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THE ROLE OF INVESTMENT ENVIRONMENT AND INCENTIVES IN ATTRACTING FOREIGN DIRECT INVESTMENTS

Master's Thesis

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The thesis conforms to the requirements for a Master's thesis

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All works and major viewpoints of the other authors, data from other sources of literature and elsewhere used for writing this paper have been referenced.

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INTRODUCTION

With the fall of the USSR and the collapse of the command economy system, the West has witnessed the emergence of several new countries on the world map and several new players on the economic scene. These countries seemed to emerge overnight from shadow onto the stage of world politics and into the game of world economics. Many of them actively turned to the West, and most of them have aimed to open up their former so closed economies, constructing their policies, right from the beginning of the 1990s, to attract foreign direct investments (FDI), in an attempt to heighten employment, welfare and local production.

FDI inflow comes with many advantages to economies. It can promote economic growth, raise employment and technological level of a country, but it is a complicated game with the risk of designing the policies, so the foreign companies get all the gain and the host economy none. "*The difference between having the right and the wrong government policies has never been greater*" [Summers 1995]. There has been a general fear that multinational corporations (MNC) are becoming more and more powerful, but despite the growing concern among certain people, most governments nevertheless welcome them to their countries, in the hope that they will bring with them power and prosperity. The Asian tiger's tremendous success based on openness to trade and investments, combined with a low tax base, have proved that openness is a more successful path to choose. "*If there is one thing worse than being exploited, it is not being exploited at all*" said Joan Robinson [Kerr 1997:4] and the CEE countries try their best to be the new economic tigers.

World FDI inflows over the last two decades have more than tripled [Narula and Portelli 2004:2]. While the West fights to keep its domestic firms on national grounds, the economies in Central and Eastern Europe (CEE) compete hard to attract outsourcing companies and their share of FDI. According to the United Nations Conference on Trade and Development's (UNCTAD) 2001 report, most changes in national FDI policies during the 90s focused on promotion of FDI and incentives. Around 95% of those changes were favourable to foreign investors [UNCTAD 2001: 6-7]. In terms of

regulatory trends relating to investment, the pattern observed in previous years has persisted: the bulk of regulatory changes have facilitated FDI. This has involved simplified procedures, enhanced incentives, reduced taxes and greater openness to foreign investors [*Ibid.* 2006:9]. FDI policy framework consists of an intricate web of policies in many layers, and while some transition countries have great success attracting FDI, others trail far behind. In this game investment environment and incentive instruments are of outmost importance. In order to retrieve the best host country gains, value judgment is are called for. Being liberal is no longer enough in the game of attracting FDI, a unique policy portfolio and a stable, attractive investment climate are needed.

The objective of this thesis is to analyse the investment environment and incentive schemes in order to elaborate proposals about the appropriate FDI policy for the CEE countries, here represented by Estonia, Hungary, Romania and The Republic of Moldova[1]. In order to achieve the objective the following research tasks have been set:

- To provide the theoretical background for the main motives and strategies connected with FDI both of the investor and the host country
- To investigate and present the theoretical background for incentive policies in regard to FDI
- To compare and contrast the overall investment environment in four selected case countries by using selected indicators and comparing the findings to FDI per capita
- To compare and contrast the principal incentive policies employed in four selected case countries with a special focus on fiscal policies
- To present, compare and analyse the results
- Make proposals about the appropriate FDI policy for the case countries

The thesis consist of two parts, firstly the study focuses on the theoretical background of the investigated topic. It will present definitions and descriptions of theoretical models and concepts important for the understanding of FDI, as well as listing and describing the policy tools and incentives used in political design to attract FDI.

[1] Further in this text the Republic of Moldova will be referred to simply as Moldova.

The second part of the thesis gives empirical evidence of the issues investigated in the theoretical part. Firstly, an introduction to the overall investment climate in the CEE transition countries will be given, followed by a broad analysis of the investment environment (IE) in the case countries. The methodology in the broad analysis will compress indicators of investment environment into eight synthetic indicators in order to limit the analysis and present a more clear and structured picture. The eight indicators are chosen to convey aspects focusing on the crucial locational advantages important to investors, when determining where to invest. Those eight aspects include market size, labour force, infrastructure, stability and growth, corruption, freedom, ease of doing business and competitiveness and innovation. The findings will be compared to FDI per capita in the final paragraph.

After the broad approach, a more narrow approach will be used to compare and contrast the use of financial, fiscal and other incentives within the case countries[2]. As fiscal incentives are the primary tool of developing economies, there will be a specific focus on the use of those. As incentive policies are a distinct and intertwined policy group, it is not possible to successfully apply a ranking scale similar to the one designed in the previous chapter, therefore the incentives will instead simply be described, compared and contrasted and a qualitative evaluation will be used.

The thesis finishes with a short discussion of the future of FDI incentives and polices in Central and Eastern Europe, before concluding remarks.

The case countries chosen are Estonia, Hungary, Romania and Moldova and have been selected to represent a wide spectrum of CEE countries[3] both geographically, in size and economy, as well as concerning policy. The first three countries represent a cross-section of the latest EU accession countries: *Estoni*a named the Baltic tiger for its rapid economic reforms, liberal, non-interventionist stance and impressing growth rate. *Hungary*, an early-leader in attracting FDI, until 1993 the only CEE country to receive any substantial FDI. Of the second newer enlargement round *Romania* is interesting due to its large size and rather promising inflow of FDI. As the final target country, not yet

[2] This thesis focuses on government incentives and so incentives offered by local municipalities are only loosely touched upon.

[3] Moldova is in some cases classified as South-East Europe, as apposed to Central Eastern Europe, however in this work it will be referred to as a Central Eastern European State.

EU member, *Moldova* was chosen to act as a contrast case. FDI in Moldova remains low, not only due to a small market, but also due to an unpredictable environment.

The empirical data was collected on the base of available statistics and surveys. When comparing statistics on this topic, it is important to keep the vulnerability of the source material in mind. UNCTAD and Eurostat are the base for most statistical input used, but they in turn compile their statistics, on FDI, based on national international sources that often compile and register their figures differently. The standardisation of data is still an ongoing process, and it is important to note that accounting practises and valuation methods differ between nations. As an example, some countries do not include the collection of data on reinvested earnings in their statistics, while some do.

Furthermore, policy decisions, especially in transition countries, can change often and rapidly, by the time some decisions have been published, translated and available, they might already be outdated. Moldova has empirically shown to be a challenge due to lacking available material in English about policies and figures. However, this study strives to be as accurate and updated as possible with the sources available and practical limitations given.

1. THEORETICAL FRAMEWORK OF FOREIGN DIRECT INVESTMENTS

1.1. Classifications of Foreign Direct Investments

FDI is transfer of capital across borders and can roughly be defined as *a long-term investment by a foreign direct investor in an enterprise resident in an economy other than that in which the foreign direct investor is based* [UNCTAD 2007]. For an investment to be categorised as a foreign direct investment, it needs a minimum of two actors: a parent enterprise and a foreign affiliate, which together form a transnational corporation (TNC). The TNC comprises of reinvested earnings, equity capital and other capital, for instance intra-company loans. Furthermore, to distinguish FDI from foreign portfolio investment, FDI must be undertaken with the intention of the parent enterprise to exercise control over the foreign affiliate [*Ibid.*]. To have control, or otherwise formulated to have an *effective voice*, does not mean that the parent enterprise has absolute power over the enterprise, only that they are able to influence the management. The UN defines control in this case as owning 10% or more of the ordinary shares or voting power of an incorporated firm, or its equivalent, for an unincorporated firm. In addition, the OECD suggests a threshold of 10% of equity ownership to qualify an investor as a foreign direct investor [*Ibid.*]. However, the thresholds value for foreign ownership various between countries and some do not even specify a threshold point. In turn, those countries take into account other evidence proving whether an investing company keeps an effective voice in the foreign firm, in which it has an equity stake. Keeping an effective voice may also include subcontracting, management contracts, turnkey arrangements, franchising, leasing, licensing and production sharing. In the large picture, which threshold is set influences little due to the large quantity of FDI

invested into majority-owned foreign affiliates [*Ibid.*]. The subsidiary into which the investment is made is called a "direct investment enterprise", and once a such is established, one has to identify, which capital flows between entities in other economies, and the enterprise need to be classified as FDI. Classified as FDI are the reinvestment of earnings and the provision of long-term and short-term intra-company loans (between parent and affiliate enterprises), as well as equity capital. Only capital provided through other enterprises related to the investor, or provided by the direct investor directly, qualifies as FDI [*Ibid.*].
FDI can be divided into five different type based on the entry mode choice of the foreign investor:

Greenfield Investments: Among the host countries policy makers Greenfield investments are the most popular type of investments, as they cover direct investment into expansion of facilities or into new facilities. This flow of money is hoped to create new production capacity and work places, as well as create linkages to the international market and transfer knowledge and technology from the foreign-owned companies to the host economy. However Greenfield investments do not necessarily add to the productive capacity of the host country, at least not initially, as profits tend to flow back to the mother company as apposed to into the host country economy [*Ibid.* 2000:29].

Mergers and Acquisitions: Mergers and Acquisitions are the most dynamic part of FDI world-wide, in developed economies it totalled a share of 74% of all FDI by the turn of the millennium [Antalocy and Sass 2001:2]. Mergers and Acquisitions consist of a simple transfer of existing assets from local firms to foreign firms. Cross-border mergers happen, when a new legal entity is established by the combining of assets or operations from existing companies in other countries. Cross-border acquisitions are the process of assets or operations being moved to a foreign company from a local company, followed by the local entity transforming itself into an affiliate of the foreign firm. Although mergers and acquisitions are the most dynamic, they are also among the least popular in host countries and are often met with an air of concern as ownership transfers from host country to foreign hands. They provide no long term benefits for the host economy, and the merger or acquisition is often followed by restructuring, which more often than not

means cutting down on the number of employees [UNCTAD 2000:27]. It also does not add to productive capacity in the host nation, however if the policy base of a nation is well designed and addresses the negative effects, mergers and acquisitions can become be a gain for foreign investors and host economy both [*Ibid.* 2000:35].

Brownfield projects: Brownfield is not as well-established a term in entry mode choice as the other categories, as it only made its own entry into the vocabulary in the end of the 90s. However, it cannot be ignored, when talking about the case of transitional countries. Brownfield investments are a hybrid entry form between Greenfield investments and acquisitions. Where Greenfield projects create a completely new company moulded to suit the investors specific interests, but with a gradual market entry process, acquisitions acquire already working companies. When acquired the investor gains direct access to the new market, but with distinctions not necessarily suiting the investor company's build-up [Meyer and Estrin 1998:4]. In such cases the foreign investor will often acquire an already established company but completely remodel it, replacing everything from organizational structure, labour force, product line and equipment, so that only the name and customer relations are left, and in some cases not even those [*Ibid.* 1998:6]. In short, Brownfield investments are acquired firms so rebuild that they seem to be a Greenfield investment [*Ibid.* 1998:4].

Horizontal FDI: When a company decides to invest in the same industry abroad as it operates in at home, it is defined as a horizontal foreign direct investment [Waldkirch 2003]. It means that the same production activities occur simultaneously in several different countries, however the headquarters will most likely remain in the home country. In certain cases the horizontal investment is simply a starting stage, before a company switches its production facilities completely to be foreign based. The change will happen, when it becomes more cost effective to produce all goods locally instead of exporting it [Chandler et al. 2003:22]. While the vertical FDI is considered a supplement to trade, the horizontal approach substitutes international trade and creates more jobs in the host economy than the vertical approach. Where Meyer and Estrin introduced the Brownfield concept to the studies of FDI, Markusen was the "father" of horizontal FDI [Markusen 1984].

Vertical FDI: In Vertical FDI, a company locates various stages of its production in different regions or countries, determining the location based on an evaluation of where the specific production stage can be done most cost effectively [Aizenman and Marion 2001]. The head quarters however are, just as with horizontal FDI, most likely to remain in the home country. Vertical FDI is typically represented in manufacturing, especially in case of electronics equipment, textiles or clothing. In the case of electronics, they will be manufactured in one location, but assembled in another [Chandler et al. 2003:22]. Vertical FDI can be broken down into forward and backward. Forward vertical FDI is, when a company's domestic production is being sold by an industry abroad. Whereas when a company's domestic production process is provided with inputs from an industry abroad, it is defined as backward vertical FDI [Waldkirch 2003]. By involving sometimes several countries or several domestic firms in a host economy, vertical FDI creates many linkages and also complement trade.

1.2. Motivation of Foreign Direct Investments

Companies can have many and varied motives for investing abroad. Where policy-makers might hope for evening out imbalances and reducing their debts, companies in turn hope for higher turnover, due to lower production costs. Most often factors in their home environment spark the wish to go abroad. These factors are labeled push factors. Empirical research performed by UNCTAD in relation to push and pull factors determine that the largest push factors are high production costs related to for instance the rising cost of labour, larger competition from domestic, as well as foreign, companies and small domestic markets. In some cases, the wish to locate abroad also comes from a wish to reduce risk, this is naturally predominant in companies from developing or otherwise economical or political instable companies [UNCTAD 006:156-157].

Various researchers have applied a wide variety of definitions in order to understand motives of companies. Narula and Dunning [2000], Dunning [1993] and UNCTAD [2006] combine the proposed means into four classifications of foreign investors based

on their investment motives. All four motivators are strongly reliant on pull factors within the host economy.

Resource Seeking: Resource seeking investments are most often found in developing countries. Resources have over time been the most important pull factor in attracting foreign investors into low-capital countries. However the primary sector output has diminished and much of the world's material is now being controlled by state-owned enterprises. This has lead about the change that foreign participation in these ventures is less likely to happen via FDI and more likely to happen via non-equity arrangements [UNCTAD 1998:31-32]. The seeked resources include labour force, minerals, oils and others. Companies most often seek production factors more favourable than those in the home country in an attempt to reduce costs or to take advantages of natural resources not available there [Lall and Narula 2004:6]. These kinds of investments can result in many linkages between host and home country. The horizontal FDI described in the above paragraph often comes in the form of resource seeking investments.

Market seeking: Expanding one's markets is a common goal of investing abroad, and the investing into transition economies often happens based on a market-seeking motive [Lall and Narula 2004:6], triggered by the decision that a market can best be served or reached by a physical presence as apposed to export or licensing. [Varblane 2000:2]. These investments are often made to maintain or penetrate new markets, expand existing ones, compete with other firms or simply to discover new grounds. The decision can also be designed in an effort to circumvent protectionist tariff barriers or other government imposed market distortions.

Restructuring and efficiency seeking: Companies will restructure their already existing foreign production in an attempt to optimise and create higher efficiency and profitability [Lall and Narula 2004:6]. It is a tool of restructuring or sometimes expanding [*Ibid.* 2004:2]. They will normally seek to use the advantage of entering into developed countries with low production costs and using economies of scale and scope, or they will focus on more industrialised developing economies, as they have stringent capability needs [*Ibid.* 2004:6]. Investments like these tend to come as additional investments and have a rather different host country effect compared to market seeking

investments, which bring an inflow of resources, management capacities and technology, as it attributes its affiliates with cross-border organizational directions [Varblane 2000:3]. This kind of investments thrives best in an environment of free trade and low government imposed barriers. For the host economy efficiency seekers are the most beneficial investor type, as their activities produce spillover effects, promote export and improve the competitive environment [Varblane and Ziacik 1999:179].

Strategic Assets seeking (also known as new asset seeking)**:** Companies investing in the hope of creating higher efficiency and profitability, looking for products, innovative ideas or even market expertise or distribution networks fall in the Strategic Assets Seeking category. They will often be attempting to protect their market position by protecting, advancing or sustaining their position. The later often happens in competitive intensive sectors such as capital, information or technology [Dunning 1992].

While the three first categories can be grouped together, as they are all using existing firm-specific assets and attempting to generate economic gain by exploiting those assets, this final category focuses on attracting or developing new assets altogether in order to generate more assets or protect already existing ones. Companies with new assets seeing motives are unlikely to enter into developing countries [Lall and Narula 2004:6].

The eclectic paradigm (OLI Framework) and The Investment development Path (IDP)

One of the most well known theories in FDI is the so-called Eclectic paradigm, whose theory was introduced by Dunning in 1977 at a Nobel Symposium in Stockholm [Dunning 2001:1] and has been developed further by Dunning during the following decades. Despite some criticism, it is still widely applied today, mostly under its nickname the OLI model, named after its three components: Organisation, Location and Internationalisation. This framework can be used to explain why MNC's choose to invest abroad as apposed to for instance licensing or outsourcing certain facilities. Dunning himself [2001:4] argues in his more recent writings that the eclectic paradigm's strong suit lies within analysing the determinants of international production, rather than being applied as a predictive theory of the MNE *qua* MNE. In addition, he stresses that it is important to remember that no one theory can cover all aspects of foreign-owned value-added activity, as the motivations and expectations have too many variables [*Ibid.* 2001:4]. However, for this study the eclectic paradigm entail the suitable variables.

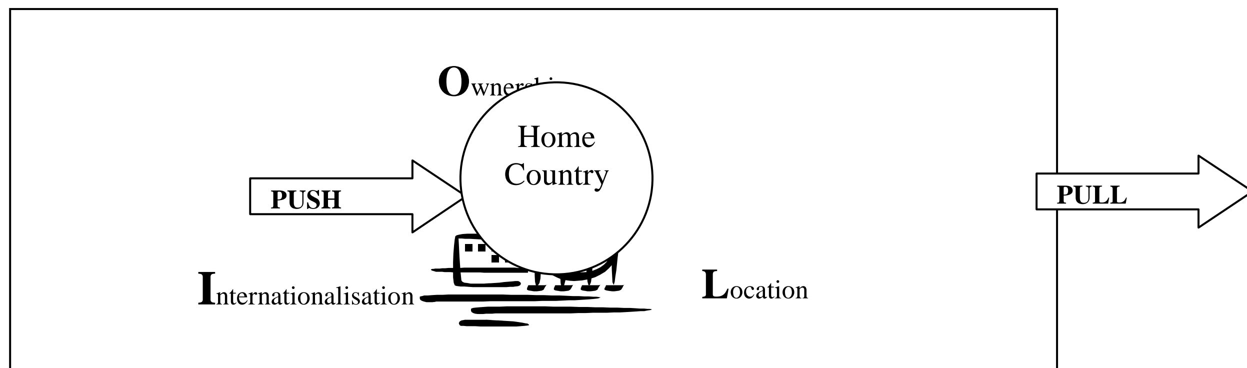

Figure 1. OLI Framework

Source: Composed by author

The three components of the framework are meant to illustrate the three determinant factors evaluated upon by a MNC, when choosing its foreign location, after a decision to invest abroad has been made. Logically it most be beneficial for a company to go abroad and it bases its evaluation of benefits on ownership, location and internalisation advantages [*Ibid.* 1993, 2000 and 2001]. The combination of these three indicators should end in a positive result for the company such as an increase in overall productivity [Vahter and Masso 2005:7]. All three need to be fulfilled for FDI to flow, if only one is fulfilled, the company can choose other means of market entering such as licensing or exporting.

Organisation advantages: Advantages of the company, which compensate for the additional costs it takes to establish an entity abroad in a foreign environment. In addition, the organisation needs to compensate their disadvantages facing the firm in comparison with local companies. Organizational advantages can be economies of scale, tariff privileges, political advantages, trademark recognition and inter-country sales links.

Locational advantages (Pull factors): Locational advantages can also be labelled pull factors, as they pull the investor from the home economy towards the host economy as mentioned above. The advantages of the host country and its location include size of market, new market, macroeconomic environment, lower production costs, lower wages, savings on transport costs, supply of raw materials, tax advantages and spillovers. In general, locational advantages can be used to generate a larger profit for the company.

Internalisation (Push factors): How the foreign company can take advantage of the two above-mentioned criteria by FDI rather than other methods such as licensing. Combined the method of FDI needs to provide a competitive advantage, possibly to avoid competition from local firms. This threat would be less, if the MNC keeps full control over their assets. Alternatively, the motivation can be the allure of penetrating a new sizable market or other motives mentioned in the previous chapter. In addition, push factors are important –maybe the economic environment in the home economy is not lucrative, maybe the wages have gone up or the political environment is turning unstable.

In general, while all three determinants are vital from the investor's point of view, the host country as such has relative little influence on step one and three, however locational advantages relies on host country characteristics and is crucial for the inflow of FDI into the host country. The more OLI advantages a company is likely to get from going abroad, the greater is the chance they will choose the model of FDI. The more OLI advantages a firm possesses the greater the propensity of adopting an entry mode with a high control level such as wholly owned venture.

Dunning has, as mentioned, developed this model further in response to critisism. In this setting, two of his attributions are important to include. Critics have voiced that the OLI framework does not take into account the impact of the situation, surroundings and the decision maker [Xuemin and Decker 2004:27]. That has lead to the incorporation of location specific determinants. Not just the locational advantages are variables, but one most take into account the relative importance of location specific determinants. They depend upon motive of investment, type of investment, sector of investment and size of investment. These determinants are all relative and due to change as the environment changes around them, this is important when determining investment policies, as what might be favourable to one region might not be so to another.

The other contributions are the introduction of what Dunning [2001:8] names *The Investment Development Path (IDP)* and Narula [1996] defines as *Stages in FDI inflow*. The hypothesis behind IDP is that the OLI configuration changes together with five stages, which are meant to illustrate the various stages a country evolves through on its development path. The stages are described shortly below:

1. Pre-industrialization: Countries are not attractive for foreign investors as there are not enough locational advantages. The country itself is to poor to invest outside. Main companies able to compete for investments are located in raw material industries. Main aim of host country government is to guarantee economy with raw materials.
2. The inflow of FDI starts to increase, but there is still a very low outflow. The domestic market starts to expand. Main target for foreign investors are still industries based on raw material and oriented to export. Cheap labour will be used heavily to market products for the investor home market.
3. Gradual decrease of FDI and increase of outflow of investments. The domestic wages are growing and labour intensive production will diminish. Competition between domestic and foreign firms will start.
4. Outflow and inflow of investments starts to balance. Domestic firms do not only compete with foreign firms on local markets but also start penetrating other markets. The service sector grows in importance also in relation to investments. Outflow will begin to exceed the inflow of investments.

5. The balance between inflow and outflow starts to fluctuate. This is the situation advanced nations are reaching currently. Cross border transactions have an increasing prosperity internalised by MNEs.

1.3. Host Country Effects of Foreign Direct Investments

As illustrated many factors can be determining, when companies decide to invest abroad, as well as when policy makers aim their policies towards attracting FDI. However, the final goal for the companies and the policy makers are similar; they expect lucrative advantages. FDI is popular, because as apposed to for instance portfolio investments, it has a more long-term character. Governments in the host economy expect various positive effects from FDI such as capital and tax revenue, fuelling of economic growth and evening out of macroeconomic imbalances within the host economy. FDI can contribute to a more competitive environment, higher exports, job creation, spillover in the fields of knowledge and technology [Blomström and Kokko 2003:2].

Due to the liberalisation of markets, national governments have lost a significant share of the tools, they used to imply to promote welfare, local employment and competitiveness; therefore they turn to the instruments left for them such as FDI instruments [*Ibid.* 2003:3]. Although liberalisation has limited governments powers, it has likewise meant that market size has begun to be less important for attracting investments due to global and regional agreements [*Ibid.* 2003:2], so now even small markets can compete in the game, if they employ the right tools. The right tools combined with other market advantages can be labelled pull factors, as they are used as tools in order to pull companies inward. Empirical research performed by UNCTAD in relation to push and pull factors determines that the largest pull factors are liberal governments offering good opportunities to investors. That may include investments in infrastructure, transparency, political and economic stability. All in all liberalisation is the key seen from the host economy perspective [UNCTAD 2006:156-157]. Other positive effects of changing policies towards more open markets, are that in short terms the costs of incentive tools are hard to see, whereas the benefits of FDI; such as rise in employment and growth of economy are visible to the broad majority. Besides simply attracting capital, the policies gain popularity among the people as the growth of

economy and links to other markets become apparent. These gains are also appealing to the policy makers in the CEE countries, who have in large numbers opened up their economies to the West in attempts to heighten employment, welfare and local production. In addition, incentives grow more generous with the change in climate [Easson 2001:272]. The hope of policy makers is that their investment in FDI incentive packages will be exceeded by the social benefits of FDI. Policy makers hope to attract knowledge by the way of FDI. In the early years after the fall of the USSR, FDI has been vital to create change within the economic systems of the former Eastern bloc countries by inducing much needed capital, generating cash revenues for empty government budgets and helping to restructure and upgrade industry and agriculture [Dunning 1991].

Many of the hopes of governments lie in spillover effects. Although a company as such might not have any direct interest in spillover, positive spillover into the host economy will benefit the reputation of a foreign company, while negative spillovers might cause bad publicity and concern from local stakeholders, unions or NGOs [Meyer 2004:260].

Spillover was first introduces into the field of FDI in the 1960s [Blomström and Kokko 2003:17] by a line of authors aiming to establish costs and benefits of FDI. Spillover is a term used in many spheres to describe the generation of qualities and the subsequent transfer into other sectors. Spillover effects, in the context of home country effects, are effects from the proximity of multinational enterprises that have invested abroad upon other local enterprises in the home country. In the context of host country effects of FDI, FDI spillovers measure how the presence of firms with foreign owners in the country affects other firms inside this host country. It can be cooncluded that spillovers in the home country take place when the MNEs cannot reap all the benefits that follow from making outward FDI abroad; some of these benefits "spill over" to the national firms in the home economy. [Vahter and Masso 2005:7-8].

In the case of FDI, it concerns mostly the spillover of knowledge and technology from foreign affiliates to the local host economy and domestic companies. When governments argue pro FDI, the benefits generated by the spillover effect are often the main argument. "*It is assumed that the spillover effects are sufficiently large to justify investment incentives*" [Blomström and Kokko 2003:9]. Spillover occurs mostly in the fields of knowledge and technology. As foreign firms enter a country, they will most

likely to some extend bring with them knowledge and technology. It is hoped that by attracting FDI, the host country will gain this new technology and know how. However, results of spillover can be mixed. Research supports the theory that both host country and host industry strongly influence spillover incidence. Depending on methodology, researchers indicate efficiency gain as a result of technology spillover, while others conclude downright negative effects [Narula and Portelli 2004:6] Some studies have showed that spillover does not always occur, because local industries or manufacturers simply do not have the capability to extract the knowledge or compete with foreign companies. In cases with a weak or poor industry, there will also be no significant modern technology transfer. There is a risk that the foreign entity only imports second grade or inappropriate technology or that transfer does not occur or spread due to various factors [Sass 2003:5]. Import preferences vary depending on host country characteristics, and it is important to note that spillovers are not considered by the foreign firms in their value assessment [Blomström and Kokko 2003:3]. Furthermore, spillover effects are hard to quantify. Not all investments have the capability to create the same amount of spillover. The division into motives earlier presented is interesting in this perspective. Resource seeking activities provide fewer spillovers than market-seeking investments, as they tend to be more capital intensive [Lall and Narula 2004:7]. Local market oriented firms have more interaction and therefore stronger positive impact than export oriented firms [Blomström and Kokko 2003:15]. It can also happen that the foreign companies will focus on a field of industry or production, where there is no competition or no prior experience in the host country with the result that little spillover can be expected [*Ibid.* 2003:14]. The closer the contact between foreign branches and local companies are, the more likely it is that spillover occurs. FDI benefits are not generated automatically [Sass 2003:3, Kathuria 1998]. The creation of linkages is vital and certain host country traits need to be in place. When all this is said, spillover does occur on a regular basis. "*Foreign presence seems to have a significant positive impact on the rates of growth of local productivity*" [Blomström and Kokko 2003:12]. MNE in a host country can lead to spillovers of inward FDI to local enterprises. If foreign firms introduce new products and/or processes in their affiliates in a host country, domestic firms and other foreign owned firms may benefit from a faster diffusion of new technology. The diffusion comes through worker mobility between

foreign owned and domestic firms, demonstration effects and through increased incentives to adopt state-of-the art technology in domestic firms, due to increased competition in the product market [*Ibid.* 2003]. Technological spillover may occur directly or indirectly. Directly via local subsidiaries of international firms or indirectly through transactions between host country firms and local subsidiaries [Sass 2003:5] Technological transfer is an important gain for the host economy as technology can be implemented in various fields ranging from change of export, import structure, infrastructure, R&D, improved productivity, changes in the human capital base [*Ibid.* 2003:5].

One form of spillover is intra-industry spillover. Via several channels, foreign presence in one sector can spill over into domestic firms around it. This can happen via transfer of employees that have been trained in the foreign affiliate and later decide to change to a domestic company or to set up their own business, bringing their knowledge with them as an asset. Also domestic companies that have prior been sceptic about new methods or designs can be inspired by foreign affiliates that bring with them new equipment or other ways of managing, distributing or selling goods. By seeing that it works for them domestic firms can decide to try new things and make new investments themselves [Meyer 2004:262]. Empirical data does, according to Meyer [2004:262-263], not support the theory of positive intra-industry spillover, however he suggest that in the case of transition economies the environment might be more favourable in that prospect.

In addition to technology transfer from the parent to its subsidiary, foreign subsidiaries themselves can be important sources for the transfer of technological knowledge and host market and foreign linkages related knowledge to the parent in the home country as well. This may occur, especially, if the affiliates are located in places with many innovative activities. [Vahter and Masso 2005:8]. Workers that will be trained in a foreign affiliate transfer knowledge later on to a local firms, for instance when the local companies become suppliers and hire workers previously trained in foreign affiliates.

An important buzzword in spillover is the creation of linkages between foreign companies and local economies. A host country's size, technological capability of local firms, government policies and local content regulation influence the extend of linkages formed [Narula and Portelli 2004:9]. In general more linkages are generated, when

communication between affiliate and parent company are costly, when the production process evolves the intensive utilisation of intermediate goods and when home and host country are not too different, when it comes to the terms of variety of intermediate goods produced [*Ibid*. 2004:8].

As mentioned previously, vertical FDI creates many linkages between a host countries domestic companies and the home country of the investor, therefore spillovers tend to be vertical rather than horizontal, as horizontal spillovers are simply the effects of FDI on other firms in the same sector (to the competitors)[*Ibid*. 2004:7]. Vertical linkages are created by the producer and customer surplus created by market transactions rather than by any externalities [Meyer 2004:264] and are especially important in generating technology spillovers [Narula and Portelli 2004:8].

Backward linkages can benefit the host economy and are generated between multinational enterprises (MNEs) and local suppliers integrated in the host economy [*Ibid*. 2004:8], although forward linkages are more likely to result in positive spillover [Sass 2003:10]. Forward linkages are created by downstream business. When domestic companies functioning as outlets for investors receive support by foreign companies perhaps as training or with the supply of machinery or goods this may increase productivity and improve sales per services [Meyer 2004:264].

Apart from knowledge and technology spillover also the competition logically initiated from the appearance of foreign firms on the market, can be said to be classified as spillover. The competition forces, or motivates, local firms to invest in newer technology and work harder or faster in order to keep up. Again, spillover is only generated, if there are interactions between locals and foreign firms, and there is a geographical dimension of positive inter-industry spillover [Blomström and Kokko 2003:12]. Domestic firms close to the foreign firms seem mainly to be affected by the positive impact of FDI. Should the foreign firms choose to focus on niche activities spillover will be small due to lack of interaction. It is also true that competition has the risk that local firms might be pressed out of market and end up in market segments of no interest to foreign firms [Blomström and Kokko 2003:14], but competition in general is proved to be favourable for generating spillover [Blomström and Kokko 2003:15].

Table 1. Spillover gains and preconditions

Expected gains from spillover	**Necessary preconditions for spillover**
Technology Transfer	Liberal business environment
Knowledge Transfer	Updated industry
Competitive environment	Well educated labour force
Creating work places	Well-functioning institutions
Capital	

Source: Composed by author

As stressed earlier spillover is NOT an automatic consequence, there are a number of necessary preconditions for spillover to occur affected by multiple host country and host industry factors. Whether a country's industry is able to benefit depends on the countries absorption capacity. Integration of FDI into host economy is an important focus area [Sass 2003:3] and the host countries capacity to absorb the spillover is vital for development. One could define absorption capacity, as the capability within a host country to accumulate, absorb and benefit from technology and know-how transferred to it via linkages with foreign affiliates operating within the economy [Narula and Portelli 2004:10]. Research has shown that host country characteristics are alpha omega for their ability to absorb and benefit from spillover effects generated by FDI inflow. A host country with a highly competitive environment, high educational level of labour force and with fewer formal requirements on the affiliates operation [Kokko and Blomström 199] will be awarded higher benefits.

One could imagine a scenario, where a weak country with a weak local industry suddenly is swamped by foreign affiliates simply due to the lack of competitive environment; in that case, the locals will be taken out of the game altogether without any gain. Ability and motivation among local firms are vital, they need to engage with foreign affiliates in order to absorb skills and knowledge [Blomström and Kokko 2003:16]. Low competition and high technology gab can prevent positive spillovers to emerge [Narula and Portelli 2004:11]. *"Weak technological capability may be an obstacle for spillover"* [Blomström and Kokko 2003:14] as the host country has no prior experience and training in dealing with, or spreading, the technology in question.

An exhausting examination by Blomström et al in 1994 concludes that spillovers are concentrated to middle-income countries, which is again linked to the question of absorption capacity. These findings are supported by Balasubramanyan in 1998, who concludes that FDI needs a certain level of well-developed infrastructure, stable

economic climate and human capital in order to be favourable to development [Blomström and Kokko 2003:16]. Narula and Dunning [2000] agree with that in their findings and add the necessity of well-defined institutional milieu. Each part is necessary and belongs at different stages of development with different costs and benefits. The main point being that investing into these components at the right stages will result in a multiplier effect for the host economy [Lall and Narula 2004:12].

1.4. Layers of Foreign Direct Investment Policy Framework

The main indicators necessary to attract FDI involve a complicated mix of economic factors, policy framework and business motives. In the competition to attract FDI there are several layers. Figure 2 attempts to illustrate these layers.

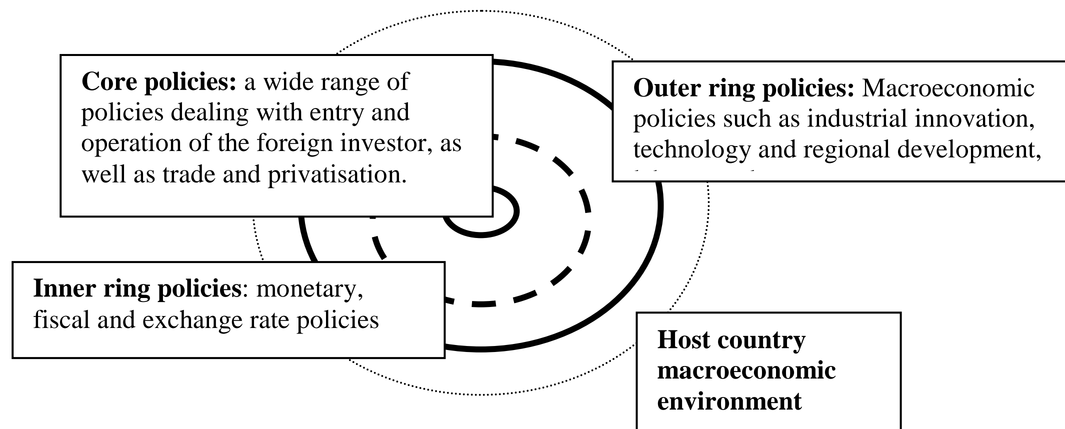

Figure 2. Layers of Policy Framework

Source: Composed by author

At the centre, there is a core, which consists of policies focused on entry and operation of the foreign investors such as regulating which rights they have and what standards of treatment they may receive, as well as policies controlling the functioning of the market as such. Supplementary core policies may be those of trade and privatisation, as they influence, directly and sometimes indirectly, the effectiveness of the other FDI policies [UNCTAD 1998].

The following layer is formed by national policies aimed at liberalising the FDI framework such as monetary, fiscal and exchange rate policies, while an outer ring of policies is aimed at attaining a favourable investment climate and promote FDI inflow and therefore balances on a macroeconomic level [UNCTAD 1998:97-99]. The outer ring entails an intricate mix of policies covering areas such as industrial innovation, technology and regional development and labour market. Finally surrounding all policies and policy decisions is the actual macroeconomic environment of the host country.

The contents of these layers differ from nation to nation depending on development level and priority areas of the government. The cores of the framework have in time become rather similar due to globalisation and regional co-operation, therefore the rings become increasingly important in order to differentiate and attract FDI. The boundaries between the layers are also becoming increasingly blurry as investors demand more of policy framework.

In order to attract FDI governments make the use of certain instruments in policy-making, those instruments can be divided into two distinct groups as defined by Oman [2000]: incentives and rule-based instruments. The terms incentives cover the fiscal and financial policies –which both belong to the inner ring of policies, while rule-based

instruments include a broader range of government instruments from the formation of inter-regional cooperation's, the set-up of economic zones or labour policies and belong at large to the outer ring. In the next chapter, those instruments will be presented.

Incentive-based instruments

The legal, political and economic stability of a country, potential growth, labour skills, its geographical location, production costs, its relative factor endowment and its size are the main factors looked upon by foreign investors when deciding where to invest [Antalocy and Sass 2001:8-9]. Although it has been much discussed, as of the later years there seems to have been formed a general consensus among scholars that FDI incentive schemes help determine, how attractive a country or a region may perform in attracting foreign investing. When companies look to invest into a quite similar region, the incentive package may form a more very important factor, when picking the final location [Antalocy and Sass 2001:9]. Theory suggests that incentive schemes are highly effective in cases where countries wish to distinguish themselves from neighbouring countries or regions. In scenarios where the business climate is already favourable and where the incentives come early and with an amount of certainty in the investment project's life circle [Bergman 2000]. With the liberalisation of the legal framework concerning FDI in Central and Eastern Europe, the incentive schemes have raised their importance there also.

For the host country to benefit from the FDI and to continuously increase the annual inflow, the economic policies will continue to be extremely important in a world that becomes more global and similar [Sass 2003:4]. Financial and fiscal policies are important, when focusing upon a country's economic stability. Among the macroeconomic policies they are the most important, as they effect investment types and decisions [Antalocy and Sass 2001:8]. To attract the foreign direct investment, the governments make use of a wide array of instruments giving the foreign companies certain advantages. "*Incentives are any measurable economic advantage afforded specific enterprises or categories of enterprises (or at the direction of) a government, in order to encourage them to behave in a certain manner*" [UNCTAD 1996]. Incentives are provided by governments and their, as well as local municipalities [Antalocy and Sass 2001:9]. At large one can divide those instruments into three main categories: monetary, fiscal (incentive based) and other incentives (rules based). Incentives of both fiscal and financial origin can be granted to foreign investors both at discretion or automatically and with or without certain conditions tied to them [Oman 2000:21]. The conditions can both be, as will be shown in the analytical part of the paper, attached to size of investment, region, length or performance requirements. The table below gives a short overview of the main incentives in all three categories.

Table 2. Specific Policy Tools for Attracting Foreign Direct Investments

Financial	Fiscal	Rule-based
• Subsidies	• Tax exemption	• Monopoly power
• Partial state ownership	• VAT exemption	• Lower price on input
• Credit guarantees	• Tax deduction	• Free or reduced real estate
• Support of personal training or retraining	• Lowering of import tariffs	• Preferential treatment
• Export guarantees	• Reinvestment allowances	• Custom free areas
• Soft loans	• Tax rebate	• Special economic zones
• Insurance and credit	• Tax credit	• Industrial parks
	• Import duties	• Promotion
	• Lower tax rates	• Free land access
	• Elimination / lowering of import tariffs	• Special conditions in tenders
	• Social security benefits paid by state	

Source: Compiled by author based on UNCTAD 1996, Sass 2003, Antalocy and Sass 2001 and Blomström and Kokko 2003

According to theory, the most used instrument in developing and transition economies are fiscal incentives, therefore they will also be the primary focus for the following comparison of case country incentive policies [UNCTAD 2000]. The reason for their popularity among developing countries, lies within the fact that they do not have to be

directly financed by public funds, which in turn in these countries is likely to be scarce [Blomström and Kokko 2003:5]. Although abolishment of import duties creates a loss of fiscal revenues, it can also attract FDI [Antaloczy and Sass 2001:16]. The most applied fiscal policies include reductions of the base income tax rate, tax holidays, exemptions from import duties or duty drawbacks, deduction of promotional and advertisement costs, capital based incentives and the possibility to carry forward losses, accelerated depreciation allowances, investment and re-investment allowances, as well as specific deduction from gross earnings for income tax-purposes or deductions from social security contributions [Oman 2000:20-23 and Antalocy and Sass 2001:9]. The majority of these aim at reducing the tax burden of foreign investors. According to empirical evidence, the general level of taxes is vital when attracting foreign FDI, since a lower level of tax usually will result in a higher level of profit for the company [Antalocy and Sass 2001:8]. As mentioned accelerated write-offs are another tool relevant for transition economies, as it reduces the expenses for investors, while encourages them to invest in new equipment, machinery and buildings.

Reduced taxes or charges on the wage bill are rarely applied in transition economies, as the tax level is already kind to foreign investors [Antaloczy and Sass 2001:16]. However smaller countries, or countries otherwise not that attractive, can gain on diminishing tax rates according to empirical evidence from Clark [Clark 2000].

There is a danger however in diminishing the expenses and tax burden of the foreign investor, as footloose companies may be attracted by tax holidays, but may very well leave again once the tax holidays expires. Tax holidays have little effect on spillover, however combined with certain political elements backward and forward linkages can be enhanced [Antaloczy and Sass 2001:15] with the gain of turning the footloose into a steady investor or make them transfer additional or other activities to the host economy.

While tax holidays may attract new investments good write-offs, tax allowances and lower tax rates for reinvested earnings help please investors already present [Antaloczy and Sass 2001:15].

While fiscal incentives are most popular in developing countries, financial incentives are the preferred tool of choice in developed countries [UNCTAD 2000]. In developed countries the amount of financial incentive per project or job created is generally much

higher than in other regions [Antaloczy and Sass 2001:16]. As well as fiscal incentives, financial incentives are applied by governments in an attempt to divert FDI to certain sectors. Where fiscal policies aim at reducing the tax burden, financial aim at providing direct financial support in an attempt to reduce the overall costs of investing.

The most important financial incentives are grants; also widely used are subsidiary loans and loan guarantees, access to subsidised loans, operational costs deduction for the foreign company or defray capital. These incentives are frequently targeted, at least nominally at specific purposes such as grants for labour training, wage subsidies, donations of land and/or site facilities [Oman 2000:20-23].

Rule-based, or outer-ring, policies are a much broader and heterogeneous group of policy instruments. They range from inter-regional cooperation, economic zones over investment agencies to labour market policies. Rules-based instruments cover incentives, which cannot be included into financial or fiscal group. The main aims of the other incentives are by non-financial means to increase the profitability of the foreign investment. Instruments may fall into various policy areas by providing infrastructure, subsidising prices for services or increasing market share. The later may be done by preferential treatment or the granting of monopoly rights [Antalocy and Sass 2001:9]. In this case structural and market policies are equally important, as are educational, training and health policies. They all influence the state of R&D in a country, its labour force, infrastructure, industrial structure and composition of economic units [*Ibid.* 2001:8-9]. This is all necessary on various levels, when it comes to attracting, and just as importantly absorbing, FDI and the benefits it brings to a host country. These mentioned tools can be used for more than simply attracting FDI, they also act in a certain extend as structural policy tools to name an example. This happens as the aim moves from simply attracting to attracting FDI into a certain industry [*Ibid.* 2001:17]. Alternatively, regional development is attempted advanced by offering cheap land or special zones to move to certain rural areas or areas of high unemployment turning it into, in the last case, a labour market tool.

FDI policy expands when new needs arise –when an economy only attracts footloose investors, quick to move again, creating linkages with the investor and the host economy become the new goal thus expanding the extend of tools and policies connected with FDI inflow.

The spillover effects policy makers hope to generate from FDI inflow are as mentioned not generated automatically. However, there is a possibility to further it by attaching performance requirements (PR) and conditions to the incentive schemes. PR's include export requirements, the requirement of domestic participation, local benefit requirements, technology transfer requirements, R&D requirements, and employment-related requirements. It most be noted that multilateral and regional conventions impose certain restrictions on the use of such clauses [Sass 2003:11].

2. COMPARATIVE ANALYSIS OF INVESTMENT ENVIRONMENT AND INCENTIVE POLICIES IN CASE COUNTRIES

2.1. Common characteristics of Central and Eastern European Transition Countries

Central and Eastern Europe attracts high inflows of FDI. It is considered the second most attractive investment area in a global perspective, only topped by Western Europe [Hoof 2006]. Improvements in stability and law framework influence the inflow rather quickly in this region, so frequent changes in policy framework occur regularly.

Prior to World War one and the Russian revolution, only Russia attracted noticeable FDI in the region due to its natural resources, however with the rise of the Bolsheviks and especially with Stalin's rise to power, this came to an end. Foreign capital and investors with their capitalistic instincts were incompatible with the idealistic idea of the Soviet Union, which became a closed area, until Gorbachev's reforms in the late 1980s [Meyer and Pind 1998:6-8]. Bureaucracy and crime continued to be the mark of many of the former communist states until the turn of the millennium, and still today continue to make hindrances for the free flow of FDI.

Empirical data suggest that the starting point for major investments into the transition economies was 1995 [*Ibid*. 1998:15], and since than the growth has continued at rocket speed. As the table below shows, the average growth rate for FDI stock in the world, as well as developed and developing countries, since 1995, has been around three times, while for the combined CEE countries the amount of inward FDI stock has grown by 11,89 times in just one decade. The amazing growth rate of the CEE becomes even clearer, when comparing the inward stock in 2005 with the figures from 1990, where

the inward stock for the CEE has grown more than 166 times. That is more than 32 times the world rate.

Table 3. Inward stock of FDI, millions of USD

Region	1990	1995	2000	2003	2005	Growth 1990/2005	Growth 1995/2005
World total	1,950,303	2,992,068	6,089,884	8,245,074	10,129,739	5,19	3,39
Developed countries	1,399,509	2,035,799	4,011,686	5,701,633	7,117,110	5,09	3,5
Developing countries	547,965	916,697	1,939,926	2,280,171	2,756,992	5,03	3
CEE	2,828	39,573	138,271	263,270	470,689	166,44	11,89

Source: Compiled by author based on UNCTAD 2004 and author's own calculations

While 1995 was the starting point for major FDI inflow into the region, 1997 was the first year Eastern Europe as a whole registered a positive GDP growth rate (see Table 14 for case country GDP growth rate).

The inflow of FDI has since the very beginning been concentrated heavily in certain countries [Kekic 2005]. Hungary quickly became one of the leaders on the level of the Asian tigers Malaysia and Singapore. Currently the share of Hungary in the overall CEE inward FDI stock is 13% [UNCTAD database]. Estonia was right behind Hungary in attracting FDI (looking at per capita) and currently has a share of CEE inward stack totalling 2,6 % [UNCTAD database]. Moldova's FDI stock, although in growth, only totals 0,2% of total CEE inward FDI stock [UNCTAD database].

The Baltic countries have all been very successful. Many attribute the success to their small size and reform-friendly governments, combined with their close proximity and ties to the Northern region.

In general, flows into the entire post-communist region have for a long time been dominated by inflows into the natural resource sector [Kekic 2005]. However focusing on the CEE, not taking into account the oil rich former states Azerbaijan, Kazakhstan and Turkmenistan further east, the largest inflow of FDI is into the financial sector, as well as into logistics and distribution. The largest investor into the region overall continues to be the USA, with Germany as the second largest contributor [LocoMonitor 2007].

When early on investors were asked about their interests in the post-communist sphere, the answers were often that the long-term potential was attracting and the first mover

potential alluring [Meyer and Pind:29], despite the high risk connected with doing business in an unstable environment.

According to Varblane [2000:4-5] the development of government policies in the CEE after WWII can be divided into three periods. The first of these ranging 1945 to mid 1950, the second from mid 1950s to the end of the 1970s, and the final one taking its beginning in the early 1980s.

In the first period the outflows of FDI came mainly from the US, and the developing countries governments were relatively indifferent. Than came a period of growing protectionist approach and restrictions. This affected not only FDI, but also foreign trade. The buzzword of the time embedded in government concern was "*import substituting industrialization*". Since the 80s, this buzzword was replaces by the new "*liberalisation"*. Governments have continued to liberalise their FDI frameworks ever since with the result of a boom in FDI stock [UNCTAD 1998:94].

In general, there are three main aims of the liberal FDI policies. The first being reducing restrictions, which aims at removing objects that distort the free flow of the market by applying specific restrictions to foreign investors such as instance tariffs, but also regarding incentives and subsidies. This is now a rule for most countries, although a few sectors of strategic importance remain protected [Varblane 2000:5]. In Central and Eastern Europe the privatisation policies have dealt with this removal of restrictions in great deal. Another aim is the strengthening of positive standards of treatment of foreign investors. This is reflected by countless bilateral, regional and multilateral agreements signed dealing specifically with the protection and treatment of FDI. This was especially the case in the beginning of the 90s, as transitional countries emerged onto the scene of world economy. The third aim of liberal FDI policies is the strengthening of market controls [UNCTAD 1998:94]. This happens to ensure that the competitive environment is functioning properly. This is ensured by making agreements and laws on disclosure of information, prudential supervision as well as competition rules. Since 1980 the number of countries with competition laws has increased to 70 from 40 [UNCTAD 1997a]. In the beginning of the new millennium, several post-communist countries joined the EU with the benefits that follow such as political stability, structural reform and upgrade of infrastructure and skills [Kekic 2005]. One should not underestimate the benefits of

accession in term of EU structural reforms and closer proximity to the EU core [*Ibid.*], which will make the countries seem more attractive to investors.

Privatisation in Central and Eastern Europe

Privatisation has been a major tool in all CEE countries in term of creating basis for FDI inflow, however the methods of privatisation has varied greatly throughout the region.
The most common method of privatising large firms worldwide is stock market flotation i.e. the general population would be invited to buy shares in an "initial public offering "(IPO). This however was not feasible in the transition context, because IPO's require developed stock markets, where the capital can be raised. In CEE, investible financial assets were small, and stock market regulatory institution, and stock markets in general, not present. Most crucially potential investors lacked detailed info on state-owned firms. Instead voucher privatisation was developed, the basic idea being that all citizens receive a voucher, which they can use to require shares in firms. This was implemented widely across CEE, and many countries used voucher privatisation as a main pillar of their privatisation process except for Hungary [Meyer 2003].
Table 4 gives an overview of methods of privatisation, distinguishing to whom the companies were transferred.

Table 4. How to privatise and to who?

	To the general population	**To current managers and/or workers**	**To previous owners**	**To outside investors, such as foreign or domestic private firms**	
By sale	Stock market flotation: from mid 1990's only	MDO, MEBO: e.g. Poland and **Romania**		Auction: Everywhere for small business	Negotiated sale, tender: **Estonia and Hungary**
By free distribution	Voucher privatisation: Most countries		Restitution: Bulgaria and East Germany		

Source: Meyer (2003)

Hungary and Estonia alike did not choose common voucher as their main privatisation method, but decided on setting the former state-owned companies up for sale, thus making it easier for

foreign investors to gain access and participate [Varblane 2003a]. They chose to give equal access to all participants domestic and foreign alike. The sales were carried out under the condition that the buyer would create of a certain number of jobs and investments over a designated period. In Estonia, this resulted in long-term reconstruction programs initiated by the foreign investors in order to raise efficiency. One of the main questions in Estonia, requiring legal solutions, in the beginning of the 1990's, was creating a legal basis for the privatisation of state property [Varul 2001]. Although the Privatisation Act in Estonia was first adopted in 1993, the process of privatisation started even before that [Estonian Institute 2003]. Estonia followed an intensive programme of privatisation in the years 1993-1996. 17% of FDI inflow in the beginning was indirectly, or directly, linked to privatisation [Hunya 2004:103]. Despite the mistrust in the success of the program from outsiders currently, only 15 years later, more than 90 % of the Estonia's industrial and manufacturing enterprises have been privatised [Nellis]. In Estonia in the beginning of 2000 performance requirements in the context of privatisation were applied for domestic and foreign actors alike. All actors are exempt from state taxes and fees [Bergman 2000:11]. The gain from privatisation is normally in the form of reinvested earnings, which in Estonia in 2001 contributed to 41% of total FDI [Hunya 2004:95].

> When companies in Romania were privatised, the government offered reduced debts of those enterprises, in some cases deleting all of the accumulated debt. In 2002, a new privatisation law was launched in Romania, which initiated financial relief in an organized way, in order to help the sale of the rest of the public sector run more smoothly [*Ibid.* 2002]. Also in Moldova, there have been several privatisation stages. The first program was approved and initiated in 1993-94 and included the launch of a Ministry of Privatisation. In 1995-1997 mass privatisation for National Patrimonial Bonds followed, together with distribution of the agricultural farms property and land, housing privatisation and sale of state property. 50 % of the shares of the agricultural products processing enterprises were given to agricultural enterprises-suppliers of raw materials [NAAI]. The latest stage has run 1997-1998, which was prolonged until 2000,

consisted mainly of sale of public property, and extending the areas in which privatisation took place. Currently 2235 enterprises have been totally or partially privatised using a mix of privatisation initiatives. 60% of the industrial production in Moldova is controlled by the private sector [*Ibid.*].

Other methods of privatisation across the CEE entail management-buy-out and management-employee-buy-out. The later was the second most important method in Hungary. In Estonia the second most important method was the voucher privatisation model. Finally, also many countries considered restitution to former owners, which has been a lengthy and complicated process [Meyer 2003: 33-35].

Other players in Foreign Direct Investment policy making

Although host policy makers are still the most important players in designing incentive and related policies, more players have taken the scene in the later years following the growing europeanisation and globalisation trends. The role of regional cooperation cannot be underestimated, and neither can regional competition. Both colour many policy decisions and may sometimes not have the most beneficial outcome [Oman 2000]. If one country aims at competing, the neighbouring nations may find it hard to stay out of the bidding race.Furthermore multilateral agreements touch upon incentives and investment rules, their coverage is still limited, but their influence is definitely not. 2495 bilateral treaties were in place by the end of 2005, along with 2750 double taxation treaties and 232 other international agreements influencing investment provisions [UNCTAD 2006:9]. In total 176 countries have signed bilateral treaties, which cover a total of 7% of global FDI stock and 22% of FDI in developing countries [Varblane 2000]. In the CEE countries 57% of FDI is covered by agreements signed in bilateral investment treaties [Varblane 2000].

Both the WTO and the OECD have tried to push for more comprehensive legislation, but till now the most comprehensive regulations concerning FDI are found within the NAFTA and the EU [Blomström and Kokko 2003:18]. Incentive policies have been necessary within the EU due to the extensive market integration and comprehensive subsidising. EU is probably the most important policy player among the CEE states, as many countries are members. In addition, three out of four of the case countries in this study are member states, however EU influences all of them. This influence began even before the membership. The competition to become an EU member state has had a great impact on the CEE countries in respect to their institution building and policy design. Potential members-states upon applying accept that the EU requires substantial changes in domestic policy in order for the states to confirm to the acquis communitaire. Often the allure of potential membership is said to boost modernisation of economic, social and political systems. Romania upon becoming a candidate country spend its pre-accession assistance on modernisation of infrastructure and heightening of ecological standards [Spendzharova 2003 :152]. Corruption is also targeted hard from the EU's side. However, studies focus on the broad overall trends instead of on the effect of specific policies, making it hard to say anything on the specific impact of the EU on policies affecting FDI. Nevertheless, EU membership and the road towards it undoubtedly influence FDI policies. For instance Hungary had to restructure its policies in connection with Free Zones that until membership were unique and very liberal. Now with the new policies Hungary has been allowed to keep the free zones, as a regional policy instrument [Hunya 2004:113]. Estonia has in turn had to apply the EU regime of export and import duties to third countries, where before there were virtually no export and import duties in place.

The old member states have voiced concern about the apparent tax competition from new member states, and suggestions of harmonisation of tax rates, either strictly or within a range, have been proposed. These suggestions are however still on an imaginative level, although this could change in the future, if FDI inflow is too strongly redirected from the west to the east [Lahrèche-Révil 2006:52]. In turn this would mean an even stronger impact on policy frameworks.

On FDI itself, scholars have concluded that the announcement of a country becoming an EU accession country efficiently increases the positive expectations to that country and boosts FDI inflow [Bevan et al. 2001:3]. On the negative side this effect does widened the gap to potential neighbouring states that do not enjoy the same status, thus creating a regional gap [*Ibid.* 2001:9]. One example can be found right here among the case country, where the gap between the new member state Romania and its poor neighbour Moldova is widening. Another issue regarding EU accession is that becoming a

candidate country gives stability, but at the same time requires many policy changes, which creates instability and risk due to changing environment, both are not appreciated in investor circles. In addition, membership normally means an increase in wages, which lead Meyer et al. [2005] to conclude that businesses may very well prefer imperfect institutional framework to frequent and unpredictable changing framework, even if the changes are in their favour [Meyer et al. 2005:10].

2.2. Comparative Analysis of Broad Policy Approach of Foreign Direct Investments

Since gaining independence in 1991, all case country governments have been determinedly pro open market economy. However, the roads travelled in order to get there have been different. In Estonia, the transformation was based on the concept of shock therapy and rapid radical market reforms. The main policies, established by the Estonian government in order to attract FDI, were aimed at stabilizing, privatising and liberalizing. Among the cornerstones were structural reforms, investing in infrastructure and creating transparent administrative procedures. The main aim being establishing an environment suited for business [Hunya 2004:106-107]. Policy wise Estonia has the most reduced form of investment incentive system and leads a policy considered beneficial to spillover. Privatisation was a major tool and a natural way of integrating neighbouring countries and FDI investors into the Estonian economy [Berghäll 1999:9]. The main strategy of the Hungarian incentive policy is trying to divert FDI flow into selected locations, sectors and activities [UNCTAD 2006:84]. Romanian policy makers have been progressive with restructuation of the banking sector and installing a fairly liberal trade policy. In the later years liberalization of capital restrictions and improvement of legal system and public administration have been among the focus areas [Euler Hermes France 2007]. Many of the changes have been fuelled by the wish to join the EU as quickly as possible and have been so successfully implemented that the World Bank in 2006 labelled Romania the world's second-fastest economic reformer that year. The Moldavian policy makers have lately been focusing on privatisation and the boosting of FDI inflow, as well as modernising infrastructure in order to attract FDI to the country.

Prior to the main analysis of the broad investment environment, here will be an introduction to the main sectors and investors in the case countries, which currently play a prominent role. The table below shows top investors by country.

Table 5. Top investors by Country 2006

Countries / Investors	Estonia	Hungary	Moldova	Romania
	Sweden	Germany	Russia	Netherlands
	Finland	Netherlands	USA	Austria
	UK	Austria	Spain	France
	Netherlands	USA	UK	Germany
	Norway	Luxemburg / France	Germany	Italy

Source: Compiled by author based on UNCTAD database, EIA, Larive Romania and ITD

Estonia is a textbook example of the importance of geographical and cultural proximity. Three quarters of Estonia's inflow of FDI stems from the capital-rich Scandinavian countries. Many larger firms from the Nordic countries have established their headquarters for Baltic activities in Estonia [Hunya 2004:96]. Germany is one of the main investors in Hungary, Moldova and Romania, but only in Moldova, do we find Russia among the main investors. In Hungary German investors cover approximately 20% of investments, the same for the Netherlands in Romania and Finland in Estonia. However, the biggest investor in Estonia is Sweden with more than 50%.

As can be seen in Table 6, the case countries attract a FDI inflow into a wide variety of sectors. In Estonia Sweden has been extremely active in the financial and telecom-sector, which together with the manufacturing is mainly foreign owned [*Ibid*. 2004:93]. In Hungary electronics, automotive components and machinery and equipment make up the main investor sectors, and only in Romania is agriculture and industry among the top 5 sectors. The Dutch investors in Romania are mainly centred on banking, insurance and retail. The Austrian, whose share of total inflow is around 14%, have bought the largest bank. The largest other investments are found in wood processing, construction and real estate [Larive Romania]. To find substantial investors into Romanian agriculture, one has to turn to Italy.

Table 6. Top sectors by investments

Countries / Sectors	Estonia	Hungary	Moldova	Romania
	Finance	Electronics	Electric, energy, gas and water supply	Agriculture
	Real estate, renting and business	Automotive components	Manufacturing Industry	Industry
	Manufacturing	Machinery and Equipments	Trade	Construction
	Other communities	Other transport services	Transport	Retail and Wholesale
	Wholesale and retail trade	Business services	Hotels and Restaurants	Tourism

Source: Compiled by author based on Eurostat, EBRD and EIA

In the following sections the broad investment environment in the case countries will be analysed using the eight indicators market size, labour force, infrastructure, stability and growth, corruption, freedom, ease of doing business and competitiveness and innovation. These indicators are chosen to establish the locational advantages of the case countries. After analysing each indicator, the case country will receive points from one to four. One indicating the best investment environment and four the worst. In the cases where more than one ranking or table is included in the evaluation, a combined ranking will be indicated. After the indicators are ranked, they will be combined in order to evaluate the absorption capacity of the case countries, and afterwards in combination with FDI per capita to determine, whether the theoretical approach to investment environment can be applied to the actual reality.

Market size: In terms of attractiveness and locational advantages market size has always been deemed important. Although regional cooperation and decreasing internationalisation has made size of less importance, it remains an important first indicator. Looking at the case countries presented in Table 7 Romania is clearly the largest both in population, which equals possible consumers and labour force, and in area.

Table 7. Market Size

	Population (in millions)	Area ('000 sq.km.)		IE
Estonia	1.4	45		4
Hungary	10	93		2
Romania	21.7	238		1
Moldova	4,2	33.8		3

Source: EBRD.

In the opposite end of the scale one finds Estonia, which is more than 5 times smaller area-wise and has a 15,5 times smaller population. Even Moldova, although smaller in area, boosts of three times the population of Estonia. Hungary's population is less than half that of Romania. However Hungary is the second largest country of the four case countries in terms of both area as well as population.

Labour Force: The allure of well-educated, low cost labour has been a motivating factor for many investors, when relocating or outsourcing to CEE, however now many voice the concern that the pool is drying out. In both Hungary and Estonia, the shortage of cheap labour is beginning to be a constraint. Executives are still available, but the number of blue-collar workers is becoming scarcer. Larger labour mobility and the failure to reform the educational system as quickly to as the economic system has put constraints on executives as well [Meyer et al. 2005:8, Varblane 2000:17]. In Romania lack of labour force this is yet a problem. Romania still has a well-educated labour force mainly centred on the service, technology, IT and engineering [PriceWaterHouseCoopers 2006]. Nevertheless, with higher mobility the problem could very well soon arise. In Moldova 30% of the work force is estimated to have left the country to find work, most of which are assumed to be leaving for neighbouring state Romania [National Bureau of statistics of the Republic of Moldova]. Calculations in Estonia suggest that around 3,000-4,000 will immigrate a year, however the prognoses concludes that most of immigrants only leave temporarily [Chandler et al. 2003:33].
Another debated issue connected to labour forces is low productivity [Hunya 2004:104-105]. However despite a rather substantial productivity gap between domestic and

foreign companies, it is important to remember that foreign capital is situated mostly in capital intensive sectors, while domestic firms make up the largest share of labour-intensive technology sectors [*Ibid*. 2004:111]. On top of scarcity of labour force, the inflow of foreign investments has inflated the salary scale, especially in manufacturing, the salaries still remain well below EU average, as can be seen in the table below. The lowest average salary is found in Moldova and the highest in Hungary. The largest difference between minimum salary and average salary is found in Estonia, where there is a total of EUR 441 mark between the minimum and the average salary.

Table 8. Monthly salary 2006 (EUR)

	Estonia	Hungary	Romania	Moldova	EU
Minimum salary	159	247	90	na	572,5
Average salary	600	632.8	434	108	1700

Source: Compiled by author based on UNCTAD database, EIA, ARIS, Eurostat and the National Bureau of Statistics of the Republic of Moldova

As empirical research has shown that a country with high unemployment is more likely to attract investors, the CEE countries have potential in that area [Barros and Cabral 2000]. The unemployment rates within them skyrocketed in the beginning of the 90s in the wake of structural reforms and privatisation schemes, but they have all climbed below 10% in the first decade of the new millennium, as can be seen below in Table 9. Moldova remains the country with the highest unemployment rate (nothing indicates that the 2004 rate should have decreased substantially). Estonia has the lowest unemployment rate at 5,9 %, but it is clear that the rates fluctuate rather much.

Table 9. Unemployment in percentage of labour force

	1998	2000	2002	2004	2006
Estonia	9,2	12,8	9,5	9,2	5,9
Hungary	8,4	6,4	5,8	6,1	7,5
Romania	5,4	7,2	8,4	8,1	7,4
Moldova	10,1	8,5	6,8	8,0	na

Source: Compiled by author based on Eurostat and the National

Education of labour force is another important indicator (See Table 10). In the clear lead on the educational level is Estonia with the highest percentage of students in tertiary education, as well as the highest amount of foreign languages learned by pupils. Furthermore almost 90% of the total Estonian population have completed upper secondary education. In Moldova almost half as many students are enrolled in tertiary education, while Hungary has the lowest amount of foreign languages learnt by pupils.

Table 10. Education 2005

	Students in tertiary education[4]	**Foreign languages learnt by pupils**	**Total population having completed upper secondary education %**		**IE combined**
Estonia	4,74	2	89,1		3
Hungary	3,85	1	76,5		3
Romania	2,94	1,9	73,1		3
Moldova	2,7	1,05	na		1

Source: Compiled by author based on EBRD, Eurostat, and National Bureau of Statistics of the Republic of Moldova

The IE scale for labour force is calculated based on the assumption that high level of education, compelled with low salary and higher unemployment (from the assumption that the registered unemployed would be available for labour and the empirical conclusion that countries with high unemployment attract most investors, as indicated earlier) should result in the best rank.

Infrastructure: Infrastructure has by almost all scholars been deemed one of the most important components of a successful FDI policy. Infrastructure is vital for setting up a business with regard to both communication and transport. The EBRD index of structural reform uses various indicators to evaluate the changes in transition economies. Hungary has been the most successful reformer in this regard scoring top point for railways, telecom and water and wastewater reforms. Romania and Estonia

[4] % of total population

both score 3,3 out of 4+ in their structural reforms, while Moldova yet again lags behind with 2,3 points. Table 11 shows all points combined.

Table 11. Indicators of structural reforms concerning infrastructure in case countries[5]

	EBRD index of structural reform	Electric power	Railways	Roads	Telecom	Water and waste water	Global technology ranking		EI
Estonia	3,3	3,3	4+	2,3	4	4	20		2
Hungary	3,7	4	3,3	3,7	4	4	33		1
Romania	3,3	3,3	4	3	3,3	3,3	55		3
Moldova	2,3	3	2	2	3	2	92		4

Source: Compiled by author based on EBRD, World Economic Forum

Stability and Growth: Moldova is often talked about as the poorest country in Europe. The collapse of the Soviet Union has left the country literally in pieces and plagued by instability both politically and economically. After the breakdown of the USSR, many years of decline and instability both economically and politically followed also in Romania, but since the turn of the millennium major reforms has lead to relative stability and major growth. Estonia's main stability issues are connected to political risk. Changing governments and the geographically close location to Russia, to which the relationship rides like a roller coaster, makes Estonia high ranked on the political risk index. All case countries have climbed several rankings down the index between 2005 and 2007, Estonia however is still the best ranking country at the 46th place, while Moldova ranks lowest at 135.

Table 12. Risk Rating

	Estonia		**Hungary**		**Romania**		**Moldova**	
	2007	2005	2007	2005	2007	2004	2007	2005
Rank	46	42	41	38	66	60	135	130
Overall Score (100)	66.01	17.71	69.08	67.57	56.55	50.61	33.89	33.19
Performance (25)	19.33	17.71	11.32	10.04	8.25	6.9	4.02	4.39
Political Risk (25)	10.03	9.33	15.84	17.07	14.78	12.47		
Credit Rating (10)	7.61	7.08	6.72	6.67	5.16	3.96	0-63	0
Coface Risk Rating	A2		A3		A5		D	

5 ... rom 1 to 4+. 1 represents little or no change from a rigid centrally planned economy and 4+ represents the standards of an industrialized market economy.

Source: Compiled by author based on Euromoney and Coface

Coface rates Moldova into group D as a country with a high-risk profile regarding economic and political environment and a very bad payment record. Estonia, Hungary and Romania are found in A2-A5 meaning that economic and political environments as well as payment record are acceptable, but not optimal. A5 being the worst in the A-group.

Inflation is an indicator of stability. High inflation rates indicate economic instability and risk for the investor. It was a high inflation rate, which prevented Estonia from joining the EMU as planned in 2007, however the rate is relatively stable comparing to Romania and Moldova, as can be seen in the Table 13.

Table 13. Inflation percentage

	1998	2000	2002	2004	2006
Estonia	8,1	4,0	3,6	3,1	4,4
Hungary	14,2	10	5,2	6,8	4,0
Romania	59,1	45,7	22,5	1,9	6,6
Moldova	18,2	18.4	4.4	12,5	13

Source: Compiled by author based on Eurostat and the National Bureau of Statistics of the Republic of Moldova

The inflation rate in Moldova reached 13% last year making it one of Europe's highest. Although Hungary's inflation rate is higher than the EU average, it is the lowest of the case countries, and the lowest the country has seen since the collapse of the USSR.

Table 14. GDP growth in percentage

	2003	2004	2005	2006		EI Combined
Estonia	7.3	8.1	10.5	11.4		1
Hungary	3.4	5.2	4.1	3.9		2
Romania	5.2	8.4	4.1	7.7		3
Moldova	6.6	7.3	7.5	4		4

Source: UNCTAD database

A stable environment will support growth. Therefore, the GDP growth rate is included in this paragraph, as an indicator of stability (see Table 14 for GDP growth). In the later years, Estonia has been labelled one of the Baltic Tigers due to tremendous economic growth brought on by rapid economic reforms. In 2006, this lead to an impressing growth rate of 11.4 %, as can be seen in the table above. Estonia's liberal politics have attracted much FDI, which in turn are believed to have fuelled this economic growth of proportions. Romania is likewise successful with a growth rate of 7,7 %. Romania's GDP figures are among the absolute EU low, however they have been growing steadily with around 6% since 2001 and reaching 7,7% in 2006, in turn making it one of the countries with the highest growth rates inside the EU [Euler Hermes France (2007)]. Hungary and Moldova can only boost half of that, but even a growth rate of 4 % is more than many old member states can pride themselves of.

Corruption: Empirical data suggest that there is indeed a negative correlation between host country corruption levels and FDI inflow [Johnson and Dahlstöm 2005: 21]. Corruption continues to affect business dealings around the world, mostly occurs because of lacking, modern institutions.

Corruption was a highly debated topic prior to the last two EU enlargement rounds. It was especially questionable, whether Romania would be able to deal with this issue and bring it below acceptable norms. The fact that corruption is an illegal activity makes it hard to measure and evaluate, however the Global Corruption barometer, which scores are reflected in the table below, bases its evaluations on perceptions of corruptions from business people, locals and country analysts. The use of the perception of business people makes it very relevant in this context. They are the ones that come into contact

with host country institutions and bureaucrats, places where corruption is generally perceived to exist and affect business dealings [*Ibid.* 2005: 5]. The survey has concluded that Romania continues to be one of the most corrupt countries in the CEE. The most corrupt institutions being customs, judiciary, and political parties. According to the Heritage Foundation's Freedom list corruption is also deemed a factor in Romania, even below Moldova, where corruption due to weak institutions however also remain an important issue.

Table 15. Corruption Perception[6]

	CPI Score	Rank	Corruption		IE
Estonia	6.7	24	64		1
Hungary	5.2	41	50		2
Romania	3.1	84	30		4
Moldova	3.2	79	29		3

Source: Compiled by author based on Corruption Perception Index, Heritage Foundation

In the Baltic countries corruption remains a smaller issue than in many neighbouring countries, however some corruption continues, mostly reflecting the common use of friendship networks often dating back to the Soviet era. In countries as small as Estonia, it continues to be an issue for foreign investor that "knowing somebody" is the key to knowledge and some times success [Berghäll 1999:72], but on the Corruption Perception Index as well as according to the Heritage Foundation, Estonia received the best ranking for least corruption of the case countries, followed by Hungary.

Freedom: Freedom is an abstract concept, but for a market to have a liberal and working free market this concept is of outmost importance. In connection to investment economic freedom as well as political and civil freedom is important.

In the case of economic freedom, Heritage House does a ranking based on several indicators ranging from business, trade, monetary and financial freedom to freedom from government and corruption.

[6] 10 (highly clean) and 0 (highly corrupt)

Table 16. Economic Freedom Ranking[7]

	Rank	Business	Trade	Fiscal	Monetary	Financial	Investment	Labour
Estonia	12	80	76,6	89,7	83	90	90	51,2
Hungary	44	71,2	76,6	79,2	76,7	60	70	66,1
Romania	67	70,9	74	91,7	69,7	60	50	61,4
Moldova	81	70	74,4	90,4	68	50	30	61,2

Source: Heritage Foundation

Table 16 shows the ranking of the case countries, as well as a selected number of indicators. According to the Heritage Foundation's 2007 index of economic freedom Estonia ranks 12th, making it no. 5 out of a total of 41 European countries. In Estonia monetary, business, investments, monetary and financial freedom are strong, and nothing directly negative is underlined, however high government spending and a rigid labour market are mentioned on the down side. Hungary ranks 44th, making it no. 25 out of 41 European countries. Monetary, business, trade freedom, labour, investment and fiscal freedom are underlined as strong, only freedom from government intervention is considered weak. Romania is ranking 67th with strong fiscal, trade and financial freedoms, however bureaucracy and corruption pulls it downwards. As no. 33 of 41 countries, Moldova occupies the 81st spot on the Economic Freedom Ranking index. Although trade, business and fiscal freedoms are considered strong, non-tariff barriers, restrictive customs and tough regulations are on the list of negatives. Monetary and investment freedoms are poor and corruption high cobbled with weak institutions.

Freedom House each year prepares a measurement of freedom concerning civil liberties and political rights on a ranking from one to seven. One being most free. As shown in the table below three of the case countries are evaluated to be free. Only Moldova is categorised as partly free due to lacking civil liberties and political rights.

Table 17. Freedom Ranking

Country	Civil liberties	Political rights	Freedom ranking		IE (both tables included)

[7] Selected areas as percentage freedom of 100.

Estonia	1	1	Free		1
Hungary	1	1	Free		2
Romania	2	2	Free		3
Moldova	4	3	Partly Free		4

Source: Freedom House

Both freedom indexes conclude the same initial ranking of the case countries and one is tempted to conclude that fee civil liberties and political rights lead to free business as well.

Ease Of Doing Business: The less bureaucracy the more attractive a country is for setting up business and production facilities. The World Bank's "Ease of Doing Business" barometer measures the ease of doing business in 175 countries across the world using ten indicators studying various aspects of a countries business environment. Below Table 18 shows the rank of the case countries, and their ranking in three selected areas.

Table 18. Ease of Doing Business

	Rank	Starting a Business	Closing a business	Employing workers		IE
Estonia	17	51	47	151		1
Hungary	66	87	48	90		3
Romania	49	7	108	78		2
Moldova	103	84	78	128		4

Source: World Bank

Estonia is without question the leader in this perspective with Moldova lacking far behind. Romania however has a remarkable ease in starting a business well ahead of even Estonia, which in turn is ranked exceptionally low on employing workers –even below that of Moldova. The rigid labour market situation in Estonia was also mentioned in the Economic Freedom Ranking evaluation.

Competitiveness and Innovation: Central and Eastern Europe have during the 90s made their way up the competitiveness rank and have achieved status as the second most

competitive region for investment on a global scale [Hoff 2006]. The regional differences however are striking. Estonia's main competitive advantages are location, both as a platform to the rest of the Baltic region, as well as to Russia, furthermore well-educated low-cost labour and good communication are highlighted [Berghäll1999:35]. These are undoubtedly also among the figures to put it up front in both the Global Competitiveness and the World Competitive Rankings carried out by World Economic Forum and IMD as can be seen below. World Economic Forum evaluates 125 economies across the globe on indicators such as institutions, macro economy, business sophistication, market efficiency, technological readiness, infrastructure and education. IMD surveys 69 economies on infrastructure, economic performance, government and business efficiency.

Table 19. Competitiveness Ranking

	Global Competitiveness 2006 Rank	Global Competitiveness 2006 Score	Global Competitiveness 2005 Rank	World Competitiveness Ranking		IE
Estonia	25	5.12	26	20		1
Hungary	41	4.52	35	41		2
Romania	69	4.02	67	57		3
Moldova	96	3.71	89	na		4

Source: Compiled by author based on World Economic Forum and IMD

Estonia ranks highest in both scoreboards, well above Hungary. However in European context Hungary scores high on multiple advantages. It is to be found ranking fourth on the top five listing of in investor's choices for manufacturing locations and 9/10 on production units. Hungary is fifth and Romania ninth on the top ten considerations for new investments or expansion [Hoff 2006]. Of the Top 15 European Countries measured by investment projects number Hungary scores the 8th place above Russia and Romania 12th [Hoff 2006]. This is also reflected on the Competitive rankings that place Hungary and Romania on 41st and Romania on 69th/57th place. Moldova is unfortunately not to be

found on among the top countries in the survey. Moldova is found in the bottom at the 96th place in the Global Competitiveness Ranking, however not listed in the World survey. Neither was it in the Innovation Scoreboard's survey. This survey places countries into four main groups Innovation leaders, followers, catching-up and trailers using a complex set of indicators divided into five dimensions measuring innovation drivers, knowledge creation, intellectual property, innovation, application and entrepreneurship [European Commission 2006:6]. The innovation leaders are Sweden, Switzerland, Finland, Denmark, Japan and Germany [*Ibid*. 2006:8], while Estonia and Hungary are categorized as trailing behind the EU25 [European Commission 2006:3]. Romania, who at the time of analysis was not yet a member of the EU, is in a separate cluster together with Cypress. A cluster categorized as fast growing and catching-up [*Ibid*. 2006:4].

Absorption Capacity and Investment Environment

In the theoretical chapter, Absorption Capacity (AC) was mentioned as a vital necessity in order to attract spillover effects to the host economy, a much-desired effect of FDI. Before turning towards the actual figures of FDI, the gathered rankings will be used to evaluate the absorption capacity of the case countries. The theoretical framework established that needed components of absorption capacity were a highly competitive environment, high educational level of labour force, good infrastructure and a liberal business environment.

One of the earlier indicators already determined competitiveness as well as infrastructure. Within the labour force indicator, we saw the levels of education in the case countries, and liberal business environment was a component of Freedom, as well as Ease of Doing Business. Those indicators have been compiled in the table below to give a realistic view of absorption capacity.

Table 20. Absorption Capacity

	Estonia	Hungary	Romania	Moldova
Competitiveness	1	2	3	4
Well-educated labour force	1	2	3	4
Liberal business environment	1	2	3	4
Infrastructure	2	1	3	4
Total Points	5	7	12	16
Rank	1	2	3	4

Source: Compiled by author based on own estimates

With five points out of sixteen Estonia clearly has the best conditions for absorption capacity, and thereby is most likely to enjoy the benefits of spillover effects such as technology and knowledge transfer. Closely behind is Hungary. Romania scores three in all categories and Moldova gathers sixteen out of sixteen points, having the least beneficial environment for spillover effects.

Table 21 shows the total accumulated points of the broad analysis of Investment Environment. The indicators used have mainly focused on locational advantages of the case countries. According to the OLI framework earlier introduced, this is the one factor that a host economy itself can influence to attract foreign investors. Which makes it an important focus for all countries wishing to attract FDI. The outcome is not surprisingly equal to that of the absorption capacity with Estonia clearly in the lead with only 14 points out of 32 and overall most locational advantages. Estonia's main weak points were those of size and a rigid labour marked. Of minor issues are infrastructure, the political risk of being geographically so close to Russia and a lack of labour force, which however is not reflected in the overall summery.

Table 21. Scoreboard of Investment Environment Points

	Estonia	Hungary	Romania	Moldova
Size	4	2	1	3
Stability and growth	1	2	3	4
Infrastructure	2	1	3	4
Ease of doing business	1	3	2	4
Competitiveness	1	2	3	4
Corruption	1	2	4	3
Labour market	3	3	3	1
Freedom	1	2	3	4

Total score	14	17	22	27
Ranking	1	2	3	4

Source: Compiled by author based on own estimates

Hungary comes second with seventeen points out of thirty-two. The strongest cards of Hungary are that of infrastructure, but also low corruption, freedom, and high competitiveness. Romania scores highest on size and ease of doing business, while growth and stability, together with labour market conditions, are pulling the large country down. Moldova was almost last in this in some aspect *unfair* comparison. High unemployment and low wages are sadly its strongest cards, with pretty much all other indicators lacking.

Looking at actual FDI inward stock Romania and Hungary have the largest accumulation (See Figure 3). To eliminate the effect of size of the country and to conclude whether this analysis reflects the current investment environment, FDI per capita will be compared to the scores of the analysis (See Figure 4 and 5).

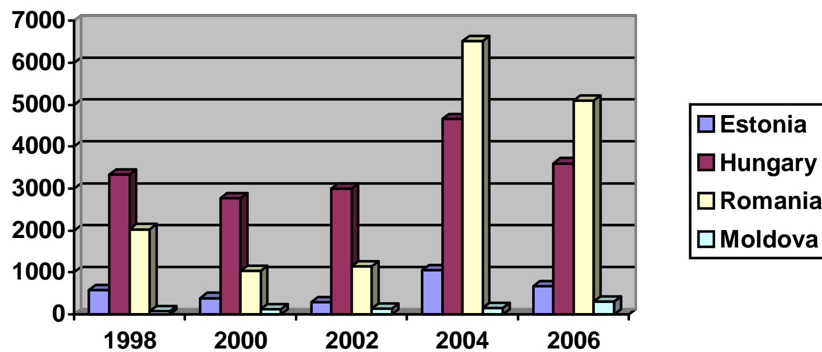

Figure 3. Inward FDI stock in million USD

Source: Compiled by author based on Freedom House, UNCTAD 2006

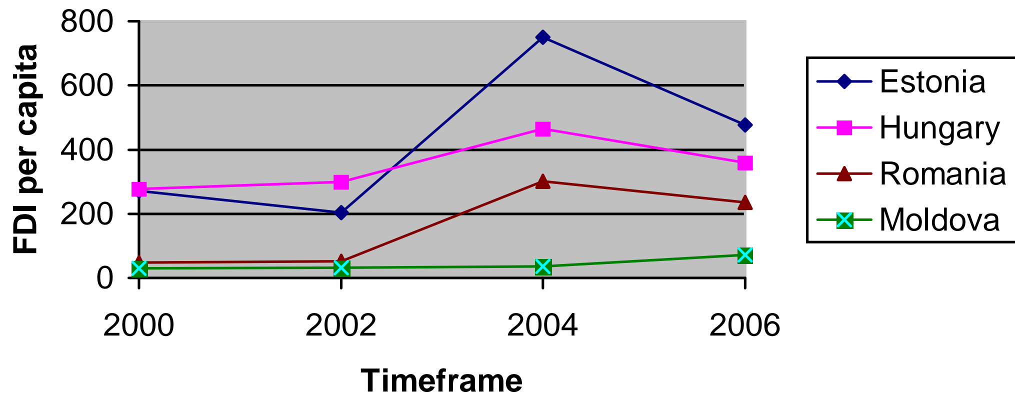

Figure 4. Dynamics of FDI

Source: Compiled by author based on Freedom House, UNCTAD 2006

Looking at the dynamics of FDI in Figure 4 it becomes obvious that some countries had a better starting point in the new millennium. Estonia and Hungary have the highest FDI per capita stocks and have both been successful in attracting FDI with an all-time high in 2004. They are clearly developing faster than the other two case countries, but their growth has been slowing down, while Romania, a late starter, has begun to pick up. Since 2000, Moldova has also had a raise in inflow, although the dynamics of FDI inflow into the country are somewhat slower. The much-needed capital boost might very well lead to a better outcome for Moldova in such an analysis in future years.

Figure 5 shows FDI per capita compared to the Investment Environment ranking and the ranking of the case countries in Absorption Capacity.

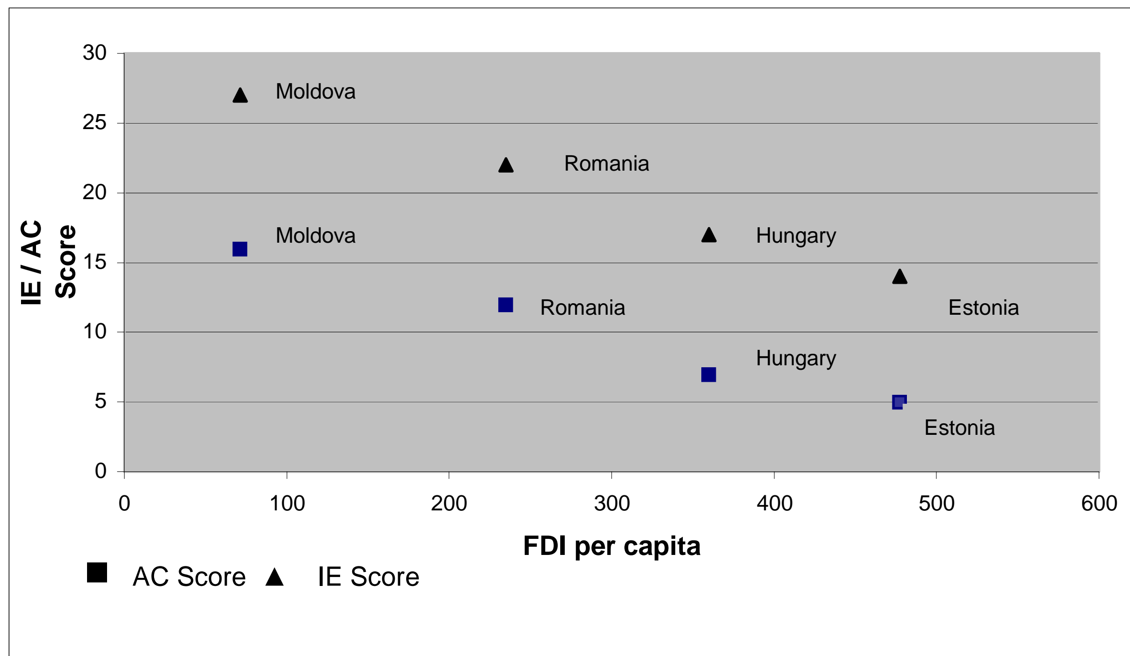

Figure 5. IE and AC Scores compared with FDI per capita

Source: Compiled by author based on own estimates

Table 5 show a clear distinction within the case countries. Estonia with the lowest score and the best ranking is clearly in the lead in FDI per capita, while Moldova, with the highest score and lowest ranking in both categories, has the lowest FDI per capita stock. Hungary, due to its larger size, has the largest FDI stock, but is second regarding FDI per capita. This can be taken as a clear indicator that good investment environment, as well as good absorption capacity, indeed is important when attracting FDI. The better the score of Investment Environment and Absorption Capacity the higher the FDI per capita

2.3. Comparative Analysis of Foreign Direct Investment Incentive Policies in Estonia, Hungary, Romania and Moldova

While not being the priority area in the first turbulent years after the collapse of the USSR, it took little less than a decade for the case countries to install a functioning

investment incentive system, beginning with the reducing of the strong trade barriers. The main catalyst for the changes being the sudden strong competition, as a huge number of countries emerging onto the world market at the same time all hungering for capital inflow. The systems in place are all unique in their build-up, although many similar tools are being used; for instance, all countries have used privatisation as a major tool, as well as established investment agencies and free trade zones along side a complicated net of tax incentives. Eligible for incentives in all case countries are foreign and domestic investors alike, although certain minor rule-based incentives in Hungary are targeted towards domestic companies only.

Hungary implemented one of the most generous incentive schemes, the generosity of which however has gradually been decreasing [Antaloczy and Sass 2001:13]. The incentive schemes have been marked by many changes, as the countries have learned from mistakes. As an example, Hungary offered tax holidays in the beginning exclusively to foreign companies, which lead to phantom joint ventures (with silent foreign partners). Strong preferential treatment of one side or another tends to inspire tricks to circumvent the laws and these rules have now been changed. In Hungary focus has been bigger on fiscal incentives than in Estonia, however many of those are currently being phased out [Antaloczy and Sass 2001:14/25-26]. The Estonian Tax Legislation has been under constant reform in the last 15 years. Most changes occurred in the early years of independence and the existing Law on Taxation came into effect in 1994, however it has since gone through several amendments. Romania launched its new tax policy in January this year. Although the continuous shifts in policies have made some foreign investors cautious, especially in the first years, there is no doubt that they have overall had the desired effect. Billions of USD in FDI flow into CEE countries each year.

Fiscal incentive policies [8]

[8] Please note in the following paragraph that Romania is making amendments in its tax policies. As of January 2007, most tax incentives offered ceased and new incentives were introduced through a special

Table 22. Fiscal Incentives

	Estonia	Hungary	Romania	Moldova
Investment minimum	No	No	USD 1 million	No
Corporate Income Tax	26%	16 %	16%	15%
Tax on dividends	26/74 of the amount of taxable payment	36 %		
Eligibility for incentives	Domestic and foreign investors	Domestically registered legal persons, or economic societies, co-operatives, entrepreneurs. In special cases only domestic firms	Domestic and foreign investors meeting certain criteria	Domestic and foreign investors
Minimum investment requirement	No	No	Depends on size and kind of company	No
Exemption from import duties/VAT on certain goods	Technology related VAT reductions. Custom duties and VAT are not applied to imported inputs that later are to be exported	Abolished in 1993, but custom duties and VAT are not applied to imported inputs that later are to be exported	Yes, in special cases.	Foreign companies in Moldova do not have to pay customs on goods imported with the intend of exporting
Corporate tax holidays	There are no corporate income tax holidays.	A wide variety of tax corporate tax holidays are offered depending on size of investment, region and amount of jobs created.	Yes, local councils can grant new incentives for investments exceeding EUR 500,000 including tax holidays	Yes, for large investments
Accelerated depreciation	No	2 - 6 % for buildings, 33 per cent for machinery (technical), 20 % for vehicles and 14 % for other machinery.	Yes, on instalments and equipment considered necessary for the investment	-
Special deductions from the tax base	There is no corporate income tax on retained earnings	A 20 % deduction from the tax base of the direct costs linked to R+D	Yes	Yes

Investment Law [PriceWaterHouseCoppers]. This paragraph deals with the old tax incentives, where not mentioned otherwise, as updates on the new initiatives have not been thoroughly available and also not yet been able to effect the FDI inflow.

		activities		
Possibility to carry forward losses	Yes	Yes	Yes	-

Source: Compiled by author based on Antaloczy and Sass 2001: annex, PriceWaterHouseCoopers, EIA, ARIS, NAAI and ITD

Estonia has no minimum investment requirements neither does Moldova. In Hungary, the previously required investment minimum of HUF 10 billion[9] was abolished [ITD]. In Romania eligible for incentives are companies, whose investments exceed USD 1 million [Larive Romania 2007].

There is no profit tax in Estonia, instead the corporate tax of 22/78 is effective if the profit will be distributed. In the beginning of the millennium, the new Estonian government also abolished the previously applied 26% tax on reinvested earnings. Nevertheless, distributed profits, for example dividends, are taxed at a 22% rate [EIA]. Estonia holds the reputation of one of the most liberal tax regimes in the world. Romania and Hungary's tax regimes might not be as equally liberal, but both boost a 16% corporate tax level [ITD and ARIS], which is one of the lowest in Europe. In Romania the tax on dividends is between 5 - 10 % for individuals subsequently to 16%, while tax on capital gains range between 1-10% and again subsequently to 16% [Larive Romania]. In Moldova the standard income corporate tax rate is 15%, and there are no local-content or export performance requirements applied [UNCTAD 2004].

Romania offers tax incentives based upon a division into three categories depending on the scale and objective of investments. Investments larger than EUR 75 million can be granted five years of incentives. Investments of a size ranging between EUR 25-75 million may receive incentives for four years, whereas the final category of EUR 25 million or less are eligible for incentives in 2,5 years. Investments have to meet certain criteria in order to benefit, such as focusing on R&D, social integration, development of HR, regional development or rehabilitation and protection of environment PriveWaterHouseCoopers]. Of other Romanian incentives can be mentioned exemptions and postponement of local taxes.

Corporate tax holidays were mostly abolished in Estonia with the latest tax reform, but they are still applied in great number in Hungary. The corporate income tax may be

[9] Hungarian forint.

reduced by up to 80 % under the title of investment tax benefit. However it has to meet certain criteria's of for instance size and also the investment must be self-financed by 25 percent of own resources and at least 30 % of the investment project must include new facilities or assets. Renovation cannot exceed 20 % of the investment costs [ITD]. Small enterprises who earn their money by providing services or realisation their own goods, are in a two-year-period entitled to 35% tax rate reduction in Moldova [UNCTAD 2004]. Enterprises that carry out production activities or render services to the populace, with up to 19 employees, and which earnings amount to MDL[10] 3 million per year, are exempted from payments of income tax [*Ibid*. 2004].

Estonia before becoming an EU member state had no import-export duties worth mentioning. After the 01.05.2004, Estonia took over the EU External Trade Policy regime and therefore the whole EU tariff system was implemented toward third countries. Foreign companies in Moldova do not have to pay customs on goods imported with the intend of exporting [*Ibid*. 2004]. Hungary abolished exemption on VAT and import duties in 1993, but offers VAT import in its free zones and industrial zones. In addition, custom duties and VAT are not applied to imported inputs that later are to be exported in neither Hungary nor Estonia. In Estonia the 18% compulsory VAT is found on almost all goods and services [EIA], however some technology related VAT (value added tax) reductions still apply [Antaloczy and Sass 2001:24-25]. Romania reformed its VAT and profit tax legislation in 2002, and offers exemption or reduction of VAT in special cases [PriceWaterHouseCoopers].

A 50% tax allowance running for a total of 5 years is offered in Hungary for investments in production facilities and hotels with an amount exceeding HUF 1 billion. This can be extended until 100%, if the investment is made in entrepreneurial or priority[11] zone or creates more than 100 jobs. For instance a 100% tax allowances for 10 years is offered to large investments exceeding 10 billion HUF, if they generate 500 jobs within two years [Antaloczy and Sass 2001:annex]. Small- and medium-sized

[10] Moldavian leu.

[11] Priority regions are northern Hungary, the northern and southern Great Plains, the central and southern Trans-Danubian planning/strategic region, the small regions of Celldömölk, Letenye, Őriszentpéter, Tét, Vasvár and Zalaszentgrót within the western Trans-Danubian [ITD].

(SME)[12] corporate tax payers in Hungary are subject to certain tax allowances such as a deduction of 40 % of the interest on an investment loan (including financial leasing) from the corporation tax payable EUR 24,000 per year [ITD]. In Romania, according to the new law of 2007, local councils can grant certain incentives for a period of up to three years in the case of investments completed and commissioned by 01.01.2007. Those incentives entail exemptions for land and building tax and a reduced tax rate of 0.25%, when computing the building tax for investments exceeding EUR 500,000. In Moldova a 50% profit tax exemption is provided for foreign investors, if their equity capital is larger than USD 250,000, and more than 50% of the income it generates is from sale of services or own goods [UNCTAD 2004].

Estonia has not implemented accelerated depreciation as an incentive, but both Romania and Hungary do. In Romania, accelerated depreciation is offered for installations and equipment necessary for the investment. In Hungary, the accelerated depreciation rate is 2-6% for buildings, 33 % for technical machinery, 20% for vehicles and 14 % for other machinery.

In Moldova, the tax liable income of companies can be deducted by 50% from the income tax, if the investments are made for the purchase or construction of fixed assets, as long as the cost of the assets is not larger than the amount of the taxed income [*Ibid*. 2004]. In Estonia tax concessions apply, and companies can deduct expenses from taxable income used on acquiring or upgrading fixed assets, if those companies are based in other regions than Tallinn and the neighbouring areas [Antaloczy and Sass 2001:24-25].

Hungary offers a 20% deduction from tax base in the case of direct costs linked to R&D activities [*Ibid*. 2001:annex]. Certain expenses are deductable in Romania such as expenses for training and development of the employees and management, R&D expenditure and environmental protection [PriceWaterHouseCoopers].

In Hungary, Estonia and Romania it is possible to carry forward losses, in Romania, this is possible for 5 years [Larive Romania 2007]. Furthermore, companies in Romania are exempt from paying land tax on land, on which buildings or other constructions are standing, if said buildings are used for agriculture [PriceWaterHouseCoopers].

[12] Small- and medium-sized are those who do not employ over 250 employees and do not have net sales revenues exceeding EUR 16 million Also the share of any 3rd party (including the state) most not be higher than 25% [ITD].

Financial incentive policies (monetary)

Table 23. Financial Incentives

	Estonia	Hungary	Moldova	Romania
Prioritised areas	Innovation and R&D	R&D on agriculture and environmental friendly initiatives	-	(Scientific and high-tech production)
Target development allocation	No	Yes, for rural and technological development	-	-
Preferential credit	No	Yes	Yes	-
Export guarantees	Yes	Yes	-	-
Job creation and training grants	Yes	Only domestic firms	-	-

Source: Compiled by author based on Antaloczy and Sass 2001: annex, PriceWaterHouseCoopers, EIA, ARIS, NAAI and ITD

In Estonia, the prioritised areas covered by financial incentives include innovation and R&D projects, while Hungary alongside R&D is focusing on agriculture and environmental friendly initiatives. Moldova is very focused on attracting FDI flows into scientific and high-tech production areas [UNCTAD 2002], but the actual financial incentives are scarce and even intensive research has not been able to distinguish specific financial incentives for Moldova. In Romania companies are eligible for preferential interest loans subsidised by the state up to 30%, state guaranteed loans and other subsidies [*Ibid.*]. In addition, Romania offers permanent financial assistance for SME development [Aris]. Estonia is also interested in supporting SMEs and supports SME job creation and training. These areas are also covered in Hungary, but only to the benefit of domestic firms [Antaloczy and Sass 2001:16]. Hungary also uses financial incentives such as preferential credit schemes and grants. Not all however are open to foreigners such as a special programme for providing below market rate credits for SME development. [*Ibid.* 2001:25-26]. In Estonia, there are no preferential credits given, [*Ibid.* 2001: annex]. In 2000 Hungary abolished targeted development allocation for economic development, however targeted development allocation for rural and technological development are open to foreign and domestic firms alike, so are the schemes for development of tourism, agricultural activities and environmental

protection as well as the labour market fund. In Estonia, companies in rural areas are offered interest and guarantee support [*Ibid.* 2001: annex]. Both the Estonian and Hungarian government offer export guarantees.

Rule-based incentive instruments

Table 24. Rule-based Incentives

	Estonia	Hungary	Romania	Moldova
Provision of low-priced real estate	No	(Yes, municipalities)	Yes	Yes, in special cases
Special institutional support	Yes, Estonian Investment Agency: www.investinestonia.com	Yes, Hungarian Investment and Trade Development Agency: www.itdh.com/engine.aspx	Yes, Romanian Agency for Foreign Investment: www.arisinvest.ro/	Yes, National Agency for Attracting Investments: www.naai.moldova.md/
Programmes to support small and medium sized enterprises	Yes, export promotion grants and free advisory services	Available only for Hungarian entrepreneurs (exception from national treatment)	Yes	-
Simplified export/import procedures	Yes, when operating in the free zone	Yes, when operating in the free zone	Yes, when operating in the free zone	Yes, when operating in the free zone
Free economic zones	Yes	The possibility exists, however no zones are currently registered.	Yes	Yes
Industrial parks	Under construction	Yes, with government support	Yes	Yes

Source: Compiled by author based on Antaloczy and Sass 2001: annex, PriceWaterHouseCoopers, EIA, ARIS, NAAI and ITD

While financial incentives have not been highly prioritised, the use of rule-based incentive instruments has become highly popular in transition countries. In the target countries, especially the establishment of free zones and investment agencies have been the first steps on the way, but also more often regional cooperation is taken into consideration. Regional cooperation has the positive effect that it can cerate larger market size and attract investors, who would otherwise not show interest for small countries. Intra-Baltic co-operation is a key word in Estonia, facing the fact that its market size is limited and that foreign investors often see the Baltic countries as one joined entity. While regional integration frameworks can cover policies from tariff

reduction to policy harmonization [UNCTAD 1998:28-29], it so far mostly centres on Internet informational pages and promotional materials [Antaloczy and Sass 2001:24-25]. All countries have signed a significant number of bilateral treaties.

In ways of using the actual FDI as a tool itself in terms of labour market or structural policy, Estonia and Hungary both offer favourable conditions for investors investing in rural areas or and high unemployment regions [*Ibid.* 2001:17].

Furthermore, in Hungary, local governments can also offer incentive schemes besides the ones already on offer from the government; these incentives include preferential real estate prices, exemption of local tax and free of charge elements of infrastructure. [Antaloczy and Sass 2001:25-26]

Special programmes to support SMEs are offered widely, for instance in Estonia via export promotion grants and free advisory services. On the other end of the scale there is no doubt that large projects enjoy a special status in most countries and can negotiate special incentives for themselves. This is not a phenomenon exclusively seen in transition economies and some countries, such as Estonia, have officially stated that it is not done [*Ibid.* 2001:14]. Underlining this preferential treatment is setting a minimum investment level, as is used in Hungary for receiving certain grants and allowances. In Romania according to the new law of 2007 local councils can grant new incentives for investments exceeding EUR 500,000. In addition, the Romanian incentive package include right to use state or local authority properties as domain and free access to utilities [PriceWaterHouseCoopers].

Investment agencies are established in all CEE countries, common for all is that they do not only offer information, but also offer to act as the binding link between investors and domestic companies, as well as acting as mediators between investors and government institutions. The Estonian investment agency, the EIA, was established in 1994 financed by the EU Phare Programme budget, and falls under the jurisdiction of the Estonian Trade and Investment Board. The Hungarian counterpart to the EIA the ITD Hungary (Investment and Trade Development Agency) was established in 1993. Although it is established by the Ministry of Foreign Affairs, local governments and chambers of commerce are also involved. The Investors Council established in 1997 by the Ministry of Economy at present hold 70% of the invested capital [Antaloczy and

Sass 2001:25-26]. In this year 2007 it will however be undergoing major restructuation from functioning under the Ministry of Economy in order to turn into a non-profit company as of July 1, 2007 [ITD]. The ministry will keep its majority share and the Hungarian Development Bank controlling up to 49% of shares. The tasks carried out will be the same, mostly investment promotion and company-related trade development tasks focusing on facilitating the operations of SMEs [*Ibid.*]. Moldova's Investment Agency is in short named NAAI and was established in 1997. The status of NAAI is defined as *a permanent state non-commercial coordination and expertise service* [NAAI]. In Romania, the investment agency is called ARIS and comes with little information of its origin. The main aim of the Investment Agencies is to help foreign actors locate domestic locations and business partners, and supply information of special help or interest to foreign investors, such as general and industry specific fact sheets about a country and its investment opportunities, help with legal matters regarding how to establish a company or apply for residence permit. Furthermore, some of the homepages, Estonia and Hungary's being the best developed, contain sector analysis, descriptions of labour market, foreign trade and tax legislation.

Establishing special zones is another well-known and used tool of FDI promotion all over the CEE region. Free zones may gain importance also in the future, as they have the advantage of reducing cost as well as risk for foreign investors. In Estonia, the Customs Law allows the establishment of these so-called free zones should the government so decree. There are in total four special zones, but only the Muuga port established in 1997 is currently in use. The three other zones are located in Sillamäe, Voru and Valga, all regions with high unemployment rates. In addition, the former restricted military base of Paldiski close to Tallinn has applied for a free zone status [Berghäll 1999:61]. The definition and rules applied to special zones vary. In Estonia, they are classified as customs territory with a duty free zone within. The benefits of the Estonian free zone are duty exemptions and other export-oriented incentives, also aimed at both foreign and domestic operators. Most of the activities in the zones are simple dealings such as packing, labelling or sorting goods. [Antaloczy and Sass 2001:24-25]. Muuga Port is an important transit hub, the other zones however resemble industrials zones more than free zones, as they also allow for assembly, production and other

industrial operations in an attempt to fight the high unemployment rates in their areas [Bergman 2000:85].

In Moldova free enterprise zone have been established with the intention of attracting FDI and Technology [UNCTAD 2004]. The first zone was established in Chisinau in 1996 and currently four more are being established in the North and South of the country. In those free zones the Moldavian government has applied a very favourable system of import-export, tax, currency, credit-financial, registration and customs. [NAAI]. In an attempt of attracting specialists and investments into the domain of production organization and management other free zones such as technical-scientific, transit, bank, insurance and development of export and import-substituting goods can be established [*Ibid.*]. Foreign investors will furthermore be exempted from customs duties for such imported goods (raw materials, half-finished products, etc.) that are used for the manufacturing of goods to be exported. Companies residing within the free zones, who have invested USD 250,000 or more into their production facilities are in a period of three yeas exempt from paying income tax. Larger investments such as USD 500,000 and above are exempt in five years and over USD 1 million are exempt from income tax for a period of ten years [*Ibid.*].

Hungary, prior to the EU accession, had a unique environment regarding free zones. Besides several industrial parks, which offered services, local tax advantages and good infrastructure, all companies were allowed to set up their own free zone into which they duty-free could import high value added equipment for own use, there were not even geographical restrictions. This was mainly an attraction for export oriented assembly companies that are attracted by skilled and cheap local labour [Antaloczy and Sass 2001:25-26]. The establishment of free zones was supported by the Ministry of Economy and attracted huge sums of Greenfield investments. It was calculated that before entering into the European Union 130 designated free zones were operating inside Hungary [Sheane 2006]. However, with the need to comply with EU regulation, all licenses were cancelled. Companies were offered the choice of transferring their assets to a non-designated status without VAT or Customs obligation or apply for a new permit, which would allow them to continue their activities in a modified environment. No companies applied for new permits, instead they choose to transfer their assets and operate under designated status [*Ibid.* 2006]. In Romania, there are currently six free

trade zones, four of which have access to waterways. They are located in Sulina, Constanta-Sud, Braila, Galati, Curtici-Arad and Giurgiu and vary in size from 7 ha to 150 ha. [*Ibid.* 2006]. In Romania's industrial parks, there are no property tax on buildings and no land tax on land [PriceWaterHouseCoopers]. When signing the agreement with the government investors gain rights to the use of buildings and land for up to 50 years. In addition, the companies are entitled to import raw material without paying customs. Companies within those zones represent a mixture of shipyards, storage, packaging, processing, handling materials, and trading [Sheane 2006].

Summery

As it is not possible to quantify the incentive schemes and evaluate them based on the model applied in the previous chapter, a qualitative evaluation will be implied instead.

Table 25. Incentive Ranking

	Estonia	Hungary	Romania	Moldova
Ranking	2	1	3	4

Source: Compiled by author based on own estimates

Looking at it from that approach Hungary would rank first, as the country makes use of, despite many changes, the most developed incentive system with a competitive tax base, accelerated deprivations, special deductions, tax holidays and the possibility to carry forward losses. It has for many years been the frontrunner in CEE in terms of FDI inflow. Lately the other countries have begun to catch up with Hungary and the growth has begun to slow. This would indicate that it would be time to focus efforts elsewhere also. A first step could be to employ the same grants and incentives to foreign and domestic actors alike. Even though only few instruments are offered exclusively to domestic firms, equal treatment might very well create a positive image and attract some extra investors. The next step would be to expand the financial and rule-based instruments as well.

On the second place would come Estonia with its very liberal and non-interventionalistic stance on FDI policy, despite recent changes brought on by EU membership. The country already has great success in attracting investors, despite the fact that the use of government incentive tools is far from as developed as the schemes

in Hungary. There are no accelerated depreciation, no major special deductions, no target development allocation and no preferential credit, but Estonia has none the less had great success in attracting FDI into the relatively small country. Already around 2003 Estonia caught up with and overtook Hungary in terms of FDI per capita. One of the reasons could very well be that Estonian policy makers have successfully understood to use other instruments than incentives. They have focused on the broad policy areas and on creating a stable and attractive macroeconomic environment, which in the long run might very well proof to have a better long-term effect than a narrow focus on fiscal incentives. While tax holidays as given in Hungary, Romania and Moldova may attract new investments, the no tax on reinvested earnings in Estonia keeps please investors already present and probably attracts new investors also.

Romania has had an impressive growth in inflow in the later years (See Figure 3) following upon restructurations, and it most be assumed that the newly implemented tax policies will continue to attract FDI into the country, which has enormous potential. This earns Romania the third place in ranking on the use of incentives. However, a shift towards also using more developed financial policy tools, as apposed to the very strong focus on fiscal incentives might very well prove profitable for Romania, and for Moldova as well, where the absence of any financial incentives seems striking. The use of financial incentives could for instance help the governments divert FDI to prioritised sectors and rural, undeveloped regions. Romania already has a competitive corporate tax level, exemptions in special cases on import duties, as well as accelerated depreciation and special deductions from the tax base. Also free economic zones, industrial parks and an investment agency are in place, but still further expansions of the incentive area would be advisable.

Moldova has the lowest corporate income tax and many generous tax incentives, as well as industrial parks and investment agencies. Moldova’s main problem in attracting FDI does not necessarily lie within its incentive policies, but is more likely to be found in the general lack of stability and macroeconomic issues of the country. It is a good example of how incentive policies only are effective if the investment climate is also stable and attracting. This is underlined by the previously introduced Economic Freedom Ranking index, which stressed Moldova’s non-tariff barriers, restrictive customs and tough regulations as affecting its freedom. Monetary and investment freedoms are poor and

corruption high cobbled with weak institutions. Moldova is also a small country, however as the case of Estonia shows, this does need to be a hindrance as such. Accelerated write-offs as applied in Hungary and Romania could be a good choice for Moldova, as it reduces the expenses for investors, while encourages them to invest in new equipment, machinery and buildings.

All case countries, except Hungary in a few cases, offer the same incentive packages to domestic and foreign firm, this is a very positive decision, as many other countries have not yet applied this logic to their policymaking. In the future, this might very well help distinguish all them positively.

3. FUTURE PERSPECTIVES OF FDI POLICIES

In research literature there used to be the agreement that when searching for a location in which to invest, economic fundamentals in the host country such as good infrastructure, market size, macroeconomic and political stability, level of income, trade policies and eventual natural resources were the vital indicators [Blomström and Kokko 2003:4]. Market size is no longer alpha and omega, as shipment of goods become easier and cheaper and local customers are no longer so vital, as they once were. Small markets with favourable climates are now just as attractive as large markets [Narula and Portelli 2004]. Estonia is a brilliant example of this. What is important is understanding the advantage points of a country and designing the right policy portfolio. When Dunning expanded his eclectic framework, he added the IDP path to show that different host country advantages are present on different development levels. Looking at the analysis outcome and this theory Hungary and Estonia can be found on stage three, where there is a gradual decrease of FDI and increase of outflow of investments. The domestic wages are growing and labour intensive production will diminish. Competition between domestic and foreign firms will start. Romania and Moldova can be found one step lower, on step two, with FDI inflow starting to increase, but still with a very low outflow, if any. Main target for foreign investors are still industries based on raw material and oriented to export. Cheap labour will be used heavily to market products for the investor home market. These are important points to keep in mind, when designing future frameworks for policy incentives.

Liberal policy frameworks are no longer the magic recipe for attracting FDI, now the frameworks included into FDI policies needs to expand and begin focusing on incorporating other policy areas into the existing portfolio. In the beginning of the 1990s opening up to foreign investments might have seem hazardous and demanded a big change both mentally and policy-wise, but now, not even two decades later, few will argue that it was not a beneficial and wise decisions. Now when the countries of the CEE have gotten over the initial scepticism towards foreign firms and FDI and have in most cases established a working incentive system and a sound investment

environment, they need to start focusing on the new changes and challenges coming their way, if they wish to keep the inflow of FDI heading their way. Hungary is a country, which in the past has received substantial inflow, but is now in need of expanding its framework and focusing elsewhere to be sure to continue to receive large amounts of FDI. However local environment and absorption capacity continue to be essential. Therefore, a competitive local business climate and local learning capability are as important, as they were ten years ago. A welcoming and stable macroeconomic environment will never become obsolete. A country like Moldova, which has a working incentive system, but a unstable environment, is an example of what happens if the first basic steps on the way to attracting investments are ignored.

The incentive package itself needs to apply equal terms for all investors. The case countries in question here have all applied that to a large extend, which is very positive. In addition, the incentive package should be devised to promote linkages and R&D activities [UNCTAD 2001]. Domestic companies should not be forgotten, they need subsidizing in order to maintain the competitive climate and strengthen their internal absorption capacity, so that they can benefit from technology transfer and knowledge potentials [Blomström and Kokko 2003:19]. Incentives should furthermore promote the education and training of locals. Investments need to go into HR, improving infrastructures, education, developing the financial sector and creating proactive institutions. In addition countries need to also broaden their scope; liberal policies and freedoms are still keywords in keeping the flow, but now free repatriation of profits and free transactions are also important [Varblane 2000], as are focus on long-term economic development strategy and co-ordination between policy areas [Sass 2003:21].

The natural next steps for the case countries would be a move away from the heavy focus on fiscal policies. As has already been stressed, it is natural that developing and transitional economies focus heavily on these areas, however more developed economies shift focus towards financial incentives and other policies. One of the most beneficial moves for al involved parties would be to stop regarding investment incentives as a policy regarding foreign investors, and towards considering it part of economic policies in general, as a natural part of a countries overall industrial policy [Blomström and Kokko 2003:19-21]. Industrial policies are important for the effects and inflows of FDI already, so integrating it would only seem a logical step.

Policymakers will also in the future need to focus their attention on new sources of FDI. Forecasts shows that FDI will start to develop onto the service sector, and policymakers will need to be ready to maximize the potential of this development [UNCTAD 2006:36]. If Moldova is able to shift its focus to the new sectors, it might be able to benefit from this development.

Another step that is already in the making is a theme, previously only shortly touched upon in this thesis: multilateral policy coordination. Estonia is already evolved in this on many levels via Baltic cooperation and on a higher level Hungary and Romania and Estonia are together in the EU. Cooperation on multiple levels might very well be the way forward to setting the "rules of the game". An overall policy approach would also help eliminate any damaging regional incentive competition [Sass 2003:23].

Nevertheless, as regional cooperation becomes more common and broader, the individual countries will simultaneously need to step up their game and distinguish themselves both in order to attract investments, but also to deal with challenges that come with the new time and new development, such as cross-boarder migration. As mentioned previously 30% of the Moldavian work force is estimated to have left the country [National Bureau of Statistics of the Republic of Moldova]. Human capital is increasingly becoming a commodity, as geographical mobility becomes easier. High skilled workers are on demand in almost all countries, and they will increasingly be willing to leave their home countries to seek opportunities abroad. Countries investing in education can no longer rely on the fact that their investments will pay of, as their students may very well leave the country after graduation [Birkenshaw 2005:18]. It becomes a new challenge for host government's policymakers to not only invest in education, but also invest in and develop ways to attract human capital from abroad, either via foreign students attending their educational facilities, or by making their countries interesting places to work for employees from other nations. Brain gain versus brain drain has already been buzz words for a decade and the competition will only increase, especially in CEE where low wages will tempt the highly skilled to go west. In Bulgaria 65 % graduates left the country for jobs abroad just during the last decade [*Ibid.* 2005:19]. The high levels of salary in its neighbouring Scandinavian countries will increasingly pressure the wages in Estonia, and while Moldova's wages, the lowest in Europe, might be a strong card in attracting investors, it is a week card in terms of

keeping the labour force at home. The picture in Estonia is quite different if estimates are correct that 3,000-4,000 will immigrate a year, however as it is estimated that most of them are temporarily leavers, the Estonian brain drain might very well be beneficial as in morphs into brain circulation [Chandler et al. 2003:33]. Namely, scholars are beginning to talk about *brain circulating* instead of brain drain, meaning when the skilled individuals move around between countries and may eventually return home, or at least create linkages and network back to the home countries, if so prompted [Birkenshaw 2005:20]. All case countries could benefit highly from this. As human capital becomes a sparse commodity they most work hard to attract new individuals to enter the country on all levels, overcoming stereotypes abroad, making entry legislations more flexible and less bureaucratic and not the last overcome their fears of foreigners entering into high ranking jobs [*Ibid.* 2005:18]. This will require new policy approaches and working to branding the country positively abroad.

An important tool in this branding process is the Investment Promotion Agencies. All case countries presented have already set up such an office, which offers information about the country, help in legal matters and links to governments and domestic firms, however in the future their tasks could devolve significantly. According to Spee [2005], due to the use of the Internet, the communication of host country information will no longer be their main task, however he suggest many other ways in which the offices could become important tools later on in the process.

They will need to tailor value propositions focusing on unique and limited markers of the region. What are the strengths and unique environment of the country? Is there a business clientele to which their region would be especially lucrative? Moreover, not only should they tailor these propositions and offer them to interested clients, they should become more pro-active in their work targeting potential investors, so that they not only welcome new investors but also attract them. Keeping the contact with investors and being helpful even after the set-up of their businesses is also a valuable asset. Service most be value-added and staff experienced and professional, changes in the environment most be monitored. Links to governments, domestic firms and NGOs will continue to be important advantages and links should be expanded and evolved. Investment promotion will turn into a business in itself. In addition, as the agencies become more proactive, they will increase their knowledge of the region and of the

potential investors, and in this, they would be able to move from simply relaying policy decisions to investors to actively participate in policy shaping. Who better to know, what would be beneficial [Spee 2005:119]?

On a final note, countries should not forget about outward investments. Estonia and Hungary are already having a rather large outflow of FDI, but this is also crucial in the future. When it comes to outward stock, Estonia is also a special and interesting case. Together with Hungary, it is the CEE country with the largest outflow of FDI in relation to country size. Due to a conservative fiscal policy, Estonia has one of the lowest budget deficits in the CEE [Varblane et al. 2003]. Moreover, government policy makers could possible learn from other emerging economies such as China in that respect. The Chinese government has prompted and helped domestic firms acquire foreign companies in an attempt to gain management expertise as well as overtaking the brand recognition of the foreign company and enter foreign markets that way or simply establishing a strong brand presence in general [Zedtwitz 2005:62]. Acquisitions as apposed to Greenfield investments also offer an ”easy” shortcut to service channels and distribution networks. The Chinese government has in this case made policies in order to support internationalisation, has set-up an online information platform and has helped a large number of companies expand and go abroad. In addition, large investments into education in for instance languages have been made [*Ibid.* 2005:64-65].

As the increase of government subsidies continues, and the areas covered in the FDI framework keep expanding, there is the risk that despite spillover benefits the companies investing are the net beneficiaries [Sass 2003:7]. However, it is the host countries role to create its policy so that it can maximize profits and make sure that both the host country and the foreign investor are winners. When creating incentives it is also vital to be aware that the higher the lacks of transparency in policies are the higher the risk for rent seeking and corruption. When designing government policies transparency is the key [Blomström and Kokko 2003:17].

There is no doubt that FDI will keep evolving and probably during the next years present very different challenges to host policy makers; New players will emerge and new sectors be targeted; new laws and methods will be needed to cope with this as well as a quicker response time to changes in the environment. Moreover, the host

governments themselves will need to become involved in a completely new way. In order to succeed in the continuously more global world new opportunities most be grasped as they arise. Changes in the environment most be closely monitored. Flexibility and adjustment are called for. Threats most be eliminated as they arise, and new policies most be implemented effectively responding to market needs and demands. The CEE countries have earlier shown their willingness and capability to adapt and quickly reform, this is a strength that should be nurtured also in the future.

CONCLUSION

Host country governments have invested much time and consideration into designing complicated, liberal policy networks in order to attract FDI and the benefits that come with it such as capital, knowledge, technology, competition and a raise of exports and employment. Now however empirical research has shown that in the growing competition, creative and liberal investment incentives are no longer enough to attract FDI inflow. In addition, it is no longer enough to focus on, or posses, a few locational advantages. A country most be able to present a wide and possibly unique policy portfolio with a combination of incentive schemes, valuable host country determinants and a good, stable investment environment. It is important for government policy makers to continue elaborating and adjusting the framework with various layers of policies in order to continue to benefit from the inflow, to strengthen educational levels and infrastructure. It is up to the host governments to deliver the right conditions in order to attract FDI, while maximising benefits and minimising negative effects of the inflow. The governments themselves are vital players with regard to creating the right environment for absorption capacity and creating opportunities for the important inter-linkages. At the same time they most also adjust to policy frameworks from above as results of regional cooperation, bi-, and multilateral agreements.

The objective of this thesis was to analyse investment environment and the incentive schemes in the four transition countries Estonia, Hungary, Romania and Moldova. The outcome of the broad analysis of investment environment was very clear. Estonia possesses the best investment environment in terms of stability, ease of doing business, a highly competitive market, low corruption and freedom. Only in labour market terms, size and with regard to infrastructure was the leading position not in hand. Hungary on the other hand scored highest on infrastructure, although also doing remarkably well in most other categories with the exception of labour market and ease of doing business. Regarding labour market conditions, Moldova had its one victory, otherwise it had to be content with facing less corruption perception than its large neighbour Romania and being slightly bigger in relation to population and area than Estonia. Size was

Romania's largest locational advantage, alongside amazing ease of starting a business, while corruption was Romania's biggest challenge.

The analysis of incentive schemes suggests that the theory regarding the use of fiscal policies as the ultimate focus area in transitional countries is very much reflected in the case countries. All four case countries have a functioning incentive system in place. Hungary has a remarkably well developed and generous incentive scheme, while Estonia seems to have understood the vital importance of a more broad policy approach. Both countries are front-runners in attracting FDI, but both need to keep adjusting and expanding their policy areas, if this is to continue. Hungary could beneficially choose to eliminate the last differences in incentives offered to domestic and foreign investors. This would in turn eliminate bureaucracy and help create transparency in the intricate web of incentives. Romania and Moldova are still somewhat behind Hungary and Estonia in terms of FDI per capita, although Romania has shown an impressive growth rate. It would be beneficial for Romania and Moldova to focus on financial incentives as a supplement to the fiscal ones already in place. All countries have shown a will to reform their systems, which is a positive feature. Estonia deserves praise for its transparent and liberal system. Furthermore, the country has managed to embrace the idea of regional cooperation, while maintaining its own unique policy portfolio.

Moldova receives the smallest amount of FDI inflow, also compared to other European countries. Since 2000, the inflow has however begun to pick-up and one most hope that continuous improvements to the policy system will continue to create larger amounts of inflow. A well-developed fiscal incentive is in place with competitive corporate income tax and other generous tax incentives, but the use of financial incentives as well could help development in undeveloped regions. For Moldova, the main challenge in the future will be eliminating macroeconomic imbalances and creating a stable investment environment politically and economically. Focus should be on core policies as well as the macroeconomic environment. Investments into the basic infrastructure will need to be improved and after that, focus on the incentive portfolio can be made. Incentives only seem to be justified if the potential of them can be fully used, this demands that the foreign affiliates attracted are different than the local firms, and that they have some assets which can spill over to the host nation, which than in turn needs to be on a certain level in order to absorb the spillover. An interesting step for Moldova would be trying

to attract inflow into the emerging *new* FDI sectors such as service, but it needs to overcome the other challenges and stop the threatening labour market migration first.

Romania has just recently reformed its tax policy showing that it has learned and been ready to reform. This kind of flexibility and adjustment is important in today's environment, the faster countries can learn from their mistakes and adjust to demands in the environment, the more they will benefit in the long run, which also the later years impressive growth in Romania has shown.

Even for countries doing well in the game of FDI, as Estonia and Hungary, adjustments are necessary to stay in the race. FDI policies have expanded; the policy areas that are connected with FDI will unquestingly continue to do so in order to meet new standards and new competition. It is important also to support domestic firms by investing into learning, so that they can benefit from potential spillovers and the competitive environment. The expansion of tools and policies has only just begun. In a more internationalised world, where decisions are being made faster, there is also the risk that companies are less stabile, less bound to location, therefore governments face the risk that companies, as well as labour force, move on to more favourable climates faster than before, possible before they have had any real positive effect on the host nation. It continues to be the main task of the host country policy makers to design the right policy decisions that will also be beneficial and competitive in the long run.

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Resume

Inflowet af udenlandske investeringer på verdensplan er mere en tredoblet indenfor de seneste to årtier. Mens man i Vesten kæmper for at beholde produktionsvirksomhederne på hjemmebane, har man i Central- og Østeuropa siden Sovjetunionens sammenbrud, og dermed kollapset af det planøkonomiske system, kæmpet hårdt for at tiltrække flest mulige udenlandske investeringer til de tidligere så lukkede økonomier. Håbet er at de udenlandske investeringer vil kunne kickstarte den økonomiske vækst ved at tilføje kapital og arbejdspladser, samt højne velfærd og konkurrenceevne.

> "Forskellen på at føre den rigtige og den forkerte regeringspolitik har aldrig været større"
> [Summers 1995].

I kampen om at tiltrække udenlandske investeringer er investeringsklimaet og det komplicerede net af politiske tiltag, der udgør investeringsfremmearbejdet, af den højeste betydning. Dette speciale fokuserer på investeringsklimaet og de motivationsfremmende politikker anvendt i fire særligt udvalgte lande i Central- og Østeuropa (Estland, Ungarn, Rumænien og Moldova) i et forsøg på at analysere og evaluere den anvendte praksis, samt komme med forslag til forbedringer og fremtidig udvikling i Central- og Østeuropa.