), the lack of independence of the judiciary and more general concerns about government favouritism in its dealings with the private sector. Further, the environment for the protection of property rights is extremely poor and worsening (122nd rank in this pillar). Private institutions also get poor marks, with corporate ethics in the country placing Russia 120th overall on this indicator.

Czech Republic is the second best TE in the GCI list with 33rd rank. Lithuania (38th), Slovenia (39th) and Slovakia (41st) are not far behind. Latvia (45th) and Hungary (47th) come both before Poland (51st).

Ukraine (73rd), Romania (74th) and Bulgaria (79th) are all scoring very badly in the GCI composite index. It is noteworthy, that in this group of three TEs, Ukraine is better than the other two. Bulgaria is ranked clearly worse than Romania. In the previous assessment, these two countries were very close to each others.

In the composite index of EIU, Bulgaria and Romania score both essentially better than Ukraine. Also in the IMD assessment Bulgaria and Romania are better than Ukraine. In the IMD competition Poland is ranked worse than Bulgaria, Romania and Ukraine.

Estonia seems to be unbeatable rival in the group of TEs, as far as the composite index competition is concerned. The EIU, the IMD and the WEF have got Estonia in the top of the list within 12 TEs under review here. In the Services Location Index, Bulgaria with her extremely low wage level is ranked the best TE. In the WEF ranking, she is on the last place in TE-ranking.

All composite indeces covered above, contain qualitative components. With survey methods, it is impossible to achieve exact results: surveys always reflect opinions. Therefore, it is understandable that assessments covered here cannot give identical clues on economic development in 12 different societies.

Some quantitative indicators are discussed below connected with price and wage levels, and foreign direct investment stocks in TE-region. Estonia has been able to attract more FDI than any other TE under review. This result is not surprising considering the above mentioned assessments on business climate differentials.

4 Price level comparisons

4.1 Price level development in TE-region

Measuring prices is an important component in compiling macro-economic indicators. Methods in making price indexes have developed enormously over time, which is good news, because economic decision-makers ought to be well informed on inflation rates.

When price levels are compared internationally, there are some difficulties, which are not easy to overcome. For example, it is rather difficult to compare housing costs in different countries. A certain part of population in every country owns the housing unit they are living in. Some of these people have paid off the mortgage (or have inherited a house) and thus, spend very little money for the housing (mainly for the maintenance and some running costs). The other part of house owners have financed the purchase of the house by borrowing money and must service the mortgage. One of the options is to rent a place (flat or house) where to live in. Renting a home takes place either in the open market, where rent is formed via supply and demand, or in the sphere of “social housing”, in which the public sector (normally municipality) subsidises rents. Therefore, comparing housing costs internationally is not easy. Rents paid in the housing market tell only a part of the housing cost story. Quality of a small flat in London is not necessarily the same as in Jakarta.

In international price comparisons it is important to measure the same “consumer basket” in all countries involved. In consumer price index, the content of the basket must be the same (contain the same goods and services). In international comparisons it is possible to construct “consumer baskets” with similar contents, but the quality of every item involved can hardly be exactly the same everywhere.

In the European Union, it is important to harmonise all economic indicators to make international comparisons as good as possible. In 2006, the EU comprised 25 countries. In 2007 the number of member states went up to 27.

The Vienna Institute for International Economic Studies (WIIW) provides international price level comparisons from these 12 countries under review. In WIIW calculations, EU (25) is marked with 100. Price competition development in TE-region can be assessed with WIIW’s database.

Table 8. Price level in TEs**EU (25) = 100**

Country	2000	2006	Growth (%) 2000 - 2006
Czech Republic	46	58	34,9
Hungary	47	56	19,1
Poland	52	55	5,8
Slovakia	43	54	25,6
Slovenia	72	71	-1,4
Bulgaria	31	37	19,4
Romania	36	50	38,9
Estonia	53	60	13,2
Latvia	50	52	4,0
Lithuania	46	51	10,9
Russia	32	56	75,0
Ukraine	18	26	44,4

Source: WIIW

The table above shows clearly, that TEs under review have lost price competitiveness in the early years of the new century. There is one exception, Slovenia, which is the richest and also the most expensive country in the region. Her price level was 72% of EU average in 2000. The equivalent figure in 2006 was 71%, indicating a drop of relative prices.

The most severe catching up of price level of EU (25) has taken place in Russia, where relative figure jumped from 32% to 56% showing a growth of no less than 75% (2000 – 2006). The equivalent growth in Ukraine was 44,4%. However, in 2006 Ukraine was still the least expensive country in the table with a price level of about one quarter of the EU average level.

Also Romania has been losing price competitiveness in the early years of the new century. Her figure increased from 36% in 2000 to 50% in 2006, which means almost 40% growth. The equivalent growth in Bulgaria, the other latecomer in the EU, is only less than 20%. Bulgaria's price level is essentially lower than that in Romania.

The Czech Republic shows strong catching up with the EU average price level: the relative figure grew by about 35% in 2000 – 2006. In Slovakia the equivalent figure is lower, about 26 %.

Latvia has been able to keep her relative price level rather stable in 2000 – 2006. In this period, the growth rate was only 4%. Latvia is in the comparison cheaper than her Northern neighbour, Estonia.

4.2 Prices and earnings in big cities

Union Bank of Switzerland (UBS) publishes every year her “Prices and Earnings Report”, which measures living costs and wages in 71 big cities around the globe. This assessment of several metropolises comprises all capital cities of these 12 TEs under review here.

UBS’s price index is based on a consumer basket, in which there are 95 goods and 27 services. The overall price index is given in two forms: one excluding and the other including rent for housing. The former is cited below.

Table 9. Prices 2006

Rank	City	Excl. rent New York = 100
1	Oslo	121,5
2	London	110,6
3	Copenhagen	109,2
4	Zürich	107,4
5	Tokyo	106,8
6	Geneva	102,9
7	New York	100,0
8	Dublin	98,3
9	Stockholm	98,1
10	Helsinki	97,0
41	Moscow	65,6
44	Ljubljana	64,4
46	Warsaw	63,7
49	Tallinn	62,0
52	Budapest	58,6
55	Prague	53,8
56	Riga	52,7
58	Bucharest	51,6
59	Bratislava	50,4
61	Sofia	50,1
63	Vilnius	49,4
66	Kiev	47,8

Source: UBC

The most expensive city (excluding rents) is Oslo, the capital city of Norway. Three other Nordic capital cities, Copenhagen, Stockholm and Helsinki are included in the top ten

metropolises with high prices. The “anchor” of the index, New York (marked with 100) is on the seventh place.

Moscow is the most expensive metropolitan area within our group of countries. It’s rank is 41st and her score is just about two-thirds of New York’s level.

In this context it is appropriate to note that rents in the index are excluded. Moscow is very expensive place for foreign business people, who want to rent a flat in downtown, or a house in the suburbs. Warehouses and office space are also very dear, because both are in short supply. Thus, there are plenty of biases in the price structure. Costs linked with business activities may be exorbitant for foreign companies. However, the index above measures prices on the basis of an average consumer basket, excluding business activity expenditure.

The second most expensive capital city in the TE-region is Ljubljana on the 44th rank. Slovenia is far the richest country within our 12 TEs under review. Thus, it is no wonder that Slovenia’s capital city is rather close to Moscow in price level comparison.

Poland is far the biggest NMS with almost 40 million people. Her capital city, Warsaw, is big and relatively expensive, only slightly below Ljubljana with 63,7 score and on the 46th rank.

Tallinn’s rank is 49th and her price level is 62% of the New York level. Estonia’s capital city has some unique features: it is only 80 km away from Helsinki. In the post-communist era, travelling between these two capital cities has expanded exponentially. The flood of visitors has caused supplementary demand in retailing, in restaurants and hotels, which have been able to enhance their prices. Shopping trips from the Nordic countries to Tallinn have become very popular, but the increasing costs in the trip destiny have caused deceleration of tourism growth.

Budapest (rank 52nd) and Prague (55th) are extremely convenient locations from the point of view of city-tourism, and thus, massively visited by continental European and even overseas tourists. Obviously, visitors have affected price levels in these two cities. However, both Budapest and especially Prague are still relatively cheap capital cities. From the point of view of shopping trips, Bratislava in Slovakia between the Czech Republic and Hungary, still has a rather low price level (about 50% of New York). Riga (in Latvia) and Bucharest (in Romania) are both more expensive places than Bratislava. Sofia in Bulgaria and Vilnius in Lithuania are moderately cheaper than Bratislava.

Kiev is the capital city of Ukraine, which scored very modestly in the light of all indicators described above. In the price competition of UBS's city table, Kiev is classified as the cheapest location in the TE-region.

It is self-evident that in every country capital city and other metropolitan areas are more expensive than small towns and villages. Therefore, price level index of metropolises does not reflect the overall price level in a country.

The UBS has in its Price and Earnings Report also gross and net wage level indices. The former is ignored here and the latter is covered below.

Table 10. Wage levels 2006

New York = 100

Rank	City	Net income
1	Zürich	124,2
2	Geneva	115,4
3	Oslo	110,8
4	Dublin	104,6
5	New York	100,0
6	Luxemburg	98,1
7	Los Angeles	97,0
8	London	96,0
9	Copenhagen	95,7
10	Chicago	94,7
42	Ljubljana	28,3
45	Prague	25,8
46	Moscow	25,4
48	Tallinn	22,1
50	Budapest	20,0
53	Bratislava	18,7
54	Warsaw	18,4
55	Vilnius	15,4
58	Riga	15,3
60	Bucharest	13,2
62	Kiev	11,6
64	Sofia	10,2

Source: UBS

Net wage figures are calculated after deduction of taxes and social security payments. Data above is in index form (New York = 100). Two Swiss cities are in the lead, because taxes are low in Switzerland. Three American cities are within the top ten as well as Oslo and Copenhagen from Nordic Europe.

Ljubljana offers the best net wage level in the TE-region. It is approximately one quarter of the top level pay, but almost three times more, than in Sofia, Bulgaria. Prague and Moscow are not far behind Ljubljana.

As pointed out above, Moscow and Ljubljana are relatively expensive cities, in both of which the prices are about one third of the New York level. As wage level gap between New York on one side and Ljubljana and Moscow on the other is rather high, Slovenians and Russians living in their respective capital cities face a relatively low pay and rather high price level. Prices in Prague are clearly cheaper than in Moscow and Ljubljana, which means that Prague inhabitants have a higher real living standard than their counterparts in Moscow and Ljubljana.

Inhabitants in Tallinn, Budapest, Bratislava and Warsaw earn net income which is about one fifth of the New York level. People living in Vilnius, Riga and Bucharest earn even less than that. At the bottom of the wage scale, citizens of Kiev and Sofia have a net pay of about one tenth of the New York level. Thus, in the above index on net wages, living standard differentials look rather high.

The problem in the net pay table is that it is not telling us how much net wage in various locations can buy. Net wages must be adjusted with the purchasing power parity (PPP), that is, different price levels must be taken into consideration, in order to be able to compare “real” income figures. UBS provides net hourly pay data PPP adjusted.

Table 11. Net hourly pay, PPP adjusted

City	New York = 100
Zürich	115,6
Geneva	112,1
Dublin	106,5
Los Angeles	105,9
Luxemburg	105,1
Chicago	102,8
New York	100,0
Berlin	99,7
Sydney	99,0
Auckland	98,7
Prague	48,0
Ljubljana	44,0
Moscow	38,8
Bratislava	37,0
Tallinn	35,6
Budapest	34,2
Vilnius	31,2
Riga	29,0
Warsaw	28,8
Bucharest	25,6
Kiev	24,3
Sofia	20,4

Source: UBS

PPP adjusted net pay figures show that Prague is the best place to live in as far as TE-capital cities are concerned. Their living standard is 48% of New York's level and the global rank is 41st. Ljubljana is not far away with an equivalent percentage of 44 (43rd rank). Moscow comes next with 38,8% of New York's figure on place 46.

Bratislava (37%), Tallinn (35,6%) and Budapest (34,2%) all enjoy a welfare, which is somewhat higher than one third of that in New York. These three cities occupy 48th, 49th and 50th place, respectively.

Vilnius (31,2%), Riga (29%) and Warsaw (28,8%) are very near each others in living standard. Bucharest (25,6%) and Kiev (24,3%) are somewhat further below. Sofia is at the bottom of the list with 20,4%.

It can be concluded that real living standard in cities under review is in average about one third of the New York level. In Kiev the equivalent figure is about one quarter and in Sofia about one fifth.

There are some oddities in price structures in TE-region. Consumer durables are in high demand. Therefore, prices are high, or even extremely high in comparison to net pay figures in TEs.

Table 12. Prices of home electronics and household appliances

City	USD	Index New York = 100
Vienna	3280	155,5
Tokyo	3250	154,0
Tel Aviv	3200	151,7
Geneva	3170	150,2
Oslo	3140	148,8
Zürich	3050	144,5
Lyon	3040	144,1
Helsinki	3010	142,7
Paris	3000	142,2
Amsterdam	3000	142,2
Moscow	2710	128,4
Tallinn	2570	121,8
Ljubljana	2550	120,9
Sofia	2490	118,0
Prague	2470	117,1
Warsaw	2460	116,6
Budapest	2420	114,7
Riga	2400	113,7
Bratislava	2310	109,5
Bucharest	2250	106,6
Vilnius	2160	102,4
Kiev	1860	88,2

Source: Prices and earnings 2006, UBS

Methodology: Costs for a basket of items consisting of: refrigerator, color TV, digital camera, electric steam iron, vacuum cleaner, frying pan, hairdryer and PC.

Consumer electronics and household appliances are not produced in massive scale in TE-region. The big bulk of them is imported. As the above table shows the price index in this group of goods is over 100 in all TE-cities of the list with the exception of Kiev.

This means in actual fact that it is more advantageous to buy your PC or washing machine in New York than in Warsaw or Prague. You can get your TV-set or digital camera cheaper in Berlin than in Moscow or Tallinn.

Obviously, one important reason for these price distortions is the competition, or better said, the lack of it in TE-region. Distributors and retailers of high value consumer goods need

capital to store and service consumer durables. Emerging competition in this branch takes time and money. It can only be assumed that presently profit margins in this sphere, especially in retailing, must be extremely high in all post-communist societies.

5 Foreign direct investment (FDI) in TE-region

In the early period of the transition from central planning into a decentralised market system it was customary to ask whether there is enough capital to establish capitalism in post-communist countries. In this context, it was easily forgotten that capital is very mobile in the present-day global economy.

After the very difficult years of the early 1990s, international companies started to realize, that TEs in their restructuring process offer golden opportunities in the FDI sphere. Risk capital has flown in massive scale from developed countries into transitional ones. This FDI inflow in TE-region during the first two decades of post-communism is not evenly distributed between TEs. Business climates show variations in the TE-sphere. Some TEs are more attractive than the others in the eyes of foreign investors.

Investment rates by themselves are not the main driver of development. Capital accumulation brings more inputs to the production process, but there is a limit to how much this process can sustain growth because of the decreasing marginal impact of additional capital. There is “the law of decreasing revenue of investment” in economics.

Therefore, the measure of success of an investment climate is not alone the quantity of investment, but the quality of it. Many cross-country studies find that FDI is qualitatively better than investment altogether in emerging economies.

The inflow of FDI to TEs yields a variety of advantages for local economies:

- the overall value of local investment increases
- new technologies and management know-how are introduced by FDI
- the range of goods and services in the local economy broadens and quality improves
- export volume and structure is enhanced by FDI
- import substitution takes place. Together with the previous point, the balance of payments of the current account improves
- foreign firms enhance budget revenue by paying taxes
- competition is advanced by FDI, disciplining domestic companies
- large-scale FDI very often create new opportunities for domestic suppliers, which enhances local employment

- a part of local profits made by foreign firms is often re-invested locally.

In sum, it can be stated that FDIs in TEs have caused a virtual circle: arrival of foreign companies improves economic growth and local business climate.

United Nations Conference on Trade and Development (UNCTAD) annually publishes its World Investment Report. These Reports contain a multitude of up-to-date information on FDI movements. The table below is made on the basis of UNCTAD's Report of 2007.

Table 13. FDI stock per capita 2006

Country	USD
Estonia	9.742
Hungary	8.095
Czech Republic	7.520
Slovakia	5.616
Slovenia	3.726
Latvia	3.275
Lithuania	3.217
Poland	2.720
Bulgaria	2.689
Romania	1.898
Russia	1.390
Ukraine	483

Source: UNCTAD, 2007

The difference between the top figure of the list (Estonia) and the bottom one is huge, factor 20. As shown in the previous chapters, Estonia is altogether assessed as the best TE as far as the business climate is concerned, while Ukraine is the clearly worst one. Therefore, there is nothing surprising in the achieved FDI results counted in relative terms (per capita). Estonia is the smallest TE under review (with 1,3 million inhabitants only), while Ukraine is relatively large (47 million citizens).

One extremely important background factor in the above FDI figures is the link to European integration. The eight best TEs in the list joined the EU in 2004. In the late 1990s it became almost certain that these 8 TEs will receive the EU-membership soon. This expectation moved FDIs into Central Eastern Europe and into the Baltic states in massive scale. In the turn of the century there was uncertainty concerning Bulgaria's and Romania's EU-membership, and thus, there was reluctance to invest in these two countries. In the middle of this decade, it was anticipated that Bulgaria and Romania will be getting the accession, which enhanced FDI flow into them. The EU-membership was given in 2007.

Russia and Ukraine are both at the bottom of the FDI scale. The former has in the transitional period imposed certain restrictions on foreign investment. As Russia is negotiating on her WTO-membership, restrictions concerning FDIs have been moderated. The country has no intention to join EU.

Ukraine has expressed interest in future EU-membership. However, due to political uncertainty in Ukraine, it is impossible to predict when eventually Ukraine will join the Union. This is one of the important background factors, which explains Ukraine's meagre results in attracting FDI.

In the FDI competition within TE-region, there is permanently the first-class group comprising Estonia, Hungary and Czech Republic. In the Baltic region, Estonia is the smallest national economy with 1,3 million inhabitants, while Latvia's equivalent figure is 2,3 million and Lithuania's 3,4 million. Within these three countries, Estonia is clearly the most expensive one. Therefore, Latvia and Lithuania have a good chance to catch up with Estonia in FDI competition. However, the latter is now far superior and it takes several years for Latvia and Lithuania to catch up with Estonia, which overall provides the best business environment in the whole TE-region.

Slovakia has been the rising star in the FDI competition in the early years of the current decade. It is essentially cheaper in labour costs than its Western neighbour, Czech Republic, and thus, has been able to attract, for example, car manufacturers to her territory. In the former Czechoslovakian Federation, car manufacturing was concentrated on Czech lands. In the post-communist era, Slovakia has been able to catch FDI in this important branch.

Slovenia is in certain respect an odd case within NMSs. It has the highest per capita GDP of the region, but a relatively modest FDI stock. This small country with only 2 million inhabitants is not an optimal location for large-scale manufacturing. FDI flows as a percentage of gross fixed capital formation were in 2004 about 10%, 2005 about 6% and 2006 about 4%. Equivalent figures in Estonia were 31%, 80% and 30%. Thus, it can be maintained that Estonia relies heavily and Slovenia modestly on FDI inflow in the investment activity.

Poland is far the largest NMS with 38 million people. Her FDI stock is more than one quarter of all foreign money invested in direct form in NMS-area. However, in per capita terms Poland's FDI result is the most modest within those TEs joining the EU in 2004. In the light of several business environment indices brought up above, Poland's relative position in the FDI list is not surprising.

According to UNCTAD data, almost 400 billion USD worth of FDI has landed in 10 TEs now part of EU. Russia's FDI stock is close to 200 billion USD. The overall population in the former is somewhat over 100 million, while Russia has over 142 million people.

Outward FDI stock in TE-region is still rather modest, but growing. In this respect, Russia is an exception. Russian oil, gas and metal companies have invested considerable sums abroad in direct form. The outward FDI stock had a total value of 157 billion USD in 2006. Thus, FDI flowing is already a two-way road in the post-Soviet Russia.

6 Conclusions

In the early stage of transition, economies of post-communist countries had all a severe slump combined with high inflation. Systemic change called for radical renewal of economic institutions. There was lack of know-how in managerial matters: enterprises had to be run under market conditions, not by obeying orders from central planners.

The second decade of transition is essentially different from the first one. State-owned assets have been privatised. Economies are booming. Inflation rates are decelerating. Institutions are restructured. Legislation considers market rules. Pan-European integration comprises several TEs. FDI has flown in and improved competition.

However, TE-region is not unified sphere of success stories in the early years of the 21st century. Certain external factors, like high prices of energy bearers and metals, have helped some TEs, especially Russia, to recover. The majority of TEs under review suffer under the relative “oil crisis”.

Institutional and legal reforms are not advancing with the same speed in all TEs. Differences in this context are not easy to measure. However, several institutions have made the effort to shed light on this difficult issue. A multitude of “competitiveness indeces” is available on annual basis. The best-known indicators in this sphere have been discussed in this short report from the point of view of 12 TEs.

Slovenia is the best TE, as far as the per capita GDP is concerned. She is also the only NMS, which has been able to join the euro-zone. This fact indicates that her economy is in good shape. In the famous Corruption Perception Index Slovenia is classified as the most honest TE under review.

However, Slovenia is not scoring superior marks in many composite indeces, which pay attention to the institutional framework. The best overall business climate in the light of indicators covered here can be found in Estonia, which is also on the top of FDI per capita statistics within the group of TEs under review.

Ukraine, Bulgaria and Romania are clearly laggards in institutional and legal reform. These three countries are assessed critically in the indeces discussed here. The results above furthermore show that many political and economic background factors are not in perfect

shape in Poland, the biggest NMS. These four TEs are not very high up in the per capita FDI list.

Russia is in many sense a special case within our selection of TEs. The country enjoys high dynamism in her economy amid the oil price boom, but receives critical assessments from corruption, efficiency of government and lack of independence of the judiciary. Thus, her investment climate is clearly sub-optimal, which is visible in the FDI statistics.

NORDI has published several research reports on competitiveness among TEs based on “hard facts”, especially on labour cost comparisons. Our previous studies show very clearly, that TEs still enjoy labour cost advantages in comparison to Western Europe. Furthermore, our research results point out that there are considerable cost differentials within TE-group of countries. Thus, these results are not repeated here.

In addition, our former calculations show that in general terms TEs are facing declining cost advantages in international comparison. Income differentials within EU (27) are evening out, not necessarily rapidly, but securely. NMSs are catching up with the “old” EU in living standard. This positive tendency is with time also eating out TEs cost and price competitiveness.

At the same time, TEs have been able to mend their institutions and gain competitiveness via this improvement. In this respect, Estonia outperforms many “traditional” EU-members. For example, Italy show weak public finances and high level of public indebtness combined with low levels of accountability plus transparency. In the WEF assessment, Italy is on the 46th place, far behind Estonia (27th).

Star performer Estonia is an exception and not the rule within our 12 TEs. Qualitative differences in our selection of countries are very deep.

The aim of this short report is to show that a variety of indicators is presently available on the global market with highly interesting assessments of relative competitiveness of different countries. However, in the light of complex indeces no ultimate and perfect list of the most and least competitive national economies can be compiled.

FDIs are looking for locations, in which profits can be maximised. The best business climate within 12 TEs is in Estonia, which has attracted in relative terms more FDI than any other country selected to our comparison. Ukraine has the worst results in both respects, in business

environment and FDI results. These two extreme cases provide proof for our point: sophistication in the investment climate affects FDI movement positively.