

Alter, Rolf; Wehrlé, Frédéric

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Intereconomics

*Suggested Citation:* Alter, Rolf; Wehrlé, Frédéric (1993) : Foreign direct investment in Central and Eastern Europe: An assessment of the current situation, Intereconomics, ISSN 0020-5346, Nomos Verlagsgesellschaft, Baden-Baden, Vol. 28, Iss. 3, pp. 126-131, <https://doi.org/10.1007/BF02928116>

This Version is available at:

<https://hdl.handle.net/10419/140400>

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Rolf Alter and Frédéric Wehrlé\*

# Foreign Direct Investment in Central and Eastern Europe

## An Assessment of the Current Situation

*Foreign direct investment is an important catalyst for the economic changes in transition economies offering host countries external resources, technology, management, and access to foreign markets. It is therefore high on the public policy agenda in the transition economies of Central and Eastern Europe and the newly independent states of the former Soviet Union and figures prominently among assistance activities at the bilateral and multilateral level. This article analyses the legal and institutional framework and the economic performance of foreign direct investment in fourteen European economies in transition at the beginning of 1993.*

In the course of the past three years, reform legislation has been enacted at a prodigious rate throughout Central and Eastern Europe and most countries have done their best to make things easier for foreign investors.<sup>1</sup> Controversy about unwelcome foreign takeovers has been usually confined to parliamentary and press debates and has had no decisive influence on government policies. All the countries surveyed<sup>2</sup> rightly consider foreign investment as basic to engage their economy in a process of fundamental changes to a market economy.

### Legal Framework for FDI

Three groups of countries can be distinguished. In the Czech and Slovak Republics and Hungary, provisions regulating FDI were subsumed into the corporate and other commercial laws for domestic investors and business. They now offer a sophisticated legal system, although, as everywhere, there are faults and gaps. Countries such as Romania, Bulgaria, Estonia, Latvia, Lithuania and Russia offer a patchwork of laws, some modern and rather sophisticated, others rather peculiar. Poland is at an intermediate stage between the above countries and the others, while in Belarus, Ukraine, Kazakhstan and Albania only the basic legal essentials for business and foreign investment are in place.

While all countries allow the formation of joint ventures and fully foreign-owned companies, government approval,

in the form of a permit, is required in Latvia and Russia for all foreign participation exceeding a given amount of money or, as in the case of Belarus, 30 per cent of the founding capital. In Ukraine, a permit is required for leasing by a foreign investor of property owned by the state or municipal authorities whose balance sheet value exceeds US\$ 1 million.

If all countries have sectoral restrictions or barriers to inward FDI, almost half of them (Bulgaria, the Czech and Slovak Republics, Hungary and Poland) have restricted foreign access in one or the other "traditional" areas of defence, public order, financial institutions, energy, aviation and shipping. Typically, the administrative procedures for registration and authorisation of FDI in these sectors are clear and transparent.

Other countries exercise a greater degree of screening and have established more important barriers to admitting FDI. Among the fourteen countries surveyed in this paper, the former Soviet Republics tend to be more restrictive toward inward FDI. The lists of sectors prohibited for foreign investors or submitted to authorisation are often rather long, particularly in the case of Russia, Ukraine and the three Baltic states, which have substantial numbers of

<sup>1</sup> For instance, in Russia, in the second half of 1992 alone, the Supreme Soviet adopted more than 1,000 measures and these did not include presidential decrees or ministerial measures, which sometimes come to dozens in a week.

<sup>2</sup> Albania, Bulgaria, the Czech and Slovak Republics, Estonia, Hungary, Latvia, Lithuania, Poland and Romania (hereafter: Central and Eastern European countries or CEECs), Belarus, Kazakhstan, Russia and Ukraine (hereafter: newly independent states or NIS).

\* OECD, Paris, France. This article is based on a forthcoming OECD publication on FDI in Central and Eastern Europe.

"market reservation" schemes in manufacturing and service industries that permit only locally owned firms to operate. For example, the Lithuanian and Latvian legislations require that foreign investments be controlled by local nationals in certain industries, including mass media (Lithuania and Latvia), oil and gas pipelines, electric power, highways and railways and publishing (Lithuania) and, in Latvia, national education, fishing, hunting and port management.

Countries which restrict access to certain sectors or to sizeable operations through investment screening and restrictions actively encourage, on the other hand, foreign investment in certain priority sectors through incentives. In fact, all countries use the tax system as well as exemption from certain import duties and free economic zones to attract FDI. Foreign investors thus often enjoy better treatment than their domestic competitors in the field of taxation. A very few East European countries are abandoning the policy of generous tax incentives, mainly because of the exponential growth of tax revenue forgone and their marginal effect on FDI flows.

Despite these discrepancies, certain common characteristics in FDI policies can be identified. All countries have committed themselves to progressively introduce new tax systems and to conclude new bilateral agreements on the prevention of double taxation. Intergovernmental agreements on the protection of foreign investment following international standards are being re-negotiated bilaterally with investment partners. There has also been an intensive legislative search for an overall amelioration of the protection of intellectual property in line with market economy regulations.

### **Privatisation Policies**

All governments of the region have been eager to develop privatisation programmes and legislation in order to reduce the role of the state as owner in the business sector. Various techniques of privatisation, conventional and non-conventional, have been conceptualised and already implemented in most countries: direct sales to predetermined owners, public auction and public tender as standard methods of privatisation; coupon system as a non-standard method. Again, legislation varies considerably: where the transition to a market economy started earlier (the Czech and Slovak Republics, Hungary, Poland), privatisation is organised by a set of practice-oriented laws, while in other countries privatisation laws often provide only a vague framework or guidelines.

Some programmes and methods have demonstrated caution about the extent of foreign involvement in the

privatisation process. In countries such as Poland, Hungary, Bulgaria, Lithuania, Russia and Ukraine, preferential conditions may apply for the employees of an enterprise, usually with the goal of ensuring social justice. In Russia, Decree 914 of 14 August 1992, which covers virtually all large and medium-sized enterprises, gives preferential rights to the workforce to purchase shares in the enterprise in which they work: up to 89 per cent of shares can be purchased by the employees and managers of the enterprise being privatised; the rest of the shares are made available to the general public, often including foreign investors. Employee and manager buy-outs, based on a kind of leasing scheme after the winding up of the state-owned company, are widespread in Poland (some 1,300 firms had been privatised by this method by June 1992).

Among the fourteen countries, Latvia, Lithuania, Kazakhstan and Russia have tended to be more selective concerning the extent of foreign involvement in the privatisation process. In two countries (Poland and Russia), special authorisation is sometimes needed by foreign investors to invest in a given privatised company; elsewhere, in Lithuania and Russia, lists of privatised enterprises barred to foreign investment have been established.

Legislation in almost all countries has also had to deal with the question of restitution or compensation, in kind or in other ways, fully or partially, to former owners whose business property was nationalised during the communist regime. This issue is important because handing back to the original owners or their heirs assets taken over by the communist regimes may constitute an obstacle to foreign investment when it takes the form of restitution of actual property instead of financial compensation. Some countries, such as the Czech and Slovak Republics, Hungary, Poland and Estonia, have tried to avoid large-scale restitution, preferring to offer financial compensation instead, while others, such as Bulgaria and Latvia, have favoured the restitution of property that had been confiscated. Elsewhere, the situation has not been completely clarified yet.

It may be too early to examine the impact of privatisation policies on FDI performance. Uncertainties with regard to privatisation programmes are very likely to put off foreign investors, while the impact of voucher systems for citizens and/or preferential treatment of enterprise employees is not a priori obvious. In Hungary, where privatisation policies follow a rather open course, US\$ 770 million of foreign capital were invested in transformed and privatised companies by the beginning of 1992, in the form of sale or share capital increase. This represented some

60 per cent of the total foreign capital that came into the country at that time.

#### FDI Performance

Foreign direct investment in Central and Eastern Europe and the newly independent states of the former Soviet Union has expanded rapidly since 1989, particularly with respect to the number of projects (Table 1). In value terms, the flows were less impressive.

At the end of 1989, less than 2,500 projects were registered in the fourteen countries. By the end of 1991, there were nearly 45,000 registered projects and by October 1992, the number had grown to 54,000, an increase of 20 per cent in 9 months. Looking at Eastern

Europe (including the ex-USSR) as a whole, almost 26,000 FDI projects had been registered by the second quarter of 1991, over 36,000 by the last quarter of that year and over 60,000 by the beginning of 1993, i.e. almost a two-fold increase between January 1992 and January 1993.

Throughout the past two years, the most spectacular growth in the number of projects occurred in Romania, from fewer than 1,000 projects in January 1991 to over 7,000 by the end of the year and to over 20,000 by the beginning of 1993. This placed Romania ahead of Hungary, where less than 4,000 projects of enterprises with foreign participation had been set up throughout the year 1992.

Among the seven former Soviet Republics, the most

Peter Behrens (Ed.)

## EEC Competition Rules in National Courts Les règles de concurrence de la CEE devant les tribunaux nationaux

Part One: United Kingdom and Italy  
Première Partie: Royaume Uni et l'Italie

The competition rules of the EEC are directly applicable in the Member States. Therefore, the national courts play an important role in the implementation of European competition law. The editor of this volume has initiated a research project which will analyse the national case law. This volume contains the national reports from the United Kingdom and Italy. Further national reports will follow.

The project is designed to make the national case law accessible to lawyers practicing in the field of European competition law. The Community organs get an overview over the implementation of Community law in Member States. Those interested in research find the materials for further comparative studies.

The authors are competition law experts from the different Member States. The editor is Professor of Law at the University of Hamburg and Member of the Board of Directors of the Institut für Integrationsforschung of the Stiftung EUROPA-KOLLEG Hamburg.

1992, 315 p., paperback, 88,- DM, ISBN 3-7890-2709-X  
(Schriften des Europa Kollegs Hamburg zur Integrationsforschung, Bd. 1)



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## FOREIGN DIRECT INVESTMENT

impressive expansion occurred in Lithuania, where the number of registered projects increased by approximately 1,000 from 1 January, 1992 to 1 October, 1992, followed by Estonia (700 new foreign investment companies had been set up by October 1992), Latvia (an increase of 500 projects), while in Russia and Ukraine it increased only by about 200 and 350, to 2,900 and 800 respectively, at the end of 1992.<sup>3</sup> At the beginning of 1993, Russia accounted for over one third of all projects in the former Soviet Republics.

An estimated average of 50 per cent of FDI projects are operational in Albania, Bulgaria, the Czech and Slovak Republics, Hungary, Poland and Russia. The typical foreign investment company in those countries is still rather small. While large investments in value terms have usually been made in manufacturing, more and more companies with foreign capital are set up in the services and trade sector.<sup>4</sup> In terms of jobs, foreign investment

companies accounted last year for about 4.5 per cent of total employment in Hungary, for 1.3 per cent in Poland and for less than one half of one per cent in Russia, Ukraine and the three Baltic states.

The mushrooming of companies with foreign participation is confirmed by the increasing number of joint ventures in the region at the beginning of 1993 as compared to the situation prevailing in 1990 and 1991. For instance, an average of 80 per cent of the total number of registered companies with foreign participation were joint ventures in Poland, the former CSFR, Slovakia and Hungary at the end of 1992.

Flows of foreign capital have increased in conjunction with the growth of foreign investment projects, but at a slower pace. FDI stocks in the fourteen economies are estimated at over 11 billion US\$ at the beginning of 1993. Hungary has attracted the biggest share, accounting for about 35 per cent.

In the Central and Eastern European countries (Poland, the former CSFR, Hungary, Romania, Bulgaria and Albania) accumulated FDI flows have reached about US\$ 9 billion at the beginning of 1993. Hungary attracted about half of it, the former CSFR about one third, Poland

<sup>3</sup> This latter figure is interesting when compared with the period 1 January 1991 – 1 January 1992, during which the number of registered projects had increased in Russia by 1,100.

<sup>4</sup> For instance, out of over 4,000 companies with foreign capital registered during the first three quarters of 1991 in Hungary, under 770 were registered in manufacturing.

**Table 1**  
**Development of Foreign Direct Investment Projects (cumulative), 1989-1992**  
(‘000s)

| Country      | 1.01.89 | 1.01.90 | 1.01.91 | 1.10.91 | 1.01.92          | 1.04.92 | 1.06.92          | 1.10.92          |
|--------------|---------|---------|---------|---------|------------------|---------|------------------|------------------|
| Poland       | 0.05    | 0.09    | 2.7     | 5.0     | 5.6              | 6.0     | 7.6              | 9.0 <sup>a</sup> |
| Ex-CSFR      | 0.02    | 0.06    | 1.6     | 5.8     | 6.2              | NA      | 9.1              | 10.7             |
| SR           | NA      | NA      | NA      | 1.1     | NA               | NA      | 2.2 <sup>b</sup> | 2.4              |
| CR           | NA      | NA      | NA      | 4.7     | NA               | NA      | 6.9 <sup>b</sup> | 8.3              |
| Hungary      | 0.27    | 1.0     | 5.7     | 10.6    | 11.0             | 12.0    | 13.0             | 13.5             |
| Romania      | NA      | 0.005   | 0.9     | 7.2     | 10.3             | NA      | NA               | 16.3             |
| Bulgaria     | NA      | 0.03    | 0.14    | 0.8     | 0.9              | 1.0     | 1.1              | NA               |
| Albania      | NA      | NA      | NA      | NA      | NA               | 0.055   | NA               | 0.07             |
| Ex-USSR      | 0.2     | 1.3     | 3.0     | 3.9     | 4.9              | 6.6     | 7.2 <sup>c</sup> | 9.1              |
| CIS          | NA      | NA      | NA      | NA      | 4.0              | 4.5     | NA               | 5.1              |
| Among CIS:   |         |         |         |         |                  |         |                  |                  |
| Russia       | NA      | NA      | 1.5     | NA      | 2.6              | NA      | 2.7              | 2.8              |
| Ukraine      | 0.07    | 0.07    | 0.15    | NA      | 0.4 <sup>d</sup> | 0.6     | 0.7 <sup>e</sup> | 0.75             |
| Belarus      | NA      | NA      | 0.04    | NA      | 0.2              | NA      | 0.4              | NA               |
| Kazakhstan   | NA      | NA      | 0.01    | NA      | 0.08             | NA      | NA               | NA               |
| Outside CIS: |         |         |         |         |                  |         |                  |                  |
| Estonia      | NA      | NA      | 0.1     | NA      | 1.1              | 1.5     | 1.6              | 1.8              |
| Latvia       | NA      | NA      | 0.05    | NA      | 0.3              | 0.3     | 0.45             | 0.53             |
| Lithuania    | NA      | NA      | 0.02    | NA      | 0.2              | 0.3     | 1.1              | 1.2              |

<sup>a</sup>31 December 1992. <sup>b</sup>30 June 1992. <sup>c</sup>July 1992. <sup>d</sup>February 1992. <sup>e</sup>August 1992.

Source: OECD/DAF data bank.

## FOREIGN DIRECT INVESTMENT

13 per cent, Romania 6 per cent, Bulgaria and Slovakia less than 5 per cent.

Investors from the developed market economies of Western Europe have played a dominant role in the growth of both foreign investment projects and FDI stocks. Germany was among the top three investor countries in most of the region in 1991 and 1992. Companies from the United States also ranked high among foreign investors, while Japan has been almost absent from the whole area up to now.

Investors from EEC countries have been predominant in Romania and Poland (more than half of total foreign capital) but less present in the former Soviet Republics. In Slovakia and Hungary, foreign capital originating in EEC and EFTA countries accounted for about a third of the total each.

Despite the growth of both foreign investment projects and foreign capital inflows, the FDI performance remains disappointing if measured against the needs and expectations of the countries in the region.

A primary explanation of the weak FDI performance may be related to the global economic situation: the external stimulus of trade and investment has considerably faded due to the global economic slow-down. Not only have international investment flows slowed down worldwide considerably since the turn of the decade, just when many countries in the region embarked on the political and economic reform process, but competition among production locations has increased due to the policy shift towards greater reliance on market forces in a number of developing countries. Moreover, previously slumping economies, particularly in Latin America, have registered a substantial economic revival increasing their attraction for international investors.

Obviously, the risk/reward ratio of projects in the region is not promising enough for many potential foreign investors. Obstacles and difficulties for a greater engagement – may they be actual or perceived – vary from country to country, but include generally a broad variety of factors, such as political uncertainties, macro-economic imbalances, the poor state of domestic financial markets, the lack of an efficient banking system, inadequate legal infrastructure for business activities, uncertain property rights, the multitude of public and private actors in the privatisation process, ill-maintained physical infrastructure, environment liabilities, complicated bureaucratic procedures and institutional bottlenecks, lack of administrative capacities, lack of information on investment opportunities etc.

Despite the tremendous work which policy-makers, parliaments, and advisors have completed in a relatively

**Table 2**

### Breakdown of Total Foreign Investment Flows (cumulative) by Country, 1990-92 (in million US\$)

| Country             | Date  | FDI flows |
|---------------------|-------|-----------|
| Poland              | 01.90 | 100       |
|                     | 01.91 | 352       |
|                     | 01.92 | 680       |
|                     | 01.93 | 1,400     |
| Ex-CSFR             | 01.90 | 256       |
|                     | 01.91 | 436       |
|                     | 01.92 | 1,100     |
|                     | 01.93 | 1,900     |
| Slovak Republic     | 10.92 | 203       |
| Hungary             | 01.90 | 550       |
|                     | 01.91 | 1,450     |
|                     | 01.92 | 3,000     |
|                     | 01.93 | 4,300     |
| Romania             | 01.91 | 113       |
|                     | 01.92 | 269       |
|                     | 06.92 | 360       |
|                     | 01.93 | 538       |
| Bulgaria            | 10.91 | 300       |
|                     | 06.92 | 320       |
| Albania             | 11.92 | 37        |
| CEEC-5 <sup>a</sup> | 01.92 | 5,239     |
| CEEC-6 <sup>b</sup> | 01.93 | 9,000     |
| Ex-USSR             | 01.90 | 837       |
|                     | 01.91 | 1,328     |
|                     | 10.92 | 5,500     |
| CIS                 | 10.92 | 5,150     |
| Russia              | 01.90 | 617       |
|                     | 01.91 | 959       |
|                     | 10.92 | 1,300     |
| Belarus             | 01.90 | 53        |
|                     | 01.91 | 101       |
| Ukraine             | 01.90 | 24        |
|                     | 01.91 | 52        |
|                     | 10.92 | 670       |
| Kazakhstan          | 01.90 | 3         |
|                     | 01.91 | 9         |
| Latvia              | 01.90 | 9         |
|                     | 01.91 | 27        |
|                     | 10.92 | 121       |
| Lithuania           | 01.90 | 14        |
|                     | 01.91 | 15        |
|                     | 10.92 | 120       |
| Estonia             | 01.90 | 45        |
|                     | 01.91 | 48        |
|                     | 10.92 | 180       |
| NIS-5 <sup>c</sup>  | 01.90 | 709       |
|                     | 01.91 | 1,100     |
|                     | 10.92 | 2,391     |
| NIS-7 <sup>d</sup>  | 01.90 | 765       |
|                     | 01.91 | 1,210     |

<sup>a</sup>Poland, CSFR, Hungary, Romania and Bulgaria. <sup>b</sup>Poland, CSFR, Hungary, Romania, Bulgaria and Albania. <sup>c</sup>Russia, Ukraine, Latvia, Lithuania, Estonia. <sup>d</sup>Russia, Belarus, Ukraine, Kazakhstan, Latvia, Lithuania, Estonia.

Source: OECD/DAF databank.

short period, there is room for improvement, particularly because of the close links of FDI legislation with the whole legal infrastructure for business activities in the host country. Whatever the legislative branch has contributed to the improvement of FDI conditions, a certain deficit in the execution must be recognised – not least due to a lack of qualified staff in the public administrations of transition economies and problems in the understanding and interpretation of the new policies at all administrative levels. Legislators have not always been in a position to assure consistency and coherence of the new laws and regulations between different levels of government and the problem of competing and contradictory legislative acts has been frequently aggravated by the political process: with different qualities of legislative acts, it remains sometimes unclear, what exactly the legal basis for a particular decision is and how and where it could be appealed.

### Outlook

Thousands of companies with foreign capital have invested in the region, the number of projects has expanded rapidly, the value of FDI flows has constantly increased – nevertheless, some serious disappointment about FDI performance in most of the region cannot be disputed.

The primary responsibility for improving the situation lies with host countries. To attract more FDI these countries need to offer closer co-ordination of economic policies. Domestic economic policies have to create credible expectations for an overall external balance and a reasonable macroeconomic situation, while functioning financial markets and a sound banking system must provide financing opportunities and allow freely any kind of financial operations including crossborder transactions. A better implementation of the legal and institutional business infrastructure is also necessary. There is room for improvement in the execution of laws and decrees.

A greater role for home country governments in facilitating FDI flows to the region could also be envisaged in various areas, bilaterally as well as through multilateral agencies. "Open market policies" in home countries could help exploit the close interlinkages between trade and investment, particularly where Eastern Europe provides a sound basis for export production. The EEC's association agreements with four Central European countries have certainly contributed to such a favourable framework for investors. However, their encouraging effect may be at least partially damaged, where quantitative import restrictions have been introduced for those sectors that are supposed to have serious competitive potential.

Multilateral development finance institutions and specialised technical agencies might review their assistance programmes, too. It would not take necessarily "more money" – a lack of viable projects in some countries seems to confirm this position. However, it may be desirable to examine whether the present mix of financial and technical assistance programmes corresponds truly to the needs of the receiving countries and whether it is sufficiently co-ordinated among international institutions.

In order to assist the reforming economies of Europe in their progress towards a market economy, the OECD Council decided in 1990 to create the appropriate infrastructure for making the experience of OECD member countries readily available to Central and East European countries. To this end, the Council established the Centre of Co-operation with European Economies in Transition (CCEET). The technical assistance covers economic development and structural adjustment, competition, labour market and social policy, banking and financial systems, taxation, trade, industry, agriculture, energy, education, environment, statistics and investment.

For foreign direct investment, the OECD has arranged informal meetings with individual countries of the East to discuss their FDI policies and trends in FDI performance. Most recently the OECD Advisory Group on Investment (AGI) has been established to tackle the issues related to foreign investment in Central and Eastern Europe. The AGI is a forum for regular consultations on FDI issues among officials and experts from the CEECs, the NIS and OECD member countries. The country coverage and the emphasis on the dialogue with the private sector contribute to the unique character of the AGI. Its central aims are to act as a network for the exchange of information on investment trends and policies in the CEECs and the NIS; to review obstacles to foreign direct investment; to discuss policy issues and instruments of investment promotion; and to promote the dialogue between government officials, experts and the private sector.

The AGI meets twice a year. The first AGI meeting took place in Paris in January 1993 with senior policy officials from 11 transition economies in Central and Eastern Europe and the former Soviet Union, OECD member governments and the private sector. Under the heading "Partners in FDI", the role of the host country governments, the home country governments and the private sector in facilitating the flows of FDI into the region was discussed. Participants identified a number of concrete measures to be taken by each of the partners and agreed to closely review the investment conditions in the region.