Reforms and Foreign Direct Investment – Possibilities and limits of public policy in attracting Multinational Corporations. A multiple case study of Romania and Croatia

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Vorwort

Die vorliegende Dissertation wurde 2009 bei der Wirtschaftswissenschaftlichen Fakultät der Universität Hohenheim eingereicht und angenommen. Sie wurde für die Veröffentlichung geringfügig bearbeitet; insbesondere wurden die Interviews anonymisiert. Die vollständigen Angaben wie Name, Funktion und Institution liegen den Gutachtern und dem Autor vor.

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Frankfurt, im Februar 2009, Dietmar Zühlke

Quick Overview

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List of Abbreviations

AHK	Außenhandelskammer (= German Chamber of Commerce)
APAPS	Autoritatea pentru Privatizare şi Administrarea Participaţiunilor Statului (= Authority for Privatization and Administration of State Assets (Romania))
APD	Asociaţia Pro Democraţia (= Romanian NGO)
APIU	Agencija za promicanje izvoza i ulaganja (= Trade and Investment Promotion Agency (Croatia))
ARIS	Agentia Romana pentru Investitii Straine (= Romanian Agency for Foreign Investments)
AVAS	Autoritatea pentru Valorificarea Activelor Statului (= Authority for State Assets Recovery (Romania))
BA-CA	Bank Austria Creditanstalt
Bfai	Bundesagentur für Außenwirtschaft, Cologne
BIT	Bilateral Investment Treaties
BTI	Bertelsmann Transformation Index
BVMW	Bundesverband mittelständische Wirtschaft (= The German Association for Small and Medium-sized Businesses)
CAGR	Compound Annual Growth Rate
CARDS	Community Program for Assistance, Reconstruction, Development and Stabilization

CEEC	Central and Eastern European Country
CEFTA	Central European Free Trade Agreement
CES	Center for Economic Studies, Munich
CICD	Center for International Cooperation and Development, Ljubljana
CIR	Center of International Relations, Ljubljana
CIS	Commonwealth of Independent States
CMSES	Croatian Ministry of Science, Education and Sports
CNB	Croatian National Bank (= Hrvatska Narodna Banka)
CNSAS	Consiliul Naţional Pentru Studierea Arhivelor Securităţii (= National Council for Research on the Communist Secret Service Archive)
CPF	Croatian Privatization Fund (= Hrvatski fond za privatizaciju)
CPI	Corruption Perception Index
DB	Deutsche Bank
DCEI	Deka Converging Europe Indicator
EBRD	European Bank for Reconstruction and Development
EEC	Eastern European Country
EFTA	European Free Trade Associationc
EIU	The Economist Intelligence Unit
ELIAMEP	Hellenic Foundation for European and Foreign Policy, Athens
EU	European Union

FDI	Foreign Direct Investment
FIAS	Foreign Investment Advisory Service
FIC	Foreign Investors Council
FPI	Foreign Portfolio Investment
FSN	Frontul Salvării Naţionale (= National Salvation Front (Romania)
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GEC	German Economic Chamber
GO	Government Ordinance
GTZ	Gesellschaft für Technische Zusammenarbeit (= German Technical Cooperation)
HDZ	Hrvatska Demokratska Zajednica (= Croatian Democratic Union)
HRK	kuna (= currency of Croatia)
HWWA	Hamburgisches Welt-Wirtschafts-Archiv
ICT	Information, Communication and Technology
ICTY	International Criminal Tribunal for the former Yugoslavia
ifo	Institut für Wirtschaftsforschung, Munich
IMF	International Monetary Fund
INSSE	Institutul National de Statistică (= National Institute of Statistics (Romania))
Intv.	Interview

IPA	Instrument for Pre-accession Assistance
ISPA	Instrument for Structural Policies for Pre-Accession
km	kilometers
MIGA	Multilateral Investment Guarantee Agency
Min.	Ministry
MNC	Multinational Corporation
NBER	National Bureau of Economic Research, Cambridge/ MA
NBR	National Bank of Romania (= Banca Natională a României))
NCC	National Competitiveness Council (Croatia)
NGO	Non-Governmental Organization
NIE	New Institutional Economics
no.	number
OECD	Organization for Economic Cooperation and Development
PHARE	Poland Hungary Assistance for Restructuring the Economy
PPP	Public-Private Partnership
PRM	Partidul România Mare (= Great Romania Party)
PSD	Partidul Social Democrat (Social Democratic Party of Romania)
R&D	Research and Development
RON	Leu, plural: lei (= currency of Romania)
S.A.	Societatea pe actiuni (= stock corporation (Romania))

S.R.L.	Societatea cu raspudere limitata (= limited liability corporation (Romania))
SAA	Stabilization and Association Agreement
SAPARD	Special Accession Program for Agriculture and Rural Development
SDP	Socijaldemokratska partija Hrvatske (= Social Democratic Party (Croatia))
SDSS	Samostalna demokratska srpska stranka (= Independent Democratic Serbian Party)
SEEC	Southern and Eastern European Country
SME	Small and Medium Enterprises
SOE	State-Owned Enterprise
sqm	square meter
SWP	Stiftung Wissenschaft und Politik, Berlin
U.S.	United States
UIS	UNESCO Institute for Statistics
UK	United Kingdom
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNECE	United Nations Economic Commission for Europe
USKOK	Ured za suzbijanje korupcije i organiziranog kriminaliteta (= Office for the Prevention of Corruption and Organized Crime (Croatia))

VAT	Value-added tax
VIG	Vienna Insurance Group
WTO	World Trade Organization
ZEI	Zentrum für Europäische Integrationsforschung, Bonn
ZUMA	Zentrum für Umfragen, Methoden und Analysen, Mannheim

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1 Introduction

Over the last four decades Foreign Direct Investments (FDIs) of Multinational Corporations (MNCs) have received increasing attention from academics as well as from politicians. The reasons for this rising interest are twofold.

Firstly, FDI flows have experienced tremendous growth and cannot be ignored as a significant economic factor anymore. The global inflow of FDI grew between 1970 and 2006 at a Compound Annual Growth Rate (CAGR)[1] of 14%.[2] In fact FDI flows have grown faster than bilateral trade relations and have been interpreted as a highly visible indicator for the rising degree of a liberalized[3] global economy.[4]

In terms of FDI growth Eastern Europe has been one of the most striking regions. Since 1990 FDI inflow has soared at an impressive CAGR of 31% in 19 Eastern European countries (EECs) until 2006.[5]

Secondly, the assessment of FDI and other activities of multinational corporations has altered in recent years. Governments in particular have adopted a more optimistic view of FDI inflows that stresses the positive effects on host economies, i. e. countries that receive inward FDI. Amongst other things they presume a positive impact of FDI on the growth of the Gross Domestic Product (GDP) and favorable spillover effects on their economies.[6] In the case

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[1] Average growth = (current value/ base value)1/# of years - 1.
[2] See UNCTAD FDI website (2008); own calculations.
[3] Note: this thesis is written in American English.
[4] See Blonigen (2005); Blomström and Kokko (2003).
[5] See UNCTAD FDI website (2008), including former Yugoslavia from 1990-1991 and without former German Democratic Republic; see also Moosa (2002), p.4; own calculations.
[6] See te Velde (2001), p.4; Enderwick (2005); Blomström (2002), p.165.

of Eastern Europe most scientific analyses have confirmed that FDI has indeed largely contributed to the growth and the transition of the former communist countries.[7]

While the importance of FDI and the interest in FDI has undoubtedly risen, the academic discussion has also become more complex. This is particularly true in relation to the reasons of companies for moving parts of their production or of their business activities abroad. The reasons why companies become MNCs and what determinants drive FDI has triggered a vast amount of research. Nonetheless, open questions remain – especially for governments of those host countries of FDIs that want to learn how they can attract further and more sustainable foreign investments in the future.

In fact when governments ask why investors come to their country rather than to any other country, they receive few consistent answers from academics. Furthermore, when they ask for specific public policy implications from academic researchers in order to attract more FDI, recommendations remain scarce or contradicting.[8]

It may appear stunning that governments have obtained only limited assistance to their obvious and compelling questions. However, four reasons are apt to help understanding why only few studies exist regarding the possibilities and limits of public policy in order to attract FDI of MNCs:

1. The common methodologies often seem too selective in their variables analysis (econometrics) and have difficulties in weighing determinants (surveys).

2. Comparatively little is known about the interdependence of MNC determinants and corresponding state actions due to the lack of an inter-

[7] See, for example, Neuhaus (2006); Eller, Haiss, and Steiner (2006) and UNECE (2001).
[8] See Mudambi (2002), p.265; Wells and Wint (2000), p.2; Goodspeed, Martinez-Vazquez, and Li (2006), p.2.

disciplinary approach, focusing too strongly on an either Economics or International Business interpretation.

3. Frameworks developed by FDI studies have until now been unable to reflect the different ways in which public policy can influence FDI determinants or the different organizational forms of investment policy.

4. Many studies lack a multi-country perspective that explains what one country can learn from the other's experience in terms of FDI attraction.

The aim of this thesis is to make a contribution to overcome this outlined paradox:

"Reforms and Foreign Direct Investment –
Possibilities and limits of public policy
in attracting Multinational Corporations.
A multiple case study of Romania and Croatia"

The theoretical approach is first of all based on the FDI theory of **locational competition** (*Siebert 1996, 2000, 2005*) sharing the view of this thesis that states are in permanent rivalry with other countries for foreign investments. The second theoretical pillar is the **New Institutional Economics** (NIE) theory (*Williamson 1975, 1985, 2000*) whose market approach and concept of institutions and organizations can overcome the limitations of current FDI theory in terms of evaluation and categorization of investment policy measures and actors.

To avoid the methodological difficulties of earlier studies the empirical part of this thesis is based on the **case study approach** (*Yin 2003*) that enables for a more comprehensive analysis of the public policy impact on the investment decision of MNCs. This makes a consideration of approaches from Economics and International Business theory as well as from political science possible.

More precisely, a pre-selected list of country determinants will be tested in expert interviews and through and company materials as well as analyzed from the state perspective based on expert interviews, state document and secondary literature.

Romania is an interesting country for FDI research because of its fairly large market size, its remarkable FDI surge in recent years and its interesting reform dynamics in the context of EU accession in 2007. **Croatia** is also an attention-grabbing example for an FDI study because of its high FDI stock, its specific reform challenges after the war in former Yugoslavia, and its current efforts in preparing a potential EU accession. Furthermore, the **combination** of the selected countries seems rewarding since Romania and Croatia are the most important FDI recipients of the Southern and Eastern European Countries (SEECs) and the cross-country analysis is conducted on a qualitative and not on a quantitative basis.

The analyzed MNCs originate from **Germany** and **Austria**; the two countries are among the three leading investors in the SEECs, possess equal language preconditions, and benefit from similar and fairly good historical ties to the host countries.

This thesis may be of particular interest for scholars from Economics and Business Economics but also for policy makers from other transition countries (such as Ukraine or Serbia) who want to learn from the experiences of Romania and Croatia and may benefit from the conclusions of this thesis for FDI policies in their countries.

In the remaining parts of this chapter, *section 1.1* elaborates key questions and hypotheses and *section 1.2* provides an overview of the structure of this thesis.

1.1 Key questions and hypotheses

Derived from the increasing relevance of FDIs – especially in Eastern Europe – and from the sketched problem of current research to provide consistent analyses of the impact of investment policy, the key research question of this thesis is:

1. *What role can public policy play in order to attract FDIs in transition countries?*

The reference to the role of public policy[9] here reflects the fact that this thesis elaborates the "possibilities and limits" *(see title)* of governments' investment policy. It is therefore analyzed to what extent states can actually influence a company's decision to invest abroad at all, what array of measures governments possess to attract FDIs and how they can influence the kind and value of the investment. This thesis' goal is to match FDI country determinants of MNCs (e. g. legal certainty, investment incentives or political stability) on the one hand with the expectations of governments and their investment policy on the other.

As part of this wider question (1), four underlying questions will also be considered. These relate to (2) the MNC's view, (3) the state's overall performance in attracting FDI, (4) the organizational forms of FDI policy, and (5) the cross-country view:

2. *What policy measures have influenced the decision of MNCs to invest in the selected countries?*

This sub-question analyzes why companies have invested in a specific country and to what extent and with what levers public policy was able to play a role in their investment decision. It also examines what factors were decisive and why

[9] See definition of "public policy" in *section 2.1.3*.

some companies may end up deciding not to invest in the selected countries at all.

3. *How successful has investment policy been in Romania and Croatia in creating attractive conditions for FDI?*

This thesis explicitly considers the countries' experience in setting up a legal, economic and political environment that is favorable for investments; therefore, it analyzes the development in specific policy areas that may have had an influence on the investment decision of MNCs since 1990. Thus this sub-question underlines this thesis' unique approach since it comprises not only the company's view but also the state's view.

4. *What state actors are most suited to create favorable conditions for FDI?*

This thesis is also interested in analyzing what state actors are most suited to induce more investments and what characteristics make them more successful in this field than other players.

5. *What can be learned from the cross-country analysis?*

Eventually, this thesis aims at going beyond the inner-country perspective and at elaborating what results from this thesis are country-specific and what results are valid in general for the experience of transition countries with investment policy.

A graphic overview of the outlined key research questions is displayed in *figure 1*.

The five questions will guide the analyses of this thesis and will be answered throughout the text and in the conclusion. Moreover, the following five initial hypotheses are supposed to sharpen the analysis of this thesis even further and focus the study on the most crucial issues:

1. *The impact of public policy on the investment decisions of MNCs is greater than assumed in the literature.*

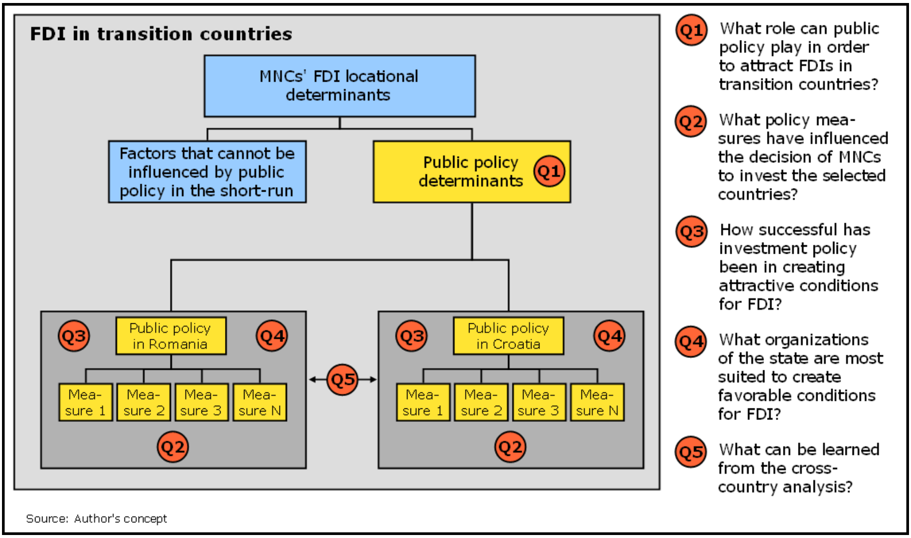

Figure 1: Overview of key questions

A review of the literature *(see section 2.2.4 for details)* shows that most classical FDI studies see only limited possibilities for governments in order to decisively improve the chances that companies will invest in their specific countries. However, more recent studies on institutional quality[10] and locational competition[11] as well as the growing interest of governments in investment tools established by international organizations, e. g. by the Organization for Economic Cooperation and Development (OECD) or the United Nations Conference on Trade and Development (UNCTAD)[12], suggest that the impact of public policy on FDIs may have been underestimated so far. Initial expert interviews also support this hypothesis, e. g. a German company deemed legal certainty – clearly

[10] See Dunning (2006); Wei (2000b).
[11] See Siebert (2000); Siebert (1996).
[12] See e. g. OECD (2006a); OECD (2006b); UNCTAD (2003b) and for the general trend Brewer and Young (1997), p.175; Hanson (2001); Enderwick (2005).

a determinant driven by public policy – to be too weak in Croatia in 2001 and thus did not invest in a tourism project at the Croatian coast.[13]

2. *Determinants of investment decisions are much more diverse than shown in most FDI studies.*

When analyzing public policy issues as determinants for FDI, academic studies have usually focused on a limited number of possible levers; public policy issues that are discussed most frequently include tax policies, investment incentives and trade policies.[14] Other determinants have usually been seen as less important for MNCs and are in addition to this, difficult to measure. However, initial interviews have indicated that determinants for a company's investment decision are much more diverse. Thus, in addition to classical FDI determinants critical issues for the interviewed companies were the legal situation, the living conditions for the expatriates, the attitude of locals towards foreigners in the host country and many more aspects.[15] Recent studies have also begun to analyze broader sets of FDI determinants that can be influenced by host governments.[16]

3. *The removal of obstacles for FDIs is more effective than the creation of investment incentives.*

An initial analysis of Romanian reforms[17] as well as initial interviews with investors in Romania and Croatia[18] lead to the conclusion that indirect policies have a more positive impact on MNCs' investment decision than specific

[13] See Intv. Germ. MNC - Engineering (2007).
[14] See for example Feldstein, Hines, and Hubbard (1995); Mallya, Kukulka, and Jensen (2004); Globerman and Shapiro (1999).
[15] See interviews with Intv. Austr. MNC - Industrial Goods I (2007) and Intv. Germ. MNC - Engineering (2007).
[16] See for example Resmini (2006); Goodspeed, Martinez-Vazquez, and Li (2006).
[17] See Zühlke (2006).
[18] See Intv. Austr. MNC - Industrial Goods I (2007) and Intv. Germ. MNC - Engineering (2007).

measures that promise financial incentives to investors. Thus, measures that do not primarily aim at foreign investors, such as a decrease in waiting time at legal trials or an increase in political stability seem to be more important for investors in transition countries than tax exemptions or direct subsidies.

4. *Organizational forms below the central government level have the greatest impact on the FDI decision of MNCs.*

Studies of public policy measures usually focus on the central government and their actions, (e. g. the modification of tax laws or the legal status of foreigners) which are proposed by a minister and ratified by the parliament.[19] However, initial interviews with figures such as the Managing Director of a Croatian authority[20] and with an Austrian investor in Romania[21] have indicated that actors on a lower state level as well as semi-state players (e. g. business chambers) have a stronger influence on the investment decision of MNCs than government actions in Zagreb and Bucharest. Thus, financial incentives seem to be less important than the efficiency of local administration and the information and contacts provided by sub-governmental organizations.

5. *Overall, Romania represents a good example for Croatia of how lagging integration efforts towards EU accession can prevent accelerated FDI inflows.*

As earlier studies have shown, the efforts of EECs to be admitted into the EU led to higher FDI flows into these countries.[22] However, the speed and intensity of integration have clearly varied across candidate countries. Initial analyses

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[19] See e. g. Nicoletti, Golub, Hajkova, Mirza, and Yoo (2003); Goodspeed, Martinez-Vazquez, and Li (2006).
[20] See Intv. Croatian Authority II (2007).
[21] See Intv. Austr. MNC - Industrial Goods I (2007).
[22] See e. g. Bevan, Estrin, and Grabbe (2001); Kušić and Cvijanović (2002); Disdier and Mayer (2003); Zakharov and Kušić (2003); UNCTAD (2004a) pp.42-45.

by the author[23] have indicated that Romanian reform efforts remained slow and hesitant until the early 2000s. It was therefore primarily the concern of the Romanian government that EU accession would be further delayed that prompted the necessary reforms. Hence, a significant increase of FDI inflows to Romania did not set in until 2003.[24] It can therefore be assumed that Croatia – a current candidate country for EU accession – could learn from the Romanian experience how to proceed and what issues to avoid in terms of EU integration in order to achieve both EU accession and higher FDI inflows as rapidly as possible.

An overview of the hypotheses that are to be tested in this thesis and their matching key questions is provided in *figure 2*.

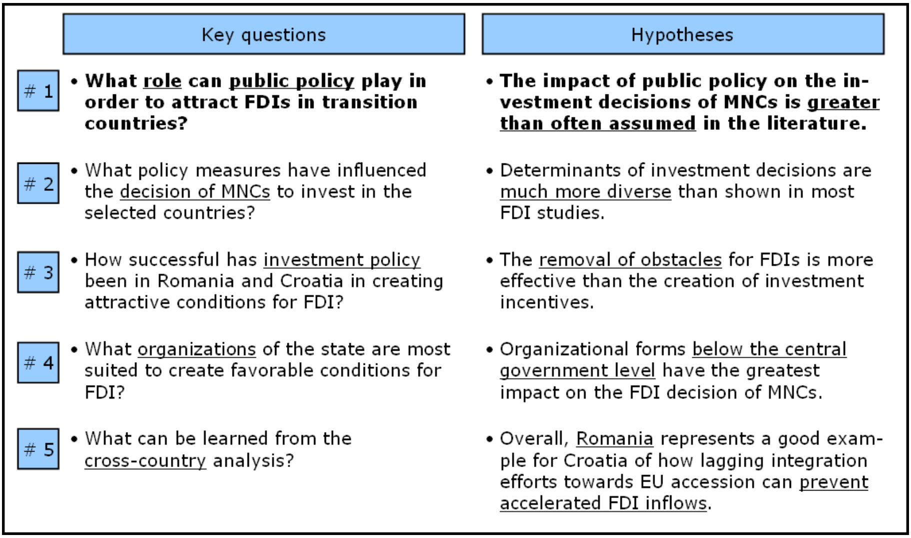


Figure 2: Key questions and hypotheses

[23] See Zühlke (2006).
[24] See *section 6.2* for details.

1.2 Structure of thesis

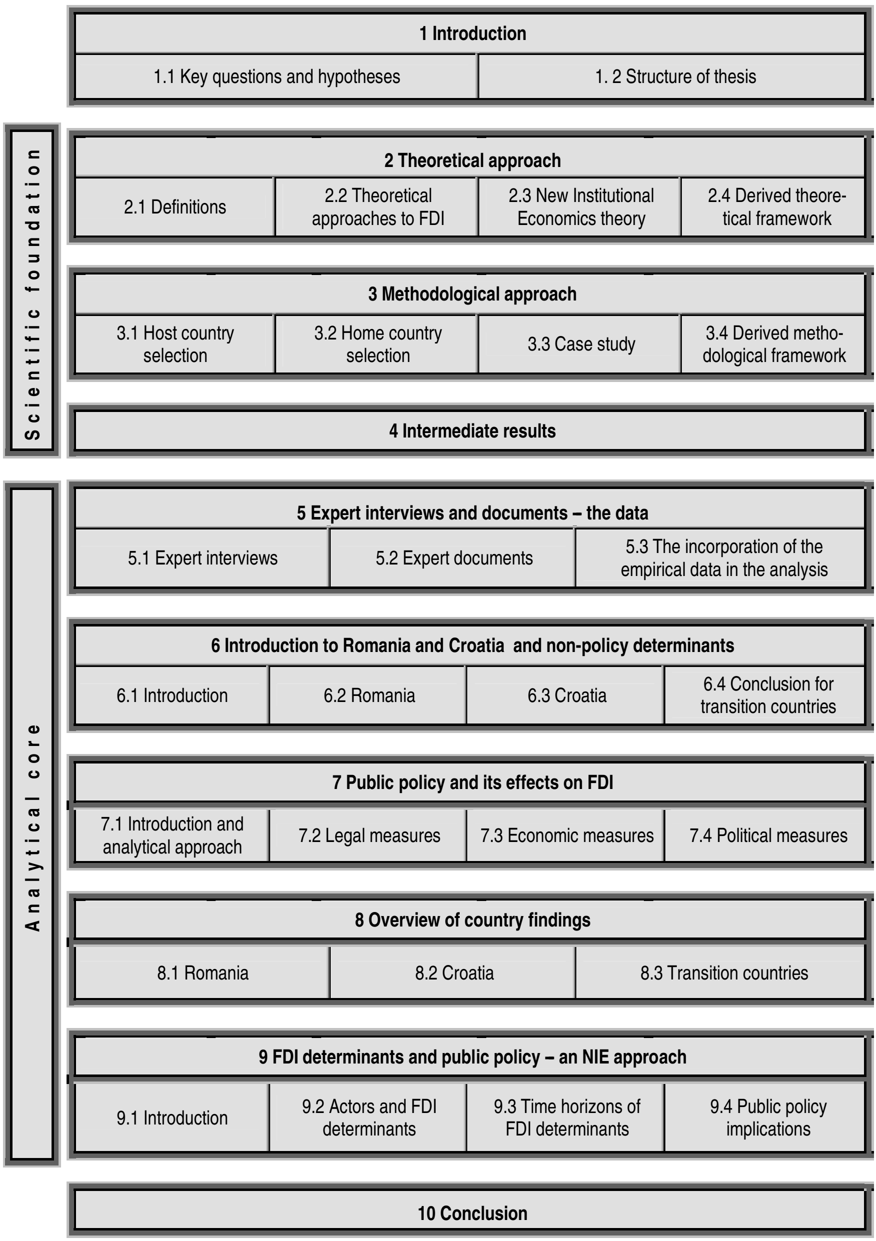
The following section gives an overview of the structure of this thesis that is summarized in *figure 3*. This thesis consists of four parts and nine chapters, each of which includes several sections and subsections. The introduction and conclusion parts (chapters 1 and 10) surround the scientific foundation for this thesis in chapters 2-4 and the analytical core of this thesis that is elaborated in chapters 5-9.

Chapter 1 gave an introduction to the topic of this thesis, developed guiding key questions as well as hypotheses and displays the thesis structure.

In **chapter 2** the theoretical approach is outlined. Key terms are defined and a review of the relevant literature and theories regarding FDI together with the key questions about its effects, occurrences and determinants is given. The NIE theory and its relevance for this thesis are also presented. The last section of this chapter summarizes the theoretical framework that serves as a basis and guideline for the proceeding in this thesis.

Chapter 3 clarifies the methodological approach of this thesis. The selection of Romania and Croatia as host countries for FDIs and the selection of Germany and Austria as MNC home countries – i. e. the countries from which FDI flows to host countries originate – is elucidated. Moreover, it is explained why the case study methodology is well-suited to answer the outlined research questions. The chapter concludes with the set-up of a methodological framework that is used throughout this thesis.

Chapter 4 outlines the intermediate results of the preceding chapters and thus summarizes the scientific foundation of this thesis.



Source: Own presentation.

Figure 3: Structure of thesis

Chapter 5 presents the empirical data – expert interviews and expert documents – and disusses how the data is incorporated in the analyses of the thesis.

Chapter 6 gives an introduction to the economic development of Romania and Croatia since the early 1990s and briefly discusses the non-policy FDI determinants for the two countries in question.

In the main section of this thesis, **chapter 7**, determinants that can be influenced by public policy are studied. Based on the expert interviews and documents as well as under the consideration of secondary literature it is explored how successful Romanian and Croatian public policy state have been since the 1990s in improving the performance of these determinants and what impact these determinant have had on the investment decision of MNCs from Germany and Austria. In a subsequent step insights for transition countries in general are derived for each determinant.

Chapter 8 gives an overview of findings for Romania, Croatia and transition countries in general.

Based on the results of the previous sections, **chapter 9** analyzes FDI determinants using an NIE approach. This chapter establishes several frameworks in order to examine the impact of different public policy actors ("organizations") as well as the relevance of the time horizons for FDI.

Chapter 10 summarizes the findings of the thesis, resumes an assessment of the initial key questions and hypotheses and also gives an outlook of potential research questions for future scholars.

The analyses of this thesis are illustrated by numerous graphs and figures. They are usually based on primary data but contain further evaluations by the author if indicated. Backup sheets for all calculations are available from the author.

2 Theoretical approach

The following chapter elaborates the foundation of the theoretical approach and the line of argumentation of this thesis. To begin with, key terms of this thesis are defined and expounded (*section 2.1*). Subsequently, the current status of FDI theory, especially regarding its four key questions, is reviewed (*section 2.2*). This section also explains why this thesis follows *Siebert's* approach of "locational competition"[25] and pre-selects the country determinants that are to be tested in the empirical part.

Section 2.3 discusses the fundamentals of the New Institutional Economics (NIE) and elaborates why its main ideas can be transfered to the FDI analysis approach used in this thesis. Furthermore, this section shows how the NIE provides a framework to analyze and categorize FDI determinants and its respective actors in a convincing manner.

The final section of this chapter (*section 2.4*) summarizes the theoretical framework based on the FDI theory of locational competition and the NIE. This theoretical framework will be applied to the remaining parts of this thesis.

2.1 Definitions

The subsequent section comprises a definition of the key terms of this thesis – FDI, MNC, public policy, reform, and transition – in order to reach an under-

[25] See Siebert (1996); Siebert (2000); Siebert (2005).

standing of the meaning and the delimitation of these terms in the context of this thesis.

2.1.1 Foreign Direct Investment (FDI)

For the purposes of this thesis, the following aspects should be clarified; (1) a definition, (2) the components, (3) the motives, (4) the forms, and (5) the different measurements of FDI (*see also title)*. The most common sources used in this field by academics and governments are the OECD benchmark definition of FDI[26] and the International Monetary Fund (IMF) balance of payment manual.[27] Despite the existence of these definitions and a considerable harmonization of international FDI statistics in recent years, country-specific differences and recurring problems of governments to provide detailed FDI data remain.[28]

(1) FDIs are **defined** as capital flows from a company that is based in one country and creates, expands or purchases an affiliate abroad. This does not only include the initial but also all subsequent investments.[29]

Investments have to fulfill two criteria in order to be classified as FDI: first of all, FDIs are only shares and acquisitions that involve a **long-term relationship** between a resident entity and a non-resident one.[30] A second precondition for FDIs is the **control** over the investment. Thus, the investor needs to exert "a significant degree of influence on the management of the enterprise resident in the other economy"[31]; a mere financial obligation of the subsidiary is not sufficient to meet the control criteria for FDI.

[26] See OECD (1996a).
[27] See IMF (1993).
[28] See Wolff (2006), p.37; UNCTAD (2005), p.298.
[29] See Krugman and Obstfeld (2005), p.157; IMF (1993); OECD (1996a).
[30] See UNCTAD (2005), p.297; see also IMF (1993) and OECD (1996a).
[31] See *section 2.1.2* for a definition of "significant"; see also UNCTAD (2005), p.297; Krugman and Obstfeld (2005), p.157.

Until the 1960s **Foreign Portfolio Investments** (FPIs) represented the classical idea of foreign investment. FPI, however, signifies the ownership of bonds and other financial assets without the ability to control the issuer of the bond etc. In further contrast to FDI, the goal of FPIs is solely the maximization of interest income through arbitrage in a rather short period of time.[32]

(2) FDI has three **components**: equity capital, reinvested earnings and intra-company loans.

The most common FDI component is **equity capital**. This is defined as the shares purchased by the investor abroad. It includes equity in all branches, subsidiaries and associates as well as other capital contributions abroad that meet the FDI criteria mentioned above.

FDIs can also consist of **earnings** that are not distributed (e. g. as dividends) but **reinvested** in host country activities by the foreign investor.

Finally, **intra-company loans** and debt transactions between parent companies and foreign affiliates are potential FDI components.[33]

(3) Theory generally distinguishes between different **motives** of FDI, the most common ones of which are horizontal and vertical.[34] **Horizontal FDI** aims at the exploration of new markets. The MNC then produces the same or similar products abroad as in the home country.

Vertical FDI, on the other hand, are investments in which parts of the production processes are moved to a different location in order to leverage cost advantages.[35]

[32] See Gokkent (1997); Fischer (1995); Heiduk (2005), p.318.
[33] See UNCTAD (2005), p.297; OECD (2006d), p.6.
[34] See *section 2.2.3.3* for the theoretical background.
[35] See Moosa (2002), pp.4-5.

(4) FDI can occur in different **forms** or **market entry modes**. Therefore, the FDI investment can consist of (a) greenfield investments, (b) acquisitions, (c) privatizations, or (d) other forms of FDI investment.

(a) **Greenfield investments** describe the set-up of new facilities and new affiliates as well as expansions of existing entities in a host country in which the foreign investor possesses partial or complete legal and operational responsibility. A greenfield investment can comprise, for example, a production site but also a sales point or a new call center.[36]

(b) **Acquisitions** or "brownfield investments" refer to the purchase of an existing local company or company part in the host country by a foreign company. Mergers with local companies are also subsumed under this category.[37]

Whether companies decide for a greenfield investment or an acquisition depends on factors such as the degree of its vertical integration, its risk-aversion and the attractiveness of the investment conditions.[38]

(c) **Privatizations** are also acquisitions, the only difference being that the state is the owner of the company being sold. In Eastern Europe privatization has been the most important driver of FDI.[39]

(d) In addition, **other forms** of investment can fulfill the requirements of FDIs. Examples are joint ventures, licensing, franchising, management contracts, marketing contracts, turnkey contracts, international subcontracting deals, production agreements, product sharing, and risk-sharing agreements. In these cases the investor generally gains sufficient control over the management to be defined as foreign direct investor without acquiring equity shares of the foreign company. However, these data often do not appear in the countries'

[36] See UNCTAD (2005), p.36.
[37] See UNCTAD (2005), p.36.
[38] See Görg (2000).
[39] See *sections 6.2* and *6.3* for details; see also Hauser (2005), p.9; Neuhaus (2005), p.15.

FDI statistics.[40]

(5) FDI can be **measured** in different ways depending on the type of FDI and the aim of the analysis. The most common measurements are inflows, outflows and stocks.

FDI inflows (or inward FDI) are defined as the capital provided by an investor to its foreign affiliate. The money can be channeled through the foreign direct investor directly or through related companies. **FDI outflows** (or outward FDI) on the other hand, are known as the activities of affiliates of national firms abroad.[41]

When statistics display **FDI stocks** they usually indicate the accumulated FDI net stock, which is defined as:

net stock year N+1 = (stock year N) + (inflow year N+1) - (outflow year N+1).[42]

This thesis looks at policies that *attract* FDIs (*see title)* and therefore focuses on FDI inflows and stocks without covering the FDI outflows of the analyzed countries.[43]

2.1.2 Multinational Corporation (MNC)

According to the definition of *UNCTAD (2005)* Multinational Corporations (MNCs) (*see also title)* "are incorporated or unincorporated enterprises comprising parent enterprises and their foreign affiliates"[44]. This generally means

[40] See Blomström (2002), p.168; Cho (2003), p.109; UNCTAD (2005), p.298.
[41] See UNCTAD (2005), p.297; Jaklič and Rojec (2005), p.9.
[42] See also UNCTAD (2005), p.298 for a more detailed definition.
[43] See Globerman and Shapiro (1999), p.514.
[44] See UNCTAD (2005), p.297.

that the parent company, the foreign investor, holds **at least 10%** of the **ordinary shares** or of the **voting power** of the enterprise in the host country.[45]

The foreign affiliates of the MNC can have different forms and names depending on the influence of the investor. The most common forms of foreign affiliates are the **branch** that is fully controlled by the investor, the **subsidiary** in which the parent company has majority rights and the **associate** in which the parent company possesses more than 10% but not more than 50% of the voting power or shares respectively.[46] Subsidiaries or branches that invest abroad themselves can be foreign-controlled companies and foreign investors at the same time.[47] The literature has created several synonyms for companies with activities abroad, including “Transnational Corporations”, “Multinational Enterprises” and MNCs; this thesis exclusively uses the term MNC.

2.1.3 Public policy

When dealing with the term “public policy” *(see also title)*, three dimensions are important to elucidate: (1) a general definition of the term, (2) the forms of public policy and the (3) potential actors of public policy.

(1) In political science public policy is a **general term for decisions and actions taken by state institutions**.[48] Throughout this thesis public policy is also comprehended in a broad and general sense as well implying all direct and indirect measures that are apt to *influence* the conditions for FDIs.

(2) Public policies are divided into (a) legal (b) economic and (c) political measures in this thesis.[49]

[45] See IMF (1993), p.86.
[46] See UNCTAD (2005), p.297.
[47] See Krugman and Obstfeld (2005), pp.157-159.
[48] See Schmidt (2004b), p.535.
[49] See also Chandler and Plano (1988), p.107.

(a) **Legal** measures represents the regulatory dimension of public policy. It comprises law-making but also – in a broader sense – the actions of central and local authorities as well as law enforcement (the work of courts).

(b) **Economic** measures are mainly distributive and redistributive policies that imply the reallocation of money (through taxation for example) or goods (through privatization for example).

(c) **Political** measures consist of constituent policies that aim at the protection of national interests (e. g. foreign policy), the modification of national goods (such as human capital) or operations (for example through the combat of corruption).[50]

(3) **Policy makers** can be governments and all institutions that are entitled to take decisions that are valid for the whole state and its entities.[51] Institutions can be the parliament, ministries, administrations and other state organs such as courts and central banks as well as state agencies.[52] In the specific context of this thesis this term can also include local authorities as well as agencies closely connected to state objectives (e. g. chambers of commerce) despite being private or semi-private institutions. The FDI analysis shows that – as also pointed out in political theory research – the distinction between public and private spheres is arbitrary[53]; nevertheless it is based on the question who could influence public policy or, in the context of this thesis, the conditions for the investment decision of MNCs. In this thesis the makers of public policy are either called by their actual function or referred to more generally as "the state".

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[50] See for this whole section Schmidt (2004b), p.535; Chandler and Plano (1988), pp.107-108.

[51] See Schmidt (2004b), p.535.

[52] See Nohlen, Schultze, and Schüttemeyer (1998), pp.615-616; Chandler and Plano (1988), pp.107-108.

[53] See Robertson (2002), pp.411-412.

2.1.4 Reform

The definition of reform can be broken down into (1) the explanation of the term and its delimitation to "public policy" and (2) the different dimensions of reform.

(1) **"Reform"** *(see also title)* is according to political science theory, the deliberate and planned *change* of a part of policy perceived as deficient. Reform has a more active connotation than public policy, implying *change* rather than just *influence*.[54]

In the specific context of Eastern Europe reforms are attempts to reduce the gulf separating living standards from those in Western Europe.[55] More specifically, reform is understood in this thesis as the change of the legal, economic and political situation of a country that has an impact on the conditions for FDI.

(2) Reference has also been made to different **categories of reform** intensity. In particular, a socialistic reform with revolutionary implications, an evolutionary change of significant parts of the economic and social system, and finally, a gradual modernization should be seen as distinctive categories.[56]

Today the category of socialistic reform has ceased to represent an option for most EECs. The second category, of **change of systems** was accomplished in most EECs until the end of the 1990s and is analyzed in this thesis together with the third category, the current **modernization** efforts of the last five to ten years.

[54] See Nohlen, Schultze, and Schüttemeyer (1998), pp.543-544; Collin (1997), p.239.
[55] See Emerson and Noutcheva (2004); Brada, Kutan, and Yigit (2003); Falcetti, Lysenko, and Sanfey (2005).
[56] See Schmidt (2004b), p.597.

2.1.5 Transition

This thesis deals with FDIs in countries in transition. In political theory transition is understood as process of countries moving from an **authoritarian regime towards a democracy**.[57] Political scientists and especially economists often use the term specifically for former communist countries where transition does not only imply political change but also the development from a centrally-planned to a market economy.[58]

International organizations usually define transition countries (also called "transition economies") as a third group of countries in addition to "developed" and "developing" countries.[59] Transition countries have traditionally been divided into four country groups: Central and Eastern European Countries (CEECs), Southern and Eastern European Countries (SEECs), Commonwealth of Independent States (CIS), and Asian transition countries. The CEECs usually comprise the Baltic republics, Czech Republic, Hungary, Poland, Slovakia, and Slovenia. The SEEC group usually consists of Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Macedonia, Montenegro, Romania, and Serbia. The CIS is defined as the twelve non-Baltic countries that emanated from the Soviet Union. The definition for Asian countries strongly differs but always comprises China and Vietnam.[60]

Recent studies have further narrowed down the term "transition country" because of the rapid political and economic development in some former communist countries, namely in Eastern Europe and Eastern Asia. Thus in its World Investment Report 2006 *UNCTAD* regards only the non-EU countries in Eastern Europe and the CIS members as transition economies.[61]

[57] See Nohlen and Schultze (2004), pp.1000-1001.
[58] See Campos and Kinoshita (2003), pp.1 and 8; Resmini (2006), p.2.
[59] See e. g. UNCTAD (2006), p.II; Andreff (2003).
[60] See for definition e. g. Zakharov and Kušić (2003); Murrell (2002).
[61] See UNCTAD (2006), p.II and p.79.

It certainly seems reasonable to exclude from the transition definition those countries that have shown a quite different development path, e. g. semi-communist countries in Asia like China and Vietnam. Nevertheless, this thesis regards ***all*** **Eastern European and CIS countries as transition countries** since it analyzes developments from the early 1990s up to now and therefore comprises a period in which these countries were clearly in a state of transition.

2.2 Theoretical and empirical approaches to FDI

Despite a vast number of publications, there is no comprehensive theory of FDI. In fact only very few theoretical FDI models exist in Economics (e. g. derived from Trade Theory) and International Business. The main reason for this is that FDI flows are complex and show strong interdependences with other external factors and are therefore difficult to explain in a full-fledged model.[62]

Due to these problems researchers tend to ask specific questions instead in order to explain FDI. The four key questions in this context are[63]:

- What are the effects of FDI on the home country? *(section 2.2.1*)
- What are the effects of FDI on the host country? *(section 2.2.2*)
- Why do FDIs occur? *(section 2.2.3*)
- What are the determinants of MNCs for a specific country? *(section 2.2.4*)

While the last question regarding the FDI determinants is the most decisive one for this thesis, the status of the other research questions is also important

[62] See Heiduk (2005), p.318.
[63] See Barba Navaretti and Venables (2004), pp.15-18; Blonigen (2005); Reker (2003), p.4; Buch and Lipponer (2005), p.2.

for policy makers and companies; therefore, these questions are also reviewed in the following section as far as they are important for answering the questions of this thesis. Moreover, the literature on FDI is far too extensive for a comprehensive review. Thus only those research results that are essential for the theoretical and methodological approach of this thesis are taken into account. This chapter closes by considering the possible contributions to FDI research of this thesis (*section* 2.2.5).

2.2.1 Effects of FDIs on home countries

It is important for governments to know if the investments of their domestic companies that take place abroad are harmful to their home economies. The answer to this question is also essential for potential foreign direct investors since negative effects of outward FDIs could increase political and social pressure on companies not to invest abroad.[64]

The potential effects of outward FDI about which home country governments seem particularly concerned are (1) employment, (2) wage level, (3) productivity, (4) technology, and (5) national politics.[65] Lastly, (6) the net effects and potential problems in this field of research are elucidated. Since this thesis focuses on FDIs by MNCs from Germany and Austria[66], this section exclusively covers home country effects in developed economies.

The most comprehensive overviews of effects of outward FDI on home economies are provided by *Kokko (2006)*, *Lipsey (2002)* and *UNCTAD (2006).*

(1) The representatives of a skeptical view of the effects of FDIs worry most about a negative impact on home **employment**, since they expect that a

[64] See Kokko (2006), pp.1 and 18; Nunnenkamp (2006).
[65] See Kokko (2006), p.2; UNCTAD (2006), p.169.
[66] See *section 3.2* for details.

relocation of production to newly established plants in low-wage countries will result into job losses in the parent company. Therefore sourcing and production of labor-intense work in low-cost countries can lead, e. g. according to the head of the German IFO institute Sinn, to a "bazar economy" and an erosion of the home job market in developed countries like Germany.[67]

However, most empirical studies have shown a less dramatic and more encouraging picture. U.S. research has only found a very small negative employment effect in the parent company following FDI activities of American MNCs.[68] On the contrary, studies for Sweden[69], Italy[70], Japan[71], and Germany[72] have shown that MNCs with more foreign activities even tend to increase employment in the parent company. Possible explanations are a higher labor demand for the steering of the new foreign operations from the parent company.[73] Moreover, *Nunnenkamp (2006)* showed that even FDIs aimed at production cost optimization can have positive employment effects on the home economy in the long-run because they can strengthen the competitiveness of the whole industry.

However, other studies have also shown that the employment effects on the home economy depend on the industry in question. Thus, manufacturing projects abroad are more likely to lead to job losses at home than service projects which tend to show positive employment effects.[74] At the same time empiric analyses have clarified that overall employment in advanced economies has not suffered from outward FDI despite industry-specific differences. The main reason is that in most developed economies the share of services exceeds

[67] See Sinn (2005).
[68] See Brainard and Riker (1997).
[69] See Blomström, Fors, and Lipsey (1997).
[70] See Federico and Minerva (2005).
[71] See Lipsey, Ramstetter, and Blomström (2000).
[72] See Nunnenkamp (2006).
[73] See Kokko (2006), p.13.
[74] See Kokko (2006), p.1.

that of the manufacturing industry and has even risen in recent years.[75] Thus *Sinn's* image of Germany as a "bazar economy" does not reflect the present situation of developed economies as a whole.[76]

(2) Critics of FDIs further argue that MNC activities abroad lead to lower **wages** in the parent company as well as in the overall home economy, since lower-skilled workers then have to compete with blue-collar workers in low-wage countries.[77] The empirical insights from the literature regarding these aspects are scarce.[78] Most of the available studies have only confirmed that the *relative* wage level of lower-skilled workers to the average wage does indeed seem to deteriorate in home countries following FDIs. More precisely, MNCs' investments abroad seem to cause salaries of high-skilled workers in the parent company to rise while wages of low-skilled workers in the home countries tend to stagnate.[79]

(3) In addition to this, home countries and scholars have asked how home **productivity** changes due to MNC activities. The number of studies that show robust results on productivity changes within home countries is still limited.[80] *Kokko (2006)* summarizes the current findings of research by stating that FDI appears to improve productivity in home economies in the long-run, while the short-term development of productivity is dependent on where the investments of the MNCs go to and in what economic condition the home country is.[81]

[75] See Horn and Behncke (2004).
[76] See also Belke, Mattes, and Wang (2007).
[77] See Slaughter (1995).
[78] See Nunnenkamp (2006).
[79] See Feenstra and Hanson (1996); Kravis and Lipsey (1988); Nunnenkamp (2006).
[80] See Nunnenkamp (2006); for Germany: Jäckle (2006).
[81] See Kokko (2006), p.17 and ibid. for more references.

(4) Another concern of home countries may be that the surging number of offshored **research and development** (R&D) activities may lead to the loss of technological knowledge in the home country.[82]

Empirical data however, shows that MNCs rarely shut down their R&D activities in the parent company entirely and that the relative share of offshoring on the global R&D expenses is still marginal. Therefore a loss of technological skills in the home country seems currently unlikely in most industries.[83] On the contrary, technological spillovers to the home country seem to prevail because MNCs absorb know-how from other (especially foreign) companies due to their operations abroad, e. g. through imitation of production processes, involvement in business associations and the enticing of high-skilled employees from other MNCs.[84]

(5) Home country governments may also be concerned that outward FDIs could increase pressure on **national politics**. This could be the case when MNCs threaten to invest abroad if the home country conditions are not altered to their advantage and the government gives in to the requests of the companies because it fears job losses, lower tax revenues and – in the end – fewer votes. Thus the increased pressure on governments could lead to a loss of political autonomy and a "race to the bottom" for better conditions for MNCs among home countries.[85]

However, these concerns do not reflect the findings from empirical analyses. Studies have focused on areas where MNCs may influence governments, e. g.

[82] See UNCTAD (2005), p.195.
[83] See UNCTAD (2005), pp.195 and 197; Kokko (2006), p.19.
[84] For Sweden see Globerman, Kokko, and Sjöholm (2000); for Italy see Falzoni and Grasseni (2005).
[85] See e. g. Rauscher (1995).

on labor and environment regulations as well as on taxes and found that the actual impact of these attempts is marginal both in the U.S. and in the EU.[86]

One reason may be that MNCs, especially in developed countries, see fewer chances of influencing home country administration to their advantage. On the contrary, they may hope to be more successful in influencing the host country of their investment and thus improving investment conditions abroad since competition may be less intense and administration may be (in some less developed countries) easier to persuade regarding the requests of the MNCs than in their home economies.[87]

(6) Overall, the negative tone of many public debates concerning the **net effects** of outward FDI on home economies does not seem to be justified. Especially outside the U.S. FDIs seem to have little or even a slightly positive impact on the economies of developed countries. On the bottom line home economies tend rather to benefit from MNC activities abroad, especially in terms of employment, rising wages for higher-skilled workers and sometimes even higher technological know-how. In addition to this, the net effect of outward FDI tends to be less significant than often proclaimed in the public debate, maybe because FDIs are not usually accompanied by an outflow of profits, technological skills or even the shut down of domestic production. Finally, net effects may also be softened because the insourcing of goods and especially services in developed nations is still higher than the outsourcing.[88]

The most apparent negative impact is the deterioration of the relative wage level of the low-skilled workers in the home country. Furthermore, the increasing number of R&D centers opened by Western European and American

[86] See Kokko (2006), p.22 and see Desai, Foley, and Hines (2006); Mendoza and Tesar (2005).
[87] See Kokko (2006), pp.18 and 20-21 with similar explanations.
[88] See Amiti and Wei (2004), p.20; Kokko (2006), pp.23-24 and 30; UNCTAD (2006), p.183.

companies in low-cost countries in Eastern Europe and Asia demonstrates that FDI and globalization in general tend to generate greater competition for all employees in developed countries. Other negative effects of outward FDIs depend, e. g. on the business conditions in the home and the host economy, the size of the home country and its political stability.[89]

Nevertheless, home countries seem to have become less worried about MNC activities and have lifted many restrictions on outward FDIs since the end of the 1980s.[90] This thesis thus presumes that home country effects do not represent a major (negative) driver for FDI country determinants or host country investment policy.

2.2.2 Effects of FDIs on host countries

Only if host countries can expect positive benefits for their countries from the inflow of FDI will they actively support policies that improve investment conditions.[91] Thus a knowledge of the overall effects of FDIs is essential for host countries as well as for this thesis.

The effects of FDI on host economies have been a key subject for FDI researchers and a large range of factors has been analyzed so far. Among the effects of FDI in the host countries that have frequently been discussed are the ones on (1) technology and training, (2) productivity and GDP growth, (3) employment, (4) wages, and (5) trade. Finally, this section discusses (6) the overall net effect of FDIs on host economies.

The most important sources for the factor selection are *Lipsey (2002), Moosa (2002)* and *UNCTAD (2006)* that also offer good overviews of the current status of this field of research.

[89] See UNCTAD (2006), p.169; Kokko (2006), pp.1, 11, 14, and 20.
[90] See Rübel (2004), p.179; Kokko (2006), pp.21 and 25-27.
[91] See Lipsey (2002), p.6.

This subsection reviews what the theory says about FDI effects, how MNCs perform in comparison to domestic firms, whether spillover effects from foreign to domestic companies exist and how significant they are. In this context special attention is drawn to findings on Eastern Europe.

(1) Neo-classical theory expects MNCs to have more advanced **technologies**, provide good **training** for their employees and thus generate positive spillovers for the entire host economy.[92]

Empirical evidence, which has also been confirmed for Eastern Europe, shows that foreign companies use more state-of-the-art technologies (in the host country) than their domestic competitors and provide more and better training for their employees.[93] One important reason is that MNCs tend to be larger and thus use high technology equipment to leverage economies of scale. MNCs also tend to set up new operation facilities. Both factors also lead to extensive training efforts of the employees by the MNCs.[94]

Many theoretical studies see technology and training as the two most important spillover effects for the host country. Important reasons seem to be that access to modern technology becomes easier for domestic companies through imitation, turnover of better-trained employees as well as through linkages to suppliers and distributors.[95] From an empirical point of view technological spillovers to domestic companies are possible but the evidence is not very clear so far and the impact appears to be smaller than expected by theorists. Thus the greatest positive spillover effects seem to materialize if the technology gap between foreign and domestic firms is rather small.[96] One example in Eastern Europe is the car industry; it has been shown with Volkswagen in the Czech

[92] See Moosa (2002), p.86.
[93] See Lipsey (2002), pp.36-39; Hunya and Geishecker (2005), p.26.
[94] See UNCTAD (2006), pp.183 and 193.
[95] See UNCTAD (2006), pp.184 and 188; Kinoshita (2001); Nunnenkamp (2006).
[96] See Maennig and Wilfling (1998), p.299; UNCTAD (2006), p.188.

Republic that FDI leads to a modernization of the sub-contractors as well as of the suppliers.[97]

Taking the positive effects of MNCs and small but positive effects from spillovers to domestic companies into account, it is not surprising that studies find, also for Eastern Europe, positive net effects of FDI for host countries as a whole leading to a higher "technologization" and an "upgrading (of) human capital"[98].

(2) Given their superiority in terms of technology and training, the theory also expects MNCs to provide higher **productivity**[99] for themselves as well as for the host economy as a whole.[100] Theory and policy makers also expect productivity gains to lead to GDP growth in the host countries.

MNCs do indeed show higher productivity than domestic firms due to higher efficiency, mostly through better technology. Other reasons are a higher capital intensity and a larger scale of production in MNC plants.[101] Among OECD countries the productivity of foreign companies in the manufacturing industry exceeds the industry average in the host country by 30%. In Eastern Europe the productivity gap seems to be even greater since MNCs tend to have better capital endowment, management, technology, and better access to international markets.[102]

However, evidence for spillovers to local firms' productivity is mixed. Positive effects may occur and may even be substantial, but quantification is difficult.[103] Positive effects seem to increase with local capability and competition, while

[97] See Zakharov and Kušić (2003), p.7.
[98] Klein, Aaron, and Hadjimichael (2001), p.2; see also Hunya and Geishecker (2005), p.26; Walkenhorst (2000).
[99] Most studies define productivity as output per capital input; see Lipsey (2002), p.35.
[100] See Dunning (1993), pp.372-374 and 287-290.
[101] See Caves (1996); Lipsey (2002), pp.34-35 and 40; Klein, Aaron, and Hadjimichael (2001), p.4.
[102] See OECD (1996b); Hunya and Geishecker (2005), p.10.
[103] See Blomström and Kokko (1998), p.24; Lipsey (2002), pp.45-46.

several studies have shown that productivity of domestic companies may even deteriorate in the short-term.[104] With regards to Eastern Europe *Hunya and Geishecker (2005)* have identified positive spillovers to domestic companies after several years of transition.[105]

Overall, FDI appears to enhance net productivity in the recipient economy, but little research has been conducted in this direction so far.[106] Eastern Europe studies on the manufacturing sector[107] and on the host economy as a whole[108] show that FDI has promoted overall efficiency increases. However, the impact seems to depend on the amount of FDI and the stage of the transition process.[109]

The theory clearly states a correlation between FDI inflow and **GDP growth**.[110] Most empirical studies also state that FDI stimulates growth but the evidence is far from clear[111], since some analyses have found only little impact or even negative growth rates. Negative growth rates could stem from a crowding out of domestic competition, but overall these appear to be temporary and go on to cause the evolution of new and more competitive industries. In the long-run, the economic growth of host countries can also be indirectly boosted by the creation of forward and backward linkages (sales organizations and suppliers respectively).[112]

However, most studies emphasize that certain preconditions have to be met by the host country in order to materialize growth effects of FDI inflow. The

[104] See Hanson (2001), p.14; Blomström and Kokko (1998).
[105] See Hunya and Geishecker (2005), p.4.
[106] See Lipsey (2002), p.59; Klein, Aaron, and Hadjimichael (2001), p.4; Borensztein, de Gregorio, and Lee (1995).
[107] See Barrell and Holland (2000).
[108] See Hunya and Geishecker (2005), p.26.
[109] See Skudar (2004), p.9.
[110] See Fillat Castejón and Wörz (2006), p.3.
[111] See Lipsey (2002), p.55; de Mello (1999); Lipsey (2000).
[112] See Fillat Castejón and Wörz (2006), p.3; UNCTAD (2006), p.183; Maennig and Wilfling (1998), p.294.

most important of these are: a minimum level and amount of human capital, a minimum degree of openness of the host economy, only a limited technological gap between home and host country and a sufficient degree of development of financial markets.[113]

Only few analyses reveal however, to what extent these preconditions are complementary or substitutional. Nevertheless, it overall seems that the growth effects are more substantial in countries in earlier development stages and in more labor-intensive industries.[114]

There is significant evidence that FDI has promoted growth in Eastern Europe. In fact, according to *Neuhaus (2005)*, FDI inflow was the most important growth driver in EECs 1994-2003, contributing 74% to total GDP growth. *Figure 4* shows that this correlation is especially true for Romania, Bulgaria, Poland, and Croatia.[115]

Nevertheless, the causality of growth versus FDI inflow is not absolutely clear since models cannot determine to what extent GDP growth stimulates FDI inflows and vice versa.[116]

(3) Many host governments are concerned about the impact of FDI on **employment**.[117] The theory highlights that FDI can influence employment in many direct and indirect ways. Overall, the theory suggests that a potentially higher employment in foreign affiliates of MNCs may have a positive multiplier effect on the whole economy.[118]

[113] See Krüger and Ahlfeld (2005), p.11; Borensztein, de Gregorio, and Lee (1995); Fillat Castejón and Wörz (2006), p.10; Bhagwati (1978); Balasubramanyam, Salisu, and Sapsford (1996); de Mello (1997); Alfaro, Chanda, Kalemli-Ozcan, and Sayek (2001).
[114] See Fillat Castejón and Wörz (2006); Nunnenkamp and Spatz (2004); Lipsey (2002).
[115] See Neuhaus (2005); see also: Campos and Kinoshita (2002).
[116] See Hunya and Geishecker (2005), p.3.
[117] See Moosa (2002), p.78.
[118] See UNCTAD (2006), p.183.

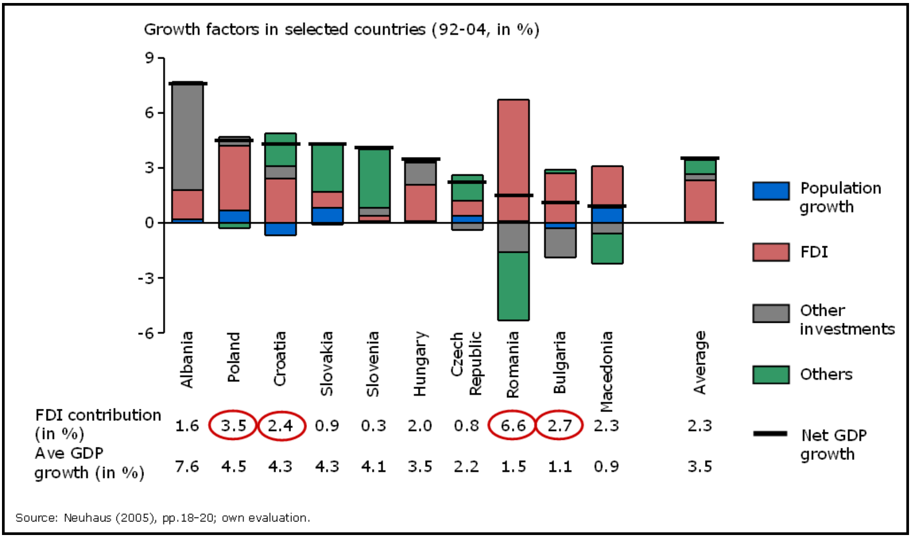

Figure 4: FDI contribution to GDP growth in Eastern Europe

With respect to **direct effects**, country studies underline the fact that the job impact of FDI depends on the type of investment and the period of analysis. In particular in Eastern Europe privatization and the subsequent restructuring of formerly state-owned enterprises often resulted in (temporary) employment decreases in the MNCs.[119] In contrast to this, greenfield investments – despite an only moderate impact on employment on a global scale – had a significant job-creating effect in Eastern Europe even in the short-run.[120]

Looking at **indirect effects**, the crowding out of domestic competition and consequent job losses in domestic firms have been identified as a common effect, also in Eastern Europe, where especially domestic small and medium enterprises (SMEs) could not survive against larger and technologically more advanced foreign market players. However, analyses have shown that domestic players

[119] See Hunya and Geishecker (2005), pp.6-7; Kalotay and Hunya (2000); UNCTAD (2004b), p.137.
[120] See UNCTAD (2006), p.192; Hunya and Geishecker (2005), pp.7 and 25.

usually steer towards other industry segments in the longer run and also build up employment themselves.[121]

The most important positive long-term impulse for employment growth seems to be located in other steps of the value chain following an FDI investment. Analogous to the FDI impact on growth, the creation of sustainable employment mainly appears to stem from suppliers and distributors of the MNCs.[122]

When measuring the net effect of FDI on employment it becomes obvious that job creation and job destruction is a dynamic and multi-faceted process. Nonetheless, global quantitative net effects of FDI on employment seem to be positive, albeit rather modest. They tend to be strongest in countries in development and transition and more significant in the (labor-intensive) manufacturing sector than in other sectors.[123] Finally, *Hunya and Geishecker (2005)* have shown for Eastern Europe that FDI also changes the employment structure of host economies, e. g. by lowering the demand for medium-skilled employees.[124]

(4) Various studies have analyzed the effect of FDIs on the **wages** of the host economy. The theory predicts a wage increase in MNCs, domestic companies and, therefore, also in the host economy.[125]

Regarding the empirical findings on the remuneration in MNCs *Lipsey (2002)* concludes: "The evidence seems to me overwhelming that foreign-owned firms in all kinds of economies pay higher wages than domestically-owned firms."[126]

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[121] See Maennig and Wilfling (1998), p.294; Hunya and Geishecker (2005), p.7.
[122] See UNCTAD (1996), pp.166-168; Cluse (1999), pp.98-102; Hunya and Geishecker (2005), pp.7-8.
[123] See UNCTAD (2006), p.192; UNCTAD (2004b), p.137.
[124] See Hunya and Geishecker (2005), p.25.
[125] See Moosa (2002), p.81.
[126] Lipsey (2002), p.29; see also UNCTAD (2006), p.192.

The literature gives many reasons for higher MNC wages. These include the MNCs' eagerness to attract the most capable workers, pressure from the host country, attempts of MNCs to avoid a high employee turnover, the limited market knowledge of MNCs, and MNCs' tendency to focus on activities in higher-wage sectors.[127] For Eastern Europe it has been pointed out, furthermore, that it is primarily the younger generation (aged below 25 years) which benefits from higher wages while older and unskilled employees face stagnating salaries or are not even hired by MNCs.[128]

The knowledge regarding spillover effects of higher MNC wages on domestic firms is vague and results of country studies are mixed.[129] Nevertheless, *Lipsey (2002)* sees enough indications from research to conclude that, in the long-run, wage spillover is positive.[130]

Overall, FDIs tend to increase the wage level in the host country even though augmentations of wage inequalities have been identified in some studies as well. However, results differ across industries and countries as empirical studies in Eastern Europe and for developing countries have shown.[131]

(5) Various researchers have investigated with mixed results, whether FDI and **trade** are complements or substitutes.[132]

Empirics demonstrate that foreign firms tend to export more than their domestic competitors. MNCs' activities abroad already indicate their tendency toward international business and they usually focus more on export-oriented

[127] See UNCTAD (2006), p.194; Lipsey (2002), pp.20-24 and 57.
[128] See Hunya and Geishecker (2005), pp.11, 22 and 26.
[129] See Crespo Cuaresma, Fillat Castejón, and Silgoner (2006), p.5; Lipsey (2002), pp.57-58.
[130] See Lipsey (2002), p.32.
[131] See Feenstra and Hanson (1996); UNCTAD (2006), p.194; Crespo Cuaresma, Fillat Castejón, and Silgoner (2006), p.5; Klein, Aaron, and Hadjimichael (2001), p.3; Maennig and Wilfling (1998), pp.296-297.
[132] See Moosa (2002), pp.84-85.

industries and also have better access to international markets than domestic firms.[133]

The spillover effect on domestic companies is less-well documented. Even though various studies found that FDI also increases the export of domestic firms[134], other authors point out that spillovers depend on the type of investment (horizontal or vertical FDI) and can sometimes even be negative.[135]

At least in the medium- or long-run the overall net effect of FDI on trade and therefore on the balance of payment appears to be positive, as most authors have reported.[136] Thus FDI and trade seem to be complements rather than substitutes. The degree of the impact, however, depends on country- and industry-specific differences as well as on the motives of FDI.[137]

(6) According to the neo-classical model, the host economy **net effects** of FDI should be clearly positive.[138]

FDI affects host countries in numerous ways and according to the majority of empirical literature in a positive fashion.[139] Studies have shown that FDI can speed up the change in economic and competitive structure. By and large it seems that developing and transition countries benefit the most from FDI.[140] For Eastern Europe *Hunya and Geishecker (2005)* have summarized that FDI has accelerated the transition process since foreign investors played a decisive role in strengthening the private sector (e. g. through privatizations), promoting market-economy behavior, modifying their economic and industrial structure

[133] See Klein, Aaron, and Hadjimichael (2001), p.5; Lipsey (2002), p.53.
[134] See e. g. Aitken, Hanson, and Harrison (1997).
[135] See Moosa (2002), p.86.
[136] See Enderwick (2005), p.104; Maennig and Wilfling (1998), p.295; Lipsey (2002), p.54.
[137] See Blonigen (1999); Blomström and Kokko (1996); UNCTAD (2006), pp.189-190.
[138] See Moosa (2002), pp.69 and 98.
[139] See UNCTAD (2006), p.183; Hanson (2001), p.13.
[140] See Klein, Aaron, and Hadjimichael (2001), p.5; Enderwick (2005), pp.104 and 106; UNCTAD (2006), p.183; Moosa (2002), p.92; Bevan and Estrin (2000); Neuhaus (2005); Hunya and Geishecker (2005), p.6.

(e. g. through greenfield investments), introducing new industries, and opening host economies to international markets.[141]

However, in order to materialize positive effects from FDI, host countries need to offer conditions such as adequate property and competition rights, a minimum of investor protection and supporting measures for struggling domestic players.[142] Moreover, the intensity of the impact depends on the entry time of the MNCs, the type and the amount of investment, the technology used, the industry in question, and various host country characteristics.[143]

These preconditions are also necessary in order to avoid potential negative net effects such as the creation or strengthening of monopolistic structures by MNCs.[144] Furthermore, FDI could cause a crowding out of inland investments; small or less productive domestic companies in particular, may have to restructure or even shut down.[145] With respect to Eastern Europe, domestic firms suffered heavily in terms of output and employment, even though in the long-run “firms became more efficient and resistant to subsequent competitive pressure”.[146]

Nevertheless, positive net effects for economies seem to dominate. The single as well as net effects of FDI on host economies and in particular in Eastern Europe are summarized in *figure 5*.[147] This shows that MNCs clearly outperform their domestic competitors in almost all analyzed factors. The direct effect on domestic companies seems to be limited, but spillovers tend to create posi-

[141] See Hunya and Geishecker (2005); see also Barrell and Holland (2000); Moosa (2002), p.92; Zakharov and Kušić (2003), p.2; Lipsey (2002), pp.59-60.
[142] See Klein, Aaron, and Hadjimichael (2001), pp.2-3; UNCTAD (2004b), p.139.
[143] See UNCTAD (2006), p.183.
[144] See UNCTAD (2006), p.195; Moosa (2002), p.92.
[145] See Lipsey (2002), p.58; Neuhaus (2005), p.19; UNCTAD (2004b), p.132.
[146] Hunya and Geishecker (2005), p.4.
[147] As mentioned before the analyzed effects only represent a selection of the most important factors. Thus, the row “net effect” does not show an average of the effects discussed but the overall effect (including other effects) of FDI on host economies as identified by researchers.

Summary of empirical finding of host country effects of FDI

Category	MNC performance vs. domestic firms	Spillovers to domestic firms	Net effect	Net effect for Eastern Europe
Technology & training	**++**	+	+	+
Productivity & growth	**++**	+	+	++
Employment	0	+	+	+
Wages	**++**	+	+	+
Trade	**+**	0	+	+
Net effect	**++**	+	+	++

-- = rather large negative effect
- = rather small negative effect
0 = marginal effect
+ = rather small positive effect
++ = rather large positive effect
bold = strong empirical evidence

Source: Author's concept

Figure 5: Summary of host country effects

tive forward and backward linkages through multipliers in the host economies, particularly in the case of Eastern Europe.[148]

However, the economic impact of FDI on the host country is almost impossible to measure in quantitative terms, especially because counter-factual activities and interdependent factors cannot easily be captured. Therefore, some empirical studies may actually overestimate the positive effects of FDI by neglecting the endogeneity of FDI, especially regarding growth, employment and wage effects that also influence FDI inflows themselves; Eastern Europe, for example, may have been attractive for foreign investors as a low-labor cost region. However, both reform efforts towards EU accession as well as the increasing demand for labor have contributed to rising labor costs in recent years. Thus FDI and other external effects may actually lead to less attractive

[148] See e. g. Hunya and Geishecker (2005).

investment conditions in the long-run.[149]

In conclusion and despite some methodological doubts, the positive contribution of FDI on host countries seems to outweigh the negative effects. The continuous liberalization of FDI regulations also suggests that governments "consider it potentially beneficial for achieving their development objectives"[150]. The policies to attract FDI therefore seem a rewarding subject to study, both for public policy makers and this thesis. Finally, the last two sections on home and host country effects have shown that FDI is not a zero-sum game. On the contrary, many of the areas that have been studied, such as technology and employment, indicate that both home and host countries benefit from FDI.

2.2.3 Why do FDIs occur?

The previous section stated that MNCs tend to perform better than domestic players. This aspect however, is not sufficient to explain why companies become MNCs in the first place, since they may show superior performance in their home countries as well. It is also important for this thesis to understand why companies choose to open up subsidiaries or build a plant instead of serving the market by exporting or licensing arrangements.[151]

As stated above, no general FDI theory exists. Furthermore, the theory of MNCs is "still in its infancy"[152]. Traditionally, economists explained FDI and MNC activities with the classical trade theory (*section 2.2.3.1*). Not until the 1960s did (mainly International Business) economists develop new MNC theories, summarized in *section 2.2.3.2*. The New Trade Theory (*section 2.2.3.3*) has also attempted to integrate new insights and developments in international

[149] See The Economist (2004); UNCTAD (2006), p.184; Heiduk (2005), p.353; Nunnenkamp (2006), p.11; Moosa (2002), pp.68-71 and 78; Reker (2003), pp.25-26.
[150] UNCTAD (2004b), p.123; see also Müller (2005), pp.135-136.
[151] See Blonigen (2005), p.2.
[152] Krugman and Obstfeld (2005), p.161; see also Johnson (2005), p.17; Rübel (2004), p.179.

financial flows into comprehensive models that extend the classical trade theory. Most issues discussed in these theories are valid for the study of MNC in general, including MNC activities in transition economies. Particular insights regarding Eastern Europe are highlighted in the subsequent sections where available. A short conclusion is provided in *section 2.2.3.4*.

2.2.3.1 Classical Trade Theory

The **classical mode** of explaining FDI has its roots in the works of *Adam Smith*[153] and *David Ricardo*[154] who first recognized the advantages of production specialization and who established early models of trade movements. However, their models assume production factor immobility which excludes FDI by definition.[155]

The **neo-classical Trade Theory** extended these early studies that had been based on goods trade to capital flows. This so-called "differential rate of return theory" is based on the Heckscher-Ohlin theorem[156] and asserts that capital will flow from capital-abundant countries (with expected low financial returns) to countries with relatively little capital (with expected high financial returns). Thus, FDI occurs in countries with higher returns as a result of arbitrage. Empirical trade research showed on the basis of U.S. data that U.S. firms had higher returns abroad than at home.[157]

While the differential rate of return theory found many supporters in the 1950s, this approach has been rigorously contested since the 1960s. Especially International Business scholars argued that the classical Trade Theory does

[153] See Smith (1776).
[154] See Ricardo (1817).
[155] See Dreyhaupt (2006), pp.20-21.
[156] The Heckscher-Ohlin theorem formulates that the export of capital-intensive goods by capital-abundant countries and the export of labor by labor-abundant countries lead to an equilibrium of goods and prices. See Dreyhaupt (2006), p.22.
[157] See Ohlin (1933); Dunning and Rugman (1985).

not overcome the deficiencies of the classical view of *Smith (1776)* etc. and unrealistically assumes perfect markets and an immobility of production factors; hence, a distinction between FPIs (pure financial flows) and FDIs (which assume the set-up of operations abroad) is not possible.[158]

This approach has also been criticized for viewing trade and FDI as substitutes for one another while empirical studies show a different picture. In addition, the "differential rate of return theory" cannot explain why FDI volumes vary across industries and why FDIs flow not only from Germany to the U.S. car industry, for example, but also from the U.S. to the German car industry.[159] Moreover, more recent empirical studies cannot confirm the above mentioned findings that higher returns lead to higher FDI flows. In fact, on a global scale, returns of MNCs declined significantly in the late 1950s while FDI flows continued to surge. Finally, the classical trade theory widely neglects firm-specific factors, preferences and strategies.[160]

Overall, the classical trade theory does not show a very realistic picture of MNC activity, "cannot explain the bulk of FDI flows"[161] and is therefore not well suited as underlying theory for this thesis.

2.2.3.2 International Production Theory & the OLI-Paradigm

The strong criticism, especially from International Business economists, of the classical Trade Theory and its limitations in explaining MNC activities led to a vast amount of other approaches, the most important of which are (1) the market imperfections approach, (2) the internalization theory and (3) the OLI-Paradigm.

[158] See Ohlin (1933); Iversen (1935).
[159] See Mundell (1957); Caves (1996), pp.25-28; Graham (1996); Kokko (2006).
[160] See Hymer (1976), pp.11-13 and 49; Caves (1996), pp.25-28; Rübel (2004), p.158; Dreyhaupt (2006), p.23.
[161] Hymer (1976), p.9.

(1) *Hymer (1976)*[162] and his **market imperfections approach** are widely accepted as the starting point for the critic of the classical Trade Theory and the beginning of a theory of International Production.[163]

He was the first scholar to view FDIs not merely as international capital flows but as a reaction of companies to structural market imperfections.[164] His main argument against the classical Trade Theory was that companies in perfect competitive markets are supposed to have equal production costs and falling profits; therefore, investors should not be able to survive in foreign markets because their higher costs, e. g. the overcoming entry barriers such as a foreign culture, language, and legal adjustments, should eliminate their profits and drive them out of the foreign market.[165]

Since, in contrast to this hypothesis, MNCs and FDIs have constantly risen after World War II, *Hymer* concluded, market imperfections had to be the reason why MNCs evolve. In order to endure in foreign markets MNCs have to possess, according to *Hymer*, specific advantages compared to their competitors in the host country. Therefore, **firm-specific or "ownership" advantages** are economies of scale, but also a superior technology or specific managerial and marketing skills. These advantages may lead to a quasi-monopolistic position of the MNCs in the host economy that can, however, only be fully exploited if the MNC has significant control over its foreign activities and therefore decides in favor of FDIs instead of FPIs.[166]

In sum, the true driver for FDI flows for *Hymer* is the leverage of companies' market power and not the host country's availability of capital or return advantages.[167]

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[162] Hymer's dissertation was already completed in 1960 but not published until 1976.
[163] See Dreyhaupt (2006), p.26.
[164] See Cantwell (2000), p.13; Johnson (2005), p.18.
[165] See Hymer (1976), pp.34-36.
[166] See Hymer (1976), pp.25-26; Johnson (2005), pp.18-19; Cantwell (2000), pp.13-14.
[167] See Dreyhaupt (2006), p.26.

Hymer has been acknowledged as the "father of the theory of the international firm"[168] and his work has functioned as a catalyst for the further development of the industrial-organization approach.[169] Nevertheless, he has also been criticized for focusing too strongly on structurally-based market imperfections and not sufficiently explaining trade as alternative option to FDIs. Most of all his approach neglects strategic investment decisions of MNCs and, for example, does not consider that the monopolistic advantage may not be a precondition but a goal for MNCs to invest abroad.[170]

(2) The **internalization theory** is also based on the idea of imperfect markets and has its origin in the works of *Coase (1937)* and *Williamson (1975, 1985)* who developed the approach that firms grow more quickly if they minimize market transaction costs, e. g. by internalizing certain processes instead of acquiring them from external providers.[171] When analyzing transactions, *Williamson (1975)* further categorizes them depending on their volume, their frequency etc. Thus intermediate goods such as marketing know-how seem especially apt for internalization, since no tradeable markets exists for these and because this is an area in which dependence on local agents can be costly or even dangerous for MNCs. Therefore, when extending its operations, a company is vulnerable to "moral hazard" or other transaction costs such as opportunity costs, if the provision of these goods is not controlled internally. Internalization thus could mean an acceleration of processes, less need for bargaining and less uncertainty in the negotiation process.[172]

Buckley and Casson (1976) extended this general idea of internalization to the international context of FDIs and analyzed what preconditions have to be

[168] Ietto-Gillies (2004), p.2.
[169] See Cantwell (2000), p.15; Pitelis (2002).
[170] See Johnson (2005), p.19; Pitelis (2002), p.21; Heiduk and Kerlen-Prinz (1999), pp.37-38.
[171] See Coase (1937), pp. 333-335, 341.
[172] See Coase (1937), p.333; Williamson (1975); Williamson (1985).

met for companies in order to own the company that runs operations abroad (FDI) or when other forms of foreign activities (licensing etc.) are more suitable.[173] *Buckley and Casson (1976)* also broadened the definition of intermediate goods to all goods that are not produced for the end-consumer (raw material, know-how, experience, management skills etc.).[174]

Internalization theory has developed three scenarios in which FDI is the best foreign market approach where MNCs are concerned about **hold-up problems**, i. e. through incomplete contracts with local agents due to uncertain market developments that may cause uncertain performance of the local agent and contract fulfillment issues, **dissipation of firm-specific assets**, i. e. through the transfer of knowledge capital to local actors that can be costly and prone for abuse, and finally about **agency cost**, i. e. the additional cost that stems from monitoring and motivating employees of the third-party organization due to asymmetric information of the MNC about its organization and working processes.[175]

The internalization theory has been a milestone for MNC theory.[176] It has especially been acknowledged for its extension of Hymer's rent-seeking approach to a more efficiency-seeking view and an integration of intermediate goods.[177] Nevertheless, it does not represent a comprehensive theory since it cannot sufficiently explain why companies go abroad in the first place instead of investing in the home country, why MNCs invest in a specific location and why FDI flows sometimes do not occur steadily but in waves.[178] Furthermore, one essential problem of the internalization theory is that it has difficulties

[173] See Krugman and Obstfeld (2005), p.160; Ietto-Gillies (2005), p.109; Dreyhaupt (2006), p.31.
[174] Buckley and Casson (1976), pp.36-37, 45.
[175] See Barba Navaretti and Venables (2004), pp.36-39; Blonigen (2005), p.2; Krugman and Obstfeld (2005), p.160.
[176] See Hennart (2003), p.131; Ietto-Gillies (2005), p.97.
[177] See Ietto-Gillies (2004), p.4; Dunning and Rugman (1985), pp.229-230.
[178] See Heiduk (2005), p.321.

measuring transaction costs and therefore has its limits in proving the quantitative advantage of internal versus external provision of intermediate goods.[179]

(3) The attempts to integrate the existing theories of international production, especially the approaches of market-imperfection and internalization, into a comprehensive framework has resulted in the **OLI-Paradigm** by *Dunning (1977, 1981, 1988)*.[180]

The framework exists of three pillars, **O**wnership, **L**ocation and **I**nternalization. More specifically (and on the basis of *Hymer's work*) a company has to have a distinctive **ownership** or asset advantage over foreign firms in order to compensate for the information disadvantage that they have in relation to the foreign firms in the host market. These asset advantages can consist of property and intellectual property rights, product innovations, management skills, technological know-how etc. Furthermore, the MNC has to be able to exclude other firms from using these assets, to transfer them to their foreign affiliates and to use them in several MNC locations at the same time. Other advantages of MNCs compared to foreign firms can be synergies from multi-plant production and sourcing, product specialization and better access to international financial and consumer markets.[181]

Furthermore, the envisaged **location** abroad has to be – according to the OLI-Paradigm – more or at least as attractive (i. e. profitable) as the home country. Thus certain country specifics are decisive in determining whether a company opts for FDI in the host country or for an investment in the home country. Locational factors include labor costs, access to natural resources, prices, infrastructure costs but also investment and trade regulations etc.[182]

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179 See Moosa (2002), p.33; Dreyhaupt (2006), pp.34-35; Ietto-Gillies (2005), p.100.
180 First presented in: Dunning (1977); Dunning (1981) and refined in: Dunning (1988).
181 See Dunning (1988), p.81; see also Johnson (2005), p.19; Heiduk (2005), pp.322-24.
182 See Dunning (1988), pp.81-84; earlier roots of this location approach can be found in: Horst (1972); Vernon (1974); Hood and Young (1979).

MNC activites and preconditions of OLI-Paradigm			
Channel for serving foreign market	Ownership advantage	Location advantage for foreign market	Internalizational advantage
FDI	Yes	Yes	Yes
Exports	Yes	No	Yes
Licensing	Yes	No	No

Source: Based on Dunning (1981)

Figure 6: MNC decision matrix based on OLI-Paradigm

Finally, the **internalization** pillar of the OLI-Paradigm asks whether companies that have an ownership advantage tend to set up their own operations or to channel their activities through partner companies (e. g. via licensing). This question mainly reflects the ideas of the internalization theory presented above; therefore, a company opts for FDI if internalization leads to lower transaction costs for certain operations (search and negotiation costs etc.) or is suitable for the protection of brand reputation, better quality control of intermediary and final products and the control of conditions for distribution, sales etc.[183]

According to the OLI-Paradigm and as shown in *figure 6*, all three criteria have to be met by FDI for companies to opt for this as an investment form.[184]

The OLI-Paradigm has been acknowledged as the first framework for a holistic decision-oriented internationalization strategy for companies.[185] However, even though *Dunning* has been recognized as one of the main contributors of MNC theory, the OLI-Paradigm has had to face some substantial criticism. Firstly, theorists have noted that the OLI-Paradigm does not embody a theory

183 See Dunning (1988), p.81; Dunning (1993), pp. 56-61, 429; see also Johnson (2005), p.19; Lawler and Seddighi (2001), p.356; Heiduk (2005), pp.323-324.
184 Based on Dunning (1981), p.32.
185 See Heiduk (2005), p.325; Lawler and Seddighi (2001), p.358; Toubal (2004), pp.9-10.

so much as only a shopping list of required factors.[186] *Dunning* has countered this criticism by clarifying that the OLI-Paradigm is not intended as a general theory, but as an eclectic paradigm functioning as an umbrella concept based on different theoretical approaches which tests companies' decisions on export, FDI or other forms of investment.[187] It can furthermore be argued that general theories are difficult to establish in the case of FDI anyway, since they are difficult to prove empirically because of the many interdependent factors influencing the investment decision of MNCs.

It has also been observed that the paradigm is rather static, only describing a one-time investment decision without considering the endogeneity of FDI, i. e. the reaction of FDI to other companies investments or public policy measures. *Dunning* has recently reacted to this criticism by adding policy and institutional variables to his model without, however, formalizing this approach so far.[188]

Overall, and despite some justified criticism, *Dunning's* OLI-Paradigm seems well suited for the general analysis of the decision-making process for companies for investments abroad, answering the questions *why?* and *how?* of the investment. However, the locational component, the *where?*, remains too vague in this framework since his paradigm merely discusses the advantages between the home country and foreign countries in general; hence, the OLI-Paradigm cannot provide a sufficient framework for a key question of this thesis – why companies decide for a *specific* foreign country. This aspect will be the subject of *section 2.2.4*.

[186] See Dunning (2000b); Ietto-Gillies (2004), p.4; Caves (1996), pp.25-28.
[187] See Dunning (2000b); Dunning (2000a); see also Heiduk (2005), pp.322-323.
[188] See *section 2.2.4.1* for more details about Dunning's institutional factors; see also Dunning (2006); Dunning (2000b).

2.2.3.3 New Trade Theory

While International Business theorists since the 1960s have revolutionized the way of interpreting the occurrence of FDI from a mainly firm- or microeconomic perspective, trade theory scholars have also made significant efforts in recent years to modernize the classical trade theory in order to create a comprehensive model explaining international capital flows. This school of thought can be divided into (1) the vertical FDI approach, (2) the horizontal FDI approach and (3) the knowledge-capital model. Subsection (4) discusses the empirical findings of these approaches. All approaches share an assumption of perfect markets (unlike the Classical Trade Theory) and increasing returns of scale; they are all based on the Heckscher-Ohlin theorem and usually aim at explaining FDI flows in general equilibrium frameworks.[189]

(1) The **vertical FDI** approach, first formalized by *Helpman (1984, 1985)*, mainly explains MNC activity with efficiency-seeking motives. Thus FDIs occur because companies want to leverage cost advantages due to diverging factor endowments in different countries, i. e. lower labor costs. In order to optimize costs along the value chain, companies transfer parts of their production processes abroad. This can lead to diversified company operations at different locations, e. g. one site for highly-qualified and another one for low-qualified work.[190]

(2) The approach of **horizontal FDI**, primarily developed by *Markusen (1984)*[191], focuses on the market-seeking motive of FDI; according to this approach, firms aim at serving foreign market demand by local production. Thus in principle the same goods are produced abroad as well as in the parent

[189] See *section 2.2.3.1*; see also Heiduk and Kerlen-Prinz (1999), pp.29-30; Rübel (2004), p.158-164; Ietto-Gillies (2005), p.140; Blonigen (2005), p.21.

[190] See Helpman (1984); Helpman (1995); see also Helpman and Krugman (1985); Buch, Kleinert, Lipponer, and Toubal (2005); Zhang and Markusen (1997).

[191] See Markusen (1984); see also Brainard (1993) and for further references Markusen and Maskus (2001).

company, even though certain product adaptations to local preferences may be necessary. According to this strand of literature, trade barriers and higher transportation costs are the main FDI drivers.[192]

(3) While the debate about the horizontal and the vertical FDI approach is continuing, the **knowledge-capital model** aims at combining these two approaches into a comprehensive model.[193] Furthermore, the model, which is in particular based on *Markusen (1995)* and *Markusen, Venables, Konan, and Zhang (1996)*, stresses that MNCs' advantages primarily emanate from knowledge-capital, i. e. intangible assets such as intellectual property rights, human capital and brand reputation.[194]

(4) **Empirical** tests of vertical and horizontal FDI have found stronger evidence for the occurrence of the latter. Other authors have described that the horizontal FDI approach as predominantly explaining MNC activities in developed countries.[195] This does not seem very surprising since almost 60% of global FDI of USD916B flowed into developed countries in 2005.[196] On the other hand, studies have found evidence for vertical FDI, also for Eastern Europe and especially for the manufacturing sector.[197] Finally, recent trends have shown an increase of vertical FDI relative to horizontal FDI, especially in Eastern European transition countries.[198]

Empirical knowledge-capital models have integrated these two views but also activities of domestic companies as endogenous variables into a comprehensive

[192] See Brainard (1997); Johnson (2005), pp.21-22.
[193] See Grossman and Helpman (2003).
[194] An overlap to the internalization theory seems obvious; see *section 2.2.3.2*; see also Markusen (1995); Markusen, Venables, Konan, and Zhang (1996).
[195] See Brainard (1993); Markusen and Venables (1998); Carr, Markusen, and Maskus (2001); Buch, Kleinert, Lipponer, and Toubal (2005), pp.54 and p.83 and see Ietto-Gillies (2005), pp.146-147 for further references.
[196] See UNCTAD (2006), p.XVII.
[197] See Marin, Lorentowicz, and Raubold (2002); Hunya and Geishecker (2005), pp.17, 26; Ietto-Gillies (2005), p.145.
[198] See Barba Navaretti and Venables (2004), p.32.

model.[199] The knowledge-capital model of *Markusen and Maskus (2002)* confirms that FDI is more consistent with the horizontal model; however, a clear distinction between horizontal and vertical FDI is not reached in their models either.[200]

In an extension of the discussed approaches, more recent empirical studies based on firm-level data suggest that MNC strategies are more complex than a mere distinction into horizontal, vertical and knowledge-capital FDI; thus an overlap of these models is common and the FDI decision-making process may include many more factors and motives than modeled so far.[201] Initial extensions to more complex MNC strategy models, e. g. in *Yeaple (2003)* and *Carstensen and Toubal (2004)* hint at a further opening towards the integration of a more diverse explication of FDI inflows.[202]

In **conclusion** the main contribution of the New Trade Theory is its effort to develop important hints regarding the motives of FDI and, in particular, to formalize FDI theory in a mathematical fashion. However, vertical and horizontal FDI approaches can only partly explain MNC activities, whereas the knowledge-capital approach adds more realism by extending the existing models.[203] Nevertheless, statistical evidence for all models of the New Trade Theory remains weak and empirical work is only its early phases, mainly because the complex decision-making process of MNCs depends on various endogenous factors and is therefore difficult to quantify.[204]

[199] See Markusen (1997); Markusen, Venables, Konan, and Zhang (1996).
[200] See also Barba Navaretti and Venables (2004), p.31.
[201] See Feinberg and Keane (2005).
[202] See Yeaple (2003), p.304; Carstensen and Toubal (2004).
[203] See Johnson (2005), p.23.
[204] See Markusen and Maskus (2002); see also Markusen and Maskus (2001), p.40.

2.2.3.4 Conclusion

This literature review has confirmed for this thesis that FDI occurs due to market imperfections and that the decision making process within MNCs is very complex. The difficulties of all approaches, i. e. Classical Trade Theory, International Production and OLI-Paradigm as well as New Trade Theory, in statistically predicting MNC actions, support hypothesis 2 of this thesis which states that *"determinants of investment decisions are much more diverse than elaborated in most FDI studies."*[205] Furthermore, even though *Dunning's* OLI-Paradigm appears well-suited for the analysis of various MNC decision processes, the location factor, i. e. the question regarding the specific country determinants of FDI, remains too vague in this framework and will be discussed more thoroughly in the subsequent section.

2.2.4 Country determinants of FDIs

As stated before, most FDI models have difficulties in explaining why FDI flows to one specific (transition) country rather than any other. This section first discusses the main location determinants theories (*section 2.2.4.1*), then reviews the most important studies on FDI in transition countries and analyzes their findings on the main country determinants (*section 2.2.4.2*).

2.2.4.1 FDI determinants theories

The FDI determinants theory – or location theory – mainly goes back to five important strands of research: (1) the classical theory of comparative advantages, (2) the New Economic Geography and the New Trade Theory, (3) the institutional quality approach, (4) *Dunning's* revised OLI-Paradigm, and (5) the locational competition theory. Good overviews of these theories are given in

[205] See *section 1.1.*

Benito and Gripsrud (1995), *Resmini (2000)*, *Kinoshita and Campos (2002)*, and *Resmini (2006)*. No isolated theory has been developed for transition countries so far.

(1) The **classical theory of comparative advantages** assumes that MNCs decide for a selected country because of specific factor endowments that make the envisaged investment more profitable than in other countries. These country advantages traditionally include market size, market growth and relative wages. Later versions of this approach added trade-related determinants such as tariffs, non-tariff-barriers etc. Thus the initial conditions of governments are essential for an investment decision that can only be influenced by governments through the change of economic fundamentals.[206]

(2) **New Economic Geography** and **New Trade Theory** further extended this classical determinants approach. According to the New Economic Geography[207], FDI is driven to a large extent by industrial agglomeration that stems from the trade-off between external economies of scale and transportation costs in specific industries. In the locational context, the New Trade Theory highlights a similar aspect, the distance of the host country to the home country; the proximity of two countries in terms of geographic distance but also in terms of shared language and culture can reduce transportation and transaction costs and thus foster FDI growth to a specific country.[208]

Like the classical theory of comparative advantages these two approaches also strongly focus on the role of the companies and do not concede states much room for maneuver.

[206] Representatives of this theory are e. g. Aliber (1970); Agarwal (1980); Kravis and Lipsey (1982); Veugelers (1991); Lucas (1993).

[207] First presented by Krugman (1991); synthesized by Fujita, Krugman, and Venables (1999); important contributions, e. g. by Wheeler and Mody (1992).

[208] See *section 2.2.3.3* for examples, but especially Brainard (1993); Eaton and Tamura (1994); Brainard (1997).

(3) The **institutional quality** approach looks more closely at policy factors influencing the investment conditions for MNCs and predicts that, for example, less corruption and a reliable legal system will promote higher FDI flows. Without a doubt, this approach gives public policy measures more credit for their role in influencing MNCs' investment decision than earlier theories. However, the evolution of this approach is still in an early stage. No comprehensive framework has been established so far; neither a clear set of location factors that actually influence the location decision nor their relative importance could be determined so far. Furthermore, the perspective of these representatives on the state is very focused since they basically set institutions equal to national bureaucracy and mainly analyze their effectiveness, e. g. how to implement already existing laws or to deal with legal backlogs.[209]

This thesis, however, follows a broader definition of public policy (*see section 2.1.3*) considering a larger set of actors (e. g. leading government officials and local agencies) as well as measures (e. g. privatization success, corporate law, promotion of the host country's image abroad).

(4) In his more recent works, *Dunning*[210] expands his earlier view of the **OLI-Paradigm** in which the locational advantage was not country-specific and merely focused on the advantages of a foreign location compared to the home country.[211]

More specifically, he acknowledges that locational factors have changed since the 1970s, focusing his analysis however, little on specific determinants and rather on the entry mode of FDI (greenfield, etc.) and on the different motivations of FDI, i. e. resource-seeking, market-seeking, efficiency-seeking, and

[209] See Campos and Kinoshita (2003), pp. 4 and 7.; Wei (2000a); Wei (2000b); Antras (2003).
[210] See e. g. Dunning (1998); Dunning (2002); Dunning (2006).
[211] See e. g. Dunning (1981).

strategic-asset seeking.[212] In comparison to the 1970s, he now sees less significance of transaction costs due to agglomeration of FDI in host countries and an increasing importance of the availability of knowledge-building capacities in the host country; furthermore, infrastructure, macroeconomic environment and the institutional environment seem to have become more important just as those factors "which governments, in their macro-organizational policies, can and do influence"[213].

In *Dunning (2006)* he also incorporates different institutional variables into the OLI-Paradigm. As in earlier works however, the revised OLI-Paradigm does not provide a formalized theory of FDI location either. It pays, moreover, only little attention to individual public policy measures that distinguish one country from another and it does not evaluate the relative impact or interdependence of factors. In the end, the revised OLI-Paradigm remains somewhat vague and enables little implications for policy makers by stating that FDIs are driven by a "gamut of government policies favorable to globalization, innovation and entrepreneurship"[214].

Overall, the revised version of the OLI-Paradigm does not seem apt as a framework in order to answer the questions of this thesis, either.

(5) The theory of **locational competition** represents the most powerful approach for this thesis because it incorporates both the company's view as well as the state's view, calls for a consideration of the interdependencies between different factors and determinants and encourages to analyze the trade-offs of decisions and actions. This approach has a long tradition in Germany where it is referred to as "Standorttheorie", while other research traditions have –

[212] See also the section on host country determinants in UNCTAD (2006), pp.157-163 that is inspired by Dunning.
[213] Dunning (1998), p.60; see also Dunning (2002).
[214] Dunning (2002), p.13; see also Dunning (2006), p.218.

to a large extent – ignored this concept so far.[215] This section covers the (a) definition, (b) assumptions, (c) findings, (d) weaknesses, and (e) relevance of locational competition for this thesis.

(a) According to *Siebert (1996, 2000, 2005)*, the most prominent representative of this approach, locational competition is **defined** as the competition between different geographic dimension, i. e. regions, countries or cities. These immobile entities compete for mobile factors, i. e. for capital, technology and labor; this competition again takes place on three different levels: firms, governments and workers.[216] Thus locational competition comprises a broader definition of competition than suggested, for example, by the New Trade Theory that only focuses on competition between firms.[217] In this context *Siebert* strongly disagrees with *Krugman (1994)* who argues that the economic growth of a country is by and large independent from the competition with other countries. He insists that competition between countries exists and has even become more intense in recent decades.[218]

(b) Locational competition **assumes** that globalization leads to lower economic distance, an international division of labor and thus creates more opportunities but also more need for countries to improve their competitive position.[219] Looking at governments, it is therefore crucial to identify "what kind of instruments [they can] use to attract or keep mobile production factors"[220]. The key problems for governments however, as they are assumed in the locational competition theory, are the opportunity costs that are caused by the attraction of immobile factors (e. g. MNCs); thus, public goods, such as infras-

[215] See Siebert (1996); Siebert (2000); Siebert (2005); see also Jahrreiß (1984). Nevertheless, scientific roots of the approach also lead to Tiebout (1956); see also Brakman, Garretsen, and van Marrewijk (2002).
[216] See Siebert (2000), pp.3-4.
[217] See Siebert (2000), p.4.
[218] See Siebert (2005), p.3; Siebert (1996), p.2.
[219] See Siebert (2000), p.12; Siebert (1996), p.10.
[220] Siebert (2000), p.6.

tructure but also investment incentives, have to be financed by taxes and fees. However, since governments want to "maximize welfare of society, national income, income per head or the votes for the party in power"[221], they need to find the right balance between different factors, e. g. expenditures for infrastructure and low taxes; in short, the optimum mix between the attraction of mobile factors and opportunity costs they cause.[222]

(c) Analyzing primarily European countries, locational competition has come up with some important **findings**. First of all, the number of possible fields of competition is manifold the most important being taxes, economic and social infrastructure, institutional rules (i. e. product standards, permitting procedures, or other legal regulations) as well as human capital.[223]

Moreover, the necessity of governments to balance policies to attract investment on the hand and keep taxes low on the other hand, also seems to avoid a long-term "race to the bottom" between competing countries as discussed in *section 2.2.1*.[224]

Finally, *Siebert* finds that increasing locational competition leads to a stronger convergence of policies and institutional arrangements across countries and – in the end – to less scope for policy makers. Especially in the context of the EU, the increasing number of harmonizations of regulations seems to decrease the number of possible policy measures for state actors.[225]

(d) Nevertheless, the locational competition approach has some **weaknesses**; up to now it has produced only limited empirical results.[226] Furthermore, the formalization of the theory is still at an early stage, considers only few variables

[221] Siebert (1996), p.2
[222] See also Siebert (2005), p.9; Siebert (2000), p.6.
[223] See Siebert (2000), pp.6-10 and 22.
[224] See Siebert (2000).
[225] See Siebert (2000), p.15; see also Dreyhaupt (2006).
[226] See also Siebert (2005), p.19; Lorz (1997).

and possibly focuses too heavily on the neo-classical approach.[227] Moreover, *Siebert* may be a little too pessimistic with regards to the impact of public policy and may not sufficiently reflect the possibility that the provision of public goods does not need to result in levying higher taxes since the production and maintenance of infrastructure etc. could be financed by fees; key FDI attractors also may not cause significant government expenditures (e. g. relations and assistance of local administration to investors) or be acceptable for voters etc. if they acknowledge the long-term benefits of the measure such as a more effective administration and implementation of laws.

(e) Despite the described weaknesses, the locational competition approach seems to be very **relevant** and well-apt as theoretical pillar of this thesis. Firstly, the approach allows for a multiple analysis of country determinants from the perspective of MNCs as well as from states since they are both part of the locational competition between countries according to *Siebert*.[228]

Secondly, locational competition confirms the assumption of this thesis that countries need to focus on those locational advantages they can influence instead of relying on given comparative advantages such as natural resources.[229]

Thirdly, the locational competition approach underscores the necessity to ask questions about the limits and trade-offs of competitive actions. For companies this means that the analysis (and interview questionnaires) need to include questions referring to country specific factors that hinder MNCs in becoming more competitive and profitable. With regards to governments this aspect means that this thesis also analyzes what limits due to pressure from voters

[227] The best incorporation of the approach can probably be found in Dreyhaupt (2006) who has used the theory extensively for his – mainly analytical – analysis of competition policy in the context of the EU.

[228] The third dimension of competition, the workers, is not considered in this thesis in order to avoid an overstretching of the – already complex – analysis.

[229] Siebert (2000), p.6.

and interest groups, for example, reduce the possibilities of policy makers in order to create favorable conditions for MNCs in the analyzed countries.

Fourthly and finally, locational competition helps to sharpen the analysis in the context of EU integration, asking to what extent reforms of candidate countries and accession to the EU have an impact on investment policy. It is particularly interesting whether those areas in which public policy may have lost some room to maneuver, are actually most relevant for the investment decision of MNCs.

Turning now to the existing empirical literature on FDI determinants this thesis now specifically focuses on transition economies.

2.2.4.2 Studies on FDI determinants in transition countries

Resmini (2006) observed that few studies have analyzed FDI determinants in transition countries so far. *Figure 7* provides an overview of the 34 most frequently cited studies; it also serves as further basis for this section in which (1) the study selection is further explained, (2) the main insights of these studies are summarized and (3) the areas in which this thesis can make a contribution to FDI research beyond the existing studies are discussed.

(1) The overview of studies in *figure 7* presents the number of transition countries analyzed in those studies, the period of the analyzed samples, a summary of the main FDI host country determinants as identified by those studies and finally, the empirical method utilized in these studies. The studies discussed only cover those that deal with countries in transition because the focus countries of this thesis, Romania and Croatia, are transition countries as well. Another reason is that research has emphasized that flows to transition countries seem

#	Authors	Transition countries analyzed	Period analyzed	Main determinants	Method
1	Genco et al (1993)	7	1991-1992	Rule of law, implementation of laws, market access, economic reform, privatization, efficient financial system, bureaucracy	Survey
2	Lankes and Venables (1996)	16	1995	Market access, market size, human capital, proximity, trade barriers, political and economic stability, natural resources	Survey
3	Savary (1997)	5	1996	Market size, factor costs, privatization, technological know-how and human capital	Survey
4	Pye (1998)	5	1989-1996	Market size and growth, labor costs, stability for investment, human capital	Survey
5	Altzinger (1999)	4	1997	Market potential, labor cost, proximity	Survey
6	Borsos-Torstila, J. (1999)	8	1990-1995	Market size, EU integration, human capital	Survey
7	AHK (2006)	14	2006	Willingness to perform, productivity, paying habits, legal certainty, educational level, tax burden, tax system, labor cost	Survey
8	Lansbury et al (1996)	3	1991-1993	Costs relative to other target countries, trade openness, private sector share, technological know-how	Econometrics
9	Altomonte (1998)	10	1990-1995	Market size, labor cost, distance, implementation of laws, investment climate	Econometrics
10	Holland & Pain (1998)	11	1992-1996	Investment climate, privatization, investment risk, EU integration, relative labor cost to other target countries, trade openness, productivity	Econometrics
11	Brenton et al (1999)	10	1992-1995	Market size, proximity, EU integration	Econometrics
12	Bevan and Estrin (2000)	11	1994-1998	Market size, trade policy & openness, investment climate, EU integration, input cost, economic and political cost	Econometrics
13	Resmini (2000)	10	1991-1995	Market size, labor cost, trade openness, agglomeration, proximity	Econometrics
14	Woodward et al (2000)	6	1990-1993	Market size, investment climate, investment incentives, privatization, political stability	Econometrics
15	Garibaldi et al (2001)	26	1990-1999	Market size, fiscal policy, monetary policy, country risk, trade policy, natural resources, investment climate, bureaucracy	Econometrics
16	Jensen (2002)	18	1993-1997	Investment climate, economic reform, political stability	Econometrics
17	Smarzynska (2002)	19	1989-1994	Market size, tax policy, property rights, effectiveness of legal regulations, privatization, corruption, trade openness	Econometrics
18	Altomonte and Guagliano (2003)	10	1990-1997	Market size and growth (potential), regional integration, labor cost, human capital, investment climate	Econometrics
19	Brada et al (2003)	14	1993-2001	Political stability, market size, trade openness, human capital, privatization, natural resources	Econometrics
20	Campos and Kinoshita (2003)	25	1990-1998	Trade openness, market size, investment climate, labor costs, education, natural resources, agglomeration & infrastructure	Econometrics
21	Disdier and Mayer (2003)	6	1991-1999	Labor cost, proximity, political freedom	Econometrics
22	Bevan and Estrin (2004)	11	1994-2000	Labor cost, private ownership, financial system, monetary policy, trade openness, rule of law	Econometrics
23	Bevan et al (2004)	12	1994-1998	Labor cost, market size, proximity, EU integration	Econometrics
24	Carstensen and Toubal (2004)	7	1993-1999	Market size, labor cost, human captial, privatization, political stability, investment climate, trade policy	Econometrics
25	Galego et al (2004)	10	1993-1999	Market size, trade openness, proximity, labor cost	Econometrics
26	Janicki and Wunnava (2004)	8	1997	Market size, investment climate, trade openness, labor cost	Econometrics
27	Merlevede and Schoors (2004)	25	1992-2002	Market size, privatization, labor cost, political stability, EU integration, natural resources, proximity	Econometrics
28	Bellak and Leibrecht (2005)	8	1995-2003	Labor cost, taxes, market size, privatization, proximity	Econometrics
29	Lahreche-Revil (2005)	8	1990-2002	Labor cost, monetary policy, taxes, incentives	Econometrics
30	Clausing and Dorobantu (2005)	28	1992-2001	Market size, EU integration, trade openness, tax policy	Econometrics
31	Demekas et al (2005)	14	1995-2003	Labor cost, tax policy, infrastructure, trade policy, distance	Econometrics
32	European Comm. (2005)	6	1998-2002	Market access, agglomeration, human capital	Econometrics
33	Pusterla and Resmini (2005)	4	1995-2001	Market demand, industry and regional characteristics, agglomeration, market accessibility, labor cost	Econometrics
34	Kinoshita and Campos (2006)	25	1990-1998	Rule of law, quality of bureaucracy, natural resources, agglomeration, trade openness	Econometrics

Figure 7: Key studies on FDI determinants in transition countries

to be driven – at least partly – by other factors than those to developing or developed countries.[230]

Furthermore, only studies with multiple country analyses have been considered in this evaluation since this thesis follows the argumentation of various authors that a cross-country view is especially effective in revealing the specific determinants of different locations.[231] The analysis of several countries is also supported by the locational competition approach; thus FDI does not embody an isolated management decision of MNCs for or against an investment, but also involves transition countries that are competing – more or less actively – for the same investment(s).[232]

The overview of the main determinants lists those factors that are identified by each of the studies as most relevant for the investment decision of MNCs in a specific transition country – either in terms of statistical significance as defined by the respective studies or based on qualitative survey evaluations. Since the differing methods of analysis in these studies do not permit a pooled quantification of determinants, *figure 7* only shows what locational factors have repeatedly been analyzed and identified as important by previous scholars. The overview cannot therefore indicate the relative importance of determinants.[233]

Finally, the presented list of determinants studies cannot be conclusive; however, other FDI determinants studies, such as surveys from governmental institutions, have received only little academic attention so far. In this context the *AHK (2006)* survey can be viewed as representative for this category of

[230] See Resmini (2006); Riedl, Leibrecht, and Bellak (2006); Holland, Sass, Benacek, and Gronicki (2000).
[231] See e. g. Merlevede and Schoors (2004); Bellak and Leibrecht (2005); Bénassy-Quéré and Lahrèche-Révil (2005); AHK (2006).
[232] These studies may actually comprise larger country samples, e. g. from Western Europe, but only the analyzed transition countries are listed in order to facilitate comparisons.
[233] In order to make this overview less complex it also does not indicate the sign of the coefficient or the different motives behind the FDI decision.

FDI research.

(2) In **formal terms**, the overview reveals that econometric studies[234] clearly dominate compared to surveys (27 versus 7). Furthermore, academic surveys were mainly used in the early phase of transition until the late 1990s, when econometric analyses were hardly feasible due to data limitations. Moreover, surveys usually cover, for reasons of practicality, a larger set of determinants than econometric studies. However, both surveys and econometric studies identify on average about five determinants as key drivers for the investment decision of MNCs. Moreover, it appears that the number of FDI studies on transition countries continues to rise, since 18 of the evaluated studies (or 52%) were published in the last four years of analysis (2003-2006). Most studies find only few differences among country groups, the most striking being that between CIS and other transition countries, whereas the former seem to rely heavily on their natural resources to attract FDI.[235]

The **assessment of the main determinants** of the 34 evaluated studies demonstrates that research has only limited consensus about the driving forces of MNCs' investment decision. After grouping the cited factors, a list of 26 determinants can be identified. A closer look at the evaluated studies reveals however that only a limited set of recurring factors is frequently cited as main FDI determinants; thus only 13 main determinants are mentioned in over four studies and only eight in over eight studies respectively. These eight main factors – market size, labor costs, investment climate, trade openness, proximity, human capital, privatization, and political stability – and their number of citations are presented in *figure 8* and will be discussed in the following

[234] Most econometric studies (16) perform a panel data analysis.
[235] See e. g. Merlevede and Schoors (2004); Kinoshita and Campos (2006).

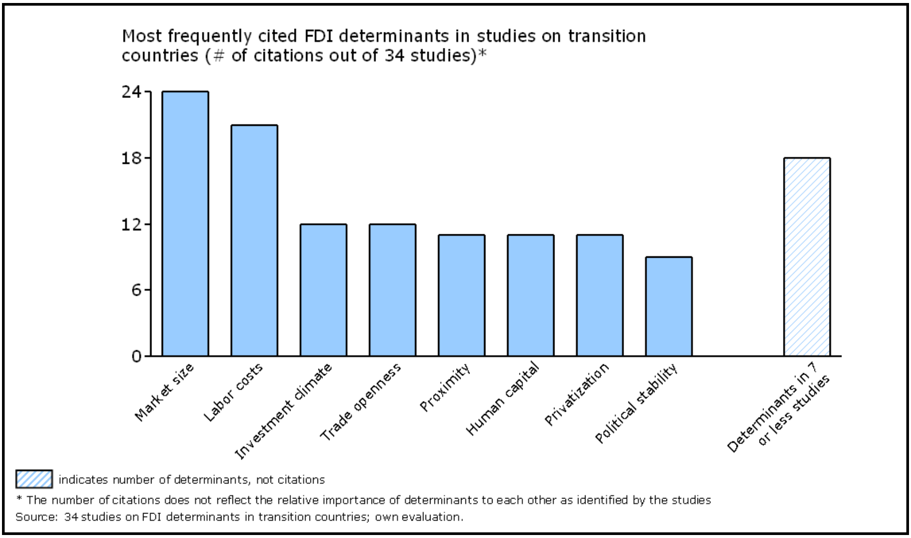

Figure 8: Main FDI determinants in transition studies

passage in further detail.

Market size, the most frequently cited FDI determinant for transition countries, is measured in different ways, but in most studies the GDP of the host country is included.[236] In addition to this, other authors add GDP per capita[237], purchasing power parity [238], land or population size [239] or GDP growth.[240] FDI flows to larger countries with better performing and faster growing economies tend to be higher because MNCs seem to expect to grow faster themselves in these host countries.[241]

[236] See e. g. Bellak and Leibrecht (2005); Campos and Kinoshita (2003); Bevan and Estrin (2004).
[237] See Clausing and Dorobantu (2005)
[238] See Brada, Kutan, and Yigit (2003)
[239] See Galego, Vieira, and Vieira (2004)
[240] See Garibaldi, Mora, Sahay, and Zettelmeyer (2001); see also Pusterla and Resmini (2005) who focus on regions instead of nations.
[241] See e. g. Janicki and Wunnava (2004).

Market size is not only the determinant most frequently cited by studies on FDI in transition economies; it is also the factor that most studies identify as the FDI determinant with the most significant (positive) impact. Studies have also suggested that market size is a key determinant, regardless of the sector in which the MNCs invest.[242] There is however, little consensus among the evaluated studies about how much more important market size is in comparison to other determinants.

Labor costs are generally measured according to the average wage level in the host country relative to the home country[243] or another set of neighboring countries.[244] Other studies proxy labor costs by the productivity level of employees[245] or specify the average wage level by only using the wages of a certain industry, e. g. the manufacturing sector.[246] Furthermore, authors use different wage categories; a majority of studies applies nominal and real labor units[247] while others utilize total labor costs[248] or gross wages.[249]

Regarding the impact of labor costs on the FDI decision of MNCs *Riedl, Leibrecht, and Bellak (2006)* conclude in their literature survey: "Empirical studies for the determinants of FDI in CEECs show a wide variety of results with respect to the size, sign and significance of the coefficient of the labor costs proxy used."[250]

Generally – and confirmed by the vast majority of studies –, higher labor costs and lower productivity seem to have a negative impact on FDI inflows,

[242] See e. g. Lankes and Venables (1996); Resmini (2000).
[243] See e. g. Pye (1998).
[244] See e. g. Resmini (2000); Carstensen and Toubal (2004).
[245] See e. g. Holland and Pain (1998).
[246] See e. g. Bevan and Estrin (2000); Disdier and Mayer (2003).
[247] See e. g. Bellak and Leibrecht (2005); Demekas, Horváth, Ribakova, and Wu (2005); Bénassy-Quéré and Lahrèche-Révil (2005); Bevan, Estrin, and Meyer (2004).
[248] See e. g. Clausing and Dorobantu (2005); Galego, Vieira, and Vieira (2004).
[249] Altomonte (1998); Resmini (2000).
[250] Riedl, Leibrecht, and Bellak (2006), p.4.

driven by the rationale that MNCs want to use production cost advantages of a certain location compared to other production sites, either in the home country or in competing host countries.[251] Nevertheless, a few studies actually find a positive correlation, which is usually explained by imperfect data proxies or skill effects in specific countries or industries.[252]

However, the different measures and definitions of labor costs outlined here lead to the conclusion that the relative significance of labor costs is difficult to determine or generalize. The impact of labor costs also depends on the motive of the investment, the sector, the required skill level of the local employees and of course, the specific country characteristics.[253]

Furthermore, **investment climate** is also one of the main determinants mentioned by the 34 studies on transition countries analyzed here; however, the definition of this term varies strongly among the studies and partly overlaps with that of other determinants. Often the investment climate is used as synonym for progress in transition.[254] The variables most frequently used are country risk derived from international credit ratings[255], FDI restrictions based on IMF statistics[256] and a business climate index comprising a larger amount of other factors, e. g. economic uncertainty, availability of venture capital or political continuity.[257] Last but not least, surveys may also include the perceived economic stability of the host country in their analysis.[258]

Even though the definition of investment climate remains somewhat vague, studies have repeatedly shown that it has a significant impact on the investment

[251] See e. g. AHK (2006).
[252] Out of the selection of 34 transition countries only Bénassy-Quéré and Lahrèche-Révil (2005); see also Riedl, Leibrecht, and Bellak (2006).
[253] See Riedl, Leibrecht, and Bellak (2006).
[254] See also Resmini (2006); Altomonte (1998).
[255] See Bevan and Estrin (2000); Janicki and Wunnava (2004); Holland and Pain (1998).
[256] See Garibaldi, Mora, Sahay, and Zettelmeyer (2001); Campos and Kinoshita (2003).
[257] See Altomonte (1998); Altomonte and Guagliano (2003).
[258] See e. g. Genco, Taurelli, and Viezzoli (1993); Lankes and Venables (1996).

decision of MNCs. *Altomonte (1998)* even finds that the investment climate "displays the highest coefficient recorded among the significant variables."[259] A key driver seems to be that progress in transition reduces investment risks, opportunity cost of waiting and economic uncertainty and thus generates higher FDI flows.[260] *Campos and Kinoshita (2003)* establish that capital controls, e. g. permit requirements and profit transfer restrictions, reduce FDI inflows to transition countries. Finally, *Garibaldi, Mora, Sahay, and Zettelmeyer (2001)* point out that restrictions on FDI seem to be more relevant than those on FPI that can supposedly more easily be avoided.

Trade openness is usually referred to as the proportion of trade (sum of exports and imports) relative to the GDP of a host country.[261] Other specifications define trade openness as the host economy's share of trade with the EU versus its overall amount of trade[262], the ratio of imports as a share of the GDP[263] or the percentage of total imports of a host country from the EU.[264]

These studies – in accordance with the more recent FDI theory (*section 2.2.3*) – come to the conclusion that larger amounts of FDI flow to transition host countries with higher trade intensity; thus, trade and investment in transition countries seem to be complements rather than substitutes.[265] This result appears to be especially true when trade takes places within the same geographical region and for companies that are export-driven.[266] Furthermore, transition countries that showed a higher degree of openness in the early stage of transition also demonstrate higher inflows in later periods than other transi-

[259] Altomonte (1998), p.19; see similar Pye (1998).
[260] See also Holland and Pain (1998); Woodward, Rolfe, Guimaraes, and Doupnik (2000).
[261] See e. g. Resmini (2000); Smarzynska (2002); Brada, Kutan, and Yigit (2003).
[262] See e. g. Holland and Pain (1998).
[263] See e. g. Clausing and Dorobantu (2005).
[264] See e. g. Bevan and Estrin (2000).
[265] See e. g. Janicki and Wunnava (2004); Brada, Kutan, and Yigit (2003).
[266] See e. g. Holland and Pain (1998); Janicki and Wunnava (2004).

tion countries.[267] Some studies see a strong correlation between market size and FDI flows on the one hand and trade flows and FDI flows on the other hand[268]; this may indicate that trade and market size are only a different way to identify attractive markets with high economic activity. Alternatively, *Kinoshita and Campos (2006)* assume that MNCs tend to invest in those countries in which they have already built up relationships and knowledge through trade.

In terms of significance, most studies find that the importance of trade openness as FDI determinant is quite substantial.[269] *Janicki and Wunnava (2004)* even describe trade openness as the most important driver for FDI in transition countries. Other scholars only report substantial industry-specific significance, e. g. for the high-technology sector.[270]

Despite these empirical results, some doubts about the actual impact of trade openness on the investment decision of MNCs remain; thus it may be questionable whether those MNCs without important trade relations to transition countries actually analyze trade statistics of potential host economies in order to decide on a specific location. Accordingly, it is far form surprising that trade openness is identified by none of the analyzed surveys as main determinant in transition countries.

Proximity is generally understood as the geographical distance between home and host country and is most frequently measured as the distance in kilometers between the two capitals of home and host country.[271] Other calculations use the distance between the host country's capital and a centrally

[267] See Kinoshita and Campos (2006).
[268] See e. g. Resmini (2000).
[269] See e. g. Holland and Pain (1998); Clausing and Dorobantu (2005).
[270] See Smarzynska (2002); see also for Resmini (2000) industry-specific results.
[271] See e. g. Bevan and Estrin (2000); Bevan, Estrin, and Meyer (2004); Galego, Vieira, and Vieira (2004); Bellak and Leibrecht (2005).

located city in Europe, e. g. Frankfurt[272] or Brussels.[273] Last not least, more complex distance calculation use weighted averages of the economic importance of the home country in the region or level out regional distortions of economic activities in the host economies.[274]

Proximity variables can however, also comprise the cultural distance between home and host country; thus, some studies add dummies for cultural ties[275] or a common language.[276]

All studies assume that increased proximity facilitates the steering and supervision of business operations abroad by the parent company. They further expect that MNCs prefer greater proximity in order to minimize time, risk and cost of transportation routes.[277]

The empirical results of the analyzed studies show that proximity plays an important role for the investors in transition countries – as suggested by the New Trade Theory.[278] *Altzinger (1999)* even finds for Austrian investors that in both geographical and cultural terms, proximity is one of the two leading determinants for FDIs in transition countries.[279] More generally, proximity seems to be an important determinant for those companies that have little experience in internationalization and want to exploit cross-border labor cost advantages. In these cases low cultural distance also seems to have some, albeit limited significance.[280]

Overall however, proximity appears to be of less importance than, for example, market size and labor costs for the investment decision of MNCs, especially

[272] See e. g. Altomonte and Guagliano (2003).
[273] See Campos and Kinoshita (2003).
[274] See e. g. Resmini (2000); Disdier and Mayer (2003).
[275] See Demekas, Horváth, Ribakova, and Wu (2005).
[276] See Pye (1998).
[277] See e. g. Altzinger (1999).
[278] See Brainard (1993) and 2.2.4.1.
[279] Market size is even more important than proximity according to Altzinger (1999).
[280] See e. g. Altomonte (1998); Altzinger (1999); Demekas, Horváth, Ribakova, and Wu (2005); Pye (1998).

because the distance from transition to investing countries from Western Europe is fairly similar. For countries that are located further away, such as the United Kingdom (UK), proximity seems to be completely irrelevant. Moreover, the importance of distance as an FDI determinant strongly differs according to the motives for FDI; therefore, it is much more important for efficiency-seeking MNCs than for market-seeking ones.[281]

Human capital is usually related to the skill level of potential host country employees or the existence of the technological know-how in the host country. The studies analyzed define the skill level of transition countries by calculating the secondary[282] and/or tertiary[283] school enrollment as share of gross school enrollment.

The technological base of a country is measured, for example, by the relative stock of patents granted to residents of the host country.[284]

Most surveys analyzed by the author conclude that human capital plays a decisive role in attracting FDI.[285] Econometric studies are more ambiguous about the quantitative impact of human capital but underline that the level of education is significant for all sectors[286], even though regional specifics may exist.[287] Furthermore, studies identify the technological base as an important – yet less significant than the skill level – driver of the investment decision of

[281] See Altomonte (1998); Resmini (2000); Brenton, Di Mauro, and Lücke (1999); Merlevede and Schoors (2004).
[282] See e. g. Campos and Kinoshita (2003); Brada, Kutan, and Yigit (2003).
[283] See Carstensen and Toubal (2004) and Altomonte and Guagliano (2003) respectively; see also European Commission (2005b).
[284] See Lansbury, Pain, and Smidkova (1996).
[285] See Savary (1997); Pye (1998); AHK (2006); Borsos-Torstila (1999).
[286] See e. g. Altomonte and Guagliano (2003).
[287] See e. g. Campos and Kinoshita (2003) who found – even though in contrast to other studies – that the level of education is only a significant FDI determinant for CIS transition countries.

MNCs in transition economies.[288]

Privatization is defined in most studies as the private sector share of the national GDP and is usually based on an EBRD index.[289] Lately it has been criticized that this index shows only little variation over time and may actually underestimate the dynamics of the privatization progress. Therefore, studies often use annual privatization revenues[290] or – more frequently – the method of privatization, e. g. vouchers, cash sales, insider privatization.[291]

Empirical results confirm that privatization increases investment opportunities for MNCs. Thus FDI inflows were higher in those transition countries with greater private sector share and higher annual privatization sales, especially in the first years of privatization until 2000, when MNCs attempted to exploit first-mover advantages.[292] However, more recent studies find more significant results for the method of privatization; *Holland and Pain (1998)* show that countries with cash sales have higher FDI inflows than those with voucher systems.[293] In contrast, the limited transparency and the favoring of domestic oligarchs in the insider privatization in CIS countries had a negative impact on FDI inflows from Western countries.[294] Moreover, *Brada, Kutan, and Yigit (2003)* remark that privatization results may be somewhat misleading because of the few large-scale privatizations that deter FDI statistics.

[288] See e. g. Lansbury, Pain, and Smidkova (1996); Savary (1997).
[289] See e. g. Lansbury, Pain, and Smidkova (1996); Holland and Pain (1998); Carstensen and Toubal (2004); Bevan and Estrin (2004); Brada, Kutan, and Yigit (2003); Smarzynska (2002).
[290] See Bellak and Leibrecht (2005).
[291] See Holland and Pain (1998); Carstensen and Toubal (2004); Merlevede and Schoors (2004).
[292] See e. g. Lansbury, Pain, and Smidkova (1996); Carstensen and Toubal (2004); Bellak and Leibrecht (2005).
[293] Likewise confirmed by Merlevede and Schoors (2004); see also Carstensen and Toubal (2004); Bellak and Leibrecht (2005).
[294] See Merlevede and Schoors (2004), p.19.

Finally, **political stability** is often measured on the basis of different EBRD transition indicators, including, for example, infrastructure, competition policy and financial reform.[295] Other methods of measuring political stability include political rights or political freedom ratings, e. g. from the Freedom House Index[296] or political stability indicators based on World Bank evaluations.[297]

Various studies support the hypothesis that a (perceived) lack of political stability reduces FDI flows to transition countries.[298] *Merlevede and Schoors (2004)* find strong impact of their political risk variable on the investment decision, while others see political rights or the type of government as an important determinant for the investment decision in transition countries.[299] For the SEECs *Brada, Kutan, and Yigit (2003)* identify the overall political stability as a major precondition for increased FDI flows.

Nevertheless, it seems impossible to determine a total impact of political stability since definitions are ambiguous and not suitable for comparison.

In **conclusion**, the assessment of the main determinants of the 34 studies on transition countries emphasized that the frequency of citation of the main FDI determinants in transition countries as presented in *figure 8* does not necessarily correspond with the relative importance of determinants to each other. While market size does indeed seem to be one of the most important determinants[300], the line of argument regarding the relative importance among other factors, e. g. labor cost or political stability, is less compelling across most studies. The main reasons for these ambiguous results are the different

[295] See e. g. Merlevede and Schoors (2004); Holland and Pain (1998); Lankes and Venables (1996).
[296] See Disdier and Mayer (2003).
[297] See Garibaldi, Mora, Sahay, and Zettelmeyer (2001).
[298] See e. g. Woodward, Rolfe, Guimaraes, and Doupnik (2000).
[299] See e. g. Disdier and Mayer (2003); Jensen (2002).
[300] See also Resmini (2006); Holland, Sass, Benacek, and Gronicki (2000); but also for developing countries Nunnenkamp and Spatz (2002) as well as for all countries Lim (2001); Blonigen (2005).

definitions, evaluation methods and data specifications.[301]

2.2.5 Opportunities for contributions to FDI research

Despite the existence of more than 30 studies on FDI determinants in transition countries **this thesis can make meaningful contributions to FDI research** because the evaluation of the existing studies discloses (1) methodological limitations, (2) a possible underestimation of policy factors and (3) an often neglected analysis of the state view.

(1) The common approaches, (a) econometric studies and (b) survey, often reveal **methodological challenges** for the in-depth analysis of FDI.

(a) On the one hand, **econometric studies** are to some extent arbitrary in their choice of determinants. Of course, they try to isolate certain factors to test their relative impact; thus they cannot reflect all potential factors of MNCs but have to estimate what the most relevant ones may be. Therefore they may be able to say something about the importance of a specific factor versus other selected factors but can hardly reveal a comprehensive set of factors that influences the investment decision of MNCs. *Figure 9* shows an example from *Galego, Vieira, and Vieira (2004)* that exposes the shortcomings discussed; the authors selected a small set of FDI determinants. Despite the fact that the statistical results show only limited significance, the selection also raises the question as to why these particular factors have been chosen as key factors for the investment decision of MNCs, neglecting other factors like the investment climate, human capital etc.[302] Other econometric studies may include larger sets of FDI determinants[303] but the dependence on external data and the risk to come to somewhat selective results remains.

[301] See also Holland, Sass, Benacek, and Gronicki (2000).
[302] Galego, Vieira, and Vieira (2004) did test the factors wages and trade openness but without statistically significant outcome.
[303] See e. g. Kinoshita and Campos (2006) with 14 analyzed factors.

Determinants of FDI flows (1993-1999) according to Galego et al (2004)

Category	GLS regression	*Standard error*
GDP per capita home country	0.875	*0.873*
GDP per capita host country	0.867(*)	*0.162*
Population home country	0.780	*0.150*
Population host country	0.786	*0.149*
Geographical distance	-0.618(*)	*0.199*
Common frontier	0.598	*0.578*
Constant	-12.962	*8.914*

(*) = significant at 1%

Source: Based on Galego et al (2004), own presentation

Figure 9: Example for methodological challenges of econometric FDI studies

(b) On the other hand, **FDI surveys** have difficulties in capturing the true motives of an investment by MNCs, since a group of researchers usually develops the questionnaire itself[304], possibly neglecting other important determinants. More crucially, the surveys usually do not weigh the determinants.

A survey of the German Chamber of Commerce (*AHK (2006)*), summarized in *figure 10*, depicts this dilemma; therefore, the institution asked investors in 14 transition countries about their country-specific determinants. The mean in the second column reveals that all factors mentioned seem to be of significant importance for the investment decision of MNCs, since the values for all of the 25 factors are between 1.54 and 2.85, where 1 represents a very important factor and 5 represents a factor that was not important for the investment decision; hence a clear statement about country determinants cannot be made.

This thesis offers a somewhat **new approach** to the displayed problem, the **combination of expert interviews, expert documents as well as**

[304] See e. g. Altzinger (1999); Pye (1998).

Locational determinants of German investors according to AHK survey (2006)

1 = very important; 5 = not important

Category	Mean	BH	BG	EE	HR	LV	LT	MC	PL	RO	SRB	SK	SV	CZ	HU
Willingness to perform	1.54	1.50	1.55	1.51	1.44	1.65	1.28	1.56	1.84	1.56	1.69	1.34	1.80	1.39	1.51
Productivity	1.54	1.60	1.63	1.62	1.50	1.57	1.26	1.38	2.00	1.46	1.75	1.35	1.64	1.28	1.50
Paying habits	1.54	1.35	1.44	1.49	1.59	1.56	1.44	1.38	1.75	1.57	1.52	1.73	1.80	1.44	1.51
Legal certainty	1.57	1.42	1.34	1.66	1.46	1.57	1.86	1.25	1.87	1.43	1.56	1.40	2.04	1.53	1.53
Educational level	1.58	1.50	1.35	1.62	1.64	1.55	1.32	1.57	1.70	1.56	1.82	1.41	1.96	1.48	1.59
Tax burden	1.62	1.62	1.61	1.51	1.75	1.69	1.61	1.24	1.90	1.63	1.82	1.47	1.56	1.70	1.58
Tax system	1.65	1.35	1.50	1.62	1.58	1.74	1.54	1.51	1.84	1.56	2.12	1.59	1.80	1.73	1.62
Labor cost	1.67	1.68	1.81	1.54	1.66	1.59	1.32	1.73	2.06	1.59	1.93	1.57	1.72	1.55	1.58
Availability of skilled workers	1.71	1.55	1.53	1.69	1.73	1.69	1.42	1.67	1.95	1.63	2.06	1.51	2.20	1.61	1.72
Political stability	1.71	1.38	1.47	1.49	1.60	1.84	1.65	1.45	2.22	1.50	1.73	1.66	2.28	1.82	1.86
Corruption & crime rate	1.71	1.26	1.63	1.62	1.53	1.69	1.69	1.36	2.00	1.47	1.90	1.78	2.52	1.71	1.76
Reliability	1.75	1.52	1.63	1.47	1.78	1.70	1.65	1.21	2.06	1.60	1.76	1.81	2.60	1.99	1.65
Local demand	1.77	1.55	1.70	1.87	1.65	2.02	1.50	1.65	1.93	1.96	1.58	1.96	1.96	1.69	1.69
EU accession	1.84		1.94	1.59	1.94	1.78	1.69		1.86	2.18		1.47	1.80	1.91	2.04
Public administration	1.87	1.46	1.72	1.73	1.57	2.02	2.03	1.64	2.17	1.71	2.06	2.10	2.04	2.08	1.87
Quality of suppliers	1.90	1.66	1.66	1.76	2.03	2.06	1.59	1.91	2.38	1.64	2.13	1.90	2.20	1.74	1.90
Flexibility of labor law	1.90	1.78	1.90	1.99	1.84	2.16	1.70	1.67	2.31	1.98	2.09	1.72	1.88	1.68	1.95
Infrastructure	1.93	1.60	1.56	1.80	2.10	2.06	1.86	1.73	2.16	1.85	2.21	2.07	2.04	2.16	1.84
Qualification of graduates	2.03	1.88	2.16	2.31	2.12	2.05	1.66	1.85	2.21	1.99	2.19	1.88	2.28	1.77	2.13
Availability of suppliers	2.12	1.72	2.31	2.02	2.29	2.11	1.94	1.94	2.34	1.78	2.13	2.26	2.60	2.08	2.21
Transparency of tenders	2.24	1.61	2.09	2.60	2.00	2.60	2.03	1.88	2.39	2.02	1.72	2.45	3.00	2.46	2.44
Regional export potential	2.29	2.37	2.50	2.00	2.18	2.50	1.84	1.47	2.15	2.54	2.34	2.52	2.60	2.43	2.61
R&D conditions	2.50	1.86	2.41	2.53	2.56	2.81	2.00	1.91	2.19	2.42	2.93	2.89	2.84	2.81	2.78
Subsidies	2.60		2.59	2.82	2.62	3.21	2.37	1.81	2.33	2.50	2.52	2.99	2.92	2.78	2.39
Availability of unskilled workers	2.85	2.71	2.84	2.49	3.38	2.90	2.35	3.27	2.55	2.26	3.47	2.63	3.08	2.95	3.04
Mean	**1.89**	**1.65**	**1.83**	**1.85**	**1.90**	**2.00**	**1.70**	**1.67**	**2.09**	**1.82**	**2.04**	**1.90**	**2.21**	**1.91**	**1.93**

Source: AHK (2006), own presentation

Figure 10: Example for methodological challenges of FDI surveys

primary and secondary source analysis. The elements of this case study approach are presented in *section 3.3*.

(2) Most studies appear to see only limited possibilities for FDI determinants to be influenced by **public policy**. Potential reasons could be (a) an overestimation of classical variables and (b) limited knowledge about public policy factors.

(a) Current FDI literature may **overestimate the impact of classical, i. e. non-policy, determinants**. Going back to the main determinants of the 34 analyzed studies on FDI in transition countries, a look at *figure 11* reveals that four of the five determinants that are most frequently cited as main FDI determinants can barely be influenced by public policy actors: market size, labor costs, trade openness, and proximity. While it may be obvious why public policy possesses only limited possibilities to influence market size and proximity, labor costs and trade openness should be further explained. Regarding labor costs it is important to keep in mind that investors usually focus on net wages without considering non-wage labor costs. Tax related policies are furthermore reflected by the country determinant tax policy that is not among the eight most frequently cited determinants of the analyzed studies. Furthermore states have only limited influence on wages in the private sector which is most relevant for investors.

Trade openness, on the other hand, only reflects the trade flows between countries and should not be confused with trade policy that includes customs, trade agreements etc. and is also a separate determinant.

Generally, the consideration of these four factors is not surprising since they belong to the classical factors suggested by FDI theory as presented in *section 2.2.3*. Thus, most scholars (also) include these determinants in their analyses

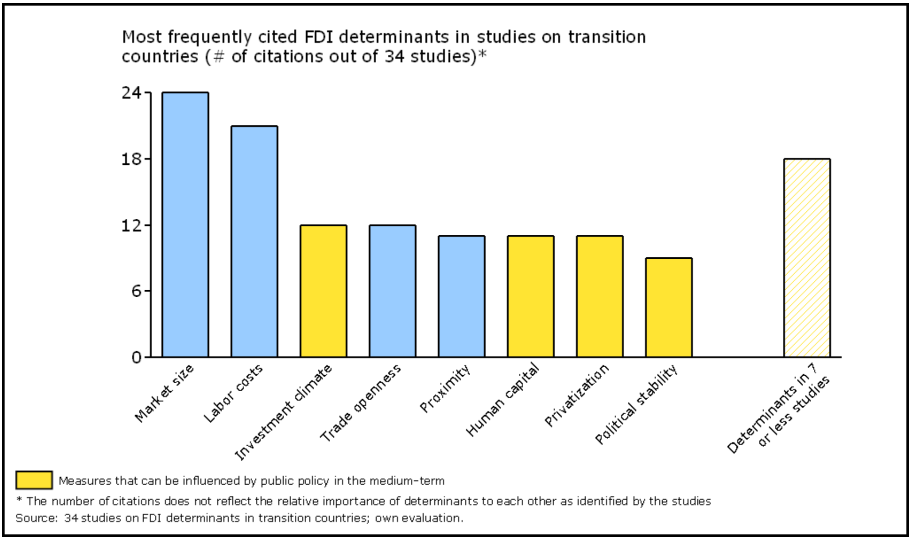

Figure 11: Main FDI determinants and public policy influence

to satisfy theory and may therefore overestimate their real importance. Nevertheless, International Business theory has traditionally assumed the role of public policy to be minimal.[305]

A look at the country characteristics of transition countries in particular also suggests that these classical non-policy factors may be overestimated; hence, market size may be an important determinant but initial interviews by the author with investors indicated that markets are more often interpreted in terms of regional potential; investors' interest in Romania, for example, has less to do with its large population than with the large market – including all SEECs – to which it has access.[306] In addition to this, labor costs and trade openness are despite some differences fairly comparable among the countries in the region[307]

[305] See Mudambi (2002), p.265.
[306] See Intv. Austr. MNC - Industrial Goods I (2007).
[307] The average hourly labor costs in 2004 were €1.45 in Bulgaria versus €1.75 in Romania; see Eurostat (2007a).

and the geographical distance, for example, of Romania or Bulgaria to a city in Northern Germany is only marginal. Therefore, the classical factors have only limited credibility in serving as a distinction between countries e. g. in the SEECs. Thus how can transition countries actually stand out as attractive location for MNCs? What distinguishes, for example, Romania from Bulgaria?

The answer could be public policy determinants; those factors that can be significantly influenced by state actors in a limited time-span, i. e. in up to ten years, seem more apt to characterize country-specific differences.

(b) Until now there is still **limited knowledge about public policy factors** as FDI determinants in transition countries. Without a doubt, authors have repeatedly attempted to integrate policy factors in their analysis; however, the survey of the 34 studies on FDI determinants on transition countries unveils once again the shortcomings of the existing literature. First of all, it lacks a clear definition of public policy variables as has been shown above for "investment climate" and "political stability".[308] Secondly, current studies are not able to present a convincing list of policy factors that influence the investment decision of MNCs, whereas the list of non-policy variables has been fairly stable in the analyzed studies. Initial interviews by the author have also indicated that the decision-making process is more complex than depicted by most FDI studies. They suggest that other public policy factors that have not been discovered by the existing literature on transition countries so far (e. g. the cooperation with local administration), may play a decisive role in attracting foreign investors.[309] Finally, because of data limitations and the above mentioned methodological challenges, results of the relative impact of public policy factors are still difficult to grasp and little robust in terms of statistical sig-

[308] See *section 2.2.4.2*.
[309] See Intv. Austr. MNC - Industrial Goods I (2007).

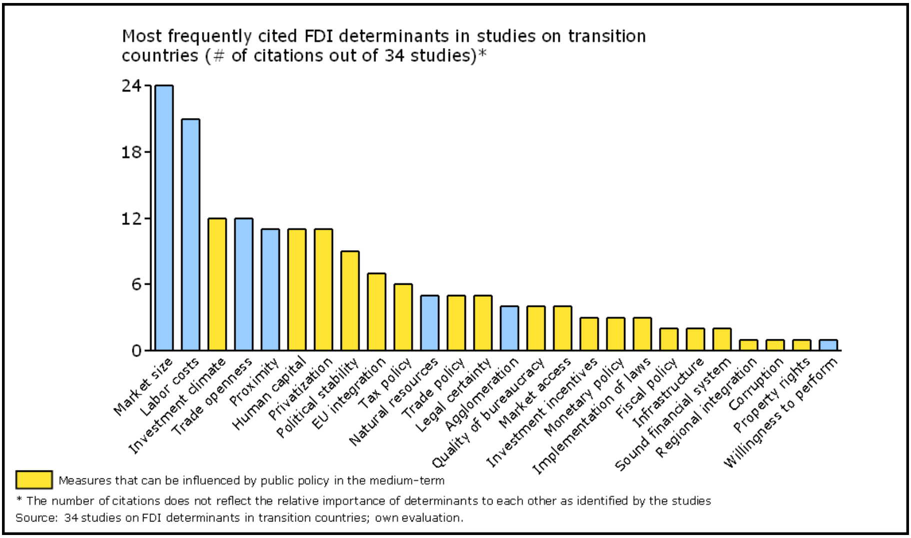

Figure 12: Detailed overview of FDI determinants

nificance.[310] More recently *Smarzynska (2002)* and others have acknowledged a more important influence of public policy with regards to classical variables than earlier studies but the evidence is far from conclusive.

Figure 12 reveals all determinants that have been identified by the 34 analyzed studies as main drivers for the investment decision of MNCs.

It confirms that little consensus about public policy factors exists among FDI studies on country determinants. This list of 19 public policy factors – again defined by the criteria as to which factors can be decisively influenced by state actors in up to ten years – is used as starting point for the empirical analysis of this thesis: investment climate, human capital, privatization, political stability, EU integration, tax policy, trade policy, legal certainty, quality of bureaucracy, market access, investment incentives, monetary policy, imple-

[310] See also Demekas, Horváth, Ribakova, and Wu (2005); Chakrabarti (2001).

mentation of laws, fiscal policy, infrastructure, sound financial system, regional integration, corruption, and property rights.

In the empirical part of the thesis, this list is to be tested in expert interviews and based on expert documents and secondary literature.

(3) Furthermore, the existing studies reveal little about the **interdependence of MNC determinants and corresponding state actions**; research often ignores that "the location of FDI is a game with two players"[311]. This is not only interesting for those countries making massive reform efforts in order to master transition but also – at least in numerous cases – to achieve EU integration. In fact literature on the interaction between host government and MNC is small and receives little attention in the studies on transition countries analyzed by the author.[312]

One reason for neglecting the state view is the limited inter-disciplinary approach: scholars from International Economics and International Business usually interpret FDI without paying much attention to the political dimension of FDI competition, leaving this part to political scientists and international organizations.

The broad theoretical set-up, various site visits and numerous expert interviews seem therefore good preconditions for this thesis to make a contribution to this dimension of existing FDI research.

2.3 New Institutional Economics (NIE) theory

The previous chapter concluded that this thesis can possibly make a contribution to FDI research in terms of methodology, extensive analysis of policy factors and adding the state view as (fairly) uncommon methods of analysis. In

[311] Mudambi (2002), p.265.
[312] See Mudambi (2002), p.265.

addition to that the New Institutional Economics (NIE) seems to be another theoretical tool that is well apt in order to gain further insights on the influence of public policy measures on FDI determinants in transition countries.

This chapter briefly discusses the main ideas of the NIE as far as they are relevant for this thesis (*section 2.3.1*) and then focuses on a framework based on *Willamson (1975, 1985, 2000)* that will act as guideline for an advanced categorization of determinants and state actors for this thesis (*section 2.3.2*).

2.3.1 Main NIE concepts and overlap with FDI theory

The following passage seeks to explain the (1) aim and main hypotheses, (2) assumptions, and (3) main definitions of NIE and their transfer to FDI theory. The last section reviews (4) the existing literature on NIE and FDI.

(1) The **aim of the NIE** is to answer questions related to growth and development differently and in a more comprehensive way than traditional economists (*Coase (1937) and North (1990a)* and others). NIE theory is based on two main **hypotheses**: first, that growth and development depend on the currently valid institutions and second, the context of decisions is essential for comprehending changes in economies.

This aim and hypotheses of NIE are also transferable to **FDI theory**. Therefore, this thesis aims at explaining the possibilities of public policy to attract FDI in a more comprehensive way. If institutions are understood as public policy determinants, FDI inflows are – analogous to growth and development in NIE theory – to a large extent influenced by the existence and interdependence of different policy measures. As the context is the key for development in NIE, the transition process and reform dynamics are the main preconditions for possibilities and limits of FDI policies in the analyzed countries, Romania and Croatia.

(2) The key **assumptions** of the **NIE theory** diverge from neo-classic theory; therefore, NIE assumes imperfect markets; this includes the concept of "bounded rationality"[313] which presumes that human beings only have limited knowledge and capacity to cope with all available information and cannot foresee all possible or ideal possibilities of decision. They try to maximize their satisfaction in the available context of information which can also lead to the opportunistic behavior of individuals.[314] NIE also assumes asymmetric information; before reaching a contract parties often have diverging or incomplete information about each other. The efficiency of allocation is therefore negatively affected.[315] According to NIE theory bounded rationality and asymmetric information cause transaction costs, i. e. costs for the use of (inefficient) markets for information, search, negotiation, implementation etc.[316] *North (1990b)* extended the concept of transaction cost to political markets (e. g. between politician and voter) where inefficiencies seem particularly striking.

Moreover, NIE theorists assume that institutional and economic changes are more likely to occur incrementally than through quick changes and are a result of the continuous interaction between different actors.[317] Last not least, NIE assumes strategic and political uncertainty; thus the entrepreneur or politician does not know what the future will bring.[318]

The outlined assumptions of NIE also seem to be transferable to the **FDI approach** used in this thesis; thus, the assumption of imperfect markets is reflected in the idea that not all countries receive the same amount of FDI.

[313] First presented in Simon (1955).
[314] See also Williamson (1975); Voigt (2002), pp.28-30; Richter and Furubotn (2003), pp.3-5.
[315] See e. g. Richter and Furubotn (2003), pp.100.
[316] First introduced by Coase (1937).
[317] See North (1990a).
[318] First introduced by Knight (1922).

MNCs have bounded rationality since they also use irrational determinants (e. g. private connections to the host country) for their investment decision. The asymmetric information of FDI is given since public policy actors do not know the true motives and determinants of MNCs. This situation again causes transaction costs for both the state and the MNCs, i. e. the investment policy of the state and country analyses through MNCs. With regards to incremental changes this thesis further assumes that underlying and time-consuming factors such as the implementation of anticorruption policy are more important for a sustainable FDI growth than isolated efforts, e. g. a single large-scale privatization. Finally, both groups of actors, MNCs and states, suffer from uncertainty, e. g. regarding the MNC behavior, government changes, EU accession etc.

(3) **NIE theory** is marked by two key terms, **institutions** and **organizations**. Institutions in NIE are comprehended as rules or system of rules as well as the mechanism to implement and guarantee these rules; they are therefore "rules of the game" as well as the "play of the game". Moreover, institutions can be formal as well as informal rules and can comprise, for example, conventions, customs, religion, rules, laws etc.[319]

In contrast, organizations represent the "players of the game". They are understood as formal or informal groups of individuals with a common purpose including political, economic and social bodies.[320]

In the **FDI context**, institutions can be interpreted as all possible factors that are apt to influence FDI decisions and embody FDI-related laws and policies as well as their implementation; they can be formal (e. g. laws and financial incentives) as well as informal (administrative services, advice etc.). Organizations in this thesis are all possible actors that are well-suited to influence these

[319] See e. g. Kiwit and Voigt (1995); Ostrom (1990), p.51; Voigt (2002), p.33; Richter and Furubotn (2003), pp.7-10.

[320] First formalized by Schmoller (1900); see also North (1990a).

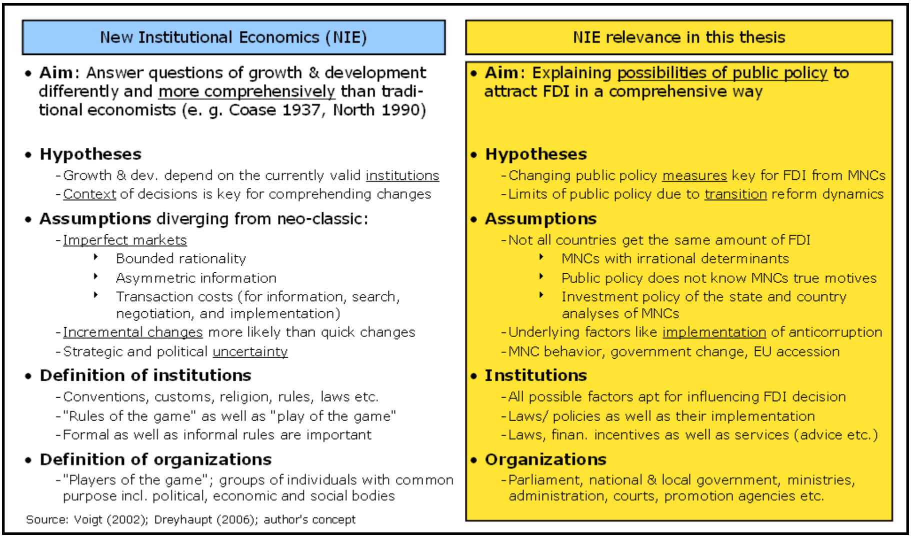

Figure 13: Similarities of NIE and FDI theory

institutions, e. g. national parliaments, national and local governments, ministries, administration, courts, but also promotion agencies etc.

The similarities of NIE and the FDI approach as understood in this thesis appear convincing, as presented in *figure 13*.

(4) FDI **literature** integrating the NIE approach is still in its infancy. Early elements of NIE thoughts (e. g. of imperfect markets) were already incorporated in *Hymer's* market imperfections approach or in the internalization theory.[321] The approach of institutional quality also examines institutions; however this tends to use organizations in the sense of NIE than institutions per se.[322] Other authors rely more heavily on NIE literature but do not specifically focus on the countries analyzed in this thesis and do not reflect the specifics regarding

[321] See *section 2.2.3.2.*
[322] See e. g. Bevan, Estrin, and Meyer (2004); Barrell and Pain (1999).

institutions and organization as suggested in NIE theory that are presented in the following section.[323]

One of the most well-thought studies that also thoroughly uses NIE concepts is the dissertation of *Dreyhaupt (2006)*. His research focus is however not the transition countries but the EU and its competition policy; nevertheless, his work serves as an important theoretical inspiration for this thesis.

2.3.2 An NIE framework for FDI analysis

As shown above, NIE theory follows an approach to Economics that is well transferable to FDI analysis as understood in this theses. Furthermore, NIE has developed tools that may help to better understand the possibilities and limits of reforms in order to attract higher levels of MNCs. One challenge of existing FDI literature is to categorize in a compelling way the large amount of country determinants that have been identified by researchers so far. In fact, various authors have attempted to group FDI determinants; *Lall (1997)* identified nine categories for his 50 plus determinants and *OECD (2006a)* also developed ten groups for their 60 plus sub-dimensions and indicators. However, the literature has not yet agreed on the general terms of FDI determinants classification. In any case, the given examples of large lists of categories do not seem to give state actors a good basis for actionable public policy implications. Moreover, two aspects have been widely neglected in this context: the different time-horizons of policy measures and the respective actors that are involved in these processes.

Williamson (2000), one of the founding fathers of NIE, has established an interesting framework to categorize institutions. He identifies four different levels of analysis. The first level is social embeddedness that includes informal institutions, customs and religion which only transform after a period of over 100

[323] See e. g. Meyer (2001); Murrell (2002); Pournarakis and Varsakelis (2004); Jacobs (2003); Bénassy-Quéré, Coupet, and Mayer (2005).

New Institutional Economics				Transfer to FDI theory	
Level	Term	Example	Transformation time	Determinants (= Institutions)	Public policy organizations
#1	• Social embeddedness	• Informal institutions, customs, religions	• 100-1,000 years	• Market size, climate, geography, natural resources	• Out of scope
#2	• Institutional environment "rules of the game"	• Polity, judiciary, constitutional & property law	• 10-100 years and after regime changes	• Constitution, infrastructure, political stability, EU accession, education	• Parliament, government
#3	• Governance "play of the game"	• Governance structure to manage contractual relations	• 1-10 years	• Laws on e. g. tax, privatization, anticorruption, environment	• Government, ministries
#4	• Resource allocation	• Adjustment of prices & incentive alignment	• Continuous	• Implementation of laws, investm. promotion, admin. procedures, incentives	• Ministries, administration, courts, local governments, agencies etc.

Can be influenced by public policy in transition countries in the medium-term

Source: Based on Williamson (2000), Voigt (2002), author's concept

Figure 14: First approach of NIE framework for FDI categorization

years. The second level is called the institutional environment, also includes formal rules such as polity, judiciary, constitutional and property laws; they can be changed, according to *Williamson*, in 10 to 100 years. The third level is referred to as governance that embodies the governance structure to manage contractual relations which can be modified within one to ten years. The fourth and last level, the resource allocation, is a continuous process and comprises, for example, the adjustment of prices and incentive alignments of companies.[324]

Figure 14 shows – in a first approach – how this framework can be transferred to and extended for the FDI research of this thesis. As well as the translation of the institutional examples into FDI determinants, this overview also adds the – preliminary – matching of institutions with the organizations involved, i. e. the respective state actors.

[324] See also Voigt (2002); Dreyhaupt (2006).

The first level of analysis, as suggested by *Williamson (2000)*, consists of institutions or determinants that can hardly be influenced by public policy in the medium-term, reflecting in FDI research, for example, market size, climate, geography, and natural resources. This level will not be focus of this thesis.

The institutional examples for the second level with regards to FDI theory could be constitutions, infrastructure, political stability, EU accession, education etc. The respective actors could be the parliament or the national government.

Level three could be translated into laws e. g. tax, privatization, anticorruption, environment etc. The responsible actors could again be the government or specific ministries.

The fourth level could be interpreted in FDI terms as the implementation of laws, the promotion of investment, administrative procedures, incentives etc. Various forms of organizations could be involved, including ministries, administration, courts, local governments, agencies etc.

This adapted FDI framework based on NIE will be thoroughly tested and adjusted throughout this thesis. It may overall help different groups of policy makers to better understand their own room for maneuver in FDI policy.

2.4 Derived theoretical framework

This chapter has considered the theoretical foundation of this thesis in depth. It has been shown that FDI tends to have positive effects on host and home economies as well as on MNCs and is therefore worth the support of governments. This is especially true in transition countries where FDI often shows beneficial effects in terms of development and reform.

Furthermore, this chapter has underlined that FDI theory is complex and research is extensive; nevertheless, the results of FDI studies often tend to be ambiguous due to methodological challenges, a possible underestimation of public policy factors and the often neglected incorporation of the state view. Furthermore, most FDI studies lack the convincing categorization of the measures and its actors necessary for a better understanding of the dynamics and limits of FDI country determinants.

This thesis therefore aims at making meaningful contributions to these issues, relying on the FDI approach of **locational competition** analyzing the possibilities and limits for public policy in attracting MNCs to transition countries. The **NIE** will help to categorize FDI institutions and organizations as well as to analyze state actions from a **political science** point of view.

Furthermore, a preliminary list of 19 country determinants – based on the existing literature – has been identified that will be the basis of the further analyses of this thesis. The methodological implementation of this theoretical and somewhat inter-disciplinary framework is the subject of the following chapter.

3 Methodological approach

This chapter elaborates the methodological approach of this thesis. *Section 3.1* explains the selection of the host countries, Romania and Croatia, *section 3.2* expounds the rationale for choosing MNCs from Germany and Austria in the analysis and *section 3.3* discusses the case study approach. Finally, *section 3.4* concludes the derived methodological framework for this thesis.

3.1 Host country selection

The following section infers the host country selection of this thesis. More specifically it is elaborated why the Eastern European transition countries are interesting for FDI studies *(section 3.1.1)*, why Romania *(section 3.1.2)* and Croatia *(section 3.1.3)* were selected as host countries for this thesis, and why the combination of the two countries is rewarding and sound *(section 3.1.4)*. The findings are wrapped up in *section 3.1.5*.

3.1.1 Eastern European transition countries

Both analyzed countries, Romania and Croatia, are defined as Eastern European transition countries; this region comprises eight CEECs[325], eight

[325] Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, Slovenia.

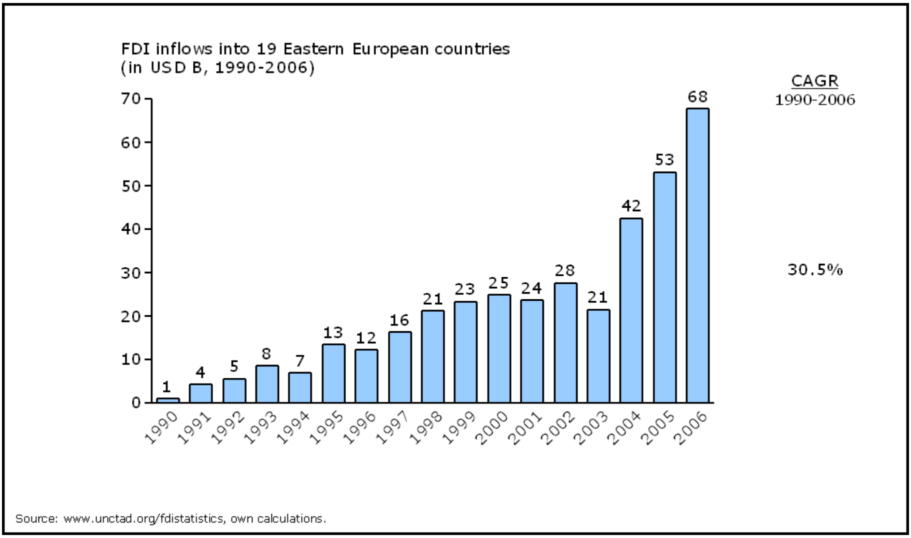

Figure 15: FDI development in Eastern Europe

SEECs[326] and the three European CIS countries (Belarus, Moldova and Ukraine).[327]

This region is of particular interest for studying the impact of policy reforms on FDI because of (1) its significant FDI inflows, (2) its specific transition situation, (3) its thriving towards the EU, and because of (4) open research questions.

(1) **FDI inflows** into Eastern Europe are **significant and growing**. Thus, FDI inflow in this region grew at a CAGR of 31% since 1990 and reached USD68B in 2006 *(see figure 15)*.[328]

[326] Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Macedonia, Montenegro, Romania, and Serbia.

[327] The non-EU CIS members are not included in order to avoid distortions due to their large distance to Western European home markets, strong economic reliance on natural resources and – in the case of Russia – large market size.

[328] 19 EECs including former Yugoslavia (1990-1991); UNCTAD FDI website (2008); own calculations.

(2) Compared to other regions of the world, Eastern Europe especially stands out as **region in transition** (*see section 2.1.5*). Therefore, a multiple case study of two transition countries particularly seems interesting because these countries had similar starting conditions and a comparable starting point in their competition for FDI inflows – the breakdown of socialism in the late 1980s.

(3) The **endeavor for EU accession** in EECs has triggered additional and significant reform dynamics. The speed and implementation of EU-specific reforms have also substantially influenced the attractiveness of these countries as investment location.[329]

(4) Last but not least, the fast-moving economic and political developments of this region have left various **open questions for academic research**. As pointed out above (*see section 2.2.5*), FDI research has so far gained only limited knowledge about public policy determinants that influence MNCs' decision to invest in a specific transition country. In addition to the academic literature reviewed above, FDI in EECs is also the subject of some publications of international organizations. They, however, mainly analyze the region on a year-to-year perspective without capturing causalities of reforms nor the context of policy changes in this region. Finally, they usually do not reflect the firm-perspective.[330]

3.1.2 Romania

Romania is an interesting subject in order to study FDI developments because of its (1) fairly large market size and high FDI stock, (2) its remarkable eco-

[329] By 2004: Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, and Slovenia; by 2007: Bulgaria and Romania. Croatia has opened accession negotiations, Macedonia is an official candidate;
Albania, Bosnia and Herzegovina, Montenegro, Serbia, and even Kosovo are potential candidate countries. See also European Commission (2006b).

[330] See e. g. CICD (2006); OECD (2006a); World Economic Forum (2006b).

nomic and FDI surge in recent years, (3) its interesting reform dynamics in the context of the recent EU accession, and because of (4) some blind spots in academic research.

(1) Romania is an important Eastern European transition country because it is sizable; it represents the **third largest Eastern European market** both in terms of population with about 21.7M inhabitants and in terms of output with a GDP of €97B in 2006. Moreover, Romania has accumulated a large stock of inward FDIs of €34.B in 2006 only trailing Poland, Hungary and Czech Republic.[331]

(2) Its recent **remarkable growth** of the economy and its increase of FDI inflows makes Romania a fascinating example for transition countries. Due to the economic surge – especially after 2000 – Romania saw high real GDP growth rates of recently 4.1% (2005) and 7.7% (2006).[332] Furthermore, FDI inflow has significantly risen in recent years, soaring at a CAGR of 27% between 1997 and 2006 – compared to 16% in the other Eastern European transition countries.[333]

(3) Romania is also interesting to study in the context of its recent aspirations in **joining the EU** which succeeded in 2007. For any years Romania suffered from political instability, stagnating reforms and conflicts among interest groups. The goal of EU accession however, set reform dynamics free that were suitable to narrow down the existing large development gap between Romania an many other EECs within a few years.

(4) FDI **literature on Romania is still scarce**. As pointed out for Eastern Europe before, the few FDI studies from banks, international organizations and business organizations usually focuses on a year-to-year perspective without a comprehensive analysis of developments and reforms in Romania.[334]

[331] See Hunya (2006); IMF website (2008); Eurostat (2007a); NBR website (2007).
[332] See Maniu, Kallai, and Popa (2001), p.22; Bfai (2005), p.33; IMF (2007b).
[333] See IMF website (2008); own calcuations.
[334] See e. g. BA-CA (2006); Rabobank (2006); European Commission (2006e); OECD (2005d); International Business Promotion (2006).

Moreover, the number of **academic studies** about FDI in Romania is limited. Of the few studies that only deal with Romania, the majority is outdated considering the rapid development in Romania in recent years[335] or rather focus on the effects of FDI on the Romanian economy instead of the determinants.[336] *Müller (2005)* may represent the most recent and comprehensive work in this context. His dissertation, however, discusses FDIs in Romania – in a non-empirical analysis – as phenomenon of system transformation and focuses little on possibilities and limits of governmental institutions to attract FDI.

3.1.3 Croatia

Croatia is an interesting country in order to study public policy effects on FDI inflows because of (1) its high FDI stock (2) its specific reform challenges following the war, (3) its current efforts in preparing a potential EU accession, and because (4) academic studies on FDI in Croatia are still rare.

(1) Croatia has accumulated a **high FDI inflow stock** of €21.4B (2006) and its FDI per capita stock of €4,577 (2006) is more than twice as high than in all other SEECs. The Croatian FDI stock accounts for 5.7% of Eastern European FDI stock while Croatians only represent 2.4% of the Eastern European population.[337] It is, therefore, interesting to scrutinize why Croatia has been so successful in attracting MNCs in the past.

(2) In addition to its transition challenges, Croatia also had to cope with a **war of independence** (1991-1995), severe after-war setbacks until the early

[335] See e. g. Radulescu (1996); Chiritoiu (1998); Maniu, Kallai, and Popa (2001); Voinea (2002); the most interesting study is probably from Hilber and Voicu (2006) that covers, however, only the years 1990-1997.

[336] See e. g. Smarzynska and Spatareanu (2002); Birsan, Moraru, Cramarenco, and Andrei (2005); Merlevede and Schoors (2005).

[337] See Hunya (2006); Der Fischerweltalmanach 2007 (2006); own calculations.

2000s and as well as with an ongoing political instability of the region. Thus it is interesting to examine how Croatia managed to continue attracting FDI under these circumstances and what the key challenges were.

(3) The analysis of Croatia is appealing because of the current reform dynamics that can be observed in Croatia's efforts to attain **EU accession**. These efforts also include aspirations to improve investment conditions for MNCs. Furthermore, the pre-accession phase enables Croatia to conduct a fairly independent investment policy without being completely formally tied to investment regulations and subsidy limitations of the EU, yet.

(4) **Research** on FDI in Croatia has **only begun to evolve**. International organization like the EU[338] and the World Bank[339] have published reports that include observations regarding the status of FDI in Croatia but strongly focus on the institutional side. This is also true for Croatian governmental institutions themselves as well as some banks that have conducted various studies on the state of competitiveness of Croatia without however, extensively reflecting the MNCs' perspective.[340]

The status of academic single country studies analyzing exclusively on Croatian FDI is analogous to Romania: the number of studies is limited, the existing ones usually do not cover the most recent reforms[341] and primarily discuss the effects of FDI[342] and do not consider – in-depth – the Croatian reform policy.[343]

3.1.4 Country combination

The methodological rationale why it is reasonable to analyze more than just one country in a multiple case study set-up is elaborated in *section 3.3*. In the

[338] See European Commission (2006a).
[339] See World Bank (2003).
[340] See e. g. NCC (2004b); BA-CA (2005).
[341] See e. g. Lovrinčević and Mikulić (2000); Babić, Pufnik, and Stučka (2001).
[342] See e. g. Skudar (2005); Kušić and Cvijanović (2002); Vukšić (2004).
[343] See e. g. Sohinger, Galinec, and Škudar (2004); Hunya and Škudar (2006).

following it is scrutinized why the combined analysis of the selected countries, Romania and Croatia, in particular is promising and feasible.

The main reasons are that (1) both countries are located in the same, interesting sub-region and (2) are the most important FDI recipients of FDIs in this sub-region and eventually, (3) this specific combination of two countries has not been analyzed by FDI theory so far. Additionally, potential criticism that the two countries are not comparable can be countered regarding (4) the different size of the countries, and (5) the supposedly different development stage.

(1) Both Romania and Croatia belong to the **SEEC group**.[344] The study of FDI in SEECs is especially appealing because of its strong FDI growth at a CAGR of 45% (1990-2006) compared to 26% in the CEECs in the same period.[345] Furthermore, most SEECs have in common that they have been somewhat affected by the wars in ex-Yugoslavia[346] and, finally, were not part of the first wave of accession of EECs to the EU.

(2) Within the SEECs Romania and Croatia are of particular interest because they have been the **most important recipients of FDIs** accounting for almost two thirds (38% and 25% respectively) of the inward FDI stock by the end of 2006 *(see figure 16)*.[347]

(3) A **study** that analyzes FDIs in only Croatia and Romania apparently **does not exist so far** – to the author's knowledge. Contributions as well as the limits of the existing studies on transition economies were reviewed in *section 2.2.4.2.* Other studies on SEECs are more descriptive, generally focus on earlier time periods.[348] They will be considered in the further analysis but

[344] See for definition *section 2.1.5.*
[345] See UNCTAD FDI website (2008); own calculations.
[346] See *section 6.2* for details.
[347] See UNCTAD FDI website (2008); own calculations.
[348] See e. g. Uvalic (2001); Hunya (2002); Zakharov and Kušić (2003).

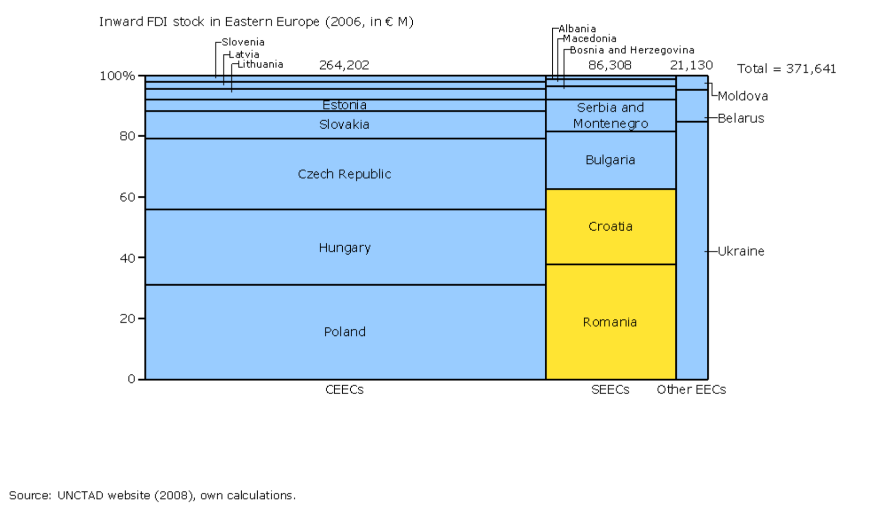

Figure 16: Inward FDI stock in Eastern Europe

leave plenty of room for new insights, especially regarding the multiple view of MNC and state strategies.

(4) Critics may evoke that a combination of the two countries is difficult because Romania and Croatia are of **different size** (22M inhabitants versus less than 5M). However, this argument is only taking the home market of the two countries into account. On the contrary, many MNCs investing into the region are strongly export-oriented and are, therefore, competing in the same markets,[349] aiming at the SEECs with more than 60M inhabitants or at even larger markets like the whole of Europe (of about 570M inhabitants).[350]

(5) Moreover, critics may point out that Romania and Croatia are difficult to compare since they are in a **different development stage**, with different

[349] See NCC (2004b), p.7.

[350] Without Russia and Turkey; see: Der Fischerweltalmanach 2007 (2006); see also interviews with Intv. Austr. MNC - Industrial Goods I (2007) and Intv. Croatian Authority II (2007).

histories (referring to Croatia's war experience) and a different political environment (referring to Romania's recent EU accession). However, it is important to point out, that this thesis does not aim at comparing the two countries in quantitative terms. Thus FDI figures or interview results will neither be pooled nor will the current stage of reforms be compared.[351]

On the contrary the combination of the two countries aims at strengthening the individual country results of the analysis, interpret them in a qualitative way and to answer question 5 of the introduction: What can countries learn from each other? In this context the pre-accession experience of Romania to the EU can be very valuable for Croatia and its public policy efforts to create favorable conditions for FDI. Thus it was already claimed by the *NCC (2004b)* that Bulgaria and Romania were reference points for competitiveness and reform for Croatia.[352]

3.1.5 Conclusion

In conclusion the host country selection of Romania and Croatia appears to be rewarding and feasible for the analysis of the impact of public policy on FDI. Firstly, both countries play a large role for FDIs in Eastern Europe and a major role among the SEECs. Secondly, the specific economic and political situation of the countries is interesting to study and thirdly, this thesis aims at multiple evidence from the two countries and at "lessons-learned" rather than at a quantitative comparison. Eventually, the current status of research regarding the two countries and the key questions of this thesis seem to leave room for further investigations.

[351] See also *section 3.3.4*.
[352] See NCC (2004b), pp. 7 and 42.

3.2 Home country selection

In addition to the selection of Romania and Croatia as host countries of FDIs, it is important to narrow down the origins of FDIs in order to delimit the factors that influence the investment decision of MNCs. In terms of the home country selection companies from Austria and Germany seem to be the most suited for the envisaged analyses of this thesis because (1) they are among the largest investors in the two countries, (2) they possess equal language preconditions and (3) both benefit from fairly good historical ties to the host countries. Furthermore, (4) research on firm-data level in this field is, especially regarding Austrian MNCs, only in the beginning.

(1) Austrian and German companies are among the three **leading investors** in both Croatia[353] and Romania.[354] Both countries are also the largest (Austria) and third largest (Germany) investor in the whole group of SEECs (*see figure 17*).[355]

(2) The **common German language** further strengthens the similarity between German and Austrian MNCs. Especially in Croatia German is an asset for investors since the knowledge of German is widely spread.[356]

(3) MNCs from Austria as well as from Germany can expect a rather positive welcome when investing in Romania and Croatia since both home countries seem to have favorable starting conditions considering their **political and cultural heritages**. Austria still has close ties to the SEECs due to its former dominance in the Austrian monarchy until 1918 and its traditional role as

[353] Austria with 28% and Germany with 14% of Croatia's FDI stock; see CNB website (2008).
[354] Austria with 23% and Germany with 10% of Romania's FDI stock; see NBR website (2007).
[355] Again with the Netherlands in second place. See Hunya (2006) for 2004 stock figures.
[356] According to an EU study 34% of the Croatians are able to conduct a conversation in German: European Commission (2006c); see also Intv. Croatian Authority II (2007).

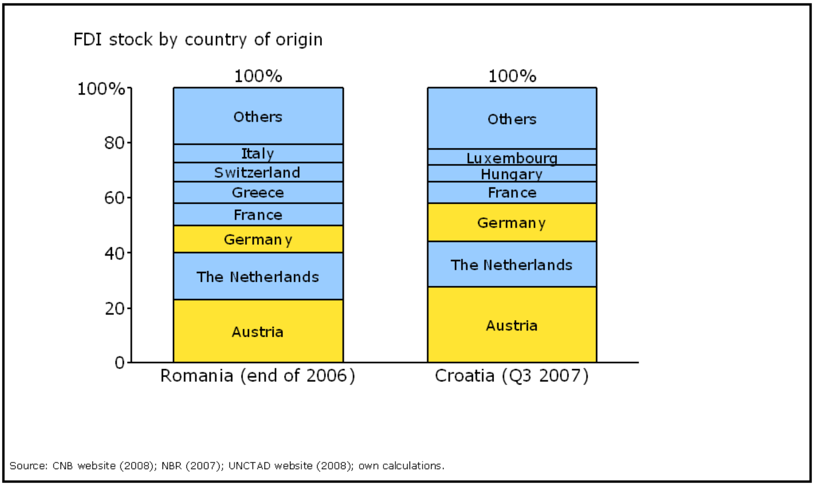

Figure 17: FDI stock by country of origin

window to Eastern Europe. Germany had a good reputation in the region as a mediator for many centuries[357] and Romania was an ally during World War II until 1944. Over and above Germany and Austria were the first countries to recognize Croatia in December 1991.[358]

(4) **Academic analysis** on home country effects of FDI from the SEEC region in Austria and Germany[359] as well as on country determinants for this region[360] is still **at an early stage**.[361] The most notable works have been brought forward for German companies based on a new firm-level database of German Bundesbank.[362] However, only few country-specific results have been explored until this point and the cross-country view of Romania and Croatia as well as the combination of the MNC view with the state perspective have been widely neglected so far.

[357] E. g. at the Balkans conference in Berlin in 1878; see e. g. Stavrianos (2000).
[358] See e. g. Armbruster (1991); Grabert (1996).
[359] See e. g. for Austria Hunya and Iara (2006) and for Germany Buch and Lipponer (2005); Jäckle (2006).
[360] See e. g. Arnold and Hussinger (2006) and in particular Toubal (2004).
[361] See for an extensive review Fontagné and Mayer (2005).
[362] See Buch, Kleinert, Lipponer, and Toubal (2005); Becker, Ekholm, Jäckle, and Mündler (2005); see also for an analysis of the structure of German FDI in Eastern Europe Buch and Kleinert (2006).

3.3 Case study

In order to circumvent some of the methodological challenges of earlier FDI studies (*see section 2.2.5*), this thesis follows the **theory-based case study approach** according to *Yin (2003)* with Romania and Croatia as two separate cases. This section presents the case study method and explains why it is a valid and rewarding approach for this thesis; *section 3.3.1* presents the goals and preconditions of case studies, while *section 3.3.2* elucidates the main characteristics of case studies. *Section 3.3.3* explains the scientific context and relevance of case studies, before *section 3.3.4* elaborates the research design of case studies.

3.3.1 Goals and preconditions of case studies

A case study, according to *Yin (2003)*, is a research strategy that "investigates a contemporary phenomenon within its real-life context, especially when the boundaries between phenomenon and context are not clearly evident."[363]

Case studies are, therefore, used to find comprehensive and casual explanations for interdependent situations and occurrences. In other words, case studies are an analytic research strategy that is well-apt for answering explanative (what?) as well as explorative (why?) study questions.[364] Thus, the case study is a promising research approach if three essential preconditions are fulfilled[365]:

(1) *Interdependences are to be captured that are new or have not been explored in a satisfying manner by researchers so far.*

This thesis aims at capturing new interdependences by analyzing the MNCs' country determinants and the corresponding public policy actions. It further explores – in a new way – how policy measures, their time-horizon and the involved state actors can be categorized. Finally, this thesis examines FDI

[363] Yin (2003), p.13.
[364] See de Vaus (2001); Saunders, Lewis, and Thornhill (2003); Robson (2002).
[365] See for a summary Wufka (2006); see also Eisenhardt (1989); Yin (2003).

attraction efforts as learning process of an EU candidate (Croatia) from a new EU member (Romania).

(2) *The analyzed phenomenon cannot clearly be delineated from its context and the examined context has myriad aspects.*

The complex context is given in this thesis since other academic approaches do not seem to be able to entirely capture the true FDI motives of MNCs. They are also sometimes too selective in their analysis of determinants. Finally, they cannot combine the multiple perspective on country determinants from MNCs as well as from state actors.

(3) *The status of research in this field is still at an early stage.*

As elaborated above research on the specific research questions of this thesis is still in the beginning, especially regarding the impact of public policy on FDI decision of MNCs in transition countries, the connection between FDI theory and New Institutional Economics and the combination of the two analyzed countries.

Therefore, the case study approach seems to be well-suited to match the complex research context of this thesis and to provide the required methodological framework in order to answer the outlined research questions.

3.3.2 Main characteristics of case studies

The main characteristics of well-founded case studies according to *Yin (2003)* are (1) the incorporation of multiple sources of evidence for the data collection, (2) the theory-based approach, (3) the openness to other academic disciplines, (4) the focus on qualitative generalizations, and (5) the strict scientific set-up and quality criteria.[366]

(1) The major strength of case studies compared to other research strategies is its usage of **multiple sources of evidence**. These data sources can be quantitative as well as qualitative. They can include questionnaires that are based on a statistic selection of questioned persons or companies, secondary data (e. g. company material), observations of specific company situations, and, eventually, guided interviews with experts.[367]

This thesis uses expert interviews with company experts and state representatives. It furthermore analyzes company and state documents, secondary literature and international rankings in order to evaluate the performance of states in attracting favorable conditions for FDI in Romania and Croatia.

(2) Following *Yin (2003)* case studies have the greatest impact if they are **theory-based**. Thus, the existing research knowledge regarding the field of study should be the basis for the study questions as well as for the derived hypotheses.

This thesis is clearly theory-driven. *Chapters 1 and 2* built up the scientific foundation including a theoretical framework, key questions and hypotheses.

(3) Case studies also allow for a **broad theoretical approach** fostering the consideration of different strands of theories and even different academic disciplines in order to achieve – if possible – a complete picture of the examined object of research.

This thesis makes use of different theoretical approaches. Its analyses are based on the FDI theory of locational competition as well as on political science in order to analyze the country determinants of MNCs and the respec-

[366] See for this whole section Yin (2003); Lamnek (2005); Eisenhardt (1989); de Vaus (2001).
[367] See also Saunders, Lewis, and Thornhill (2003).

tive state actions. In addition to this, the envisaged categorization of country determinants and state actors is inspired by the NIE.

(4) Usually, case studies have difficulties to **generalize results** in a quantitative way if they do not incorporate statistically relevant data evaluation methods in their analysis. They are, however, well-suited to generalize qualitative contextual aspects and causalities; therefore case studies contribute to the testing of existing findings and theories.[368]

Qualitative results from the conducted company expert interviews will be tested through state expert interviews, the analysis of primary documents and secondary literature. Further qualitative generalizations are generated through the cross-country analysis and through the categorization of country determinants and its actors in *chapter 9.*

(5) Finally, modern case studies are characterized by a **strict scientific set-up and quality criteria**.

This thesis follows a clear-cut and pre-defined research process which will be discussed, however, in detail in *section 3.3.5*.

In conclusion the case study approach is not simply a data collection method but a comprehensive research strategy that analyzes different issues and problems from various angles. It seems well-suited in order to explain the dynamics and impact of policy on MNCs' investment decisions in a new and more compelling way.

[368] See also Bortz and Döring (2002), p.323.

3.3.3 Scientific context and relevance of case studies

According to *Saunders, Lewis, and Thornhill (2003)* case studies can be distinguished from other empirical research strategies, in particular from (1) experiments, (2) surveys, (3) action research as well as from (4) grounded theory and theory-building case studies.[369]

(1) **Experiments** are especially used in science-related studies in which a hypothesis is tested through the measurement of certain occurrences. Their disadvantage is that they only focus on a few variables in a controlled environment whereas this thesis aims at the analysis of a multitude of variables (country determinants) in an environment with many actors (politicians, MNCs etc.) and uncertainties (EU accession etc.)

(2) **Surveys** also use a deductive (or theory-testing) approach and are usually based on a standardized questionnaire in order to collect as many data points as possible. Again a limited number of variables is usually analyzed with this methodology. While a quantitative generalization is possible, surveys have difficulties to analyze the specific context and the causalities of variables. With regards to this thesis, surveys can confirm a certain set of variables (country determinants) but cannot explain the interdependencies of different determinants and cannot explain the strategy of the state's investment policies.

(3) **Action research** is an inductive (or theory-building) research methodology; accordingly, researchers become or are part of a company etc. in order to understand and interpret the context and changes of organizations. With regards to this thesis, the action research approach will not be used because it lacks the possibilities to generalize results in a quantitative or qualitative way since the insights on a MNC's investment strategy are limited to the unit of analysis, i. e. one company.

[369] See also for this whole section Wufka (2006); Yin (2003).

(4) Studies based on **grounded theory** collect data without prior theory; this data is then used for building hypotheses that are tested through further observations.[370] Grounded theory is closely related to the **theory-building case study** according to *Eisenhardt (1989)* in which the case study is conducted without initial theoretical framework; in a second step, a theory is derived by comparing the case study outcome with existing theories. In contrast, the advantage of the theory-based case study – as it is used in this thesis – is its broad incorporation of different theories that already enable a consideration of all relevant issues during the selection of the case studies as well as during the data collection phase.[371]

Overall the broad methodological approach of theory-based case studies avoids the danger of predetermination and a precipitation of one-dimensional conclusions of other research strategies – in particular purely quantitative measurements.[372]

In terms of **scientific relevance**, it was once believed that case studies are only a legitimate research tool for the exploratory phase of an investigation that cannot describe or test propositions.[373] However, case studies have increasingly gained attention as research methodology. One major reason for the enhanced scientific acceptance of case study as a valid research methodology has been the clear-cut criteria for the preconditions, research design and quality proof as suggested as developed by *Yin (2003)*.[374] Furthermore, researchers have more and more realized that this scientific case study approach may not be confused with other types of case studies, e. g. those forms of case studies used for recruiting and teaching purposes or anecdotes in business literature.[375]

[370] See e. g. Suddaby (2006); Glaser and Strauss (1967).
[371] See also Paré (2004).
[372] See Bortz and Döring (2002).
[373] See e. g. Lamnek (2005).
[374] See *sections 3.3.4*.
[375] See for references other examples and references Lamnek (2005).

Case studies have traditionally been used in social science research[376] but have gained increased importance in other academic disciplines as well, in particular in International Business.[377] *Marschan-Piekkari and Welch (2004b)* point out that qualitative research has always played role in International Business research, albeit a minor role.[378] In their analysis of six leading International Business journals between 1991 and 2001 *Andersen and Skaates (2004)* found that only 10% of the studies were based on qualitative studies. *Johanson and Vahlne (1977)*, for example, used qualitative interviews in their ground-breaking study to analyze the internationalization decision of Swedish companies. *Lindqvist (1991)* who wrote about the same topic divided his research in two empirical phases the authors first conducted qualitative interviews managers and then extended their research to about 100 companies with quantitative mail survey.

In Economics full-fledged case studies are still rare, even though some recent examples showed an increased openness to this methodology. Both *Marinova and Marinov (1999)* and *Hannula (2005)* use the case study approach in a FDI context, analyzing, however, only single companies.[379] In contrast, this thesis follows a multiple case study approach, use countries instead of companies as cases and incorporates different levels of analysis which are elaborated in further detail in the following section.

3.3.4 Case study research design

Based on the framework by *Yin (2003)* a sound case study research design should comprise and define four elements: (1) study question, (2) case study

[376] See for a good example Uzzi (1997); see Yin (2003) for further references.
[377] See for interesting methodological insights for this thesis in Klaiber (2005); Obadia and Vida (2006); Wufka (2006).
[378] See Marschan-Piekkari and Welch (2004b), pp.5-7; Daniels and Cannice (2004), pp.186-187.
[379] They analyze Interbrew SA and Sanoma Magazines International respectively.

type, (3) case study design, and (4) units of analysis. The research design components and their consideration in this thesis are also summarized in *figure 18*.

(1) Case studies should always start with a **study question** that describes the goal of the study.[380] Furthermore, case studies should develop a theoretical framework and formulate hypotheses. In this thesis the study question is equivalent to question 1: *"What role can public policy play in order to attract FDIs in transition countries?"* The theoretical framework (FDI theory of locational competition and NIE)[381] as well corresponding hypotheses[382] have already been developed in the previous sections.

(2) Furthermore, theory suggests different **case study types**. Most importantly it distinguishes between a single and multiple case study. The former is usually used if the analyzed case represents the critical case and if a well-formulated theory is tested.[383] The latter is generally recommended because evidence from multiple cases is more robust and more compelling than from single case studies.[384] A precondition of multiple case study is however, that it follows a replication logic selection that requires a well-founded rationale for the selection of the cases.[385]

This thesis uses the multiple case study approach with Romania and Croatia as analyzed cases. This approach reflects that the theory regarding the impact of public policy factors is not very advanced so far as it would be required for a single country case study. Furthermore, the cross-country analysis enables more robust insights on the effects of public policy and is of special interest with

[380] See Yin (2003), pp.21-22.
[381] See *section 2.2.5* and *2.3.*
[382] See *section 1.1.*
[383] See Yin (2003), pp.39-41.
[384] See e. g. Herriott and Firestone (1983); de Vaus (2001), p.226.
[385] See Yin (2003), pp.48-49; see also Stake (1994).

regards to the reforms in both countries that aim(ed) for EU accession. The replication logic is taken into account since the cases, Romania and Croatia, have been carefully selected in *section 3.1* and since the same steps of analysis (*see below section 3.4*) are used for both countries without pooling (statistical) results.

(3) Academic researchers of case studies should moreover, decide on the specific **case study design** which can be an embedded or a holistic one.[386] In the embedded approach the same case study may involve more than one level of analysis. The holistic approach is used if no logical sub-units of the case study or studies can be identified.[387]

The embedded approach seems to be more rewarding for this thesis; the suggested embedded elements in both analyzed countries are the MNCs on the one hand and the state actors on the other. This two-sided analysis appears to be a major contribution of this thesis to previous studies by generating a broader understanding of the possibilities and limits of public policy in attracting FDI.

(4) **Units of analysis** in the case study research design can be individuals, places, countries but also decisions.[388]

In the context of this theses the units of analysis are the direct and indirect public policy measures that are apt to influence FDI inflows that are analyzed from two different angles (MNCs and state) in two different countries (Romania and Croatia).

[386] See Yin (2003), pp.42-43.
[387] See de Vaus (2001), pp.220-221.
[388] See de Vaus (2001), p.220.

	Definition	Explanation
Study question	• What role can public policy play in order to attract FDIs in transition countries?	• Public policy impact seems to be underestimated in literature • Based on FDI theory and NIE
Case study type	• Multiple case study of Romania & Croatia	• Enables cross-country view, more robust • EU accession as special interest of study
Case study design	• Embedded design integrating state view as well as company view	• Two-sided view goes beyond existing literature
Units of analysis	• Country determinants of MNCs that can be influenced by public policy	• Enables a fuller understanding of study question

Source: Based on Yin (2003); author's concept

Figure 18: Case study research design

In conclusion, the selected approach of this thesis seems to be well in line with the outlined requirements of research design for case studies.

3.3.5 Expert interviews

The case study approach encourages the use of qualitative methods and particularly the conduct of qualitative interviews if the research project involves complex interdependencies and phenomena that are difficult to delineate from their context. This thesis uses qualitative expert interviews in order to obtain a richer picture of public policy actions that are apt to influence the investment decision of MNCs in favor of Romania and Croatia respectively. The interviews are conducted with company as well as state experts and are based on the preliminary list of MNCs' country determinants that has been derived from various FDI studies (*figure 12*). The interview analysis thrives for the test of the hypotheses elaborated in *section 1.1.*

This section elaborates the methodology for all expert interviews in this thesis with company and state experts in both Romania and Croatia; it discusses – in the order of the research procedure – the (1) rationale and definition of expert interviews, (2) expert selection methodology, (3) forms of expert interviews, (4) document analysis, (5) interview guide, (6) duration, (7) pretest, (8) documentation, (9) analysis, and (10) quality control. This section is wrapped up with a (11) conclusion.[389] Each subsection first evaluates the academic state-of-the-art and then presents how these methodological issues are echoed in the expert interviews of this thesis. Useful insights regarding the discussed aspects are particularly provided in various contributions in *Bogner, Littig, and Menz (2002)*, by *Marschan-Piekkari and Welch (2004a)* and by *Lamnek (2005).*

(1) This section explains the **rationale** for choosing expert interviews as empirical methodology and provides a **definition** of expert interviews. It is shown (a) why qualitative interviews in general are prolific, (b) how expert interviews are positioned in research, (c) how experts and expert knowledge

[389] See for the structure of this section, e. g. Mayer (2004), p.41.

are defined, (d) what key characteristics expert interviews contain, (e) what distinguishes expert interviews from other types of qualitative interviews, and (f) how these aspects are reflected in the expert interviews conducted as part of this thesis.

(a) The advantages of qualitative compared to quantitative research have been discussed in detail in *section 3.3*. **Qualitative interviews** in International Business and Economics are seen as a good research tool in order to analyze complex and interdependent issues which are common in these fields when analyzing different companies, industries or economies. Theorists also recommend qualitative interviews for cross-cultural studies to avoid cultural bias. They particularly propose qualitative interviews for developing and transition countries to overcome existing data gaps and inconsistencies.[390]

(b) For a long time **expert interviews** had not been seen as stand-alone methodology but as part of other qualitative interviews. A more thorough definition and guideline for their conduct has first been elaborated by *Meuser and Nagel (1991)*.[391]

Authors see the particularity of expert interviews in the interest in specific topics and the distinctive style of interviewing. Accordingly, expert interviews can be "crystallization points"[392] of insider knowledge that account for a multitude of observations. The interviews are viewed as part of a reflective process to pressure-test a pre-formulated theoretical concept. The use of different interview and data generation methods serves as a tool to avoid pre-determination

[390] See Marschan-Piekkari and Reis (2004); Marschan-Piekkari and Welch (2004b).
[391] See also Kassner and Wassermann (2002), pp.102 and 104; see for a first comprehensive analysis of expert interviews as research methodology Bogner, Littig, and Menz (2002).
[392] Bogner and Menz (2002b), p.7.

and bias.[393]

(c) **Experts** are defined as people in key positions that have professional and specialized knowledge as well as knowledge from real life and experience. Experts are important not as individuals but as advisers on a certain topic. They have privileged access to information that would not be accessible for the researcher otherwise or only in a less efficient way.[394] This **expert knowledge** can be technical knowledge, process knowledge and interpretative knowledge. Some authors add that experts should also be capable of implementing their knowledge.[395]

(d) **Key characteristics** of expert interviews are (i) that they are semi-structured and (ii) that the interviewer has a special role. Specific issues need to be considered if (iii) the expert interviews are conducted with managers.

(i) Expert interviews are generally **semi-structured**. The research questions are given, the interviews are usually based on an interview guide, rather contain topics than questions and are thus flexible regarding the wording of the questions. During semi-structured interviews the interviewer may answer questions, make clarifications and add or delete questions. A minimum of standardization is, however, necessary to facilitate the comparability of different expert interviews. The catalog of questions is thus prepared in advance but its content and order can be modified.[396]

(ii) In expert interviews the **role of the interviewer** is of particular importance. First of all the researcher needs to appear as "quasi-expert"[397] to win

[393] See Pfadenhauer (2002), p.113; Meuser and Nagel (1991); Bogner and Menz (2002b), p.8.
[394] See Meuser and Nagel (1991), pp.442-444, 447; Bogner and Menz (2002a), pp.37, 43-46.
[395] See Bogner and Menz (2002b), p.8; Pfadenhauer (2002), p.116.
[396] See Schnell, Hill, and Esser (2005), p.322; Berg (2007), p.93; Bortz and Döring (2002), p.315.
[397] Pfadenhauer (2002), p.113; see also ibid, p.120; Bogner and Menz (2002a), p.50-62.

the trust of the interviewee that is essential to elicit useful information. Persistence, openness and flexibility are also required from the researcher in order to attain detailed information, to give the interviewees room to jump back and forth between topics, to elaborate their own thoughts and to develop linkages between different topics. These challenges lead to the presumption that expert interviews for a specific study should be conducted by a single researcher to get the maximum impact.[398]

(iii) *Trinczek (2002)* shows that **management interviews** represent a particular case of expert interviews that follow different rules. First these interviews are set in the business world in which the manager is the boss who generally shows strong signs of dominance – at least in the beginning of the interview. Furthermore, managers expect short and precise questions from the interviewer and requests for long narration early in the interview tend to fail. However, management interviews often have a second phase in which the manager is more relaxed once mutual trust between the interview partners has been established. Managers are then often more open to self-reflexions and even to discussions of sensitive topics.[399]

(e) Expert interviews can be **distinguished from other forms of qualitative interviews**, namely (i) narrative, (ii) in-depth and (iii) problem-centered interviews.

(i) **Narrative interviews** are mainly interviews that focus on the specific biographical background of an individual while expert interviews are interested in insights on specific topics that can be collected from several experts.[400]

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[398] See Lamnek (2005), pp.348-350; Mayring (2002), pp.68-69; Mayer (2004), p.36.
[399] See Trinczek (2002), pp.212-214, 216 and 220.
[400] See Mayring (2002), pp.72-75; Bortz and Döring (2002), pp.315-318.

(ii) Unlike expert interviews **in-depth (or intensive) interviews** attempt to uncover unconscious motives and thoughts of the interviewee and are closely related to psychoanalysis.[401]

(iii) **Problem-centered interviews** focus on a specific topics.[402] Their main difference to expert interviews is the interviewee selection; the respondents of problem-centered interviews are selected from the general population and do not necessarily need to have specialized knowledge. Furthermore, the role of the interviewer in problem-centered interviews is not as critical and they can also be conducted by several researchers.[403]

(f) The rationale and definition of expert interviews seems to well reflect the approach and the requirements of **this thesis**. The reviewed theoretical discussion confirms that expert interviews are an appropriate method to investigate the guiding research question of this thesis – the context and the interdependencies of public policy actions and their influence on the investment decision of MNCs. Qualitative interviews seem to be a good approach to reduce potential cultural and linguistic misunderstandings when interviewing experts from Germany, Austria, Romania and Croatia. Moreover, interviews with experts and their documents seem to help circumventing data deficiencies both in Romania and particularly in Croatia where not many information about FDI and the activities of MNCs exist so far.

Expert interviews can indeed function as crystallization points with experts who possess valuable insights in the investment decision of many foreign companies since they have extensive contacts to investors and investment policy

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401 See e. g. Friedrichs (1990), pp.224-234; Bortz and Döring (2002), p.315; Lamnek (2005), p.371.

402 They are also sometimes called focus interviews; see Kassner and Wassermann (2002), p.101.

403 See Lamnek (2005), pp.364, 370 and 382; Mayring (2002), pp.67-72.

makers. This also underscores that in this thesis the expert knowledge on certain topics is decisive and not the individual biography of the interviewee.

The selected interviewees for the company interviews should be in key positions in the business world, either closely involved in the decision making process of MNCs or with privileged knowledge about MNCs' investment decision, for example as their lawyers. The interviewees for the state view should be experts of Romanian or Croatian investment policy, either as state representatives or as close observers of the recent reform efforts in both countries, for example German embassies.

These interviews need to be conducted with experts since other respondents from the general population could not provide this kind of information. The outlined key characteristics of expert interviews are reflected by using a semi-structured interview guide and pretests. The special situation of management interviews is facilitated by the author's job experience in this field as management consultant in which he conducted, supervised and evaluated a total of more than 400 interviews on various topics. The author is the only interviewer of the conducted interviews for this thesis.

(2) This section elaborates the **expert selection methodology**. It discusses the (a) theoretical sampling, (b) sampling categories, (c) sample size, (d) response rate and gatekeepers , and (e) implementation of these aspects in this thesis.

(a) The interviewee selection in qualitative research is not based on statistical representation – as in quantitative research – but on **theoretical sampling**. This is necessary because the total of a given population of experts on a certain topic, for example, is often impossible to determine. Furthermore, qualitative research is not interested in the examination of specific subjects but of specific contents. Nevertheless, expert interviews have to aim at the generalization of results and insights should be transferable to other cases. A categorization and pre-selection according to specific characteristics is thus important in order to avoid distortions.[404]

(b) Theoretical sampling implies the set-up of **categories** that are sufficient to cover all dimensions of the research topic and that are generally based on previously developed research questions.[405] According to *Merkens (2004)* the categories should enable "theoretical saturation" of the research questions. Therefore, different preconditions of the expert knowledge, different points of view, typical cases as well as unusual cases should be represented in the sampling. With respect to expert interviews it is of particular importance to identify the correct contact person with the best available knowledge within an organization. In this context *Meuser and Nagel (1991)* have pointed out that these people are often not in the top level of organizations but located in the second or third level of the hierarchy because they are the ones who prepare key decisions.[406]

(c) There cannot be a strict rule for the **sample size** of qualitative and expert interviews as discussed above. The number of people to talk to also depends on the topic of the research. All the same experienced qualitative researchers speak of at least 20 and a maximum of 50 interviews on a specific topic. 30 interviews seems to be an average figure that is also recommended for PhD theses.[407]

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[404] See Merkens (2004), p.291; Mayer (2004), p.38; Lamnek (2005), pp.385-386.
[405] See Mayer (2004), p.38; Lamnek (2005), p.384.
[406] See Meuser and Nagel (1991), pp.443-444; see Lamnek (2005), pp.313-314; Mayer (2004), p.41.
[407] See Warren (2004), p.521; Stroh (2000), p.201; Meuser and Nagel (1991); Mayer (2004), p.40.

(d) The selection of interviewees also depends on the expected **response rate**. Since experts and functional elites such as managers have little time and receive numerous research requests, scholars may have difficulties to get the ear of the minister by simply writing a fax with an interview request.[408] Therefore, it is essential for researchers who conduct expert interviews to take advantage of **gatekeepers**. Gatekeepers are in central positions or have good connections to experts and can mediate access to them. Once a contact to an expert is established, the expert often gives clues to other experts and can even recommend the researcher to them.[409]

(e) **This thesis** uses theoretical sampling for the selection of expert interviewees. Categories need to be established that are based on the key questions from *section 1.1.* They aim at filtering out those experts who can evaluate the decision process of German and Austrian MNCs in favor of Romania and Croatia as well as the impact of public policy actions on the decision of MNCs. The number of appropriate experts is obviously extensive. The following categories should, however, be covered by the interviewees in order to enable a rich picture of the research issues. The author established contrasting pairs of categories in order to identify a large span of answers and themes as well as to cover as many dimensions as possible while (i) reflects the selection of experts for company interviews and (ii) lists the categories for the state expert selection. In both cases the first six categories refer to the organization of the interviewee, while the remaining categories consider the actual respondent of the expert interview:

(i) Categories for the **company expert selection** in Romania and Croatia are:

[408] See Wai-chung Yeung (2004).
[409] See Merkens (2004), p.293; Odendahl and Shaw (2001), p.307; Bogner and Menz (2002b), p.8.

- **Internal versus external**: Experts can be found within companies and in external organizations. The internal experts should be closely involved in the decision making process of FDIs in MNCs, while external (foreign or domestic) experts should be used as "crystallization points" (*see above*) who have observed many investment decisions of German and Austrian MNCs.

- **Domestic versus foreign**: The interviewed investors should be from Austria and Germany in equal parts. The external experts should include both foreign but also Romanian and Croatian experts to acquire also the perspective from the home market such as through the Chamber of Commerce.

- **Large firms versus SMEs**: Large investors have high visibility in host countries like Romania and are important interview partners. However, SMEs account for the bulk of FDIs and their country determinants may significantly differ; thus experts from both types of companies should be interviewed. Companies are defined as large in this thesis when generating sales of more than €500M as industrial and more than €100M as service company.

- **Industry versus services**: The parameters for the investment decision may diverge among investors from different business sectors. Companies are therefore roughly divided into industry- and service-based ones. The service category also includes retail companies. Accordingly, experts from both sectors should be interviewed for this thesis.

- **Greenfield versus brownfield**: FDI determinants may depend on the form of the investment and interviews should comprise companies with greenfield investments and acquisitions or privatizations respectively (*see section 2.1.1*).

- **Date of (initial) investment decision**: Drastic economic and political changes both in Romania and Croatia occurred following government changes, namely in 2000 when Ivica Račan became became prime minister in Croatia and in 2004 when Traian Băsescu became president in Romania. Interviews should therefore include companies that invested before and some that also invested after these dates in the respective countries. In order to deliver a holistic picture of country determinants, interviews should include investors as well firms that were interested but finally did not invest in Romania or Croatia respectively.

- **Top versus medium hierarchy level**: Experts from different hierarchy levels should be interviewed (*see above*). The top level is defined as the CEO or director and the board while the medium level consists of all other staff who have influence or significant insights on the decision making process of MNCs.

- **General versus specific questions**: Some experts can give useful insights regarding the general country decision for FDIs by MNCs (e. g. CEOs) while other experts have knowledge about specific questions of the investment (e. g. lawyers); both types of experts should be interviewed in this thesis.

(ii) Categories for the **state expert selection** in Romania and Croatia are:

- **State representative versus external expert**: State representatives are decision makers who are clearly associated with the creation of investment conditions such as the ministry of economy or an investment promotion agency. External experts such as academics or foreign embassies have special knowledge about these aspects but have less possibilities to implement this knowledge.

- **Domestic versus foreign**: Due to their diverging perspectives on investment policy developments foreign as well as domestic experts should be interviewed.
- **Governmental versus other organization**: Governmental institutions often show a strong commitment to investment policy decisions; in order to avoid bias other institutions with respective expertise should thus be selected, too.
- **National versus regional representation**: Regional experts such as mayors sometimes may have a different, more critical view of the overall investment policy than national experts and should thus not be neglected in the interviews.
- **Direct versus indirect involvement in FDI policy**: Some organizations influence FDI policy themselves through laws etc., while others have indirect influence through pressure, for example, from international organizations.
- **Intense versus occasional MNC interaction**: Interviews should contain state experts with strong ties to MNCs (e. g. promotion agencies) and those with only occasional contact that may have a different image of MNCs.
- **Top versus medium hierarchy level**: *(see above)*
- **General versus specific questions**: *(see above)*

On the basis of these designed categories four matrices are developed for company and state expert interviews in Romania (*figures and 20*) and for company and state expert interviews in Croatia (*figures 21 and 22*). Interview constellations are needed in which all categories and dimensions are reflected by a multitude of interviews. The numerical goal of this thesis is to conduct 60 expert interviews and hence 30 in each country which is in line with the recommended average sample size. This makes 15 expert interviews each on the investor's and the state's view on FDIs in both Romania and Croatia. Such a set of experts covering all elaborated categories should be able to achieve theoretical saturation regarding the key questions of this thesis. Different matrices for Romania and Croatia exist because the interview results of both countries are not pooled but analyzed as two separate case studies whose results are examined together in the incorporated cross-country analysis throughout this thesis.

To identify and interview a sufficient number of experts who fit into the established matrix of categories is challenging. First experiences show that expert response rates are rather low. Therefore, gatekeepers play an important role to give access to experts in both countries. *Gerromod2007*, for example, recommended the author to various investors, business organizations etc. in Romania. *Intv. Croatian Company - Real Estate (2007)* accomplished the same for expert interviews in Croatia. Moreover, the visit of expert conferences and fairs has provided further expert contacts.[410]

(3) This section discusses the **forms of expert interviews**, elaborates why (a) method triangulation is rewarding, sketches out (b) face-to-face, (c) telephone and (d) e-mail interviews and presents (e) the proceeding in this thesis.

(a) Case studies in general and qualitative interviews in particular call for **method triangulation**. By and large verbal (face-to-face and telephone) as well as written interviews are possible and reasonable. They mainly differ in terms of the interaction between interviewer and interviewee and the degree of

410 Conference on European Economic Integration 2006. The Changing Landscape of FDI in Europe, Vienna, Nov 20-21; Hanover trade fair 2007. Romania day, April 17.

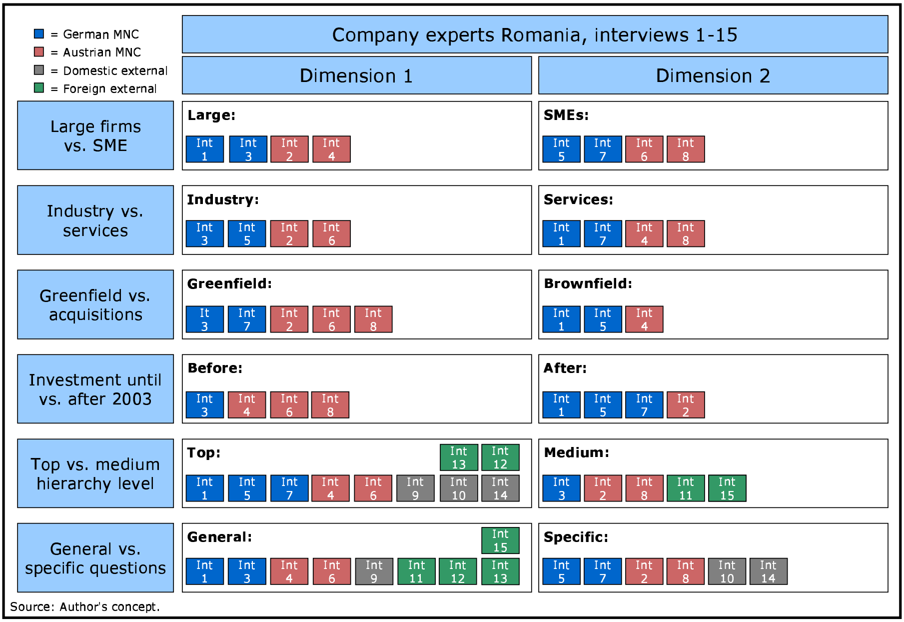


Figure 19: Interviewee selection matrix Romania (1) – investor's view

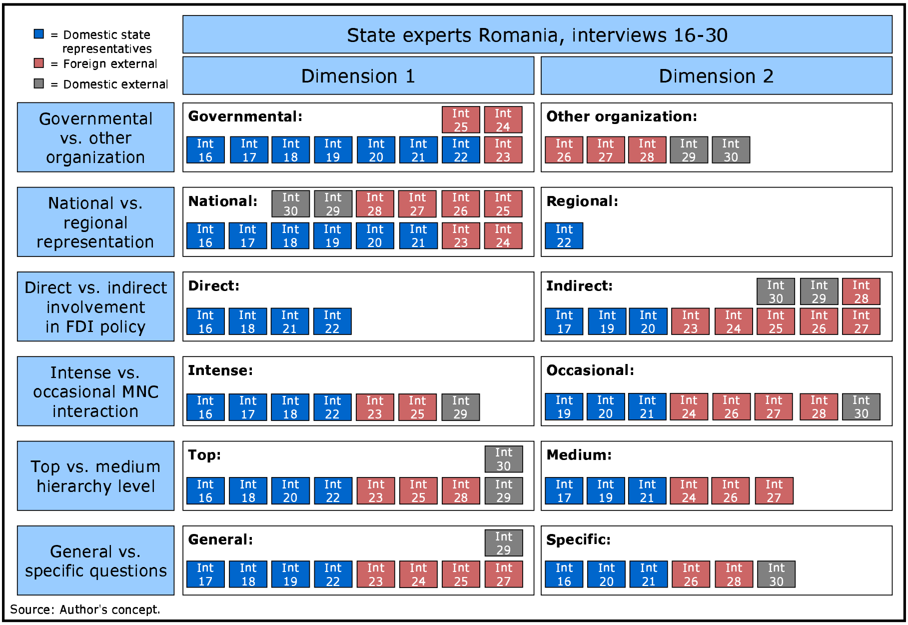
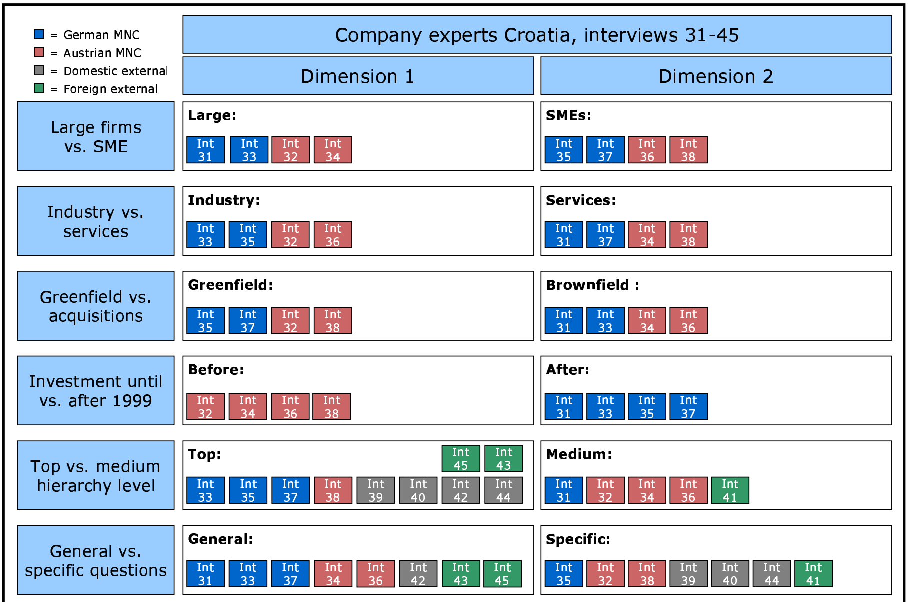


Figure 20: Interviewee selection matrix Romania (2) – state's view



Source: Author's concept.

Figure 21: Interviewee selection matrix Croatia (1) – investor's view

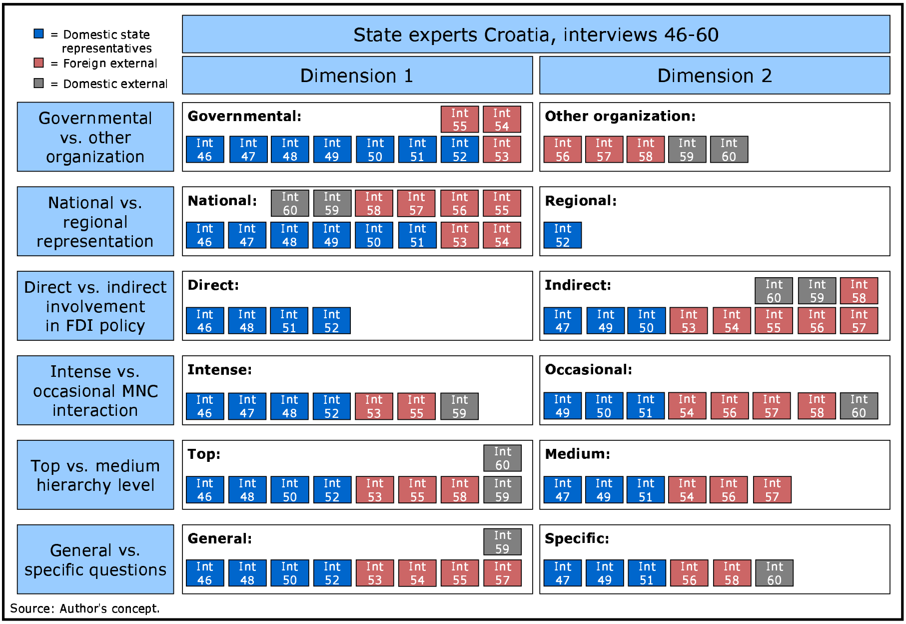


Figure 22: Interviewee selection matrix Croatia (2) – state's view

standardization of the interview questions.[411]

(b) **Face-to-face interviews** are the most common form of expert interviews. These in-person interviews are often more interactive than other forms of interviews, may at times cause more accurate responses because of the natural conversation and the possibility of the interviewer to react to non-verbal hints. Moreover, this interview form may be particularly appropriate to discuss sensitive and complex issues.[412]

(c) Researchers frequently use **telephone interviews** for qualitative research. Their critics however point out that these interviews are more challenging to conduct, because they are more impersonal, more difficult to control and the reaction of the interviewee is harder to assess than in face-to-face interviews.[413]

However, sometimes face-to-face interviews are logistically impossible, particularly with managers and politicians who often travel; in this cases experts are easier to reach via phone, the response rate seems to be higher and cancellations are easier to compensate. Answers in phone interviews tend to be shorter and more precise. Some researchers prefer phone interviews to ask sensitive questions because they are more anonymous. Overall, phone interviews seem justified when research and interview questions are well defined and when they complement face-to-face interviews.[414]

(d) Expert interviews can also be **written interviews** even though their use is less frequent because they are less spontaneous and need to focus on few topics; the limited interaction makes inquiring difficult and answering in

[411] See Atteslander (2006) p.126
[412] See Lamnek (2005), p.343; Shuy (2001), pp.541-544.
[413] See Atteslander (2006), p.148; Lamnek (2005), p.346; Odendahl and Shaw (2001), p.308.
[414] See Berg (2007), pp.108 and 110; Shuy (2001), pp.537, 540-541 and 545.

written from is more tiresome for the interviewee. On the other hand written interviews allow for a higher degree of privacy and more flexibility regarding time and location. In fact due to time and logistic constraints written interviews are sometimes the only way to reach the participation of some experts.[415]

(e) The use of different interview methods in **this thesis** avoids bias through a specific interview form and reflects the wishes and constraints of the interviewees.

Face-to-face interviews should be the dominant form of interviews in this thesis. They are particularly appropriate to study general evaluations of the investment decision and interdependencies between different country determinants. They are also best-suited for specification questions and the alleviation of cultural challenges.[416]

Telephone and e-mail interviews particular favor the treatment of specific investment aspects. The special circumstances of expert interviews even sometimes make them unavoidable. The challenges of phone and e-mail interviews discussed above find only limited appliance in this thesis. Being experts on MNCs' investment decision or investment policy, their answers should be also accurate over the phone and written answers should not be tiresome for them. Since the personal involvement of the expert is unimportant, the private atmosphere, the interaction and the spontaneity of face-to-face interviews is not as crucial. To improve the interview quality an introduction to the study, a list of topics to be discussed and a short CV to explain the academic and professional background of the author is sent beforehand to all interviewees. Furthermore, telephone as well as e-mail interviews are exclusively used for later stages of the research; the researcher can thus gain sufficient experience

[415] See Bortz and Döring (2002), p.308; Lamnek (2005), p.343; Berg (2007), p.113.
[416] See also Shuy (2001), p.544 and Odendahl and Shaw (2001), p.308.

and knowledge in prior face-to-face interviews.[417]

(4) Qualitative interviews are often enriched by a **document analysis**, particularly in International Business.[418] Documents are all sources including texts, movies, etc. that give legitimate conclusions about activities and intentions of the documents' author(s) and the representing organization. They cannot be used as stand-alone source since they do not prove how the author(s) really acted. The documents need first to be described and evaluated before they are analyzed.[419] In **this thesis** documents are collected from the experts of the qualitative interviews as additional primary source for the better interpretation of the statements in the interviews about the investment decision of MNCs and specific public policy actions.

(5) Expert interviews are generally conducted on the basis of **interview guides**.[420] Semi-structured guided interviews avoid pre-determination by the researcher and can flexibly respond to unexpected topics and to respondents with different knowledge, background, language and characters. By using open questions the use of interview guides also avoids social desirability by renouncing to ask leading questions – particularly regarding sensitive issues – in which the respondent may give some misleading answers only to fulfill an allegedly expected social image.[421]

This section discusses (a) the definition of an interview guide and its structure[422] that can be divided into (b) introduction, (c) warm-up questions, (d)

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[417] See also Atteslander (2006), pp.151-152; Berg (2007), p.109.
[418] See e. g. de Geer, Borglund, and Frostenson (2004), pp.332-334.
[419] See Wolff (2004), pp.503-504 and 511; Mayring (2002), pp.47 and 49.
[420] See Trinczek (2002), p.209 and 218; Meuser and Nagel (1991), p.448; Mayer (2004), p.36.
[421] See Welman and Kruger (2001), pp.161, 169; Warren (2004), p.523; Lamnek (2005), pp.341.
[422] See for interview guides structures Friedrichs (1990), p.227; Bortz and Döring (2002), p.314.

key questions, (e) additional questions and (f) conclusion. All aspects are reflected (g) in this thesis.

(a) The interview guide is **defined** as a check list for researchers that helps not to miss important topics or themes to be covered in an expert interview. The questions are neither standardized nor previously worded and no strict order of the questions exists. The questions asked in the interview are open-ended and not closed-ended.[423] Despite this flexibility structure and processes are important for a generalization of results and for a certain comparability of the data.[424]

(b) In the **introduction** of the guided interview the researcher briefly explains the study without revealing concept or hypotheses in order to avoid pre-determined answers. Moreover, the researcher offers a copy of the final report and discusses the degree of confidentiality of the interview. In this context a complete removal of "any elements that might indicate the subjects' identities"[425] is generally not necessary for expert interviews; scholars agree however that (verbal) informed consent of the interviewee is needed. The researcher has to explain the use of the interview and suggest how interviewees can remain completely or partly anonymous.[426]

(c) The actual interview should start with some **warm-up questions** about the interviewees and their organization. Additionally, some easy, non-

[423] See Stroh (2000), p.199; Atteslander (2006), p.139; Mason (2004a), p.518; Lamnek (2005), p.355; Daniels and Cannice (2004), p.192; Welman and Kruger (2001), p.161.
[424] See Wilkinson and Young (2004), p.207; Bogner and Menz (2002a), p.38; Mayer (2004), p.36.
[425] Berg (2007), p.79; see also Warren (2004), p.521; Sieber (2004), p.474; Lamnek (2005), p.368.
[426] See Kent (2000), pp.81-84; Daniels and Cannice (2004), pp.195, 198; Trinczek (2002), p.214.

threatening questions that are clearly connected to the research topic should assure the respondent that the interviewer knows the topic and is a reliable interview partner.[427]

(d) The following **key questions** of the expert interview should cover the essential elements of the research study and include questions for specifications. Themes may jump back and forth and the researcher should give the respondents room to expand their knowledge and create interdependencies without too many interruptions. Scholars have recommended that the tone of interviewing should remain neutral and stimulating-passive but the researcher should, nevertheless, not hesitate to take challenging positions and to ask sensitive questions.[428]

(e) Subsequently **additional questions** can be raised in order to receive insights on issues of the study that are of somewhat less priority, to get overall assessments and to discuss previously untouched topics. Over and above contacts to other experts and further materials (documents etc.) can be requested.[429]

(f) In the **conclusion** phase of the interview the researcher shows gratitude toward the respondent and repeats the offer to share the results of the study.[430]

(g) In **this thesis** the interview guide is a useful tool not to miss any important FDI determinants or issues of the analysis. A flexible order of questions seems indispensable considering the long list of potential country determinants

[427] See Gorden (1977); Warren (2004), p.522; Berg (2007), p.105.
[428] See Lamnek (2005), pp.344, 356 and 368; Welman and Kruger (2001), pp.169-170; Kvale (1996), pp.133-134; Stroh (2000), p.204.
[429] See Stroh (2000), p.207; Atteslander (2006), p.125.
[430] See Bortz and Döring (2002), p.310.

and different knowledge of the interviewees and to avoid the danger of predetermined analyses of some econometric FDI studies. The open-ended questions also help to elicit interdependencies between several determinants by the interviewee. Finally, the coverage of sensitive questions including corruption and subsidies, requires a flexible approach.

The guide for the expert interviews in this thesis – as presented in *figure 23 for interviews with MNCs* – starts with a personal introduction and summarizes the approach and status of the thesis. Informed consent (*see above*) is achieved by discussing how data is used, confidentiality compromises are reached by agreeing that critical statements can either be deleted from the audio-file or disguised in the analysis. The following easy warm-up questions contain general interviewee information and facts about the company and its investment in Romania or Croatia, including the description of the investment project.

The key questions of the interview guide – not all of them can usually be covered – focus on the actual investment decision. Questions include the major reasons for investing in Romania or Croatia respectively and the discussion of individual country determinants derived from the theoretical part of this thesis; the interviewer lets the experts freely elaborate their knowledge but he can ask for more details including recent developments, institutions involved or further determinants (*key questions 1 to 3 of this thesis*). Language challenges in the expert interviews will be reduced by wording the questions straightforward and by covering only one topic per question.

Additional questions on the interview guide ask for an assessment of the influence of Romania's or Croatia political institutions on investment policy and a comparison of both countries' performance to countries (*key questions 4 and 5*). This interview phase should also be used to ask for related materials and documents and for expert contacts. The conclusion of the interview guide reminds the interviewer to show his gratitude towards the interviewee and repeat his offer to share the interview results.

The interview guides for interviews with external company experts, state representatives and external state experts follow very similar patterns to the one introduced. They only drop the questions about the investment facts and the decision-makers within the MNCs and include questions about potential differences among industries (external company experts) and the responsibilities for reforms of public policy actors (state expert).

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PhD thesis: "Reforms and Foreign Direct Investment.
Possibilities and limits of public policy in attracting Multinational Corporations. A multiple case study of Romania and Croatia"

GUIDE FOR INVESTOR INTERVIEWS

Introduction

A. Introduction
- Background Dietmar Zühlke
- Background PhD thesis and interview status

B. Informed consent of audio-taping and reproduction
- No publication of confidential information without prior permission
- No mentioning of company without prior permission

C. Offer to share in-depth analysis/ final PhD thesis

Warm-up questions

D. Interviewee information
- Name (last and first)
- Position in company
- Interview location
- E-Mail-Address
- Phone number
- Career before joining the company

E. Company information
- Location of company business abroad
- Location of company's headquarters
- Total number of locations abroad
- Industry sector

F. Investment facts
- Description of investment project
- Date of initial investment (year)
- Amount of initial investment (estimate)
- Type of initial investment
- Subsequent investments

Key questions

G. Investment decision
- Persons involved, sources used, duration of decision-making process
- Major reasons for investing abroad
- **Major reasons for investing in Romania or Croatia**
- **Specific reasons: importance, recent and expected developments in Romania or Croatia, players and institutions involved:**

- Investment climate
- Human capital
- Privatization policy
- Political stability
- EU integration
- Tax policy
- Trade policy
- Quality of bureaucracy
- Market access
- Investment incentives
- Monetary policy
- Implementation of laws
- Fiscal policy
- Infrastructure
- Financial system
- Regional integration
- Legal certainty
- Corruption
- Property rights
- ***Other reasons***

Extra questions

- Influence and performance of political institutions
- Government relations of MNC (past and current)
- Overall evaluation of Romania/ Croatia as FDI location
- Comparison of FDI policy to other countries

H. Material and contacts
- Other material that is helpful for thesis
- Contacts to other investors, expert, state institutions

Conclusion

I. Closing remarks
- Insights from interview
- Gratitude towards interviewee
- Repeat offer to share results

Figure 23: Example guide for investor interviews

(6) The **duration** of expert interviews strongly varies but can range from 15 minutes to several hours. The average seems to be about 45 minutes. Telephone interviews are usually shorter and do not tend to last longer than 20-30 minutes.[431]

30 minutes is the minimum goal for face-to-face and 20 minutes for telephone interviews **in this thesis** because shorter interviews may lack the required depth for complex issues such as FDI decisions or policies. The length of written answers will depend on the specific questions asked and the respondent's effort.

(7) Various authors stress the importance of **pretests** before the actually conduct of the expert interviews, particularly if the sample size is fairly large. In these pretests the researcher verifies location, duration, interview guide structure and questions. It needs to be confirmed that all hypotheses can be tested with the interview guide.[432]

In this thesis three pretests were conducted with one FDI and two methodological experts: The author presented the research and interview questions in detail to Prof. Dr. L. Resmini (University of Bocconi); Prof. Dr. J. Hoffmeyer-Zlotnik (Zentrum für Umfragen, Methoden und Analysen, ZUMA) proofread the interview guide and critically verified the number, set-up and duration of the expert interviews; Prof. Dr. H. Schuler (University of Hohenheim) confirmed the general methodological approach of this thesis.

(8) Elements of the **documentation** of expert interviews can be divided in (a) audio-taping, (b) notes, (c) transcription, (d) formal database, and (e) storage that are also reflected (f) in this thesis.[433]

[431] See Lamnek (2005), pp.354-355; Warren (2004), pp.521-522; Johnson (2001), p.103; Atteslander (2006), p.125; Berg (2007), p.107; Shuy (2001), p.542.
[432] See Friedrichs (1990), pp.234-235; Mayer (2004), p.44; Mason (2004a), p.518.
[433] See also for this selection Bortz and Döring (2002), p.312.

(a) Interview data must be recorded in some way and **audio-taping** seems to be the most helpful tool because it can easily be retrieved and hardly distorts the interview process. In some cases interviewees deny being tape-recorded especially when sensitive issues are involved or if employees feel awkward to answer questions without the explicit permission of their supervisor; sometimes the latter may occur, for example, in transition economies like Romania and Croatia.[434]

(b) The documentation quality of expert interviews is further enhanced by the usage of **notes** during the interview. They help structuring the answers and preventing a potential audio data loss. Notes can facilitate to ask specification questions in later stages of the interview.[435] *Daniels and Cannice (2004)* point out, however, that respondents may also be more cautious when notes are taken by the researcher.

(c) Traditionally the recordings from audio-tapes are transfered to verbatim transcriptions. Various authors have, however, questioned what a valid translation from oral to written language is. Therefore, verbatim transcriptions do not necessarily increase the trustworthiness of the transcription, the content of the interview and especially not its interpretation. For expert interviews transcripts are important for "what is said, rather than how it is said."[436] Especially for extensive, semi-structured interviews a complete verbatim transcription would be too complex, time-consuming and even confusing. Thus, extensive transcripts and notation systems are neither necessary nor common for expert interviews. Researchers rather use **transcript protocols** to reduce the magnitude of material. In these transcript protocols researchers paraphrase

[434] See Lamnek (2005), p.387; Mayer (2004), p.46; Marschan-Piekkari and Welch (2004b), p.10; Berg (2007), p.80; see regarding Eastern Europe Michailova (2004), p.372.
[435] See Poland (2001), p.637.
[436] Poland (2001), p.630; see also ibid, p. 636; Kvale (1995), p.27; Mayring (2002), p.97.

facts, opinions, judgments, observations in their own words; abbreviations as well as citations can be used while the questions of the researchers are generally not documented.[437]

Despite these transcript liberties all interview aspects need to be documented in the protocol. Furthermore, after a first transcription of the interview headlines are defined and the content is sequenced under these headlines putting the text in a contextual order to facilitate the subsequent analysis.[438]

(d) Some scholars also propose a **database of formalities** to document the conducted interviews. The documentation should contain all relevant information about the interviewees, their representing organization and the interview settings such as location, duration, language etc. Spreadsheets are generally sufficient as database.[439]

(e) All documentation material should be stored safely and **electronically** if possible. This comprises the audiotape, notes, transcripts and the formal database.[440]

(f) The goal for **this thesis** should be to audio-tape at least 90% of the interviews considering the specific difficulties in Eastern Europe. A modern tape player is used that allows to copy audiofiles directly to the computer. Notes are taken in all interviews to store a maximum of information and to be able to jump back to other questions even though some of the easiness of the conversation may be lost.

[437] See Mayring (2002), pp.97-99; Meuser and Nagel (1991), pp.455-457, 460; Berg (2007), p.79.
[438] See Meuser and Nagel (1991), pp.455-456; Mayring (2002), p.99.
[439] See also Eisenhardt (1989); Lamnek (2005), p.391.
[440] See Poland (2001), pp.634-635; Bortz and Döring (2002), p.313.

Since not the exact wording but the content of the expert interviews is important, transcript protocols seem to be sufficient to master 60 interviews of about 45 minutes totaling to about 2700 minutes of audio material; a detailed protocol including some citations should take about 5 pages totaling to about 300 pages. This documentation method should therefore produce plenty of useful material to cover in the subsequent analyses. In a following step headlines are found in the transcripts and the material is brought into a logical order. The protocol also helps to overcome language issues since all answers are summarized in English while the actual interviews may be conducted in German, English, French or even in Romanian or Croatian (with an interpreter) depending on the skills of the interviewee.

All formalities are documented in an Excel database (*see section 5.1.1*) and are stored together with all other interview material electronically as discussed above.

This procedure is valid for both face-to-face and phone interviews while the documentation of e-mail interviews contains the written exchange of the interview partners and further material from the respondent.

(9) This section discusses the two types of **analysis** used in this thesis, that are (a) the formal analysis and (b) the content analysis.

(a) The **formal analysis** shows how the introduced methodological requirements are fulfilled in this thesis and presents an overview of the conducted interviews including information on number, duration, interviewee etc. for all interview types. A separate analysis describes the received expert documents.

(b) Expert interviews usually use **content analyses** as data evaluation technique.[441] This section discusses (i) the definition of content analysis and the steps of this approach which include (ii) categorization, (iii) structuring and (iv) analytical generalization. Section (v) describes the procedure in this thesis.

(i) Content analysis is **defined** as the analysis of texts such as interviews – derived from a theoretical framework – in a systematic way, evaluating the material step-by-step and based on a category system.[442] It is thus not important to find the individually different aspects of the expert interviews but to elaborate the representative and generalizable statements and interpretations. Content analysis is generally not a numerical but a qualitative test of pre-defined hypotheses. The reader of a study generally cannot directly follow all steps of the content analysis; it is, therefore, important to make the single steps of the analysis transparent.[443]

(ii) The first step of the content analysis encompasses a **categorization** in order to enable an analysis of all expert interviews on a common basis.[444] Different dimensions of categories should be developed to classify the material in order to test the previously established theoretical framework of the study.[445]

(iii) In a second step the **structuring** brings the interview material in order. The answers of the individual interviews are clustered according to the established categories even though it is not compulsory to find answers from all interviews for all categories. Passages of the text must be torn apart because the insights on certain topics and not the individual experts are important.[446]

(iv) The core of the content analysis aims at the **analytical generalization** of the interview results. Commonalities, differences and tendencies of the

[441] See Welman and Kruger (2001), p.195.
[442] See Mayring (2002), p.114; Berg (2007), p.134.
[443] See Mason (2004b), p.1021; Stroh (2000), p.202; Lamnek (2005), p.407.
[444] See Meuser and Nagel (1991), pp.451-452; Mayer (2004), p.48; Berg (2007), p.135.
[445] See Gorden (1977); Lamnek (2005), p.406; Meuser and Nagel (1991), pp.457-458.
[446] See Schmidt (2004a), pp.448-449; Mayring (2002), p.115; Meuser and Nagel (1991), p.458.

structured and categorized material that go beyond the individual example are elaborated and generalized. These generalizations are then evaluated and compared to the previously developed theoretical framework including its hypotheses. This comparison between a predicted and an empirically based pattern is also described as pattern-matching. Scholars recommend to cite typical cases to clarify the generalization results. The analysis of the received documents will further strengthen the results.[447]

(v) The content analysis seems to be well-suited to master the multitude of the material and the typical challenges for qualitative expert interviews in **this thesis** (*chapter 5*). The structuring of the interviews is implemented in an evaluation spreadsheet and prepares the subsequent analytical generalization that filters the common insights from the conducted expert interviews that go beyond the single interview.

(10) **Quality control** is essential for the conduct of expert interviews to meet the high methodological requirements of case studies. The quality control approach can be borrowed from the *Yin's* case study approach and should therefore consist of (a) construct validity, (b) internal validity, (c) external validity, and (d) reliability. Section (e) shows the implementation of these dimension in this thesis.[448]

(a) **Construct validity** of qualitative expert interviews needs to be ensured in order to avoid biased or misleading interpretations. This can be achieved by method triangulation such as using multiple techniques and sources of

447 See Ghauri (2004), p.118; Yin (2003), p.31; Lamnek (2005), pp.403-404; Berg (2007), p.134; Mayer (2004), p.46; Meuser and Nagel (1991), p.452; Mayring (2002), p.118.

448 See Yin (2003), pp.33-38.

evidence.[449]

(b) Furthermore, **internal validity** is required in order to guarantee the quality of expert interviews.[450] The goal is therefore to establish causal relationships and to be able to explain a specific phenomenon in detail in the context of a specific event or environment.[451] This can be achieved by analytical generalization, i. e. the juxtaposition and comparison of the empirical results with theoretical patterns.[452]

(c) In addition to this, **external validity** is assured if qualitative interviews can be generalized and are also valid for other cases, situation and times. Following the replication logic a further interview would not alter the overall study outcome.[453]

(d) The **reliability** criteria of qualitative interviews is met if a later researcher can follow the same methodological steps as the interviewer and gets the same results.[454] *Mayer (2004)* suggests that the researcher explains in detail how data has been generated and documents the interview process.[455]

(e) **In this thesis** construct validity is guaranteed by conducting guided expert interviews with open-ended questions with internal and external, company and state experts. Moreover, different interview forms are used (face-to-face, telephone and e-mail interviews). Finally, company material (documents on

449 See Yin (2003), pp.34-35; Lamnek (2005), pp.316-317; Hurmerinta-Peltomäki and Nummela (2004), pp.164 and 167; Meuser and Nagel (1991), p.441; Bogner and Menz (2002a), p.38.
450 See e. g. de Vaus (2001), p.233.
451 See Bortz and Döring (2002); Yin (2003), p.36.
452 See also Pauwels and Matthyssens (2004), p.131.
453 See de Vaus (2001), pp.237-238; see also Yin (2003), p.37; Mayer (2004), p.40.
454 See Yin (2003), p.37.
455 See Mayer (2004), p.55; see also Lamnek (2005), p.390.

the location decision process etc.) is collected and analyzed from various companies. Internal validity represents the core of the determinants analysis (*chapter 7*) using analytical generalization to evaluate the conducted expert interviews and to analyze to what extent the empirical results of the interviews match the findings of the existing FDI literature. External validity is achieved in this thesis by a thorough expert selection through theoretical sampling and a semi-structured interview guide. Finally, reliability is considered in this thesis by the storage of the audiofiles and notes, the transcription of the conducted interviews and the generation of a database of formalities and a database with all categorized answers from the interviews.

(11) In **conclusion** this thesis uses semi-structured expert interviews with interviewees selected through theoretical sampling. The interviews are based on an interview guide with open-ended questions. Most of the interviews are conducted face-to-face, some over the phone or via e-mail. The interviews as well as written material received from the respondents are assessed by the content analysis method. The quality requirements are met by construct, external and internal validity as well as reliability.

3.4 Derived methodological framework

This section summarizes the derived methodological framework. Bearing in mind the requirements of case studies, this thesis follows four steps of analysis.

In **step 1** of the analysis the preliminary list of 19 public policy country has been elaborated – emanating from the evaluation of 34 existing studies on transition countries – in *section 2.2.5* and that will be the basis of the further analyses.[456]

[456] See also *figure 12*.

Step 2 of the analysis aims at a fuller understanding of country determinants of MNCs; hence, expert interviews are conducted with MNCs from Germany and Austria, external company experts, state representatives from Romania and Croatia, and with external state experts.[457] The advantage of the expert interviews is that determinants that are usually not considered in FDI surveys or econometric studies can be identified. Moreover, the interviews with key decision makers allow for a better understanding of the casual relationship between different determinants as well as of the actual potential of public policy makers to influence their investment decision.[458] Company and state documents that the author collects from the interviewees help to interpret the expert statements.

At the end of this step a revised list of determinants is elaborated that presents those aspects that are most frequently considered by MNCs during their investment decision process (*chapters 5 and 6*)

In **step 3** each of the determinant and possible sub-determinants are analyzed for Romania and Croatia. The performance of the determinants is examined as well as the reform measures of public policy actors. Furthermore, the impact of the determinants on in the investment decision of MNCs is analyzed. Finally, generalizable results are derived for transition countries (*chapters 7 and 8*).

The country determinants are categorized in **step 4** of the analysis based on the NIE theory (*chapter 9*). The aim is to cluster these determinants according to the public policy actor groups involved as well as to the time horizons that are needed for MNCs to take an investment decision and for public policy actors to achieve significant improvements of the FDI determinants.

457 The expert interviews also comprise examples from those companies that considered investing in one of the respective countries but, in the end, decided not to invest there.

458 See Welman and Kruger (2001); see also *section 3.3.5* for the rationale and set-up of expert interviews in this thesis.

4 Intermediate results

The first part of this thesis has elaborated the theoretical and methodological framework and established an scientific foundation for the proposed research.

It has identified the possibilities and limits of **public policy factors** in attracting FDI from MNCs as an academic question as well as the secondary questions and hypotheses that this implies. It has also been explained why the effects of FDI on home and host countries tend to be positive overall. Based on an extensive analysis of the existing literature on FDI determinants in transition countries, different dimensions have been identified in which this thesis can make meaningful contributions.

This thesis uses the **locational competition theory** as its first theoretical framework. This theory helps to establish a research approach that covers the view of both MNC and the states.[459] Locational competition furthermore legitimizes the broad search for those factors that public policy can actually influence. In this context a preliminary list of the 19 most important policy factors has been identified that will be the basis for the further analyses of public policy measures of this thesis. Moreover, the locational competition approach becomes important for the consideration of the limits of specific measures to attract FDI; a contribution of this thesis to FDI research seems especially possible in the analysis of trade-offs of public policy actions in each of the selected countries, Romania and Croatia, as well as in the envisaged cross-country view and in the consideration of the success and challenges of EU accession.

[459] This lack of a combined view has also been criticized in Mudambi (2002).

The **NIE** has been identified as second theoretical pillar for this thesis because its assumptions (i. e. imperfect markets, incremental changes and uncertainty) and approach (including the definition of institutions and organizations) are well in line with the proceeding in this thesis; in addition, it can contribute to a new and more realistic categorization of measures and public policy actors in the context of FDI.

With respect to the **methodological framework** the selection of Romania and Croatia has been explained; the rationale of analyzing only MNCs from Austria and Germany has also been presented. Moreover, the methodological challenges of existing FDI research have been discussed; an alternative approach, the case study, has been presented and elaborated as the methodological approach of this thesis. The selection of the type of cases (explanatory, theory-based, multiple and embedded) enables the thesis to achieve a more comprehensive understanding of the impact of public policy factors on the investment decision of MNCs. It has been highlighted that the case study approach is especially advantageous due to its openness to other disciplines and to its use of multiple sources of evidence. In this context it has been pointed out that this thesis relies on a broad base of sources including expert interviews, company material, state documents, secondary literature as well as national and international statistics.

In conclusion, the first part of this work has created a comprehensive and sound theoretical and methodological framework in preparation for the analytical core of the subsequent chapters of this thesis.

5 Expert interviews and documents – the data

The following chapter presents the empirical data of this thesis, expert interviews (*section 5.1*) and expert documents (*section 5.2*). *Section 5.3* outlines how the empirical data has been incorporated into subsequent analyses.

5.1 Expert interviews

The conducted expert interviews are analyzed with respect to the fulfillment of the formal requirements (*section 5.1.1*) and to the interview contents (*section 5.1.2*) which also includes a revision and new categorization of the pre-defined list of FDI determinants from the theoretical part of this thesis (*section 2.2.5*).

5.1.1 Formal analysis

The formal analysis of the conducted expert interviews reflects the methodological requirements and goals for these interviews elaborated in *section 3.3.5*. This section discusses (1) an overview of the conducted interviews, (2) theoretical sampling, (3) the expertise of the interviewees, and (4) further interview details.

(1) **Overall**, the author conducted **90 semi-structured expert interviews** between March and December 2007 – the targeted number was 60 interviews. Of the 90 interviews, 53 focused on FDI in Romania and the remainder on Croatia. 50 investors and company experts were interviewed. The remaining interviewees were Romanian and Croatian state representatives and external

state experts. Four trips to Croatia, two to Romania, two to Austria as well as numerous trips within Germany were necessary to conduct these interviews.

All interview details are documented in the database of formalities. Excerpts with the most important information are presented in *figures 24* to *27*.

Int #	Interview citation	Expert type	Name	Institution	Home country of institution	Year of investment decision	Position of interviewee	Nationality of interviewee	Expertise	Interview form	Duration (in min.)
Interview details - company expert interviews Romania											
1	Intv. Germ. MNC - Retail (2007)	Internal	*Disguised*	*Disguised*	Germany	2005	*Disguised*	German	*Disguised*	Phone	30
2	Intv. Austr. MNC - Industrial Goods I (2007)	Internal	*Disguised*	*Disguised*	Austria	2006	*Disguised*	German	*Disguised*	Face-to-face	120
3	Intv. Germ. MNC - Automotive (2007)	Internal	*Disguised*	*Disguised*	Germany	1999	*Disguised*	German	*Disguised*	Phone	45
4	Intv. Austr. MNC - Financial Services II (2007)	Internal	*Disguised*	*Disguised*	Austria	2001	*Disguised*	Austrian	*Disguised*	Phone	30
5	Intv. Germ. MNC - Industrial Goods III (2007)	Internal	*Disguised*	*Disguised*	Germany	2005	*Disguised*	German	*Disguised*	Face-to-face	45
6	Intv. Austr. MNC - Primary Goods II (2007)	Internal	*Disguised*	*Disguised*	Austria	2002	*Disguised*	Austrian	*Disguised*	Phone	30
7	Intv. Germ. MNC - Legal Services I (2007)	Internal	*Disguised*	*Disguised*	Germany	2005	*Disguised*	German/ Romanian	*Disguised*	Face-to-face	60
8	Intv. Austr. MNC - Legal Services (2007)	Internal	*Disguised*	*Disguised*	Austria	1996	*Disguised*	Romanian/ Austrian	*Disguised*	Phone	30
9	Intv. Romanian Company - Advertising (2007)	External	*Disguised*	*Disguised*	Romania	n/a	*Disguised*	Romanian	*Disguised*	Face-to-face	45
10	Intv. Rom. Company - Consulting (2007)	External	*Disguised*	*Disguised*	Romania	n/a	*Disguised*	Romanian	*Disguised*	Face-to-face	90
11	Intv. German Econ. Association III (2007)	External	*Disguised*	*Disguised*	Germany	n/a	*Disguised*	Romanian	*Disguised*	Face-to-face	45
12	Intv. Austrian Econ. Association I (2007)	External	*Disguised*	*Disguised*	Austria	n/a	*Disguised*	Austrian	*Disguised*	Phone	30
13	Intv. German Econ. Association V (2007)	External	*Disguised*	*Disguised*	Romania	n/a	*Disguised*	Romanian	*Disguised*	Face-to-face	45
14	Intv. Germ. MNC - Legal Services II (2007)	External	*Disguised*	*Disguised*	Romania	1996	*Disguised*	Romanian	*Disguised*	Face-to-face	75
15	Intv. German Econ. Association II (2007)	External	*Disguised*	*Disguised*	Germany	n/a	*Disguised*	Romanian	*Disguised*	Face-to-face	90
Additional interviews											
61	Intv. Germ. MNC - Software (2007)	Internal	*Disguised*	*Disguised*	Germany	2006	*Disguised*	German	*Disguised*	Phone	60
62	Intv. Austr. MNC - Financial Services I (2007)	Internal	*Disguised*	*Disguised*	Austria/ Italy	1997	*Disguised*	Italian	*Disguised*	Face-to-face	60
63	Intv. Germ. MNC - Logistics (2007)	Internal	*Disguised*	*Disguised*	Germany	1998	*Disguised*	German	*Disguised*	Phone	30
64	Intv. Int'l MNC - Utilities (2007)	Internal	*Disguised*	*Disguised*	International	1992	*Disguised*	German	*Disguised*	Face-to-face	60
65	Intv. Germ. MNC - Consulting I (2007)	Internal	*Disguised*	*Disguised*	Germany	1992	*Disguised*	Romanian	*Disguised*	Face-to-face	45
66	Intv. Germ. MNC - Utilities (2007)	Internal	*Disguised*	*Disguised*	Romania	1999 (not realized)	*Disguised*	Romanian	*Disguised*	Face-to-face	75
67	Intv. Germ. MNC - Financial Services III (2007)	Internal	*Disguised*	*Disguised*	Germany	1998	*Disguised*	German/ Romanian	*Disguised*	Phone	45
68	Intv. Germ. MNC - Industrial Goods II (2007)	Internal	*Disguised*	*Disguised*	Germany	2008 (planned)	*Disguised*	German	*Disguised*	Phone	90
69	Intv. Austr. MNC - Consumer Goods (2007)	Internal	*Disguised*	*Disguised*	Austria	2006	*Disguised*	Austrian	*Disguised*	Phone	30
70	Intv. Germ. MNC - Consulting II (2007)	Internal	*Disguised*	*Disguised*	Germany	2003	*Disguised*	German	*Disguised*	Phone	45
71	Intv. German Econ. Association I (2007)	Internal	*Disguised*	*Disguised*	Germany	n/a	*Disguised*	German	*Disguised*	Face-to-face	90
72	Intv. German Econ. Association VII (2007)	Internal	*Disguised*	*Disguised*	Germany	n/a	*Disguised*	Romanian/ German	*Disguised*	Phone	30
73	Intv. Germ. MNC - Medical Techn. (2007)	External	*Disguised*	*Disguised*	Germany	n/a	*Disguised*	Romanian	*Disguised*	Face-to-face	60
74	Intv. German Econ. Association VIII (2007)	External	*Disguised*	*Disguised*	Germany	n/a	*Disguised*	German	*Disguised*	E-mail	-
75	Intv. Int'l Econ. Association (2007)	External	*Disguised*	*Disguised*	International	n/a	*Disguised*	Romanian	*Disguised*	Face-to-face	60
76	Intv. German Econ. Association VI (2007)	External	*Disguised*	*Disguised*	Germany	n/a	*Disguised*	German	*Disguised*	Phone	30

Source: Author's database of formalities.

Figure 24: Interview details – company expert interviews Romania

Int #	Interview citation	Expert type	Name	Institution	Home country of institution	Position of interviewee	Nationality of interviewee	Expertise	Interview form	Duration (in min.)
Interview details - state expert interviews Romania										
16	Intv. Romanian Authority II (2007)	State Representative	*Disguised*	*Disguised*	Romania	*Disguised*	Romanian	*Disguised*	Face-to-face	75
17	Intv. Romanian Authority I (2007)	State Representative	*Disguised*	*Disguised*	Romania	*Disguised*	Romanian	*Disguised*	Face-to-face	60
18	Intv. Romanian Ministry IV (2007)	State Representative	*Disguised*	*Disguised*	Romania	*Disguised*	Romanian	*Disguised*	Face-to-face	75
19	Intv. Romanian Ministry V (2007)	State Representative	*Disguised*	*Disguised*	Romania	*Disguised*	Romanian	*Disguised*	Face-to-face	90
20	Intv. Romanian Ministry I (2007)	State Representative	*Disguised*	*Disguised*	Romania	*Disguised*	Romanian	*Disguised*	Face-to-face	45
21	Intv. Romanian Ministry III (2007)	State Representative	*Disguised*	*Disguised*	Romania	*Disguised*	Romanian	*Disguised*	Face-to-face	30
22	Intv. Rom. Local Authority I (2007)	State Representative	*Disguised*	*Disguised*	Romania	*Disguised*	Romanian	*Disguised*	Face-to-face	30
23	Intv. German Authority IV (2007)	External	*Disguised*	*Disguised*	Germany	*Disguised*	German	*Disguised*	Face-to-face	60
24	Intv. German Authority I (2007)	External	*Disguised*	*Disguised*	Germany	*Disguised*	German	*Disguised*	Face-to-face	60
25	Intv. Supranational Authority I (2007)	External	*Disguised*	*Disguised*	International	*Disguised*	Romanian	*Disguised*	Face-to-face	45
26	Intv. Germ. Legal Expert (2007)	External	*Disguised*	*Disguised*	Germany	*Disguised*	German	*Disguised*	Face-to-face	90
27	Intv. Germ. Research Institute I (2007)	External	*Disguised*	*Disguised*	Germany	*Disguised*	German	*Disguised*	Face-to-face	90
28	Intv. Germ. Political Foundation II (2007)	External	*Disguised*	*Disguised*	Germany	*Disguised*	German	*Disguised*	Face-to-face	60
29	Intv. Romanian Econ. Association II (2007)	External	*Disguised*	*Disguised*	Romania	*Disguised*	Romanian	*Disguised*	Face-to-face	60
30	Intv. Romanian NGO (2007)	External	*Disguised*	*Disguised*	Romania	*Disguised*	Romanian	*Disguised*	Face-to-face	45
Additional interviews										
77	Intv. Romanian Ministry II (2007)	State Representative	*Disguised*	*Disguised*	Romania	*Disguised*	Romanian	*Disguised*	Face-to-face	30
78	Intv. Rom. Local Authority II (2007)	State Representative	*Disguised*	*Disguised*	Romania	*Disguised*	Romanian	*Disguised*	Face-to-face	60
79	Intv. Romanian County Council (2007)	State Representative	*Disguised*	*Disguised*	Romania	*Disguised*	Romanian	*Disguised*	Phone	45
80	Intv. German Ministry (2007)	External	*Disguised*	*Disguised*	Germany	*Disguised*	German	*Disguised*	Phone	60
81	Intv. Austr. Research Institute (2007)	External	*Disguised*	*Disguised*	Austria	*Disguised*	Hungarian/ Austrian	*Disguised*	Phone	45
82	Intv. German Political Adviser (2007)	External	*Disguised*	*Disguised*	Germany	*Disguised*	German	*Disguised*	Phone	30
83	Intv. Romanian Econ. Association I (2007)	External	*Disguised*	*Disguised*	Romania	*Disguised*	Romanian	*Disguised*	Face-to-face	40

Source: Author's database of formalities.

Figure 25: Interview details – state expert interviews Romania

Interview details - company expert interviews Croatia

Int #	Interview citation	Expert type	Name	Institution	Home country of institution	Year of investment decision	Position of interviewee	Nationality of interviewee	Expertise	Interview form	Duration (in min.)
31	Intv. Germ. MNC - Telecommunications (2007)	Internal	*Disguised*	*Disguised*	Germany	2000	*Disguised*	German	*Disguised*	Face-to-face	90
32	Intv. Austr. MNC - Construction (2007)	Internal	*Disguised*	*Disguised*	Austria	1995	*Disguised*	Croatian	*Disguised*	Face-to-face	105
33	Intv. Germ. MNC - Food Products (2007)	Internal	*Disguised*	*Disguised*	Germany	2004	*Disguised*	German	*Disguised*	Face-to-face	75
34	Intv. Austr. MNC - Financial Services I (2007)	Internal	*Disguised*	*Disguised*	Austria/ Italy	1997	*Disguised*	Italian	*Disguised*	Face-to-face	60
35	Intv. Germ. MNC - Industrial Goods I (2007)	Internal	*Disguised*	*Disguised*	Germany	2002	*Disguised*	German	*Disguised*	Phone	30
36	Intv. Austr. MNC - Primary Goods I (2007)	Internal	*Disguised*	*Disguised*	Austria	1996	*Disguised*	Austrian	*Disguised*	Phone	45
37	Intv. Germ. MNC - Engineering (2007)	Internal	*Disguised*	*Disguised*	Germany	2001 (not realized)	*Disguised*	German	*Disguised*	Face-to-face	90
38	Intv. Austr. MNC - Real Estate (2007)	Internal	*Disguised*	*Disguised*	Austria	1998	*Disguised*	Austrian	*Disguised*	Phone	30
39	Intv. Croat. Company II - Legal Services (2007)	External	*Disguised*	*Disguised*	Croatia	n/a	*Disguised*	Croatian	*Disguised*	Face-to-face	60
40	Intv. Croat. Company - Utilities (2007)	External	*Disguised*	*Disguised*	Croatia	n/a	*Disguised*	Croatian	*Disguised*	Face-to-face	75
41	Intv. German Econ. Association IV (2007)	External	*Disguised*	*Disguised*	Germany	n/a	*Disguised*	German/ Croatian	*Disguised*	Face-to-face	60
42	Intv. Croatian Company - Real Estate (2007)	External	*Disguised*	*Disguised*	Switzerland/ Croatia	2003	*Disguised*	Croatian	*Disguised*	Face-to-face	120
43	Intv. Austrian Econ. Association II (2007)	External	*Disguised*	*Disguised*	Austria	n/a	*Disguised*	Austrian	*Disguised*	Face-to-face	45
44	Intv. Croat. Company I - Legal Services (2007)	External	*Disguised*	*Disguised*	Croatia	n/a	*Disguised*	Croatian	*Disguised*	Face-to-face	60
45	Intv. Austr. MNC - Consulting (2007)	External	*Disguised*	*Disguised*	Austria	2003	*Disguised*	Croatian/ Austrian	*Disguised*	Phone	30
Additional interviews											
84	Intv. Germ. MNC - Financial Services I (2007)	Internal	*Disguised*	*Disguised*	Germany	1998	*Disguised*	German/ Croatian	*Disguised*	Face-to-face	75
85	Intv. Austr. MNC - Retail (2007)	Internal	*Disguised*	*Disguised*	Austria	1998	*Disguised*	German	*Disguised*	Face-to-face	45
86	Intv. Germ. MNC - Software (2007)	Internal	*Disguised*	*Disguised*	Germany	2004	*Disguised*	German	*Disguised*	Phone	60
87	Intv. Germ. MNC - Financial Services II (2007)	Internal	*Disguised*	*Disguised*	Germany	1997	*Disguised*	Croatian	*Disguised*	Face-to-face	45

Source: Author's database of formalities.

Figure 26: Interview details – company expert interviews Croatia

Interview details - state expert interviews Croatia

Int #	Interview citation	Expert type	Name	Institution	Home country of institution	Position of interviewee	Nationality of interviewee	Expertise	Interview form	Duration (in min.)
46	Intv. Croatian Authority II (2007)	State Representative	*Disguised*	*Disguised*	Croatia	*Disguised*	Croatian	*Disguised*	Face-to-face	45
47	Intv. Croatian Authority I (2007)	State Representative	*Disguised*	*Disguised*	Croatia	*Disguised*	Croatian	*Disguised*	Face-to-face	60
48	Intv. Croatian Ministry II (2007)	State Representative	*Disguised*	*Disguised*	Croatia	*Disguised*	Croatian	*Disguised*	Face-to-face	75
49	Intv. Croatian Ministry I (2007)	State Representative	*Disguised*	*Disguised*	Croatia	*Disguised*	Croatian	*Disguised*	Face-to-face	60
50	Intv. Croatian Government Team (2007)	State Representative	*Disguised*	*Disguised*	Croatia	*Disguised*	Croatian	*Disguised*	Face-to-face	45
51	Intv. Croatian Ministry IV (2007)	State Representative	*Disguised*	*Disguised*	Croatia	*Disguised*	Croatian	*Disguised*	Face-to-face	60
52	Intv. Croatian Mayor (2007)	State Representative	*Disguised*	*Disguised*	Croatia	*Disguised*	Croatian	*Disguised*	Phone	30
53	Intv. German Authority III (2007)	External	*Disguised*	*Disguised*	Germany	*Disguised*	Austrian	*Disguised*	Face-to-face	60
54	Intv. German Authority II (2007)	External	*Disguised*	*Disguised*	Germany	*Disguised*	German	*Disguised*	Face-to-face	90
55	Intv. Supranational Authority II (2007)	External	*Disguised*	*Disguised*	International	*Disguised*	US American	*Disguised*	Face-to-face	45
56	Intv. Germ. Research Institute II (2007)	External	*Disguised*	*Disguised*	Germany	*Disguised*	German/ Croatian	*Disguised*	Face-to-face	75
57	Intv. European Institution (2007)	External	*Disguised*	*Disguised*	International	*Disguised*	Croatian	*Disguised*	Face-to-face	45
58	Intv. Int'l Research Institute I (2007)	External	*Disguised*	*Disguised*	Germany	*Disguised*	German	*Disguised*	Phone	30
59	Intv. Former Croatian Minister (2007)	External	*Disguised*	*Disguised*	Croatia	*Disguised*	Croatian	*Disguised*	Face-to-face	45
60	Intv. Croatian University (2007)	External	*Disguised*	*Disguised*	Croatia	*Disguised*	Croatian	*Disguised*	Face-to-face	30
Additional interviews										
88	Intv. Croatian Ministry III (2007)	State Representative	*Disguised*	*Disguised*	Croatia	*Disguised*	Croatian	*Disguised*	Phone	30
89	Intv. Germ. Political Foundation I (2007)	External	*Disguised*	*Disguised*	Croatia	*Disguised*	German	*Disguised*	Face-to-face	60
90	Intv. Croatian Econ. Association (2007)	External	*Disguised*	*Disguised*	Croatia	*Disguised*	Croatian	*Disguised*	E-mail	-

Source: Author's database of formalities.

Figure 27: Interview details – state expert interviews Croatia

(2) The interviewee selection was based on **theoretical sampling** and on complex interviewee selection matrices that were elaborated in the methodological part of this thesis and that were summarized in *figures 19* to *22*.

The conducted interviews fulfilled all categories established in the methodological part or even exceeded the expectations due to the many additional interviews. *Figures 84* to *87* in the appendix show how the interviewee selection matrices and their categories and different dimensions have been translated into matching comprehensive interview tables with company and state experts in Romania and Croatia.[460]

Accordingly, company expert interviews for both countries cover large firms and SMEs (21 versus 20 interviews), industry- and service-oriented companies (15 versus 26), investors specialized in greenfield and brownfield investments (24 versus 17), and investors whose investment decision took place until and after 2003 in Romania (13 versus 7) and until and after 1999 in Croatia (7 versus 6).[461] State expert interviews were conducted for Romania and Croatia with governmental and other organizations (25 versus 15), national and regional representations (35 versus 5), experts with direct and indirect involvement in FDI policy (10 versus 30), and with frequent and occasional contact to MNCs (19 versus 21).[462]

(3) As demanded in the methodology chapter, the interviewees have distinctive **expertise** in the fields that are relevant for this thesis. Company as well as state expert interviews included interviewees in top and medium positions in their organizations (54 versus 36) and those with general but also with specific knowledge regarding FDI conditions and policies (56 versus 40).

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[460] Therefore, the numerations of the matched interviews in *figures 84* and *86* correspond to those in *figures 19*; *20*; *21*, and *22*.

[461] See section 3.3.5 for the rationale of the selected periods.

[462] Multiple mentions are possible, for example, when a company has invested in both greenfield and brownfield activities.

The company experts interviewed were in key positions in the business world, often directly involved in the investment decision of MNCs. More than 20 CEOs and managing directors were interviewed for Romania and Croatia. Interviewed state experts were closely involved in FDI policy or in other areas of reform policies relevant for these thesis. 19 state interviewees had specific expertise in economic issues, 12 in political and four in legal affairs while six interviewees were experts in more than one of these fields.

Further information regarding the explicit expertise of the interviewees are documented in the interview details in *figures 24* to *27*.

(4) **Further interview details** are documented in the database of formalities.[463] As targeted in the methodological part the great majority of interviews (about 70%) were conducted face-to-face. The interviews lasted an average of 56 minutes, and all ranged between 30 and 120 minutes. 62 interviews were conducted in German. The other ones were held in English with the exception of one, which was held in Croatian with the help of an interpreter. The response rate of the contacted interview partners was one third and therefore higher than expected. 90% of the interviews were tape recorded and notes were taken in all interviews. The transcript protocols of the 90 interviews conducted for this thesis add up to 415 pages, an average of 4.6 pages per interview.

The complete database of formalities reveals further interview details such as information on the investment history of the interviewed companies, details regarding the disguised interviewees, contact details of all interviewees, dates and locations of the interviews, and information regarding the contact gatekeepers.

[463] See figures 24 to 27 for a summary.

In **conclusion**, the formal requirements of theoretical sampling as well as the other interview-related criteria that were elaborated in *section 3.3.5* have not only been met but have even exceeded expectations. This is also due to the various additionally conducted interviews. Overall, this formal analysis of the conducted interviews already indicates that the envisaged theoretical saturation may have been reached; this will however be examined further in the subsequent content analysis of the interviews.

5.1.2 Content analysis

This thesis uses content analysis as data evaluation technique (*see section 3.3.5*) which includes (1) categorization, (2) structuring and analytical generalization, the latter of which is used in *chapters 6 and 7.*

(1) All expert statements are scrutinized following the transcription of the 90 interviews. As the transcription show the experts discussed many of the 19 predefined FDI determinants from the theoretical part of this thesis but also made important contributions to other country determinants (such as court system or reputation of a country) or even to other topics (such as the influence of political actors or potential future fields of FDI). In consequence it seems that motivations for MNCs' investment decision as well as potential FDI policies are very broad and should not be neglected if they go beyond the experiences of individual experts.

There therefore seems to be a compelling need for the revision of the predefined FDI determinants. As a subsequent step the statements of each expert as documented in the transcript protocols are re-grouped according to topics, for example, to company registration, contacts for FDI decision etc.This also leads to the elimination of the chronological order of the transcript protocols which is necessary for a later generalization of the statement analysis.

All relevant statement topics (not only all discussed FDI determinants) are categorized and clustered in six different levels (general statements, legal measures, economic measures, political measures, non-policy factors, and further aspects), 42 categories and 92 sub-categories **(categorization)**. These categories are also presented in *figure 28*, where bold type reflects the 19 pre-determined country determinants of the theoretical part of this thesis.[464]

(2) Subsequently, a content analysis database is established in order to track all statements and to facilitate their later analysis. The database includes the same elaborated categories for all four interview types (Romania company and state, Croatia company and state).[465] The expert statements are then transferred from the re-grouped transcript protocols to the content analysis database and to their corresponding categories **(structuring)**. The complete database contains more than 6,700 entries with expert statements about FDI conditions and policies in Romania and Croatia. In order to reach a thorough understanding of the issues discussed, all categories in all four interview types are backed by at least three entries and at least two different sources. In fact, the evaluation of the database as documented in *figure 29* reveals that a multitude of statements and sources are used for all established categories.

[464] Including the pre-defined non-policy factors.

[465] Even though a few additional country-specific sub-categories exist such as the performance of political actors or the impact of the war heritage in Croatia.

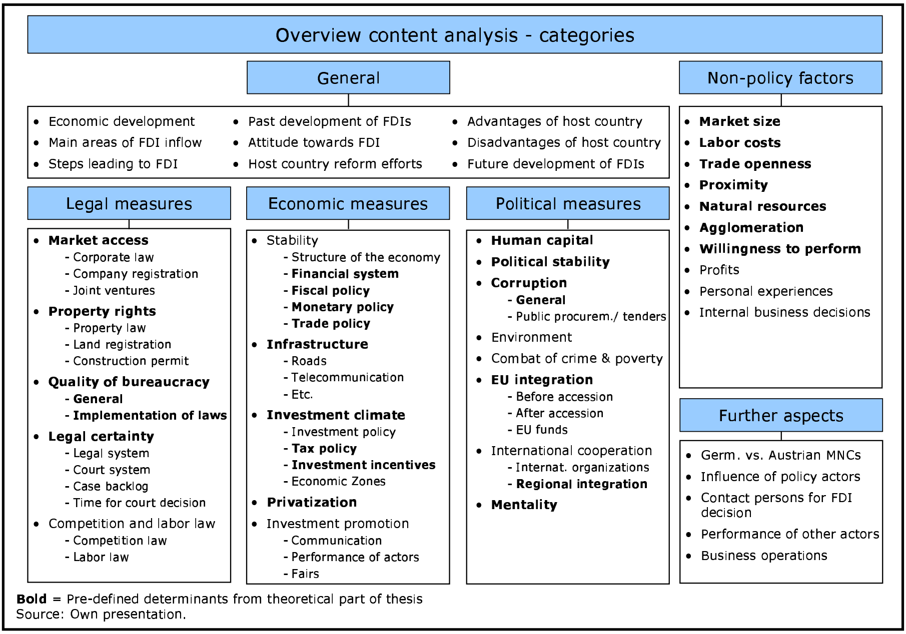


Figure 28: Overview content analysis - categories

Formal evaluation of expert interview content analysis							
Item	Romania Company	Romania State	Croatia Company	Croatia State	Romania Total	Croatia Total	TOTAL
# of interviews	32	21	19	18	53	37	**90**
# of transcript pages	150	93	93	79	243	172	**415**
# of categories	42	42	42	42	42	42	**42**
# of categories in "General"	9	9	9	9	9	9	**9**
# of categories in "No public policy influence"	10	10	10	10	10	10	**10**
# of categories in "Legal measures"	5	5	5	5	5	5	**5**
# of categories in "Economic measures"	5	5	5	5	5	5	**5**
# of categories in "Political measures"	8	8	8	8	8	8	**8**
# of categories in "Further aspects"	5	5	5	5	5	5	**5**
# of entries	1.858	1.574	1.601	1.671	3.432	3.272	**6.704**
Average # of entries per category	44,2	37,5	38,1	39,8	40,9	39,0	**39,9**
Categories with < 3 entries	0	0	0	0	0	0	**0**
Categories with >10 entries	31	26	31	26	28,5	28,5	**28,5**
# of sources used*	32	24	23	22	56	45	**101**
Entries per source	58	66	70	76	61	73	**66**
Average # of sources per category	13,7	7,9	9,4	7,6	10,8	8,5	**9,7**
Categories with <2 sources	0	0	0	0	0	0	**0**
Categories with >7 sources	30,0	21,0	24,0	21,0	51,0	45,0	**96,0**

* Deviations to number of interviews above due to consideration of expert statements to other country.

Source: Author's content analysis database; own calculations.

Figure 29: Formal evaluation expert interview content analysis

5.2 Expert documents

Expert documents are a further source type used in this thesis for the analysis of the impact of public policy on the conditions for FDI in Romania and Croatia. As already briefly discussed in *section 3.3.5*, expert documents are supposed to specify and further explain expert statements. For company experts documents help to interpret investment decision in the context of business operations while documents of state experts may be, for example, strategies that explain the interdependences of governmental actions. In addition, both company and state documents may help to avoid potential misunderstandings of verbal statements.

The documents for this thesis are generally retrieved from the experts interviewed and include internal documents, presentations and reports from companies as well as from external and state organizations. Some of the documents may also be publically available but are generally difficult to retrieve and most importantly serve for more thorough interpretation of the expert interviews.

Figures 30 and *31* present the expert documents for this thesis. Of the large amount of collected materials 40 documents are used for this thesis. 20 documents are collected for each country, 24 documents are designated state documents and the remaining ones are company documents. 73% of the documents were collected from the pool of interviewed experts, while the other ones were received from further experts that had been contacted but with whom an interview could not be arranged with such as the Romanian embassies in Vienna and Berlin. Half of the documents are in English, one in Romanian and the remaining ones are written in German. More than eight out of ten documents were composed in 2006 and 2007, and 65% of the material was received as electronic version. The total number of pages amounts to 1,929 of which the *National program for the accession of Croatia to the EU*[466] accounts for 38%. The complete document database contains various further information, for example, regarding the distributor and more thorough analyses of the content of the documents.

In **conclusion**, the formal and content analyses of both expert interviews and documents seem to confirm that the empirical data enables theoretical saturation and is a solid empirical foundation for the subsequent analyses in this thesis. Finally, quality control (*see section 3.3.5*) has been fulfilled since multiple sources – interviews and documents – are used (construct validity), theoretical and empirical results are matched through the revision of the predefined categories (internal validity), a replication of the same results is possible due to the used theoretical sampling (external validity), and since all data

[466] See Doc - Min. of Foreign Affairs (2007).

gathering steps are thoroughly explained and documented in this section and in the content analysis database (reliability).

#	Document citation	Category	Expert type	Author	Title/ description	Explanation	Form	# of pages	Language
Documents - company view Romania									
1	Doc - Austr. MNC - Industrial Goods I (2005a)	Company	Internal	*Disguised*	Country selection for investment decision	Strategy paper (excerpt)	Electronic	5	German
2	Doc - Austr. MNC - Industrial Goods II (2005b)	Company	Internal	*Disguised*	Grundstücke in Rumänien	Analysis of investment condition at Romanian sites	Electronic	3	German
3	Doc - Austr. MNC - Industrial Goods III (2005c)	Company	Internal	*Disguised*	Standortentscheidung ist von Gewichtung abhängig	Country strategy with factor prioritization (excerpt)	Electronic	1	German
4	Doc - DLA Piper (2006)	Company	Internal	DLA Piper	Experience with expansion and FDI in CEE and SEE - a law firm's point of view	Presentation about investment conditions incl. clients experience	Paper	11	English
5	Doc - Economic Chamber Vienna (2007)	Company	External	Economic Chamber Vienna	Chancen für die Wiener Wirtschaft durch den EU-Beitritt von Rumänien und Bulgarien	Speech about of President Brigitte Jank about FDI opportunities in ROM & BUG	Electronic	8	German
6	Doc - German Economic Chamber Romania (2007)	Company	External	German Economic Chamber Romania	Konjunkturbericht Rumänien 2007	Company survey about investment conditions in Romania	Electronic	36	German
7	Doc - Austrian Economic Chamber Romania (2007b)	Company	External	Austrian Economic Chamber Romania	Österreichische Investitionen in Rumänien	General presentation about Austrian FDI in Romania	Electronic	19	German
8	Doc - Austrian Economic Chamber Romania (2007a)	Company	External	Austrian Economic Chamber	AWO-Wirtschaftsreport Rumänien	Economic report Romania	Electronic	6	German
9	Doc - Bank Austria Creditanstalt (2007)	Company	External	Bank Austria Creditanstalt	Sectors in CEE. Which are the winners?	Presentation on FDI in CEE	Electronic	10	English
Documents - state view Romania									
10	Doc - Rom. Ministry V (2007)	State	State representative	Romanian Ministry - Anonymous	Outline of the Operational Programmes under the convergence objective	Strategy paper about absorption of EU money	Electronic	5	English
11	Doc - Romanian Embassy Berlin (2007a)	State	State representative	Romanian Embassy Berlin	Rumänien – Wirtschaft und Investitionsanreize	Overview of economic conditions and incentives	Electronic	2	German
12	Doc - Romanian Embassy Berlin (2007b)	State	State representative	Romanian Embassy Berlin	Wirtschaftliche Entwicklung und Investitionsanreize in Rumänien	Presentation of Economic Department on economic conditions incl. FDI in ROM	Electronic	26	German
13	Doc - Ministry of Justice (2005b)	State	State representative	Ministry of Justice	Action plan to implement "The national anti-corruption strategy for 2005-2007"	Internal document on strategy implementation	Electronic	20	English
14	Doc - Ministry of Justice (2005a)	State	State representative	Ministry of Justice	Action plan for the implementation of the "Strategy on the reform of the judiciary 2005 – 2007"	Internal document on strategy implementation	Electronic	63	English
15	Doc - Ministry of Justice (2006)	State	State representative	Ministry of Justice	The public manager and public administration reform	Strategy paper on Young Professionals Scheme	Electronic	21	English
16	Doc - ARIS (2007)	State	State representative	ARIS	Romania your business partner	Description of reasons to invest in Romania (incl. CD-ROM)	Paper	23	English
17	Doc - City of Sibiu (2007)	State	State representative	City of Sibiu	Development guide. The City of Sibiu. Where traditions shape the future	Goals and guidelines for development of the city	Paper	44	English
18	Doc - Local Romanian Authority (2007)	State	State representative	*Disguised*	Conferință de presă	Detailed description of the work of the local authority	Paper	24	Romanian
19	Doc - GTZ (2006b)	State	External	GTZ	Das Wirtschaftsklima in Rumänien	Company survey on economic conditions in Romania	Paper	56	German
20	Doc - KAS (2007)	State	External	Fischer-Bollin, Peter	Cooperation of Konrad-Adenauer-Stiftung with Political Parties in Central, Eastern and Southeastern Europe	Analysis of political parties including Romania	Paper	63	English

Source: Author's document database.

Figure 30: Expert documents – Romania

#	Document citation	Category	Expert type	Author	Title/ description	Explanation	Form	# of pages	Language
Documents - company view Croatia									
21	Doc - Germ. MNC - Engineering (2001)	Company	Internal	*Disguised*	Regionalentwicklungsstudie	Analysis of potential investment location in HR	Electronic	58	German
22	Doc - Germ. MNC - Food Products (2007a)	Company	Internal	*Disguised*	Investment in Croatia	Survey on investment in Croatia	Paper	3	English
23	Doc - Germ. MNC - Food Products II (2007b)	Company	Internal	*Disguised*	Unternehmenspräsentation	Company presentation including activities in Croatia	Paper	29	German
24	Doc - INA (2006)	Company	Internal	INA	Privatization prospectus	Company presentation incl. analysis of market and privatization conditions	Paper	214	English
25	Doc - Austrian Economic Chamber Croatia (2006)	Company	External	Austrian Economic Chamber Croatia	Europäische Wirtschaftsumfrage in Kroatien der Außenhandelsstelle Zagreb unter Investoren aus den EU-	Company survey about investment conditions in Croatia	Electronic	8	German
26	Doc - German Economic Chamber Croatia (2007)	Company	External	German Economic Chamber Croatia	Investment conditions in Croatia	10 documents about legal conditions	Electronic	33	German
27	Doc - Bank Austria Creditanstalt (2007)	Company	External	Bank Austria Creditanstalt	Sectors in CEE. Which are the winners?	Presentation on FDI in CEE	Electronic	10	English
Documents - state view Croatia									
28	Doc - National Competitiveness Council (2007)	State	State representative	National Competitiveness Council	The analysis with integrated commentaries on the study "Business and investment climate in South-Eastern	Respone to GTZ Study	Electronic	22	English
29	Doc - Government of Croatia (2006)	State	State representative	Government of the Republic of Croatia	Strategic development framework for 2006-2013	Long-term economic strategy incl. investment conditions	Paper	82	English
30	Doc - Ministry of Foreign Affairs (2007)	State	State representative	Ministry of Foreign Affairs and European Integration	National program for the accession of Croatia to the EU	Road maps, strategies and implementation plans	Electronic	726	English
31	Doc - Croatian Privatization Fund (2001)	State	State representative	Croatian Privatization Fund	Privatize Croatia	Overview of privatization process and conditions (incl. CD-ROM)	Paper	14	English
32	Doc - GTZ (2006a)	State	External	GTZ	Business and Investment Climate in South-Eastern Europe, Central Asia and the Caucasus	Internal Working Paper for Croatian authorities	Electronic	53	English
33	Doc - Ekonomski Institut Zagreb (2007)	State	External	Ekonomski Institut Zagreb	Croatia's accession to EU: expected economic effects	Economic study	Electronic	32	English
34	Doc - European Commission Zagreb	State	External	European Commission	Business environment and SME-policy, innovation policy	Evaluation of conditions for SMEs (excerpt)	Electronic	10	English
35	Doc - KAS (2007)	State	External	Fischer-Bollin, Peter	Cooperation of Konrad-Adenauer-Stiftung with Political Parties in Central, Eastern and Southeastern Europe	Analysis of political parties including Croatia	Paper	63	English
36	Doc - Croatian Chamber of Commerce (2007a)	State	External	Croatian Chamber of Commerce	Bank assets	Description of share distribution	Electronic	1	English
37	Doc - Croatian Chamber of Commerce (2006a)	State	External	Croatian Chamber of Commerce	Banking system in the Republic of Croatia	Overview presentation of development and status	Electronic	8	English
38	Doc - OECD (2007)	State	External	OECD	Progress for investment reform for Croatia	Presentation of results of Investment Reform Index	Paper	29	English
39	Doc - Croatian Chamber of Commerce (2006b)	State	External	Croatian Chamber of Commerce	Potential for investment in Croatia by business sector	12 documents with data, analysis & outlook	Paper	72	English
40	Doc - Croatian Chamber of Commerce Dubrovnik (2006)	State	External	Croatian Chamber of Commerce Dubrovnik	The economy guide of Dubrovnik-Neretva County	Presentation of economic activities and potential areas of investment	Electronic	16	English

Source: Author's document database.

Figure 31: Expert documents – Croatia

5.3 The incorporation of the empirical data in the analysis

The empirical data – expert interviews and documents – presented in this chapter is used throughout the subsequent analyses of this thesis. The categorization and structuring of the material was helpful to make verbal and written statements processable for this thesis. *Figure 32* shows how the established categories and the statements are incorporated in the thesis. A few categories are not integrated in the analyses, because no clear conclusions could be drawn from the material (for example for intellectual property, environment policy or combat of crime) or they were of only limited help for answering the research questions of this thesis, for instance the statements regarding the general economic development in Romania and Croatia. Most of the covered categories are integrated in the core of the analysis of this thesis – the FDI determinants that can be influenced by public policy (*chapters 7* and *8*). Other categories are incorporated into the country introductions and the FDI analysis from an NIE perspective in *chapters 6* and *9*.

Incorporation of empirical data into the analyses of the thesis

Level	Category	Aspects covered (examples)	Section of this thesis
• General	• Main areas of FDI inflow	• Industries, geography etc.	• Chapters 6, 7 and 8
	• Attitude toward FDI and reforms		
	• FDI determinants of host country	• Advantages & disadvantages	
	• Future development of FDI	• Regions, industries, amount	• Chapter 6
• No PP influence	• **Market size**		• Chapter 6
	• **Labor costs**		
	• **Proximity**	• Geography, cultural ties	
	• **Other aspects**	• Trade openness, agglomeration	
• Legal measures	• **Market access**	• Corporate law, firm registration	• Chapters 7 and 8
	• **Property rights**	• Property law, land registration	
	• **Quality of bureaucracy**	• Permits, **implementation of laws**	
	• **Legal certainty**	• Legal system, court system	
	• Labor law	• Competition and labor law	
• Economic measures	• Stability	• **Monetary policy**, **trade policy**	
	• **Infrastructure**	• Roads, telecommunication	
	• Investment climate	• **Taxes, incentives**, free zones	
	• **Privatization**	• Method, speed	
	• Investment promotion	• Communication, IPAs	
• Political measures	• **Human capital**	• Skill level, mobility	
	• **Political stability**	• Internal & external	
	• **Corruption**	• Development, public tenders	
	• **EU integration**	• Before accession, EU funds	
• Further aspects	• Influence of political actors	• National, regional	• Chapter 9
	• Contact persons for FDI decision	• Domestic, host country	

Source: Own presentation; note: **bold** = pre-defined determinants from theoretical part of thesis

Figure 32: Incorporation of empirical data into analysis

6 Introduction to Romania and Croatia and non-policy determinants

6.1 Introduction

This chapter provides an analogous introduction to the two host countries of FDI under analysis, Romania and Croatia (*sections 6.2* and *6.3*). First the economic fundamentals of both countries since the early 1990s will be discussed, followed by an investigation of those FDI determinants that cannot be influenced by public policy in the short-term. *Section 6.4* will provide a conclusion to the chapter. Despite the main focus on policy factors in this thesis, the analysis of the non-policy factors is essential because it improves the understanding of the basic conditions for FDI policy makers in both countries. Morevoer, the existing influence of these factors on the investment decision of MNCs cannot be neglected. This chapter embeds secondary sources, interview statements and document insights.

6.2 Romania

This section discusses the key economic developments of Romania (*section 6.2.1*) and non-policy country determinants of Romania (*section 6.2.2*).

6.2.1 Economic fundamentals since early 1990s

This section depicts (1) the main tendencies of the Romanian economy since the early 1990s, the development of (2) GDP, (3) inflation, (4) unemployment,

(5) trade, and (6) FDI. It gives (7) an economic outlook and also discusses respective expert statements, and (8) concludes the section and provides an overall assessment. A map of Romania and the country's key economic indicators can also be found in the appendix (*figures 88* and *89*).

(1) In the first years after the end of communism and the dictatorship of Ceauşescu (1965-1989) the Romanian economic development was marked by a slow transition from a centrally planned state towards a market economy. The economic upward trend was hampered by challenges specific to Romania. Problems stemmed from a – even in communist terms – desolate economic situation at the end of the 1980s due to outdated industrial equipment as well as from Ceauşescu's aim for economic independence and a strong focus on an (inefficient) agricultural sector.[467] Moreover, Romania's economy recovery was slower than that of other EECs because of internal difficulties. The alliance between ex-communists and right-wing extremists until 1996 hindered the implication of reforms. The end of the wars on the Balkans and the financial crisis at the end of the 1990s contributed to an economic turning point under the center-right government of President Constantinescu (1996-2000) and the left-wing government of President Iliescu (2000-2004).[468] During the final period before EU accession under President Băsescu (since 2004) the economy gained further momentum and since 2006 observers have repeatedly spoken of Romania as a boom country or “Balkan tiger”.[469]

(2) The economic turmoils in Romania in the mid 1990s led to a dramatic decline in **GDP** dropping to only 37% (1992) compared to 1989 and did not

[467] See Leiße (2006), p.11 and Bfai (2005) pp.32-33.
[468] See Rabobank (2006), p.2.; Müller (2005), pp.144-145; Maniu, Kallai, and Popa (2001), pp.14-15, 22; Gabanyi (2005), p.22; BA-CA (2006), p.10.
[469] See Irish Independent (2006); Rompres (2007b); Financial Times (2007); Die Presse (2007); Pfaller (2007).

return to former levels until 2003.[470] After continuously high growth rates of 8.5% (2004), 4.1% (2005) and 7.7% (2006) Romania's GDP reached €97B in 2006 after €79B in 2005. With an average growth rate of 6.8% in these three years Romania was among the fastest growing economies in Eastern Europe, second only to the Baltic states.[471] Main contributors to the increase in GDP were private consumption, trade and FDI. Meanwhile the per-capita income of the Romanians jumped from €1,500 (1999) to €4,500 (2006). The Romanian purchasing power parity nevertheless equaled only 39% of the EU 27 average in 2006.[472]

(3) One of the most striking problems of the Romanian economy in the 1990s was the (hyper-)**inflation** that peaked at 256% in 1993 and rebounded after some years of lower depreciation of money to 155% in 1997. Inflation constantly decreased in subsequent years but remained high. In fact, Romanian price increase averaged 33.5% between 1998 and 2004, representing the third highest inflation average of 17 EECs during that period.[473] Inflation did not drop below double digits (9.1%) until 2005 and was with 6.6% in 2006 still higher in Romania than in all EU member states.[474]

(4) The economic turbulences of the 1990s also had negative effects on **employment** in Romania. The restructuring of the state-owned enterprises (SOEs), the dismantling of the public administration and limited competitiveness of Romanian companies in the international markets resulted in unemployment rates of 10.9% in 1994 which – after a short recovery – culmi-

470 See IMF website (2008); Bfai (2005), p.33; own calculations.
471 See Maniu, Kallai, and Popa (2001), p.22; IMF (2007b); exchange rate conversion for the whole section based on EIU (2007c); annual changes based on national currency.
472 See Eurostat (2007b); IMF (2007b); Neuhaus (2005).
473 Belarus: 97.9% and Serbia: 39.2%; see Eurostat website (2008); own calculations.
474 EU average: 2.2%, Bulgaria: 7.4%; see Eurostat website (2008); IMF (2007b).

nated in 11.8% in 1999.[475] Since 2000 Romania has seen a constant decline of the unemployment rate. It reached 5.9% in 2005 and 5.2% in 2006 reflecting the overall economic upward trend. Even higher unemployment and high inflation rates were probably avoided due to a large dependence on small farm subsistence.[476] In quantitative terms 42% of the Romanian labor force worked in the agricultural sector in 1999. While this share declined to 30.5% by 2006, it was still significantly higher than, for example, in Bulgaria (23.8%), Hungary (4.9%) or Slovakia (4.4%).[477]

(5) Looking at its **trade** performance Romania could hardly be considered an open economy until the mid 1990s. Romania had an "openness indicator"[478] of only 34% in 1991. Since then this ratio constantly increased to 74% in 2004 before it dropped to 69% in the following two years. On a seven-year basis (2000-2006) Romania is ahead of Poland (57%) but behind all other Eastern European EU members regarding its openess to trade.[479]

Overall, Romania's trade volumes strongly increased in recent years, particularly between 2000 and 2006 when growth rate averaged 21% and climbed up to €67B in 2006. Exports reached €25.9B and imports €40.8B in 2006. In this context Romania has repeatedly been criticized for its strong dependency on imports – contributing to the current account deficit of -15% – that has even increased in recent years.[480]

Russia has clearly lost its importance for Romania's trade statistics. Its share declined from 24% (1991) to less than 5% (2006). Today the EU is the most

[475] See ILO website (2008).
[476] Another reason for moderate unemployment rates may have been a large shadow economy.
[477] See ILO website (2008); own calculations.
[478] (Exports + Imports)/ GDP; see Maniu, Kallai, and Popa (2001), pp.68 and 73.
[479] See Eurostat website (2008); INSSE website (2008); own calculations.
[480] CAGR (2000-2006) was at 14.8% for exports and at 19.2% for imports; see Eurostat website (2008); INSSE website (2008); DB Research (2006); own calculations.

important trading partner and accounts for almost 65% of Romania's overall trade volume.[481] Exports from Romania are driven by machinery products (20% in 2006) while textile products account for 16% but have been strongly decreasing in recent years (25% in 2002). Machinery and electric products are the predominant import categories (24%) followed by oil products (15%).[482]

(6) **FDI inflows** to Romania remained scarce after the end of communism with, for example, only about €80M in 1993. A massive rise of FDI inflows did not occur until the increase of privatization sales in 1997 when inflows of €1.1B exceeded the accumulated FDIs of 1991-1996. Inflows reached €5.2B in 2005 and even €9.1B in 2006 while the per capita basis jumped from €48 (1997) to €419 (2006). The FDI stock increased between 1997 and 2006 at a CAGR of 36% from €2.1B to €34.5B.[483] As discussed in the methodological part Romania also showed an impressive FDI performance in the regional comparison.[484] FDI was the most important driver for Romania's economic boost; it also gained in importance relative to Romania's GDP; while the FDI/ GDP ratio averaged only 2.6% between 1994-2003 and rose to 9.3% in 2006.[485]

The number of foreign investors has considerably increased. Whereas about 91K MNCs held subscribed capital in Romania in 2002, the number rose to about 132K by the end of 2006.[486] While brownfield and greenfield investments have about equal shares of the FDI stock in 2006, privatization has been the dominating form of FDI inflows in recent years. Their significance becomes

[481] See European Commission (2007b).
[482] See INSSE (2003) INSSE (2007); NBR (2007).
[483] See NBR website (2007); UNCTAD FDI website (2008); Hunya (2007); NBR (2007); International Finance Group (2005); own calculations.
[484] See section 2.2.2.
[485] FDI inflows/ GDP in Bulgaria even reached 16.4% in 2006 due to a lower GDP per capita and a relatively higher importance of FDI than in Romania; see section ibid.; UNCTAD FDI website (2008); IMF (2007b); own calculations.
[486] See The National Trade Register Office (2007a); The National Trade Register Office (2004).

apparent considering some large privatizations such as the oil company Petrom that was acquired by the Austrian OVM for about €1.4B in 2004 – more than a third to Romania's FDIs in 2004. The formerly SOE Banca Comerciala Romana (BCR) was acquired by Austria's Erste Bank for €3.8B and contributed 24% to Romania's FDI inflows in 2006.[487] Greenfield investments soared from 113 projects in 2002 to 362 projects in 2006; Romania was therefore ahead of larger competing countries of FDI such as Ukraine (124) or Poland (323) in 2006. *Larive Romania (2007)* however stresses that Romania's greenfield projects have reflected smaller volumes recently compared to previous years.[488]

The sectoral distribution of FDI has been strongly influenced by investments in the manufacturing industry (primarily in the metal and food processing industries) which accounted for 37% of Romania's FDI stock in 2005. However, the importance of this sector has significantly decline in recent years (from 51% in 2003) while other industries such as retail trade (2003: 11% and 2005: 15%) and financial services (2003: 9% and 2005: 15%) have gained in relevance.[489] In terms of regional distribution FDIs have concentrated on the Greater Bucharest region which received 64% of FDI in 2006. The North-Eastern region along Moldavian border has only sporadically attracted FDI so far.[490]

With respect to the home countries of FDI *figure 17* already presented the countries with the largest equity shares in Romania in 2006: Austria with 23%, the Netherlands with 17% and Germany with 10%. Austria in particular had gained importance, given its share of only 15% in the previous year. In sum more than 80% of the FDI stock was held by companies from EU countries in 2006. In addition to this, it is interesting to see that Italian companies which

[487] Only €2.2B of the BCR sale went to the Romanian state; the deal was closed in 2005 but not booked until 2006; see Voinea (2002), pp. 4-5; OECD (2005d), p.18; own calculations.
[488] See also UNCTAD (2007), p.210; ABN-Amro Romania (2006), p.22; NBR (2007).
[489] See Hunya (2007), p.91.
[490] Between 1991 and 2006 the Bucharest region received 59% of foreign subscribed capital, the North-East region only 3.1%; see NBR (2007); The National Trade Register Office (2007a).

only hold 7% of the FDI stock in Romania account for 16% or more than 21K of the registered foreign companies. Germany is also very present with SMEs (about 14K) while Austrian and Dutch investments tend to be larger but less numerous (2.7K and 4.2K companies).[491]

(7) The overall **outlook** for the Romanian economy for 2007-2009 is optimistic. Nevertheless, five external observers[492] evaluated for this thesis claim that the peak of the current economic boost has been reached. Accordingly, the Romanian economy is only expected to grow between 5.5% and 6.3% in both 2007 and 2008 and to decrease to about 5% in 2009. Positive growth drivers mentioned are private consumption fostered by booming credit and rising salaries, effects from EU accession as well as growth in the service and construction sector. Negative effects may be caused by the turbulences on the international financial markets that could also influence the credit demand, negative weather effects on agricultural output (in 2007), lower privatization sales and lower manufacturing sector growth.[493]

Inflation is expected to drop further to 4.3%-4.8% in 2007. The development of the inflation rate in 2008 and 2009 is a matter of controversy among the analysts. Expectations range between 4.0% and 7.2%.[494] Some observers expect the National Bank of Romania (NBR) to play an active role in slowing down the devaluation of money.[495] Other observers predict inflationary pressure due to high wage pressure, particularly from the private sector and real estate prices. Lax fiscal policy and excessive government spending (predominantly in the election year 2008) represent further concerns in this context. There is

[491] See NBR (2007).
[492] Publications between October 2007 and January 2008; see Raiffeisenbank (2008); BA-CA (2007b); DB Research website (2008); EIU (2007b); IMF (2007c).
[493] See all considered analysts for details.
[494] See particularly DB Research website (2008); EIU (2007b).
[495] See e. g. IMF (2007c).

uncertainty with respect to the volatile food prices and an unclear exchange rate development.[496]

Observers expect unemployment to further decrease to a level below 5% from 2007 until 2009. They base their arguments on the tight labor market in a growing economy and the many workers who have emigrated abroad.[497]

With respect to the Romanian trade development observers expect imports to rise faster than exports in 2007 (forecasts ranging from 16%to 26% versus 10% to 13%). While *DB Research website (2008)* and *EIU (2007b)* see a shrinking trade deficit in 2008 for the first time since 2002, the overall current account deficit is expected to remain significant and represents an increasing threat to Romania's economic equilibrium. The continuous high imports are driven by private consumption, mainly as a result of the EU accession and a strong national currency, the leu (RON). Potential softening of the deficits may be established through generation of greater export capacities and a stronger depreciation of the RON through a more active NBR. Yet, the exchange rate development is uncertain in the eyes of most observers.[498]

The observers being analyzed anticipate decreasing FDI levels for Romania in the future. They estimate inflows between €5.8B and €7.3B in 2007 and between €5.5B and €6.8B for the two following years. Some privatization sales and re-investments of existing MNCs are expected as well as some new greenfield investments particularly in the real estate sector. On the downside potential observers see the end of privatizations approaching, the dwindling effects of EU accession and a diminishing confidence of foreign investors in the economic stability of Romania.[499]

The **expert interviews** confirm this perspective on future FDI inflows in Romania. Company as well as state experts estimate that the FDI demand in

[496] See particularly Raiffeisenbank (2008); BA-CA (2007b); EIU (2007b).
[497] See section 7.4.1.2 for details; EIU (2007b); IMF (2007c); BA-CA (2007b).
[498] See section 7.3.1.2; see EIU (2007b); Raiffeisenbank (2008); BA-CA (2007b).
[499] See EIU (2007b); Raiffeisenbank (2008); BA-CA (2007b); DB Research website (2008).

Romania is still high in many areas. Since the country has been avoided for a long time, it seems that Romania still has some catching up to do, the market is not saturated and good business opportunities continue to exist.[500] As a result experts forecast that FDI will continue to flow to Romania even though many experts agree that the very high rates of 2005 and 2006 will be impossible to sustain.[501] More moderate FDI levels may be caused by higher salaries, the labor shortage, and higher real estate prices; other locations like Slovakia may then have similar cost levels but be more productive than Romania.[502] Some experts point out however, that the largest players are already in the market, most privatizations are completed and that the momentum of EU accession may dry off soon.[503]

From the perspective of the experts the most important industries for future FDI in Romania will be the construction and infrastructure industry for which the current boom is expected to last for another ten years.[504] Secondly, the energy sector is believed to attract major foreign investments, including some further privatizations and modernizations.[505] On the demand side of the Romanian market experts see increasing FDI inflows into services such as real estate,

[500] See Intv. German Econ. Association III (2007); Intv. Germ. MNC - Consulting I (2007); Intv. Austrian Econ. Association I (2007); Intv. Int'l Econ. Association (2007); Intv. Romanian Company - Advertising (2007); Intv. Germ. MNC - Consulting II (2007).

[501] See Intv. Germ. MNC - Consulting I (2007); Intv. Int'l Econ. Association (2007); Intv. Germ. MNC - Consulting II (2007); Intv. German Econ. Association III (2007); Intv. Austr. Research Institute (2007).

[502] See Intv. German Econ. Association VII (2007); Intv. Germ. MNC - Consulting II (2007); Intv. Germ. MNC - Legal Services I (2007); Intv. German Econ. Association VI (2007); Intv. Romanian County Council (2007).

[503] See Intv. Rom. Company - Consulting (2007); Intv. German Authority IV (2007); Intv. German Authority I (2007); Intv. Int'l Econ. Association (2007).

[504] See Intv. Rom. Company - Consulting (2007); Intv. Austrian Econ. Association I (2007); Intv. German Econ. Association VII (2007); Intv. German Econ. Association VI (2007); Intv. German Econ. Association V (2007); Intv. Int'l Econ. Association (2007); Intv. Romanian Ministry V (2007); Intv. German Authority IV (2007); Intv. Romanian Authority I (2007).

[505] See Intv. Germ. MNC - Software (2007); Intv. German Econ. Association VII (2007); Intv. Germ. MNC - Financial Services III (2007); Intv. Germ. MNC - Legal Services II (2007); Intv. Germ. MNC - Utilities (2007); Intv. Germ. MNC - Consulting I (2007); Intv. German Authority I (2007); Intv. German Authority IV (2007).

banking (for example due to the privatization of the CEC bank) or call centers.[506] Moreover, retail and consumer goods activities (such as higher-quality clothes and groceries) reflecting the increasing purchasing power of Romanians are expected to rise.[507] In the long-run experts also see potential for FDI in the environmental sector[508] and some potential in tourism (for example in Transylvania).[509] Only few experts anticipate significant inflows into agricultural businesses.[510] The textile industry, a former key industry for FDI, does not seem to have any more chances in Romania due to rising labor costs.[511] Most experts do not think that Romania has remained a top location for labor intensive low-cost production which is better established in the Ukraine etc.[512] By contrast, most experts being interviewed believe that greenfield investments and re-investments in manufacturing industries will focus more on higher-added value productions with higher skilled workers and a larger share of automation-assisted production, for example in the car industry.[513] Moreover, some experts are skeptical that Romania will see many large industrial investments, such as

[506] See Intv. Romanian Company - Advertising (2007); Intv. German Econ. Association V (2007); Intv. Germ. MNC - Legal Services II (2007); Intv. German Authority I (2007); Intv. Supranational Authority I (2007); Intv. Rom. Local Authority I (2007); Intv. Romanian Econ. Association I (2007).

[507] See Intv. Austr. MNC - Primary Goods II (2007); Intv. Rom. Company - Consulting (2007); Intv. Germ. MNC - Consulting II (2007); Intv. Romanian Ministry I (2007); Intv. German Authority I (2007).

[508] See Intv. Rom. Company - Consulting (2007); Intv. Austrian Econ. Association I (2007); Intv. Romanian Ministry V (2007); Intv. German Authority IV (2007); Intv. German Ministry (2007); Intv. Romanian Authority I (2007).

[509] See Intv. German Econ. Association VI (2007); Intv. German Econ. Association V (2007); Intv. Rom. Local Authority I (2007).

[510] See Intv. German Econ. Association III (2007); Intv. Int'l Econ. Association (2007); Intv. German Authority IV (2007).

[511] See Intv. Germ. MNC - Financial Services III (2007); Intv. Supranational Authority I (2007); Intv. German Authority I (2007).

[512] See Intv. German Authority I (2007); more optimistic with respect to low-cost production see Intv. German Econ. Association VI (2007).

[513] See Intv. Germ. MNC - Automotive (2007); Intv. German Econ. Association VI (2007); Intv. Germ. MNC - Financial Services III (2007); Intv. Germ. MNC - Legal Services II (2007); Intv. Supranational Authority I (2007); Intv. German Authority I (2007); Intv. German Econ. Association VII (2007); Intv. Int'l Econ. Association (2007); Intv. German Authority IV (2007).

the automotive industry, in the future.[514] Nevertheless, the experience from other EECs may indicate that no major shutdowns or relocations of current MNC production are to be expected either.[515]

With respect to the regional differences of future FDI development the expert interviews give a mixed picture: some interviewees perceive a stagnation or even a decrease of investment in rural areas[516]; whilst others assume that rural areas will start to benefit from the urban labor shortage.[517] A further group of interviewees assume a shift between urban regions; therefore insufficient capacities to further absorb FDI in boom towns like Timişoara and Sibiu may lead to a stronger focus on other cities like Cluj and Braşov.[518] Representatives from Sibiu are more optimistic that the end of the year as European Capital of Culture will end the focus on cultural activities of the city and will re-invigorate FDI inflows into industry sectors.[519]

Both groups of interviewees, company and state experts, share broadly a similar perspective regarding the future development of FDI in Romania. State representatives are however – understandably – more optimistic with respect to the expected amount of FDI. They think that the current inflow "is just the beginning."[520] State experts are particularly convinced of the benefits of the expected EU funding in order to attract future FDI[521] while this issue is interpreted more controversially by company experts.[522] State experts also see opportunities for FDI as more broadly spread than company experts do. They not only see potential in the above mentioned industries but also predict

[514] See Intv. Germ. MNC - Automotive (2007); Intv. German Econ. Association V (2007).
[515] See Intv. Germ. MNC - Financial Services III (2007).
[516] See e. g. Intv. Austr. MNC - Primary Goods II (2007).
[517] See e. g. Intv. Romanian County Council (2007).
[518] See e. g. Intv. Germ. MNC - Automotive (2007); Intv. German Econ. Association III (2007).
[519] See Intv. Rom. Local Authority I (2007); see also Intv. Romanian Econ. Association I (2007); Doc - City of Sibiu (2007).
[520] Intv. Romanian Ministry I (2007).
[521] See Intv. Romanian Ministry V (2007); see also Intv. German Authority IV (2007).
[522] See section 7.4.4 for details.

"breakthroughs"[523] in areas such as pharmaceuticals, telecommunication and IT.[524] They also evaluate higher potential for forestry and tourism than firms do.[525] State representatives are more optimistic that FDI in the environmental sector will arrive quickly and that FDIs in the automotive industry will remain at existing levels, particularly in Sibiu.[526] Later sections of this thesis will discuss the extent to which the broad approach by state representatives towards possible industries for FDI may be a disadvantage for a successful FDI policy.

Against this prognosis, some company experts see Romania's future potential less as a location for foreign industrial production and more as an important sourcing market for production elsewhere. This view is based on the increasing prices and the rising quality of the production of Romanian companies.[527]

(8) In an overall **assessment** of its economic performance Romania has without a doubt shown remarkable progress in all dimensions analyzed not only because of its difficult initial conditions but also compared to other transition countries of the region. From a struggling and widely neglected country Romania has become one of the evolving stars in Eastern Europe with high GDP growth, decreasing inflation and unemployment and rising trade and FDI volumes. Romania's EU accession in 2007 can be seen as culmination of this development. Nevertheless, it seems that Romania still has significant potential to make up leeway in many areas compared to other EECs, for example, in terms of FDI stock per capita (*figure 33*).[528]

[523] Intv. Romanian Authority I (2007).
[524] See Intv. Romanian Authority I (2007); Intv. Romanian Ministry I (2007); see also Intv. German Authority IV (2007); Intv. Austr. Research Institute (2007); Intv. Supranational Authority I (2007).
[525] See Intv. Romanian Econ. Association I (2007); Intv. Rom. Local Authority I (2007).
[526] See Intv. Romanian Ministry V (2007); Intv. Rom. Local Authority I (2007); Intv. Romanian Authority I (2007); Intv. Romanian Econ. Association I (2007); see also Intv. German Authority IV (2007); Intv. German Ministry (2007).
[527] See e. g. Intv. German Econ. Association III (2007); Intv. Int'l MNC - Utilities (2007).
[528] See Hunya (2007); WIIW figures with minor deviations from author's calculations due to different population and currency conversion assumptions.

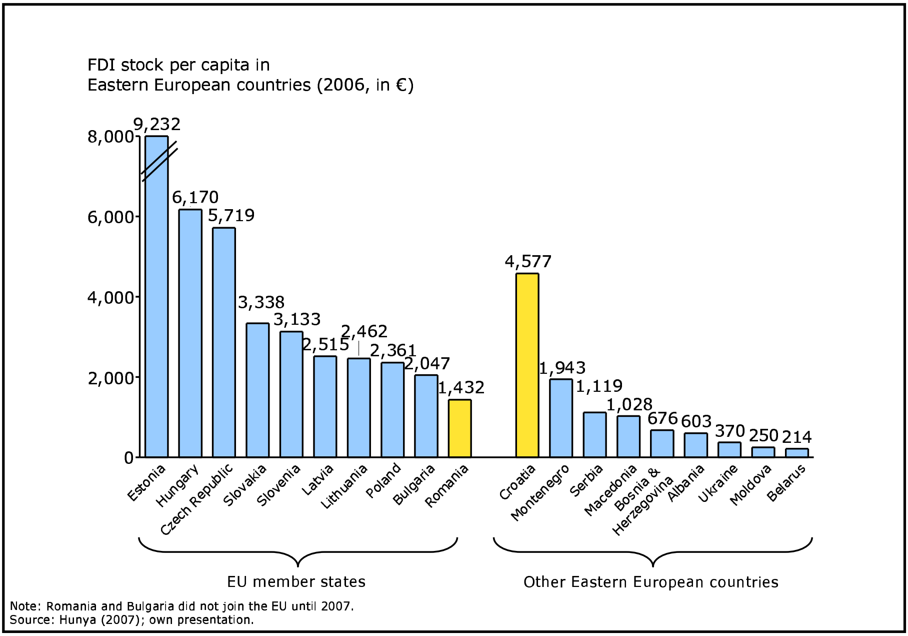


Figure 33: Per capita FDI stock in Eastern Europe

Deka Converging Europe Indicator (DCEI)*					
#	Country	1995	2004	2005	2006**
1	Czech Republic	71	81	85	85
2	Slovenia	56	83	82	83
3	Estonia	52	84	79	81
4	Slovakia	57	74	79	81
5	Poland	48	74	77	79
6	Latvia	41	69	76	77
7	Hungary	34	71	73	75
8	Lithuania	34	71	73	74
9	Bulgaria	21	59	61	65
10	Romania	27	41	59	63
11	Croatia	45	48	54	59
12	Turkey	23	29	39	47

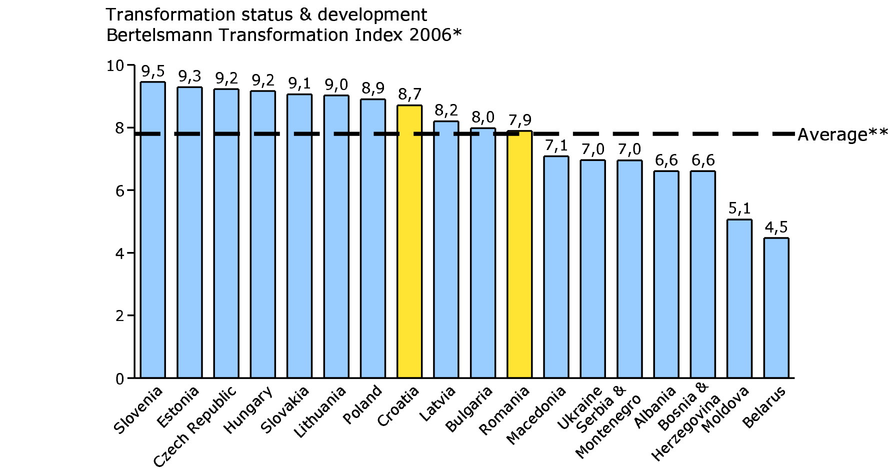
*100 = Western European standards; **estimate
Source: Hornung (2006); own presentation.

Figure 34: Deka Converging Europe Indicator (DCEI)

This evaluation is also confirmed by the Deka Converging Europe Indicator (DCEI) (*figure 34*). This macroeconomic scoring model measuring progress in institutional, monetary, real economic, and fiscal convergence indicates that Romania has reached a level of 63% (2006) of Western European standards and is still behind all other Eastern European EU members including Bulgaria, which was on a lower level than Romania in 1995. The DCEI also signalizes that Romania's convergence progress clearly picked up after 2004 outpacing all analyzed countries.[529]

Similarly the analysis of the Bertelsmann Transformation Index (BTI), which is based on 32 political and economic transformation indicators, leads to the conclusion that Romania shows an average performance among Eastern European transition countries between Eastern European EU members and most SEECs *(figure 35)*.[530]

[529] See Hornung (2006).
[530] See Bertelsmann Stiftung (2006a).



BTI-ranking 2006	1	2	3	5	6	7	9	11	14	16	19	29	32	33	37	37	75	83
BTI-ranking 2003	2	6	2	1	2	2	7	15	12	18	21	34	44	29	38	50	79	85

*Score: 0=worst possible score, 10= best possible score; ** Average of analyzed countries
Source: Bertelsmann Stiftung (2006); own evaluation.

Figure 35: Bertelsmann Transformation Index

The economic future of Romania seems to be uncertain, mainly regarding the impact of EU accession and the development of trade and FDI.[531] It would be interesting to analyze the impact of non-policy determinants (*next section*) and what state actors can do – policy determinants – in order to maintain or even increase current FDI levels (*chapter 7*), especially in reference to the future FDI influence.

6.2.2 Country determinants without short-term public policy impact

The core of the analysis of this thesis, the policy determinants, are analyzed in *chapters 7-9*. As pointed out in the introduction of this section however, it is important for policy makers to understand how an investor's decision in favor of a specific location can be influenced by country determinants that are largely independent of public policies. This section discusses the most important non-policy determinants of Romania that are (1) market size, (2) labor costs, (3) proximity, and (4) other aspects. The last section (5) draws a conclusion on Romania's non-policy factors. For each determinant analyzed the procedure is as follows:

- Brief description of the country determinant
- Discussion of the arguments of the experts interviewed and their documents
- Analysis of the differences between company and state representatives
- Overall assessment of the determinant, including the consideration of the discussed FDI studies from *section 2.2.4.2* and international comparisons

These steps of analysis correspond to the concept of analytic generalization presented in *section 3.3.5*, elaborating interpretations that go beyond the

[531] See for expected trade effects through EU accession Nitsch and Sturm (2004).

individual example and matching them with hypotheses and theory (pattern-matching).

(1) As already examined in the theoretical part **market size** is defined in multiple ways but most frequently as GDP, GDP per capita, purchasing power parity, GDP growth, and land or population size.[532] The first four of these aspects have already been discussed in the previous section. Furthermore, Romania's land surface of about $240,000 km^2$ is roughly equivalent to that of Great Britain and is with 21.6M inhabitants the third largest Eastern European market after Ukraine and Poland. In economic terms it is advantageous that the population is quite evenly distributed throughout the country and that 20 cities have more than 150K inhabitants.[533] However, a significant birth rate decline and a high emigration rate have contributed to a population decline of 4.9% (1992 versus 2002) that still has not come to an end (2006: -0.3%).[534]

The **experts interviewed** regard market size as important factor for the investment decision in general but also in favor of Romania[535], for example, compared to Bulgaria, Hungary or countries of the former Yugoslavia.[536] For many investors market size also seems to be more important than labor costs in Romania.[537]

Experts agree that Romania's increasing purchasing power and the rising demand for many products and services in many areas in which Romania still shows a need to catch up, makes the country particularly attractive (market-seeking). This seems to be especially true for consumer goods such as cars

[532] See section 2.2.4.2.
[533] See Bfai (2005), pp.13, 47; Der Fischerweltalmanach 2007 (2006).
[534] See for labor shortage effects section 7.4.1.2; see Maniu, Kallai, and Popa (2001), p.25; IMF website (2008); EBRD (2005b), p.12; Frankfurter Allgemeine Zeitung (2007d).
[535] See Intv. Germ. MNC - Consulting I (2007); Intv. German Econ. Association VIII (2007); Intv. German Authority I (2007); Intv. Germ. MNC - Utilities (2007); Intv. Romanian County Council (2007).
[536] See Intv. Int'l MNC - Utilities (2007); Intv. Int'l Econ. Association (2007); Intv. German Econ. Association III (2007); Intv. Supranational Authority I (2007).
[537] See Intv. German Authority IV (2007).

and supermarket products but also for construction and financial services.[538] Insurance companies like the find the Romanian market attractive because of the low insurance premium as share of GDP.[539]

Market size tends to be less important however, for investors who only look for outsourcing projects or investments mainly aiming at exports (efficiency-seeking).[540] Interestingly, other experts point out that market size is an important factor, but that because Romania is still fairly small in absolute terms, this is not a decisive factor for them.[541] Others clarify that market size alone is not sufficient if regulations are not favorable. *Intv. Germ. MNC - Industrial Goods II (2007)* for example, a producer of environmental technologies, intended to sell its products to SEECs, but could not fully exploit the Romanian market because environmental regulations in Romania were low and Romanian manufacturing firms did not have to use the high-quality filters of the German MNC; this situation changed with the respective adoption and implementation of the EU acquis.

Looking at **differences between company and state experts** it seems that company experts tend to see limitations of the market size as a single and decisive factor for the investment decision of both – market- and efficiency seeking MNCs – and frequently refer to interdependences with other determinants.[542] State experts are also more convinced that a growing market (for example in terms of GDP growth) is important per se, whilst company experts emphasize more that growth needs to reach the potential consumers.[543]

[538] See Intv. Germ. MNC - Consulting II (2007); Intv. Romanian County Council (2007); Intv. Germ. MNC - Consulting I (2007); Intv. German Econ. Association III (2007).

[539] See Intv. Austr. MNC - Financial Services II (2007); see also Intv. German Political Adviser (2007); Intv. Romanian Ministry I (2007).

[540] See Intv. Germ. MNC - Consulting I (2007); Intv. Austr. MNC - Industrial Goods I (2007).

[541] See e. g. Intv. Austr. MNC - Industrial Goods I (2007).

[542] See Intv. Austr. MNC - Industrial Goods I (2007); Intv. Germ. MNC - Industrial Goods II (2007).

[543] See Intv. German Econ. Association III (2007); Intv. German Authority I (2007); Intv. Romanian Ministry I (2007).

Furthermore, state experts are more aware of the importance of urban agglomeration and of the fact that a large population is not sufficient when many people live in rural areas with insufficient infrastructure.[544]

The **assessment** of Romania's economic development, the interview analysis and the revision of the 34 analyzed FDI studies lead to several conclusions regarding market size as country determinant for Romania. First of all, market size is generally viewed as a very important driver since setting up and running a business is usually more efficient in larger markets and since Romania's specific market size indicators seem to be favorable.[545]

Secondly however, the right measurement of the market size determinant is crucial when comparing Romania with other countries such as Ukraine. Factors such as population, geographic size, GDP, and even GDP growth are never mentioned by neither experts nor FDI studies in such comparisons. This is despite the fact that Ukraine has a similar or an even "larger" market size in these categories compared to Romania.[546] The measurement of the market size determinant that is adequate for the individual MNC seems to depend on the investors's perception of the right reference point. Romania tends to be compared with Bulgaria rather than with Ukraine for geographical, political and economic reasons.[547] Furthermore, the market size determinant seems to be driven by the expected market opportunity, more than the current status which is, for example, indicated by a rather low but fast growing purchasing power or specific industry measures, which indicates a need for catching up.[548]

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[544] See Intv. Romanian Econ. Association I (2007); Intv. Romanian County Council (2007).
[545] Only few studies reveal Romania-specific results; see e. g. Brada, Kutan, and Yigit (2003); Carstensen and Toubal (2004); Pye (1998); see also Doc - BA-CA (2007).
[546] Figures for Ukraine vs. Romania (2006): population: 46.6M vs. 21.6M; size: $640,000 km^2$ vs. $240,000 km^2$; GDP: €97B vs. €85B; average GDP growth (2001-2006): 7.7% vs. 6.1%; see IMF website (2008); Eurostat website (2008); Der Fischerweltalmanach 2007 (2006).
[547] Which are discussed throughout this thesis.
[548] See above the example from the insurance market.

Thirdly, there is a clear interdependence of market size with other determinants that influence MNCs' decision since market size alone cannot explain oscillations in Romania's FDI stock and the low inflows in the 1990s.[549] Possible explanations given by FDI studies are Romania's late privatization[550] or the lack of political and economic stability in the 1990s.[551] Interviews also show that the regulative environment is essential for entering a large market.

Finally, the analysis of the interviews shows the complex strategies of MNCs that make the frequently used distinction between market- and efficiency seeking FDI difficult – at least in the Romanian case, because companies can seldom be clearly categorized. To give one example, the investment of *Intv. Austr. MNC - Consumer Goods (2007)* primarily aims at lower production costs. However, *Intv. Austr. MNC - Consumer Goods (2007)* also chose the specific location because it may serve as a sourcing and even end-consumer market in the future.[552] Another strategic insight is that larger markets are particularly interesting when investors are able to exploit a first mover advantage in their industry.[553]

Overall, external observers tend to mention market size as a key determinant for FDI in Romania, while statistics and a closer look at the expert interviews do not confirm this perception or at least suggest strong interlinkages with other determinants.

549 Romania attracted, for example, five times higher FDI inflows in 1997 than in 1996 despite a decline of real GDP by 6.1%.
550 See Carstensen and Toubal (2004).
551 See Brada, Kutan, and Yigit (2003).
552 See Intv. Austr. MNC - Consumer Goods (2007); see also Intv. Germ. MNC - Automotive (2007).
553 See Pye (1998).

(2) **Labor costs** are frequently cited as major determinant in favor of Romania.[554] Romania's hourly pay and non-pay labor costs average at €3.17 which represent only 12% of the EU 15 average (2006).[555] Romania is therefore among the countries with the lowest labor costs in Europe (*see figure 36*) with only Serbia (€2.1), Bulgaria (€1.8) and Ukraine (€1.3) at even lower levels. *Figure 37* shows that Romania's labor cost increase has drastically accelerated since 2004 when labor costs were still below €2 per hour. This increase of 60% (2004-2006) is particularly remarkable considering that Bulgaria's wage level only increased by 20% during the same period.[556] Romania has an average productivity of 39% (2006) relative to the EU-27 which is ahead of Bulgaria (35%) and has significantly increased since 2001 (14%), the largest improvement of the selected countries in Eastern Europe (*see figure 38*).[557]

The analysis of the **expert interviews** confirms that labor costs are generally an important determinant when choosing a location.[558] Most experts also agree that labor costs have been among the major reasons why investors decided to go to Romania[559], particularly in the early 2000s when labor costs were even lower and when Western European cost pressure was particularly high in some industries such as the metal components industry. Moreover, labor had already become scarce in some other EECs like Czech Republic.[560] Many experts also agree that the cost of labor remains among the leading country determinants

[554] See 2.2.4.2. Labor costs are defined as non-policy factor because state actors have only limited influence on the labor costs of MNCs which are only relevant for this thesis; the state sector influences private business wage levels and productivity only in the longer-run and tax issues are dealt with in section 7.3.

[555] See EIU (2007c); see also Financial Times (2006a); own calculations.

[556] Ukraine's labor cost even increased by 83% during this period but started on a significantly lower level (€0.68); see again EIU (2007c); own calculations.

[557] Estonia, which is not depicted in the figure even showed an increase by 16% to 64%; see Eurostat website (2008).

[558] See Intv. German Econ. Association V (2007); Intv. Germ. MNC - Industrial Goods II (2007); Intv. Romanian Authority I (2007).

[559] See Intv. Austr. MNC - Industrial Goods I (2007); Intv. Germ. MNC - Financial Services III (2007).

[560] See Intv. German Econ. Association I (2007); Intv. Germ. MNC - Automotive (2007); Intv. Germ. MNC - Industrial Goods III (2007).

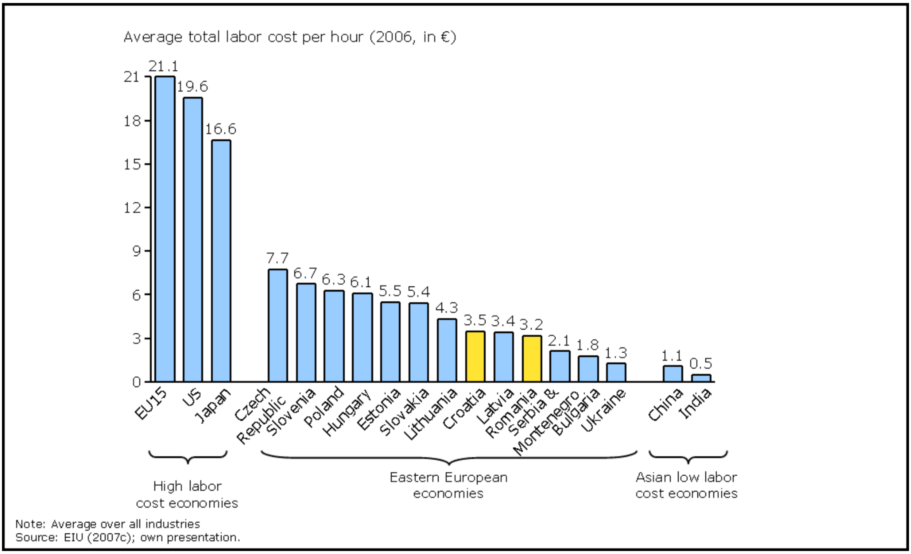

Figure 36: Labor costs in Eastern Europe

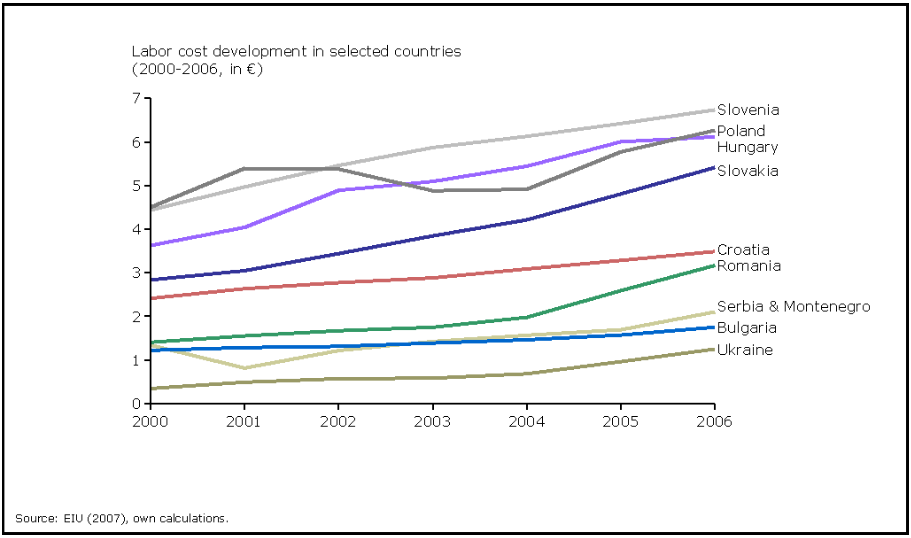

Figure 37: Labor cost development in Eastern Europe

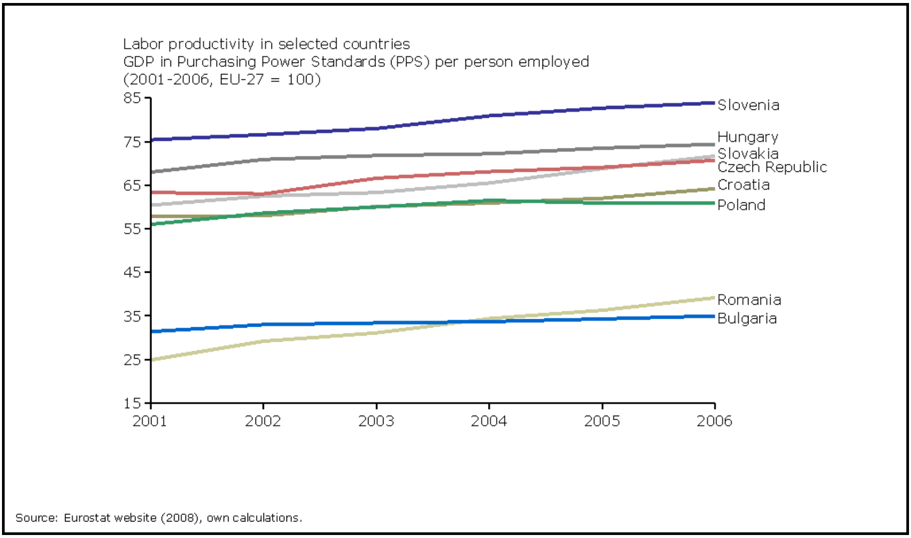

Figure 38: Labor productivity in Eastern Europe

for MNCs to go to Romania[561]; particularly for companies aiming at exporting products[562] and when countries like Poland, Czech Republic and Hungary are the alternative options, lower labor costs can be the decisive factor in favor of Romania.[563]

However, many experts are skeptical about the future advantage of Romania with respect to labor costs.[564] Even though interviewees state that labor costs in Romania will probably not reach Western European levels for several decades[565], to some experts even today "Romania is not a low labor cost coun-

561 See Intv. Germ. MNC - Consulting I (2007); Intv. German Econ. Association III (2007); Intv. Romanian Ministry I (2007); Intv. Supranational Authority I (2007); Intv. Romanian County Council (2007).
562 See Intv. Austr. MNC - Industrial Goods I (2007); Intv. Germ. MNC - Consulting II (2007); Intv. German Econ. Association VIII (2007).
563 See Intv. Germ. MNC - Industrial Goods III (2007); Intv. German Econ. Association I (2007).
564 See Intv. German Authority I (2007); Intv. Romanian County Council (2007).
565 See Intv. Romanian County Council (2007); Intv. Germ. MNC - Legal Services II (2007); Intv. Romanian Company - Advertising (2007); Intv. Germ. MNC - Consulting I (2007).

try anymore"[566] since labor costs are rising faster than labor productivity.[567] Experts confirm the data that Romania is losing ground especially compared to Bulgaria; in industries such as IT salaries in Bulgaria are only 60% of the level in Romania.[568] Some experts however assume that the main drivers for the increasing labor costs are not the actual salary gains but the increase of non-wage labor costs.[569] On the other hand some experts know that those investors for whom labor costs are extremely important go straight to the Ukraine. Asian locations tend not to be seen as alternative options.[570]

The semi-structured interview approach allowed for challenging some of these expert statements and after discussing the labor cost factor in more detail various interviewees, mainly company experts, relativized the importance of the labor cost determinant: They describe the challenge to incorporate future labor cost developments in their investment decision since effects like the EU accession or differences in regional developments are difficult to forecast. Investors have admitted that they may have underestimated the labor cost increase, particularly in urban areas and due to frequent job changes rather than to productivity gains.[571] Some even point out that production in Austria or Germany may now be cheaper than in Romania – depending on the labor's share of the costs – if labor hours in the home countries and automization of production are increased and all available subsidies are used.[572]

Beyond this, experts emphasize that low labor costs are not a strong enough determinant if labor is insufficiently available which can also lead to rising labor

[566] Intv. Germ. MNC - Legal Services II (2007).
[567] See Intv. Germ. MNC - Consulting I (2007); Intv. Austr. MNC - Financial Services I (2007).
[568] See Intv. Germ. MNC - Software (2007); Intv. Int'l MNC - Utilities (2007).
[569] See Intv. Romanian Econ. Association I (2007).
[570] See Intv. German Econ. Association I (2007); Intv. German Authority I (2007).
[571] See Intv. Austr. MNC - Industrial Goods I (2007); Intv. Germ. MNC - Industrial Goods III (2007); Intv. Int'l Econ. Association (2007).
[572] See Disguised company expert statement; see also Intv. Germ. MNC - Industrial Goods II (2007); Intv. German Econ. Association VIII (2007).

costs. The example of Ukraine also shows that low labor costs are insufficient factor if investors are worried about political and economic stability or the reliability of political decisions. Labor costs also become less important when other production costs such as energy costs are significantly lower elsewhere than in Romania.[573] Finally, salary increases can even be good news for market-oriented investors such as retailers.[574]

No significant deviations can be found when comparing **company to state** statements on labor costs. Overall both groups of interviewees agree on the importance of the determinant but are also skeptical to what extent it will remain a driving factor for Romania in the future and not only MNCs but also state representatives are aware of the fact that "low labor costs are not enough to succeed in this competitive market for FDI"[575].

The **assessment** of the available data, the FDI studies and the conducted expert interviews permit several conclusions: The general importance of the labor cost factor is undeniable even though some FDI studies do not find any significant impact on MNCs' investment decision.[576] Interviews as well as FDI studies indicate that labor costs are interdependent on various other factors such as the market entry strategy, the industry sector[577], the availability of (skilled) labor[578], the point of the transition process[579] and various policy factors discussed in *chapter 7*. Analogous to the market size determinant, labor

[573] See Intv. Int'l MNC - Utilities (2007); Intv. Germ. MNC - Industrial Goods III (2007); Intv. Germ. MNC - Legal Services II (2007); Intv. German Econ. Association I (2007).
[574] See Intv. Austr. Research Institute (2007); Intv. Int'l MNC - Utilities (2007); Intv. German Authority IV (2007).
[575] Intv. Romanian Authority I (2007).
[576] See for significant impact, e. g. Holland and Pain (1998); Bevan and Estrin (2000); see for insignificant impact, e. g. Campos and Kinoshita (2003); Merlevede and Schoors (2004).
[577] See for examples from FDI studies e. g. Altomonte (1998); Resmini (2000).
[578] See e. g. Janicki and Wunnava (2004).
[579] See for diverging effects e. g. Merlevede and Schoors (2004); Demekas, Horváth, Ribakova, and Wu (2005).

costs alone cannot explain why Romania received only little FDI until the end of the 1990s despite very low labor costs.[580]

These interdependences make it difficult to judge whether labor costs are a more important factor overall for Romania than, for example, its market size. The judgment also seems to be highly changeable and also depends on the anticipated labor cost development. Romanian state representatives particularly seem to be right to be skeptical about the long-term benefit of this factor, especially considering the strong increase of salaries in recent years. The interviews also show that labor costs are often an important issue mainly in the first phase of the investment decision process but seem to become less important the more an MNC is analyzing a specific country with respect to strategic or policy factors.[581] In contrast Romanian productivity level is of only limited interest for investors[582], possibly because companies know that they have to train their staff anyway and they can influence the productivity level that way.

The image and expectation of Romania as low labor cost location often seems to be more important than the actual wage level. According to a survey of the AHK, German investors were more satisfied with labor costs in Romania than in Bulgaria even though Romania's wage level is higher (*see figure 36*).[583] Since interviews show however an increasing awareness of rising labor cost deviations to Bulgaria, policy makers may need to inform about remaining cost advantages of Romania in the future, for example in specific industries and regions.

(3) **Proximity** is also an often cited non-policy country determinant.[584] One important measurement is the geographic distance in kilometers between the

[580] See also Carstensen and Toubal (2004).
[581] See similar Pye (1998).
[582] See various interviews but also Holland and Pain (1998).
[583] See AHK (2006); EIU (2007c).
[584] See 2.2.4.2.

capitals of the home and the host country. As depicted in *figure 39* Bucharest is quite far away from Berlin (1,294km) and Vienna (858km) compared to other Eastern European cities[585]; from Berlin only Sofia is even 25 kilometers (km) further away, while the air distance from Vienna to Sofia is even 37km less than to Bucharest.[586] Romania has sales potential into five neighboring states and is close to sales regions such as Western Europe, the Balkans, some CIS countries, the Middle East and North Africa. A geographic advantage in this context are the water routes via the Black Sea and the Danube.[587] Romania may be attractive for investors from Austria and Germany because Romanian is a Latin language in contrast to the large majority of countries in the region with Hungarian or various Slavic languages which are more difficult to learn and less frequently taught in Western European schools. As elaborated in *section 3.2* Austrian and German investors may furthermore benefit from a common cultural and historical heritage with Romania.

In line with theory, the smaller geographic distance of many locations in Romania to Europe or other production sites in Eastern Europe compared to many sites in Bulgaria is mentioned as an advantage in the **expert interviews**.[588] Others clarify that the labor cost situation was more important than the proximity of the location for their investment decision.[589] A few experts also mention that Romania is well located within Eastern Europe for access to other Eastern European markets such as Ukraine and Russia and may therefore compensate for an only limited market size.[590]

585 This statements neglects country-specific deviations in distance.
586 See www.mapcrow.info; www.wcrl.ars.usda.gov/cec/java/lat-long.htm.
587 See EBRD (2006b), p.4.
588 See Intv. German Econ. Association III (2007); Intv. Int'l Econ. Association (2007); Intv. German Econ. Association I (2007); Intv. Austr. MNC - Consumer Goods (2007); Intv. German Econ. Association VII (2007).
589 See Intv. Germ. MNC - Industrial Goods III (2007); Intv. Germ. MNC - Automotive (2007).
590 See Intv. Germ. MNC - Consulting I (2007); Intv. Romanian Ministry I (2007); Intv. Austr. MNC - Industrial Goods I (2007).

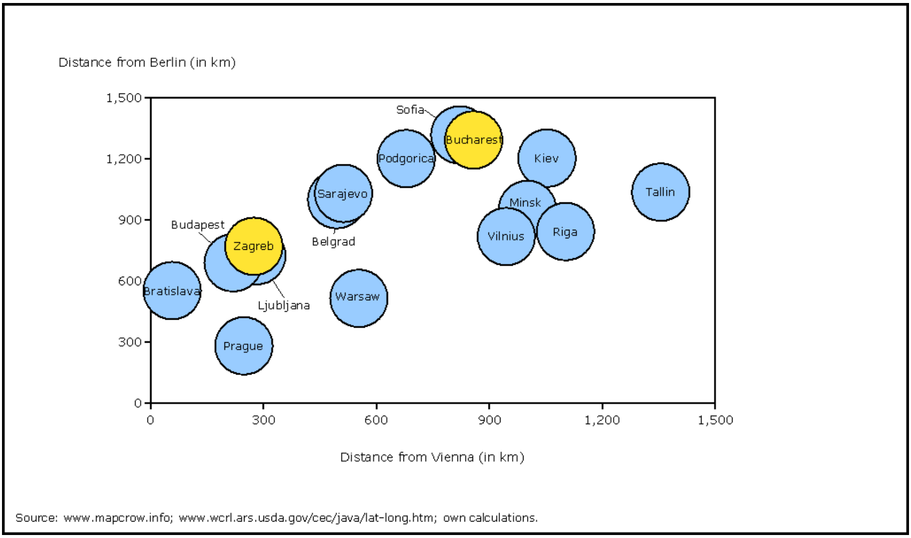

Figure 39: Geographic distances home vs. host country

The lower language barrier of Romania as "Latin island in a Slavic ocean"[591] is repeatedly underscored as an advantage, particularly when compared to Hungary and Bulgaria.[592] This is either because of Latin skills of investors from school[593] or because Romanian is easier to read than, for example, the Cyrillic letters of the Bulgarian language.[594] A minority of experts believe that the language advantage is mainly a reason for French and Italian companies but less for German and Austrian MNCs.[595] Investors also admit that they nonetheless may have underestimated the language barrier and some language difficulties continue to exist today even several years after the investment.[596]

[591] Intv. German Econ. Association II (2007).
[592] See Intv. Germ. MNC - Industrial Goods III (2007); Intv. German Econ. Association III (2007).
[593] See Intv. Germ. MNC - Industrial Goods III (2007).
[594] See Intv. Germ. MNC - Industrial Goods II (2007).
[595] See Intv. Germ. MNC - Consulting I (2007).
[596] See Intv. Germ. MNC - Industrial Goods III (2007). The language skills of the Romanian population are analyzed in section 7.4.1.2.

Experts also agree that cultural links are important for a locational decision.[597] They elaborate however, that cultural heritage is mainly a regional issue in Romania; Germans are rather attracted by the Saxon tradition in Transylvania and particularly by the German ties to the county of Sibiu. For the region of Timişoara, for example, the cultural ties have been mainly important for Italian MNCs.[598]

Finally, investment decisions may be promoted by personal ties of the investors to Romania. Several employees, for example, working for a Bavarian MNC with Romanian roots (coming to Germany in the 1980s) supported the preparation of the investment decision and were of particular value due to their easy access to culture and language.[599] The strong personal ties of Romanians to Western Europe are also visible by the large amount of interviewed investors and experts who lived for longer periods in either Germany or Austria.[600]

Differences between **state and company** experts become visible with the analysis of the advantage of locations within Romania. Both groups interviewed agree that cultural ties, for example, between Sibiu and Germany are important, but while state experts believe that Sibiu's geographic location within Romania is very attractive as well[601], investors point out that Timişoara's location close to the Hungarian border and highway system gives the latter an advantage over Sibiu.[602] Moreover, state experts highlight more clearly that

597 See Intv. Austr. MNC - Financial Services I (2007).

598 See Intv. Austr. MNC - Financial Services I (2007); Intv. Romanian Authority I (2007); Intv. German Econ. Association VII (2007); Intv. Germ. MNC - Legal Services I (2007); Intv. Rom. Local Authority I (2007); Intv. Germ. MNC - Automotive (2007).

599 See Intv. Germ. MNC - Industrial Goods III (2007); see also Intv. German Authority IV (2007); Intv. Romanian Econ. Association I (2007).

600 See e. g. Intv. Germ. MNC - Financial Services III (2007); Intv. German Econ. Association III (2007); Intv. German Econ. Association V (2007); Intv. German Authority IV (2007); Intv. Germ. MNC - Legal Services I (2007); Intv. Germ. MNC - Utilities (2007); Intv. Austr. MNC - Legal Services (2007); Intv. Germ. MNC - Consulting II (2007).

601 See Intv. Rom. Local Authority I (2007); Intv. Romanian Econ. Association I (2007); Doc - City of Sibiu (2007).

602 See Intv. Germ. MNC - Industrial Goods III (2007); Intv. Germ. MNC - Automotive (2007); Intv. German Econ. Association I (2007).

the importance of the cultural ties particularly in Transylvania with respect to German speaking investors is even increasing due to the growing number of investors in the region.[603]

When **assessing** stylized facts, FDI studies and expert interviews it becomes apparent that geographic distance represents a factor important for investors to lower costs but with a less significant impact than, for example, market size or labor costs.[604] In the end FDI studies cannot definitely confirm trade theory's assumption for Romania that net FDI will increase and replace exports with greater distance from a specific home country.[605] In contrast, the interviews indicate that geographic distance alone cannot explain evolutions in Romania's FDI inflows.

Besides, the actual advantage of Romania versus Bulgaria is questionable, to say the least, as geographic differences to Germany and Austria are negligible or even in favor of Bulgaria (*figure 39*). The geographic advantage seems to depend on the perception of the individual, on the location in the home and host country but most of all on the infrastructure situation – the major driver for time, costs and efforts to transport goods. Trade policy may also play a role with respect to a smooth border crossing.[606]

The interviews seem to confirm that lower language barriers and existing cultural and personal ties are interesting for investors in Romania but mainly in the first phase of their investment decision. In this phase smaller investors in particular may be getting first experiences in the region and having an easier personal access to Romania than, for example, to Bulgaria, Serbia or Ukraine. While *Demekas, Horváth, Ribakova, and Wu (2005)* found out that cultural distance loses its significance at higher levels of FDI, interview statements

[603] See Intv. Rom. Local Authority I (2007); Intv. Romanian Econ. Association I (2007).
[604] See also Altomonte (1998); Disdier and Mayer (2003); Bevan, Estrin, and Meyer (2004); only minor impact identified by Resmini (2000).
[605] See Brenton, Di Mauro, and Lücke (1999); Resmini (2000).
[606] Infrastructure will be discussed in detail in 7.3.2.2, trade policy in section 7.3.1.2.

rather indicate that clusters of strong foreign communities, such as the German one in Sibiu, may actually re-invigorate historical ties – at least in some regions in Romania. Romanian policy makers may be advised to use more actively existing personal ties such as to Romanian emigrants in Germany, for example, through Chambers of Commerce or the Romanian embassy, since employees with Romanian roots seem to have a strong influence in triggering an initial interest in Romania among decision-makers in MNCs.

(4) **Other aspects** that were among the most frequently cited non-policy determinants in *section 3.2* are trade openness, agglomeration and natural resources.

With respect to **trade openness**[607] investors interviewed only occasionally detect that higher trade volumes may indicate higher FDI volumes.[608] State experts on the other hand, note the reversed effect and point out that FDI inflows to Romania have a positive impact on Romania's export performance and on the reduction of the trade deficit.[609] The assumption that higher trade flows also increase FDIs[610] can therefore not be confirmed by the interviews. This strengthens the hypothesis of the theoretical section that companies do not necessarily use trade as first step to approach Romania.

Agglomeration effects – identified as major driver for FDI by the New Economic Theory (*section 2.2.4.1*) – are generally assumed when companies follow other domestic or foreign companies to a specific country or region because they have imperfect information and suppose that the presence of many other investors indicates that the location is attractive and that companies benefit

[607] Trade related aspects that can be influenced by public policy are analyzed in section 7.3.1.
[608] See Intv. Austr. MNC - Financial Services I (2007); Intv. Germ. MNC - Logistics (2007).
[609] See Intv. Supranational Authority I (2007); Intv. Romanian Ministry IV (2007).
[610] See Holland and Pain (1998); Clausing and Dorobantu (2005); Janicki and Wunnava (2004).

from each other, for example, as suppliers.[611] By contrast, MNCs interviewed reveal that the FDI development or the presence of other investors in Romania was only of limited importance for their investment decision.[612] Agglomeration may however be more important for investors like *Intv. Germ. MNC - Industrial Goods III (2007)*, a spin-off, for whom the opening of a subsidiary by the parent company half a year earlier was an important factor for the management team since the vicinity to the parent company enabled some co-operation.[613] In contrast to most company experts state experts tend to see stronger benefits from agglomeration, particularly when clusters of companies from the same home country are numerous in a specific location such as Sibiu.[614] Overall, a significant agglomeration of investors can – with the exception of Bucharest – not be determined for Romania in the data of the National Trade Register even though some regions like the North East and the South West of the country have attracted only little FDI.[615]

Natural resources are mentioned by a few FDI studies on transition economies as a possible country determinant.[616] Romania could possibly benefit from limited deposits of oil, gas, salt, gold, silver, and wood. More recent discoveries have also identified some potential for the exhaustion of lead, zinc, copper, iron ore and manganese. In the interviews conducted natural resources are rarely mentioned as country determinant of Romania. An exception is an

611 See Krugman (1991); Fujita, Krugman, and Venables (1999); Head, Ries, and Swenson (1999).
612 See Intv. Austr. MNC - Industrial Goods I (2007); Intv. Austr. MNC - Consumer Goods (2007).
613 See Intv. Germ. MNC - Industrial Goods III (2007).
614 See Intv. German Authority I (2007); Intv. Romanian Ministry I (2007); Intv. Rom. Local Authority I (2007).
615 Adding up to 6.6% of the companies and 5.7% of the subscribed capital in 2006; see The National Trade Register Office (2007b); see for diverging results but without country specific results for Romania Pusterla and Resmini (2005); European Commission (2005b).
616 See Lankes and Venables (1996); Garibaldi, Mora, Sahay, and Zettelmeyer (2001); Brada, Kutan, and Yigit (2003); Merlevede and Schoors (2004); Kinoshita and Campos (2006).

Austrian investor that decided to invest in Romania because it is dependent on the natural resources in Romania while other countries with significant resources in the region like Ukraine, Belarus and Russia were politically more insecure than Romania.[617] Some experts see future opportunities for Romania in its nature and in higher FDI in tourism even though the required infrastructure is not in place yet.[618] The FDI studies analyzed that find significant impact of natural resources on FDI do not show country-specific results.[619] The interview results seem to be in line with *Merlevede and Schoors (2004)* who find that EECs – unlike CIS countries – do not have enough natural endowments in order to significantly influence FDI inflows. For Romania in particular it can be added that the requirements for the more complicated exhaustion of natural resources have not yet been met.[620]

The overall **assessment** of these "other aspects" suggest a limited impact on an investment decision for Romania. These aspects alone cannot explain oscillations in FDI flows and they do not necessarily indicate why Romania has an advantage or disadvantage versus neighboring countries like Bulgaria. The possible positive correlation between trade and FDI flows cannot be confirmed on an expert level, agglomeration may occur in individual cases but a common pattern for Romania cannot be derived from the data, and finally the large forest areas are identified as the only natural resource that can currently materialize significant FDI inflows to Romania.

(5) In **conclusion** of Romania's non-policy country determinants, this section has confirmed most FDI theories and analyzed FDI studies that market size, labor costs and to some extent cultural ties seem to be the most important

[617] See Intv. Austr. MNC - Primary Goods II (2007).
[618] See Intv. Romanian Econ. Association I (2007); Intv. Rom. Local Authority I (2007); Intv. German Authority IV (2007); Intv. German Econ. Association V (2007).
[619] See e. g. Kinoshita and Campos (2006); Garibaldi, Mora, Sahay, and Zettelmeyer (2001).
[620] See also Maniu, Kallai, and Popa (2001), p.24; Rabobank (2006), p.2; PI Partners (2007), p.67.

non-policy factors in favor of Romania. Other aspects, some of those identified by the New Economic Geography theory, are less relevant for the investment decision of MNCs in favor of Romania according to the experts interviewed. This section has also shown that interdependences with policy factors need to be further analyzed in order to understand MNCs' decision in favor of Romania since low inflows in the 1990s and oscillations even in recent years could not be explained otherwise. Finally, this section indicates that deviations in the importance of a certain country determinant are not so much driven by the market entry strategy but rather by the moment in the investment decision process. Therefore non-policy factors seem to lose importance the longer an investor analyzes Romania. This aspect will be further explored in *chapter 9*.

6.3 Croatia

Analogous to the approach for Romania this section examines the key issues of Croatia's economic development since the early 1990s (*section 6.3.1*) before analyzing the major non-policy country determinants of Croatia (*section 6.3.2*).

6.3.1 Economic fundamentals since the early 1990s

This section reviews (1) the main features of Croatia's economic development since the early 1990s, the evolution of (2) GDP, (3) inflation, (4) unemployment, (5) trade, and (6) FDI. The (7) economic outlook also comprises the expert perspective and (8) provides an assessment of the issues analyzed. A map of Croatia and its key indicators can again be found in the appending *figures 90* and *91*.

(1) Croatia's **economic development** in the beginning of the 1990s was mainly driven by the overcoming of the Socialist heritage, the collapse of the former Yugoslavia and the effects of the war. These three aspects were often

linked to each other.[621] Even though the economy in Yugoslavia – even under Tito (1945-1980) – had not been as closed and as rigidly communist than in other EECs, it nevertheless suffered from the breakdown of the Eastern European markets after 1990, the decline of industrial production and the lack of competitiveness in the state-owned enterprises.[622] More specifically, independence from Yugoslavia in 1991 worsened the economic situation for Croatia since production had been located by function within the former Yugoslavia and was now unable to fully respond to Croatian needs. Despite some important existing industries (food, some industrial production) Croatia became dependent on new industries and imports in various fields.[623]

Finally and most dramatically, the war of independence against Serbia (1991-1995) had a significant impact on Croatia's economic (and political) situation. More than 500K Croatians, also from Bosnia, fled their homes due to the war, and about 30% of the Croatian territory was occupied for several years in which the internationally not recognized Republic of Serbian Krajina was established. Some parts of Eastern Slavonia remained occupied by Serbia under the protection of the United Nations (UN) until 1998. Beyond this, the war generated massive economic turbulences including high government spending and economic standstill in some regions.[624]

Under President Tuđman (1990-1999) Croatia was able to win the war (with the help mainly of the US), but it was led in an authoritarian style and sometimes with the help of less capable favorites. The economic situation started to significantly improve after the death of Tuđman and the end of the financial crisis in 1999 under the left-wing government of Prime Minister Račan (2000-2003). The economic upswing continued during the further approach to the European Union under President Sanader (since 2003, re-elected in

[621] See Grupe and Kušić (2005); Bertelsmann Stiftung (2006b).
[622] See Bertelsmann Stiftung (2006b).
[623] See Bfai (2004), p.40.
[624] See Zunec and Kulenović (2007); Grupe and Kušić (2005).

2007).[625]

(2) Despite the above mentioned turmoils and a decrease of industry production by about 50% in the early 1990s, the Croatian economy remained astonishingly robust. **GDP** declined by 8.0% in 1993 but the following four years saw average growth rates of 6.3% due to massive government spending.[626] The financial crisis in the late 1990s caused a short slump including a GDP decline of 0.9% in 1999. Since then Croatia has shown solid growth rates of 4.8% on average (2000-2006).[627] Despite this positive evolution an analysis of 15 analyzed EECs shows that twelve of them had higher average growth rates than Croatia's between 2004 and 2006. Overall, Croatia's GDP grew from €9.2B in 1993 at a CAGR of 11% to €34.2B in 2006.[628]

In terms of GDP per capita Croatia developed from €4,092 in 1999 to €7,696 in 2006 which equals €11,566 in purchasing power parity or 48% of the EU average. This puts Croatia behind the Eastern European EU members but ahead of all other SEECs.[629] Furthermore, the former war zones are still lagging behind with a GDP per capita, for example, in Vukovar of only 33% compared to Zagreb.[630]

Main drivers for Croatia's GDP growth in the 2000s were public spending (e. g. 40% of GDP growth in 2003 and 2004), exports, private consumption, and FDI. [631]

[625] See section 7.4.4 for details; see European Commission (2005a), p.35; Kasapović (2007); Ramet, Clewing, and Lukic (2006); Zunec and Kulenović (2007); Bertelsmann Stiftung (2006b), pp. 2 and 7; Grupe and Kušić (2005).

[626] Croatia's economy declined by 5.9% annually between 1985 and 1995; see World Bank (2006b); IMF website (2008); Bertelsmann Stiftung (2006b), p.2.

[627] 4.3% in 2004 and 2005 and 4.8% in 2006; IMF website (2008); Neuhaus (2005), p.18.

[628] See IMF website (2008); Bertelsmann Stiftung (2006b), p.6.

[629] See IMF website (2008); Bertelsmann Stiftung (2006b), p.6; European Commission (2007a), p.66.

[630] Calculated in purchasing power parity as well; see European Commission (2005a), p.36.

[631] See NCC (2007), p.12.; IMF (2006a), p.8; Neuhaus (2005), p.18; CICD (2006), p.11.

(3) Hyper-**inflation** peaked at more than 1,500% in 1993, which had dramatic effects on the population but was stopped due to a rigid monetary policy with the end of the war. The average inflation of 3.9% was even lower than in all other EECs between 1995 and 2000. Since then inflation has remained at moderate levels averaging 2.6% (2001-2006) despite somewhat higher values for 2005 (3.3%) and 2006 (3.2%). Levers to mitigate inflations rates were restrictive loan, finance and income policies. In the same period however five other EECs had even lower inflation rate averages than Croatia.[632]

(4) **Unemployment** figures for Croatia vary depending on the measurement technique. Whichever statistics are considered however, unemployment remains one of Croatia's greatest problems.[633] Looking at registered unemployment[634] Croatia has not been able to significantly decrease unemployment, which amounted to 14.8% in 1994, peaked at 23.1% (2001) and only diminished slightly to 17.0% in 2006. Croatia has repeatedly been among the EECs with the highest annual unemployment rate.[635] The war and its consequences (destroyed homes, refugees etc.) aggravated the situation but unemployment seems to have more structural problems in Croatia.[636] Most new jobs have been created in the service sector in recent years while the agricultural sector that never played a large role lost still more importance for the labor market.[637]

[632] See IMF website (2008); Eurostat website (2008); World Bank (2006b); p.2; CNB (2007); EBRD (2005a), p.16; Bertelsmann Stiftung (2006b), p.3; European Commission (2005a), p.35.

[633] See European Commission (2005a), p.38.

[634] Other data is often based on labor force surveys; see also Vidovic and Gligorov (2004), p.3.

[635] See WIIW (2008); Bertelsmann Stiftung (2006b), p.2; ILO website (2008).

[636] See subsequent section and chapter 7 for details.

[637] See European Commission (2005a), p.45; Bertelsmann Stiftung (2006b), p.9; World Bank (2006b); APIU (2006b), p.12; OECD (2005b), p.11.

(5) Croatia's **trade** openness has constantly improved from 61% (1998) to 74% (2006) and was therefore greater than, for example, Romania's.[638] Goods exports from Croatia have remained on a similiar level of €4B to €5.3B between 1992 and 2002 with only minor oscillations. After 2002 export volumes started to increase to €6.6B (2004), €7.2B (2005) and even €8.4B (2006). Imports on the other hand have grown more significantly from €4.5B (1992) at a CAGR of 15% until 1997 and – after a moderate decrease during the financial crisis – further grew at a CAGR of 13% since 2000 to €16.8B in 2006.[639] The widening trade deficit that reached 24% of GDP in 2006 has, as in Romania, attracted increasing criticism from external observers, particularly since the external debt has risen to 85% of GDP in 2006.[640] Main reasons are the high private demand, the oil price development and Croatia's export weaknesses due to a strong local currency (kuna), limited FDI inflows and unsatisfactory competitiveness of domestic companies.[641]

Most important export categories in recent years have been transport equipment, refined petroleum and chemical products. Exports of products with high knowledge rose by about 50% between 2001 and 2004 while the share of low-value-added exports (textiles and agricultural products) have significantly declined. Imports are mainly driven by machinery products and consumer goods.[642]

Trade in services is of special significance for Croatia, mainly due to the strong tourism industry that accounted for 16% of GDP in 2006 and that has been recovering after a strong decline due to the war (CAGR 1995-2005 of

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[638] See Eurostat website (2008); WIIW (2008).

[639] See Eurostat website (2008); WIIW (2008); European Commission (2007a), p.66; NCC (2004a).

[640] See BA-CA (2007a); Eurostat website (2008); European Commission (2007a), p.67.

[641] See more details about these aspects in chapter 7; see NCC (2007); WIIW (2001); p.3; IMF (2006a), p.5; Grupe and Kušić (2005); p.2; European Commission (2005a), pp.5, 38 and 67; CICD (2006), p.11; Dresdner Bank (2004), p.6.

[642] See NCC (2004b), p.21; Dresdner Bank (2004), p.6; European Commission (2005a), p.46; Bfai (2004), p.40.

-15.2%) reaching 10M guests in 2005.[643] The EU is Croatia's most important trading partner with 64% of exports and 67% of imports. However, countries of the former Yugoslavia as well as Russia and China have gained importance in recent years.[644]

(6) Due to the war **FDI** inflows to Croatia remained very low until 1995, only adding up to €298M since 1992. In 1999 inflows exceeded €1B for the first time (€1.4B) but continued to be volatile and depended mostly on privatizations. They remained under €2B until 2005 averaging €1.4B. In 2006 FDI inflows boosted significantly by 97% to €2.8B benefiting from high privatization sales. Croatia's FDI stock grew at a CAGR of 37% from €1.7 (1998) to €21.4B (2006).[645] Even though FDI inflows and stock may not be very high in absolut terms compared to other EECs, Croatia's per capita performance has nonetheless been remarkable. With €4,577 Croatia has the third largest FDI per capita stock in Eastern Europe, after Hungary and Czech Republic (*see figure 33*).[646] In this context the strong kuna may have helped Croatia's FDI performance in the regional comparison.

FDI in Croatia has mainly been driven by privatization sales such as the sale of the Hrvatske Telekomunikacije to the Deutsche Telekom (2000), the oil company INA to the Hungarian MOL (2003) or the pharmaceutical company Pliva to the US Baar Laboratories.[647] Greenfield investments have been less common in Croatia so far particularly when it comes to industrial manufactur-

[643] See European Commission (2007a), p.17; Der Fischerweltalmanach 2006 (2005); CICD (2006), p.11; NCC (2004a), p.20.
[644] See European Commission (2007a), pp.23 and 67; European Commission (2005a), p.46.
[645] See UNCTAD (2007); UNCTAD FDI website (2008); Hunya (2002), p.6; CNB (2008), p.48; Hunya (2007), p.8; own calculations.
[646] See Hunya (2007); WIIW figures with minor deviations from author's calculations due to different population and currency conversion assumptions.
[647] See MIGA (2006), p.38; Grupe and Kušić (2005), p.2; Doc - INA (2006).

ing.[648] *UNCTAD (2007)* registered only between 33 and 46 annual greenfield projects between 2002 and 2006 and an upward trend is not recognizable.

The key sector for FDI to Croatia in 2006 was the financial services sector (43%) that even gained importance in recent years followed by the chemical industry (22%), the food sector (7%) and wholesale activities (5%). Overall, about 2,500 affiliates of foreign companies were registered in Croatia in 2006.[649]

As already shown in *figure 17* Austria (28%), the Netherlands (17%) and Germany (14%) are the greatest contributor to Croatia's FDI stock.[650] In 2006 94.5% of FDI inflows originated from the EU 15 whose share has increased over the years while US firms have lost importance as investors.[651]

(7) In their economic **outlook** for Croatia (2007-2009) five observers analyzed[652] expect a continuation of the current robust trend or even a slight improvement.

The observers expect an increase in GDP growth to 5.5%-6.0% in 2007 resulting from high private demand and pre-election government spending. For the years after the election they expect a moderate cooling off to 4.7%-5.2% (2008) and 4.2%-5.5% (2009). Private consumption will be fueled by the ongoing credit growth, rising wages, strong consumer confidence, and the prospect of EU accession.[653]

Inflation is expected to drop to 2.2%-2.5% in 2007 and to moderately increase to 2.5%-3.3% in 2008 and 2009. Reasons for moderate rates may be modest

[648] Below below 8% of overall FDI in 2006; see CNB website (2008); MIGA (2006).
[649] See CNB (2008), pp.53-54; CNB website (2008); Hunya (2007), p.87; Hunya (2002), p.6; UNCTAD (2007).
[650] Figures for third quarter 2007; see CNB website (2008); UNCTAD FDI website (2008).
[651] Registring issues may however distort the picture, for example, since Baar Laboratories originally a US company that bought Pliva is registered in the Netherlands; see CNB (2008), pp.53-54; CNB website (2008); Hunya (2007), p.8.
[652] Publications between October and November 2007; see EIU (2007a); IMF (2007c); BA-CA (2007a); Raiffeisenbank (2007); European Commission (2007d).
[653] See particularly European Commission (2007d); BA-CA (2007a).

salary gains in line with productivity growth as well as a more rigid monetary and fiscal policy. Accelerating effects could be caused by higher agricultural and food prices.[654]

All observers analyzed believe that a rising GDP and productivity gains will enable Croatia to further drop the registered unemployment rate. Estimates range from 15.1% to 16.6% in 2007, dropping to 15-16% in 2008 and reaching 14.5%-15.5% in 2009 and therefore remain comparatively high in regional comparison.[655]

Croatia's trade volumes and the trade deficit are predicted to continue rising. Observers' assume exports to grow between 5% and 7% (2007-2009) while their estimated growth figures for imports range between 6% and 8%. Export acceleration is expected due to EU's GDP growth, rising competitiveness and a growing tourism sector while imports are fostered by private demand.[656]

Regarding Croatia's FDI development the observers are rather skeptical and no clear trend is visible. They estimate inflows of €2.3B-3B in 2007, €1.7B-2B in 2008 and €1.9B-2.2B in 2009. Main predicted drivers for future FDI inflows are privatizations, recapitalizations of banks and the prospect of EU accession.[657]

The Croatia **experts interviewed** for this thesis share the moderate optimism of the observers with respect to future FDI inflows. Accordingly, they do not expect major FDI inflows in the future apart from some potential privatizations, at least not before an accession to the EU that may cause a push for FDI. Some FDIs are expected through re-investments of existing MNCs.[658] A few

[654] See e. g. IMF (2007c); European Commission (2007d); BA-CA (2007a).
[655] See e. g. EIU (2007a); Raiffeisenbank (2007); European Commission (2007d).
[656] See EIU (2007a); European Commission (2007d).
[657] These issues will be discussed in detail in chapter 7; see Raiffeisenbank (2007); European Commission (2007d).
[658] See Intv. Austr. MNC - Retail (2007); Intv. European Institution (2007); Intv. Austr. MNC - Consulting (2007); Intv. Austr. MNC - Real Estate (2007); Intv. Germ. MNC - Financial Services I (2007); Intv. Supranational Authority II (2007).

experts assume that domestic investments and FPI will gain more importance for the Croatian economy than FDI.[659] Reasons mentioned by the experts for the stagnation or even slight decrease of FDI inflows in the next years are Croatia's limited market size, its high labor costs and the policy obstacles discussed in *chapter 7*.[660]

Despite the limited optimism of the experts with respect to the amount of inflows they still see various industries with potential for future FDI inflows.[661] In line with the observers analyzed above, the experts interviewed see the greatest opportunities in tourism as a huge number of hotels are still awaiting privatization and investments have been below potential in recent years.[662] With respect to pharmaceuticals and biotechnologies the expert opinion is more biased; some interviewees see significant future potential due to existing know-how and companies such as Pliva[663], while others mention that too few capacities exist in order to speak of a sizable sector for FDI.[664]

The future of the Information, Communication and Technology (ICT) sector in Croatia is a matter of even more controversy. Some experts foresee no or only minor FDIs in the next years[665] while others are convinced that this sector – the telecommunication sector in any case and the IT sector if it is given the

[659] See Intv. Croat. Company II - Legal Services (2007); Intv. Croatian University (2007); Intv. German Authority II (2007).

[660] See Intv. Croat. Company II - Legal Services (2007); Intv. Germ. MNC - Financial Services I (2007); Intv. Austr. MNC - Real Estate (2007); Intv. Austr. MNC - Consulting (2007).

[661] See e. g. Intv. Austr. MNC - Real Estate (2007); Intv. Austr. MNC - Financial Services I (2007).

[662] See Intv. Germ. MNC - Financial Services II (2007); Intv. Croatian Company - Real Estate (2007); Intv. German Econ. Association IV (2007); Intv. Austr. MNC - Financial Services I (2007); less optimistic Intv. Austr. MNC - Consulting (2007); Intv. Supranational Authority II (2007); Intv. Croatian Ministry II (2007).

[663] See e. g. Intv. Germ. MNC - Financial Services I (2007); Intv. Croatian Ministry II (2007); Intv. Croatian Authority II (2007); Doc - Croatian Chamber of Comm. (2006b).

[664] See Intv. Croat. Company II - Legal Services (2007); Intv. Supranational Authority II (2007).

[665] See Intv. Germ. MNC - Financial Services I (2007); Intv. Germ. MNC - Software (2007); Intv. Supranational Authority II (2007).

right attention by public policy – may become crucial for domestic and foreign investments.[666]

Moderate potential for FDI is estimated in existing industries such as infrastructure (for example harbors), food processing, automotive supply, real estate and some re-capitalizations in the banking sector.[667] Some minor privatizations, such as the finalization of the telecommunication sale and the privatization of the logistics company as well as the further liberalization of the energy sector, are expected.[668]

In the longer run the agricultural sector, not mentioned by the external observers at all, is also expected to become an attractive field for FDI, particularly after integration into the EU. This is due to the large spaces of untouched nature since the war (for example in Slavonia), less use of pesticides and fertilizers, the great need for modern technology, and the rising demand in Western Europe for healthy food.[669]

Large inflows into the manufacturing sector are not expected by the experts.[670] The potential is mostly identified in service industries and higher value-added products as well as R&D activities, also since the Croatian GDP is clearly service-oriented and Croatia is developing towards a knowledge-based

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[666] See Intv. Croatian Company - Real Estate (2007); Intv. Croatian Ministry II (2007); Intv. Croatian Authority II (2007); Intv. Former Croatian Minister (2007); Intv. Germ. MNC - Telecommunications (2007).

[667] See Intv. Austr. MNC - Real Estate (2007); Intv. Austr. MNC - Construction (2007); Intv. Germ. MNC - Financial Services I (2007); Intv. Croatian Authority II (2007); Intv. Croatian Ministry II (2007); Intv. Supranational Authority II (2007); Intv. Croatian Company - Real Estate (2007); Intv. European Institution (2007).

[668] See Intv. Croatian Ministry II (2007); Intv. Croatian Authority I (2007).

[669] Significant de-mining efforts would still be required; see Intv. Germ. MNC - Financial Services II (2007); Intv. Croatian Mayor (2007); however, the adaptation to EU standards will also cause significant costs for Croatia; see Doc - Ekonomski Institut Zagreb (2007).

[670] See Intv. Croatian Ministry II (2007); Intv. Croatian University (2007).

society.[671] In terms of company size FDIs are expected to be mainly driven by SME investments particularly in tourism.[672]

In contrast to most company experts the state experts interviewed see greater potential in greenfield investments and even in manufacturing; they identify a greater amount of potential FDI fields even though they repeatedly state that the state needs to focus on key industries for FDI.[673] When it comes to industries state experts tend to expect the ICT sector to attract more and larger investors than the company experts do.[674] Croatian state experts are alone in mentioning significant potential for investments for renewable energies.[675] On the other hand state experts are more skeptical regarding great potential for FDI in tourism.[676] This may be because they are more aware of the persisting reluctance of Croatian local politicians to sell the land to international investors than MNCs.

(8) Coming to an overall **assessment** of its economic development, Croatia has overcome the challenges outlined – especially the turbulences of war – with amazing swiftness and is today among the most advanced and stable economies in Eastern Europe. The Western Balkan republic has reached a high GDP per capita on a level with Poland and clearly ahead of all other SEECs as well as

[671] See Intv. Croatian Ministry II (2007); Intv. Croatian Authority II (2007); Intv. Croatian Company - Real Estate (2007).
[672] See Intv. German Authority II (2007); Intv. Croatian Mayor (2007); Intv. German Econ. Association IV (2007); Intv. Croatian Ministry II (2007).
[673] See Intv. Croatian Authority II (2007); Intv. Former Croatian Minister (2007); Doc - Croatian Chamber of Comm. (2006b); see also Intv. Croat. Company II - Legal Services (2007); Intv. Austr. MNC - Consulting (2007).
[674] See Intv. Croatian Authority II (2007); Intv. Croatian Ministry II (2007).
[675] See Intv. Croatian Authority II (2007); Doc - Croatian Chamber of Comm. (2006b); while non-Croatian experts seem more skeptical; see Intv. Supranational Authority II (2007); Intv. German Econ. Association IV (2007).
[676] See Intv. Croatian Authority II (2007); Intv. Croatian Ministry II (2007); Intv. Croatian Authority I (2007).

an impressive FDI stock. This positive performance is also reflected in a fairly respectful position in the BTI (*see figure 35*).[677]

Nevertheless, Croatia's transition process "is far from being completed"[678]. Croatia still shows strong dependence on private (often credit-based) demand and a strongly subsidized tourism industry.[679] Furthermore, exports and FDIs remain below expectations and the GDP growth – hovering around 5% – is not as dynamic as in neighboring countries. Finally, the economic improvements have not reached the whole population, leaving a large share of Croatians unemployed. These less favorable aspects are also reflected in the DCEI (*see figure 34*) in which Croatia is placed second last, only ahead of Turkey. The low convergence of only 59% to Western European standards is mainly due to the low score in the real economy driven by the large foreign debt, the high unemployment rate and a fairly high share of the agriculture of the GDP (about 25%).[680] Nevertheless, a strong improvement in the DCEI from 2005 to 2006 indicates some important changes in recent years. Subsequent sections analyze to what extent these convergence factors have an effect on FDI inflows since Croatia's poor DCEI performance compared, for example, to Romania, does not correspond to a significantly higher FDI stock per capita.

Despite Croatia's positive economic development, the analyses of this section suggest that further reforms need to be undertaken in order to set Croatia's growth and development path on a higher level, not because Croatia is performing so badly but because other countries of the region are catching up very fast. Much of the economic future seems to depend on the success of future FDI flows. The many arbitrary expert interviews regarding the future fields of FDI in Croatia indicate that public policy still lacks a clear vision of future developments. It seems however, that Croatia still has a lot of potential

[677] See also Eurostat (2007b); CICD (2006), p.11.
[678] Bertelsmann Stiftung (2006b), p.9.
[679] See NCC (2004b), pp.12 and 20; Bfai (2004), p.7
[680] See Hornung (2006).

for tourism, particularly in the mid-range sector and on the islands. ICT also offers a wide range of possibilities, since many Croatians are high-skilled[681] and since this sector is well suited for SMEs. By contrast, Croatia appears to have only limited advantages in agriculture compared to other SEECs, for example to Romania. Furthermore, the potential for large pharmaceutical activities may be scarce considering the limited existing capacities and the specialized know-how that is necessary for this sector.

6.3.2 Country determinants without short-term public policy impact

In correspondence to the procedure for Romania this section analyzes the major non-policy determinants for Croatia: (1) market size, (2) labor costs, (3) proximity, and (4) other aspects. (5) provides a conclusion for this section. Definitions and references to theory already given in previous sections are not repeated here.

(1) With respect to **market size** Croatia's major economic indicators have already been discussed in the previous section. In terms of land size Croatia is fairly small with $56,542km^2$ which makes it the 11th largest of 19 EECs just ahead of Bosnia and Herzegovina ($51,129km^2$). With 4.4M inhabitants Croatia is the 10th largest Eastern European market in terms of population. Due to the war Croatia's population declined by 7.2% between 1991 and 2002 but has remained stable since then. For a small country Croatia has quite a few large cities, namely Zagreb, Split, Rijeka, and Osijek, all which have more than 100K inhabitants.[682]

The **experts interviewed** for Croatia agree that the size of a market can be an important determinant for an FDI decision. At a first glance it seems apparent to many experts that its small domestic market is a disadvantage for

[681] See section 7.4.
[682] See Der Fischerweltalmanach 2007 (2006); Bfai (2004); EBRD (2005a), p.50.

Croatia.[683] However, experts also note some limitations to this rather negative judgment. MNCs coming from a small home country like Austria may feel more comfortable in a comparable market like Croatia.[684] Furthermore, the market size is only of limited importance for those investors exclusively producing for exports.[685] More importantly many experts interviewed have seen and see significant market opportunities in Croatia despite its limited market size. Opportunities arose after the war due to the destruction and the struggling domestic economy. Today the Croatian market is particularly attractive because of its high purchasing power, the continued lack of modern consumer products, limited domestic production, and the positive perception of foreign products.[686]

Looking at the differences between **state and company** experts it seems that the former are more optimistic with respect to the perception of Croatia as part of a larger market. Particularly with respect to a potential EU accession company experts are more skeptical whether the market potential will significantly improve.[687]

In **conclusion** the analysis of the FDI studies, the data and the expert interviews indicate that its small market size did not hurt Croatia's FDI performance; in fact, Croatia has the third highest per capita FDI stock in Eastern Europe.[688] Differing from the Romanian example and somewhat in contrast to FDI theory the market size therefore seems to play only a limited role for Croatia. Major reasons seem to be the perception of Croatia as part

683 See Intv. German Authority II (2007); Intv. Austr. MNC - Consulting (2007); Intv. Former Croatian Minister (2007); Intv. Supranational Authority II (2007);Intv. Austrian Econ. Association II (2007); Intv. Germ. MNC - Financial Services II (2007).

684 See Intv. Austrian Econ. Association II (2007).

685 See Intv. Germ. MNC - Industrial Goods I (2007).

686 See Intv. Austr. MNC - Primary Goods I (2007); Intv. Austr. MNC - Retail (2007); Intv. Austr. MNC - Financial Services I (2007); Intv. Germ. MNC - Engineering (2007).

687 See Intv. Croatian Authority II (2007); Intv. Germ. MNC - Industrial Goods I (2007); Intv. Austr. MNC - Consulting (2007); Intv. European Institution (2007).

688 See section above; see also Garibaldi, Mora, Sahay, and Zettelmeyer (2001); Brada, Kutan, and Yigit (2003).

of a larger market, large opportunities on the demand side and various public policies discussed in *chapter 7*.

(2) According to *EIU (2007c)* Croatia's pay and non-pay **labor costs** averaged €3.49 per hour in 2006 (13% of the EU 15 average). Even though seven EECs have higher labor costs Croatia is more expensive than all other CEECs and than three EU members (*figure 36*). Being on a fairly high level for many years, labor costs in Croatia increased rather moderately compared to other EECs in recent years. The rate of 45% (2001-2006) is the fourth lowest rate in Eastern Europe (*figure 37*).[689] Croatia's productivity reached 64% of the EU 27 in 2006 and is fairly average amongst the EECs. However, productivity rates' improvements have been fairly low since 2001 (6.4%) and were outpaced by salary rises which caused increases in real unit costs (*figure 38*).[690]

Croatia's labor costs are perceived as fairly high by most **experts interviewed** and as competitive disadvantage. They may discourage potential investors to Croatia since particularly countries in the region are cheaper. Serbia, for example, has only 60% of Croatia's labor costs.[691] Experts agree that the salary levels have always been fairly high in Croatia.[692] Experts estimate that gross wages currently amount to €750-800 and net wages to €400-600.[693] From their perspective labor-intensive and manufacturing investors prefer not to invest in Croatia.[694] Experts also state that labor costs per se are not as decisive

[689] See EIU (2007c).
[690] Third lowest rate in Eastern Europe; see EIU (2007c); see also European Commission (2005a), p.46.
[691] See Intv. Austr. MNC - Consulting (2007); Intv. Austr. MNC - Real Estate (2007); Intv. Austr. MNC - Primary Goods I (2007); Intv. Croatian University (2007); Intv. Former Croatian Minister (2007); see also EIU (2007c).
[692] See Intv. Austr. MNC - Real Estate (2007); Intv. Croatian Ministry II (2007).
[693] See Intv. Germ. MNC - Financial Services I (2007); Intv. Croatian Ministry II (2007); see also APIU (2006b), p.23.
[694] See Intv. Austr. MNC - Real Estate (2007); Intv. Austr. MNC - Financial Services I (2007); Intv. Germ. MNC - Financial Services I (2007).

as productivity but Croatia's mediocre productivity performance cannot, from their perspective, compensate for the fairly high labor costs.[695]

As stated earlier for Romania the evaluation of non-policy determinants by MNCs strongly depends on the country of comparison: One German investor interviewed, for example, was looking for a location with available workers and comparable labor costs to Czech Republic which made Croatia quite attractive.[696] Therefore, labor costs may become less decisive for companies that only works within local markets.[697] Moreover, compared to Western European countries salaries are still very competitive in Croatia. They are, for example, three to five times lower than in Austria.[698]

A comparison of **state and company** interviews reveals that both groups are skeptical as to what extent Croatia's labor costs are an attractive factor. Also *Intv. Croatian Authority II (2007)* agrees that Croatia is "definitely not the competing country with its cost of labor"[699]. It seems however, that company experts are possibly more aware of the fact that Croatia's labor costs may strongly differ depending on the region[700] and the sector. Salaries, for example, for the personnel of a German investor interviewed are on comparable levels in Romania and Croatia.[701]

Data analysis, FDI studies and expert interviews lead to the **conclusion** that Croatia has the reputation of being a high labor cost country which may however, be somewhat unjustified; according to *AHK (2006)*, for example, investors already present in Croatia are less satisfied with labor costs than in most other EECs. However, a look at pay and non-pay cost levels confirms

[695] See Intv. Croatian Authority II (2007); Intv. Austr. MNC - Consulting (2007); Intv. Austr. MNC - Financial Services I (2007).
[696] See Intv. Germ. MNC - Industrial Goods I (2007)
[697] See Intv. Austr. MNC - Primary Goods I (2007).
[698] See Intv. Croatian Authority II (2007).
[699] See similar Intv. Croatian Ministry II (2007); Intv. Supranational Authority II (2007).
[700] See Intv. Germ. MNC - Financial Services I (2007).
[701] See Intv. Germ. MNC - Software (2007).

the evaluation of some of the (company) experts above that Croatia's costs may be more competitive than expected in some regions and comparable for high-skilled jobs.[702] Overall, a correlation of labor costs and FDI seems questionable for Croatia.[703] On the contrary, this section indicates – like for Romania – that MNCs are not primarily looking for the location with the lowest labor costs in absolute terms but at a set of country determinants of which labor costs appear to play only a minor role for Croatia. As a matter of fact, labor costs seem to be even less important for MNCs deciding for Croatia than those in other SEECs, namely for Romania.

(3) In terms of geographic **proximity** Croatia is one of the most attractive locations for Austrian and German investors with Zagreb being only 274 and 771km away from Vienna and Berlin respectively.[704] Croatia has five neighboring countries and over 1,000km of coastline permitting easy access to Western European and also North African countries. A disadvantage for some forms of investments may be the long distance within the country from Slavonia to Dalmatia with Bosnia and Herzegovina and the mountains in between as well as the 1,185 islands of which only 47 are inhabited.[705] Croatia's potential cultural ties to Austria and German have already been highlighted in *section 3.2*.

The **interview experts** show that the geographical proximity for Austrian but also German companies, for example from Bavaria, is a positive determinant in favor of Croatia.[706] The shorter distance may somewhat compensate for its smaller market size in the eyes of some investors.[707] Many Austrians, whose

[702] See also Holland and Pain (1998).
[703] See also Demekas, Horváth, Ribakova, and Wu (2005).
[704] See figure 39; www.mapcrow.info; www.wcrl.ars.usda.gov/cec/java/lat-long.htm.
[705] See Government of Croatia website (2007); European Commission (2005a).
[706] See Intv. Austrian Econ. Association II (2007); Intv. German Econ. Association IV (2007); Intv. Austr. MNC - Retail (2007).
[707] See Intv. European Institution (2007).

border is only 60km away from Croatia, perceive Croatians as neighbors.[708] The county of Varaždin with its Free Economic Zone in Northern Croatia in particular seems to benefit from its proximity to Austria.[709]

This short distance is of interest for industries like tourism[710] or for those investors for whom the transportation of goods further than 200km is too expensive.[711] The short distance facilitates the steering of operations abroad and enables MNCs to quickly react to changing market demands, for example, regarding retail or fashion products.[712]

Nevertheless, distance is not an exclusive country determinant for MNCs. One German investor, for example, decided – among other reasons – against an extension of the existing site in the Czech Republic because they expected to find more available workers in Croatia. This was despite the fact that the Croatian site was further away from the Bavarian home site than the Czech one.[713]

The majority of experts describe Croatia's geographic location as very attractive since "Croatia is on the crossroads of Europe"[714]. More specifically, the pan-European corridors 10 and 5 and the access from Western Europe to the Black Sea are interesting for investors as well as Croatia's position as bridge to other SEECs, particularly to the former Yugoslavia.[715] This fact also leads

708 See Intv. Austrian Econ. Association II (2007).
709 See Intv. Former Croatian Minister (2007).
710 See Intv. Germ. MNC - Engineering (2007).
711 See Intv. Austr. MNC - Primary Goods I (2007).
712 See Intv. Croatian Ministry II (2007); Intv. Austr. MNC - Financial Services I (2007).
713 See Intv. Germ. MNC - Industrial Goods I (2007).
714 Intv. Croatian Company - Real Estate (2007); see also Intv. Germ. MNC - Financial Services II (2007); Intv. Austr. MNC - Construction (2007); Intv. Supranational Authority II (2007).
715 See Intv. Austr. MNC - Consulting (2007); Intv. Germ. MNC - Financial Services II (2007); Intv. Croatian Company - Real Estate (2007); Intv. Austr. MNC - Financial Services I (2007).

to the conclusion of several experts that the size of Croatia's domestic market is not as important for most investments.[716]

Experts evaluate the cultural ties of Croatia to Austria and Germany as an important location determinant. A large number of experts confirm that a common history, architecture, land registration, schools, and some language elements remain in the minds of many Austrians and Croatians; these influences especially seem to continue to exist in Vienna on the one hand where emigrants from former Yugoslavia represent the largest minority[717] and in Northern Croatia on the other hand where some experts identify a certain nostalgia with respect to the era of the Austrian empire.[718] Experts also recognize continued ties with Germany. This is particularly true in the case of to Bavaria that recently opened a representation office. Germany's active role in Croatia's struggle for independence also plays an important role in this context.[719]

Intv. Austrian Econ. Association II (2007) however also points out that – despite a certain subconscious cultural and sociological consensus – cultural ties are only of limited relevance for doing business in Croatia on a daily basis or in public tenders.[720] Like in Romania personal ties seem to play a significant role for MNCs in their first interest for Croatia but also for later business operations. Various experts give accounts of contacts to Croatia even before the investment decision[721] and various experts interviewed with Croatian roots

[716] See Intv. Croatian Authority II (2007); Intv. Croatian Company - Real Estate (2007); Intv. German Authority III (2007).

[717] In Germany many Croatians live in Bavaria, officially more than 50K of which more than half live in Munich, see Bayerisches Landesamt für Statistik und Datenverarbeitung (2007).

[718] See e. g. Intv. Austrian Econ. Association II (2007); Intv. Germ. Research Institute II (2007); Intv. Austr. MNC - Construction (2007); Intv. Austr. MNC - Retail (2007).

[719] See Intv. German Econ. Association IV (2007); Intv. Germ. MNC - Telecommunications (2007); Intv. Germ. Research Institute II (2007).

[720] See Intv. Austrian Econ. Association II (2007).

[721] See Intv. Germ. MNC - Engineering (2007); Intv. Austrian Econ. Association II (2007).

lived in German-speaking countries before moving or returning to Croatia due to business opportunities.[722]

These personal ties seem to be the only proximity aspect that is less recognized by state experts than by company experts.

In the **assessment** of the proximity determinant it seems conclusive that the short geographic distance to the analyzed home countries and its geographic location are attractive factors in favor of Croatia. It may in fact compensate for other potential policy and non-policy deficiencies and explain to some extent why Croatia has accumulated a fairly high FDI stock per capita.[723]

It seems that the access to other markets is more important for Croatia than, for instance, for Romania. Perhaps, tastes and demands may be more similar in the countries of former Yugoslavia than in countries like Romania im comparison to Ukraine.

While the importance of personal ties seem comparable for Romania and Croatia, the general cultural ties are apparently even more important for investors considering Croatia as investment location than those interested in Romania. One reason may be that Croatia is also popular and better known as tourist a destination. Furthermore, cultural ties to Croatia seem to be more important for Austria than for Germany. The interviews have however generated doubts whether these ties are not mainly important to raise a first interest of MNCs for Croatia; in subsequent steps of their country selection other aspects – to be discussed in subsequent sections – become more decisive for their final investment in favor or against Croatia.

The question is furthermore how sensitive FDI reacts to proximity. As shown in *figure 39* several other locations are fairly close to Vienna and Berlin as well but show diverging FDI performance and *Resmini (2000)*, for example, also

[722] See e. g. Intv. Germ. MNC - Financial Services I (2007); Intv. Germ. MNC - Financial Services II (2007); Intv. German Econ. Association IV (2007); Intv. Austr. MNC - Real Estate (2007); Intv. Austr. MNC - Consulting (2007).

[723] See Altomonte (1998); Disdier and Mayer (2003); Bevan, Estrin, and Meyer (2004).

doubts that the relative advantage among closely located countries is actually significant for Western European MNCs. Therefore, other determinants such as infrastructure may be important interdependent factors for proximity.[724]

(4) **Other aspects** that may be potential non-policy determinants for Croatia are trade openness, agglomeration and natural resources.

No clear correlation between **trade openness** and FDI inflows can be recognized for Croatia based on primary and secondary sources. In line with the interviews the analyzed FDI studies either show no significant effect[725] or conclude that it is unclear if FDI influences trade or vice versa.[726] This evaluation is also supported by the fact that statistics show that trade volumes have constantly been rising since 2000, while FDI inflows to Croatia were subject to strong oscillations. By contrast, various interviewed state experts notice that FDI has positive effects on Croatian exports, namely in the Free Economic Zone in Varaždin as the most striking example where 95% of the produced goods are export-oriented.[727] They also see a lot of potential for FDI to further boost exports in the future.[728] Yet, it is questionable if the success of Varaždin is representative for the development in Croatia which will also depend on the progress of domestic companies to benefit from FDI spillovers – as already discussed in *section 2.2.2* – by creating greater export capacities themselves.

Most investors interviewed do not see **agglomeration** as important for a decision in favor of Croatia. The examples of a German who was among the first investors in Varaždin, and of the acquisition of the HT by the *Deutsche Telekom* show that investments neither depend on the existence nor on the

[724] See section 7.3.2.3.
[725] See Smarzynska (2002); Brada, Kutan, and Yigit (2003).
[726] See Resmini (2000).
[727] See Intv. Croatian Authority II (2007).
[728] See Intv. Former Croatian Minister (2007); Intv. Int'l Research Institute I (2007); Intv. Supranational Authority II (2007); Intv. German Econ. Association IV (2007).

anticipated future presence of other investors.[729] By contrast, Croatian state representatives are more convinced that the existence of companies attracts further companies, for example, for add-on operations and R&D activities for existing investors or in clusters like Varaždin.[730]

Overall, agglomeration seems more a desired goal of state representatives and less in line with the actual investment approach of MNCs in Croatia. This also leads to a more skeptical view of the analyzed FDI studies identifying positive agglomeration effects, even though Croatia-specific results are scarce.[731]

With respect to its **natural resources** Croatia has limited deposits of oil, gas, coal, bauxite, iron ores, calcium, silica, clays, and salt. It also benefits from its access to the Adriatic Sea and about 2M hectare of forests.[732]

According to the experts Croatia's most important resource is its landscape, especially its long coast line which is the basis for the tourism industry but also one of the reasons why foreign investors appreciate living in Croatia. Some experts also mention that tourism has a future potential, for example in the large untouched areas in the up-country of the coast.[733] Other investors point out that Croatia relied for too long on its attractive natural conditions without developing comprehensive development strategies.[734] Experts anticipate that Croatia will gain more strongly from its land through agriculture in the future. The soil is good for farming, agriculture is not yet very advanced in Croatia, and demand in Europe is also rising.[735]

[729] See Intv. Germ. MNC - Telecommunications (2007); Intv. Germ. MNC - Industrial Goods I (2007); see for a different perspective Intv. Austr. MNC - Construction (2007).

[730] See Intv. Croatian Authority II (2007); Intv. Former Croatian Minister (2007); Intv. Croatian Ministry II (2007).

[731] See Resmini (2000); but see also Krugman (1991); Fujita, Krugman, and Venables (1999); Head, Ries, and Swenson (1999).

[732] See Bulgaria Economic Forum (2006), p.9; Bfai (2004), pp.32-34, 84.

[733] See Intv. Germ. MNC - Financial Services II (2007); Intv. German Authority III (2007); Intv. Supranational Authority II (2007).

[734] See Intv. German Authority II (2007); Intv. Former Croatian Minister (2007).

[735] See section 6.3.1; see Intv. Germ. MNC - Financial Services II (2007); Intv. Austr. MNC - Consulting (2007); Intv. Croatian Mayor (2007); Doc - Croatian Chamber of Comm. Dubrovnik (2006).

The high amount of FDI in tourism and the expert statements support those FDI studies that find a correlation between natural resources and FDI inflows to Croatia.[736] Nevertheless, the overall effect of natural resources on FDI inflows – for example with regards to tourism – seems to be closely linked to public policy actions such as investment policies, privatization policies and property rights that will be further discussed in *chapter 7*.

The **assessment** of these "other aspects" reveals that trade and agglomeration only seem to have limited effects on FDI flows to Croatia. For trade it seems that FDIs rather tend to influence trade (exports) than the other way round; agglomeration is desired by policy makers, for example, in Varaždin but does not seem to significantly influence investors' decision. By contrast, the natural endowments seem to be a major asset for Croatia. However, for all of these determinants – and analogous to the Romanian case – it becomes apparent that they are strongly dependent on other factors such as legal, economic and political determinants.

(5) In **conclusion** this section has shown that the two most frequently cited non-policy determinants according to FDI theory, market size and labor costs, are aspects that are likely to represent disadvantages for Croatia even though Croatia has been among the most attractive FDI recipients in Eastern Europe.

Among non-policy determinants proximity and natural resources seem to be more important for Croatia. In this context the image of Croatia has been identified as a major aspect for the investment decision, being a beautiful country with strong cultural ties to Germany and Austria that is an ideal bridge to South-Eastern Europe. It seems that this positive image, attractive business opportunities and favorable investment conditions can easily compensate for deficiencies of Croatia in other areas. To what extent public policies have been

[736] See Garibaldi, Mora, Sahay, and Zettelmeyer (2001). Most studies however do not define tourism as part of natural resources; see Merlevede and Schoors (2004).

able to successfully support these determinants will be analyzed in *chapters 7 and 8*.

6.4 Conclusion for transition countries

This section draws conclusions for transition countries regarding (1) the economic development, (2) the major non-policy determinants, (3) differences between the state and company perspective, and (4) the characteristics of non-policy factors.

(1) Transition countries experienced significant **economic struggles** after the end of communism, often aggravated by country-specific challenges such as political instability in Romania or even by war in Croatia. In result many economic indicators performed poorly in most transition countries until the end of the 1990s. After the end of the financial crisis and the opening of their economies, transition countries seem to have experienced an upward trend including higher FDI inflows, with Croatia as an example for developing moderately but stable and with Romania as a prototype for starting off at lower level but catching up at high speed in recent years culminating in EU accession.

(2) Various **non-policy determinants** were analyzed in this section.

Market size categories such as population, geographic size, GDP and GDP growth do not seem to be of major importance for investors in transition countries in general. More important indicators are an increasing purchasing power parity and high demand for Western products among consumers. Differences may occur in terms of market definition (for example, in the definition of Romania as a rather isolated market and of Croatia as part of regional market).

Labor costs seem to be – at least at first glance – a potential driver for the investment decision in transition countries. The importance of the factor in the eyes of MNCs may vary depending on the labor share of investments, the risk-aversion and the strategic approach of the investors. Other factors, such as political stability, skill level etc. may also compensate for higher wages. Regional and sectoral differences in the host country may also lead to labor cost deviations. Productivity seems to receive little attention from investors. Particularly for fast-changing economies like Romania MNCs have difficulties to forecast labor cost developments, and unexpected salary jumps may even deter potential investors even though cost advantages may persist for many more years.[737]

The importance of geographic distance seems to depend strongly on other issues such as infrastructure even though some transition countries like Croatia seem to benefit from the short distance to Western Europe. The varying cultural proximity of transition countries to home countries seems to be a determinant which investors are well aware. It is particularly appealing for a first approach to a potential investment location. The importance of cultural proximity seems to decrease, however, in later stages of the investment decision process.[738] Furthermore, transition countries seem to strongly benefit from personal ties to emigrants to Western Europe, mainly in the 1980s – a factor that may be exploited further by public policy.

A clear interdependence of trade and FDI flows is difficult to determine for transition countries. Diverging market entry strategies of MNCs and different effects of public policies rather seem to indicate an only weak influence of trade on FDI. It does appear likely, nevertheless, that trade may improve the export capacities of transition countries.[739] The presence of other companies (agglomeration) does not seem to significantly influence investment decisions; in any case the meeting of other conditions such as an attractive infrastructure or investment incentives seem to be necessary as well.

[737] See also Holland and Pain (1998); Pye (1998).
[738] See also Demekas, Horváth, Ribakova, and Wu (2005).
[739] See similar e. g. Resmini (2000).

The possible exhaustion of natural resources such as base or precious metals only seems to play a minor role FDI in transition countries[740] except in the case of some niche industries in some countries (like wood in Romania).[741] Landscape in a more general sense on the other hand is perceived as an important driver for FDI. Croatia is a good example of this; its specific natural advantages such as a long coast line, mild climate and the many islands, represent a major asset both as investment location but also as an attractive living location for investors. Again, public policy still seems to have a strong influence as to how far this advantage can be materialized into FDI.

(3) Several **differences between company and state experts** can be identified for transition countries in general. From the perspective of MNCs, image, perception and expectations are very important for the evaluation of non-policy determinants. Furthermore, the reference point of their assessment is decisive. This can be, for example, the home country, an existing operation in another EEC or the neighboring countries of the targeted host country. The perception of MNCs may actually be misleading from time to time, for example, by underestimating the distance of Romania versus Bulgaria or by over-estimating labor costs in Croatia. The existence of a certain host country image may also explain why non-policy factors seem more important for the initial phase in MNCs' investment decision process when a broader knowledge of (particularly legal) investment conditions is still limited. Fostering certain images and perceptions of investors in favor of host countries may be an interesting and rewarding task for policy makers that will be further examined in subsequent chapters.

Compared to state experts MNCs tend more to see interdependencies with other factors and are more aware of regional differences (e. g. in terms of labor

[740] Other measures like land size seem to represent a very rough proxy for natural resources; see Brada, Kutan, and Yigit (2003).
[741] See also Garibaldi, Mora, Sahay, and Zettelmeyer (2001).

costs). Interviews also underlined the somewhat more pragmatic approach of MNCs that easily abandon concepts of cultural ties in later steps of their investment decision when factors like the availability of labor or infrastructure come into play.

State experts tend to be more optimistic with respect to the impact of different non-policy factors. This is understandable since they are also promoters of the success of economic policy and their interview participation can in a way be understood as investment promotion itself. Generally, state representatives do evaluate fairly realistically the limits of the impact of country determinants, particularly regarding the limited significance of labor cost advantages for their country. Interestingly, deviations between state and company experts seem to be greater in Romania than in Croatia - an evaluation that will need to be further assessed in subsequent chapters.

(4) This chapter has shown that **non-policy factors** alone can neither drive FDI nor sufficiently explain oscillations of FDI inflows to transition countries. First of all their importance depends on different market entry strategies or modes; many MNCs have several or evolving strategies and may be exporting and later also market-exploiting; some companies again may enter the market via greenfield investments but participate in privatization auctions as well.

Secondly, this section has shown that country-specific deviations regarding non-policy factors do exist, and the complex investment decision process of MNCs can lead to rapid changes in the evaluation of these factors.

Thirdly and most importantly, the analyzed non-policy factors can only be understood in the light of interdependent public policies driving the overall decision for a specific location of MNCs.[742] This chapter therefore confirms the main idea of the theory of locational competition that countries are in constant rivalry for mobile factors such as FDI; it also supports the finding

[742] See Carstensen and Toubal (2004).

that competition for FDI has become more intense in recent years. States may actually have significant influence in creating locational advantages – within their given conditions like market size and natural resources – in order to attract FDI. In line with *Siebert (2005)* and hypothesis #2[743] of this thesis it seems apparent that the levers of public policy are indeed manifold. It can be added that it is difficult for countries to determine the reference point and the perception of investors on certain country determinants apart from the data. How governments can actively influence the perception and the actual conditions for FDI in transition countries and how successful these actions are, will be discussed in the following chapter.

[743] See section 1.1.

7 Public policy and its effects on FDI

This chapter analyzes public policy determinants with direct or indirect influence on investment conditions in Romania, Croatia and in transition countries in general. *Section 7.1* provides an introduction, followed by the analysis of legal, economic and political measures (*sections 7.2-7.4*).

7.1 Introduction and analytical approach

Figure 40 presents the public policy determinants analyzed in this chapter. The list of 14 determinants and 29 sub-determinant is the result of the predefined list of FDI determinants from the theoretical part of this thesis as well as a first revision of this list based on the content analysis of the expert interviews and documents (*chapter 5*). It reflects all of those determinants and sub-determinants that are considered more in detail by investors before investing in a transition country, namely Romania and Croatia. The categorization into legal, economic and political measures enables a systematic approach to analysis and a good understanding of the different actors and fields of FDI policy. The determinants are analyzed in a logical order. Legal measures follow the steps of investment; they start out with the most general pre-conditions and become more specific. Economic measures are also categorized according to their increasing specification. They start with more indirect FDI policies (economic stability) to policies that focus more directly on FDIs and MNCs such as investment promotion. Political measures are ranged in order from policies focused on a national level to measures aiming more at an international level.

The analysis follows similar patterns like the one for non-policy determinants of the previous chapter:

- Definition of the determinants from the investor's perspective
- Analogous determinant analysis for Romania and Croatia
  - Analysis of the performance of the determinants and sub-determinants based on expert statements (including documents and the analysis of deviations between company and state perspective), secondary literature, FDI studies, and international statistics
  - Analysis of the importance of the determinants and sub-determinants on the investment decision of MNCs (based on the same sources as above)
- Generalizations for transition countries and reflection of FDI theory

7.2 Legal measures

This section analyzes legal measures influencing conditions for FDI in transition countries, namely market access (*7.2.1*), property rights (*7.2.2*), quality of bureaucracy (*7.2.3*), legal certainty (*7.2.4*) as well as labor law (*7.2.5*). *Section 7.2.6* provides an overview of the results of this section.

Country determinants – order of analysis

Level	Determinant	Sub-determinant
• Legal	• **Market access**	• Corporate law, company registration, joint ventures
	• **Property rights**	• Property law, land registration, construction permit
	• **Quality of bureaucracy**	• General quality, **implement. of laws,** regional differences
	• **Legal certainty**	• Legal system, court system
	• Labor law	• Labor law
• Economic	• Stability	• Financial system**, Monetary policy**, **trade policy**
	• **Infrastructure**	• Roads, real estate
	• Investment climate	• Investment policy, **taxes, investment incentives**
	• **Privatization**	• **Privatization**
	• Investment promotion	• Investment promotion
• Political	• **Human capital**	• Education level, availability of labor
	• **Political stability**	• Internal political stability, external political stability
	• **Corruption**	• **Corruption**
	• **EU integration**	• **EU integration**, EU funds

Bold = Pre-defined determinants from theoretical part of thesis
Source: Own presentation.

Figure 40: Country determinants - order of analysis

7.2.1 Market access

7.2.1.1 Definition

Easy market access is defined by investors as ease of initiating a business in a host country and lack of major legal or bureaucratic obstacles. More specifically, they may expect for Romania (*7.2.1.2*) and Croatia (*7.2.1.3*) that (1) corporate law offers sufficient possibilities, (2) company registration is straightforward and quick, and (3) joint ventures are possible and generally seem to succeed. For all areas MNCs will expect equal treatment compared to domestic investors. Sub-sections (4) provide short country conclusions and *section 7.2.1.4* derives results for transition countries in general.[744]

7.2.1.2 Romania

(1) Expert interviews and documents, secondary sources as well as FDI studies and international statistics reveal that Romania's **corporate law** (a) has undergone significant improvements, (b) is no major concern for MNCs today (c), only leaves minor problems, and (d) is overall only of limited importance for the investment decision of MNCs for Romania. Section (e) provides an assessment.

(a) Romania has achieved **significant improvements** regarding its corporate law. It was first established in 1990 based on French law and underwent major revisions, namely in 1997 and 2003.[745] Accordingly, equal treatment of Romanian and foreign investors was established and foreigners became eligible as board members or managing directors in Romanian companies without any restrictions.[746] While the period between 2001 and 2004 saw 24 revisions in corporate law legislation, regulations became more stable and predictable

[744] See also OECD (2005a), pp.11-12; World Bank (2005), p.23; OECD (2006a), pp.31, 48.
[745] See Laws no. 31/1990, 195/1997 and 359/2004.
[746] Maximum share rules for foreigners were also abandoned; see European Commission (2005c), p.46; Müller (2005), pp. 149 and 156; Tripon (2003), p.45; BA-CA (2006), p.31; Dresdner Bank (2004), p.22; Menzer (2005).

after 2004.[747] It seems that remaining major deviations from Western European standards have been eliminated since EU accession. Notable improvements identified by the experts interviewed since 2006 are, for example, the introduction of supervisory boards and various amendments with respect to stock corporations including more flexible control systems.[748]

(b) Expert interviews reveal that Romania's corporate law is today **no major concern** of potential investors since the possible company forms are sufficient and quite similar to regulations in Austria and Germany.[749] MNCs generally choose the Societatea cu raspudere limitata (S.R.L.), the Romanian limited liability corporation, which is seen as the most convenient type of company, particularly for greenfield investments, because it is more flexible and comfortable than, for example, a non-incorporated or a stock corporation, the Societatea pe actiuni (S.A.).[750]

(c) Based on the experience of the experts, **only minor problems** with corporate law remain, for instance when investors lack a clear business idea and do not know what kind of company to establish[751], or in the interpretation of some of the new regulations such as the exact requirements of supervisory boards. The missing possibility to establish partnerships has not been a problem for investors so far but could be a challenge with an increasing number of craftsmen coming to Romania.[752]

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747 See Law no. 441/2006 and Government Emergency Ordinance no. 82/2007; see also Pachiu & Associates (2007); The National Trade Register website (2008); Tripon (2003), p.45.

748 See Intv. Germ. MNC - Legal Services I (2007); Intv. Austr. MNC - Legal Services (2007).

749 See e. g. Intv. Austr. MNC - Industrial Goods I (2007); Intv. Germ. MNC - Legal Services II (2007).

750 E. g. entrepreneurs can take more influence in an S.R.L. than in an S.A.; see Intv. Austr. MNC - Industrial Goods I (2007); Intv. Germ. MNC - Legal Services II (2007); Intv. German Econ. Association II (2007); Intv. Germ. MNC - Consulting I (2007); Intv. Austr. MNC - Legal Services (2007).

751 See Intv. German Authority IV (2007).

752 See Intv. Germ. MNC - Legal Services I (2007).

(d) The overall **importance** of corporate law for the investment decision of MNCs for Romania appears to be limited, particularly since legal deviations between Romania and other Eastern European EU members are negligible since Romania's EU accession. Furthermore, MNCs encounter comparable advantages in most transition countries such as commonalities to Western European law systems and disadvantages such as frequently changing legislations until the early 2000s.[753] Finally, interviews suggest that potential corporate law problems can easily be outsourced to lawyers and accountants.[754]

(e) The **assessment** of primary and secondary sources likewise suggests that Romania is performing well in terms of corporate law – despite some room for minor improvements. Romanian public policy actors may have only limited possibilities to use corporate law as differentiating factor to other Eastern European EU members; they may however, elaborate differences and highlight Romania's advantages in this field in comparisons with non-EU locations such as Ukraine and Serbia as part of an active locational competition.

(2) The analysis of Romania's **company registration** shows that (a) conditions were unsatisfying until 2004, but (b) have significantly improved since then, even though (c) some issues remain. The (d) importance of the determinant has meanwhile decreased. Section (e) assess the findings.

(a) According to the experts interviewed[755] but also to external studies[756], company registration was still a **substantial barrier to investment until 2004** in Romania. Procedures were very slow, complicated and required extensive documentation. Deviations from ordinary registrations such as the change of the production site were particularly time-consuming. Ordinary registration

[753] See similar also CICD (2006); OECD (2006a).
[754] See Intv. Austr. MNC - Industrial Goods I (2007); Intv. German Econ. Association III (2007).
[755] See Intv. Germ. MNC - Industrial Goods III (2007); Intv. Germ. MNC - Consulting I (2007).
[756] See FIC (2002), p.8; EBRD (2005b), p.20; Müller (2005), p.156.

of foreign companies took an average of three months and never less than one month at that time.[757]

(b) Experts and external sources see **significant improvements** in the registration conditions since 2003/ 2004 when several breakthrough regulations were passed that led to a simplification of registration formalities, a clearer distinction between company registration and business operations and to the introduction of an electronic registration system.[758] The National Trade Register Office became a public institution under the Ministry of Justice and responsible for registration procedures as a so-called one-stop shop.[759] The establishment of the National Agency for Small and Medium Sized Enterprises and Co-operatives and simplifications for SME registrations were further steps towards an easier market access.[760]

As a result expert interviews confirm that company registration has become simpler, faster and cheaper with equal rights for foreigners as for domestic investors.[761] Company registration is now "one of the most unbureaucratic acts in Romania"[762] requiring only six documents for a common one-man S.R.L.[763] Registration time has been brought down to three to 14 days according to experts' experiences and averaging about one week. An austrian MNC interviewed even had its company registered within one day in a Free Economic Zone.[764]

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757 See also Intv. Romanian Company - Advertising (2007); more positive: Intv. German Authority IV (2007).

758 See most importantly Law no. 359/2004.

759 See Emergency Government Ordinance 129/2002; OECD (2006a), p.154.

760 See OECD (2005d), pp.13, 46; BA-CA (2006), p.33; Zühlke (2006).

761 See Intv. Romanian County Council (2007); Intv. Germ. MNC - Consulting II (2007); Intv. Austrian Econ. Association I (2007); Intv. German Econ. Association II (2007); Intv. Romanian Company - Advertising (2007); Intv. German Authority IV (2007); Intv. Austr. Research Institute (2007).

762 Intv. Germ. MNC - Consulting II (2007); see also Intv. German Authority I (2007).

763 See Intv. Int'l Econ. Association (2007); Intv. Romanian Authority I (2007); Intv. Germ. MNC - Consulting II (2007); Intv. German Authority IV (2007).

764 See Intv. Austr. MNC - Industrial Goods I (2007); see also Intv. Germ. MNC - Legal Services II (2007); Intv. Germ. MNC - Consulting I (2007); Intv. Germ. MNC - Legal Services I (2007); Intv. Romanian Authority I (2007).

Experts also assess company registration in Romania positively because it is not expensive. According to *Intv. German Econ. Association II (2007)* a regular company set-up costs between €1,000 and €1,200 in 2007 including all fees for lawyers.[765]

How unbureaucratic and fast company registration has become, is also underlined in a regional comparison. *Figure 41*, based on World Bank's "Ease of Doing business" survey[766], confirms by and large the figures of the interviewees and shows that Romania has the second fastest average registration time (14 days) among 19 Eastern European states and is therefore significantly faster than neighboring countries such as Ukraine (27 days) or Bulgaria (32 days). Moreover, in only two Baltic states do companies fewer procedural steps than in Romania (5 versus 6). This position is indeed remarkable considering Romania's poor performance only two years earlier when it still took 28 days to register a company according to the same survey[767] and even longer according to some of the experts interviewed.

(c) Experts agree however, that **some problems remain**. Particularly company experts mention that professional external help is a precondition for company registration to be as easy as described. Lawyers, accountants or local specialized firms that know where to go and what documents are required are used by all large and also most smaller MNCs.[768] Company experts also find more other remaining registration problems than state experts; for example, registration is not possible without a residence in the country which foreigners usually do not have. To circumvent this problem MNCs often take official

[765] See also Intv. Int'l Econ. Association (2007).
[766] See World Bank (2007a), data between April 2006 and June 2007; see also CICD (2006).
[767] Figures for January 2004; see World Bank (2004b), p.249; also confirmed in OECD (2005a).
[768] See Intv. Austr. MNC - Financial Services I (2007); Intv. Germ. MNC - Industrial Goods III (2007); Intv. German Econ. Association II (2007); Intv. Int'l Econ. Association (2007); Intv. German Econ. Association III (2007); Intv. Austr. MNC - Industrial Goods I (2007).

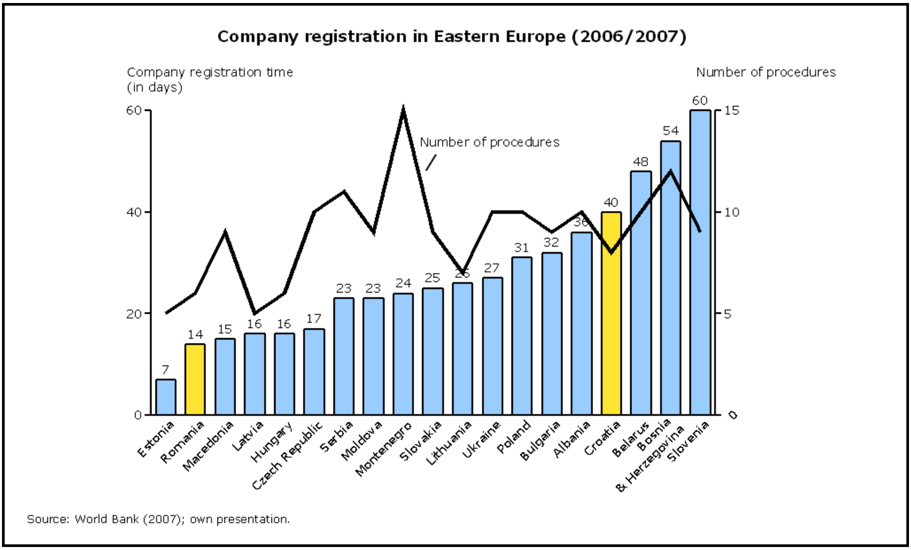

Figure 41: Company registration in Eastern Europe

residence in their lawyers' office in the first phase until registration is completed.[769] The low minimum amount for the registration of a S.R.L. of only €65[770] can also be regarded as a downside since this may attract less serious and credible market participants which could endanger the trust of clients, banks and external observers[771] and, in the end weaken the reputation of the entire economy.

Regarding the registration time experts also note that rural administrations tend to be faster than urban ones and that the speed of the registration for other

[769] See Intv. Germ. MNC - Legal Services I (2007); Intv. Germ. MNC - Industrial Goods III (2007).
[770] See PI Partners (2007).
[771] See similar Intv. German Econ. Association VI (2007).

company forms but S.R.L. may still be significantly slower.[772] Finally, some experts criticize a lacking transparency regarding the closure of a company.[773]

(d) The evaluation of the **importance** of the company registration process for the MNCs investment decision appears to be controversial. A smooth company registration is viewed by many state representatives[774] and various publications of international organizations[775] as a very important FDI determinant for Romania. However, company experts interviewed[776] but also several FDI studies for Romania[777] and for transition countries in general[778] rather suggest that short and unbureaucratic registration procedures per se have not been an FDI enhancing factor for Romania. Since 2004 a registration of, for example, less than two weeks rather seems to be a "nice to have"[779] but less as something that determinedly influences the locational decision for Romania. On the contrary however, a bad registration performance may have been an important constraining factor for MNCs when deciding whether to invest in Romania. An example is provided by the early 1990s when registration for one out of three companies took longer than six months.[780] It therefore seems that Romanian public policy makers had to establish a minimum set of company registration rules in order to reach a certain level at which company registration turned from a negative and important factor to a positive and less important factor.

[772] See Intv. Germ. MNC - Legal Services II (2007); Intv. German Econ. Association II (2007); Intv. Austr. MNC - Industrial Goods I (2007).
[773] See e. g. Intv. Int'l Econ. Association (2007).
[774] See e. g. Intv. Romanian Authority I (2007); Intv. Romanian County Council (2007).
[775] See and OECD (2006a); World Bank (2005); OECD (2005d).
[776] See Intv. German Econ. Association VI (2007); Intv. Austr. MNC - Financial Services I (2007).
[777] See Genco, Taurelli, and Viezzoli (1993).
[778] See Kalotay (2000); UNCTAD (1998).
[779] Intv. German Econ. Association VI (2007).
[780] The highest share of the six analyzed EECs by Genco, Taurelli, and Viezzoli (1993); see also for transition countries in general also Kalotay (2000); te Velde (2001).

Furthermore, it seems that successful company registration rules may indeed have significant impact on MNCs' decision, but only in indirect terms and with respect to the perception of Romania as investment location. It seems that "registration time is something companies look at"[781], because it gives hints about the quality of administration in general.[782] Transparent and quick procedures may suggest – justified or not – that subsequent administrative barriers are low as well and that doing business is easy in Romania. A good performance at these first contacts with investors seems to help particularly with German investors who tend to be skeptical regarding the quality of the Romanian bureaucracy.[783]

(e) In **conclusion** this section elucidated that concise reform efforts – such as the streamlining of processes and institutional concentration – generated remarkable improvements even in a short period of time that have made company registration in Romania very attractive even in regional terms. This success is also not substantially watered down by the need for external help for registration since foreigners will ask for assistance in most cases anyway, for example, in order to avoid language problems. The consideration of interviews has particularly helped to understand the mechanisms of the changing importance of company registration as FDI determinant. Public policy makers should further analyze its indirect impact on Romania's (still ambiguous) image and become even more aware of the significance of the registration procedure as the generally first encounter of MNCs with Romanian authorities and therefore as business card of the country.[784]

(3) Before accessing the Romanian market, MNCs sometimes consider **joint ventures** as possible form of cooperation. The analysis of primary and sec-

[781] Intv. Germ. MNC - Consulting I (2007).
[782] See also Intv. German Econ. Association III (2007).
[783] See also Intv. Germ. MNC - Consulting II (2007).
[784] See also for the discussion of image promotion section 7.3.5.

ondary sources discloses that (a) MNCs were rather skeptical towards joint ventures in the past, (b) they may succeed today if certain requirements are met, (c) but even today many problems persist; however the (d) overall importance of them is limited for MNCs. Section (d) presents an assessment.

(a) Expert interviews reveal that joint ventures have never been a predominant investment form but were more frequent **in the past**.[785] They assume that joint ventures may have been a first step of investment to Romania for some investors, but MNCs tended to decide in favor of greenfield investment once their comfort level regarding the investment conditions and legal certainty in Romania started to rise.[786] FDI studies found for the early 1990s that the "lack of managerial mentality"[787] was one of the greatest problems for successful joint ventures in Romania.

(b) **Today** joint ventures are **mainly used** when MNCs want to explore the Romanian market since sourcing remains difficult without market knowledge. MNCs often cooperate, for example, with food producers and in projects where the state is involved such as in Public-Private-Partnerships (PPP) supporting R&D activities.[788] Successful joint ventures require, according to several experts, that they focus on specific projects, that rules and inputs are clearly defined, that foreign investors avoid becoming a minority stake holder, and that they involve country experts who can mediate between the different parties from the beginning.[789]

(c) Even today MNCs seem to **often decide against joint ventures** because they want to avoid unclear property situations[790] or damage to their

[785] See e. g. Intv. Germ. MNC - Consulting I (2007).
[786] See Intv. Germ. MNC - Consulting I (2007).
[787] Genco, Taurelli, and Viezzoli (1993).
[788] See Intv. Germ. MNC - Consulting II (2007); Intv. German Econ. Association II (2007); Intv. German Econ. Association III (2007); Intv. Int'l MNC - Utilities (2007); Intv. Romanian Econ. Association I (2007).
[789] See Intv. Germ. MNC - Consulting I (2007); Intv. Germ. MNC - Utilities (2007); Intv. German Econ. Association II (2007).
[790] See Intv. Germ. MNC - Industrial Goods III (2007).

reputation due to quality issues with their Romanian partners.[791] Interviews partly confirm earlier FDI studies and indicate that German entrepreneurs in particular seem to have problems in establishing relationships of trust with Romanian companies because of the different (business) mentality of domestic companies. MNCs have repeatedly made the experience that Romanian firms do not fulfill everything or do not use money the way they agreed to. Experiences of investors show that Romanians tend to want to distribute all profits from the beginning whereas MNCs are more interested in re-investing (some of the) profits.[792] *Intv. Germ. MNC - Legal Services II (2007)* even concludes that they "have not accompanied a single Romanian-German joint venture that was successful so far."

(d) Since there is no legal obligation to form joint ventures in order to access the Romanian market, experts interviewed only see limited **importance** of joint ventures as country determinant for Romania so far. They do not assess the above mentioned problems as deterrence for FDI to Romania because other possible market entry forms like acquisitions or greenfield investments help to circumvent these problems and because past investments rather focused on efficiency-seeking FDI.[793]

(e) In the **assessment** of joint ventures it becomes apparent that a good legal framework alone is not sufficient to overcome differences in business mentality between Romanian and Western European entrepreneurs. One approach to make joint ventures more successful could be the creation of more rigid rules and, for example, making an external mediator compulsory. On the other hand, additional rules may cause additional (opportunity) costs for the

[791] See Intv. Germ. MNC - Consulting II (2007).
[792] See Intv. Germ. MNC - Legal Services II (2007); Intv. Int'l MNC - Utilities (2007); Intv. German Econ. Association VI (2007); Intv. German Econ. Association II (2007); see also Doc - DLA Piper (2006).
[793] Intv. Germ. MNC - Consulting I (2007) mentions China as example for often mandatory joint ventures; see also Intv. Germ. MNC - Consulting II (2007); Doc - Austr. MNC - Industrial Goods III (2005).

companies and make joint ventures less attractive. In any case it seems worthwhile for public policy makers in Romania – but also for academic study that widely neglects this topic – to analyze the future potential for joint ventures, particularly considering the increasing opportunities for MNCs to exploit the Romanian market in cooperation with domestic partners since EU accession, for example in retail.

(4) In **conclusion** Romania's legal but also actual market access conditions have significantly improved in recent years. The conducted interviews have helped to interpret secondary sources and FDI studies in a more comprehensive way and understand that market access has developed from a rather constraining determinant to a neutral or even (indirectly) enhancing determinant for Romania.

7.2.1.3 Croatia

(1) The analysis of Croatia's **corporate law** based on primary as well as secondary sources discloses that (a) Croatia already established high standards early in its transition, (b) investors are satisfied with the current conditions and (c) that corporate law in Croatia has only little importance for the investment decision of investors. Section (d) provides an assessment.

(a) Croatia's corporate law was already largely **established early in its transition** (1993) based on German and Austrian company laws.[794] Most important legal forms for MNCs are the limited liability company (Društvo s ograničenom odgovornošću (d.o.o.)) and the joint stock corporation (Dioničko društvo (d.d.)). In contrast to other countries of the region such as Romania, the Croatian corporate law has already provided various possibilities of partnerships for many years.[795] Amendments in 1999, 2004 and 2006 led to further

[794] See Law no. 111/1993; see Bertelsmann Stiftung (2006b), p.7.
[795] See APIU (2006b), p.29; OECD (2005a), p.18.

harmonizations with EU law and led among others thing to a simplification and acceleration of bankruptcy procedures.[796]

(b) Today, company and state experts interviewed regarding FDI in Croatia **do not see any important obstacles** in Croatia's corporate law for foreign investors. MNCs seem to be satisfied with the possibilities corporate law offers[797] and particularly German and Austrian companies seem familiar with regulations since they are to about 80% identical to their home legislation.[798] Experts also point out that requirements are the same for domestic and foreign investors for company set-ups[799] with exceptions only for companies from non-members of the World Trade Organization (WTO) without reciprocal agreements.[800] Overall, the European Commission also finds that Croatian corporate law is "largely aligned with the acquis"[801] and interviewed state representatives expect the closure of the respective EU accession negotiation chapter by 2008.[802]

(c) Experts interviewed only see **limited importance** of the corporate law for MNCs' decision to go to Croatia. First of all they only find few problems and the remaining issues can easily be outsourced to local lawyers.[803] Moreover, corporate law is not an enhancing factor for Croatia, either; MNCs interested in Croatia seem to expect a good performance from Croatia in this field close to Western European level anyway and the existing conditions meet their expectations but they also do not exceed them.

[796] See e. g. Intv. European Institution (2007); see also APIU (2006b), p.30; European Commission (2005a), p.56; Dresdner Bank (2004), p.7.
[797] See Intv. Croat. Company II - Legal Services (2007); Intv. Croatian Government Team (2007).
[798] See Intv. Croat. Company I - Legal Services (2007).
[799] See Intv. Croatian Government Team (2007); Intv. Croatian Econ. Association (2007).
[800] See APIU (2006b), p.40; Bertelsmann Stiftung (2003a), p.6.
[801] European Commission (2007a), p.29.
[802] See Intv. Croatian Government Team (2007).
[803] See e. g. Intv. Germ. MNC - Engineering (2007).

(d) Interviews confirm the **assessment** based on secondary sources that Croatia has established a reliable corporate law framework. The goal for public policy in Croatia will be to close the respective EU negotiation chapter as quickly as possible in order to level out remaining gaps to competing Eastern European EU members.

(2) With respect to **company registration** Croatia has (a) performed rather poorly in the past and (b) recent reforms also seem to have generated (c) only limited improvements. Nevertheless, (d) experts do not seem to perceive company registration very negatively and only find (e) limited importance for the investment decision of MNCs. Section (f) assesses this section.

(a) Various external reports[804] and expert statements[805] confirm that company registration in Croatia was very cumbersome only **a few years ago**; it was complex, required on average 13 procedures and interaction with many different authorities, and took on average 50 days until completion.[806]

(b) It is undeniable that Croatia has initiated **significant reforms in recent years** to improve company registration procedures.[807] Selective improvements started in 2003 when registration simplifications for SMEs and craft professions were launched. The introduction of a single identification number for companies for all official matters also seems rewarding.[808] Both expert[809] and secondary sources[810] indicate however, that the most significant step of reform in this context has been the establishment of the service unit Hitro as single access point for companies at FINA, Croatia's financial agency, in

[804] See Dresdner Bank (2004), p.7; Bfai (2004), p.58.
[805] See e. g. Intv. German Authority II (2007); Intv. Croatian Ministry II (2007).
[806] See World Bank (2004a).
[807] See also World Bank (2007b); Bertelsmann Stiftung (2006b).
[808] See European Commission (2005a), p.45; Ministry of Economy (2006), p.3; OECD (2006a); OECD (2005a), pp.28, 56; see also Doc - EU Commission Zagreb (2007).
[809] See e. g. Intv. European Institution (2007); Intv. Croatian Ministry II (2007); Doc - EU Commission Zagreb (2007).
[810] See UNCTAD (2006); European Commission (2005a); OECD (2005a).

2005.[811] It seems that the bundling of processes in one institution has already led to somewhat quicker processes, better communication between public and private sectors and less possibilities for corruption.[812] A major advantage for MNCs in this context seems to be that all procedures are now dealt with by one agency[813] and that online services assist the registration process.[814]

A few experts interviewed conclude that Hitro has been one of the most important reforms of Croatia in recent years and that implementation is going well so far.[815] Most experts point out however, that it is too early to evaluate the performance of Hitro or even observe that it has only had limited impact so far[816] and that registrations directly via Hitro still seem to be less common than through external providers.[817] Looking at differences between company and state experts it is interesting to see that both groups acknowledge the establishment of Hitro, but some state experts are more skeptical regarding the authority's impact than most company experts are.[818] State representatives may be little content with a new authority such as Hitro that may weaken existing organizations. Perhaps state representatives also anticipate that the incorporation of Hitro as a dependent unit into FINA may obstruct drives to increase efficiency. The financial agency is a huge apparatus with more than 5,000 employees and strongly influences the registration process.[819] FINA may be predominantly interested in concentrating administrative power but because of its sheer size, incapable of initiating and implementing significant efficiency gains.

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811 The improvements due to Hitrorez will be discussed in section 7.2.3.

812 See Intv. Croat. Company I - Legal Services (2007); Intv. Croatian Company - Real Estate (2007); Intv. Croatian Ministry II (2007); Intv. European Institution (2007); see similar Intv. Austrian Econ. Association II (2007).

813 See Intv. Croatian Ministry II (2007).

814 See Intv. European Institution (2007); Intv. Croatian Government Team (2007).

815 See e. g. Intv. European Institution (2007).

816 See Intv. German Authority II (2007) .

817 See Intv. German Econ. Association IV (2007).

818 See Intv. Former Croatian Minister (2007); Intv. Croatian Ministry II (2007).

819 See FINA (2006); APIU (2006b), p.31.

(c) Despite these mentioned reforms, international statistics show that Croatia's registration **performance continues to be mediocre** considering its long duration (40 days) with only three EECs behind Croatia and many procedures (eight) (*figure 41*).[820] Studies evaluate company registration still as far from optimal and Croatia's goal to register companies within three days by 2008 as very challenging.[821] Major reasons for the slow registration seem to be the overloaded commercial courts and the shortage of judges[822], but maybe also the limited distinction between registering a firm and authorizing business activities.[823]

Further registration problems from the experts' experiences are that a Croatian name is mandatory for the investor's company[824] and that equity transactions need to be registered in only one month.[825] External sources assume that registration without a lawyer is basically impossible[826] and interviews at least confirm that external help is used most of the times in order to avoid problems with language and access to authorities.[827] Last but not least, starting a business is fairly expensive in Croatia. Total costs of starting a d.o.o. add up to 12% of Croatia's GDP per capita, making Croatia the 15th most expensive of 19 EECs.[828]

(d) It may appear astonishing that the **perception** of quite a few experts is more positive than international statistics would suggest.[829] Even though some experts evaluate registration as lengthy[830] several others do not think it

[820] See World Bank (2007a).
[821] See also Jansson (2006a); CICD (2006), p.29; OECD (2005a), p.27.
[822] See OECD (2005a), p.45.
[823] The dealing with permits and licenses will be analyzed in section 7.2.3.
[824] This is supposed to change in 2008; see Intv. German Econ. Association IV (2007).
[825] See Intv. Austr. MNC - Construction (2007).
[826] See OECD (2005a), p.45.
[827] See Intv. European Institution (2007); Intv. Germ. MNC - Engineering (2007).
[828] Costs include all official fees; see World Bank (2007b); see also OECD (2005a), p.45; Bulgaria Economic Forum (2007), p.52; APIU (2006b).
[829] See e. g. Intv. Austr. MNC - Financial Services I (2007); Intv. German Econ. Association IV (2007).
[830] See Intv. Austr. MNC - Consulting (2007); Intv. German Authority II (2007).

is very time-consuming[831] and the vast majority of experts agree that registration time and procedures have clearly improved compared to a few years ago.[832] *Intv. Austrian Econ. Association II (2007)* even expresses that company registration has been a strength of Croatia. Moreover, experts generally state registration times that tend to be below official statistics for Croatia.[833] On the one hand different interpretations may depend on the experience of the MNCs in the market. Experienced MNCs have been involved in Croatia for many years, work with many local managers, are large in size, and may therefore have fewer problems with authorities.[834] On the other hand, MNCs rarely seem to attempt registering without external help in Croatia, also because of the intensive work of some of the foreign Chambers of Commerce like the German one that annually accompanies 15-20 registrations.[835] MNCs therefore do not necessarily experience the problems and obstacles themselves since they outsource all related tasks.

(e) Secondary sources and the many governmental activities in this field since 2005 would imply that company registration is of major **importance** for Croatia, particularly for state actors. Most interviewees however contend that company registration is not of great importance for investors in their decision in deciding for or against Croatia.[836] *Intv. Croat. Company II - Legal Services (2007)* points out that the time to register a company is mainly a political issue and "investors do not really care whether their company will be

831 See Intv. Croat. Company I - Legal Services (2007); Intv. Austrian Econ. Association II (2007).

832 See e. g. Intv. Croat. Company I - Legal Services (2007); Intv. European Institution (2007); Intv. German Authority II (2007).

833 With an average of 3 to 4 weeks instead of 5 to 6 weeks as suggested by World Bank (2007a); see also Intv. Croat. Company I - Legal Services (2007); Intv. Austr. MNC - Construction (2007); Intv. German Econ. Association IV (2007); Intv. Austrian Econ. Association II (2007).

834 See e. g. Intv. Austr. MNC - Construction (2007).

835 See Intv. German Econ. Association IV (2007); see also Intv. Germ. MNC - Engineering (2007); Intv. European Institution (2007).

836 See Intv. Austr. MNC - Financial Services I (2007); Intv. Germ. MNC - Engineering (2007).

registered overnight or within one month" because their investment decision is driven by long-term perspectives. A shorter company registration time is therefore only one piece of an overall reform framework but not substantial "as long as registration does not take six months"[837]. *Intv. Austrian Econ. Association II (2007)* even assumes that the strong emphasis on Hitro may lead to a negligence of more important areas of the business environment.

In contrast to most studies of international organizations[838] and some FDI studies[839], expert interviews also generate some doubts as to whether significant improvements in terms of registration time would lead to higher FDI inflows. Even indirect positive effects, for example, by creating a better image of the bureaucracy as a whole (as discussed for Romania), seem uncertain, since even state experts are skeptical regarding the potential of Croatian authorities to reform.

(f) In the **assessment** of Croatia's company registration procedures, it seems that the establishment of Hitro has not led to significant improvements so far. By contrast, good self-marketing of the Croatian government and MNCs' stronger focus on other determinants for the investment decision may be the reasons why criticism of the mediocre performances has remained limited. Considering the strong progress in neighboring countries public policy actors may, nevertheless, have to further streamline respective processes in order to avoid that company registration becomes a locational disadvantage for Croatia.

(3) This section examines **joint ventures** in Croatia. While (a) the legal possibilities seem sufficient, (b) MNCs' experiences with joint ventures and (c) their importance for FDI tend to vary by sector. Section (d) provides an assessment.

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[837] Intv. Former Croatian Minister (2007); similar Intv. Croatian Ministry II (2007); see for a more positive assessment Intv. European Institution (2007).

[838] See EBRD (2005a); OECD (2006a); World Bank (2005); UNCTAD (1998).

[839] Despite the lack of explicit statements for Croatia; see e. g. Kalotay (2000).

(a) Business partners can choose from **different legal types** of joint ventures depending if the partners want to establish a legal entity or not.[840] Expert interviews confirm that these possibilities are generally sufficient for their activities.[841]

(b) Expert interviewees reveal that MNCs' **experiences** with joint ventures depend on the business sector. While joint ventures in construction, for example, seem to be common and to run without major difficulties[842], problems in other areas such as the banking sector or in the production of industrial goods may be more frequent and often even lead to failures.[843] Different expectations and business mentalities seem to make establishing and implementing common statutes challenging.[844] Apart from the interaction with Croatian firms, MNCs often seem frustrated by Croatian authorities in this context. They often perceive that authorities give local companies preferential treatment; examples are the evaluation of assets or the distribution of work shares and responsibilities in public tenders that involve joint ventures.[845] Furthermore, company experts seem to be more aware of difficulties with joint ventures than state experts, as suggested by the content of the interviews but also by the fact that company experts were more likely to speak unprompted about these difficulties in the semi-structured interviews.[846]

(c) The **importance** of joint ventures seems to be limited – similar to Romania – for the investment decision in most sectors, since other forms of market entry such as acquisitions are possible and generally more rewarding.[847] On

[840] See APIU (2006b), p.29; OECD (2005a), p.18.
[841] See e. g. Intv. Austr. MNC - Construction (2007).
[842] See Intv. Austr. MNC - Construction (2007).
[843] See Intv. Croat. Company II - Legal Services (2007); Intv. Germ. MNC - Food Products (2007); Doc - Germ. MNC - Food Products (2007).
[844] See Intv. German Econ. Association IV (2007).
[845] See Intv. Germ. MNC - Food Products (2007); see also Intv. Austr. MNC - Construction (2007).
[846] See e. g. Intv. Croat. Company II - Legal Services (2007).
[847] See e. g Intv. Germ. MNC - Food Products (2007); Doc - Germ. MNC - Food Products II (2007).

the opposite, conditions for joint ventures are essential for the construction industry but they generally meet the expectations of the investors.[848]

(d) In the **assessment** of this section it seems that the performance of local authorities may be more important for the success of joint ventures in Croatia than, for instance, in Romania. Public policy actors may thus work on more transparent procedures whenever state actors are involved and improve local training to increase equal treatment in the interaction with foreign and domestic firms.

(4) In **conclusion** market access seems to be no major hurdle for investors interest in the Croatian market even though deficiencies in company registration and partly regarding joint ventures leave room for further improvements. However, interviews may have contributed to a more thorough interpretation of the rather pessimistic picture of secondary sources. As a consequence, this section provided numerous arguments suggesting that the importance of the market access determinant is limited or even over-estimated for Croatia.

7.2.1.4 General insights for transition countries

This section presents generalizable results for transition countries regarding (1) corporate law, (2) company registration, (3) joint ventures, (4) the importance of market access as FDI determinant, and (5) the influence of state actors. This section also discusses country-specific deviations from the analysis of Romania and Croatia as well as misperceptions between MNCs and state actors.

(1) The analysis of Romania and Croatia as well as the evaluation of further literature on transition countries reveals that satisfaction with **corporate law** conditions seems to be present when regulations are based on Western European standards, a harmonization with EU is at least initiated and when

[848] See Intv. Austr. MNC - Construction (2007).

too frequent changes are avoided. Most transition countries seem to have made serious improvements in this respect in recent years. As a result, MNCs seem to be content with the flexibility and possibilities of corporate law in transition countries. In most cases conditions for domestic and foreign company registration are also comparable.[849]

(2) Performance in **company registration** procedures seem to vary strongly across transition countries with Romania and Croatia as two rather contrasting examples. Benchmark indicators for good conditions in transition countries seem to be a registration time of about two weeks, less than nine procedures involved and costs that represent less than 6% of the host country's GDP per capita.[850] Important drivers seem to be the establishment of legally binding maximum response times for administrations and a distinction between the company registration and business authorization process.[851] Furthermore, online registration may help facilitate the process; while their impact in transition countries may not be fully visible so far, future positive effects can be expected considering the successful experiences in other regions.[852] Apparently the rising number of international statistics also adds to awareness – state interviewees frequently mentioned them –, transparency and a positive competition among host countries for favorable investment conditions.

Even more crucial for a well functioning company registration process is an effective organizational set-up. Many transition countries have opted for one-stop shops that are generally interpreted as drivers for successful FDI promotion.[853] However, this section and various other studies show that success is far from self-evident, especially when the establishment of the one-stop shops

[849] See e. g. Sinn and Weichenrieder (1997); OECD (2005a); European Commission (2006b).
[850] Figures reflect a current performance among the best of Eastern European transition countries; see World Bank (2007a).
[851] See e. g. OECD (2005a).
[852] See e. g. for Asia Jacobs (2003); Japan Bank for International Cooperation (2002).
[853] See e. g. UNCTAD (1998).

does not remove underlying administrative barriers.[854] The example of Croatia also shows that a single authority can have a positive impact on a country's image but does not automatically lead to a reduction of required procedures or registration time; at the worst one-stops may be an additional registration hurdle.[855] Governments may either establish a new authority or integrate the one-stop shop in an existing authority.[856] In any case, studies point out that registration authorities need legal independence and skilled staff with a positive mindset towards entrepreneurship.[857] Company registration seems quite difficult without external help in transition countries and is usually outsourced by MNCs. Private one-stops may often have good access to investors but seem to lack adequate government authorities.[858] By contrast in Romania, smaller and cost-driven investors more frequently try to save money and conduct the (fairly) easy company registration process themselves. In other countries the need for external help may be a deterrence for smaller MNCs.

(3) For **joint ventures** transition countries tend to have an adequate general legal framework in place. Nevertheless, joint ventures often seem to fail, partly because of mentality differences as in Romania, or because of problems with the implementation on the local administrative level as in Croatia. Due to these experiences MNCs often prefer greenfield investments or acquisitions over joint ventures.[859] Public actors may invest in stricter rules of conducts or may even make a mediator compulsory in order to promote this form of cooperation.

(4) The analysis of the **importance** of the market access for transition countries focuses on company registration and distinguishes between the general business environment and the FDI inflows. It seems incontestable that a refined registration process and low entry regulations are important for better

[854] See e. g. Morisset and Neso (2002).
[855] See also Rajan (2004); World Bank (2007a); UNCTAD (1999).
[856] The often used investment promotion agencies will be discussed in section 7.3.5.
[857] See UNCTAD (1999); OECD (2005a), p.24; OECD (2006a); OECD (2006b).
[858] See Jacobs (2003); te Velde (2001).
[859] See also UNIDO (2003); Lankes and Venables (1996); Ferencikova (2002).

business conditions. Most transition countries have elaborated relevant agendas because they acknowledge that fast and transparent company registration fosters private sector development and decreases corruption and grey market economy.[860]

Various studies also see evidence that a smoother company registration and the introduction of one-stop shops stimulates FDI inflows to host countries in general[861] and to transition countries in particular[862] even though only few FDI studies actually consider this factor.[863]

In some transition countries unfavorable registration conditions may indeed have deterred potential investors from investing, for example in Romania in the 1990s.[864] For most transition countries there seems to be a threshold of minimum conditions that have to be met before the registration environment turns from a constraining factor to a neutral or unimportant factor (as in Croatia). Constraining factors could exist if corporate law rules provide unequal treatments of domestic and foreign investors or if registration takes more than four months.[865] In some countries in transition a superior registration performance may even have an enhancing effect, particularly in countries in which investors are rather skeptical regarding investment conditions and the quality of administration in general.[866] Attractive conditions for MNCs may generate the expectation of efficient subsequent administrative steps and even higher FDI inlows. By contrast, in other transition countries such as Croatia a better performance may have only limited impact since investors would probably expect fairly good conditions there anyway. Nevertheless, a worse performance is unlikely to have

[860] See e. g. OECD (2005a); UNCTAD (2002).
[861] See e. g. Dunning (2002); Dunning (2005).
[862] See Falcetti, Sanfey, and Taci (2003), p.21; Garibaldi, Mora, Sahay, and Zettelmeyer (2001).
[863] AHK (2006), for example, covers 26 factors but not market access.
[864] See Genco, Taurelli, and Viezzoli (1993).
[865] See also te Velde (2001).
[866] See also Kalotay (2000); OECD (2005a), p.11.

a constraining effect on FDI flows, as long as Croatia's registration conditions does not dramatically deteriorate.[867]

Furthermore, registration time and costs may be important for SMEs and those investors who want to start production as quickly as possible in order to exploit the envisaged cost advantage.[868]

Overall, the direct importance of this determinant may be somewhat overestimated by international organizations and some state experts and – if a certain threshold is reached – is rather a "nice to have" without decisively influencing the investment decision of MNCs in favor of a specific transition country.

(5) **State actors** have significant **influence** on the design of market access to transition countries, particularly with regard to corporate law and company registration, while they only seem to have limited possibilities to make different forms of cooperation such as joint ventures successful. This analyses of this section indicate that implementation is more crucial for transition countries than the establishment of the legal environment and also requires more strategic planning for the entire process and more and well-qualified staff than the draft of the respective laws. Particularly the creation of a new authority as one-stop shop may also cause rivalries among state authorities that encumber reforms. Governments in transition countries also may not under-estimate the potential of local authorities (as in Croatia) to actively influence market access conditions in order to pursue their interest.[869]

On the other hand, state actors may not run the risk of neglecting other important fields of reform. Despite the advantages of a lean registration process it is questionable whether laborious administrative efforts, for example, to reduce

[867] E. g. with registration times longer than four months.
[868] See e. g. Intv. Austr. MNC - Consumer Goods (2007); Intv. Germ. MNC - Industrial Goods III (2007).
[869] See also OECD (2005a), p.23.

registration time by two days actually generate significant additional benefits for companies.

Finally, it seems that favorable market access is an issue actively dealt with by most transition countries in recent years regardless of their current transition status or their integration with the EU. Romania, for example, initiated most of the reform facilitating company registration before the reform wave aiming at EU accession.

7.2.2 Property rights

7.2.2.1 Definition

Investors consider **property rights** in host countries like Romania (*7.2.2.2*) and Croatia (*7.2.2.3*) to be favorable if (1) property laws provide satisfactory rights for investors, (2) if land registration and (3) construction permit procedures are quick and transparent. Sub-sections (4) provide country conclusions and *section 7.2.2.4* reveals findings for transition countries.[870]

7.2.2.2 Romania

(1) Expert interviews and documents as well as secondary sources suggest that Romanian **property law** (a) was a key constraint for investors in the past, (b) but significant reforms have been initiated since 2005 and (c) restitution cases represent one of the few remaining obstacles. Overall, (d) the importance of property law has decreased for MNCs' investment decision. Sub-section (e) comprises an assessment.

(a) **Legal history** shows that Romania's property law and particularly foreigners' right to purchase land has been a sensitive and very political topic since the end of communism.[871] The right to own property was originally based on

[870] See for this section also OECD (2006b), p.13; World Bank (2004b), pp.1, 9, 85.
[871] See Maniu, Kallai, and Popa (2001), p.36

Law no. 18/1991 but excluded – like the constitutional amendment of 2003 – any equivalent rights for foreigners.[872] Some state interviews suggest that property rights were no major deterrence in the past after all, but interviews with company experts on the contrary, reveal conclusively that sometimes MNCs already present in Romania even warned potential investors of coming to the country because of the worrisome property law situation.[873] Accordingly, legal access to property was still difficult for MNCs, restitution claims of property from socialist times were frequent and the future of the legal development was unsure until the early 2000s.[874] As a consequence some investors decided to rent instead of buying land and often chose a location in a free zone owned by the state in order to avoid legal issues with former private owners.[875]

(b) According to the experts interviewed, Romania's property law situation has significantly improved for MNCs **since about 2005** when integration towards the EU pressured Romania to liberalize its legislation. Experts recognize improving conditions in property law for investors and also a decrease in changes in regulations. Since EU accession in 2007 EU nationals and entities with residency in Romania can acquire land in Romania under the same conditions as Romanians[876] and experts interviewed agree that complaints about legal conditions for land and property purchase have become rare and no longer represent an obstacle for investments.[877] Many interviewees even perceive the current conditions as fairly liberal.[878] FDI studies and international statistics

[872] Law no. 429/2003 and article 44 of the Romanian constitution.

[873] See Intv. Germ. MNC - Legal Services II (2007); Intv. Germ. MNC - Consulting I (2007); Intv. German Econ. Association V (2007); Intv. Romanian County Council (2007).

[874] See Intv. German Econ. Association V (2007); Intv. Germ. MNC - Industrial Goods III (2007).

[875] See Intv. Austr. MNC - Industrial Goods I (2007); see for a different approach Intv. Germ. MNC - Retail (2007); Intv. Austr. MNC - Primary Goods II (2007).

[876] See Law no. 312/2005; see also PI Partners (2007), p.65; Stalfort (2005).

[877] See Intv. Germ. MNC - Legal Services II (2007); Intv. German Econ. Association II (2007); Intv. Germ. MNC - Legal Services I (2007); Intv. German Econ. Association VII (2007); Intv. German Authority I (2007); Intv. Romanian County Council (2007).

[878] See e. g. Intv. Germ. MNC - Automotive (2007); Intv. Romanian County Council (2007); Intv. Supranational Authority I (2007).

also confirm the experts' statements that Romania's weak property rights performance until the early 2000s[879] and significantly improved by 2006 with a BTI score of 9 out of 10 points (*see figure 92 in appendix*).[880]

(c) According to both primary[881] and secondary sources[882], **restitution cases** represent one of the remaining negative aspects of property law in Romania. Persisting problems in this context are the lack of consistency in jurisprudence and difficulties in the evaluation of land and property appreciation.[883] These respective problems seem to have become somewhat less significant since the introduction of a legal framework (Law no. 10/2001) and recent modifications in accordance with EU demands. MNCs also seem less involved in restitution disputes than in the past.[884]

A further remaining problem with property law is that EU citizens – unlike companies – without residency in Romania are not permitted to purchase land and farming land until five and seven years after EU accession respectively.[885] And even after this period the purchase of land by foreigners can be limited by Romanian authorities, for example, according to Government Ordinance (GO) no. 92/97 that requires economic reasons for the land purchase by foreigners.[886]

(d) Overall, property law seems to have been quite an **important** constraining determinant for Romania from the expert's view until the early 2000s, particularly when investors wanted to start production quickly.[887] This effect

[879] See e. g. Pierpont (2007) for 2003 with Romania clearly trailing behind Hungary and Poland; see also McGee (2003).
[880] Only issues of outstanding implementation of the regulation regarding foreign ownership seem to have prevented a full score; Bertelsmann Stiftung (2006c).
[881] See Intv. Germ. MNC - Consulting I (2007); Intv. Germ. MNC - Legal Services II (2007); Intv. German Econ. Association VII (2007); Intv. Supranational Authority I (2007).
[882] See also OECD (2005d), p.49; Bfai (2005), p24; European Commission (2006e), p.4.
[883] See e. g. Intv. Austr. MNC - Legal Services (2007); Intv. Germ. Research Institute I (2007); see also Doc - GTZ (2006b).
[884] See Law no. 247/2005; Brenscheidt (2006).
[885] See PI Partners (2007), pp.65-66.
[886] See BA-CA (2006), p.47; Dresdner Bank (2004), p.22.
[887] See Intv. Germ. MNC - Industrial Goods III (2007); Intv. Austr. MNC - Industrial Goods I (2007); Doc - GTZ (2006b).

described by company experts is also generally affirmed by *UNCTAD (2004b)* and *Pierpont (2007)*.

It seems however, that the alignment with EU law functioned as a threshold for Romania, beyond which property law as country determinant for Romania decreased in significance. This evaluation also casts doubts on the assertion of some state representatives interviewed who even interpret the alignment with EU law as a major determinant in favor of Romania.[888]

(e) An **assessment** of property law shows that Romania may have introduced legal reforms too late for many risk-averse investors who decided to rather invest in Hungary etc. in the 1990s. However, the prohibition of the purchase of land by foreigners was probably not the greatest problem since MNCs were able to circumvent regulatory problems fairly easily by establishing a Romanian firm. Rather problems tended to occur after the land purchase and involved issues that were interlinked with other determinants such as land register and the legal system (see next sub-section and *section 7.2.4*). Public policy should keep these interdependences in mind and may also focus on a fast closure of all remaining restitution issues by setting clear dates for retroactive claims.

(2) While the legal environment for property rights seems largely in place in Romania, important deficiencies exist on the administrative level, namely regarding **land registration**.[889] Some (a) general problems endure, even though (b) regional differences exist and (c) some reforms have been initiated. Yet, (d) Romania's performance remains weak in this field which also has (e) significant impact on land registration as determinant for FDI. An assessment is provided in sub-section (f).

[888] See Intv. Romanian County Council (2007).
[889] The same issues apply for property registration that also has to be executed by Romania's Land Registry Office; see also World Bank (2007b).

(a) Romania's **general problems** with a functioning land registry and its slow reform process were criticized from early on by external observers such as the EU Commission.[890] Experts interviewed were concerned that land registers do not exist for every region, that entries are often ambiguous and not always reliable.[891]

(b) In a **regional comparison** within Romania it seems that land registration is more transparent and more reliable in Transylvania, where a similar system existed for many centuries, than in other parts of the country. These regional differences may also stem from the fact that land registration has not been seen as a task of central state authorities for a long time.[892]

(c) However, some **improvements** have been made recently, for example, by introducing land registers, consistent regulations and an electronic registration system across the country.[893] Furthermore, Law no. 247/2005 attempts a further acceleration and simplification of the compilation process of the land registers.[894] As a result, experts notice that title checks are now somewhat easier.[895]

(d) Nevertheless, Romania's land registration **performance remains weak**. Experts stress that trust in land registration is still limited, that legal verification – also in Transylvania – is still necessary and that the situation is still not comparable to Western Europe. Interviewees are also skeptical regarding the success of the electronic land register since it is not certain that all cases and

[890] See e. g. European Commission (1998), p.32; European Commission (1999), p.45; European Commission (2003), p.67.
[891] See e. g. Intv. Austr. MNC - Industrial Goods I (2007); Intv. Germ. MNC - Retail (2007); Intv. German Authority IV (2007).
[892] See Intv. Germ. MNC - Retail (2007); Intv. Germ. MNC - Legal Services II (2007); Intv. Germ. MNC - Legal Services I (2007); Intv. German Authority IV (2007); Intv. Germ. MNC - Consulting II (2007).
[893] See e. g. Law no. 18/1995; Law no. 7/1996.
[894] See Brenscheidt (2006); Dresdner Bank (2004).
[895] See Intv. Germ. MNC - Legal Services I (2007); Intv. Germ. MNC - Legal Services II (2007); Intv. German Econ. Association V (2007); Intv. Germ. MNC - Retail (2007); Intv. Austr. Research Institute (2007); Intv. Supranational Authority I (2007).

communities have been covered yet.[896] As for company registration, working with internal[897] or external lawyers[898] seems necessary, not least to overcome language barriers. Lawyers may also become essential when unclear ownership status or counterfeited titles require lawsuits.[899]

The skepticism regarding the quality of the land registry process in Romania by the interviewees is also reflected by international statistics. As presented in *figure 42* land or property registration takes 150 days in Romania (2006/2007) and is a far quicker process in neighboring countries such as Bulgaria (19) and Ukraine (93). Improvement since 2004 has been gradual (170 days).[900] In contrast, registration costs of property seem to be on the same level in Romania as in the average of EECs (2.8% of the property value).

(e) While external studies tend to suggest that land registration is **important** for FDI[901], expert interviews can specify these findings for Romania. Some interviewees, for instance, believe that the fairly good register situation is one reason for the strong focus of (German) investors on the Sibiu region.[902] The land register situation also appears to represent a key issue for investors in Romania who frequently buy real estate or who want to start production quickly.[903] Interestingly, some investors may actually over-estimate the importance of the land register issue. *Intv. Germ. MNC - Legal Services I (2007)* reports, for instance, that German investors occasionally want too many proofs regarding the ownership situation and occasionally even call off

[896] See Intv. Germ. MNC - Legal Services I (2007); Intv. German Econ. Association VI (2007); Intv. Germ. MNC - Retail (2007); Intv. Germ. MNC - Legal Services II (2007); Intv. German Authority IV (2007); Intv. German Political Adviser (2007).
[897] See Intv. Germ. MNC - Retail (2007).
[898] See Intv. Germ. MNC - Industrial Goods III (2007); Intv. Germ. MNC - Legal Services I (2007).
[899] See Intv. Germ. MNC - Automotive (2007); Intv. Germ. MNC - Legal Services I (2007); Intv. Austr. MNC - Primary Goods II (2007); Intv. German Econ. Association VI (2007).
[900] See World Bank (2004b), p.249.
[901] See e. g. for six transition countries Dale and Baldwin (2000); Pierpont (2007); Kikeri, Kenyon, and Palmade (2006).
[902] See Intv. Germ. MNC - Legal Services II (2007).
[903] See Intv. Germ. MNC - Retail (2007); Intv. Germ. MNC - Industrial Goods III (2007).

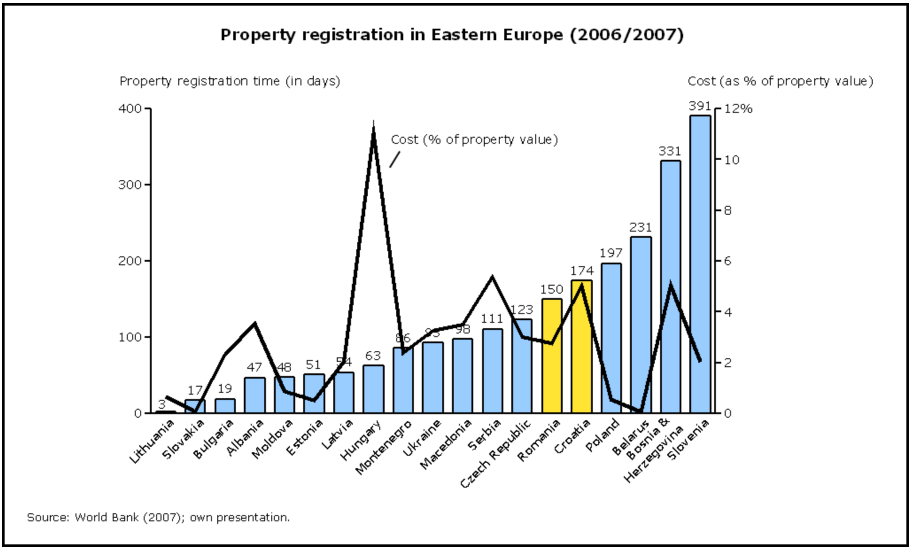

Figure 42: Property registration in Eastern Europe

a planned investment despite fairly clear register entries. In contrast, other investors, particularly Austrians, seem to be more willing to take risks.[904]

(f) In the **assessment** of Romania's land registration performance it seems unavoidable that public policy makes this field a key priority in their efforts to establish a favorable environment for FDI in Romania. Only the creation of a comprehensive and complete registration system will enable a more equal distribution of FDI within Romania (*see section 6.2.1*). In addition to existing studies, interviews show that public policy could pay more attention to the specific needs of certain country groups, for example, by prioritizing reform efforts (and maybe increasing staff) in regions of specific potential interest to German investors.

[904] See Intv. Germ. MNC - Legal Services I (2007).

(3) Romania's performance regarding **construction permits**[905] seems to be (a) quite satisfactory for investors, partly because (b) related procedures are quite liberal; however, (c) regional deviations exist. Construction permits seem to have an (d) average importance as an FDI determinant for Romania. Sub-section (e) gives an assessment.

(a) Overall, Romania seems to **perform fairly well** on construction permit procedures. Statistics indicate that it takes on average 30 days to receive a permit. This puts Romania in a good position compared with competing EECs such as Ukraine (30 days) and Hungary (60).[906] Figures regarding building permits should be handled with care since additional steps such as locational permits[907] may exist, which can lead to a difference in the total amount of time necessary to complete the construction of any project, for instance, of a plant. Nevertheless, various interviewees state that, overall, approvals seem to be granted more quickly in Romania than, for example, in Germany or Austria.[908]

(b) A further major advantage seems to be that construction regulations are **quite liberal**. Experts interviewed refer to the fact that regulations have basically no restrictions regarding what may be built on the real estate.[909] As a consequence, constructions without permission seem to be rare.[910] A downside in this context is that some state decision sometimes seem arbitrary since urban development plans are often modified for short-term interests.[911] Despite flexible regulations MNCs also repeatedly run the risk of committing errors

[905] Also called building permit; see World Bank (2007b).
[906] Figures for 2006/2007; see World Bank (2007b).
[907] E. g. locational permits are necessary in Croatia and in Ukraine; see World Bank (2007b).
[908] See Intv. Austr. MNC - Industrial Goods I (2007); Intv. Germ. MNC - Legal Services I (2007); Intv. German Econ. Association VII (2007).
[909] See Intv. German Econ. Association V (2007).
[910] See Intv. Germ. MNC - Legal Services II (2007).
[911] An example from Bucharest would be the change of designation of a park to construction land; see Intv. Germ. MNC - Consulting II (2007).

because the provision of technical requirements differ from most Western European countries. Thus many MNCs rely on external advisers or lawyers.[912]

(c) Particularly company experts pointed out that the speed of construction permits in Romania seems to depend on the **region** or even on the community in question.[913] In some rural areas in Western Romania, for example, investors had very positive experiences with easy processes and approval times of only six weeks.[914] In other regions construction permits still follow rather intransparent procedures and can require up to six months. One example is in Bucharest where delays are caused by the large work load of the administration.[915]

(d) FDI studies and international reports suggest that construction permit procedures have an average **importance** for the FDI decision of MNCs in transition countries in general.[916] Interviews confirm this evaluation for Romania, suggesting that construction permits are seen as part of a set of permit procedures that are unavoidable and laborious in most countries. Romania's fairly decent performance means that this aspect does not have a strongly deterring effect on potential investors.

(e) In the **assessment** of its construction permit procedure Romania seems to have attained an acceptable level in comparison with neighboring competing countries. Furthermore, investors are generally already in the country when they deal with these issues and will generally not pull out of the investment anymore. Nevertheless, room for improvement remains including a further streamlining of procedures and a better leverage of regional best practice

[912] See Intv. Germ. MNC - Legal Services II (2007); Intv. German Econ. Association V (2007).
[913] See e. g. Intv. Germ. MNC - Consulting II (2007).
[914] See e. g. Intv. Austr. MNC - Industrial Goods I (2007).
[915] See Intv. Germ. MNC - Legal Services I (2007); Intv. Germ. MNC - Consulting II (2007); Intv. German Econ. Association VII (2007).
[916] Insights for Romania are scarce; see for transition countries Coolidge (2003); Demekas, Horváth, Ribakova, and Wu (2005); Kikeri, Kenyon, and Palmade (2006); OECD (2005a).

experiences for cities like Bucharest.

(4) In **conclusion** property rights are a key determinant for the FDI decision of MNCs in Romania. The late introduction of reform measures has been an important constraining factor, particularly for more risk-averse investors. Earlier centralized measures to create a consistent framework would also have helped to avoid regional disparities. The importance of the legal framework may have decreased since Romania's accession to the EU but related downstream issues such as restitution and land registration are still crucial and far from optimal. Interviews in particular helped to elaborate home country specific differences and highlighted again the need for external help for the early stages of investments in Romania.

Overall, Romanian public policy should put more emphasis on the role of property rights in creating a favorable investment environment and give more recognition to the interdependence with factors such as quality of bureaucracy and legal certainty (*see subsequent sections*).

7.2.2.3 Croatia

(1) Croatia's **property law** situation has been (a) relatively unsatisfactory for investors in the past and despite some (b) recent improvements, it is (c) still a cause for major concerns for MNCs and (d) of continuing significance to their decision to invest. Sub-section (e) provides an assessment.

(a) Croatia's property law situation was **relatively unsatisfactory** for investors **in the past**. Despite the introduction of a private property regime in 1993, the adoption of a new law of ownership and other proprietary rights in 1996 and the guarantee to acquire and own property in Croatia's constitution (article 48)[917], even state experts acknowledge in interviews that clear

[917] See Law no. 91/1996; see also Bertelsmann Stiftung (2006b); European Commission (2007a), p.12; European Commission (2005a), pp. 19 and 89.

regulations and procedures regarding land and real estate purchase were often missing even in the early 2000s.[918]

Furthermore, foreigners interested in Croatian property suffered from various restrictions. Generally the acquisition of real estate by foreigners was only possible if reciprocal agreements with their home country existed.[919] Until the early 2000s the acquisition of Croatian land required the approval of the Ministry of Foreign Affairs.[920] Moreover foreigners were discriminated in areas dominated by the state, such as air transportation and tourism.[921] FDI studies point out that Croatia has attempted to discourage Italian investors in particular by creating legal and administrative barriers to investment at the coast. In contrast, resentment towards German and Austrian investors seems to have been less frequent.[922] Interviews[923] also confirm the reports of external sources[924] which state investors repeatedly suffered from restitution claims. Many investors were therefore afraid to "buy something that you do not own"[925].

The situation was further aggravated by many illegitimate seizures of land and property during as well as after the war. The large number of cases and weaknesses in the court system led to a significant backlog of untreated cases (*section 7.2.4*).[926] An FDI survey from 2003 reveals Croatia's fairly weak property rights performance, which is on the same level as Serbia and Romania and behind that of Moldova and Bulgaria.[927]

918 See e. g. Intv. Croatian Ministry II (2007).
919 See APIU (2006b), p.40; see also Intv. Croatian Ministry II (2007).
920 See European Commission (2005a), p.90.
921 See European Commission (2005a), pp.52-53; European Commission (2006a), p.27.
922 See e. g. Sinn and Weichenrieder (1997).
923 See Intv. Germ. MNC - Telecommunications (2007); Intv. Croat. Company - Utilities (2007).
924 See European Commission (2005a), p.14.
925 Intv. Germ. MNC - Engineering (2007).
926 See European Commission (2005a), p.28.; European Commission (2006a), p.10; European Commission (2007a), p.12; FIAS (2002), p.41.
927 See McGee (2003).

(b) Both external sources and interviews stress that **important progress** has been made in terms of reforming Croatia's property law in the last couple of years.[928] Amendments of the Property Act in 2005 and 2006 appear to be a step in the right direction.[929] The newly established right of EU nationals (legal persons and individuals) to purchase land and real estate in Croatia is seen not only as an important improvement for Croatia's investment environment but also as an important step towards EU accession.[930] External studies conclude that general property rights are well defined by now and their enforcement is beginning to cause less problems.[931] Croatian interviewees also emphasize, as was the case for Romania, that some problems and restrictions can be avoided when MNCs establish a Croatian company.[932] An Austrian retail company, for instance, has not had any major legal problems with property purchased since 2005.[933]

(c) Nevertheless, both primary[934] and secondary[935] sources show that Croatia's property law continues to present **significant challenges**. The fairly high BTI score of 9 out of 10 points (which gives Croatia the same score as Romania and an even better one than neighboring non-EU countries like Bosnia and Serbia) may be misleading in this context (*see figure 92*). *European Commission (2007a)*, for example, emphasizes that Croatia's legal framework may be well advanced, but difficulties in exercising property rights are still prevalent. Some state experts interviewed even mention property regulations as the area with

[928] See e.g. Intv. Austr. MNC - Real Estate (2007).
[929] See European Commission (2006a), p.29.
[930] See Intv. Croatian Ministry IV (2007); Intv. German Econ. Association IV (2007); Intv. Germ. Research Institute II (2007); European Commission (2007a), pp.6, 28; Ministry of Economy (2006).
[931] See Bertelsmann Stiftung (2006b), p.8.
[932] See Intv. Croatian Ministry II (2007); Intv. German Econ. Association IV (2007).
[933] See Intv. Austr. MNC - Retail (2007); he does admit that they decided not to purchase several pieces of land, when they were not sure of the ownership situation.
[934] See Intv. Germ. MNC - Industrial Goods I (2007); Intv. Austr. MNC - Consulting (2007).
[935] See Bertelsmann Stiftung (2006b), p.8.

the greatest problems for investors.[936] Property regulations still lack transparency in many cases and are often seen as contradictory.[937] Interviewees also call for better coordination between state and regional authorities and a swifter implementation.[938]

Moreover, certain limitations on foreign ownership (even for EU nationals) continue to exist, including restrictions for the purchase of agricultural land, forests and protected parts of landscape.[939] This problem is also confirmed by state representatives.[940] Company interviewees are particularly irritated by continued resentment towards MNCs at the coast, where both legal and administrative means are used in order to prevent foreign investors from buying land or houses.[941] As interviewees point out, the paradoxical situation is especially clear in tourism. On the one hand, a large number of hotels awaits privatization and Croatia needs foreign investors and hotel chains to stimulate economic growth.[942] On the other hand, the legal situation of many hotels and of the land on which they stand is not always clear. In addition to this, foreigners are frequently given only limited property rights (such as hereditary construction titles) which are not very attractive for investors.[943] Furthermore, it seems that specific problems regarding restitution claims of Serbs remain.[944]

Finally, interviewees and external sources stress that MNCs remain reluctant to go to court to implement their rights because of the continued long duration of trials[945] and because they may be worried about biased verdicts.[946]

[936] See Intv. Croatian Mayor (2007); Intv. Croatian Authority I (2007); Intv. Croatian Authority II (2007).
[937] See EBRD (2005a), pp.23 and 59.
[938] See e. g. Intv. Germ. MNC - Telecommunications (2007).
[939] See European Commission (2005a), p.19; European Commission (2006a), p.29.
[940] See e. g. Intv. Croatian Authority I (2007); Intv. Croatian Authority II (2007).
[941] See Intv. Austr. MNC - Financial Services I (2007); Intv. German Authority II (2007).
[942] See Intv. European Institution (2007).
[943] See Intv. German Authority II (2007).
[944] See Intv. Croatian Authority I (2007).
[945] Despite a reduction of the case backlog; see European Commission (2005a), pp.15 and 85.
[946] See Intv. European Institution (2007); see also Bertelsmann Stiftung (2006b), p.8.

(d) Both external studies[947] and most interviews – company and state – conclude that the difficult property law situation was and still is a very **important and discouraging factor** for the investment decision of MNCs interested in Croatia. Property rights therefore belong to the weakest points of Croatia's investment environment.[948]

Experts agree that a clear ownership situation is absolutely necessary for any investment in Croatia.[949] The unsatisfactory situation has been quite a significant deterrence for Croatia so far[950] and for one German investor interviewed was even the main reason for their decision not to invest in Croatia.[951] More specifically, *Intv. European Institution (2007)* points out that FDI in tourism could have been a lot higher if all existing property law problems had been resolved years ago. It also seems that sporadic efforts at the coast to keep some groups of foreigners away with questionable methods tend to discourage investors overall.[952] In this context it is interesting to see that state experts are very aware of the legal problems and confirm that investors look at the property rights situation first when making their investment decision.[953]

(e) An **assessment** of Croatia's property law performance makes its mediocre performance apparent. Interviews are particularly useful for showing why the legal reality is still worrisome despite some recent legal changes. In this context, it is striking that even state representatives interviewed admit that property rights are still among the greatest problems for investors. It seems that (unlike in Romania) Croatia's authorities have specific problems in enforcing equal and unbiased treatment of foreigners on the local level. Finally,

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947 See e. g. FIAS (2002); McGee (2003); European Commission (2007a), p.20.
948 See also Bertelsmann Stiftung (2006b), pp.1-3; UniCredit Group (2006), p.8.
949 See Intv. Germ. MNC - Engineering (2007); Intv. Germ. MNC - Telecommunications (2007).
950 See Intv. Former Croatian Minister (2007).
951 See Intv. Germ. MNC - Engineering (2007).
952 See Intv. Int'l Research Institute I (2007).
953 See e. g. Intv. Croatian Mayor (2007); Intv. Former Croatian Minister (2007).

this sub-section implied that Croatia's property law situation is – even more than in Romania – interrelated with other determinants, namely privatization, the court system and natural resources. A comprehensive strategy, most notably for tourism, will have to be a priority for public policy that covers all related aspects.

(2) **Land and property registration** are a further reason for Croatia's weak performance with respect to property rights. The situation (a) has been intransparent for many years and (b) recent reforms have had (c) only limited impact so far. Land registration (d) remains an important constraint for MNCs' investment decision for Croatia. An assessment is presented in sub-section (e).

(a) Croatia's **intransparent land registers** represented a significant problem in the early stage of transition.[954] Croatia had a land registration and cadaster office that was established during the period of Austrian governance. However, people did not register their property during socialist times, the land registration was outdated by 1990[955] and a legal basis was not established until 1996.[956] Interviews[957] and external[958] sources confirm that (even in the early 2000s) regulations were far from consistent, registers did not necessarily show the actual ownership status and entries were far from complete. Problems were caused during privatization when buildings were registered but not the land on which they were built.[959] These difficulties seem to have been similar everywhere across the country. State representatives claim that Croatia had to cope with more important issues such as the war and the economic stabilization and

[954] See Bertelsmann Stiftung (2006b), p.3; OECD (2003a), p.9; FIAS (2002).
[955] See Intv. German Econ. Association IV (2007);Intv. Croatian Ministry IV (2007).
[956] See Law no. 91/1996.
[957] See Intv. Croat. Company II - Legal Services (2007); Intv. Croatian Ministry I (2007).
[958] See e. g. FIAS (2002); OECD (2003a), p.18; Dresdner Bank (2004), p.7.
[959] See also Intv. Croatian Authority I (2007); Intv. Croatian Ministry II (2007); Intv. Croatian Ministry IV (2007).

therefore had to postpone decisive reforms for many years.[960] They also assert that central authorities like the Ministry of Justice had only limited possibilities for improving the register situation. Owners are encouraged to register their property themselves without external pressure.[961]

(b) Some **improvements** have been noted in external sources[962] and interviews.[963] Reforms started in 2000 and were partly supported and co-financed by the World Bank and the EU's Community Program for Assistance, Reconstruction, Development and Stabilization (CARDS).[964] Significant progress was achieved by the digitalization of the land registers and the possibility for potential buyers to access the central database of cadastral records online.[965] Digitalization also shortens the time needed for administrative procedures and avoids arbitrary decisions.[966] Prime Minister Sanader claimed in 2006 that the electronic register was complete.[967] Interviewees acknowledge that the ownership situation has become more reliable than it was three to five years ago and that internet queries are possible and helpful.[968] Progress is also achieved by the simplification of registration procedures and the replacement of judges with land registry clerks.[969]

(c) Representatively for many interviewees but also for external sources[970] *Intv. Germ. Political Foundation I (2007)* describes the **current situation**:

[960] See Intv. Croatian Ministry I (2007).
[961] See Intv. Croatian Ministry IV (2007).
[962] See OECD (2003a); European Commission (2005a).
[963] See Intv. Austr. MNC - Real Estate (2007); Intv. Austr. MNC - Primary Goods I (2007); Intv. Croatian Ministry III (2007); Intv. Former Croatian Minister (2007).
[964] See Intv. Croatian Ministry I (2007); Intv. European Institution (2007).
[965] See Ministry of Economy (2006); see also Intv. Austrian Econ. Association II (2007); Intv. Austr. MNC - Primary Goods I (2007); Intv. Croatian Ministry II (2007).
[966] See Intv. Croatian Ministry III (2007); Intv. Croatian Ministry I (2007).
[967] See Sanader (2006).
[968] See Intv. Austr. MNC - Real Estate (2007); Intv. European Institution (2007); Intv. Croatian Ministry I (2007).
[969] See European Commission (2005a), p.42; World Bank (2005), p.38.
[970] See OECD (2003a), p.44.

"Land registration has strongly improved but is still not very good."[971] Even though a large amount of the data seems, entries in the cadaster offices often remain unclear or outdated and have to be verified by other authorities.[972] Furthermore and in contrast to the statement of Prime Minister Sanader, interviewees explain that digitalization is not yet completed in all regions (Slavonia, for example), and may take another couple of years.[973] Electronic excerpts may in some cases not represent the actual ownership status either and are not legally binding.[974]

Registration time for property has strongly improved from a long 956 days in 2004 to 174 days in 2006/2007.[975] Despite this improvement registration still takes longer in Croatia than in 15 other EECs including Romania. Interviewees specify that the length of time depends on the location and may be faster in smaller cities "but cannot happen anywhere in 15 days."[976] Further problems and delays occur when a number of people – which may be as large as ten – claims ownership for the same piece of land. This may lead to delays of three or five years.[977] Legal advice is therefore indispensable for land registration.[978] These technical and time-related problems also seem to increase the vulnerability of authorities to corruption.[979]

(d) Interestingly, external studies assume that land registration has only been of minor **importance** for investors in Croatia.[980] By contrast, interviewees confirm for Croatia some conclusions found for Romania, that land registration has

971 See also Intv. Austr. MNC - Primary Goods I (2007); Intv. Germ. MNC - Telecommunications (2007); Intv. Supranational Authority II (2007).
972 See Intv. German Econ. Association IV (2007); Intv. Croatian Authority I (2007).
973 See Intv. European Institution (2007); Intv. Croatian Ministry I (2007).
974 See Intv. Austrian Econ. Association II (2007); Intv. Croatian Ministry I (2007); Intv. Austr. MNC - Real Estate (2007).
975 See World Bank (2004b), p.249; World Bank (2007a).
976 Intv. Croat. Company I - Legal Services (2007).
977 See Intv. Croat. Company I - Legal Services (2007); Intv. Croatian Authority I (2007); see similar CICD (2006), p.11; Doc - GTZ (2006a).
978 See Intv. German Econ. Association IV (2007); Intv. Croatian Ministry I (2007).
979 See Intv. Germ. Political Foundation I (2007).
980 See OECD (2003a), p.59.

significant importance for investors in the country in question. However, the quality of the entries and registration procedures represent a more significant obstacle for FDI in Croatia than in Romania.[981] This is also affirmed by state representatives interviewed.[982] In this context, *Intv. Germ. MNC - Telecommunications (2007)* clarifies that the digitalization is of little importance since it does not solve the actual problems such as the reliability of the entries.

(e) In the **assessment** of this sub-section it becomes apparent that Croatia had better starting conditions than Romania in terms of land registration since land registers were largely in place across the country in 1990. However, the unclear legal situation, the disadvantageous institutional set up and late reform efforts have made land registration a critical factor for Croatia's investment climate. To some extent, the efforts to digitalize entries covered problems without solving them. It is a promising sign that interviews show little attempts of state representatives to sugarcoat these issues. These mostly younger interviewees seem often eager to establish a public administration based on meritocracy and will hopefully contribute to more successful property rights reforms. They may help, for example, to uncouple weak points in the land registration process, for example by further reducing the influence of the judiciary and combating corruption more forcefully.

(3) The analysis of the conditions for obtaining a **construction permit** in Croatia shows that (a) major complications existed in the past, (b) some important reforms have been initiated, (c) although the current situation is still problematic. However, (d) the direct importance of construction permits for the investment decision seems limited for Croatia. Sub-section (e) provides an assessment.

981 See Intv. Austr. MNC - Primary Goods I (2007); Intv. Germ. MNC - Telecommunications (2007); Intv. German Authority II (2007).
982 See Intv. Croatian Authority II (2007).

(a) Primary[983] and secondary[984] sources show that investors experienced **major difficulties** in obtaining a construction permit in Croatia even in the early 2000s. The greatest problem was the complex procedure that actually required three permits, the location[985], building[986] and operation permit.[987] Overlaps among the required permits but also with land registration procedures as well as the involvement of different authorities led to long waiting times and intransparent decisions.[988] According to a World Bank study[989], conditions in Zagreb were particularly difficult and processes in smaller cities like Rijeka were described as more efficient. Interviewees add that until recently many buildings were erected in Croatia without official permission since specific permits were difficult to obtain.[990]

(b) All interviewees appreciate some **recent reforms**, especially the merger of construction and location permits initiated in 2007.[991] Experts interviewed see further simplification on the way; amongst other improvements, smaller buildings not longer require a specific permit.[992] Positive results are also expected from the fact that licenses are now issued on a sub-national level.[993] Company interviewees also confirm that the number of constructions without permits has fallen significantly, following a couple of prominent lawsuits five to

[983] See Intv. Germ. MNC - Engineering (2007); Intv. Croat. Company II - Legal Services (2007).
[984] See e. g. FIAS (2002).
[985] See Law no. 30/1994, 68/1998, 32/2002 and 100/2004
[986] See Law no. 175/2003 and 100/2004
[987] See FIAS (2002); Ministry of Economy (2006); APIU (2007).
[988] See Intv. Croat. Company I - Legal Services (2007); Intv. German Econ. Association IV (2007); see also FIAS (2002).
[989] See FIAS (2002), p.55.
[990] See Intv. Germ. MNC - Engineering (2007); Intv. Croat. Company II - Legal Services (2007).
[991] See Intv. Croatian Ministry I (2007); Intv. Austr. MNC - Real Estate (2007); Intv. Croat. Company II - Legal Services (2007).
[992] See Intv. German Econ. Association IV (2007); see also Intv. Croat. Company I - Legal Services (2007).
[993] See Intv. Croatian Ministry I (2007).

seven years ago as well as the demolition of illegally constructed buildings in coastal areas in 2006.[994]

(c) Interviews confirm the observation of external studies that **some problems** regarding construction permits **continue to exist** in Croatia. Importantly, the process is still very slow. According to the World Bank, it took an average of 65 days to obtain a construction permit and an additional 45 days for a location permit in 2006/ 2007.[995] Company experts know that obtaining a construction permit may even take up to 1.5 years[996] or about four years if neighbors challenge the permits.[997] *Intv. Austr. MNC - Real Estate (2007)* also points out that problems may actually occur because of the merger of the two types of permit; accordingly, no proceedings have been defined for situations when, for example, a location permit is based on the old system and the construction permit is based on the new one. Apart from these legal issues, interviews indicate that the majority of remaining problems occur on the local level and mainly at coastal areas.[998] Important issues are that a comprehensive space planning is missing for the coast[999], local authorities sometimes attempt to prevent foreigners from building at the coast (*see previous section*)[1000] and corruption is still an imminent problem whenever dealing with construction permits.[1001]

(d) As in Romania, the process for acquiring construction permits seems to be of limited **importance** for Croatia's investment climate despite a mediocre performance. Interviewees acknowledge that investors are aware that similar problems exist, even in South European EU members.[1002] Neither do inter-

[994] See Intv. Austr. MNC - Real Estate (2007).
[995] See World Bank (2007b).
[996] See Intv. Croatian Company - Real Estate (2007).
[997] See Intv. Croat. Company I - Legal Services (2007).
[998] See e. g. Intv. Austr. MNC - Real Estate (2007); Intv. European Institution (2007).
[999] See Intv. Croatian Ministry II (2007); Intv. German Authority II (2007).
[1000] See Intv. Int'l Research Institute I (2007).
[1001] See Intv. European Institution (2007)
[1002] See Intv. Int'l Research Institute I (2007).

viewees see any negative effects from this Croatia's efforts towards EU integration.[1003] However, more important than, for example, in Romania, interdependences with other deficient areas such as property rights in general, local bureaucracy etc. come into play and may have an indirect negative effect on MNCs' perception of Croatia.

(e) The **assessment** of Croatia's provisions for acquiring construction permit shows that the state has taken some important measures to overcome earlier drawbacks and that investors have become more careful. The next months and years will show to what extent these legal improvements will lead to a faster and more transparent implementation by local authorities. In this context, public policy will need to improve the coordination among different local authorities and the equal treatment of foreign investors.

(4) In **conclusion**, property rights have been, according to various sources, among Croatia's greatest problems in the past. Many interviews even define the weak property rights situation as the most important constraining factor for Croatia in the past. Other problems, such as economic stability, may have been reasonable priority areas of public policy in the past. However, interviews suggest that the little attention paid to any dimension of property rights in public policy led to significant lower inflows of FDI in Croatia, particularly in tourism. It seems that FDI studies and those of international organizations may underestimate these aspects for Croatia.

Recent reforms and the awareness of these problems shown by state representatives in interviews are promising. Nevertheless, the state of Croatia's property rights remains unsatisfactory. Public policy will have to promote a better cooperation between local and central levels. Most importantly, public actors should recognize their own possibilities and responsibilities. For example,

[1003] See Intv. Austr. MNC - Real Estate (2007).

local authorities can improve the property law situation by a more consistent and transparent implementation of regulations and even central authorities can improve land registration, for example, through better technical support for the digitalization of the registry entries. More generally, authorities should overcome remaining nationalist sentiments and reduce bottlenecks in procedures, mainly in the court system (*section 7.2.4*).

7.2.2.4 General insights for transition countries

This section discusses general findings with respect to property rights for transition countries. It concludes that (1) property rights have been a very important FDI determinant for transition countries, (2) some key problems can be identified, (3) recent improvements across all dimensions can be recognized, and (4) that some tools for public policy makers can be derived.

(1) *North (1993)* already points out the general **importance** of property rights for a well functioning market economy. Secondary sources confirm the insights of the interviews that well defined and enforced property rights are a key dimension for transition countries when seeking to improve the investment environment.[1004] Various FDI studies show that, particularly in the early 1990s, the lack of property rights was an important reason for fairly low FDI inflows to Eastern Europe.[1005] This positive correlation between property rights and FDI inflows appears to be stronger in Eastern Europe than in other regions of the world.[1006] This seems to be particularly true for capital-intensive industries.[1007] However, the interview with one German MNC shows that unclear property rights can even be the decisive reason not to invest in the service sector.[1008]

[1004] See OECD (2006a), p.50.
[1005] See e. g. Garibaldi, Mora, Sahay, and Zettelmeyer (2001); Bénassy-Quéré, Coupet, and Mayer (2005); Li and Resnick (2003).
[1006] See Pierpont (2007).
[1007] See for the Czech Republic Benacek and Visek (1999); for various countries Barrell and Holland (2000); Tondel (2001).
[1008] In fact in the Croatian tourism sector; see Intv. Germ. MNC - Engineering (2007).

Interviews even provide significant evidence that a certain minimum level of property rights is a precondition for FDI to flow to transition countries at all (even if other conditions may be favorable).

Interviews also indicate that property rights are generally a more important country determinant than non-policy determinants or market access, maybe because the latter are not decisive for all sectors and problems can be circumvented more easily. *Holland and Pain (1998)* also assume that the protection of property rights influences the perception of the business environment in general. This seems particularly true due to the even stronger interdependence between property rights and legal certainty, for example but also privatization issues, combat of corruption and access to natural resources. FDI studies[1009] assume that economic and political stability is even more important for MNCs' investment decision than property rights. These are analyzed in later sections.

(2) Investors may face some **key problems** in reference to property rights in transition countries. Generally, transition countries have only recently established consistent legal frameworks to deal with property rights questions, since this area of reform was not among the priorities of governments for a long time.[1010] Some sensitive aspects such as the treatment of foreigners seem to require external pressure, for example from the EU, in order to trigger effective reforms.[1011] However, legal compliance as suggested, for example, by the BTI or other international studies, may not necessarily imply actual satisfaction of investors. Difficulties in exercising property rights, restitution cases and the accumulated backlog of cases (as in Croatia) may be related problems. Interviews have shown that too many different licenses, for example regarding construction procedures, create time-consuming overlaps, controversial responsibilities

[1009] See Hauser (2005); Tondel (2001).
[1010] See also Pierpont (2007); OECD (2006a).
[1011] See e. g. OECD (2005a); Doc - DLA Piper (2006).

and may in the end promote corruption. The analysis of land registration procedures shows that the lack of cadasters in the early transition phase (as in some regions in Romania) does not necessarily represent a discriminating factor, since an existing and consistent system did not help Croatia to overcome problems more quickly than other transition countries.[1012]

The vast majority of transition countries continues to show a mediocre performance regarding registration time with only three countries faster than three weeks *(figure 42)*.[1013] Long procedures may be particularly difficult for MNCs with a specific focus on cost-saving investments, for example in countries with a large amount of cost-sensitive MNCs like in Romania.

In comparison to state representatives, company experts seem to be more aware of regional differences regarding property rights with rural areas frequently offering faster and easier procedures. However, authorities of smaller communities may sometimes be more biased than in larger cities (as discussed for Croatia).

Finally, interviews show (unlike statistics) that problems with property rights may depend on the home country of the MNCs in question. Governments may, for instance, treat country groups differently (for example regarding their rights to access coastal areas) but the behavior and concerns of the MNC may also vary depending on its home country (as shown for Romania regarding the risk-aversion of German investors).

(3) Interviews confirm the findings from various external studies that transition countries have initiated **significant reforms** since the early 2000s, including the legal harmonization with EU regulations in countries most interested in further EU integration, the updating of land registries, an increasing

[1012] See also World Bank (2007b).
[1013] See World Bank (2007a).

digitalization and a reduction of pending legal cases.[1014] Again it seems that EU pressure was helpful in encouraging countries to stimulate reforms and to enable a simplification and reduction of procedure times.[1015] On the other hand, permit procedures, such as merger of construction and location permit in Croatia, seem to be driven by internal reform pressure more than by EU influence.[1016]

(4) The analysis of property rights in transition countries helps to draft some **potential tools** for future reform efforts of public policy actors. First of all, governments should not underestimate (as identified for some state experts interviewed) their influence in designing a favorable property rights regime for both domestic and foreign investors.[1017] A minimum level of complete and consistent rules is necessary, even early in transition, in order to avoid legal loopholes and a paralysis of the administration and the legal system.[1018] The Croatian experience furthermore shows that a strong involvement of (traditionally rather slow) court systems in administrative procedures of property rights (such as land registration) should be avoided in order to reduce procedural times. Whether timing of the reform can be seen as right may depend on the industry sector. From the perspective of those MNCs of the manufacturing sector that were interested in low-cost production sites, property rights reforms (such as those implemented in Romania) may have been initiated too late, as many large investors had already decided to locate elsewhere. For other industries, such as tourism in Croatia, future property rights reforms can still have significant positive impact, since these investments are generally possible in multiple locations.

[1014] See e. g. Pournarakis and Varsakelis (2004); OECD (2006a); Pierpont (2007).
[1015] See also World Bank (2004b); World Bank (2007b).
[1016] See also Intv. Austr. MNC - Real Estate (2007).
[1017] See also Cho (2003); World Bank (2004b), pp.1-2, 9.
[1018] See also Jacobs (2003); Intv. Croat. Company II - Legal Services (2007).

Governments should set clear deadlines for the registration of property, but also for possible restitution claims in order to reduce the number of pending trials and to increase legal certainty. Interviews also suggest that public policy should prioritize among different reform areas of property rights; the quality of the land registry entries, for example, seems to be more urgent and complex than their digitalization. Governments should work on an equal treatment of foreign and domestic firms both in legal and actual terms. This may be difficult to enforce comprehensively on the local level; however, it may be less important to give foreigners rights and access to all areas of the host country, but governments may want to define some attractive priority areas with access for foreigners in which full rights are guaranteed and actually enforced.

Finally, governments should increase their interaction with MNCs in oder to better understand their needs and to benefit from their specific knowledge, for example regarding regional differences of property rights conditions in host countries (as shown with the interviews above).

7.2.3 Quality of bureaucracy

7.2.3.1 Definition

After entering the market and settling property issues MNCs frequently come into contact with host countries' bureaucracies in the course of their investment operations. Interactions include permits, licenses, inspections, customs etc. In this context investors expect (1) a general good quality of bureaucracy, (2) an effective implementation of laws and (3) equally satisfactory administrations across the country.[1019] The following sections analyze the conditions in Romania (*7.2.3.2*), Croatia (*7.2.3.3*) and in transition countries in general (*7.2.3.4*).

[1019] See also World Bank (2004b); OECD (2006a).

7.2.3.2 Romania

(1) The **general quality of Romania's bureaucracy** was (a) a major concern of investors in the past. However, (b) improvements are visible, but (c) some problems remain. Apparently, (d) the interaction between MNCs and authorities decreases over time. The quality of the administration is (e) important for MNCs but has only an indirect impact on their investment decision. Sub-section (f) provides an assessment.

(a) In line with the statements analyzed in earlier sections interviewees agree that bureaucracy was still very slow and unpredictable **in the late 1990s**.[1020] External sources also criticize the lack of reliability of administrative decisions at that time. They explain this with reference to the limited professional competence of the administrative staff and a susceptibility to manipulation of administrative decisions.[1021] *Intv. Romanian Authority I (2007)* also agrees that "it is true that there used to be a lot of bureaucracy in Romania." External reports[1022] and interviewees in particular report on problems with tax authorities and, for example, on arbitrary punishments in the context of tax controls during this period.[1023] Furthermore, it seems that Romania used to have significant problems in establishing well-functioning institutions and administrative procedures in order to cope with EU matters.[1024] Nevertheless, *Genco, Taurelli, and Viezzoli (1993)* show in their survey analysis that bureaucratic delays and problems with local authorities were significant in the early 1990s but less so in comparison with, for example, Bulgaria, Hungary and Poland. It seems that MNCs have been able from early on to find workarounds and to outsource existing problems to external advisers.

[1020] See Intv. German Econ. Association V (2007).
[1021] See e. g. FIC (2002), p.9; OECD (2003c).
[1022] See European Commission (1998).
[1023] See e. g. Intv. German Econ. Association V (2007); Intv. Germ. MNC - Legal Services I (2007).
[1024] See Intv. Romanian NGO (2007); see also European Commission (1998); European Commission (2004a).

(b) Both primary[1025] and secondary[1026] sources find **significant improvements** in Romania's general quality of bureaucracy in recent years, particularly since 2004. Due to the increasing integration with the EU, administrations and their procedures seem to have become simpler, more transparent and more reliable.[1027] Further improvements have been noted by the interviewees since the accession to the EU including a simpler reimbursement of the value-added tax (VAT)[1028] or invoicing procedures.[1029]

An important measure to improve the quality of Romania's public administration was the reform of the public administration that was launched in the early 2000s.[1030] In the following years an increasing number of trainings was introduced for public servants and a public manager program was initiated in order to make public administration more attractive for highly skilled young graduates.[1031] State representatives interviewees add that twinning programs[1032] with EU members have also been very helpful in increasing the (technical) know-how in the Romanian administration.[1033] Correspondingly, experts note a strong and increasing willingness in the Romanian bureaucracy to resolve problems, particularly among young officials.[1034] Investors also acknowledge improvements in the often criticized financial administration (see below); bribery seems to be less of an issue since inspectors rotate more frequently and

[1025] See e. g. Intv. German Econ. Association VII (2007); Intv. German Authority IV (2007); Intv. Austr. Research Institute (2007).
[1026] See OECD (2006a); European Commission (2005c).
[1027] See also Intv. Austr. MNC - Consumer Goods (2007); Intv. Germ. MNC - Consulting I (2007); Intv. Germ. MNC - Automotive (2007); Intv. German Econ. Association I (2007).
[1028] See Intv. German Authority IV (2007).
[1029] See Intv. Germ. MNC - Consulting II (2007).
[1030] See most importantly Law 699/2004.
[1031] See OECD (2005d); European Commission (2005c); see also Intv. Romanian Ministry III (2007); Intv. Rom. Local Authority II (2007); Doc - Min. of Justice (2006).
[1032] Institution building program of Western European EU members and EU accession candidate based on bilateral partnerships; see European Commission website (2008).
[1033] See Intv. Romanian Ministry V (2007); Intv. Romanian Ministry III (2007).
[1034] See Intv. Int'l MNC - Utilities (2007); Intv. Austr. Research Institute (2007).

top level officials show more integrity in their treatment of MNCs in the course of preparation of EU accession than previously.[1035]

Summarizing these reforms, experts interviewed perceive that Romania's administrative requirements are generally fairly liberal today[1036], in many ways comparable to Western European standards[1037] and do not represent an obstacle for foreign investors.[1038] Compared to Bulgaria in particular, administrative decision processes such as contracts, permits, registrations as well as financial services seem to be faster in Romania.[1039] In direct contrast to this positive evaluation by the interviewees, some FDI studies compare Romania's bureaucracy unfavorably with that of Bulgaria.[1040] The reason for this difference may be that these studies were completed in 2005 without taking into account the latest reform efforts that raised the quality of Romania's bureaucracy to a level that was comparable, if not better, than that of Bulgaria.

(c) Nevertheless, experts interviewed identify **remaining problems** in Romania's bureaucracy. Due to the many reforms in recent years (particularly since 2004) and the many new regulations, administrations have sometimes been uncertain as to which legislation they should follow; the Romanian or the European one or actually both.[1041]

More skeptical company experts assert that Romania's administration is – despite some improvements – still very bureaucratic, badly organized, quite unpredictable, and often frustrating for investors.[1042] Company experts in particular complain that too many stamps are required for daily business oper-

[1035] See Intv. Germ. MNC - Legal Services I (2007); Intv. Int'l MNC - Utilities (2007).
[1036] See e. g. Intv. Supranational Authority I (2007); see similar Intv. German Authority I (2007).
[1037] See Intv. German Econ. Association VII (2007); Intv. Austr. MNC - Consumer Goods (2007); Intv. Austr. MNC - Primary Goods II (2007).
[1038] See Intv. Supranational Authority I (2007); Intv. Romanian Econ. Association II (2007).
[1039] See Intv. Austr. MNC - Consumer Goods (2007).
[1040] See Hannula (2005); see also Müller (2005).
[1041] See Intv. Int'l MNC - Utilities (2007); Intv. Germ. MNC - Automotive (2007).
[1042] See Intv. Germ. MNC - Consulting II (2007); Intv. Austrian Econ. Association I (2007); Intv. German Political Adviser (2007).

ations[1043], many permit procedures are still too slow and intransparent[1044] and that conditions in some areas are very strict, for example regarding safety requirements.[1045]

In general, the work of the local financial authorities remains problematic considering the many and detailed inspections.[1046] Finally, the recently introduced computer-aided tax declaration is not working well so far[1047] and actually creates extra work since a paper declaration still has to be submitted as well.[1048]

With regard to Romania's bureaucracy in general, state representatives also recognize that a large geographic distance between authorities even within cities can make procedures more complex and time-consuming.[1049] State experts also note some resistance of Romanian bureaucracy to external advice[1050] and to the delegation of work; therefore, even decisions concerning daily operations are dealt with on a very high level.[1051] Finally, state experts are also concerned about a high employee turnover, a lack of experienced personnel and too few lawyers in Romanian administrations. Without a continuity in administration, which makes use of the extensive (practical) experiences of the personnel and specialized knowledge, the quality of the law-making and the reliability of ad-

[1043] See Intv. Germ. MNC - Industrial Goods III (2007).
[1044] See Intv. Germ. MNC - Consulting I (2007); Intv. Germ. MNC - Industrial Goods III (2007).
[1045] For instance, supermarkets have to have security at night; see Intv. Germ. MNC - Retail (2007).
[1046] See e. g. VAT payments. Intv. Germ. MNC - Legal Services I (2007); Intv. Germ. MNC - Industrial Goods III (2007); Intv. Int'l Econ. Association (2007); Intv. Int'l MNC - Utilities (2007); Doc - Austrian Econ. Chamber Romania (2007b).
[1047] Apparently because it had not been tested well enough ahead of time; see Intv. Germ. MNC - Legal Services I (2007).
[1048] It seems that administrations are reluctant to use online declarations alone because they think they are unsafe; see Intv. Int'l Econ. Association (2007).
[1049] See e. g. Intv. Romanian County Council (2007).
[1050] See e. g. Intv. Germ. Research Institute I (2007).
[1051] One effect is that officials from foreign ministries generally deal with Romanian counterparts that are at least one position higher; see Intv. German Ministry (2007).

ministrative and discretionary decisions may be at risk.[1052] The main reason for the high labor mobility and the shortage of highly skilled officials seems to be that jobs in the business sector offer quicker promotions and much higher salaries.[1053] The interview with a local financial authority revealed, for example, that an official of the authority with a university degree and eight years of work experience earns 2,000 RON per month (about €550) which is lower than the initial salary of a comparable business job for a graduate.[1054]

These remaining problems in building up a more professional public administration are also reflected in Romania's BTI score regarding the efficient deployment of administrative resources (*figure 93 of the appendix*). Therefore, Romania reached only an average position among Eastern European states with 7 out of 10 possible points.[1055] In accordance with the interviews, *Bertelsmann Stiftung (2006c)* states that Romania's administration still suffers from politicization, limited strategic visions and inconsistency in decision-making.

(d) The need for interaction **between MNCs and state authorities** seems to decrease over time. Several interviewees state that the work with the Romanian administration can be more intense in the early investment phase than in Western Europe (up to 50% of the working time)[1056] but may reduce once operations are running smoothly. Some MNCs outsource most of the interaction with the administration from the beginning.[1057] Relationships and networks then gain importance in order to overcome administrative obstacles in

[1052] See Intv. Germ. Legal Expert (2007); Intv. German Ministry (2007).
[1053] The salary gap between business and public sector is generally greater than in Western Europe; see Intv. German Econ. Association III (2007); Intv. Austrian Econ. Association I (2007); Intv. Germ. MNC - Consulting II (2007).
[1054] See Intv. Rom. Local Authority II (2007); Doc - Local Romanian Authority (2007).
[1055] Whereas 10 would be a perfectly efficient use of financial and human resources.
[1056] See Intv. German Econ. Association I (2007).
[1057] See Intv. Romanian Company - Advertising (2007); Intv. German Political Adviser (2007); by contrast, Intv. Germ. MNC - Industrial Goods III (2007) sees thorough need for interaction.

daily operations.[1058] If MNCs work in the market together with a local partner (for example, for distribution services) the latter usually deals with the authorities.[1059] Nevertheless, some direct contacts are generally unavoidable, for example to labor inspection or custom authorities.[1060] Investors are generally welcomed with open arms by the local administration[1061], even though some investors may wonder in later stages as to what extent private interests motivate the negotiation behavior of some local politicians and authorities.[1062]

(e) The general quality of bureaucracy seems to be an **important factor** for Romania's overall business climate, but less so for the initial investment decision of MNCs interested in Romania than previously. FDI studies and interviews suggest that problems with bureaucracy in general were a major reason for low FDI inflows to Romania in the past.[1063] However, it seems that recent reforms have decreased investors' focus on that topic and it may not be as important for the initial investment decision anymore – compared to property rights for example – because MNCs only deal with the bureaucratic aspects covered above in a second phase of the investment process. Today, the quality of bureaucracy may mainly have an indirect impact on an investor's choice of FDI. Deficiencies in administrative reforms impact many other areas such as combat of corruption, legal system and EU integration.[1064] Furthermore, company experts in particular suggest that MNCs that are already present in Romania are important mediators of the image of the bureaucracy and can influence FDI through their communication with potential investors.[1065]

[1058] See also Intv. Germ. MNC - Industrial Goods III (2007); Intv. Romanian NGO (2007); Intv. Austr. MNC - Financial Services I (2007).
[1059] See Intv. Germ. MNC - Logistics (2007).
[1060] See Intv. Austr. MNC - Consumer Goods (2007); Intv. Germ. MNC - Retail (2007).
[1061] See Intv. Germ. MNC - Industrial Goods II (2007); Intv. German Econ. Association I (2007); Intv. Austr. MNC - Consumer Goods (2007).
[1062] See Intv. Germ. MNC - Industrial Goods II (2007).
[1063] See Hannula (2005); see also Intv. German Econ. Association V (2007).
[1064] See sections below; see also Intv. Germ. Research Institute I (2007).
[1065] See e. g. Intv. Germ. MNC - Legal Services I (2007); Intv. Germ. MNC - Industrial Goods III (2007).

(f) This section has shown positive and negative aspects of Romania's general quality of bureaucracy. In an **assessment**, it seems that the encouraging signs outweigh the constraining factors. Apparently, Romania has caught up with other countries of the region, notably Bulgaria. Without a doubt significant deficiencies remain, especially compared with Western European standards. Interviews with state experts give especially good insights into some of the problems of the internal functioning of the administration. However, interviews also suggest (helping to better understand external sources' critical evaluations) that many hold-ups were caused through the EU accession and seem to decrease over time. Interviews with company experts also reveal that an experience with bureaucracies may differ among MNCs. Possible explanations are that improvements seem to have been implemented very rapidly in recent years and that experiences in the same location in 2004 may have been quite different from the one a couple of years later. Furthermore, it seems that smaller investors who tried to deal with administrative issues themselves were particularly frustrated. However, interviews do not reveal industry-specific differences in this context. Regional differences may exist as well and are discussed below. Public policy should try to overcome EU related obstruction as quickly as possibly, should better understand the differences in the experiences of MNCs and make the work in authorities more attractive for skilled labor.

(2) The **implementation of laws** (a) was a major problem for investors in the past, (b) still is a problem and (c) an important but rather indirect concern of Romania's investment environment. Sub-section (d) provides an assessment.

(a) Interviews[1066] and secondary[1067] sources show that the implementation of laws was a **larger problem** for Romania than the actual law-making **in the past**. Even in the early 2000s decisions were often adopted by politicians, while

[1066] See Intv. Germ. MNC - Automotive (2007); Intv. German Econ. Association I (2007).
[1067] See e. g. European Commission (2004a); Müller (2005); OECD (2005a).

central and local administrations had not heard about them when confronted by investors. This insecurity also led to a greater need for MNCs to contact administrations in that period.[1068] Moreover, problems were often solved on a local level without a legal basis (including bribery).[1069] FDI studies also show that the application of nation-wide legislation was rarely consistent or predictable across the country.[1070]

(b) Even today various **problems** regarding the implementation of laws **continue to exist**. Interviewees confirm the observations of external studies[1071] that planning and implementation is – despite some improvements – often more problematic in Romania than the legislation which is largely based on laws of the EU and other Western countries.[1072] It seems that problems occur on both central and local level.

On the central level, company experts in particular mention that implementation regulations are often scarce, late or imprecise and thus open to further interpretation.[1073] Local levels also sometimes complain that central authorities do not communicate their policy goals, do not consult them sufficiently ahead of time and therefore some laws have nothing to do with reality.[1074] Furthermore, interviewees assume that the high degree of centralization of Romania also leads to some of the problems.[1075] *Intv. Romanian County Council (2007)* as representative of the local level also points out that regional and decentralized projects are often quicker and more effective than central ones

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1068 See e. g. Intv. Germ. MNC - Automotive (2007); Intv. German Econ. Association I (2007).

1069 See ibid.

1070 See Cluse (1999), pp.301-302; Müller (2005).

1071 See Hannula (2005).

1072 See e. g. Intv. Germ. MNC - Legal Services I (2007); Intv. Germ. MNC - Consulting I (2007); Intv. German Authority I (2007); Intv. Romanian NGO (2007); Doc - Rom. Emb. Berlin (2007b).

1073 See Intv. German Econ. Association I (2007); Intv. German Econ. Association III (2007); Intv. German Econ. Association VI (2007).

1074 See also Intv. Romanian NGO (2007).

1075 See e. g. Intv. Germ. MNC - Automotive (2007).

because the decision-making is closer to the actual problems and officials can more easily focus on single projects.[1076]

On the other hand, state experts assume that implementation sometimes exceeds the capabilities of local authorities. They may not always be well informed regarding the current legislation and are sometimes less than eager to change existing rules.[1077] According to many interviewees[1078] but also to external reports[1079], problems with financial authorities are the most prominent ones on the local level. A major concern are in this context tax related regulations. Some old fiscal laws were not abandoned despite new EU regulations and tax inspectors still sometimes refer to these old laws. External studies also confirm that lower levels of other administrative bodies, for example in Romania, are sometimes unwilling to implement political projects.[1080] Furthermore, experts mention cases in which institutions were not set up in time or lacked sufficient resources in order to implement new regulations, for example in the agricultural sector.[1081]

However, others experts interviewed point out that the performance of the bureaucracy often depends less on whether local or central authorities are involved than on the individual and personal relationships.[1082]

(c) The **importance** of Romania's performance regarding the implementation of laws as FDI determinant seems to be **comparable to the general quality of bureaucracy**. FDI studies already showed for various transition countries that the enforceability of laws is an important country determinant.[1083] Furthermore, company experts agree for Romania that the local

1076 He mentions the extension of the Sibiu airport as an example.
1077 See Intv. Romanian Econ. Association II (2007).
1078 See e. g. Intv. Germ. MNC - Legal Services I (2007); Intv. German Authority I (2007).
1079 See e. g. European Commission (2006e); OECD (2005d).
1080 See Carter, Sader, and Holtedahl (1996).
1081 E. g. the direct payments system; see Intv. Romanian Ministry I (2007).
1082 See Intv. German Econ. Association VII (2007); Intv. Romanian NGO (2007).
1083 See Altomonte (1998); see similar Smarzynska (2002).

handling of legal parameters is important for the investment process.[1084] However, state experts emphasize the importance more than company experts. State experts assume that the implementation of laws is something looked at closely by investors.[1085] and that this field is one of the largest problems of Romania's investment environment.[1086] By contrast, MNCs point out that this aspect cannot usually be assessed until the investment has actually been made[1087] and that investors usually find ways to avoid implementation complications, for example by receiving temporary permits etc.[1088]

(d) In the **assessment**, interviews and external sources suggest that Romania still has more deficiencies in the implementation of new laws than, for example, in other aspects of its bureaucracy. Existing problems may not be as crucial for MNCs' investment decision as often assumed by external studies and state experts. However, they have a significant indirect impact on the investment conditions and also influence related fields, such as a higher number of court trials, more problems regarding political stability and a greater tendency to corruption. It is difficult to assess what level – central or local – is more responsible for the problems mentioned. In any case the lack of lawyers seems worrisome on both levels. Public policy should thus focus on establishing better know-how on both central and local level, lowering the labor mobility of officials and improving the communication between central and local level and among local authorities.

(3) The quality of bureaucracy in Romania seems to vary greatly across **regions**. The analysis of interviews and secondary sources suggests some (a) general insights. Positive examples are seen particularly in (b) Sibiu and (c) to

[1084] See Intv. Germ. MNC - Utilities (2007).
[1085] See Intv. Romanian County Council (2007).
[1086] See Intv. Supranational Authority I (2007).
[1087] See Intv. Austr. MNC - Consumer Goods (2007).
[1088] See Intv. Austr. MNC - Industrial Goods I (2007).

some extent in Timişoara. This aspect (d) can be very important for MNCs. Sub-section (e) provides an assessment.

(a) **Generally**, all interviewees are aware that the quality of bureaucracy **differs from region to region** in Romania.[1089] Company experts have learnt by experience that administrations in the western part of Romania are especially efficient.[1090] The evaluation of the work of specific municipalities varies but all interview statements on Sibiu were positive, and administrations in Timişoara and Arad[1091] also received positive assessments in general. Company experts know of mixed experiences in Braşov, Cluj and Iaşi. However, in many communities there seems to be an effort to improve administrative conditions for MNCs.[1092] It seems that investors have had increasingly positive experiences in smaller cities with smaller bureaucracies and more direct access to decision-makers.[1093]

(b) The administration of **Sibiu** is frequently cited as **a positive example** for a well-functioning and business-friendly administration.[1094] Interviewees believe that mayor Klaus Johannis (since 2000), who belongs to the German minority, has created an administration with motivated, skilled and often German-speaking officials who have a positive attitude towards MNCs and are allowed to take far-reaching decisions themselves.[1095] Furthermore, city officials often meet with the business community, for example with the German

[1089] See Intv. Germ. MNC - Industrial Goods III (2007); Intv. German Ministry (2007); Intv. Romanian County Council (2007).

[1090] See Intv. German Econ. Association I (2007).

[1091] See also Doc - Austr. MNC - Industrial Goods II (2005); Doc - City of Sibiu (2007).

[1092] See Intv. Austr. MNC - Industrial Goods I (2007); Intv. Int'l MNC - Utilities (2007); Intv. German Econ. Association VIII (2007); Intv. Austr. Research Institute (2007); Intv. German Authority IV (2007); Intv. German Econ. Association VII (2007).

[1093] See Intv. Austr. MNC - Industrial Goods I (2007).

[1094] See e. g. Intv. Germ. MNC - Legal Services II (2007); Intv. German Ministry (2007); Intv. German Econ. Association VIII (2007); Intv. Romanian Econ. Association I (2007); see also Intv. Romanian County Council (2007).

[1095] See Intv. German Econ. Association VII (2007); Intv. Germ. MNC - Legal Services II (2007); Intv. Germ. MNC - Legal Services I (2007); Intv. Germ. MNC - Industrial Goods III (2007).

Business Club.[1096] In addition to this, the cooperation and distribution of work with the county council and the trade register is apparently working well.[1097] It is also worth mentioning that state representatives are well aware of remaining room for improvement in lengths of procedures etc.[1098] A key advantage of Sibiu seems to be the early establishment of an investment promotion unit that makes active investment policies and in which interested MNCs have one contact person who deals with all related issues.[1099] The importance of this unit is also shown by its physical location: right next to the mayor's office; in contrast, other and even larger cities do not have a stand-alone investment promotion unit at all. The most prominent example for Sibiu's successful investment policy is the opening of the industrial park close to the airport (2002). Experts are particularly complementary about the quick provision of infrastructure, including access to roads, gas and electricity.[1100]

Interviews[1101] and external sources[1102] conclude that administrative barriers seem to be lower in Sibiu than in other parts of the country and particularly German companies prefer to come to the county. The administration actually seems to work more efficiently than the central government.[1103]

(c) Interviews suggest a **positive evaluation** of the administration in **Timişoara overall**.[1104] However, experiences seem to vary depending on the level of the administration investors have been dealing with. Investors seem to

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1096 See Intv. Germ. MNC - Legal Services I (2007); see also Intv. Romanian County Council (2007).
1097 See Intv. Germ. MNC - Legal Services II (2007); see also Intv. Romanian County Council (2007).
1098 See Intv. Romanian County Council (2007); Intv. Rom. Local Authority I (2007).
1099 See Intv. Germ. MNC - Industrial Goods III (2007); Intv. Germ. MNC - Legal Services I (2007); Intv. German Authority IV (2007); see also Doc - City of Sibiu (2007).
1100 See Intv. Romanian Econ. Association I (2007); see also Intv. Int'l Research Institute I (2007); see also Bulgaria Economic Forum (2006).
1101 See e. g. Intv. Romanian Econ. Association I (2007).
1102 See e. g. Pfaller (2007); Süddeutsche Zeitung (2007).
1103 See Intv. German Econ. Association VII (2007); Intv. Germ. MNC - Legal Services II (2007); Intv. Germ. MNC - Legal Services I (2007).
1104 See Intv. German Econ. Association VII (2007); Intv. German Econ. Association III (2007); Intv. German Econ. Association VIII (2007).

be quite satisfied with the work of top officials including the mayor and the county council.[1105] In contrast, some company experts indicate that Timişoara has been less successful compared to Sibiu in recent years due to more internal political difficulties between local authorities and sometimes limited openness to foreign investment in the lower levels of the administration. Furthermore, officials seem to have less interest in direct contact to investors, such as to the German-Speaking Business Club in Timişoara.[1106]

(d) The performance of local administrations seems to be **very important** for investors once MNCs have decided on Romania and are then choosing a location within the country. Company experts confirm that investors quickly spread the good news of reforming municipalities.[1107] *Hilber and Voicu (2006)* also suggest in their FDI study a correlation between FDI inflows and bureaucratic reforms in Western Romania.

(e) In the **assessment**, it seems that MNCs are well aware of regional differences regarding administrative reforms. An administration's performance may in part depend on the effort of individuals, but Transylvanian counties seem to have created particularly successful bureaucracies. Investors may already have come to the region before due to the cultural proximity but recent reforms have created a basis for a longer-lasting FDI boost. However, despite the overwhelmingly positive statements of the interviewees some doubts are worth mentioning. Interviews were conducted mainly with experts on German and Austrian investments and Sibiu in particular actually represents a German island in Romania. Other regions and administrations that may be successful as well such as Constanţa are not mentioned by German and Austrian investors at all, maybe also because of the larger geographical distance. In contrast,

[1105] See Intv. German Econ. Association III (2007); Intv. German Econ. Association I (2007).
[1106] See Intv. Germ. MNC - Legal Services II (2007); Intv. German Econ. Association I (2007).
[1107] See Intv. Int'l MNC - Utilities (2007).

FDI statistics suggest that both regions attract similar levels of FDI.[1108] Regional policy actors, for example of Eastern and Southern Romania, may therefore promote more strongly their success stories of administrative reforms to investor groups from home countries that have traditionally located in other regions but that may be worried about rising costs and labor shortage in Sibiu and elsewhere.

(4) In **conclusion**, this section has given encouraging signs that the quality of Romania's bureaucracy is slowly but surely approaching Western European levels. State interviews have been helpful for clarifying some deficiencies in the functioning within administrations. The general quality and the implementation of laws may – this is suggested by company interviews and specifies earlier findings of academic research – only have indirect importance as FDI country determinant for Romania, since MNCs usually face related problems not until a later stage of their investments; however, these aspects have a significant impact on the overall image of the investment location and are interdependent with other factors such as combat of corruption, legal system, EU integration etc. Furthermore, interviews with company experts showed that existing regional differences in the performance of local bureaucracies may have a decisive impact on MNCs' investment decision within Romania which explains why German-speaking investors are particularly satisfied with the performance of some of the Transylvanian counties. Public policy should attempt to overcome remaining administrative obstacles following EU accession and level out regional disparities. It will be essential in this context to improve consultation and cooperation among authorities but also with MNCs.

[1108] Both regions have attracted about €1,000 per capita in terms of FDI stock; see NBR (2007).

7.2.3.3 Croatia

(1) The **general quality of Croatia's bureaucracy** was (a) strongly criticized in the past. Some (b) recent reforms have led to improvements; however, (c) problems seem to remain significant, (e) even though MNCs generally find solutions in the interaction with authorities. Overall, the general performance of authorities is (d) one of the greatest obstacles for higher FDI in Croatia. The findings are assessed in sub-section (f).

(a) According to external sources[1109] and interviewees MNCs encountered significant **problems** with bureaucracy in Croatia **in the past**, apart from the aspects covered in previous sections. Company experts give examples of sluggish and intransparent administrations both on the central and local level in the early 2000s.[1110] Apparently, potential investors were often deterred by the hierarchical structures[1111] and the unprofessional treatment of applicants that are reminiscent of socialist times.[1112] External reports also criticize that administration reform has not been made a priority by Croatian governments in the past.[1113]

(b) External sources and interviewees see **some improvements** in the performance of Croatia's bureaucracy since about 2002 .[1114] Several new laws paired down the administrative requirements for businesses[1115] and some initiatives were introduced to automatize procedures.[1116] Furthermore, a Civil

[1109] See e. g. FIAS (2002); European Commission (2005a); World Bank (2003).
[1110] See e. g. Intv. Germ. MNC - Telecommunications (2007); Intv. Germ. MNC - Financial Services II (2007).
[1111] See Intv. German Authority III (2007).
[1112] See Intv. Germ. MNC - Engineering (2007); Intv. Croatian Company - Real Estate (2007).
[1113] See European Commission (2005a), p.13; World Bank (2003).
[1114] See e. g. Intv. Croatian Ministry II (2007); Intv. Germ. MNC - Food Products (2007).
[1115] See also European Commission (2004c) for examples.
[1116] See Intv. Croatian Company - Real Estate (2007); Intv. Croatian Government Team (2007).

Service Training Center was founded in Zagreb in 2003 and EU training programs were also launched.[1117]

While little mentioned by company experts, state experts evaluate the establishment of Hitrorez ("regulatory guillotine") in 2006 as a key reform in improving the quality of bureaucracy in Croatia.[1118] It scanned about 2,000 regulations related to doing business in Croatia and came up with 800 (non-binding) recommendations.[1119] They aim at the simplification of existing procedures (for example invoicing), the disclosure of contradictory regulations (for example with still valid Yugoslavian laws or newly introduced EU regulations) and the transfer of competences on the sub-national level (for example licensing).[1120] Experts interviewed assess that Hitrorez represents a "good"[1121] or even a "decisive"[1122] reform effort of Croatia in order to improve the investment climate and to cut administrations business costs.

Further improvements are expected from the repositioning of the assistant ministers from a politician to a civil servant. This change is expected to depoliticize administrative work and facilitate the elaboration of long-term strategies.[1123] More generally, interviewees point out that EU accession, the initiated public administration reforms and additional twinning efforts will help to further decrease administrative barriers, build up capacities and accelerate the transfer of know-how.[1124] On the other hand experts warn that an accession to the EU will not bring any instant improvements in the administration since these procedures take a very long time.[1125]

[1117] See European Commission (2005a), p.13; European Commission (2007a), p.8.

[1118] See e. g. also Doc - NCC (2007).

[1119] See Intv. Croatian Ministry I (2007); Intv. Croatian Ministry II (2007).

[1120] Adoption of 125 recommendations by November 2007; see Intv. Croatian Ministry I (2007); Intv. Croatian Ministry III (2007); Intv. German Authority II (2007).

[1121] Intv. Former Croatian Minister (2007); Intv. Croatian Ministry III (2007).

[1122] Intv. European Institution (2007); see also Intv. Croatian Ministry I (2007).

[1123] Adoption expected after November 2007; Intv. Croatian Ministry IV (2007).

[1124] See Intv. Germ. Research Institute II (2007); Intv. Germ. MNC - Telecommunications (2007); Intv. German Authority III (2007); Intv. Austr. MNC - Retail (2007).

[1125] See Intv. German Authority II (2007); Intv. Croatian Mayor (2007).

Interviewees also state that Croatia's bureaucracy may be difficult but that dealing with licenses in some industries (a brick production plant for example) is not easy in Western Europe either.[1126] Furthermore, experts agree that most problems can be solved when MNCs find competent help in and outside of the administration.[1127]

(c) Nevertheless, not only external sources[1128] but also state and company experts[1129] see **significant remaining problems** with respect to Croatia's bureaucracy and a need for a comprehensive reform. Problems most frequently cited are the great number of permits, documents and stamps that are required for business operations.[1130] Furthermore, experts confirm the criticism of external sources[1131] that the decision-making process is in many cases slow[1132], intransparent, unreliable, and arbitrary.[1133]

Problems may also occur when the state is a contractor or a partner; MNCs then frequently do not know who is responsible (central government, counties, communities) and who is for or against the project. As a result MNCs project implementations may be pending for several years.[1134] As in Romania problems with financial authorities are very common, mainly due to the frequent inspec-

[1126] See Intv. Austr. MNC - Primary Goods I (2007).
[1127] See Intv. Germ. MNC - Food Products (2007).
[1128] See NCC (2004a); European Commission (2005a); EBRD (2005a); UniCredit Group (2006); European Commission (2007a).
[1129] See e. g. Intv. Croatian Ministry III (2007); Intv. Croatian Mayor (2007); Intv. Croatian Authority II (2007); Intv. Croatian Government Team (2007); Doc - Gov't. of Croatia (2006), p.29; Intv. Germ. MNC - Financial Services I (2007); Intv. Germ. MNC - Software (2007).
[1130] See Intv. Austr. MNC - Construction (2007); Intv. Germ. MNC - Food Products (2007); Intv. Austr. MNC - Retail (2007); see also Intv. Croatian Mayor (2007).
[1131] See e. g. EBRD (2005a), p.23; Wirtschaftsblatt (2007).
[1132] Apparently, it would take about two years to start a business when all procedures required were followed; see Intv. Germ. MNC - Financial Services II (2007).
[1133] See Intv. Germ. MNC - Software (2007); Intv. German Authority III (2007); Intv. European Institution (2007); Intv. Croatian University (2007); Intv. Croatian Mayor (2007).
[1134] See Intv. German Econ. Association IV (2007); Intv. Germ. MNC - Software (2007).

tions (particularly for MNCs).[1135] However, company interviews also indicate that bribery is less frequent in this context than in Romania.[1136]

Company and state experts point out that Croatia's administration is too large[1137] and continues to grow.[1138] Interviewees see more clearly than external sources[1139] that Croatia's administration is still very hierarchically organized and strongly politicized and that many issues are decided on too high a level.[1140] Furthermore, old officials from the middle level are often still in the same position as during socialist times, not always well educated and sometimes actively or passively blocking reforms.[1141] *Intv. Croatian Ministry IV (2007)* believes that a young generation of state officials will be necessary in order to overcome these problems. As in Romania, experts also see in Croatia an increasing salary gap between jobs in private companies and administration.[1142] Furthermore, they see problems in an intransparent promotion system of state officials, with few possibilities of motivating them.[1143] Nevertheless, experts think that Croatia's administrations have only limited recruiting problems because junior staff is largely attracted by existing securities.[1144]

Finally, some experts state that the impact of the regulations modified by Hitrorez is not visible so far.[1145] Various recommendations may not be implemented because authorities do not have enough capacities, are afraid of legal

[1135] See Intv. Croatian Company - Real Estate (2007); Intv. Germ. MNC - Food Products (2007).
[1136] See e. g. Intv. Croat. Company - Utilities (2007).
[1137] See Intv. Croatian Ministry III (2007); Intv. German Authority II (2007); Intv. Germ. MNC - Telecommunications (2007); Intv. Croatian Government Team (2007).
[1138] See Intv. Austrian Econ. Association II (2007).
[1139] See World Bank (2003), p.18.
[1140] Sometime the decision on location of an event or a logo is decided by a secretary of state; see Intv. German Authority III (2007); see also a disguised state expert statement.
[1141] See Intv. Germ. Political Foundation I (2007); Intv. Germ. Research Institute II (2007); Intv. Int'l Research Institute I (2007); see also World Bank (2003), p.17.
[1142] See Intv. Croat. Company - Utilities (2007).
[1143] See Intv. German Authority III (2007).
[1144] See Intv. German Authority II (2007).
[1145] See Intv. Former Croatian Minister (2007); Intv. European Institution (2007).

gaps with respect to other regulations or worry about redundant work due to EU integration.[1146]

International statistics confirm this overall critical tone of the interviews. According to *AHK (2006)* Croatia is second last among 14 EECs in a measurement of the satisfaction of MNCs with the general quality of bureaucracy.[1147] Furthermore, the BTI score 7 out of 10 measuring the efficient use of administrative resources also suggests that significant room for improvements remains (*figure 93)*.

(d) Company experts confirm that a cooperative **interaction of MNCs with Croatian authorities** is important, especially in the first investment phase.[1148] Large investors in particular need good ties to bureaucracy since they are frequently dealing with customs, work permits etc.[1149] Experts have noticed (as in Romania) that MNCs need more staff to deal with bureaucracies than in their home countries when they decide to deal directly with authorities.[1150] Several company experts assume that communication between authorities and investors could still be improved, for example regarding the timeframe of their decision-making process.[1151] Interviews suggest that MNCs have – besides the financial authorities – the most frequent interactions with the veterinarian, foodstuff and custom authority.[1152] Once investors are more experienced an interaction seems to be become less relevant.[1153] Furthermore, it seems that

[1146] See Intv. Croatian Ministry I (2007).

[1147] MNCs are more dissatisfied only in Macedonia; even though some company experts interviewed believe that Croatia's performance is not as worrisome as in other countries of the region; see Intv. Croatian Company - Real Estate (2007); Doc - Germ. MNC - Food Products (2007).

[1148] See e. g. Intv. Austr. MNC - Primary Goods I (2007).

[1149] See e. g. Intv. Germ. MNC - Telecommunications (2007); see also World Bank (2003), p.4.

[1150] See Intv. Germ. MNC - Telecommunications (2007).

[1151] See Intv. Germ. MNC - Telecommunications (2007); Intv. Austr. MNC - Construction (2007); Intv. Germ. MNC - Software (2007).

[1152] See Intv. Germ. MNC - Food Products (2007); Intv. Austr. MNC - Financial Services I (2007).

[1153] See Intv. Germ. MNC - Telecommunications (2007).

Croatian authorities have learnt a lot from dealing with MNCs and have become more professional.[1154] Investors interviewed also acknowledge that problems with local administration are usually minimized when issues are handled by the local management directly which is ideally staffed with domestic managers.[1155]

(e) The general quality of bureaucracy is, according to the interviewees, amongst the **most important FDI determinants** for Croatia (in contrast to Romania) and is on a comparable level with property rights. Several company experts[1156], but interestingly even state representatives[1157], call the inefficient bureaucracy one of the greatest obstacles for higher FDI inflows and the area with greatest need for further reform in Croatia. *Intv. German Authority II (2007)* even believes that the reform of the administration "is the task of the century" for Croatia.

Interview results therefore confirm external reports and FDI studies.[1158] The findings are also well in line with *AHK (2006)* that reports that bureaucracy is generally only of average importance in transition countries (15th of 25 determinants) but the fifth most important determinant in Croatia.

Interviews suggest that administrative problems have represented a constraining factor for FDI inflows for many years, particularly in areas with a traditionally strong need for state interaction, for example in the exploitation of natural resources[1159] or in newly privatized areas.[1160] Investors may eventually decide to make their investment, but may delay decisions or reduce the

[1154] See Intv. Croat. Company - Utilities (2007); Intv. Austr. MNC - Construction (2007).
[1155] See Intv. Germ. MNC - Food Products (2007); Doc - Germ. MNC - Food Products II (2007).
[1156] See Intv. Austr. MNC - Construction (2007); Intv. Germ. MNC - Software (2007); similar: Intv. Germ. MNC - Financial Services II (2007); Doc - Austrian Econ. Chamber Croatia (2006), p.7; different: Intv. Germ. MNC - Engineering (2007); maybe because their investment did not take place and the contact with authorities remained scarce.
[1157] See Intv. Croatian Authority II (2007); Intv. Croatian Mayor (2007); Intv. Croatian Government Team (2007); see also Intv. German Authority III (2007).
[1158] See e. g. McGee (2003); NCC (2004b); Pommer (2007), p.145; Moore and Vamvakidis (2007).
[1159] See e. g. Intv. Austr. MNC - Primary Goods I (2007).
[1160] See Intv. Germ. MNC - Telecommunications (2007).

initially targeted investment sum. However, interviewees also underline that recent improvements in public administration may lead to higher FDI.[1161]

(f) The **assessment** of Croatia's general bureaucracy shows that its quality has been fairly poor. Without a doubt administrative procedures in Western Europe are somewhat cumbersome as well and may be even worse in other countries of the region; however, MNCs generally expect a better performance in Croatia, also considering its drive for EU accession, and may then be disappointed. Thus, in various cases bureaucracy seems to be a constraining factor for FDI in Croatia. Interviews show that Croatia's specific starting conditions – that were more difficult than those in Romania, for example – including the overcoming of socialism, Yugoslavia and war, led to fundamental and structural problems. These will not be overcome quickly and require a sensitive approach to reform. On the one hand top officials show impressive self-criticism of Croatia's administrative deficiencies in interviews. On the other hand some of those officials who had already been part of the bureaucracy in the 1980s and 1990s, seem reluctant to participate in further reforms. Public policy makers need to find the right mixture of pressure and benefits needed to achieve reforms without internal blockades. Authorities may also want to use more external advice if they realize that some tasks and issues go beyond their capabilities. Hitrorez seems to be a very good approach for solving some of the existing problems. Public policy actors should increase efforts so that the recommendations are fully implemented and enhance the awareness of these successes among investors who seem to know only little about these reforms.

(2) The **implementation of laws** represented (a) a substantial concern of investors in Croatia in earlier years and (b) despite some improvements (c)

[1161] See e. g. Intv. Croatian University (2007); Intv. Croatian Company - Real Estate (2007).

major deficiencies remain. It is (d) important but not essential for the decision of MNCs to invest in Croatia. Sub-section (e) provides an assessment.

(a) External sources[1162] and interviews [1163] suggest that the enforcement of laws has been **troublesome** for investors **in the past**. Administrations were often confronted with outdated regulations from Yugoslavian times that were not abandoned when new laws were introduced. The situation was aggravated when contradicting new laws on the basis of the EU acquis were passed and administrations – similar to Romania – did not know which rules to follow.[1164]

(b) Despite this, it seems that the harmonization with EU law and more recent legal reforms[1165] have led to **some improvements** and a more consistent legal framework that creates a more stable basis for administrative actions.[1166] Hitrorez (*see above)* will most likely play an important role in this context.[1167] Experts also assume that the implementation of laws is still more reliable and consistent than in neighboring countries including Bosnia and Herzegovina and Serbia.[1168] *Intv. Croatian Authority II (2007)* also doubts that recently acceded EU members like Romania and Bulgaria are fully implementing the acquis.

(c) Nevertheless, external sources[1169] and the vast majority of interviewees hint that Croatia may have good laws – generally copied from the EU or Western Europe – on paper, but that implementing and enforcing them **remains a major problem**.[1170] *Intv. Croatian Ministry II (2007)* concludes that "many times the legal framework is more developed than the administrative proce-

[1162] See World Bank (2003); European Commission (2005a), p.13; FIAS (2002).
[1163] See e. g. Intv. Germ. MNC - Engineering (2007); Intv. Germ. Research Institute II (2007).
[1164] See e. g. Intv. Croatian Ministry III (2007); Intv. Germ. Research Institute II (2007).
[1165] See section below and for examples European Commission (2006a).
[1166] See e. g. Intv. Austr. MNC - Retail (2007).
[1167] See also Intv. German Authority III (2007).
[1168] See e. g. Intv. German Econ. Association IV (2007); Intv. Int'l Research Institute I (2007).
[1169] See NCC (2004a); World Bank (2003); European Commission (2007a).
[1170] See Intv. Croatian Company - Real Estate (2007); Intv. Croat. Company I - Legal Services (2007); Intv. Croatian Authority II (2007); Intv. German Authority III (2007).

dures." More specifically interviewees state that the implementation of laws is are often lacking[1171] or slow[1172] and administration is too large to effectively deal with new regulations.[1173] Interviews also indicate that the implementation problems are closely related to difficulties in the court system; thus judges often do not know which laws have to be applied by administrations.[1174]

Some external sources[1175] and several interviewees[1176] see the majority of problems on the central level, for instance, due to the high degree of institutional centralization, the frequently used enforcement of liability by central authorities and the limited legal possibilities of municipalities to take over more responsibility.[1177] *Intv. Croatian Mayor (2007)* also knows from his own experience that the frequent change of strategies on the central level increases the problem of implementation. Other sources assume that local communities simply do not receive sufficient money in order to adequately implement laws.[1178] In addition to this – rather than in contradiction to the insights above – experts interviewed assume that decisions are sometimes hampered by local authorities who have their own interests and often try to keep their actions and decisions intransparent, even when dealing with Zagreb.[1179] Finally, the expansion of local bureaucracies, from 104 to 560 sub-national governments during the 1990s alone, caused highly fragmented local entities and additional costs for the coordination and implementation of regulations.[1180]

1171 See Intv. Austr. MNC - Construction (2007).
1172 See Intv. German Econ. Association IV (2007).
1173 See Intv. Croatian Authority II (2007).
1174 See Intv. Croat. Company I - Legal Services (2007) who cites an example in which a judge gave a false statement that TRIPs rules regarding pharmaceuticals were not applicable in Croatia.
1175 See e. g. NCC (2004a); World Bank (2003).
1176 See Intv. Croatian Mayor (2007); Intv. Germ. Political Foundation I (2007).
1177 See Intv. Germ. Political Foundation I (2007); see also European Commission (2005a), p.13; European Commission (2007a), p.8.
1178 See Intv. Germ. Research Institute II (2007); see also FIAS (2002), p.66.
1179 See Intv. European Institution (2007); see also Intv. Germ. MNC - Financial Services II (2007); Intv. Int'l Research Institute I (2007).
1180 See World Bank (2003).

(d) The analysis of primary[1181] and secondary sources[1182] suggests that the ability to implement existing laws is **important** for Croatia as investment location. From a lawyer's point of view the unsatisfactory enforcement of existing laws may even be the biggest problem in Croatia.[1183] It seems, however, that investors are less deterred by potential implementation problems than, for example, by Croatia's property rights situation or general performance of its bureaucracy. One reason for this may be that it is more difficult for investors to estimate the actual performance of a state in this field.[1184] Investors may also assume that the performance of other competing countries is not significantly better than Croatia's.[1185] Finally, they may expect that the situation will further improve with progressing integration with the EU in the years to come.

(e) The **assessment** of the performance of Croatia's bureaucracy in implementing laws suggests that the problems discussed above continue to be of significance. Reasons could be identified on both central and local level. They seem to be strongly interlinked with the overall deficiencies of Croatian public administration but also with the court system discussed below. Public policy makers may keep in mind that the accession criteria for Croatia are stricter than they used to be for Romania and Bulgaria. A comparison with the performance of neighboring or other EU countries may sugarcoat Croatia's problems. Nevertheless, company interviews also show that the importance of improving implementation is essential for Croatia to enter the European Union but less decisive for the attraction of FDI.

[1181] See e. g. Intv. German Authority III (2007).
[1182] See European Commission (2005a), p.45; World Bank (2003), p.3.
[1183] See Intv. Croat. Company I - Legal Services (2007).
[1184] International statistics also seem to be scarce.
[1185] See Intv. Croatian Authority II (2007).

(3) Some **regional differences** exist in Croatia regarding the quality of bureaucracy. An analysis reveals (a) some general insights, (b) a positive example in Varaždin and (c) less favorable experiences in Slavonia. The (d) importance of these differences seems to be significant. An assessment is presented in subsection (e).

(a) Experts interviewed **generally** recognize some significant regional differences in the quality of bureaucracy in Croatia. The county of Varaždin and its free economic zone are frequently cited as the most positive example.[1186] Investors also seem to have had fairly good experiences in medium-sized cities like Karlovac. Experiences in Zagreb are mixed; authorities are generally open to foreign investors and digitalization is quite advanced in many areas but procedures seem to take a long time. Most problems of investors have been reported – according to the interviewees – in small towns, namely in Slavonia[1187] but also in coastal areas in Southern Croatia.[1188]

(b) Not only external sources[1189] but also company experts interviewed evaluate the bureaucracy of **Varaždin** very positively.[1190] *Intv. Germ. MNC - Industrial Goods I (2007)* praises the good and quick support as well as the high commitment of all authorities involved from the beginning, including the mayor, the president of the local Chamber of Commerce and Mr. Mikac.[1191] Even today *Intv. Germ. MNC - Industrial Goods I (2007)* deals with authorities regarding customs, permits etc. on a daily basis and no problems have

[1186] See e. g. Intv. Germ. MNC - Industrial Goods I (2007).
[1187] See Intv. Germ. MNC - Industrial Goods I (2007); Intv. Austr. MNC - Primary Goods I (2007); Intv. Germ. MNC - Food Products (2007); but see also Intv. Croatian Mayor (2007).
[1188] See e. g. Doc - Germ. MNC - Engineering (2001), p.55; see also OECD (2003a), p.35.
[1189] See e. g. Simeunović (2006).
[1190] See e. g. Intv. Germ. MNC - Financial Services I (2007).
[1191] The mastermind of the zone and Managing Director of APIU; see Intv. Croatian Authority II (2007).

occurred so far. This positive assessment is also confirmed by various other company experts.[1192]

(c) The quality of the bureaucracy in **Slavonia** seems to be below the country's average. According to the interviewees procedures are longer-lasting, less transparent and less automatized than elsewhere.[1193] Furthermore, authorities are often very passive, and according to reports it is often difficult to find out who is responsible for a certain matter. Administrative decisions apparently tend to lack reliability and are often politically motivated.[1194] The use of local networks therefore seems to be a key for successful investments.[1195] Potential investors have also discovered that Slavonian administrations did not have adequate structures in place in order to successfully handle larger projects with EU involvement.[1196]

(d) The performance of regional bureaucracy seems relatively **important** for the FDI decision of MNCs. To some extent investors seem to be aware of regional differences as discussed above; interviews also reveal examples in which investors actually decided not to invest in Slavonia because of difficulties with the local bureaucracy.[1197] However, in contrast to Romania, for instance, the general quality of bureaucracy detached from regional issues seems to be more important for investors interested in Croatia, also because of the strong influence of central authorities and the limited country size which makes regional differences less prominent.

[1192] See e. g. Intv. Austrian Econ. Association II (2007); Intv. Austr. MNC - Consulting (2007); Intv. Germ. MNC - Financial Services I (2007).

[1193] See Intv. Austr. MNC - Retail (2007); Intv. Croatian Ministry I (2007); sees no significant differences to other regions, for example, Istria: Intv. Germ. MNC - Food Products (2007).

[1194] See Intv. Austr. MNC - Primary Goods I (2007); Intv. Germ. MNC - Industrial Goods I (2007).

[1195] See Intv. Germ. MNC - Food Products (2007); Doc - Germ. MNC - Food Products (2007).

[1196] See Intv. Germ. MNC - Industrial Goods I (2007).

[1197] See Intv. Germ. MNC - Industrial Goods I (2007).

(e) In the **assessment** of Croatia's deviations in regional differences it seems that bureaucracy seems to be functioning very well in **Varaždin**; however, the county may not be representative for Croatia, since it has been strongly supported by the central government. It also seems that – in comparison to Sibiu for example – its success was significantly based on a few individuals and less on a comprehensive administrative reform effort. It also has to be acknowledged that problems of some Croatian regions are partly caused by war damages, particularly in Vukovar, and that reforms of public administration and investment policy is understandably somewhat behind other regions. Nevertheless, interviewees suggest (as in Romania), that local actors should not underestimate their influence despite a high degree of centralization. Most importantly local public policy makers should try to make administrative decision more transparent and less influenced by personal and short-term interests.

(4) In **conclusion**, this section has shown that Croatia's administrative reforms are still in an early stage and that a better bureaucracy may lead to higher FDI inflows to Croatia, particularly in rural areas like Slavonia. The analysis of interviews and external sources revealed that positive efforts exist but that their full impact remains to be seen. Interviews with state experts in particular have clarified that key decision makers are well aware of many of the problems but that a sense of urgency is still lacking in many cases. Recent improvements in Romania, for example, show that external pressure, as provided in the further course of EU accession negotiation, may lead to somewhat more dynamic and thorough reform efforts.

7.2.3.4 General insights for transition countries

The analyses of this section and a further look at relevant FDI studies offer important insights into the quality of bureaucracy as FDI determinant for transition countries. The (1) weak performance of bureaucracy has been a key problem for all transition countries and (2) has had an significant impact on FDI flows. This section enables the (3) establishment of some key success factors for public policy actors.

(1) The **weak performance** of bureaucracy and problems in implementing regulations have been a key problem for transition countries on central as well as local levels. *Dunning (2005)* even finds that it has been the second greatest weakness of transition countries; out of 19 determinants only corruption was deemed to have had a more negative effect. In most EECs related issues were only superficially considered in the early phase of transition, also because more severe problems such as hyper-inflation (as in Romania) or even war (as in Croatia) demanded more political attention.[1198] For later development phases external studies find, in line with the conclusions of this section, that transition countries often elaborated a modern and adequate legal framework but bureaucracies frequently failed to provide adequate implementation. *Jacobs (2003)* therefore sees "an implementation gap between increasingly liberalized policies and legislation and the day to day reality faced by investors dealing with the many arms of bureaucracy."[1199] In this context regional differences as to how they handle these gaps within host countries have become more important, sometimes creating successful communities decoupled from the central development (as Sibiu in Romania)[1200] or even promoted by the central government (as Varaždin in Croatia).

The interaction with financial authorities seems to be the most cumbersome aspect of bureaucracy in most transition countries.[1201] Company interviews have been particularly helpful in showing that problems with bureaucracy –

[1198] See also Murrell (2002).
[1199] See also Intv. Croatian Ministry II (2007); Intv. Austr. MNC - Construction (2007).
[1200] See also Kikeri, Kenyon, and Palmade (2006).
[1201] See also Lejour (2007).

often called “red tape”[1202] – tend to affect those (often smaller) MNCs who cannot outsource related problems. On the other hand, the need for interaction seems to decrease over time for most investors once all required permits etc. have been issued. Investors that continuously expand (for example retailers) or that are active in highly regulated sectors (such as telecommunication) will continue to have significant interaction with authorities and will need to establish well-functioning relations from early on.[1203]

Nevertheless, all transition countries have shown improvements in recent years.[1204] Efforts to decrease the size of administration generally already started in the late 1990s, but more thorough attempts to make bureaucracy more efficient and to increase the performance of the officials[1205] were launched only recently and generally in the course of EU accession preparations (as in Romania).

(2) Even though difficult to measure[1206], recent FDI literature has identified good administration as an **important determinant** to attract FDI.[1207] *Baniak, Cukrowski, and Herczynski (2005)* conclude that time requirements, transparency and complexity of bureaucratic procedures are among key determinants for FDI to transition countries. Therefore, a poor quality of bureaucracy causes transaction costs, confusion and uncertainty for investors.[1208] *Jacobs and Coolidge (2006)* calculate that the reduction of bureaucracy costs for MNCs will increase FDI flows by 5%.

[1202] See e. g. Jacobs and Coolidge (2006); Merlevede and Schoors (2004).
[1203] See also Intv. Austr. MNC - Retail (2007); Intv. Germ. MNC - Telecommunications (2007).
[1204] See also Dunning (2005).
[1205] See also Kikeri, Kenyon, and Palmade (2006).
[1206] See Hanson (2001).
[1207] See Murrell (2002); Campos and Kinoshita (2003); Bénassy-Quéré, Coupet, and Mayer (2005).
[1208] See Kinoshita and Campos (2006); Holland, Sass, Benacek, and Gronicki (2000).

The analyses of this section share the assumption of a positive correlation between good quality of bureaucracy and FDI inflows in general. It seems likely that Eastern Europe would have attracted more FDI inflows in the 1990s, if authorities had been more professional and more open to investors. However, it also seems apparent that the importance is less significant than, for example, property rights since MNCs are usually confronted with many of the problems discussed not until they have already decided in favor of a specific host country. *Globerman and Shapiro (2002)* also indicate that the standard of bureaucracy may be less important than other factors. Furthermore, company interviews show that the quality of the implementation of laws is especially difficult to measure for investors and they generally assume that all transition countries have similar problems even after entering the EU (as in Romania). In contrast, regional differences may have a very important impact on the investment decision of MNCs within a country. They can be enhancing (as in Sibiu in Romania and Varaždin in Croatia) or constraining (as in Slavonia in Croatia). Finally, the importance of this factor is strongly interlinked to other factors such as market access, property regulations, corruption, and court system.[1209]

(3) This section showed that state representatives interviewed are well aware of most of the existing deficiencies in transition countries; however, they also need to recognize their own possibilities and to make use of their own powers to contribute to the reform process both on the central and local level. From the analyses above several **key success factors** can be derived for a high quality bureaucracy in transition countries. Good administrations contain quick bureaucratic procedures and reliable decisions free from personal interests. Administrations should have an open approach to service and be helpful towards domestic and foreign investors. Successful administrations should have a lean

[1209] See also EBRD (2004); Wei (2000a).

structure, employ sufficient lawyers and aim at compensation comparable to the business sector, for example through more effective incentives schemes.[1210] Administrations' leaders need to give up some of their control and delegate work in order to avoid the backlog of work.[1211] The influence of local authorities may differ among transition countries[1212], but governments everywhere should further decentralize administrative procedures in order to enable the adjustment of investment conditions according to local needs. On the local level a clear distribution of responsibilities between the Chamber of Commerce, the city as well as the country administration seems to be essential.[1213] Finally, the example of Hitrorez also shows that all improvements have to be accompanied by appropriate public relations measures in order to increase the awareness of investors.[1214]

7.2.4 Legal certainty

7.2.4.1 Definition

Once MNCs have begun their investment and are running their operations in the host country, they expect that full legal certainty to be given in an ideal investment environment. They demand (1) a consistent and unmistakable legal basis (the legal side of legal certainty), a well-functioning implementation of laws by bureaucracy (as discussed in the previous section) and (2) a reliable court system that helps them to enforce contracts etc (the juridical side of legal certainty).[1215] Section (3) provides country-specific conclusions.

[1210] See also Jacobs and Coolidge (2006), p.12; Kikeri, Kenyon, and Palmade (2006).
[1211] See Intv. Int'l MNC - Utilities (2007); Intv. Croatian Ministry IV (2007); Intv. Croat. Company - Utilities (2007); Intv. German Authority III (2007); Intv. German Authority II (2007).
[1212] They seem to be more independent, for example in Romania than in Croatia.
[1213] See also Intv. Int'l MNC - Utilities (2007); Intv. Germ. MNC - Industrial Goods III (2007).
[1214] See also the example of Macedonia; Intv. Former Croatian Minister (2007).
[1215] See also Dresdner Bank (2004), p.22; OECD (2005d), p.43; Leiße (2006), p.9.

7.2.4.2 Romania

(1) Romania's **law-making side of legal certainty** drew (a) significant criticism in earlier years of transition, but has undergone (b) fundamental reforms since the early 2000s. Some (c) minor problems remain, but for now legal certainty has (d) become an enhancing factor for FDI in Romania. Section (e) presents an assessment.

(a) **In the early years** of transition external observers identified **substantial problems** in Romania's law-making process, marked by contradicting laws and legal gaps which led to the adoption of several hundred emergency ordinances annually.[1216] Interviewees also remember that Romania passed a large number of new laws in many areas in the 1990s[1217] that were not always thought through, were frequently modified, many times ad-hoc, and sometimes even ex-post.[1218] External sources agree that long-term planning was therefore difficult for MNCs, for example, because tax bases and rates were frequently changed.[1219] Overall, a solid legal basis was not given in most areas until the early 2000s.[1220]

(b) External sources[1221] and the great majority of interviewees[1222] agree that the law-making process and legal certainty have **significantly improved** in Romania since the early 2000s. Interviewees point out that laws now change less frequently. Furthermore, the law-making process has become more reliable, transparent and predictable as well as less contradictory.[1223] One important

[1216] See European Commission (1999), p.64; IMF (2001), p.56; European Commission (2005c), p.11.
[1217] See already previous sections for examples.
[1218] See e. g. Intv. Int'l MNC - Utilities (2007); Intv. Germ. MNC - Financial Services II (2007).
[1219] See Müller (2005), p.194; FIC (2002), pp. 16, 25.
[1220] See Intv. German Econ. Association V (2007).
[1221] See e. g. EBRD (2005b), p.5; European Commission (2005c); OECD (2005d).
[1222] See e. g. Intv. Int'l MNC - Utilities (2007); Intv. Romanian County Council (2007); Intv. German Econ. Association VII (2007).
[1223] See Intv. Supranational Authority I (2007); Intv. Austr. MNC - Legal Services (2007); Intv. German Authority IV (2007); Intv. Int'l MNC - Utilities (2007).

reason for this is that all ministries and interest groups concerned (such as industry associations) now have to be consulted before a law is passed.[1224]

Apparently, most of the relevant improvements were initiated during the EU accession process. Interestingly, this is mainly acknowledged by external company and state expert interviewees than by investors interviewed, maybe because the latter tend to have less legal expertise.[1225] Yet, investors now seem to be quite satisfied with the law-making side of the legal certainty, also because rights could now be enforced via European courts.[1226] They evaluate Romania's situation comparable to other EECs[1227] or even better than, for example, in Ukraine.[1228]

(c) Nevertheless, **some problems remain** with respect to Romania's legislative dimension of legal certainty. Interviewees[1229] and external sources[1230] still see some examples of consistency gaps, often because old laws are not eliminated, yet. *Intv. Austr. MNC - Legal Services (2007)* also states that existing laws are still not fully established and subject to more updates than, for instance, in Western Europe. Some experts interviewed even make the criticism that legal certainty is still not given in many cases and has not improved significantly in recent years.[1231] However, the examples they cite, such as arbitrary decisions, lacking distribution of powers and enforcement of rights, tend to con-

[1224] The so-called sunshine-law; Law no. 52/2003; see also European Commission (2005c), p.11.; OECD (2005d), p.41; Intv. Romanian NGO (2007).

[1225] See Intv. Austrian Econ. Association I (2007); Intv. Austr. MNC - Legal Services (2007); Intv. German Econ. Association VI (2007); Intv. German Authority I (2007); Intv. Germ. MNC - Utilities (2007); Intv. Romanian County Council (2007); Intv. Supranational Authority I (2007); Intv. German Econ. Association III (2007).

[1226] See Intv. Austr. MNC - Financial Services I (2007); Intv. Supranational Authority I (2007); Intv. Germ. MNC - Automotive (2007); Intv. Austrian Econ. Association I (2007); Intv. German Econ. Association VI (2007).

[1227] See Intv. Austr. MNC - Industrial Goods I (2007); Intv. Romanian Econ. Association II (2007); Intv. Romanian Ministry I (2007).

[1228] See Intv. German Econ. Association III (2007).

[1229] See Intv. German Econ. Association I (2007); Intv. Germ. MNC - Consulting I (2007).

[1230] See Mihai (2005); European Commission (2005c), p.12; Müller (2005), pp.209-210.; FIC (2005), p.11; European Commission (2006d), p.51; DB Research (2006).

[1231] See Intv. German Political Adviser (2007); Intv. Germ. MNC - Retail (2007).

cern the court system and are discussed in the following section. A survey of the German Economic Chamber also shows that legal certainty was among the worst performing determinants of Romania's investment conditions (22nd out of 26) in 2006.[1232] This evaluation may, however, not reflect the most recent improvements due to EU accession and may also be driven by the fact that the survey also does not distinguish between the legal and the juridical side of legal certainty.

(d) Legal certainty represents an **important motivation** for the investment decision of MNCs.[1233] Investors generally examine the legal environment thoroughly before deciding on an investment.[1234] Consistency and transparency in the administrative law seem to be most relevant in this context.[1235] Both primary[1236] and secondary sources[1237] give evidence that law-making deficiencies led to legal uncertainty until the early 2000s and contributed to lower FDI flows to Romania – at least in the early 1990s. External sources however also find that MNCs worried less about intransparent legislation in Romania than, for example, in Bulgaria or Poland.[1238]

Interviews and FDI studies suggest that Romania's accession to the EU has transformed the legal aspect of legal certainty from a constraining to an enhancing factor.[1239] Company experts interviewed have heard of various MNCs who waited for Romania to enter the EU in 2007 before initiating their investment. State representatives are even convinced that the increasing legal certainty will

[1232] See AHK (2006).
[1233] See Intv. German Econ. Association V (2007); Intv. Austr. MNC - Industrial Goods I (2007).
[1234] See Intv. Austr. MNC - Industrial Goods I (2007).
[1235] More important than e. g. civil law, criminal law or human rights; see Intv. Germ. Legal Expert (2007).
[1236] See Intv. German Econ. Association V (2007).
[1237] See Genco, Taurelli, and Viezzoli (1993); Dresdner Bank (2004), p.22.
[1238] See Genco, Taurelli, and Viezzoli (1993).
[1239] See e. g. Intv. German Econ. Association III (2007); Intv. Romanian Ministry I (2007); more skeptical: Intv. German Political Adviser (2007).

help to enhance Romania's credibility and FDI inflows in the future.[1240] In contrast, interviews with company experts tend to indicate that this positive effect may cease in the coming years.[1241] This interpretation is also supported by the survey of *AHK (2006)* in which a decrease of the importance of legal certainty can be noted from 2006 to 2007.[1242] According to the survey, legal certainty was the most important determinant for investors in 2006, maybe because only German investors participated in the survey who are – as shown for property rights above – particularly eager to minimize risks.

(e) The **assessment** makes it apparent that the poor quality of Romania's legislation may have deterred some investors in the early years of transition. However, the legislative dimension of legal certainty underwent significant improvements in recent years, mostly under the pressure of the EU in the accession process. However, it seems that some external studies and public policy makers may sometimes overestimate the impact of this factor. In fact, investors interviewed often knew only little about details in legal harmonization in Romania – for example regarding the changes due to EU pressure – and generally more regarding administrative procedures. EU accession may have increased the awareness of Romania's legally codified legal certainty, but most of the laws relevant for investors had already been adjusted to EU standards in the previous years.[1243] Public policy makers should therefore be aware that the positive, FDI-enhancing effect will vanish soon – investors may just have delayed investments that they had been planning anyway. Public policy should nevertheless increase efforts to provide rewarding information to investors about the legal framework in Romania in order to overcome existing

[1240] See Intv. Romanian Econ. Association II (2007); Intv. Romanian Ministry I (2007).
[1241] See e. g. Intv. Germ. MNC - Consulting II (2007); Intv. German Econ. Association III (2007).
[1242] See also Doc - German Econ. Chamber Romania (2007) for 2007 figures.
[1243] Even though the enforcement of rights in European courts was impossible until EU accession.

knowledge gaps and continued worries of risk-averse investors.

(2) Romania's judiciary side of legal certainty, the **court system**, has (a) performed fairly poorly in the past, (b) reforms are ongoing, but (c) significant problems persist, d) even though the factor may only have average importance on the investment decision of investors. An assessment for Romania is presented in sub-section (e).

(a) The work of Romania's courts was frequently **criticized in the past**. According to interviewees[1244] and external sources[1245], existing laws were not always sufficiently enforced. Decisions were often intransparent or even arbitrary and white-collar crimes were rarely brought to court. Reasons for these shortcomings mentioned in external studies include the low number of judges and their often deficient education, strong political pressure on judges and the fears of some judges of physical threats at that time.[1246] In addition to this, company experts remember that trials were inefficient and lengthy, even in the early 2000s, and could take several years. Sometimes investors had to wait for 7-8 years for a decision in trials, also because even small issues could be brought all the way up to the highest court.[1247]

(b) Both primary[1248] and secondary sources[1249] see **some progress** as well as signs of modernization and europeanization of Romania's court system. Reforms were initiated to strengthen the independence of the jurisprudence which was codified in the constitution. The establishment of the Superior Council of

[1244] See Intv. Germ. MNC - Financial Services III (2007); Intv. Int'l Econ. Association (2007).
[1245] See European Commission (2001), p.20; FIC (2002), p.9; Leiße (2006), p.9; Menzer (2006).
[1246] See also European Commission (1999); p.64; European Commission (2002a), pp.24-26.
[1247] See e. g. Intv. German Econ. Association V (2007).
[1248] See e. g. Intv. German Econ. Association III (2007); Intv. Germ. Political Foundation II (2007); Intv. Germ. MNC - Automotive (2007); see also Doc - Min. of Justice (2005a).
[1249] See European Commission (2005c); OECD (2005d); IMF (2006b).

Magistracy (2003) seems to be a major achievement in this context.[1250] The council comprises judges, public prosecutors and the minister of justice and aims at the increase of judicial independence from political influence, for example through the exclusive supervision of appointments, transfer and actions of judges.[1251] External sources[1252] and interviewees[1253] acknowledge that the council has helped state attorneys and judges to act more independently of politics and to become more open to reforms. Furthermore, the number of judges was increased from 1,513 (1990) to 3,671 (2005).[1254] The law of practice was reformed and since 2004 extraordinary revisions are not possible anymore. An electronic archive of claims was established and thus also increases legal certainty for investors. In 2005 Romania signed the OECD Declaration on International Investment and Multinational Enterprises.[1255] Interviewees add that the duration of lawsuits has decreased, also because limitations of levels of jurisdiction were introduced[1256], court decisions have become more reliable[1257] and seem little biased towards foreigners today.[1258]

In particular state experts interviewed point out that most of these improvements were initiated under the pressure of accession preparations to the EU.[1259]

1250 Laws no. 317/2004 and 247/2005; see Intv. Germ. Legal Expert (2007); Intv. Germ. Research Institute I (2007).

1251 See Superior Council of Magistracy website (2008); see also Intv. Austr. MNC - Legal Services (2007).

1252 See e. g. European Commission (2006e), p.6.

1253 See Intv. Germ. Legal Expert (2007); Intv. Austr. MNC - Legal Services (2007); Intv. Germ. Research Institute I (2007).

1254 See National Institute of Statistics (2007).

1255 See OECD (2006c), p.18; OECD (2005d), pp.43-44; European Commission (2005c), p.14.

1256 See Intv. German Econ. Association V (2007).

1257 See Intv. Austr. MNC - Legal Services (2007); see also Intv. German Authority IV (2007).

1258 See Intv. Austrian Econ. Association I (2007).

1259 See Intv. Supranational Authority I (2007); Intv. Romanian NGO (2007); even though some reforms were already initiated before the actual EU accession process under Minister of Justice Diaconescu (until 2004); see also Intv. Romanian County Council (2007); Intv. Germ. Legal Expert (2007).

While foreign external sources[1260] generally give much credit to Minister of Justice Macovei (2004-2007), interviewees are more skeptical. Critics state that she quickly became a speaker of President Băsescu in his quarrel with Prime Minister Popescu-Tăriceanu.[1261] Furthermore, some experts criticize that "the EU has made Ms. Macovei a hero of legal reform without seeing that some of the laws actually reduce the independence of the justice system."[1262] These aspects are further analyzed in the following section.

(c) Various **essential problems** in the Romanian court system **remain**. Court decisions as well as their implementation still take too long in the perception of the experts (up to 4-5 years)[1263], even though they may be lengthy in other SEECs as well.[1264] Even state representatives complain that the long duration of trials can be an obstacle for them, for example, for the progress of local projects such as public tenders.[1265] International statistics confirm this mediocre evaluation of the interviewees regarding the time required to settle legal issues. According to *World Bank (2007b)*, the enforcement of contracts, for example, takes on average 537 days in Romania and is faster in nine of 19 EECs (*figure 43*).

Reasons given for this long duration are an insufficient number of judges and supporting staff[1266], deficiencies in the general and specific training of

[1260] See e. g. BA-CA (2007b); The International Herald Tribune (2008).
[1261] See section 7.4.2 for further details; see Intv. Germ. Research Institute I (2007); see also Intv. Romanian NGO (2007); Intv. Germ. Legal Expert (2007).
[1262] Intv. Germ. Research Institute I (2007).
[1263] See Intv. German Econ. Association III (2007); Intv. Germ. MNC - Automotive (2007); Intv. Int'l Econ. Association (2007); Intv. Austrian Econ. Association I (2007); Intv. Germ. MNC - Consulting I (2007); Intv. German Authority IV (2007); Doc - Min. of Justice (2005a); less critical Intv. Romanian Authority I (2007).
[1264] See Intv. Austr. MNC - Financial Services II (2007); Intv. Supranational Authority I (2007).
[1265] See Intv. Romanian County Council (2007).
[1266] See Intv. Austrian Econ. Association I (2007); Intv. Germ. Legal Expert (2007).

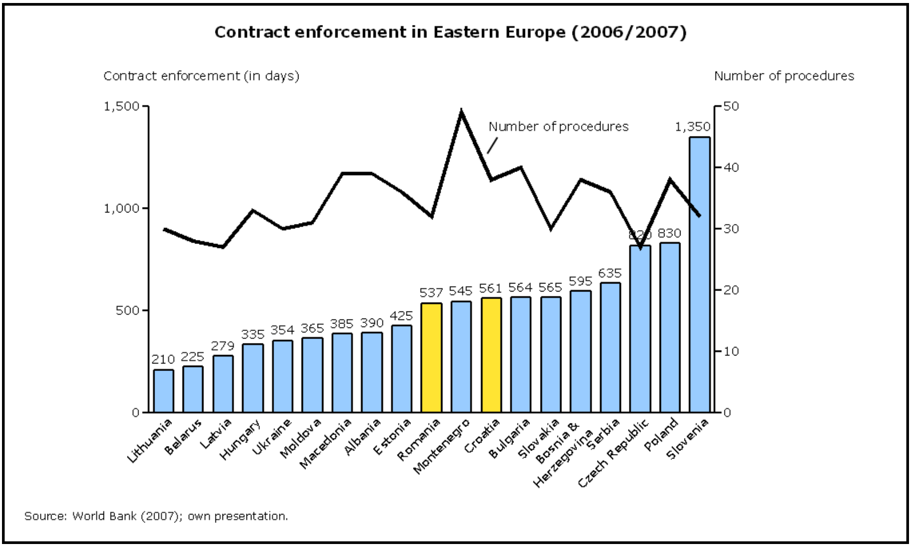

Figure 43: Contract enforcement

judges[1267], low salaries that affect motivation[1268], the lack of specialized courts (for example for labor law)[1269], and the high turnover of judges.[1270] Interviews do not give a clear evaluation regarding judges who are still in place from socialist times – maybe because of diverging personal experiences. Some experts think that they are willing to execute reforms and are often better educated than younger ones[1271], while others believe that the court system would initiate reforms more quickly if more of the former judges from socialist times had been replaced.[1272]

1267 See Intv. Supranational Authority I (2007); Intv. Germ. MNC - Consulting II (2007); Intv. Germ. Research Institute I (2007); Doc - Min. of Justice (2005a); see also OECD (2003c).
1268 See Intv. Germ. Research Institute I (2007).
1269 See Intv. Int'l Econ. Association (2007).
1270 Some become lawyers, other may be promoted etc.; see Intv. Austr. MNC - Legal Services (2007).
1271 See e. g. Intv. Germ. Legal Expert (2007).
1272 See Intv. Germ. Political Foundation II (2007).

Procedural problems mentioned by interviewees are that gaps between sessions are too long, and too many hearings are possible[1273], an attorney is not required[1274], too many possibilities exist to delay a final decisions including the quick transfer to the next higher level.[1275] Moreover, attorneys are paid by session and number of written submissions and therefore have an interest in prolonging cases.[1276]

Furthermore, jurisdiction is still not always consistent and depends on the individual judge.[1277] One reason may be Romania's large number of courts – 187 local courts and 15 courts of appeal[1278] – which makes consistent decisions difficult.[1279]

External[1280] and primary sources[1281] also see continued dangers to the independence of the justice system from politics, for instance with regard to the combat of corruption in politics.[1282] The modifications of the statute of judges and prosecutors[1283] mean that leading judges and state attorneys are only appointed for three years and can only be selected after very positive evaluations through their peers. Experts may wonder if sufficient positions can be filled and if political pressure, for example regarding evaluations can be avoided. Further recent legal changes require judges to pay compensations for errors in procedures and substantive law and may also endanger the independence of

[1273] See Intv. Germ. Legal Expert (2007).
[1274] As a result cases may be prolonged when some Romanians defend themselves.
[1275] See Intv. Germ. MNC - Consulting I (2007); Intv. Austr. MNC - Legal Services (2007); Intv. Germ. MNC - Automotive (2007).
[1276] In German, for example, attorneys' renumeration is based on the value of the claim; see Intv. Germ. Legal Expert (2007).
[1277] See Intv. German Econ. Association VI (2007); Intv. Germ. MNC - Retail (2007); Intv. Germ. Legal Expert (2007); see also European Commission (2006d), p.34.
[1278] E. g. North Rhine-Westphalia has only 3 courts of appeal and 16M inhabitants (vs. 22M).
[1279] See Intv. Austr. MNC - Legal Services (2007); Intv. Germ. Legal Expert (2007).
[1280] See e. g. Financial Times (2006a); European Commission (2006d), p.51.
[1281] See e. g. Intv. Germ. Political Foundation II (2007); Intv. Germ. Legal Expert (2007); Intv. Austr. Research Institute (2007); Doc - Min. of Justice (2005b).
[1282] See section 7.4.3.
[1283] Law no. 303/2004 republished.

judges.[1284] In sum, (mainly legal) experts wonder if some of the recent legal reforms (mostly under Minister Macovei) may have increased transparency and humans rights but also weakened the independence of the justice system.[1285]

Some problems may have been aggravated by the EU.[1286] The EU asked for comprehensive concepts and reforms but did not always detail clearly enough her demands nor provide enough time and resources in order to give useful advice.[1287]

Interviewees' perception of the integrity of judges is mixed. While some are certain that briberies do not occur[1288], others assume that decisions are still bought occasionally even though less frequently than ten years ago.[1289] In any case it seems that judges are quickly replaced in the course of trials even when there are little proofs that they could be biased. This again may prolong cases and undermine the independence of the magistracy.[1290]

The justice system remains one of the areas which is most heavily monitored and criticized by the EU even after accession.[1291] Some interviewees even conclude that the juridical aspects of legal certainty have not much improved in the last five years at all[1292], even though they may ignore too much the reform efforts discussed above.

(d) Interviews with state representatives suggest Romania's court system is a question of fundamental **significance** for the locational decision of in-

1284 See e. g. Intv. Germ. Legal Expert (2007); Intv. Germ. Research Institute I (2007).
1285 See Intv. Germ. Legal Expert (2007); Intv. Austr. MNC - Legal Services (2007).
1286 See Intv. Germ. Legal Expert (2007); see also Intv. Austr. Research Institute (2007).
1287 See Intv. Germ. Legal Expert (2007).
1288 See Intv. Austrian Econ. Association I (2007); Intv. Germ. Legal Expert (2007).
1289 See Intv. Germ. MNC - Consulting II (2007); Intv. Germ. MNC - Financial Services III (2007); Intv. Germ. MNC - Retail (2007); Intv. Austr. MNC - Primary Goods II (2007).
1290 See Intv. Germ. MNC - Automotive (2007); Intv. Germ. Legal Expert (2007).
1291 E. g. regarding administrative capacities for the superior council of magistracy; see Intv. Supranational Authority I (2007); Intv. Romanian Ministry I (2007); see also European Commission (2007e).
1292 See Intv. Germ. MNC - Retail (2007); Intv. Germ. MNC - Consulting II (2007); Intv. German Political Adviser (2007).

vestors.[1293] However, and despite the various problems discussed, company interviews rather suggest that MNCs are not greatly deterred by the judiciary part of legal certainty. It seems that (particularly smaller) investors do not necessarily expect to get much in contact with courts in the first place and that many of them indeed have not.[1294] Interviews further suggest that experiences in Romania do not greatly vary from those in other Eastern European markets.[1295]

Therefore, it seems that legal harmonization has been rather important for investors' perception of legal certainty and as a country determinant for Romania, at least in the course of accession to the EU. This evaluation is also somewhat reflected in comparative international surveys; according to *CICD (2006)* 20% of investors see the work of courts in Romania as essential barrier in 2005 and therefore on a similar level as in Bulgaria (17%) but less problematic than, for example, in Macedonia (31%).

(e) When **assessing** the judicial dimension of legal certainty it becomes apparent that Romania's court system has not progressed as much as its law-making in recent years. To some extent this is understandable because changes in the court system such as education, jurisdiction etc. take longer than the adoption of new laws. Interviews with legal experts were particularly helpful for identifying remaining problems. In contrast, most investors generally feel that the work of courts is improving but only slowly and that they should try to avoid going to court, not because they worry about bias but because of the cumbersome procedures. Therefore, the independence of judges seems less relevant for their FDI decision. Another reason for the limited importance of the court system as a FDI determinant may be that some MNCs are also

[1293] See Intv. Romanian NGO (2007); Intv. Germ. Research Institute I (2007); Intv. Germ. Legal Expert (2007).
[1294] See e. g. Intv. Germ. MNC - Legal Services I (2007); Intv. Int'l MNC - Utilities (2007); Intv. Austr. MNC - Consumer Goods (2007).
[1295] See e. g. Intv. Austr. MNC - Financial Services II (2007).

somewhat naive to expect they will have not contact with the courts at all. On the other hand, state representatives may occasionally overestimate the importance of these aspects, perhaps because they have experienced constant pressure from the EU for improvements in this field.

Romanian public policy makers will need to work more thoroughly on finding an adequate balance between the independence of the court system and the achievement of political goals, such as the fight against corruption. In this context, a thorough analysis of the status – for example regarding the required number of staff – and a single and comprehensive concept are needed to overcome remaining problems. Public policy should also increase the knowledge about Romania's court system in authorities that are in frequent contact with investors, such as the Romanian Agency for Foreign Investments (ARIS), to be able to quickly answer all relevant questions. Overall, the further strengthening of the court system may not have so much direct influence on FDI inflows to Romania but it will help to fulfill the remaining demands of the EU and improve the rights of citizens and businesses.

(3) In **conclusion**, this section has shown that the legal and judicial dimension of legal certainty were important constraining factors for FDI to Romania in earlier years. Improvements on the legal side were substantial, while the court system still shows significant room for improvements. After EU accession it seems that legal certainty will lose some of its importance and interviews reveal that state experts may even somewhat overestimate the impact of this determinant while company experts know often less about the specifics of legal certainty than, for example, regarding administrative procedures; they generally assume that conditions regarding legal certainty are similar in all Eastern European EU members. Finally, this section indicates interdependences of le-

gal certainty mainly with corruption, EU accession and political stability (*see sections below*).

7.2.4.3 Croatia

(1) The analysis of Croatia's **law-making dimension** of legal certainty shows that (a) investors were very concerned in the course of the 1990s, but (b) laws have been significantly harmonized in recent years. Even though (c) many problems remain, (d) the importance of the factor as a country determinant is decreasing for Croatia. Sub-section (e) presents an assessment.

(a) **For the 1990s** and even the early 2000s, primary[1296] and secondary[1297] sources find **substantial deficiencies** in the consistency and comprehensiveness of Croatia's legal framework. Company experts interviewed remember that investors were skeptical in that period whether legal certainty was given.[1298] As for administrative procedures most legal problems occurred in the real estate sector in which legislative gaps and the lack of rule of law made investments very risky.[1299]

(b) Croatia has made – according to interviews[1300] and secondary[1301] sources – **significant improvements** in reforming its legal framework and strengthening its rule of law **in recent years**, particularly since 2002. "The law making process is functioning in Croatia"[1302] and seems to be less of a problem than implementation (*as discussed above*). Most Croatian laws are based on German and Austrian models and are increasingly influenced by the EU acquis.[1303]

[1296] See e. g. Intv. Croat. Company II - Legal Services (2007); Intv. Germ. MNC - Engineering (2007).
[1297] See e. g. NCC (2004b); European Commission (2005a).
[1298] See Intv. Germ. MNC - Engineering (2007); Intv. Germ. MNC - Telecommunications (2007).
[1299] See Intv. Croat. Company II - Legal Services (2007).
[1300] See e. g. Intv. Supranational Authority II (2007); Intv. Croatian Ministry III (2007).
[1301] See e. g. European Commission (2007a); Moore and Vamvakidis (2007).
[1302] Intv. German Authority III (2007).
[1303] See also sections above; see APIU (2006b), p.40; Intv. Germ. MNC - Financial Services I (2007).

Already now most Croatian laws seem to be in compliance with European standards or even superior to Western European laws.[1304]

To most interviewees Croatian laws seem to provide sufficient legal certainty for investors today in order to enforce their claims.[1305] State representatives also emphasize that the Croatian legal framework does not distinguish between domestic and foreign investors.[1306] In terms of legal certainty Croatia is seen as the second safest country of former Yugoslavia after Slovenia.[1307] Interviewees expect that the legal side of legal certainty including the removal of old Yugoslavian laws will further continue in the course of EU integration.[1308]

(c) However, **some problems** with regard to Croatia's law-making **remain**. Interviewees criticize some continued legal gaps, overlaps due to the different origins of legislation and the still frequent changes of legislation.[1309] State representatives also assume that laws are sometimes drafted and adopted too quickly and require more reflection and coordination.[1310] Furthermore, company experts express that MNCs do not always feel completely legally on par with domestic firms.[1311]

1304 See Intv. Austr. MNC - Construction (2007); Intv. Germ. MNC - Financial Services II (2007).

1305 See Intv. Austr. MNC - Real Estate (2007); Intv. German Authority II (2007); Intv. Germ. MNC - Telecommunications (2007); Intv. Austr. MNC - Financial Services I (2007).

1306 See e. g. Intv. Croatian Econ. Association (2007).

1307 See Intv. Germ. MNC - Industrial Goods I (2007).

1308 See Intv. Austr. MNC - Primary Goods I (2007); Intv. Austr. MNC - Construction (2007); Intv. Austr. MNC - Retail (2007); Intv. Germ. MNC - Financial Services I (2007).

1309 See Intv. Germ. MNC - Telecommunications (2007); Intv. Croatian Ministry IV (2007); Intv. Croatian University (2007); with respect to tax legislation: Intv. Germ. MNC - Financial Services II (2007).

1310 See Intv. Croatian Ministry IV (2007); Intv. Croatian Ministry III (2007).

1311 See Intv. Austr. MNC - Financial Services I (2007).

Overall both primary[1312] and secondary sources[1313] raise doubts that legal certainty has been fully established. Various interviewees point out that the legal harmonization and legal certainty remain a main area of future reform in Croatia[1314] which will be challenging in the context of EU integration in particular since requirements of the EU are higher for Croatia than, for example for Romania.[1315] Main areas of concern remain real estate issues[1316], but also cross-border services.[1317]

(d) Investors interested in Croatia generally seem to regard legal certainty as an **important factor** for their investment decision[1318], particularly in sectors with frequently changing legislation such as real estate.[1319] Legal certainty apparently remained a constraining factor for Croatia until recently. *Intv. Germ. MNC - Engineering (2007)* explains that legal certainty was one of the most important reasons behind the decision not to invest in Croatia in the early 2000s (together with property rights). According to other investors, legal certainty was in doubt in that period but was seen as an acceptable risk, at least for larger investors .[1320] The problems discussed above were often the reason why Croatia was only the second choice of investors in the region after Slovenia.[1321] Interviewees state that these issues also explain why there is so little Greenfield investment in Croatia and why many investors preferred FDI in privatizations, re-capitalizations and acquisitions in order to avoid as many legal

[1312] See e. g. Intv. Austr. MNC - Primary Goods I (2007); Intv. Germ. MNC - Telecommunications (2007).
[1313] See European Commission (2005a); European Commission (2006a); Intv. Supranational Authority II (2007).
[1314] See Intv. German Authority II (2007); Intv. Croatian Ministry III (2007); Intv. Croatian Authority II (2007); Intv. Croatian Government Team (2007).
[1315] See section 7.4.4; see Intv. Germ. Political Foundation I (2007).
[1316] See Intv. Croatian Company - Real Estate (2007).
[1317] See European Commission (2006a).
[1318] See for external sources e. g. Intv. Supranational Authority II (2007).
[1319] See Intv. Austr. MNC - Real Estate (2007); Intv. Austr. MNC - Primary Goods I (2007); see also Intv. Former Croatian Minister (2007).
[1320] See Intv. Germ. MNC - Telecommunications (2007).
[1321] See Intv. Germ. MNC - Industrial Goods I (2007).

problems as possible.[1322] Lack of legal certainty functioning as a deterrent in FDI apparently started to lose its importance after 2002 when many Western investors were already present in Slovenia and law-making started to become more stable in Croatia.[1323]

(e) In the **assessment** of the legal dimension of legal certainty, this section has shown that Croatia has made significant improvements in recent years. Remaining deficiencies, compared to Romania for example, seem understandable since EU accession negotiations created an additional push in reforming the existing legal framework. It seems that (comparable to the Romanian situation) the legal side of legal certainty is turning from a constraining into an enhancing factor for FDI with increasing integration towards the EU. Even though interviewees do not seem to recognize a breakthrough in this direction so far, public policy may be able to learn from the Romanian example and use the momentum of approaching legal certainty more actively for investment promotions before the effect ceases. The improvements with respect to law-making and legal harmonization should be used to differentiate Croatia from other countries of former Yugoslavia that may be more competitive in other areas such as labor costs or GDP per capita growth.

(2) This section gives insights regarding (a) problems in Croatia's **court system** in the early phase of transition, (b) some gradual improvements since the early 2000s and (c) substantial continued problems today. The (d) importance of the court system seems to be significant as FDI determinant for Croatia. An assessment is provided in sub-section (e).

(a) Investors apparently had **major concerns in the past** that legal certainty could not be guaranteed by Croatia's courts. Criticism from experts in-

[1322] See Intv. European Institution (2007).
[1323] See Intv. Germ. MNC - Industrial Goods I (2007).

terviewed[1324] and secondary sources[1325] include that lawsuits often took many years, foreigners frequently felt discriminated (particularly by local courts), bribery was repeatedly necessary in order to be successful in court, and the enforcement of laws was very cumbersome. A major problem at that time was the large backlog of 1.1M pending cases in Croatian courts (2001)[1326] which was significantly higher than, for example, in Romania with 340K cases.[1327] An important reason for this seems to have been the procedural law that enabled sending cases back to the first instances for an unlimited time before a final decision was taken. Furthermore, interviewees and external sources criticize the shortage of judges and the lack of practical education at that time.[1328] In this context, interviews in particular suggest that war time incorporated additional challenges to Croatia's court system. Many judges were dismissed during that period, not because of incompetence or lack of integrity but due to political pressure. They were often succeeded by young, inexperienced and sometimes incompetent judges.[1329]

(b) **Improvement and modernization** of the judicial system were a top priority for Croatian governments since 2001[1330] and five reforms and the support of World Bank and CARDS programs helped to make the Croatian courts system gradually more efficient.[1331] However, substantial actual reforms did not commence until 2005 when a more comprehensive strategy was established, including various actions plans and when the annual budget of the judicial system

[1324] See e. g. Intv. Germ. MNC - Engineering (2007); Intv. Croatian Ministry IV (2007).
[1325] See e. g. FIAS (2002); OECD (2003c).
[1326] See OECD (2003c); see also FIAS (2002), p.48; McGee (2003).
[1327] Romanian figures for 1999. Croatia with 1 case per 4 inhabitants and Romania with 1 per 50 inhabitants; see also European Commission (1999), p.12; own calculations.
[1328] See FIAS (2002); European Commission (2005a), p.15; Intv. Croatian Ministry IV (2007).
[1329] See Intv. Croat. Company II - Legal Services (2007); Intv. Croatian Ministry IV (2007); see also Intv. German Authority II (2007).
[1330] See EBRD (2005a), p.49; see also OECD (2006a).
[1331] See Intv. Croat. Company II - Legal Services (2007); see also Bertelsmann Stiftung (2006b), pp.1, 5.

was increased by 16%.[1332] Independent appeal procedures were established[1333], the number of hearings and the time between hearings were reduced.[1334] State representatives point out that further measures are about to be adopted in order to cut off possibilities for extending and prolonging lawsuits.[1335]

After a rise in the backlog to 1.4M cases in 2004 the Enforcement Act (2005) and an order of the constitutional court (that decided to deal with old cases first, before starting to work off new ones) helped to reduce the number of backlog cases to about 1M cases in 2007, mainly driven by a reduction of enforcement cases.[1336] The government also tackled the duration of trials and introduced an obligation for judges to finish a case within a reasonable amount of time.[1337] Interviewees also point out that commercial courts (which do not even exist in Romania) generally function well in Croatia[1338] and have some well-educated and motivated judges nowadays who finish cases within an average of two months.[1339] In fact, education of court staff in general has apparently improved in recent years – for example, due to the establishment of education centers for judges in several Croatian cities – and may be even better than in other SEECs including Romania.[1340]

[1332] See Intv. Croatian Ministry IV (2007); Intv. Croatian Government Team (2007); Intv. Germ. Political Foundation I (2007); see also European Commission (2005a), pp.11 and 84.
[1333] See OECD (2006a).
[1334] See Intv. Croat. Company II - Legal Services (2007).
[1335] See e. g. Intv. Croatian Ministry III (2007).
[1336] See Intv. Croatian Ministry IV (2007); Intv. Croatian Government Team (2007); Intv. Croat. Company I - Legal Services (2007) see also Intv. German Authority II (2007); Bertelsmann Stiftung (2006b), p.1; European Commission (2005a), p.85; European Commission (2007a), p.49.
[1337] Depending on the type of case; see Intv. Croatian Ministry IV (2007); Intv. Croatian Ministry III (2007).
[1338] See Intv. Germ. MNC - Financial Services II (2007).
[1339] See Intv. Croat. Company I - Legal Services (2007).
[1340] See Intv. Int'l Research Institute I (2007); Intv. Croatian Ministry III (2007); Intv. Croatian Ministry IV (2007); see also European Commission (2005a), p.84.

(c) Both primary[1341] and secondary sources[1342] report **significant and complex remaining problems** regarding Croatia's court system. According to both interviewees[1343] and external sources[1344], the long duration of trials remains a key problem of the judiciary dimension of legal certainty for investors. *World Bank (2007a)* finds that contract enforcements take on average 561 days and are thus even 24 days longer than in Romania (*figure 43*). Experts interviewed even speak of an average time of six years for general lawsuits[1345], but a complete litigation can also take up to ten years. MNCs are sometimes actually uncertain if the case is going to be completed at all.[1346] Therefore, experts state that "you cannot speak of legal certainty"[1347]. An example often cited is the acquisition of shares of the Tvornica Duhana Zadar by British American Tobacco in the late 1990s. The purchase was challenged by the domestic monopolist Tvornica Duhana Rovinj based on competition issues and a lengthy lawsuit followed. When courts eventually decided in favor of the MNC eight years later, British American Tobacco had already determined to divest.[1348]

Furthermore, interviewees clarify that the reduction of the backlog is still neither significant nor sufficient. Experts interviewed assume that a substantial reduction will take ten years when the current amount of staff and speed

[1341] See e. g. Intv. Croatian Ministry IV (2007); Intv. Austr. MNC - Real Estate (2007); Intv. Germ. MNC - Financial Services I (2007); Intv. European Institution (2007).
[1342] See e. g. Bertelsmann Stiftung (2006b); European Commission (2007a).
[1343] See e. g. Intv. Austr. MNC - Primary Goods I (2007); Intv. German Authority II (2007).
[1344] See European Commission (2005a); European Commission (2007a), p.49.
[1345] See e. g. Intv. Austrian Econ. Association II (2007); only slightly more optimistic: Intv. German Econ. Association IV (2007); Intv. German Authority II (2007); Intv. Croatian Ministry III (2007).
[1346] See Intv. Austr. MNC - Primary Goods I (2007); Intv. Croat. Company II - Legal Services (2007); Intv. Germ. MNC - Telecommunications (2007); see similar European Commission (2005a), p.42.
[1347] Intv. Croat. Company I - Legal Services (2007); even though lawsuits seem to take less time in smaller cities than in Zagreb or Split; See Intv. Austr. MNC - Real Estate (2007).
[1348] See Intv. Supranational Authority II (2007); see also Jansson (2006b).

are maintained.[1349] Most problems are seen in property rights, land registration and other civil cases.[1350] State authorities also contribute to the backlog by taking legal actions even when the case seems to have little chance to succeed.[1351]

Despite recent initiatives most experts interviewed still criticize the large number of judges (Croatia has one of the highest number of judges per capita in Europe)[1352], deficiencies in their education (particularly with respect to EU law) and their low salaries.[1353] Judges also seem to make only little use of their right to reduce the number of hearings and length of procedures.[1354] External sources demand a better use of modern information and communication technologies and a more equal distribution of work, since main courts seem to be overwhelmed with work, while smaller and local courts are often not fully used.[1355] Croatia still has very many courts overall (253 in 2007)[1356], whereas interviewees point out the need for more specialized courts, including fast track courts for petty claims and additional administrative courts.[1357]

Lawyers may also contribute to some of the problems; they tend to prolong court trials because they are paid (as in Romania) by written submission and

[1349] See Intv. Croat. Company I - Legal Services (2007); Intv. Croatian Ministry IV (2007); Intv. German Authority II (2007); Intv. German Authority III (2007).

[1350] Especially regarding financial obligations of debtors and mortgage claims; see Intv. Croatian Ministry IV (2007); Intv. Austr. MNC - Real Estate (2007); Intv. Croatian Authority I (2007); see also European Commission (2005a), p.15.

[1351] See European Commission (2007a), p.49.

[1352] See Doc - NCC (2007), p.11.; Doc - GTZ (2006a); see also Intv. Germ. Political Foundation I (2007); Intv. Croatian Ministry III (2007); Intv. Croatian Ministry IV (2007) .

[1353] See Intv. Int'l Research Institute I (2007); Intv. Croatian Ministry III (2007); Intv. Croatian Ministry IV (2007); Intv. German Authority II (2007); see also European Commission (2005a), p.15.; EBRD (2005a), p.49; more positive: Intv. Croat. Company I - Legal Services (2007).

[1354] See European Commission (2007a), p.49; EBRD (2005a), p.49; see also Intv. Croatian Ministry IV (2007); Intv. Croatian Ministry III (2007).

[1355] See European Commission (2007a), p.49; see also Bertelsmann Stiftung (2006b).

[1356] In April 2007 a plan was adopted to reduce the number of courts reduced to 130; European Commission (2007a), p.49.

[1357] Croatia has only one administrative court now; see Intv. Croatian Government Team (2007).

not on the basis of the amount in dispute (as in Germany).[1358] The Croatian Chamber of Lawyers is apparently very powerful and effectively lobbies against any changes that reduce the fees or powers of lawyers. Therefore, foreign law firms are not allowed to open a branch in Croatia. This is unlikely to change until EU accession.[1359]

Investors point out more strongly than external sources that court decisions, particularly on the local level, frequently seem to be influenced by politicians.[1360] and are also today sometimes biased against foreigners.[1361] Various interviewees assume that the legal system remains one of the most corrupt areas in Croatia.[1362] The European Commission may thus overestimate the performance of Croatia in this context when stating that "the Croatian judiciary is formally independent and also appears to act independently in practice."[1363]

In sum and despite the reforms discussed above, some investors do not see significantly improvements in recent years.[1364] Legal experts also believe that the performance of Croatia's court system is still unsatisfactory and worse than the one of the administration.[1365] Some investors interviewed speak of "mixed"[1366], others of "only negative experiences"[1367] with the Croatian court system so far. Entrepreneurs are therefore often reluctant to go to court – particularly on the local level – to implement their rights.[1368]

[1358] See Intv. Croatian Ministry IV (2007); Intv. Croatian Government Team (2007); Intv. German Authority II (2007); see also European Commission (2005a), p.15.
[1359] See Intv. Croatian Ministry IV (2007); see also Doc - DLA Piper (2006).
[1360] See e. g. Intv. Austr. MNC - Primary Goods I (2007); Intv. Germ. MNC - Financial Services II (2007).
[1361] See e. g. Intv. Germ. MNC - Telecommunications (2007); Intv. Austr. MNC - Primary Goods I (2007).
[1362] See Intv. German Authority II (2007); see similar Intv. Germ. MNC - Financial Services II (2007).
[1363] European Commission (2005a), p.90.
[1364] See Intv. Austrian Econ. Association II (2007); Intv. German Authority II (2007).
[1365] See Intv. Croat. Company II - Legal Services (2007); Intv. Croat. Company I - Legal Services (2007); see similar Intv. Croatian Government Team (2007).
[1366] Intv. Germ. MNC - Telecommunications (2007).
[1367] Intv. Austr. MNC - Primary Goods I (2007).
[1368] See Intv. European Institution (2007); Intv. Supranational Authority II (2007).

(d) Croatia's problems with reference to the court system are substantial and significantly deteriorate legal certainty for both citizens and investors.[1369] In contrast to Romania, the problems seem to be so **important** that they represent a considerable deterring factor for FDI inflows to Croatia even today. As in Romania various MNCs in Croatia have hardly been in contact with courts so far[1370] and as in Romania Croatian state experts are a lot better informed regarding the details of the deficiencies of the courts. Nevertheless, most interviews reveal that the general distrust in the work of courts is even greater in Croatia than, for example in Romania. The vague knowledge and Croatia's negative reputation, also promoted through prominent cases such as British American Tobacco, therefore seem sufficient in order to deter investors interested in Croatia. This seems to be particularly true for smaller investors who can hardly handle or afford intransparent and long court trials.[1371] As a result this section also indicates a greater importance of the court system on FDI than assumed in some FDI studies that only find a general but not decisive impact of the quality of courts on FDI.[1372]

(e) In the **assessment** of Croatia's court system it becomes apparent that recent reform efforts have not been sufficient to overcome a certain quality threshold and to abolish existing worries of investors regarding the judiciary side of legal certainty. In this context the speed and effectiveness of court decision seem most crucial, while the independence of judges only represents a secondary factor. International organizations have provided detailed analyses of Croatia's court system, whereas FDI studies seem to have focused (too) little on related aspects so far. For public policy makers it will be essential to understand that judiciary reforms are indispensable not only for Croatia's EU

[1369] See e. g. Intv. Croat. Company II - Legal Services (2007).
[1370] See e. g. Intv. Germ. MNC - Industrial Goods I (2007); Intv. Germ. MNC - Food Products (2007).
[1371] See Intv. German Authority II (2007).
[1372] See Murtha and Lenway (1994).

aspirations but also for its investment climate. They will need to reduce the number of pending cases as quickly as possible and decrease possibilities of procedural law to prolong cases even before EU accession despite the pressure of lobbying groups. This should include the concentration of hearings and a modification of the renumeration system of lawyers. Croatia can learn from the Romanian experience, especially when it comes to the improvement of the land registration processes that lead to most of the backlogged cases, a better distribution of work among courts and a reduction of political influence and bias towards foreigner in local courts. Finally, Croatian public policy actors should better involve companies in judiciary reforms in order to quickly identify pain points.

(3) **In conclusion**, this section on Croatia's legal certainty has illustrated that reforms have been initiated but are progressing slowly. However, ongoing reforms may help Croatia to turn the legal dimension from a constraining to an enhancing factor. Improvements seem to materialize a lot slower on the judiciary side of reform and interviews have helped to understand that Croatia's weak performance has significant negative impact on Croatia as investment location, particularly on the local level.

7.2.4.4 General insights for transition countries

The analysis of Romania and Croatia as well as the consideration of further FDI studies reveal (1) some general insights regarding the importance of legal certainty in transition countries, (2) some common problems in this area and several (3) implications for public policy actors.

(1) The **importance** of legal certainty for the investment decision of MNCs – as shown for Romania and Croatia – is also strongly confirmed by various

FDI studies for transition countries in general. Studies identify some[1373] or even significant impact[1374] of legal certainty for host countries' investment environment. According to *McGee (2003)*, transition countries "that do not have a rule of law or that have unclear legislation or legislation that is not applied uniformly by an efficient and fair judicial system are at a competitive disadvantage when competing for FDI." Many studies do not distinguish between the legal and the judicial dimension of legal certainty[1375], but some separate insights do exist.

Various studies point out that a weak legal system is an obstacle to FDI in transition countries.[1376] For the early 1990s *Genco, Taurelli, and Viezzoli (1993)* even find that the lack of clearly defined legislation was the most important concern for investors in transition countries, even more important than property rights. However, a clear legislation seems to be mainly important for larger firms[1377] and in areas with strong state interaction (for example for licenses or privatizations). Furthermore, the analyses of this section indicate that law-making even has the potential to become an enhancing factor for FDI in transition countries, for example in the course of EU accession (as Romania). The effect may, however, depend on the situation in the surrounding countries. When all neighbors are EU members (for example in the case of Czech Republic) the relative advantage of the legal dimension of legal certainty may be limited. Yet, these countries have to establish good law-making conditions because they are pressured by the EU and they would otherwise risk legal certainty becoming a constraining factor for FDI in the locational competition.

[1373] See e. g. Brada, Kutan, and Yigit (2003); Demekas, Horváth, Ribakova, and Wu (2005); Cho (2003).

[1374] See UNCTAD (2007).

[1375] See e. g. Bénassy-Quéré, Coupet, and Mayer (2005); Bevan and Estrin (2000).

[1376] See Campos and Kinoshita (2003); Kinoshita and Campos (2006); FIAS (2007); Pierpont (2007).

[1377] See also Genco, Taurelli, and Viezzoli (1993).

On the other hand, several studies confirm – in line with the findings of this section – the general importance of independence and efficiency of court systems for transition countries in general.[1378] Smaller firms in particular may be deterred by a weak performance of courts since they face significant challenges to cope with lengthy and costly trials. The examples of Romania and Croatia suggest that the court system has little chance to become an enhancing factor for transition countries and only one – in the best case – that is neglected by investors, since MNCs generally want to avoid contact with courts anyway.

(2) Transition countries seem to face **similar problems** regarding legal certainty. Major problems for the law-making of transition countries in the 1990s were apparently the (too) frequent legal changes that also increased the danger of legal gaps and the demand for emergency ordinances (as shown for Romania). It seems that EU pressure helps to improve the quality and consistency of the legal framework of transition countries.[1379]

Judiciary reforms seem to take an even longer time than the improvement of the legal framework. Interviews suggest that the long duration of trials is probably the most negative aspect of the court system for potential investors. This is crucial, for example, when MNCs sue a financially weak company for not having paid a bill that goes bankrupt during a long court trial.[1380] Companies also have to worry that receivables are written off after a certain period.[1381] Finally, slow court decisions may also delay privatizations.[1382]

It seems that courts in larger cities are often slower, while local courts may be more strongly influenced by local interests and tend to be more biased against foreigners (as in Croatia). The example of Croatia also showed that

[1378] See Jacobs and Coolidge (2006); Cho (2003); Murrell (2002).
[1379] See also Bevan and Estrin (2004).
[1380] See Intv. European Institution (2007); see also Doc - DLA Piper (2006).
[1381] See Intv. Croat. Company II - Legal Services (2007).
[1382] See Intv. Croatian Authority I (2007).

the institutional set up alone is not sufficient to reduce substantial concerns of investors, since the existence of commercial and administrative courts did neither lead to more efficient courts nor to a better evaluation through investors. In this context, it may also be problematic from an investor's perspective that judiciary reform is mainly perceived by state representatives (as interviews suggest) as part of the reforms on their path towards EU accession and not as an important reform per se. Finally, those reforms initiated under the pressure of the EU may somewhat overemphasize issues such as independence and institutional arrangements while key concerns of investors (regarding legal certainty) such as the speed and consistency of decisions possibly do not receive as much attention by the EU and policy makers.

(3) The analyses of this section allow for some **recommendation for public policy makers** in order to enhance legal certainty in transition countries. Regarding the law-making process, public policy actors need to strengthen public institutions[1383], through measures such as the provision of better legal advice to members of parliaments and an increase of continuity in the staff of ministries who prepare most of the laws. Public policy makers should use the window of opportunity when a good legal framework establishes formal legal certainty and turns into an FDI-enhancing determinant for a limited time. In this period, for example right before and after EU accession, public policy should extensively increase the awareness of these legal benefits among MNCs (regarding legal certainty), since the positive effect seizes after a short period with increasing normality as EU member and with continued reforms of neighboring non-EU countries.

Reforms in the judiciary require more in-depth analysis upfront (for example regarding the required number of courts, judges, state attorneys etc.) as

[1383] See also World Economic Forum (2006b), p.23.

well as more comprehensive strategic long-term planning as often determined for transition countries. Within the court system judges may need to learn to feel less like civil servants but as independent powers of democracy and use their powers more effectively to make proceedings more efficient.[1384] In judicial reforms public policy makers may also keep in mind that simplifications (for example of procedural laws) may cause citizens to fear that they will be deprived of their rights of litigation.[1385]

Finally, public policy actors in non-EU transition countries should understand that strengthening legal certainty is not only an important factor for EU accession, but is also essential for their business climate. Substantial reforms should therefore not be delayed until EU accession negotiations (as happened in Romania and Croatia). In this context, it will also be the task of governments (as well as of other players like Chambers of Commerce etc.) to give better guidance for MNCs how to successfully reach legal certainty in their host country in order to decrease the great mistrust of many present and potential investors.

7.2.5 Labor law

7.2.5.1 Definition

From the perspective of MNCs, favorable labor law conditions exist in host countries of FDI when requirements regarding hiring and dismissing employees are liberal and daily operations with labor issues cause little legal or administrative obstacles for MNCs.[1386] The subsequent sections analyze these issues for Romania (*7.2.5.2*), Croatia (*7.2.5.3*) and transition countries in general (*7.2.5.4*).

1384 See Intv. German Authority II (2007).
1385 See Intv. Croatian Government Team (2007); Intv. Romanian NGO (2007).
1386 See also UNCTAD (1999), p.264; World Bank (2007b).

7.2.5.2 Romania

The analysis of Romania's **labor law** conditions reveals that (1) employing domestic and foreign staff is fairly easy, while (2) official procedures for dismissals are rather cumbersome and (3) some issues in daily operations persist. The labor law performance seems to have (4) only limited impact on FDI in Romania. Sub-section (5) presents an assessment. Most relevant labor regulations were unified in the labor code Law no. 53/2003 with a major amendment in 2005.[1387]

(1) Investors generally seem to be quite satisfied with the possibilities for **employing domestic and foreign staff** in Romania. Company experts state that hiring **domestic staff** is fairly easy and does not provide any major legal or bureaucratic obstacles.[1388] Potential areas of improvements are the further reduction of paperwork.[1389] In contrast to this positive evaluation, the difficulty of hiring index of the World Bank suggests that employing is nowhere in Eastern Europe more difficult than in Romania.[1390] Reasons listed are the fairly long time to register the employee's work place at the Trade Register Office (14-180 days) and fairly low maximum duration of fixed-term contracts (24 months).[1391] However, interviews help to explain that these aspect may only have limited impact on their operations. Investors suggest that, in practice, workers can start working even without a registered work place and that the length of fixed-term contracts is currently less of a problem than finding and keeping staff that long in one work place.[1392]

[1387] See EBRD (2005b); OECD (2006c).
[1388] See e. g. Intv. Romanian Company - Advertising (2007); Intv. Romanian Authority I (2007); Intv. Germ. MNC - Automotive (2007).
[1389] See e. g. Intv. Int'l Econ. Association (2007); see also OECD (2005d), p.42.
[1390] Out of 19 countries; see World Bank (2007a).
[1391] See World Bank (2007b); see also OECD (2006c).
[1392] See section 6.2.1; see Intv. Romanian Company - Advertising (2007); Intv. Austr. MNC - Financial Services I (2007).

Romania has elaborated principal secondment regulations for the entry, stay and exit of **foreign staff**, the so-called expats.[1393] Apparently regulations have improved compared to the early 2000s when MNCs had to prove that no Romanian was able to do the job.[1394] Most interviewees indicate that no legal or administrative obstacles exist for the registering of expats today; some limited bureaucratic procedures are unavoidable but are generally conducted by the human resources department of the MNCs and do not represent a problem for investors.[1395] Furthermore, authorities have apparently been fairly lax, even if investors from Western Europe did not have a valid working permit.[1396] Since Romania's accession to the Union working permits are not necessary for expats from EU countries anymore.[1397]

Primary and secondary sources still find aspects of minor criticism: regulations regarding residency permits seem to be quite confusing[1398], too many documents are needed to obtain a work permit for expats[1399] and the replacement of a country manager can be quite complicated procedure, which even has to be confirmed in court.[1400]

(2) **Dismissing staff** does not seem to be very easy in Romania from a legal perspective. Company[1401] but also state interviewees[1402] as well as external

[1393] See Law No. 203/1999, amended by Ordinance No. 32/2003; see Emergency Ordinance No. 194/2002; see also Bulgaria Economic Forum (2005), p.107.
[1394] This was generally given because of language requirements; see Intv. Germ. MNC - Legal Services I (2007).
[1395] See Intv. German Econ. Association III (2007); Intv. Austr. MNC - Consumer Goods (2007); Intv. Germ. MNC - Consulting I (2007).
[1396] See Intv. Int'l MNC - Utilities (2007).
[1397] See Intv. Germ. MNC - Legal Services I (2007)
[1398] See Intv. Int'l MNC - Utilities (2007).
[1399] 13 documents according to OECD (2006c).
[1400] For EU expats only until 2006; see Intv. Germ. MNC - Industrial Goods III (2007).
[1401] See e. g. Intv. Romanian Company - Advertising (2007); Intv. Germ. MNC - Consulting I (2007); Intv. Int'l Econ. Association (2007); Intv. Germ. MNC - Industrial Goods III (2007).
[1402] See e. g. Intv. Romanian Authority I (2007); Intv. Germ. Research Institute I (2007).

sources[1403] agree that the current labor law is fairly rigid and well in favor of the employee.

In order to be able to dismiss employees, companies have to specifically define work places and establish a complex evaluation system. Only after three consecutive poor evaluations can an employee be finally dismissed.[1404] According to the interviewees, many smaller companies do not comply with the respective rules and often do not have the capacities to introduce and operate an evaluation system. Employees may therefore easily bring forward formal objections regarding a dismissal.[1405] According to the dismissal index of the World Bank's 'Ease of doing business' survey, only three EECs have more rigid regulations for dismissing employees.[1406] Despite this, interviews show in constrast to international statistics that dismissals cause little problems for investors in reality. Most importantly, MNCs currently have more problems finding sufficient employees than dismissing them due to the increasing labor shortage in some regions and due to the high labor turnover (*see section 6.2.1*).[1407] In this context the short cancellation period of work contracts of only 14 days may be problematic for MNCs.[1408] Furthermore, companies always seem to find ways to dismiss low-performing employees. These employees are either dismissed during the probationary period[1409] or – even though ethical concerns may exist – will eventually resign themselves, for instance when firms put strong pressure on them.[1410] Finally, larger investors generally have the required system in place

1403 See e. g. OECD (2006c); EBRD (2005b).

1404 See e. g. Intv. Germ. MNC - Industrial Goods III (2007); Intv. Romanian Company - Advertising (2007); Intv. Germ. MNC - Consulting I (2007); Intv. Germ. MNC - Legal Services I (2007); see also OECD (2005d), p.42.

1405 See e. g. Intv. Romanian Company - Advertising (2007).

1406 Slovenia, Croatia and Estonia; see World Bank (2007a).

1407 See e. g. Intv. Germ. MNC - Legal Services I (2007); Intv. Germ. MNC - Automotive (2007).

1408 See Intv. Int'l MNC - Utilities (2007); Intv. Germ. MNC - Automotive (2007).

1409 See e. g. Intv. Austr. MNC - Consumer Goods (2007).

1410 See e. g. Intv. Romanian Company - Advertising (2007); Intv. Austr. MNC - Primary Goods II (2007).

and have little problems with labor regulations.[1411] As a result investors seem to have (currently) only little problems regarding the dismissal of staff.[1412] The practical context is also the reason why experts point out that in effect conditions to dismiss employees are not more protective in Romania than in Western Europe, for example, in France.[1413] This interpretation – the relatively slight relevance of quite rigid formal rules in practice – is also underlined by the survey in *AHK (2006)*, according to which MNCs are quite satisfied with the flexibility of labor law ranking Romania third out of 14 EECs (only behind Estonia and Latvia).

(3) In **daily operations** the conditions of labor law seem to be satisfactory for investors in Romania overall. The collection of the various labor laws in the labor code seems to have been helpful in making the decisions of authorities more transparent and reliable.[1414] While inspections of the labor authority may be cumbersome[1415], interviewees acknowledge that foreign companies do not seem to face any different treatment to that of Romanian companies in these inspections.[1416] The degree of unionization is only low among employees in Romania[1417], maybe also because the protection of workers' rights is less urgent in times of economic upswing.[1418] Most investors interviewed point out that the record books of Romanian employees – in which all important steps of the work history are documented including change of jobs, positions and even salaries – are a very bureaucratic and outdated tool. These hand-written entries are often made several times a year and represent a significant bureaucratic

[1411] See e. g. Intv. Germ. MNC - Retail (2007); Intv. Int'l MNC - Utilities (2007).
[1412] See Intv. Germ. MNC - Legal Services I (2007); Intv. Int'l MNC - Utilities (2007); Intv. Austr. MNC - Consumer Goods (2007).
[1413] See Intv. Germ. MNC - Consulting I (2007); Intv. Germ. MNC - Automotive (2007).
[1414] See Intv. Int'l Econ. Association (2007); see also OECD (2006c).
[1415] See section 7.2.3; see also Intv. Romanian Company - Advertising (2007).
[1416] See Intv. Germ. MNC - Industrial Goods III (2007).
[1417] With only about 2M formal trade union members; see ILO website (2008).
[1418] See Intv. Germ. MNC - Consulting I (2007).

effort for companies.[1419] With increasing IT capacities experts expect record books to vanish within the next years.[1420] Finally, external sources suggest that Romania's labor law requires some further improvements regarding the equal treatment of women and men.[1421]

(4) Labor law regulations seem to be of only limited **importance** for investors interested in Romania at the moment but may increase in future. Interviews indicate that MNCs do consider the responsibilities and risks regarding labor law before investing in the Romanian market.[1422] However, and although some factors may be constraining[1423], interviews suggest that investors are aware from the beginning that most problems can be circumvented and that rigid or cumbersome legal and bureaucratic elements of labor law do not significantly endanger the investment of MNCs.[1424] Even for MNCs using a high share of labor, the labor conditions seem to have only average importance.[1425] This evaluation of the interviewees is also confirmed by external studies according to which the flexibility of labor law is only the 20th most important determinant for Romania of 26 determinants analyzed.[1426] Only the increased efforts of the Romanian government to significantly raise the minimum wages may become more critical when cost advantages of Romania start to diminish significantly.[1427]

(5) In the **assessment** of this section, it becomes apparent that Romania's rules are still fairly rigid, particularly regarding the dismissal of employees.

[1419] See Intv. Germ. MNC - Industrial Goods III (2007); Intv. Int'l Econ. Association (2007); see also Intv. Rom. Local Authority II (2007).
[1420] See Intv. Germ. MNC - Automotive (2007).
[1421] See European Commission (2006d), p.49.
[1422] See e. g. Intv. Austr. MNC - Industrial Goods I (2007).
[1423] See also CICD (2006).
[1424] See also Intv. Germ. MNC - Consulting I (2007); Intv. Germ. MNC - Legal Services I (2007).
[1425] For example with 25% of labor share of production cost: Intv. Austr. MNC - Industrial Goods I (2007).
[1426] It is the 17th most important determinant in Eastern European; see AHK (2006).
[1427] See Intv. Austr. MNC - Industrial Goods I (2007).

However, interviews contributed to a better understanding of international statistics and showed that formal problems may be of only limited practical relevance since MNCs can find ways to avoid problems, especially in the current economic upswing. This section also showed the interdependence of labor law with the economic development, the quality of bureaucracy and labor costs. Nevertheless, public policy should reduce the over-regulation of labor in some areas. Most importantly, the steps to dismiss employees should be simplified and then consistently supervised by labor authorities in order to make a compliance by all companies realistic. State representatives should also carefully listen to the concerns of investors regarding the raise of minimum wages and may rely more on market forces to determine fair salaries.

7.2.5.3 Croatia

With respect to Croatia's **labor law** investors seem to face (1) only limited obstacles when employing domestic or foreign staff. Possibilities for (2) dismissing staff are acceptable and labor conditions (3) do not seem to cause any major problems in daily operations either. (4) The importance of this factor seems to be limited for the investment decision of MNCs. Section (5) assesses the results for Croatia. Most labor-related regulations are comprised in the Labor Code from 2003, which has since undergone some amendments. Labor laws are often based on German laws and have largely been aligned with European legislation in recent years.[1428]

(1) As in the case of Romania, the conditions for **employing staff** in Croatia seem to be more complicated in formal terms than in reality. According to the World Bank, hiring is fairly difficult in Croatia, which ranks 14th out of 19 EECs.[1429] Main reasons for this negative evaluation are the maximum duration

[1428] Law no. 137/2004; see Doc - Germ. MNC - Engineering (2001), p.54; European Commission (2005a), pp.39 and 77; APIU (2006b), p.41; European Commission (2007a), p.44; Doc - German Econ. Chamber Croatia (2007).

[1429] 61 points; 100 points represent the worst possible score; see World Bank (2007b).

of fixed-term contracts of only 36 months (which is, however, twelve months longer than in Romania) and high minimum wages.[1430] In sharp contrast to this negative assessment of external studies, investors interviewed emphasize that they have not experienced any significant problems when hiring **domestic staff** at all until now.[1431] Reasons for this discrepancy may be that these formal issues rather concern domestic firms. MNCs, on the other hand, often have a long-term vision, are therefore mainly interested in permanent contracts, generally pay quite high salaries compared to domestic companies, and are not affected by regulations regarding the minimum wage (so far).

Some problems may occur when investors send **expats** to Croatia. *Intv. Germ. MNC - Telecommunications (2007)* recalls that procedures were very complicated and time-consuming in the late 1990s and early 2000s and even today many human resources departments complain about the long waiting times for working permits. Problems regarding the tax eligibility of expats may also arise[1432], partly because of the limitation of foreign workers through annual quotas.[1433] Nevertheless, it seems that working conditions have improved for expats in recent years, especially for those from EU countries.[1434] Quotas are more favorable and key staff in companies from EU member states are not required to obtain a work permit at all.[1435]

(2) Analogous to employing staff, international statistics give a more skeptical image of Croatia's labor law conditions for **dismissing employees** than expert interviews suggest. External studies repeatedly point out that Croatian labor rules make dismissals difficult[1436] and are supposedly more rigid

[1430] In fact temporary contracts were only rarely allowed until 2003; see IMF (2004), p.31; see World Bank (2007b); see also Doc - German Econ. Chamber Croatia (2007).
[1431] See Intv. Germ. MNC - Industrial Goods I (2007); Intv. Germ. MNC - Telecommunications (2007).
[1432] See Intv. Germ. MNC - Telecommunications (2007).
[1433] See APIU (2006b), p.41; Doc - Gov't. of Croatia (2006), p.136.
[1434] See Intv. Austr. MNC - Construction (2007).
[1435] Check articles 87 and 95 of the Aliens Act; see Doc - Gov't. of Croatia (2006), p.136.
[1436] See e. g. IMF (2004), p.31; EBRD (2005a), p.21; European Commission (2005a), p.78.

than in any other EEC (except in Estonia).[1437] Reasons for this evaluation are that employers must notify the labor authorities before dismissing an employee and dismissals are only possible when the employee cannot be reassigned or retrained.[1438] Furthermore, lay-offs seem to be very expensive for companies, equaling on average 39 weeks compared to an average of 27 weeks in Eastern Europe.[1439]

On the contrary, investors interviewed do not see any major problems for dismissing poorly performing staff in Croatia.[1440] They agree that labor is in general well protected, but informal agreements to find a mutual consensus (for example including a generous compensation) seem to be common and investors rarely face legal charges in labor matters.[1441] The dismissal of employees may even be somewhat easier than, for example, in Romania, since the establishment of a complex evaluation system is not compulsory.[1442] MNCs may also have less problems with low-performing employees than domestic firms, since they often offer better working conditions, more attractive salaries etc. and therefore attract more skilled members of the labor force. Finally, MNCs may need to dismiss employees less frequently than domestic firms, since they generally perform better in economic terms.[1443]

(3) In **daily operations** investors seem to find labor conditions satisfactory. According to interviews as well as to secondary sources, general regulations such as job descriptions and safety rules do not seem to differ much from other EECs[1444] and variances in the benefit system in Croatia compared to

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[1437] Out of 19 countries; see World Bank (2007b); similar: AHK (2006).
[1438] See World Bank (2007b).
[1439] Dismissals are therefore more expensive only in Slovenia and Albania out of 19 EECs; See IMF (2004), p.31; see also World Bank (2007a).
[1440] See Intv. Austr. MNC - Primary Goods I (2007); Intv. Austr. MNC - Retail (2007); Intv. Germ. MNC - Industrial Goods I (2007); Intv. Germ. MNC - Telecommunications (2007).
[1441] See e. g. Intv. Austr. MNC - Construction (2007); Intv. Austr. MNC - Retail (2007).
[1442] See Intv. Austr. MNC - Construction (2007).
[1443] See also for the characteristics of MNCs versus domestic companies section 2.2.2.
[1444] See Intv. Austr. MNC - Primary Goods I (2007), see also European Commission (2007a).

Western Europe do not seem to be a problem, either.[1445] Larger companies generally seem to experience less difficulties with labor conditions than smaller MNCs.[1446] Further adjustments are expected in the course of EU integration including the loosening of working restrictions for women and more formal rules for work places.[1447] In this context, external sources praise that the Croatian government has started a broad consultation process involving economic and social partners in order to successfully implement EU regulations.[1448]

Employees' record books also exist in Croatia (as in Romania) that contain (only on paper) entries regarding education, employers, trainings etc. MNCs in Croatia also consider these record books a largely unnecessary bureaucratic obligation, even though they seem less detailed than in Romania.[1449]

The interaction with trade unions seems to be more relevant and occasionally more unwieldy for MNCs in Croatia than in other EECs, notably in Romania. 64% of Croatian workers were union members in 2005.[1450] While strikes are allowed and numerous, they generally do not last long[1451], maybe because several labor unions are generally represented within one company whose quarrels often prevent a long-lasting common approach.[1452] The experiences of investors interviewed with unions have been mixed. Some have had only little interaction so far[1453], while others have dealt extensively with them, for example, regarding complaints of excessive overtime work.[1454]

[1445] See IMF (2004), p.30.
[1446] See Intv. Germ. MNC - Telecommunications (2007).
[1447] See European Commission (2005a), p.78; see also Doc - Gov't. of Croatia (2006), p.51; Doc - Ekonomski Institut Zagreb (2007).
[1448] See European Commission (2006a), p.44.
[1449] E. g. salaries are not documented; see e. g. Intv. Austr. MNC - Construction (2007).
[1450] See EBRD (2005a), p.50.
[1451] See European Commission (2005a), p.50; Doc - GTZ (2006a).
[1452] See Intv. Germ. MNC - Food Products (2007); Doc - Germ. MNC - Food Products (2007).
[1453] See e. g. Intv. Austr. MNC - Retail (2007).
[1454] See Intv. Germ. MNC - Food Products (2007).

(4) Interviews indicate that labor law regulations are of only limited **importance** for the investment decision of investors interested in Croatia.[1455] Apparently, investors do not rely much on international statistics in this context and anticipate that employing and dismissing staff in Croatia is of a comparable level with other countries of the region. Furthermore, MNCs also often invest in sectors like tourism, in which high labor demand and high salaries make labor rules less relevant.[1456] Several comparative surveys confirm this interpretation of the interviews. According to *CICD (2006)*, only 3% of managers interviewed identified labor regulations as major constraint for investments in Croatia. German investors also perceive the flexibility of Croatia's labor law rules as only the 16th most important of 26 determinants in terms of importance according to *AHK (2006).* These findings make a strong argument to refute the statement of the IMF that "strict employment protection is also likely to have discouraged entry or expansion of new businesses in Croatia"[1457]. It also seems unlikely that rigid labor rules (alone) significantly contribute to Croatia's high unemployment as suggested by some studies[1458] since, for example, Romania has even more rigid labor markets but a substantially lower unemployment at the same time.

(5) In the **assessment** of Croatia's labor regulations, this section has shown that formal rigidities exist but only have limited impact on the fairly positive experiences and evaluations of MNCs. Interviews (mainly those with company experts) and external surveys confirmed the results for Romania also for Croatia that international statistics may draw a picture of the country's labor market that is somewhat too pessimistic and may to some extent ignore the investment reality of MNCs.

[1455] See e. g. Intv. Germ. MNC - Engineering (2007); Intv. Austr. MNC - Primary Goods I (2007); Intv. Germ. MNC - Telecommunications (2007).

[1456] See e. g. Intv. Germ. MNC - Engineering (2007); see also Doc - Germ. MNC - Engineering (2001).

[1457] IMF (2004), p.31.

[1458] See e. g. Vidovic and Gligorov (2004); IMF (2004), pp.28 and 32; see also Hina (2006).

However, in the further course of EU integration the regulations of Croatia's labor law may gain importance for investors when rules become more formalized and MNCs lose some of the possibilities for using informal agreements for labor issues. Public policy actors in Croatia will, therefore, be confronted with the challenge to comply with EU regulations on the one hand and to maintain favorable conditions for MNCs on the other hand.

7.2.5.4 General insights for transition countries

The analysis of the country cases as well as the consideration of further relevant studies allows for some general insights regarding labor law as FDI determinant for transition countries. The (1) performance of transition countries may be better than international statistics suggest, (2) the importance seems to be only limited for FDI flows and (3) some public policy implications can be derived.

(1) With respect to the **labor law performance**, transition countries have undertaken significant reforms in the 1990s[1459] and those on their way towards the EU further adjusted their legal framework in the course of preparations to EU accession.[1460] A stronger codification of labor rules has, however, also led to (or confirmed existing) inflexibilities. As a result, international statistics and reports indicate that rules for employing and dismissing staff are quite strict in most transition countries.[1461]

On the contrary, interviews and external surveys suggest that the labor law conditions of transition countries are probably more satisfactory for MNCs than formal analyses may indicate. It seems that the informal way to deal with labor issues is well established in transition countries – probably better than in Western Europe – and employers and employees generally find a solution without insisting on their formal rights. Even for the early 1990s, *Genco,*

[1459] See e. g. Altomonte (1998).
[1460] See e. g. OECD (2006a).
[1461] See World Bank (2007a); see also IMD (2006).

Taurelli, and Viezzoli (1993) already found that labor market rigidities were only a minor weakness of transition countries and less disturbing than, for example, permit procedures, legal certainty and taxation. Literature assumes that larger firms are generally more affected by labor regulations[1462], while interviews rather suggest that larger firms have less problems in dealing with many of the existing barriers such as evaluation systems (as in Romania)[1463] or the secondment of expats (as in Croatia in the past)[1464]. Further potential problems, which may also differ across transition countries, are high minimum wages and sometimes also the work of unions.

(2) Regarding the **importance** of labor law, external studies indicate that more liberal regulations may foster GDP growth and employment in transition countries.[1465] Some studies also suggest that a less flexible labor market will lead to lower FDI inflows.[1466] Interviews and external surveys rather suggest that rigid labor laws have an only very limited (negative) impact on FDI inflows.[1467] Most importantly, the strict formal rules only seem to have little relevance for MNCs. Reasons are that MNCs generally pay wages above the minimum wage, frequently get the more skilled members of the labor market, restrictions for expats from EU countries are often fairly low, and the (current) economic environment produces more concerns regarding labor shortage in many EECs than dismissing staff. Furthermore, informal possibilities to dispute resolution of labor issues seem to be sufficient and can compensate for stricter formal rules. In addition to this, investors seem to expect actual labor conditions to be similar in most EECs.

[1462] See Genco, Taurelli, and Viezzoli (1993); World Bank (2004b), p.148.
[1463] See e. g. Intv. Germ. MNC - Retail (2007).
[1464] See e. g. Intv. Germ. MNC - Telecommunications (2007).
[1465] See e. g. World Bank (2007b), p.20; Kikeri, Kenyon, and Palmade (2006); Moore and Vamvakidis (2007).
[1466] See e. g. van den Berghe, Douglas A. F. (2003).
[1467] See also CICD (2006); AHK (2006); see also World Bank (2004b), p.148.

Interviews confirm FDI studies of transition countries that state that regional differences of labor conditions within host countries appear to be insignificant for FDI[1468]; furthermore, unionization does not seem to have much influence on FDI[1469], as long as the number of labor conflicts does not become excessive.[1470]

However, this overall limited importance of labor rules on FDI may increase in economic downturns and when governments of transition countries introduce high minimum wages that deteriorate the business calculations of MNCs and investment, particularly in labor-intensive industries, no longer pay off.[1471]

The effect of stricter labor rules in the course of EU integrations seems to be limited as well. Even though *Belke, Göcke, and Hebler (2005)* confirm that EU accession may lead to greater labor market rigidities and higher unemployment, external studies and interviews do not indicate any significant negative effects on FDI due to changing labor rules in transition countries. They seem to accept that labor regulations in all EECs are approaching EU standards, since all of them are in principal aiming at EU accession – albeit at different speed.[1472] From the perspective of investors, converging labor law regulations do therefore neither seem to deter the interest in a specific country nor in investing in Eastern Europe in general.

Interestingly, econometric FDI studies give little insights regarding the effects of labor policies on FDI flows in transition countries. In fact, none of the 34 studies on transition countries analyzed[1473] integrated labor standards in their econometric analysis. This may be a future field of research, particularly in order to get a better understanding of effects of minimum wages and EU integration on FDI.

[1468] See Hilber and Voicu (2006).
[1469] See Head, Ries, and Swenson (1999).
[1470] See Hilber and Voicu (2006).
[1471] See also Intv. Austr. MNC - Industrial Goods I (2007).
[1472] See also Intv. Austr. MNC - Primary Goods I (2007); World Bank (2007a).
[1473] See section 2.2.4.2.

(3) Some **public policy implications** can be derived from this section. Public policy actors in transition countries should rely more on the business perspective regarding labor market regulations than on international statistics in order to create or maintain a favorable environment for FDI. Nevertheless, they need to comply with international norms and conventions which is particularly challenging in the process of EU integration.[1474] The options of public policy makers for improving formal labor rules are indeed manifold as suggested by *Bellak and Leibrecht (2005)*.[1475] However, the analyses of this section suggest that public policy should tackle – even more importantly – some of the greatest worries of investors in transition countries which usually refer to the bureaucratic efforts of labor regulations. These include the abolishment of work books, the simplification of evaluation systems (as in Romania) and the reduction of documents needed for various labor-related procedures.

7.2.6 Overview of findings on legal measures

This section provides an overview of the findings of legal determinants. These findings reflect the summary of the previous sub-sections and indicate qualitative tendencies rather than quantitative statistically relevant results.

Figure 44 presents a summary of the **performance** of Romania's and Croatia's legal determinants including their sub-determinants. It focuses on the most recent developments in the two countries in question since the early 2000s. The qualitative evaluations are denoted using (+) and negative (-) signs. The evaluations are based on key words in the interview analysis such as "very satisfactory conditions" or "rather disappointing performance" and are transfered into qualitative evaluations.[1476] A positive evaluation means that positive aspects

[1474] See also UNCTAD (2007), p.173; Moran (2003), p.1.
[1475] They suggest, amongst other things, re-training, shortening of unemployment periods, wage subsidies and incentive schemes for employment.
[1476] In the cases mentioned "rather satisfactory conditions" would be transferred into (+) and "disappointing performance" into (–).

of the evaluation outweigh the negative ones, while a neutral evaluation (0) is defined by a balance between positive and negative aspects. Insights from the primary documents, data and external studies further strengthen the evaluation. The procedure is exemplified in the following for company registration in Romania:

Analyses in *section 7.2.1.2* have shown that company registration was a weak point in Romania's investment environment for many years but that significant reforms have been initiated since 2003. Interviewees describe company registration as "one of the most unbureaucratic acts in Romania"[1477], "major reform success"[1478] and "not a problem for investors"[1479] today. The consideration of international statistics (i. e. the registration time in *World Bank (2007a)*) further strengthens this positive evaluation. However, some remaining concerns, such as the continued need for external help and the requirement of Romanian residency for registration leads to the evaluation that Romania's current performance in company registration is "good" equaling (++). This methodology is repeated for all legal sub-determinants for Romania as well as for Croatia and the results are presented in *figure 44*.

Figure 45 summarizes the findings of this section in relation to the **importance** of legal determinants on FDI and focuses on the insights for transition countries in general that were given at the end of the analysis of each determinant. Possible impact categories are very low, low, medium, high, and very high. The evaluation of the respective importance follows a similar methodology as presented for the determinant performance above. Key statements of interviewees that are generalizable for transition countries are assessed. The evaluation is then checked against expert documents and further FDI studies. *Figure 45* represents the summary of the more detailed database of the author

[1477] Intv. Germ. MNC - Consulting II (2007); see also Intv. German Authority I (2007).
[1478] Intv. German Econ. Association III (2007).
[1479] Intv. Germ. MNC - Legal Services I (2007).

that contains a comprehensive analysis of the factor importance that lists all corresponding expert statements and study findings.

Overview legal determinants – current performance of Romania and Croatia

Determinant	Sub-determinant	Romania		Croatia	
		Performance	Comment	Performance	Comment
• **Market access**	• Corporate law	**(++)**	• Flexible, close to EU standards	**(+)**	• ~80% in line with home country laws
	• Company registration	**(++)**	• Improved since 2003, takes about one week, electr. registration system, one-stop shop, but external help necessary	**(-)**	• Takes about 40 days, overloaded courts, fairly expensive, but MNCs outsource problems, Hitro may improve situation
	• Joint ventures	**(--)**	• Legal framework in place, but often fail because of mentality differences	**(-)**	• Depends on the sector, problems with authorities and mentality differences
• **Property rights**	• Property law	**(0)**	• Fairly liberal since about 2005, some problems with restitutions and acquisitions by foreigners	**(--)**	• Laws with progress but still some contradictions, problems with implementation, resentments towards foreigners at coast
	• Land registration	**(--)**	• Takes a long time (150 days), land registers far from complete	**(--)**	• Digitaliz. not everywhere complete, data often unreliable, very slow (174 days)
	• Construction permit	**(+)**	• Liberal regulations, quite fast (30 days), great regional differences	**(--)**	• Slow (110 days), prone to corruption, merger with location permit may help
• **Quality of bureaucracy**	• General quality	**(+)**	• Improved since 2004, better than often expected by MNCs, but still quite slow, often badly organized & intransparent	**(--)**	• Many permits needed for operations, slow, unreliable and intransparent authorities, Hitrorez may improve situation
	• Implementation of laws	**(-)**	• More problematic than law-making, often late and imprecise, little communication among authorities, very centralized	**(-)**	• Changing strategies, central authorities too large, local level with own interests, linked to problems in court system
	• Regional differences	**Depends**	• Sibiu very positive example, investor-friendly, fast & competent administration	**Depends**	• Varaždin very supportive, swift administr. Slavonia often slow, passive, more biased
• **Legal certainty**	• Legal system	**(++)**	• Few changes, quite reliable, transparent & predictable since EU integration	**(+)**	• Harmonization with EU acquis since 2002, some legal gaps and overlaps remain
	• Court system	**(--)**	• Long trials (up to 5 years), jurisdiction often not consistent, problems with independence and integrity of judges	**(---)**	• Very long trials (average 6 years), slow contract enforcement, large backlog of cases, problems with corruption
• **Labor law**	• Labor law overall	**(0)**	• Very rigid regulations for dismissing staff, but workarounds exist	**(0)**	• Fairly rigid regulations for firing staff, workarounds exist, unionization high
• **Legal measures**	• Legal measures overall	**(0)**	• Many improvements since 03/04, regional differences, implementation lags	**(--)**	• Very weak bureaucracy and court system, often weak local administrations

Note: **(+)** = rather good, **(+++)** = very good performance, **(-)** = rather weak, **(---)** = very weak performance, **(0)** = neutral
Source: Own presentation.

Figure 44: Overview legal determinants – performance

Overview legal determinants – importance for FDI in transition countries			
Determinant	Sub-determinant	Importance on FDI	Explanation/ interdependence
• **Market access**	• Corporate law	• Low	• EU harmonization creates comparable conditions in most EECs • Problems can be outsourced to lawyers etc.
	• Company registration	• Low • Impact decreases in most TCs with better performance	• Threshold of minimum requirements exists, otherwise constraining factor (as in Romania in 1990s) • Performance above expectations may have enhancing effect, but only indirect since good quality of bureaucracy is anticipated
	• Joint ventures	• Very low	• Other forms of market entry help to circumvent problems (e. g. mentality differences (Romania) or administration (Croatia)) • More important for market-seeking MNCs (construction, retail etc.)
• **Property rights**	• Property law	• Very high for non-EU countries • Medium for EU members	• EU harmonization significant driver of improvements • Also strongly linked to court system and quality of bureaucracy • Constraining when MNCs are discriminated vs. domestic firms
	• Land registration	• High	• Particularly important for risk-averse MNCs (e. g. from Germany) • Regional differences may be significant (Romania)
	• Construction permit	• Low for new entrants • Medium for MNCs already in the country	• MNCs expect similar conditions in most transition countries • Regional differences driven by administration (as in Romania) • Only very little interdependence with EU accession
• **Quality of bureaucracy**	• General quality	• Depending on country expectations	• Medium and only with indirect impact (on overall investment climate) if expectations are met (Romania) • Highly constraining if performance is below expectations (Croatia)
	• Implementation of laws	• Medium	• Difficult to evaluate for MNCs, but problems can be mitigated by good connections to administration • Performance with interdependences with political stability, corruption etc.
	• Regional differences	• High	• Very important for the decision within the country; experiences of other investors often serve as influencers
• **Legal certainty**	• Legal system	• High, but declining with EU accession	• Particularly for risk-averse investors: very constraining factor in early 1990s, enhancing factor after accession to the EU for a short time, then impact decreases • Less important for smaller MNCs, also depends on neighboring states
	• Court system	• Medium to very high	• MNCs do not expect much interaction and similar conditions in EECs • Constraining factor, if below minimum quality threshold (Croatia)
• **Labor law**	• Labor law overall	• Very low (but rising)	• Less relevant for MNCs than for domestic firms; informal dispute resolutions help to circumvent rigidities • Importance may increase in times of economic downturns in EECs
• **Legal measures**	• Legal measures overall	• High	• But declining with higher performance in TCs, EU accession represents important threshold, particularly significant for risk-averse investors

Source: Own presentation.

Figure 45: Overview legal determinants – importance

7.3 Economic measures

This section analyzes economic measures that host country governments may use in order to influence the investment conditions in transition countries including economic stability (*7.3.1*), infrastructure (*7.3.2*), investment climate (*7.3.3*), privatization (*7.3.4)*, and investment promotion (*7.3.5*). An overview of the findings on economic measures is presented in *section 7.3.6*.

7.3.1 Economic stability

7.3.1.1 Definition

Governments' options for influencing the economic stability in transition countries are numerous. Factors that are most frequently cited by external studies[1480] and interviewees with a possible impact on FDI are (1) a sound financial system, including the banking- and the non-banking sector, (2) a predictable monetary policy that leads to moderate and consistent inflation and exchange rates as well as (3) a liberal trade regime including low custom barriers. Section (4) provides conclusions for Romania and Croatia respectively.[1481]

7.3.1.2 Romania

(1) The Romanian **financial system** seems to be (a) fairly satisfactory for investors, despite (b) some problems. However, (c) the quality of the financial system is only of little importance for MNCs in Romania. Sub-section (d) provides an assessment.

[1480] See section 2.2.4.2.
[1481] See also Loewendahl (2001); Bevan and Estrin (2004); Brada, Kutan, and Yigit (2003).

(a) According to external sources[1482] and experts interviewed[1483] the quality of the Romanian financial system is **generally satisfactory overall** and reaches fairly high standards today. After the end of the financial crisis in the late 1990s, significant reforms of the **banking sector** were initiated and enhanced after 2004. This caused a comprehensive transformation of the Romanian banking sector. Reforms included large-scale banking privatizations after 1997 (namely of the BCR[1484]) and the liberalization of market entry rules under the pressure of the EU in the course of accession preparations, but also institutional improvements such as the establishment of an agency to monitor the credit risk of consumer loans. As a result, banking assets in domestic ownership decreased from 88% (1997) to 47% (2000) and reached less than 10% (2007). Therefore, 26 out of 31 banks operating in Romania in 2006 were foreign-owned. The most important remaining domestic banks are the state-owned CEC and the private Transylvania Bank. In addition to this, the share of non-performing loans could be reduced from 59% in 1998 to less than 2% since 2003.[1485]

From the investors' point of view these improvements and the large presence of foreign banks (including Erste Bank and Raiffeisenbank from Austria) have helped to make Romania's banking sector healthier, more liquid and reliable.[1486] Furthermore, experts interviewed acknowledge that a wide range of products is now available to private and business clients and access to credit

[1482] See e. g . Keren and Ofer (2003); Barisitz (2004); Roland Berger Strategy Consultants (2007).
[1483] See e. g. Intv. Germ. MNC - Financial Services III (2007); Intv. Supranational Authority I (2007); Intv. Int'l Econ. Association (2007).
[1484] See section 7.3.4.
[1485] See Intv. German Political Adviser (2007); Intv. Supranational Authority I (2007); Intv. German Econ. Association V (2007); Intv. Int'l Econ. Association (2007); Intv. German Authority I (2007); see also Keren and Ofer (2003); Barisitz (2004); OECD (2005d); EBRD (2007b).
[1486] See Doc - Economic Chamber Vienna (2007); Roland Berger Strategy Consultants (2007); Keren and Ofer (2003); Eller, Haiss, and Steiner (2006); Bertelsmann Stiftung (2006c).

is generally fairly easy (at least for private households).[1487] External experts project a strong growth of the Romanian banking market outperforming all other countries of the region.[1488]

International statistics also reflect these positive developments. According to the BTI, Romania's banking sector scored 8 (out of 10 points) in 2006. This does not take the latest legislative improvements due to Romania's EU accession in 2007 into account.[1489] Moreover, Romania climbed in the banking reform index of the EBRD from 2.33 in 1998 up to 3.33 in 2007.[1490]

Finally, experts interviewed evaluate rather positively that the **non-banking** sector is expanding. Even though starting on a low level, the stock-market capitalization and trading volumes are growing and the leasing and insurance sectors are prospering fostered by the entrance of large foreign players.[1491]

(b) Nevertheless, primary[1492] and secondary[1493] sources identify some **remaining weaknesses** in Romania's financial system. Company experts in particular notice that banks do not always offer the same services as they do in mature markets.[1494] Conditions for customers are still not optimal, including fairly restrictive credit rules for small companies such as high guarantees and interest rates.[1495] According to the Global Competitiveness Report access to

[1487] See Intv. Germ. MNC - Financial Services III (2007); Intv. Supranational Authority I (2007); World Bank (2007a).

[1488] Expected annual growth rate of 27% versus 17%; see Mühlberger (2007).

[1489] 10 being the best possible score; see Bertelsmann Stiftung (2006a).

[1490] Out of 5 whereas 5 represents the highest possible score; see EBRD (2007b).

[1491] See Intv. Supranational Authority I (2007); Intv. Austr. MNC - Financial Services II (2007).

[1492] See e. g. Intv. Romanian Econ. Association II (2007).

[1493] See e. g. CICD (2006).

[1494] See Intv. German Econ. Association VI (2007); Intv. Germ. MNC - Financial Services III (2007).

[1495] See Intv. Romanian Econ. Association II (2007); Intv. German Econ. Association VI (2007); Intv. Germ. MNC - Legal Services II (2007); Intv. Germ. Research Institute I (2007); CICD (2006).

finance is still the fifth most problematic factor for doing business in Romania in 2007.[1496]

A few experts also wonder if there are too many banks in Romania to guarantee a fully efficient market, even though the increasing competition may lead to mergers and a normalization of the status.[1497]

Furthermore, rules in the non-banking sector are not always well established; for example, there is a clear lack of rules in civil or tax law with respect to operating leasing.[1498] External sources also see a significant need for better regulations in the securities markets.[1499] Thus, according to EBRD's index on securities markets and the non-banking sector, significant room for improvements remains (2.67 of 5).[1500]

(c) According to the interviewees the financial system **does not have a significant impact** on the investment decision of MNCs that are interested in Romania. None of the state or company experts interviewed mention – neither unprompted nor prompted – the financial system as important factor.

On the contrary, FDI studies find – for several transition countries including Romania – that the state of the banking system has a significant impact on FDIs for transition countries including Romania.[1501] According to these studies, the importance is driven by the demand for easy access to finance, a well-functioning payment system and the worry about a potential banking crisis.[1502] However, the analyses above show that the last two aspects may simply have become less significant for MNCs as the stability of the Romanian banking system increases, particularly since EU accession. Besides, interviews

[1496] Even though a slight improvement can be noted in recent years; World Economic Forum (2007); World Economic Forum (2006a); World Economic Forum (2006b).
[1497] See Intv. Int'l Econ. Association (2007).
[1498] See Intv. German Econ. Association VI (2007).
[1499] Romania only ranked 91th in this category of the Global Competitiveness Report; see World Economic Forum (2007).
[1500] Figure for 2007; see EBRD (2007b).
[1501] See e. g. Bevan and Estrin (2004); Brada, Kutan, and Yigit (2003).
[1502] See also Falcetti, Sanfey, and Taci (2003).

show that access to finance is of little importance for MNCs, because they generally receive financing from their parent company or from a bank in their home country.[1503] Therefore, the importance of the banking sector as an FDI determinant may be somewhat overestimated by the FDI studies analyzed. On the other hand, FDI studies are in line with the results of the interviews stating that the quality of the non-banking sector has apparently had little relevance for MNCs.[1504]

Both interviews[1505] and external sources[1506] show that the financial sector itself has been attractive for FDI. By the end of 2006 financial intermediation and insurance represented the second largest sector in terms of FDI stock with €7.7B or 22.2%.[1507] The privatization efforts and the increasing purchasing power parity apparently made the financial sector attractive for FDI, particularly in the last three or four years.[1508] Nevertheless, it seems that FDI in banking will deteriorate after the end of the major privatizations in the next couple of years.[1509]

(d) The **assessment** of this section shows that Romania has been developing a solid banking system in the last ten years mainly driven by the sale of SOEs to foreign banks and the harmonization of legislation in accordance to the EU acquis. On the other hand, Romania's banking and non-banking sectors are still fairly small and far from mature and will undergo further evolutions in terms of size, market structure and product offer in the future. In contrast to several FDI studies, interviews have shown that the quality of the financial system has little impact on MNCs' investment decision. However, the recent

[1503] See e. g. Intv. Austr. MNC - Industrial Goods I (2007).
[1504] See e. g. Bevan and Estrin (2004); Brada, Kutan, and Yigit (2003); Genco, Taurelli, and Viezzoli (1993).
[1505] See Intv. Germ. MNC - Software (2007); Intv. Austr. MNC - Financial Services I (2007); Intv. Int'l Econ. Association (2007); Intv. German Authority I (2007).
[1506] See e. g. NBR (2007); The National Trade Register Office (2007a).
[1507] After manufacturing; see NBR (2007).
[1508] See also Doc - Rom. Emb. Berlin (2007a).
[1509] See 6.2.1; see also Intv. German Authority I (2007).

banking privatizations may have brought Romania into the spotlight as attractive investment location and may therefore have a positive indirect effect on FDI in Romania in general.

The possibilities for public policy actors may seem limited today due to the adoption of EU rules; nevertheless, rules to access finance for smaller foreign firms should be improved, since they may have less possibilities to lend money at home.

(2) This section analyzes Romania's **monetary policy**. After (a) a very problematic development until the mid-1990s, (b) some major improvements can be identified since 1996, even though (c) some problems and threats remain. Today, Romania's monetary policy seems to be of (d) only limited importance for the investment decision of MNCs. An assessment is presented in sub-section (e).

(a) Romania's monetary policy faced some **major problems in the early 1990s.** The most severe challenge was – as already touched upon in *section 6.2.1* – the very high inflation with rates above 30% throughout the decade.[1510] Major reasons were the wage increase exceeding productivity growth, the lack of financial discipline of Romanian governments and their weak commitment to reforms until 1996.[1511] As a consequence monetary policy was challenging for the central bank, the NBR. It had "quasi-fiscal functions"[1512] in order to finance excessive government spending and thus contributed to higher inflation by accelerating money growth (seigniorage).[1513]

Furthermore, exchange rate policy often remained erratic until the mid-1990s.[1514] Even though the leu was officially free-floating, the NBR frequently

[1510] See Eurostat website (2008); see also figure 89 in the appendix.
[1511] See European Commission (1998); IMF (2001), pp.7, 15, 26.
[1512] See European Commission (2002a).
[1513] E. g. in 1994 for the financing of the agricultural program; see IMF (2001); Radulescu (2003).
[1514] See Maniu, Kallai, and Popa (2001).

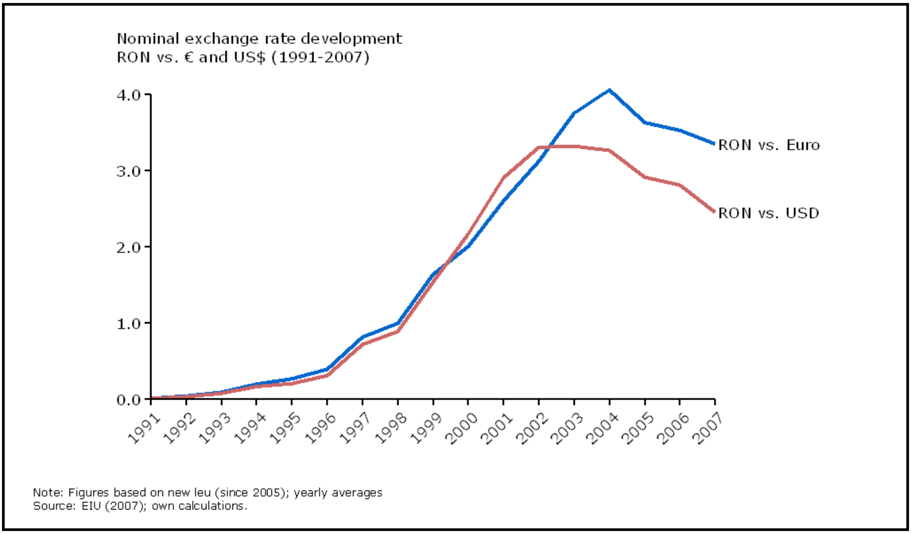


Figure 46: Exchange rate development of the leu

intervened, for instance by raising interest rates in order to lower inflation and to bolster domestic companies (appreciation) or by selling its foreign reserves in order to pay its external obligations (depreciation).[1515] The exchange rate was also affected in the early 1990s by restrictions on purchases of domestic and foreign currencies as well as by price controls that were introduced to protect local markets and limit inflation.[1516] In sum, the nominal exchange rate of the leu depreciated strongly throughout the 1990s (*figure 46*), while the real effective exchange rate remained highly volatile.

Furthermore, exchange rate policy did little to reduce inflation, interest rates stayed too low in order to stimulate savings and reserves only reached (in 1997) the generally targeted reserve minimum of three months.[1517]

[1515] See IMF (1997); European Commission (1998); IMF (2001); Müller (2005), pp.168-169.
[1516] See European Commission (1998); IMF (2001), pp.11-12; Müller (2005), p.167.
[1517] See Maniu, Kallai, and Popa (2001); IMF (2001).

Moreover, monetary policy lacked a clear vision and a well-defined role for the NBR.[1518] The independence of the NBR was therefore still limited throughout the 1990s. *Maliszewski (2000)* shows that Romania's central bank had the second lowest independence of 20 transition countries due to limitations in the legal framework but also to the frequent interventions of public policy.[1519]

The monetary turbulences peaked in 1996, when a widening current account deficit led to a further reduction of foreign exchange reserves and forced the Romanian government to introduce foreign exchange controls in 1996. This again caused the establishment of a gray economy in which companies started to trade foreign currency amongst one another.[1520]

(b) Monetary policy underwent **radical reforms** after 1996 when the government under President Constantinescu took office. The exchange rate was unified, foreign exchange restrictions were partly lifted and the full convertibility of currency was achieved (by 1998).[1521] The leu depreciated strongly in real terms in early 1997 and again in 1998/1999 (*figure 47*) and thus increased Romania's competitiveness. However, a further (short) period hyperinflation that peaked at 155% in (1997) showed that monetary stability was still at risk.[1522] Nevertheless, monetary policy became more predictable when Romania adopted a managed float regime in 1999 and with the help of (speculative) foreign capital inflows and decreasing inflation rates, the NBR was able to stabilize the real effective exchange rate within a small corridor until 2004. The moderate appreciation as well as a more cautious reserves policy helped to build up foreign currency reserves since the early 2000s.[1523]

At the same time the NBR gradually changed the goals of monetary policy from managed floating to inflation targeting and flexible exchange rates which

[1518] See also Figuet and Nenovsky (2006).
[1519] See also European Commission (1999).
[1520] See Maniu, Kallai, and Popa (2001).
[1521] See IMF (2001); Maniu, Kallai, and Popa (2001); Müller (2005), p.167.
[1522] See European Commission (1998); Maniu, Kallai, and Popa (2001).
[1523] See European Commission (2002a); Müller (2005), pp.168-169; IMF (2007a).

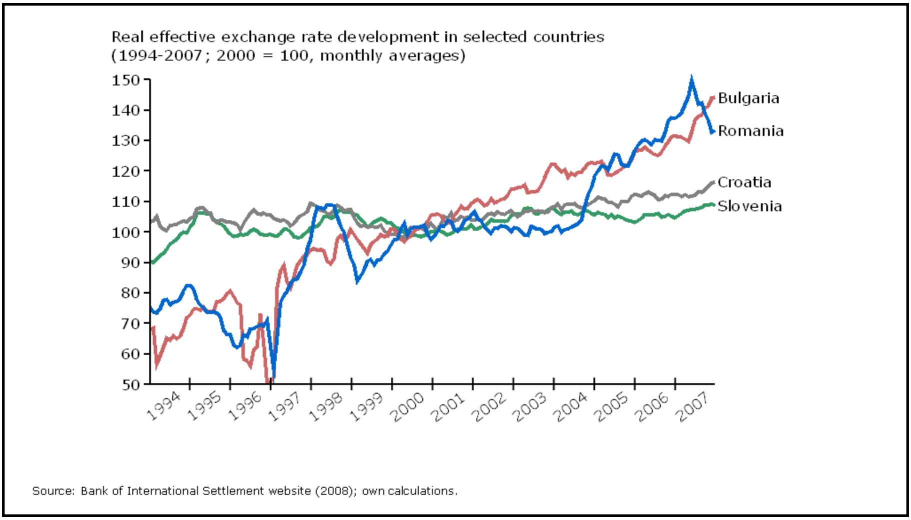


Figure 47: Real effective exchange rate development

came fully in effect in 2004. In July 2005 Romania eliminated four zeros of the leu and introduced the "new leu".[1524] The role of the NBR also was gradually strengthened. Firstly, the control of the NBR over commercial banks was enhanced, for example, regarding lending conditions.[1525] Secondly, primary and secondary sources confirm that the independence of the NBR from political influence was increased, for example by the prohibition of the NBR to finance governments' budget gaps.[1526] The legal framework concerning the NBR are in line with the EU acquis since 2004 and its financial and human resources seem sufficient.[1527]

[1524] Law no. 312/2004; Regulation no. 4/2005; see Figuet and Nenovsky (2006); Bulgaria Economic Forum (2007); Doc - ARIS (2007); EIU (2007b).

[1525] See Bertelsmann Stiftung (2003b); Bertelsmann Stiftung (2006c).

[1526] Law on the Statute of the National Bank of Romania of May 26, 1998, amended as of June 28, 2004; see e. g. European Commission (1998); Intv. Supranational Authority I (2007).

[1527] See European Commission (1999); Dvorsky (2004); Bertelsmann Stiftung (2006c).

The currency reform (2004/2005), NATO accession in 2004 and the prospect of EU accession led to a significant appreciation of the leu (2004-2007), both in nominal (18%) and in real terms (49 points).[1528] Despite this strong appreciation, various interviewees perceive the leu as quite stable and on a satisfactory level today.[1529] In 2006 the leu was awarded the title of European currency of the year by Bloomberg.[1530] External surveys also confirm the evaluation of some interviewees that the introduction of the euro would be welcome but would have no significant impact on monetary stability.[1531]

Finally, currency and monetary reforms are generally interpreted as the end of hyper-inflation.[1532] Therefore, the NBR contributed to bringing down inflation to 6.6% in 2006 as discussed in *section 6.2.1*. For the following years the NBR has formulated inflation targets of 4% (2007), 3.8% (2008) and 3.5% (2009).[1533]

(c) However, primary and secondary sources also reveal **some remaining problems** regarding Romania's monetary policy since the late 1990s. First of all, the strong depreciations of the real effective exchange rate in early 1997 and in 1998/1999 (*figure 47*) may have helped to increase the competitiveness of Romania in the short-term, but Romania also suffered from a temporary decline of output at that time (with decreasing GDP from 1997-1999) and rising unemployment from 6.6% in 1996 to 11.8% in 1999.[1534]

[1528] See EIU (2007c); Bank of International Settlements website (2008); own calculations.
[1529] See e. g . Intv. Austr. MNC - Primary Goods II (2007); Intv. Supranational Authority I (2007).
[1530] See IMF (2007a); Doc - Austrian Econ. Chamber Romania (2007a), p.3; Intv. German Econ. Association V (2007); Intv. Germ. MNC - Utilities (2007).
[1531] See Doc - German Econ. Chamber Romania (2007); Intv. Austr. MNC - Primary Goods II (2007).
[1532] See e. g. BA-CA (2006).
[1533] NBR (year-end) targets are therefore more ambitious than the inflation rates expected by externaly observers analyzed; see section 6.2.1; EIU (2007b).
[1534] See European Commission (1998); Maniu, Kallai, and Popa (2001); see figure 89.

Some interviewees (as well as many external sources) are also concerned regarding the appreciation pressure of the leu after 2004.[1535] They worry that a strong leu hurts the competitiveness of export-oriented MNCs. They also assume that bad news could quickly deter the monetary equilibrium since the appreciation was primarily driven by optimism towards the future and not backed by productivity gains.[1536]

In fact, the recent sharp real depreciation since mid-2007 can also be understood as a more realistic evaluation of the potential of the Romanian economy and as a reaction to the large amount of private debts.[1537] However, it may also bolster pundits who worry that the leu remains highly volatile after all – also in comparison to other countries of the regions (*figure 47*) – with negative effects on the credibility of Romania's monetary policy.[1538]

Finally, external observers worry that the NBR is making only moderate progress in combating inflation, since Romania's inflation remains the highest in the EU.[1539] They also wonder if the fairly moderate disinflation targets of the NBR suggest that its capabilities to steer inflation are (still) limited. [1540] *IMD (2006)* also assesses the impact of the NBR on the economy skeptically ranking Romania 42nd out of 61 countries and 6th out of 8 EECs.

(d) Interviews reveal – in line with FDI literature[1541] – that investors do observe monetary stability including inflation and exchange rate developments before making an investment in Romania.[1542] However, the **importance** of

[1535] See Bank of International Settlements website (2008); EIU (2007b); CICD (2006).
[1536] See Intv. German Econ. Association V (2007); Intv. Germ. MNC - Industrial Goods III (2007) EIU (2007b); Doc - Austrian Econ. Chamber Romania (2007a), p.3.
[1537] The global financial market turbulences may play a role as well; see EIU (2007b); Intv. Austr. Research Institute (2007); Intv. Romanian Econ. Association II (2007).
[1538] See e. g. Financial Times (2006a).
[1539] EU average: 2.2%; see section 6.2.1; see Eurostat website (2008); IMF (2007b).
[1540] See European Commission (2006e); EIU (2007b).
[1541] See e. g. Brada, Kutan, and Yigit (2003).
[1542] See Intv. Austr. MNC - Industrial Goods I (2007); see also Doc - Austr. MNC - Industrial Goods I (2005).

monetary policy on the investment decision has apparently been decreasing and is **limited today**.

External sources in particular assume that the great monetary imbalances such as high inflation rates and real exchange rate volatility were important factors for low FDI inflows to Romania during the 1990s and this is confirmed by the relevant data.[1543] A direct correlation between monetary indicators and FDI is difficult to determine, however, due to the low levels of FDI. FDI increased, for example, despite high inflation rates in 1997, but also at decreasing rates in the early 2000s.[1544]

For the period since the early 2000s, interviews reveal that the currency and legal reforms and the greater economic stability transformed monetary policy from a constraining factor to one of little importance for investors interested in Romania.[1545] Interviews and data suggest – in contrast to most FDI studies[1546] – that the level of the exchange rate seems to have little impact on FDI. Despite the theoretical assumption that MNCs are deterred by appreciating exchange rates[1547], Romania's greatest FDI surge started in a phase of strong real exchange rate appreciation.[1548]

Interviewees rather indicate that (positive) political and economic expectations since the early 2000s fostered FDI inflows to Romania and the real exchange rate appreciation in equal terms.[1549]

Interviews deny that an increasing exchange rate volatility significantly influences investments in Romania as long as it does not return to the levels of the 1990s, even though frequent adaptations of business calculations may be necessary when inputs and salaries are calculated in different currencies. Investors

[1543] See e. g. Maniu, Kallai, and Popa (2001); Müller (2005), p.164.
[1544] See figure 89 in the appendix.
[1545] See e. g. Intv. Austr. MNC - Industrial Goods I (2007); Doc - GTZ (2006b).
[1546] See for references Blomström and Kokko (2003); Blonigen (2005).
[1547] See Brewer (1993) for further references.
[1548] See 6.2.1; see Intv. Supranational Authority I (2007); Blonigen (2005).
[1549] See Intv. German Econ. Association V (2007); Intv. Germ. Research Institute I (2007).

will generally not delay a follow-up investment because of exchange rate swings either, since investments usually take several months and the opportunity costs of waiting would be higher than those of potential exchange rate deviations.[1550]

Foreign currency regulations and inflation seem to be of very little importance for investors in Romania and have been negligible issues for doing business in Romania in the last years.[1551] Interviews do not disclose any suggestion that the role and strength of the NBR has any effect on their investment decision, either.

Finally, interviewees do not expect an increase of importance of monetary policy on the investment decision of MNCs for Romania in the near future. In contrast, it seems that monetary policy would further lose its importance for FDI with the adoption of the euro and the full integration into the European Monetary Union.[1552]

(e) The **assessment** of this section reveals that monetary policy has been crucial for Romania's transition. In the 1990s monetary imbalances apparently contributed to a greater political and economic instability which probably had a negative impact on FDI inflows. Policy makers clearly waited too long to take decisive counter measures. However, reform efforts since the late 1990s seem to have been thorough, sustainable and credible; in fact, all experts interviewed were optimistic that the times of hyper-inflation and high exchange rate volatility are now over, even though the economic turbulences did not end in Romania until recently.

This section, however, also showed that monetary policy is difficult to evaluate and predict for MNCs. As shown in the analysis of the economic trends, interpretations strongly varies, for example with respect to the current level

[1550] See Intv. Germ. MNC - Retail (2007); Intv. Germ. MNC - Industrial Goods III (2007); Intv. Supranational Authority I (2007).

[1551] Both factors have been considered as problematic for Romania by less than 5% of respondents in surveys since 2003; see World Economic Forum (2007) and earlier editions.

[1552] See e. g. Intv. Austr. MNC - Primary Goods II (2007).

and future trend of the leu. This may also be one reason why investors tend to analyze the monetary development only very generally before an investment decision. Furthermore, those MNCs that are already in the country seem little affected by monetary developments, maybe also because they do not expect situations to strongly differ in Romania from other SEECs. Furthermore, investors interested in Romania seem to be less concerned about the level of the exchange rate but rather focus on exchange rate volatility, probably because it effects their daily business operations in a stronger way. In sum, the direct impact of monetary policy on FDI in Romania may be lower than often assumed by external studies. This section rather suggests that monetary policy only has a very indirect and long-term impact on FDI, primarily by contributing to a predictable investment environment and to economic stability.

Romanian monetary policy should focus on price stability and the avoidance of any large exchange rate volatility. In this regard, the quick integration of Romania into the European Monetary Union may have a further stabilizing impact.

A field for future research that has been little explored by external studies so far is the extent to which the recent real exchange rate appreciation contributed to an increase in market-oriented FDI, for example in order to anticipate an expected or actual purchasing power growth in Romania.

(3) From the perspective of MNCs, Romania's **trade policy** was (a) gradually liberalized since the mid 1990s and (b) regulations and procedures apparently cause little problems since EU accession. Trade policy tends to have (c) a positive impact for MNCs' decision in favor of Romania, particularly versus non-EU countries. Sub-section (d) presents an assessment.

(a) Romania **gradually opened its economy for foreign trade** in the 1990s. Despite its membership in the General Agreement on Tariffs and Trade

(GATT) since 1971, interviews[1553] and secondary sources[1554] show that Romania's trade policy remained fairly protectionist in the early years of transition. Trade regulations were restrictive and custom duties quite high in the early 1990s in order to promote infant industries against external competition. Furthermore, Romanian governments caused uncertainty among investors because of continual deviations from formal tariffs. In 1993 Romania only had free trade agreements with half a dozen countries including the U.S.

With the adoption of the Association Agreement with the EU (1993), the application for EU membership (1995) and the new government (1996), Romania turned towards a more liberal trade policy. In a first step custom tariffs on imports of high tech products were eliminated and other industrial as well as IT products followed until the end of the 1990s.[1555] In a second step customs duties on textile, food products and agriculture were lifted. This liberalization as well as the adoption of various new trade agreements lowered or even eliminated custom duties for many countries, most notably from the EU.[1556] However, interviewees emphasize that industry-specific differences remained and not all MNCs benefited from custom liberalization before EU accession.[1557] FDI surveys also suggest that – despite the improvements observed – trade policy remained one of Romania's weak spots even in the early 2000s with only two out of eleven EECs having a weaker performance than Romania.[1558]

[1553] See Intv. Romanian Ministry IV (2007); Maniu, Kallai, and Popa (2001).
[1554] See Freedom House (1998); Dragulin and Radulescu (1999).
[1555] In 1997 Romania joined the ITA agreement of the WTO; Law 332/2001; see also IMF (2001); Maniu, Kallai, and Popa (2001); European Commission (2002a), p.119.
[1556] See Intv. Romanian Ministry IV (2007); see also Maniu, Kallai, and Popa (2001); European Commission (2004a), p.134.
[1557] See e. g. Intv. Austr. MNC - Industrial Goods I (2007); see also Intv. Austr. MNC - Primary Goods II (2007).
[1558] That were Albania and Macedonia; see McGee (2003).

Apart from the trade regime, the majority of interviewees[1559] and external sources[1560] confirm the insights of *section 7.2.3.2* on the quality of bureaucracy, also with respect to daily custom procedures. The tariff payment system was highly complex before EU accession and required a lot of paper work; furthermore, custom clearance at the border was cumbersome and prone to bribery. As a result *IMD (2006)* ranks Romania 57th out of 61 countries analyzed regarding the ability of customs authorities to facilitate transit of goods.

(b) With the **accession to the EU** all remaining trade barriers, affecting EU countries were removed, and the responsibility for Romania's trade policy was transferred to the EU. Interviews reflect a very positive evaluation of trade conditions for MNCs today.[1561] Overall, the elimination of customs proceeded without any major problems in Romania and with less delays than many professionals had expected. The abolishment of customs has apparently made trading goods very straightforward.[1562] Since trucks do not have to wait at the border to other EU countries anymore, logistics have improved, transportation times are shortened and costs are lowered.[1563] As a result, the volume of goods transported from and to Romania have increased since 2007.[1564] International statistics also show that the trade regime is quite liberal today[1565] and that the trading of goods has become significantly cheaper and faster. The length of time necessary to complete all formalities for imports has fallen from 38 days

[1559] See Intv. Austr. MNC - Industrial Goods I (2007); Intv. Austr. MNC - Primary Goods II (2007); Intv. Austr. MNC - Consumer Goods (2007); Gabanyi (2005).
[1560] See Intv. Germ. MNC - Logistics (2007); see also European Commission (2005c), pp.88-89.
[1561] See Intv. Romanian Ministry IV (2007); Intv. Austr. MNC - Consumer Goods (2007).
[1562] See Intv. Austrian Econ. Association I (2007); Intv. Germ. MNC - Logistics (2007).
[1563] See Intv. Austr. MNC - Industrial Goods I (2007); Intv. Int'l MNC - Utilities (2007).
[1564] See Intv. Germ. MNC - Logistics (2007); see also BA-CA (2007b).
[1565] Romania scores 4.3 out of 5 points of the foreign exchange and trade liberalization index of the EBRD since 1998; see EBRD (2007b); see also Bertelsmann Stiftung (2006c).

(2006) to 13 days (2007).[1566] Procedures are therefore among the four fastest in Romania of 19 EECs.[1567]

However, interviews and external sources still see some room for further improvements, for example regarding the speed and transparency of the work of custom authorities.[1568] Finally, the adoption of the EU's trading rules by Romania has also caused the situation for those MNCs that are mainly exporting to non-EU countries to deteriorate, since countries like Ukraine and Russia have import customs for the EU but did not previously have any for specific goods from Romania.[1569] However, this aspect seems to be relevant only for a minority of MNCs in Romania.

(c) Primary and secondary sources show that trade policy in general has been **important** for the investment decision of MNCs. This seems to be true in particular for export-oriented MNCs and is also in line with the general findings of FDI literature.[1570] Thus *McGee (2003)* seems to be right when stating that the weak trade conditions represented a competitive disadvantage for Romania; however this finding needs to be interpreted primarily in an administrative rather than in a legal sense.

Interviews help to understand that procedural barriers and the time needed at the border are more essential for MNCs than the trade regime itself or the level of custom duties as long as they are not excessive.[1571] Therefore, it seems that the gradual decrease of custom duties since the late 1990s was hardly noticed by foreign investors and therefore had only limited effect on FDI to Romania since administrative barriers continued to exist.[1572]

[1566] Average figures including imports from non-EU countries; see World Bank (2007b).
[1567] See World Bank (2007a).
[1568] In the ranking of the burden of customs procedures of World Economic Forum (2007) Romania takes 66th of 131 countries; see also Intv. German Authority IV (2007).
[1569] See Intv. Austr. MNC - Primary Goods II (2007).
[1570] See Balasubramanyam, Salisu, and Sapsford (1996); Holland and Pain (1998); Holland, Sass, Benacek, and Gronicki (2000).
[1571] See Intv. Austr. MNC - Industrial Goods I (2007); Intv. Int'l MNC - Utilities (2007).
[1572] See also Intv. Romanian Ministry IV (2007); Intv. Austr. Research Institute (2007).

In contrast, various MNCs interviewed agree that the complete elimination of custom barriers at the borders in 2007 was very beneficial and some even saw it as one of the most important consequences of EU accession.[1573] In the context of locational competition the recent improvements are especially advantageous for Romania versus non-EU members such as Ukraine, where investors frequently complain about cumbersome custom procedures and are an important step for Romania to close competitiveness gaps to existing EU members (such as Hungary).[1574]

(d) In the **assessment** of this section it becomes apparent that trade policy has developed in a positive way, whereas the biggest step represented the accession to the EU. Perhaps Romania should have started decisive liberalization efforts earlier since there is little evidence to show that the protection of domestic firms in the early 1990s had a positive effect on Romania's economy. Furthermore, it seems that the belated opening to global markets promoted monetary imbalances, deterred (at least to some extent) FDI and thus contributed to a slowdown of Romania's transition.

This section reveals that state expert interviewees primarily affiliate improvements in trade conditions with the gradual legal liberalization of trade to and from Romania, while company experts have been even more worried about daily bureaucratic obstacles of the trade regime, namely caused by customs authorities at the borders of Romania. This is particularly interesting since the actual costs of customs may be higher than those caused by dealing with customs authorities. Reasons may be that modifications and exceptions of the tariff system were confusing for MNCs and made a calculation of the actual costs difficult in the past. Furthermore, it seems that MNCs were strongly interested in the

1573 See Intv. Austr. MNC - Industrial Goods I (2007); Intv. Germ. MNC - Logistics (2007); Doc - Rom. Emb. Berlin (2007b); different for those MNCs mainly exporting to non-EU countries: Intv. Austr. MNC - Primary Goods II (2007).

1574 See Intv. Austr. MNC - Consumer Goods (2007); Intv. Germ. MNC - Logistics (2007); see also Doc - Economic Chamber Vienna (2007).

reliability of sending goods and were deterred by constant worries if goods will reach their destination in times, if graft will be necessary etc. Therefore, the perceived (opportunity) costs of the administrative barriers of trade policy were (until EU accession) apparently higher for quite a few MNCs than the actual legal ones. Even those investors who are aware of these interrelations may be willing to accept higher actual costs when they can avoid laborious endeavors at the same time.

Possible implications from this section for Romania are that public policy should quickly tackle remaining problems with custom authorities and think of ways how to support those companies that primarily trade with non-EU countries, for example by searching for political support from other new EU members in order to achieve a further reduction of reciprocal tariffs of the EU and neighboring third countries by the relevant institutions in Brussels.

(4) In **conclusion**, this section has shown that there was little sustainable economic stability in Romania throughout the 1990s. Despite initial reform efforts that were launched in the mid 1990s, investors have only recently begun to conditions as reliable. This applies to the financial and monetary systems as well as to the trade policy. Only within the next couple of years, will Romania have the opportunity to clearly benefit from the recent achievements; preconditions are that remaining obstacles for investors are removed and Romania's locational advantages – particularly versus non-EU members – are actively promoted. In contrast, with the increasing integration towards the EU, the chances for Romanian public policy to influence economic stability have deteriorated, as has the importance of this factor as a determinant for FDI.

Finally, this section has shown that the different dimensions of economic stability are often interdependent with other determinants including corruption, privatization and bureaucracy, whereas interviews in particular have clarified that – at least the perception of – administrative barriers are often more important for MNCs than legal obstacles.

7.3.1.3 Croatia

(1) Croatia's **financial system** is (a) well advanced today and (b) problems are limited. Yet, (c) its impact on FDI is low. Section (d) provides an assessment.

(a) The analysis of primary[1575] and secondary sources[1576] show that Croatia's financial system including the banking and the non-banking sector **clearly come up to the expectations** of MNCs. The Croatian banking sector had already been fairly advanced during socialist times.[1577] The most important measure to reform the banking sector in the 1990s was privatization that already started in the early 1990s. The listing of the Zagrebačka Banka at the stock exchanges in Zagreb and London (1995 and 1996) represented a further milestone in this context.[1578] The bulk of banking privatization was completed fairly early compared to other EECs.[1579] By 2000 only 5.7% of Croatian banking assets were left in state ownership, while the Romanian governmment, for instance, still owned more than 50% of the banking assets in that year. The fairly quick sale of the state banks may also have contributed to the low rate of non-performing loans (5.9% in 2006).[1580] Today, banking privatization is almost completed and further sales of state-owned banks, such as the Croatian post, are currently not expected by experts.[1581]

[1575] See e. g. Intv. Germ. MNC - Financial Services I (2007); Intv. Austr. MNC - Financial Services I (2007); Intv. Supranational Authority II (2007).
[1576] See e. g. Bertelsmann Stiftung (2006b), pp.1, 7; EBRD (2007b); European Commission (2007a), p.21; Mühlberger (2007).
[1577] See Brada, Kutan, and Yigit (2003).
[1578] See Intv. Croat. Company - Utilities (2007); Intv. Croatian Ministry II (2007).
[1579] See Intv. Germ. MNC - Financial Services I (2007).
[1580] See EBRD (2007b).
[1581] See e. g. Intv. Germ. MNC - Financial Services II (2007); Intv. European Institution (2007); see also Dresdner Bank (2004), p.6; European Commission (2005a), p.42.

In addition to these structural developments that have increased stability in the eyes of investors, experts interviewed praise the legal framework of the Croatian banking sector that is already largely harmonized with the EU acquis including the equal treatment of domestic and foreign banks.[1582]

As in Romania, foreign banks in Croatia also benefited the most from banking reforms and privatization. By the end of 2006 foreign banks held 90.8% of banking assets, mainly from Italy (44%) and Austria (35%). In contrast, domestic private banks particularly suffered from the banking crisis in the late 1990s, which led to bankruptcies, take-overs and thus to a decrease in number from 54 (1997) to 18 (2006).[1583]

Interviews also indicate that the high quality of the Croatian banking sector is underlined by a broad and complex portfolio of products offered that often reach Western European standards and are more advanced than those in other countries such as Romania. These include investments in commodity products by pension funds, currency hedging and a high degree of mortgage lending.[1584]

Overall, experts interviewed acknowledge that the banking sector belongs to the most successful areas of reform of Croatia in recent years; today it is apparently very stable, healthy, solvent, and shows high turnovers; in many ways the banking system seems to be more advanced in Croatia than in most other SEECs.[1585] This is also confirmed by a high BTI banking system score of Croatia (9 out of 10 points) and by Croatia's good performance in the EBRD

[1582] See Banks Act 84/2002; see Intv. Croatian Econ. Association (2007); Intv. Germ. MNC - Financial Services I (2007); Intv. Germ. MNC - Financial Services II (2007); Mühlberger (2007).

[1583] See EBRD (2007b); Doc - Croatian Chamber of Comm. (2006a); Doc - Croatian Chamber of Comm. (2007); see also Intv. Austr. MNC - Real Estate (2007); Intv. Austr. MNC - Financial Services I (2007); Intv. Croatian Econ. Association (2007); Intv. Germ. MNC - Financial Services II (2007).

[1584] See Intv. Germ. MNC - Financial Services I (2007); Intv. Austr. MNC - Real Estate (2007); Mühlberger (2007).

[1585] See Intv. Former Croatian Minister (2007); Intv. Germ. MNC - Financial Services II (2007); Intv. Germ. MNC - Financial Services I (2007); see also Doc - EU Commission Zagreb (2007).

banking reform index (4 out of 5 points) representing the best score of 19 EECs.[1586]

Experts interviewed also see very positive developments in the non-banking sector. For example, a new leasing law (2007) has established stricter, more transparent and more concise rules for the leasing market. Markets for leasing and insurance products are also expanding quickly. Furthermore, the market capitalization has strongly increased to more than €50B which also seems to be driven by the merger of the two Croatian stock exchanges in 2007.[1587]

(b) Despite this favorable development **some problems** with the Croatian financial system **remain**. With respect to the banking sector, primary[1588] and secondary sources[1589] see some obstacles to access finance. Procedures for receiving credits in particular remain complex for SMEs. Therefore, Croatia shows only an average performance in the World Bank's Ease of Doing Business statistics in comparison to other EECs.[1590] However, problems seem to decrease, for example since the establishment of the Croatian Registry of Credit Obligations (HROK) in 2007.[1591]

On the other hand, Croatia's private credits have significantly grown lately from 63% of GDP in 2005 to 72% in 2006, which may harm Croatia's future economic equilibrium. Nevertheless, annual private credit growth was still lower in Croatia with 18% between 2000 and 2006 than the Eastern European average of 21%.[1592]

[1586] Score shared with four other countries; see EBRD (2007b); Bertelsmann Stiftung (2006b).

[1587] See Intv. Austr. MNC - Real Estate (2007); Intv. Germ. MNC - Financial Services II (2007); Doc - EU Commission Zagreb (2007); see also EBRD (2007a), p.20.

[1588] See e. g. Doc - Germ. MNC - Engineering (2001); Intv. Germ. MNC - Telecommunications (2007); Doc - GTZ (2006a).

[1589] See e. g. EBRD (2005a), p.22; European Commission (2007a), p.45.

[1590] See World Bank (2007a).

[1591] See Doc - NCC (2007).

[1592] Based on eight countries; see Egert and Mihaljek (2007); European Commission (2007a), p.21; EBRD (2005a); European Commission (2005a), p.39; Intv. Austr. Research Institute (2007).

Some problems also remain with respect to the non-banking sector. Primary[1593] and secondary sources[1594] see room for improvement, for example, regarding the legal framework of capital markets (including limitations for short-term capital flows and investments abroad) but also regarding the liquidity of the share market. International statistics give Croatia only mediocre grades for its non-banking and securities sector, for example 3 out of 5 points from the EBRD and a 70th rank of 131 countries analyzed by the World Economic Forum.[1595] However, these statistics possibly do not take the most recent developments discussed above into account.

(c) In line with the findings for Romania, interviews **do not reveal** that the soundness of the financial system has had **any major impact** on the investment decision of MNCs interested in non-financial investments in Croatia. At most, the good performance of the financial system may have had an indirect positive effect on FDI, by fostering economic stability in Croatia. Single investors interviewed indicate that difficult financing conditions for SMEs may have deterred some investors in the late 1990s and early 2000s.[1596] However, the World Competitiveness Report records that access to finance has been losing its importance as constraining factor for doing business in Croatia (from 3rd (2005) to 7th most problematic factor (2007)).[1597] The survey presented in *CICD (2006)* also confirms that financing conditions are of little importance for MNCs interested in Croatia today and less of a constraint for doing business than in any other SEEC.

By contrast, the financial sector itself has been very attractive for FDI inflows to Croatia since the early 2000s.[1598] FDI in financial intermediation has

[1593] See e. g. Intv. Germ. MNC - Telecommunications (2007); Doc - EU Commission Zagreb (2007); Doc - Ekonomski Institut Zagreb (2007).
[1594] See e. g. World Economic Forum (2006b).
[1595] See EBRD (2007b); World Economic Forum (2007).
[1596] See Intv. Germ. MNC - Engineering (2007).
[1597] See World Economic Forum (2007).
[1598] See Intv. Croatian Ministry II (2007).

also gained in importance relatively to other sectors; therefore, its share of the FDI stock rose from 19% in 2001 (as third most important sector for FDI) to 49% in 2006 becoming the most important sector for FDI. As a result, financial intermediation does not play a greater role in any other EEC today.[1599] Privatization opportunities, the high market sophistication and the high purchasing power of Croatians have made investments in the banking but also in non-banking sectors like insurance and leasing very attractive.[1600]

However, it is questionable to what extent this high level of FDI inflows into the financial sector can be maintained since various indicators (such as banking assets[1601]) show that the Croatian financial market is already quite mature and the need for catching up is less than in other EECs.[1602]

(d) In the **assessment** of this section, it becomes apparent that Croatia's financial system has been performing on very high standards for several years already (except in some areas of the non-banking sector) and seems to be more mature than in most other SEECs including EU members like Romania. The favorable starting conditions (including well-educated staff), the early introduction of privatization in the banking sector and the open attitude towards foreign investments in this sector have helped to create an advanced financial system in Croatia. EU integration, therefore, did not seem to be a prerequisite for reforms in this area for Croatia. This is particularly interesting given that the pressure from the EU seemed to be essential for most legal determinants (as discussed above) in order to initiate substantial improvements in Croatia.

Nevertheless, interviews with both company and state experts confirm the results for Romania that the importance of the financial system for FDI, that are not focused on the financial sector, is limited. The great importance of the

[1599] See Hunya (2002); Hunya (2007).
[1600] See also section 6.3.1.
[1601] With a level over 120% in 2006 Croatia already reached a level higher than all other EECs; see Mühlberger (2007).
[1602] See ibid.; see also section 6.3.1.

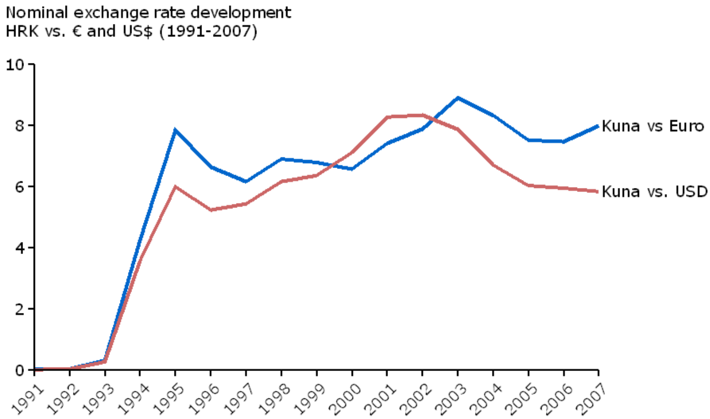
Croatian financial sector itself for FDI may deteriorate faster than in other SEECs, since the market is already quite mature and a likely EU accession may not generate an additional boost. Yet, public policy should focus its reforms on the non-banking sectors in order to further enhance possibilities for sector-specific FDI.

(2) **Monetary policy** in Croatia has been an important factor for economic stability. After (a) difficult years during the first years of war, (b) the monetary situation significantly stabilized after 1994 and (c) only subordinate problems remain today. The determinant has a (d) slightly positive effect on FDI in Croatia. An assessment is presented in sub-section (e).

(a) Political and economic transition as well as the beginning of the war led to a short but **significant instability** of Croatia's monetary policy **in the early 1990s**. The Croatian dinar that replaced the Yugoslavian dinar in December 1991 quickly devaluated, peaking at monthly rates of over 30% in 1993.[1603] Inflation was apparently beyond the control of the young Croatian National Bank (CNB) until 1994.[1604] Due to the war turbulences the CNB also had significant difficulties to control the exchange rate of the kuna that was offically fixed to the German mark (*figure 48*). In this context, the CNB had only limited steering possiblities since it started its work without any international reserves.[1605]

Furthermore, the independence of the CNB was still fragile in this period and weaker than in the majority of transition countries.[1606] Political influence was apparent, for example, when the first governor of the CNB, Ante Cicin-

[1603] See section 6.3.1 and figure 91 in the appendix; see also European Commission (2004c), p.40; IMF (2006a), p.40.
[1604] The CNB was established in December 1990.
[1605] All reserves were held by the National Bank of Yugoslavia; see Kraft (2003); Daviddi and Uvalic (2003).
[1606] See Maliszewski (2000).



Note: Figures based on kuna introduced in 1994; annual averages.
Source: EIU (2007); own calculations.

Figure 48: Exchange rate development of the kuna

Sain, was pressured to resign in 1992 as a result of his opposition to direct government financing.[1607]

(b) Some deliberate reform efforts, already initiated during the war, led to **significant improvements** of Croatia's macroeconomic environment and monetary policy contributed to a continued stable development since then. The stabilization program, launched in late 1993, partly liberalized the foreign exchange market and interest rates; the convertibility of the current account was established and this increased the confidence of citizens that they could convert domestic currency to foreign exchange in times of crisis. Direct credits of the CNB to subsidized sectors such as agriculture were eliminated.[1608] In a currency reform in 1994, the kuna (HRK) was introduced, managed floating (without a pre-determined path) was adopted as exchange rate regime and price stability

[1607] See Dvorsky (2004).

[1608] Capital accounts restrictions were not eased until 2001; see Daviddi and Uvalic (2003); Kraft (2003); European Commission (2004c), p.40.

was formulated as most important goal of monetary policy. These measures as well as the end of the war (increase in confidence) resulted in a brief nominal appreciation of the kuna which also fostered the sharp decline of inflation to only 1.9% in 1995. In the subsequent years the CNB successfully kept inflation at levels below 6%, averaging 2.4% (2002-2006).[1609]

In this context, the exchange rate policy has been the CNB's most important stabilizer, anchoring the kuna versus the German mark and later versus the euro. Exchange rate swings have mostly been driven by seasonal tourism. The CNB usually uses interventions on the exchange market such as auctions but also indirect open market tools such as the modification of reserve requirements and refinancing credits. As a result the exchange rate has remained in a narrow corridor, generally oscillating not more than ±6% versus the euro in nominal terms. [1610] With respect to the real effective exchange rate (*figure 47*), only Slovenia showed less currency volatility of eleven EECs analyzed.[1611] At the same time foreign exchange reserves strongly accumulated already reaching over €1B in 1994 and over €9B in 2007.[1612]

The personal and functional independence of the CNB was strengthened with a respective Act in 2001[1613] that largely aligned the legal framework with the EU acquis and even enabled the CNB to propose legal acts regarding monetary policy.[1614] Finally, the amendment of the National Bank Act in 2006 abolished the possibility – which had been often criticized by external sources – that

[1609] See European Commission (2004c), pp.40, 82; European Commission (2005a), p.39; IMF (2006a), p.40; European Commission (2007a); section 6.3.1.

[1610] See European Commission (2004c), pp.40, 45; European Commission (2005a), p.39; EBRD (2005a), p.17; Bertelsmann Stiftung (2006b), pp.8-9; European Commission (2007a), p.18.

[1611] Deviation of value scaled to 2000: 12.6 in Croatia, 11.9 points in Slovenia, 49 points in Eastern European (average), see EIU (2007c); Doc - Gov't. of Croatia (2006); own calcuations.

[1612] See Daviddi and Uvalic (2003); Schweigert (2004); European Commission (2007a).

[1613] See Law no. 36/2001; see also Doc - Croatian Chamber of Comm. (2006a).

[1614] See European Commission (2004c); Dvorsky (2004); European Commission (2005a), p.74.

losses of the CNB are financed by the government.[1615] Interviewees confirm that the CNB can largely act without political interference nowadays.[1616]

Overall, primary and external sources judge that "a sound monetary policy framework"[1617] is in place in Croatia and that the CNB has built up credibility and contributed to stable exchange and low inflation rates since the mid-1990s.[1618]

(c) Regarding Croatia's monetary policy, primary and secondary sources identify **only few remaining problems**. Interviewees in particular emphasize that the strength of the kuna has been artificial and does not fully reflect the competitiveness of the Croatian economy. As a result most goods are quite expensive in Croatia compared to other SEECs.[1619] Various sources also worry that the slight appreciation pressure of the recent years in the course of growing FDI inflows and EU expectations will rise further, particularly following accession to the EU.[1620]

Primary and secondary sources also agree that the role of the CNB in countering appreciation is challenging. First of all, the CNB's room for maneuver is limited since the kuna is not fixed and a large proportion of the economy has already substituted the kuna for the euro. Furthermore, the possibilities for a devaluation are limited since the CNB has to cope with large and growing amounts of private and public credit.[1621] Further issues for reform are the

[1615] See Law no. 135/2006; Dvorsky (2004); European Commission (2004c), p.82; Doc - Gov't. of Croatia (2006); European Commission (2006a), p.42; CNB (2007).
[1616] See Intv. Germ. MNC - Financial Services II (2007).
[1617] European Commission (2007a), p.18.
[1618] See Intv. Germ. MNC - Financial Services II (2007); Intv. Germ. MNC - Industrial Goods I (2007); Intv. Austr. MNC - Financial Services I (2007); see also IMF (2006a), p.16; European Commission (2006a), pp.20, 22; UniCredit Group (2006), p.3.
[1619] See Intv. Former Croatian Minister (2007); Intv. Austr. MNC - Real Estate (2007); Intv. Germ. MNC - Financial Services II (2007).
[1620] See Intv. Germ. MNC - Financial Services I (2007); Bfai (2004), p.28; Doc - Gov't. of Croatia (2006); European Commission (2006a), p.19.
[1621] See Daviddi and Uvalic (2003); IMF (2004), p.4; Bfai (2004), p.28; IMF (2006a), p.17; Intv. Germ. MNC - Financial Services II (2007); Intv. Austr. Research Institute (2007); Intv. Germ. MNC - Financial Services I (2007).

completion of formal independence of the CNB and the full liberalization of short-term financial credit flows.[1622]

(d) The analysis of the importance of monetary policy suggests that this determinant has a **slight positive effect on FDI** in Croatia. Company experts in particular praise the fact that the long-term stability of the kuna for many years has been supportive for the planning of investments but also of the daily operations and risk calculations of the investors who are already present in Croatia. In this context Croatia seems to have an advantage compared to other countries in Eastern Europe under increasing real appreciation pressures such as the Czech Republic.[1623]

In contrast to claims made by various FDI studies[1624], the (low) volatility of the domestic currency seems to be more important for the investment environment in Croatia than the level of the (real) exchange rate. Interestingly, this evaluation is mainly brought forward by company experts and even export-oriented MNCs interviewed do not mention the high level of currency as deterrent. Thus they seem to worry little about a deterioration of the competitiveness level. One reason may be that the cost level is (as shown for labor costs in the ICT sector in *section 6.3.2*[1625]) lower than often assumed at least in some sectors; in contrast, state experts are more critical of the strong kuna and its possible negative effects, for example on greenfield investments. This may be because they tend to overestimate the cost disadvantage of Croatia compared to other SEECs and possibly overlooks the fact that managers of MNCs tend to aim at stable cost developments rather than at the lowest possible cost level.

Interviews and international statistics further suggest that other aspects of monetary policy such as inflation, foreign currency restrictions or the role of

[1622] See European Commission (2007a), p.41; CNB (2007); Doc - Gov't. of Croatia (2006).
[1623] See Intv. Germ. MNC - Industrial Goods I (2007); Intv. Austr. MNC - Financial Services I (2007); Intv. Austr. MNC - Retail (2007); see also APIU (2007), p.2; Intv. Germ. MNC - Financial Services I (2007).
[1624] See Blonigen (2005); Brada, Kutan, and Yigit (2003).
[1625] See also Doc - BA-CA (2007).

the CNB are of very limited importance for the investment decision of MNCs that are interested in Croatia. Banks may sometimes complain about credit restrictions that the CNB tries to impose but this does not seem to deter FDI in financial intermediation (as data and the sub-section above have shown), maybe because business opportunities have nonetheless been significant in recent years.[1626]

(e) The analyses of this section result in the **assessment** that Croatia reacted more quickly and thoroughly than many other SEECs including Romania to the monetary challenges of the 1990s. In order to achieve long-lasting stability and low inflation rates Croatia accepted that the kuna has been high (maybe even overvalued) with some harm to its competitiveness.

In this context state interviewees may somewhat overestimate the negative effects of the strong kuna on greenfield investments in the past. It seems that other determinants including those involving legal issues (as shown above) are more responsible for lower inflows of efficiency-seeking MNCs. In contrast, interviews show that monetary policy was successful from the perspective of MNCs interested in Croatia since they prefer stability to a low-valued but erratically developing exchange rate. Furthermore, Croatia is likely to benefit from this stability approach once it has entered the European Monetary Union. However, these effects are still little investigated by existing FDI literature and may be a rewarding field for future research.

This goal of stability and the strong dependence on the tourism sector leaves the CNB little room for discrete decisions – room which will completely disappear with the entrance into the European Central Bank System after accession to the EU – and may cause future problems in containing growing credits. Nevertheless, the CNB should maintain its focus on stability factors since they represent the cornerstones of Croatia's monetary and economic

[1626] See Intv. Germ. MNC - Engineering (2007); World Economic Forum (2007) and earlier editions.

stability.

(3) **Trade policy** in Croatia has (a) progressed somewhat in the 1990s, (b) led to significant liberalizations since 2000 and (c) leaves only limited problems today. Findings on the (d) importance of this determinant are mixed and are assessed in sub-section (e).

(a) **In the 1990s** Croatian trade policy was **somewhat deterred** by war and the protectionist attitude under President Tuđman. Furthermore, the EU stopped the first negotiations about a trade agreement after Croatia's military operations "flash" and "storm" in Serbia in 1995.[1627] Until the end of the decade Croatia only had one bilateral trade agreement, with Macedonia (since 1997). The simple rate for imports still averaged 12.1% in 1998 and duties of at least 15% had to be paid for every fourth tariff item.[1628] At the same time various agreements were in preparation in the ministries including the accession to the WTO and a potential free trade agreement with the EU.[1629]

(b) Under the new government of Prime Minister Račan (2000-2003) **significant reforms were initiated.**[1630] Croatia joined the WTO in 2000 which led to a continued reduction of tariffs for other member states.[1631] In 2001 Croatia signed the Stabilization and Association Agreement (SAA) with the EU. The trade-related part of the SAA entered into force in 2002 and resulted in the abolishment of most custom barriers between the EU and Croatia.[1632]

Croatia also liberalized trade with other economies in the early 2000s. For example, Croatia signed 35 bilateral free trade agreements between 2001 and

[1627] "Bljesak" and "Oluja"; see McGee (2003); Pommer (2007), pp.154-155; BA-CA (2007a), p.15.
[1628] See World Trade Organization (2000), p.14; own calculation.
[1629] See Bulgaria Economic Forum (2007).
[1630] See Uvalic (2005).
[1631] See European Commission (2005a), p.104; Doc - NCC (2007).
[1632] The full SAA came into effect in 2005; see Doc - NCC (2007); Doc - German Econ. Chamber Croatia (2007).

2006 alone, including one with the members of the European Free Trade Association (EFTA).[1633] Also of interest is the free trade agreement with the old opponent, Serbia, that was signed in 2002 (only seven years after the end of the war) and entered into force in 2004.[1634] In 2005 the Central European Free Trade Agreement (CEFTA) under the patronage of the stability pact and the EU Commission came into force in Croatia; it replaces about 30 existing bilateral free trade agreements among SEECs and will establish a market free of customs by 2010.[1635] In sum, Croatia receives very good grades in international statistics for its commitment to multilateral and regional trade agreements.[1636]

As a consequence of these agreements, custom regulations including institutional obligations have been aligned step by step with EU standards.[1637] The majority of customs duties and quantitative restrictions to and from the EU were abolished by 2004 and most of the remaining ones (mainly for agricultural products) were eliminated by 2007.[1638] Average custom tariffs for both industrial and agricultural products for the trade with other WTO members are evaluated as very competitive in comparison to other SEECs by external studies.[1639]

Overall, Croatia opened up towards the global economy in the early 2000s, extensively liberalized its trade policy and largely reaches, in the perception of various external sources, Western European standards today.[1640] According to *OECD (2006a)* Croatia's trade policy is therefore as advanced as those of

[1633] See APIU (2006b), p.16; Doc - NCC (2007).
[1634] See section 6.3.1; European Commission (2005a), p.31.
[1635] See World Bank (2003); European Commission (2005a), p.30 Bulgaria Economic Forum (2007); European Commission (2007a), p.15; Dow Jones (2007).
[1636] See OECD (2006a), p.145; see also Doc - OECD (2007).
[1637] See for legal references Doc - German Econ. Chamber Croatia (2007); see also Dresdner Bank (2004), p.8.
[1638] See OECD (2006a), p.132; Bulgaria Economic Forum (2007); Doc - German Econ. Chamber Croatia (2007); BA-CA (2007a), p.11.
[1639] See OECD (2006a), p.131.
[1640] See World Bank (2003); European Commission (2005a), p.46; Bertelsmann Stiftung (2006b).

the EU member states Romania and Bulgaria and more liberalized than in any other SEEC. This positive evaluation is also reflected in the score of 4.3 out of 5 points in the EBRD foreign exchange and trade liberalization index which Croatia has been holding since 2000.[1641]

(c) Despite this positive evolution, primary and secondary sources identify **some remaining problems** regarding Croatia's trade policy. Most importantly (and well in line with the findings for Romania), some interviewees complain about the administrative trading barriers. Experts know about laborious procedures to cross Croatia's border.[1642] FDI studies and international statistics confirm that trading is still cumbersome and exporting, for example, takes on average 22 days including all formalities required. It is therefore significantly longer than, for example, in the same process in Serbia which takes 12 days. Especially the preparation of documents and customs clearing take longer than in Serbia.[1643] *IMD (2006)* confirms the mediocre performance of Croatian custom authorities ranking Croatia 53rd out of 61 countries.[1644] Several interviewees agree that they generally do not have to pay any duties but that registration and documentation may be slow and fairly expensive.[1645] A few MNCs interviewed also point out that some of the remaining custom duties are very high and – for example adding up to 30% including 10% punitive tariff for importing butter – may lead to prices that are hardly competitive in the host market.[1646]

In contrast, statistics also show that administrative trade conditions in particular are improving. Times required for exporting and importing were reduced by 37% and 57% respectively since 2005.[1647] Interviewees in economic zones

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1641 In line with the Eastern European EU members; see EBRD (2007b).
1642 See Intv. Austr. MNC - Financial Services I (2007).
1643 8 vs. 2 days an 4 vs. 2 days; see World Bank (2007a); see also McGee (2003).
1644 With Romania being the only out of 9 EECs scoring lower.
1645 See e. g. Intv. Germ. MNC - Industrial Goods I (2007).
1646 See e. g. Intv. Germ. MNC - Food Products (2007); Doc - Germ. MNC - Food Products (2007).
1647 See OECD (2006a), p.140 ; own calculations.

also point out that they deal with Croatian customs authority every two days without any problems (in contrast, for example to the Czech Republic) or the need for bribery.[1648]

Finally, interviewees and external sources criticize that the Croatian government still lacks clear visions with regards to trade policy. State experts in particular see that the Croatian government does not always fully use its possibilities in trade policy, for example, regarding a pro-active promotion of export-oriented production (as seen by the limited export focus of APIU[1649]) or that the outlined policy goals remain vague and do not receive sufficient capacities for a successful implementation, for example regarding the recent export offensive.[1650]

(d) The evidence from the interviews regarding the importance of trade policy suggests a **slight positive effect on FDI in Croatia**. For greenfield investors trade conditions seem to have a limited or moderately positive impact on their investment decision overall, particularly when they are familiar with conditions in other EECs. The low tariffs for most goods and the expected accession to the EU therefore seem to compensate for remaining technical and bureaucratic procedures for MNCs interested in vertical FDI in Croatia.[1651] Furthermore, potential investors who are interested in FDI in sectors that are still partly protected (such as agriculture) consider the full abolishment of trade barriers after an accession to the EU as an important step for improving investment conditions. On the contrary, the number of MNCs that are operating in protected sectors and that wish to maintain their exclusive position due to higher market entry barriers is limited.[1652]

[1648] See e. g. Intv. Germ. MNC - Industrial Goods I (2007).
[1649] See also section 7.3.5.3 on investment promotion.
[1650] See Intv. German Authority III (2007); Intv. Former Croatian Minister (2007); Intv. Supranational Authority II (2007); see also OECD (2006a), p.143.
[1651] See Intv. Germ. MNC - Industrial Goods I (2007); Intv. Austr. MNC - Financial Services I (2007); Intv. Austr. MNC - Retail (2007).
[1652] See Intv. Germ. MNC - Food Products (2007); see also Intv. Austr. MNC - Retail (2007).

In contrast, service-oriented MNCs, for example those focused on tourism, indicate that trade conditions were not important for their investment decision, neither constraining nor enhancing.[1653]

Overall, FDI studies with specific results for Croatia are scarce, but existing company surveys seem to confirm the findings of the interviews that customs regulations and duties seem to be only a minor obstacle (only 9th most deterring of 11 determinants) and less deterring than, for example, bureaucracy, the justice system or land register.[1654] The findings of FDI studies that suggest that FDI inflows to Croatia remained limited because of remaining trade barriers are therefore questionable; FDI inflows remained on a similar level until 2005 (*figure 83.*), although trade had been intensively liberalized since 2000 (as shown above).[1655] Interviews suggest that FDI was not replaced by trade in Croatia; instead, other FDI determinants (discussed throughout the thesis) may simply have been more decisive than trade policy in influencing FDI flows and keeping them on the same level for many years.

(e) In the **assessment**, this section has shown that Croatia's trade liberalization was carried out quite late (after 2000) but that the measures taken were thorough and generally well implemented. This is interesting, as the liberalization was mainly initiated by a left-wing government. Overall, interviewees confirm the positive evaluation of most external sources that Croatia's favorable aspects of trade conditions clearly outweigh the disadvantages and that the expected reform in the course of the preparation of EU accession will contribute to a further easing of remaining tariff and non-tariff barriers.

Interviews also show that the effects of trade policy depend strongly on the sector, the business model of the MNC, but also on the location of the investment, since trade issues seem to be handled more swiftly in free economic zones.

[1653] See e. g. Intv. Germ. MNC - Engineering (2007).
[1654] See Doc - Austrian Econ. Chamber Croatia (2006); more skeptical: Doc - GTZ (2006a).
[1655] Trade volumes significantly increased after 1999 with a trade openness growing from 53% to 74% (1999-2004); see section 6.3.1; see figure 91; see McGee (2003).

Overall, it appears that trade conditions have become a slightly enhancing factor for most MNCs in Croatia and that conditions are a little more favorable here than in the majority of SEECs.

The analyses show that trade policy developed well despite the fact that Croatia is not in the EU yet, even though a further surge of investments may occur after accession because of the further abolishment of existing barriers. As in Romania it seems that some state experts as well as several FDI studies may somewhat overemphasize the legal barriers and underestimate remaining administrative barriers.

Public policy should carefully evaluate the benefits of remaining entry barriers. In the agricultural sector in particular, the complete abolishment of trade barriers, also for MNCs from non-EU countries, may contribute to a significant rise in FDI inflows in related sourcing industries (*see section 6.3.1*); this may also justify a corresponding weakening of the domestic firms.

(4) In **conclusion**, this section has shown that Croatia's significant improvements in all sub-determinants analyzed – financial system, monetary policy as well as trade policy – have contributed to a very stable economy overall. Interestingly, these respective reform efforts were less triggered by EU pressure (as shown for various legal determinants) but rather by a genuine thrive for reform by public policy actors.

On the other hand, interviewees have helped to understand some of the remaining issues, mainly regarding the implementation of the legal environment and in the daily interactions with MNCs and state authorities. Furthermore, this section has emphasized that determinants of economic stability are important for Croatia's investment environment and may have a slight enhancing effect on FDI (besides high sector-specific inflows). However, the short-term impact may be less significant than often assumed by state representatives and may even deteriorate with increasing integration towards the EU.

7.3.1.4 General insights for transition countries

Based on the analyses of this section but also under consideration of further secondary FDI literature, several prerequisites for a satisfactory economic stability as well as findings regarding their importance for FDI can be derived with respect to (1) the financial system, (2) monetary policy and (3) trade policy. The options of public policy makers in transition countries for influencing economic stability are analyzed in section (4).

(1) With respect to the **financial system**, interviews have revealed that MNCs seem to be in favor of a large part of the banking assets (greater than 50%[1656]) being in foreign hands, as this seems to indicate credibility and liquidity of the banking sector. The nationality of these banks is generally not decisive; however, some smaller MNCs may find access to finance easier when these foreign banks come from their home countries. In this case Austrian (and Italian) companies seem to have a particular advantage since banks from their home countries are among the leading banks in most SEECs.[1657]

The examples of Romania and Croatia suggest that an early privatization of the banking sector helps to stabilize the banking sector, increases the solvency of the financial intermediaries, accelerates the establishment of a wide product range, and attracts more domestic and foreign investors that are credible and interested in long-term investments.

The findings of various FDI studies that identify a positive impact of banking sector reforms on FDI flows[1658] can generally be confirmed by the analyses of this section. However, the importance may be limited and seems to decrease

[1656] Which is not given, e. g. in Belarus, Moldova, Slovenia and Ukraine; see EBRD (2007b).
[1657] Together with those from Italy; see Altzinger (1999); Intv. Austr. MNC - Financial Services I (2007).
[1658] See Brada, Kutan, and Yigit (2003); Dunning (2005); Dunning (2006).

with growing reform efforts.[1659] Moreover, the worries of a banking crisis as identified in earlier studies may currently not be a major obstacle for FDI in transition countries.[1660] Furthermore, analyses of this section show that good financing conditions are important for foreign SMEs – which are often a weak point in the legislation of transition countries (as in Romania). They may be less relevant for larger MNCs (as suggested by some studies[1661]) since these are able to get financing abroad.

The combination of these indicators presented – the share of foreign bank assets, timing of privatization and financing conditions – may be helpful to econometrically determine the impact of the banking system on FDI in future research. They may represent somewhat more realistic indicators than those often used by FDI studies including the country risk of international rating agencies, the lending-deposit spread, banking assets in % of GDP or even the money supply (which would rather indicate the impact of monetary policy).[1662]

With respect to the non-banking sector interviews are in line with various FDI studies that this sector has less impact on FDI than the banking sector.[1663] However, advanced non-banking markets, such as capital markets, seem to gain in importance for MNCs when higher levels of FDI are reached and the purchasing power of the citizens in the transition country has attained a considerable level. The speed of development and the current level of maturity of the non-banking sector however, seem to strongly differ among transition countries, with Croatia as a particularly positive example.[1664]

1659 See Kalotay (2000).
1660 See Bevan and Estrin (2004).
1661 See e. g. Falcetti, Sanfey, and Taci (2003).
1662 See Janicki and Wunnava (2004); Brada, Kutan, and Yigit (2003); Galego, Vieira, and Vieira (2004).
1663 See Genco, Taurelli, and Viezzoli (1993); Bevan and Estrin (2004); Dunning (2005); Dunning (2006).
1664 See also Intv. German Econ. Association VI (2007).

Nevertheless, both interviews as well as secondary sources show that the financial sector itself has been important for the attraction of FDI in transition countries in the banking sector (particularly in the 1990s) and in the non-banking sector (more recently).[1665]

(2) With respect to **monetary policy**, investors seem to be indifferent to the inflation level as long as it stays below an annual growth rate of 10% (as in Romania since 2005 and in Croatia since 1995). Most external studies confirm that the inflation rate generally has only limited impact on the investment decision of MNCs in transition countries.[1666]

The findings of FDI literature regarding the impact of the exchange rate on FDI are mixed. The theoretical foundation seems to be stronger than the empirical work, even though this aspect has been intensively analyzed for many years.[1667] Various studies find that FDI is driven by the level of exchange rates. For example, a real depreciation supposedly attracts FDI in EECs.[1668] This result is not supported by the findings of this thesis which suggest that the actual level of the exchange rate seems to play a minor role for MNCs in transition countries. Likewise, MNCs appear indifferent towards the exchange rate regime.[1669]

In contrast, interviews show that the exchange rate may indeed become a deterring factor when it is highly volatile and breaks out of a corridor of ±10% of its real effective exchange rate (as it happened in Romania in the late 1990s). This finding is also backed by an important strand of FDI literature.[1670] How-

[1665] See Galego, Vieira, and Vieira (2004); Doc - BA-CA (2007).
[1666] See e. g. World Economic Forum (2007).
[1667] See Aliber (1970); Reker (2003); Blonigen (2005).
[1668] See Bénassy-Quéré and Lahrèche-Révil (2005); see also Froot and Stein (1991); Blonigen (1997); Bevan and Estrin (2004); Antras and Desai (2007).
[1669] Different findings: Toubal (2004), pp.103.
[1670] See Toubal (2004), pp.88-89; Siebert (2005); Baniak, Cukrowski, and Herczynski (2005); more critical: Brada, Kutan, and Yigit (2003); Disdier and Mayer (2003).

ever, this thesis suggests that a greater volatility of the exchange rate will increase uncertainty and thus deter FDI (as shown for Romania), while several FDI studies seem to predict the contrary effect.[1671]

Furthermore, analyses indicate that the work of the central bank has only an indirect effect on the investment decision of MNCs in transition countries. Economic stability increases when the central bank of the host country has a strong position from early on in the transition process that focuses on the stability of prices and the exchange rate. In this context the actual control of the central bank of the monetary policy is more important than the legal protection of its independence or the alignment with international standards. A high amount of foreign reserves apparently increases the confidence of MNCs and creates greater leeway of the central bank in transition countries (as shown for Croatia). The abolishment of foreign currency restrictions seem to be helpful but not essential for a favorable monetary environment.

(3) Regarding **trade policy**, interviews show that MNCs generally assess a potential host country more positively when it is a member of the WTO. The closure of the SAA also seems to have a slight positive effect on FDI. However this section has also shown – in line with several FDI studies – that trade regulations tend to lose their importance once transition countries accede to the EU.[1672]

Governments need to calculate the overall benefits of trade liberalization, but even though host countries may be affected by the loss of some trade advantages versus non-EU countries (as in Romania) or of advantages for companies operating in protected areas (as in Croatia), the overall effects for transition countries seem to outweigh the disadvantages.

[1671] See for examples Blonigen (2005).
[1672] See similar Holland and Pain (1998); Nunnenkamp and Spatz (2002); Resmini (2006).

Interviews do not reveal any insights regarding a specific order in which the elimination of custom duties should proceed, but interviewees clearly indicate that the introduction of exceptional tariff changes (as in Romania) and punitive tariffs (as in Croatia) have a negative effect on the predictability of the trade policy and are evaluated as a disadvantage for FDI in potential host countries. The most important insight in this context for transition countries from the interviews is, however, that the level of the tariffs and the costs for trading per se are not decisive for MNCs – as long as the total costs allow to set prices that are still competitive in the sales market (as problematized for Croatia). The avoidance of cumbersome administrative efforts tends to be more important for an investment environment than the minimization of actual costs. MNCs expect that waiting times are limited. Interviews and international statistics suggest that 14 days represent a satisfactory performance for all export-related requirements and 17 days for importing.[1673] In this context, statistics show that EU accession does not necessarily lead to a better performance since Greece and Slovakia only score 90th and 100th regarding average trading times.

Therefore, the analyses of trade policy in this section confirm the multitude of FDI studies that find that trade policy is an important driver for FDI in transition countries in general and not a substitute for trade.[1674] The findings question those studies concluding that the trade regime is one of the most important factors of FDI[1675] and reveal that it is less the legal than the administrative environment that drives the importance of this determinant.[1676]

It may be little surprising that an increasing number of studies focusing on trade versus FDI effects reach apparently contradictory conclusions. Besides

[1673] Representing a performance among the best 20% of 179 countries; see World Bank (2007a).

[1674] See Lankes and Venables (1996); Estrin, Hughes, and Todd (1997); Blomström and Kokko (2003); Bevan, Estrin, and Meyer (2004); Kobrin (2005).

[1675] See Demekas, Horváth, Ribakova, and Wu (2005).

[1676] Also skeptical regarding the effects of trade policy on FDI: Globerman and Shapiro (1999).

different definitions of trade policy[1677] the different forms of FDI seem to play an important role in this context. However, the often identified pattern according to which low trade barriers lead to higher vertical and decreasing horizontal FDI inflows[1678], cannot be confirmed by the interviews. The analyses of this section rather suggest that low trade barriers lead to higher vertical FDI, but have little impact on horizontal FDI in transition countries and may decrease investments of those MNCs that are already active in protected areas of the host country.[1679]

(4) **Public policy makers have significant influence** in establishing the fundamentals of economic stability and can decisively determine the speed and thoroughness of all sub-dimensions discussed above. The examples of Romania and Croatia have shown that deliberate reforms can be made by any political party without endangering credibility. However, governments seem to lose – as suggested by both interviews and more general FDI studies – some of their possibilities in steering economic policy once a certain threshold of economic stability is reached, most state-owned banks are sold and competences in monetary and trade policy are transfered to supranational organizations such as the WTO and the EU.[1680]

It is not surprising that external sources as well as theory emphasize that this loss of leeway is a positive sign and that conditions are best for both domestic and foreign firms if they are left to the market.[1681] However, this section has shown that public policy makers need to understand that their work in the

[1677] See Resmini (2000).
[1678] See for details Protsenko (2003), pp.17-19; see also Balasubramanyam, Salisu, and Sapsford (1996); Brainard (1997); Holland, Sass, Benacek, and Gronicki (2000); Demekas, Horváth, Ribakova, and Wu (2005).
[1679] See similar Buch, Kleinert, Lipponer, and Toubal (2005).
[1680] See also Blomström and Kokko (2003); Demekas, Horváth, Ribakova, and Wu (2005); Resmini (2006).
[1681] See e. g. Bénassy-Quéré and Lahrèche-Révil (2005).

early transition phase is decisive and that they should deploy their competences cautiously in order to establish a sustainable and well-founded framework for economic stability before their influence vanishes. Furthermore, public policy can and should work on the remaining levers in more advanced phases of the transition process, mainly regarding the improvement and shortening of administrative procedures, particularly since these are one of the few occasions in which MNCs are in direct contact with state authorities.

Nunnenkamp and Spatz (2002) confirm the findings of this thesis that public policy action relating to economic stability is strongly interdependent with other determinants, most notably privatization, bureaucracy, market entry, and trade openness. The right timing of liberalization, privatization and the integration into supranational organization is crucial in this context in order to reach a maximum effect. Future FDI research could, for example, explore to what extent the quick approaching of WTO and EU may generate a positive short-term effect (as in Croatia) but may lose its impact more quickly than in cases when these two events are further apart from each other.

The central bank of transition countries is probably the institution facing the greatest challenges in the early transition process. First of all, its work generally starts out with staff that has little experience, low reserves and under high government pressures. Secondly, central bankers, particularly in transition countries, usually have to cope with the dilemma that they would need to combat inflation by increasing interest rates, which again fuels foreign capital inflows resulting in an appreciation of the domestic currency and thus in a lower competitiveness of domestic companies which is particularly harmful in the beginning of transition.[1682] Governments can be supportive in this early phase by providing sufficient staff, financial resources and training, but also by providing a legal framework that targets price stability as primary goal, guar-

[1682] See similar Sorsa, Bakker, and Duenewald (2007); Müller (2005), p.164.

antees far-reaching independence of the central bank and enables the extensive supervision of all financial intermediaries by the central bank in order to early react to erroneous trends (such as bad loans etc.).

7.3.2 Infrastructure

7.3.2.1 Definition

From an investor's point of view, the provision of a good infrastructure is essential for transition economies in order to enable efficient and effective business activities in the host country. Furthermore, the infrastructure sector itself is often attractive for investments, because of its great need for capital and know-how, particularly in transition countries.[1683] This section analyzes two infrastructure areas on which investors in transition countries focus most heavily, (1) roads and (2) real estate. Section (3) provides conclusions for Romania and Croatia respectively.[1684]

7.3.2.2 Romania

(1) The quality of **roads** in Romania (a) was very poor in the past, (b) only limited improvements took place in recent years and (c) today's standards are still very low. Overall, (d) the impact of road infrastructure on FDI seems to increase, also because of rising opportunities for FDI in this sector. Section (e) provides an assessment.

(a) Various interviewees[1685] and external sources[1686] confirm that the quality of Romania's roads was **very poor in the 1990s**, particularly in rural areas. A major problem was the lack of financing for the upgrade and extension of the

[1683] See Müller (2005), pp.131-133 and 205-206.
[1684] See for a similar selection Nicoletti, Golub, Hajkova, Mirza, and Yoo (2003), p.40.
[1685] See Intv. Romanian Econ. Association II (2007); Intv. Austr. MNC - Industrial Goods I (2007); Intv. Int'l MNC - Utilities (2007).
[1686] See e. g. Carter, Sader, and Holtedahl (1996); EBRD (2007b).

road system in the early 1990s. As part of Ceauşescu's isolation policy (*section 6.2.1*), Romania had paid back all its foreign debt at the end of the 1980s, which led to a lack of financial resources in the early 1990s to invest in state projects like Romania's infrastructure.[1687] The National Road Administration in particular suffered from this shortage. Its budget in 1992, for example, did not allow for more than 500km of maintenance (out of 70,000km of roads).[1688]

(b) **Some improvements** were initiated in the early 2000s. The upgrade and especially the extension of the road network were high on the list of government priorities in Romania since 2001.[1689] Due to government spending, support from international organizations (such as EBRD and World Bank) as well as higher sector-specific FDI, 2,300km of national roads were renewed and 100km of highways were completed between 2000 and 2005.[1690] Interviewees agree that some of these improvements are visible today[1691], particularly in Bucharest and in other areas with high movement of goods such as Timişoara.[1692] In fact, investors who are located in the western part of Romania and mainly focus on exporting to Western Europe seem to have only limited problems with the current state of Romania's infrastructure and acknowledge that basic needs of investors are met.[1693] These increasing efforts are also reflected in the transition reform index of the EBRD for road infrastructure according to which Romania only made minimum progress until the mid-1990s (1 out of 5 points), but has captured with increasing efforts a decent level of 3 points since 2000.[1694]

[1687] See also Zühlke (2006).
[1688] See Carter, Sader, and Holtedahl (1996).
[1689] See Maniu, Kallai, and Popa (2001), p.64; see also Intv. Romanian Authority I (2007).
[1690] See Rabobank (2006); Larive Romania (2007); Bfai (2005), pp.72-73 and 175; see also Intv. Germ. MNC - Financial Services III (2007).
[1691] See Intv. Germ. MNC - Logistics (2007); Intv. Germ. MNC - Consulting I (2007).
[1692] See Intv. Germ. MNC - Logistics (2007); Intv. Rom. Local Authority I (2007).
[1693] See e. g. Intv. Germ. MNC - Automotive (2007); Intv. Austr. MNC - Industrial Goods I (2007).
[1694] Bulgaria with 2.7 and Ukraine with 2 points in 2007; see EBRD (2007b).

State representatives interviewed emphasize that infrastructure will remain a centerpiece of Romania's investment strategy both on the central and local level, including the completion of highways from Bucharest to Constanţa and from Braşov to the Western border within the next five to six years.[1695] According to interviewees the relative share of road infrastructure to FDI will also rise, primarily driven by the increasing inflows of EU financing that is expected to amount to €5.7B until 2013.[1696] Overall, state experts seem more optimistic than company experts that the expected EU funding will significantly improve Romania's road infrastructure.

(c) However, **remaining problems** regarding Romania's roads seem to be overwhelming and progress only slow and quite limited overall. Interviewees[1697] as well as external sources[1698] stress that "the quality of many Romanian roads is still very poor"[1699] and experts believe that European standards will not be reached for another 10 to 20 years.[1700] This evaluation is also reflected in a German survey, according to which investors in Romania placed infrastructure third on a list of factors deemed by them to be unsatisfactory.[1701] Moreover, in an international survey presented in *FIAS (2007)*, 29% of respondents called

[1695] See Intv. Romanian Authority I (2007); Intv. Romanian County Council (2007); see also Intv. Germ. MNC - Retail (2007); Intv. Germ. MNC - Logistics (2007).

[1696] For transport infrastructure; Bfai (2007b); Doc - Rom. Ministry V (2007); see Intv. Romanian Authority I (2007); Intv. German Authority IV (2007); Doc - German Econ. Chamber Romania (2007).

[1697] See e. g. Intv. Romanian Econ. Association II (2007); Intv. Germ. MNC - Retail (2007); Intv. Germ. MNC - Logistics (2007); Intv. Germ. MNC - Consulting I (2007); Doc - Austrian Econ. Chamber Romania (2007b).

[1698] See e. g. European Commission (2004a), p.11; Müller (2005); Socol and Socol (2007).

[1699] Intv. Austr. MNC - Industrial Goods I (2007); driving on Romanian highways can be dangerous due to the different types of vehicles including tractors and horses; see Intv. Germ. MNC - Industrial Goods III (2007).

[1700] See Intv. Germ. MNC - Logistics (2007); Intv. Int'l MNC - Utilities (2007); Intv. Austr. Research Institute (2007); see also Rabobank (2006).

[1701] See AHK (2006).

transportation networks the most important future work for Romanian governments.[1702]

The most significant deficiency from the perspective of investors seems to be the low extension of the highway network, with only about 200km completed from Bucharest to Constanţa and from Bucharest to Pitesti.[1703] Experts point out that a car journey takes longer from Bucharest to the border (12 hours for about 420km) than from the border to Germany (10 hours for about 760km).[1704] Highway networks in the smaller neighboring countries Bulgaria and Hungary are more extensive[1705] and also better in quality according to experts interviewed.[1706] *Intv. Austrian Econ. Association I (2007)* assumes that 1,800km of highway would be required for a sufficient infrastructure network in Romania.

Furthermore, the state of the non-highway roads seems to remain very poor which slows down transportation to a speed of about 30-40km per hour compared to 50 to 70 in Germany.[1707] In fact and despite recent efforts, only 26% of all roads were renewed in Romania since 1990 by 2005.[1708] According to the Global Competitiveness Report of the World Economic Forum (*figure 94 in the appendix*), the quality of Romania's roads was ranked 123rd out of 131 countries (2007).[1709]

[1702] Therefore, the classification of Romania's infrastructure as "highly developed" seems too euphemistic; see Doc - Rom. Emb. Berlin (2007b).

[1703] See Intv. Germ. MNC - Industrial Goods III (2007); Intv. Germ. MNC - Industrial Goods II (2007); Intv. Germ. MNC - Consulting I (2007); Intv. Germ. MNC - Consulting II (2007); Intv. Austr. MNC - Legal Services (2007); Intv. Austr. Research Institute (2007); Intv. German Authority I (2007).

[1704] Travel distances from Bucharest to Arad and from Arad to Munich; see Intv. Germ. MNC - Consulting I (2007); Intv. German Authority I (2007); see also www.mapcrow.info.

[1705] Bulgaria with 290km and Hungary with 350km; see Socol and Socol (2007).

[1706] See Intv. Germ. MNC - Logistics (2007); Intv. Int'l MNC - Utilities (2007); Intv. Austr. Research Institute (2007).

[1707] See Intv. Germ. MNC - Retail (2007); Intv. Germ. MNC - Automotive (2007).

[1708] See Bfai (2005), pp.72-73 and 175.

[1709] See World Economic Forum (2007).

For the regional level interviewees point out that by-passes are often missing and actually should be built before highways.[1710] Furthermore, both state and company experts agree that road infrastructure in the mountain area as well as in the Eastern part of Romania seem to be poor in particular. Some experts, however, also point out that regional politicians have only little power to accelerate constructions since highways and by-pass roads are generally in the hands of the central government.[1711]

Interviews and external sources help to identify some major factors for these shortcomings described. First of all, clear plans and time schedules often seem to be missing in Romania's infrastructure policy, and strategies often do not reflect the increasing number of vehicles.[1712] Others point out that plans and EU funds may be available, but Romania has not provided its contribution to the financing so far.[1713] Even state representatives admit that no great projects in the infrastructure sector have been initiated until the inflow of EU subsidies.[1714]

Furthermore, infrastructure policy seems to be influenced by political quarrels in Romania. For example, works at several highways were stopped after the change of government in 2004 following complaints about inflating costs; nevertheless constructions at a different highway were started at the same time.[1715] Delays also seem to be caused by long-lasting tenders and maybe even by corruption.[1716] Interviews with foreign experts suggest that domestic companies are sometimes given preference in tenders. Furthermore, domestic construction

[1710] See Intv. Germ. MNC - Industrial Goods III (2007); Intv. Int'l MNC - Utilities (2007).
[1711] See Intv. Germ. MNC - Logistics (2007); Intv. German Econ. Association V (2007); Intv. Romanian Authority I (2007); Intv. Romanian County Council (2007).
[1712] See Intv. German Econ. Association VI (2007); Intv. German Econ. Association VII (2007).
[1713] See Intv. German Authority I (2007); Intv. German Econ. Association VII (2007).
[1714] See Intv. Romanian Authority I (2007).
[1715] See Intv. Germ. MNC - Legal Services I (2007); see also Bfai (2005), p.70-71.
[1716] See Intv. Germ. MNC - Consulting II (2007); Intv. Austr. MNC - Primary Goods II (2007).

companies do not always provide high quality work or keep the quality of work intentionally low in order to receive subsequent service contracts.[1717]

(d) On the basis of primary and secondary sources three time periods in the **importance** of the quality of roads can be evaluated for Romania as investment location. In the early 1990s the poor quality of roads was – according to *Carter, Sader, and Holtedahl (1996)* – a major impediment to operations of investors in Romania. In fact, investors' concerns regarding road infrastructure were greater only in Croatia (out of ten countries) at that time. With increasing improvements (*see above*) the importance of transport infrastructure apparently decreased for FDI in Romania; according to *Falcetti, Sanfey, and Taci (2003)* infrastructure was the least important of seven factors analyzed as investment barriers in Romania in 2002 with only less than 10%.[1718] Since the last couple of years – the third phase – road infrastructure has regained its importance as major deterrent factor for investing in Romania. This is also confirmed by external surveys.[1719] Basically all companies as well as state interviewees confirm that the lack of sufficient and high quality roads is one of the most important reasons why FDI in Romania are lower than they could be. It seems to be a major obstacle for investors interested in Romania but also for MNCs that are already present in Romania and that consider an extension of their business.[1720] Company experts state that infrastructure deficiencies have a negative impact on FDI in almost all areas, efficiency- and market-seeking, industry and services as well as greenfield and acquisitions.[1721]

[1717] See Intv. Germ. MNC - Consulting II (2007); Intv. German Authority IV (2007); Intv. Germ. MNC - Financial Services III (2007).

[1718] Less important than taxation, financing, corruption, regulation, judiciary and crime.

[1719] See World Economic Forum (2006a); World Economic Forum (2007).

[1720] See Intv. German Econ. Association II (2007); Intv. Austrian Econ. Association I (2007); Intv. German Authority I (2007); Intv. Romanian Authority I (2007); Intv. Austr. Research Institute (2007); Intv. Austr. MNC - Legal Services (2007); Intv. Germ. MNC - Legal Services I (2007).

[1721] See Intv. German Econ. Association V (2007); Intv. Austr. MNC - Industrial Goods I (2007); Intv. Germ. MNC - Retail (2007); see also Doc - Austr. MNC - Industrial Goods I (2005).

Furthermore, experts point out that effects of Romania's poor road infrastructure are particularly visible on a regional level. First of all, many productions sites are often selected close to the Hungarian border and highway system, particularly by automotive suppliers, since just-in-time deliveries are hardly possible from other parts of the countries. Therefore, FDI in other regions such as Eastern Romania suffer the most from the weak infrastructure.[1722] Finally, a weak infrastructure also aggravates investors' current difficulties in finding sufficient labor, since available workers often live in rural areas who have problems reaching potential jobs in cities due to the weak infrastructure.[1723]

Interviewees and external sources identify the road construction sector as one of the most attractive sectors of FDI for the future, because of the great demand, the EU support and expected increase in transparency of contract awards.[1724]

(e) In the **assessment**, this section reveals that road infrastructure was a weakness for Romania because of financing problems but also because governments waited too long for external support (in the 1990s). Good conditions in Western Romania were less a success of Romanian infrastructure policy but a result of the proximity to the (better) Hungarian road network. Investors perceived the poor road infrastructure as a weakness in the past but other problems such as property rights and political issues seem to have been more important for their investment decision. While many of the legal and political aspects have been losing their importance in recent years, infrastructure seems to capture an increasing amount of attention from both state representatives and investors. The remaining deficiencies seem to keep MNCs away from expanding their investments, particularly regarding increasing market exploita-

[1722] See Intv. German Econ. Association I (2007); Intv. German Econ. Association III (2007).
[1723] See Intv. Int'l MNC - Utilities (2007); Intv. Romanian County Council (2007).
[1724] See 6.2.1; Intv. Austrian Econ. Association I (2007); Intv. Romanian County Council (2007); Intv. Romanian Authority I (2007); Intv. German Authority IV (2007); UniCredit Group (2007).

tion activities following the growth of purchasing power.[1725] Therefore, only if Romania solves its infrastructure problems can it benefit from its good access to other markets and its fairly large market size.

State representatives do not lack awareness of these issues, even though they may be somewhat too optimistic regarding positive effects of the incoming EU funding.

Road infrastructure has many interdependences with other FDI determinants, including political stability and corruption but also with non-policy determinants such as market size and proximity. Public policy should transfer more road construction responsibilities to regional and local authorities, improve the access of foreign companies to the construction sector and increase Romania's capabilities to successfully absorb the respective EU funds. Furthermore, construction works should be based on economic priorities, for example, by focusing on by-pass roads rather than on roads across cities.

(2) Regarding the **real estate** situation in Romania, this section identifies (a) major concerns regarding rising prices, even though some evidence exists that (b) the situation is not as bad popularly perceived. Nevertheless, the real estate situation is of (c) increasing importance for MNCs, also as field of FDI. An assessment is presented in sub-section (d).

(a) Primary sources and experts interviewed confirm that **prices** in Romania's real estate market **have drastically increased** in recent years.[1726] This seems to be true for land as well as for apartments, offices, and plants. Similar developments seem to be valid for rented as well as purchased real estate.

[1725] E. g. The need for a good road network for the delivery of products to supermarket chains.

[1726] See Intv. Austr. MNC - Financial Services II (2007); Intv. German Econ. Association VII (2007); Intv. Germ. MNC - Retail (2007); Intv. Rom. Local Authority I (2007); Intv. Germ. Political Foundation II (2007); see also Bfai (2007a); The Housing Unit (2004).

According to the experts, real estate is sometimes more expensive in Bucharest than in Munich or Vienna and prices in other Romanian cities like Cluj and Sibiu are also significantly higher than in Bulgaria and also comparable to Western European levels.[1727] External sources confirm that price increase in Romania is one of the fastest in Europe.[1728] While one square meter (sqm) of (purchased) office space used to cost about €200 in Bucharest in the late 1990s, prices now go up to €3,500.[1729] Land is expensive particularly for retail companies that generally acquire buildings that are only one-story high. *Intv. Germ. MNC - Retail (2007)* calculates about €5M just for the piece of land for a store of about 4-5,000 sqm in urban areas. For renting office space experts calculate between €20 and 25 per sqm in larger business buildings.[1730]

Some key reasons for this evolution can be identified. First of all, there seems to be a significant shortage of supply of modern offices, plants and private buildings due to outdated structures from communist times and the recent economic boom that has increased the demand of firms and the competition among new market entrants.[1731] Apparently, local governments have done too little to expand the supply of land and offices in cities; furthermore, local authorities' willingness to sell real estate are limited.[1732] Various experts also assume that the price increase is partly driven by speculations that have been fueled by Romania's accession to the EU.[1733]

[1727] See Intv. Supranational Authority I (2007); Intv. German Authority I (2007); Intv. German Political Adviser (2007); Intv. Germ. MNC - Legal Services II (2007); Intv. Rom. Local Authority I (2007).
[1728] See Süddeutsche Zeitung (2007); Bfai (2007a).
[1729] See Intv. Germ. MNC - Legal Services II (2007); Intv. German Econ. Association II (2007).
[1730] See Intv. German Econ. Association II (2007); see also Süddeutsche Zeitung (2007).
[1731] See 6.2.1; see also Intv. German Econ. Association VII (2007); Intv. Germ. MNC - Retail (2007); Intv. Romanian Company - Advertising (2007).
[1732] See Intv. German Econ. Association V (2007).
[1733] See Intv. Rom. Company - Consulting (2007); Intv. Germ. MNC - Industrial Goods II (2007); Intv. Germ. MNC - Legal Services II (2007); Intv. Germ. MNC - Financial Services III (2007).

As a result, experts are skeptical that real estate prices actually reflect the purchasing power of Romanians.[1734] However, several interviewees and external sources expect that prices will continue to rise (especially for the upper price segment) as long as demand continues to heavily exceed supply and the banks are willing and able to give out credits[1735], even though the largest price growth may be over by now.[1736]

(b) Nevertheless, interviews also give some hints that the price situation in Romania's real estate market **may be not as bad** as sometimes suggested. In most parts of the country, aside from the boom regions, for example in Târgu Mureş (Transylvania), land is still cheaper than in Western Europe.[1737] Furthermore, MNCs often have the possibility to go to industrial parks where prices are significantly lower than in urban areas *(section 7.3.3)*.[1738] Furthermore, agricultural land is still fairly cheap, even though prices increased by a factor of five since the early 2000s as well.[1739] Finally, prices may be high in some Romanian regions due to the shortage of office space, but the supply of space still seems to be higher than, for example, in Ukraine.[1740]

Interviews and some external sources also indicate that real estate prices will slow down or even deteriorate in the medium-term, particularly for apartments.[1741] This is suggested by a respective development in other EECs after EU accession and the currently significant construction activities.[1742]

[1734] See Intv. German Econ. Association V (2007).
[1735] This is not expected to happen until another three to five years; see Intv. German Econ. Association VII (2007); Intv. German Authority I (2007); Intv. Germ. MNC - Legal Services II (2007); Raiffeisenbank (2008); BA-CA (2007b); Ernst & Young (2008).
[1736] See Intv. Austr. MNC - Financial Services II (2007); see also Bfai (2007b).
[1737] See Intv. Germ. MNC - Automotive (2007); Intv. Germ. MNC - Industrial Goods II (2007); Intv. Germ. MNC - Retail (2007); Intv. Austr. MNC - Primary Goods II (2007).
[1738] E.g . the rent of land in the park of Timişoara only costs €0.10 per sqm per year; seee Intv. German Econ. Association III (2007).
[1739] See Intv. German Political Adviser (2007).
[1740] See Intv. Austr. MNC - Consumer Goods (2007).
[1741] See Intv. Germ. MNC - Retail (2007); Intv. Germ. MNC - Legal Services II (2007); Intv. German Authority I (2007); Intv. Supranational Authority I (2007); see also Bfai (2007a); Bfai (2007b).
[1742] See Intv. Supranational Authority I (2007); Intv. Rom. Local Authority I (2007).

(c) In the last couple of years, real estate prices **have apparently been gaining importance for FDI** in Romania. Several interviews indicate that they are becoming a substantial obstacle for higher FDI.[1743] Some investors may have decided, for example, against investing in Sibiu because prices were possibly too high for apartments, production sites etc.[1744] Foreign SMEs have difficulties in finding affordable office space in cities like Bucharest since offers usually start at 1,500 sqm. Large investors often have problems finding affordable pieces of land for greenfield investments.[1745] Some investors may also ask why they should pay €3 per sqm of rent for a production hall in bad shape in Romania, while the rent for a new one, for instance in Leipzig, would only be €1.50.[1746]

Rising costs for real estate seem to be one of many disadvantageous cost developments including rising labor and energy costs.[1747] Some MNCs interested in Romania may actually hesitate to invest because of these, while interviews show that those investors who are already present are likely to invest and expand anyway, since a stagnation would contradict their market-oriented business model.[1748] Efficiency-oriented MNCs know the market conditions well and invest in rural areas in which they will be less affected by the price development.[1749] The lack of space or land may be especially crucial for investors who want to start production quickly and would be willing to pay a higher purchasing price in order to benefit from the lower production costs quickly.[1750]

[1743] See Intv. German Econ. Association V (2007); Intv. Germ. MNC - Legal Services I (2007); Intv. Germ. MNC - Financial Services III (2007); Intv. Supranational Authority I (2007).

[1744] See Intv. Rom. Local Authority I (2007).

[1745] See Intv. Germ. MNC - Financial Services III (2007); Intv. German Econ. Association II (2007).

[1746] See Intv. Germ. MNC - Consulting II (2007).

[1747] See Intv. Austr. MNC - Primary Goods II (2007); Intv. German Econ. Association VII (2007).

[1748] See e. g. Intv. Germ. MNC - Retail (2007).

[1749] See Intv. Austr. MNC - Primary Goods II (2007).

[1750] See Intv. Austr. MNC - Consumer Goods (2007).

Individual expert statements asserting that investments are currently not advisable due to the high real estate prices at all[1751] seem, however, somewhat too pessimistic considering the possibilities for circumventing existing problems described above.

There seems to be good reason why a few investors interviewed assume that rental (particularly from the state) will become more important than purchasing real estate, since production sites tend to be outdated quickly anyway and renting may also help to avoid legal issues regarding property (*section 7.2.2*).[1752]

Primary[1753] and secondary[1754] sources confirm that the real estate sector provides significant potential for foreign investors, partly because of the need for capital, know-how in projects and civil engineering, and because foreigners seem to experience little discrimination in this sector.

(d) In the **assessment** of this section it becomes apparent that rising real estate prices become an increasing concern of investors, particularly because they are coupled with other inflating costs. As a result, it is generally more difficult for MNCs to find an adequate piece of real estate than it is to set up a company in Romania. However, for the most part this development does not seem to be crucial so far, also because investors still have various possibilities to circumvent these problems. Nevertheless, interviews indicate that state representatives are not always sufficiently aware of the downside potential of this development and tend rather to see the opportunities for FDI in real estate. They also tend to underestimate their influence to steer real estate prices.

[1751] See Intv. German Political Adviser (2007).

[1752] See Intv. Austr. MNC - Consumer Goods (2007); Intv. Germ. MNC - Financial Services III (2007).

[1753] See e. g. Intv. Austr. MNC - Financial Services II (2007); Intv. German Econ. Association VIII (2007); Intv. German Econ. Association V (2007).

[1754] See e. g. Hannula (2005); UniCredit Group (2007); Süddeutsche Zeitung (2007); Raiffeisenbank (2008).

In order to decrease price pressures and to avoid the real estate situation becoming a more significant deterring effect on FDI, public policy should invest more actively in urban and rural real estate developments, particularly on the local level. Legal possibilities for public and private actors to acquire and sell real estate should be increased. These efforts should also be strongly interlinked with Romania's other infrastructure reforms. Public policy thus needs to provide not only land but also make it accessible for investments including roads, electricity etc. Finally, an adequate monetary policy *(see above)* will be needed to preclude possible imbalances on the financial markets and prevent an overheating of the real estate market.

(3) In **conclusion**, infrastructure issues, such as road infrastructure and the real estate situation, were not the focus of investors and public policy actors in Romania for a long time, because other problems were more urgent, the number of investors was still limited, and because little FDI was oriented towards expansion and market exploitation. This section suggested that infrastructure did not significantly hinder FDI in early investments periods but affected the increase of inflows and expansions later, once a higher level of FDI was reached in the mid 2000s. Due to economic growth and EU accession the demand for infrastructure goods has increasingly outpaced the existing supply. Infrastructure deficiencies may not only obstruct higher FDI inflows but also increase development gaps within Romania. Overall, the potential negative impact of infrastructure deficiencies seems to be more crucial than existing opportunities for FDI in infrastructure (also because only a limited number of companies can benefit from the sectoral growth in infrastructure).

In this context it seems that public policy actors are more aware of road infrastructure problems than of those that are related to the real estate situation. In reference to both dimensions discussed local responsibility needs to be enhanced, legally and actually. Local actors may also rather have an interest in finishing infrastructure projects quickly because results are more visible and beneficial for them.

7.3.2.3 Croatia

(1) The quality of Croatia's **road infrastructure** was (a) poor throughout the 1990s, but (b) significant improvements have led to a very satisfactory state for MNCs today and (c) only minor problems remain. Yet, (d) road infrastructure seems to have only limited impact on FDI in Croatia. Sub-section (e) assesses the findings.

(a) Both primary and secondary sources confirm that Croatia had **significant problems** with its road infrastructure **in the 1990s**. In the course of the war of independence, Croatia's infrastructure was severely affected and the connections between Zagreb an the southeastern and southwestern regions were disrupted and partly destroyed.[1755] Destruction, different government priorities, a difficult geography, lack of money, and the little know-how of domestic construction companies effectuated that only few major constructions actually took place throughout the 1990s and that traveling, for example, to and at the coast was tedious.[1756] *Carter, Sader, and Holtedahl (1996)* conclude that Croatia had the worst performance in terms of road quality out of 10 EECs in the 1990s.

(b) Since the late 1990s significant construction efforts generated **substantial improvements** of Croatia's road infrastructure. Interviews[1757] and exter-

[1755] See Bertelsmann Stiftung (2006b), p.2.

[1756] See Intv. Germ. MNC - Engineering (2007); Intv. Austr. MNC - Construction (2007); Intv. Germ. MNC - Telecommunications (2007).

[1757] See e. g. Intv. Germ. MNC - Engineering (2007); Intv. Germ. MNC - Logistics (2007); Intv. Germ. MNC - Telecommunications (2007); Intv. Germ. Political Foundation II (2007).

nal sources[1758] indicate that large infrastructure projects were already launched under President Tuđman and then intensified under Prime Ministers Račan and Sanader. As a consequence, the highway system expanded from 300km to about 1,000km (1995-2006).[1759] The connection between Zagreb and Split was completed in 2004 and Varaždin was hooked up to the highway system in the following year.[1760]

Interviews reveal several reasons for the success of the upgrade and extension of road infrastructure in Croatia. President Tuđman presented the Croatian highway system as a national project of prestige that would also help to better defend Croatia against potential (Serbian) aggressions. His successors gained support by focusing on the economic impact of the highway extension, notably on the construction and tourism industries. In this context, the high visibility of the projects guaranteed the support of top politicians and helped to convey the importance to stakeholders, financiers and voters compared to other large projects.[1761] Other success factors include the increasing number of public tenders and the positive development in the construction sector (mainly due to tourism) including the enhanced involvement of foreign players.[1762] Furthermore and in contrast, for instance, to Romania, Croatia did not wait for a co-financing from the EU but started constructions on its own.[1763] As a result, investors seem very satisfied with the extension and quality of the highway network in Croatia, particularly with the north-south highway to the coast

[1758] See e. g. Bertelsmann Stiftung (2006b), p.8 ; NCC (2004b); European Commission (2007a), p.22.

[1759] See World Bank (2003); European Commission (2007a), p.68; APIU (2007); see also Intv. Austrian Econ. Association II (2007).

[1760] See Intv. Germ. MNC - Industrial Goods I (2007); see also NCC (2004b).

[1761] See Intv. Austr. MNC - Construction (2007); Intv. Germ. Research Institute II (2007); Intv. Austr. Research Institute (2007); Intv. German Authority III (2007); see also European Commission (2004c), p.51.

[1762] See Bfai (2004), pp.57-58; European Commission (2004c), p.92; see also Intv. Austr. MNC - Construction (2007).

[1763] See Intv. Austr. Research Institute (2007).

and they acknowledge that Croatian highways reach Western European standards.[1764]

In addition to this, investors interviewed also see progress in the quality of non-highway roads in recent years that add up to about 29,000km today.[1765]

The high standard of Croatia's road infrastructure is also reflected in international statistics. In the Global Competitiveness Report (*figure 94 in the appendix*) Croatia ranks 36th out of 131 countries in terms of road quality in 2007 and is therefore the second best EEC after Lithuania.[1766] External surveys also show that transportation is only regarded as a minor problem in Croatia today.[1767] Other international statistics that assess a merely mediocre performance of Croatia[1768] do not seem to be representative, since they analyze infrastructure in general (including energy, ports etc.) and do not give specific results for roads.

(c) Nevertheless, interviews and external sources also hint at **some minor problems** regarding Croatia's road infrastructure. Interviewees mention some missing parts of the highway system such as the route from Zagreb to the airport and even more importantly a 30km stretch through Slovenia is required to connect Croatia to Western Europe's highway system – apparently a political issue between the Slovenian and Croatian governments.[1769] External sources also state that some maintenance problems of the highway system exist.[1770]

[1764] See Intv. Austrian Econ. Association II (2007); Intv. German Econ. Association IV (2007); Intv. Austr. MNC - Primary Goods I (2007); Intv. Germ. MNC - Software (2007).

[1765] See Intv. Austr. MNC - Real Estate (2007); Intv. Austr. MNC - Retail (2007); Intv. Germ. MNC - Industrial Goods I (2007); Intv. Supranational Authority II (2007); see also APIU (2007).

[1766] Out of 18 EECs analyzed, Lithuania ranks 32nd; Croatia apparently reaches 85% of EU standards in terms of road quality; see World Economic Forum (2007); Doc - NCC (2007).

[1767] See FIAS (2007).

[1768] See e. g. AHK (2006); IMD (2006).

[1769] Slovenia may expect some co-financing from Croatia; see Intv. Germ. MNC - Industrial Goods I (2007); see also Intv. Austrian Econ. Association II (2007).

[1770] See European Commission (2007a), p.22.

Furthermore, the quality of non-highway roads still varies greatly from region to region. In Slavonia, quite a few roads have still not been renewed since the end of the war.[1771] Some interviewees also point out that conditions are difficult for any nation-wide distribution departing from the main roads, particularly in the hinterland of the coast and on the many islands.[1772] Some of these problems seem to originate on the local level. The high degree of centralization apparently decreases the options available to local public policy actors.[1773] On the other hand, local infrastructure projects may sometimes be based on arbitrary decisions and more affected by interests of individuals and networks than those originating from central level.[1774]

Some interviewees as well as external sources also criticize that too much money and efforts were invested into the extension and upgrade of highways, while urban infrastructure, railroads and port infrastructure received less attention.[1775] Experts and external sources also warn that infrastructure expenditures may further increase Croatia's foreign debt.[1776] Finally, some of the public tenders, including the award of contract for the Zagreb-Split highway to Bechtel, have also brought criticism. Even today the construction business seems to be quite political and does not always follow fully transparent rules.[1777]

(d) Despite this, in an evaluation of Croatia's road infrastructure the positive aspects clearly outweigh the complaints. Nevertheless, road quality only seems to be an **average enhancing factor** in favor of Croatia as investment location so far. Primary and secondary sources admit that good roads are generally

[1771] See Intv. Croatian Mayor (2007).
[1772] See Intv. Germ. MNC - Food Products (2007); Intv. Austr. MNC - Retail (2007).
[1773] See Intv. Croatian Mayor (2007).
[1774] See Intv. Austr. MNC - Real Estate (2007).
[1775] See Intv. Germ. MNC - Telecommunications (2007); Intv. Germ. MNC - Financial Services II (2007); Intv. Austr. MNC - Construction (2007); see also EBRD (2005a), p.20; NCC (2004b), p.31; European Commission (2004c), p.51.
[1776] See CICD (2006), p.11.
[1777] See also Intv. Germ. Research Institute II (2007); Intv. Austr. MNC - Construction (2007).

an advantage, because they strengthen Croatia's reliability as business-friendly location[1778], facilitate connection to other markets and may represent the future backbone of a new transit route from Asia (via Turkey) to the EU.[1779] Further market potential may also exist for MNCs in the construction sector in the completion of the highway network, the development of local roads and through a further consolidation of the construction industry following stricter licensing rules expected for spring 2008.[1780]

However, these advantages seem to have only limited direct impact on FDI (besides in tourism and construction) so far. Interviews do not indicate that investment decisions are substantially driven by Croatia's good roads.[1781] External surveys also confirm that the relative importance of infrastructure versus other determinants is fairly low (19th on a list of 26 determinants).[1782]

(e) In the **assessment** of this section the analyses show that Croatia has made remarkable progress in recent years regarding the modernization and extension of its road infrastructure. Starting with very difficult geographic and political conditions Croatia has clearly performed better than other SEECs including Romania. It seems reasonable that governments did not wait for EU financing to arrive (as did Romania) but accepted rising debts; Croatia was therefore able to reach a competitive locational advantage compared to other SEECs and to drive employment. It was also prudent to concentrate construction efforts on highways since other projects may not have received the same support and a focus on the modernization of regional road networks

[1778] See Intv. Croatian Ministry II (2007).

[1779] See Intv. Germ. MNC - Engineering (2007); Intv. Germ. MNC - Financial Services I (2007); Intv. Supranational Authority II (2007); see also NCC (2004b), p.14.

[1780] This is expected to reduce the number of domestic firms; see Intv. Austrian Econ. Association II (2007); Intv. Austr. MNC - Construction (2007); UniCredit Group (2006), p.8.

[1781] See Intv. German Econ. Association IV (2007); Intv. Austr. MNC - Primary Goods I (2007).

[1782] See AHK (2006).

may have exceeded the capabilities of local governments as analyses of earlier sections suggest.

It may be somewhat disappointing that the good road infrastructure has not materialized in significant FDI so far. It has, however, helped to foster growth in the tourism sector overall (*see section 6.3.1*). More importantly, and looking at the Romanian example, it seems likely that infrastructure will gain in importance in the years to come once EU accession has been achieved (and customs barriers are lifted completely) and higher levels of FDI are reached. Both issues will lead to greater opportunities for Croatia as a market in itself and as attractive transit country.

Nevertheless, public policy will need to establish some further preconditions, in order for Croatia to actually benefit from its earlier construction efforts in terms of FDI inflow. These include the overcoming of some of the legal obstacles analyzed above (most of all regarding property rights and bureaucracy). Croatian public policy should also develop a more regional perspective, since a better road infrastructure in other SEECs (notably in Bosnia and Herzegovina) will be essential even for market-seeking MNCs in Croatia. Public policy will also need to cooperate more closely with Slovenian leaders in order to close the remaining highway gap which would also represent a symbolic completion of the connection to Western Europe.

Moreover, Croatia should now delegate more of the responsibilities of road infrastructure to local levels since the maintenance of the highway system and the modernization of other roads will be most effectively conducted by local actors.

Finally, it is worth noting that company experts emphasize achievements in terms of road infrastructure more than state representatives do. This may be because company experts are more aware of the fact that the speed of the modernization and the high quality of the network is exceptional in the regional comparison. Public policy actors should therefore emphasize these aspects more actively when promoting Croatia as an attractive investment location.

Overall, interdependences with other determinants are apparently even more important for Croatia's road infrastructure than for Romania's. They include regional cooperation, EU funds, corruption, proximity, market size, and trade policy.

(2) With respect to Croatia's **real estate situation**, investors seem to have (a) some concerns regarding the price development, but (b) quality and bureaucratic issues seem to be more worrisome. The (c) importance of this determinant is apparently minor for FDI in Croatia. This section concludes with an assessment (d).

(a) Interviews[1783] and external sources[1784] show a complex picture regarding Croatia's **real estate prices**. Housing prices are apparently quite high and on a comparable level to Western Europe cities.[1785] The purchase of office space is also expensive and can cost between €1,000 and €3,500 per sqm in Croatia, while rental prices range from €5 to €17.[1786] On the other hand, purchasing prices seem to be fairly low for industrial sites in Croatia with €28 per sqm, also in comparison to neighboring countries such as Hungary (€39), Bosnia and Herzegovina (€41), and Serbia (€141).[1787]

Sources analyzed confirm that real estate prices (most notably land prices and office rents) have been rising in Croatia, particularly in the period up until 2005. However, prices in Croatia's real estate market did not develop as dramatically as in other Eastern European markets and may even start to decrease. House prices, for example, only grew moderately at 2.7% annually

[1783] See Intv. Germ. MNC - Engineering (2007); Intv. Austr. MNC - Financial Services I (2007); Intv. Austrian Econ. Association II (2007).
[1784] See e. g. EBRD (2007a); IMF (2004); CNB (2007).
[1785] See Egert and Mihaljek (2007).
[1786] See APIU (2007).
[1787] Including ancillary expenses; see MIGA (2006); own calculations.

(1997-2001)[1788] and in the following years still less than in most other EECs with 8.7% (2002-2006).[1789]

Reasons for this fairly moderate development may be that prices were already quite high even in the 1990s and attractive objects for foreign investors are more spread out (especially at the coast) than, for example in Romania, where investments seem quite concentrated on a few boom centers. Therefore, price gaps within the country seem to be less dramatic in Croatia. Furthermore, the construction of apartment and office buildings after 2000 increased the supply and eased the price pressure as well (e. g. from about €20 in 2005 to an average of €13 per sqm for office rent).[1790]

Findings regarding the future development of real estate prices in Croatia are mixed. Some sources assume that prices will increase more slowly[1791] or even decrease (for example for office space to about €10 per sqm)[1792], while others expect that an increasing demand and an accession to the EU will lead to an enhanced price surge, taking a similar experience in other Eastern European economies into account.[1793]

(b) Overall, prices seem to be less of a **problem** for investors interested in real estate in Croatia than the **quality of buildings offered and bureaucratic hurdles**. Interviewees confirm that the supply of modern office space and production sites in Croatia is still limited and that investors often encounter infrastructure problems at old sites, particularly regarding gas and electrification.[1794] Even more importantly and as already touched upon in *sections 7.2.2.3* and *7.2.3.3*, investors frequently experience arbitrary and

[1788] 2.9% in Hungary, 6.3% in Slovenia and 15.4% in Czech Rep.; see Egert and Mihaljek (2007).
[1789] Czech Republic with 10.9%, Hungary with 13.4% and Estonia with 35.7%; see ibid.
[1790] See Intv. Austr. MNC - Financial Services I (2007); Intv. Austrian Econ. Association II (2007); see also European Commission (2004c), p.43; Egert and Mihaljek (2007).
[1791] See Global Property Guide (2006).
[1792] See e. g. Intv. Austrian Econ. Association II (2007).
[1793] See Doc - Ekonomski Institut Zagreb (2007); Hina (2007).
[1794] See Intv. Austrian Econ. Association II (2007).

sometimes biased decisions of authorities when selling and renting land etc. Primary[1795] and secondary[1796] sources also criticize the fact that foreigners tend to have more problems acquiring real estate than Croatian firms and that the need for good networks is more troublesome than the price or quality of the real estate.

(c) Nevertheless, interviews with investors suggest that the real estate situation **has hardly any influence** on the investment decision of most MNCs for or against Croatia.[1797] Some investors may consider that higher real estate prices today make an investment, particularly in tourism, less attractive than in the early 2000s[1798], but most investors acknowledge that Croatia has been on a fairly high price level anyway and that real estate prices are still moderate versus the overall price level compared to other EECs. Furthermore, the poor quality of some objects, for example of old production sites, seems to be less relevant for FDI in Croatia, since MNCs' interest in greenfield investments is limited, anyway (*see section 6.3.1*) and because they generally rather set up new state-of-the art production sites in order to fully leverage their technological advantages versus their competitors.[1799] Real estate has only played an a limited role as a target sector for FDI. Inflows in real estate accounted for only 1% between 1993 and 2003 and for 4% between 2003 and 2006 of FDI inflows to Croatia overall.[1800] With an FDI stock of 2% (2005) real estate was therefore clearly less relevant for Croatia than for Romania (6%), Bulgaria (9%) or Serbia (12%).[1801] Nevertheless, some future potential may exist, especially in tourism as identified in *section 6.3.1.*

[1795] See e. g. Intv. Austr. MNC - Retail (2007); Intv. Austr. MNC - Primary Goods I (2007).
[1796] See e. g. OECD (2006a), p.48; European Commission (2004c); UniCredit Group (2006), p.8.
[1797] See Intv. Germ. MNC - Engineering (2007); Intv. Austrian Econ. Association II (2007).
[1798] See Intv. Germ. MNC - Engineering (2007).
[1799] See also Intv. Austrian Econ. Association II (2007).
[1800] See Sohinger (2004); Doc - NCC (2007).
[1801] See Sorsa, Bakker, and Duenewald (2007); see also European Commission (2007a), p.68.

(d) In the **assessment** of this section it becomes apparent that the real estate situation in Croatia is less problematic than that in Romania. Despite a currently similar price level at least for housing and office spaces, the price increase in Croatia has been less drastic in recent years than in other EECs due to a lower demand. Moreover, real estate prices may be more in line with the generally high price level in Croatia than in other EECs. Fairly low inflation rates may also have contributed to this moderate development.

It also seems that investors have less reason to fear significant increases of higher real estate prices in the years to come. Apparently earlier price surges and the strong kuna anticipated the current development in other CEECs and SEECs. Furthermore, it seems that recent construction efforts are well-suited in order to ease price pressures, at least in the cities. Tourism may be the only sector for increasing speculations particularly when real estate markets are actually opening fully to foreign investors.

Nevertheless, Croatia's public policy should work on giving MNCs better access to the real estate market and on dismantling bureaucratic hurdles and establishing more transparent rules of tenders. Public policy actors need to become more aware of this interdependence of the real estate situation with the existing bureaucratic obstacles (as particularly mentioned by company experts interviewed) in order to foster FDI growth, particularly in the tourism sector.

(3) In **conclusion**, this section has shown that Croatia is performing quite well regarding those dimensions of infrastructure that are most crucial to investors in general. The analyses with respect to road infrastructure in particular have shown how concentrated reforms can lead to visible successes, even though direct benefits are not yet clearly visible. Infrastructure may, therefore, be of only limited importance for FDI in Croatia for now, but this section gave

substantial evidence that it may gain in importance as locational determinant with higher levels of FDI and EU accession. However, interviews with company experts in particular have shown that capitalizing on these benefits requires an increased awareness on the part of Croatia's state actors of the country's strengths and weaknesses. Bottlenecks in local bureaucracies also need to be overcome as quickly as possible.

7.3.2.4 General insights for transition countries

Based on the analyses above and on further external studies several conclusions can be derived for infrastructure as FDI determinant for transition countries: The (1) importance of infrastructure seems to depend on various factors, while the (2) performance differs significantly across transition countries. Some public policy implications are presented in section (3).

(1) More than for other FDI determinants analyzed before, the **importance** of infrastructure **depends on a multitude of factors**. External sources confirm for transition countries what has been shown for Romania and Croatia in particular that a good infrastructure (including roads and real estate) is generally important for investors and their investment decision.[1802] In line with the theory of locational competition, empirical studies show that a better infrastructure and a greater liberalization of infrastructure policy may reduce opportunity costs for production, transportation and communication.[1803]

On the other hand, interviews show that infrastructure is generally not a decisive determinant for FDI flows to transition countries, and FDI studies confirm that infrastructure is of only limited importance relative to other de-

[1802] See Intv. Rom. Local Authority I (2007); Intv. Austr. Research Institute (2007); see also Dunning (2005); Calderón and Servén (2004).

[1803] See Baniak, Cukrowski, and Herczynski (2005); Brada, Kutan, and Yigit (2003); Borensztein, de Gregorio, and Lee (1995); see also Siebert (2000); Siebert (2005); Intv. Austr. MNC - Industrial Goods I (2007).

terminants.[1804] Interviews show that investors – particularly those from Germany – are more willing to renounce a good infrastructure than, for example, clear property rights and political stability. These findings are also backed by the OLI paradigm that sees an interdependence of infrastructure to other locational factors in order to materialize into FDI including labor costs, access to natural resources, bureaucracy, trade regulations etc.[1805] The importance of the relative performance of related factors also becomes apparent in the analysis of the real estate situation. High real estate prices in Romania, for example, may rather have a deterring effect because they are in sharp contrast to the (still) fairly low labor costs. By contrast, a high price level does not seem to surprise investors too much in Croatia, since MNCs expect fairly high price levels there, anyway.

Therefore, *Wheeler and Mody (1992)* may somewhat overestimate the importance of infrastructure when they conclude that tax and short-term incentives are not necessary in the competition for FDI if a good infrastructure is in place. The theory of locational competition seems to strike a more accurate tone when it calls for the right balance between government expenditures and low taxes.[1806]

These aspects also lead to a connection of infrastructure to the development stage and level of FDI in the host country. In line with the findings of the sections above, *Demekas, Horváth, Ribakova, and Wu (2005)* assume that infrastructure becomes more important once a country has reached a certain amount of FDI. This section suggests that basic requirements are met by then and more MNCs, that are interested in the exploration of the market or the cooperation with local suppliers, thoroughly assess the infrastructure situation of transition countries. This may also be one reason why some FDI studies iden-

[1804] See e. g. Lankes and Venables (1996); ; Kalotay (2000); AHK (2006) according to which infrastructure is only the 19th of 26 determinants in terms of importance.
[1805] See Dunning (1988); see also section 2.2.3.2.
[1806] See Siebert (2000); Siebert (2005).

tify only a minor impact of infrastructure on FDI in transition countries in the early 1990s when FDI inflows were still scarce.[1807] Therefore, the importance of infrastructure may further increase with the accession of transition countries to the EU when basic investment conditions are met and market-exploitation opportunities increase.[1808] Before a minimum of basic requirements is fulfilled, a good infrastructure is mainly important for manufacturing companies that need good access to their export markets.[1809]

Finally, the speed of change in infrastructure may indirectly influence the importance of this determinant. Thus the rapid and highly visible change in road infrastructure, as in Croatia in recent years, may create the perception that the host country is reform-oriented in general. In contrast, sharp increases in real estate prices, as recently in Romania, may cause investors to worry that public policy lacks the (macroeconomic) ability to smooth sudden changes in costs and prices in general.

(2) The **performance** of transition countries in terms of infrastructure **strongly differs** from country to country. Overall, EECs only provided a weak infrastructure in the 1990s, particularly with regards to roads.[1810] In the early 1990s the density of road networks was 60% lower in transition countries than in Western countries and only 62% of roads were paved in EECs in 1993 compared to 92% in Western Europe.[1811] However, this thesis has already shown that transition countries had – understandably – other short-term priorities at that time, including the overcoming of war as well as economic and political turbulences.

While improvements were implemented at different speeds across transition countries Croatia remained one of the countries most dedicated to road con-

[1807] See e. g. Lankes and Venables (1996); Dunning (2005).
[1808] E. g. through the complete abolishment of customs barriers.
[1809] See European Commission (2005b).
[1810] See Holland, Sass, Benacek, and Gronicki (2000).
[1811] See Carter, Sader, and Holtedahl (1996).

struction for a long time. *Dunning (2005)* perceives a significant momentum after 2002 when various EECs were given a clear path towards EU accession that provided political and financial incentives in order to speed up reforms.

EU accession also helped to expand real estate markets by lifting the last barriers to ownership by EU citizens. As a consequence, average real estate prices in the new member states increased significantly - by an average of 30% on the national level and 40% in the capitals.[1812] Regional differences for real estate development may, however, exist. Depending on the price history of the country, but possibly also on the size of the market, significant regional differences in the rate of real estate development may exist. Developments in smaller countries like Hungary and Slovakia are rather expected to slow down than in a large country like in Poland.[1813]

FDI in the construction and real estate sectors depend on country specifics such as the strength of a certain sector (as tourism in Croatia), the extensive need for foreign know-how (as in real estate in Romania) or the legal and actual barriers for MNCs. However, it seems that FDI rises with the growth of the respective sectors. While infrastructure was only of limited importance as industry attracting FDI in Eastern Europe throughout the 1990, FDI projects grew by 57% between 1997 and 2006 in line with the domestic sectoral growth in transition countries.[1814]

(3) Some **implications for public policy** can be drawn from this section. Public policy may not be able to overcome all existing obstacles in terms of infrastructure. However, it seems that public policy makers have more options to orient infrastructure policy towards attracting FDI than realized by some state representatives especially on the local level. At the same time, public policy has to be aware that infrastructure is more difficult to steer than other

[1812] See Doc - Ekonomski Institut Zagreb (2007).
[1813] See Intv. Supranational Authority I (2007).
[1814] See Kalotay (2000); Hunya (2002); FIAS (2007).

determinants because supply and demand (for example of real estate) oscillate strongly and depend on factors like prices, capital markets etc. that are difficult to influence or predict by governments. Potential measures for public policy actors to actively influence real estate developments that can be derived from the interviews are a tight monetary policy, state-driven construction efforts and transparent bureaucratic procedures. Furthermore, the Croatian case of highway construction has shown that compact and decisive efforts can lead to far-reaching successes even in a fairly short period of time. Public policy makers in transition countries should be aware that there is no single way to an ideal infrastructure for MNCs. While Croatia was probably right to focus on the highway system, other priorities (for example the modernization of harbors or railroad networks) may be more reasonable in other countries. Nevertheless, all dimensions of infrastructure should meet some minimum requirements in order to enable the inflow of some FDI at all.

Another important insight from the experience of Romania and Croatia is that transition countries should not wait for EU funding (in case they are not yet EU members) to start comprehensive construction projects since they are apparently fairly easy to fund (for example through debt, tolls and other international donors) and generally get the broad support of the public.

While central governments seem to be best suited in the early years of transition to conducting effective infrastructure policy, they should be aware of when the moment has come to delegate operational and financial responsibility. First of all they can decrease their dependence on public investments and extend PPPs, particularly for various types of infrastructure projects. Furthermore, a well-planned delegation from the central to the local level can increase an effective implementation, particularly regarding the maintenance of existing projects.

Finally, public policy should increase the promotion of success of infrastructure reforms. As in the case of Croatia's highways system, state representatives often seem to be little aware of their achievements in a regional context. They can also use successful projects more actively as examples for an effective and reform-oriented government that aims for a business-friendly environment.

7.3.3 Investment climate

7.3.3.1 Definition

Interviews conducted[1815] as well as external studies[1816] suggest that MNCs generally define an ideal investment climate as (1) a coherent investment policy that provides national treatment of MNCs and a positive atmosphere towards foreign investors. Furthermore, MNCs tend to appreciate host countries with (2) a simple tax system and low tax rates. Finally, many studies believe that MNCs are attracted by (3) investment incentives that follow transparent rules without many restrictions and that reflect the different needs of MNCs. Sections (4) provide conclusions for Romania and Croatia respectively.

7.3.3.2 Romania

(1) Primary and secondary sources show that (a) there was hardly any **investment policy or strategy** in place in Romania until the late 1990s. Since then (b) investment policy has fundamentally improved, even though (c) further room for improvements remains. The (d) importance of this determinant seems to be fairly significant for FDI in Romania. An assessment is provided in sub-section (e).

[1815] See e. g. Intv. German Econ. Association VII (2007); Intv. Former Croatian Minister (2007); Intv. Austr. MNC - Real Estate (2007).

[1816] See e. g. Dunning (1993); Blomström and Kokko (2003); Müller (2005), pp.174, 190; OECD (2006a).

(a) Interviews as well secondary sources suggest that Romania's investment policy was **poorly developed**, badly structured and partly even "chaotic"[1817] **in the early 1990s**. The legal framework was incomplete, changed several times and contained several restrictions for foreigners. Law no. 35/1991 foresaw an equal treatment of domestic and foreign investors and guaranteed a compensation in the case of "nationalization, expropriation, requisition, and measures with similar effect". However, the law contained various limitations for FDI in strategic areas as well as ceilings for the repatriation of profits.[1818] Subsequent laws tended to serve short-term policy needs rather than follow a comprehensive strategy. One example is Law no. 71/1994, the so-called "Daewoo Law", that mainly regulated investment conditions that had been negotiated in the course of the acquisition of the Craiova plant by Daewoo.[1819]

Policy actors seemed to lack a clear vision of the benefits of FDI both on the central and local level. Interviews show that policy actors were skeptical towards MNCs in the early transition phase, less because of nationalistic resentments than fears of negative impacts on the economy due to (expected) restructuring, lays-offs etc.[1820] Some critics were apparently worried that FDI would undermine the government's strategy of gradual reforms that was supposed to ease negative economic effects of transition.[1821] Other pundits of FDI feared that foreign investors would aggravate Romania's property problems by buying real estate before the difficult ownership situation of Romanian land was clarified.[1822] More generally, many policy actors simply did not see the

1817 Intv. German Econ. Association V (2007); see similar Maniu, Kallai, and Popa (2001).
1818 See Tripon (2003), p.39; UNCTAD (2003a), p.14; Bulgaria Economic Forum (2007).
1819 See Chiritoiu (1998); Maniu, Kallai, and Popa (2001); Tripon (2003); Müller (2005), p.189.
1820 See Intv. Supranational Authority I (2007).
1821 With limited success as shown in section 6.2.1.
1822 See section 7.2.2.2; Maniu, Kallai, and Popa (2001), pp.36, 41; Chiritoiu (1998), p.3.

need for Romania to have an investment policy and key decision makers made little efforts to understand the problems and needs of investors.[1823]

(b) Romania visibly **opened its economy for FDI** since the late 1990s.[1824] The Government Emergency Ordinance no. 31/1997 regulated the stimulation of FDI for the first time[1825] and Law no. 332/2001 aimed at the promotion of FDI with significant impact on the economy. Apart from the regulation of incentives (*discussed below*), these two laws also strengthened the rights of foreign investors in general. Accordingly, MNCs now receive full national treatment, can repatriate all capital and profits, may invest in all sectors (with the exception of air traffic), and do not face any performance requirements or limitations in equity stakes.[1826] Overall, Romania receives good grades from both interviewees and external studies for its non-discriminatory (legal) treatment of foreigners and its open and liberal FDI regime, also compared to other SEECs.[1827]

This active investment policy of Romania is furthermore observable in the many Bilateral Investment Treaties (BIT) that Romania had concluded since the mid-1990s. BITs have been used to increase confidence in Romania as an investment location. Even though they contain few obligations and rights, they signalize Romania's willingness to promote a favorable investment climate with reliable conditions. Romania is the country with the largest number of BITs (84) in Eastern Europe (*see figure 95 in the appendix*) ahead of Bulgaria (67) and Hungary (58).[1828]

[1823] See Intv. German Econ. Association VIII (2007); Intv. German Econ. Association V (2007).
[1824] See Intv. Austr. MNC - Financial Services I (2007); Intv. Int'l Econ. Association (2007); see Zühlke (2006).
[1825] Several modifications followed.
[1826] See Tripon (2003), p.40; Müller (2005), p.191; Bulgaria Economic Forum (2007).
[1827] See OECD (2005d); OECD (2006a), p.50; Intv. Supranational Authority I (2007).
[1828] See UNCTAD BIT website (2008); own calculations.

Interviews help to understand that the change in attitude of political decision makers towards FDI is even more important than the ameliorations in the legal environment with regards to investment policy. Politicians and bureaucracies seem to be more aware of the benefits of FDI for Romania and employees generally like working for companies from Western Europe or the U.S.[1829] Interviewees also notice that foreign business associations have been experiencing stronger support from authorities since the early 2000s. This more positive attitude towards FDI as well as a more active investment policy were first noted in some local communities, such as Sibiu, where a comprehensive development strategy was established at that time.[1830]

(c) Nevertheless, primary and secondary sources reveal **some shortcomings** of Romania's current investment policy. External sources as well as interviewees note that the majority of remaining problems are related to property rights[1831], which were already discussed in *section 7.2.2.2.*

Moreover, interviewees criticize that a comprehensive long-term strategy for FDI (of at least three to five years) is still missing for Romania.[1832] It seems that state authorities are not always eager to give up control and are therefore sometimes skeptical regarding the sale of state assets to MNCs. Some interviewees point out that authorities are often primarily looking for short-term profits when doing business with investors without considering long-term consequences.[1833] Furthermore, many investment strategies seem to fail because human and financial resources are missing in central authorities and the coordination of projects with locals levels remains weak. Company experts therefore

[1829] See Intv. German Econ. Association VI (2007); Intv. Romanian NGO (2007); Intv. Romanian Authority II (2007); Intv. German Econ. Association II (2007).

[1830] See Intv. Germ. MNC - Legal Services I (2007); Intv. Romanian County Council (2007); Intv. Austr. Research Institute (2007); Intv. Austrian Econ. Association I (2007).

[1831] See OECD (2006a), p.53; Intv. Germ. MNC - Consulting I (2007); Intv. Germ. MNC - Legal Services II (2007).

[1832] See Intv. German Econ. Association VIII (2007); Intv. Int'l Econ. Association (2007); Intv. Germ. Research Institute I (2007).

[1833] See Intv. German Econ. Association V (2007); Intv. German Authority IV (2007).

conclude that the central government is well-suited to provide information but not to conduct a complex investment policy in Romania.[1834] Interviewees also accentuate that the quality of local investment policies strongly varies across Romania and that some communities are still skeptical regarding foreign investment in general.[1835]

From a legal point of view, external sources show that FDI rules are spread out over numerous regulations, but no comprehensive law on FDI exists so far.[1836] Finally, the accession to the EU has also contributed to a retrenchment of Romania's leeway in investment policy. Firstly, the possibilities for BITs are reduced because they do not wholly comply with EU competition policy.[1837] In fact, ten of Romania's BITs had to be canceled since 2002 and several others had to be re-negotiated.[1838] Secondly, the current investment promotion law (332/2001) lost its validity with accession to the EU (even though the general regulations on the legal status of MNCs are still binding) and the Romanian government is in the preparation of passing a new investment law.[1839]

(d) With respect to the **importance** of investment policy, international studies, FDI literature as well as interviews suggest a positive correlation with FDI flows to transition countries including Romania. Hence, the legal weaknesses of the investment framework have probably contributed to lower inflows to FDI in the 1990s.[1840]

However, interviews suggest that the attitude of authorities towards FDI – especially on the local level – is even more important than the legal framework

[1834] See e. g. Intv. German Econ. Association II (2007).
[1835] See Intv. German Political Adviser (2007); Intv. Germ. MNC - Industrial Goods III (2007).
[1836] See e. g. OECD (2005d), p.14.
[1837] E. g. when more freedoms are acknowledged to third countries than designated in the EU regulations on the freedom of capital.
[1838] See European Commission (2001), p.92; UNCTAD BIT website (2008); see also Intv. Romanian Ministry IV (2007); Intv. Romanian Ministry II (2007).
[1839] See Brenscheidt (2006), p.1; UniCredit Group (2007), p.10.
[1840] See e. g. Lankes and Venables (1996); Pye (1998); Campos and Kinoshita (2003); Intv. Int'l MNC - Utilities (2007); Intv. German Econ. Association V (2007).

for their investment decision of MNCs. Again experts point out a strong interdependence with the quality of bureaucracy since authorities are generally the mouthpiece for the ideas and positions of the politicians. In the end, expert interviews suggest that the reduction of administrative barriers is more important for FDI in Romania than investment policy.[1841]

Nevertheless, it seems that Romania benefits from an improving investment policy. The subsequent sub-sections will analyze the extent to which these efforts are sufficient to differentiate Romania from other SEECs in the long-run.

(e) In the **assessment** of investment policy in Romania this section has shown that the legal and political conditions have improved. State experts in particular helped to understand that earlier resentments were driven less by nationalistic than economic worries. Romania started late in its transition to conduct an active investment policy. Initial successes in privatization and the macroeconomic stabilization may have also contributed to a more open approach towards FDI.

In fact, it is worth noting that interviewees indicate a later turning point towards a better investment policy than most external studies do. Even though much of the legal environment was already in place in the late 1990s, company experts interviewed did not see significant improvements until 2001, when a new government was in place, or even not until 2004/ 2005 when the course toward the EU became irrevocable. It seems that these 'softer' factors require some time in order to reach the awareness of MNCs.

Possibly, MNCs will continue to come to Romania even without a decisive investment strategy, but public policy should be aware that a long-term vision on both a central and a local level will help to steer FDI and smooth regional imbalances considering the inflow of FDI. A more active approach may also become necessary, because Romania is losing comparative advantages to other

[1841] See Intv. Germ. MNC - Utilities (2007); Intv. Int'l MNC - Utilities (2007); Intv. Germ. MNC - Industrial Goods III (2007).

SEECs due to the rising salaries in recent years.

(2) **Tax policy** was (a) a major constraint for MNCs in Romania for a very long time. Despite (b) significant improvements since the early 2000s, (c) various problems remain. Tax policy seems to have (d) a slight positive impact on FDI in Romania. An assessment is presented in sub-section (e).

(a) Primary[1842] and secondary sources[1843] show that the tax system comprised various problems and pitfalls for companies for many years of Romania's transition process. Experts interviewed state that the frequent changes in the tax system were probably the greatest challenge and led to investor insecurity. Modifications pertained many parameters including new taxes, change of tax rates, tax base, and depreciation possibilities. The decision process was often less than transparent without a distinctive strategy and appeared to be based on quarterly ad-hoc decisions.[1844] Tax rates were little competitive with a corporate tax rate of 38% since 1995 and a VAT rate of 22% since 1998. Administrative barriers of the financial bureaucracies – that were already discussed in *section 7.2.3.2* – also contributed to the bad image of the Romania's tax system for many years.[1845]

(b) The Romanian tax policy underwent **significant reforms in recent years**. In a first step the corporate tax rate was reduced to 25% and the VAT rate to 19% in 1999. However, the first substantial improvement of Romanian tax policy represented – in the eyes of the experts interviewed[1846] – the establishment of the fiscal code that entered into force in 2004. Most importantly,

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[1842] See Intv. Germ. MNC - Legal Services I (2007); Intv. Int'l Econ. Association (2007); Intv. Germ. MNC - Financial Services III (2007).

[1843] See e. g. European Commission (1998), pp.62-63; FIC (2002), p.8.

[1844] See Intv. Austr. MNC - Legal Services (2007); see also Dresdner Bank (2004), p.22.

[1845] See also FIC (2002).

[1846] See Intv. Germ. MNC - Consulting I (2007); Intv. Germ. MNC - Legal Services I (2007).

it unified most of the fiscal-related laws into one body of laws. Furthermore, it aligned the fiscal principles with EU law and codified the appeal procedures.[1847]

Even more visible was the comprehensive tax reform in 2005, also called "big-bang tax reform"[1848] in which the progressive income tax (18% to 40%) was replaced by a flat tax of 16% and the corporate tax rate was reduced from 25% to 16%.[1849] The large majority of experts interviewed agree (in line with external surveys[1850]) that the introduction of the flat tax was "a very good idea of the Romanian government"[1851] or even "one of the best ideas of the Romanian government ever"[1852]. They concur that tax payment obligations have become lower and Romania's tax system simpler and more predictable overall.[1853] As a result experts report that tax compliance of investors has improved, offshore-payments for managers in order to avoid high income taxes have decreased and government revenues have grown.[1854]

(c) However, interviewees and external sources identify **various remaining problems** of Romania's tax policy. First of all, the tax system is still complicated, mainly because a multitude of taxes exists – despite the flat tax.[1855] According to *World Bank (2007a)* companies have to pay 15 types of taxes in Romania of which many are due several times per year, adding up to 96

[1847] See European Commission (2003), p.72; OECD (2005d), p.64; BA-CA (2006); PI Partners (2007).
[1848] See HVB Bank (2006), p.18.
[1849] See Intv. Austr. MNC - Legal Services (2007); Intv. German Authority IV (2007); Intv. Rom. Local Authority II (2007); Haarmann Hemmelrath (2005).
[1850] See Walther (2006); AHK (2006).
[1851] Intv. Germ. MNC - Legal Services II (2007); see also Intv. Supranational Authority I (2007); Doc - GTZ (2006b).
[1852] Intv. German Econ. Association VII (2007); see also Intv. Germ. MNC - Consulting I (2007).
[1853] See also section 7.2.3.2; see Intv. Austr. MNC - Legal Services (2007); Intv. Germ. MNC - Consulting I (2007); Intv. Int'l Econ. Association (2007); European Commission (2005c), pp.61-62.
[1854] See Intv. Int'l MNC - Utilities (2007); Intv. Germ. MNC - Automotive (2007); Intv. Austr. MNC - Primary Goods II (2007); Intv. German Econ. Association VII (2007).
[1855] See e. g. Intv. Rom. Local Authority II (2007); Intv. Austr. Research Institute (2007); see also Doc - GTZ (2006b); Doc - Local Romanian Authority (2007).

tax payments per year. Only in Ukraine and Belarus are more payments necessary, while companies in Latvia only have to pay taxes 7 times per year.[1856] Interviewees agree that companies generally need good accountants in order to manage the payments successfully in Romania and MNCs still try to shift tax obligations internally instead of paying taxes in Romania in order to circumvent the complicated procedures. As already touched upon in *section 7.2.3.2* on bureaucracy , the simplification of the tax declaration has made little progress so far.[1857]

More importantly, international statistics in particular show that the level of taxation is fairly high despite the flat tax. *Figure 49* shows that Romania captures a good position among Eastern European countries regarding the statutory corporate tax rate of 16% which is also signficantly lower than in the home countries analyzed, Austria (25%) and Germany (38%). However, when adding up all taxes companies have to pay per year, the total tax rate (without VAT) adds up to 47% of profits. Mainly due to high payments for social security, health and unemployment insurance, Romania's tax position is less competitive than originally assumed (11th out of 19 EECs) and only little more favorable than in Austria (55%) and Germany (51%).[1858] In fact, when tax revenues decreased after the introduction of the flat tax, several indirect tax rates were raised including those for dividends, alcohol etc.[1859]

It is therefore not surprising that international surveys with managers still identify the overall tax burden as well as the tax regulations in Romania as problematic factors for doing business in Romania in 2007.[1860] Several company experts interviewed agree that taxation is inflated by additional costs; never-

[1856] 16 payments are due in Germany and 22 in Austria.
[1857] See Intv. Romanian Company - Advertising (2007); Intv. Germ. MNC - Consulting I (2007); Intv. Germ. MNC - Legal Services I (2007); Intv. German Authority I (2007); Intv. Rom. Local Authority II (2007); Intv. Int'l Econ. Association (2007).
[1858] See World Bank (2007a); Eurostat website (2008); KPMG (2007); own calculations.
[1859] See Larive Romania (2007), p.45; Haarmann Hemmelrath (2005); BA-CA (2007b), p.46.
[1860] See World Economic Forum (2007); see also AHK (2006).

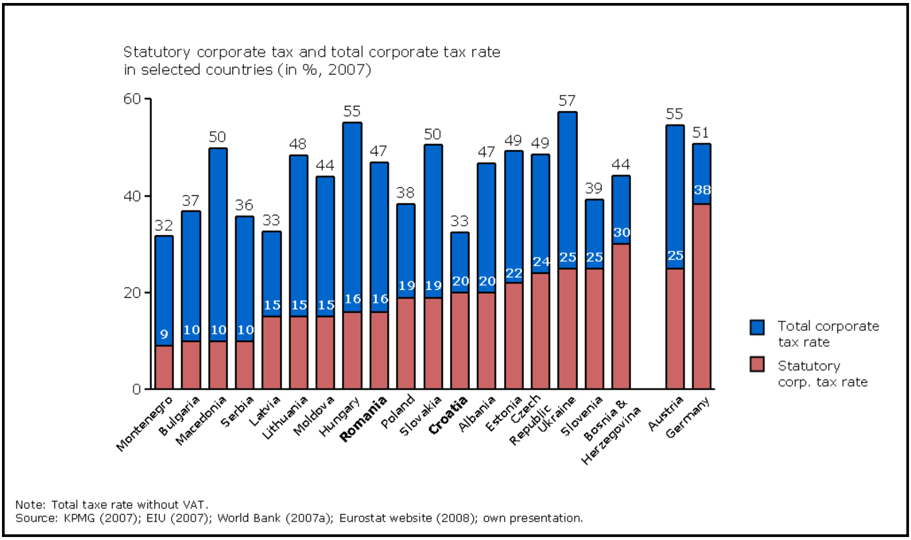

Figure 49: Corporate tax in Eastern Europe

theless, interviews rather suggest that investors do not evaluate Romania's tax policy as negatively as surveys do, because they appreciate the improvements that Romania has made in recent years.[1861] The difference between the statements made in interviews and findings of the surveys may be due to the fact that the former also consider the perceptions of those MNCs that have not invested in Romania yet and are consequently less aware of the actual taxation reality in Romania, including the problems described above.

(d) The evidence regarding the **importance** of tax policy for FDI inflows to Romania is mixed. Some experts interviewed – both company and state – indicate that the introduction of the flat tax represents a locational advantage for Romania, had a positive impact on the investment decision of MNCs and may therefore play a significant role in explaining the FDI boom in Romania in

[1861] See Intv. Germ. MNC - Consulting I (2007); Intv. Germ. MNC - Legal Services I (2007); Intv. Int'l Econ. Association (2007); Intv. German Econ. Association VI (2007).

recent years. Smaller investors in particular may be attracted by the prospect of a lower corporate tax.[1862] Other experts as well as several external and FDI studies, indicate that the positive effect of the flat tax may exist but that it was less driven by its low rate than by the simplifications of the tax system and administrative procedures that it caused.[1863]

However, some interviewees also raise doubts regarding the impact of the flat tax on FDI in Romania. They believe (as did some of the companies interviewed) that investors would probably have come anyway and that most MNCs would not rely on the prospect of low tax rates since they can be changed quickly, for example following a change of government. Larger companies can easily shift their tax obligations to the location with the lowest tax rate. Furthermore, many MNCs tend to have little profits in the early years of the investment anyway; therefore taxation is only a long-term issue for MNCs. Other investors interviewed assert that state aids may be more beneficial overall than a low tax rate. Surveys also suggest that the tax burden is only of mediocre importance for (German) investors in Romania.[1864]

In sum, it seems that the introduction of the flat tax and the recent reforms of the tax system have had a slightly positive but rather indirect effect on FDI in Romania. Reforms showed potential investors that the government is working on improving the investment climate. Therefore, the positive signs were more significant than the actual outcome regarding the various remaining shortcomings of tax policy including the high total tax rate, the complicated

[1862] See Intv. Germ. MNC - Industrial Goods III (2007); Intv. German Econ. Association III (2007); Intv. Germ. MNC - Automotive (2007); Intv. Romanian Authority I (2007); Intv. German Authority IV (2007).

[1863] See e. g. Intv. German Econ. Association V (2007); Intv. Int'l MNC - Utilities (2007); see also AHK (2006); European Commission (1998), pp.62-63; Bellak and Leibrecht (2005).

[1864] See Intv. Germ. MNC - Legal Services I (2007); Intv. Austr. MNC - Industrial Goods I (2007); Intv. Germ. MNC - Software (2007); Intv. Germ. MNC - Legal Services II (2007); Intv. Germ. MNC - Automotive (2007); Intv. Austr. MNC - Primary Goods II (2007); see also AHK (2006).

tax system and the various countries of the region with still lower corporate tax rates.[1865]

This analysis therefore shows the importance of the perceived performance of tax policy for FDI in Romania. This may in fact be a more plausible driver than those of many FDI studies which are generally based on actual tax rates, industry-specifics or different types of FDI[1866] but often come up with findings that reflect little significance[1867] or are even ambiguous.[1868]

(e) In the **assessment** of this section, the analyses suggest that Romania has significantly improved its tax policy in recent years. Potential investors in particular without personal experiences in Romania seem to acknowledge the financial benefits of the flat tax. Those companies that have already been present in Romania for several years also welcome the improvements but tend to focus more on the administrative dimension of the tax system.

It seems that the timing of the Romanian government was favorable. With the tax reform concurring with the decisive steps towards EU accession (*section 7.4.4.2* below), the awareness of Romania has significantly increased among potential investors. Public policy has therefore been able to use tax policy as an active locational instrument and to suggest that Romania is a dynamic reform country. However, public policy makers should not rely on this success because the positive impact may decrease after a while; furthermore, other countries of the region have been reducing their corporate taxes as well and MNCs seem to remain skeptical that tax laws can quickly be changed by a new government. Public policy makers should therefore rather work on long-term strategies, including the unification of taxes and contributions, the reduction of the administrative obstacles and the stabilization of the law-making process.

1865 See also Intv. Germ. MNC - Legal Services II (2007); Intv. Austr. Research Institute (2007); Intv. Romanian Authority I (2007).

1866 See Blonigen (2005), p.9.

1867 See e. g. Carstensen and Toubal (2004).

1868 See Goodspeed, Martinez-Vazquez, and Li (2006), p.2; de Mooij and Ederveen (2003).

Other determinants such as infrastructure may be more important factors in the long-run for Romania because they promise to generate longer lasting benefits.

(3) Romania's **investment incentives** have been focused (a) on different company sizes and (b) regional needs. However, primary and secondary sources identify (c) significant problems, (d) particularly since Romania's accession to the EU. The (e) importance of investment incentives seems limited for the investment decision of most MNCs. Section (f) provides an assessment.

(a) Romania's investment laws distinguish between **different company sizes**; the most frequently discussed incentives refer to large and micro-enterprises.[1869]

According to Law no. 332/2001 large MNCs with investments over USD1M are allowed to import capital goods such as machines and software without paying duty. They also benefit from a reduced profit tax and accelerated depreciation models.[1870] These incentives were decreased step by step in the course of the tax reform in 2004 but also as a prerequisite for EU accession since EU competition policy sets strict guidelines with regards to investment incentives.[1871]

Furthermore, micro-enterprises with less than ten employees and revenues up to €100K do not have to pay tax on profits but only 2% of their revenues.[1872] According to the revision of the fiscal code that entered into force in 2007, the promotion of micro-enterprises was extended even after the EU accession

[1869] See Larive Romania (2007).
[1870] Exceptions exist for MNCs from the financial sector; furthermore, certain environment and safety requirements have to be met; see UNCTAD (2003a), p.14; Dresdner Bank (2004), p.23.
[1871] See Brenscheidt (2006).
[1872] See Bfai (2005), p.141; PI Partners (2007); see also Intv. Germ. MNC - Legal Services I (2007).

of Romania. However, the tax rate was raised to 2.5% in 2008 and 3% in 2009.[1873]

Interviewees appreciate this promotion of micro-enterprises because it makes accounting easier and tends to promote entrepreneurship. One problem may be that companies also have to pay taxes when they make losses.[1874] Furthermore, it seems that large companies sometimes use workarounds in order to benefit from the lower tax burden for micro-enterprises as well, for example by making their staff self-employed and therefore artificially decreasing revenues. However, the government has tried to encounter some of these problems, for example by better defining the type of companies that are eligible for these incentives.[1875]

(b) Various **regional incentives** were designed in Romania, of which the most important are the introduction of free zones and industrial parks.[1876]

The legal framework for free zones was already established in 1992 and revised several times.[1877] Accordingly, investors were able to use land and buildings for up to 50 years; further benefits included the exemption of the profit tax, the VAT and customs. In July 2006 159 enterprises were operating in six free zones throughout Romania.[1878] With EU accession the exemption of profit tax and VAT payments expired by mid-2007 while the reduction of the royalty was extended until 2011.[1879]

Experts interviewed give a mixed picture of the free zones. On the one hand, it seems that the financial advantages through of the free zones are limited, partly because investors have to pay for services provided by the free zone that may sometimes even be more expensive than on the free market (such as

[1873] See Brenscheidt (2006); PWC (2007), pp.13, 40.
[1874] See e. g. Intv. Romanian Company - Advertising (2007); see also Brenscheidt (2006).
[1875] See PWC (2007), p.40; see also Intv. Romanian Company - Advertising (2007).
[1876] See also Bfai (2005), p.43; OECD (2005d), pp.67-69.
[1877] Law no. 84/1992, see also Law no. 244/2004 and Ministry Order 1431/2002.
[1878] See OECD (2005d), p.47; BA-CA (2007b); p48; Sheane (2006); Brenscheidt (2006); Bulgaria Economic Forum (2007).
[1879] See Dresdner Bank (2004); p.23; OECD (2005d), p.68; see also Intv. Germ. MNC - Consulting I (2007); Intv. Romanian Ministry II (2007).

electricity) and many of the advantages seize after a few years. Interviewees also complain that many zones are still little used and that MNCs are afraid of losing contact to other businesses outside the zones.[1880] On the other hand, interviewees point out that the contacts in the free zones were very helpful when dealing with administrative problems. Apparently, investors have made good experiences, for example in the Curtici-Arad free zone.[1881]

Industrial parks are generally developed and financed by local communities based on GO no. 65/2001.[1882] They can only be run by Romanian companies. The main benefits are the provision of infrastructure and the reduction of several taxes including those for property and land. By 2007 about 50 parks were in place. [1883]

Interviews reflect mixed experiences with industrial parks in Romania.[1884] In many cases industrial parks only consist of a street sign, only a minority of parks is actually in operation and parks for specific industries (such as environmental parks) are scarce.[1885] In many industrial parks in operation, investors complained about insufficient infrastructure such as gas, electricity and roads (for example in Şura Mică). Apparently, Romanian politicians sometimes assumed that providing land was incentive enough and expected investors to invest in the necessary infrastructure themselves.[1886] On the other hand, state experts point out that Romania still needs more industrial parks in order to fulfill the needs of a growing economy and to ease the price pressure on the real estate market.[1887]

1880 See Intv. Austr. MNC - Financial Services I (2007); Intv. Germ. MNC - Legal Services II (2007).
1881 See Intv. Austr. MNC - Industrial Goods I (2007); see also Intv. Austr. MNC - Consumer Goods (2007).
1882 See also Intv. Romanian County Council (2007).
1883 See PWC (2007) p.47; UNCTAD (2003a), p.23.
1884 See Intv. German Authority IV (2007).
1885 See Intv. Germ. MNC - Legal Services II (2007); Intv. Germ. MNC - Industrial Goods II (2007).
1886 See Intv. German Econ. Association III (2007); Intv. German Authority IV (2007).
1887 See Intv. Austr. Research Institute (2007); Intv. Romanian Authority I (2007).

An example for a successful industrial park often cited by experts in interviews seems to be that in Sibiu. Investors are satisfied with the proximity to the airport, the fairly low prices of land and that most utilities were in place from the beginning. It helped that the local administration integrated investors in the planning of the park from early on.[1888] State experts interviewed also agree that the establishment of the industrial park has been a major advantage for the economic development of Sibiu in recent years.[1889]

(c) Some **general problems** can also be identified with regards to investment incentives in Romania. One of the greatest problem refers to the many changes in legislation and the limited predictability. For example, potential investors experienced a drawback in 1999 when Romania suspended all tax incentives and custom exemptions of Law no. 241/1998 (even though it had been valid for five years) in order to consolidate the government budget.[1890]

In sum, according to the interviewees, investors have received few incentives in Romania in recent years. Direct incentives such as tax breaks are no longer being offered.[1891] It is therefore not surprising that surveys describe incentives as the least satisfactory determinant (out of 26) in Romania.[1892] According to *IMD (2006)* investment incentives are only less attractive in six out of 61 countries analyzed. This dissatisfaction may, however, also be driven by problems in the distribution of EU subsidies (*section 7.4.4.2*).

(d) A further reason for the critical evaluation of Romania's investment incentives may be the legal uncertainty of MNCs due to the **expiration of many**

[1888] See Intv. Germ. MNC - Legal Services II (2007); see also Intv. Rom. Local Authority I (2007).
[1889] See Intv. Rom. Local Authority I (2007); Intv. Romanian Econ. Association I (2007); Intv. Romanian County Council (2007).
[1890] See Müller (2005), p.192.
[1891] See Intv. Germ. MNC - Consulting II (2007); Intv. Austr. MNC - Industrial Goods I (2007); Intv. Germ. MNC - Legal Services II (2007); Intv. Germ. MNC - Retail (2007); Intv. German Econ. Association V (2007).
[1892] See AHK (2006).

incentives in 2007 and because no specific investment scheme currently exists in Romania.[1893]

For the interim period until the adoption of a new investment law, the government has passed a law facilitating grants for investments above €30M that create more than 300 jobs.[1894] However, few investors seem to know about this.[1895]

At the same time a new specific investment law is being drafted by the Romanian government.[1896] The new law establishes three categories corresponding to the amount of the investment.[1897] Investments have to be conducted in predefined areas including rural areas, environmental and R&D projects and have to be initiated within three years after the approval and for at least 15 years (for large projects). Incentives comprise grants, support for infrastructure and tax breaks.[1898]

Primary and secondary sources criticize that incentives of the current draft are limited, that the minimum investment time is too long and that the legislation does not provide them with any advantage compared to domestic investors who have comparative advantages such as market knowledge, supplier contacts etc.[1899]

(e) FDI studies[1900] as well as external surveys show that investment incentives are **of little importance** for the investment decision of MNCs for Romania, ranking only 25th out of 26 determinants in terms of importance.[1901] Interviews help to substantiate these findings. Experts agree that investment

[1893] Status November 2007; see also Brenscheidt (2006); PWC (2007); Intv. Germ. MNC - Consulting I (2007); Intv. Supranational Authority I (2007); Intv. Austr. MNC - Primary Goods II (2007).
[1894] See Intv. Romanian Authority I (2007); Intv. German Authority IV (2007).
[1895] See also Intv. Germ. MNC - Retail (2007); Intv. Germ. MNC - Legal Services I (2007).
[1896] See PWC (2007); see also Intv. Supranational Authority I (2007).
[1897] 1st: investments over €75M, 2nd: between €25M and €75M, 3rd: below €25M.
[1898] See also Intv. Romanian Authority I (2007).
[1899] See e. g. Intv. German Econ. Association III (2007); Stalfort & Partner (2006).
[1900] See e. g. Lankes and Venables (1996); Holland, Sass, Benacek, and Gronicki (2000).
[1901] See AHK (2006).

incentives are generally not very important for investors interested in Romania. Most MNCs interviewed invested in Romania even though incentives were rare and those MNCs that did receive financial incentives would probably have decided in favor of Romania anyway, even though they knew that most financial benefits would expire with Romania's accession to the EU.[1902]

In contrast, non-financial investment incentives may play an important role for the investment decision of MNCs. Good administrative support, the provision of infrastructure and an investor-friendly environment in some free zones and industrial parks were apparently an important factor in the decision for Romania in general and for specific locations within the country. This seems especially true for foreign investors who are risk-averse and have little previous experience in Romania, and who expect the staff of these zones and parks to overcome legal and administrative barriers in the early phase of the investment process.[1903]

(f) In the **assessment** of this section it seems that the Romanian government made the right-trade off by initiating the tax reform but eliminating exceptions and incentives at the same time. First of all, many of the incentives had not been in compliance with EU law anyway and most custom duties had already been eliminated years ago. Furthermore, it seems that the government realized that it had initiated its investment scheme too late in order to distinguish Romania from other locations since, for example, Poland and Hungary had already successfully established free zones in the mid-1990s.[1904] Incentive policy thus had only limited effect and the elimination of the incentives was an

[1902] See Intv. Germ. MNC - Legal Services II (2007); Intv. Austr. MNC - Primary Goods II (2007); Intv. German Econ. Association V (2007); Intv. Austr. MNC - Industrial Goods I (2007); Intv. Germ. MNC - Automotive (2007).

[1903] See Intv. Austr. MNC - Industrial Goods I (2007); Intv. Austr. MNC - Financial Services I (2007); Intv. Romanian Econ. Association I (2007); Intv. Germ. MNC - Legal Services I (2007); Intv. Romanian Authority I (2007).

[1904] See also OECD (2003c), p.180.

adequate way of increasing tax revenues and to foster the good ideas behind the tax reform and the flat tax.

Public policy should focus more strongly on the non-financial aspects of investment incentives. The positive experiences of some investors show that Romania still has a lot of potential in leveraging the investor-friendly environment and the administrative know-how in industrial parks – even though some state interviewees may somewhat overestimate the potential of industrial parks in Romania.

Finally, investment incentive policy seems to suffer from significant information gaps. Not only did companies know little about possibilities for receiving benefits for incentives that remain, but also the local Chambers of Commerce interviewed were not informed about investment schemes for investors and referred to the local and central government for further information.

(4) In **conclusion**, the determinants of the investment climate discussed in this section were identified only recently by Romanian public policy makers as a tool for promoting FDI and economic growth. However, the awareness of investment, tax and incentive policy of Romanian politicians has significantly increased in recent years, particularly since the signature of the EU accession treaty in 2005. Romania's efforts in reforming its tax system are widely seen as one of the most successful reforms in Romania's transition. In contrast, financial investment incentives were less successful and will continue to lose their importance in the following years. The analyses of company interviews in particular suggest that actual financial benefits have been less important for the attraction of FDI than the perceived investment climate (through investor-friendly bureaucracy and reform-oriented policy makers).

7.3.3.3 Croatia

(1) Croatia (a) did not follow a specific **investment policy** in the 1990s, but (b) some important initiatives have been launched since the early 2000s, (c) although some problems remain. The (d) investment policy seems to have little impact on FDI in Croatia. The findings are assessed in sub-section (e).

(a) Primary[1905] and secondary sources[1906] show (as for other determinants such as the land register previously) that domestic issues, primarily the war and its consequences, had **a greater priority** for Croatian public policy actors **in the 1990s than investment policy**. Since some investors were already coming to Croatia, mainly to the coast and to the Zagreb region, many politicians did not (as they did in Romania) see the need for an active investment strategy. Experts interviewed also agree that Croatia focused too much on brownfield investments and neglected the positive effects of greenfield investments, including the strengthening of exports.

Furthermore, parts of the government and the population still showed a negative attitude towards foreign investors at that time. Some unpopular measures by some early MNCs in 1990s such as restructuring, a de-investment after a short time or environmental issues (as in the case of Rockwall in Istria) increased political pressure against FDI in Croatia. Domestic companies with a strong lobby were often afraid of greater competitive pressure and of losing control.[1907] Nationalistic resentment against foreign investments, that arose as a result of the young statehood and the war experience, also played a role, for example, against potential investments Serbia and Italy.[1908]

[1905] See Intv. Germ. MNC - Engineering (2007); Intv. Croat. Company II - Legal Services (2007); Intv. Austr. MNC - Financial Services I (2007); Intv. Germ. MNC - Industrial Goods I (2007); Intv. Former Croatian Minister (2007).

[1906] See FIAS (2002); World Bank (2003); Hunya and Škudar (2006).

[1907] See e. g. Intv. Former Croatian Minister (2007); Intv. Germ. MNC - Engineering (2007).

[1908] Several disguised expert statements.

Despite this limited openness towards FDI, equal treatment of domestic and foreign investors was largely ensured by Croatian law even in the 1990s. As pointed out in *section 7.2.1.3*, Croatia's corporate laws from 1993 stipulates that domestic and foreign companies could conduct their business activities under equal conditions.[1909] In addition, the Croatian constitution guaranteed the free repatriation of profits and capital invested from Croatia. However, Croatian law foresaw a restriction for both domestic and foreign investors in some designated areas, mainly regarding land directly located at the coast and in national parks.[1910]

(b) **After 2000** Croatia introduced **a more active foreign investment strategy** with the Investment Promotion Act being the most visible tool.[1911] In the following years Croatia also adopted further regulations in order to promote investments from both foreign and domestic companies; the government under Prime Minister Sanader continued the work of its predecessor after 2003. The legal status and rights of foreign investors were confirmed and the number of restricted areas for investments was reduced. Furthermore, some key industries for FDI were identified by the Croatian government and APIU including the ICT, biotechnology, pharmaceuticals as well as the business services and logistics sector. In 2007 a new Investment Promotion Act came into force. Details are discussed below.[1912]

Croatia has concluded a large number of investment treaties (58 BITs). This is well above the average figure of 49 among EECs whilst still significantly less than Romania's 84 (*see figure 95 in the appendix*).[1913]

[1909] See Law no. 111/1993; see also APIU (2007).
[1910] See APIU (2006b); Dresdner Bank (2004), p.7; Croatian Chamber of Commerce (2007).
[1911] Law no 73/2000; see also Dresdner Bank (2004), p.7.
[1912] See Doc - Gov't. of Croatia (2006); Intv. Croatian Ministry II (2007); BA-CA (2005), p.23; Intv. Croatian Authority II (2007).
[1913] See UNCTAD BIT website (2008); OECD (2006a); own calculations.

Experts interviewed confirm that authorities have become more open towards FDI and MNCs since the early 2000s.[1914] From the investors' point of view Croatia's key politicians are more aware of the importance of FDI in general and "the government generally says the things investors want to hear"[1915]. Some communities in particular such as Varaždin seem to be very open to FDI.[1916] Most investors interviewed do not know of any significant aversion towards foreign investors in recent years. The attitude towards German and Austrian investors in particular seems to be very positive.[1917]

Overall, international surveys confirm that Croatia has reached a fairly good position in terms of non-discrimination and international investment cooperation with 4.25 out of 5 points behind Romania and Bulgaria but ahead of six other SEECs.[1918]

(c) **Remaining problems** of Croatia's investment policy refer to legal as well as to attitude issues. Primary and external sources see the need for some further legal adjustments of the investment policy framework since it is not currently aligned with the EU acquis such as the VAT reduction in tourism and regulations of the new Investment Promotion Act. Restrictions for investors in sectors such as energy, air, rail, maritime, and agriculture continue to exist.[1919] Property rights issues and the problems of the court system make experts interviewed skeptical as to what extent the national treatment of foreign investors can actually be enforced, particularly because of local interests discussed in earlier sections.[1920]

[1914] See Intv. Germ. MNC - Engineering (2007); see also Intv. Former Croatian Minister (2007).
[1915] Intv. Germ. MNC - Financial Services I (2007); see also Intv. Croatian Mayor (2007); Intv. European Institution (2007); Intv. Croatian Government Team (2007).
[1916] See Intv. Germ. MNC - Industrial Goods I (2007).
[1917] See Intv. Austr. MNC - Real Estate (2007); Intv. Austr. MNC - Retail (2007).
[1918] See OECD (2006a), p.50.
[1919] See European Commission (2005a), p.72; Doc - Gov't. of Croatia (2006); OECD (2006a), p.48; Intv. Croatian Authority II (2007); European Commission (2007a), pp.27-28.
[1920] See several disguised expert statements.

Worries about economic disadvantages for the Croatian job market and about the sellout of land to foreigners remain as well. However, skepticism towards MNCs seems to be prevalent only in some visible areas such as tourism, while the presence of foreign banks, for example, was hardly contested in recent years.[1921] In contrast, Serbian investment remains a sensitive topic. While the government calls for a positive attitude towards FDI from Serbia, more hostile statements were heard in the election campaign in fall 2007[1922] and from many local authorities: "It would be highly sensitive for a Serbian company to purchase a Croatian company"[1923].

Not only company and state experts interviewed but also external sources still see deficiencies regarding a clear strategy and commitment to FDI among many Croatian politicians, not to mention implementation plans for the target areas of FDI discussed above. Sometimes politicians seem to want FDI only in areas where domestic companies are not successful or where the state has no interests of its own.[1924] Some problems may also originate on the local level where authorities occasionally block (good) ideas of the central government and rarely develop investment strategies on their own.[1925]

(d) Interviews reveal that investment policy may have had a slight negative impact on FDI in Croatia in the past and is of **little importance** today.

FDI appears to have been negatively affected – as was also shown for Romania — by a sometimes hostile attitude towards FDI in Croatia in the 1990s,

[1921] See Intv. Austr. MNC - Construction (2007); Intv. Supranational Authority II (2007); Intv. Germ. Research Institute II (2007).

[1922] See Intv. Germ. Research Institute II (2007); see also European Commission (2007a), p.l3; OECD (2006a).

[1923] Intv. Supranational Authority II (2007).

[1924] See Intv. Austrian Econ. Association II (2007); Intv. Former Croatian Minister (2007); Intv. German Authority II (2007); Intv. Supranational Authority II (2007); Intv. Croat. Company II - Legal Services (2007); Hunya and Škudar (2006); Gallagher and Bozic (2006).

[1925] See Intv. Germ. MNC - Financial Services I (2007); Intv. Supranational Authority II (2007); Intv. Austr. MNC - Financial Services I (2007); Intv. European Institution (2007).

while the lack of a legal framework and a vision of investment policy was less important for MNCs. The more nationalistic tone, particularly in the years directly after the war and the stronger lobby of domestic firms than, for example, in Romania may have resulted in a deterrence of some investors, especially at coastal areas. Some interviewees believe that deficiencies of investment policy were among the reasons why Croatia failed to attract many large investors throughout the 1990s.[1926]

The increasing amount of positive experiences as well as the stronger political and legal support by the central government in recent years seem to have contributed to a change in the impact of this determinant in Croatia – despite the remaining problems. Investment policy may therefore be on the verge of becoming a neutral or even slightly enhancing factor for FDI in Croatia.[1927]

However, most experts interviewed agree that investment policy is only one of many measures for increasing FDI and economic development in Croatia overall.[1928] Company experts also bring forward that Croatia may have become more open towards FDI, but that these improvements are offset by a greater number of (foreign) competitors and higher real estate prices.[1929]

(e) In the **assessment** of this section it becomes apparent that Croatia's attractiveness for FDI in tourism made a decisive investment policy unnecessary for a long time. With increasing competition for FDI among SEECs, Croatian policy makers realized the need for a more active approach. The negative evaluation of the lack of investment policy and nationalist resentments by some interviewees may actually be too pessimistic; some large investors are present in Croatia after all (for example in telecommunications and banking) and aversion towards foreigners seem to be limited to particular areas (such as tourism) and

[1926] See Intv. Germ. MNC - Financial Services II (2007); Intv. Former Croatian Minister (2007); see also Intv. Germ. MNC - Engineering (2007).
[1927] See Intv. Austr. MNC - Primary Goods I (2007).
[1928] See Intv. German Authority III (2007); Intv. Croat. Company II - Legal Services (2007).
[1929] See e. g. Intv. Germ. MNC - Engineering (2007).

particular nationalities (mainly Serbs) which are also decreasing. Furthermore, Croatia's focus on a more indirect investment strategy including the establishment of a good infrastructure and a sound financial system may have been at least as important for future FDI inflows than an active investment policy.

Public policy should cooperate better with potential investors but should also deal with the remaining worries of domestic companies with regards to FDI. Public policy should also use education policy in order to overcome existing resentments and fears. As recommended for Romania, public policy should focus more on establishing an investor-friendly attitude and a clear commitment to FDI than on codifying investment policy. Finally, local authorities should adapt the insights of the central government and focus investment policy on greenfield instead of brownfield FDI.

(2) Regarding **tax policy** Croatia (a) introduced a widely praised tax system in the early 1990s which (b) is still quite competitive despite its dismantling since 2000. The tax policy (c) seems to be of only limited importance for Croatia as investment location. Sub-section (d) presents an assessment.

(a) **In 1994** Croatia introduced a tax system that was acknowledged both by external sources[1930] as well as by experts interviewed[1931] as **modern, simple and transparent**. It consisted of consumption-based personal and corporate income taxes. Therefore, company profits were only charged on equity income in excess of some "normal" profit, the so-called protective interest. Tax computation was based on the change in the value of equity and firms were allowed to deduct the costs of their equity financing.[1932]

(b) However, the tax system has been **corroded since 2000**. The government led by the Social Democratic Party (Socijaldemokratska partija Hrvatske

[1930] See Law no. 109/1993; see also Rose and Wiswesser (1998); Keen and King (2003).
[1931] See e. g. Intv. Austr. MNC - Real Estate (2007); Intv. German Econ. Association IV (2007).
[1932] See Keen and King (2003); Svaljek (2005).

(SDP)) believed that the old tax system was responsible for low tax revenues, a high government deficit and low investments. The restructuring of both income and corporate taxes included the elimination of the protective interest (in 2001).[1933] Furthermore, additional consumption taxes, exceptions and depreciation possibilities were also introduced in the following years by the subsequent government.[1934] However, experts continue to assess the tax system as fairly simple compared to Western European standards as well as to other EECs. No tax on capital gains or dividends has to be paid in Croatia, for example. Most regulations also seem to be already in line with EU requirements.[1935] The analysis of the *World Bank (2007b)* also shows that companies only have to make 28 annual tax payments for six different taxes in Croatia (compared to 96 for 15 taxes in Romania). Therefore, several experts interviewed point out that they do not see a need for Croatia to introduce a flat tax in order to become more competitive and transparent.[1936]

Nevertheless, Croatia's tax system is fairly negatively evaluated in external surveys. According to *AHK (2006)* German investors were only less satisfied with five out of 26 determinants in 2006. And the Global Competitiveness Report finds that tax regulations have been the 2nd to 4th most problematic factors for doing business in Croatia since 2004.[1937] Maybe this reflects the disappointment of the transformation of the tax system in recent years as well as the link to the performance of the (financial) administration which has already been evaluated as mediocre in *section 7.2.3.3* above.

[1933] See Keen and King (2003); World Bank (2003), pp.19-20; Svaljek (2005), p.1219.
[1934] See Intv. Germ. MNC - Financial Services I (2007); Intv. Austr. MNC - Real Estate (2007); Intv. Croat. Company - Utilities (2007); Intv. Germ. MNC - Telecommunications (2007); Intv. Croatian Government Team (2007).
[1935] See e. g. Intv. Austr. MNC - Real Estate (2007); Intv. Austr. MNC - Construction (2007); see also Doc - OECD (2007).
[1936] See e. g. Intv. Supranational Authority II (2007); Intv. European Institution (2007).
[1937] See World Economic Forum (2007) and earlier editions.

The corporate tax rate was reduced from 35% to 20% in 2000.[1938] Interviews[1939] as well as external sources[1940] show that MNCs are not very satisfied with the (corporate) tax rate in Croatia, where the statutory rate is 2.2% higher than the average rate in 18 EECs.[1941] However, a look at the total tax rate of Croatia (*figure 49*) reveals that the actual tax burden is quite low for firms in Croatia compared to other countries of the regions. A tax of 33% on profits represents the second lowest tax rate of 18 EECs.[1942] Interviews help to understand that some of the criticism of the Croatian tax rates are caused less by the corporate tax than by the income tax which is quite high (15-45%) and is further increased by regional and local surtaxes that may amount to 30% of the profit tax.[1943] Furthermore, the VAT rate of 22% is less competitive in neighboring countries such as Bosnia and Herzegovina (17%) and Serbia (18%).[1944]

(c) Overall, interviews and external sources show that the tax system as well as the tax rate have **only limited impact** on the investment decision of MNCs. For the 1990s external sources suggest that the few existing analyses give little evidence that the progressive tax system had either a significant positive or negative impact on FDI.[1945]

With respect to the current taxation conditions in Croatia, interviews suggest – as they did for Romania previously – that MNCs often have only little profits in the first years, they re-invest earnings in the investments or find ways to shift

[1938] See Hunya (2002), p.6; see also Intv. German Econ. Association IV (2007); Intv. Austr. MNC - Financial Services I (2007).

[1939] See Intv. German Econ. Association IV (2007); Intv. Austr. MNC - Real Estate (2007); Intv. Supranational Authority II (2007); Intv. Int'l Research Institute I (2007); Intv. Austr. MNC - Consulting (2007).

[1940] Among the five most deterring factors since 2002; see World Economic Forum (2007) and earlier editions; similar AHK (2006).

[1941] See World Bank (2007b); KPMG (2007); own calculations.

[1942] Only behind Montenegro; EECs averags 49%; see also World Economic Forum (2007).

[1943] See Intv. Germ. MNC - Financial Services I (2007); Intv. Germ. MNC - Telecommunications (2007).

[1944] See Dresdner Bank (2004), p.8; World Bank (2007b); APIU (2006b), p.45.

[1945] See e. g. Svaljek (2005).

profits internationally.[1946] Only single experts interviewed see some importance of this determinant, for example for SMEs.[1947]

Furthermore, it seems that MNCs are little aware of the advantages of Croatian tax policy. For example, none of the interviewees point out that the total tax rate is fairly low compared to most other EECs. This confirms the findings on Romania that the perception of the tax system is more important than the actual performance. Croatia is perceived as an average performing country in terms of tax policy in line with MNCs' expectations and the determinant is only of limited importance for their investment decision. This evaluation is also confirmed by external surveys, for example with Austrian investors[1948] according to whom taxation only has little impact on doing business in Croatia.[1949]

(d) In the **assessment** of this section, economists may wonder if the tax experiment of the 1990s was not abandoned too early to show sustainable successes. In contrast, none of the experts interviewed seem to regret the abolishment of the innovative tax system. Croatia has nonetheless been able to maintain some benefits over the years. In fact, Croatia is actually performing better than Romania in terms of tax policy even without a flat tax or low statutory corporate tax rate.

However, Croatian public policy needs to market of these benefits more effectively. At the same time it should curb other tax burdens, notable taxes and surtaxes on income and continue the reduction of administrative hurdles.

(3) The analysis of **investment incentives** in Croatia shows that (a) the old Investment Promotion Act (2000) provided a wide range of support for investments. Furthermore, (b) regional incentives were introduced. Nevertheless, (c)

[1946] See e. g. Intv. Germ. MNC - Telecommunications (2007); Intv. Germ. MNC - Engineering (2007).
[1947] See Intv. German Econ. Association IV (2007).
[1948] See Doc - Austrian Econ. Chamber Croatia (2006).
[1949] See similar: NCC (2004b), p.25; AHK (2006).

various general problems can be identified. The (d) new Investment Promotion Act (2007) aims at a more effective approach, but the (e) importance of this determinant seems to be limited for FDI overall. An assessment is provided in sub-section (f).

(a) Croatia's most important incentive tool in the past was the **Investment Promotion Act** (2000-2006). It provided incentives through exemptions, reductions and holidays on profit tax, VAT and customs. The profit tax was reduced to 10% for investments of at least €540K (and 10 new employees) and even to 0% for investments greater than €8.1M with 75 new employess.[1950] Incentives for both domestic and foreign investors were also granted for companies investing in large infrastructure projects (at least €1M), creating a large amount of new jobs (worth at least €10M) or re-educating and training new staff.[1951]

From the perspective of the interviewees the success of the Act was limited, because application procedures were strongly centralized and complicated. Regulations were also quite strict should the investor need to lay off employees; the MNC would then lose benefits for the entire period for which they were approved and would also have to reimburse received benefits plus interest. In addition to this, the minimum investment duration of ten years was seen as an obstacle. Finally, external sources point out that the legislation favored large investors rather than SMEs.[1952]

(b) Croatia also introduced **regional incentives**, mainly the concept of free zones and industrial parks in the early 2000s. The first free zones had already been established in 1997; the Free Zones Act unified several special regulations in 2002 and aimed at the promotion of export-oriented production.[1953] According to the Act, investors benefit from tax and customs reductions in free

[1950] See APIU (2006b), p.30; APIU (2006a), p.50; Intv. Croatian Ministry II (2007).
[1951] See Hunya (2002), p.6; Dresdner Bank (2004), pp.7-8; APIU (2006b), p.50.
[1952] See APIU (2006b), p.50; OECD (2003a), p.47.
[1953] See APIU (2006b), p.51.

zones that go beyond the incentives discussed above.[1954] Officially, 13 free zones are established, mainly at the sea side and rivers close to harbors. However, state experts interviewed concur that only six zone actually have production sites.[1955]

As mentioned previously, investors seem very satisfied with the conditions in Varaždin. However, in contrast to state experts interviewed, company experts point out that the benefit of Varaždin is less a financial one but driven – as already shown for Romania – by the commitment of some top officials who are responsible for a good administrative support of the authorities as well as for a good infrastructure including production facilities.[1956] Therefore, company experts clarify that other zones in Croatia with less senior support also tend to perform less well.[1957] Interviews also suggest that the (economic) success of Varaždin cannot be very representative since it is located close to Western European markets and has a strong industrial tradition.[1958]

Croatia has also enabled communities to establish industrial parks[1959] since 2000. A development program (2004-2007) foresaw the construction of industrial parks near all the larger cities by 2007, meaning that businesses were assured of infrastructure needs such as gas and electricity.[1960] Interviewees explain that differences in the quality among the 142 existing parks (2008) are enormous and an overall assessment seems impossible. State experts interviewed point out that industrial parks help to create more reliable conditions

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[1954] For investment greater than €136K pay investors do not have to pay any corporate income tax for five years; see Intv. Croatian Ministry II (2007); APIU (2006b), p.51.

[1955] See Intv. Croatian Ministry II (2007); Intv. Croatian Authority II (2007); see also APIU (2006a).

[1956] Other positive examples are Slavonski Brod and Rijeka; see Intv. Austrian Econ. Association II (2007); Intv. Germ. MNC - Industrial Goods I (2007).

[1957] See Intv. Austrian Econ. Association II (2007); Intv. Austr. MNC - Consulting (2007); Intv. Supranational Authority II (2007); Intv. Austr. Research Institute (2007).

[1958] See Intv. Former Croatian Minister (2007).

[1959] Also called business park, economic zone or entrepreneurial zone.

[1960] See also Doc - NCC (2007); Bfai (2004), p.28; Intv. Croatian Ministry II (2007).

for investors[1961] while others remain skeptical as to what extent the conditions can be maintained after an accession to the EU.[1962]

Croatia also developed six technology centers and nine centers for Entrepreneurship and Business Incubators as well as one biotechnology park (in Varaždin). Other regional incentive schemes were also adopted, including a reduction of the profit tax rate for investments in the mountain area, an exemption from profit tax in Eastern Slavonia for MNCs until 2012 and state funding for education programs in the same region.[1963]

(c) Despite all these opportunities, investors **do not seem entirely satisfied** with the options for state aid in Croatia. One reason for this may be that the multitude of investment policies is somewhat confusing for investors since they do not follow one single investment strategy.[1964] Many of the investment incentives are broadly defined and do not distinguish between the needs of domestic and foreign investors (for example regarding administrative support for foreigners including the translation of relevant documents etc.).[1965] External sources also see shortcomings in the coordination between public policy and the business community regarding potential incentive schemes.[1966]

Furthermore, investment incentives were often subject to modifications, for example, regarding various amendments to the Profit Tax Act and its clauses regarding tax reliefs related to employment, R&D and training.[1967] Local administrations have apparently not always been very supportive about giving out

[1961] See Intv. Croatian Ministry II (2007).
[1962] See Intv. Supranational Authority II (2007); Intv. Austrian Econ. Association II (2007); Intv. Austr. Research Institute (2007); see also APIU website (2008).
[1963] See Intv. Austr. MNC - Retail (2007); APIU (2006b), pp.25, 51; APIU website (2008).
[1964] See Intv. Austr. MNC - Retail (2007).
[1965] See also Intv. Croatian Ministry II (2007).
[1966] See European Commission (2005a), p.79.
[1967] See Doc - Gov't. of Croatia (2006); see also Intv. Austr. MNC - Real Estate (2007).

incentives. As a consequence of these deficiencies, several investors interviewed were unsuccessful in their application for larger incentives in Croatia.[1968]

International statistics seem to confirm this skeptical evaluation of Croatia's investment incentives. In the IMD World Competitiveness Yearbook Croatia ranks only 53rd out of 61 countries with regards to investment incentives and only slightly ahead of Romania (56th).[1969] This is confirmed by the survey among German investors presented in *AHK (2006)*.[1970]

(d) The **new Investment Promotion Act** shows that the government acknowledges the need for a more effective incentive approach. The new scheme is well aligned with the EU acquis and defines specific areas for investments instead of functions (such as real estate purchase, employment and training). Incentives are given to companies with manufacturing operations aimed at export, outsourcing, share center, and R&D activities. Profit tax reductions are basically in line with the former regulations. The goal of public policy makers is to attract FDIs of €1B annually based on the new Investment Promotion Act.[1971] Even though both interviewees and external sources agree that it is still too early to judge on the effects of this new Act, many experts remain skeptical because corresponding measures on the regional level are missing so far and incentives may not be generous enough to attract large amounts of greenfield investors.[1972]

[1968] See e. g. Intv. Germ. MNC - Food Products (2007); see also Intv. Austr. MNC - Retail (2007).

[1969] See IMD (2006).

[1970] Investment incentives are the 18th of 26 determinants in terms of satisfaction.

[1971] See Intv. Croatian Ministry II (2007); see also sub-section on investment policy.

[1972] See Intv. Austrian Econ. Association II (2007); Intv. German Econ. Association IV (2007); European Commission (2007a), p.32.

(e) Interviews[1973] but also surveys and FDI studies[1974] show that investors do consider incentives in their investment decision but the overall **impact** of Croatia's incentive policy on FDI **has remained limited so far**.

According to both company and state experts interviewed the result of the old Investment Promotion Act was rather disappointing.[1975] In all, less than 60 investors received incentives based on the Act. Half of these were service-oriented, whilst the other projects were industry projects with a less production-oriented focus such as R&D investments.[1976] The recent revision of the Act may have improved investment conditions, but Croatia has been unable to establish a comparative advantage over other countries of the region so far.

With regards to the free zones and industrial parks, interviews as well as data analyses show that the positive effects of their establishment has been limited despite the attraction of about 350 companies with about 7,500 employees. Firstly, many of these investors were domestic firms; secondly, investments remained focused on three or four zones and finally, the extent for which free zones will continue to function as an incentive for investors after Croatia's accession to the EU is not certain.[1977] Furthermore, interviewees point out that industrial zones are rather suited to promote business in Croatia in general, while the incentives appear to be too weak to actually attract investors. As a consequence, many industrial parks seem to be inactive.[1978]

[1973] See e. g. Intv. Germ. MNC - Engineering (2007); Intv. Austr. MNC - Real Estate (2007); Intv. Germ. MNC - Telecommunications (2007); Intv. German Authority III (2007); Doc - Germ. MNC - Food Products (2007).

[1974] Incentives were 19th of 26 determinant in terms of importance; see AHK (2006); see also CICD (2006), p.11; Lankes and Venables (1996).

[1975] See e. g. Intv. Croatian Ministry II (2007); Intv. German Econ. Association IV (2007).

[1976] See Intv. Croatian Ministry II (2007); see also Intv. Austrian Econ. Association II (2007).

[1977] See Intv. Croatian Ministry II (2007); Intv. Croatian Authority II (2007); APIU website (2008).

[1978] See Intv. Austrian Econ. Association II (2007); Intv. Croatian Ministry II (2007).

Finally, on the regional level invectives would have been interesting for several MNCs interviewed, but the lack of administrative support was apparently too high in several cases in order to receive significant state funding.[1979]

(f) In the **assessment** of this section it seems that Croatia initiated investment incentives very late in its transition process. Furthermore, the approach of the old Investment Promotion Act was probably too broad, since it was open to both domestic and foreign investors and did not focus on specific industries. Those incentives (with some exceptions, such as the free zone in Varaždin) had little success, because they tended to follow a patchwork strategy rather than a comprehensive approach and because many local administrations were not supportive enough (in contrast to some communities in Romania who assisted with bureaucratic problems etc.) to compensate for the limited attractiveness of the financial incentives. Until the expected EU accession Croatia may actually have the (legal) possibility to offer more attractive financial incentives than in most Eastern European EU member states; however, the new Investment Promotion Act does not seem to fully use this advantage.

Nevertheless, public policy will need to maintain the existing incentive scheme in order to avoid Croatia being given the reputation of being unsupportive of FDI. However, incentives will only bring rewards if investment policy becomes a more local matter and administrative structures significantly improve (using communities such as Varaždin as best practice). Finally, public policy needs to communicate existing investment incentives to potential investors more effectively. Interviews revealed that MNCs did not know much about Croatia's incentives or the different possibilities free zones or industrial parks offered.

[1979] See Intv. Germ. MNC - Industrial Goods I (2007); Doc - Germ. MNC - Food Products (2007); received some support for training in Slavonia: Intv. Austr. MNC - Retail (2007).

(4) In **conclusion**, the components of Croatia's investment climate determinant have developed in different directions, with investment policy and investment incentives improving and tax policy rather deteriorating (but remaining on a positive level) in recent years. However, none of the sub-determinants was used by Croatian governments as decisive tool for the attraction of FDI.

The awareness of the potential of public policy in this field has strongly increased but policy actors have not yet been able to close information gaps of MNCs and to implement sustainable strategies that distinguish Croatia from other economies in the region. However, the deficiencies outlined may have been compensated by improvements of other economic determinants including infrastructure and monetary stability. Croatia should continue to improve the improvement of the attitude of all politicians, bureaucracies and citizens towards any kind of foreign investment and work on the facilitation of doing business, particularly on the local level.

7.3.3.4 General insights for transition countries

Based on the analysis for Romania and Croatia and under consideration of further FDI studies several insights can be derived regarding the investment climate determinant for transition countries. They reflect (1) the importance and (2) performance of this determinant and allow for (3) some policy implications.

(1) The analyses of the **importance** of the investment climate and its sub-determinants show that more investor-friendly rules and attitudes as well as financial benefits have a positive but limited impact on FDI in transition countries. However, the impact of this determinant seems to depend on the investment phase.

In the first investment phase, when investors only vaguely consider several country options, interviews show that eye-catching reforms can be important in order to attract the interest of potential investors. In this context, the introduction of the flat tax, for example in Slovakia and Romania, are striking examples.[1980] Company experts confirm that the introduction of the flat tax already signalizes a business-friendly environment and a lean administration, even if the system is not flawless. Furthermore, the statutory tax rate seems to be more important than the total tax rate and the perception of the investment climate performance strongly depends on the country of comparison (either with the home country or with other EECs) which is also suggested by several FDI studies.[1981] Apparently this curiosity, that may be triggered by some outstanding investment climate reforms, often helps MNCs to narrow down the country selection to a few locations.

In the second phase of the investment decision, when this selection is scrutinized (often by site visits), it seems that the attitude of authorities both on the central and local level can be important for the investment decision of MNCs. This is especially true for investors who are active in regulated areas, for example in sectors related to natural resources.[1982] Investors appreciate an open mind towards foreign investors and a dynamic reform atmosphere, even if actual conditions are not yet codified or settled.[1983] Interviews also confirm the general finding of FDI literature that BITs do not seem to affect FDI flows.[1984] A low tax rate and investment incentives alone may only be a driving factor for some small investors who have short-term investment aspirations and that may be more flexible than large MNCs to relocate an operation once the investment expires.[1985] By contrast and in accordance with only a minority of FDI

[1980] See also Intv. Germ. MNC - Telecommunications (2007); Intv. Germ. MNC - Consulting I (2007); Intv. German Authority II (2007).
[1981] See e. g. Blonigen (2005); Bellak and Leibrecht (2005).
[1982] See e. g. Intv. Austr. MNC - Primary Goods I (2007).
[1983] See also Intv. Austrian Econ. Association II (2007); more emphasis on the importance of investment rules: Campos and Kinoshita (2003); Altomonte and Guagliano (2003).
[1984] Se e. g. Hallward-Dreimeier (2003); Blonigen and Davies (2004).
[1985] See also Intv. Germ. MNC - Industrial Goods II (2007); Intv. Germ. MNC - Legal Services II (2007).

studies[1986], tax rates and financial investment incentives seem to only make a difference for most MNCs, when all other legal, political and economic conditions are equal between two potential host countries.[1987] In fact data shows – in contrast to some of the findings from FDI studies[1988] – that countries with low total tax rates do not necessarily attract larger amounts of FDI than others, for example Latvia with 33% and €569 FDI inflows per capita versus Estonia with 49% and €954.[1989]

In a third phase, once MNCs are operating in the country, the administrative barriers seem to play an important role, for example regarding the complexity of the tax system. In contrast, corporate tax rates seem hardly important since MNCs often do not have profits in the first years and generally aim at long-term commitments. Few investors believe in sustainable tax rates considering that tax policy is a highly political issue and often changes quickly.[1990] It also seems that few investors will move to a different location because of a high tax burden or expired tax incentives, since re-location costs are significant for most MNCs and tax payments can be shifted internally.[1991] Nonetheless, MNCs are less likely to recommend the host country to other potential investors if the conditions in this phase are perceived as unsatisfactory.

(2) In the evaluation of the **performance** of this determinant it becomes apparent that the timing and success of investment strategies has strongly

[1986] Only limited or no effect on FDI: see e. g. Glickman and Woodward (1989); Graham and Krugman (1991); Wheeler and Mody (1992); findings with larger impact: see e. g. Swenson (1994); Scholes and Wolfson (1990); Cummins and Hubbard (1995); Moosa (2002), p.54.

[1987] See Intv. Germ. MNC - Telecommunications (2007); Intv. German Econ. Association V (2007).

[1988] See for references Hanson (2001), p.12.

[1989] Tax figures for 2007; FDI figures for 2006; see figure 49; see also Hunya (2007); already finding a fairly low sensitivity fo tax poliy and FDI: Hartman (1984) and Hartman (1985).

[1990] See Intv. Germ. MNC - Food Products (2007); Intv. Germ. MNC - Engineering (2007); Intv. Austr. MNC - Financial Services I (2007); see also Hines (1996).

[1991] See also Intv. Germ. MNC - Telecommunications (2007); Intv. Austr. MNC - Consumer Goods (2007); see also Hartman (1985); Hartman (1984).

varied across transition countries. While Romania and Croatia are examples for a rather late opening for FDI, other countries like Czech Republic and Hungary used the possibilities of investment policy from early on. The frequent change of investment legislation (especially in reference to taxation) may also have contributed to the perception that coherent investment strategies were missing in some of the transition countries (such as Romania and Croatia).[1992]

Today, it seems that many EECs offer quite attractive investment conditions, often even better than in Austria and Germany, particularly with respect to the tax burden.[1993] All transition countries guarantee equal treatment of foreign and domestic investors, protection against expropriation and free repatriations of profits. Exceptions to the national treatment have apparently decreased in most countries; the remaining issues generally concern property rights and land registers.[1994] With increasing EU integration the possibilities for transition countries to make the investment climate (for example regarding free zones) an important driver for the attraction of FDI further decrease.[1995] Furthermore, governments seem to suffer from the problem that reforms are watered down as shown for tax policy in Croatia in the early 2000s and for Romania only recently.

Furthermore, interviewees reveal that the success of investment climate determinants depends heavily on individuals, with attitudes of key politicians towards FDI, the work of financial authorities and the support by administration in overcoming bureaucratic obstacles (for example in free zones such as Curtici-Arad in Romania or Varaždin in Croatia playing a particularly impor-

[1992] See also Intv. European Institution (2007); Intv. German Authority II (2007); Intv. Austr. MNC - Real Estate (2007); Intv. Austr. Research Institute (2007).

[1993] See also Intv. Germ. MNC - Food Products (2007); Intv. Croatian Government Team (2007).

[1994] See OECD (2006a), p.45.

[1995] See also Blomström (2002); Intv. Austr. Research Institute (2007).

tant role).[1996] Especially in the early 1990s MNCs criticized resentments by local actors in various transition countries including the Czech Republic, sometimes because of nationalistic resentments but mostly because of economic concerns.[1997] In this context, state interviewees sometimes seem to underestimate the impact of local actors; they falsely assume that most of the competences related to the investment climate (such as taxation and incentives) are bound to the central level.[1998] In fact, locally established industrial parks seem to be among the most successful examples of incentive policy in transition countries. They seem particularly useful for risk-averse investors as well as if the transition country has a weak infrastructure, problems with property rights and if it owns many abundant assets, for example after a privatization.[1999]

(3) With respect to **public policy implications** the analysis of the investment climate indicates that governments often find good reasons not to act, as long as (some) investors are already coming without active investment policy. Investors may be attracted by low salaries (Romania) or natural resources (coast line in Croatia); but given the increasing competition among transition countries for FDI, public policy makers need to realize that these pre-conditions are not sufficient anymore and investment policy may be one possible lever in this context.[2000] Furthermore, governments need to keep present companies satisfied because – as the analyses have shown – they can strongly influence the decision-making process of further potential investors from their home countries.

Transition countries need to provide a minimum of acceptance towards FDI both on the central and local level. Public policy actors should then work on

[1996] See also Intv. Germ. MNC - Financial Services I (2007); Intv. Croatian Government Team (2007).
[1997] See Intv. Germ. MNC - Industrial Goods I (2007).
[1998] Disguised expert statement.
[1999] See e. g. Intv. Austr. Research Institute (2007); Intv. Romanian County Council (2007); Intv. Croatian Ministry II (2007).
[2000] See OECD (2006a); Estrin, Hughes, and Todd (1997).

the elaboration of long-term strategy (for example to avoid legal gaps like in Romania after the expiration of the Investment Act). A key success factor will be the further analysis of the current investment environment and the identification of best practices as benchmarks, for example for industrial parks, since interviews show that communities often do not know why some MNCs, that were interested in a location, do not end up investing. In this context, a stronger focus on specific industries or home countries of FDI or company groups (such as micro-enterprises) may be more helpful than a broad approach that comprises higher hurdles and a lower scope for investments (as in the old Investment Promotion Act in Croatia).

On the other hand, governments in transition countries should not rely too strongly on surveys and opinions of the business world that will – understandably – always aim for lower tax rates. Public policy should therefore evaluate the actual benefits of an incentive competition including tax reductions and investment incentives and take into account potential negative effects such as a decrease in tax revenues (Laffer curve) or a fizzling out of these measures if neighboring countries offer even better conditions. The success of the investment climate also depends on the right timing of reforms since EU integration provides a similar level playing field for most EECs. Only when public policy makers can introduce policies, for example, as first transition country (such as the flat tax in Slovakia) or in chronological distance to its competitors (such as the flat tax in Romania), is an investment strategy likely to cause sufficient awareness and generate a significant FDI boost. This aspect will also play an important role in the analysis of the subsequent determinant, privatization.

Finally, reforms and good performances only pay off if they are conveyed well to potential investors as Croatia's problems with its low total tax rate suggest.

7.3.4 Privatization

7.3.4.1 Definition

A successful privatization, the sale of former SOEs to domestic and foreign investors, is a key success factor for the economic growth of transition countries. This is particularly true when public policy alone has failed to reform and restructure these enterprises. From the perspective of investors, privatization sales are an attractive investment opportunity to reduce (some) market access risks and also to facilitate the search for available labor.[2001]

7.3.4.2 Romania

The analysis of primary and secondary sources reveals that Romania's **privatization** experienced significant problems. They were related to the (1) speed and timing, (2) institutional set-up and (3) methodology of privatization. Nevertheless, the sale of SOEs (4) is quite advanced today and (5) has played an essential role for FDI inflows to Romania overall. An assessment is provided in section (6).

(1) With respect to the **introduction and speed** of the privatization process, interviewees[2002] as well as external sources[2003] reveal that Romania was among the last transition countries to begin privatization in the 1990s and that the process here was particularly slow. *Figure 50* shows that not even half (45%) of the economic activity was in private hands in Romania by 1995. This was the lowest rate among (today's) ten Eastern European EU member states.

The privatization of large state monopolies was especially slow to start, particularly before 1995. During this period the Romanian government was

[2001] See Müller (2005), p.41; Cluse (1999), p.130; Belke, Baumgärtner, and Schneider (2005), p.25.

[2002] See e. g. Intv. German Econ. Association III (2007); Intv. Germ. MNC - Legal Services I (2007).

[2003] See EBRD (2007b).

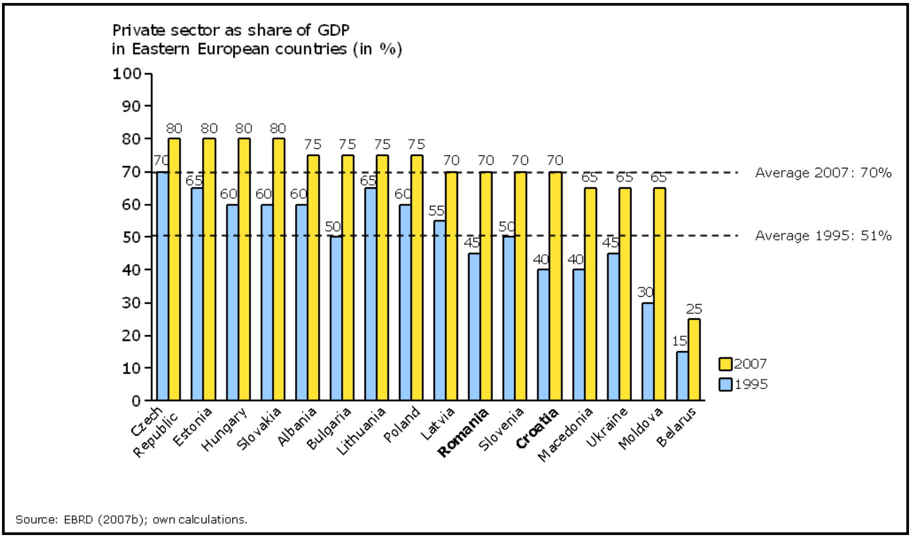

Figure 50: Development of private sector in Eastern Europe

criticized by international organizations for its inadequate response to the bankruptcy of many large SOEs. Romania received, for example, only 2 out 5 points in the EBRD transition indicator for large-scale privatizations.[2004] Some experts also point out that the Romanian government missed the chance for a "shock therapy" of a more painful but faster privatization in the early 1990s.[2005]

The sluggish start in the sale of SOEs had both legal and political reasons. Firstly, from the perspective of foreign investors, the legal framework for privatization remained incomplete and unclear for many years, even though a corporatization law was already passed in 1990.[2006] Thus until the mid-1990s foreign investors could only acquire 40% of shares of privatized companies. Fur-

[2004] See EBRD (2007b); see also Freedom House (1998); European Commission (1998), p.18; NBR (2002), p.13; Deloitte (2006), p.33.

[2005] See Intv. Germ. Research Institute I (2007); see also Maniu, Kallai, and Popa (2001), p.41.

[2006] See Law no. 15/1990; see also Intv. German Econ. Association V (2007).

ther legal restrictions, for example, with respect to the acquisition of real estate (*section 7.2.2.2*) also limited possibilities for privatization sales by MNCs.[2007]

Secondly, interviewees[2008] and external sources[2009] suggest that political reasons also prevented an active privatization policy in Romania for many years. As already touched upon in sections before, key politicians were afraid that privatization would lead to restructuring, higher unemployment and – in the end – less votes. Furthermore, some negative experiences with previous privatizations, in which both domestic and foreign investors had mainly acquired former SOEs because of their real estate value, also made politicians reluctant to give up control over the countries' assets.[2010]

Not only continuing economic problems in the mid-1990s, such as high inflation rates and government deficits, but also positive privatizations experiences in other transition countries and a change of government in 1996 led to a more active privatization approach in Romania since the mid-1990s.[2011] They resulted in better protection of investors, a change of the privatization method (see below) and a corresponding acceleration of the process as a whole. A first privatization wave of smaller companies took place in 1995/96.[2012] Large-scale privatization began in 1997 and banks were amongst the first institutions to be privatized (*see above section 7.3.1.2*).[2013] State interviewees in particular indicate that the increasing pressure of the EU led to a further push towards large-scale privatization after 2000. This led to some large non-financial privatizations, including that of the steel company Sidex (2001) and the telecom-

[2007] See Maniu, Kallai, and Popa (2001), p.37; Dresdner Bank (2004), p.21; Müller (2005), pp.79 and 171; Eckert (2007), p.245; Intv. Romanian Authority II (2007); Intv. Supranational Authority I (2007).

[2008] See e. g. Intv. Germ. MNC - Utilities (2007); Intv. German Econ. Association V (2007).

[2009] See e. g. Freedom House (1998); OECD (2005d).

[2010] See also Intv. German Econ. Association III (2007); Intv. Romanian Authority II (2007).

[2011] See Intv. Germ. MNC - Utilities (2007); Intv. German Econ. Association V (2007).

[2012] See Maniu, Kallai, and Popa (2001), p.42; Freedom House (1998).

[2013] See OECD (2005d), p.61; European Commission (2005c), p.34; European Commission (1998), p.18; Deloitte (2006), p.33; NBR (2002), p.13.

munications company Romtelecom (2002). The privatization peak was reached with the sales of Petrom (2004) and the BCR (2005/2006).[2014]

Experts interviewed bring forward contrasting evaluations of the overall timing of Romania's privatization process. A minority of experts points out that a delay of some privatization projects may actually have been beneficial for Romania. For example, since the BCR was among the last banks to undergo privatization in Eastern Europe, Romania was able to increase the awareness of potential investors and the bank realized a high sales price.[2015] Furthermore, a later privatization may have helped those involved to learn from past privatization mistakes in Romania, when very generous conditions had been offered to some investors (for example to Daewoo).[2016]

By contrast, the majority of interviewees emphasizes – in accordance with external sources as well as FDI literature[2017] – that the delayed privatization in Romania hampered economic growth. On the one hand, the lack of financing for the modernization of SOEs and the operation of these by state officials, who were often disinterested in the commercial success of the SOEs, often led to high losses and sometimes even to bankruptcies. On the other hand, the lack of FDIs meant that their often beneficial effects on productivity, growth, employment etc were lacking. (as discussed in the theoretical part of this thesis).[2018]

(2) The **institutional set-up** represented a **further problem** for the privatization process in Romania for many years. Between 1990 and 2002 alone eight privatization laws were passed. This meant that privatization-related institu-

[2014] See section 6.2.1; see also Intv. Supranational Authority I (2007); Intv. Germ. Research Institute I (2007); Intv. Austrian Econ. Association I (2007); Intv. Romanian Econ. Association II (2007).

[2015] See Intv. Supranational Authority I (2007); Intv. German Econ. Association III (2007).

[2016] See Intv. Austr. MNC - Legal Services (2007); Intv. Romanian Ministry IV (2007); Intv. Romanian Econ. Association II (2007).

[2017] See e. g. Mungiu-Pippidi (2001); Müller (2005); Eller, Haiss, and Steiner (2006); Eckert (2007).

[2018] See section 2.2.2; see e. g. Intv. Germ. MNC - Legal Services I (2007); Intv. Germ. MNC - Utilities (2007); Intv. Romanian Authority II (2007); Intv. Austr. Research Institute (2007); see OECD (2005d), p.30.

tional competences changed hands and were broadly distributed. A National Agency for Privatization was established in 1991, followed by the foundation of the State Ownership Fund and five Private Ownership Funds.[2019] However, some of the SOEs were also allocated to the Ministry of Economy, others to the State Ownership Fund, while the privatization of agricultural companies was decentralized. In 1997 the State Ownership Fund was placed under the authority of the Ministry of Reform but was later transformed into the Authority for Privatization and Administration of State Assets (APAPS). This received the status of a ministry in 2001.[2020]

Law no. 137/2002 led to a stronger streamlining of the privatization process since APAPS received the most important SOEs. After the sale of the bulk of the portfolio, in 2004 APAPS and the Authority for Valorization of Banking Assets were merged into the new Romanian Authority for State Assets Recovery (AVAS). Since the merger, AVAS coordinates the privatization of the remaining SOEs and newly liberalized sectors and supervises the post-privatization process. As a consequence of the smaller remaining number of companies, AVAS also absorbed the Privatization Office of the Ministry of Economy, including its portfolio (such as large utilities, energy, mining companies etc.) in 2007.[2021]

Interviewees acknowledge that the changing landscape of institutions has been necessary to some extent in order to cope with the developing portfolio of SOEs that Romania wanted to privatize. Nevertheless, it seems that the multitude of institutions and departments, particularly in the 1990s, strongly contributed to the slow rate of sales evolution. Experts interviewed also criticize the fact that the various privatization authorities tended to lack the legal competence and political power needed to accelerate privatization in Roma-

[2019] See Freedom House (1998); Bertelsmann Stiftung (2006c), p.12; Intv. Romanian Authority II (2007).
[2020] See European Commission (2005c), pp.104-105; OECD (2005d), pp.32-35.
[2021] See OECD (2005d), p.35-37; Deloitte (2006), p.33; Intv. Romanian Authority II (2007).

nia.[2022] *Intv. Romanian Authority II (2007)* also points out that privatization would possibly have been more successful if privatization authorities had been more independent and privately organized (as in Hungary), albeit under government supervision. From his perspective a private organization would have been an important precondition to avoid frequent political interferences in the work of the privatization authority and to be able to increase share capital, make investments etc.

(3) Romania has used various privatization **methods**, often combining several at the same time. The most important ones have been the voucher system, management and employee buy-outs, direct sales, and share issuing.[2023]

Vouchers were issued in two waves in Romania. In 1990/1991 and again – under the pressure of the IMF – in 1995/1996, Romania gave out vouchers to citizens for a direct subscription but also for shares in small-scale companies. This coupon privatization was the preferred method in the early phase of transition because the Romanian government was trying to prevent the sale of companies to strategic investors and the socially unacceptable measures that they expected from them.[2024]

According to interviewees and external sources, this method had little success because the transfer of the vouchers into company shares proceeded only slowly and the majority of the SOEs were not actually part of this mass privatization. Romanian citizens generally had little experience in exercising their shareholder rights and usually reassigned them to a higher level, mostly to one of the Private Ownership Funds. Since these Funds were run by state appointees, the actual privatization effect of this method remained limited in both voucher rounds.[2025]

[2022] See e. g. Intv. German Econ. Association V (2007); Intv. Supranational Authority I (2007); Intv. German Econ. Association III (2007); Intv. Romanian Ministry IV (2007).

[2023] See Intv. Supranational Authority I (2007).

[2024] See also Intv. Supranational Authority I (2007); Eckert (2007), p.247.

[2025] See Freedom House (1998); Maniu, Kallai, and Popa (2001), p.37; OECD (2005d), p.30; Eckert (2007); Intv. Romanian Authority II (2007); Intv. Supranational Authority I (2007).

In **management and employee buy outs** the staff affiliated with the company received priority rights in the sale of company shares on the market. This method, mainly used between 1993 and 1997, led to a large share of inside owners of Romanian companies, averaging 65% per company in that period.[2026]

Critics of this system point out that the (employee) shareholders generally had little management experience and no interest in restructuring companies. Furthermore, the capitalization of these shareholders was generally lower compared to that of outsiders and the Romanian government was often forced to financially assist these companies.[2027]

Romania also privatized some SOEs by selling minority shares of the state on the **stock market** since 1997, but large firms were not involved until 2001. This method, however, has been only rarely used; between 1993 and mid-2004 only 219 out of 7,566 privatized companies were sold on the capital market.[2028]

The analysis of the interviews reveals that the sales price of this method is less predictable and the preparation of the sale requires more work and effort than the former methods. Nevertheless, most experts interviewed make positive comments about this privatization method because of its transparency and the significant modernization of these companies before the public offering.[2029] Some experts conclude that Romania should have tried to sell more SOEs via the stock exchange.[2030]

Finally, Romania also used **direct sales** as a privatization method, either via negotiations or auctions. After the new government came to power in 1996, the use of this method strongly increased (particularly for the sale of large companies), although direct sales had been possible since the early 1990s. An important obstacle was removed in 2002 when the requirement of a minimum

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[2026] See OECD (2005d), p.30; Freedom House (1998).
[2027] See Eckert (2007), pp.251-252; OECD (2005d), p.30.
[2028] See Freedom House (1998); Eckert (2007), pp.251-252; OECD (2005d), p.30.
[2029] See Intv. Romanian Authority II (2007); Intv. Supranational Authority I (2007); Intv. Romanian Econ. Association II (2007).
[2030] See e. g. Intv. Supranational Authority I (2007).

sales price (determined by state authorities) was abolished and a sale for a symbolic price of one euro, mainly for bankrupt companies, became possible in 2002. Because of the guidelines of the EU, direct sales today are generally only possible through public tenders.[2031]

Both primary and secondary sources generally evaluate this method, particularly auctions, as the most effective and most successful privatization method for Romania.[2032] However, state experts interviewed agree that – from today's perspective – Romania was often too naive in previous negotiations by agreeing to very favorable conditions for buyers and low sales prices.[2033] Furthermore, according to various interviewees, some auction privatizations did not follow fully transparent rules even in recent years.[2034] One reason for the lack of transparency is the frequent change of the legal framework which represents a challenge for both buyers and state authorities.[2035] Some SOEs could have realized better terms, according to *Intv. Romanian Authority II (2007)*, if they had been sold through negotiations instead of public auctions. Nevertheless, interviewees clarify that the legal framework as well as compliance with the rules greatly improved in privatization auctions, also as a consequence of Romania's integration with the EU.[2036] Privatizations are more formalized and fulfill European standards most of the time.[2037]

In sum, many expert interviews suggest that some of the privatization methods that were used in Romania, particularly the voucher system and the management and employee buy-outs, prevented a faster transition of Romania's

[2031] Law no. 137/2002; see Eckert (2007), p.249; OECD (2005d) p.32.
[2032] See Intv. Austr. Research Institute (2007); Intv. Romanian Authority II (2007); Intv. Romanian Ministry IV (2007).
[2033] See Intv. Romanian Ministry IV (2007); Intv. Romanian Authority II (2007).
[2034] See Intv. Germ. MNC - Legal Services I (2007) and some disguised experts statements.
[2035] See Intv. Romanian Authority II (2007).
[2036] See Intv. Romanian Ministry IV (2007); Intv. Austr. Research Institute (2007); Intv. Romanian Authority II (2007).
[2037] See Intv. Austr. MNC - Financial Services II (2007); Intv. Germ. MNC - Utilities (2007); Intv. Romanian Authority II (2007); Intv. Supranational Authority I (2007); Intv. Austr. MNC - Legal Services (2007).

economy in the 1990s. The protection of the companies did little to help smooth the economic challenges caused by the breakdown of the centrally planned economy. Interviewees also agree that many larger privatizations in the 1990s did not follow modern, transparent privatization rules.[2038] In line with the interview findings, *OECD (2005d)* concludes that "Romania's choice of privatization methods has largely been responsible for the postponement of restructuring the economy and is a source of bad governance."

(4) Interviewees[2039] as well as external sources[2040] confirm that privatization is quite advanced in Romania **today**. Between 1992 and 1999 about 6,100 companies were privatized and about 1,400 have been privatized since then (*figure 51*).[2041] Sales volumes have been driven by large-scale privatization in recent years, mainly in the banking and energy sector with peaks in 2004 and 2006.[2042] The share of the private sector reached 70% of Romania's GDP in 2007. This is equivalent to the average of 16 EECs.[2043]

According to the EBRD transition indicator, Romania reaches 3.7 points (out of 5) both for large- and small-scale privatization. This gives Romania a good position particularly in terms of large-scale privatization in comparison to other EECs (average 3.3).[2044]

Nevertheless, a higher share of the private sector in other EECs, for example 80% in Czech Republic, indicates that Romania still has potential for further privatizations. With regards to small-scale privatization in particular, Romania seems to lag behind. Only Bosnia and Herzegovina and Belarus score lower

[2038] See Intv. German Econ. Association III (2007).
[2039] See e. g. Intv. German Econ. Association II (2007); Intv. Romanian Authority II (2007); Intv. Supranational Authority I (2007); Intv. Austr. MNC - Financial Services I (2007).
[2040] See e. g. Raiffeisenbank (2007); EIU (2007b).
[2041] See AVAS (2008); Intv. Romanian Authority II (2007); IMF (2006b), p.113.
[2042] See 6.2.1; Deloitte (2006), p.30; Larive Romania (2007), p.46.
[2043] See figure 50; EBRD (2007b).
[2044] See EBRD (2007b).

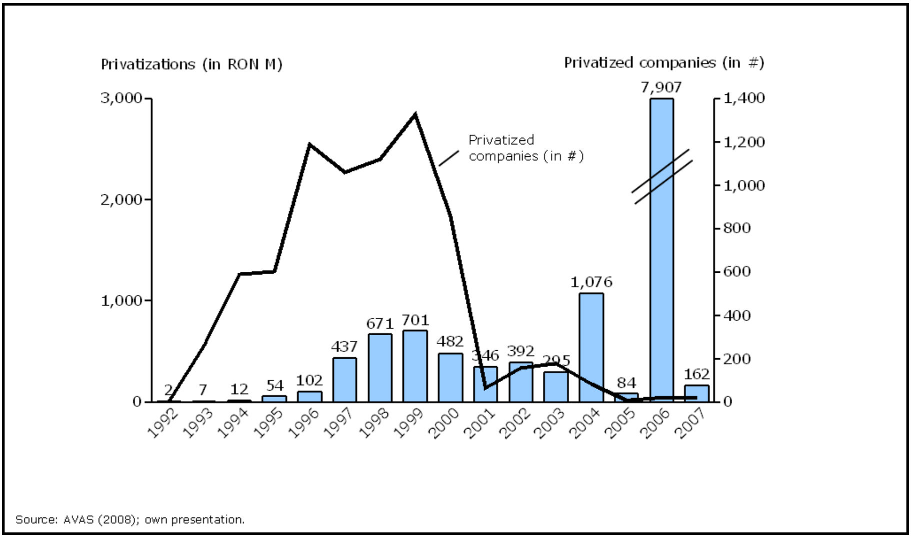

Figure 51: Privatizations in Romania

than Romania in the EBRD index.[2045] According to *Intv. Romanian Authority II (2007)* more than 1,000 (mostly small) companies are still waiting to be privatized, of which more than half are under bankruptcy and often with high debts and many employees. This weak performance of the remaining SOEs is also reflected in the enterprise restructuring index of the EBRD in which Romania scores 2.7 while the average of other Eastern European EU members is 3.24.[2046]

However, the peak for sales volumes has apparently been reached (*see section 6.2.1*) and AVAS has the task of finalizing the sale of its portfolio by 2008. AVAS assumes that only 400-450 companies (out of the about 1,000 SOEs left)

[2045] Average for small-scale privatization among 19 EECs: 3.95; see EBRD (2007b); see also OECD (2005d), p.30; Müller (2005); Bertelsmann Stiftung (2006a).

[2046] See EBRD (2007b); European Commission (2006e), p.15; Intv. German Econ. Association V (2007).

actually have a chance to be fully privatized. The state is a majority shareholder in about 60 of these.[2047]

From the perspective of several company experts interviewed, not many attractive SOEs are left. Some of the remaining parts of the energy sector (including the thermal and hydro power companies) could be attractive for investors.[2048] The CEC bank, formerly the most important private bank in Romania, could also become a target for privatization. A first sale was stopped in 2007 because the government was not able to find a buyer for the envisaged price. A privatization is now predicted not until 2009 following investments in the modernization of the bank.[2049] Most experts interviewed agree that it would have been better if the CEC had already been sold at the last opportunity as it is losing fast market shares as well as its most important advantage – the extensive and often exclusive presence in Romania's rural areas. Furthermore, the current investment in the modernization of the bank was not described as raising the CEC's prospects.[2050]

Further companies up for privatization are the pharmaceutical company Antibiotice, some chemical companies and, in the future, the waste and waste water providers on the local level.[2051]

However, a discussion has recently been resumed about the general benefits of privatization, mainly between the prime minister and the president. As a result AVAS achieved an interruption of the privatization in the energy sector in late

[2047] See Intv. Romanian Authority II (2007).
[2048] See Intv. German Econ. Association III (2007); Intv. Germ. MNC - Legal Services II (2007); Intv. Int'l Econ. Association (2007); Intv. Austr. MNC - Legal Services (2007); see also Intv. Supranational Authority I (2007).
[2049] See Mühlberger (2007); Intv. Romanian Authority II (2007); Intv. German Authority I (2007).
[2050] See e. g. Intv. Germ. MNC - Financial Services III (2007); Intv. German Econ. Association V (2007).
[2051] See EIU (2008); Intv. Romanian Authority II (2007); Intv. German Ministry (2007).

2006, the sector with the greatest political explosiveness and the authority is awaiting a new strategy of the government.[2052]

(5) Privatization has been a **significant factor for FDI inflows** to Romania.[2053] Interviews confirm the insight of general FDI studies (presented in the theoretical part of this thesis (*section 2.2.4.2*)) that the slow privatization, the difficult legal environment and the complex and poorly market-oriented approach did hinder higher FDI inflows to Romania in the first ten years of transition. Interviewees confirm that many privatizations at that time were mainly driven by interests for real estate, with the aim of avoiding major legal challenges in the land registration process.[2054] The analyses of this section also confirm the findings of *Holland and Pain (1998)* and others that direct sales are more attractive for MNCs and FDI than a voucher system.[2055]

Both interviewees and data presented in *section 6.2.1* confirm that the improvements in the privatization procedures became a major driver for FDI in Romania.[2056] FDI sales increased in recent years together with privatization sales volumes. Furthermore, the relative significance of foreign investors of Romania's privatization sales has risen from only 6% of sales (1992-1996) to 74% (2000-2004).[2057]

Several interviewees assume that FDI will decrease and fewer privatization sales are expected for the future. However some company experts interviewed also indicate that the improvements in the handling of privatization procedures had a significant (indirect) effect on FDI in Romania. Due to their experience, many authorities that were involved in the privatization process and in public tenders have become more efficient and more professional in their work and

[2052] See Intv. Romanian Authority II (2007); see also Mediafax (2006).
[2053] See also OECD (2005d), p.13.
[2054] See e. g. Intv. German Econ. Association III (2007); Intv. Int'l Econ. Association (2007).
[2055] See also Merlevede and Schoors (2004); see also Carstensen and Toubal (2004); Bellak and Leibrecht (2005).
[2056] See Intv. Int'l Econ. Association (2007).
[2057] Latest figures available; see OECD (2005d), p.32; see also Carstensen and Toubal (2004).

have generally become more open towards (foreign) investors. Therefore, even MNCs that are not engaged in a privatization tend to benefit from privatization in Romania.[2058]

(6) The **assessment** of this section shows that the bulk of privatizations was initiated late in Romania compared to most other EECs and suffered from many difficulties until only recently. Nevertheless, privatization has represented a key factor for Romania's economic and FDI growth. As already shown above, privatization also played a decisive role in the transition of the financial system.

However, a focus on privatization in recent years, coupled with a disregard of a sustainable investment policy, may have had a negative impact on the development within Romania. Since most privatizations took place in Bucharest and in a few formerly industrialized zones, other regions received little attention and investments leading to an increase of the regional development gaps.

State experts tend to see fewer problems in the transparency of privatizations in Romania in the past than company experts. However, company experts do acknowledge that it was in many cases reasonable to begin the privatization, in order to sell unprofitable SOEs and open protected markets to competition.

When evaluating the timing of privatization in Romania, it seems that those advocates who criticize the late privatization in Romania have the stronger arguments. It seems that an earlier privatization of large companies in particular would have contributed to faster productivity gains of Romanian companies and higher government revenues that would have helped to cope with the financial crisis at the end of the 1990s. This would have resulted in higher investments in sustainable projects such as infrastructure upgrades. In many cases an earlier privatization would probably have prevented the bankruptcy of some SOEs; due to the delay of many privatization a large amount of companies ended up in the hands of AVAS and have few chances of being sold in the near future.

[2058] See also Intv. Austr. MNC - Financial Services II (2007).

Public policy actors should quickly come to an agreement regarding Romania's future privatization strategy that enables a quick sale of the remaining SOEs including loss-making companies but also the CEC since it seems unlikely that state authorities will be able to prevent a further decline of market shares.

7.3.4.3 Croatia

Croatia has faced some important problems in terms of (1) speed, (2) institutions, and (3) methodology of privatization. However, only few areas are left for (4) further privatizations. This determinant (5) has been very important for FDI in Croatia and is assessed in sub-section (6).

(1) In comparison to Romania, Croatia **began** decisive privatization efforts even **later** and proceeded **more slowly**, at least in the early 1990s.[2059] In 1991 Croatia's private sector share accounted for 20% of GDP and made only a moderate climb to 40% by 1995, representing the third lowest rate of 16 EECs (*figure 50*). Large-scale privatization in particular proceeded (as in Romania) fairly slowly.[2060]

Interviews and external sources show that major reasons for the problems in the early phase of privatization in Croatia were the problems inherited from the Yugoslavian system, implications of the war, political factors, legal and bureaucratic issues, and the weak economic performance of many SOEs.

In contrast to many other socialist and communist countries, Croatian enterprises were not state but rather socially-owned (actually meaning employee-owned).[2061] This strong position of employees and managers continued after

[2059] See also World Bank (2003), p.123.
[2060] 3 out 5 points in the respective EBRD index; see EBRD (2007b).
[2061] Yet firms were controlled by party officials and production plans; see Law on the Transformation of Socially-Owned Companies (1991); see also European Commission (2004c), p.42; Doc - CPF (2001).

independence in 1991 and often prevented privatizations and sales to strategic investors.[2062]

The war period also led to an increasing number of sales to loyal partisans of President Tuđman. Therefore, the number of privatizations during this period was significant and two thirds of the 3,600 state and socially-owned enterprises were sold before 1996. However, only a small number of (domestic) "tycoons"[2063] benefited from the sales and the sales value that they generated totaled only 1.4% of GDP.

In line with the analysis of the investment climate (*see above*), interviewees show that political resentments against privatization sales only diminished slowly after the end of the war. At sites of special national interest, such as the coast, many politicians apparently want to prevent too many foreign privatization sales even today, despite equal rules for domestic and foreign investors.[2064]

Legal and bureaucratic problems, mainly related to ownership issues and acquisition conditions (including the maintenance of number of employees and the salary level), slowed the privatization of the remaining SOEs down in Croatia.[2065] Company experts interviewed also give examples with quite significant problems regarding the work of local authorities in the privatization process. Due to local and political interests, privatization deals have been pending for years or have led to long-lasting lawsuits, for example in the case of an Austrian investor in Slavonia, which lasted for ten years.[2066]

[2062] See Kušić (2001); World Bank (2003), p.123; Intv. Supranational Authority II (2007); Intv. Former Croatian Minister (2007); Intv. Germ. MNC - Industrial Goods I (2007).

[2063] World Bank (2003), p.85; see European Commission (2004c), p.42; Pommer (2007), p.116.

[2064] See Intv. Croatian Authority I (2007); Intv. Supranational Authority II (2007); Intv. Croatian Ministry II (2007); Intv. Austr. MNC - Financial Services I (2007); Intv. Former Croatian Minister (2007).

[2065] See Intv. Croatian Authority I (2007); Intv. Germ. MNC - Financial Services I (2007); Intv. Croat. Company - Utilities (2007); see also World Bank (2003), p.85; European Commission (2007a), p.20.

[2066] See Intv. Austr. MNC - Primary Goods I (2007); see also Intv. Germ. MNC - Software (2007); Intv. Germ. MNC - Engineering (2007).

Finally, profound economic deficiencies of SOEs have caused further privatization delays. Privatization preparations proceeded slowly, particularly in those industries in which extensive restructuring was necessary before a sale to investors including utilities and other large state monopolies.[2067] Furthermore, many SOEs did not recover from the war and went bankrupt. In 2000, for example, 56% of SOEs were operating at loss. Therefore, in some regions (most notably in Slavonia) and industries (such as steel mills, shipyards and railways), not many attractive SOEs were left for privatization after 1995.[2068]

The increasingly westward orientation which was also documented in the SAA (2001) and a more liberal investment policy (*see above*) led to increasing privatization efforts in Croatia. In 2002 an operational plan was adopted for the privatization of the remaining SOEs, although this plan is currently under revision.[2069] The banking sector represented the first target for large-scale privatizations, which began with Zagrebačka Banka (1995) and accelerated after the banking crisis in the late 1990s to include Slavonska banka (1997), Riječka banka (2000) and Privredna banka (2000). Large privatization deals in other industries followed, including Hrvatske Telekomunikacije (2000), INA (2003) and Pliva (2006) *(see section 6.3.1)* which are generally evaluated as success stories by both primary and secondary sources.[2070] The most recent privatizations are those of the steel plants in Split and Sisak.[2071]

In sum, experts interviewed, in line with external studies, make the criticism that privatization was carried out rather slowly in Croatia in the 1990s, in comparison to other EECs.[2072] Furthermore, privatization had the reputation

[2067] See KPMG (2001); European Commission (2007a), p.22.
[2068] See World Bank (2003), p.86; Intv. European Institution (2007); Intv. Croatian Mayor (2007); Intv. Croatian Authority I (2007); Intv. Germ. MNC - Telecommunications (2007).
[2069] See IMF (2006a), p.20; Raiffeisenbank (2006), p.13; CPF website (2008).
[2070] See also Hunya (2002), pp.5-6; European Commission (2005a), p.41; Intv. Germ. MNC - Financial Services I (2007); Intv. European Institution (2007); Doc - INA (2006).
[2071] See EBRD (2007a), p.26; Bfai (2004), p.74.
[2072] See also Kušić (2001); Dresdner Bank (2004), p.7.

of being "Wild West privatizations"[2073] or "robbery privatizations"[2074] during the war period. Even for the early 2000s external sources and interviewees comment that privatization proceeded more slowly than expected considering the delays regarding shipyards and agricultural privatization.[2075]

However, some experts interviewed also argue that privatization may actually have started too early in Croatia since the mishandling during the war led to negative economic effects and caused a strong frustration in the population.[2076]

(2) The **institutional arrangement** of privatization itself has been less of a problem in Croatia than, for example, in Romania. The responsibility for the privatization was mainly given to the Croatian Privatization Fund (CPF) that was founded in 1992 (Law no. 84/1992).[2077] It was given the task of steering, transforming and privatizing about 3,600 socially-owned enterprises into public companies.[2078]

Nevertheless, the CPF had to withstand strong pressures from politics, companies and also from unions (*see above*).[2079] The negative effects of this pressure became manifest in the CPF scandal in June 2007 in which most members of the management of the CPF had to resign and eight senior officials were arrested due to charges of accepting bribes and selling SOEs without legal bids.[2080] Interviewees criticize that the reaction of the government was still too tentative. Three ministers were on the supervisory board but did not have to bear any

[2073] Intv. Germ. MNC - Financial Services I (2007).
[2074] Intv. Austrian Econ. Association II (2007).
[2075] See Pommer (2007), p.147.
[2076] See e. g. Intv. Former Croatian Minister (2007).
[2077] Ministry of Economy with some influence; see Intv. Germ. MNC - Financial Services II (2007).
[2078] See European Commission (2004c), p.42; OECD (2005c), p.22.
[2079] See also World Bank (2003), p.85; EBRD (2007a), p.19; European Commission (2007a), p.20.
[2080] The so-called Operation Maestro; see e. g. European Commission (2007a), pp.20, 50.

consequences.[2081] Furthermore, observers seem to start asking about the extent to which corruption may have played a role in other privatizations as well.[2082]

(3) As in Romania, several privatization **methods** have been used in Croatia in recent years, most importantly management and employee buy-outs, direct sales, and share issuing. They have mainly been based on the Privatization Act of 1993, which has been amended several times.[2083]

The **management and employee buy-out** was the method most frequently used in Croatia between 1991 and 1996 and reflected the gradual transition from the system of socially-owned firms. These insider sales often came along with large discounts and installment schemes which put further pressure on the government budget. Moreover, many employees sold back their shares to the state because they were defaulting or anticipating the bankruptcy of the company.[2084]

Interviewees confirm the evaluation of external sources that the strong position of managers and insiders was a major burden for Croatia's economic development towards a market economy. They emphasize that employees have a very strong controlling power in many Croatian companies, including significant influence on benefits (such as holidays) and good wages.[2085]

As mentioned above **direct sales** (both by public tenders and negotiations) were already used during the war when influential investors acquired companies and assets at very low prices. Starting at the end of the 1990s, large state monopolies and strategic assets such as banks were also often sold through public tenders. Today, it is the most common form of privatization in Croatia (together with share issuing).[2086]

[2081] See Intv. German Authority II (2007); Intv. Supranational Authority II (2007).
[2082] See Intv. German Econ. Association IV (2007); Intv. Austr. MNC - Construction (2007).
[2083] Laws no. 21/1996, 71/1997 and 73/2000; see also European Commission (2004c), p.42.
[2084] See Kušić (2001); World Bank (2003), p.87; Brada, Kutan, and Yigit (2003).
[2085] See e. g. Intv. Supranational Authority II (2007); Intv. Germ. MNC - Telecommunications (2007); see also World Bank (2003), p.123; European Commission (2004c), p.42.
[2086] See World Bank (2003), p.85; European Commission (2004c), p.42.

Interviewees criticize that the direct sales during the war had negative effects on management, strategy and operations of the company but also on the economy as a whole because these investors invested neither capital nor ideas; as a result, the companies' economic performance quickly deteriorated before they were sold again. Furthermore, these powerful individuals still play a major role in Croatia's politics and economy today. By contrast, Croatia has received increasing appreciation for the use of this method by international organizations in recent years, for example in the context of the privatization of utilities and banks.[2087]

Share issuing was used for the first time with the listing of the Zagrebačka Banka in 1995 and of Pliva in the following year as discussed in *section 7.3.1.3*. Further examples followed (including INA in 2006) in which initial public offerings were used for gradual privatizations, particularly in the case of large companies.[2088]

Interviewees tend to be most satisfied with this privatization method. The generally transparent procedures have apparently increased the number of strategic investors as well as the credibility of Croatia's economy and administration.[2089]

Overall, expert interviewees[2090] as well as secondary sources[2091] state that the problematic use of some privatization methods in the 1990s, most notably of the management and employee buy-outs and direct sales to loyal partisans, promoted corruption and substantially harmed the reputation of the Croat-

[2087] See Intv. Germ. MNC - Financial Services I (2007); Intv. Supranational Authority II (2007); Intv. Austrian Econ. Association II (2007); Intv. Germ. MNC - Telecommunications (2007); Intv. Austr. MNC - Construction (2007); see also World Bank (2003), p.124; European Commission (2004c), p.42.

[2088] See e. g. EBRD (2007a); European Commission (2007a).

[2089] See Intv. Croat. Company - Utilities (2007); Intv. Germ. MNC - Financial Services I (2007); Intv. Croatian Ministry II (2007).

[2090] See e. g. Intv. Germ. MNC - Telecommunications (2007); Intv. Austr. MNC - Construction (2007); Intv. Germ. MNC - Financial Services I (2007).

[2091] See e. g. Kušić (2001); Grupe and Kušić (2005), p.3.

ian economy. These problems apparently also led to continued problems in the market structure of Croatian companies and competition issues like large monopolies. However, procedures now seem to be fairly transparent and mostly in line with EU rules in recent years.

(4) **Today**, 16 years after its independence, Croatia's privatization is fairly advanced. About 1,200 companies were sold out of the portfolio of the CPF between 1993 and 1999 and about 1,000 between 2000 and 2007. The private sector share reached 70% in the same year (as in Romania).[2092] Small-scale privatization is very advanced (4.3 points of the EBRD index in 2007) and Croatia is therefore among the leading nine EECs since 1996.[2093] In contrast, large-scale privatization is somewhat weaker, reaching 3.3 in the EBRD index which is equivalent to the average of 19 EECs.[2094]

The CPF's goal to sell off the remaining 880 SOEs (of which 100 are majority-owned by the state) has been postponed from 2007 to 2009, also due to the turmoils following the CPF scandal.[2095] The CPF also faces the problem that a large share of these companies continues to make losses and is thus difficult to privatize.[2096] The continued need for investments and restructuring of remaining SOEs is also reflected in the mediocre EBRD score for enterprise restructuring of 3 points in 2007.[2097]

From the perspective of the interviewees the most attractive companies were privatized by the early 2000s and there are few remaining opportunities.[2098] Important remaining objects for privatizations have already been discussed in

[2092] See figure 50; see also EBRD (2007b); Bertelsmann Stiftung (2006b), p.1; see Misak (2001); Intv. Croatian Authority I (2007); Doc - CPF (2001).
[2093] See EBRD (2007b).
[2094] See EBRD (2007b).
[2095] See CPF website (2008); see also IMF (2006a), p.18; EBRD (2007a) p.24; European Commission (2007a), p.20; Intv. European Institution (2007).
[2096] See Intv. European Institution (2007); Intv. Austr. MNC - Retail (2007).
[2097] See EBRD (2007a), p.26; see also European Commission (2007a), p.22.
[2098] See Intv. Croatian Mayor (2007); Intv. Germ. MNC - Engineering (2007); Intv. Germ. MNC - Financial Services I (2007).

section 6.3.1 including the shipyards, the finalization of the privatization in the telecommunications sector, some parts of the energy sector, companies in the agricultural but also in the tourism sector as well as in local infrastructure.[2099] Experts interviewed see less chances for a complete privatization of the Croatian energy company, Hrvatska Elektroprivreda and the remaining pharmaceutical companies.[2100]

(5) The **importance** of the privatization for FDI inflows to Croatia has been very significant – both in positive and negative terms. Interviewees agree with external studies that the poor privatization environment and the slow progress in the 1990s was a major deterrent for many MNCs. At that time the slow privatization process represented a disadvantage for Croatia as an investment location. Furthermore, the preference given to insiders and partisans as well as certain resentments about the influence of foreigners during and directly following the war appear to have been a reason for lower FDI inflows as well.[2101] Moreover, interviewees confirm that legal and political obstacles in the privatization process were a major constraint in the investment decision of many MNCs.[2102] Nevertheless, several interviewees point out that the unstable legal and political conditions of the 1990s including the difficulties in establishing a company and registering property (*see above*), made privatizations (even though their number was limited) still more attractive to many investors than, for example, greenfield investments.[2103] In fact, 65% of the accumlated FDI inflows were privatization-related in the period 1993-1999.[2104]

[2099] See CPF website (2008); EBRD (2006a); IMF (2006a), p.4; EBRD (2007a), pp.5, 15; Intv. Croatian Ministry II (2007); Intv. Supranational Authority II (2007).
[2100] See e. g. Intv. Supranational Authority II (2007); Intv. European Institution (2007).
[2101] See Intv. Supranational Authority II (2007); Intv. Germ. MNC - Industrial Goods I (2007); Intv. European Institution (2007); see also Kušić (2001); European Commission (2004c), p.40.
[2102] See Intv. Croatian Authority I (2007); Intv. Germ. MNC - Industrial Goods I (2007).
[2103] See Intv. Croatian Ministry II (2007); Intv. European Institution (2007).
[2104] See Hunya (2000); own calculations.

In the late 1990s, privatization increasingly became a major enhancing factor for FDI flows to Croatia. Particularly due to the large-scale deals in the early 2000s, privatization visibly became a major driver for FDI as shown in *section 6.3.1*.[2105]

Furthermore and as in Romania, it seems that privatization has also had an important indirect effect on FDI since the improving transparency, notably after 2000, helped to boost the credibility of Croatia and the Croatian economy.[2106]

(6) In the **assessment** of this section it becomes apparent that Croatia's starting conditions for privatization were far more difficult than in many other EECs in the first years of transition due to the low level of state assets, the legal heritage and the war experience. Privatization also suffered from an inconsistent strategy and strong political pressure on the decision-makers. As a consequence the mediocre work of the CPF was not more successful than, for example the performance of the many Romanian privatization authorities, despite its more favorable institutional set-up.

A main deficiency of the CPF was its failure to restructure SOEs more successfully. Furthermore, it seems that the insider privatization and the preferential treatment of some partisans often led to inefficient companies and may therefore also have contributed to the high structural unemployment rate Croatia has to deal with until today (as discussed in *section 6.3.1*). The analysis of this suggests that the long-lasting impact of these mistakes of the 1990s are often underestimated by both companies and foreign public policy makers today.

Recent privatizations have been more transparent and successful and represent an important step for a mature market economy striving for EU accession.

[2105] See Intv. European Institution (2007); Intv. Croatian Ministry II (2007); Doc - CPF (2001); see also European Commission (2004c), p.40; Brada, Kutan, and Yigit (2003).
[2106] See e. g. Intv. Croat. Company - Utilities (2007).

The small number of privatizations in recent years causes only limited worries about potential dependence on a small number of investors as in the 1990s; current MNCs rather seem to aim at long-term investments, and the positive benefits of their commitments are generally confirmed by both foreign and domestic interviewees.

Nevertheless, Croatian public policy should counter potential monopolies by maintaining a strong competition framework (in line with the EU and including a strengthening of the court system), accelerating small- and large-scale privatizations and promoting entrepreneurship by facilitating market access and creating more attractive incentives for both foreign and domestic investors (*see above*).

7.3.4.4 General insights for transition countries

The analysis of privatization policies in Romania and Croatia as well as the consideration of further FDI studies allow for some general insights regarding (1) the importance and (2) performance in transition countries. Some public policy implications are presented in sub-section (3).

(1) The analyses for Romania and Croatia confirm the insights of various empirical studies presented in *section 2.2.4.2* stating that privatization policy has been of **very great importance** for FDI in transition countries. While exact figures of the privatization share of FDI in EECs are not available, most studies suggest that at least half of the Eastern European FDI stock is privatization-related even though the peak of privatization sales has been reached in most countries (including Romania and Croatia).[2107]

However, analyses have shown that the private sector share and annual privatization sales – as suggested by various FDI studies[2108] – are less appropriate

[2107] See e. g. Holland, Sass, Benacek, and Gronicki (2000); Hunya (2000); UNCTAD (2005).
[2108] See e. g. Lansbury, Pain, and Smidkova (1996); Barrell and Holland (2000); Smarzynska (2002); Bellak and Leibrecht (2005).

indicators in order to measure the impact of privatization on FDI than several other privatization determinants discussed in this section.[2109]

Firstly and most importantly, the political and social willingness to accept privatizations in general and acquisitions from foreigners in particular are decisive for FDI.[2110] For example, economic and nationalistic resentments in both Romania and Croatia were probably the most important obstacles for an early and open privatization policy and also affected the legal environment for foreign investors (such as restrictions in certain areas). In other EECs, for example in Hungary, a more open approach in the early 1990s also contributed to higher FDI inflows in the same period. While frequently quoted by interviewees, this aspect is not generally considered by FDI studies as important privatization factor.[2111]

Secondly, interviews[2112] confirm the insights of several empirical studies[2113] that the method of privatization is essential for the impact on FDI in transition countries. Direct sales (through auction) seem to be the best form for attracting FDI followed by stock issuing. The latter seems to be somewhat less preferable since it is often used when a certain investor is already envisaged as potential owner. By contrast, voucher and insider privatizations as well as management and employee buy outs seem to have a deterring effect on MNCs. Therefore, countries using these methods in the early 1990s, such as Romania and the Czech Republic, apparently had lower privatization revenues from MNCs during that period.[2114]

[2109] See also Holland and Pain (1998).

[2110] See Intv. Supranational Authority II (2007); Intv. Austr. MNC - Primary Goods II (2007); see also Sinn and Weichenrieder (1997).

[2111] See, however, Brada, Kutan, and Yigit (2003).

[2112] See e. g. Intv. Germ. MNC - Telecommunications (2007); Intv. Supranational Authority I (2007); Intv. Romanian Ministry IV (2007); Intv. Germ. MNC - Financial Services I (2007).

[2113] See e. g. Holland and Pain (1998); Carstensen and Toubal (2004); Merlevede and Schoors (2005).

[2114] See also Smarzynska (2002); Brada, Kutan, and Yigit (2003); Toubal (2004).

Thirdly, the analyses of this section also reveal (although this aspect tends not to be covered by FDI studies) that the work of the privatization institutions may – at least indirectly – affect the decision of foreign investors to participate in privatizations in transition countries. Coordination problems among the various institutions responsible for privatization (as in Romania), the low levels of transparency of the decision-making process (as in Croatia) as well as the problems in restructuring SOEs (in both countries) decreased the attractiveness for MNCs to invest in these countries.[2115]

Finally, some important interdependences can be identified. An attractive privatization policy only seems to be enhancing factor for a larger number of foreign investors if a certain macro-economic stability (as in Poland in 1992 when the stabilization program kicked in)[2116] and a minimum of legal standards is achieved. Legal factors such as property rights and legal certainty actually seem to have been even more important as determinants for the investment decision for many MNCs in EECs in the 1990s than privatization policy was.[2117] Furthermore, privatization policy can also have a positive impact on greenfield investments (as shown above) when a more progressive privatization strategy comes along with a more investor-friendly environment and more transparent bureaucratic procedures.[2118]

(2) The **performance** of privatization policy has strongly differed across transition countries. Most CEECs apparently started privatization faster and more effectively than SEECs and European CIS.[2119] By 1995 the private sector

[2115] See e. g. Intv. Germ. MNC - Financial Services II (2007); Intv. Austr. MNC - Construction (2007); Intv. German Econ. Association V (2007).
[2116] See Altomonte (1998).
[2117] See also Genco, Taurelli, and Viezzoli (1993); Savary (1997).
[2118] See Intv. German Authority II (2007); Intv. Austr. MNC - Real Estate (2007); Intv. Germ. MNC - Consulting I (2007); see also Brada, Kutan, and Yigit (2003); Holland, Sass, Benacek, and Gronicki (2000).
[2119] See for country group definitions: section 3.1.1.

share of the first group had already reached 61%, but only 47% in SEECs and 30% in European CIS (*figure 50*).[2120]

The speed and success apparently strongly depended on the method of privatization, whereas CEECs focused more strongly on direct sales even in the early phase of transition, while SEECs (as shown for Romania) rather relied on insider privatizations as well as management and employee buy-outs in the early 1990s (as in the former Yugoslavian countries).[2121] CEECs were also more active in large-scale privatizations in the early 1990s. The eight CEECs reached an average score in the respective EBRD index of 3.21 in 1995, whilst the eight SEECs only reached 1.75.[2122]

However, SEECs significantly accelerated privatization efforts in the late 1990s and are – unlike European CIS – more or less on the level of CEECs today.[2123] Accordingly, the private sector reached an average of 76% and 71% of GDP in CEECs and SEECs respectively (while the European CIS are still trailing with 52%).[2124]

Large-scale (3.95 out of 5 points) and small-scale privatizations (3.33) are on average quite advanced in EECs, while the greatest problem remains enterprise restructuring averaging 2.72. As in Romania and Croatia, privatization authorities apparently still have many loss-making companies in their portfolio for which they have problems in finding adequate buyers.[2125]

(3) Several **public policy implications** can be drawn for privatization policy in transition countries. Privatization has been necessary and useful for tran-

[2120] SEECs without Serbia, Montenegro and Bosnia and Herzegovina; see EBRD (2007b); see also Lankes and Venables (1996); Holland, Sass, Benacek, and Gronicki (2000).
[2121] Czech Republic and Slovakia also with strong focus on voucher privatization in early phases; see Holland, Sass, Benacek, and Gronicki (2000); see also World Bank (2003), p.85; Brada, Kutan, and Yigit (2003); Broadman, Anderson, and Claessens (2004), pp.224-226.
[2122] The three European CIS with 2.22; see EBRD (2007b).
[2123] See also Brada, Kutan, and Yigit (2003)
[2124] See EBRD (2007b); see also Broadman, Anderson, and Claessens (2004), p.252.
[2125] See EBRD (2007b); see also Broadman, Anderson, and Claessens (2004); Intv. Supranational Authority II (2007); Intv. European Institution (2007).

sition countries but the analyses show that higher private sector shares and privatization sales do not necessarily generate higher FDI inflows per se. They also do not automatically lead to higher competition, lower product prices or higher quality in transition economies. Therefore, public policy actors need to consider certain prerequisites in order to benefit from privatization.

Public policy makers should accept privatization as a top priority for the creation of a favorable investment environment. Given the highly sensitive nature of privatization, even more than investment climate (*discussed above*), public policy should work towards full political support of a consistent and transparent privatization strategy free from resentments and local interests.

Public policy should focus on direct sales and stock issuing – even before transition countries enhance EU integration – since these methods tend to decrease possibilities of corruption and generally increase the number of reliable and strategic investors. Other methods, such as voucher privatizations, often lead to inefficient company structures and are not necessarily more socially acceptable.

Privatization should be organized through a single authority whose work is based on a strong legal framework and is ideally privately organized (with government supervision) in order to act flexibly. Employees of the authority and the officials restructuring SOEs should be renumerated based on an incentive-oriented salary scheme which rewards a quick sale of healthy and competitive companies.

Public policy needs to provide economic structures that can successfully cope with the effects of large privatized companies in the hand of strategic investors; they need to exploit the possibilities of competition policy but also anticipate potential restructuring, for instance, by strengthening re-education measures (*see below*).

With these conditions fulfilled, governments should not hesitate to privatize remaining SOEs as quickly as possible without awaiting the opportunity for better deals (as discussed for Romania) since the risks and negative effects (on company, employees and consumers) outweigh the potential benefit of a higher sales price.

Finally, public policy makers have to realize that their influence on economic measures is shrinking with the continued sale of state assets. Therefore, governments need to focus more on the facilitation of greenfield investments, also by a stronger investment promotion of their countries.

7.3.5 Investment promotion

7.3.5.1 Definition

In order to promote investments, public policy makers may attempt to improve the awareness and knowledge of transition countries. Investors may be attracted in particular by direct promotion efforts of central and local politicians, an effective investment promotion agency as well as by a positive image of the country.[2126]

7.3.5.2 Romania

With respect to **investment promotion** in Romania, interviewees show – although the insights of FDI literature regarding this subject are rare – that (1) the commitment of politics has varied from government to government and (2) that the impact of Romanian Agency for Foreign Investments (ARIS) has been limited. The (3) image of Romania has been rather negative abroad but is improving in recent years and (4) the impact of investment promotion seems to

[2126] See Wells and Wint (2000); Loewendahl (2001); Cho (2003); UNIDO (2003); OECD (2003c); Rajan (2004).

be quite significant for the attraction of FDI in Romania overall. An assessment of the findings is presented in sub-section (5).

(1) Interviews suggest that an active investment promotion barely existed in Romania in the 1990s. **Governments** did not see the need for promoting the country abroad and no coherent **strategy** was established.[2127]

With increasing reform efforts aiming at EU accession, politicians apparently acknowledged the necessity to campaign for Romania, mainly in political terms in order to gain support for EU membership (*section 7.4.4*) but also in economic terms since the competition among EECs for investors became more intense in the early 2000s.[2128] Most interviewees agree that the government of Prime Minister Năstase (2000-2004) was the first one that accepted the task of a more active investment promotion. Thus several members of the cabinet themselves were actively canvassing potential investors, for example, by several trips abroad to fairs. The prime minister came to Germany three times within four years in order to speak to potential investors. Roadshows organized by the embassies also increased at that time.[2129]

Following the change in government (2004) most interviewees agree that investment promotion has decreased again.[2130] This is exemplified by less promotion visits abroad – Prime Minister Popescu-Tăriceanu did not come to Germany for investor talks until mid-2007 –, and by the experience of MNCs that the access to ministers has become more difficult.[2131] Reasons for this development may be different policy priorities, but also the ongoing political

[2127] See Intv. Germ. MNC - Consulting I (2007); Intv. Austr. Research Institute (2007); Intv. Germ. Research Institute I (2007); Intv. Romanian Ministry I (2007).

[2128] See Intv. Germ. MNC - Consulting I (2007); Intv. German Econ. Association II (2007).

[2129] See Intv. German Econ. Association V (2007); see also Intv. Int'l MNC - Utilities (2007); Intv. German Econ. Association II (2007); Intv. Romanian Ministry V (2007); Intv. German Authority IV (2007).

[2130] See e. g. Intv. Int'l MNC - Utilities (2007); Intv. Romanian Econ. Association II (2007); Intv. Romanian Ministry I (2007); more positive: Intv. Austrian Econ. Association I (2007).

[2131] See e. g. Intv. Austr. MNC - Primary Goods II (2007); Intv. German Econ. Association V (2007); see also Intv. Austr. Research Institute (2007).

quarrels (*section 7.4.2*) and the perception that a promotion of Romania has become less important since EU membership has been reached and FDI inflows are significant anyway.[2132]

Interviewees also identify significant regional differences in terms of investment promotion. In Bucharest investment promotions seem to be widely neglected and no specific authority exists. Communities with a better reputation for an active investment promotion are, for instance, Baia Mare (with about 20 employees in the respective department) and to some extent Iaşi and Timisoara.[2133] Sibiu is again mentioned as a positive example. Yet, even Sibiu does not have a special marketing strategy (besides one for tourism) that would comprise certain target country groups or industries. Investment promotion is rather based on a positive attitude towards FDI there and a fairly efficient bureaucracy (*see above).*[2134]

(2) The Romanian Development Agency, founded in 1991, was hardly in use, had no visible success and was closed in 1997. As a consequence of a more active approach towards investment promotion since the early 2000s (*see above*), Romania established the **(ARIS**) in 2002 (Law no. 390/2002).[2135]

The responsibility of ARIS is to identify potential investors, establish contacts between investors and authorities, improve the image of Romania abroad, and advise MNCs throughout their investment engagement, for example, regarding the location of their investment within Romania. All services provided by ARIS are free of charge. Its specific focus is large greenfield investments of at least €1M.[2136] According to *Intv. Romanian Authority I (2007)* ARIS primarily targets investments from the EU, followed by other European FDI

[2132] See also OECD (2006a), p.61.
[2133] See e. g. Intv. German Authority IV (2007); Intv. German Econ. Association I (2007).
[2134] See Intv. German Authority IV (2007); Intv. Romanian County Council (2007); Intv. Rom. Local Authority I (2007).
[2135] See e. g. Hunya (2000); BA-CA (2006), p.30.
[2136] See ARIS website (2008); BA-CA (2006), p.30; Intv. Romanian Econ. Association II (2007); Intv. German Authority I (2007); Intv. Romanian Authority I (2007).

before investments from MNCs outside of Europe such as the U.S. and Eastern Asia (with increasing focus on China). ARIS is therefore in contact with foreign institutions in Romania (such as business clubs, GTZ etc.) and also participates in events abroad such as business exchanges and roadshows, for example in Austria and Germany but also in China.[2137]

Interviews and data suggest several insights regarding the performance of ARIS. Overall, the majority of MNCs does not seem to be overly satisfied with the work of ARIS.[2138] Most importantly, the success of ARIS in attracting investors has remained limited. Whereas several hundred projects registered for doing business in Romania through ARIS since 2002[2139], the number of projects that were actually successfully assisted and monitored by ARIS has been more moderate, for example, 12 projects in 2004 as well as nine and 24 projects in the subsequent years.[2140] Furthermore, despite its official focus on large-scale (greenfield) investments, projects that were assisted by ARIS remained rather small and even decreased in terms of volume in recent years averaging €24M (2004), €21M (2005) and €20M (2006).[2141] Interviewees confirm: "Large companies did not come to Romania via ARIS."[2142]

The reasons for these shortcomings seem to be manifold. First of all, ARIS has lacked a consistent strategy and personnel since it has constantly been re-organized since 2002 and leaders were frequently exchanged. ARIS has also been given only little power in establishing tools in order to attract FDI while

2137 See also Intv. Int'l MNC - Utilities (2007); Intv. German Authority IV (2007); Intv. Austrian Econ. Association I (2007).
2138 See e. g. Intv. Int'l MNC - Utilities (2007); Intv. Germ. MNC - Legal Services II (2007); Intv. Germ. MNC - Utilities (2007); Intv. Austr. Research Institute (2007); Intv. Int'l Econ. Association (2007).
2139 391 projects until mid 2005 alone; see Larive Romania (2006), p.44; OECD (2005d).
2140 17 additional projects to be implemented between 2003 and 2008; see ARIS website (2008); see also Intv. Germ. MNC - Utilities (2007).
2141 See ARIS website (2008); own calculations.
2142 Intv. Int'l MNC - Utilities (2007).

most of the important decisions are taken in the ministries.[2143] Moreover, the budget of ARIS has remained fairly low with about €500K in 2005 and only increased to about €650K in 2008.[2144] The number of staff has stayed on a low level with 26 employees in late 2007 (of which 12-14 have direct contacts to investors) which is significantly lower than in investment promotion agencies of other EECs.[2145] For example, CzechInvest had 179 employeed in 2006.[2146]

Furthermore, the relevance of ARIS and its work has apparently decreased since Romania's accession to the EU. Various interviewees point out that the work of ARIS has been hampered by stricter EU rules regarding investment incentives (*see above*), and more severely by political quarrels that have been aggravated by the appointment of the agency's leading figures from rivaling parties. Apparently, some members of the central government did not see the need to assist large investors free of charges. ARIS may sometimes be headed by politicians without detailed knowledge regarding the concerns of investors and only limited international experience and foreign language skills.[2147]

The necessity to receive important information from ARIS has decreased for many investors in recent years since more information has become publicly available (also due to EU accession) and more investors are present in Romania who can provide first-hand experience to potential investors. Finally, an increasing number of other organizations offer similar information and assistance including economic clubs, chambers of commerce, business consultants etc. Interviews suggest that MNCs often prefer services by these organizations, even if they have to pay fees for them, because assistance from organizations

[2143] See e. g. Intv. Austr. Research Institute (2007); Intv. Austr. MNC - Primary Goods II (2007); Intv. Int'l Econ. Association (2007); Intv. German Econ. Association I (2007); see also OECD (2006a), pp.60-61.

[2144] See also ARIS website (2008); Larive Romania (2007); OECD (2005d); own calculations.

[2145] See also Intv. Romanian Authority I (2007).

[2146] See Intv. Int'l Econ. Association (2007); see also CzechInvest (2007).

[2147] See Intv. Romanian Econ. Association II (2007); Intv. German Authority IV (2007); Intv. German Econ. Association III (2007); Intv. German Econ. Association I (2007); Intv. Germ. MNC - Consulting II (2007).

that are not associated with the Romanian government may seem to be less biased and more credible.[2148]

Nevertheless, interviews also show that those MNCs that did receive support from ARIS were generally satisfied, particularly when the investments were conducted between 2004 and 2006. They appreciated the helpful and efficient assistance in the pre-investment phase (including the organization and execution of site visits) as well as in later investment periods when ARIS employees apparently helped to overcome bureaucratic hurdles and to facilitate access to local and central authorities.[2149]

(3) The **image** of Romania has been fairly bad among Western Europeans overall. This is reflected, for example, in the limited support of the public in EU countries for Romania's EU accession in the past. As shown in *figure 52* the German support for Romania has remained low since the mid-1990s and only reached 29% in late 2006 at a time when Romania had already been granted accession to the EU.[2150] It is certatin that the limited support of the German population (in line with the findings for other old EU member states) for EU enlargement is largely due to fears about its economic, social and political impact.[2151] However, *figure 52* reveals that country-specific differences do exist. Accordingly, five out of eight countries analyzed of the region received more support from the German public than Romania in 2006 including (albeit only minimal) Bulgaria (31%) and Ukraine (30%). Furthermore, the support of Germans in favor of Romania's EU accession increased by only 7 percent

[2148] See e. g. Intv. Germ. MNC - Legal Services II (2007); Intv. Austr. MNC - Consumer Goods (2007); Intv. Int'l MNC - Utilities (2007); Intv. Austr. MNC - Primary Goods II (2007).

[2149] See Intv. Austr. MNC - Industrial Goods I (2007); Intv. Austr. MNC - Primary Goods II (2007); Intv. German Econ. Association II (2007).

[2150] See European Commission (1996b); European Commission (2002b); European Commission (2007c); according to a different survey of "Die Welt" 39% of Germans were in favor Romania's EU accession; see Focus website (2006).

[2151] See also Gabanyi (2005); Menzer (2006); Leiße (2006); Pfaller (2007).

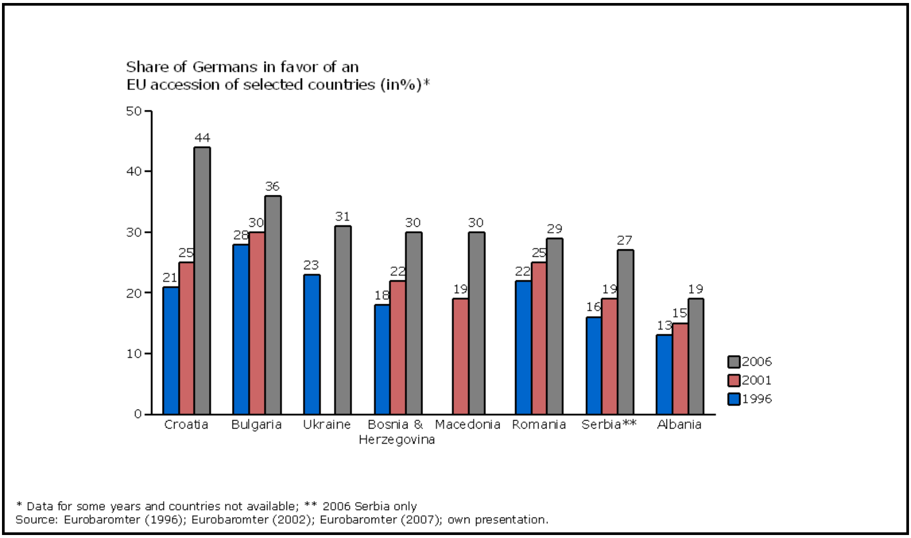

Figure 52: Public opinion about EU accession in selected countries

points from 1996 to 2006 which represents the second lowest improvement of eight countries analyzed (after Albania).

Interviewees and secondary literature confirm that Romania has traditionally had a reputation of being a particularly poor country. In this context, Western Europeans often seemed to connect Romania to its minority problems, namely to the Roma, whose lifestyle and presence in Western European countries has caused prejudice and resentments among inhabitants of these countries for centuries.[2152]

Furthermore, the public in Germany and other Western European countries has apparently been skeptical for many years as to whether Romania is capable of establishing an effective democracy, given the authoritarian leaderships of Gheorghe Gheorghiu-Dej (until 1965) and Nicolae Ceauşescu, and the polit-

[2152] See e. g. Intv. German Econ. Association III (2007); Intv. Austrian Econ. Association I (2007); see also Boia (2006).

ical instability of Romania in the early 1990s (*section 7.4.2.2*). The political classes of some EU countries tended to observe Romania critically in the early 1990s because they were concerned that Romania would strive to become an important power again, comparable to the times of Greater Romania (1918-1940).[2153] Even recent surveys suggest that some prejudice among decision-makers remain; a survey among EU officials in mid-2006 produced that 66% of the respondents considered Romania an old-fashioned country and 52% of them believed that Romania was disorganized.[2154]

Interviewees agree that Romanian governments have done little in the past in order to actively improve the image of their country; apparently, most key politicians have assumed that the successes in reform efforts itself, including EU accession, would improve the reputation of Romania.[2155]

Nevertheless, the image of Romania has started to improve in recent years. The main reasons for this were that people in Western Europe expected that the situation would improve with Romania's integration towards the EU. In the course of EU negotiations Romania increasingly drew the attention of political and economic observers which also resulted in a more extensive media coverage in Western European countries. Moreover, MNCs, who had good experiences with their investments, served as multipliers. Finally, some of the measures to promote investments discussed above may also have contributed to this improvement in an indirect way.[2156]

(4) FDI research dealing with the **impact** of investment promotion on FDI inflows in general and regarding Romania in particular is very scarce.[2157] How-

[2153] See several disguised state expert interviews; see also Boia (2006).
[2154] See Europa Digital (2006).
[2155] See Intv. Romanian Ministry I (2007); Intv. Germ. Research Institute I (2007); Intv. German Econ. Association III (2007).
[2156] See Intv. Int'l MNC - Utilities (2007); Intv. German Econ. Association II (2007); Intv. German Econ. Association V (2007); Intv. Germ. MNC - Consulting I (2007); Intv. German Authority IV (2007).
[2157] See Intv. Austr. Research Institute (2007); see also Hunya (2000); Loewendahl (2001); Cho (2003); Rajan (2004).

ever, interviews[2158] and a few studies[2159] suggest that the three dimensions analyzed (the government commitment, the work of ARIS as well as Romania's image in Western Europe) have had a significant impact on FDI in Romania. With respect to the 1990s, mainly the negative image of Romania and (to some extent) also the absence of an effective investment promotion agency apparently had a deterring effect on some investors, particularly on more-risk averse MNCs, for example from Germany.

Most interviewees also acknowledge that investment promotion could have been an important enhancing factor in Romania since 2000.[2160] A stronger government commitment and a more effective work of ARIS may have helped to improve the image of Romania, close the large information gaps of potential investors and – in the end – lead to higher FDI in Romania. However, interviewees emphasize, in line with general findings from external studies[2161], that MNCs repeatedly decided not to invest in Romania because they did not know enough about the country and its investment conditions. Therefore, it seems that ARIS has not reached many investors. Various experts interviewed had not heard of ARIS, only very few had been in contact with the agency and the great majority of interviewees believes that most MNCs would also have come to Romania without the existence of ARIS.[2162]

In sum, the investment promotion of Romania in recent years has somewhat contributed to a better knowledge of investors, but has definitely not reached

[2158] See e. g. Intv. Romanian Ministry IV (2007); Intv. Germ. MNC - Legal Services II (2007); Intv. Romanian Econ. Association II (2007).
[2159] See e. g. International Centre for Entrepreneurial Studies (1999); OECD (2006a).
[2160] See e. g. Intv. German Econ. Association II (2007); Intv. Germ. Research Institute I (2007).
[2161] See UNCTAD (2006), p.220.
[2162] See Intv. Germ. MNC - Legal Services I (2007); Intv. Germ. MNC - Consulting II (2007); Intv. Germ. MNC - Industrial Goods III (2007); Intv. Int'l MNC - Utilities (2007); Intv. Germ. MNC - Consulting I (2007).

its full potential in order to create a significantly better image of Romania and facilitate higher levels of FDI inflows.[2163]

(5) The **assessment** of investment promotion in Romania suggests that public policy makers have realized the possibilities of an active investment promotion fairly late. More importantly, they have underestimated the negative effects of a bad reputation, stereotypes and a lack of information on potential MNCs from Western Europe, also compared to other EECs.

With its accession to the EU Romania's possibilities to actively design a favorable investment environment, for example regarding investment incentives, monetary policy etc. have become more limited. Therefore, investment promotion will gain more importance and Romania will need to work on all (interlinked) dimensions discussed.

In particular, ARIS' potential has not fully been tapped so far. Based on a new investment law (*see above*) and following the overcoming of the ongoing political quarrels, ARIS may have the opportunity to play an important role in providing helpful information in times of increasing real estate prices and labor shortage in Romania. With an effective set-up, sufficient budget and close cooperation with central and local authorities, ARIS may have an advantage over other information providers in helping smoothing investment imbalances and mitigating the effects of asymmetric information among potential investors.

7.3.5.3 Croatia

The (1) commitment of Croatia's governments to promote investments has only recently increased significantly. In this context, (2) the Trade and Investment Promotion Agency (APIU) has not reached its full potential, yet. The (3) image of Croatia is fairly good abroad. However, (4) investment promotion has not

[2163] Understandably with a more positive view: Intv. Romanian Authority I (2007).

been able to significantly influence FDI inflows to Croatia so far. An assessment is provided in sub-section (5).

(1) Interviews and secondary literature show that Croatian public policy makers did not see the need for an **active investment promotion** until the early 2000s. FDI was – as discussed in several sections before – not always desired by Croatian officials and, furthermore, it appeared that FDI (particularly in tourism) was flowing in even without distinctive government marketing policies.[2164]

When the Tuđman era ended in the late 1990s, investment promotion represented a tool for Croatian public policy actors to support the envisaged integration into Western Europe and also to counter the ongoing disputes with the International Criminal Tribunal for the former Yugoslavia (ICTY) regarding the extradition of former members of the Croatian armed forces who were accused of war crimes (*see section 7.4.2.2*).[2165]

Under Prime Minister Sanader the commitment of the Croatian government to present Croatia as an attractive investment location further increased. This was also in order to back up the EU accession negotiations that started in 2005 and following the trend of a more active investment promotion in many other EECs. Therefore, Sanader and his government used many of their visits abroad (after taking office in 2003) to campaign for Croatia's EU accession but also for Croatia as investment location.[2166] Many experts certify that Croatia is doing quite well today overall in terms of self-marketing.[2167]

Nevertheless, interviewees identify some important remaining shortcomings of Croatia's investment promotion policy even today. Various interviewees make the criticism (as they do for Romania) that investment promotion still does

[2164] See e. g. Intv. German Authority III (2007); Intv. Former Croatian Minister (2007).
[2165] See e. g. Intv. Germ. MNC - Engineering (2007); Intv. Germ. MNC - Telecommunications (2007).
[2166] See e. g. Sanader (2006).
[2167] See Intv. Germ. MNC - Industrial Goods I (2007); Intv. Germ. MNC - Telecommunications (2007); Intv. German Authority II (2007).

not follow a coherent strategy and that political commitment of top officials remains very abstract. For example, experts interviewed refer to several business-related conferences in which senior officials canceled their participation at the last minute. Furthermore, experts see room for improvements regarding the communication of investment goals to (domestic and foreign) investors, for example by making bilingual tenders compulsory and enhancing e-government services.[2168] Experts also criticize that Croatia's participation at fairs has been quite unprofessional with regards to the organization, distribution of responsibilities, materials etc.[2169]

As in Romania, the performance of regional investment promotion seems to depend strongly on individuals and the quality of respective policies generally corresponds to the performance in other policy fields discussed including the quality of bureaucracy, investment policy etc. Finally, experts interviewed perceive that local communities that are further away from Zagreb receive less support from central authorities in terms of investment promotion.[2170]

(2) The assistance of investors interested in Croatia was usually handled by local authorities in the past and – even though the Investment Facilitation Division had already been established in the Ministry of Economy in the early 2000s – a functioning investment promotion agency did not exist in Croatia for a long time.[2171] In late 2005 (**APIU**) became fully operational because the government aimed at a more active investment promotion approach and because many local communities did not know how to deal with foreign investors.[2172]

[2168] See e. g. Intv. Former Croatian Minister (2007); Intv. Croatian Company - Real Estate (2007); Intv. Croatian Ministry II (2007).
[2169] See disguised expert interview; see also Intv. Supranational Authority II (2007).
[2170] See Intv. German Authority II (2007); Intv. German Authority III (2007); Intv. German Econ. Association IV (2007).
[2171] See Intv. Former Croatian Minister (2007); Bulgaria Economic Forum (2005), p.60.
[2172] See Intv. German Authority III (2007); Intv. Croatian Authority II (2007); OECD (2006a) p.61.

APIU's main tasks are to facilitate higher investments by providing economic and legal information, organizing site visits, assisting investors in getting permits, and connecting potential investors to local and central authorities as well as to business partners. Services are (as in Romania) provided free of charges.[2173] In 2006 APIU also received the right to establish PPPs.[2174]

A comprehensive evaluation of APIU's performance may be somewhat too early. Nevertheless, interviews reveal some first insights.

Apparently, investment promotion has significantly improved since the full establishment of APIU and the agency has helped to provide more reliable information and somewhat contributed to a better marketing of Croatia as attractive investment location. The positive assessment is mainly associated with the person of the Director, Dr. Mikac. He has the reputation of being a fairly good political support, hands-on and of "knowing how to talk to business people"[2175].

On the other hand, interviewees criticize that the strong focus of investment promotion on one person may also have had – at least in the beginning – negative side effects, including a very hierarchical set-up of the agency and little delegation of work.[2176] Furthermore, interviewees as well as external sources still do not recognize a comprehensive investment promotion strategy; state experts in particular believe that the strategies developed for specific target industries (*see above*) still lack sufficient detail and resources for a successful implementation. They also see problems in an insufficient coordination of in-

[2173] See OECD (2005b), p.23; Intv. Croatian Authority II (2007); APIU (2007); APIU website (2008).

[2174] GO 104/2006 and GO 138/06; see Doc - Gov't. of Croatia (2006), p.168; APIU website (2008).

[2175] Intv. Supranational Authority II (2007); see also Intv. Croatian Company - Real Estate (2007); Intv. German Authority II (2007); Intv. German Authority III (2007); Intv. Former Croatian Minister (2007); Intv. Germ. MNC - Software (2007); Intv. Germ. MNC - Financial Services I (2007); OECD (2005a),p.45.

[2176] See several disguised expert statements.

vestment promotion with other agencies including the various Croatian Chambers of Commerce.[2177]

Despite Croatia's re-organization of APIU (which followed some of the ideas of CzechInvest), the gaps still seem to be significant according to interviewees and secondary literature considering that APIU only has about 15% of the number of staff of CzechInvest.[2178] Interviewees also criticize that APIU used to provide very little pro-active support of potential and existing MNCs and that many of the activities and materials tended to lack the required professionalism including various mistakes in publications.[2179]

Overall, most interviewees report that very few investors have taken advantage of the assistance of APIU so far.[2180]

Finally, some experts also argue that the re-organization and strengthening of APIU may have taken place too late considering that other EECs have been able to establish a competitive advantage with their investment promotion agencies and that the possibilities of an active investment policy for Croatia decrease once it has acceded the EU.[2181]

(3) Croatia has traditionally had a fairly positive **image** among Western Europeans. *Figure 52* reveals that 44% of Germans were in favor of an EU accession of Croatia in 2006, the highest value for the eight countries analyzed. Furthermore, Croatia's image significantly improved since 1996 when only 21% favored an EU accession of Croatia.[2182]

[2177] See Intv. German Authority II (2007); Intv. German Authority III (2007); Intv. Former Croatian Minister (2007); Intv. Germ. MNC - Software (2007); see also OECD (2006a), pp.60-61.

[2178] 30 employees in 2007; budget figures are not open to the public; see OECD (2006a), p.61; APIU website (2008); Intv. German Authority II (2007); Intv. German Econ. Association IV (2007).

[2179] See several disguised expert statements.

[2180] See Intv. Austr. MNC - Consulting (2007); Intv. German Authority III (2007); Intv. Germ. MNC - Industrial Goods I (2007).

[2181] See Intv. Austr. Research Institute (2007); also OECD (2006a), p.62; Doc - OECD (2007).

[2182] See European Commission (2007c).

Interviews[2183] and secondary literature[2184] help to explain this evolution. Croatia's mediocre performance in public opinion in the mid-1990s seems to have been driven by the impact of the war. Many foreign observers evaluated the whole Western Balkan region as too risky for closer political and economic cooperation. Furthermore, Croatia's involvement in the war, disputes with the ICTY (*see above*) as well as the authoritarian style of President Tuđman led to resentment not only amongst the public but also in the political classes both in EU member states like Germany but also in the European Commission.

However, Croatia was apparently able to quickly regain the support of the Western European public when the country opened up to the West again, the cooperation with the ICTY increased and the political stability of Croatia and the region in general improved since the late 1990s (*section 7.4.2.3*). This dramatic recovery of Croatia' reputation was built on a fairly good country image that goes back to the time before 1990, when Croatia (as part of Yugoslavia) had already been known among many Western Europeans as attractive (and fairly cheap) tourist destination. This positive image was also fueled by the impression that Tito's socialism had not been as rigid as the political conditions in other EECs.[2185] Finally, Croatia quickly gained the reputation in the 2000s of being a quite wealthy nation with good living conditions similar to Western European standards (*section 3.1.3*) A further improvement of Croatia's image following its accession to the EU.[2186]

Nevertheless, experts interviewed identify some remaining problems regarding Croatia's image. Apparently, the perception of Croatia's war heritage strongly varies among Western Europeans, especially if they are not very familiar with the region. Some wonder if political tensions, landmines etc. still make

[2183] See Intv. Austrian Econ. Association II (2007); Intv. Croat. Company - Utilities (2007); Intv. Austr. MNC - Retail (2007).
[2184] See also Hajdinjak (2001); Kušić and Grupe (2005).
[2185] See section 6.3.1; see also Doc - Germ. MNC - Engineering (2001); Ott (2005).
[2186] See Intv. Supranational Authority II (2007); see also Altmann (2005a); Altmann (2005b); Lejour, Mervar, and Verweij (2007); Doc - Ekonomski Institut Zagreb (2007).

working and traveling in Croatia and neighboring countries dangerous.[2187] Others apparently do not consider the war heritage to have any impact on doing business in Croatia at all. In reality, company experts reveal, the war heritage sometimes becomes an issue in a later stage of investment planning, for example, when they consider FDI in Slavonia where some the urban landscape as well as the economic viability of the region is still affected by material damage. Investors also suggest that the re-integration of Serbs can still be a sensitive topic that can be problematic for them.[2188]

More recently, the positive image of Croatia seems to suffer from the problems and obstacles that some foreign investors experienced during their commitment in Croatia (as analyzed, for example, for various legal measures above). The actual performance of Croatia may not have been worse than in other SEECs, but the generally positive image of Croatia led to higher expectations, for instance, with respect to the quality of bureaucracy and land registration. It seems that the disappointments of some investors are also experienced by potential investors in their home countries and contribute to a somewhat more skeptical image of Croatia.[2189]

The Croatian government is apparently aware of these remaining problems. Thus the improvement of Croatia's international image was already declared as one of five government priorities of the Sanader administration after the election in 2003 and is also passed on as a task to subsequent authorities including Croatian embassies.[2190]

(4) The **impact** of investment promotion in Croatia has not been tested systematically by FDI studies so far.[2191] However, interviews reveal that the

[2187] See e. g. Intv. Germ. MNC - Financial Services I (2007).
[2188] See e. g. Intv. Germ. MNC - Software (2007); Intv. Austr. MNC - Real Estate (2007); Intv. Austr. MNC - Financial Services I (2007); Intv. Austr. MNC - Retail (2007); Intv. Croatian Mayor (2007).
[2189] See Intv. Austrian Econ. Association II (2007); Intv. Germ. MNC - Software (2007).
[2190] See European Commission (2004c), p.6; Pommer (2007), p.126.
[2191] See Intv. Austr. Research Institute (2007).

problems with investment promotion were a deterring factor for FDI inflows to Croatia in the 1990s. Particularly the negative image of Croatia being located in a politically unstable region (*see below*) apparently led to the decision of potential MNCs to invest elsewhere. In fact, state interviewees in particular point out that the war and its heritage may actually have been an essential problem for FDI in Croatia, since it supposedly missed the first wave of the largest and most attractive MNCs.[2192] Furthermore, the limited interest and organization to assist investors both on the local and central level has apparently somewhat contributed to lower inflows in Croatia in the 1990s and early 2000s.[2193]

The findings of the interviews suggest that the current "status" of the different dimensions of investment promotion (government commitment, APIU performance and country image) only have limited impact on FDI. To some extent Croatia seems to benefit from the positive elements of its image which is, however, somewhat put into perspective by the more skeptical experiences of some investors. Furthermore, APIU seems to be fully operational too shortly in order to significantly influence the investment decision of MNCs.[2194]

(5) In the **assessment** of this section it becomes apparent that Croatia realized fairly late (as did Romania too) the necessity for an active investment promotion – although this delay may be understandable in the context of the war – and relied too long on its natural advantages (such as the coastline). It also neglected the damage on the image of Croatia as investment location that has been caused by the war as well as by legal and administrative deficiencies.

Nevertheless (and maybe even more clearly than in Romania), it seems that Croatia's officials have acknowledged the need for an improvement of the country's reputation abroad even if they do have always acted accordingly until

[2192] See Intv. Croatian Ministry II (2007); Intv. Former Croatian Minister (2007); Intv. Croatian Mayor (2007).

[2193] See Intv. German Authority III (2007); Intv. Germ. MNC - Financial Services I (2007).

[2194] See e. g. Intv. Austrian Econ. Association II (2007); Intv. German Authority III (2007); Intv. Germ. MNC - Industrial Goods I (2007).

now. Furthermore, it seems that some company experts interviewed may actually underestimate the potential long-term benefits of APIU. The agency will be able to establish better information for Western Europeans (who often lack sufficient knowledge regarding the situation) in the years to come, for example, with respect to the political stability of Croatia and the region in general.

By contrast, state interviewees may somewhat overestimate the negative impact of the war on FDI inflows since other determinants (discussed before in this thesis) seem to play a major role in this context as well. Public policy actors should improve investment promotion through an even more credible commitment of top politicians (for example regarding the participation of business events). APIU should also become more effective including a better delegation of work. Croatia still seems to have significant potential for large-scale FDI (in contrast to the opinion of some state experts), since re-locations continue in Europe and within Eastern Europe and economic growth will generate large MNCs and potential FDI in the future as well.

MNCs in Croatia should also consider a stronger coordination with other key influencers, for example by the establishment of business clubs (as in Romania), in order to serve as contact point for unfiltered information for potential investors and to better bundle MNCs' interests in a non-governmental organization which may be more credible partners for the Croatian government than, for example, semi-public Chambers of Commerce.

7.3.5.4 General insights for transition countries

The analysis of the previous country sections and the study of related FDI studies allows for several insights regarding investment promotion in transition countries in general, especially with respect to (1) its significance, (2) differences between state and company interviewees and some (3) public policy implications.

(1) The qualitative findings of this section confirm the few FDI studies that empirically examine the **impact** of investment promotion on FDI; therefore, higher investment promotion seems to foster FDI growth.[2195] It seems that investment promotion can be among the most important determinants for FDI attraction for transition countries comparable to property rights and privatization, particularly when a country image is fairly poor and knowledge about the country is limited. However, it seems that many countries have not yet learned how to use this factor effectively.

The empirical FDI studies analyzed focus on the impact of the investment promotion agency. It seems that agencies with high budgets, large staff, visible presence abroad, reporting mechanisms to higher policy levels, continuity in the leadership team, strong cooperation with investors, and focus on specific countries and industries (as mentioned in the case of CzechInvest) have the greatest potential to influence the investment decision of MNCs.[2196]

In functional terms, interviews suggest that the impact of these agencies is specifically driven by their ability to provide useful information and to give assistance when problems occur, for example with licenses on the local level. Furthermore, they can be essential when economic constraints (such as labor shortage and high real estate prices in Romania) may lead to informative advantages of state agencies compared to other providers.[2197]

In addition to this (and in accordance with several theoretical studies[2198]), this thesis suggests that other dimensions of investment promotion, namely gov-

[2195] See Wells and Wint (2000); Morisset and Andrews-Johnson (2004); Gabriel (2006).
[2196] CzechInvest also won various international prices for its work including European Investment Promotion Agency of the Year 2000 and 2001; see CzechInvest website (2008); see also Hunya (2000); te Velde (2001); Morisset (2003); UNCTAD (2006), p.223; Intv. German Econ. Association VI (2007); Intv. Austr. Research Institute (2007); Intv. Germ. MNC - Consulting II (2007).
[2197] See Intv. Germ. MNC - Legal Services II (2007); Intv. Former Croatian Minister (2007); Intv. Austr. MNC - Financial Services I (2007); see also Loewendahl (2001); FIAS (2007), p.4.
[2198] See e. g. Loewendahl (2001); Cho (2003); Rajan (2004); OECD (2006a).

ernment commitment and country image, also influence the investment decision of MNCs. *FIAS (2007)* finds that "opinions, perceptions and anecdotal experience play a crucial role in shaping the investors' image of a country's attractiveness." *UNCTAD (1998)* even assumes that the country image is among the most important factors for business facilitation.[2199] Interviews indicate that the country image can be crucial for the first approach to a country. A (subjective) negative image may mean that MNCs will not even consider an investment in a specific country (as in Romania in the 1990s). This seems especially to be true for smaller investors for which personal reasons play a more important role in the country selection than for larger companies in which more decision-makers are involved in the investment planning.[2200] An important problem for many transition countries was apparently their fairly poor image after 1990s which stemmed from stereotypes, lack of knowledge, war (in former Yugoslavia) as well as other country-specific deficiencies discussed throughout the thesis.[2201]

Regarding the government commitment, analyses suggest that a pro-active promotion of investors abroad by key politicians is positively perceived by potential investors and may help to overcome first objections towards a country. However, it seems (as in the case of Croatia) that governments need to follow this approach continuously and as part of a coherent strategy in order to be credible and successful.[2202]

(2) The analyses of interviews show some important **differences between state and company interviewees**. State representative tend to somewhat underestimate the importance of the country image. As in the case of Romania, governments often (falsely) believe that reforms alone will prove critics and

[2199] See also Kalotay (2000).
[2200] See Intv. Supranational Authority II (2007); Intv. Romanian Ministry I (2007).
[2201] See also Falcetti, Sanfey, and Taci (2003); OECD (2006a).
[2202] See Intv. Germ. MNC - Consulting I (2007); Intv. Supranational Authority II (2007).

stereotypes wrong, while company experts are generally more aware of the long-lasting effects of the image of the host country.[2203]

On the other hand, company experts may sometimes underestimate the effects of investment promotion policies, notably of investment promotion agencies. They generally believe that companies would also invest without the agencies but neglect the long-term benefits with respect to image- and information-building of these institutions. In some transition countries (particularly when the number of investors is still limited in absolute terms as in Croatia) MNCs may also underestimate their own impact on influencing the image of the host country in their home countries, for example, through the establishment of business clubs etc.[2204]

(3) **Public policy** makers in transition countries should be aware that country stereotypes are difficult to overcome. For example, many Western Europeans apparently have had a more negative image of Romania regarding some of its legal determinants (*see above)* than the analysis of its performance would suggest. On the other hand, the example of Croatia shows that high expectations may sometimes be disappointed in reality which can lead to a deterioration in the country image, at least among business people. Public policy actors should therefore thoroughly evaluate the outside perceptions of their country. They should then use investment promotion agencies as well as key politicians in order to disperse (negative) misperceptions abroad (such as the alleged striving for power by Romania). Governments may also make use of emigrants (which could be helpful for both Romania and Croatia) as multipliers and country promoters. They should however, carefully use the different possibilities of investment promotion, since an unprofessional participation at fairs, for example, may actually harm the reputation of a country.[2205]

[2203] See sections above of for various references.

[2204] See also Intv. German Econ. Association III (2007); Intv. Germ. MNC - Engineering (2007).

[2205] See Intv. German Authority III (2007); see also te Velde (2001).

Furthermore, public policy has to tackle those deficient fundamentals (such as corruption in various transition countries) for which a negative image may have a real cause.[2206] Therefore, investment promotion alone is generally not sufficient but interdependent to other determinants depending on the host country situation.

Overall, public policy should be aware that investment promotion is a laborious task that takes a lot of time, continuity and political support from all political participants in order to be successful. State actors should not feel deterred by pundits who question the impact of investment promotion, even though the success of the work is generally only an indirect one. Yet, it seems that investment promotion starts to replace investment policy with decreasing possibilities of investment incentives in many progressing transition countries.[2207]

7.3.6 Overview of findings on economic measures

This section presents a summary of the analyses of this thesis with respect to economic measures. *Figure 53* gives an overview of the findings regarding the **performance** of Romania's and Croatia's economic determinants and presents an evaluation based on the analyses of the interviews conducted, expert documents and secondary studies. The results of the analyses of this section regarding the **importance** of economic determinants for transition countries in general are presented in *figure 54*. The evaluation of both performance and importance follows the same methodology as presented in the overview of the legal measures (*section 7.2.6*).

[2206] See also Intv. Former Croatian Minister (2007).
[2207] See also Hunya (2000).

Overview economic determinants – current performance of Romania and Croatia					
Determinant	Sub-determinant	Romania		Croatia	
		Performance	Comment	Performance	Comment
• **Economic stability**	• Financial system	**(+)**	• <10% domestic bank assets, but limited product portfolio, few rules in non-banking sector	**(+)**	• Healthy and solvent banking sector, high foreign presence, but growing private credits, weak non-banking sector rules
	• Monetary policy	**(0)**	• Clear stabilization since early 2000s, moderate inflation, strong appreciation	**(+++)**	• Low inflation, stable and strong kuna, high foreign reserves, independent CNB
	• Trade policy	**(++)**	• Elimination of barriers for EU MNCs since accession, fairly quick admin. processes, some problems with non-EU trade	**(+)**	• Many international agreements, but slow & complex administrative procedures, some high duties for MNCs from EU
• **Infrastructure**	• Roads	**(---)**	• Quality is still very poor, only ~200km of highway, by-passes are missing	**(++)**	• Very good highway system, missing piece to Slovenia, mixed quality of other roads
	• Real estate	**(--)**	• Very high prices in Bucharest and boom centers, but less dramatic elsewhere	**(0)**	• High price level but only moderate rise, supply sufficient, but bureaucratic hurdles
• **Investment climate**	• Investment policy	**(+)**	• Liberal policy and attitude towards FDI, but no long-term strategy, no comprehensive legal framework, legal gaps	**(-)**	• Framework not completely in line with EU standards, some resentments towards foreigners, no clear strategy for tourism
	• Taxes	**(+)**	• Flat tax of 16% since 2005, but total tax rate 47% of profits, system still complex	**(+)**	• Tax system getting more complex, low total tax rate (33%) but perceived as higher
	• Investment incentives	**(0)**	• Some good experiences in industrial parks, only few incentives in recent years, expiration with EU accession	**(0)**	• Good conditions in Varaždin, strongly depends on attitude of authorities towards FDI, effects of new Act unclear
• **Privatization**	• Privatization overall	**(-)**	• Bulk of privatization only since early 2000s, today quite advanced but delays due to political quarrels	**(--)**	• Privatized SOEs suffer from earlier insider sales; fairly advanced now, but many remaining SOEs loss-making, CPF scandal
• **Investment promotion**	• Investment promotion overall	**(-)**	• Recent decrease in government commitment, mediocre performance of ARIS, only recent improving of country image	**(0)**	• Good initiatives but commitment depends on individuals (e. g. APIU), positive image suffers from weak legal determinants
• **Economic measures**	• Economic measures overall	**(0)**	• Important reforms in recent years, but weak infrastructure and country image	**(+)**	• Stable econ. framework, but few eye-catching reforms, hampered by admin.

Note: **(+)** = rather good, **(+++)** = very good performance, **(-)** = rather weak, **(---)** = very weak performance, **(0)** = neutral
Source: Own presentation.

Figure 53: Overview economic determinants – performance

Overview economic determinants – importance for FDI in transition countries

Determinant	Sub-determinant	Importance on FDI	Explanation
• **Economic stability**	• Financial system	• Generally low • Very high as sector for FDI	• Non-banking sector generally has low impact on FDI, decreasing for banking sector with higher stability; MNCs avoid financing problems by borrowing at home • However, financial sector itself very important for FDI (mainly due to privatizations and increasing purchasing power)
	• Monetary policy	• Low	• Only deterring if volatility and imbalances are very high and slightly enhancing impact with high stability and problems in neighboring countries (Croatia) • Level of exchange rate not important, impact may decrease for EU members
	• Trade policy	• Medium	• Procedural and time barriers more important than costs and trade regime • Mainly important for exporting MNCs, additional short-term boost at EU accession
• **Infrastructure**	• Roads	• Medium • High as sector for FDI	• Constraining if quality is very poor (Romania), but very good quality not necessary (Croatia), great impact on investment decision within the country • One of the most attractive sectors for FDI
	• Real estate	• Low to medium	• Very high prices and low adequate supply deter MNCs that want to start production quickly, may delay investment of others, depends on expectation of MNCs
• **Investment climate**	• Investment policy	• Low	• Attitude of authorities more important than legal framework, may be of medium importance for investors in regulated areas
	• Taxes	• Very low	• Only decisive if all other aspects are equal in competing country, since tax rates may change, MNCs with little profits in first years, large MNCs can shift tax burden • Perception (based on statutory rates and eye-catching reforms) more important than actual tax burden (total tax rate)
	• Investment incentives	• Low	• Most MNCs would decide for the specific TC anyway, incentives generally too low and limited to the period before EU accession • Non-financial incentives may be attractive for risk-averse MNCs with little experience in EECs (e. g. administrative support, infrastructure)
• **Privatization**	• Privatization overall	• Very high (but declining with sales progress)	• Attitude, method and institutions affect foreign share of privatization • Better privatization conditions often go along with more effective bureaucracy • Key source of FDI in TCs and more important than greenfield investments
• **Investment promotion**	• Investment promotion overall	• High	• Can be an important enhancing factor but often not fully exploited by TCs (e. g. investment promotion agencies, provision of information) • Public policy often underestimates the negative impact of the country image
• **Economic measures**	• Economic measures overall	• Medium	• Impact strongly driven by perception and expectations of MNCs, investment climate and stability factors for most TCs less important than assumed by theory

Source: Evaluation based on interviews and analyses; own presentation.

Figure 54: Overview economic determinants – importance

7.4 Political measures

This section discusses political measures that can be influenced by public policy actors in order to create – directly or indirectly – favorable conditions for FDI. Determinants analyzed are human capital (*7.4.1*), political stability (*7.4.2*), corruption (*7.4.3*), and EU integration (*7.4.4*). *Section 7.4.5* provides an overview of the results.

7.4.1 Human capital

7.4.1.1 Definition

Interviewees and FDI studies (as discussed in *section 6*) indicate that **human capital** is an important determinant for the investment decision of MNCs. FDI studies generally focus on enrollment ratios of tertiary level students, while interviews suggest a more thorough approach.[2208] Therefore, this section analyzes (1) the education level of host country employees focusing on the two most important groups for MNCs, skilled workers and university graduates (mainly engineers and business economists). Subsequently, (2) the availability of labor is analyzed including the performance of the education system, emigration and labor mobility. Country-specific conclusions for Romania and Croatia are presented in sections (3).[2209]

7.4.1.2 Romania

(1) The analysis of the **level of education** in Romania reveals that investors are (a) generally satisfied with the skill level of their Romanian staff, even though (b) problems exist with the education of skilled workers. Significant (c) differences exist with respect to the university education. The skill level (d) is

[2208] See also Blomström and Kokko (2003); Dunning (1993); Globerman and Shapiro (1999).
[2209] See also for this approach OECD (2006a); Doc - Austr. MNC - Industrial Goods III (2005); .

quite important for the investment decision of MNCs. The results are assessed in sub-section (e).

(a) Interviews indicate that investors are quite satisfied with the **general educational level** of the labor force in Romania. Apparently, MNCs have often been positively surprised – particularly in early years of transition – by regards to the skill level of Romanians. MNCs also report that the skill level in competing countries, such as Ukraine and Bulgaria, seems to be lower than in Romania overall.[2210]

Interviews suggest that MNCs are especially satisfied with the science skills of Romanian employees.[2211] Romania's good performance in this field is also confirmed by international statistics. According to *World Economic Forum (2007)*, the quality of Romania's math and science education is ranked 12th out of 131 countries. This position is also the second highest among 18 EECs (only behind Czech Republic (9th)) and clearly ahead of important competitors in the region including Hungary (23rd), Ukraine (44th) or Bulgaria (50th).[2212]

Furthermore, interviewees state that MNCs are quite satisfied with the foreign language skills of Romanians.[2213] By contrast, data reflect a somewhat more critical evaluation in this field. *Figure 55* shows that 29% of Romanians speak English well enough for conversations, which is just below the average of 33% of eight EECs analyzed, while the value for German (6%) is the lowest. Furthermore, 53% of Romanians speak – accordingly to the survey of the European Commission – no foreign language at all, a rate that is only worse in

[2210] See e. g. Intv. Germ. MNC - Legal Services II (2007); Intv. Germ. MNC - Industrial Goods III (2007); Intv. German Econ. Association III (2007); Intv. Austr. MNC - Consumer Goods (2007); Intv. Austr. MNC - Financial Services II (2007).

[2211] See e. g. Intv. Germ. MNC - Utilities (2007); Intv. Germ. MNC - Industrial Goods III (2007); Intv. Germ. MNC - Legal Services II (2007).

[2212] Austria ranks 26th and Germany 36th.

[2213] See Intv. Germ. MNC - Legal Services II (2007); Intv. German Econ. Association I (2007); Intv. Germ. MNC - Automotive (2007); Intv. Austrian Econ. Association I (2007); Intv. German Econ. Association VII (2007); Intv. Romanian Authority I (2007); Intv. Rom. Local Authority I (2007).

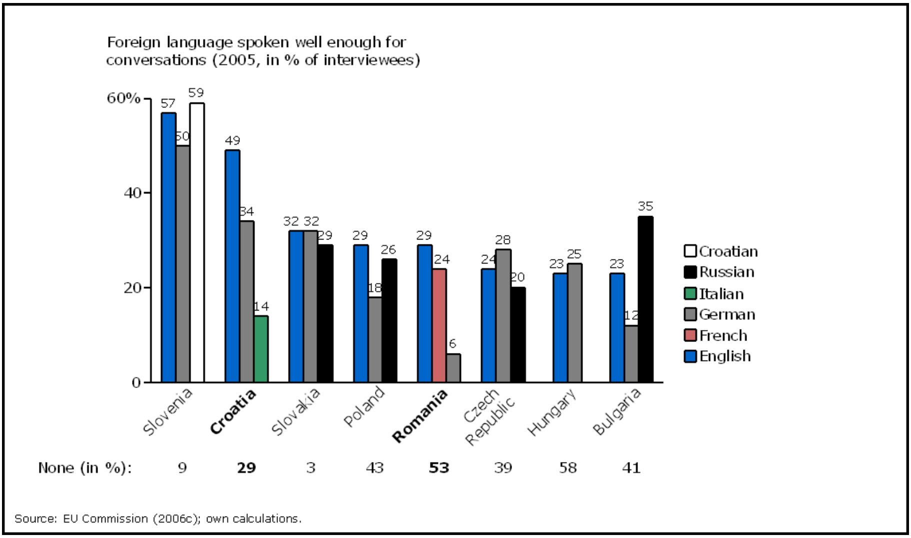

Figure 55: Foreign language skills in Eastern Europe

Hungary.[2214] It therefore seems that interviewees somewhat overestimate the language skills of Romanians in general, probably because MNCs are mostly engaged in boom regions such as Bucharest, where people are usually better educated, or regions with a German minority (such as Transylvania).

Some more critical interviewees indicate that the general educational level is – despite its positive aspect – not comparable to Western Europe[2215] and that it may actually have decreased in the last years. Reasons for this evolution may be that education policy and – more specifically – the curriculum on all levels of education has been modified many times. Furthermore, experts point out that education spending for the 52 institutions for tertiary education is fairly low today. This is confirmed by a comparison with other countries of the

[2214] See European Commission (2006c); own calculations.
[2215] See also OECD (2006a), p.176.

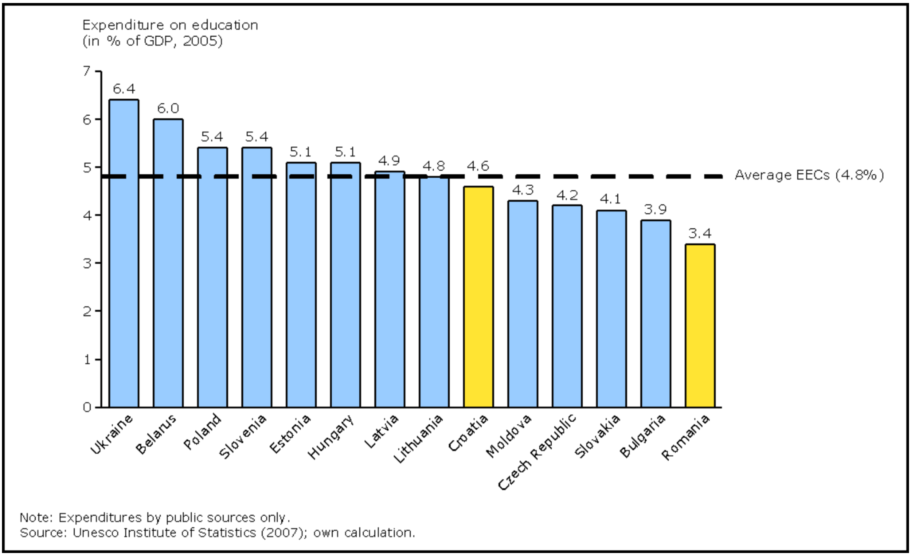

Figure 56: Education spending and graduate share in Eastern Europe

region (*figure 56*).[2216] Therefore, Romania's public spending on educational institutions reached 3.4% of its GDP in 2005 which is lower than, for example, in Ukraine (6.4%) and Bulgaria (3.9%).[2217]

(b) With regards to the education level of **skilled workers** in Romania, company experts criticize that no comprehensive education scheme exists: "The education of skilled workers is only extemporized"[2218]. Professional schools existed during communist times but most of them apparently vanished with the privatization of SOEs since 1990. Vocational training is thus rare, apparently very theoretical and little accepted among Romanians.[2219]

[2216] See Intv. Germ. MNC - Legal Services I (2007); Intv. German Political Adviser (2007); Intv. Austr. Research Institute (2007); Intv. German Econ. Association VII (2007).

[2217] Apparently, the rate was increased to 5.2% in the 2007 budget; see Rompres (2006); see also UIS (2007); Intv. Romanian Ministry I (2007); INSSE website (2008).

[2218] Intv. Germ. MNC - Utilities (2007); see also Intv. Germ. MNC - Legal Services I (2007).

[2219] See Intv. German Econ. Association V (2007); Intv. German Econ. Association III (2007); Intv. Germ. MNC - Automotive (2007); Intv. German Econ. Association VII (2007); Intv. German Political Adviser (2007).

From the perspective of MNCs, the Romanian government does not fully recognize the importance of the education of skilled workers and does not sufficiently invest in these programs. As a result, company experts interviewed see deficiencies among skilled workers in various fields such as the construction industry, in craftsmen professions and in rural areas. MNCs also tend to focus on skilled workers under 35 years old, since they worry that older employees may not have a very performance-oriented working attitude.[2220] It seems that MNCs have to invest a lot of money, time and capacities in the education of skilled workers. Larger MNCs such as Siemens, Continental and Metro, have started their own education programs while smaller investors rather try to recruit skilled workers from other investors.[2221]

This rather negative evaluation is interesting in the light of the study presented in *OECD (2006a)* according to which Romania's vocational training strategy (adopted in 2005) is the most advanced program out of nine SEECs.[2222] Apparently, this strategy has not had sufficient impact on the daily operations of MNCs so far and may also be undermined by the increasing labor shortage discussed below.

(c) Experts interviewed indicate that MNCs are generally quite satisfied with the quality of Romanian **universities**.[2223] Especially in Western Romania higher education seems to benefit from the Austrian heritage. Universities that frequently receive a positive evaluation from interviewees are those in Timişoara and Braşov (for technical programs) and Cluj (particularly for law), but occasionally also those in Bucharest and Iaşi.[2224]

[2220] See Intv. Austr. MNC - Industrial Goods I (2007); Intv. Germ. MNC - Legal Services I (2007); Intv. Int'l Econ. Association (2007); Intv. Romanian County Council (2007).

[2221] See Intv. Germ. MNC - Automotive (2007); Intv. German Econ. Association VII (2007); Intv. German Authority I (2007); Intv. German Econ. Association V (2007); Intv. German Econ. Association III (2007).

[2222] Ssee also Intv. German Political Adviser (2007); Intv. German Authority I (2007).

[2223] See Intv. German Econ. Association I (2007); Intv. Germ. MNC - Automotive (2007).

[2224] See Intv. Germ. MNC - Automotive (2007); Intv. German Econ. Association III (2007); Intv. German Authority IV (2007); Intv. Germ. MNC - Legal Services II (2007).

However, many experts interviewed comment that the quality of the Romanian university education has also deteriorated in recent years. Therefore, entering university has become easier, the drill of earlier years has decreased and the curriculum is – from the investors' perspective – not always sufficiently linked to business reality.[2225] With professors who are often still in the same position as in 1990, overburdened with work and receiving low salaries, it is not surprising that experts interviewed have repeatedly heard about bribes for better grades and degrees in Romanian universities.[2226] This rather skeptical evaluation of the university education overall is also reflected in international statistics. Therefore, Romania ranks 54th out of 131 countries (or 11th out of 18 EECs) in the higher education and training ranking of the Global Competitiveness Report.[2227]

In contrast to the general evaluation of the university education, the large majority of interviewees acknowledge that the technical education, namely engineering and IT, is very good in Romania. The strong industrialization of Romania before 1990 as well as the presence of IBM in Romania since the mid-1970s apparently created a strong tradition in these fields.[2228] Particularly (Romanian) state experts interviewed assess these skills as major asset for Romania.[2229] With respect to IT even company experts interviewed agree

[2225] See Intv. Germ. MNC - Legal Services I (2007); Intv. Germ. MNC - Automotive (2007); Intv. German Econ. Association VII (2007); Intv. Germ. Research Institute I (2007); Intv. German Authority IV (2007); Intv. Int'l Econ. Association (2007).

[2226] See e. g. Intv. Int'l MNC - Utilities (2007); Intv. Germ. MNC - Automotive (2007); Intv. German Econ. Association VII (2007); Intv. Germ. MNC - Legal Services I (2007).

[2227] Bulgaria is the only EU member behind Romania (66th); Austria: 17th, Germany: 20th; see World Economic Forum (2007).

[2228] See Intv. Austrian Econ. Association I (2007); Intv. Austr. MNC - Consumer Goods (2007); Intv. Germ. MNC - Industrial Goods III (2007); Intv. Germ. Research Institute I (2007); more critical: Intv. Austr. MNC - Industrial Goods I (2007).

[2229] See Intv. Romanian Authority I (2007); Intv. Romanian Econ. Association I (2007); Intv. Romanian Ministry IV (2007).

that Romanian universities may have better-educated graduates than many other EECs.[2230]

In contrast, interviews show that Romanian business administration education has a poor reputation among MNCs. Most experts criticize business courses as too theoretical and lacking focus on the needs of modern enterprises; specific gaps seem to exist in marketing and controlling. Therefore, MNCs tend to have problems in finding appropriate staff for their middle management.[2231] While new providers of management schools are pouring into the country, they mostly do not meet international standards yet; accordingly, Romania only ranks 80th of 131 countries in the management school ranking of the Global Competitiveness Report.[2232]

(d) As already observed in the theoretical part of this thesis, FDI studies generally find a positive **impact** of human capital and FDI. However, the measures of these studies usually refer to the availability of labor and less to education levels of potential employees.[2233] In contrast, interviews indicate for Romania that the educational level of employees has played a very important role for the investment decision of MNCs but that this is now decreasing slightly.[2234]

The overall positive perception of the skill level of Romanians by MNCs – which may not always have been in line with empirical findings as shown above – apparently played an important enhancing role for FDI in Romania, particularly in the late 1990s and early 2000s. The fairly high educational level stuck out as positive characteristic of Romania's investment environment at

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[2230] See Intv. Germ. MNC - Consulting I (2007); Intv. Germ. MNC - Consulting II (2007); Intv. German Authority I (2007); Intv. Germ. MNC - Legal Services II (2007); see also Financial Times (2006d).

[2231] See e. g. Intv. Germ. MNC - Legal Services I (2007); Intv. Int'l MNC - Utilities (2007); Intv. Germ. MNC - Automotive (2007); Intv. German Authority IV (2007).

[2232] Only slightly better than Bulgaria (83) and Ukraine (85th); Austria: 24th, Germany: 25th; see World Economic Forum (2007); see also Intv. Austrian Econ. Association I (2007).

[2233] See section 2.2.4.2.

[2234] See Intv. German Econ. Association II (2007); Intv. Austr. MNC - Industrial Goods I (2007); Intv. Germ. MNC - Consulting I (2007); see also Lankes and Venables (1996).

that time and was actively communicated from investor to investor, while other factors (including tax policy and infrastructure) were less discussed at that time.[2235]

With a decreasing performance in some educational fields and reforms related to other determinants, investors who are present in Romania now do not seem to count the skill level as one of the decisive FDI determinants. This is also confirmed by the survey results presented in *AHK (2006)* according to which the qualification of graduates only represents the 21st most important criterion (out of 26) for investors in Romania. However, interviews also show that the education level still plays an important role for MNCs who are interested in initial investment in Romania and who have little knowledge about the country.[2236]

(e) In the **assessment** of this section the analyses have shown that Romania's economy and investment climate have benefited from a high level of education for a long time. However, it seems that the perception of many MNCs of the skill level has sometimes been even more positive than statistics would suggest. This may also be influenced by the specific needs (engineers) and location (Transylvania) of many investments. However, state experts also occasionally seem to overestimate Romania's advantages compared to other countries in the region.

Public policy should increase efforts to maintain the actual and perceived advantage in the education level of its workforce. Public policy makers should primarily work on increasing the practical knowledge of education. Most importantly, they should improve the education of business economists and skilled workers. For the latter group, three-year vocational training, as it exists in

[2235] See Intv. Germ. MNC - Automotive (2007); Intv. Germ. MNC - Financial Services III (2007); Intv. German Econ. Association III (2007); Intv. German Econ. Association VII (2007); Intv. German Econ. Association I (2007).

[2236] See also Intv. Germ. MNC - Automotive (2007); Intv. Austr. MNC - Financial Services II (2007); Intv. German Econ. Association V (2007); Intv. Romanian Authority I (2007); Intv. Romanian Ministry I (2007).

Germany, may not be realistic, but a minimum of practical training co-financed by central or local authorities, seems essential in order to satisfy the demands of a strongly growing economy.

(2) The **availability of labor** (a) represents a major problem for MNCs in Romania despite some regional and industry-specific differences. The labor shortage seems to be driven by (b) some non-policy factors, (c) deficiencies in the education system, (d) emigration, and (e) a lack of mobility among Romanians. This determinant seems to be (f) very important for the investment decision of many MNCs. An assessment is presented in sub-section (g).

(a) The great majority of interviewees confirms that Romania suffers from a **general labor shortage**, particularly since the beginning of 2007.[2237] MNCs especially have troubles finding sufficient staff in Bucharest and in Western Romania. In Timişoara company experts interviewed have recognized a shortage since late 2004. Other regions, such as Moldova and in the Danube region towards Bulgaria but also rural areas around boom centers like Sibiu, still seem to offer larger amounts of available workers.[2238]

From the perspective of the MNCs even unskilled workers are lacking in Romania to some extent. However, the greatest problem for recruiting departments is in obtaining young skilled workers and academics in various fields, especially when specialized skills are required. Industries with the greatest problems are the construction industry as well as the banking sector, but man-

[2237] See Intv. Austrian Econ. Association I (2007); Intv. Austr. MNC - Primary Goods II (2007); Intv. Supranational Authority I (2007); Intv. Int'l Econ. Association (2007); Intv. German Econ. Association V (2007).

[2238] See Intv. Germ. MNC - Retail (2007); Intv. Germ. MNC - Utilities (2007); Intv. Germ. MNC - Industrial Goods III (2007); Intv. Austr. MNC - Consumer Goods (2007); Intv. Rom. Local Authority I (2007).

agers, engineers, sales people, accountants, and craftsmen are missing in many industries as well.[2239]

(b) Some reasons for this labor shortage can or should **not be influenced by public policy**. Firstly, the recent economic boom – as discussed in *section 6.2.1* – has probably been the main driver for the low unemployment (5.2% in 2006) with rates below 3%, for example in Sibiu. The corresponding salary surge in many industries also aggravated the problem of finding adequate and affordable labor.[2240]

Secondly, many MNCs complain about a significant turnover of employees in Romania, which also seems to be higher than in other EECs. In some service-related jobs including insurances, advertising companies, retail sales etc. more than half of the staff apparently changes jobs within one year. Reasons are the many opportunities due to the economic boom, low company loyalty and the prospect of higher salaries and better benefits.[2241] Apparently, some MNCs in boom areas, for example in Sibiu, have responded to the labor shortage with a tacit agreement according to which companies do not recruit employees from each other.[2242]

However, Romanian public policy makers may not want to influence these factors, since counter measures, such as minimum wages or minimum duration contracts, are not advisable – as suggested in *section 7.2.5* on labor law – and could stall the economic upswing.

2239 See e. g. Intv. Germ. MNC - Consulting I (2007); Intv. Germ. MNC - Legal Services I (2007); Intv. Int'l MNC - Utilities (2007); Intv. Austr. MNC - Financial Services II (2007); see also AHK (2006).

2240 See Intv. Int'l Econ. Association (2007); Intv. Germ. MNC - Industrial Goods III (2007); Intv. Austr. MNC - Primary Goods II (2007); Intv. Rom. Local Authority I (2007).

2241 The turnover among top mangers seems to be less significant; see Intv. Austr. MNC - Financial Services II (2007); Intv. Austr. MNC - Financial Services I (2007); Intv. Germ. MNC - Retail (2007); Intv. Romanian Company - Advertising (2007); Intv. Germ. MNC - Software (2007); Intv. Germ. MNC - Financial Services III (2007).

2242 See Intv. German Econ. Association VII (2007); Intv. German Authority I (2007).

(c) Apparently, the **education system** does not produce enough high-skilled labor, particularly not in the fields relevant for MNCs. *Figure 96* in the appendix indeed reveals, in line with FDI studies[2243], that Romania's gross enrollment ratio in tertiary education (the share of tertiary students of the total relevant age group (generally 18-23 years old)) is at 52% fairly low, compared to the average of 15 EECs (60%) and especially important competitors such as Ukraine (73%) and Hungary (69%).[2244]

However, this ratio does not reveal how many students actually finish the programs they started and, more importantly, it does not give any insights regarding the distribution of students by field. *figure 57* gives a better reflection of the perspective of MNCs on the education system. As discussed before, interviewees generally mention engineering, business and law graduates as the most important fields for the operations of MNCs;[2245] they account for 64% of the Romanian 175K graduates in 2006, the third highest value of the countries analyzed. However, the evaluation of Romania becomes less favorable when these figures are related to the size of the population. Therefore, only 5.2 out of 1,000 inhabitants graduated in Romania in 2006 in those fields of study that are most relevant for MNCs, clearly trailing behind Lithuania and Latvia (7.2) as well as four further EECs.[2246]

These findings are also in line with the interviews that suggest that Romanian public policy makers should work on making engineering and business education more attractive in Romania and invest in staff, research capacities but also in a stronger cooperation with Western European universities and MNCs.[2247]

2243 See section 2.2.4.2; Carstensen and Toubal (2004); Altomonte and Guagliano (2003).

2244 Bulgaria only with 46%; UIS (2007); own calculations; see also OECD (2006a), p.176.

2245 See also Intv. Germ. MNC - Industrial Goods III (2007); Intv. Austr. Research Institute (2007); Intv. Romanian Company - Advertising (2007); Intv. Germ. MNC - Consulting I (2007).

2246 Weighted average of 15 EECs: 6.2; UIS (2007); own calculations; see for a similar approach: Doc - BA-CA (2007).

2247 See Intv. Austr. MNC - Industrial Goods I (2007); Intv. German Econ. Association I (2007); Intv. German Ministry (2007); Intv. Austr. MNC - Financial Services II (2007).

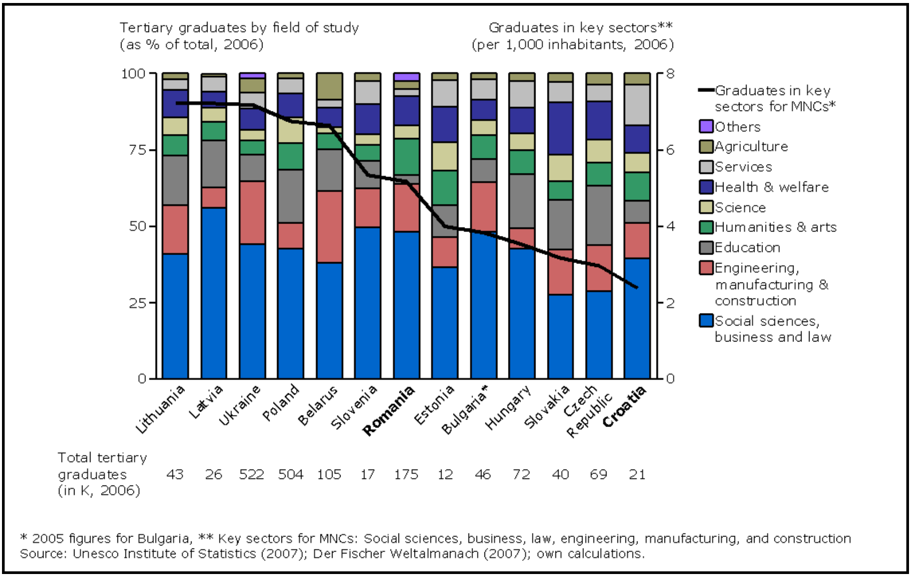

Figure 57: Graduates of tertiary programs by study field

(d) A further reason for the labor shortage in Romania is the large-scale **emigration** of workers to Western European countries. According to figures of the European Commission about 500K Romanians worked abroad in 2005 and this figure had risen to over one million by 2007.[2248] External reports speak rather of 2M[2249] and interviewees even of 3M emigrants (even though the peak of emigration flows may have been reached).[2250] Apparently, most Romanian emigrants go to Italy (59%) and Spain (29%) which are particularly attractive due to the low language barriers for Romanians.[2251] Interviewees confirm that especially young and well-educated Romanians emigrate, some only for summer

[2248] See EurActiv (2007b); own calculations.
[2249] See e. g. Pfaller (2007); Salzburger Nachrichten (2007).
[2250] See e. g. Intv. Austr. MNC - Industrial Goods I (2007); Intv. Austrian Econ. Association I (2007); Intv. Germ. MNC - Software (2007); Intv. German Authority IV (2007); Intv. Romanian NGO (2007).
[2251] See EurActiv (2007b); own calculations.

jobs (in the agricultural and construction sector) but many also for a longer period including engineers and managers. [2252]

Important reasons for emigration in the past were the language advantages compared to other Eastern Europeans in some countries, the large salary gap between Romania and Western countries, the freedom of travel due to intensified EU integration, supposedly better working conditions, and a liberal immigration policy in target countries like Spain. Especially when they have worked before in an MNCs in Romania for a while, employees seem to find a job abroad easily.[2253]

Experts agree that public policy should actively work on reversing emigration.[2254] Apparently, the Romanian government has also realized the need for more decisive measures and announced a strategy to motivate emigrants to return to Romania including better information regarding recent reforms and salary increases.[2255]

(e) Interviews suggest that a lack of **mobility** of Romanians also contributes to the labor shortage in the country. Apparently, many Romanians show little willingness to move within Romania for a job and will rather emigrate for a job offer. Experts interviewed see evidence for this inflexibility in any region, for every educational level (besides the top management) and age group in Romania.[2256]

The reasons most frequently mentioned are the high price level and high rents in Romanian cities, particularly in boom areas, on the one hand and moder-

[2252] See Intv. Germ. MNC - Consulting I (2007); Intv. Germ. MNC - Automotive (2007); Intv. Rom. Local Authority I (2007); Intv. Germ. MNC - Utilities (2007).

[2253] See Intv. Int'l Econ. Association (2007); Intv. Romanian Company - Advertising (2007); Intv. Germ. MNC - Industrial Goods III (2007); Intv. Germ. MNC - Automotive (2007).

[2254] See e. g. Intv. Austr. MNC - Industrial Goods I (2007); Intv. German Econ. Association VI (2007); Intv. German Authority IV (2007).

[2255] See Salzburger Nachrichten (2007).

[2256] See Intv. German Econ. Association III (2007); Intv. Austr. MNC - Industrial Goods I (2007); Intv. Romanian Company - Advertising (2007); Intv. Austr. MNC - Primary Goods II (2007).

ate salaries on the other hand; therefore, living in rural areas (generally in the dwelling of the parents) rather pays off for young graduates even if more attractive job opportunities exist in the cities. Experts interviewed emphasize that public policy needs to invest in social housing in order to make living in cities affordable. Furthermore, interviewees point out that the bad infrastructure (including roads, public transportation, railroad network etc.) between rural and urban areas also prevents an increase of labor mobility. For parts of the Hungarian minority in Western Romania potential language difficulties may also affect the mobility of the workforce.[2257] As a consequence, some MNCs have started to provide housing for their employees and introduced shuttle services to rural areas that are too distant to reach for employees who do not have a car.[2258]

(f) Experts interviewed agree that the current labor shortage is a **very important** constraint for higher FDI in Romania.[2259] Various investors interviewed even define the labor shortage as the most important constraint for doing business in Romania today.[2260] Particularly those MNCs that are already in the country with a focus on high-skilled labor and bound to a specific location are often restrained in their investment potential. Potential investors now often receive warnings from country experts that finding labor is an important impediment to doing business in Romania. On the other hand, potential investors seem slightly less deterred by the labor shortage since many of them rather have the chance to invest in areas with abundant labor.[2261]

[2257] See Intv. Germ. MNC - Legal Services II (2007); Intv. Germ. MNC - Legal Services I (2007); Intv. Int'l MNC - Utilities (2007); also acknowledged by: Intv. Romanian County Council (2007).

[2258] See also Intv. Germ. MNC - Automotive (2007); Intv. Austr. MNC - Consumer Goods (2007); Intv. Germ. MNC - Industrial Goods III (2007).

[2259] See Intv. Int'l MNC - Utilities (2007); Intv. Austrian Econ. Association I (2007).

[2260] See also Intv. Germ. MNC - Financial Services III (2007); Intv. Germ. MNC - Automotive (2007); Intv. Austr. MNC - Primary Goods II (2007); Intv. Romanian Authority I (2007).

[2261] See Intv. Int'l MNC - Utilities (2007); Intv. Austr. MNC - Consumer Goods (2007).

Experts confirm the findings of FDI studies for Romania that the low tertiary enrollment is an important factor in this context[2262], but interviews show that more factors are driving this shortage including the distribution of students by study field, emigration[2263] and mobility. FDI studies generally do not evaluate the availability of labor as dramatic because they were completed before the recent tightening of the Romanian labor market.[2264] Overall, primary sources indicate that the availability and as well as the skills of labor (discussed above) are just as important for the investment decision for MNCs interested in Romania as the actual labor costs.[2265]

(g) The **assessment** of this section shows that the availability of labor is a complex determinant that is not only driven by economic forces but also by various factors that can be influenced by the government. Romanian public policy has reacted too late with regards to the different dimensions analyzed in order to prevent the current shortage that also decreases the potential of FDI inflows to Romania today. The labor shortage may be somewhat mitigated with the next economic downturn but the structural problems of labor availability in Romania that were discussed still need to be tackled. In order to do so, education policy makers, need to realize that an increasing number of MNCs comes to Romania for the production of high-value goods and that this requires an increase of highly-skilled graduates and a shift within the academic fields of study. Public policy should also aim at an improvement of infrastructure (*see above*) and an increase of social housing in order to improve the mobility of the Romanian workforce. The involvement of local policy makers seems essential in this context. Romania should also enhance efforts to reverse emigration; ARIS

[2262] See Lankes and Venables (1996); Pye (1998); Altomonte and Guagliano (2003); Carstensen and Toubal (2004).

[2263] See also IMD (2006).

[2264] See also several surveys that present the availability of workforce as medium constraint for doing business in Romania, e. g. AHK (2006); World Economic Forum (2007).

[2265] See e. g. Doc - Austr. MNC - Industrial Goods III (2005); Intv. Germ. MNC - Legal Services I (2007).

(in cooperation with Romanian embassies abroad) could be supportive in this context, for example, by providing useful information for emigrants regarding job opportunities and trainings at home but also by establishing contacts to MNCs that often appreciate employees with international experience. Finally, the labor shortage may be further reduced by improving conditions for immigrants from other countries as already commenced for construction workers from China.[2266]

(3) In **conclusion**, this section has shown that human capital has been among the key factors influencing Romania's investment climate. Company experts may somewhat overestimate the quality of education and the problem of labor shortage but public policy makers should not neglect the long-term effects of the current deficiencies and work on the structural problems, mainly the education system, but also on interdependent factors such as infrastructure.

7.4.1.3 Croatia

(1) Croatia's **educational level** is (a) generally evaluated by MNCs in a positive way. More specifically, (b) the capabilities of skilled workers are apparently satisfactory, while (c) differences exist in different fields of university education. This (d) determinant seems to be quite significant for the investment decision of MNCs. An assessment is provided in sub-section (d).

(a) Interviews and secondary sources certify that the **general education level** of the Croatian workforce is "fairly good"[2267] or even "excellent"[2268] even though it may not fully reach Western European levels. Company experts report

[2266] See Rompres (2007a); Intv. Germ. MNC - Consulting I (2007).

[2267] Intv. Germ. MNC - Software (2007); see also Intv. Germ. MNC - Financial Services I (2007); Intv. Germ. MNC - Food Products (2007); Intv. Germ. MNC - Telecommunications (2007); Intv. German Authority II (2007); OECD (2003b), p.286; Dresdner Bank (2004), p.7; Doc - OECD (2007).

[2268] Intv. Germ. MNC - Industrial Goods I (2007); see also Intv. Croatian Company - Real Estate (2007).

for Croatia that the skill level in cities and rural areas are equally high, while the latter tends to be lower in many other SEECs including Romania.[2269] Experts interviewed appreciate the broad knowledge of Croatians and particularly – as for Romania – their technical and science skills[2270]; the quality of the latter is confirmed by *World Economic Forum (2007)* according to which Croatia is ranked 28th in math and science; Croatia therefore ranks 16 places behind Romania and 18 behind Serbia, but is still the 8th out of 18 EECs and math and science skills still seem better in Croatia than in other competing countries including Slovenia (37th) or Bosnia and Herzegovina (54th).

Interviewees specifically emphasize the good foreign language skills of Croatians[2271], which also corresponds to survey data; more than 70% of Croatians apparently speak a foreign language well enough to make conversation (*figure 55*); 49% of the population speaks English and 34% speaks German. These are the highest values in the region (only behind Slovenia).[2272] Particularly in Northern Croatia MNCs apparently find many employees – not only on the management level – with foreign language skills.[2273] Since 2005 further measures have been introduced in order to promote the learning of foreign languages form the first school year.[2274]

Nevertheless, interviews agree that education is still somewhat too theoretical; this seems to be one of the reasons why expats generally support the first investment phase of MNCs in Croatia and responsibility to locals is only passed on in a later stage.[2275] However, company experts interviewed also state that

[2269] See e. g. Intv. Austr. MNC - Retail (2007); Intv. Austr. MNC - Financial Services I (2007).
[2270] See Intv. Croatian Company - Real Estate (2007); Intv. Austr. MNC - Construction (2007).
[2271] See e. g. Intv. Austr. MNC - Real Estate (2007); Intv. Austr. MNC - Retail (2007).
[2272] See UIS (2007); APIU (2006b), p.12.
[2273] See also Intv. Germ. MNC - Industrial Goods I (2007); Intv. Germ. MNC - Financial Services I (2007).
[2274] See European Commission (2005a), p.97.
[2275] See e. g. Intv. Austr. MNC - Real Estate (2007); see also skeptical: Intv. Supranational Authority II (2007); Intv. Former Croatian Minister (2007).

these deficiencies are partly compensated by a high motivation, particularly among young employees.[2276]

In sum – and in contrast to the findings for Romania – interviews and secondary sources suggest that the quality of education in Croatia is generally improving. As a response to the remaining problems (and also to criticism by international organizations[2277]) an Adult Education Strategy (2004), an Education Development Plan 2005-2010 (2005) as well as corresponding action plans were adopted.[2278] The overall goal is to transform Croatia into a knowledge-based society; reforms include a revision of the curricula and a stronger decentralization of the education system which comprises a greater autonomy for education institutions. On the other hand, a stronger centralization of the evaluation of the education system was initiated by the foundation of a National Center for the External Evaluation of Education in 2005.[2279] Yet, external sources still see room for improvements considering that education spending remains fairly low with 4.6% compared to the Eastern European average of 4.8% (*figure 56*) but also to Western Euorpean countries (5-8%).[2280]

(b) Interviews show that MNCs seem to be quite satisfied with the quality of **skilled workers** in Croatia, especially in the metal processing industry. Apparently investors can still rely on a large pool of employees who have benefited from a well-advanced vocational training in Croatia in the 1980s.[2281]

However, experts interviewed are more critical in their the evaluation of the current vocational training. Even though a respective system continued

[2276] See Intv. Germ. MNC - Industrial Goods I (2007); Intv. Austr. MNC - Real Estate (2007); Intv. Germ. MNC - Telecommunications (2007); Intv. Austr. MNC - Financial Services I (2007).

[2277] See e. g. OECD (2003b), p.276.

[2278] See CMSES (2007); Intv. Croatian Authority II (2007).

[2279] See OECD (2006a), p.174; European Commission (2005a), pp.96-97; UIS (2007).

[2280] See OECD (2003b), p.279; NCC (2004b), p.32; EBRD (2005a), p.51; Bertelsmann Stiftung (2006b), p.2.

[2281] See Intv. German Econ. Association IV (2007); Intv. Germ. MNC - Industrial Goods I (2007); Intv. German Authority II (2007); Intv. German Authority III (2007); see also Intv. Germ. MNC - Engineering (2007); see also CMSES (2007), p.39.

to exist after 1990, the possible fields of training and curricula often did not match the need of the business world and institutions lacked sufficient qualified staff.[2282] Therefore, young entrants, for example in production and retail, often require further education provided by the companies even after the attendance of vocational programs.[2283] The German dual system was introduced in the late 1990s but has apparently not progressed much so far and has received little support from companies. The reform of the education system mentioned above also included a revision of the vocational training. A national agency for vocational training was set up in 2005 and the curriculum is apparently being adjusted to the needs of the labor market; however, external sources as well as experts interviewed point out that the visible impact of these reforms is scarce so far.[2284]

(c) Company experts suggest that MNCs are quite satisfied with the general quality of **university** education in Croatia, maybe even slightly more than in Romania. They note the fact that the Bologna process was introduced (in 2005), the teaching staff is generally quite qualified, the curricula basically provide a good theoretical foundation, and that many international programs exist, meaning many university graduates have studied abroad for some time.[2285]

Remaining problems identified by interviewees are again the practical dimension of academic education and a slow adaptation of the curricula to the economic development.[2286] In the ranking of higher education and training pre-

[2282] See e. g. OECD (2003b), pp.298-299; European Commission (2005a), pp.44, 97; CMSES (2007), p.35.

[2283] See Intv. Austr. MNC - Primary Goods I (2007); Intv. Austr. MNC - Retail (2007); Intv. Former Croatian Minister (2007).

[2284] See also European Commission (2007a), p.57; EBRD (2005a), p.50; OECD (2006a), pp.174-175; see also Intv. German Authority II (2007); Intv. German Authority III (2007).

[2285] See Intv. Germ. MNC - Software (2007); Intv. Austr. MNC - Real Estate (2007); Intv. Germ. MNC - Telecommunications (2007); Intv. Austr. MNC - Financial Services I (2007); Intv. German Authority II (2007); more skeptical: Intv. Austr. MNC - Consulting (2007); Intv. Germ. MNC - Food Products (2007).

[2286] See Intv. Austr. MNC - Construction (2007); Intv. Croatian Authority II (2007); Intv. Former Croatian Minister (2007).

sented in *World Economic Forum (2007)* Croatia takes 46th place (out of 131 countries) behind eight Eastern European member states but ahead of all other SEECs including Romania. Furthermore, national authorities have apparently realized that the Croatian university system has to undergo significant changes in order to reach the goal of a knowledge-based society.[2287]

As for Romania, experts interviewed speak highly of the academic education of Croatian engineers which appears to be at least as valuable as in other EECs.[2288]

Regarding the evaluation of the business education the evidence from the interviews is mixed. Interestingly, company experts are mostly satisfied with the business skills of the Croatian workforce, particularly of young graduates.[2289] In contrast, Croatian company and state experts are more skeptical regarding the management education in Croatia. They criticize that the education is too theoretical and often based on old curricula.[2290] The different evaluation can probably be explained by the fact that MNCs can generally recruit the most skilled graduates since they have the reputation of being able to offer – as discussed previously – higher salaries, more attractive incentive schemes and better working conditions than domestic firms. Therefore, the somewhat more skeptical view of the non-MNC interviewees give a more realistic picture of the average skill level of business education in Croatia. The mediocre per-

[2287] See OECD (2003b), p.311; NCC (2007); European Commission (2005a), p.97; CMSES (2007), p.136.

[2288] See Intv. Austr. MNC - Financial Services I (2007); Intv. Austr. MNC - Construction (2007); Intv. Germ. MNC - Financial Services I (2007); Intv. Former Croatian Minister (2007); see also Dresdner Bank (2004), p.7; more skeptical: Intv. Austr. MNC - Consulting (2007).

[2289] See Intv. Germ. MNC - Industrial Goods I (2007); Intv. Austr. MNC - Primary Goods I (2007); Intv. Germ. MNC - Food Products (2007).

[2290] See Intv. Croat. Company - Utilities (2007); Intv. Supranational Authority II (2007); Intv. Former Croatian Minister (2007); Intv. Austr. MNC - Consulting (2007).

formance of management schools is also supported by findings of the World Competitiveness Report ranking Croatia's 71st behind Slovenia (44th).[2291]

(d) The education level of the domestic employees is quite **important** for the investment decision of MNCs and a strong argument in favor of Croatia. It seems that the skills of Croatian workers and academics can make a difference if the country selection is narrowed down to a few options. Good foreign language skills and the broad knowledge among Croatian university graduates in particular seem to compensate the (perceived)[2292] high labor costs.[2293] Interviews therefore suggest a higher importance of this determinant for Croatia than the FDI surveys in *AHK (2006)* suggests, which only see a mediocre importance of qualification in general (9th out of 26) and a low impact for MNCs regarding the skill level of graduates (21st).[2294]

However, interviews also reveal that the importance of the skilled labor force is somewhat decreasing for MNCs in Croatia. This may be because the interest in industrial FDI is decreasing. In tourism, where many unskilled workers are employed, the skill level also seems to play only a secondary role.[2295]

(e) In the **assessment** of this section it seems that Croatia benefits from a fairly good education system that has been very competitive among SEECs. The very positive perception of MNCs may however not give a full picture of the status of Croatia's current education system. The Croatian education system may in fact have some important deficiencies; however, MNCs (especially if they are large and well-known) are probably less affected by them since they can generally recruit the most talented staff by offering attractive benefits.

2291 But ahead of Serbia (84th) and Bosnia and Herzegovina (104th); see World Economic Forum (2007).

2292 See section 6.3.2

2293 See Intv. Germ. MNC - Industrial Goods I (2007); Intv. Austr. MNC - Construction (2007); Intv. German Authority III (2007).

2294 See similar: Lankes and Venables (1996).

2295 See Intv. Germ. MNC - Engineering (2007).

Besides, Croatia's high unemployment creates less problems of labor shortage as in Romania.

However, interviews with state representatives show that public policy makers are well aware of Croatia's need to invest more in education to remain competitive and to enable high future FDI inflows. Most importantly, Croatia needs to implement the envisaged reform of the vocational training for skilled employees and continue with the reforms in the university, most notable of business education including the promotion of private management schools.

(2) The **availability of labor** is also for Croatia (a) a general problem, although to lesser extent than in Romania. While (b) non-policy determinants are less decisive, (c) the education system seems to be an important reason for the labor shortage. Furthermore, (d) emigration and (e) labor mobility apparently only play a subordinate role in this context. The ability of labor (f) has a medium importance for the investment decision of MNCs in Croatia today. Sub-section (g) provides an assessment.

(a) According to the interviewees, MNCs repeatedly complain about a **general labor shortage** in Croatia albeit less than in Romania.[2296] Compared to the situation in the early 2000s, investors seem to have more difficulties in finding highly-skilled employees today, such as engineers (for example for the construction industry), but also employees for the management and administration of their operations including accountants as well as specialized production workers. The availability of highly-skilled labor apparently decreases in rural areas distant from the large universities.[2297] Nevertheless, (large) foreign investors seem to have fewer problems in recruiting sufficient employees

[2296] See Intv. Germ. MNC - Industrial Goods I (2007); Intv. Austr. MNC - Retail (2007).

[2297] See Intv. Germ. MNC - Industrial Goods I (2007); Intv. Austr. MNC - Real Estate (2007); Intv. Croatian Company - Real Estate (2007); Intv. Austr. MNC - Primary Goods I (2007); Intv. Austr. MNC - Construction (2007); Intv. Supranational Authority II (2007); Intv. Former Croatian Minister (2007).

than domestic firms for the reasons mentioned above.[2298] The availability of unskilled workers seems to be less of a problem for MNCs in Croatia (also in comparison to Romania).[2299]

(b) **Non-policy factors** do not seem to play an important role in explaining this shortage of adequate labor for MNCs in Croatia.[2300] As elaborated in *section 6.3.1*, Croatia has been suffering from high unemployment for many years, with a registered unemployment rate of 17.0% in 2006. Furthermore, the turnover rate seems to be lower than, for example, in Romania and employee fluctuation mainly affects the jobs in public administration and in some tourist hotspots at the coast.[2301]

(c) Problems of the **education system** seem to be most important in explaining labor shortage in Croatia. According to *figure 96 in the appendix* only 44% of Croatia's relevant age group were enrolled in a tertiary program in 2006. This is 16% below the Eastern European average and even 39% less than in Slovenia. Accordingly, public policy has not been able to enroll the majority of Croatians – either in vocational training or university programs – after finishing high school.[2302]

Furthermore, *figure 57* shows that only 21K tertiary students graduated in Croatia which represents 4.7 out of 1,000 inhabitants. More importantly, only 2.4 graduates came from key sectors for MNCs (engineering, business administration etc.). This is the lowest value of the 13 EECs analyzed.[2303]

It seems that the vocational training has significantly lost its attraction; the decrease of employees with vocational training from 37% in 1988 to 18% in 2003

[2298] See Intv. Germ. MNC - Software (2007); Intv. Germ. MNC - Telecommunications (2007).
[2299] See e. g. Intv. Austr. MNC - Construction (2007); see also NCC (2004b), p.33.
[2300] See e. g. Intv. Former Croatian Minister (2007).
[2301] See Intv. Germ. MNC - Industrial Goods I (2007); Intv. Austr. MNC - Primary Goods I (2007); Intv. Austr. MNC - Retail (2007); Intv. Croatian Ministry IV (2007).
[2302] See Intv. Former Croatian Minister (2007); Bertelsmann Stiftung (2006b), p.10; CMSES (2007), p.136.
[2303] Some MNCs may also recruit staff from "services" programs.

may reflect the de-industralization in all transition countries, but according to the interviewees as well as secondary sources, the quality of vocationally-trained employees has fallen below acceptable levels.[2304]

Furthermore, the seven public universities and 16 public polytechnics do not seem to produce enough students with skills needed by MNCs. Interviews[2305] and secondary sources show[2306] that students would appreciate lower bureaucratic hurdles for entering universities. The investment strategy focusing on high-technologies such as biotechnology (*section 7.3.5.3*) is apparently not sufficiently reflected in the programs offered by the universities. Finally, young people from rural areas also find the offers for tertiary education significantly less attractive than in larger cities.

(d) **Emigration** seems to have only limited influence on the labor shortage experienced by MNCs. No precise figures exist but official sources speak of about 40,000 Croatians with tertiary education working abroad.[2307] Even if the total number of Croatian emigrants (including unskilled workers) reached 200K – as some other sources suggest – the share of emigrants of the total population would still be significantly lower (about 1-5%) than in Romania (about 10-15%). The main reasons for Croatians to work abroad seem to be the experience abroad and better working conditions rather than economic motives (as in Romania). Most of these emigrants apparently return after some time and are well appreciated by MNCs for their professional and language skills.[2308]

(e) Some interviews suggest that the limited **mobility** of Croatians may also influence the labor shortage. As in other EECs, young Croatians tend

[2304] See CMSES (2007), p.176; Intv. Croatian Authority II (2007).
[2305] See Intv. Croatian Company - Real Estate (2007); Intv. Austr. MNC - Construction (2007); Intv. Croatian Authority II (2007).
[2306] See OECD (2003b), p.278; NCC (2004b), p.33; Grupe and Kušić (2005), p.2; APIU (2007); CMSES (2007).
[2307] This does not comprise those Croatian who left the country before 1990 as discussed in section 6.3.2; see CMSES (2007), p.42.
[2308] See Intv. Germ. MNC - Software (2007); Intv. Germ. MNC - Telecommunications (2007); NCC (2004b), p.33; CMSES (2007), p.42; own calculations; more skeptical: IMD (2006).

to live longer at home with their families than in Western Europe. However, Croatians rather seem to be willing to move or commute for a job than in Romania, also because infrastructure is better, the relative real estate prices are lower (*see above*) and distances are less remote.[2309] Finally, Croatians may be used to moving, given the recent experience of war, when many families from the southern and eastern parts of the country moved to safer cities in Northern Croatia.

(f) Interview results are in line with the finding of FDI studies that the availability of unskilled workers has basically no **impact** on FDI in Croatia, while the availability of high-skilled labor has medium importance on the investment decision of MNCs that are interested in Croatia.[2310] Most importantly, MNCs seem less affected by the labor shortage than domestic firms due to their good reputation among top graduates in Croatia. MNCs also seem to benefit from many Croatians who switch from high-profile government jobs to the business world (even more than in Romania). [2311]

(g) In the **assessment** of this section, analyses have shown that Croatia has a labor shortage despite a very high unemployment rate. Therefore, public policy should take actions quickly in order to meet the requirements of the business world better; most importantly, the number of tertiary graduates, especially in engineering and business administration needs to be increased. Even though MNCs may not be as strongly affected today, public policy should anticipate their increasing problems in finding sufficient labor, also considering Croatia's ambitious targets to boost FDI in technology-oriented industries. A connection of the availability of labor to the education level therefore seems more prominent in Croatia than, for example, in Romania, since an increase of

[2309] See Intv. Germ. MNC - Industrial Goods I (2007); Intv. Austr. MNC - Construction (2007); Intv. Croatian Mayor (2007); Intv. Germ. MNC - Telecommunications (2007).

[2310] See AHK (2006); see also Brada, Kutan, and Yigit (2003).

[2311] See also Intv. Croat. Company - Utilities (2007); Intv. Croatian Ministry IV (2007); Intv. Germ. MNC - Engineering (2007); Intv. Germ. MNC - Telecommunications (2007); Intv. Croatian Company - Real Estate (2007).

the average education level could enlarge the pool of future high-skill graduates and potential employees for both domestic and foreign businesses in Croatia.

(3) In **conclusion**, human capital is a quite important factor for FDI in Croatia. Analyses have shown that MNCs are in a better position than, for example, MNCs in Romania since MNCs here have to compete more with domestic companies for the top graduates (who are also less mobile) of the host country.

7.4.1.4 General insights for transition countries

Based on the analysis of prevision sections and further secondary sources, several insights can be derived regarding human capital in transition countries. Findings comprise (1) the performance of transition countries, (2) the importance of this factor and (3) several implications for public policy makers.

(1) MNCs seem to be quite satisfied with the educational level of skilled workers and academics in transition countries.[2312] Various statistics show that most EECs are **performing** quite well in terms education, particularly regarding science and technical skills. In the math and science ranking presented in *World Economic Forum (2007)* 18 EECs analyzed take a (weighted) average 36th position out of 131 countries (and even ahead of the EU 15 (40th)).[2313] Engineers are generally well perceived by investors across most former communist countries; however, cases such as the Romanian one, suggest that various countries have not sufficiently adjusted their curricula according to the needs of today's economy up to now.[2314] It seems that some governments have realized

[2312] See Intv. Austr. MNC - Retail (2007); Intv. Germ. MNC - Software (2007); Intv. Austr. MNC - Financial Services I (2007).

[2313] Weight based on population; see also Der Fischerweltalmanach 2007 (2006); own calculations.

[2314] See for further examples: OECD (2006a), pp.169-189; see also Intv. Supranational Authority I (2007).

only lately that the demand of their economies has been shifting from low to higher skilled workers with good tertiary education, particularly in the fields that are most asked for by investors including engineering, business economy as well as law.[2315] The level of business education still seems to be significantly lower in the vast majority of transition countries than in Western Europe and often lacks a systematic approach. This is also reflected in management school rankings in which EECs take a (weighted) average 71st place clearly behind the EU 15 (21st).[2316] Language skills seem to strongly differ from country to country with some very positive examples (such as Croatia), while the knowledge seems to depend on the education level and the region in other EECS (such as Romania).

(2) Human capital seems to be a very **important** FDI determinant for transition countries and on comparable levels like labor costs or infrastructure[2317], even though state interviews may to some extent overestimate the positive aspects (as suggested for Romania). The skill level generally seems to be more important for investors than the availability of labor because MNCs are often in a privileged position regarding the search for highly-skilled employees and are frequently able to recruit the most skilled workers of their field. These insight expands the findings of FDI studies that generally focus on enrollment ratios.[2318] The impact of emigration on human capital seems to depend on host country characteristics (such as liberal immigration legislations in Spain and the UK)[2319] as well as home country specifics whereas lower language barriers (as for Romanians) and high unemployment (as in Poland) may be

[2315] See also Intv. Austr. MNC - Construction (2007); Intv. Former Croatian Minister (2007).
[2316] See World Economic Forum (2007); Der Fischerweltalmanach 2007 (2006); own calculations; see also Pommer (2007), p.142.
[2317] See e. g. Doc - Austr. MNC - Industrial Goods III (2005); Intv. Germ. MNC - Logistics (2007).
[2318] See also Savary (1997); Pye (1998); AHK (2006); Borsos-Torstila (1999).
[2319] Even though UK increased migration barriers for Bulgaria and Romania; see Sofia Echo (2007); EurActiv (2007a).

important factors. When emigrants return they are generally well appreciated as employees by MNCs because they bring language skills, flexibility and motivation.[2320] According to interviews and secondary sources the availability of unskilled workers generally does not seem to be an important criteria for MNCs in any transition countries. In fact, German investors in 11 out of 14 EECs evaluate the availability of unskilled workers as the least important of 26 determinants overall.[2321]

(3) Possibilities of **public policy** to improve human capital are manifold despite constraints such as low unemployment and high turnover rates. Most EECs should increase government spending in education, particularly regarding the education of skilled workers (vocational training) as well as in key academic fields in order to close remaining gaps to Western Europe. Furthermore, tertiary education in rural areas should be enhanced.[2322] Transition countries should also increase the cooperation with both foreign and domestic companies in order to better understand the skills needed by the economy.[2323] Cooperations with foreign universities (as shown for Romania) may also be helpful in this context. Furthermore, education policy should be closely linked to the goals of investment promotion (*see above*). Investment promotion agencies may also help to facilitate the return of emigration and their placement in MNCs. Finally, governments should work on interdependent factors that further influence human capital, most importantly infrastructure. Social housing should be increased in order to decrease living costs and increase the mobility of the work force.[2324]

[2320] See also Intv. Romanian Company - Advertising (2007)
[2321] In Romania, Estonia and Slovakia among the three least important factors; see AHK (2006).
[2322] See also Intv. Austr. Research Institute (2007).
[2323] See also Intv. Austr. MNC - Construction (2007); Intv. Former Croatian Minister (2007).
[2324] See also Intv. German Political Adviser (2007).

7.4.2 Political stability

7.4.2.1 Definition

As elaborated in the theoretical part of this thesis (*section 2.2.4.2*), political stability is frequently cited in FDI studies as important driver for FDI in transition countries.[2325] Interviews suggest that MNCs distinguish between two different types of political stability when they analyze the attractiveness of potential host countries – internal and external political stability.[2326] The (1) internal political stability refers to the political situation within the host country including the maturity of democracy as well as the functioning of institutions and the government; the reliability of political decisions and country-specific issues (such as minority policy) may also play a role in this context. When MNCs from Austria and Germany scrutinize the (2) external political stability of transition countries, they generally consider the relationship to Western Europe and to neighboring countries but also the cooperation with international organizations. Sections (3) provide conclusions for Romania and Croatia respectively. EU integration, also an important dimension of political stability, is analyzed separately in *section 7.4.4*.

7.4.2.2 Romania

(1) Crucial aspects of Romania's **internal political stability** are (a) the attitude of Romanians towards their leaders, (b) the exchange of elites, (c) the stability of the political system, (d) the participation of civil society, and (e) the reliability of government decisions. The (f) importance of this determinant was high but decreased over time. An assessment is provided in sub-section (g).

[2325] See e. g. Brada, Kutan, and Yigit (2003); Woodward, Rolfe, Guimaraes, and Doupnik (2000).

[2326] See e. g. Intv. Austr. MNC - Industrial Goods I (2007); see also Bertelsmann Stiftung (2006a), pp.93-94.

(a) Many investors and observers from Western countries have doubted Romania's ability to establish a stable democracy for a long time considering its tendency to support **strong leaders**. Political opposition in Romania remained limited during Ceauşescu's regime compared to other EECs. Even after its end external sources identify a trend towards authoritarianism in Romania, since all new presidents (Iliescu (1989-1996 and 2000-2004), Constantinescu (1996-2000) and Băsescu (since 2004)) were celebrated as saviors by the Romanian population. Characteristically, president Iliescu led a party alliance after 1989, that was called the National Salvation Front (Frontul Salvării Naţionale (FSN)). Romanians have also expected large changes to be initiated rather by the president than by the parliament. Nevertheless, observers acknowledge that Romania is in little danger of sliding into a regime that is opposed to democracy today, also because Romanian presidents have hardly been able to fully use their powers (*discussed below*).[2327]

(b) After the end of communism in Romania – which was the bloodiest one in Eastern Europe with more than 1,000 fatalities – the **exchange of elites** proceeded only slowly. Many sources raise doubts that a clear rupture with the past was carried out since Romania was the only EEC in which the political leadership was not significantly exchanged (with the exception of Slovenia) and in which various former communist cadres governed Romania between 1989 and 1996 including the president who had been a second rank communist himself under Ceauşescu. Therefore, the first years of the post-communist period were marked more by continuity than by change.[2328] One important reason was that no underground opposition existed under Ceauşescu (as in Poland or Czech Republic because opponents of the regime were expelled) that could have stepped up to establish a credible political restart after 1990. As a con-

[2327] See Kunze (2000); Maniu, Kallai, and Popa (2001), p.14; Lisske (2001); Boia (2006).
[2328] See e. g. Lisske (2001), Maniu, Kallai, and Popa (2001), pp.14-15; Intv. Germ. Political Foundation II (2007); different: Intv. Germ. Research Institute I (2007).

sequence, the rupture with communism was not finalized until 1996 when the center-right politician, Emil Constantinescu, became president. Nevertheless, politicians who had been active during communist times can be traced in most political parties even today.[2329]

Furthermore, many former members of the secret police force, the Departamentul Securităţii Statului (Securitate), were apparently able to stay in key positions even after 1990. Various experts also assume that former Securitate members were successful in privatizations because they had good access to information and key decision makers. Some experts interviewed point out that a network of former Securitate members may exist even today with significant influence on public policy.[2330] The authority to study the past of the Securitate, the Consiliul Naţional Pentru Studierea Arhivelor Securităţii (CNSAS), was established in 1999 but lacked the political support during the left-wing government from 2000-2004. Under the new government the CNSAS revealed some spectacular connections of politicians to the Securitate (including the former Minister of Culture, Mona Musca). A special commission installed by the president presented a report about the consequences of communism in December 2006 which was interpreted as important step towards a clarification of the role of the Securitate during and after communism. However, a systematic examination of the Securitate archives has not been accomplished so far and a lustration law has been debated in parliament since 2006. Primary and external sources also criticize that the work of the CNSAS has repeatedly been abused and use to pressure political opponents instead of serving as a basis for systematically addressing issues of the past. Most recently, the work of the

[2329] See Intv. Germ. Political Foundation II (2007); Maniu, Kallai, and Popa (2001), p.21; Lisske (2001).

[2330] See e. g. Intv. Germ. Political Foundation II (2007); Intv. Germ. MNC - Consulting II (2007).

CNSAS has even been questioned in general by a controversial verdict of the constitutional court.[2331]

(c) Many observers have mistrusted the **stability of the political system** throughout Romania's transition. Western observers doubted in the past that Romania was on its way towards a democratic and reform-oriented country considering various difficult government constellations and the strength of extremist parties. This seemed to be particularly true when the rightist extremist Partidul România Mare (PRM) was part of the government of 1994-1996, together with the post-communist Partidul Social Democrat (PSD).[2332]

Many experts were thus relieved when the center-right government took office in 1996. The achievement of the political Copenhagen criterion in 1997 can also be understood as an acknowledgment of the European Commission of Romania's development towards a democratic political system.[2333] Company experts confirm that they do not expect a future political radicalization (neither towards the right nor the left) and that political stability could be maintained even if extremists become part of a Romanian government again one day.[2334]

Another aspect worth mentioning are the quarrels between the president and the prime minister which have a long tradition in Romania and have often resulted in a delay of reforms. Problems originate from a weak constitutional description of rights and duties of the two functions as well as in the obligation (that recalls of the French cohabitation) of president and prime minister to cooperate even if they are from different political parties. However, personal issues may aggravate these institutional challenges.[2335] The most recent conflict, for example, between President Băsescu and Prime Minister Popescu-Tăriceanu is

[2331] See Gray (2004); Dill, Vasiu, and Voinea (2006); Der Tagesspiegel (2008).
[2332] See Maniu, Kallai, and Popa (2001), p.21; Wagner (2001); Boia (2006), p.18.
[2333] See European Commission (1997), p.19; European Commission (1998), p.12; BA-CA (2006), p.7; see also Intv. Supranational Authority I (2007).
[2334] See Intv. German Econ. Association I (2007); Intv. Austr. MNC - Industrial Goods I (2007); see also Doc - KAS (2007).
[2335] See Intv. Romanian NGO (2007); Maniu, Kallai, and Popa (2001); Gabanyi (2005).

interpreted by various experts interviewed as the fight for supremacy between two ambitious men.[2336] Experts criticize the harsh and unprofessional tone of this "embarrassing duel"[2337] and even state representatives assume that this conflict – also called "war of the palaces"[2338] – reveals deficiencies in Romania's political culture.[2339] The current quarrels caused a constitutional crisis in July 2005 when president and prime minister argued about reelections as well as in a (failed) impeachment procedure against President Băsescu in May 2007.[2340] *Figure 58* underlines that the functioning of government – which also reflects the quarrels between the president and the prime minister – remains the weakest point in Romania's political system and leads to a lower performance in the Freedom House ranking compared to all other Eastern European EU members as well as Croatia.[2341]

Nevertheless, most experts assume that the political quarrels (of these two prominent figures) will be over after the parliamentary and presidential election in November 2008.[2342] Experts interviewed emphasize that – despite all political struggles – institutions are functioning in Romania and that important political reforms have been accomplished (including EU accession). Therefore, both company and state experts agree that internal political stability is generally given in Romania today.[2343] External sources also acknowledge that Romania has – despite all problems mentioned – significantly strengthened its

[2336] See Intv. Germ. MNC - Consulting II (2007); Intv. Romanian NGO (2007); Intv. German Authority IV (2007).
[2337] Intv. Germ. MNC - Utilities (2007).
[2338] The prime minister resides in the Victoria Palace and the president in the Cotroceni Palace.
[2339] See Intv. Romanian Ministry I (2007); Intv. Germ. Political Foundation II (2007).
[2340] See Intv. German Authority I (2007); Intv. Romanian NGO (2007); Intv. Germ. MNC - Software (2007); Intv. German Econ. Association II (2007); Intv. Germ. Research Institute I (2007).
[2341] See Freedom House (2007); see also Bfai (2005), p.26.
[2342] See e. g. Intv. German Econ. Association III (2007).
[2343] See Intv. German Authority I (2007); Intv. Germ. MNC - Automotive (2007); Intv. Germ. Political Foundation II (2007); Bfai (2005), p.26; AHK (2006).

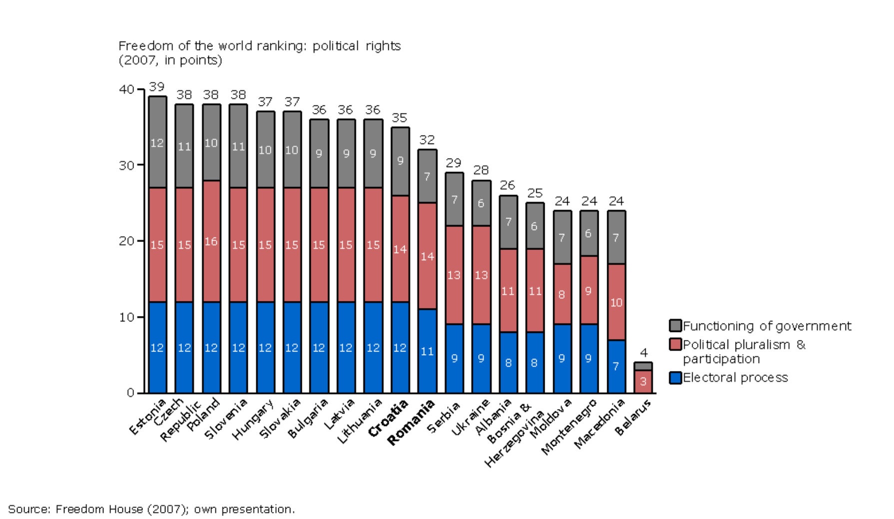

Figure 58: Political rights by category in Eastern Europe

democratic system in recent years and *figure 59* indicates that political rights have reached a decent level since the change of government in 1996.[2344]

(d) Interviews show that many **Romanians are frustrated by politics** as a result of the ongoing political quarrels.[2345] External studies confirm that the trust of Romanians in politicians is very low in general, placing Romania 112th out of 131 countries in a respective ranking in 2007 (representing the second worst place of 18 EECs only ahead of Bosnia and Herzegovina).[2346]

Furthermore, the participation of civil society remains limited. Apparently, Romanians are not always sufficiently aware of their civic and political rights and experts identify few good non-governmental organizations (NGOs); active support is often low because citizens are afraid to share personal data

[2344] See Freedom House (2007); see also CICD (2006), p.15.
[2345] See e. g. Intv. Germ. Political Foundation II (2007); Intv. German Econ. Association V (2007).
[2346] See World Economic Forum (2007); Lisske (2001).

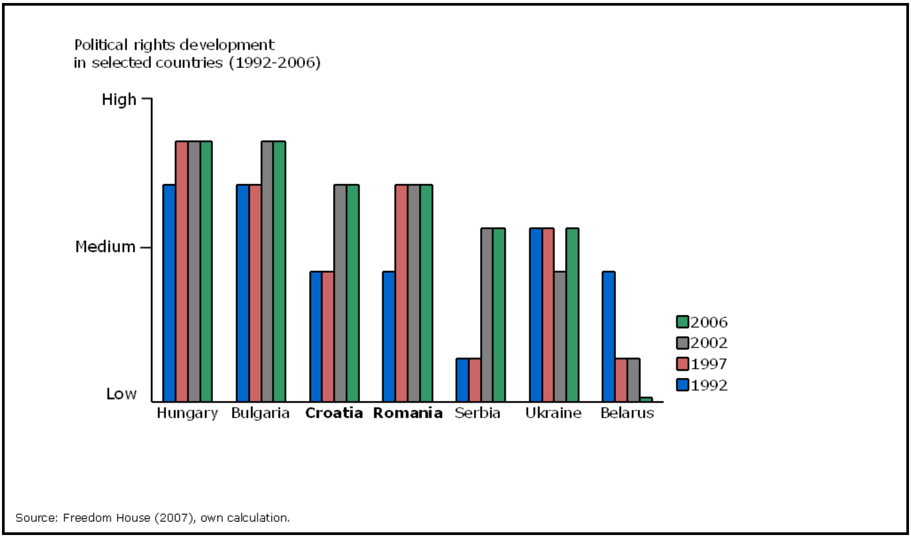

Figure 59: Political rights development in Eastern Europe

(for example when signing a petition) based on their negative experiences during communist times.[2347] Moreover, the commitment of the youth to involve themselves in political matters seems quite low as well. Overall, Romania only receives 5 out of 10 points in terms of social self-organization according to the BTI. Serbia as well as Bosnia and Herzegovina are the only countries out of 15 EECs with lower scores.[2348]

(e) The **reliability of government decisions** was not always present in Romania throughout the 1990s, since decisions that had once been taken were often revised due to political pressure or changing government priorities.[2349] By contrast, the majority of investors acknowledges that the reliability of government decisions increased during the second term of President Iliescu (and

[2347] See Intv. Germ. Political Foundation II (2007); Intv. Romanian NGO (2007).
[2348] With four points; see Bertelsmann Stiftung (2006c); see also Habersack (2002).
[2349] See Intv. Austr. MNC - Financial Services I (2007); see also FIC (2005), p.15; Müller (2005), p.195.

Prime Minister Adrian Năstase (2000-2004)). Apparently the former communists had learned from their mistakes of the first term and realized that credible government decisions were necessary in order to overcome the existing economic and social problems that had hampered Romania's transition in the 1990s (see *section 6.2.1* on the economic development). The pressure from the EU to fulfill the acquis also increased the necessity of reliable political decisions.[2350]

However, the current quarrels between president and prime minister have apparently decreased the continuity, reliability and effectiveness of Romanian politics again. Experts interviewed make the criticism that this conflict led to many institutional re-organizations and to the shuffling of many ministers and state officials (even on lower levels of the bureaucracy).[2351] As a consequence, many processes, reforms and political decisions were delayed or even stalled that are important, for example, for privatizations and infrastructure projects.[2352] Funds from the EU have also been put on hold. This impairs local projects and the motivation of state officials.[2353] In sum, some company experts find political decisions in Bulgaria, for example, to be more reliable than in Romania today.[2354]

(f) Interviews reveal that the internal political stability is an **important factor** that MNCs look at before an investment in Romania.[2355] However, several specifications can be drawn from the expert interviews.

[2350] See e. g. Intv. Romanian Econ. Association II (2007); Intv. German Econ. Association V (2007); Intv. Germ. Research Institute I (2007); Intv. Germ. MNC - Legal Services II (2007); Intv. Austr. MNC - Primary Goods II (2007).
[2351] See Intv. Austr. MNC - Primary Goods II (2007); Intv. German Econ. Association III (2007); Intv. German Econ. Association I (2007); Intv. Int'l MNC - Utilities (2007).
[2352] As shown for privatizations in section 7.3.4.2.
[2353] See Intv. Romanian County Council (2007); Intv. Germ. MNC - Software (2007); Intv. Germ. MNC - Utilities (2007); Intv. German Political Adviser (2007); Intv. Germ. MNC - Legal Services I (2007).
[2354] See e. g. Intv. Int'l MNC - Utilities (2007).
[2355] See Intv. Austr. MNC - Industrial Goods I (2007); Intv. Germ. MNC - Automotive (2007); see also Doc - GTZ (2006b).

According to both interviews[2356] and FDI studies[2357] the importance of the determinant was very significant until the early 2000s. The somewhat undemocratic tendencies as well as inefficient and unreliable governments (at least until 1996) were apparently important obstacles for many investors from Austria and Germany, particularly in comparison with more stable EECs such as Czech Republic and Poland. The lack of exchange of elites as well as of civil society participation and the constitutional set-up contributed to a greater insecurity of potential investors in the 1990s, particularly when MNCs were little experienced in transition countries. However, increasing progress in reforms showed many potential investors in the early 2000s that Romania's internal political stability had reached a point of no return. Therefore, interviews show that political stability has become either irrelevant for the investment decision of MNCs[2358] or even an enhancing factor in favor or Romania for companies that consider Ukraine or Moldova as alternative country options.[2359]

The current quarrels apparently do not have any major influence on investors and their investment decision so far.[2360] Interestingly, interviews show that political turmoils, for example, in Hungary in 2006 regarding the state of the economy and the credibility of the government of Ferenc Gyurcsány (since 2004) had a more severe impact on the investment climate than the ongoing quarrels in Romania. The main reason seems to be – once again – the specific perception of Romania; MNCs are less surprised about political imbalances in

[2356] See e. g. Intv. Germ. MNC - Consulting I (2007); Intv. Austr. MNC - Financial Services I (2007).
[2357] See e. g. Brada, Kutan, and Yigit (2003); Holland and Pain (1998).
[2358] See e. g. Intv. Austr. MNC - Financial Services II (2007); Intv. Germ. MNC - Retail (2007).
[2359] See Intv. Supranational Authority I (2007); Intv. German Econ. Association III (2007); Intv. German Econ. Association I (2007).
[2360] See e. g. Intv. Germ. MNC - Legal Services II (2007); Intv. Germ. MNC - Consulting II (2007).

Romania but would generally not expect them in Hungary and may prefer to wait with follow-up investments there.[2361]

Experts interviewed also point out that internal political stability does not represent an obstacle for MNCs anymore, because the economic development seems to be decoupled from politics. According to them, the economy is developing very well despite the current political quarrels and only a significant aggravation of the current crisis and a long-lasting standstill of reforms would influence the investment decision of MNCs.[2362] State experts even believe that "the political situation of a country is not as important since investors are looking at the mere economic performance"[2363].

Finally, the importance of the internal political stability depends on the type of investment and seems to be most crucial for MNCs interested in privatizations or FDIs in areas with high political visibility (including financial intermediaries). Yet, this group of investors has apparently not been largely deterred by the current political quarrels so far which is shown by the significant privatization sales and FDI inflows from banks and insurance companies since 2004 as well as by the recent acquisition of the Craiova plant by Ford.[2364] If political quarrels continue to aggravate, they may also represent a "push factor" for MNCs who have been thinking about leaving the country anyway (even though the main reason may be a different one, such as labor shortage).[2365]

[2361] See Intv. Germ. MNC - Financial Services III (2007); Intv. Germ. MNC - Software (2007); Intv. Germ. MNC - Industrial Goods II (2007); see also Financial Times (2006b); Mayer (2006).

[2362] See Intv. Austr. MNC - Financial Services II (2007); Intv. German Authority IV (2007); Intv. Austrian Econ. Association I (2007); Intv. Germ. MNC - Legal Services II (2007); Intv. Germ. MNC - Legal Services I (2007).

[2363] Intv. Romanian Authority I (2007); see also Intv. Romanian Ministry I (2007).

[2364] See Intv. Austr. MNC - Legal Services (2007); Intv. Austr. MNC - Financial Services II (2007); Intv. Germ. MNC - Financial Services III (2007); Intv. Germ. MNC - Software (2007); see also Siebenbürgische Zeitung (2007).

[2365] See Intv. Germ. MNC - Software (2007); Intv. German Econ. Association II (2007); Intv. Romanian Authority II (2007); Intv. Romanian County Council (2007); Intv. Germ. Political Foundation II (2007).

(g) In the **assessment** of this section it becomes apparent that there was little or hardly any internal political stability in Romania in the 1990s but that this significantly increased between 1996 and 2004. The evaluation of the current situation is mixed. Shortcomings in the past such as deficiencies in definition of political functions and a lack of a comprehensive dealing with the past have contributed to today's remaining problems. Interviews have also shown that the evaluation of internal political stability is a highly subjective matter for MNCs that is strongly influenced by the perception that investors have of Romania. In this context Romania may actually benefit from lower expectations in its internal political stability since political turmoils may have less deterring effects than in (supposedly) more stable countries.

The impact of political stability on the economic development and on FDI may have decreased for Romania in recent years but some state representatives may somewhat underestimate the (potentially negative) impact of current political quarrels, given the effects that these can have on law-making, reforms, privatization, and Romania's country image. Public policy should work not only on establishing a mature political culture but also on the deeper causes, including a comprehensive examination of misdemeanors before 1990.

(2) The analysis of the **external political stability** shows that Romania has undergone important developments with respect to (a) international cooperations in general and (b) IMF and (c) NATO in particular. This determinant has been (d) of medium importance for the investment decision of MNCs for the most part of Romania's transition. An assessment is provided in sub-section (e).

(a) Romania's **international cooperation in general** remained vague in the first years of its transition. President Illiescu attempted a balancing act aiming at improving ties to both the West as well as to Russia. Efforts of Prime

Minister Petre Roman's (1989-1991) however, failed to make Romania more open to the West. When Romania's isolation of the 1980s continued, Iliescu had to change his policy, proclaiming EU integration and NATO accession as strategic priorities of Romania's foreign policy in 1993.[2366]

The section about the image of Romania (*section 7.3.5.2*) revealed that some Western countries remained skeptical regarding the goals of Romanian foreign policy in the early years of transition. They doubted the sincerity of its westward orientation and were afraid of, for example, ambitions for a Greater Romania when the PRM became part of the government. As a consequence, the relationship of Romania, for example, to Germany remained frosty during the chancellorship of Helmut Kohl (until 1998) who mad no formal visit to Romania. Since the early 2000s relations with Western countries improved (*see below*) as well as the cooperation with neighboring states such as Hungary, Bulgaria and Ukraine with respect to bilateral subjects including border issues. In 2002 Ferenc Mádl became the first Hungarian president to visit Romania after the breakdown of communism.[2367]

The relationship of Romania to Russia remained difficult. Apparently Russia in particular attempted to prevent Romania's accession to NATO for a long time and contacts to Russia did not normalize until late 2001 when Russia's geostrategic priorities shifted.[2368]

(b) Romania's relationship with the **IMF** symbolizes the ambiguous development of the country's cooperation with international organizations, which often changed depending on the government in power and the respective policy goals. Romania had been an IMF member in 1972 but Bucharest suspended cooperation in 1984. The IMF repeatedly granted financial support but also demanded drastic fiscal and monetary measures, for example, following the

[2366] See Strelchuk (2003); Georgescu (2004); see also Intv. Int'l Econ. Association (2007).
[2367] See Intv. Germ. Research Institute I (2007); Intv. German Econ. Association I (2007); see also Strelchuk (2003), p.19; Bertelsmann Stiftung (2003b), p.22.
[2368] See Gabanyi (2002), pp.30-31; Habersack (2002).

years of stagnating reforms (1989-1994). Under president Constantinescu Romania gave priority to the calls of the IMF for budget consolidation in 1999 even though these measures caused the elimination of investment incentives and drew significant protest from political opponents and businesses. In 2004 the IMF announced financial support amounting to over USD60M; nevertheless, Romania suspended the cooperation with the fund in 2005 after a dispute over its reform policies (including the introduction of the flat tax), and the stand-by agreement was not extended in 2006.[2369]

The ambivalent relationship to the IMF (as well as the ambiguous course towards the EU, *see below*) were apparently main drivers why Romania only took an average position in the BTI ranking of international cooperation in a regional comparison in 2006 as shown in *figure 97* in the appendix according to which all other Eastern European EU members as well as Croatia performed better.[2370]

(c) Despite Iliescu's slalom course in the very first years of transition between West and East, Romania was aiming at **NATO** membership quite early in its transition, when compared to other EECs. After initial talks with NATO in 1991 and the publicly announced goal of membership in 1993, Romania became the first former communist country in Eastern Europe to sign a "Partnership for Peace agreement" with NATO in 1994.[2371] Under president Constantinescu the rapprochement towards NATO increased further, also because the government expected this to increase the attractiveness of Romania for foreign investors.[2372] Moreover, Romania missed the first wave of accession in 1999 (which comprised Czech Republic, Hungary and Poland) because it did not meet the political criteria since NATO recognized shortcomings in its human rights policies due to problems with the integration of the Hungarian and Roma minorities; some

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[2369] See Maniu, Kallai, and Popa (2001), p.42; Bfai (2005), p.27; Rabobank (2006), p.4.
[2370] See Bertelsmann Stiftung (2006c), p.18; see also ABN-Amro Romania (2006), p.25.
[2371] See Habersack (2002); Gabanyi (2002), p.24; Georgescu (2004).
[2372] See Chiritoiu (1998), p.73; Gray (2004), p.93.

observers also assume that NATO tried to reduce the fears of Russia of a new military front by limiting the number of new entrants at that time.[2373]

Despite this failure Romania continued its cooperation with the alliance in subsequent years irrespective of which political party was in power. The turning point in the relationship with NATO (but also in terms of international cooperation in general) was Romania's positive role in the Kosovo war in 1999 when the country opened its air space for NATO planes.[2374] Furthermore, a change in the NATO enlargement strategy set in after the terrorist attacks on September 11th, 2001 and strategic aspects became more important than political criteria for accession. Romania also re-emphasized its accession efforts by sending troops to Afghanistan as the only NATO candidate country to do this.[2375] The support of the great majority of parliamentary parties as well as of the Romanian population remained strong throughout these years, reaching 64% in 1996 (representing the second highest value in EECs after Poland with 69%) and 84% in 2002.[2376]

In 2004 Romania became a NATO member under the left-wing government of Prime Minister Năstase, together with six other EECs. This was broadly interpreted as an important sign of a further increase in external political stability to very high levels today.[2377]

(d) Interviews reveal that the external stability of Romania has been of medium **importance** for the investment decision of MNCs. In the 1990s the uncertain foreign policy goals contributed somewhat to the skepticism of some investors and were a medium constraining factor for FDI (even though this

[2373] See Sharp (1997); Mungiu-Pippidi (2001), p.177; Gabanyi (2002), p.31.
[2374] See Intv. Germ. Research Institute I (2007); see also Habersack (2002); Gabanyi (2002), p.16.
[2375] See Gabanyi (2002), p.5; Habersack (2002); Strelchuk (2003), p.19.
[2376] See European Commission (1996a); see also Gabanyi (2002); Strelchuk (2003), p.18.
[2377] The other new members were Bulgaria, Estonia, Latvia, Lithuania, Slovenia, and Slovakia; see Habersack (2002); Müller (2005), pp.145, 209; BA-CA (2006), p.4, PWC (2007), p.15.

aspect was less discouraging than Romania's internal political stability).[2378] While *Brada, Kutan, and Yigit (2003)* find evidence that the Kosovo crisis (1999) may have contributed to lower FDI inflows to Romania, interviewees do not see such a correlation.

With increasing orientation towards the West since the early 2000s, external political stability became a slightly enhancing factor for FDI in Romania. According to the experts interviewed, the accession of Romania to NATO in 2004 was even an important encouraging factor for FDI to Romania – at least for one or two years.[2379] By contrast, Romania's difficult relationship to the IMF apparently had only little impact on the investment decision of MNCs. For instance, primary and secondary sources evaluate the introduction of the flat tax as a more important factor for FDI than the end of the support by the fund; furthermore, interviewees acknowledge that other foreign policy goals, most importantly EU accession, were not obstructed in any way by the dispute with the IMF.[2380]

(e) The **assessment** of this section reveals that Romania's initial hesitations to open up fully to the West disturbed its external political stability (in the perception of Western European MNCs) for a long time. Despite a clear orientation towards NATO and EU since 1993 and significant efforts by various governments, Romania had substantial problems to convince external observers from its open foreign policy course. In the end, external events such as the Kosovo crisis and the attacks of September 11th, 2001, were necessary to change the image of Romania. External political stability is clearly given today. Nevertheless, Romanian public policy makers should be aware that problems, for example with neighboring states (such as Moldova), may affect

[2378] See also Intv. Austr. MNC - Industrial Goods I (2007); Intv. Germ. Research Institute I (2007).

[2379] See Intv. Germ. MNC - Utilities (2007); Intv. German Econ. Association I (2007); Intv. Romanian Ministry IV (2007); Intv. German Econ. Association V (2007).

[2380] See e. g. Intv. Austr. MNC - Industrial Goods I (2007); ABN-Amro Romania (2006); Müller (2005), p.74.

the positive image again that Romania has attained with great efforts and that this could also have a negative impact on FDI.

(3) In **conclusion**, political stability has been an important determinant for MNCs in the analysis of Romania as a location for FDI. The downside potential of a poor performance has proved to be greater for Romania than the upside potential since forward-looking measures, such as accession to NATO, seem to lose their impact fairly quickly. Romania mainly has to work on its internal political stability including the constitutional set-up of its leading political functions as well as its political culture and confrontation with its history.

7.4.2.3 Croatia

(1) Croatia's **internal political stability** was (a) fragile in the 1990s. The situation significantly improved after the death of Tuđman in 1999 and when the political system was characterized by (b) a more democratic institutional set-up, (c) a strengthening of minority rights and (d) more reliable government decisions. Today, (e) Croatia seems to be well advanced in terms of internal political stability. The (f) importance of this determinant has been very significant for FDI in Croatia. Sub-section (g) assesses the findings.

(a) Primary and secondary sources agree that Croatia's internal political stability was extremely weak **in the 1990s**. Problems mainly stemmed from democracy deficits that were caused by the authoritarian regime style under President Tuđman.[2381] The former general and nationalistic dissident under Tito became the first president of Croatia in 1990. He was elected by the parliament and confirmed in a general election in 1992 (with 56.7% of votes). Deficiencies during his presidency that are identified by interviewees and external observers include a personally-tailored constitution (adopted in 1990)

[2381] See e. g. Intv. Germ. Research Institute II (2007); Intv. German Authority II (2007); Intv. Germ. MNC - Engineering (2007).

that gave him far-reaching competences (for example, versus the (prime) ministers), an authoritarian-led party, the Croatian Democratic Union (Hrvatska Demokratska Zajednica (HDZ)) and limited civil rights (for example regarding the freedom of the press). Opposition politicians also faced repressive measures.[2382]

Observers acknowledge that the slow democratization of Croatia in its early years was aggravated by the war that required a somewhat quicker decision-making process and a less democratic governance than during peace times. It also seems little surprising that Tuđman's leadership was hardly questioned in Croatia during the war. However, the government style did not change significantly after the end of the war. Press freedom in particular continued to be limited, for example, through strict defamation laws and the extensive control of publishing houses through the HDZ. Furthermore, external observers refer to continued pressures on political opponents even in the late 1990s. Tuđman was confirmed in presidential elections in 1997 (with 61%) and a new political era did not begin until his death in 1999.[2383]

(b) Under President Stjepan Mesić (since 2000, HDZ) and Prime Minister Račan (2000-2003, SDP) **institutional reforms** facilitated a stronger democratization of Croatian policy. Constitutional amendments in 2000 and 2001 decreased the powers of the president in favor of the parliament and the prime minister which turned Croatia into a classic parliamentary system.[2384]

Even though the SDP as well as the HDZ governments (since 2003) had difficulties integrating the different coalition parties, the system itself proved to

[2382] See Intv. Germ. Research Institute II (2007); Intv. Germ. Political Foundation I (2007); Intv. Austr. MNC - Construction (2007); Bertelsmann Stiftung (2003a), p.2; Kušić (2003); OECD (2005b); Helmerich (2005), p.242; EBRD (2005a), p.47; Pommer (2007), p.117.

[2383] See Bertelsmann Stiftung (2006b), p.2; Schönfelder (2005); Kušić (2003); OECD (2005b).

[2384] See European Commission (2004c), p.11; EBRD (2005a), p.47; Bertelsmann Stiftung (2006b).

be stable and also functioned also with a president from a different political party. At the same time extremist parties have lost considerable influence in recent years, receiving less than 2% of the votes in the last two parliamentary elections.[2385] Furthermore, the HDZ became less hierarchical and more democratic under Prime Minister Sanader. Even though some observers also see a certain chance that HDZ will separate one day (since very different political currents exist within the party), the general stability of the party system does not seem to be in danger and interviewees identify a quite stable party system in Croatia today.[2386] The EU Commission also acknowledges that Croatia's democratic institutions are functioning properly and that free and fair elections are assured, for example in the parliamentary elections in 2003.[2387] *Figure 59* emphasizes this positive development after the change of government in 2000 when Croatia's political rights score significantly improved.[2388]

(c) Various sources also point out that the protection and integration of **minorities** have improved in Croatia in recent years. During the 1990s the situation of the Serbs in particular had been very difficult. The Serbian proportion of the population dropped from 12% in 1991 to 4.5% in 2004. Some Serbs voluntarily left the country, others were expelled during the war. Some of those who attempted to return to their homes after the war became victims of violence and harassments. Offenses against Serbs were often only hesitantly stopped and persecuted by Croatian police and courts.[2389]

[2385] See Bertelsmann Stiftung (2006b), pp.2-3, 13; IMF (2006a), p.1; Die Presse (2008).
[2386] See Doc - KAS (2007); Intv. Germ. Research Institute II (2007); Intv. Int'l Research Institute I (2007); EBRD (2005a), p.47.
[2387] See European Commission (2005a), p.10.
[2388] See Freedom House (2007).
[2389] See Doc - GTZ (2006a); OECD (2003b); European Commission (2004c), p.6; EBRD (2005a), p.50; European Commission (2005a), pp.10, 31-32; Pommer (2007), pp.54, 111, 117.

After 2000 Croatian governments have significantly increased efforts to improve the rights and protection of minorities.[2390] Most importantly, the Constitutional Law on the Rights of National Minorities from 2002 provided a respective legal framework. The current legislation also stipulates the election of minority representatives to the parliament, a certain degree of self-determination (including the rights for minority schools) and their representation in public institutions. National and local advisory bodies were established to promote the implementation of the framework.[2391] Croatia concluded mutual agreements with Serbia and Montenegro to protect minorities in their countries and increased funding for minority organizations. Croatia also signed various agreements of the UN and the Council of Europe regarding the protection of minorities.[2392]

External observers acknowledge that minority protection has improved and that the political participation, for example of the Serbian minority, has increased. In fact, the Independent Democratic Serbian Party (Samostalna demokratska srpska stranka (SDSS)) became part of the new government under Prime Minister Sanader in 2007 and sent Slobodan Uzelac as Vice Prime Minister and Minister for Regional Development, Reconstruction and Return.[2393]

However, interviews[2394] and external sources[2395] identify some remaining deficiencies, especially regarding the implementation of the Constitutional Law and with respect to the representation of minorities on the local level. Other criticism refers to the problems of Serbs applying for Croatian citizenship, in finding adequate employment, retrieving expropriated property, and receiving

[2390] Firs efforts to improve the living conditions of Serbs in Eastern Slavonia were already launched in the Erdut Agreement in 1995; see European Commission (2004c), p.25.
[2391] See European Commission (2004c), pp.12, 25; EBRD (2005a), p.50; Pommer (2007), p.136.
[2392] See European Commission (2005a), p.20; Bertelsmann Stiftung (2006b), p.15; European Commission (2007a), pp.12, 53; see also Intv. Germ. Political Foundation I (2007).
[2393] See European Commission (2005a), p.22; EBRD (2005a), p.48; Die Presse (2008).
[2394] See e. g. Intv. Germ. Political Foundation I (2007); Intv. European Institution (2007).
[2395] See European Commission (2005a), pp.13, 20; Pommer (2007), pp.124-125.

equal treatment at court. As pointed out in the section on investment policy (*7.3.3.3*), remaining nationalistic resentments make investments from Serbs a highly sensitive issue in Croatia. These problems are also reflected in a lower score in the political pluralism and participation score of the respective Freedom of the World ranking (*figure 58*).[2396]

(d) Primary and secondary sources also acknowledge that Croatian politics have become more **coherent and reliable** since the early 2000s. Interviewees agree that government policies have become more predictable, main parties have similar political goals and that changes of government have caused only few modifications of internal politics (also because of the pressure from the EU). In fact, company experts do not see that changes of government had major visible effects on their operations.[2397] Nevertheless, interviewees also emphasize that room for improvements continues to exist and that political decisions are even more reliable in other CCEs such as Slovenia.[2398] Particularly on the local level a change of government may still have negative consequences for investors, for instance, regarding the support of privatization projects but also because local politics lack the resources and the know-how to quickly implement new government strategies.[2399]

Overall, Croatian citizens seem to have decent trust in their politicians. Croatia takes the 69th out of 131 countries in the Global Competitiveness Report and is the 4th out of 18 EECs (only behind Slovenia, Estonia and Lithuania). Furthermore, the Sanader administration was one of the first governments in transition countries to be re-elected (in November 2007).[2400]

[2396] See Freedom House (2007); see also European Commission (2007a), pp.13-14.
[2397] See Intv. Germ. MNC - Telecommunications (2007); Intv. Germ. MNC - Industrial Goods I (2007); Intv. Austr. MNC - Financial Services I (2007); Intv. Int'l Research Institute I (2007); Intv. Germ. MNC - Financial Services I (2007).
[2398] See Intv. German Authority II (2007); Intv. German Authority III (2007).
[2399] See Intv. Austr. MNC - Primary Goods I (2007); Intv. Austr. MNC - Real Estate (2007); Intv. Int'l Research Institute I (2007); Intv. Croatian Mayor (2007).
[2400] See World Economic Forum (2007); see also Intv. Germ. MNC - Financial Services II (2007).

Interviewees also recognize a high political participation (with turnouts in national elections of over 70% since the 1990s) and an active civil society that developed after the end of the war with various NGOs, a bourgeoisie that survived socialist time and participates in political debates as well as an influential catholic church (even though it has been less active and independent than, for example, in Poland. In the BTI score for social self-organization Croatia receives 8 out of 10 points with only Slovenia having a higher score out of 18 EECs.[2401]

(e) **In sum**, both primary and secondary sources acknowledge that internal political stability significantly increased in Croatia since the early 2000s. This country is now an irreversible and quite mature democracy.[2402] This was also confirmed by the first comprehensive EU report on Croatia in 2004 that recognized Croatia as functioning democracy according to the Copenhagen criteria.[2403] Interviewees also point out that Croatia's internal political stability is greater than in any other former Yugoslavian country (except Slovenia).[2404]

(f) Interviews show that internal political stability has been a **very important aspect** for the investment decision of MNCs in Croatia.[2405] Interviews confirm the findings of some FDI studies[2406] that the rigid course of Tuđman, including human rights abuses and a lack of government reliability, contributed – as did a rather hostile attitude towards MNCs and general nationalistic resentments towards foreigners – to lower FDI inflows to Croatia during the 1990s.

[2401] See also Intv. Germ. Political Foundation I (2007); Zakošek (2004); Pommer (2007), pp.115-116.

[2402] See Intv. Germ. MNC - Engineering (2007); Intv. Austr. MNC - Construction (2007); Intv. Croatian Ministry III (2007); Intv. Former Croatian Minister (2007); Intv. Germ. Research Institute II (2007).

[2403] See European Commission (2004c); see also Bfai (2004), p.18; CICD (2006), p.11.

[2404] See e. g. Intv. German Econ. Association IV (2007); Intv. Austrian Econ. Association II (2007).

[2405] See Intv. Austr. MNC - Primary Goods I (2007).

[2406] See e. g. McGee (2003).

According to experts interviewed, the strong improvements in internal political stability since the early 2000s removed an important obstacle and represents an FDI-enhancing factor for Croatia today when MNCs' alternative country options are, for example, Serbia as well as Bosnia and Herzegovina. For example, *Intv. Austr. MNC - Primary Goods I (2007)* decided to invest in Croatia and not in Serbia after the assassination of Prime Minister Zoran Đinđić in 2003. Moreover, interviews do not suggest that the somewhat lower performance of Croatia compared to Slovenia (or Western European countries) embodies a disadvantage for Croatia since a sufficiently high level of internal political stability has already been reached. Deficiencies in Croatia's minority policy may be disturbing for some managers once they are in the country but they do not seem to have any major impact on the investment decision of MNCs anymore.[2407]

Only investors who are dependent on political support (for instance in highly regulated industries) may consider local problems of internal political stability as a slightly constraining factor for FDI; they may postpone an investment decision before an election in order to wait and see if investor-friendly politicians come into power.[2408]

(g) The **assessment** of this section shows that internal political stability has been a crucial issue for Croatia throughout its transition process. The break with the past after 1999 seems dramatic and has been very positively acknowledged by MNCs. In fact, internal political stability seems to be (together with economic stability) a major anchor of Croatia's investment climate. Croatia apparently benefits in this context from the fact that investors generally compare Croatia with countries of the region that all show a significantly poorer performance in this field. Public policy should further extend the promotion

[2407] See Intv. Germ. MNC - Telecommunications (2007); Intv. Croatian Company - Real Estate (2007); Intv. Germ. MNC - Industrial Goods I (2007); Intv. Austr. MNC - Primary Goods I (2007); Intv. Germ. MNC - Financial Services II (2007); Intv. Austr. MNC - Construction (2007); Intv. Austr. MNC - Real Estate (2007).

[2408] See Intv. Austr. MNC - Primary Goods I (2007); Intv. Germ. MNC - Telecommunications (2007).

of these advantages of Croatia and tackle remaining problems that relate more to the local level, for example regarding the integration of Serbs.

(2) Croatia's **external political stability** was (a) lacking in the 1990s but strongly improved after the death of Tuđman, which is mainly reflected in a (b) clear westward orientation and a (c) positive regional role of Croatia. The determinant had (d) a very significant constraining impact on FDI in the 1990s and a slightly enhancing effect since then. The findings are assessed in sub-section (e).

(a) The external political stability of Croatia was lacking **in the 1990s** and the political situation of Croatia (as well as in other former Yugoslavian states) was very different to the one in other EECs.[2409] The most obvious reason for this was the war, which endangered the territorial integrity of the new state until 1995. However, even in the late 1990s some MNCs experienced an atmosphere of "crisis and civil war"[2410] in Croatia. Moreover, the isolationist course of President Tuđman and his refusal to cooperate with international organizations (including the ICTY) prevented an approximation towards the West for many years. As a result, Croatia was one of the few transition countries in 1999 without a Partnership for Peace with NATO and without an association agreement with the EU.[2411]

(b) With the SDP government in power since 2000, Croatia significantly **opened towards the West** and announced EU integration as its most important political goal (*see section 7.4.4.3*) and cooperation with the ICTY somewhat improved. This course was also strongly supported by most opposition parties in parliament including the HDZ. The governments under Prime Min-

[2409] See e. g. Intv. Croatian Ministry II (2007).
[2410] Intv. Germ. MNC - Engineering (2007); see also Intv. Austr. MNC - Retail (2007); European Commission (2005a), p.23.
[2411] See Intv. Germ. Research Institute II (2007); Intv. Croatian Ministry II (2007); Kušić (2003).

ister Sanader further attempted to present Croatia as reliable partner abroad, also because public policy makers realized that external political stability was essential for the evaluation of Croatia through the EU.[2412] International cooperation was enhanced with both international organizations (including IMF, World Bank etc.) and neighboring countries.[2413] Relations with Hungary and Bosnia do not seem to cause any major problems today and remaining issues with Slovenia regarding the border and fishing rights can apparently be solved within the next couple of years with the support of the EU.[2414] Relations with Serbia have also improved and normalized in recent years. In 2004 Sanader became the first Croatian Prime Minister to officially visit Belgrade since Croatia's independence in 1991.[2415]

Finally, Croatia increased its cooperation with NATO (that had already started in the mid-1990s). In 2000 Croatia joined the Partnership for Peace and signed a Membership Action Plan.[2416] It soon became clear that NATO membership was more about values and international recognition than about military alliance. This idea received increasing support by Croatians (52% in 2007) and an invitation to accession was extended to Croatia at the Bucharest summit of NATO in April 2008.[2417]

This clear westward course of Croatia (unlike, for example, in Serbia) together with its international cooperation is not only appreciated by the experts interviewed[2418], but are also reflected in the BTI score for international cooperation (*figure 97* in the appendix) according to which Croatia received 9 out

[2412] See Intv. Croatian Authority II (2007); Intv. Croatian Company - Real Estate (2007); Intv. Int'l Research Institute I (2007); Intv. Croatian Ministry IV (2007); Intv. Germ. MNC - Financial Services I (2007); see also Bertelsmann Stiftung (2006b).
[2413] See Intv. German Authority III (2007); see also Bfai (2004), p.27.
[2414] See e. g. Intv. Croatian Mayor (2007); Intv. Int'l Research Institute I (2007).
[2415] See European Commission (2005a), p.30; OECD (2005b), pp.4-5; EBRD (2006a), p.2.
[2416] See EBRD (2005a), p.48.
[2417] See Intv. Croatian Ministry III (2007); Wheaton (2001); Financial Times (2006c).
[2418] See e. g. Intv. Croat. Company - Utilities (2007); Intv. Int'l Research Institute I (2007); Doc - Germ. MNC - Food Products (2007).

of 10 points in 2006 representing the 9th out of 18 EECs and a position ahead of Poland as well as all SEECs.[2419]

(c) External sources as well as experts interviewed appreciate that Croatia has started to play an important stabilizing **role in the region of South East Europe**. Croatia has been able to mediate in some of the remaining conflicts (such as in Bosnia and Herzegovina) and has announced that it will continue doing so in its position as a non-permanent member of the UN Security Council 2008-2009.[2420] According to the interviewees, Croatia "has been doing very well politically in the international arena"[2421] in recent years and has shown in a credible way its interest in stability and regional cooperation without aiming at political power.[2422] Therefore, Croatia is now sufficiently stable so that the ongoing problems in the region, notably with respect to the situation in Kosovo, are generally not associated with Croatia.[2423]

(d) External political stability has been a very **important determinant** for the investment decision of MNCs interested in Croatia. FDI studies, interviews and data suggest that Croatia (as well as the other former Yugoslavian countries) were not part of the investment map of foreign investors in the 1990s. As already covered in the FDI sub-determinant country image (*7.3.5.3*), the collapsing former Yugoslavia appeared to be a very risky investment location throughout the 1990s. Croatia indeed received only marginal FDI inflows of only about €100M annually until 1995.[2424]

Brada, Kutan, and Yigit (2003) find that the Dayton Peace agreement (1995) had a first important positive impact on FDI in Croatia; however, interviews

[2419] See Bertelsmann Stiftung (2006a).
[2420] See Intv. Croatian Ministry III (2007); see also EBRD (2007a), p.70.
[2421] Intv. Supranational Authority II (2007).
[2422] See e. g. Intv. Germ. Research Institute II (2007); see also European Commission (2005a), p.23.
[2423] See Intv. Croatian Ministry III (2007); Intv. Former Croatian Minister (2007); Intv. Austr. MNC - Financial Services I (2007); Intv. Croatian Company - Real Estate (2007).
[2424] See e. g. Intv. Croatian Ministry II (2007); see also figure 91 in the appendix.

suggest that only the increasing westward orientation since the early 2000s enabled higher FDI inflows (of over €1B annually) to Croatia. The trust of investors thus increased in the external stability of Croatia (which has become a minor enhancing factor) compared with other countries of the region, notably Serbia. Croatia may benefit from those investors who use Croatia as bridge for occasional operations in other former Yugoslavian countries.[2425] However, interviews also show that some unpredictable developments in the region, for example regarding the situation in Kosovo, could also have a negative impact on FDI in Croatia, since investors may hesitate to invest when they are interested in a regional distribution of goods (such as retail companies).[2426]

Interview results relating to NATO accession are mixed. State representatives expect NATO accession to boost the Croatian economy including higher FDI inflows (as in the case of Romania).[2427] By contrast, company experts do not see any direct impact of NATO accession on Western European investors since it is only one (rather unimportant) part of a general westward orientation of Croatian foreign policy.[2428]

(e) In the **assessment** of this section it becomes apparent that external political stability was achieved in Croatia a lot later than in other EECs. However and in contrast to Romania, Croatia was able to achieve this by virtue of its own efforts and the westward orientation became a logical step to guarantee its territorial security also in the future. Croatia's external political stability is hardly contested today despite some issues such as the situation in Kosovo and its unpredictable effects on FDI in the whole region. With respect to NATO accession state representatives seem to overestimate the potential impact on FDI because Croatia has already been quite stable since the early 2000s and

[2425] See Intv. German Authority III (2007); Intv. Croatian Authority II (2007); Intv. Croat. Company I - Legal Services (2007); Doc - Germ. MNC - Food Products (2007).
[2426] See Intv. Croatian Government Team (2007); Intv. Germ. Political Foundation I (2007); Intv. Austr. MNC - Financial Services I (2007).
[2427] See e. g. Intv. Croatian Ministry III (2007).
[2428] See Intv. Germ. MNC - Engineering (2007); Intv. Austr. MNC - Real Estate (2007).

investors do not seem to be waiting for another sign of stability as was the case, for instance, for Romania in 2004.

Public policy should address remaining issues including the further normalization of relations to Serbia, the overcoming of the border issues with Slovenia and an even more extended cooperation with ICTY. Finally and most importantly for FDI inflows, Croatia should continue its positive role in the region.

(3) In **conclusion**, political stability has been a very important asset for Croatia's investment climate in recent years. Common political goals of all major parties, successful institutional reforms, a positive image in Western Europe, and a more difficult situation in neighboring countries have led to the transformation of this determinant in the early 2000s – in a very short period – from a strongly deterring to an enhancing factor for Croatia. This is especially true for those MNCs that also consider operations in other former Yugoslavian states (except Slovenia) and that do not expect to be affected by an increase of the Kosovo crisis (2007/2008).

7.4.2.4 General insights for transition countries

The analysis of the country sections and the consideration of further FDI studies allow for some general insights regarding political stability in transition countries. Key issues are the (1) performance, (2) impact on FDI and (3) public policy implications.

(1) In the analysis of the **performance** it becomes apparent that most EECs have made tremendous improvements in terms of both internal and external political stability in the last 10 years of transition and only Belarus is clearly lagging behind *(see figure 58)*.[2429] With respect to internal stability, most Eastern European transition countries faced similar challenges, such as establish-

[2429] See also Bertelsmann Stiftung (2006a).

ing a functioning, democratic and pluralistic governmental system as well as strengthening minority rights. Many of them elaborated quite effective constitutions and legal frameworks which often were based on the legislation of Western European countries. In contrast, the establishment of non-legal aspects of a modern democracy such as a political culture of debate, an active civil society, the actual integration of minorities (as shown for Croatia) and the exchange of elites, have proceeded a lot more slowly. Delays in the removal of old cadres and addressing the past in particular seem to have negative effects on the functioning of the democratic systems even today, as the current debates in Romania and in Poland show.[2430]

In terms of external political stability, many countries faced dramatic challenges in the 1990s including independence (as the Baltic states), secession (as in Czechoslovakia in 1992/1993) or even war (as in the former Yugoslavia). In fact, 14 out of 19 EECs analyzed did not exist in this form in 1989.[2431] Western observers may sometimes underestimate the enormous efforts that these countries had to undertake in order to establish external political stability and that countries like Croatia were surprisingly successful in decoupling from political turmoils of neighboring states within only five years.[2432] For many of the countries Western integration (including rapprochement to EU and NATO) appeared to be the best solution to guarantee territorial integrity and overcome bilateral problems. The cooperation with other international organizations has strongly differed from country to country and was often driven by pragmatic short-term strategies (as shown for Romania and the IMF), but has reached a fairly advanced level in most transition countries today (*figure 97 in the appendix*).

[2430] See also Kappert (2008).
[2431] Including Czech Republic and Slovakia that originated from Czechoslovakia in 1993.
[2432] See Intv. Germ. MNC - Engineering (2007).

(2) With regards to the **importance**, interviews confirm the findings of various FDI studies[2433] that political stability was a crucial determinant for transition countries in the 1990s and investors looked closely at country-specific differences both with regards to internal and external stability in the course of their investment decision. In the case of war or a failure to reach a certain level of stability (for example in former Yugoslavia states until the late 1990s) these countries were clearly avoided as investment locations even if not the whole country was affected (as shown for Croatia).[2434]

Political stability is therefore a factor – other than many other determinants analyzed in this thesis – which alone can lead to the decision of an MNC not to invest in a specific country, even without the consideration of other determinants. Therefore, some transition countries are still rarely considered as investment locations even today, either because internal stability is not given (as in Belarus) or external political stability is in danger (as in Moldova).[2435] Interviews also show that less visible aspects of political stability, such as an unclear westward integration (as in Romania in the early 1990s) or an authoritarian tendency (as in Croatia under Tuđman) may have deterred foreign investors. Furthermore, interviews suggest that the relations between the home and (potential) host country of MNCs can play an important role in the evaluation of political stability by MNCs (as in the case of Romania and Germany under Chancellor Kohl).[2436]

Increasing political stability since the late 1990s apparently contributed to higher FDI inflows in most transition countries.[2437] Certain threshold events, such as NATO accession, have been of particular importance for FDI in those countries in which investors had been more skeptical regarding their external

[2433] See Lankes and Venables (1996); Pye (1998); Disdier and Mayer (2003); Carstensen and Toubal (2004)
[2434] See also Intv. Germ. MNC - Engineering (2007).
[2435] See also Intv. Supranational Authority I (2007).
[2436] See also Intv. Germ. Research Institute I (2007).
[2437] See e. g. Merlevede and Schoors (2004); Brada, Kutan, and Yigit (2003).

political stability (as in the case for Romania).[2438] It also remains an enhancing factor when neighboring states continue to struggle (as in former Yugoslavia).

Interviews also show that the impact of internal political stability strongly depends on the perception, the experience of MNCs and the type of investment.[2439] Internal political turmoils (as they currently exist in Romania) seem to have only limited impact on FDI today, if stability is expected to decline, companies have already gathered some experiences in the country and their investment is less connected to government decisions; they may have, however, significant effects if they occur in supposedly stable countries (as in Hungary).

(3) Some **public policy implications** can be drawn from this section for transition countries. Public policy should be aware that a political sign, such as NATO accession for Romania, can have the same weight as the level playing field for an investor[2440]; however, transition countries with low political stability also need to realize that the mere announcement of the goal to accede international organizations, such as EU or NATO, is not sufficient in order to increase political stability.

Public policy should be aware that both internal and external political stability are more fragile than often assumed[2441], even in transition countries that are already in the EU. Even though the economies of transition countries may react less sensitively to political turbulences once a certain minimum threshold of internal political stability has been reached[2442], interviews show that this sensitivity apparently depends on the perception and expectation of the business world (as discussed for Hungary), and public policy makers should not underestimate the negative long-term consequences of political imbalances (as

[2438] See also Intv. German Econ. Association I (2007).
[2439] See similar: Woodward, Rolfe, Guimaraes, and Doupnik (2000); Merlevede and Schoors (2004).
[2440] See also Intv. Romanian Ministry IV (2007).
[2441] See e. g. Intv. German Authority I (2007).
[2442] See e. g. Intv. Austr. MNC - Financial Services II (2007).

shown for Romania). A clear definition of political functions may reduce the impact of political turmoils.

The experience of Romania also shows that public policy should adopt a clear and consistent foreign policy course as early as possible in order to attain maximum credibility and trust among investors (which seems to be difficult, for instance, in the case of Serbia and Ukraine today). In spite of all political efforts, bilateral cooperations remain unpredictable and often challenging for the external political stability of transition countries. As various debates show, for example in Croatia (with Slovenia), but also in the Baltic states (with Russia), public policy makers should make use of international mediation (most notably of the EU) from early on in order to avoid more substantial crises. Political efforts should be strongly dovetailed with significant economic integration (as shown for Croatia's cooperation with Serbia) in order to increase the advantages of cooperation.

7.4.3 Corruption

7.4.3.1 Definition

Corruption is a topic that has been identified only recently by FDI studies as an interesting determinant for the country location of MNCs. The theory of institutional quality has (as pointed out in the theoretical part of this thesis) put special emphasis on the effect of corruption (*section 2.2.4.1*).[2443]

Both company and state experts make unprompted reference to corruption as a crucial aspect for Romania and Croatia. Major issues are petty corruption to speed up daily operations of MNCs (at customs and local authorities for example), more far-reaching administrative decisions (such as permits, public pro-

[2443] See also Wei (2000a); Baniak, Cukrowski, and Herczynski (2005).

curement and privatizations which will be called “medium-level corruption”) and top-level corruption (for example with respect to law-making).[2444]

7.4.3.2 Romania

Corruption (1) was a major problem for Romania in the past. A (2) large number of strategies and laws to lower corruption since the late 1990s have (3) led to some success. However, (4) the remaining problems in all relevant areas seem to be even more essential. These are caused by (5) institutional and political challenges. Nevertheless, (6) the importance of this determinant seems to be limited for most investors interested in FDI in Romania. Sub-section (7) provides an assessment of the results.

(1) **In the 1990s** (and even before then) Romania had the reputation of being very corrupt, also when compared to other EECs. Even though data points are rare, various interviewees and external sources identify massive briberies in the administration both on the local and the central level at that time. Public procurement in particular had been an eye-catching area for corruption for many years when contracts were generally given away without tenders.[2445] State representatives interviewed also admit: “It is true that there used to be a lot of corruption in Romania.”[2446]

Reasons include those mentioned earlier (for example bribes for tax authorities, the judiciary systems and customs authorities[2447]) – the poor qualification of the personnel, the low salaries, the lack of loyalty of public servants to their employer (the state), and the limited experience of a meritocracy.[2448]

[2444] See OECD (2006a); FIC (2005), pp.35-36.
[2445] See Bfai (2005); Müller (2005), p.144; Leiße (2006), p.10; Zühlke (2006); see also Intv. Int’l MNC - Utilities (2007); Intv. Germ. Research Institute I (2007).
[2446] Intv. Romanian Authority I (2007).
[2447] See sections 7.3.1.2 and 7.2.4.
[2448] See also Scheele (2004); FIC (2005), p.36; Intv. Germ. MNC - Software (2007); Intv. Austr. MNC - Industrial Goods I (2007); Intv. Austr. MNC - Consumer Goods (2007).

(2) In the mid-1990s Romanian governments took the first steps to enhance the **fight against corruption**. Important legislative steps were the anticorruption law (1996) and several laws dealing with money laundering, public service and asset monitoring in subsequent years. In 2001 a National Anticorruption Strategy was launched. This was renewed in 2005 and accompanied by corresponding action plans.[2449] Furthermore, several sector-specific regulations and codes of conduct have been elaborated in recent years, for example for customs. Romania also introduced the "whistleblower law" (in 2004) according to which state officers can report the breaking of rules by their authorities without fearing negative consequences. Romania has also ratified all major international conventions and is a member of the group of states against corruption (GRECO) of the Council of Europe. Interviewees as well as external sources point out that EU pressure was an important driver to initiate these comprehensive changes and was also responsible for corruption becoming one of the central topics in the presidential campaign in 2004 and remaining a top priority for President Băsescu until today.[2450] Thus *OECD (2006c)* finds that Romania and Bulgaria (EU aspirants in 2006) were the only two out of 9 SEECs that had created and adopted a clear anti-corruption strategy including some evidence of implementation by 2006.

Various institutions have been established that focus on the implementation of the anticorruption policies in Romania. In 2002 the National Anticorruption Prosecution Office (NAPO) was established within the Ministry of Interior and Public Administration to coordinate Romania's anti-corruption policies. It was re-organized several times and became the National Anticorruption Directorate (NAD) in 2006. It is now attached to the High Court of Cassation and Justice and deals with bribery with involving sums of over €10K. The Anticorruption

[2449] See Gabanyi (2005), p.17; World Bank (2006a), p.65; Doc - Min. of Justice (2005b).

[2450] See EBRD (2005b), p.14; Leiße (2006), p.10; World Bank (2006a), p.XII; see also Intv. Germ. MNC - Automotive (2007); Intv. Romanian NGO (2007).

General Directorate (DGA) was founded in 2005 and investigates corruption in the public sector. The Department for the Fight against Fraud (DLAF), which controls the distribution and use of EU funds, was set up in 2004 within the Prime Minister's Chancellery. Finally, a National Integrity Agency was founded to verify assets, incompatibilities and potential conflicts of interest of higher public servants and elected officials.[2451]

With respect to public procurement, the Emergence GO 60/2001 regulates contract awarding for the first time on the basis of EU law and prohibits the split of orders in order to remain under the minimum for public tenders. Contracts of over €2,000 can be awarded through the electronic tender system since 2002 (VO 20/2002).[2452]

(3) As a result, both primary and secondary sources identify some **improvements**. Several experts interviewed find that corruption has decreased since the early 2000s and particularly since 2004.[2453] A few interviewees even find significant progress.[2454] Especially corruption in public procurement and the willingness of younger civil servants to accept bribes seem to have sunk.[2455] Experts interviewed also notice that bribery at customs has significantly decreased with Romania's accession to the EU. Generally, Western companies in particular seem to have little problems with corruption today.[2456]

The combat of top-level corruption seems to show some progress as well. 260 higher state officials were charged with corruption between 2000 and 2004, among them four ministers and ten mayors. Important trials were initiated including one against former Prime Minister Năstase. Some top politicians have

[2451] See Law no. 78/2000; Government Emergency Ordinance no. 43/2002; Law no. 54/2006, see also FIC (2005), p.35; European Commission (2006e), p.7.
[2452] See Bfai (2005), pp.114-116; Gabanyi (2005), p.17; European Commission (2007e), p.2.
[2453] See e. g. Intv. German Econ. Association III (2007); Intv. Austr. MNC - Financial Services II (2007).
[2454] See Intv. Austrian Econ. Association I (2007); Intv. Romanian Authority I (2007).
[2455] See World Bank (2006a), p.57; see two disguised expert statements.
[2456] See section 7.3.1.2; see Intv. Austr. MNC - Industrial Goods I (2007); Intv. Int'l MNC - Utilities (2007).

apparently left politics due to prosecutions or public pressure and corruption in all political parties seems to have decreased.[2457]

Despite the success of some of the legal reforms both primary and secondary sources suggest that indirect measures have been even more important and effective for Romania's combat of corruption. Therefore, the World Bank finds that recent reforms of the tax and the judicial system (such as the flat tax and higher salaries for judges (*sections 7.2.4* and *7.3.3*)) have been the most important drivers for lower corruption in Romania.[2458] Experts interviewed also point out that the efforts to increase the electronification of data (for example, regarding land registration, tax declaration and public procurement) etc. have particularly helped to decrease the number of possibilities for corruption. Only 5% of firms viewed bribery as frequent in tax administration in 2005.[2459]

Overall, interviewees agree that the awareness of corruption as a nation-wide problem has increased in Romania and that of many Romanian officials and civil servants are visibly committed to fight against corruption.[2460]

(4) However, **remaining problems** seem to outweigh the ameliorations identified. Company and state experts interviewed agree that corruption still exists in Romania, even though MNCs – understandably – deny ever having paid bribes.[2461] Some experts even point out that Romania's anticorruption fight did not reach the expectations of the EU Commission by 2007, although the Union did not postpone the accession for political reasons (*see section below*).[2462]

[2457] See Gabanyi (2005), p.17; OECD (2006c), p.98.
[2458] See World Bank (2006a), pp.47-48, p.55; see also European Commission (2006e), p.6.
[2459] See Intv. Germ. MNC - Legal Services II (2007); see also Bfai (2005), pp.115-116; OECD (2006c), p.102.
[2460] See Intv. Romanian Econ. Association II (2007); Intv. German Authority I (2007).
[2461] See e. g. Intv. Austr. MNC - Industrial Goods I (2007); Intv. Romanian Econ. Association II (2007); Intv. Germ. MNC - Industrial Goods III (2007); Intv. Germ. MNC - Software (2007); Intv. Romanian Authority I (2007).
[2462] See e. g. Intv. Supranational Authority II (2007).

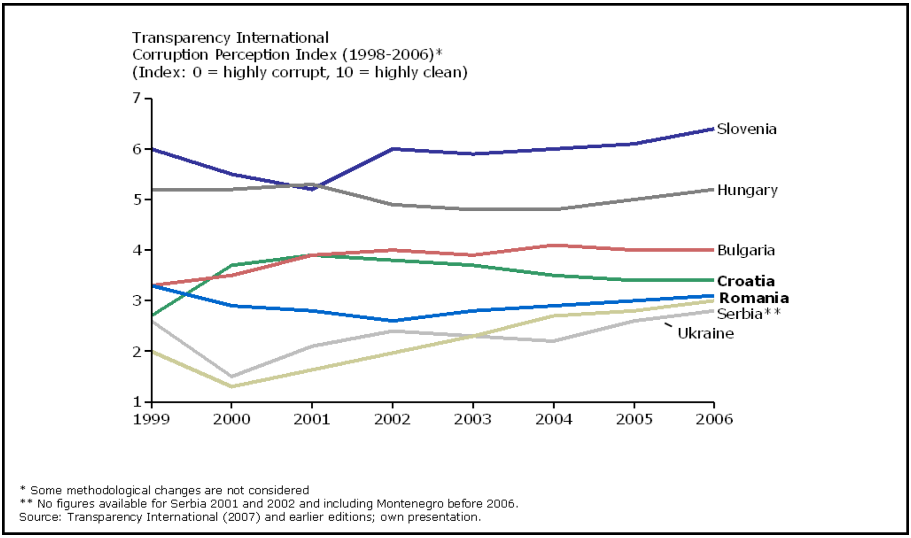

Figure 60: Perceived corruption in Eastern Europe

The frequently cited Corruption Perception Index (CPI), developed by Transparency International and presented in *figure 60*, also suggests only limited improvements of Romania in recent years; after a decline between 1999-2002, the score improved only marginally to 3.1 (out of 10 points in 2006). Romania is thus clearly behind important competitors such as Hungary (5.2) but also behind Bulgaria (4.0) that has been improving its anticorruption performance faster than Romania since the late 1990s; even Ukraine has been catching up fast in recent years (2.8).[2463]

Other surveys confirm that investors still find corruption to be very present in Romania and to have a stronger effect than in many other EECs.[2464] In a

[2463] See Transparency International (2007); more optimistic: Intv. Rom. Company - Consulting (2007); Intv. Germ. MNC - Utilities (2007).

[2464] E. g. 8th out of 9 EECs only ahead of Poland according to IMD (2006).

World Bank survey 80% of respondents admitted that they had paid bribes for a public service in 2005.[2465]

Interviews suggest that petty cash corruption in particular still seems to be very frequent in Romania. Often cited examples are schools[2466] and the health system.[2467] Some investors even believe that petty corruption is sometimes inevitable.[2468]

Experts interviewed are also aware of continued corruption in daily (local) administration procedures as already discussed for earlier determinants (*section 7.2.2*). This is usually to speed up processes (where not more than €100 are involved), for example for car inspections or permits and licenses on the local level. Investors also heard about cases in which authorities attempted to make the approval of permits dependent on, for example, the purchase of land by a relative.[2469]

Several interviewees also assume that privatizations and public procurement are still often affected by corruption because large amounts of money are involved.[2470] The construction and infrastructure industry seems to be the fields most vulnerable to corruption, as discussions of contract awarding to Bechtel (U.S.) and Vinci (France) in 2004 have shown. However, the privatization of Petrom (discussed in *section 7.3.4.2*) has also come under criticism lately.[2471] Experts make the criticism that tenders should actually decrease the possibilities for briberies, but are still very complex and lengthy and their imple-

[2465] See World Bank (2006a); Müller (2005), p.144; Leiße (2006), p.10.
[2466] When students are urged to take private lessons from the teacher in order to avoid bad grades.
[2467] When patients are urged to give money or presents in order to get a treatment.
[2468] See several disguised experts statements.
[2469] Experts who have heard about that: see e. g. Intv. Int'l Econ. Association (2007); Intv. Int'l MNC - Utilities (2007); Intv. Austr. MNC - Consumer Goods (2007); Intv. Germ. MNC - Industrial Goods II (2007).
[2470] See e. g. Intv. Germ. MNC - Legal Services II (2007); Intv. Germ. Research Institute I (2007).
[2471] See Bfai (2005); see also Intv. Germ. MNC - Consulting II (2007); Intv. Germ. MNC - Legal Services I (2007).

mentation often exceeds the capabilities and capacities of local authorities.[2472] External surveys confirm this evaluation. According to a survey of EBRD and World Bank, 10-20% of respondents admitted that in Romania bribery is frequently use when obtaining government contracts.[2473] Some experts also point out that problems with the distribution of EU funds (see *section 7.4.4* for details) have even led to a certain re-increase of corruption in public tenders since EU accession.[2474]

As a consequence of these remaining shortcomings, the EU established a monitoring system even after Romania's accession to the EU. In the so-called "cooperation and verification mechanism" for judiciary and corruption matters, the European Commission gives advice and can even enforce counter measures.[2475]

(5) Several **reasons** have been responsible for these remaining problems. Firstly, it seems that the large number of anticorruption initiatives led to frequent legal and institutional changes as well as overlaps and gaps in the definition of tasks and competences.[2476] For example, 1.5 years after the adoption of the "whistleblower law" only about 15% of the public institutions had implemented it.[2477]

Secondly, legal prosecutions may have increased but the conviction rate is still very low, especially in cases involving senior officials. The cases may be difficult to prove but some experts also argue that the justice system is still not as independent of political influence as it should be. In this context experts interviewed also point out that political interests may sometimes prevent a more comprehensive approach against corruption. The political combat of high-level

[2472] See e. g. Intv. German Ministry (2007); Intv. German Econ. Association V (2007).
[2473] See European Commission (2004a), p.53; Gabanyi (2005), p.19; OECD (2006c), p.101.
[2474] See Intv. Austr. MNC - Primary Goods II (2007); see disguised state expert interview.
[2475] See European Commission (2007e); Frankfurter Allgemeine Zeitung (2007b).
[2476] See FIC (2005), p.9 and 35; European Commission (2005c), p.11; Gabanyi (2005), p.18; Leiße (2006), p.10; European Commission (2007e), p.3; Intv. German Authority I (2007).
[2477] A roundtable by the Romanian NGO Asociaţia Pro Democraţia (APD) then helped to increase implementation; see Intv. Romanian NGO (2007).

corruption still seems to be greatly politicized in Romania and is often used – as in the case of the coping with Romania's Securitate past (*section 7.4.2.2*) – as a political weapon against opponents.[2478] The commitment to fight high-level corruption may actually have decreased since the resignation of Minister of Justice, Ms. Macovei in April 2007 (despite the mixed evaluation of her work).[2479]

Thirdly, experts interviewed point out that it may take another generation to abolish a traditional mentality in the Romanian society that generally views petty corruption as something acceptable and to create sufficient awareness of the legal and moral problems of corruption among Romanians.[2480]

Finally, it seems that the increasing salary gap between private and public jobs also runs contrary to the envisaged faster decrease of corruption in the administration.[2481]

(6) Some more recent FDI studies and other publications assume that corruption was among the greatest barriers for higher FDI in Romania for a long time[2482] and is still a crucial factor for MNCs and their investment decision regarding Romania.[2483] However, interviews show that the **importance** of corruption on the investment decision for MNCs interested in Romania depends on the experience of investors and is only limited overall.

The level of corruption is doubtless an issue for MNC that consider Romania for an initial investment. Various MNCs interviewed report that they were worried about being confronted with corruption in Romania, for example, during

[2478] See Intv. Romanian Ministry I (2007); see also Gabanyi (2005), pp.15 and 17.

[2479] See Intv. Romanian Company - Advertising (2007); Intv. Germ. MNC - Consulting II (2007); Intv. Germ. Political Foundation II (2007); Intv. German Authority I (2007); see European Commission (2007e).

[2480] See Intv. German Econ. Association VII (2007); Intv. German Authority I (2007); Intv. Germ. MNC - Consulting II (2007); Intv. Germ. MNC - Consulting I (2007); Intv. Germ. MNC - Legal Services I (2007).

[2481] See 7.2.3.2.

[2482] See Müller (2005), p.144; Leiße (2006), p.10; see similar Smarzynska (2002).

[2483] See also AHK (2006).

their first site visits.[2484] The lack of transparency in the administrative procedures was even the decisive reason for Schuko to back pedal from an earlier investment project because they did not want to get involved in corruption.[2485]

However, Schuko pursued a different investment project in Romania; this example therefore shows that investors may be deterred from a specific investment opportunity but they generally will not be deterred by Romania as investment location per se by such an experience. *Intv. Supranational Authority I (2007)* therefore seems to be right when stating that "corruption is an important matter but investors will probably not rule out Romania because of it"[2486].

Furthermore, those investors who are already in the country do not evaluate corruption as an important issue that could obstruct follow-up investments or even force them out of Romania. With increasing experience they even assume that corruption may be lower than often expected by external observers and that Romania may still suffer from its bad reputation of the past.[2487] More experienced MNCs also often assume that they do not need to pay bribes in Romania as long as they know their rights and are willing to wait somewhat longer. Since most MNCs are assisted by lawyers and other experts they may also be less helpless than Romanian citizens or companies.[2488] Moreover, some important areas of petty corruption listed above (such as the health system), seem to be less relevant for investors than for Romanians and therefore foreigners may be less confronted with corruption.[2489] Finally, it seems that companies

[2484] See e. g. Intv. Austr. MNC - Industrial Goods I (2007); Intv. Germ. MNC - Industrial Goods III (2007).
[2485] See Intv. Germ. MNC - Industrial Goods II (2007).
[2486] See similar: Intv. Germ. MNC - Consulting I (2007).
[2487] See e. g. Intv. Austr. MNC - Industrial Goods I (2007); Intv. German Econ. Association II (2007); Intv. Germ. MNC - Consulting I (2007); Intv. Germ. MNC - Financial Services III (2007).
[2488] See Intv. Int'l MNC - Utilities (2007); Intv. Germ. MNC - Legal Services II (2007).
[2489] See e. g. Intv. Germ. Political Foundation II (2007); Intv. Int'l Econ. Association (2007); Intv. German Authority I (2007).

are sometimes even willing to pay some low bribes when they can avoid complicated, time-consuming and expensive procedures with (local) authorities.[2490]

In contrast, interviews show that Romania's strong focus on anti-corruption policies in recent years also causes some problems for investors. The omnipresent fear of persecution apparently makes many civil servants insecure and reluctant to decide quickly or – in some cases – decide at all because they do not want to come under the suspicion of corruption. This seems to be true for the judicial system as well in which almost all trials go to the highest level in order to avoid reproaches of intransparency.[2491] These aspects may not prevent MNCs that are interested in an initial engagement in the country from investing in Romania. However, follow-up investments of some of those MNCs that are already in the country may be delayed.[2492]

(7) In the **assessment** of this section the long list of strategies and measures indicate that the combat of corruption is generally taken seriously in Romania today and public policy makers seem to do well in tackling the myriad dimensions of corruption at the same time; yet, indirect reforms (such as simplifications in the administrative procedures and electronifications) have been more successful than, for example, the juridical persecution of corruption.

Nevertheless, corruption still exists both on the local and the central level, but the actual level is difficult to determine since corruption has become such a central and highly politicized issue in Romanian politics and in Western European media. The problems with the implementation of anticorruption strategies and the new difficulties due to the distribution of EU funds may, in the end, effectuate that corruption has remained on a comparable level as in the early 2000s.

[2490] Several disguised company expert interviews.
[2491] See Intv. German Econ. Association V (2007); Intv. Germ. MNC - Automotive (2007); Intv. Germ. MNC - Financial Services III (2007); Intv. Romanian County Council (2007).
[2492] See Intv. German Ministry (2007).

Even though many MNCs assumed that paying bribes was an unavoidable aspect of doing business in Romania in the early 1990s, corruption has apparently not had any substantial negative impact on FDI so far. It seems that investors can avoid paying bribes, are willing to pay low sums or accept to lose some money because of longer procedural times. Overall, some state representatives may overestimate the negative impact of corruption on FDI in Romania.

However, the existing delays of political, administrative and juridical decisions, due to the problems of the implementation of anticorruption policy, may cause negative indirect effects on FDI in the future. Romanian public policy makers thus need to decrease the existing insecurities and fears within the authorities. Anticorruption measures may sometimes be too restrictive and regulations like the "whistleblower law" may actually jeopardize the cooperation among state officials and paralyze bureaucracies. Nevertheless, further efforts are needed to decrease corruption in a sustainable way in order to catch up to more advanced countries of the region.

7.4.3.3 Croatia

Croatia performed (1) very poorly in the 1990s in terms of corruption, but (2) significant measures were initiated in the post-Tuđman era that (3) showed some first improvements. Nevertheless, (4) an overall rather negative evaluation remains and this has (5) several root causes. Corruption (6) seems to have a medium impact on FDI in Croatia. This section is assessed in sub-section (7).

(1) According to interviewees[2493] and external sources[2494] corruption was omnipresent in Croatia **in the 1990s**. The authoritarian and nepotistic tendencies, the slow administrative reforms as well as the lack of awareness of corruption as something condemnable under Tuđman apparently facilitated

[2493] See e. g. Intv. Croat. Company II - Legal Services (2007); Intv. Germ. MNC - Engineering (2007).

[2494] See e. g. Schmidt-Häuer (2000); Bertelsmann Stiftung (2003a).

the existence of corruption. It was most visible in the privatization process – as already shown in *section 7.3.4.3* – when insiders and Tuđman minions were often favored. Furthermore, corruption was very common in the judiciary and in the bureaucracy at that time, for example, when dealing with land registrations, permits or licenses on the local level (*sections 7.2.3.2* and *7.2.2.3*). As a result, Croatia received only 2.7 points (out of 10) in the CPI in the last year of Tuđman's presidency (1999). This put Croatia behind Romania (3.0) (although ahead of Serbia with (2.0)) (*figure 60*).[2495]

(2) Under Prime Minister Račan significant **measures** were initiated to combat corruption in Croatia and were further extended under Prime Minister Sanader. Two subsequent national anticorruption programs were launched for 2002-2005 and 2006-2008. In this context the Office for the Prevention of Corruption and Organized Crime (USKOK) was established. Its goals are the disclosure and prosecution of corruption. USKOK was strengthened and upgraded several times and was also given the responsibility of tracing corruption in public offices (2007).[2496]

Important legal steps included laws on public procurement (2001), prevention of conflict of interest in pursuance of public offices (2003), internal financial control within public sector (2006), and on the financing of political parties (2006). Moreover, a National Council was established in 2006 to monitor the implementation of the National Anti-Corruption Program.[2497] Furthermore, Croatia has become a GRECO member in 2000 and ratified various international treaties including the UN convention against corruption (2005). Overall, both primary and secondary sources identify that a substantial legal framework

[2495] See Transparency International (2007).

[2496] See Doc - Gov't. of Croatia (2006); Doc - NCC (2007); Intv. Croatian Ministry IV (2007); see also Bertelsmann Stiftung (2003a), p.4; OECD (2003a); EBRD (2005a), p.4; European Commission (2005a), p.16; European Commission (2007a), p.50.

[2497] See Doc - Gov't. of Croatia (2006); EBRD (2005a), p.49; OECD (2006a), p.100; Doc - NCC (2007); see also Intv. Germ. Research Institute II (2007).

is in place which is largely aligned with EU regulations and enables – in theory – an effective fight against corruption.[2498]

State interviewees also point out that the increase of awareness for corruption has become an important dimension of the recent Anticorruption Program including public seminars with state officials, citizens and companies.[2499]

(3) Both interviewees[2500] and secondary studies[2501] identify **some positive effects** of Croatia's efforts and a certain decrease in corruption in recent years. A few (Croatian) interviewees even find "very significant"[2502] improvements. Complaints about briberies in the areas of company registration, tax authorities, customs, public procurement, and in the judiciary seem to be less frequent.[2503] However, it seems that reforms which focus indirectly on corruption were belonged to the most effective ones. An example here is the electronification of the case management in the judiciary and the introduction of Hitro and Hitrorez.[2504]

External sources also see some progress in the combat of top-level corruption. Therefore, some high-level officials had to resign due to a corruption affair, for example, Foreign Minister Žužul (2005). International organizations also acknowledge that USKOK has prosecuted an increasing number of corruption cases (156 in 2006) and also discovered the scandal in the CPF in June 2007.[2505] As a consequence, MNCs interviewed report that the awareness of corruption as

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[2498] See Intv. Croatian Ministry IV (2007); see also European Commission (2005a), pp.16, 87; OECD (2006a), p.97; European Commission (2007a), pp.10, 50.

[2499] See e. g. Intv. Croatian Ministry IV (2007); see also European Commission (2007a), p.62.

[2500] See e. g. Intv. Int'l Research Institute I (2007); Intv. Germ. MNC - Logistics (2007); Intv. Croatian Ministry IV (2007).

[2501] See e. g. World Bank (2006a), p.9; European Commission (2007a), p.10.

[2502] Intv. Croatian Company - Real Estate (2007); see also Intv. Croat. Company II - Legal Services (2007).

[2503] See Intv. Austr. MNC - Construction (2007); Intv. Croat. Company I - Legal Services (2007); Intv. Croat. Company II - Legal Services (2007); Intv. German Authority III (2007); World Bank (2006a), p.50.; OECD (2006a), p.102.

[2504] See also sections 7.2.3.3 and 7.2.4.3; World Bank (2006a), p.50; OECD (2006a), p.105.

[2505] See OECD (2003a), p.14; EBRD (2005a), p.49; European Commission (2007a), pp.10, 50.

criminal offense has somewhat increased among state officials and two members of the parliament gave up their supervisory board seats and demanded the same from all state officials and ministers.[2506]

These improvements are also reflected in the CPI, according to which Croatia jumped significantly from 2.7 in 1999 to 3.7 points in only one year (*figure 60*) and therefore climbed from the 75th to the 57th percentile of the countries analyzed by Transparency International.[2507]

Most interviewees assume that corruption will decrease in the course of Croatia's further EU integration and may be less dominant than in most other SEECs today including Romania, Bulgaria or Bosnia and Herzegovnia.[2508]

(4) In line with the findings for Romania, **remaining problems** with corruption seem to be greater in Croatia than the improvements sketched above. Interviews[2509] confirm the findings of external studies[2510] that corruption is still widespread. Interestingly, Croatian state representatives depict an even more dramatic overall image of the situation than company experts. *Intv. Croatian Authority II (2007)*, for example, describes corruption as "the greatest problem" in Croatia.[2511]

Corruption seems to be most problematic in the Croatian bureaucracy. Petty corruption is apparently frequently used to speed up processes in the administration for daily procedures such as licenses and permits (for instance for land

[2506] See e. g. Intv. German Authority II (2007).

[2507] 74th out 99 countries (1999) and 51st out of 90 countries (2000); see Transparency International (2007) and earlier editions.

[2508] See Intv. Germ. MNC - Software (2007); Intv. Supranational Authority II (2007); Intv. Int'l Research Institute I (2007); Intv. Austr. MNC - Primary Goods I (2007); see similar: OECD (2006a), pp.103-104.

[2509] See e. g. Intv. Germ. MNC - Financial Services I (2007); Intv. Austr. MNC - Retail (2007); Intv. Germ. MNC - Industrial Goods I (2007); Intv. Supranational Authority II (2007); Intv. Germ. MNC - Telecommunications (2007).

[2510] See e. g. OECD (2003a); Bertelsmann Stiftung (2003a), p.9; NCC (2004b); European Commission (2005a), p.16; European Commission (2007a), p.10.

[2511] See similar: Intv. Croatian Mayor (2007); Intv. Croatian Ministry IV (2007).

registration).[2512] One company expert admits: “If you have problems with the local administration, the use of petty corruption helps you to solve these problems in a fairly short time.”[2513] Another one agrees: “I do not know anybody who would not pay some extra money to avoid problems with local administration.”[2514]

The second field of corruption that is frequently cited is the court system. Many verdicts continue to be influenced by political pressure or by briberies. Furthermore, few corruption charges have actually led to a conviction so far.[2515]

Moreover, public procurement remains prone to corruption, for example, regarding infrastructure projects.[2516] According to external surveys 10%-20% of the respondents said that bribery to get a government contract was common (in 2005).[2517] *Intv. Austrian Econ. Association II (2007)* points out that “we, unfortunately, know more cases in which public tenders ended with a disreputable outcome than fully transparent ones”.

Primary and secondary sources also identify significant top-level corruption. Interviewees see a tendency for government decisions to be unfairly influenced, using existing loopholes of the new legislation on party financing.[2518]

[2512] See also section 7.2.2.3; Intv. Germ. Political Foundation I (2007); Intv. Austrian Econ. Association II (2007); Intv. Austr. MNC - Consulting (2007); Doc - NCC (2007); Doc - GTZ (2006a); OECD (2003a), p.35; European Commission (2005a), p.16; Pommer (2007), p.142.

[2513] Disguised company expert interview.

[2514] Disguised company expert interview.

[2515] See Intv. Supranational Authority II (2007); Intv. Croatian Ministry III (2007); Intv. German Authority II (2007); Intv. Germ. Research Institute II (2007); see also Bertelsmann Stiftung (2003a), p.12; NCC (2004b), p.27; European Commission (2007a), p.50.

[2516] See Intv. Croat. Company I - Legal Services (2007); Intv. German Authority III (2007); Intv. Croat. Company II - Legal Services (2007); see also European Commission (2005a), p.16.

[2517] See OECD (2006a), p.101.

[2518] See Doc - NCC (2007); Intv. Austr. MNC - Retail (2007); Intv. Supranational Authority II (2007); Intv. Croatian Ministry IV (2007); Intv. Germ. Research Institute II (2007); European Commission (2005a), p.16.

Finally, corruption in privatization remains an important issue as underlined by the scandal in the CPF (*section 7.3.4.3*).[2519] This scandal has led some observers to ask what role corruption may have played in other privatizations.[2520] Thus, the INA privatization, for example, could have been a case in which corruption is not completely unlikely.[2521]

As a result, it seems that anticorruption policy has only had limited success in Croatia so far and the high expectations in Croatian governments since 2000 for the fight against corruption were somewhat disappointed.[2522] This explains why Croatia's performance of perceived corruption, according to the CPI, even slightly decreased from 3.9 points in 2001 to 3.4 in 2006 while neighboring countries such as Serbia and Slovenia improved their performance in recent years (*figure 60*).[2523] According to *IMD (2006)* Croatia is the 4th most corrupt country out of 9 EECs.

(5) Several **reasons** may explain why anticorruption policies have had only limited success in Croatia so far. Firstly, external sources still see some deficiencies in the legal framework of Croatia's anticorruption fight. For example, ethics codes and codes of conduct are still lacking for many areas in the public and private sector, some laws (such as the ones on conflict of interest and asset declaration) need better definitions and clearer interpretation. Some elements of the international conventions has not been fully accomplished yet.[2524]

More importantly, interviewees identify significant shortcomings regarding the implementation of the existing anticorruption legislation. In 2007 the Ministry of Justice only had five officials to monitor the implementation progress of the anticorruption laws and the resources of USKOK are apparently too low

[2519] See Intv. Croatian Ministry III (2007); European Commission (2007a), p.20.
[2520] See Intv. German Econ. Association IV (2007); Intv. Supranational Authority II (2007).
[2521] Disguised company expert statement.
[2522] See NCC (2004b), p.3; European Commission (2005a), p.16.
[2523] See Transparency International (2007); Intv. Austrian Econ. Association II (2007).
[2524] See OECD (2006c); European Commission (2007a), pp.50-51; see also Intv. Croatian Ministry IV (2007); Intv. Croatian Authority II (2007).

as well. The implementation of international conventions also seems to be not fully accomplished so far.[2525]

Finally, the awareness of the criminal nature of corruption still seems to be low (despite recent efforts discussed above). Interviewees point out that citizens, bureaucracy as well as top officials need to understand better that even petty corruption is not acceptable and something that has to be sanctioned.[2526] Interviews also show that local authorities may underestimate their responsibility since local politicians interviewed consider corruption mainly to be a problem of the central authorities.[2527]

(6) Corruption seems to have a medium **impact** on FDI in Croatia overall, but the specific impact varies depending on the type of investment. In the 1990s corruption was one of the problems that led to lower FDI inflows in Croatia. However, MNCs generally did not perceive corruption as a separate issue but as part of weak governing in Croatia overall at that time which included a poor performance of bureaucracy, the favoritism of a small elite of Tuđman minions and a weak internal and external political stability.[2528]

Interviews suggest that since the early 2000s corruption has become less important for large firms, greenfield investors and particularly MNCs that were already present in Croatia and who realized that conditions were comparable or even better than in some of the neighboring countries.[2529] In contrast, smaller and medium-sized MNCs may postpone or even suspend investment decisions if they expect the need for higher briberies or strongly dependent on central or

[2525] If the increase to 15 people by 2008 will be enforced needs to be seen; Intv. Croatian Ministry IV (2007); Intv. Croatian Authority II (2007); see also European Commission (2005a), pp.16, 87.

[2526] See Intv. German Authority III (2007); Intv. Croatian Ministry III (2007); Intv. Croatian Ministry IV (2007); see also European Commission (2007a), p.10.

[2527] See Intv. Croatian Mayor (2007).

[2528] See e. g. Intv. Germ. MNC - Engineering (2007).

[2529] See e. g. Intv. Austrian Econ. Association II (2007); Intv. German Econ. Association IV (2007); Intv. Croatian Company - Real Estate (2007).

local government support, for example in privatizations, investments in natural resources or when a multitude of licenses are needed.[2530]

These findings also put the evidence from the survey of the World Competitiveness Report into perspective that states that corruption is the second most problematic factor for doing business in Croatia (after inefficient bureaucracy).[2531]

Recent scandals, such as the CPF, do not seem to irritate MNCs and their investment decision. Rather, the discovery of former shortcomings is seen as progress.[2532] Nevertheless, several interviewees point out that more scandals and ongoing problems with corruption would contribute to a more negative country image of Croatia and its bureaucracy.[2533]

(7) The **assessment** of this section reveals that corruption was highly present in the 1990s. It is still a problem today that is mainly driven by the deficiencies that were already discussed under the legal measures of this thesis (notably the quality of bureaucracy and court system).

Important anticorruption measures have been established and the framework and institutional set-up has probably been more streamlined than in Romania.

Top officials seem to be very willing to accept corruption as a crucial issue. They may even overemphasize it because they are aware that the EU looks closely at anticorruption policies of candidate countries. Moreover, rigid anticorruption policies do neither seem to be abused as political weapon nor represent an obstacle for business operations as it is sometimes the case in Romania.

[2530] See e. g. Intv. Austr. MNC - Primary Goods I (2007); Intv. Germ. MNC - Financial Services II (2007); Intv. Austr. MNC - Retail (2007); Intv. European Institution (2007); see also EBRD (2005a).
[2531] See World Economic Forum (2007); see also CICD (2006).
[2532] See Intv. German Authority III (2007); European Commission (2007a), p.20.
[2533] See Intv. Austrian Econ. Association II (2007); Intv. European Institution (2007); see also Doc - NCC (2007).

In contrast, local politicians still seem to lack the awareness that they also have a responsibility for improving the situation.

The majority of investors interested in Croatia does not seem to be deterred by corruption because they know that the situation in other SEECs may be even worse and they may actually be willing to pay some bribes (although none of them will, of course, publicly admit that).

Croatian public policy should focus on reforms of the legal measures discussed above in order to establish more transparent procedures and decrease the possibilities of corruption. In contrast, the completion of the legal framework and a more successful prosecution of corruption cases only seem to have a secondary importance for an effective and sustainable reduction of corruption in Croatia.

7.4.3.4 General insights for transition countries

The analysis of Romania, Croatia and further FDI studies allows for some general insights regarding (1) the impact of corruption on FDI, (2) the performance of transition countries and (3) possible recommendations for public policy makers.

(1) The large majority of FDI studies dealing with corruption assumes that a higher level of corruption has a negative **impact** on FDI, particularly in transition countries. They assume that corruption is a sign of weak institutions and therefore a less attractive investment location.[2534] Some studies even find that corruption has been among the most important reasons why some transition countries received little FDI, particularly in the 1990s.[2535]

The analysis of the interviews offers a more detailed picture of the effects of corruption. It suggests that corruption only has a medium constraining impact

[2534] See Wei (2000a); Bevan and Estrin (2000); Morisset and Neso (2002); Campos and Kinoshita (2003); Bénassy-Quéré, Coupet, and Mayer (2005); Blonigen (2005); Goodspeed, Martinez-Vazquez, and Li (2006); Eigen (2006).

[2535] See McGee (2003); Dunning (2005).

on FDI overall.[2536] Greenfield investors seem to be confronted with medium- or top-level corruption quite rarely. Larger MNCs may have few difficulties with petty corruption and do not seem to exploit the possibilities of influencing the decision-making of top-level politicians as may be the case for domestic companies. Furthermore, MNCs that already have experiences in the host country do not seem to be greatly deterred by corruption.[2537] They seem to be aware that they will not have to pay bribes as long as they know their rights or are even willing to participate in petty corruption in order to speed up daily administrative procedures (as shown for Romania and Croatia).[2538] Interviews cannot confirm the findings of *Smarzynska (2002)* that corruption encourages the establishment of joint ventures with domestic firms since the analyses in *section 7.2.1.2* suggested that potential problems with local partners exceed those of corruption from the perspective of MNCs.

However, corruption does seem to have a deterring effect on companies with little experience in transition countries in general and that frequently have to cooperate with authorities (for example for privatizations, permits etc.) and therefore often face medium-level corruption. However, these MNCs will only decide in favor of a different country if conditions are significantly better there (as shown for Croatia).[2539]

In addition to this, corruption seems to have some negative indirect effects on FDI levels in transition countries. Important aspects are that the longer consideration time and uncertainty of MNCs, whether corruption is involved as part of a envisaged investment project, may delay or even postpone the investment decision of MNCs (although they usually stick to their country

[2536] See similar Wheeler and Mody (1992); Demekas, Horváth, Ribakova, and Wu (2005).
[2537] See e. g. Intv. Austrian Econ. Association II (2007); Intv. Germ. MNC - Legal Services II (2007).
[2538] See several disguised expert statements.
[2539] See e. g. Intv. Austr. MNC - Primary Goods I (2007); Intv. Germ. MNC - Financial Services II (2007).

decision as shown for Romania).[2540] Corruption also increases bureaucratic inefficiencies. This delays procedures and business operations (as shown for the court system in Croatia). An overstretched combat of corruption may also have a negative indirect effect on FDI, if it is used as political weapon as it creates insecurity and standstill in the bureaucracy and political reform.[2541]

(2) Most transition countries **performed** only poorly in their anticorruption fight in the 1990s. Awareness and frameworks barely existed and the persecution of corruption by MNCs was difficult since bribery was not illegal abroad in many Western European countries. Respective laws were not adopted in Germany and Austria until 1999. However, even today most transition countries seem to suffer from fairly high corruption in "all areas where the state is involved"[2542]. Interviews as well as secondary sources confirm that corruption can be traced in all dimensions discussed (petty, medium-level and high-level corruption) and is most frequent at customs, tax authorities, public procurement, permit procedures, and conflict of interest. A larger disparity of salaries between the public and private sector also seems to increase corruption (as shown for Romania).[2543]

Even though most EECs have established substantial anticorruption frameworks including regulations, institutions and strategies, international organizations see only limited effect so far. In fact, indirect measures, such as the simplification and shortening of administrative procedures and constant pressure from the EU (which actually may also overemphasize this aspect as negotiation tool), seem to be more effective for reducing corruption in transition countries

[2540] See e. g. Intv. Supranational Authority I (2007); Intv. Germ. MNC - Industrial Goods II (2007); Intv. Austr. MNC - Industrial Goods I (2007).

[2541] See e. g. Intv. German Econ. Association V (2007); Intv. German Ministry (2007).

[2542] Disguised expert statement.

[2543] See Intv. Germ. Political Foundation I (2007); Intv. Germ. MNC - Software (2007); EBRD (2004); OECD (2006a), p.104; Eigen (2006).

.[2544] The awareness among top officials may therefore have increased but is still limited among local authorities (as shown for Croatia) and citizens today. The fight against corruption thus remains one of the weakest points of reform policies of transition countries[2545] and interviews suggest that a genuine change of mentality will take another generation.[2546]

(3) Several **public policy implications** can be derived from this section. Firstly, the combat of corruption is (together with EU integration) the determinant with the largest amount of interdependences with other determinants that influence FDI in transition countries including the quality of bureaucracy, company registration, property rights, privatization, and infrastructure. Corruption thus needs to be understood as part of an overall reform process and less as an isolated aspect.[2547]

Secondly, prevention seems to be more effective than punishment in the fight against corruption in transition countries. Therefore, public policy makers should work on clear regulations as well as simple and quick procedures of bureaucracy in order to minimize the possibilities for corruption (as discussed for Croatia and Hitrorez). Furthermore, the fight of corruption needs better definitions (for example through codes of conducts) since many actors involved – foreign and domestic companies, citizens, civil servants, and top-level politicians – often have only a vague or contradictory understanding of corruption, for example, with respect to the difference between gratefulness and bribery in petty corruption. At the same time public policy needs to prevent administrative actions coming under the suspicion of corruption in general (as discussed for Romania). The prosecution of corruption cases only represents a helpful factor in the combat of corruption if not only (top-level) officials but also cit-

[2544] See Intv. German Econ. Association IV (2007); Intv. Germ. Political Foundation I (2007); see also EBRD (2004); OECD (2006a), p.91; World Bank (2006a), p.XVIII.
[2545] See McGee (2003); OECD (2006a), p.91.
[2546] See e. g. Intv. Austr. MNC - Retail (2007).
[2547] See also Intv. Croatian Government Team (2007).

izens and companies are actually convicted. Otherwise the credibility of the host country and its court system can actually suffer which may even have a slightly deterring effect on investors in the longer-run.[2548]

Thirdly, public policy makers should be aware that EU integration includes both opportunities and risks in the fight against corruption. The pressure of the EU to establish anticorruption norms and preemptive measures may represent a chance to increase the awareness and barriers for corruption. On the other hand, the distribution of EU funds and the many new regulations may actually cause confusion and corruption (as in Romania).[2549] EU candidates (such as Croatia) should therefore examine closely how Eastern European EU members have dealt with these challenges and schedule sufficient time to establish functioning institutions and regulations.[2550]

7.4.4 EU integration

7.4.4.1 Definition

The experience of the EECs that acceded to the EU in 2004 as well as the analysis of the interviews conducted suggests that the relationship between host countries of FDI and the EU is an aspect observed closely by potential investors. Investors may expect from EU accession important advantages such as the harmonization and simplification of the legal framework but also higher market potential through access to the internal market of the EU. The most relevant aspects in this context seem to be the (1) development of EU integration and (2) EU funding. Sections (3) provide conclusions for the countries in question.[2551]

[2548] See also Intv. Romanian Ministry I (2007); Intv. Former Croatian Minister (2007); Intv. Germ. Political Foundation I (2007); Baniak, Cukrowski, and Herczynski (2005).
[2549] See also next section.
[2550] See Oman (2000); Charlton (2003); World Bank (2006a), p.81.
[2551] See Müller (2005), pp.111-137; Neuhaus (2005), pp.13-16; Larive Romania (2006), p.43.

7.4.4.2 Romania

(1) Romania's **EU integration** is based on (a) the development of relations with the EU towards accession, (b) Romania's perspective on this evolution, (c) the results of Romania's reform process and the (d) impact of EU integration on the investment decision of MNCs. Section (e) provides an assessment of the findings.

(a) Romania's **path towards EU accession** was long and complicated. Romania was the first EEC to conclude a trade agreement with the European Community in 1974. Diplomatic relations were established in 1990 and this was followed by a trade and cooperation agreement in the following year. The Association Agreement was signed in 1993, came into force in 1995 and was called Europe Agreement. It mainly foresaw free trade with the EU and the adoption of the acquis.[2552]

Despite this initial progress in integration, the EU remained skeptical regarding to Romania's application for accession in 1995 and interviewees agree that Romania's EU accession was uncertain in the 1990s. This is also reflected in the first monitoring reports of the European Commission (since 1998). Brussels criticized (as discussed in previous sections) the slow transition process, the instable political situation and the difficult economic development. When Romania showed more substantial reform efforts in the late 1990s, the EU decided to promote Romania's course, increased the financial support and opened accession negotiations in 2000. After a slow beginning, the adoption of the acquis accelerated after 2001 and was largely completely by 2003.[2553]

In 2004 Romania was able to conclude negotiations and signed the accession treaty on April 25th, 2005. However, the attitude of the EU to Romania's actual accession remained cautious. One reason for this was the bad experi-

[2552] See section on trade policy 7.3.1.2; see Leiße (2006), p.7; Hartwig (2001).

[2553] See European Commission (1998); see also Intv. Austr. MNC - Financial Services I (2007); Intv. Romanian Ministry I (2007).

ence with the Romanian implementation of reforms since some regulations had been implemented late or only partially. As mentioned previously Romania also had problems finding advocates for its accession due to the large reform gaps compared to other EECs and its poor reputation in Western Europe (*section 7.3.5.2*).[2554]

The reservations of the European Commission and many EU member states also explain the establishment of safeguard clauses to allow a delay or even suspension of Romania's accession. The first safeguard clause (that also existed for the other ten countries that already joined the Union in 2004) enabled the EU to take counter measures – and even prevent accession with an unanimous vote of the European Council – if the implementation of certain obligations was deemed insufficient and included home and justice affairs. The second safeguard clause, which was only developed for Bulgaria and Romania, foresaw a postponement of accession until 2008, if reforms in important areas were deemed insufficient. Finally, the EU designed a "super safeguard clause" exclusively for Romania, with eleven requirements regarding domestic and justice affairs which Romania had to fulfill before accession. A qualified majority of the European Council would have been sufficient in order to postpone Romania's accession to 2008.[2555] Nevertheless, the final monitoring report of the European Commission and the confirmation by the European Council in late 2006 cleared Romania's way to accession on January 1st, 2007.[2556]

In their assessment of the timing of accession some experts criticized the EU for letting Romania in too early considering Romania's weak performance

[2554] See European Union (2005); Leiße (2006), p.6; Gabanyi (2005), pp.6-7; see also Intv. Germ. Research Institute I (2007); Intv. German Econ. Association I (2007).
[2555] See European Union (2005), articles 36-38, annex IX; Gabanyi (2005).
[2556] See European Commission (2006d); European Commission (2006e); European Council (2006); EBRD (2005b), pp.14-15, 46; Bfai (2005), pp.25, 125-127; Leiße (2006), pp.7-8.

in the judicial sphere and the fight against corruption.[2557] In contrast, other experts point out that a later EU accession would not have changed much, since a delay would only have postponed Romania's reform efforts.[2558]

As discussed in the previous section on corruption, a cooperation and verification mechanism remained in place even after Romania's EU accession. Here the EU reserved the right to survey the progress of reforms (in food safety, payment of EU funds, justice and anticorruption measures) and even introduce sanctioning measures such as the suspension of the applicability of Romanian court decisions in the other member states of the EU. However, none of the experts interviewed expects that the EU will actually impose sanctions on Romania.[2559] This is also suggested by the moderate tone of the European Commission's first post-accession report in June 2007, which concluded that "much remains to be done"[2560] but which did not mention any possible consequences for the shortcomings of Romania's efforts in the fields in question.

(b) From the **Romanian perspective**, EU accession had been a goal of all governments since the early 1990s (*section 7.4.2.2*). However, interviews suggest that a clear and reliable commitment of local and national Romanian public actors to EU accession from did not set in until the early 2000s.[2561] On the other hand, the the Romanian population's support of EU membership was high from early on and reached 81% in 2003. This represented the highest value of 13 countries surveyed.[2562]

[2557] See e. g. Intv. Austr. MNC - Primary Goods II (2007); Intv. Supranational Authority II (2007); Intv. German Political Adviser (2007); Intv. Germ. Political Foundation I (2007); see also Intv. German Econ. Association III (2007).
[2558] See e. g. Intv. German Authority I (2007).
[2559] See also Intv. Germ. MNC - Utilities (2007); Intv. Austr. MNC - Primary Goods II (2007); Intv. Romanian Ministry I (2007); Intv. German Authority I (2007).
[2560] European Commission (2007e), p.1; see Intv. Romanian Ministry I (2007).
[2561] See Intv. Austrian Econ. Association I (2007); Intv. German Econ. Association II (2007); Intv. Germ. MNC - Industrial Goods III (2007).
[2562] Croatia was not considered in the survey; European Commission (2004b).

Nevertheless, internal power struggles repeatedly endangered the progress of accession negotiation and contributed to the irritations of the European Commission and EU member states. Between 2000 and 2004 the implementation of the required reforms was sometimes impeded by the many former communists still in the parliament, who were unwilling to abolish the laws of the socialist times.[2563]

Furthermore, Romanian governments apparently did not always show much commitment to the promises and actions of previous governments. Interviews refer to statements made by President Băsescu in front of EU officials to the effect that (amongst others his predecessor had negotiated badly and he was planning to reverse some of the decisions made in earlier years, including several privatization sales. He is also referred to asserting that Romania wanted to accede to the EU together with Moldova.[2564]

As a result of these political roadblocks within Romania, experts acknowledge that Romania's willingness alone would probably not have been sufficient to implement the reforms necessary to enter the EU. They assume that strong and relentless reform pressure of the EU was essential to bring about the accomplishments enabling Romania to enter the Union.[2565] This evaluation also seems to be validated by the fact that many interviewees see a significant decrease of Romania's reform efforts since EU accession (and the decreasing EU pressure).[2566]

(c) The vast majority of interviewees welcomes the fact that EU integration caused significant reforms in Romania, although company experts in particular

[2563] See for the problems regarding the exchange of elites: also 7.4.2.2; see Intv. German Econ. Association V (2007); Intv. Germ. MNC - Consulting I (2007); Intv. German Econ. Association III (2007).
[2564] See Intv. Germ. Research Institute I (2007).
[2565] See e. g. Intv. Int'l MNC - Utilities (2007); Intv. Austr. MNC - Legal Services (2007).
[2566] See Intv. German Authority I (2007); Intv. Germ. Political Foundation II (2007).

agree that most of the **effects of these reforms** did not become visible until 2004 or even later.[2567]

Most improvements were part of a gradual process and cover a large number of determinants and sub-determinants previously analyzed. Experts interviewed point out that EU integration has strongly contributed to better, more reliable and more credible business conditions in Romania overall.[2568] More specifically, they acknowledge a higher political and economic stability, more legal certainty, a strengthening of property rights, a harmonization of the legislation, and a simplification of administrative procedures.[2569] Company experts also emphasize that the motivation and willingness of civil servants and the labor force increased strongly after EU membership became within Romania's grasp.[2570] Romania also received much more public attention abroad as the prospect of accession drew nearer (media coverage has increased significantly since 2006) and was able to improve its fairly poor image in Western Europe (*section 7.3.5.2*).[2571]

The most visible immediate improvement that set in with EU accession in 2007 was the abolishment of the remaining trade barriers for goods that were traded within the EU. This was discussed in *section 7.3.1.2*. For many MNCs

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2567 See Intv. Romanian Ministry V (2007); Intv. Supranational Authority I (2007); Intv. Austr. MNC - Industrial Goods I (2007); Intv. German Econ. Association V (2007).

2568 See Intv. Austr. MNC - Financial Services I (2007); Intv. Germ. MNC - Legal Services II (2007); Intv. Int'l Econ. Association (2007); Intv. Germ. MNC - Consulting I (2007); Intv. Romanian Econ. Association II (2007).

2569 See Intv. Germ. MNC - Consulting II (2007); Intv. German Econ. Association V (2007); Intv. Austr. MNC - Financial Services I (2007); Intv. German Econ. Association VII (2007); Intv. Austr. MNC - Financial Services II (2007); Intv. Germ. MNC - Software (2007).

2570 See Intv. Austr. MNC - Consumer Goods (2007); Intv. Austr. MNC - Legal Services (2007).

2571 See Intv. German Econ. Association II (2007); Intv. Germ. MNC - Legal Services II (2007); Intv. Germ. MNC - Utilities (2007); Intv. Germ. MNC - Consulting I (2007); see also Dückers (2007).

this aspect was also the most important reform aspect of EU accession overall.[2572]

Despite this predominantly positive evaluation of EU integration, experts interviewed also note some (mostly temporary) deteriorations of the investment climate due to Romania's accession to the EU. Thus, irritations of authorities increased for several months due to the many new regulations.[2573] As elaborated previously, EU integration also led to an increasing amount of emigration to other EU countries[2574] and may have negatively affected those MNCs that mainly trade goods with non-EU countries.[2575] Finally, some experts also associate the EU accession with an increase of salaries and real estate prices in Romania[2576], while others point out that they would have risen anyway.[2577]

(d) Interviews show that EU integration had little impact on FDI in Romania until the early 2000s but that it has become a very **important factor** since then.[2578]

Romania's application for membership (1995) and the beginning of accession negotiations (2000) had few consequences for FDI inflows. This finding from the interviews is in contrast to the majority of FDI studies that suggest that even these steps have a positive impact on FDI levels of transition countries.[2579]

[2572] See Intv. Austr. MNC - Industrial Goods I (2007); Intv. Germ. MNC - Industrial Goods III (2007); Intv. Germ. MNC - Logistics (2007); see also Intv. Int'l MNC - Utilities (2007); Intv. Germ. MNC - Automotive (2007).

[2573] See Intv. Germ. MNC - Automotive (2007); Intv. Austr. MNC - Primary Goods II (2007).

[2574] See Intv. Germ. MNC - Industrial Goods III (2007); Intv. Germ. MNC - Automotive (2007).

[2575] See Intv. Austr. MNC - Primary Goods II (2007); see also Intv. German Authority IV (2007).

[2576] See Intv. Germ. MNC - Industrial Goods III (2007); Intv. Austr. MNC - Financial Services I (2007); Intv. Germ. MNC - Software (2007).

[2577] See e. g. Intv. Germ. MNC - Consulting II (2007).

[2578] See e. g. Intv. German Econ. Association III (2007); Intv. Germ. MNC - Consulting I (2007); Intv. Austr. MNC - Industrial Goods I (2007); Intv. Austr. MNC - Legal Services (2007).

[2579] See e. g. Brenton, Di Mauro, and Lücke (1999); Merlevede and Schoors (2004); Clausing and Dorobantu (2005).

Interviews suggest that the investment decisions of large and less risk-averse MNCs in particular were not dependent on the state of Romania's EU integration or the prospect of accession. In fact, they even benefited from the lower market saturation and prices until the early 2000s.[2580]

However, the great majority of experts interviewed indicates – in line with FDI theory[2581] – that the interest in Romania as an investment location significantly increased among potential investors from Germany and Austria when the likelihood of Romania's accession to the EU increased in 2004/2005.[2582] EU accession was one of the reasons, for example, an Austrian investor interviewed to invest in Romania instead of Ukraine in 2006.[2583] Experts also agree that FDI surged sharply following Romania's accession in 2007 and that EU accession seems to be one of the most important reasons for higher FDI inflows today.[2584] Experts point out that in the first months after accession the FDI of smaller MNCs and those MNCs increased that were waiting for an increasing of political stability, legal certainty and lower market entry barriers (such as financial service providers).[2585] *Intv. Supranational Authority I (2007)* also emphasizes that Romania (and Bulgaria) benefited from the fact that they were the only countries joining the EU in 2007, which drew additional attention from potential investors. State experts in particular point out that EU accession will

[2580] See Intv. Austrian Econ. Association I (2007); Intv. Austr. MNC - Financial Services II (2007); Intv. Germ. MNC - Retail (2007); see also Intv. German Authority I (2007).

[2581] See e. g. UNCTAD (2002); Zakharov and Kušić (2003).

[2582] See Intv. German Authority IV (2007); Intv. Germ. MNC - Industrial Goods II (2007); Intv. Austr. MNC - Financial Services I (2007); Intv. Germ. Research Institute I (2007); Intv. Supranational Authority I (2007).

[2583] See Intv. Austr. MNC - Consumer Goods (2007).

[2584] See Intv. Austr. MNC - Legal Services (2007); Intv. German Econ. Association II (2007); Intv. Int'l Econ. Association (2007); Intv. German Econ. Association VII (2007); Intv. Romanian Ministry I (2007).

[2585] See Intv. Austr. MNC - Legal Services (2007); Intv. Austrian Econ. Association I (2007); Intv. German Authority IV (2007); Intv. Germ. MNC - Consulting II (2007); Intv. German Econ. Association III (2007).

remain the most important factor for the attraction of FDI in Romania for the next couple of years.[2586]

Nevertheless, a minority of interviewees warns that EU accession may also have a certain deterring effect on FDI in the long-run, due to increases in prices, salaries and competition.[2587]

(e) The **assessment** of this section reveals that Romania has adopted and implemented an impressive reform framework in a very short time of only six or seven years. This surprised many external observers, given the slow transition of Romania in the 1990s and the turbulences of internal Romanian politics until today.

The mere prospect of EU accession was an important driver for FDI to Romania. However, it seems that the effect became noticeable fairly late, due to observers' doubt as to whether Romania was able to accomplish the requirements of EU accession. The increasing confidence in Romania's accession and its positive effects on FDI since 2004 may be difficult to isolate from those attributed to NATO accession (*section 7.4.2.2*) but interviews clarify that the growth of FDI inflows in the subsequent years (2005 and 2006) was strongly driven by the prospect of EU accession (together with higher privatization sales).

However, public policy makers should be aware that the positive effect of EU accession may have already peaked in 2007 and that state interviewees may be overestimating the long-term effects of EU integration. Even though the benefits of EU integration still seem to outweigh the disadvantages (such as higher prices and salaries), public policy makers should work hard on improving the deficiencies discussed for previous determinants and focus on higher-value FDI in order to receive comparable high levels of FDI in the years to come.

[2586] See Intv. Supranational Authority I (2007); Intv. Romanian Econ. Association II (2007).
[2587] See Intv. Rom. Company - Consulting (2007); Intv. Germ. MNC - Industrial Goods III (2007).

The current slowdown of reforms may be due to the internal political quarrels described above and probably does not have any direct effect on the investment climate. Nevertheless, public policy makers should work on the remaining issues (as sketched in the reports of the European Commission) in order not to jeopardize the good image that Romania has elaborated in recent years.

(2) The analysis of primary and secondary sources shows that **EU funding** (a) strongly increased for Romania since the late 1990s, (b) but various problems occurred regarding the use and distribution of the money. The (c) impact of EU funding on the investment of MNCs remained low but seems to have increased recently with higher amounts flowing in. This section is assessed in sub-section (d).

(a) **The EU's financial support** for Romania has strongly increased over the years. In 1991 Romania joined the PHARE program.[2588] Assistance increased to about €650-700M annually since the beginning accession negotiations in 2000 and Romania also became a recipient of ISPA (for transport and environment)[2589] and SAPARD (for agriculture)[2590]. Romania received €1.2B as a pre-accession support until 2007.[2591] Finally, Romania will receive a total of €32B of EU subsidies between 2007 and 2013. Of this amount €13B are provided for agricultural projects and the remaining €19B for structural projects (such as infrastructure and environment). In this context special focus is given to the promotion of SMEs.[2592] State representatives expect that MNCs will

[2588] The PHARE program was established in 1989 and stands for Poland Hungary Assistance for Restructuring the Economy. The group of beneficiaries was soon extended.
[2589] ISPA stands for Instrument for Structural Policies for Pre-Accession.
[2590] SAPARD stands for Special Accession Program for Agriculture and Rural Development.
[2591] See Georgescu (2004); Larive Romania (2006), pp.45-46; Deloitte (2006), p.29.
[2592] See Intv. German Authority I (2007); Intv. Romanian Ministry V (2007); Intv. Supranational Authority I (2007); Intv. Austrian Econ. Association I (2007); see also Agence France Press (2006).

mainly play a role as contractors for institutions, for example in infrastructure projects.[2593]

Interviewees expect that the increase in EU subsidies will help to improve the desolate infrastructure situation.[2594] Experts assume that the positive effects of the EU funds will improve the investment conditions in Romania overall and compensate for other disadvantages of EU accession (such as the expiration of some investment incentives).[2595]

(b) Romania has experienced significant problems with the **use and distribution of EU funds**. An important example for the deficiencies is Romania's **use** of the assistance received through the PHARE program from which Romania obtained a total €2,6B in the period between 1999 and 2005.[2596] The European Court of Auditors examined the use of PHARE money between 2000 and 2005 in a special report. The report concludes that the projects goals were largely in compliance with the general goals of PHARE; however, in more than half of the projects, the money was not used for the planned goals and in many cases the planning was running more than 2 years behind schedule (for 3 year projects). The report comments that Romania often lacked a coherent strategy for the implementation of the PHARE projects and provided too few human and financial resources.[2597]

Furthermore, the **distribution** of the large amounts of the new and large amount of EU assistance (of €32B) is still behind schedule. Main problems seem to be the lack of effective structure to absorb EU funds, complicated procedures of the application process that require either good contacts to local authorities or external help, the strong centralization of the projects (that are

[2593] See Intv. Romanian Ministry V (2007); Intv. Romanian Authority I (2007).
[2594] See Intv. Germ. MNC - Automotive (2007).
[2595] See Intv. Austr. MNC - Financial Services II (2007); Intv. Austr. MNC - Industrial Goods I (2007).
[2596] See EBRD (2005b), p.33; HVB Bank (2006), p.17; Deloitte (2006), p.29; ABN-Amro Romania (2006), p.26.
[2597] See European Court of Justice (2006).

generally steered from the ministries and tend to neglect local requirements), and the limited preparation of the local authorities. Interviewees also report that plans for infrastructure projects, for instance, exist and the funds of the EU are available but Romania has not provided its contribution to the financing so far.[2598] In sum, *Intv. Austr. MNC - Primary Goods II (2007)* describes the situation regarding the distribution of EU funds since Romania's accession to the EU as "chaotic". Therefore, even though 3,000 companies had already applied for EU funds no project had been approved by June 2007.[2599] Other experts criticize that the deficiencies in the distribution of money increase the chances for corruption.[2600] On the other hand, *Intv. German Ministry (2007)* points out that the authorities responsible for the distribution seem to be more cautious to grant subsidies because they are afraid of coming under suspicion of corruption.[2601]

Regarding this recent EU funding, experts also point out that Romanian authorities have not been able to present enough appropriate projects to absorb such a large amount of money so far. Municipalities (that are generally responsible for the elaboration of these projects) seem to lack staff, experience and contacts in the ministries steering the projects. State interviewees also point out that MNCs have made little progress (compared to Romanian companies) in their preparations for absorbing EU subsidies and still need time to understand the opportunities and procedures required.[2602] However, experts also clarify that Romania understandably has difficulties identifying sufficient projects considering that Romania would have to invest, for example, about

[2598] See Intv. Germ. MNC - Consulting II (2007); Intv. German Econ. Association II (2007); Intv. Romanian County Council (2007); Intv. German Authority I (2007); Intv. German Political Adviser (2007); Intv. German Ministry (2007).
[2599] See Intv. Romanian Ministry V (2007).
[2600] See Intv. Germ. MNC - Legal Services II (2007); Intv. Austr. MNC - Primary Goods II (2007).
[2601] For example the Central Financing and Contracting Unit.
[2602] See e. g .Intv. Romanian Ministry V (2007).

five times more money in the environmental sector within the next six years than in the 17 years since 1990 in total.[2603]

(c) The **importance** of EU financial support for FDI inflows in Romania has increased over the years. In the 1990s when Romania mainly received assistance through PHARE, interviewees assume that only few investors decided to come to Romania, based on the prospect of receiving EU subsidies.[2604]

However, during the preparation of EU accession the availability of funds as well as the awareness of EU supported projects increased strongly. Therefore, interviewees now recognize an increasing number of MNCs that are interested in investment opportunities in Romania because of the available EU funding, particularly in the infrastructure (and construction), energy and environmental sector.[2605] Some MNCs that are already in the country may also perceive the EU subsidies as a way of compensating for the lower productivity of their operations in Romania compared to the home country.[2606] However, large companies usually do not expect to receive any EU subsidies.[2607]

Nevertheless, since none of the projects had been approved by the end of the interview phase of this thesis, the actual direct and indirect effect of EU funding on FDI remains to be proven.[2608]

(d) The **assessment** of this section shows that Romania has had significant problems with the use and distribution of EU funding (demonstrated by the assistance from the PHARE program). Its implementation appears to have often exceeded the capabilities and capacities of local authorities. With respect

[2603] See Intv. German Ministry (2007); see also Intv. Romanian County Council (2007); Intv. Supranational Authority I (2007).
[2604] See e. g. Intv. German Econ. Association V (2007); Intv. German Econ. Association III (2007).
[2605] See Intv. German Econ. Association II (2007); Intv. Germ. MNC - Consulting II (2007); Intv. Austr. MNC - Industrial Goods I (2007); Intv. Austr. MNC - Financial Services II (2007); Intv. Germ. MNC - Consulting I (2007).
[2606] See Intv. Germ. MNC - Consulting II (2007).
[2607] See Intv. Germ. MNC - Retail (2007).
[2608] See Intv. Germ. MNC - Legal Services II (2007).

to the absorption of the future EU funding it seems that Romanian authorities have until now underestimated the preparation time, efforts and financial contribution that are required for a successful absorption of EU funds. This may be because until only recently they were preoccupied with the finalization of accession to the EU. However, only when Romanian public policy manages to quickly establish effective organizations and structures to absorb the EU funds can this expected large amount of money – totaling to about €4.6B annually or 50% of FDI inflows in 2006[2609] – fulfill its potential to become an important driver for FDI in Romania.

(3) In **conclusion**, this section shows that EU integration has been a very important driver for FDI in Romania in recent years, whereas the impact of EU funding on the investment decision of MNCs will depend on the decision and action taken by Romanian authorities in the future. FDI research is still at an infant stage with regards to the effects of both EU integration and EU funding on FDI in Romania and will be an interesting field for further research.

7.4.4.3 Croatia

(1) Croatia's **EU integration** (a) proceeded slowly in the 1990s but accelerated in recent years and (b) Croatian public policy showed strong efforts to reach the common goal of EU accession. Experts expect (c) some important effects on the investment climate with the country's accession to the EU. This (d) may have quite a significant impact on future FDI inflows. An assessment is provided in sub-section (e).

(a) The EU strongly supported Croatia in the early phase of its independence and established diplomatic relations in 1992. However, the **relationship between EU and Croatia** deteriorated in the mid-1990s, when the EU criticized

[2609] See figure 89; own calculations.

Croatian conduct during the last weeks of the war in 1995 (such as the expulsion of Serbian minorities), its ambiguous policy towards Bosnia and Herzegovina, Tuđman's autocratic leadership, and his unwillingness to cooperate with the ICTY.[2610] Financial support of the EU for Croatia (*see below*) was suspended and EU accession seemed very unlikely under Tuđman. After his death (1999) a rapprochement (and a somewhat better cooperation with the ICTY) began. This led to the signing of the SAA in 2001 which came fully into force in February 2005 and also included Croatia's participation in twinning projects. In 2003 Croatia officially applied for EU membership and was granted a candidate status by the EU in 2004. In 2005 the European Commission published a first progress report.[2611]

However, the EU hesitated to initiate accession negotiations because it doubted Croatia's full cooperation with the ICTY, particularly in regard to General Ante Gotovina, who had been charged with crimes against humanity because of his role in the Operation Storm and the expulsion of the Serbian minority from the Krajina. Nevertheless, the EU decided to open accession negotiations in October 2005 even before the detention of Gotovina on the Canary Islands and his extradition to the ICTY in December 2005.[2612]

As a consequence of the difficulties of the new members states – particularly of Romania and Bulgaria – in meeting the requirements of accession, the EU introduced opening benchmarks (such as the proof of a legal harmonization or implementation) for ten (out of 33) chapters. These must be fulfilled by Croatia before the initiation of the actual negotiations including competition policy,

[2610] See Bertelsmann Stiftung (2003a), p.3; European Commission (2004c); Pommer (2007), pp.160-162.

[2611] See also the analysis of Croatia's trade policy in section 7.3.1.3; Kušić (2003); European Commission (2005a), pp.4, 7; Intv. Germ. Political Foundation I (2007).

[2612] See also section 6.3.1; CICD (2006), p.11; Frankfurter Allgemeine Zeitung (2007a); European Commission (2005a), pp.23-24; Pommer (2007), p.175.

justice, agriculture etc.[2613] Croatia is thus facing hurdles that are higher than those in other acceding countries and require more time, institutions, staff and financing.[2614] However, even state experts interviewed feel that Croatia should accept all obligations and become a regular member state “instead of becoming a second-class member state like Bulgaria and Romania”[2615] (since they are still monitored by the EU).

The mandatory screening process – the comparison of the Croatian legislation with the EU acquis – was completed in October 2006 and 14 negotiations chapters were opened and two of them (science and research as well as education and culture) were provisionally closed by November 2007.[2616]

With respect to the accession schedule it seems that the EU, Croatian policy makers and MNCs have little doubt that Croatia will join the EU one day.[2617] Many interviewees assume that Croatia probably would have joined the Union earlier had it not been for the heritage of the war and the Tuđman regime.[2618] Croatia had envisaged an accession by 2007 (before the dispute about the cooperation with the ICTY) but then changed the goal to 2009.[2619] The interviews reveal that most of the state and company experts expect an accession not until 2010 or 2011.[2620] Reasons for a likely postponement of accession include a

2613 See Intv. Croat. Company - Utilities (2007); Intv. Croatian Government Team (2007); Intv. Germ. Political Foundation I (2007); Doc - OECD (2007); see also Frankfurter Allgemeine Zeitung (2007c); European Commission (2007a), p.6.

2614 See Intv. Germ. MNC - Financial Services I (2007); Intv. Germ. Research Institute II (2007).

2615 Intv. Croatian Government Team (2007).

2616 See European Commission (2007a), p.6; Financial Times (2006c); Intv. Germ. Research Institute II (2007).

2617 See Intv. Germ. MNC - Telecommunications (2007); Intv. Croatian Company - Real Estate (2007); Intv. German Authority II (2007).

2618 See Intv. Croat. Company - Utilities (2007); Intv. Croatian Company - Real Estate (2007); Intv. Germ. Political Foundation I (2007).

2619 See Dresdner Bank (2004), p.8; Sanader (2006); EBRD (2006c), p.2.

2620 See Intv. Austr. MNC - Primary Goods I (2007); Intv. German Econ. Association IV (2007); Intv. Austr. MNC - Retail (2007); Intv. Int’l Research Institute I (2007); Intv. Croatian Ministry III (2007); Intv. Croatian Government Team (2007); see also Pommer (2007), p.221.

delay in the negotiation process, the strong focus of the EU on the ratification of the Treaty of Lisbon (2007), the current enlargement fatigue in the EU, and the related discussion about an accession of Turkey.[2621] In contrast, Croatia may have an advantage in that it is a small country whose accession will cause few objections. Croatia's accession is also perceived as contributing to a greater regional stability on the Western Balkans. Furthermore, experts assume that accession could hardly be refused once Croatia has fulfilled all requirements of the EU despite political concerns and the general enlargement fatigue.[2622]

(b) From the **Croatian perspective**, EU accession may have been "the logical goal even before the end of the war"[2623]; however, as pointed out in relation to external political stability, EU accession did not become a publicly discussed and realistic goal of Croatian politics (similar to the case of Romania but for different reasons) until the early 2000s (*section 7.4.2.3*). Experts also emphasize that this aspect represents an important difference to the situation in Serbia where the EU orientation strongly depends on the ruling party.[2624] Under Prime Minister Sanader the commitment and efforts enabling accession have increased further. Experts also agree that all major parties are aiming at EU accession and a government change would not cause a deviation of this course.[2625] This is also emphasized by the National Committee for the Supervision of Croatia's Memberships Talks (established in 2005) that coordinates and streamlines the EU requirements and the negotiation procedures. It includes not only all major parties, but also trade unions and representatives of employees and attempts to avoid negotiation talks leading to ongoing disputes

2621 See Intv. German Econ. Association IV (2007); see also Frankfurter Allgemeine Zeitung (2007c); Zühlke (2008).
2622 See e. g. Intv. Austr. MNC - Financial Services I (2007); Intv. Romanian Ministry IV (2007); Intv. Int'l Research Institute I (2007).
2623 Intv. Croatian Company - Real Estate (2007).
2624 See Intv. German Authority III (2007); Intv. Croat. Company - Utilities (2007).
2625 See Intv. Germ. MNC - Telecommunications (2007); Intv. Croatian Government Team (2007); Intv. Germ. Research Institute II (2007); Intv. Germ. MNC - Financial Services I (2007); see also Dresdner Bank (2004), p.6; Bertelsmann Stiftung (2006b), p.2.

about accession in general. Croatia also set up a large negotiating team of 30 members, supported by a total staff of 2,000.[2626]

The majority of experts interviewed acknowledge that Croatia has not made any major mistakes in the negotiating phase so far and that accession preparations are advancing fairly well, especially since Croatia has to fulfill the opening benchmarks.[2627] Interestingly, some state experts are more pessimistic stating that reforms are proceeding rather slowly, are mainly driven by EU pressure and that the difficult chapters (such as agriculture, competition, fishery and energy) are still ahead of Croatia.[2628] *Intv. Croatian Authority II (2007)* even admits that "Romania and Bulgaria show in many areas better results than Croatia".

In contrast to the general support for EU accession amongst the political class in Croatia, much of the general population has remained skeptical regarding the EU in general and Croatia's EU accession to the EU in particular. Only 37% of the respondents in an EU survey carried out in 1996 had a positive opinion of the Union and this value had only increased to 40% in 2006. In the same year only 48% of Croatians were clear supporters of a Croatian EU membership.[2629] Apparently, Croatians have been dissatisified with the EU, the many delays of the negotiation process and the rigid evaluation regarding cooperation with the ICTY, considering the fact that Gotovina is still perceived as a war hero among many Croatians. Furthermore, many Croatians seem to expect only limited advantages from an EU membership and worry more about deteriorations in Croatia's economic performance (in the agricultural sector for

2626 See European Commission (2005a), p.8; Sanader (2006); Financial Times (2006c).

2627 See Intv. Croatian Government Team (2007); Intv. German Authority III (2007); Intv. Croat. Company - Utilities (2007); Intv. Austr. MNC - Construction (2007); Intv. Germ. MNC - Telecommunications (2007).

2628 See Intv. Int'l Research Institute I (2007); Intv. Croatian Government Team (2007); Intv. Germ. Research Institute II (2007); Intv. Croatian Mayor (2007).

2629 See European Commission (1996a); see for an analysis of the 2006 PULS survey: Pommer (2007), pp.192, 194.

example).[2630] Experts interviewed also point out that accession negotiation (as well as issues of external political stability) remain a very emotional field in Croatia in which public support can quickly jump or drop depending on how negotiations develop.[2631]

Furthermore, interviews also reveal a certain disappointment amongst Croatians about the fact that their country missed the first two waves of EU accession of transition countries. There is evidence of a feeling that Croatia deserved to join the Union at least as early as Slovenia but especially at the same time as Romania and Bulgaria (and definitely before Serbia). This is due to a focus on fairly good economic performance of Croatia. Thus some Croatians seem to believe that Croatia should avoid making further concessions to the EU and should even consider a delay of an accession if necessary.[2632]

(c) Interviews suggest that EU integration generally has positive **effects** on the investment climate of Croatia.[2633] Experts acknowledge that Croatia's accession efforts thus far have contributed to a clear westward orientation (and therefore greater (external) political stability), an important degree of legal harmonization with the European regulative framework and first positive signs of a more flexible and transparent bureaucracy.[2634]

Experts interviewed expect further gradual improvements due to the continued integration. Most importantly they anticipate a further legal harmonization (for example in sensitive areas such as food safety and environment), a decrease of old elites' influence and local networks, a higher reliability of political deci-

[2630] See Pommer (2007), pp.7, 196-199; see also Intv. Croatian Government Team (2007).

[2631] See Intv. Croatian Ministry III (2007); Intv. Croatian Government Team (2007).

[2632] See Intv. Croat. Company - Utilities (2007); Intv. Germ. Political Foundation I (2007); Intv. Croatian Government Team (2007); Intv. Germ. MNC - Food Products (2007); Intv. Germ. MNC - Industrial Goods III (2007); Intv. Austr. MNC - Construction (2007).

[2633] See Intv. Germ. MNC - Industrial Goods I (2007).

[2634] See 7.4.2.3; see also Intv. Germ. MNC - Telecommunications (2007); Intv. Germ. MNC - Financial Services I (2007); Intv. Croat. Company - Utilities (2007); Intv. Croatian Ministry II (2007); Intv. Germ. MNC - Software (2007).

sions, and an improvement of the court system.[2635] Some experts also believe in a certain positive effect in the combat of corruption due to EU pressure.[2636] Moreover, *Intv. Austrian Econ. Association II (2007)* assumes that Croatia will receive at least partly the attention that has been given to Bulgaria and Romania right before accession.

Company experts mainly expect that the accession itself will lead to a greater legal certainty as well as the abolishment of all remaining legal, financial and administrative barriers for goods and capital (for example regarding cash pooling). They also assume that international recruiting and training of employees will become easier.[2637] *Intv. Germ. Political Foundation I (2007)* points out that an EU accession of Croatia will increase the external stability of the Western Balkan region.

In contrast to Romania, experts interviewed worry less about potential negative effects for Croatia from EU integration. They do not expect that EU integration will lead to an increase of bureaucratic difficulties.[2638] However, neither do these foresee that EU accession will increase Croatian salaries; in contrast, retailers and financial service providers rather expect prices to drop because of the increasing competition in the market.[2639]

Finally, several interviewees expect that "not many things will change in Croatia."[2640] They argue that Croatia has already significantly progressed in

[2635] See Intv. Austr. MNC - Primary Goods I (2007); Intv. Croatian Econ. Association (2007); Intv. Austr. MNC - Retail (2007); Intv. Austr. MNC - Construction (2007); Intv. Germ. MNC - Software (2007); Intv. Austrian Econ. Association II (2007); Intv. Germ. MNC - Financial Services II (2007).

[2636] See Intv. German Econ. Association IV (2007); Intv. Supranational Authority II (2007); see also Frankfurter Allgemeine Zeitung (2007c).

[2637] See Intv. Austr. MNC - Retail (2007); Intv. German Econ. Association IV (2007); Intv. Germ. MNC - Industrial Goods I (2007); Intv. Austr. MNC - Construction (2007).

[2638] See Intv. Germ. MNC - Industrial Goods I (2007); see also Intv. Croatian Authority II (2007).

[2639] See e. g. Intv. Austr. MNC - Retail (2007); Intv. Austr. MNC - Real Estate (2007).

[2640] Disguised expert statement; see also Intv. Germ. MNC - Software (2007); Intv. Supranational Authority II (2007).

terms of legal harmonization (for example with respect to tax legislation).[2641] However, they assume that EU integration will contribute only slightly to a solution for some of the most serious investment obstacles in Croatia, such as the deficiencies in the work of the bureaucracy or regarding the combat of corruption.[2642]

(d) EU integration is quite an **important** aspect for the investment decision of MNCs that are interested in Croatia. Interviews show that investors and potential investors studied Croatia's progress in EU integration closely in the past. Therefore, *Intv. Germ. MNC - Engineering (2007)* points out that EU integration (namely the signing of the SAA in 2001) was an important factor when MNCs considered an investment in Croatia in the early 2000s. Others confirm that the opening of accession negotiations in late 2005 created a further interest for investors in Croatia.[2643] However, most experts assume that Croatia will benefit the most in the following years when more risk-averse investors and those interested in a first-mover advantage are attracted by the prospect of accession as well as by the reform efforts that were discussed above.[2644] This increasing impact of EU integration on FDI is also underlined by the fact that the German Economic Chamber of Commerce is receiving and increasing amount of queries from potential investors about when Croatia will supposedly accede the EU.[2645]

Furthermore, the majority of experts interviewed expects a boost of FDI inflows when Croatia enters the EU (as also predicted by theory)[2646]. However,

[2641] See also Intv. Austr. MNC - Construction (2007); Intv. Germ. Political Foundation I (2007).
[2642] See Intv. Germ. MNC - Telecommunications (2007); Intv. Supranational Authority II (2007); Intv. Former Croatian Minister (2007); Intv. German Authority II (2007).
[2643] See e. g. Intv. Germ. MNC - Financial Services I (2007); Intv. European Institution (2007); see also Bertelsmann Stiftung (2006c), p.9.
[2644] See Intv. German Authority III (2007); Intv. Germ. MNC - Industrial Goods I (2007); Intv. Austr. MNC - Real Estate (2007); see also Bulgaria Economic Forum (2006), p.2.
[2645] See Intv. German Econ. Association IV (2007).
[2646] See Zakharov and Kušić (2003).

they mainly anticipate a pull for larger, market-oriented companies that benefit from the elimination of the borders. EU accession may foster FDI growth particularly in those areas that lose their current protection such as tourism, nature, agriculture etc. (see also *section 6.3.1* on Croatia's economic development).[2647] In the longer run interviewees as well as external sources suggest that the impact for EU integration on FDI will decrease again.[2648]

(e) In the **assessment** of this section it becomes apparent that Croatia's EU integration started very late. This was caused by internal political problems that were analyzed before. Interviews suggest that visible progress is only limited in Croatia so far, even though accession negotiations have been going on for more than two years now. The most important reason seems to be that Croatia had already been quite advanced in terms of legal harmonization while the main challenges for Croatia's investment climate, such as the increase of the quality of the Croatian bureaucracy, will take more time and long-lasting pressure of the EU. This is also acknowledged by top officials and leading politicians who agree that a delay of the accession date may actually be beneficial for the thoroughness and sustainability of Croatian reforms. In contrast, parts of the population (and in fact some foreign companies as well) seem to overestimate Croatia's performance in terms of transition and may focus too strongly on the economic performance of the country. Therefore, public policy makers should increase their efforts to explain in detail the benefits of EU accession to the population

Nevertheless, Croatia can expect positive future effects for FDI from EU accession. This seems particularly true because Croatia may be the only country that will join the EU within the next five years. This will cause a special

[2647] See Intv. German Econ. Association IV (2007); Intv. Germ. MNC - Logistics (2007); Intv. Austr. MNC - Real Estate (2007); Intv. Austrian Econ. Association II (2007); Intv. Germ. MNC - Financial Services II (2007); see similar: IMF (2006b), p.11; more pessimistic.

[2648] See also Bulgaria Economic Forum (2006), p.2.

attention from potential investors. Nevertheless, Croatia's EU accession is in danger to be ignored because of its small country size; therefore, public policy makers should enhance marketing efforts for Croatia abroad.

(2) Croatia has started to benefit from **EU funds** (a) only lately on a larger scale and (b) has only limited experience with the use and distribution of the subsidies so far. EU funds (c) may become a slightly enhancing factor for FDI in the years to come. Sub-section (d) assesses the findings.

(a) Croatia was included in the PHARE program in 1995. However, since the relations to the EU cooled down in the mid-1990s (*see above*), the payments were suspended and did not resume until the signing of the SAA (2001). Thus between 1991 and 2000 Croatia only received EU assistance to a total value of €367M (mainly for humanitarian purposes) whereas Albania, for example, received €912M during the same period.[2649] As a result, Croatia had to master its economic transition (and the consequences of the war) mainly on its own.[2650] After the re-invigoration of the relations with the EU, Croatia received €279M between 2000 and 2004 as part of the CARDS program, mainly for the assistance of the economic development and administration capacity building.[2651] As a candidate country Croatia has become a beneficiary of pre-accession assistance programs, of which the most important ones are PHARE, ISPA (2005-2006) and SAPARD (2006).[2652] In 2005 Croatia received €105M and €140M in 2006 in terms of pre-acession financing. Since 2007 Croatia also receives support through the Instrument for Pre-accession Assistance (IPA) (€141M in 2007) which focuses on institution building and the preparation for the implementation of the agricultural and cohesion programs. For 2008 and

[2649] See European Commission (2002c), p.23; Ott (2005), p.21; own calculations.
[2650] See Kušić (2003).
[2651] See European Commission (2005a), p.6; Bertelsmann Stiftung (2006b), p.14; European Commission website (2008).
[2652] See Bfai (2004), p.35; European Commission (2005a), p.6.

2009 Croatia can expect financial support as part of IPA totaling of €146M and €151M.[2653]

(b) As shown above, EU funding in Croatia has remained limited so far, as has the experience of interviewees with the **use and distribution** of EU funds. Experts have experienced difficulties in receiving funding on the local level, for example *Intv. Germ. MNC - Industrial Goods I (2007)*, who found no administrative structure in place in Slavonia in order to absorb EU assistance and who had difficulties to find the right contact person only a few years ago. *Intv. Germ. MNC - Food Products (2007)* has found that authorities in Romania are less restrictive and more willing to grant European subsidies than in Croatia. Interviews also suggest that Croatian authorities have made little effort to contact new EU members and learn from their experiences in retrieving EU assistance thus far.[2654] The European Commission also agrees that the institutional and administrative set-up for the absorption of EU financial assistance is still only in the beginning stages so far and that the use of EU assistance still suffers from certain weaknesses including an effective program evaluation.[2655]

Nevertheless, the European Commission recognizes some important progress in recent years and praises, for example, a stronger decentralization of the pre-accession aid and good progress in the implementation of some of the programs, namely SAPARD (for instance, regarding the establishment of mandatory standards for the eligibility of applicants).[2656]

(c) Regarding the **importance** of EU financing for the investment decision of MNCs, interviews suggest that it has had only little impact on FDI in Croatia so far. It seems that the amounts available were too small and in areas that have been of little interest for the majority of foreign investors (such as administrative capacity development and agricultural development). However, it

[2653] See European Commission (2006a), p.5; European Commission (2007a), p.6.
[2654] See e. g. Intv. Romanian Ministry V (2007); Intv. Croatian Ministry IV (2007).
[2655] See European Commission (2007a), p.6.
[2656] See European Commission (2005a), pp.6, 63-64; European Commission (2007a), p.7.

seems that only few investors have already entered the country in expectation of increasing EU funds in the future, also because the date of accession is still uncertain.[2657]

Nevertheless, experts interviewed assume that Croatia will also benefit from somewhat higher FDI inflows once Croatia enters the EU and qualifies for larger amounts of EU assistance. Interviewees expect inflows particularly from SMEs winnig tenders in projects related to tourism, agriculture and environment.[2658] However, interviewees also point out that many investors believe that state incentives (as discussed in *section 7.3.3.3*) may continue to be more important (and more realistic) than potential EU funds.[2659]

Finally, interviews also suggest that Croatia will benefit from EU funding indirectly, because the use and distribution of EU financing will lead to a strengthening of central and local authorities. They may learn how to set measurable goals, work with different methodologies of implementation and cooperate with different partners.[2660] In sum, the quality of Croatian bureaucracy may improve which may also, in the long-run, lead to higher levels of FDI (see above *section 7.2.3.3*).

(d) An **assessment** of this section reveals that Croatia has shown that it is capable to master economic transition even without significant help of the EU. The low payments of the EU in the 1990s may help to explain the resentments towards the EU among many Croatians. More importantly, the low inflow of EU money caused Croatia's weak spot, the bureaucracy, not be mordernized earlier. FDI inflows may become more significant due to higher EU funding after accession than currently assumed. Croatian public policy makers should thoroughly scrutinize the experiences of other EECs in order to maximize the

[2657] See Intv. Croatian Company - Real Estate (2007); Intv. Germ. MNC - Industrial Goods I (2007).
[2658] See e. g. Intv. German Econ. Association IV (2007).
[2659] See Intv. Croatian Company - Real Estate (2007).
[2660] See Intv. German Authority III (2007).

impact of the increasing EU funds. Nevertheless, the much smaller amount of EU assistance expected, compared to Romania for example (due to Croatia's smaller population), may simply not be significant enough in order to attract a large amount of (additional) investors to Croatia.

(3) In **conclusion**, this section has shown that the legal and political dimension of EU integration has been a very important factor for FDI inflows to Croatia, while the financial aspects has had limited impact so far. Further EU pressure is likely to help Croatia master the necessary reforms in many areas touched upon in previous sections of this thesis including bureaucracy, corruption and judiciary.

7.4.4.4 General insights for transition countries

This section presents several insights regarding the impact of EU integration on (1) FDI in transition countries and (2) the reforms of transition countries. Section (3) discusses some implications for public policy makers.

(1) The analysis of the country sections and further FDI studies shows that EU integration has a very important **impact** on the decision of MNCs to invest in a specific transition country. In this context, interviews suggest that the gradual success in reforms (as part of accession preparation) is the most important aspect for those MNCs that are already in the country, while potential investors tend to be attracted by a clear prospect and the actual accession to the EU by country in question. However, interviews as well as FDI studies on earlier accession rounds suggest that the positive impact on FDI ceases within several years after accession. In fact, historical analyses of the impact of EU accession on FDI suggests that the effect for new EU members decreases every

EU accession round.[2661] As a consequence, Croatia may see a shorter period of beneficial FDI effects after EU accession than, for example, Romania.

FDI studies generally focus on the experience of CEECs and their integration process. According to the great majority of these studies (but also to those experts with experience in other EECs), transition countries benefited strongly from the prospect of EU accession in general in terms of FDI inflows.

Furthermore, FDI studies as well as experts interviewed identify important events as psychological thresholds for investors such as the application for membership, the public commitment of the EU to Eastern enlargement in Essen in 1994, the beginning of individual accession negotiations as well as the first wave of accession in 2004. SMEs in particular seem to be attracted by the increasing legal harmonization, easier market access and greater legal certainty that is established in the course of EU integration.[2662]

Interviews and data show that concerns of some studies, that countries that acceded later (namely Romania and Bulgaria) would attract lower FDI inflows, were unfounded. Interviews show that MNCs were for a long time unconvinced that Romania would actually join the union but once accession became irrevocable Romania (and Bulgaria) benefited from the special position of being the only countries joining the EU in 2007. The prospect of the large amounts of EU funding available may also have contributed to this push.[2663]

The remaining SEECs and European CIS that have not joined the EU so far also seem to benefit strongly from the perspective of EU integration in terms of FDI inflows. Particularly due to a long period of political instability, the more

[2661] See Brenton, Di Mauro, and Lücke (1999); Merlevede and Schoors (2004); Clausing and Dorobantu (2005); see also Intv. Germ. MNC - Consulting I (2007); Intv. German Authority IV (2007).

[2662] See Borsos-Torstila (1999); Brenton, Di Mauro, and Lücke (1999); Bevan and Estrin (2000); UNCTAD (2002); Zakharov and Kušić (2003); see also Intv. Germ. MNC - Consulting I (2007); Intv. German Authority IV (2007); more skeptical: Intv. Germ. MNC - Industrial Goods I (2007).

[2663] See Intv. Austr. MNC - Legal Services (2007); Intv. Austr. MNC - Industrial Goods I (2007); Bevan and Estrin (2000).

recent steps of EU integration (such as the signing of SAAs by Macedonia and Croatia in 2001 or the opening of accession negotiations as in the case of Croatia in 2005) seem to be major drivers for risk-averse investors. An EU accession may have less effect on FDI in Croatia than it may have on other non-EU countries, as Croatia is already perceived (by many potential MNCs) quited stable and having made good progress in reforms. Therefore, EU accession may be an even even more important factor for other countries in question (including Serbia and Ukraine) and their future FDI development. Interviews suggest that the region may become more attractive particularly for large investors after EU accession leads to the lifting of remaining trade barriers and easier market access. EU funding seems to have only limited impact on FDI in non-EU countries but may grow once more is available directly before and after accession.[2664]

(2) EU integration has contributed significantly to the good **performance** of many Eastern European transition countries to implement significant reforms since the early 1990s. Particularly countries that only recently initiated reforms (such as Romania and Croatia) showed an impressive catching up process in recent years. EU integration therefore helped some EECs to make up for an only gradual reform process in the 1990s. The case of Romania shows that EU pressure enabled reforms that did not seem possible to many observers in such a short time. EU integration apparently has a positive impact on investment conditions in all EECs. Experts interviewed praise the legal harmonization in particular as well as the improvement of the legal certainty and the positive effects on the functioning of the bureaucracies in the course of EU integration.[2665]

Interviews also show many challenges in the accession preparation of EU aspirants. They include the risk of frequently changing government policies (as

[2664] See Intv. Croatian Company - Real Estate (2007); Intv. Austr. MNC - Construction (2007); see also Kalotay (2000); UNCTAD (2004b).

[2665] See e. g. Intv. German Econ. Association V (2007); Intv. Romanian Ministry I (2007); Intv. Austr. MNC - Retail (2007); Intv. German Authority III (2007).

shown for Romania) and a limited support of the population (as in Croatia). Interviews and external studies also confirm that the use and distribution of EU funds cause difficulties in the great majority of EECs (for example, Czech Republic and Bulgaria) before and after EU accession.[2666]

The varying speed of EU integration has mainly been driven by the reform efforts of candidate countries, but the EU also plays a vital role in this process. State interviewees point out that negotiations are often slowed down by the length of time that national authorities have to wait for an evaluation of certain reform steps by the European Commission.[2667] Company experts interviewed also criticize that requirements of the EU often suppress business reality because they do not sufficiently consider the perspective and demands of domestic and foreign investors (for example regarding customs regulations).[2668] The analysis of EU funding in Romania also raises the question as to whether the EU does not sometimes promise unrealistically high financial assistance for the years after accession, since – even if Romania was perfectly prepared formally – such large amounts seem to be difficult to absorb in such a short time for a sufficient number of adequate projects.[2669] Finally, state experts in particular show that the political motives of EU enlargement policy can be irritating or even dangerous for reform efforts. Therefore, Croatian authorities may ask whether comprehensive efforts, for example with respect to the combat of corruption, are actually necessary, when Romania and Bulgaria (which are both seen as having a worse corruption record) were still able to accede the Union.[2670]

[2666] See Intv. Austr. MNC - Primary Goods II (2007); see also European Court of Justice (2006).
[2667] See Intv. Romanian Ministry II (2007).
[2668] See e. g. Intv. Austr. MNC - Primary Goods II (2007).
[2669] See e. g. Intv. German Ministry (2007).
[2670] See also Intv. Germ. Political Foundation I (2007); Intv. Croat. Company - Utilities (2007); Intv. Supranational Authority II (2007).

(3) Several **public policy implications** can be derived with regards to EU integration. Firstly, interviews suggest that a successful accession preparation is driven by a very good chief negotiator of the host country (politically and technically), a capable and independent Ministry of European Integration, a good communication between the different ministries regarding EU related issues, a clear scheduling with timelines, tasks and responsibilities and a good statistical basis that facilitates the gathering of the information demanded by the European Commission throughout the accession process.[2671]

Secondly, public policy makers should not underestimate the potentially negative effects of EU integration, including an increase in prices and salaries, a possibly higher level of corruption (due to problems in the distribution of EU money) and a shortage of labor. Public policy should therefore introduce counter measures (including social housing, changes in education policy etc.) early enough to mitigate negative effects.[2672]

Thirdly, public policy makers should be aware of the potential negative effects of a delayed accession. A delay may not be as bad for investors for whom the prospect of accession may be just as important as the actual accession. However, a delay – whether driven by the EU or by political problems in the host country – may frustrate authorities and slow down necessary reforms.[2673]

Finally, public policy should prepare well for the phase after accession to the EU. It should be prepared to deal with possible disappointments of the population that positive effects are less visible than expected.[2674] Countries could also actively ask for the maintenance of cooperation and a mechanism to keep up the EU pressure and prevent a slowdown of reforms in sensitive areas. Public policy actors should also elaborate further in advance a strategy for an effective absorption of EU funding. It seems in this context that transition

[2671] See Intv. Germ. Research Institute I (2007); Intv. Romanian Ministry II (2007).
[2672] See also Intv. Germ. MNC - Legal Services II (2007).
[2673] See also Intv. Austr. MNC - Financial Services I (2007).
[2674] See also Intv. Germ. Political Foundation I (2007).

countries often ignore the fact that a significant contribution on their part (in terms of human and financial resources) is necessary.[2675] They also seem to ask only rarely for advice from other EECs with similar experiences.[2676]

7.4.5 Overview of findings on political measures

The findings of the analyses regarding the political determinants are summarized in this section. *Figure 61* presents an overview of results regarding the **performance** of these determinants by Romania and Croatia since the early 2000s whereas the evaluation is based on the expert interviews, documents collected and external publications studies. The **impact** of political measures on FDI in transition countries is summarized in *figure 62* following the same methodology as for legal and economic determinants.

[2675] See Intv. German Ministry (2007); see also Intv. Croatian Government Team (2007).
[2676] See Intv. Croatian Government Team (2007).

Overview political determinants – current performance of Romania and Croatia					
Determinant	Sub-determinant	Romania		Croatia	
		Performance	Comment	Performance	Comment
• **Human capital**	• Education level	**(+)**	• Good science & language skills, but somewhat overestimated, poor education of managers & skilled labor	**(++)**	• Fairly good & improving, very good language skills, business education too theoretical, MNCs can recruit the best
	• Availability of labor	**(--)**	• Major problem for MNCs, but mainly in boom centers, caused by university education, emigration and lack of mobility	**(-)**	• Labor shortage due to low number of tertiary graduates (particularly from engineering and business administration)
• **Political stability**	• Internal political stability	**(0)**	• No danger of radicalization, generally functioning institutions, but political quarrels (Prime Min vs. president), limited exchange of elites & participation	**(++)**	• Well-functioning institutions, reliable government, high participation, but some minor problems with minorities on the local level
	• External political stability	**(+++)**	• Clear westward orientation (NATO, EU), former disputes with international organizations (IMF) no problem for MNCs	**(++)**	• Clear westward policy since early 2000s (NATO & EU accession highly likely), positive role in SEE, minor border conflicts
• **Corruption**	• Corruption overall	**(---)**	• Some awareness and legal reforms, but still high petty corruption and "acceleration money" in admininistr., under EU watch, greatly politicized	**(--)**	• Some successes of USKOK, but problems in bureaucracy, judiciary and public procurement (especially on the local level), CPF scandal
• **European integration**	• EU integration	**(++)**	• Significant reforms due to preparations for accession (2007), highly contested by EU members, still under EU watch	**(+)**	• Common goal of politicians, but only limited public support, mediocre progress in negotiations from Croatia & EU
	• EU funds	**(--)**	• Inefficient use of PHARE money, great problems in preparing absorption of expected €32B, some errors caused by EU	**(0)**	• Only little experience so far, administration on the local level only little prepared and quite passive (e. g. in Slavonia)
• **Political measures**	• Political measures overall	**(+)**	• Achievement of EU & NATO accession, but major problems with corruption	**(+)**	• Very strong pol. stability, reform success due EU integr. needs to be proven

Note: **(+)** = rather good, **(+++)** = very good performance, **(-)** = rather weak, **(---)** = very weak performance, **(0)** = neutral
Source: Own presentation.

Figure 61: Overview political determinants – performance

Overview political determinants – importance for FDI in transition countries			
Determinant	Sub-determinant	Importance on FDI	Explanation
• **Human capital**	• Education level	• High (but decreasing)	• Positive characteristic: science & language skills, but in many Eastern European transition countries, sometimes overestimated by state representatives • Mainly for MNCs interested in initial investment, less important for services, decreasing impact with better knowledge of countries
	• Availability of labor	• High for MNCs already in the country • Medium for potential investors	• MNCs that are already present with less options to search for abundant labor • Potential investors more free to search for labor also in less popular regions (Romania), unskilled workers less crucial for MNCs' decision • Less relevant for MNCs than for domestic firms
• **Political stability**	• Internal political stability	• Very high in 1990s • Medium today	• Very significant in the 1990s, investors looked at country-specific differences, authoritarian regimes are constraining (Croatia under Tuđman) • With stabilization in most TCs impact has been decreasing, but can have negative impact if instabilities are not expected (Hungary)
	• External political stability	• Medium to very high	• In the case of war or significant instability, country is not considered • Westward orientation, relations to home & neighboring countries also important • In countries that are perceived as more instable, threshold events (e. g. NATO accession) can be decisive
• **Corruption**	• Corruption overall	• Medium	• Constraining for MNCs that are inexperienced or constantly dealing with authorities (permits etc.), increases uncertainty of MNCs & inefficiencies of bureaucracies • However, MNCs often less confronted than domestic firms, MNCs with experience in TCs not deterred, sometimes even willing to pay bribes to accelerate processes
• **European integration**	• EU integration	• Very high (but decreases after accession)	• For those MNCs already in the country: most attracted by gradual reforms • For potential investors: most attracted by clear prospect and actual accession • Less impact in case of high political stability & advanced legal harmon. (Croatia)
	• EU funds	• Medium for large new EU members • Low for non-EU countries	• Increases with EU accession if large amounts are available, but usually not decisive • Low impact on EU aspirants since amounts are limited and difficult to receive (often less likely than state incentives)
• **Political measures**	• Political measures overall	• High	• Thresholds (e. g. EU and NATO accession) very important for less stable countries, decreasing importance since early 2000s

Source: Evaluation based on interviews and analyses; own presentation.

Figure 62: Overview political determinants – importance

8 Overview of country findings

This chapter provides an overview of this thesis' findings with respect to all FDI policy determinants analyzed, together with the most important results for Romania (*section 8.1*), Croatia (*section 8.2*) and transition countries in general (*section 8.3*).

8.1 Romania

The previous sections have provided important insights regarding public policy reforms that have influenced the environment for FDI in Romania. This section summarizes the findings on Romania's (1) performance in creating a favorable investment environment and (2) the impact of policy determinants on FDI.

(1) *Figure 63* summarizes Romania's current **performance** by converting the findings into a graph that were already presented in the sections at the end of the analysis of the legal, economic and political determinants (*figures 44, 53* and *61*). According to this, Romania performs rather well in twelve out of 28 sub-determinants[2677] and rather weakly in eleven other determinants. For five determinants assessments balance between positive and negative evaluations. Legal determinants (such as corporate law, company registration and legal system) are among the most successful factors today from the perspective of the interviewees. The figure also reveals that political factors are included amongst the determinants with the greatest need for further reforms (such as corruption, EU funds and availability of labor). It is also worth noting that

[2677] Regional differences of bureaucracy are not considered since performances strongly vary.

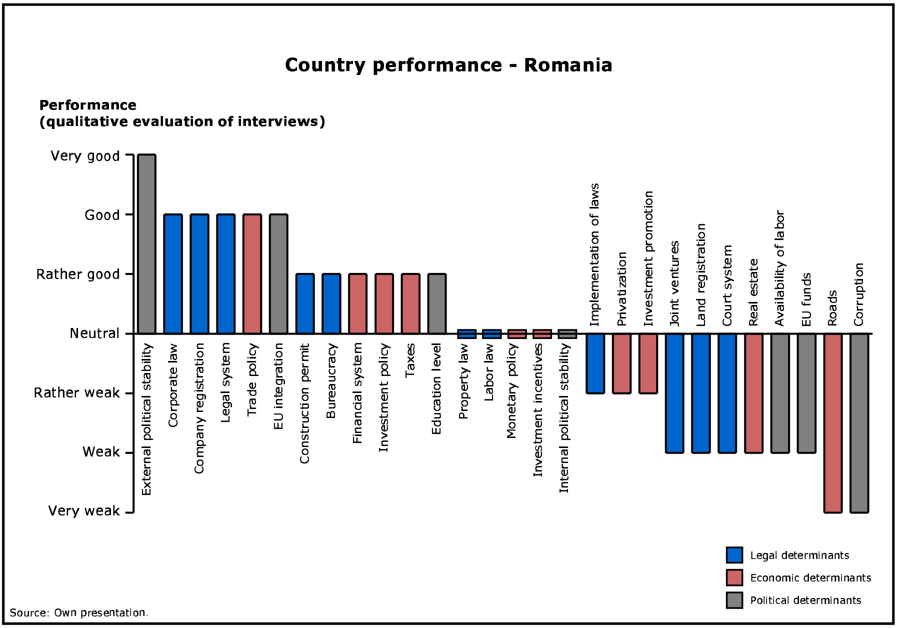


Figure 63: Country performance – Romania

Romania's performance has been only partly driven by EU accession preparations. For example, reforms leading to a good or rather good performance of company registration, construction permit and educational level were not so much instigated as a response to EU pressure but were rather part of overall reform efforts in Romania (particularly since the early 2000s).

(2) The analyses of this thesis have also shown that the performance of Romania's determinants often does not correspond to their **impact** on the investment decision of MNCs. Looking at the impact of all determinants analyzed in this thesis, *figures 64* and *65* present four key enhancing and four constraining determinants for FDI in Romania that were most frequently cited by interviewees. Therefore, Romanian public policy makers should emphasize these key benefits (legal system, privatization, external political stability and

Key enhancing public policy determinants for FDI – Romania

Description	Comment
1. Legal system	Major improvements since ~2000 as part of overall reforms & EU accession preparations • Improved law-making, legal harmonization (with Romanian & EU laws), higher legal certainty, fewer consistency gaps • Particularly important for risk-averse investors & advantage versus Ukraine • Closed important competitive gap to more advanced EECs (e. g. Hungary)
2. Privatization	Since late 1990s sale of large-scale SOEs, significant improvements of procedures • Benefited in some cases from belated privatization compared to other EECs (e. g. Petrom and BCR) which maximized privatization revenues and FDI and increased public attention abroad • Experience with tenders also caused more professional administration and more open cooperation with (foreign) investors; therefore, greenfield investors also (indirectly) attracted by privatization
3. External political stability & EU accession	Since Kosovo crisis (1999) increasing external stability peaking in EU accession (2007) • NATO accession (2004) and EU accession negotiation major signs of stability that boosted FDI • Important aspect for risk-averse MNCs and for improving country image • Important advantage versus Ukraine and Serbia but effects may cease after a while
4. Company registration	2003/2004 significant reforms including simplification of procedures, one-stop shop • Transparent & quick procedures indicate a good administration in general important indirect effect • Important positive impact because gives first good impression of Romania • Enhancing because better performance than expected by MNCs (and better than in most EECs)

Source: Own presentation.

Figure 64: Key enhancing FDI determinants – Romania

company registration) when promoting Romania as an investment location to existing and potential investors. However, they should also be aware of the decreasing impact of some of these factors (as shown for privatization and external political stability) and elaborate future strategies for the attraction of FDI, namely greenfield investments. Furthermore, Romanian public policy actors should work on the greatest impediments to higher levels of FDI, including road infrastructure and labor availability (whereas monetary policy and property rights had their greatest deterring effect on the investment decision of MNCs in the 1990s).

Key constraining public policy determinants for FDI – Romania

Description	Comment
1. Monetary policy (1990s)	Severe imbalances throughout the 1990s • Hyperinflation up to 155% (until 1997) and high volatility of currency • Slowdown or even decrease of GDP • Potential MNCs deterred because operational planning becomes difficult • Large share of gray economy made business operations difficult for investors
2. Property rights	Significant problems with property law and land registration until 2005 • Intransparent, many limitations for foreigners, large number of restitution cases, slow registration • Major constraint in the 1990s (perception maybe more negative than actual performance • Has strongly influenced regional decision of MNCs (in favor of Transylvania)
3. Road infrastructure	Very weak supply of highways as well as other roads • Constraining for all forms of FDI; limits expansion of existing MNCs and increases transportation costs of investors • Becomes even more important with growing economic activity (and more vehicles) • Has led to regional disparities (e. g. clusters close to the Hungarian highway system), also causes problems regarding with availability of labor
4. Availability of labor	Labor shortage has become an increasing concern of investors about 2004 • Important policy problems are deficiencies in the education system, little mobility of workforce, weak infrastructure, high emigration and problems with real estate • MNCs that are already present also suffer from regional disparities • Potential investors are already warned from other MNCs

Source: Own presentation.

Figure 65: Key constraining FDI determinants – Romania

8.2 Croatia

This section summarizes the key results of the main chapter for Croatia regarding (1) the performance of the factors analyzed and (2) their impact on MNC investment decisions in favor of Croatia.

(1) *Figure 66* shows that the distribution of determinants in Croatia with a positive (11), negative (12) or neutral (5) **performance** is similar to that of Romania. Interestingly and in contrast to Romania, Croatia's strengths are clearly the political as well as the economic factors which have often been successful for many years (such as monetary policy and political stability). In contrast, legal measures (such as bureaucracy, property rights and the judicial system) clearly show the greatest need for further improvements. Croatia appears to have relied for many years on its success in stabilizing the country after the turbulences of the 1990s and public policy makers have failed to initiate sustainable reforms in the legal field in recent years. This is also in comparison to other countries in the region. The actual legal framework of these measures may already be in place but in many cases implementation (particularly on the local level) is being delayed. Further pressure from the EU will probably only have limited success in this context since accession preparations focus only little on administrative reforms.

(2) Four key factors with enhancing and constraining **impact** respectively on FDI in Croatia are presented in *figures 67* and *68*. Therefore, interviews indicate that MNCs interested in Croatia are most attracted by its internal political stability, positive country image, economic stability, and high level of education. The most significant deterring factors for FDI in Croatia used to be the lack of political stability and the problems with privatization in the 1990s. The property rights situation and the quality of the bureaucracy are identified as today's greatest constraints for Croatia as investment location. As pointed out previously, Croatia strongly benefits from its impressive achievements in

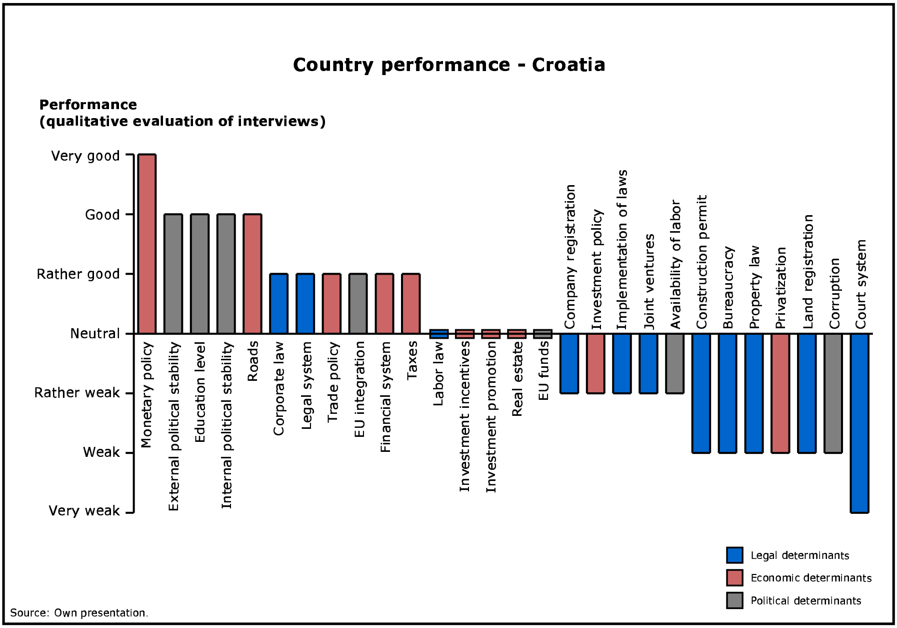


Figure 66: Country performance – Croatia

Key enhancing public policy determinants for FDI – Croatia

Description	Comment
1. Internal political stability (since early 2000s)	Significant improvements under the successors of Tuđman • Constitutional reforms strengthened democracy and minority rights • Consensus on policy goals in the political class, increasing reliability of government decisions, fairly high political participation • For MNCs important advantage compared to other countries of the region (e. g. Serbia)
2. Country image (as part of investment promotion)	Traditionally positive image of Croatia in Western Europe (even without much state effort) • Beautiful country & tourist destination, more open socialism in the 1980s, quite wealthy • Helped to cover up deficiencies until recently, e. g. regarding bureaucratic reforms • Helped Croatia to attract investors quite quickly after the war even though damages still existed
3. Economic stability	Combination of stable financial system and monetary policy since the late 1990s • Fast economic recovery after the war, high purchasing power • Sound banking system, including high foreign bank penetration • Low inflation, strong central bank, low volatility of kuna • Stability enables reliable planning for MNCs and was especially important after the end of the war significant advantage compared to other countries of the region • Financial sector itself also very attractive for FDI
4. Level of education	Good skills of tertiary graduates as well as skilled workers (since socialist times) • Good engineering and language skills, recent efforts to improve tertiary education • Very positive perception (maybe even better than actual performance) • Good skills compensate for higher labor costs compared to neighboring countries

Source: Own presentation.

Figure 67: Key enhancing FDI determinants – Croatia

the past in stabilizing the country. In contrast, daily operations are still constraining for investors. Counter measures of public policy actors seem urgent since MNCs (that are already present in Croatia) increasingly pass on information to potential investors about Croatia's (mostly bureaucratic) deficiencies. This may result in a deterioration of the positive country image which has been a major asset for Croatia as investment location.

8.3 Transition countries

This thesis derived general insights for transition countries from the generalizable findings from the country cases (Romania and Croatia) in addition to the analysis of further external FDI studies and data. This section summarizes

Key constraining public policy determinants for FDI – Croatia	
Description	**Comment**
1. Internal & external political stability (in the 1990s)	War (1991-1995) and Tuđman's authoritarian regime (until 1999) major constraints for FDI • War and young statehood made planning and safe investments difficult • Internal problems included deficiencies in democracy (e. g. weak role of the prime minister), lack of government reliability, appointments of partisans and minority problems • MNCs also deterred by generally nationalist resentment towards foreigners at that time • Lower FDI for the whole region throughout the 1990s
2. Privatization (in the 1990s)	Substantial problems with method of privatization and disadvantages for MNCs in the 1990s • Sale of SOEs started late and proceeded slowly (until the end of the war) • Problems for MNCs because of significant insider and partisan sales as well as management and employee-outs • MNCs skeptical regarding the acquisition of SOEs even today, since many of them are loss-making and because CPF corruption scandal damaged credibility of procedures
3. Property rights	Major problems of MNCs to exercise their rights and register land until today • Property law with regulatory gaps and contradictions, limitations for EU nationals • Land registration with poor quality of entries, very slow registration process • Some resentment towards MNCs from local authorities at the coast (e. g. in tourism) • Constraining especially for smaller MNCs that want to avoid many ownership claims and long court trials
4. Quality of bureaucracy	Very weak public administration on the central level but particularly on the local level • Slow, intransparent, large and very hierarchical administration, many permits needed • Lack of business-friendly attitude, little understanding of benefits from FDI • Major constraint because investors expect better conditions in Croatia than in other EECs; particularly constraining for FDI in restricted areas & large state involvement

Source: Own presentation.

Figure 68: Key constraining FDI determinants – Croatia

the findings regarding the (1) importance of FDI determinants in transition countries and the (2) key differences between company and state experts based on the analysis of the interviews.

(1) *Figure 69* presents the qualitative results regarding the **importance** of the different determinant categories (legal, economic and political) and FDI sub-determinants on the investment decision of MNCs in transition countries in general. It converts the previous summaries at the end of the sections dealing with the legal, economic and political measures into a graph (*figures 45, 54* and *62*). Several insights can be derived from this figure:

Firstly, legal and political measures tend to have a somewhat greater overall impact on FDI than economic measures. This is also interesting because the 34 most frequently cited FDI studies on transition countries (that were presented in *section 2.2.4.2*) put a strong emphasis on economic measures in their analyses (as highlighted in *figure 69*).

Secondly, the removal of barriers tends to be more important than the provision of incentives. Therefore, the reduction of the time required for administrative procedures (for example regarding land and company registration or at customs), as well as the reduction of uncertainties (for example, regarding the goals of foreign policy) seem to have a greater impact on FDI in transition countries than the provision of investment incentives, low taxes, EU assistance etc.

Thirdly, the graph shows that the importance of several determinants with high or even very high importance seems to decrease as transition progresses. Examples are property law and internal political stability (with improving performance), privatization (once only few SOEs are left to be sold) or EU integration (whose effect tends to decrease after several years of accession).

Finally, public policy makers should be aware that the importance of FDI determinants may vary across countries, forms of investments and MNCs from

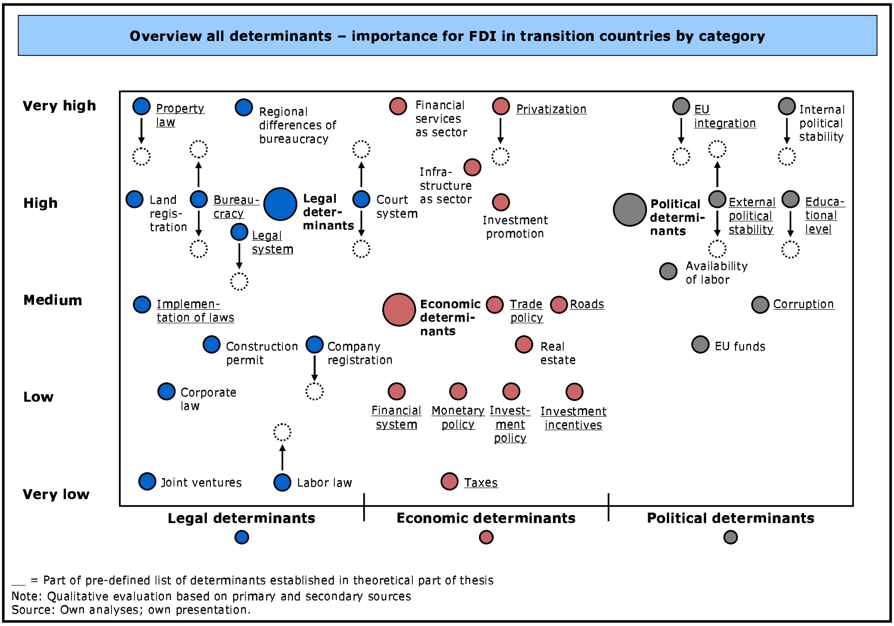


Figure 69: Overview all determinants – importance

different home countries. *Figure 69* supports the results of previous analyses, which showed that differences may exist if a certain quality threshold has been reached (court system). The impact may also depend on the country expectation of investors (as for bureaucracy) or regional circumstances (external political stability).

(2) The analyses of the 90 interviews conducted with experts and the 30 expert documents collected, permit a more differentiated picture of the diverging opinions and perceptions held between **company and state experts**. The four most striking differences are summarized in *figure 70*. They include corruption, country image, external political stability and a diverging evaluation of legal and administrative barriers.

Key differences between state and company experts in transition countries

Description	Comment
1. Corruption	State experts tend to overestimate negative effects of corruption on FDI • The examples of Romania and Croatia show that state actors are well aware of the remaining problems in all areas (including petty, medium- and top-level corruption) and frequently worry about negative effects on the business environment • However, MNCs confirm that corruption has only a medium impact on their investment decision, because they are less confronted with corruption than domestic firms, can avoid briberies when they know their rights or are even willing to pay "acceleration money"
2. Country image	State representatives often seem to underestimate the effects of the country image on FDI • State actors may underestimate the negative effects of a bad reputation and stereotypes on potential MNCs from Western Europe (as in Romania until only recently) • Company experts are generally more aware of the long-lasting effects of the image of the host country, although they may underestimate the significant potential of investment promotion agencies to provide information and establish a better image
3. External political stability	State experts sometimes overestimate the effects of external political achievements on FDI • MNCs suggest that threshold events (such as NATO accession or EU integration in Romania) cease to have an enhancing effect on FDI after a couple of years while state experts are more optimistic • State experts may also overestimate this effect in countries that have already reached a high level of stability; Croatia may therefore benefit less from NATO & EU accession
4. Legal versus administrative barriers	State experts tend to overestimate legal and underestimate administrative measures, e. g. • Taxation: State experts focus on tax rates, but MNCs can shift tax burdens internally, have low profits in first years & are more concerned about troubles with tax authorities • Trade: State actors tend to focus on lowering duties, while MNCs are mostly bothered by custom procedures • As a result, state experts may sometimes underestimate the influence of local actors, whereas company experts frequently cite their responsibility for investment conditions

Source: Own presentation.

Figure 70: Key differences state versus company experts

The next chapter elaborates how the findings of this theses help to derive further insights regarding the possibilities of investment policy in transition countries with the help of the NIE theory.

9 FDI determinants and public policy – an NIE approach

9.1 Introduction

Section 2.3 elaborated how the NIE approach can help to analyze the findings of this thesis from a different angle and maximize the insights for public policy makers. It has been elucidated that NIE frameworks allow for a more realistic picture of FDI policies because they assume "bounded rationality" (asymmetric information of MNCs and state actors) and highlight the possibilities and constraints of organizations (public policy makers), institutions (FDI determinants) and the time they need for the realization of their policies.

This chapter analyzes the impact of different public policy actors on FDI in transition countries (*section 9.2*) and the time horizons of FDI determinants (*section 9.3*). The most important public policy implications are summarized in *section 9.4*.

9.2 Actors and FDI determinants

FDI determinants are influenced by different (and often several) public policy actors. Public policy actors may ask which group is best suited to influence FDI determinants (*key question #4.*)[2678] These aspects appear to have not yet been systematically analyzed in FDI literature dealing with transition countries.[2679]

[2678] See section 1.1.

[2679] See e. g. for a distinction between local and central level (but without the consideration of the political and bureaucratic differences): Murrell (2002).

This section elaborates (1) a definition and methodological approach for the analysis of the impact of different public policy actors and (2) presents the results of the analyses.

(1) Based on the interview statements with company and state experts, six groups of actors with the greatest influence on FDI policies can be **defined**[2680]:

- Central governments (including the president and ministers with their key staff as well as the members of the parliament)
- Central authorities (including state officials in ministries and state agencies, such as privatization and investment promotion agencies, central banks etc.)
- Local governments (including mayors as well as key local and regional politicians)
- Local authorities (including local and regional administrations and agencies (such as land registers, construction authorities, trade registers etc.)
- Courts (including central, regional and local courts)
- European Union (including the European Commission and EU member states)

In a subsequent step the interviews are analyzed and ranked based on the question which of these actor groups – the "players of the game" in NIE theory[2681] – have the greatest potential to improve each of the FDI determinants considered (followed by the second most influential actor and so forth). An analysis of interviews for Romania as well as for Croatia appears legitimate in this context because responsibilities of specific public policy actors do not seem to depend on specific country characteristics.

[2680] See also Jacobs (2003); Kikeri, Kenyon, and Palmade (2006).
[2681] See also North (1990a).

The ranking methodology is exemplified for road infrastructure focusing on highways: Interviews show that central authorities are identified as being in the best position to improve the quality of road infrastructure in transition countries. Accordingly, infrastructure projects most frequently suffer from slow implementation, intransparent procedures and wrong use of funding (and less from inadequate planning and financing by politics). These aspects are generally in the responsibility of the Ministry of Transport and Construction and subordinate authorities.[2682] Central governments seem to be the second most influential actors, because they are responsible for elaborating reasonable long-term goals, providing sufficient financing and cooperating with other national governments on transnational projects (as in the case of Croatia and Slovenia).[2683] Local authorities seem to be the third most influential actor because they are often responsible for the tender procedures of the infrastructure projects and can help making procedures swifter and more transparent. However, their impact is less obvious than that of the the central level because many projects do not even reach the local level.[2684] The EU is identified as the fourth most influential actor because it can provide funding based on realistic analyses of the transition country's needs and capacities, but it does not have direct influence on the design and implementation of infrastructure projects.[2685] Finally, local governments represent the fifth most influential policy actors for improving road infrastructure. Their formalized influence on (highway) projects may be

[2682] See e. g. Intv. Germ. MNC - Retail (2007); Intv. Germ. MNC - Logistics (2007); Intv. Austr. MNC - Primary Goods II (2007).

[2683] See e. g. Intv. Germ. MNC - Industrial Goods I (2007); Intv. Austr. MNC - Primary Goods I (2007); Intv. Germ. MNC - Financial Services II (2007); Intv. Germ. MNC - Consulting II (2007).

[2684] See e. g. Intv. Germ. MNC - Industrial Goods III (2007).

[2685] See e. g. Intv. Austr. MNC - Industrial Goods I (2007); Intv. Austr. MNC - Primary Goods II (2007).

Overview determinants - influence of public policy actors								
#	Cate-gory	Determinant	Sub-determinant	Most influential actors	2nd most influential actors	3rd most influential actors	4th most influential actors	5th most influential actors
1	Legal measures	Market access	Corporate law	Central governments	Local authorities	European Union		-
2			Company registration	Local authorities	Central governments	Central authorities	Courts	-
3			Joint ventures	-	Central governments	Local authorities	-	-
4		Property rights	Property law	Central governments	Local authorities	European Union		-
5			Land registration	Local authorities	Central authorities	Central governments	Courts	Local governments
6			Construction permit	Local authorities	Central governments	Local governments	-	-
7		Quality of bureaucracy	Bureaucracy	Local authorities	Local governments	Central governments	Central authorities	-
8			Implementation of laws	Local authorities	Central authorities	Central governments	Local governments	European Union
9			Regional differences	Local governments	Local authorities	-	-	-
10		Legal certainty	Legal system	Central governments	Central authorities	European Union	-	-
11			Court system	Courts	Central governments	Local governments	Central authorities	European Union
12		Labor law	Labor law overall	Local authorities	Central governments	European Union	-	-
		Legal measures	**Legal measures overall**	**Local authorities**	**Central governments**	**Central authorities**	**Local governments**	**European Union**
13	Economic measures	Economic stability	Financial system	Central governments	Central authorities	-	-	-
14			Monetary policy	Central authorities	Central governments	European Union	-	-
15			Trade policy	Central authorities	Central governments	-	-	-
16		Infrastructure	Roads (highways)	Central authorities	Central governments	Local authorities	European Union	Local governments
17			Real estate	Local governments	Central authorities	Central governments	-	-
18		Investment climate	Investment policy	Central governments	Local governments	Local authorities	-	-
19			Taxes and tax system	Central governments	Local authorities	-	-	-
20			Investment incentives	Local authorities	Central governments	-	-	-
21		Privatization	Privatization overall	Central governments	Central authorities	Local authorities	Local governments	Courts
22		Investment promotion	Investment promotion overall	Central authorities	Central governments	Local authorities	Local governments	-
		Economic measures	**Economic measures overall**	**Central governments**	**Central authorities**	**Local authorities**	**Local governments**	**European Union**
23	Political measures	Human capital	Education level	Local authorities	Central authorities	Central governments	-	-
24			Availability of labor	Local governments	Local authorities	Central authorities	-	-
25		Political stability	Internal political stability	Central governments	Central authorities	Local authorities	Local governments	-
26			External political stability	Central governments	Central authorities	-	-	-
27		Corruption	Corruption overall	Local authorities	Central authorities	European Union	Courts	Central governments
28		EU integration	EU integration	Central governments	Central authorities	European Union	Local authorities	Courts
29			EU funds	Local authorities	Central authorities	European Union	Central governments	-
		Political measures	**Political measures overall**	**Central authorities**	**Central governments**	**Local authorities**	**Local governments**	**European Union**

Figure 71: Influence of public policy actors – overview

limited, but they can have some impact by pressuring central governments to proceed more quickly with national highway projects (as shown for Sibiu).[2686]

This methodological approach for road infrastructure is followed for all 29 FDI sub-determinants. The summary of the analyses is presented in *figure 71*. The detailed documentation of the analysis, including the rationale for each ranking as well as the interview references, is recorded in a comprehensive database of the author.

The analysis does not necessarily comprise all possible actors possible but reflects the perception of the interviewees. A clear ranking is difficult for some of the less influential actors because of the low number of data points. In these cases (such as taxes and tax systems) ranking has been limited to the most important actors. No actor could be defined as the most influential in the case of joint ventures. Here interviews reveal that the greatest problems with this

[2686] See e. g. Intv. Romanian County Council (2007); Intv. German Econ. Association V (2007); Intv. Germ. MNC - Food Products (2007).

determinant relate to mentality differences between domestic and foreign companies and that legal (central government) and administrative barriers (local authorities) are only of secondary importance.[2687]

(2) The **analysis** of the responsibilities of public policy actors allows for several insights regarding (a) the influence of the actors on different policies, (b) the impact of the actors in relation to the importance of FDI determinants, as well as (c) in relation to the different categories of FDI determinants.

(a) *Figure 72* presents a graphical summary of the **influence of public actors** on policies that are relevant for the investment conditions in transitions countries. It shows that central governments are the most important actors to improve the conditions of the FDI determinants analyzed. They represent the most influential actors in ten out of 29 sub-determinants because they generally initiate reforms and new ideas (such as the tax reform in Romania).[2688] This insight is in contrast to *hypothesis #4*[2689] that assumed sub-national actors to be the most influential public policy makers in transition countries.

Local authorities – which are often essential for the implementation of governmental reforms – are the second most influential actors overall and are often in key positions for the improvement of those determinants that benefit the most from a removal of administrative and technical barriers (such as company registration) and for which legal frameworks are of only secondary importance.[2690] This quite strong influence of local authorities is also confirmed by some FDI studies.[2691]

Central authorities are the third most important actor group for twelve sub-determinants. They often have the responsibility to detail and implement

[2687] See 7.2.1; see also Meyer (2001).
[2688] See section 7.3.3.2.
[2689] See section 1.1.
[2690] See section 7.2.1.
[2691] See Morisset and Neso (2002); Campos and Kinoshita (2003); Jacobs (2003); Kikeri, Kenyon, and Palmade (2006).

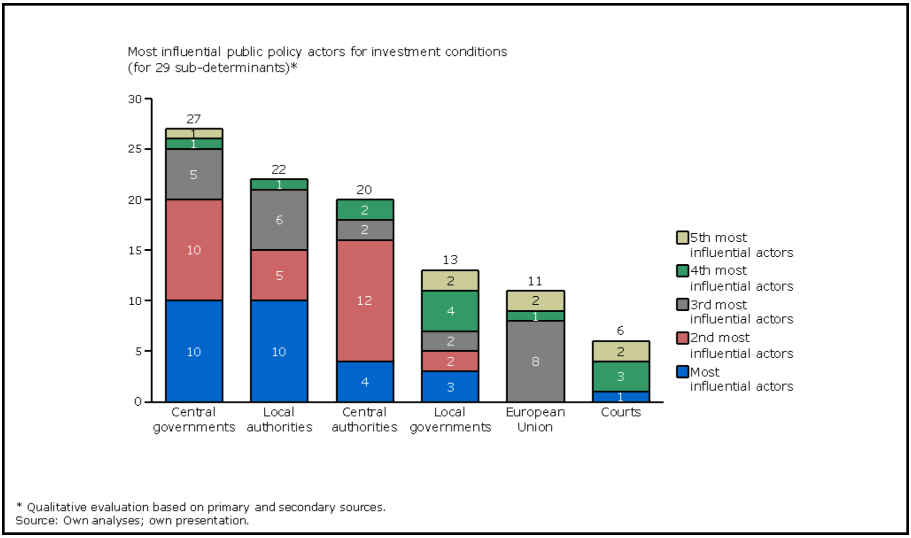


Figure 72: Most influential public policy actors

strategies of the central governments (especially for political determinants such as a NATO accession strategy by the Ministry of Foreign Affairs).[2692]

Interestingly, local governments – the fourth most important actor group – seem to have a lower impact on investment conditions than, for example, local authorities. The high degree of centralization in many transition countries – a heritage of socialism – is apparently an important reason why the central level either realizes investment policies itself or passes responsibilities or tasks for implementation directly to the local authorities with only minor involvement of local governments.[2693]

Finally, the EU and courts seem to have only limited impact on the investment conditions in transition countries.

[2692] See also section 7.4.2.
[2693] See also Murrell (2002).

(b) The findings regarding the influence of public policy actors are now matched with the **impact of FDI sub-determinants** on the investment decision of MNCs in transition countries (that were already presented in *figure 69*).

Figure 73 depicts the three most influential actor groups for all FDI sub-determinants (derived from *figure 71*). The width of the sub-determinants represents the importance of the determinant for the investment decision of MNCs.[2694] The most influential actors for the most important determinants are therefore in the upper right part of the graph. Accordingly, central governments in transition countries are in a key position to improve several of those determinants which have the greatest impact on the investment decision of MNCs, including privatization, EU integration, internal political stability, and property law (*emphasis I. in figure 73*).[2695]

Furthermore, the graph shows that local authorities are also in key positions for many policies, but rather for determinants that are less decisive for FDI in transition countries such as the implementation of laws and construction permits (*emphasis II.*).[2696] Nevertheless, local authorities may want to focus more on these aspects, rather than investing efforts and resources on determinants in which they only have a secondary or tertiary role (such as internal political stability).

Finally, the previous findings for central authorities that this actor group often plays an important role for the execution of the strategies of central governments (*emphasis III.*) are confirmed. The coordination with key politicians therefore seems to be a main challenge for central authorities (for example regarding an effective sale of SOEs).

[2694] The width is converted from the qualitative findings presented in figure 69.
[2695] See also for the distribution of competences for privatization: Belke, Baumgärtner, and Schneider (2005).
[2696] See also section 7.2.3 on bureaucracy; see Morisset and Neso (2002); Kikeri, Kenyon, and Palmade (2006).

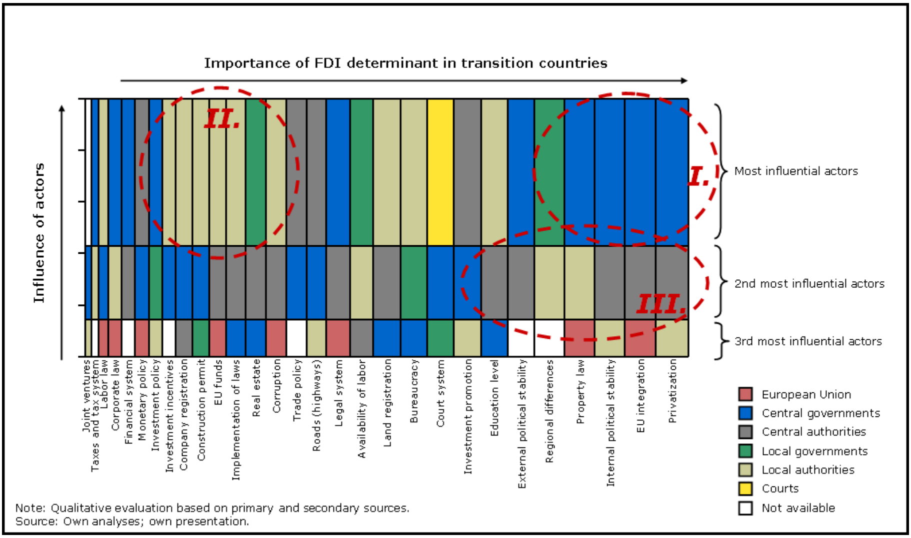


Figure 73: Public policy actors and impact on FDI

(c) In a next step the most influential groups of public policy actors (*figure 72*) are matched with the impact of **FDI determinants categories** (based on *figure 69*). The results are presented in *figure 74*. They suggest that local authorities are essential for the success of legal determinants (*emphasis I.*). This means that local authorities need to make sure that they have highly-skilled employees (with legal and administrative skills which also puts pressure on the education system) and to minimize the turnover rate of the most skilled civil servants (as in Romania).[2697]

Moreover, *figure 74* reveals that key influencers of economic determinants are generally on the central level, either the central government (for example, by defining the speed and method of privatization) or central authorities (for

[2697] See also section 7.2.3; see Morisset and Neso (2002).

example, by designing and realizing effective investment promotion) (*emphasis II.*).[2698]

Finally, this graph shows that central governments are in a key position to influence the policies with the greatest impact on FDI (*emphasis III.*). However, all of these aspects, which represent key responsibilities of the central government (property law, privatization, EU integration, and internal political stability) are in danger of losing their significance for FDI (for reasons discussed in *section 8.3*). This insight seems to confirm the assumption of the locational competition theory according to which state actors lose their possibilities to influence FDI flows over time.[2699] However, this may be only partly true because central governments may increase their involvement in those determinants in which they only represent the second most important actor group (for example regarding investment promotion and court system (*figure 73*)) or they may work on less decisive determinants (such as the legal framework for the non-banking sector in Romania and Croatia)[2700]. Last but not least, the decrease of influence does not seem to be valid for all public policy actor groups. This aspect will be further verified in the next sections.

9.3 Time horizons of FDI determinants

The NIE theory emphasizes that changes of economic conditions take place incrementally, rather than suddenly. Therefore public policies should be analyzed in the light of political constraints and the decision-making processes of all actors involved.[2701] This section examines the relation between the time dimension of FDI determinants on the one hand and the impact of these determinants on the investment decision of MNCs on the other hand, using the

[2698] See sections 7.3.4 and 7.3.5 on privatization and investment promotion for further examples.
[2699] See Siebert (2000); Siebert (2005); see also Dreyhaupt (2006).
[2700] See section 7.3.1.
[2701] See Williamson (2000); see also section 2.3.

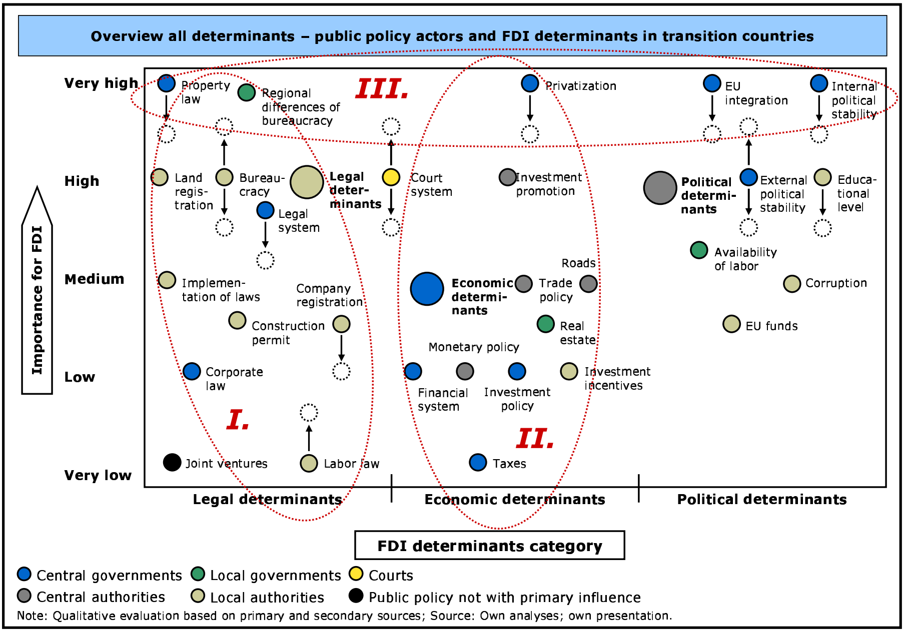


Figure 74: Influence of public policy actors and determinants category

two angles that have been essential for this thesis: the company and the state view.

Section 9.3.1 analyzes FDI determinants in relation to the different phases in the decision-making process of MNCs. The relevance of the time requirements in the transformation of FDI determinants by public policy is analyzed in *section 9.3.2*.

9.3.1 Phases of MNCs' investment decision and FDI determinants

This section provides (1) a definition of the different phases of the investment decision process of MNCs and presents (2) several analyses.

(1) MNCs do not have a full set of FDI country determinants in mind at the very beginning of their considerations to invest abroad. Due to limited information and irrational procedures, MNCs tend to elaborate their investment decision in different phases (which reflects the NIE concept of transaction costs).[2702] The intensity of the contact with public policy actors may differ from phase to phase.[2703]

Based on the interviews conducted with MNCs and external company experts four decision phases in relation to the initial investment (pre-analysis, information gathering, business model, and host country visit) can be defined, as well as an additional phase for follow-up investments[2704]:

- Pre-analysis (stereotypes): Investors consider investing in one of the transition countries, without specifying further and usually without carrying out anything more than a superficial assessment. Much of the attitude at this point is governed by emotion and personal experiences without

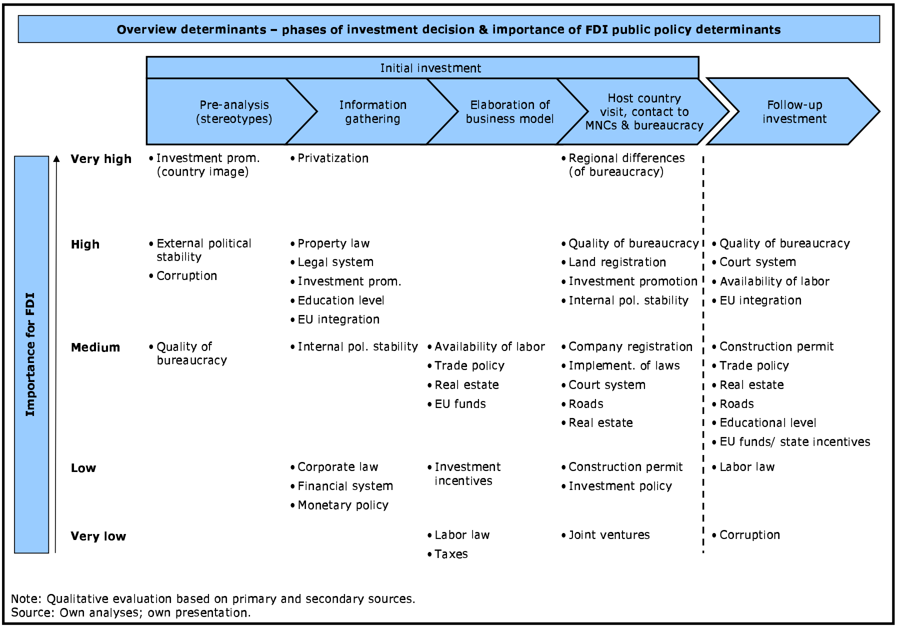
[2702] See also North (1990b); Peng, Lee, and Wang (2005).
[2703] See also Meyer (2001).
[2704] Data points are not sufficient in order to analyze the rationale of MNCs that exit the market; see e. g. Intv. Austr. MNC - Industrial Goods I (2007); Intv. Germ. MNC - Industrial Goods II (2007); Intv. German Econ. Association I (2007); Intv. Croatian Company - Real Estate (2007); see also Dunning (2005); OECD (2006a).

deeper knowledge of the markets (for example regarding stability, image, corruption etc.)[2705]

- Information gathering: Investors collect information about specific countries (for example regarding legal requirements, skill levels etc.) from national and international institutions such as ARIS, APIU, AVAS, CPF, EU, and EBRD[2706]
- Elaboration of business model: Information on costs (such as taxes and incentives) and cost drivers (such as the availability of labor) is gathered and analyzed. This decision phase is also crucial for the analysis of non-policy determinants such as labor costs[2707]
- Host country visit, contact to other MNCs and bureaucracy: Talks with ministries, mayors, business clubs, and foreign institutions (such as the German Embassy) as well as further collection of data[2708]
- Follow-up investment: Phase in which MNCs that are already in the country reconsider some of the determinants of their location decision, generally based on own experiences and some further information (such as state incentives)[2709]

(2) This categorization permits the carrying out of **analyses** relating to (a) the decision phases of MNCs and their relation to the impact of FDI determinants, (b) the relevance of different FDI categories for the investment decision

[2705] See also Intv. Germ. MNC - Engineering (2007); Intv. Austr. MNC - Industrial Goods I (2007).
[2706] See e. g. Intv. Germ. MNC - Legal Services II (2007); Intv. Austr. MNC - Retail (2007).
[2707] See e. g. Intv. Germ. MNC - Legal Services I (2007); Intv. German Econ. Association II (2007); Intv. Austr. MNC - Construction (2007).
[2708] See e. g. Intv. Germ. MNC - Industrial Goods I (2007); Intv. Germ. MNC - Industrial Goods II (2007); Intv. Int'l MNC - Utilities (2007); Intv. German Authority IV (2007).
[2709] See e. g. Intv. Austr. MNC - Primary Goods II (2007); Intv. Austr. MNC - Primary Goods I (2007); Intv. Germ. MNC - Food Products (2007).



Note: Qualitative evaluation based on primary and secondary sources.
Source: Own analyses; own presentation.

Figure 75: Investment decision phases and FDI determinants

phases and (c) the impact of different public policy actors on the different phases of the investment decision.

(a) In a first step, the **FDI determinants** are matched with the established investment decision phases. The interviews are examined with respect to the question what determinants are considered in more detail in each investment decision phase. The results are recorded in a database of the author and summarized in *figure 75*. This allows for several conclusions.

Firstly, the pre-analysis phase contains determinants with high or even very high importance for FDI in transition countries, including the country image (as part of investment promotion, external political stability, and corruption). An initially positive impression of the country and an acceptable performance of these specific determinants seem to be crucial for host countries. Public policy actors should therefore try to get in contact with potential investors in this early phase in order to guarantee that the transition country is considered for a more detailed analysis.[2710] This phase is especially important for smaller investors who do not have sufficient human and financial resources to analyze a large number of potential investment locations.[2711]

Secondly, some FDI determinants are considered several times. Their respective impact on the investment decision can vary depending on the investment decision phase. For example, the quality of bureaucracy is already considered by MNCs in the pre-analysis phase and generally has a medium impact on the country evaluation. During the next stages this determinant is not considered since reliable numerical information is scarce. Once the potential investors visit the host country the quality of bureaucracy gains in importance again, because foreign managers are then personally confronted with the positive and negative aspects of bureaucracy. Investors also reconsider the quality of bureaucracy when considering a follow-up investment. Their experiences with both local and central authorities are then of significant importance for a decision in favor or against the expansion of their commitment in the host country.[2712] Public policy makers should therefore be aware of the challenge of having to fulfill different roles throughout the MNCs' investment decision process. ARIS, for example, may help to create a positive image of Romania abroad (pre-analysis), provide helpful general data for the investment conditions in different regions of Romania (information gathering) and – as in the case of one Austrian MNC

[2710] See e. g. Intv. Former Croatian Minister (2007); Intv. Germ. MNC - Consulting I (2007).

[2711] See e. g. Intv. Germ. MNC - Industrial Goods II (2007); Intv. Germ. MNC - Industrial Goods III (2007); Intv. Supranational Authority II (2007).

[2712] See Intv. Austrian Econ. Association II (2007); Intv. Germ. MNC - Industrial Goods III (2007); Intv. Germ. MNC - Consulting II (2007); Intv. Austr. MNC - Consulting (2007).

interviewed – organize a site visit and be available as external adviser (host country visit).[2713]

Thirdly, the host country visit seems to be the most crucial phase in the investment decision process of MNCs (however, insights from FDI studies regarding this phase are quite scarce).[2714] The number of potential country locations is then generally narrowed down to about three countries. *Figure 75* shows that a large number of determinants (13) is considered in detail with five determinants with high or even very high impact on their investment decision.[2715] Therefore, public policy makers should be aware that their personal contact belongs to the crucial factors for the final investment of potential MNCs.

Finally, the sum of FDI determinants considered in detail seems to decrease for follow-up investments. This is also confirmed by other economic studies.[2716] For example, external political stability is not re-evaluated in detail if the current investment is not negatively affected by border issues and if no substantial crisis (such as war) can be expected.[2717] Interestingly, four of the determinants reconsidered seem to have an increasing importance for FDI flows to transition countries, including court system, availability of labor, labor law, and construction permit. Investors either may have underestimated problems regarding these determinant before their initial investment (regarding the court system in Croatia for example)[2718] or face larger challenges once they are bound to a specific location and its conditions within the host country, especially if they

[2713] See Intv. Austr. MNC - Industrial Goods I (2007); see also Intv. German Econ. Association I (2007); Intv. German Econ. Association III (2007).

[2714] The importance for companies to have the right contact person is also emphasized by NIE; see e. g. Henisz and Zelner (2004).

[2715] See also Intv. Austr. MNC - Industrial Goods I (2007); Intv. Germ. MNC - Industrial Goods I (2007); Intv. Int'l MNC - Utilities (2007); Intv. German Econ. Association IV (2007).

[2716] See e. g. Peng, Lee, and Wang (2005).

[2717] See e. g. Intv. Germ. MNC - Software (2007); Intv. Austr. MNC - Real Estate (2007); Intv. Austr. MNC - Primary Goods I (2007).

[2718] See section 7.2.4.3.

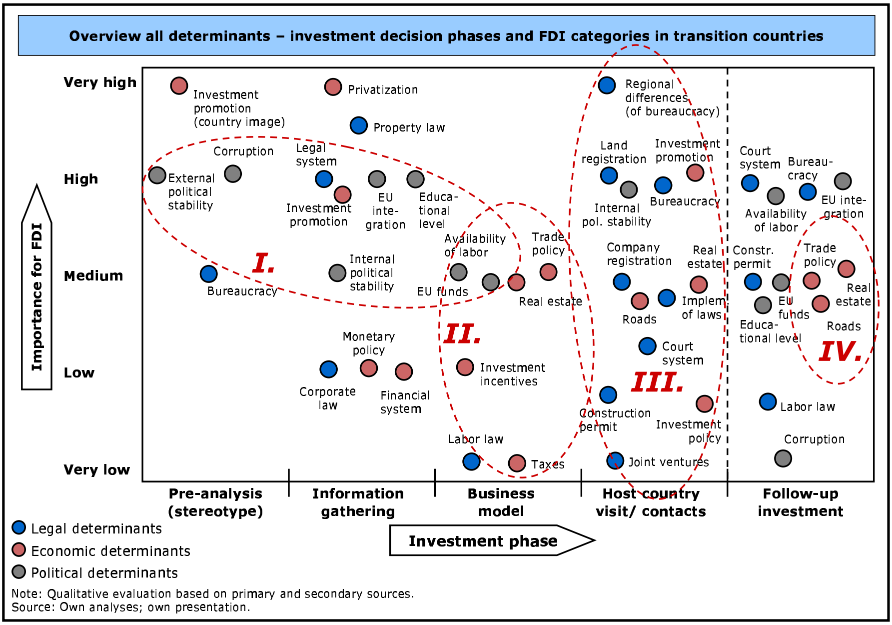


Figure 76: Investment decision phases and FDI categories

are efficiency-seeking MNCs (for example regarding labor shortage in parts of Transylvania).[2719]

(b) In a subsequent step, the investment decision phases are matched with the three **FDI categories** of this thesis (legal, economic and political determinants). The results are depicted in *figure 76* and allow for several conclusions.

First of all, political factors seem to be given detailed consideration during the early stages of the decision making process but are only superficially assessed during the host country visit (*emphasis I.*). Findings show that the performance of political determinants can be verified and analyzed fairly easily (for example with respect to the progress of EU accession).[2720] Therefore, investors tend

[2719] See section 7.4.1.2.

[2720] See e. g. Intv. Austr. MNC - Financial Services I (2007); Intv. Germ. MNC - Software (2007); Intv. Austr. MNC - Retail (2007).

to have formed quite a clear opinion about the political determinants before visiting the country (even if this opinion does not fully correspond with the reality). As a result, an acceptable performance of these determinants as well as transparent and easily accessible information is essential for transition countries to reach the last round of country selection by MNCs.

Legal determinants are hardly considered in the business modeling phase (with the exception of labor law conditions, *emphasis II.*). It is understandable that financial data such as real estate prices or the availability of EU funding, have a more tangible impact on the business case of MNCs than, for example, the quality of bureaucracy. This phase does not contain FDI determinants with high or very high impact on the investment decision of MNCs, probably because non-policy factors, namely labor and energy costs, are the most important factors for the business case of MNCs.[2721]

Legal aspects dominate the determinants that are considered during the host country visit of MNCs (*emphasis III.*). Especially the bureaucratic dimension of these determinants, such as the speed and transparency of land and company registration as well as regional differences of bureaucracy, seem to be important. The evaluations of the MNCs are mostly based on first hand experiences with authorities and field reports of other investors (and foreign institutions).[2722] Public policy makers may want to push foreign business communities (that are already present in the host country and important contacts for potential investors) to recommend central authorities, for example ARIS and APIU, for the organization of site visits.[2723] In the preparation of these site visits central authorities may want to identify best practice bureaucracies on the local level and assist communities in optimizing their self-portrayal.

[2721] See e. g. Intv. Germ. MNC - Legal Services I (2007); Intv. German Econ. Association II (2007); Intv. Austr. MNC - Construction (2007).

[2722] See e. g. Intv. German Econ. Association V (2007); Intv. German Econ. Association VI (2007); Intv. Austr. MNC - Industrial Goods I (2007); Intv. Germ. MNC - Utilities (2007); Intv. Germ. MNC - Financial Services I (2007).

[2723] See similar Meyer (2001); Mallya, Kukulka, and Jensen (2002); Murrell (2002).

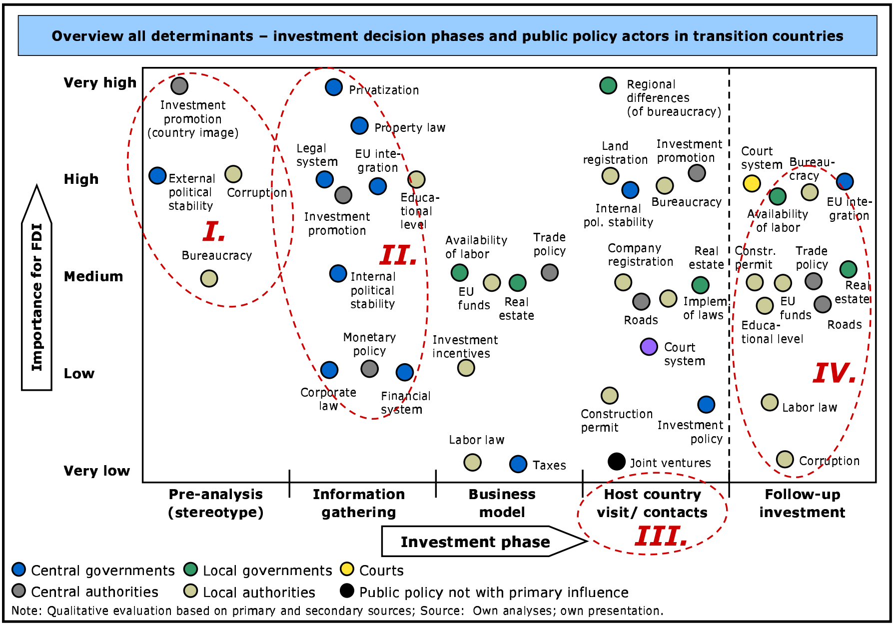


Figure 77: Investment decision phases and most influential actors

Finally, aspects from all categories are re-considered for follow-up investments. However, economic measures do not seem to have a significant importance on the investment decision of MNCs in this phase anymore (*emphasis IV.*). Investors apparently come to terms with the economic conditions of the host country as they gain more working experience and if conditions maintain an acceptable level (for example regarding monetary policy).[2724]

(c) In a final step of analysis the investment decision phases of MNCs are matched with the **most influential public policy actors**. The results are presented in *figure 77* and several findings can be derived from this analysis.

[2724] In contrast, the impact of road infrastructure may be higher for follow-up investments in Romania where the poor quality prevents an extension of the business; see also Intv. Austr. MNC - Legal Services (2007); Intv. Germ. MNC - Consulting II (2007); section 7.3.2.2.

Firstly, all authorities as well as central governments play an important role in creating a positive image of the host country in the pre-analysis phase of MNCs (*emphasis I.*). This calls for a comprehensive analysis of actors from all levels in order to give a more detailed understanding of the way in which potential MNCs, located in different home countries, perceive the potential host country. They then should work on the existing weaknesses and spotlight the country's achievements. This is especially important if achievements (for example regarding recent improvements in Romania's bureaucracy) are less well-known abroad.[2725]

Furthermore, the actors on the central level are essential in the information gathering phase (*emphasis II.*). Central governments seem to be especially important for providing information regarding the status of privatization, EU integration or the financial system.[2726] The central level may consider the centralization of this kind of information in a special agency because the examples of Romania and Croatia show that investors often lack sufficient and consistent data (for example regarding the work of ARIS).[2727]

All national actor groups have a key responsibility for determinants that are considered by MNCs during their site visits (*emphasis III.*). Given the large number of determinants that are considered by investors in this period, public policy actors should aim at a comprehensive orchestration of such a visit since it is the last and generally most important hurdle before the investment decision of MNCs. Public policy actors should establish channels to receive information about site visits of potential investors (through the foreign business community, embassies in the home and host country, offices of investment promotion agencies etc.). They may want to establish a task force that can quickly set up a tour for potential investors, including visits of best practice authorities.

[2725] See also Intv. German Authority I (2007); Intv. Int'l Econ. Association (2007); Intv. Supranational Authority I (2007).
[2726] See also Pournarakis and Varsakelis (2004).
[2727] See section 7.3.5.

The coordination of such a visit and the various public policy actors that are involved may be more successful if handled by a central authority such as an investment promotion agency. CzechInvest and ARIS (in the period between 2004 and 2006) represent interesting examples in this context.[2728]

Finally, *figure 77* reveals that local actors are highly relevant in the follow-up investment decision phase (*emphasis IV.*)[2729], while central governments seem to have only limited influence.[2730] It is possible to confirm the finding of the locational competition theory with regards to the decreasing impact of state actors on FDI: the dominant role of central governments may decrease but local actors gain in importance for follow-up investments. Central governments can also conduct successful FDI policy through the improvement of less prominent determinants (*see above*). Local actors need to be aware that they have a key responsibility for FDI once investors have entered the country because their reform efforts will lead to a positive evaluation, for instance, of the availability of labor, the bureaucracy or permit procedures. Good ties to MNCs and the (displayed) willingness to reform may be helpful tools for local actors in this context.

9.3.2 Transformation time and public policy actors

This section analyzes the time needed by public policy actors to achieve significant transformation of the FDI determinants in question. Section (1) presents the methodology and section (2) discusses the results of the analyses.

(1) The change of public policy variables does not occur suddenly but demands much time and effort.[2731] Based on the interviews and the previous

[2728] See section 7.3.5.
[2729] This finding is also confirmed by FDI studies that focus on the impact of institutions on FDI; see e. g. Pournarakis and Varsakelis (2004).
[2730] See Intv. German Econ. Association I (2007); see also Intv. Rom. Local Authority I (2007); Intv. Int'l Research Institute I (2007).
[2731] See also North (1997); Henisz (2004); Henisz and Zelner (2005).

analyses five periods of transformation time can be **defined**: less than 3 years, 3 to 5 years, 6 to 10 years, 11 to 15 years, and over 15 years.

In a subsequent step, the FDI determinants of this thesis are analyzed (based on the experiences of Romania and Croatia) in relation to the question of how much time public policy makers realistically need in transition countries (reflecting political constraints, elections, implementation, legal revisions etc.) in order to accomplish satisfactory conditions for MNCs. This **methodological** procedure is exemplified for corporate law: Romania already introduced a corporate law in 1990 but the legal framework remained incomplete and unsatisfactory for MNCs. 1997 saw the introduction of major revisions, which were completed by 2006 (after about 9 years). Croatia established a corporate law based on German and Austrian law in 1993 but did not create reliable conditions for (foreign) investors.[2732] The regulations were significantly modernized after the death of Tuđman in 1999 and interviews and the reports of the European Commission indicate that the status is satisfactory for investors today (8 years).[2733] Corporate law is therefore defined as determinant of the 6-10 year period.

This approach is being followed for all FDI sub-determinants and the results are presented in *figure 78*. Accordingly, two sub-determinants are further specified. A distinction of the transformation time is introduced for investment incentives (regional incentives versus the regulatory framework) and investment promotion (institutions and government commitment versus country image). For some determinants a satisfactory level has not been achieved so far and the categorization is based on the expectations of the experts interviewed or the experience of the second country analyzed (for example regarding Croatia's EU integration).

[2732] See section 7.2.1.2.
[2733] See section 7.2.1.3.

Transformation time for FDI determinants in transition countries

Category	Determinant	Sub-determinant	Time needed for significant change	Example from transition countries
Legal measures	Market access	Corporate law	6-10 years	Romania: Introduced in 1990, major revisions in 1997-2006; Croatia: Established in 1993, major revisions since 1999, EU satisfied today
		Company registration	6-10 years	Romania: Breakthrough regulations introduced 2003/2004, implemented until today Croatia: Reforms started in 2003, but far from complete
		Joint ventures	More than 15 years	Romania: Mentality problems persist since the early 1990s (despite legal reforms) Croatia: Sector-specific differences, but problems since the early 1990s (at least)
	Property rights	Property law	11-15 years	Romania: First reforms in late 1990s, more significant 2005-2006, some open issues Croatia: Reforms since 1996 and since 2005 but ongoing problems (e. g. at the coast)
		Land registration	More than 15 years	Romania: Continued problems since early 1990s (documentation, reliability etc.) Croatia: Registers since >100 years, but legal bases not established until 1996, still major problems
		Construction permit	6-10 years	Romania: Satisfactory regulations already in the 1990s Croatia: Working on reforms since the early 2000s (merger with location permit in 2007)
	Quality of bureaucracy	Bureaucracy	More than 15 years	Romania: Takes several generations according to some experts, but acceptable level today Croatia: Experts speak of the challenge of a century for Croatia, but succes with Hitro, Hitrorez
		Implementation of laws	11-15 years	Romania: Efforts to improve implementation taken since the early 2000s, further reforms needed Croatia: Problems in communication between central & local authorities, many changes of laws
		Regional differences	3-5 years	Romania: E. g. Sibiu with significant reforms since 2000, investors already satisfied in 2004 Croatia: E. g. Varaždin with successful reforms since 2002
	Legal certainty	Legal system	6-10 years	Romania: Significant better law-making since early 2000s (driven by EU preparation) Croatia: Significantly improved between 2002 and 2007
		Court system	More than 15 years	Romania: Various reforms since 1990, but ongoing problems with duration of trials & quality of verdicts Croatia: Various reforms and EU pressure, but still slow trials, large backlog, problems with corruption
	Labor law	Labor law overall	3-5 years	Romania: Unification of labor code 2003 and 2005 led to significant changes Croatia: Labor code from 2003, problems with sending expats will decrease with EU accession
Economic measures	Economic stability	Financial system	6-10 years	Romania: Banking reform & privatizations after the end of the financial crisis in the late 1990s Croatia: First reforms and privatizations in mid-1990s, quite advanced in early 2000s already
		Monetary policy	6-10 years	Romania: Radical reforms since 1996 and 2004/2005 (currency reform) Croatia: Significant stabilization after currency reform 1994, stable since early 2000s
		Trade policy	11-15 years	Romania: Began trade liberalization in mid-1990s, but customs authorities still cumbersome Croatia: Substantial opening since early 2000s, to be fully liberalized by accession to the EU
	Infrastructure	Roads	11-15 years	Romania: Only few improvements since 1990, very weak, experts estimate another 10-20 years of work Croatia: First highway extension under Tuđman, significant & quic improvements since 2000
		Real estate	6-10 years	Romania: Many communities have failed to expand supply and develop real estate strategies since 2000 Croatia: Construction of office buildings since the early 2000s eased demand and price pressures
	Investment climate	Investment policy	6-10 years	Romania: Legal framework in place since late 1990s but no significant improvements until 2004/2005 Croatia: After 2000 more active investment policy, legal frameworks in 2000 and 2007
		Taxes and tax system	6-10 years	Romania: Tax reforms in 1999 and 2005, but still very complex, problems with bureaucracy Croatia: New tax system successfully introduced 1994, but corroded after 2000
		Investment incentives (regional incentives)	3-5 years	Romania: Successful industrial parks in early 2000s Croatia: Good regonial conditions in a short time (Varaždin, in early 2000s)
		Investment incentives (regulatory framework)	6-10 years	Romania: First legal framework in early 2000s but requires revision after EU accession Croatia: Weak legal measures since 2000
	Privatization	Privatization overall	6-10 years	Romania: Bulk of large-scale privatization between 1997 and 2005 Croatia: Major privatizations between 2000 and 2006
	Investment promotion	Investment promotion (institutions, commitment)	3-5 years	Romania: Strong commitment under Năstase, ARIS established in 2002 and quite effective 2004-2006 Croatia: With Sanader in office (since 2003) stronger APIU and commitment since 2005
		Investment promotion (country image)	More than 15 years	Romania: bad image since the 1990s, stronger commitment to image promotion since 2004 Croatia: positive image despite mediocre investment environment, only recently counter measures
Political measures	Human capital	Education level	11-15 years	Romania: Socialist effects deteriorated since early 2000s, problems with skilled workers since mid 1990s Croatia: Various measures since 2004, but success only partly visible so far
		Availability of labor	11-15 years	Romania: Strategy necessary, reforms in education system, roads, and social housing necessary Croatia: Problems since the late 1990s to make tertiary education more attractive
	Political stability	Internal political stability	6-10 years	Romania: Consolidations since 1996 but still ongoing (and currently affected by political quarrels) Croatia: Since death of Tuđman (1999) clear improvements, despite remaining problems
		External political stability	6-10 years	Romania: Clear approach of West since Kosovo crisis (1999) Croatia: Stabilization since the death of Tuđman (1999)
	Corruption	Corruption overall	More than 15 years	Romania: Various initiatives and institutions since 1996, but no breakthrough so far Croatia: First anticorruption program in 2002, but far from satisfactory today
	EU integration	EU integration	6-10 years	Romania: Begin of negotiations in 2000 Croatia: Begin of negotiations in 2005, but important reforms already after SAA (2001)
		EU funds	6-10 years	Romania: Despite important efforts since 2000 no effective use and distribution of EU funds so far Croatia: Only limited experience so far, but similar problems expected as in Romania

Figure 78: Transformation time of FDI determinants in transition countries

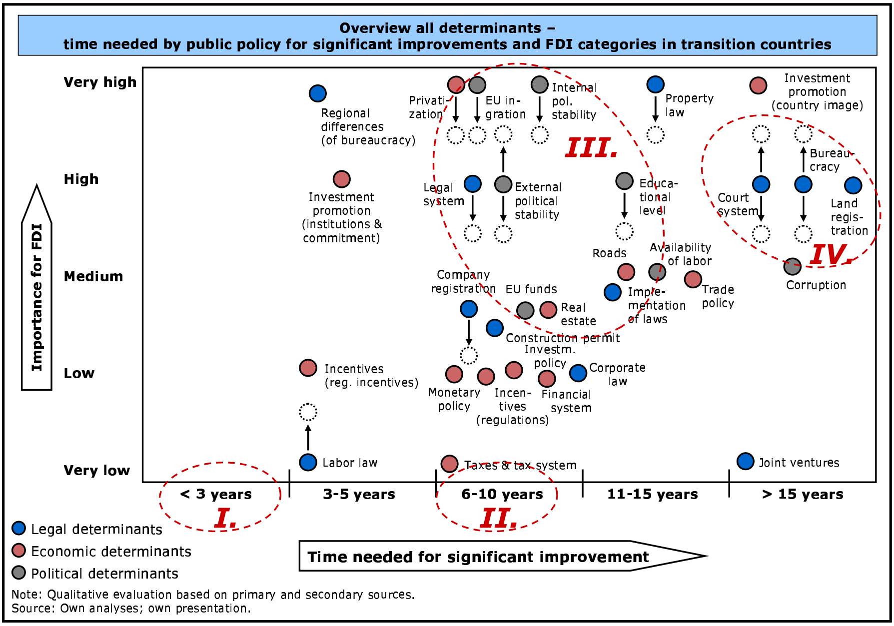


Figure 79: Transformation time and FDI categories

(2) The results of the **analyses** are interpreted in relation to (a) the different FDI categories and (b) public policy actors involved.

(a) *Figure 79* reveals some important insights regarding the transformation time and FDI **categories**.

Firstly, all determinants analyzed need at least three years in order to achieve significant change (*emphasis I.*). This confirms the assumption of NIE that changes are incremental and difficult to implement given the political and economic constraints.[2734] At the same time, this finding also proves that the assertion in the theoretical part of this thesis (*see figure 14*) – according to which significant improvements of many determinants can be achieved "continuously"

[2734] See North (1990a); see also section 2.3.1.

– was too optimistic for transition countries facing a multitude of simultaneous reform challenges. This is certainly the case for Romania and Croatia.

Rather, the bulk of determinants in Romania and Croatia (45%) only reached a satisfactory level after six to ten years of significant reforms (*emphasis II.*). The country examples have underlined that improvements are basically never based on a single action (such as a GO) but require several rounds of strategic planning, the establishment of a (legal) framework and implementation. Public policy actors also seem to require substantial time to decide on a revision of poor existing frameworks. This is demonstrated by the case of the investment incentive frameworks in Romania and Croatia (from the early 2000s) that were running without much success for many years before new regulations were brought forward only recently.[2735]

Figure 79 also shows that the reform of political determinants requires at least five years to reach an acceptable level (*emphasis III.*). Change in this areas is especially challenging because many actors are involved (including foreign actors for EU integration for example[2736]) and often require substantial efforts and financial resources (for the improvement of the educational level for example).[2737]

Finally, six of the determinants analyzed require more than fifteen years of reforms before significant improvements are achieved. This has been shown by the difficulties experienced by Romania and Croatia in their fight against corruption.[2738] Legal determinants seem to belong to the most crucial aspects in this context (*emphasis IV.*) because they usually require the development of a new working culture (for example in the bureaucracy) or the exchange

[2735] See section 7.3.3; see also UNCTAD (1998).
[2736] See also Pournarakis and Varsakelis (2004).
[2737] See also sections 7.4.4 and 7.4.1.
[2738] See section 7.4.3.

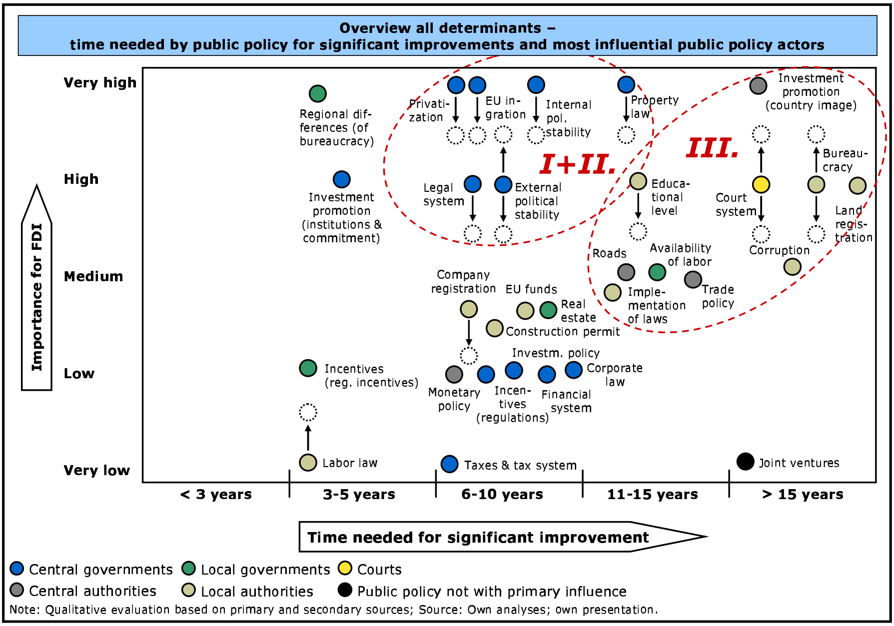


Figure 80: Transformation time and public policy actors

of specialists that can only succeed gradually (as with regards to the court system).[2739]

The final step of analysis relates the transformation time of FDI determinants to the most influential public policy **actors**. Several conclusions can be derived from *figure 80*.

Firstly, many of the most important FDI determinants are successfully changed by central governments in the period of six to ten years (*emphasis I*).[2740] From the perspective of the national politicians, this means that key improvements generally require more than one legislative period (generally of four or five years). This may cause the dilemma that central governments have

[2739] See also Murrell (2002).
[2740] Property law with eleven to 15 years.

little motivation to achieve significant reforms in these fields because results will not be visible before the next election.[2741] These issues therefore require a general consensus amongst the political parties in order to be implemented successfully (as shown for Croatia's efforts towards EU accession).[2742]

The dilemma described is further aggravated by the fact that five of the determinants in which central governments are key influencers tend to show a decreasing impact on the investment decision of MNCs (*emphasis II.*). Therefore, central governments may be frustrated that reforms (for example regarding the legal system)[2743] take a long time but do not have a long-lasting effect on FDI. However, public policy makers should be aware that these efforts are necessary in the location competition of transition countries in order to reach a minimum performance threshold (for example regarding property rights) and in order to be considered for an investment at all.[2744]

Finally, *figure 80* reveals that long-term changes of at least ten years are mostly in the responsibility of (central and local) authorities (*emphasis III.*). Therefore, the implementation of strategies and regulations (which is often the key task of authorities) is one of the greatest challenges of transition countries. Authorities suffer from a combination of remaining old elites, lack of experience amongst the more junior staff and the high mobility of the most skilled staff.[2745]

9.4 Public policy implications

Some public policy implications are summarized with respect to (1) the actor groups, (2) timing of reforms and (3) possible reform priorities.

(1) The analysis of the different public policy **actor groups** has shown that central governments and local authorities are of particular importance for the

[2741] Even though MNCs do not have the right to vote.
[2742] See also section 7.4.4.
[2743] See section 7.2.4; see also Jacobs (2003); Pournarakis and Varsakelis (2004).
[2744] See section 7.2.2.
[2745] See also Morisset and Neso (2002); Kikeri, Kenyon, and Palmade (2006).

creation of satisfactory investment conditions in transition countries. However, there is a need for strong cooperation among all levels involved since a good performance of FDI determinants is generally dependent on the efforts of various actor groups.[2746] Public policy makers face the challenge that their influence changes in the course of transition, with higher levels of FDI and in different investment decision phases of investors. A thorough and realistic analysis of the investors' needs and the capabilities of the actor group is therefore crucial for the creation of favorable investment conditions.

(2) Regarding the **timing** of reforms public policy makers need to be aware that significant changes require quite a long time (of at least three to five years). This may be challenging for public policy makers who aim at visible results before the next election. Authorities are often in key positions to reform those determinants that particularly require a long period for significant improvements (of more than ten years as the experience from Romania and Croatia show).[2747]

However, some specific areas of reform – for which local governments are the most influential actor group – such as the improvement of the regional bureaucracy or the establishment of industrial parks can be accomplished fairly quickly.

(3) As a result of the previous analyses a qualitative list of three possible reform **priorities** for each actor group is derived (*figure 81*), including the approximate time that is needed for significant change, the investment decision phase(s) in which the determinant is of greatest importance for MNCs and a rationale for the prioritization.[2748]

[2746] See also Jacobs (2003).
[2747] Even though significant changes may not require as much time as sometimes suggest by NIE theory, for example with respect to property rights; see e. g. Benham and Benham (1997).
[2748] The priorities for each group are not ranked by importance.

Reform priorities for public policy actor groups in transition countries

Public policy actor group	Priorities	FDI sub-determinant	Time needed for significant change	Investment decision phase	Explanation
Central governments	# 1	Privatization	6-10 years	Information gathering	Significant direct & indirect effects on FDI
	# 2	External political stability	6-10 years	Pre-analysis	Crucial for host countries in order to be considered more in detail by MNCs, threshold events may be enhancing factor
	# 3	EU integration	6-10 years	Information gathering, follow-up investment	Significant direct effects on FDI, important for various determinants
Local authorities	# 1	Quality of bureaucracy	>15 years	Pre-analysis, host country visit, follow-up investment	Strongly influences perception of MNCs, effect on many other determinants (e. g. corruption)
	# 2	Educational level	11-15 years	Information gathering, follow-up investment	High skill level especially important with increasing high-value FDI, positive effects from socialist time are running out
	# 3	Land registration	>15 years	Host country visit	Reliable process particularly important for risk-averse investors, important for regional distribution of FDI
Central authorities	# 1	Country image	>15 years	Pre-analysis	Very important determinant for countries to be considered in detail at all
	# 2	EU integration	6-10 years	Information gathering, follow-up investment	Only involved as second most influential actor but very important for overall reform success
	# 3	Road infrastructure	11-15 years	Host country visit, follow-up investment	Important for long-term development of FDI, bottleneck for other determinants (such as availability of labor)
Local governments	# 1	Regional differences of bureaucracy	3-5 years	Host country visit	Fairly easy to accomplish, very important for investors, strong effects on other determinants
	# 2	Regional incentives	3-5 years	Business model	Fairly easy to accomplish (industrial parks), can make difference in regional competition
	# 3	Availability of labor	11-15 years	Business model, follow-up investment	Crucial for follow-up investments & with increasing economic growth (mobility concepts, social housing etc.)

Figure 81: Possible priorities for public policy actors

10 Conclusion

This conclusion (1) summarizes the approach of this thesis, (2) revises the initial research questions and hypotheses and (3) highlights possibilities for further research.

(1) Based on a comprehensive theoretical and methodological **approach** this thesis has analyzed the impact of public policy on the investment decision of German and Austrian MNCs in transition countries, using Romania and Croatia as two parts of a multiple case study. A pre-selected list of 19 public policy determinants was analysed in depth, using the locational competition theory as a point of reference (this theory represented the first theoretical pillar) and was based on the evaluation of 34 FDI studies on transition countries. (*chapter 2*).

The case study approach laid the methodological groundwork for this thesis (*chapter 3*). In 2007 the author conducted 90 experts interviews (based on an interview selection matrix) with MNCs, company experts, state representatives, and external state experts. 40 experts documents providing further interpretation of the expert statements were collected (*chapter 5*). These primary sources and the analysis of the non-policy determinants were used as a basis for a revision of the pre-defined list of FDI determinants (*chapter 6*). This resulted in the analysis of three FDI categories (legal, economic and political), including 14 determinants that were divided into 29 sub-determinants in the main part of this thesis, including the 19 determinants from the FDI studies derived from the theoretical part (*chapter 7* and *8*). The analysis was focused on Romania and Croatia but various insights for transition countries in general could be derived (under the consideration of further secondary studies).

The second theoretical pillar, the NIE theory, permitted further analyses that enabled a better understanding of the results for transition countries in reference to the actors involved and the time horizons of decisions and changes (*chapter 9*).

(2) The analyses of this thesis enable a revision of the key **questions and hypotheses** of the introductory chapter *(section 1.1)*. The answers are summarized in *figure 82*.

	Key questions	Hypotheses	Answers
# 1	**What role can public policy play in order to attract FDIs in transition countries?**	**The impact of public policy on the investment decisions of MNCs is greater than often assumed in the literature.**	**True. Public policy has significant impact, needs to fulfill minimum requirements, can take extra steps and keep MNCs satisfied**
# 2	What policy measures have influenced the decision of MNCs to invest in the selected countries?	Determinants of investment decisions are much more diverse than shown in most FDI studies.	True. Legal and political measures are most important, many interdependences exist, impact may change
# 3	How successful has investment policy been in Romania and Croatia in creating attractive conditions for FDI?	The removal of obstacles for FDIs is more effective than the creation of investment incentives.	True. Successful reforms since early 2000s, FDI growth esp. in Romania, "race for quality" most rewarding
# 4	What organizations of the state are most suited to create favorable conditions for FDI?	Organizational forms below the central government level have the greatest impact on the FDI decision of MNCs.	Partly true. Central governments most influential group but local authorities essential in later transition and investment phases
# 5	What can be learned from the cross-country analysis?	Overall, Romania represents a good example for Croatia of how lagging integration efforts towards EU accession can prevent accelerated FDI inflows.	Not necessarily true. Romania was lagging behind in the 1990s but represents a positive example for many reform areas in recent years

Figure 82: Key questions, hypotheses and answers

Key question #1: Public policy determinants are indeed significant for FDI inflows to transition countries. Non-policy determinants may trigger the interest of MNCs for an investment abroad in general (such as labor costs) or for a specific region (such as market potential) as suggested by the majority of econometric FDI studies. However, this thesis has found that public policy determinants are essential for FDI as well. Public policy determinants can make a difference particularly when investors are choosing between transition countries. This is largely because non-policy determinants are generally quite similar (at least on a regional basis, for example regarding proximity and labor costs in SEECs).

Furthermore, the possibilities of public policy actors to influence these factors are manifold. Four different roles of public policy makers have been discussed most frequently in this thesis:

Firstly, public policy actors have to provide a satisfactory level of public policy determinants overall. A weak performance of the sum of public policy determinants (as was the case for Romania until the late 1990s) tends to deter most serious investors.

Secondly, public policy makers have to provide a minimum quality level for some specific policy determinants so that their host countries are considered as potential investment location by MNCs at all (this is demonstrated with relation to external political stability for Croatia in the 1990s as well as for property rights).[2749]

Thirdly, public policy actors can make a difference – as implied by the findings of locational competition theory – when the "playing field" (such as a legal harmonization with the EU acquis) between potential host countries is otherwise on the same level. This can be done by taking extra reform steps or aiming (and reaching) at threshold events that are clearly visible to investors and significantly increase the foreign attention of the host country.[2750] Examples include Romania's NATO accession, the introduction of one-stop shops (in Romania and Croatia) and a belated privatization (as discussed for the Romanian BCR). In this context the increased awareness is more influential

[2749] See also Pournarakis and Varsakelis (2004).
[2750] See also Henisz and Zelner (2005).

for FDI than the actual performance as shown by the positive attention of the "big-bang tax reform"[2751] in Romania 2005 despite a continued high total tax rate for companies.

Finally, the NIE approach has shown that public policy actors play an essential role in influencing the perception of the policy determinants by MNCs throughout the investment decision process. Public policy actors can therefore influence the host country assessment particularly by creating a positive image (in the pre-analysis phase), providing reliable and comprehensive information since investors often have information gaps as shown for investment incentives for Romania and Croatia (information gathering phase) and organizing a successful host country visit of the potential MNCs (as shown for the visit organized for one Austrian MNC interviewed by ARIS).[2752] Just as important – and often underestimated by state experts – is the follow-up investment phase. In this phase it is the state actors (particularly local authorities) who are responsible for keeping investors satisfied because MNCs can delay or cancel investments and generally act as multipliers for other MNCs. Examples from different regions in Romania have shown strong deviations in the extent to which public policy actors keep in contact with MNCs and how investors' demands are analyzed and transformed into policy changes.

Key question #2: The broad methodological approach and the in-depth analysis of the 29 FDI sub-determinants have also confirmed (and in contrast to many FDI studies) the finding of the locational competition theory that the investment decision of MNCs is indeed extremely complex, influenced by a great variety of FDI determinants and is often determined by the perception and expectations of investors.

[2751] See HVB Bank (2006), p.18.
[2752] See Intv. Austr. MNC - Industrial Goods I (2007); see section 9.3.1.

The most important determinants identified for FDI in transition countries in general are privatization, EU integration, internal political stability, property law, regional differences of bureaucracy, and the country image. Furthermore, investment opportunities in growing financial and infrastructure sectors are often important drivers for FDI as well.

Overall, legal and political determinants tend to be more important for FDI in transition countries than economic determinants. Classical determinants such as taxes, incentives and corruption seem to have a lower impact on the investment decision of MNCs than suggested by some of the 34 FDI studies on transition countries analyzed.

Furthermore, significant interdependences have been identified for various FDI determinants. Factors that seem to influence most frequently the performance of other determinants are corruption, the quality of bureaucracy and EU integration.

The analysis of the impact of FDI determinants also shows the limits of public policy. The importance of several determinants with high or even very high importance seems to decrease as transition progresses. Examples are property law and internal political stability (with improving performance), privatization (once only few SOEs are left to be sold) or EU integration (whose effect tends to decrease after several years of accession). However, other determinants (such as availability of labor) may gain in importance and interviews suggest that the impact of public policy does not change over time overall.

Finally, a comparison between state and company view reveals that some misperceptions exist regarding the impact of FDI determinants. For example, state experts seem to overestimate the effects of corruption, external political stability and legal barriers while they tend to underestimate the impact of a negative country image and administrative barriers.

Key question #3: Progress in transition and the reform of the investment climate in particular began late and proceeded slowly in Romania and Croatia for many years. Progress was also slowed by economic, internal and external political factors. Therefore, Romania and Croatia were unable to attract significant amounts of investors in the 1990s despite good basic conditions. Significant reforms started in both countries in the late 1990s and were important drivers for the large FDI stock in Romania (€34.5B in 2006) and Croatia (€21.4B) today.

Although Romania initiated reforms in the late 1990s significant results were not visible until 2004, when EU pressure but also reform efforts independent of the EU accession preparations, caused substantial improvements. In recent years Romania has attracted FDI based on various policy determinants, particularly due to a good legal system, a company registration process that performs above the expectations of MNCs, attractive privatization conditions, and a high external political stability (including a largely successful EU integration). Important remaining constraining factors are the weak road infrastructure and rising labor shortage.

Croatia started gradual reforms after the end of the Tuđman era in 1999. Reforms may accelerate further with the approaching of EU accession (probably 2010 or 2011). Major enhancing determinants for Croatia as an investment location have been its political and economic stability since the early 2000s, the high educational level and the positive country image. The property rights situation and the weak bureaucracy continue to represent the most significant constraining factors for FDI.

For transition countries in general, the removal of administrative barriers (such as the reduction of the amount of bureaucratic procedures and time that is required for land and company registration or at customs) as well as the reduction of uncertainties (for example, regarding the goals of foreign policy) seem to have the greatest impact on FDI. These appear to be more effective than the provision of investment incentives, low taxes, EU assistance etc.[2753] Most MNCs are thus willing to renounce incentives and even accept somewhat higher costs (for example regarding registration processes or at customs) if procedures are quick, reliable and transparent. This finding may also comfort those critics who worry that FDI policy may exaggerate the impact of the state on economic activities and disturb market mechanisms. In contrast, successful and active public policy means a good marketing of the country in the competition for FDI and an aiming at reforms that are beneficial to transition countries in general without excessive government spending. Therefore, FDI competition policy is not in danger to become "a race to the bottom"[2754] among transition countries but rather "a race for quality". For example, Romania is developing from a country that is in focus due to its low labor costs to an investment location that is attractive because of the increasing quality of its public policy determinants.

This quality goal may also be a guideline for situations in which state actors face potential trade-offs of public policy measures. Therefore, the qualitative advantages that come along with EU accession for transition countries clearly outweigh potential negative benefits (such as salary increase and higher trade barriers with non-EU countries) as long as public policy makers consider adequate counter measures such as an adjustment of the education system in order to avoid unemployment.[2755]

Key question #4: Six public policy actor groups were identified that have the greatest influence on FDI determinants in transition countries: central governments, central authorities, local governments, local authorities, courts, and

[2753] See also Mallya, Kukulka, and Jensen (2002); Kikeri, Kenyon, and Palmade (2006).
[2754] See e. g. Rauscher (1995).
[2755] See also Müller (2005), p.63; Belke, Göcke, and Hebler (2005).

the EU. A successful design of investment conditions requires a constant interaction between all of these actors. In contrast to *hypothesis #4* central governments – rather than sub-national actors – seem to be the most influential public policy actor group both in terms of iniating the most significant reforms and in addressing the greatest concerns of MNCs in particular. The point during the transition process at which local authorities seem to become more significant in relation to central governments is when the strategies are actually implemented, and in the follow-up investment decision phases of investors. At this stage administrative barriers, human capital and attitude towards (foreign) business may be the most crucial factors for FDI. They also represent the key to the reform of determinants that traditionally take a long time to be significantly altered (i. e. a period of more than ten years) such as corruption and land registration.

Public policy actor groups should generally tackle the deficiencies of those determinants for which they have the greatest influence for significant improvements rather than working on secondary issues even if the determinants may be somewhat more influential for the FDI decision of MNCs (*see figure 73*).

Key question #5: Romania was clearly lagging behind in terms of reforms in the 1990s and did not represent a positive example for other transition countries (let alone EU candidate countries) at that time. However, Romania has shown an impressive catching up process since the early 2000s, particularly with regards to the legal and economic measures. Therefore (and in contrast to *hypothesis #5*), the current Romania may not be such a bad example for other transition countries after all. It has proved that the goal of external stability (e. g. through NATO accession), economic stabilization (e. g. through the currency and tax reforms) and EU accession caused substantial reforms that impressed and attracted foreign investors. The case of Romania also shows that decisive reforms (for example with respect to company registration) do not necessarily only occur under the pressure of EU accession.

Croatia did not need to work as hard as Romania in the past on reforms because it inherited fairly good living standards from the 1980s and benefited from the image of being a beautiful and quite advanced EEC. Despite the increasing locational competition, Croatian state representatives have realized only lately the need for more thorough reforms. Croatia has shown in the past that it has the capabilities for comprehensive reforms (for example regarding major legal adjustments) and sustainable projects (such as the quick extension of the highway system) as well. Croatia should make use of these capabilities in order to accomplish its part of EU accession negotiations and overcome the remaining deficiencies for higher levels of FDI that are often underestimated by Croatia (such as the quality of bureaucracy).

(3) The in-depth analyses and the multi-angle approach of the case study methodology of this thesis helped to contribute to FDI research. It is hoped that it has provided a means to a more thorough understanding of the possibilities and limits of public policy to attract MNCs in transition countries in general and to Romania and Croatia in particular. Throughout this thesis references were given with respect to potential **future research** questions, including an econometric analysis of the FDI impact (specifically for Romania and Croatia) of labor standards, monetary policy and investment promotion.[2756]

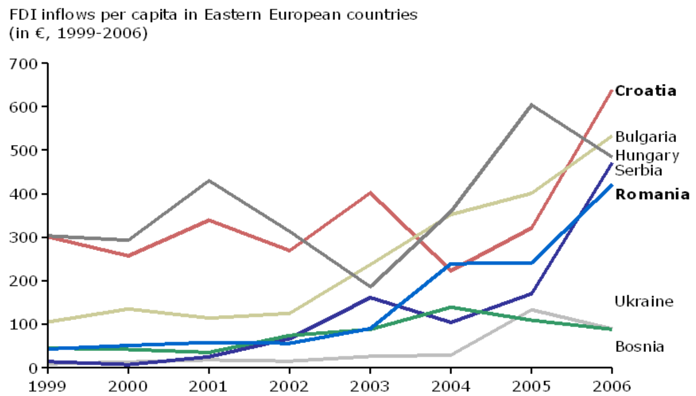
With respect to Romania and Croatia, an analysis of those public policy determinants that contribute to a termination of an investment project could be of interest to public policy makers. An analysis of the impact of FDI determinants for MNCs from other EECs or Asia could also become important, given the increasing FDI inflows from these regions.[2757]

[2756] See sections 7.2.5, 7.3.1 and 7.3.5.

[2757] See also Intv. Romanian Authority I (2007); Intv. Croatian Authority II (2007).

Finally, research projects focusing on a formalization of the NIE approach may also be rewarding. NIE frameworks are also well suited to analyze in a more comprehensive way the impact of the MNCs' perception of the determinants' quality on their investment decision.

11 Appendix



Source: Hunya (2007); own presentation.

Figure 83: FDI per capita development

Formal analysis - company expert interviews Romania										
		Interviewed organization						Interviewee		
Int #	Interviewee (fulfills following categories:)	Internal vs. external	Domestic vs. foreign	Large firms vs. SMEs	Industry vs. services	Greenfield vs. Brownfield	Investment until vs. after 2003	Top vs. medium hierarchy level	General vs. specific questions	All categories fulfilled
1	Intv. Germ. MNC - Retail (2007)	Internal	German	Large	Services	Both	After	Top	General	✓
2	Intv. Austr. MNC - Industrial Goods I (2007)	Internal	Austrian	Large	Industry	Greenfield	After	Medium	Both	✓
3	Intv. Germ. MNC - Automotive (2007)	Internal	German	Large	Industry	Greenfield	Before	Medium	General	✓
4	Intv. Austr. MNC - Financial Services II (2007)	Internal	Austrian	Large	Services	Brownfield	Before	Top	General	✓
5	Intv. Germ. MNC - Industrial Goods III (2007)	Internal	German	SME	Industry	Brownfield	After	Top	Both	✓
6	Intv. Austr. MNC - Primary Goods II (2007)	Internal	Austrian	SME	Industry	Greenfield	Before	Top	General	✓
7	Intv. Germ. MNC - Legal Services I (2007)	Internal	German	SME	Services	Greenfield	After	Top	Specific	✓
8	Intv. Austr. MNC - Legal Services (2007)	Internal	Austrian	SME	Services	Greenfield	Before	Medium	Specific	✓
9	Intv. Romanian Company - Advertising (2007)	External	Domestic	SME	Services	n/a	n/a	Top	General	✓
10	Intv. Rom. Company - Consulting (2007)	External	Domestic	SME	Services	n/a	n/a	Top	Specific	✓
11	Intv. German Econ. Association III (2007)	External	Foreign	n/a	n/a	n/a	n/a	Medium	General	✓
12	Intv. Austrian Econ. Association I (2007)	External	Foreign	n/a	n/a	n/a	n/a	Top	General	✓
13	Intv. German Econ. Association V (2007)	External	Foreign	n/a	n/a	n/a	n/a	Top	General	✓
14	Intv. Germ. MNC - Legal Services II (2007)	External	Domestic	SME	Services	n/a	n/a	Top	Specific	✓
15	Intv. German Econ. Association II (2007)	External	Foreign	n/a	n/a	n/a	n/a	Medium	General	✓
Additional interviews										
61	Intv. Germ. MNC - Software (2007)	Internal	German	Large	Services	Both	After	Medium	Both	
62	Intv. Austr. MNC - Financial Services I (2007)	Internal	Austrian	Large	Services	Brownfield	Before	Medium	General	
63	Intv. Germ. MNC - Logistics (2007)	Internal	German	Large	Services	n/a	Before	Top	General	
64	Intv. Int'l MNC - Utilities (2007)	Internal	International	Large	Industry	Both	Before	Top	General	
65	Intv. Germ. MNC - Consulting I (2007)	Internal	Foreign	Large	Services	Greenfield	Before	Medium	Specific	
66	Intv. Germ. MNC - Utilities (2007)	Internal	German	Large	Industry	Brownfield	Before	Top	Specific	
67	Intv. Germ. MNC - Financial Services III (2007)	Internal	German	Large	Services	Both	Before	Medium	Specific	
68	Intv. Germ. MNC - Industrial Goods II (2007)	Internal	German	SME	Industry	Both	After	Medium	Both	
69	Intv. Austr. MNC - Consumer Goods (2007)	Internal	Austrian	SME	Industry	Greenfield	After	Top	General	
70	Intv. Germ. MNC - Consulting II (2007)	Internal	German	SME	Services	Greenfield	Before	Top	General	
71	Intv. German Econ. Association I (2007)	Internal	German	SME	Both	Greenfield	Before	Top	General	
72	Intv. German Econ. Association VII (2007)	Internal	German	SME	Services	Greenfield	Before	Top	General	
73	Intv. Germ. MNC - Medical Techn. (2007)	External	Domestic	SME	Industry	n/a	n/a	Top	General	
74	Intv. German Econ. Association VIII (2007)	External	Foreign	n/a	n/a	n/a	n/a	Top	General	
75	Intv. Int'l Econ. Association (2007)	External	Foreign	n/a	n/a	n/a	n/a	Top	General	
76	Intv. German Econ. Association VI (2007)	External	Foreign	n/a	n/a	n/a	n/a	Top	General	

Source: Author's database of formalities and author's concept.

Figure 84: Formal analysis – company expert interviews Romania

Formal analysis - state expert interviews Romania

		Interviewed organization						Interviewee		
Int #	Interviewee (fulfills following categories:)	State representative vs. external expert	Domestic vs. foreign	Governmental vs. other organization	National vs. regional representation	Direct or indirect involvement in FDI policy	Intense vs. occasional MNC interaction	Top vs. medium hierarchy level	General vs. specific questions	All categories fulfilled
16	Intv. Romanian Authority II (2007)	State representative	Domestic	Governmental	National	Direct	Intense	Top	Specific	✓
17	Intv. Romanian Authority I (2007)	State representative	Domestic	Governmental	National	Indirect	Intense	Medium	General	✓
18	Intv. Romanian Ministry IV (2007)	State representative	Domestic	Governmental	National	Direct	Intense	Top	General	✓
19	Intv. Romanian Ministry V (2007)	State representative	Domestic	Governmental	National	Indirect	Occasional	Medium	General	✓
20	Intv. Romanian Ministry I (2007)	State representative	Domestic	Governmental	National	Indirect	Occasional	Top	Specific	✓
21	Intv. Romanian Ministry III (2007)	State representative	Domestic	Governmental	National	Direct	Occasional	Medium	Specific	✓
22	Intv. Rom. Local Authority I (2007)	State representative	Domestic	Governmental	Regional	Direct	Intense	Top	General	✓
23	Intv. German Authority IV (2007)	External expert	Foreign	Governmental	National	Indirect	Intense	Top	General	✓
24	Intv. German Authority I (2007)	External expert	Foreign	Governmental	National	Indirect	Occasional	Medium	General	✓
25	Intv. Supranational Authority I (2007)	External expert	Foreign	Governmental	National	Indirect	Intense	Top	General	✓
26	Intv. Germ. Legal Expert (2007)	External expert	Foreign	Other	National	Indirect	Occasional	Medium	Specific	✓
27	Intv. Germ. Research Institute I (2007)	External expert	Foreign	Other	National	Indirect	Occasional	Medium	General	✓
28	Intv. Germ. Political Foundation II (2007)	External expert	Foreign	Other	National	Indirect	Occasional	Top	Specific	✓
29	Intv. Romanian Econ. Association II (2007)	External expert	Domestic	Other	National	Indirect	Intense	Top	General	✓
30	Intv. Romanian NGO (2007)	External expert	Domestic	Other	National	Indirect	Occasional	Top	Specific	✓
Additional interviews										
77	Intv. Romanian Ministry II (2007)	State representative	Domestic	Governmental	National	Direct	Occasional	Medium	Specific	
78	Intv. Rom. Local Authority II (2007)	State representative	Domestic	Governmental	Regional	Indirect	Intense	Medium	Specific	
79	Intv. Romanian County Council (2007)	State representative	Domestic	Governmental	Regional	Direct	Intense	Top	General	
80	Intv. German Ministry (2007)	External expert	Foreign	Governmental	National	Indirect	Occasional	Medium	Specific	
81	Intv. Austr. Research Institute (2007)	External expert	Foreign	Other	National	Indirect	Occasional	Medium	General	
82	Intv. German Political Adviser (2007)	External expert	Foreign	Other	National	Indirect	Intense	Top	General	
83	Intv. Romanian Econ. Association I (2007)	External expert	Domestic	Other	Regional	Indirect	Intense	Top	Specific	

Source: Author's database of formalities and author's concept.

Figure 85: Formal analysis – state expert interviews Romania

Formal analysis - company expert interviews Croatia										
		Interviewed organization						Interviewee		
Int #	Interviewee (fulfills following categories:)	Internal vs. external	Domestic vs. foreign	Large firms vs. SMEs	Industry vs. services	Greenfield vs. Brownfield	Investment until vs. after 1999	Top vs. medium hierarchy level	General vs. specific questions	All categories fulfilled
31	Intv. Germ. MNC - Telecommunications (2007)	Internal	German	Large	Services	Brownfield	After	Medium	General	✓
32	Intv. Austr. MNC - Construction (2007)	Internal	Austrian	Large	Industry	Both	Before	Medium	Both	✓
33	Intv. Germ. MNC - Food Products (2007)	Internal	German	Large	Industry	Brownfield	After	Top	General	✓
34	Intv. Austr. MNC - Financial Services I (2007)	Internal	Austrian	Large	Services	Brownfield	Before	Medium	General	✓
35	Intv. Germ. MNC - Industrial Goods I (2007)	Internal	German	SME	Industry	Greenfield	After	Top	Specific	✓
36	Intv. Austr. MNC - Primary Goods I (2007)	Internal	Austrian	SME	Industry	Brownfield	Before	Medium	General	✓
37	Intv. Germ. MNC - Engineering (2007)	Internal	German	SME	Services	Greenfield	After	Top	General	✓
38	Intv. Austr. MNC - Real Estate (2007)	Internal	Austrian	SME	Services	Greenfield	Before	Top	Specific	✓
39	Intv. Croat. Company II - Legal Services (2007)	External	Domestic	SME	Services	n/a	n/a	Top	Specific	✓
40	Intv. Croat. Company - Utilities (2007)	External	Domestic	Large	Industry	n/a	n/a	Top	Specific	✓
41	Intv. German Econ. Association IV (2007)	External	Foreign	n/a	n/a	n/a	n/a	Medium	Specific	✓
42	Intv. Croatian Company - Real Estate (2007)	External	Domestic	SME	Services	n/a	n/a	Top	General	✓
43	Intv. Austrian Econ. Association II (2007)	External	Foreign	n/a	n/a	n/a	n/a	Top	General	✓
44	Intv. Croat. Company I - Legal Services (2007)	External	Domestic	SME	Services	n/a	n/a	Top	Specific	✓
45	Intv. Austr. MNC - Consulting (2007)	External	Foreign	Large	Services	Greenfield	After	Top	General	✓
Additional interviews										
84	Intv. Germ. MNC - Financial Services I (2007)	Internal	German	Large	Services	Both	Before	Medium	Specific	
85	Intv. Austr. MNC - Retail (2007)	Internal	Austrian	Large	Services	Both	Before	Top	General	
86	Intv. Germ. MNC - Software (2007)	Internal	German	Large	Services	Greenfield	After	Medium	Both	
87	Intv. Germ. MNC - Financial Services II (2007)	Internal	German	Large	Services	Both	Before	Medium	Specific	
Source: Author's database of formalities and author's concept.										

Figure 86: Formal analysis – company expert interviews Croatia

Formal analysis - state expert interviews Croatia										
		Interviewed organization						Interviewee		
Int #	Interviewee (fulfills following categories:)	State representative vs. external expert	Domestic vs. foreign	Governmental vs. other organization	National vs. regional representation	Direct or indirect involvement in FDI policy	Intense vs. occasional MNC interaction	Top vs. medium hierarchy level	General vs. specific questions	All categories fulfilled
46	Intv. Croatian Authority II (2007)	State representative	Domestic	Governmental	National	Direct	Intense	Top	General	✓
47	Intv. Croatian Authority I (2007)	State representative	Domestic	Governmental	National	Indirect	Intense	Medium	Specific	✓
48	Intv. Croatian Ministry II (2007)	State representative	Domestic	Governmental	National	Direct	Intense	Top	General	✓
49	Intv. Croatian Ministry I (2007)	State representative	Domestic	Governmental	National	Indirect	Occasional	Medium	Specific	✓
50	Intv. Croatian Government Team (2007)	State representative	Domestic	Governmental	National	Indirect	Occasional	Top	General	✓
51	Intv. Croatian Ministry IV (2007)	State representative	Domestic	Governmental	National	Direct	Occasional	Medium	Specific	✓
52	Intv. Croatian Mayor (2007)	State representative	Domestic	Governmental	Regional	Direct	Intense	Top	General	✓
53	Intv. German Authority III (2007)	External expert	Foreign	Governmental	National	Indirect	Intense	Top	General	✓
54	Intv. German Authority II (2007)	External expert	Foreign	Governmental	National	Indirect	Occasional	Medium	General	✓
55	Intv. Supranational Authority II (2007)	External expert	Foreign	Governmental	National	Indirect	Intense	Top	General	✓
56	Intv. Germ. Research Institute II (2007)	External expert	Foreign	Other	National	Indirect	Occasional	Medium	Specific	✓
57	Intv. European Institution (2007)	External expert	Foreign	Other	National	Indirect	Occasional	Medium	General	✓
58	Intv. Int'l Research Institute I (2007)	External expert	Foreign	Other	National	Indirect	Occasional	Top	Specific	✓
59	Intv. Former Croatian Minister (2007)	External expert	Domestic	Other	National	Indirect	Intense	Top	General	✓
60	Intv. Croatian University (2007)	External expert	Domestic	Other	National	Indirect	Occasional	Top	Specific	✓
Additional interviews										
88	Intv. Croatian Ministry III (2007)	State representative	Domestic	Governmental	National	Indirect	Occasional	Medium	Specific	
89	Intv. Germ. Political Foundation I (2007)	External expert	Foreign	Other	National	Indirect	Occasional	Top	Specific	
90	Intv. Croatian Econ. Association (2007)	External expert	Domestic	Other	National	Indirect	Intense	Medium	Specific	
Source: Author's database of formalities and author's concept.										

Figure 87: Formal analysis – state expert interviews Croatia

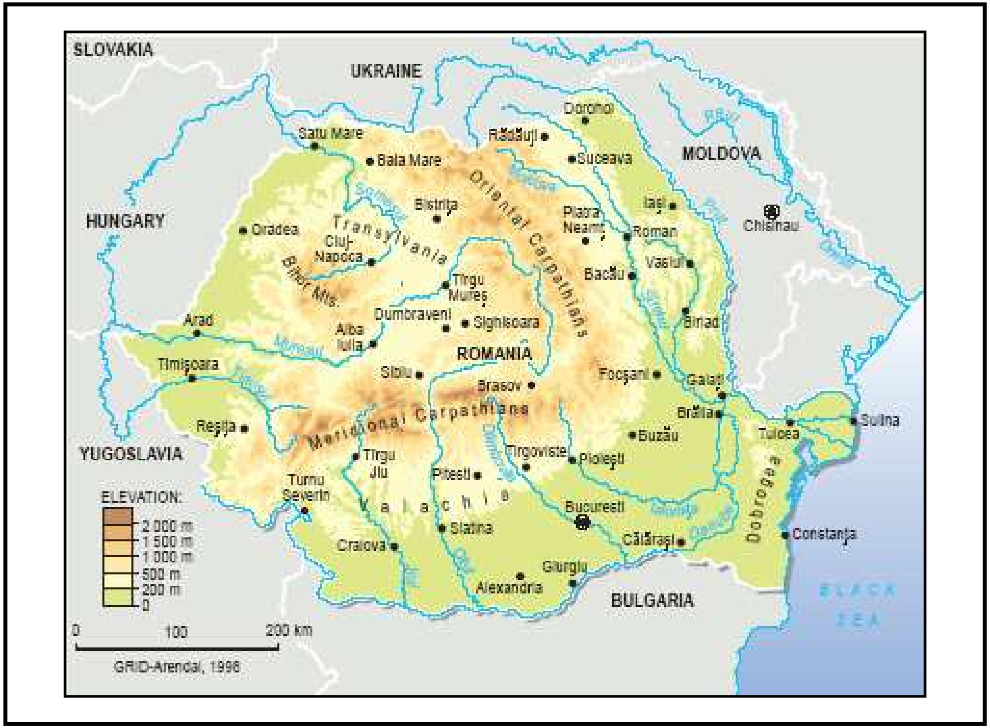


Figure 88: Map of Romania

Key economic indicators - Romania																			
Category	Unit	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
GDP																			
Total	€ B	48.6	30.0	23.9	15.1	22.5	25.3	27.1	27.8	31.0	37.6	33.5	40.1	44.9	48.5	52.6	60.7	79.4	97.1
Annual change*	%	-5.8	-5.6	-12.9	-8.8	1.5	3.9	7.1	3.9	-6.1	-4.8	-1.2	2.1	5.7	5.1	5.2	8.5	4.1	7.7
GDP per capita	€	2,098	1,295	1,031	654	979	1,109	1,196	1,233	1,381	1,683	1,507	1,813	2,037	2,210	2,407	2,787	3,655	4,486
GDP per capita in PPP	€	5,106	4,329	4,010	3,593	4,152	4,374	4,370	4,797	5,155	5,047	5,341	6,465	7,253	7,381	6,651	6,775	7,290	8,063
Inflation	%	0.9	127.9	161.1	210.4	256.1	136.7	32.3	38.8	154.8	59.1	45.8	45.7	34.5	22.5	15.3	11.9	9.0	6.6
Unemployment	%	n/a	n/a	3.0	8.2	10.4	10.9	9.5	6.6	8.9	10.4	11.8	10.5	8.8	8.4	7.4	6.2	5.9	5.2
Hourly labor costs	€	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	1.41	1.55	1.67	1.75	1.98	2.59	3.17
Trade																			
Exports (FOB)	€ B	n/a	n/a	3.4	3.4	4.2	5.2	6.0	6.4	7.5	7.4	8.0	11.3	12.7	14.7	15.6	18.9	22.3	25.9
Imports (CIF)	€ B	n/a	n/a	4.7	4.8	5.6	6.0	7.9	9.0	10.0	10.5	9.8	14.2	17.4	18.9	21.2	26.3	32.6	40.8
Trade openness	%	n/a	n/a	34	54	43	44	51	55	56	48	53	64	67	69	70	74	69	69
FDI																			
Inflows	€ M	0	0	32	59	80	287	320	207	1,071	1,813	963	1,144	1,293	1,211	1,957	5,242	5,204	9,074
Inflows per capita	€			1	3	3	13	14	9	48	81	43	52	59	55	89	241	240	419
Stock	€ M			35	94	183	338	628	864	2,131	4,041	5,316	7,523	9,323	8,254	10,777	16,507	20,786	34,512
Stock per capita	€			2	4	8	15	28	38	95	181	239	340	423	376	493	758	957	1,595
Inflows/ GDP	%			0.1	0.4	0.4	1.1	1.2	0.7	3.5	4.8	2.9	2.9	2.9	2.5	3.7	8.6	6.6	9.3
Population	M	23.2	23.2	23.2	23.1	23.0	22.8	22.7	22.6	22.4	22.3	22.2	22.1	22.0	21.9	21.9	21.8	21.7	21.6

Sources: Eurostat website (2008); IMF (2008); UNCTAD website (2008); ILO website (2008), INSSE website (2008) currency conversion from US$ to € according to EIU (2007).
* Based on national currency not reflecting currency development

Figure 89: Key economic indicators Romania

Figure 90: Map of Croatia

Key economic indicators - Croatia																
Category	Unit	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
GDP																
Total	€ B	7.9	9.2	12.3	14.4	15.7	17.7	19.3	18.6	19.9	22.2	24.4	26.2	28.7	31.2	34.2
Annual change*	%	n/a	-8.0	5.9	6.6	5.9	6.8	2.5	-0.9	2.9	4.4	5.6	5.3	4.3	4.3	4.8
GDP per capita	€	1,665	1,985	2,713	3,229	3,483	3,874	4,289	4,092	4,546	4,998	5,483	5,892	6,459	7,027	7,696
GDP per capita in PPP	€	4,792	5,104	5,566	5,590	6,160	7,358	7,843	8,188	10,328	11,252	11,442	10,287	10,043	10,784	11,566
Inflation	%	n/a	1,517	97.8	1.9	3.5	3.6	5.7	4.0	4.6	3.8	1.7	1.8	2.0	3.3	3.2
Unemployment**	%	n/a	n/a	14.8	15.1	15.9	17.6	18.1	20.4	22.6	23.1	21.3	18.7	18.5	17.8	17.0
Hourly labor costs	€	0.54	0.70	0.98	1.48	1.64	1.89	2.09	2.24	2.41	2.63	2.77	2.88	3.09	3.28	3.49
Trade																
Export of goods (FOB)	€ B	4.60	3.90	4.26	4.63	4.51	4.17	4.08	4.12	4.95	5.31	5.29	5.57	6.60	7.22	8.43
Import of goods (CIF)	€ B	4.46	4.67	5.23	7.51	7.79	9.10	7.71	7.22	8.42	9.89	11.25	12.55	13.33	14.74	16.80
Trade openness	%	115	93	77	84	79	75	61	61	67	69	68	69	70	70	74
FDI																
Inflows	€ M	10	103	98	87	402	474	834	1,367	1,170	1,490	1,190	1,812	987	1,437	2,832
Inflows per capita	€	2	22	22	20	90	104	185	300	267	336	268	408	222	324	638
Stock	€ M	97	210	306	365	779	1,883	1,724	2,402	3,807	4,347	6,383	7,505	9,933	11,661	21,353
Stock per capita	€	21	45	68	82	173	412	383	527	869	980	1,437	1,689	2,238	2,625	4,808
Inflows/ GDP	%	0.1	1.1	0.8	0.6	2.6	2.7	4.3	7.3	5.9	6.7	4.9	6.9	3.4	4.6	8.3
Population	M	4.7	4.6	4.5	4.5	4.5	4.6	4.5	4.6	4.4	4.4	4.4	4.4	4.4	4.4	4.4

Sources: Eurostat website (2008); IMF (2008); UNCTAD website (2008); ILO website (2008), EU Commission (2007); DZS (2008); WIIW (2008) currency conversion from US$ to € according to EIU (2007).

* Based on national currency not reflecting currency development; ** registered unemployment

Note: Some indicators due to war not available

Figure 91: Key economic indicators Croatia

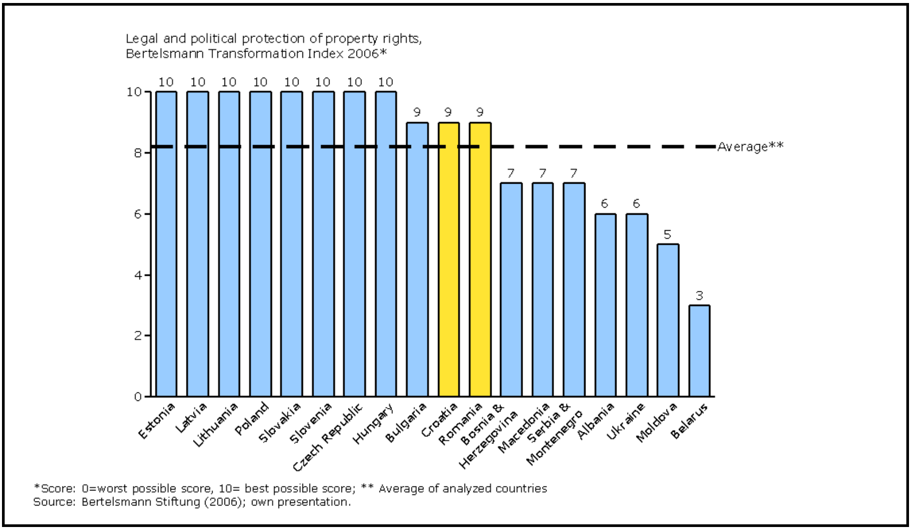


Figure 92: Property rights in Eastern Europe

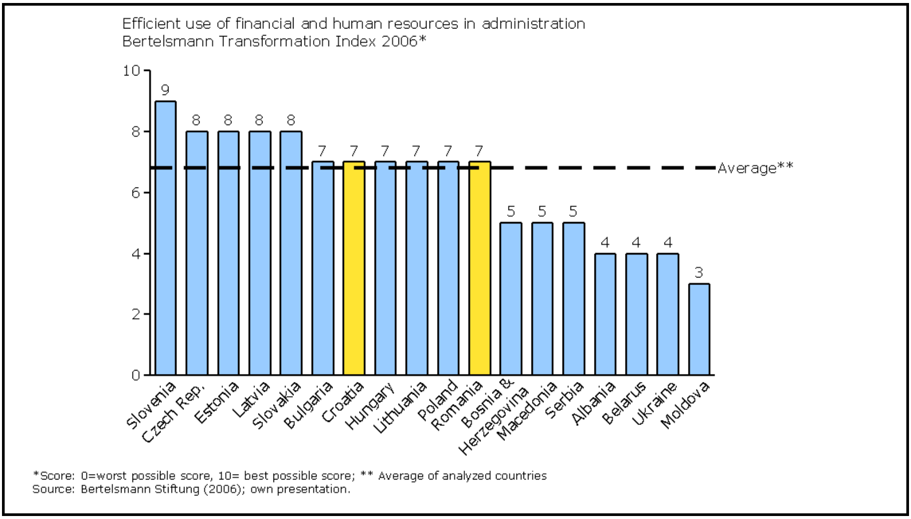


Figure 93: Efficient use of administrative resources in Eastern Europe

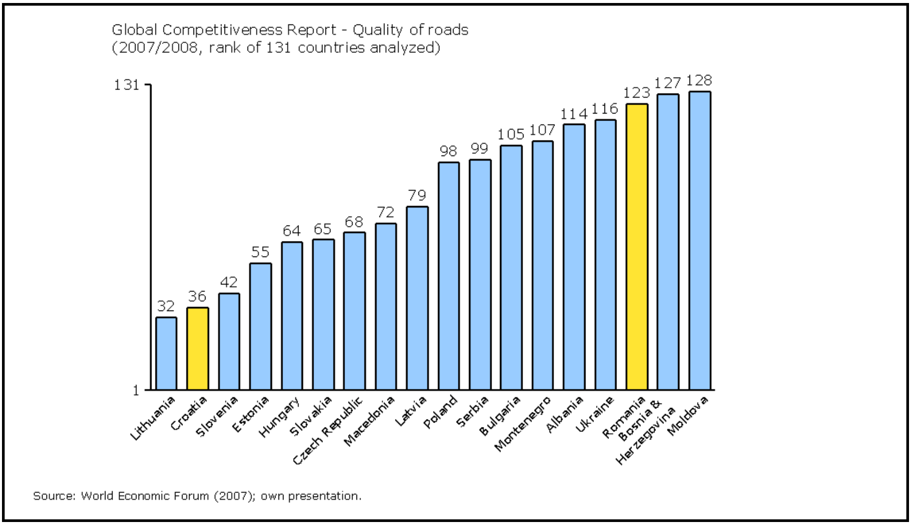


Figure 94: Quality of roads in Eastern Europe

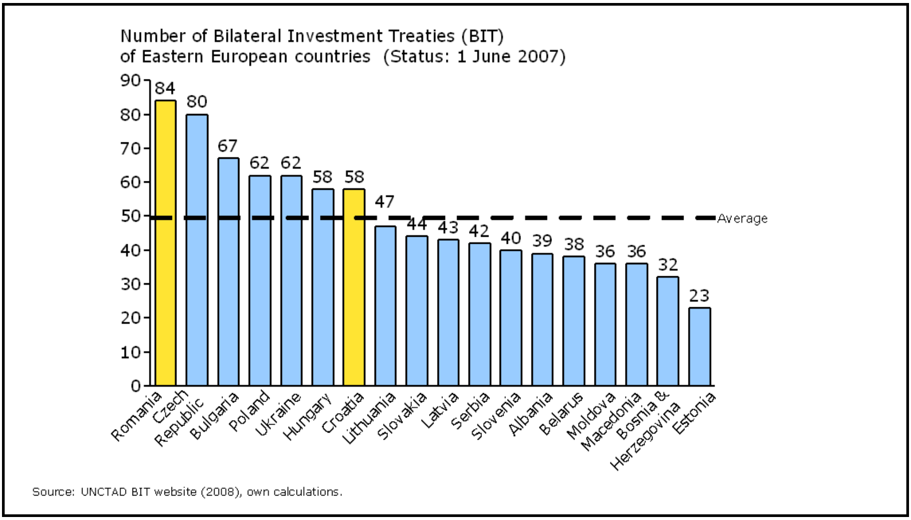


Figure 95: Bilateral Investment Treaties

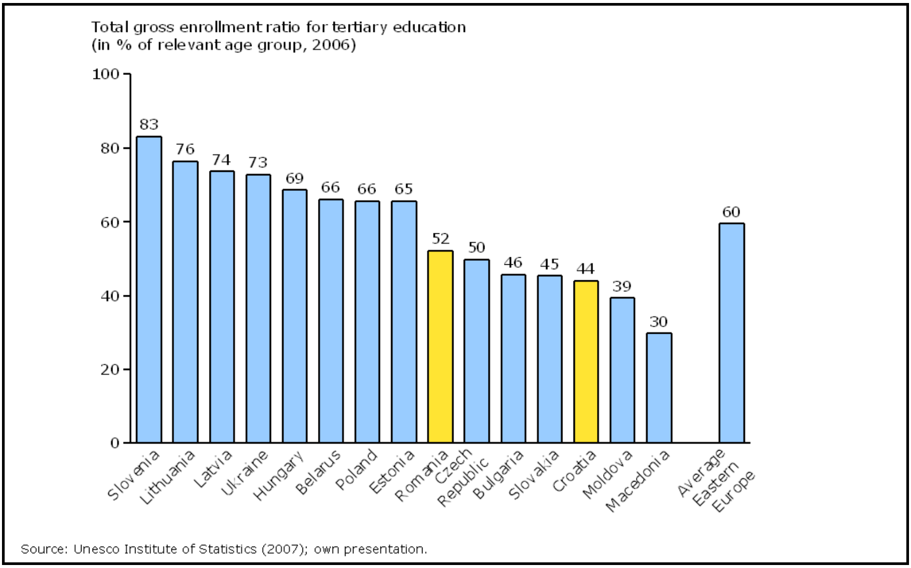


Figure 96: Gross enrollment of tertiary education in Eastern Europe

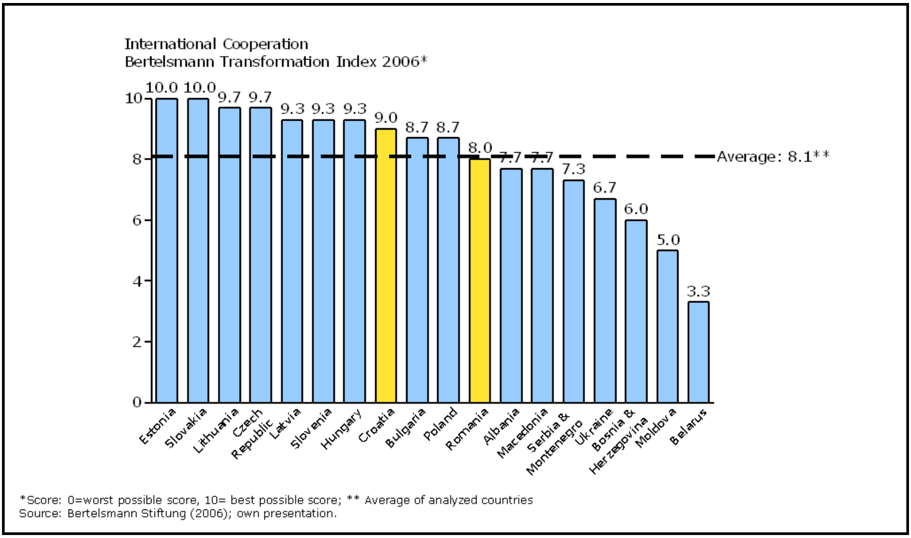


Figure 97: International cooperation

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