

**Recent FDI trends, policies and challenges in SEE countries
in comparison with other regions in transition**

by Gábor Hunya

The Vienna Institute for International Economic Studies (WIIW)

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Contents

1.	Main characteristics of FDI in South Eastern Europe as compared to Central European transition countries.....	1
1.1	Economic development and FDI	1
1.2	FDI by investing countries and economic activities.....	5
1.3	The relationship of privatization and FDI in SEECs	9
2	Characteristics of foreign penetration in manufacturing	12
3	Government policies related to FDI	15
3.1	FDI policy frameworks and incentives	15
3.2	Privatization-related FDI policies: the role of commitments	17
4	Corruption and state capture.....	18
5	Conclusions	22
5.1	How to explain low FDI in SEECs ?	22
5.2	Benefits and problems related to foreign penetration and takeovers: lessons from CEECs.....	24
5.3	Policy conclusions.....	25
	References	27
	Appendix: Policies diverting FDI: the case of Romania.....	28
	Appendix references	33
	Statistical Appendix	

List of Tables and Figures

Table 1	Basic indicators of CEEC-7 and SEEC-5, 1999	2
Table 2	FDI stock in SEEC-5, by investing countries, 1999, shares in %	6
Table 3	FDI stock in SEECs, by sectors, 1999, USD mn, shares in %	7
Table 4	Distribution of enterprise assets among privatization methods in selected South-East European countries, up to 1998, per cent	9
Table 5	Privatization-related FDI inflows in selected Central and Eastern European countries, 1991-1999, USD million and per cent	10
Table 6	Share of foreign investment enterprises (FIEs) in main indicators of manufacturing companies, 1996, 1998, per cent	12
Table 7	Industries with significant above-average shares of FIEs in sales, 1994, 1996, 1998, per cent.....	13
Table 8	Romania: foreign penetration (share of FIEs in sales) and export intensity by manufacturing industries, 1998, per cent	14
Table 9	Corruption and state capture in South Eastern Europe: overview of sources and indicators.....	19
Figure 1	FDI stock per GDP, per cent 1999.....	4
Figure 2	FDI and economic development in CEECs and SEECs.....	4
Figure 3	Annual per capita FDI inflows 1995-1999, USD	5

Recent FDI trends, policies and challenges in SEE countries in comparison with other regions in transition

1. Main characteristics of FDI in South Eastern Europe as compared to Central European transition countries

1.1 Economic development and FDI

In the wake of the Balkan crisis, the Central and East European transition countries have been put into two groups, the seven South-East European countries (SEEC-7¹) and the five Central European countries (CEEC-5²). SEEC-7 have not only been more immediately affected by the crisis but also show several common features of economic underdevelopment and distorted transition to a market economy. In order to help their future development, the Balkan Stability Pact has been set up. One of the aims of this internationally funded programme is to reduce investment risk in the region and lay the foundations for the inflow of private capital. This section looks at the main characteristics of foreign direct investment (FDI) in the region in comparison with CEECs. Further sections of the paper will provide a deeper insight into some crucial areas – foreign penetration in the manufacturing sector, FDI-related policies and privatization as a vehicle of FDI. As every country is a distinct case and the scope of this paper does not allow to go into details, one country, Romania, is picked to highlight FDI policy problems (Appendix). The paper is complemented by a statistical appendix on FDI in SEECs.

South-East European countries are generally less developed, receive less FDI and are more backward in terms of transformation than CEECs (Table 1). Although the number of population in SEECs is only twenty per cent lower than in the CEECs, the overall GDP of the former group is one third of the latter's. Looking at per capita GDP levels of the individual countries, it turns out that the SEECs, with the important exception of Croatia, have around USD 1500 or less per capita, while the CEECs two or three times that level. The difference hardly diminishes if the purchasing power parity is taken as a basis for calculation. Major differences between the two groups of countries appear concerning the trends of economic development. While CEECs have by and large reached the pre-transformation per-capita income level, SEECs are lagging behind.

¹ Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FR Yugoslavia, FRY Macedonia, Romania.

² Czech Republic, Hungary, Poland, Slovakia, Slovenia.

Table 1

Basic indicators of SEEC-7 and CEEC-5, 1999

	Population	GDP	GDP/capita	GDP/capita	1990-1998 average	GDP growth, real, in %		
	ths. persons	in USD mn, calc.	USD at exchange rate	USD at PPP ¹⁾		1999	2000 WIIW forecast	2001
Albania	3400 ²⁾	3665 ²⁾	1149 ²⁾	.	-1,3	7,3 ²⁾	7,0	8,0
Bosnia and Herzegovina	3750 ³⁾⁴⁾	4418 ³⁾	1178 ³⁾	.	38,7 ⁵⁾	8,0 ³⁾	15,0	14,0
Bulgaria	8208	12405	1510	5170	-4,4	2,4	4,5	4,0
Croatia	4500	20176	4485	7120	-2,7	-0,3	1,5	2,5
FR Yugoslavia	8372 ⁶⁾	16450 ⁷⁾	1965	.	-7,1	-23,2 ³⁾	5,0	3,0
FYR Macedonia	2020	3432	1699	4530	-1,3 ⁸⁾	2,7	4,0	5,0
Romania	22458	34027	1515	5920	-2,7	-3,2	1,0	2,0
SEEC-7	52708	94573	.	.	.	.	.	.
Czech Republic	10283	53118	5166	13030	-0,5	-0,2	2,2	3,0
Hungary	10044	48203	4790	11190	-0,6	4,5	5,5	5,5
Poland	38654	154146	4024	8840	1,8	4,1	4,5	5,0
Slovakia	5395	18842	3654	10710	-0,2	1,9	2,0	3,0
Slovenia	1986	20011	10078	15580	0,4	4,9	4,5	4,5
CEEC-5	66361	294321	.	.	.	.	.	.

Notes: 1) WIIW calculation. - 2) Estimated. - 3) Preliminary. - 4) Excl. refugees - 5) 1994-1998. - 6) Excluding Kosovo and Metohia. - 7) According to World Bank estimates. - 8) 1991-1998.

As to the current rate of economic growth, the differences are more within than between the two groups. GDP growth in 1999-2000 has been robust only in some of the CEECs: Hungary, Poland and Slovenia. Also most of the southern countries show relatively high economic growth rates following the Kosovo war. Albania as well as Bosnia-Herzegovina witness a reconstruction-type upswing fuelled by domestic consumption which is financed from abroad. Macedonia and Bulgaria have medium-high rates of growth after years of severe transformational recessions. The less successful countries, Romania, Croatia – in some respects similar to the Czech Republic and Slovakia – still struggle with slow growth due to protracted transformation. The Yugoslav economy is a special case due to distortions inflicted by war and embargo. Per capita GDP is currently only one third of the level ten years ago and it is not expected that the reconstruction process will be very fast.

The relationship between FDI and economic growth is twofold: FDI stimulates economic growth, but also reacts to economic growth and progress of transformation. Growth is generated by FDI through imported means of investment, new technologies and capabilities transferred by foreign multinationals and international networking. On the other hand, foreign investors react positively to the consolidation of market-economy rules and the resumption of economic growth. Among the CEECs, Hungary has had an economic recovery strongly supported by the inflow of FDI. Poland, on the other hand, started to receive substantial amounts of foreign capital only after economic growth became robust. The most advanced CEEC with stable if not very impressive rates of economic growth is Slovenia, which has not attracted much FDI. In principle, all these three success stories can be the basis for feasible recommendations for the Balkan region. But for more backward SEE economies with a low rate of domestic capital accumulation, it may be necessary to have a more intensive FDI inflow to kick-start economic growth.

FDI stock per GDP is fairly even among countries of different development levels. Most of the countries under discussion have this indicator in the range of 10-20% (Figure 1), which is the world average. The relationship of development and FDI is demonstrated by the similarity of per capita GDP and per capita FDI (Figure 2). Outliers matter most in this case. Countries above the regression line have higher FDI stocks than the level of economic development would suggest. Among the CEECs, Hungary and, less so, the Czech Republic have higher than average FDI stock/GDP. Especially in the case of Hungary, this indicates a special economic development path connected with a strong presence of foreign multinationals.

Negative outliers are found both among the CEECs (Slovenia, Slovakia) and the SEECs. Macedonia and most probably also the two countries without an up-to-date FDI statistics, Bosnia-Herzegovina and Yugoslavia, attracted less FDI than their development level would allow. These countries have been exposed to war and were thus avoided by investors. It is possible that political settlement in the region would in itself generate enough FDI to bring

these countries in line with the others in the region. But in fact all the other SEECs have less FDI per GDP than successful newly industrializing countries. Thus the scope for improving the investment environment and the policy framework is enormous.

Figure 1

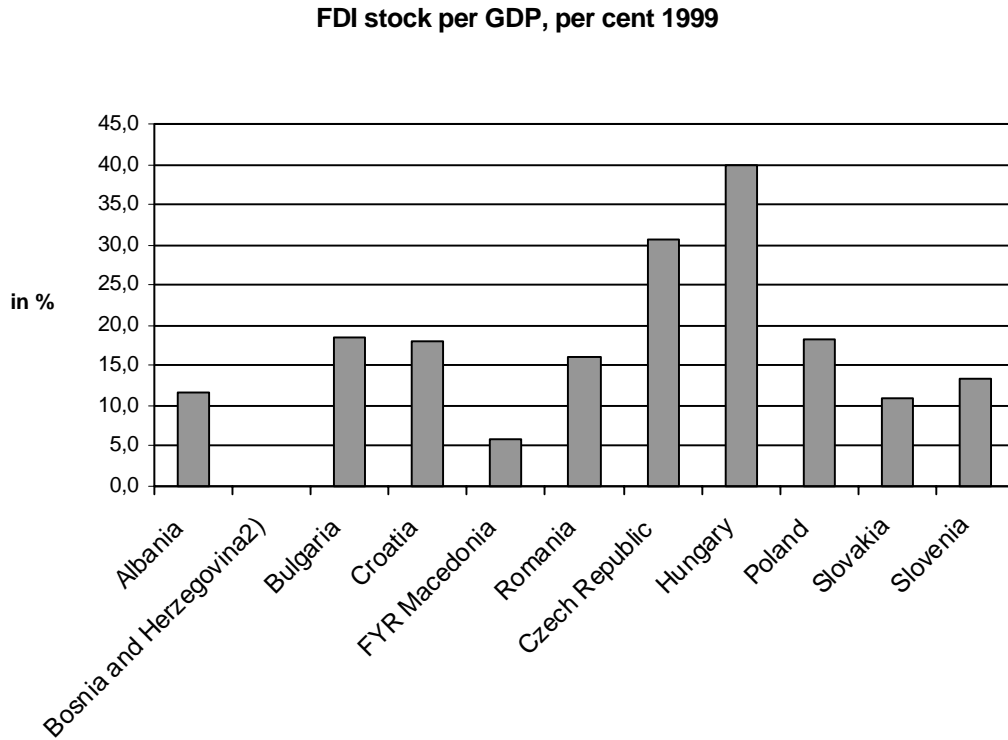
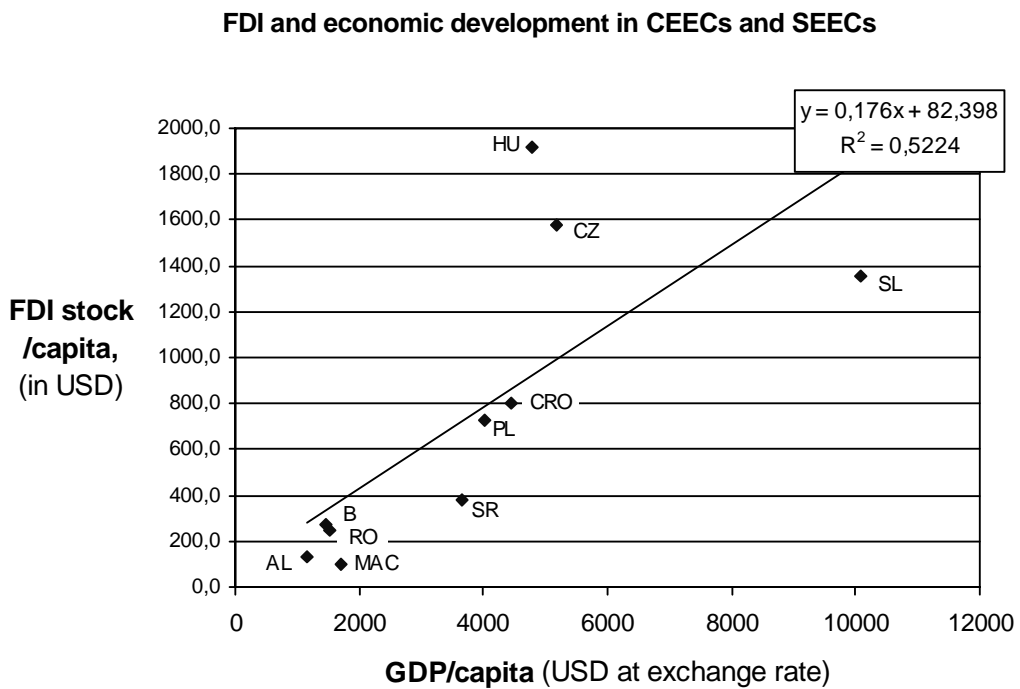


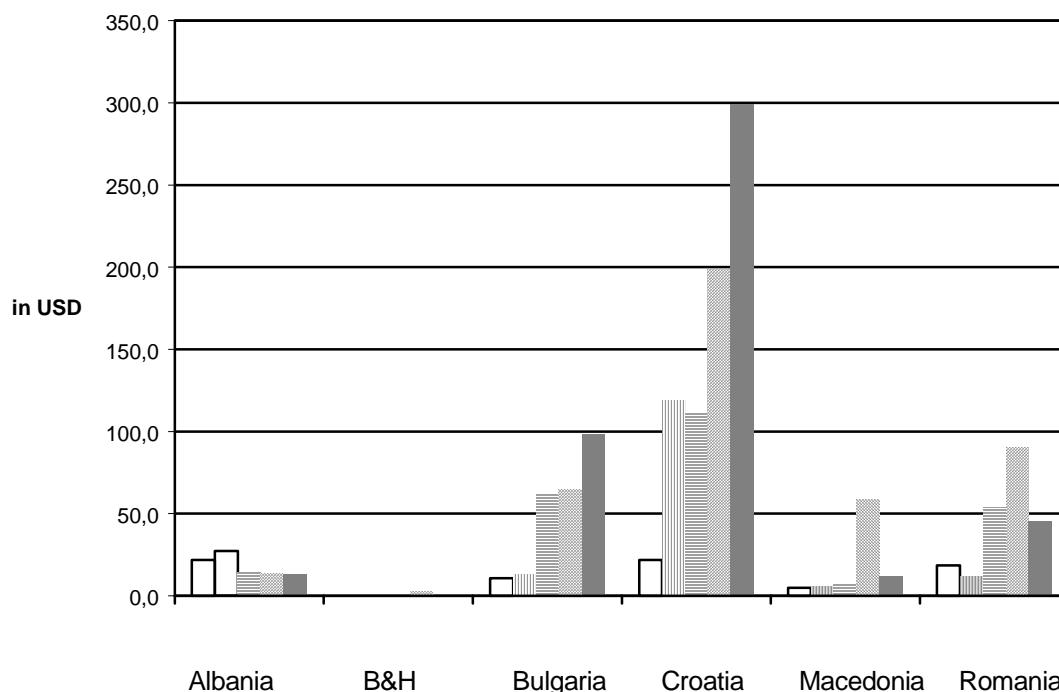
Figure 2



Although the basic framework for FDI and the major risk factors do not change very rapidly, annual inflows show considerable fluctuations. In the Western Balkans this is primarily related to military action. In other countries, policy changes and major privatization deals hike FDI inflows in certain years (see for details the section on privatization). The impact of war is obvious in the case of Croatia where significant foreign investment activity started only in 1996. In Bosnia-Herzegovina, FDI activity started as late as 1998 and is still insignificant. There was a clear setback of FDI inflows in Macedonia during the 1999 Kosovo conflict. The conclusion is that without a basic level of political stability, no investor ventures into the region.

Figure 3

Annual per capita FDI inflows 1995-1999, USD



1.2 FDI by investing countries and economic activities

The country of origin of investors in SEECs is basically similar to that in CEECs. The major capital-exporting countries to eastern countries such as Germany, USA, Netherlands, Austria and Italy are among the top investors (Table 2).

At the same time, features specific to the regions are also important. EU countries are less important investors in SEECs than in CEECs. The more stable and attractive SEE countries Bulgaria, Croatia and Romania have an about 60% EU share, less but similar to CEECs. In Macedonia and Bosnia-Herzegovina, regional and Near-East

investors take the lead. In all SEECs a significant part of investments come from outside the EU, especially from:

- neighbouring countries such as Greece and Turkey;
- countries within the region, such as Slovenian investments in Croatia, Croatian investments in Bosnia and Herzegovina – but some of these investments result from the disintegration of Yugoslavia and do not represent new investments;
- tax heaven countries such as Cyprus. It is a widely held opinion that investors coming through Cyprus and Liechtenstein are either SEEC domestic individuals or of Russian origin;
- more remote countries, such as Korea and Kuwait, also show up, mostly with a very limited number of projects. Korean Daewoo is a major investor in Romania.

Table 2

FDI stock in SEEC-5, by investing countries, 1999

shares in %

	Bulgaria ¹⁾	Romania ²⁾	Croatia ¹⁾	Macedonia ¹⁾	Bosnia and Herzegovina ¹⁾
				1998	July 1998
EU	60,2	56,8	61,2	42,5	30,4
Austria	4,5	5,1	19,6	7,1	4,2
Germany	15,3	10,2	27,3	10,9	16,9
France	3,0	7,1	1,8	1,3	2,5
Italy	1,2	7,6	1,5	8,1	4,2
Netherlands	6,0	11,6	3,8	2,6	.
Other	30,2	15,1	7,2	12,5	2,5
USA	7,1	7,7	27,5	3,7	.
Japan	0,2	0,1	.	.	.
CEECs	0,7	4,5	2,2	0,7	6,2
SEECs	.	0,6	0,4	1,5	16,7
Cyprus	9,0	7,9	0,0	30,2	.
Greece	3,1	2,7	.	7,8	.
Russia	5,5	0,1	0,3	0,0	.
Turkey	3,8	4,4	.	1,5	12,1
Other countries	10,3	15,2	8,4	12,1	34,7
Total	100,0	100,0	100,0	100,0	100,0
<i>Total, USD mn</i>	<i>2778,1</i>	<i>4364,0</i>	<i>3653,4</i>	<i>207,9</i>	<i>75,0</i>

Notes: 1) Equity capital, reinvested earnings, loans. - 2) Equity capital subscribed given by National Trade Register.

Not only capital flows but also trade flows show some orientation towards South-East European partners. Certain features of regionalization are thus present in SEECs. It is no specific feature to SEECs that local knowledge, cultural similarities and short physical distance attract investment flows from the neighbourhood. But even the wider environment is not rich in mobile capital and experienced multinational investors. Small and less reputable investors appear where the prominent ones do not take the risk to invest. Also the relatively small size of many of these countries is a handicap in attracting major multinationals. This aspect is known from experience in Slovenia and Slovakia.

The distribution of FDI by economic activity is not very well documented; a detailed breakdown by NACE categories is only available for Croatia. No data are available for Albania and Yugoslavia. The latest year of reporting is 1998 for Bosnia-Herzegovina and Macedonia. Based on available information (Table 3), manufacturing is the most important activity for investment, with about 45% of the invested capital. Further favoured branches are trade, telecommunications and financial services. Differences in the progress of privatization explain higher or lower FDI levels in telecommunication. Industry distribution features in SEECs are similar to those of CEE countries. The notable exception is Macedonia, with very high, 85% of the invested capital in manufacturing and mining.

Table 3

FDI stock in SEECs, by sectors, 1999

USD mn, shares in %

Code NACE	Bulgaria ¹⁾	Romania ¹⁾²⁾	Croatia ⁵⁾	B&H July 1998	Macedonia 1997-1998
A,B Agriculture, forestry, fishing	0.3	3.0	0.0	.	.
C Mining and quarrying	.	.	3.4	.	.
D Manufacturing	54.2 ³⁾	43.8 ³⁾	46.5	42.8	84.5 ⁶⁾
E Electricity, gas, water supply	.	.	0.8	.	.
F Construction	1.0	2.3	1.3	5.4	1.1
G Trade, repair of motor vehicles, etc.	19.5	24.1	4.1	3.1	6.0
H Hotels and restaurants	5.1	0.8	1.0	.	.
I Transport, storage, communications	4.5	2.3	30.0	.	1.2
J Financial intermediation	11.7	23.7 ⁴⁾	12.5	13.1	2.8 ⁷⁾
K Real estate, renting, etc.	.	.	0.4	31.5	.
Other	3.7	0.0	0.0	4.1	4.4
Total	100.0	100.0	100.0	100.0	100.0
Total, USD mn	2778	4364	2961	75	143

1) Adjusted to NACE. - 2) Data according to National Trade Register Office. - 3) Industry total(C+D+E). - 4) Services total. - 5) Equity capital. - 6) Manufacturing and mining (C+D). - 7) Financial, technical, business and insurance service (J+K).

Manufacturing FDI in the region is concentrated in capital- and labour-intensive branches and avoids skill-intensive industries. It seems that most of the investment projects are local-market-oriented. Such ventures can cope with higher investment risk and higher transaction costs than export-oriented ventures. The investors in manufacturing industries like the food industry and household chemicals go in for the demand of local private consumers while electrical machinery producers expect government-financed investments in the energy sector.

Available data for Croatia and Romania suggest that some export-oriented ventures appeared in the industries clothing, shoes, furniture and building materials (see also the section on the manufacturing industry). This specialization is typical of less developed countries. At a higher stage of development, e.g. in the CEECs, electronics and car manufacturing would be the major export-oriented industries. FDI in such branches in SEECs would require more economic and legal stability, an investor-friendly environment and better transport connections to the rest of Europe. In Romania car manufacturing, electronics and electrical machinery assembly plants have appeared recently.

The banking sector is to play a key role in transformation and investment financing but has been plagued by bad debts. It collapsed in Bulgaria in 1996 and underwent painful restructuring in Romania and Macedonia. The usual pattern was that bad loans were taken over by a rehabilitation agency and banks with cleared balance sheets were put up for sale. From the state's point of view, these were loss-making operations as the value of recapitalization usually exceeded the sales revenues for bank shares. But the overall economic impact should be positive as the new owners injected also fresh capital and introduced new know-how and technology. Foreign investors took over some of the largest banks recently: Bulbank in Bulgaria was taken over by Unicredito, Italy in October 2000; Stopanska Banka in Macedonia was taken over by the National Bank of Greece in March 2000; the Romanian Development Bank was bought by Societe Generale in 1999, and General Electric Capital invested in PostBank in 2000. In other cases, delays in privatization aggravated the problems and bank failures could not be avoided (e.g. Bancorex in Romania). In many SEECs, bank privatization was one of the main driving forces behind FDI inflows in the last few years and the share of the banking sector in FDI stocks increased. It can be expected that major foreign takeovers and a healthy selection process can clear up the banking system to such an extent that it may finally play an active role in financing investments. For the time being, investment outlays in SEE economies are low and domestic companies finance them mostly by retained profits.

1.3 The relationship of privatization and FDI in SEECs³

Table 4 highlights that FDI has been an important form of privatization, and privatization has been a major conduit for FDI. It has nevertheless been an unequal relationship: while privatization has undoubtedly dominated FDI inflows, FDI has not been the dominant form of privatization. In 1997-1999 FDI was higher than earlier in Bulgaria, Croatia and Romania due to accelerated privatization.

Table 4

Distribution of enterprise assets among privatization methods in selected South-East European countries, up to 1998

per cent

Country	Sales to foreign	Sales to domestic	Equal access			Still state
	investors ¹⁾	investors ¹⁾	voucher	Insider ²⁾	Other ³⁾	property
Bulgaria	1	...	39 ⁴⁾	6	...	54
Croatia						
Macedonia	1	1	-	62	12	24
Romania	3	2	25	10	-	60
Slovenia ⁵⁾	1	8	18	27	21	25

Remark: Dots (...) indicate unavailability of data; a dash (-) indicates that data are zero or negligible.

Notes: 1) Includes both direct and portfolio sales. - 2) Management buy-out and employee share ownership programme. - 3) Leasing, debt-equity swaps, restitution, transfer to social security funds and local organizations, and liquidation. - 4) Data on equal access vouchers include also sales to domestic investors. - 5) Data available from the privatization agency.

Source: UNCTAD; Djankov (1998), adjusted with data drawn from EBRD (1998); and estimates adapted from Hunya (1998).

Privatization is understood as one of the basic pillars of transformation into a market economy, together with liberalization, stabilization and institutional reforms. In most countries the policies related to the scope and method of privatization underwent several changes during the last decade, yet there are important general features:

- small companies, shops were privatized by restitution or auctioned fairly fast;
- medium-size and larger state-owned enterprises were subject to voucher privatization to a varying extent;
- employees and the management were offered special schemes of leveraged buy-out;
- auctions and direct sales played a minor role, the access of foreigners to privatization was sporadic;
- an important chunk of state-owned companies remained in public ownership, either because they were unattractive for investors or the state opted for special treatment;

³ This section relies on findings to be published in Hunya and Kalotay (2000).

- privatization of banks was usually treated as a separate issue; privatization started later but with a more active involvement of foreign capital than in the case of industrial enterprises;
- utilities privatization is on the agenda, but is a protracted process.

Table 5

**Privatization-related FDI inflows in selected Central and East European countries,
1991-1999**

USD million and per cent

Country	Indicator	1993	1994	1995	1996	1997	1998	1999	Total
Bulgaria	Total FDI ¹⁾	40	105	90	109	492	505	476	1 817
	Privatization-related	3	28	63	36	340	216	227	912
	Privatization-related as share of total (%)	8	26	70	33	69	43	48	50
Croatia	Total FDI ¹⁾	88	105	83	437	320	591	1 146	2 769
	Privatization-related	53	92	79	4	169	449	951	1'798
	Privatization-related as share of total (%)	61	88	95	1	53	76	83	65
Macedonia FYR	Total FDI ¹⁾	..	20	1	5	9	103	10	148
	Privatization-related	..	..	..	..	5	26	3	34
	Privatization-related as a share of total (%)	..	..	..	..	57	25	35	23
Romania	Total FDI ¹⁾	37	188	207	151	655	1 346	656	3 240
	Privatization-related	6	33	82	16	335	1'131	..	1 604
	Privatization-related as a share of total (%)	17	17	40	11	51	84	..	49

Remark: The data presented in this table are not strictly comparable because the definition of 'privatization-related inflows' varies from country to country.

Note: 1) Foreign equity inflows paid in cash only.

Source: UNCTAD FDI/TNC database.

There has been a recent shift of privatization methods from the distribution of property to direct sales and international tenders. The motivation of privatization shifted from social and distributional considerations to raising state revenues and improving corporate governance. Especially Bulgaria, Croatia and Romania speeded up privatization and attracted FDI under the pressure of mounting external and internal deficits. It is mainly the supply of state assets that determines the amount of privatization-related FDI. Poor demand played a role only in extreme cases, such as during the Kosovo conflict in 1999 which deterred potential investors. Still, also normal demand for SEE assets is not very strong. A proper selection of investors can often not be granted. Sales prices are depressed compared to CEECs. Privatization in SEECs generates less revenues for the state, less inflow of foreign capital and remains more debated politically. Some

governments, such as the Albanian, have in fact not much to sell as assets available for privatization have already been given away in various ways to insiders or the public at large, leaving little scope for foreign investors.

Primary privatization is declared to be by and large over in most SEECs. The Macedonian government declared privatization completed by end-1999. Bulgaria and Romania envisage this target by the end of 2001. Full privatization is usually understood excluding utilities. Primary privatization means that in the process of ownership divestiture, mainly insiders and dispersed owners came in the possession of shares. Control over companies is exerted mainly by the management. The role of the state has not disappeared in the post-privatization era. Many of the privatization contracts involve instalment payments, performance requirements, etc. In many cases the restructuring of the former state-owned enterprises (SOEs) cannot be undertaken by the new owners and the problem of lossmaking and inefficiency may fall back to the government at some point of time.

The state has been left with several problem cases. Large, lossmaking companies need fundamental restructuring and even afterwards may not be viable. They are overstaffed, but mass-scale release of workers is a politically sensitive issue. These companies are usually the generators of financial arrears which disturb payment flows in the whole economy. Programmes trying to isolate lossmakers from the healthier part of the economy have had partial success. Governments still lack the money and courage needed to initiate a fundamental restructuring of these companies. There are also several healthy or prospective companies waiting for large foreign investors, such as the Bulgarian telecom company or the Romania oil company.

On the other hand, also 'second privatization' is under way with ownership concentration and the involvement of foreign investors. This process is necessary to strengthen corporate governance and inject new capital in companies privatized to insiders or by vouchers. Concentration of ownership is generated either by negotiation with small shareholders or through the Stock Exchange. At some later point, controlling stakes may be brought into a joint venture with a foreign firm or sold to a foreign investor. As a recent example, the Austrian brewery BrauUnion took over three Romanian breweries from a domestic investment company.

Regarding the benefits of privatization through FDI, there is an agreement of specialists that, particularly at the micro level, foreign investors, using their distributional, financial, technological and managerial advantages, tend to induce deeper and faster transformation than local investors. Experience in CEECs is well documented, while research results in SEECs are very few few.

2 Characteristics of FDI penetration in manufacturing

The size of foreign penetration can be calculated by the share of foreign affiliates (foreign investment enterprises, FIEs) in the nominal capital, assets, value added, employment, sales, export sales, investment outlays and profits derived from the income statements/tax declarations of companies in the Czech Republic, Hungary, Poland and Slovenia and for fewer indicators in the case of Romania (Table 6). The role of FIEs has increased for all four countries and by almost all indicators over the period 1994 to 1998.

Table 6

Share of foreign investment enterprises (FIEs) in main indicators of manufacturing companies, 1996, 1998

per cent

	Equity capital	Employment	Investments	Sales	Export sales
	1996; 1998	1996; 1998	1996; 1998	1996; 1998	1996; 1998
Czech Republic	21.5 ¹ ; 27.9	13.1; 19.6	33.5; 41.6	22.6; 31.5	15.9; 47.0
Hungary	67.4 ² ; 72.7 ²	36.1; 44.9	82.5; 78.7	61.4; 70.0	77.5; 85.9
Poland	29.3; 43.2	12.0; 26.0	30.6; 51.0	17.4; 40.6	26.3; 52.4
Slovenia	15.6; 21.6	10.1; 13.1	20.3; 24.3	19.6; 24.4	25.8; 32.9
Romania	n.a.; n.a.	n.a.; 7.8	n.a.; 23.1	n.a.; 14.1	n.a.; 13.4

Notes: 1) Czech Republic 1996: own capital. – 2) Hungary: nominal capital in cash.

Coverage: Czech Republic: companies with 100 or more employees; Hungary: all companies; Poland: companies with 50 or more employees; Slovenia: all companies; Romania: companies with 50 or more employees.

The highest share of FIEs by all indicators was reached by Hungary. In 1998 70% of manufacturing sales came from FIEs which employed 45% of the manufacturing labour force. The investment share of FIEs came close to 80% in 1994 and increased only slightly in the subsequent years. It seems that foreign penetration in Hungarian manufacturing has already reached a level where any further increase cannot be very dynamic. There is nevertheless still very intensive FDI activity in the form of capital increase in existing FIEs, and the number of important greenfield projects is growing.

The second place is occupied by Poland with 41% of sales and 26% of employment. Foreign penetration doubled between 1996 and 1998 – the most rapid expansion of the foreign sector among the five countries. An upswing of privatization stimulated foreign takeovers and greenfield investments were attracted by the rapidly growing domestic market. While economic growth on the whole was strong in the second half of the 1990s, its main driving force changed from newly established domestic SMEs to foreign affiliates.

In the Czech Republic the share of FIEs reached 32% in sales and 20% in employment in 1998. In the period 1996-1998 the Czech economy underwent a second transformational recession. Despite the general output decline, the foreign sector maintained its dynamism, relied more on foreign markets and replaced domestic enterprises on the Czech market. The competitiveness problem that appeared due to the overvalued exchange rate affected the domestic companies more strongly than the FIEs, which had more opportunity to increase prices.

Romania is the only SEEC for which comparable data are available for 1998. Foreign penetration in this country is very small compared to the CEECs. Only 14% of manufacturing sales was produced by foreign affiliates. But similar to CEECs, the labour productivity and investment propensity in the foreign sector is much higher than in the domestic sector. The main difference between the foreign sector in CEECs and in Romania appears in terms of export propensity. While in the more developed countries foreign affiliates have a decisive role in the export performance of the country, in Romania they are responsible only for 13% of exports.

Table 7

Industries with significant above-average shares of FIEs in sales, 1994, 1996, 1998

per cent

Hungary				Czech Republic			
1994	1996	1998		1994	1996	1998	
99.6	99.2	100	Coke and petroleum	60.0	66.9	81.7	Motor vehicles
99.5	98.7	95.7	Tobacco	37.2	43.8	45.6	Rubber and plastic
78.4	82.7	79.9	Electrical machinery	25.9	29.0	38.3	Publishing, printing
72.0	84.8	96.9	Motor vehicles	23.7	45.6	45.5	Non-metallic minerals
70.0	71.8	48.6	Other transp equipment	13.2	32.0	48.3	Electrical machinery
61.0	79.0	82.8	Radio and TV sets	(4.8)	35.9	57.7	Radio and TV sets
(53.7)	78.7	83.6	Chemicals	3.3	26.5	39.4	Manufacturing n.e.c.
55.4	61.4	70.0	<i>Manufacturing total</i>	12.5	22.6	32.1	<i>Manufacturing total</i>
Poland				Slovenia			
1994	1996	1998		1994	1996	1998	
86.9	94.1	96.7	Paper, paper products	100.0	100.0	100	Tobacco
8.4	90.7	95.3	Tobacco	64.5	82.3	83.1	Transport equipment
49.9	82.5	89.9	Motor vehicles	42.9	35.4	48.1	Paper
52.4	66.7	81.8	Radio, TV sets	.	40.4	42.6	Radio, TV sets
46.0	55.6	60.4	Manufacturing n.e.c.	.	21.3	26.1	Machinery n.e.c.
17.4	31.9	40.6	<i>Manufacturing total</i>	16.9	19.6	24.4	<i>Manufacturing total</i>

The main common branch with above-average foreign penetration in the CEEC-5 is the manufacturing of motor vehicles (Table 7). This industry has over 80% foreign

penetration. The car industry was attracted both by unsatisfied domestic demand and by favourable conditions for low-cost production. Also tobacco manufacturing is usually foreign-owned as only big international companies can cope with the brand names and promotion costs of this industry. Electrical machinery shows a high rate of foreign presence in the Czech Republic and Hungary. In the other three countries, where the paper industry is a major export industry, this has also become a foreign-controlled branch. High foreign penetration in the chemical industry is specific to Hungary, due most probably to the pharmaceutical industry which is one of the most internationalized activities world-wide.

Foreign direct investment has helped CEECs to shift their product structure to become more similar to the more developed EU countries. This may give further impulses to economic growth and narrow the development gap between the more advanced CEECs and the EU. The deeper the foreign penetration, the faster was the speed of structural change: Hungary was followed by the Czech Republic and Poland. Duality between foreign- and domestic-dominated industries appeared in all countries and is growing over time. The dichotomy of performance between the foreign- and the domestic-owned companies in the same industry is largest in Hungary and smallest in Slovenia.

Table 8

**Romania: foreign penetration (share of FIEs in sales) and export intensity
by manufacturing industries, 1998**

per cent

NACE Industry	Share of FIEs in sales, %	Export sales per sales, %
DA Food, beverage, tobacco	26.4	1
DB Textiles	22.1	74
DC Leather, shoes	28.6	37
DD Wood products	13.5	71
DE Paper, publishing	12.5	21
DF Petroleum products	0.0	0
DG Chemicals, man-made fibres	26.0	28
DH Rubber and plastic	4.1	10
DI Non-metallic minerals	11.7	26
DJ Basic and fabricated metals	5.0	65
DK Machinery and equipment	4.5	55
DL Electrical and optical equipment	34.7	14
DM Transport equipment	5.6	54
DN Manufacturing n.e.c.	6.8	72
D Total manufacturing	14.1	25

Data for Romania by industrial activities show lower overall penetration and fewer export oriented industries (Table 8). High foreign penetration can be found in the export-oriented

light industries utilizing cheap labour: textiles and clothing, shoes and furniture. Domestic market oriented industries like food and electrical machinery have much lower rates of foreign penetration than in CEECs which may also indicate large redundant capacities in the domestic sector.

The impact of the foreign sector on the balance of payments is not only of benefit. Increasing export-competitiveness of FIEs went hand in hand with increasing import-demand thus the foreign trade balance deteriorated. Hungary also started to have large dividend outflows in recent years.

3 Government policies related to FDI

3.1 FDI policy frameworks and incentives

In Dunning's theory (1993), FDI flows are 'shaped' by three sets of factors. First, the ownership advantages, second, the locational advantages, and third, the internalization advantages of multinational companies. Locational advantages represent those advantages that make production in the given place more profitable/advantageous from the point of view of the investor than exporting the product from a foreign production unit to the given market, or locating new production capacities to a third country. The economic policy of a given FDI-recipient country can influence the relative locational advantages of a country, region or township. We focus below on policies at the national level, but it must be kept in mind that sub-national policies are also important, down to the characteristics of specific investment sites. Locational characteristics appear in the form of general and FDI-specific conditions of investments. General conditions cover the overall stability and development pattern of the economy, the skills of the labour force as well as the regulatory framework such as the tax system. This section looks at the regulatory framework more directly related to FDI.

National treatment and almost no direct FDI incentive is the basic rule of law in CEECs and SEECs alike. International treaties like OECD membership and EU association restrict discriminatory policies and demand equal rights for domestic and foreign firms. But also many countries not invited to join the EU take care not to introduce policies which are not in conformity with EU practice. This commitment may sometimes be over-ambitious and lead to losses of opportunities without bringing the date of accession any closer.

In several CEECs, policy has recently shifted from stabilization to growth promotion. This includes more investment incentives than earlier. Corporate tax has been low in Hungary, has been lowered lately in the Czech Republic and Poland, and completely abolished in Estonia. Countries long suffering from low FDI levels, such as Slovenia, have introduced some incentives. Despite the wide range of incentive schemes in the various countries, the

efficiency of these policy tools are not properly investigated. Although Hungary has the most complex incentive scheme, ranging from tax and customs allowances to R&D- and infrastructure-related subsidies, it is not really proven what the impact of these arrangements has been. The effects of incentives can hardly be separated from other locational factors.

Investment promoting policies can be even more necessary in SEE countries with low rates of capital accumulation, significant barriers to entry and low interest on the part of potential foreign investors. Corporate taxes were lowered in Romania this year and will be lowered in Bulgaria next year. Romania has a complex incentive scheme for investors, regions and SMEs, but no FDI promotion as such (see Appendix for details). Bulgaria and Macedonia, on the other hand, have strong foreign investment promotion agencies.

The general framework for the establishment of foreign ventures is regulated by the foreign investment law. Incentives and other technical regulation are subject to special legislation or are spread about in different laws. The incentives are listed in a special investment promotion law in Croatia (2000), a government programme in Macedonia (1999), the annual budget in Romania, and the Foreign Investment Act in Bulgaria. While national and equal treatment of all investors is a much quoted fundamental principle, governments have claimed discretionary rights to provide special incentives to specific investors they consider of great importance.

Investment incentives are given in general or subject to certain conditions related to the size or the target of investment. Some preference is usually provided for large investors. This is a hidden bias in favour of foreign investors, who are more often able to launch larger ventures than domestic companies. Small and medium-size domestic firms cannot meet the minimum investment and employment requirements to become eligible for tax breaks or to receive direct investment incentives. It is mainly large foreign investors who benefit. The result can be illustrated by the indicators for the Hungarian manufacturing industry: foreign affiliates produce 86% of the pre-tax profit but pay only 59% of the corporate tax revenues of the budget (1998 data). This is partly the result of the preferences provided to large investors, partly the result of tax holidays provided to foreign investors before 1996. Productivity and profitability is generally higher in foreign affiliates than in domestic firms and the gap between the two ownership categories can widen due to unequal access to incentives.

Corporate income tax allowances benefit the operation and not the establishment of ventures. Special incentives may be considered necessary to foster the start-up of new firms and greenfield investments. Start-up benefits may comprise import duty allowances for equipment which are applied in several countries. New ventures may benefit from subsidies for infrastructure, industrial parks, and special economic zones. Duty-free zones

attract mostly storage companies; off-shore processing is rare. None of the SEE countries apply the attractive Hungarian duty-free-zone legislation which is a preferential legal status for export-oriented producers and is not related to a particular geographical area. Other policies have also investment promotion components: regional policy and labour market policy.

The potential scope for an active investment policy is limited by the budgetary situation of the countries in the region. Tight fiscal policies do not allow for spending on incentives. The dispute of the Romanian government trying to provide benefits for (foreign) investors and the IMF's concern about the level of the budget deficit is enlightening in this respect. The macroeconomic approach taken by the IMF to tackle high budget deficits suggests to apply no incentives at all. But the government has been more concerned about attracting potential buyers for key companies and also wanted to relaunch economic growth (see for details the section on Romania).

3.2 Privatization-related FDI policies: the role of commitments⁴

Large privatization sales usually involve foreign investors. In that case the privatization process and the privatization contract are in fact FDI policy instruments. Governments pursue various goals with privatization. Beyond the great variety of the forms of privatization, the conditions set for the privatization sales reflect the government's concern about the impact of a particular deal on the labour market, regional development and the environment. Although the price may be the central criterion in the evaluation of bids, the authorities try to get further commitments from the buyer concerning future investments and employment. These commitments prove to be necessary when there is an evident lack or weakness of proper policies in the given field (e.g. employment policy, R&D policy). What makes the transition economies specific in this respect is that they inherited weak policies (or sometimes none at all) from the previous economic and social system.

Further commitments are meant to ensure good future prospects of the company. In this respect it is certainly important to select a reputable investor and evaluate its business plan. But the actual investment and output growth will depend on many unforeseeable business conditions. The sales price is usually indicative of the future intention of the investor: the higher the amount he is willing to risk with the investment, the more he will care for ensuring profitable operation later. It does not seem to be a sound industrial policy to block efficiency increase in a specific company by specific regulations beyond the limits of general labour, environmental etc. regulations and competition policy. An in-depth appraisal of the Hungarian experience with such criteria (Csáki and Macher, 1998) has found that:

⁴ This section relies on findings to be published in Hunya and Kalotay (2000).

- the enforcement of the 'soft' – environmental, employment etc. – conditions stipulated in the privatization contracts cannot be considered successful;
- unfulfilled contractual commitments have not been penalized, particularly because some of these conditions by nature are difficult to quantify (e.g. an estimate of the costs of environmental cleanup is extremely difficult);
- the incorporation of such conditions in the contract in most cases resulted in the reduction of the purchase price; and as the fulfilment of the commitments proved to be uncertain and unpenalizable, the country turned out to be a net loser in this respect.

Hence the question arises under what conditions the government can afford the trade-off between revenues and commitments, especially when privatization takes place under budgetary pressures with a need to maximize revenues. In this respect, a comparative study of privatization sales to foreign investors in the Czech Republic, Hungary, Poland and Slovenia (Rojec, 1995) suggested the following policies:

- ensure competition between potential buyers;
- a realistic price should be determined through bidding and negotiating with potential buyers as the proper valuation of assets before sale is not really possible;
- a premium can be required for the purchase of a controlling share in an enterprise, as compared with the purchase of minority stakes;
- in most cases, the national, non-discriminatory treatment of investors is enough; special treatment of foreigners is to be limited to a minimum.

In sum, an optimum policy on privatization sales to foreign investors should focus on two basic criteria: on the one hand, on the sales price offered, and, on the other hand, the reputation and business plan of the investors.

4 Corruption and state capture

Can the quality of public governance be quantified? The large literature on the subject is based mainly on surveys of limited size (Table 9). Here we refer to one of them which has the largest sample: the 1999 Business Environment and Enterprise Performance Survey (BEEPS) was carried out for 20 CEE and FSU countries (Hellman et al., 2000, also EBRD, 1999). It looks at various features of government capture, administrative corruption, government transparency and public interference in the economy by asking a sample of company executives about experience. Beyond various studies in individual countries, this is the main source of information to compare various regions and countries within regions. Some of the features are summarized below.

Table 9

**Corruption and state capture in South Eastern Europe:
overview of sources and indicators**

	ALB	B&H	BUL	CRO	MAC	ROM	FRY
EBRD Privatization Index ¹⁾	3.0	2.0	3.0	3.7	3.5	3.0	.
Selected Corruption Indicators							
Transparency International Index (0-10) in 2000 ²⁾	2.3	.	3.5	3.7	3.3	2.9	1.3
(Rating among 90 countries under survey)	(84)	.	(52)	(51)	(63)	(68)	(89)
KKZ: Graft Index in 1997 ³⁾	-0.99	-0.35	-0.56	-0.46	-0.52	-0.46	.
International Country Risk Guide: Corruption (0-6) in Dec. 99 ⁴⁾	2	.	4	2	.	3	.
Freedom House: Corruption/3 in 1998 ⁵⁾	4	3	3	3	3	3	4
EBRD: Percentage of firms bribing frequently or more in 1999	.	.	23.9	17.7	.	50.9	.
EBRD: Average bribe tax in 1999, % of annual firm revenues	.	.	3.5	2.1	.	4.0	.
Selected Legal/Judicial Indicators							
Freedom House: Rule of Law in 1998 ⁶⁾	5.25	6.00	3.75	4.75	4.50	4.25	.
World Development Report: Predictable Judiciary in 1997 ⁷⁾	4.66	.	4.61	.	4.28	.	.
KKZ: Rule of Law Index in 1997 ⁸⁾	-0.92	-1.11	-0.15	0.15	-0.26	-0.09	.
International Country Risk Guide: Law&Order (0-6) in Dec.99 ⁹⁾	2	.	4	5	.	4	.
Indicators on Government Services							
Freedom House: Government & Public Administration in 1998 ¹⁰⁾	5	6	4	4	4	4	5
Int. Country Risk Guide: Bureaucratic Quality (0-4) in Dec.99 ¹¹⁾	1	.	2	3	.	1	.
World Bank: Share of Firms Affected by Different Forms of State Capture, %							
Parliamentary legislation	12	.	28	18	.	22	.
Presidential decrees	7	.	26	24	.	20	.
Central Bank	8	.	28	30	.	26	.
Criminal courts	22	.	28	29	.	14	.
Commercial courts	20	.	19	29	.	17	.
Political party finance	25	.	42	30	.	27	.
<i>State Capture Index</i>	16	.	28	27	.	21	.

(Table 9 continued)

Table 9 continued

Notes: 1) The privatization index is an average of small-scale and large-scale privatization indices. - 2) Composite of survey indicators (from up to 14 sources). Larger values indicate less corruption. Data for Albania and FYR Macedonia refer to 1999 (rating among 99 countries under survey). - 3) Kaufmann, Kraay, and Zoido-Lobaton Graft Index; sample size 155 countries; composite index of various survey indicators; larger values indicate less corruption. - 4) Sample size 140 countries; measures corruption within the political system; higher values indicate less corruption. - 5) Sample size 28 countries; 1-7 scale based on expert perceptions; lower values indicate less corruption. - 6) Sample size 28 countries; 1-7 scale based on expert perceptions; lower values are an indication of judicial independence and human rights protection. - 7) Sample size 67 countries; average response on a 1-6 scale, agreeing or disagreeing with statement that "unpredictability of the judiciary presents a major problem for my business operations"; from WDR 1997 survey of private firms. - 8) Kaufmann, Kraay, and Zoido-Lobaton Rule of Law Index; sample size 166 countries; composite index of various survey indicators; larger values indicate greater law and order. - 9) Sample size 140 countries; law and order each comprises zero to three points, and assesses the strength and impartiality of the legal system, and popular observance of the law respectively; higher values indicate greater law and order. - 10) Sample size 28 countries; 1-7 scale based on expert perceptions; lower values indicate greater transparency, decentralization, and power of the legislature. - 11) Sample size 140 countries; the institutional strength and quality of the bureaucracy is another shock absorber that tends to minimize revisions of policy when governments change; high points are given to countries where the bureaucracy has the strength and expertise to govern.

In terms of government capture (private influence on the formation of laws and regulations) the three SEECs under survey – Bulgaria, Croatia and Romania – performed much worse than Central European countries (Czech Republic, Hungary, Poland) but better than CIS countries. The frequency of bribing public officials to avoid taxes or other regulation showed similar differences. Among the SEECs, Croatia usually features better than the other two countries. The efficiency of government services is considered good by 25% in Bulgaria, 28% in Romania and 40% in Croatia. The latter is in line with the CEEC average. In terms of the frequency, amount and effectiveness of bribery in more general terms, Romania performed much worse than the other two SEECs which were comparable with CEECs. Not only the high amount of bribes is a problem in Romania, but also the relatively low rate of delivery of the 'paid' service. Investors may consider this messy situation especially risky. In contrast, Croatia together with Slovenia was among the transition countries with the lowest level of administrative corruption.

As for the functioning of the legal system, corruption or dishonest behaviour of courts has been witnessed by 40% of companies in the three SEECs. The security of contracts and property rights is questioned by more than 40% in Romania and Bulgaria and 34% in Croatia. The predictability and transparency of state legislation is generally weak in Romania and Bulgaria. The situation in Croatia is considered even better than in Hungary and the Czech Republic. These data explain why many investor surveys consider legal risk as one of the major impediments of investment in transition countries but especially in Romania and Bulgaria.

Weak governments and corrupt institutions may not totally deter FDI. As another survey found out, local-market-oriented projects may come in lower-technology sectors and in the form of joint ventures (Smarzynska and Wie, 2000). Corruption reduces inward foreign investment and shifts the ownership structure towards joint ventures. As corruption makes

the local bureaucracy less transparent, the value of using a local partner to cut through the bureaucratic maze increases. Export-oriented, greenfield, 100% foreign FDI projects in technologically advanced industries have the strongest positive economic effects on host countries in terms of growth, employment and external balance, but it is exactly this kind of investment that is mostly hindered by corruption.

In countries liable for government capture, investors rely on tailored legislation in single cases of privatization or other large investment projects. While this can be a necessary stimulus for those who benefit, it is detrimental for the legal system and competition. Examples of tailor-made incentives appear in Romania in the Renault–Dacia takeover while other investors withdrew from projects when agreed benefits were abolished (Akmaya–Petromidia).

5 Conclusions

5.1 How to explain low FDI in SEECs ?

The economic development in the past ten years has been disappointing, the institutional framework is still far from being efficient, and FDI inflow is meagre. Foreign investors react to instability and lack of development by avoiding these countries as investment sites. The origin of problems is complex. Analysts stress one or the other aspect, but good policies have to take all of them into consideration. This section provides an overview of the explanations given for bad economic performance and low FDI in the Balkans; the following section provides a few ideas how to overcome them.

A. Path dependence. This has to do with inherited economic structures and institutions. In some countries, severe distortions emerged under communist rule. Capacities and capabilities were built in juxtaposition to market demand. Price and other regulatory systems corresponded to the arbitrary development targets. These rigid systems were especially unsuitable for absorbing shocks. When liberalization came, even in a gradual Romanian way, it was a big shock as the required structural change was immense. The economy was put under considerable “strain”, to use the term of Daniel Daianu, a prominent advocator of path dependence (Daianu, 1997 and 2000). Path dependence in the form of distorted structures certainly explains some of the transformation problems of Albania, Bulgaria and Romania. These distortions were in these countries larger and the communist rules stiffer than in most CEECs.

Foreign investors may to a certain extent benefit from penetrating countries with distorted structures. Their advantage over domestic firms is so big that they can drive out any local competitor from the domestic market and introduce own products either imported or assembled on the spot. To avoid this, many governments introduced protective measures

either directly or indirectly to serve the interest of local producers (providing subsidies, tolerating tax arrears, etc.). In Albania, on the other hand, the previous economy, especially industry, was crashed and not really replaced.

The post-Yugoslav republics have had to struggle with less structural distortion as their past experience in Yugoslavia was to a large extent different from that of the other transition countries. Companies were much more integrated into Western production structures by trade, licensing and subcontracting than other SEECS and even CEECs. There was also some direct investment. A reconstruction of such ties seems to be more feasible for Croatia than the present Yugoslavia.

The self-management system has made privatization by sales less appropriate in the post-Yugoslav republics. FDI in the form of privatization-related takeover has been almost impossible. But the success of Slovenia in economic development and some promising developments in Croatia demonstrate that the restructuring needs of inherited capacities have not been very big and progress could be achieved without the help of foreign investors.

B. Primacy of policy. This approach means not only that suitable policies can be found in any circumstances, but also that some general policy package exists which leads to successful transformation and a rapid inflow of FDI. The primacy of policy is the natural approach of governments and international financial organizations conducting consulting activity in the region. Governments have also viewed specific policies related to FDI, restructuring or investments as a necessary stimulus for increasing FDI. Such policy measures may be erroneously regarded as substitutes for general economic and legal stability. In addition, inappropriate policies can produce new impediments to FDI.

For most of the transformation period, SEE countries lacked coherent economic strategies. They have mostly acted with the technical assistance of international donor organizations but not really internalizing the know-how of good policymaking. Policy mistakes largely contributed to growing external and internal debts which put tight limits on future policy choice. Frequent legislative changes (see Appendix on Romania) discouraged investors. The privatization process messed up rather than clarified ownership rights (see section on privatization).

Investment and FDI policies are widespread in the region, but show important differences among countries. One extreme is the new Croatian investment promotion law which puts together all related aspects. The other extreme is Romania where investment and FDI promotion have been merged with regional development. Whatever the position of investment promotion, available funds are usually scarce and not competitive on the international scale.

C. Disintegration, war and ethnic conflict. The most distinct feature of the western part of the Balkans is that it has been involved in violent conflicts. War misallocated resources and demolished wealth. Institutions were transformed and human capabilities restructured to meet the needs of the war economy.

The split-up of former Yugoslavia, even if it had proceeded in a peaceful manner, would have increased strain in the emerging national economies. The size of the freely accessible market shrank and trade reorientation incurred additional costs. In small countries the size of the market does not attract local-market-oriented FDI and the local skill level may not allow much successful export-oriented production either. If political conflicts can be solved, a re-integration process can be expected: resumption of regional trade, regional networking and investment activity of companies.

Violent disintegration made the division of markets even more abrupt. There is considerable difference by countries concerning the involvement in segregation and violent action. Croatia emerged, after severe war-related losses, as an intact country with a rapidly improving environment for FDI. The reconstruction of promising industries such as tourism, services and part of manufacturing has started. In contrast, Bosnia and Herzegovina lacks a unified internal market. It relies on international aid for financing consumption. Aid may generate some FDI in the retail and service sectors but mainly crowds out productive investments. No reconstruction of the economy is in sight. Investment guarantee schemes introduced by the World Bank and the EU try to cover political risk. But the administrative and legal framework remain so cumbersome and unpredictable that investors continue to avoid the country. FR Yugoslavia is not war-damaged albeit by bombing. But it is exhausted, and impoverished by a decade of warship and international isolation. Even after the Milošević regime has been voted out, there is still a very long way to go until normal investment conditions are created. Old productive capacities have not been maintained for ten years, investment needs for relaunching production are huge. Macedonia has not been damaged by wars but negatively affected by its indirect impacts. The locked-in geographical position has been a major impediment to trade and investment.

For all countries in the region, a re-integration of markets is essential for the attraction of manufacturing investments. As a first step, border controls must be improved, procedures simplified and cleared from bribing. Low tariffs and simple tariff systems as well as free-trade agreements can be useful steps.

D. Economic and institutional underdevelopment. What are the more relevant problems of SEE countries, those of economic transformation or those related to backwardness ? One line of thought stresses the latter and relies on hard facts concerning the level of income either due to communist past (Albania), transformational recession

(Bulgaria) or war-related damages (Yugoslavia). Falling back in terms of economic performance for most of the 1990s, SEE countries suffered an erosion of industrial and organizational skills. A process of de-industrialization and ruralization took place: the share of industry in GDP declined rapidly while that of agriculture increased. In the wake of land redistribution, large masses returned to subsistence farming. The new Balkan economy, a mix of subsistence farming and small-scale trade and services, attracts FDI mostly in the retail, tourism and banking sectors. At the same time, advantages in terms of schooling and industrial skills still remain compared to developing countries of similar development levels. A recovery policy may rely on the skills of the labour force.

Not only poverty makes these countries a development case but also their weak institutions (see also section on corruption). Vladimir Gligorov et al. (2000) stress that corporate governance can hardly function properly without the proper functioning of public governance. Market institutions can hardly deliver efficiency if the political and legal institutions are distorted and dysfunctional.

5.2 Benefits and problems related to foreign penetration and takeovers: lessons from CEECs

Countries can transform and grow faster if they rely on foreign direct investment

- Progress in transformation, FDI inflow and economic growth are interdependent. The pace of restructuring has been fastest in countries where FDI was attracted also by privatization. Economic growth is usually low during stepped-up restructuring but accelerates later.
- The economic recession in some transition countries (Czech Republic, Bulgaria and Romania) in the second half of the 1990s could not be cured without a restructuring of the enterprise sector. These countries need both massive capital investments and the integrating force of foreign capital to improve their access to knowledge and international networking.
- Technologies relevant for growth are principally developed by multinationals and can only be accessed within their networks. A country which, like Hungary, encourages foreign penetration in the economy may develop up-to-date industrial and export structures faster than others.
- A comparison of the performance of domestic-owned and foreign-owned enterprises in CEECs proves the overall positive effects of FDI in terms of structural upgrading and increasing competitiveness.

Problems emerging in connection with high foreign penetration

- Foreign direct investment inflows cannot be treated as unrequited transfers: they finance profit-oriented ventures whose foreign owners expect to realize and, to a

smaller or larger extent, also to repatriate the generated profit. Current account deficits are in part produced by FDI inflows.

- National economic policies in countries with intensive foreign penetration are exposed to high competition between locations of production and consumption. They are limited regarding the choice of policy targets and policy tools (e.g. tax increase). But under strict foreign competitive control, the likelihood of grave policy mistakes may also diminish.
- Most of the FDI in transition countries has been local-market-oriented. Such investments depend on the development of the purchasing power and the size of the potential market. With the ageing of the projects, the motivation of entry becomes less important, subsidiaries take up new functions, enlarge or shrink their original task in the multinational networks.

5.3 Policy conclusions

The experience with public policies in the region has been disappointing for reasons connected with weak states and corrupt practices. Strengthening public institutions and building credibility can be development targets of their own. In the given situation, policy recommendations must keep in mind that these countries can only cope with simple policies; they are unable to run very sophisticated programmes or apply complicated tools. General recommendations may include the following:

- a. Reduce political risk by supporting peace and democracy. Donor countries may increase funds to guarantee against political risk in the region. Too much aid may drive out private investment and fund corruption.
- b. Support re-integration, ease border controls, reduce transaction costs. The size of attainable markets must grow in order to attract larger and export-oriented investment projects.
- c. Investment promotion policies must become more stable and transparent.
- d. Restructuring and privatization of ailing industries, restructuring and capitalization of the banking system as well as policies directed at the promotion of small and medium-size businesses are necessary to strengthen market-economy rule.
- e. Available local knowledge and skills are to be utilized as the basic educational level of the population is good.
- f. The legal system must become more transparent and less corruptible. Simple legislation and institutions (smaller governments) are usually less corruptible than more complex, fuzzy ones.

In general, one may keep in mind that the situation of each economy must be assessed from all relevant aspects in order to arrive at applicable policies yielding the expected results. Policy advice must be honest about delineating the area and the conditions under which it is applicable. The suggestion of Alan Winters should be taken seriously: 'International organizations and donors (...) frequently talk about "best practice". For long-run objectives like development, this raises serious questions of how we know what is best. Some clarity on this would be welcome. Most of what we say will, at best, be provisional.' An especially cautious approach is necessary when advising on transformation-related issues such as privatization and the role of the foreign sector in the economy.

However cautious the approach of recommendations, the benefit of having efficient firms in support of economic growth is obvious. Efficient firms emerge under good corporate governance and in international networking. These are benefits that strategic investors can bring to a country. The experience of the Central European countries clearly demonstrates that FDI has on the whole benefited economic growth and international competitiveness and that transformation may proceed much more slowly without than with the penetration of foreign capital.

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Appendix

Policies diverting FDI: the case of Romania

In general, the low level and declining trend of economic development, backward infrastructure, unfavourable geographical location, and functional problems of market-economy institutions have deterred FDI from Romania. At the same time, other factors such as the relatively large size of the country, its diversified industry and low labour costs are remarkable factors of attraction. All these factors are not enough to explain the overall low level of FDI in Romania and especially its fluctuation over the past ten years. This country stands as an example for a country of institutional uncertainty and government capture.⁵

Legal, policy and institutional change during 1997-2000

Starting in early 1997, a number of changes regarding the legal and institutional framework for FDI have taken place. A brief summary of the changes may show the legal mess investors have been facing:

- End-1996 to early 1997: Law no. 35/1991 regarding foreign investment was abolished. This law was in force for more than six years. It provided positive discrimination to foreign investors in the form of fiscal incentives, like two to five years of tax holiday depending of the field of investment. It guaranteed legal consistency and protected the investor against future changes of the law.
- June 1997: Emergency Ordinance no. 31/1997 was introduced in place of the former law. It granted less incentives and these only to larger investors. It introduced a threshold of 350,000 US dollars for incentives and a complex scheme for granting them, including mathematical formulas. This Ordinance could not be enforced. Its application norms were enacted only on 29 December 1997. At the same date, the institution nominated to implement it, the Romanian Development Agency, ceased to exist.
- 30 December 1997: Emergency Ordinance no. 92/1997 was issued concerning the stimulation of investments. This Ordinance introduced national treatment (the equality of treatment for Romanian and foreign investors), at the same time it drastically reduced the incentives (mainly fiscal – no more tax holidays) to investors.

⁵ The words of Romanian President Emil Constantinescu (in his speech of 17 July 2000) explaining why he refrains from standing as a candidate for a second term sheds some light on the political situation in his country:

'We live in a time of people who sell and purchase principles, ideologies, seats in Parliament and Government, using lies, blackmail, vulgarity and manipulation of people by any means. Far too many see the political function just as a means for bringing power and wealth. I have tried through my conduct to dispel this opinion, but I don't think I succeeded.' Dismayed by the little help he received in his campaign against corruption, Constantinescu reminded that three years ago 'in Romania there used to be a mafia-type system where an octopus of front companies benefited from the high protection of state institutions. A small number of professionals has managed, despite enormous pressures, to uncover the entire system.' Currently the situation has only become worse.

- 1998: Emergency Ordinance no. 92/1997 was debated in the Romanian Parliament during 1998 and was promulgated as Law on direct investment no. 241 in December 1998.
- March 1999: Despite the fact that Law no. 241/1998 stipulated that its provisions would not be changed for a period of five years (a rather unusual provision), only three months after its promulgation, in March 1999, the incentives granted to investors were suspended by the 1999 Budget Law. The fact that the budget law was considered in force since 1 January 1999 determined a retroactive application and hence a suspension of the incentives already and legally granted to investors. Particularly affected were some companies that had signed privatization deals on the specific assumption that the law was to be maintained for at least five years (Akmaya for the privatization of Petromidia, Britten Norman for the privatization of Aerostar Bacau).
- May 1999: Emergency Ordinance no. 67/1999 regarding some measures for the development of economic activity re-established a number of incentives for investment projects in excess of USD 50 million.
- June 1999: Government Decision no. 519 established (following discussions with the International Monetary Fund) an indefinite moratorium on the granting of incentives.
- Current situation: The present legal framework provides national treatment for foreign investors, no incentives for any investors (Romanian or foreign). Incentives can be applied in the framework of specific policies such as for disadvantaged areas, free trade zones, rural tourism, oil exploration.

This rapid succession of changes in the foreign investment regime has had extremely negative effects, generating a strong reserve on the part of foreign investors to operate in such a volatile climate. Known examples are: Solectron (a large US company in the electronics sector) that had in view to create 5,000 jobs in Timisoara and had to reduce its plans in order to adapt to the current environment; Continental AG, that delayed for more than one year its decision to invest in a tire factory due to the volatility of the legislation.

Current government and international standpoints concerning FDI in Romania

FDI has not been in the focus of the Romanian governments' economic policy in the last few years. Aside of some general statements on public occasions, FDI is not even a subject included in the medium-term (2000-2004) strategy. This negative position of the Romanian government can be mainly explained by the strong influence of local economic interests. Political stakeholders and their economic associates are in no way xenophobic. They just feel that they cannot compete with foreign investors in an open and transparent environment and try to maintain an advantage by keeping these foreign investors at a distance.

Local analysts also draw a parallel between the attitude of the government and that of some international organizations. The International Monetary Fund, the World Bank and the European Commission, which are closely monitoring the Romanian economy, do not mention FDI promotion in their recommendations. The EU Commission generously funded, after 1990, the establishment of foreign investment promotion agencies in all Central and East European countries (Hungary, Poland, Czech Republic, Romania, Bulgaria) and also in the Baltic states. In Romania, the Commission provided, during 1991-1996, over ECU 5 million to the Romanian Development Agency for the foreign investment promotion activity. Given these circumstances, it may be difficult to understand the total silence of the Commission regarding the recent FDI policy of the Romanian governments and especially the closing of the foreign investment promotion agency set up with EU money.

Position of the foreign business community

Representatives of the Association of Foreign Investors claim that they have to pass through rather non-transparent procedures and have been faced with high transaction costs. One of the most difficult aspects is represented by the fact that the whole system (legal and institutional) is unpredictable: even issues that have been agreed upon or even included in a law can be changed discretionally. (For a detailed description of procedures see FIAS, 1999a.) Many investors believe that the coalition in power does not want foreign investors because these investors could affect the personal Romanian interests involved in privatization or various businesses.

A point supporting the above can be found in Tismaneanu (1999): 'Romania got stuck in the first phase of transition. A certain sector, made up by people either belonging to the old nomenklatura or those who directed themselves extremely fast into the slots of opportunities that appeared in the first period of transformation, is no longer interested in securing and generating the second phase of transition in which it is possible that the new types of competition could lead to the loss of the monopoly they have.'

A similar view was expressed by representatives of the Foreign Investors' Council (1999 and 2000). The main difficulties for foreign investors were summarized in the following recommendations:

- An in-depth improvement is required for the process of developing, introducing and applying laws. Laws need to be coherent, understandable and practical. Currently laws are devised without the economic players being given the opportunity to provide their input and advice, and then they are implemented without the necessary training, equipment and enforcement system.
- The fight against corruption and development of an underground economy is not visible enough – the results of this lack of action being a significant shortfall in governmental revenues and unfair treatment of those law abiding enterprises that pay taxes.

- The clarification of the long-term status of property is also essential to stability and confidence.
- More attention should also be given to create a stronger spirit of entrepreneurship and decreasing bureaucracy. A strong and growing medium-size and small enterprise sector is essential for stable, sound development.

The Association of German Investors conducted a survey among its members in December 1996 and repeated it in December 1999. The findings show that a deterioration of the business environment was perceived between the two dates. Again the volatility of the legal and institutional framework was invoked together with the high transaction costs.

Position of local business community, researchers and the public

The local business community is confronted with the same problems as foreign investors. They have the same complaints (legal and institutional instability, high transaction costs, fiscal repression of business) and even started to join their efforts in the discussions with the Romanian government. Starting in spring 2000, the Foreign Investors' Council often appeared together with the Romanian Association of Businessmen and requested a more friendly business climate. This shows that there are no tensions between foreign and local investors.

In a study published by the International Centre for Entrepreneurial Studies in Bucharest, (1999), Costea Munteanu lists causes of the low level of FDI in Romania: the volatility of the political environment, the inefficiency of the administration, general corruption. He also includes the absence of a foreign investment promotion agency.

In a very well documented Ph.D. thesis on FDI, Anda Mazilu (Mazilu, 1999) identifies among the causes that have placed Romania in an unfavourable position:

- the volatility of the legislative and institutional framework;
- the counter-productive role played by the State Ownership Fund (SOF) in relation to foreign investors. Its operation has not been transparent, business-friendly and consistent;
- the generally high level of bureaucracy;
- uncertainty on the right of foreign investors to own land until early 1997.

The general public acknowledges the positive effects of foreign investors on the supply of goods and on securing workplaces. Strong feelings of the public against some privatization deals involving foreign investors were caused by the gross non-observance of the contracts by the investors and not by their foreign status. The privatization of Romtelecom to the Greek OTE has been under investigation of several Parliamentary commissions due

to the fact that the Greek investors abused certain contractual provisions and increased excessively the telephone tariffs, exploiting the monopoly position they enjoy until end of 2002. At the same time, the investment commitments have not been fulfilled. The privatization contract of TEPRO Iasi SA (a metallurgy plant producing metal pipes and slabs) with the Czech company Zelezarny Vesely was under investigation and is now very close to revision because the investor did not fulfil its contractual obligations: almost no investment has been made, the equipment was partly exported as scrap metal, more than the agreed number of staff has been laid off.

The topic of FDI is little present in current public discussion, priority being given to day-to-day problems. The sharp decline of purchasing power of the population and the serious dysfunction of the public institutions are much hotter issues than FDI. The November elections may also put the FDI subject on a lower position because the perception is that the electorate is much more sensitive to its individual needs than to macroeconomic problems.

General investment promotion

Starting in 2000, investment promotion has substituted FDI policy. Although some observers and foreign investors consider it premature, the abolition of FDI-related incentive schemes is in line with EU regulations. Investments are stimulated by general rules of taxation, by regional policy and by the policy related to small and medium-size enterprises (SMEs).

The general level of corporate income tax has been lowered to 25%. (For the earlier system see FIAS, 1999b.) A specific exception to the rule is that profits tax incentives can be granted for investments exceeding USD 50 million, at the discretion of the government. This allows for special treatment in the case of large, mainly foreign investment projects. Profits earned on sales for exports are taxed 5% only. In addition, a 10% fiscal credit for financing technological equipment has been provided. Only SMEs benefit from customs duty and VAT exemption on imported technology equipment. They are given priority when state-owned assets are sold. They can pay in instalments during three to five years following a downpayment of 5-20% of the price. A special credit guarantee fund as well as several internationally financed projects and credit schemes serve the easier access of SMEs to financial means of investment.

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