

## **WESTERN INVESTMENT IN CENTRAL AND EASTERN EUROPE: INCENTIVES, CONSTRAINTS, CONTEXTS**

### **New European Democracies Project Report**

**July 2008**

In the fall of 2007, the CSIS New European Democracies Project (NEDP) launched an initiative to focus on salient economic issues impacting the states of Central and Eastern Europe (CEE) entitled, “Western Investment in Central and Eastern Europe: Incentives, Constraints, Contexts.” The three-part meeting series addressed challenges facing Western investors in the region, including institutional incapacities, corruption, political volatility, social and regional disparities, and negative geo-strategic interests. As a new market of close to 100 million people, with a favorable geographic location and a highly educated workforce, the region has much to offer potential investors.

Between September 2007 and June 2008 CSIS held three high-level roundtables with the participation of regional analysts, scholars, and policymakers to generate ideas for increasing foreign investment, fostering self-sustaining economic development, and furthering international integration throughout the region. This report summarizes the key points generated by the project and includes recommendations for overcoming current challenges and improving the region’s investment climate.

#### **Institution Building as a Priority**

At the beginning of the 1990s, the countries of CEE were confronted with the arduous task of transitioning from centrally planned economic systems based on socialist ideology to ones founded almost exclusively on the principles of free market capitalism. For many of these states, the transition transpired in a difficult environment characterized by mounting inflation, widespread macroeconomic instability, shifting and often diminishing trade relations, and evaporating export markets. During the initial stages of this transition, the international community encouraged short-term political reforms, macroeconomic stabilization efforts and, most palpably, various structural transformations, the vast majority of which entailed privatization of state-owned enterprises.

Emphasis was placed on these areas at the expense of much needed institution building, which, until recently, failed to receive the attention it warranted. While ample pressure to adopt specific laws and decrees was directed toward the CEE states, far less weight was given to strengthening the legal and judicial institutions associated with these procedures and mechanisms. An evident lack of transparency, coupled with inexperience and a weak overall capacity, resulted in sporadic implementation by the institutions charged with interpreting, employing, and enforcing laws passed by the legislatures of CEE countries. As a result, public trust in these institutions plummeted precipitously in the early 1990s,

simultaneously discouraging wary investors concerned with inconsistencies in the application of the rule of law.

### **Measuring Political Risk and Instability**

Political risk, defined as the probability of loss to an investor or owner due to changes in a country's political structure or policies, remains relatively high in CEE, despite evident progress made since the start of transitional reforms nearly two decades ago. Transition countries, by their very nature, are locations where political decisions typically have far greater implications for markets than they do in more established economies. This, from the perspective of potential investors, reduces the utility of employing economic indicators to assess the potential risks associated with a given market. Therefore, more emphasis is placed on relative intangibles and hard to quantify factors, such as the likelihood of nationalization, prospects for widespread civil unrest, regulatory stability, and the instability of political regimes. Analysts typically utilize two comprehensive indicators to assess a country's overall stability: the capacity of state officials to pursue reforms, particularly during times of spontaneous volatility, and the ability of these same individuals to avoid producing volatility of their own. Countries lacking both are highly susceptible to political risk.

Similarly, political instability is a factor that needs to be considered. There are three categories of domestic political instability: (1) policy—a set of wide-ranging changes that involve shifts in the preferences of state officials; (2) government—an alteration in the individuals who control and operate government institutions; and (3) regime—a change in the institutions of government or the rules of the political game.<sup>1</sup> For the first time since the start of the transition period in the early 1990s, CEE countries are exhibiting substantial resistance to continued transformation. Some analysts and Western investors are concerned that current trends, which can be characterized as partial stagnation, may ultimately evolve into outright backsliding.

Romania illustrates the significance of political tension as an influential determinant of overall political risk. According to some observers, ongoing discord between Prime Minister Calin Popescu-Tariceanu's minority government and President Traian Basescu is distracting from reforms needed to tackle the growing macroeconomic imbalance evident in a widening current-account deficit and rising inflation, undermining an otherwise business-friendly investment climate. At the same time, the pursuit of diverging policies by state institutions is a principal source of short-term political risk in Romania.

In the Czech Republic the expedited reform process witnessed during the 1990s has slowed down considerably since the election of Euroskeptic President Vaclav Klaus and the formation of a coalition government led by Prime Minister Mirek Topolánek. A hung parliament prevented Topolánek from implementing many of his intended tax and spending reforms and adjustments to the Czech welfare system. In some CEE countries,

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<sup>1</sup> CSIS Presentation. Ugo Amoretti, "Similar but Different: A Political Risk Perspective on Bulgaria and Romania," presented at the Center for Strategic and International Studies, Washington D.C., May 22, 2008.

populist and demagogic parties have been included in ruling government coalitions. The 2006 elections in Slovakia brought to power populist Prime Minister Robert Fico, who ran on the promise to reverse some of the groundbreaking economic policies enacted by the Mikulas Dzurinda government, claiming that the country had been sold out. Fico included the nationalist Slovak National Party (SNS) into the ruling coalition, which has incited tensions with the country's minority populations.

According to some observers, the populist policies of the Kaczynski government in Poland created substantial volatility from its inception in July 2006 until its collapse in September 2007. The subsequent election of Donald Tusk as prime minister in October 2007 accelerated reforms markedly and reversed what were regarded as anti-EU policies. In the fall of 2006, Hungary witnessed demonstrations and civil unrest as citizens and the political opposition protested both the legitimacy of the prime minister and the government's economic programs sparked by a scandal within the ruling party. The country's main political parties have been deadlocked on these issues since. These tensions contribute to perceptions of growing volatility in the region.

## **Corruption**

According to most commonly accepted indicators of corruption, considerable progress has been made in CEE countries in recent years. Far fewer firms, for example, are reporting corruption in the tax administration. A decline in the frequency of bribes in most tax systems appears to have reduced overall corruption significantly. As a result, many countries in the region have surpassed EU member states from the first Mediterranean enlargement, namely Greece and Portugal, where corruption in the tax administration continues to be problematic. According to Western firms operating in CEE countries, a direct correlation exists between the policies and institutional design of a given tax system and the level of corruption in that society. A more complex and thus burdensome system is significantly more likely to generate corruption than a simplified tax structure in which the incentives for adherence outweigh the expected advantages of unlawful circumvention. It is no coincidence, therefore, that CEE countries are global leaders in implementing low and often flat-rate income taxes.

In Slovakia, for example, the 2004 tax and benefits system reforms, which included the introduction of a relatively low flat-rate tax, increased competitiveness markedly.<sup>2</sup> The vast majority of Western firms in Slovakia have praised these reforms, which, since being implemented, have resulted in declining tax evasion and a reduction in bribes. In most CEE countries, however, the principal tax policy issue for Western investors concerns high labor taxes and various social contributions. This form of tax results in a disparity between the cost of labor to an employer and the nominal wage of an employee, thus explaining the relatively low rates of formal employment in many of the region's countries.

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<sup>2</sup> *Anticorruption in Transition 3: Who is Succeeding...and Why?* (Washington, D.C.: The World Bank, 2006), 49.

Despite evident progress in the domain of tax system reform, CEE countries have failed to address what many foreign investors perceive as a key, yet lingering, challenge: stagnation in the level of judicial corruption. The attainment of Western rule of law standards will require significant advancements in the independence, responsiveness and accountability of judicial institutions. To this end, the following measures are widely accepted as being effective: (1) promoting and preserving merit-based mechanisms for judicial appointment; (2) providing suitable judicial salaries and training for judges, public prosecutors, and other court officials; (3) ensuring transparency in judicial proceedings; and (4) prosecuting high-profile corruption cases involving government leaders or influential and prominent individuals.<sup>3</sup>

Strategies involving one or more of these components have been pursued by most CEE countries. In Romania, judicial salaries are quickly approaching the average private sector salary. An inevitable corollary of such trends has been an increase in the prestige of judicial professions and the attractiveness of such careers to the most capable individuals. Slovakia, in addition to developing merit-based appointment processes, has expanded its efforts to increase governmental capacity in prosecuting judicial corruption by establishing a special court and prosecution agency to manage cases pertaining to corruption and organized crime. In an effort to increase transparency, ministries of justice throughout the region are utilizing information technology (IT) networks to disclose details regarding judicial calendars, important laws, and individual cases.

Much like judicial reform, government procurement appears to be an area in which little or no progress is being made. While the average kickback tax, or percentage of contract value that firms must provide to state officials to obtain government contracts, has declined steadily in most CEE countries, the incidence of bribes has not. Within the region, however, no correlation exists between wealth, aggregate country-wide levels of corruption, and corruption in government procurement. Romania, a relatively poor country even by regional standards possessing high levels of general corruption, is experiencing a reduction in the frequency of bribes associated with government procurement. The wealthier Czech Republic, on the other hand, is reporting an increase in government procurement related corruption, which remains among the highest in CEE. Western investors operating in the region maintain that frequent corruption in government procurement, particularly with regard to large contracts, will often have large political implications, exacerbating state capture and thus undermining the overall attractiveness of CEE markets. Many governments, however, have demonstrated a willingness to address corruption in this area by enacting new public procurement laws and setting up state procurement offices with transparent, well-defined mandates. While the adoption of such measures, from the perspective of foreign investors, is a step in the right direction, an improvement in the investment climate will require clear and consistent implementation of procurement laws.

According to the World Bank's *Doing Business in 2008* report, "Eastern Europe and the former Soviet Union surpassed East Asia in the ease of doing business," adding that "several of the region's countries have gone even further, surpassing many Western

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<sup>3</sup> Ibid., 54.

European economies.”<sup>4</sup> Reduced red tape and simplified bureaucracies have made CEE countries significantly more attractive destinations for Western investments. The average tax time, or amount of time investors spend interacting with public officials, has decreased significantly throughout the region. Problems associated with business licensing, however, continue to plague most CEE countries, while legislative reforms have done little to address these lingering problems. A clear relationship exists between bribery, corruption, and business licensing: informal payments diminish as countries simplify licensing procedures. Reducing regulations and eliminating contact between government officials and foreign firms should not become an end in itself, however. Rather, CEE countries should aim to streamline bureaucratic processes that often discourage Western investors from entering their respective markets while maintaining policies and procedures that serve a legitimate public function.

### **The Russia Factor**

After years of relative absence, Russia’s presence in the region has increased significantly. In recent years, Russian outward foreign direct investment (OFDI) in CEE countries has grown considerably, with an evident emphasis being placed on energy and natural resource-based activities. Efforts to increase investments in the oil and gas sector stem in part from a desire to dominate the region’s refineries and distribution infrastructure, thereby securing sales outlets for Russian natural resources, reducing transportation costs and making Europe increasingly dependent. Investments by non-natural resource-based companies are rare due to the uncompetitive and unmarketable nature of Russian firms and products.

According to the Central Bank of Russia, Russian OFDI surpassed USD 100 billion in 2004, which represents a fivefold increase since 2000. The principal motive for many Russian firms operating in CEE, much like their counterparts from non-EU countries, remains the desire to gain access to protected EU markets. The key problem with Russian investment, according to Western investors operating in the region, is that many of their Russian counterparts are accustomed to the bribery and corruption present in their own country and are often inclined to continue such conduct in CEE countries, thus undermining existing, and obstructing future, reforms in the region.

### **EU Membership: A Catalyst for Reform**

The European Union and its accession process have acted as both a push and pull for candidate countries, representing a considerable incentive for judicial reform and the application of policies aimed at eliminating corruption. In 1981, few considered Greece sufficiently prepared for full membership in the European Community just seven years after the country’s democracy was restored. Similar attitudes were expressed in 1986 when Spain and Portugal joined. Since their accession in the 1980s, however, Greece, Spain, and Portugal have illustrated the capacity of the EU to not only consolidate

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<sup>4</sup> The World Bank, *Doing Business Overview*; available at [http://www.doingbusiness.org/documents/fullreport/2008/DB08\\_Overview.pdf](http://www.doingbusiness.org/documents/fullreport/2008/DB08_Overview.pdf)

democracy, but to help establish and sustain functional, independent, and effective judicial institutions.

Beginning with the signing of the Europe Agreements in 1991-1992 and concluding with formal membership in 2004, the allure of eventual accession to a prestigious club of wealthy, stable European democracies served as the ultimate source of motivation for political elites in CEE. In addition, the strict and unyielding conditionality of EU enlargement policy, most palpable in its requirements regarding the convergence of local laws with the *acquis communautaire*, pushed CEE countries to enact and implement the many reforms necessitated by Brussels. Demands and suggestions from the European Commission were accompanied by sizeable technical assistance and implementation funds, all of which played a critical role in facilitating and expediting the region's transition. By explicitly outlining standards and evaluating candidate countries throughout the accession process, Brussels was able to monitor and assess both the pace and depth of the reforms undertaken in the CEE countries.

Nevertheless, while the appeal of eventual EU membership served as a vital impetus, the nature of the process, with its explicit emphasis on *acquis* harmonization, reinforced the overall approach of the international community toward countries in transition, which generally tended to favor short-term political reforms through lawmaking at the expense of longer-term institution building. The determination of Brussels to verify that candidate countries were capable of implementing and enforcing the laws and regulations of the *acquis*, however, ensured that the existence of an effective judicial system would at the very least be a *de facto* requirement.

In December 1997, the European Council, recognizing both the fundamental importance of responsive institutions and their lagging transformation in CEE countries, issued the Luxembourg Declaration, which, in addition to officially inaugurating the accession partnerships, identified “the reinforcement of administrative and judicial capacity” as a priority area for future technical assistance to candidate countries.<sup>5</sup> As a result, the Commission committed itself to allocating approximately 30 percent of its pre-accession funds toward institution-building in CEE countries. Questions, however, remain regarding the capacity of the EU to promote the continuation of reforms after accession.

According to some observers, the attainment of EU membership by CEE countries, once representing the ultimate carrot in Brussels' arsenal of persuasion, has eliminated key incentives for continued transformation, resulting in reform fatigue. Olli Rehn, EU Enlargement Commissioner, in fact acknowledged that “after a country has a seat around the table, it is much harder to apply pressure to it.”<sup>6</sup> Although it is reasonable to speculate that CEE societies have to a large extent reached a self-perpetuating stage of development in which significant regression appears unlikely, the reduced leverage of Brussels over its CEE member states in the post-accession era represents an undeniable

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<sup>5</sup> James H. Anderson, David S. Bernstein and Cheryl W. Gray, *Judicial Systems in Transition Economies: Assessing the Past, Looking to the Future* (Washington DC: The World Bank, 2005), 18.

<sup>6</sup> “Europe's Marxist dilemma: It is easier to influence a country before than after it joins the club,” *Economist*, 24 April, 2008.

reality. As a result, reforms in most countries have slowed to a crawling pace. There is a clear and consistent pattern in the region: intensive efforts to qualify for membership are quickly supplanted by a discontinuation of reform efforts upon accession.

The Commission, however, even after accession, is not without recourse. Bulgaria and Romania, for example, have been threatened with sanctions entailing the withdrawal of subsidies and regional aid. The accession treaties of the aforementioned member states also include so-called “safeguard clauses” that allow the EU to take punitive measures in the form of a refusal to recognize court decisions. In Romania, the constitutional court recently ruled that parliament must sanction the investigation of high-ranking officials, prompting President Basescu to refer to the court as “a shield for corruption.” A comparable situation persists in Bulgaria where the Commission continues to express concern regarding the mismanagement of EU funds and a perceived lack of commitment in the fight against corruption.

A Commission monitoring report on judicial reform in the two Balkan countries is expected in late July 2008. Depending on the report’s final conclusions, Justice and Home Affairs Commissioner Franco Frattini may opt to suggest a series of sanctions against Sofia and Bucharest. If reforms continue to lag in CEE, the region’s countries may find themselves in an increasingly precarious position following the adoption of the proposed Lisbon Treaty, which provides the EU with a number of additional sticks, including the ability to suspend a country’s membership rights upon the agreement of 80 percent of member states and the consent of the European Parliament.

## **Recommendations**

*Regional Competition can stimulate reform efforts.* While Brussels’ ability to incentivize CEE member states has been visibly reduced in the post-accession era, growing competition between the countries of the region for FDI will inevitably help drive reforms during this period. In order to increase their attractiveness as investment destinations vis-à-vis intra-regional competitors, CEE countries will have to continue, and in many cases, accelerate the reforms process. Political elites throughout the region have acknowledged the importance of actively undertaking investment-promotion policies that will augment FDI inflows and ensure continued economic development. Some states have been more successful than others in pursuing business-friendly reforms that can create an environment more conducive to FDI.

Evidence of a positive correlation between a given policy and increased investments will often develop into an accepted best practice emulated throughout the region. In January 1994, Estonia enacted a series of tax-related reforms founded on a 26 percent flat tax. Since then, an avalanche of flat taxes has swept across the wider CEE region, including Slovakia, Latvia, Lithuania, Bulgaria, Romania, Serbia, Montenegro, Macedonia, and the Ukraine. Countries in CEE will increasingly compete with each other to attract what appears to be diminishing global OFDI, particularly with regard to non-natural resource-based industries. The case of the flat tax is illustrative of the existing, albeit largely latent, momentum for reform that remains in CEE. Brussels, Washington, and individual

Western investors should aim to stimulate this momentum by generating a strong sense of healthy, motivational competition among the region's countries.

*International rankings as key markers.* Much like competition for FDI, international rankings, such as Transparency International's Corruption Perceptions Index (CPI), serve an important role in sustaining current and encouraging new reforms throughout the region. These rankings provide valuable information to both local leaders and potential investors. Recognizing the often decisive weight given to a country's standings by prospective investors, particularly in relation to other potential investment destinations, the vast majority of CEE political elites have committed themselves to advancing their respective country's global rankings. The best way to achieve such progress is to accelerate the adoption and implementation of the many institutional reforms discussed above. These reforms seldom go unnoticed by organizations such as Transparency International and Freedom House, resulting in improved international rankings and a corresponding shift in the attractiveness of a given market.

*Alternative Dispute Resolution mechanisms to supplement judicial institutions.* While increasing the responsiveness and efficacy of judicial institutions should remain a top priority for CEE countries, the further development of alternative dispute resolution (ADR) mechanisms would contribute significantly to the formation of a more favorable business climate. The sluggish nature of judicial processes in most CEE countries coupled with a partial or entirely absent implementation of court decisions increases the attractiveness and probable utility of ADR, particularly from the perspective of Western investors.

The International Finance Corporation (IFC), for example, has established an ADR Program in the wider CEE region that aims to "help SMEs [small and medium-sized enterprises] cut through judicial red tape and unlock blocked assets."<sup>7</sup> The principal activities of the Program include: (1) introducing a legal and regulatory framework capable of sustaining mediation throughout the region; (2) maintaining a regional network of 10 mediation centers; (3) financing seminars that train local mediators; (4) supporting civil society institutions committed to the expansion of mediation; (5) educating judges, prosecutors and other court officials regarding the utility of mediation; and (6) promoting a public awareness campaign to increase demand for mediation services. The International Finance Corporation's ADR Program should serve as a model for future regional initiatives.

*Continued education of government officials.* Finally, Western capitals and NGOs must increase their collaboration in activities pertaining to the education of government officials and business representatives in CEE. The acceleration of reforms and the creation of a more favorable business climate are unachievable without local leaders who possess both the capacity and the willingness to continue with reforms. The Helsinki Foundation for Human Rights (HFHR), for example, recently organized a two-day seminar on the critical role of strategic litigation in transition countries. During the

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<sup>7</sup> International Finance Corporation, *Alternative Dispute Resolution – About*; available at [http://www.ifc.org/ifcext/pepse.nsf/content/ADR\\_About](http://www.ifc.org/ifcext/pepse.nsf/content/ADR_About)

seminar, participants, in addition to attending lectures by numerous experts, utilized the event as an opportunity to exchange ideas and experiences regarding the advancement of rule of law standards in CEE.

The education of local leaders should be a key component of any strategy to accelerate the region's development. Seminars and training exercises have been decisive in this regard. However, much remains to be done. The seemingly temporary stagnation in reforms in many CEE countries has the potential to develop into a more permanent recess. Western governments, business representatives and NGOs must continue to support processes that will counter reform fatigue in the region. This will, of course, require a corresponding readiness by local leaders to supplement such efforts with domestic initiatives aimed at continuing the transformation.

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