Foreign Direct Investment, Corruption, and European Union Membership in Central and Eastern Europe

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FOREIGN DIRECT INVESTMENT, CORRUPTION, AND EUROPEAN UNION MEMBERSHIP IN CENTRAL AND EASTERN EUROPE

By

Eloisa Vladescu

A DISSERTATION

Submitted to the Faculty of the University of Miami in partial fulfillment of the requirements for the degree of Doctor of Philosophy

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UNIVERSITY OF MIAMI

A dissertation submitted in partial fulfillment of
the requirements for the degree of
Doctor of Philosophy

FOREIGN DIRECT INVESTMENT, CORRUPTION, AND EUROPEAN UNION
MEMBERSHIP IN CENTRAL AND EASTERN EUROPE

Eloisa Vladescu

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The Central and Eastern European (CEE) region underwent a series of substantial political and economic transformations in the 1990s and 2000s, from the transition to democratic rule to the establishment of a free market economy. While foreign investors recognized the region’s market potential, opportunities for corruption also arose in the post-communist era. Corruption became an issue of particular concern as many of the countries in the region applied to join the European Union (EU). By the late 1990s and throughout the 2000s, however, the countries in the CEE region had also experienced unprecedented inflows of foreign direct investment (FDI) and economic growth. This study examines the impact of corruption and EU membership on inward FDI in ten cases in the CEE region, and Romania more specifically, from 1998 to 2008. A mixed methods research design provides supporting quantitative and qualitative evidence for the hypotheses that corruption is not a significant determinant of inward FDI and that the reputational effects of EU membership contribute to investor confidence. The scope of this study is timely and relevant for academics and policy makers as the CEE states continue to fight corruption, while the findings contribute a framework for the analysis of significant determinants of FDI in periods of transition.
ACKNOWLEDGEMENTS

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I would also like to express my gratitude to my parents, Luiza and Paul, for the sacrifices and efforts they have made to provide me with opportunities of which I might otherwise only have dreamed. They have made it possible for me to achieve my goals and have been cheering me on with love along the way.

Finally, I dedicate my doctoral dissertation to my grandfather, Alecsandru Necula. At the age of 91, he inspires me to continue learning, face challenges with resolve, and excel in anything I set out to do.

While there are many others whose support I would like to recognize, the list is simply too long to include here. To everyone that has been a part of my doctoral journey: thank you, multumesc, merci, gracias, obrigada, and danke.
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<tr>
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<tr>
<td>AVAS</td>
<td>Romanian Authority for State Assets Recovery</td>
</tr>
<tr>
<td>BCR</td>
<td>Banca Romana Comerciala (Romanian Commercial Bank)</td>
</tr>
<tr>
<td>BEEPS</td>
<td>Business Environment and Enterprise Performance Survey</td>
</tr>
<tr>
<td>BIC</td>
<td>Bayesian Information Criterion</td>
</tr>
<tr>
<td>CEE</td>
<td>Central and Eastern Europe</td>
</tr>
<tr>
<td>CI</td>
<td>Consumers International</td>
</tr>
<tr>
<td>CMEA/COMECON</td>
<td>Council for Mutual Economic Assistance</td>
</tr>
<tr>
<td>CPI</td>
<td>Corruption Perceptions Index</td>
</tr>
<tr>
<td>CTR</td>
<td>Corporate tax rate</td>
</tr>
<tr>
<td>CTRCORR</td>
<td>Control of Corruption Index</td>
</tr>
<tr>
<td>DG</td>
<td>Directorate General</td>
</tr>
<tr>
<td>DNA</td>
<td>Romanian Anti-Corruption Directorate</td>
</tr>
<tr>
<td>EBRD</td>
<td>European Bank for Reconstruction and Development</td>
</tr>
<tr>
<td>ECAN</td>
<td>Economic Crime Agency Network</td>
</tr>
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<td>ECSC</td>
<td>European Coal and Steel Community</td>
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<tr>
<td>EFTA</td>
<td>European Free Trade Association</td>
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<tr>
<td>EU</td>
<td>European Union</td>
</tr>
<tr>
<td>EUMAP</td>
<td>European Union Monitoring and Advocacy Program</td>
</tr>
<tr>
<td>EUMEM</td>
<td>European Union membership</td>
</tr>
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<td>FCPA</td>
<td>Foreign Corrupt Practices Act</td>
</tr>
<tr>
<td>FDI</td>
<td>Foreign Direct Investment</td>
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<td>FE</td>
<td>Fixed Effects</td>
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<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
</tr>
<tr>
<td>GDGPLOW</td>
<td>Annual GDP growth</td>
</tr>
<tr>
<td>GOVEFF</td>
<td>Government Effectiveness Index</td>
</tr>
<tr>
<td>GRECO</td>
<td>Group of States Against Corruption</td>
</tr>
<tr>
<td>GSP</td>
<td>Generalized System of Preferences</td>
</tr>
<tr>
<td>IBA</td>
<td>Invest Bulgaria Agency</td>
</tr>
<tr>
<td>ICRG</td>
<td>International Country Risk Guide</td>
</tr>
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<td>ICSID</td>
<td>International Center for Settlement of Investment Disputes</td>
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<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
</tr>
<tr>
<td>IPE</td>
<td>International Political Economy</td>
</tr>
<tr>
<td>IPO</td>
<td>Initial public offering</td>
</tr>
<tr>
<td>JAPTI</td>
<td>Slovenian Agency for Entrepreneurship &amp; Investment</td>
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<tr>
<td>LABOR</td>
<td>Labor costs as monthly minimum wages</td>
</tr>
<tr>
<td>LDC</td>
<td>Less Developed Country</td>
</tr>
<tr>
<td>LN</td>
<td>Natural logarithm</td>
</tr>
<tr>
<td>LN(GDPCAP)</td>
<td>Natural logarithm of GDP per capita</td>
</tr>
<tr>
<td>LN(POP)</td>
<td>Natural logarithm of population</td>
</tr>
<tr>
<td>MEBO</td>
<td>Management and employee buyout</td>
</tr>
<tr>
<td>MFN</td>
<td>Most Favored Nation</td>
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<tr>
<td>MNC</td>
<td>Multinational Corporation</td>
</tr>
<tr>
<td>MNE</td>
<td>Multinational Enterprise</td>
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<tr>
<td>Abbreviation</td>
<td>Full Form</td>
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<tr>
<td>NATO</td>
<td>North Atlantic Treaty Organization</td>
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<tr>
<td>NATRES</td>
<td>Natural resources rents</td>
</tr>
<tr>
<td>NGO</td>
<td>Nongovernmental Organization</td>
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<tr>
<td>OAS</td>
<td>Organization of American States</td>
</tr>
<tr>
<td>OECD</td>
<td>Organization for Economic Cooperation and Development</td>
</tr>
<tr>
<td>OLAF</td>
<td>Office de Lutte Anti-Fraude</td>
</tr>
<tr>
<td>OLI</td>
<td>Ownership-Location-Internalization Framework</td>
</tr>
<tr>
<td>OLS</td>
<td>Ordinary Least Squares</td>
</tr>
<tr>
<td>OMV</td>
<td>Österreichische Mineralölverwaltung</td>
</tr>
<tr>
<td>OSI</td>
<td>Open Society Institute</td>
</tr>
<tr>
<td>PAI</td>
<td>Polish Information and Foreign Investment Agency</td>
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<tr>
<td>PAIZ</td>
<td>Polish State Foreign Investment Agency</td>
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<tr>
<td>PHARE</td>
<td>Poland &amp; Hungary: Assistance for Restructuring Economies</td>
</tr>
<tr>
<td>PNL</td>
<td>Romanian National Liberal Party</td>
</tr>
<tr>
<td>POLSTB</td>
<td>Political Stability Index</td>
</tr>
<tr>
<td>PPP</td>
<td>Purchasing power parity</td>
</tr>
<tr>
<td>PPPEX</td>
<td>Purchasing power parity conversion factor</td>
</tr>
<tr>
<td>PRIREV</td>
<td>Privatization revenues as a percent of GDP</td>
</tr>
<tr>
<td>PROPRD</td>
<td>Property Rights Index</td>
</tr>
<tr>
<td>PSD</td>
<td>Romanian Social Democratic Party</td>
</tr>
<tr>
<td>REGQUAL</td>
<td>Regulatory Quality Index</td>
</tr>
<tr>
<td>RFTC</td>
<td>Romanian Foreign Trade Center</td>
</tr>
<tr>
<td>RULAW</td>
<td>Rule of Law Index</td>
</tr>
<tr>
<td>SEC</td>
<td>U.S. Securities and Exchange Commission</td>
</tr>
<tr>
<td>SOE</td>
<td>State-owned enterprise</td>
</tr>
<tr>
<td>SPSS</td>
<td>IBM Statistical Package for the Social Sciences</td>
</tr>
<tr>
<td>TI</td>
<td>Transparency International</td>
</tr>
<tr>
<td>TICPI</td>
<td>Transparency International Corruption Perceptions Index</td>
</tr>
<tr>
<td>TRG</td>
<td>The Rompetrol Group</td>
</tr>
<tr>
<td>UK</td>
<td>United Kingdom</td>
</tr>
<tr>
<td>UN</td>
<td>United Nations</td>
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<tr>
<td>UNCTAD</td>
<td>United Nations Conference on Trade and Development</td>
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<tr>
<td>UNDP</td>
<td>United Nations Development Program</td>
</tr>
<tr>
<td>US</td>
<td>United States</td>
</tr>
<tr>
<td>VAT</td>
<td>Value added tax</td>
</tr>
<tr>
<td>VIF</td>
<td>Variance Inflation Factor</td>
</tr>
<tr>
<td>VOCIAC</td>
<td>Voice and Accountability Index</td>
</tr>
<tr>
<td>WCO</td>
<td>World Customs Organization</td>
</tr>
<tr>
<td>WCR</td>
<td>World Competitiveness Report</td>
</tr>
<tr>
<td>WDI</td>
<td>World Development Indicators</td>
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<tr>
<td>WTO</td>
<td>World Trade Organization</td>
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Chapter 1: The Paradox of Corruption and Investment

In recent years, the European Union (EU) has undertaken a series of enlargements in an effort to allow the post-communist countries of Central and Eastern Europe (CEE) to reestablish close political, economic and social ties with the West. These enlargements, however, have also brought significant attention to the issue of corruption. On the one hand, several justice experts have expressed their concern that the newly admitted member states have not adequately enforced laws to reduce or eliminate corruption and have subsequently experienced a backslide in the fight against corruption since their admittance to the EU. In fact, the term “enlargement fatigue” has been coined to describe the challenges and shortcomings of the EU’s expansion. On the other hand, the CEE countries experienced unprecedented levels of economic growth and foreign direct investment (FDI) inflows in the late 1990s and throughout the 2000s, a promising sign that they are catching up to the West. While observations about the performance of the CEE countries are often contradictory, much of the International Political Economy (IPE) and economics literature has suggested that corruption hinders FDI inflows. There are many factors, however, that foreign investors take into consideration when deciding where to establish businesses in the long-term, from market size to labor costs. Are corruption and EU membership, therefore, among the significant determinants of FDI inflows?

In an effort to answer such a complex question, this research project explores the relationship between FDI inflows, levels of corruption, and other
determinants of foreign investment in ten of the EU’s recently admitted CEE member states, looking more specifically at the case of Romania. Corruption is defined here as the misuse of public funds or public office for private gains. FDI refers to the investment of foreign assets into domestic businesses, structures, equipment and organizations, often contributing to the establishment of longer-term equity within a country. Given the economic growth in this region in the late 1990s and 2000s and the relatively high levels of corruption in many of these countries, the answer to such a question attempts to bridge a noteworthy gap in the literature. This gap stems from the challenge of empirically assessing the relationship between the effects of corruption, among other independent variables, and EU membership on FDI inflows.

Considering the impact that inward FDI has had on helping CEE countries to develop economically and the significance of corruption as a political, economic and judicial issue, the research outlined in this study is both timely and relevant to transnational economic linkages as well as to the core issues of the EU and its newly admitted CEE member states. The contribution to the literature centers on an analytical framework through with which to examine the impact of corruption on FDI inflows in light of the CEE countries’ entry into the most extensively integrated regional organization.

The contention put forth in this research project is that corruption is not a significant determinant of FDI inflows in the CEE countries that have recently become EU member states. This claim challenges some of the theories put forth in the IPE and economics literature and attempts to examine the impact of
corruption and EU membership among other determinants of FDI. In the late 1990s and throughout the 2000s, levels of corruption fluctuated only slightly in comparison with previous years. During this same period, however, foreign investment became an engine for unparalleled economic development in the CEE region. Consequently, this study also argues that EU membership is a significant determinant of FDI. Foreign investment in the CEE countries increased considerably during both the candidacy and accession periods, evidence of the reputational effects of EU membership. The implementation of political and economic reforms and adherence to a strict legal code served to boost investor confidence and act as a guarantor of investor stability, allowing even the most corrupt of the CEE states to attract unprecedented levels of FDI.

A Historical Transition

In order to investigate the claims made in this study, it is essential to provide a fundamental understanding of the historical experiences shared by the CEE countries. The political, economic, and social parallels among the states in this region can explain many of their challenges, particularly in terms of the struggle with corruption, as well as their potential for development and patterns of foreign investment. This is particularly true of the CEE countries that were under the control of communist regimes for many decades after World War II and were then sent into a whirlwind of transition, democratization and privatization in the 1990s.
After World War II, communist regimes were established across Central and Eastern Europe as a result of Soviet imposition. Although each government was unique and national leaders often determined the particular course their administration would take, the socialist agenda called for central planning of the economy, nationalization of all major industries, collectivization of agriculture, universal state employment, elimination of private property, and the imposition of one party rule with Russian military force available to prop the state up if necessary. “While from the perspective of capitalism the design of the socialist economy may seem irrational, such an assumption misunderstands its purposes. In fact, planning and control were put in place to achieve rationality and undo inefficiencies associated with market fluctuations,” (Bandelj 2008, 32). In theory, communist governments and socialist economic structures were supposed to eliminate inequalities, provoke a class struggle, and attain the Marxist communist utopia of rule by the working class. In practice, however, such a utopia would prove impossible to achieve in the CEE countries after many decades of fruitless attempts.

In capitalist economies, companies and industries tend to operate under hard budget constraints while minimizing inefficiencies and losses, expanding target markets, and maximizing profits. In communist countries, however, “the challenge in the socialist economy was supply. Because of shortages, it was customers who had to be innovative, relying on interpersonal networks to get what they needed. A second economy—the production, consumption, distribution, and exchange of goods outside state regulation—developed,
contributing to the consolidation of two distinct spheres, the official and the unofficial,” (Bandelj 2008, 33). The unofficial sector, often referred to as the Black Market, opened doors to corrupt practices and illegal exchanges that became commonplace in communist countries. Corruption, graft, blat, and bribery are words that have been used interchangeably and that have existed in various forms for centuries. The notion of a “culture of corruption” in the CEE countries, however, was born of this historical period and has evolved in the past several decades.

The state in most of the CEE countries was responsible for providing all of the public sector services and developed a sizable bureaucratic machine with which to carry out its functions. “The unprecedented scope of administrative control of communist institutions created many temptations to misuse official positions for private gain, even more so as public moral norms were contradictory. The fulfillment of the economic plan was the highest state priority, but illegalities committed for its sake were justified,” (Karklins 2005, 76). Corrupt practices in communist systems took on a multitude of forms, from demands for gifts or favors to obtaining scarce goods during periods of economic shortage. For instance, public officials were often not adequately paid for their work. “Communist citizens who wanted to live a halfway decent life used blat because official access to the same goods was near impossible… Blat was a response to the inadequacies of the formal political and economic system,” (Karklins 2005, 78-79). The term ‘blat’ usually refers to the informal agreements or unofficial networking in which people in the CEE countries engaged to procure scarce
goods and services. Petty corruption or blat, therefore, frequently served as compensatory mechanisms for public officials who felt they were entitled to accept gifts or bribes in an effort to make up for shortcomings in their state salary or the shortage of goods and services.

Corruption in communist states had many other purposes aside from contributing to personal gains or compensating for inefficiencies or shortages. Corrupt practices also helped people to cope with the restrictive policies of the state. Since the quality of health care or access to the best housing or university studies often depended on the type or amount of a bribe, people found the most effective way of ensuring that they could gain access to the most basic services. Bribes in communist states did not always take a monetary form. In many cases, they consisted of political favors on the part of the communist party, access to the best sanatoriums, all-expenses paid vacations to seaside or mountain resorts, coffee, chocolate, cartons of cigarettes, and countless others. In fact, by the 1980s, one of the most desirable bribes was the VCR, capable of playing videos depicting ideal life in the West.

Decades of strict political controls, inefficient allocation of resources, failing economic policies, and social unrest would all eventually contribute to the deterioration of the communist governments behind the Iron Curtain. Some countries, such as Poland and Hungary, had begun implementing gradual economic reforms in the 1980s aimed at facilitating the transfer of state-owned companies and industries to the hands of the private sector. Other countries, such as Romania and Bulgaria, were so tightly controlled by the communist
leadership that the notion of a transition to a free market economy was not only
dismissed, but also vilified as an instrument of Western exploitation.

By the late 1980s, a series of revolutionary events took place in the CEE
countries: communist states were falling apart, the Berlin Wall was dismantled,
the Iron Curtain was lifted, and the Cold War finally came to an end. For both
policy makers and academics alike, a series of general and crucial questions
arose in light of the implications of such watershed events. How would the
implementation of democratic rule and a free market economy take place? What
role would the Western European countries play in the transition? How would the
process of privatization unfold? How would the transition affect the societies of
the CEE countries?

For the purpose of the research conducted in this study, other important
questions have surfaced simultaneously. What role would FDI play in the
economic recovery and development of the CEE region? What measures would
the new governments take to implement policies and standards required for
admittance into the European Union? Would the corrupt practices of the
communist era continue and, if so, what impact would they have on foreign
investment? Government officials, representatives of international organizations,
economists, officials from Western countries, academics, researchers, and think
tanks were among the many groups prepared to address such questions, but it
would become apparent that complex answers would produce multifaceted
solutions unique to each CEE country.
Economic development in the post-communist era would be characterized both by the challenges of transition and by the potential for unparalleled growth. Many CEE states adopted legislation and implemented policies to attract FDI, convinced that the establishment of permanent commercial relations in the domestic market would contribute to the process of economic rebuilding. Foreign investment was expected to expedite technological convergence, promote the modernization of businesses, industries, and infrastructure, restructure enterprises, and improve the overall prospects for economic growth over time, (Barrell and Holland 2000). In addition, the governments of the CEE countries had limited revenue to invest in the maintenance and modernization of state-run companies, leaving little choice but to privatize those companies and industries that the private sector could run more efficiently.

The result of economic restructuring and privatization in the CEE region was a race to attract foreign investment. Some countries, such as Slovenia, were hesitant to allow foreign investors to buy out companies that controlled strategic national assets like military equipment manufacturing plants or railroads. Others, like Hungary and Romania, were eager to privatize unproductive or disorganized national enterprises in the hopes that foreign investors would provide the know-how and the financial resources to make such companies profitable in the future. In fact, the “privatization process played a key role in attracting FDI in the early years of transition. It acts as a strong signal of the commitment of the government to private ownership… The one-off opportunities offered by the
transfer of state monopolies into the private sector, particularly of public utilities, gave a strong incentive for strategic investments," (Barrell and Holland 2000, 484). For instance, Veolia, a French water management company that is among the largest and most influential in the industry, won a 25-year tender to manage the Bucharest water utility. With the cost of investments in modernization and local infrastructure representing only a fraction of the sizeable revenues that this foreign firm would produce over time, the appeal of privatization became evident to many other investors in various parts of the world.

The prospect of considerable profits was enough for some foreign investors to consider permanent ventures in the CEE. For others, however, there were additional factors that would be taken into account. For the purpose of this study, the traditional and transition-specific determinants of FDI will be grouped and analyzed according to the role that market size, factors and cost, privatization and economic openness, and governance play in shaping FDI inflows. There are a couple of potential causal factors, however, whose impact on FDI has been the subject of lengthy and wide ranging discussions in recent years: EU membership and corruption.

The Path to EU Membership

As the CEE countries began the processes of political restructuring and reintegration into the global economy, the initial response of the EU consisted of economic aid and preferential trade agreements. The ultimate goal, however, was to prepare the region for pre-accession negotiations and eventual
membership through the gradual adoption of the *acquis communautaire*. In order to improve their economic outlook and smooth out many of the bumps associated with the transition to free market economies, the CEE candidates agreed to accept EU institutional controls, along with certain “sovereignty bargains,” and implement the required reforms for admittance, including the long-term commitment to combat corruption, graft, and organized crime, (Litfin 1997, 167-204).

Laying the groundwork for EU membership would prove to be a challenge because each CEE country was a different level of political and economic development and plans for accession would have to be tailored to their unique situations and characteristics. The Eastern Enlargement represented the “most spectacular broadening in [EU] history—it almost doubled in size... [as] in 2004, ten countries were added in a single move, eight of which had been part of the Soviet bloc for almost 60 years... [and] in early 2007, two other countries, Romania and Bulgaria, joined the EU, bring the member total to 27,” (Roy 2008, 2). For all the former communist countries that became part of the EU in 2004 and 2007, membership in this exclusive regional trade organization would offer a wide range of economic benefits.

The opportunities that arose from EU membership were unprecedented in the CEE region, particularly in terms of foreign investment. “Originally attracted by low cost locations, relatively well-educated workforces and the attraction of having virtually tariff-free access to the EU from the CEE region, MNEs poured into the region. Further attracted by privatization programs of the post-socialist
governments, MNEs had the opportunity to acquire and restructure companies across all sectors of the economy,” (Akbar 2006, 221). The link between EU membership and economic development was constantly reinforced as foreign companies made various types of long-term investments in the CEE region, setting up new manufacturing facilities or modernizing old ones. The increase in FDI by MNEs in the CEE region began shortly after the beginning of the transition period, at approximately the same time as countries in the region were in the process of signing pre-accession treaties with the EU. It is not surprising, therefore, that the prospect of EU membership contributed to a boost in investor confidence.

For companies investing in the CEE region, the EU’s reputational effects also served as guarantors of investor stability. The legal reforms associated with membership would protect private property rights, while restructuring of the judiciary would promote the rapid resolution of trade disputes. In addition, “enhanced credibility of commitment to liberal economic policies and improved market access…increased flows of trade as well as of direct and portfolio investments as investors faced lower institutional and policy risks due to an improvement in a country’s business climate,” (Kaminski 2001, 4). The pace of the implementation of the reforms laid out in the *acquis communautaire*, along with safeguards put in place by the EU trade policies, provided foreign investors with a glimpse of the expectations for success of each CEE state’s reform policies. Some of the CEE countries would outperform others, not only in terms of the rate of reforms, but also in relation to their ability to attract FDI. What
became apparent in the mid-1990s, however, was that the very mention of EU
candidacy and membership made many investors consider the CEE region for
long-term projects.

According to many scholars, EU membership has not only boosted
investor security and helped countries attract FDI, but it has also required
candidates and members to pursue anti-corruption strategies as part of its
initiatives to tackle crime and improve the overall business climate. A
comprehensive EU policy on corruption, the development of a Strategic Concept
on Tackling Organized Crime, and a series of resolutions passed by the Council
of Ministers outlining the criminalization of bribery are among some of the steps
taken by the EU to reduce corruption. In addition, the establishment of the
European Anti-Fraud Office, OLAF (Office de Lutte Anti-Fraude), and the
Economic Crime Agency Network (ECAN) have institutionalized the EU’s
commitment to fighting corruption. In recent years, the Council of Europe has
created a number of monitoring groups, such as the Multidisciplinary Group on
Corruption (established in 1994) and GRECO (created in 1997), to pressure new
member states to adopt legislation and judicial reforms that would combat
corruption. The Organization for Economic Cooperation and Development
(OECD) signed the Convention on combating bribery of foreign public officials in
international business transactions in 1997 as part of a widespread effort to
reduce corruption. In late 2005, the UN’s Convention Against Corruption went
into effect with 140 signatory states. The Open Society Institute’s European
Union Monitoring and Advocacy Program (EUMAP) has also issued a series of
reports on corruption and judicial capacity that have been used by the EU to make policy recommendations.

These instruments have intensified the EU’s efforts to combat economic crime, however, there remains a disconnect in the CEE region between the adoption of such policies and the successful conviction of those accused of engaging in corrupt activities. What is interesting to note is that, while corruption is still an issue that needs to be tackled, the reputational effects of EU membership have been and continue to be considerably advantageous for foreign investment.

Perceptions of Corruption

The transition period in the CEE region was marked by fundamental changes in governance, commerce, and social relations, as well as preparations for EU membership. Leaders attempted to navigate through a series of difficult decisions about the direction that their countries would take, but most institutional functions remained indistinguishable from those of the past. Average citizens continued to bribe government agencies and functionaries to meet their everyday needs, from health care to education. Of particular concern was the staggering number of government leaders and public officials also taking bribes from private individuals, businesses and contractors in exchange for securing government contracts, providing immunity, facilitating the establishment of certain relationships, or simply agreeing to look the other way. At the same time, the role of foreign investment in promoting economic development was becoming
increasingly apparent and public officials were working to implement policies and offer tax and other incentives to make the region more attractive for FDI. These trends generated significant interest among many regional and international organizations attempting to determine the impact of corruption on FDI inflows into the CEE countries and how graft and bribes were generally perceived in this region.

Transparency International’s Corruption Perception Index (CPI) examines the perception of corrupt activities within a country by conducting widespread surveys and interviewing local authorities. The World Bank's Governance Indicators, notably the Control of Corruption, are based on more than 350 variables and measure institutional quality or governance throughout the world. According to these indices and governance indicators, the perceptions of levels of corruption have improved slightly in some of the countries of the CEE region, while others have deteriorated or remained unchanged. FDI inflows, however, showed a steady acceleration throughout the period from 1998 to 2008. Investors and academics alike have pointed out the significance of the impact of corruption and EU membership, among many other factors, as determinants of inward FDI. Some scholars monitoring recent EU accession programs have noted that EU membership has had positive effects for FDI, but that “harmonization with EU standards has done relatively little to reduce corruption,” (Reed 2002, 1). The result of a seemingly paradoxical relationship between economic growth and the detrimental effects of corruption in the newest EU member states has raised a number of important theoretical issues that warrant an in-depth investigation.
Overview of Theoretical Framework

The theoretical issues raised by the impact of corruption and EU membership as determinants of FDI, along with many other factors, have been the subjects of extensive analysis in various bodies of IPE and economics literature. The economic challenges that arose during the period of transition of the early 1990s pushed many of the CEE countries to attract foreign investment as a means of promoting commerce and economic development. At the same time, multinational enterprises (MNEs) and investors from all over the world were becoming increasingly aware of the emerging opportunities in the region. The result of this dynamic was a significant expansion of long-term investment, both in terms of greenfield and brownfield FDI. Greenfield FDI has fostered the establishment of new manufacturing plants and commercial offices, as well as the expansion of foreign retail and service oriented industries in the CEE region. Goods produced in the CEE region, for instance, would then be shipped and sold in other parts of Europe and throughout the world. Brownfield investment has provided the capital, resources, and know-how needed to modernize existing facilities and utilities, from oil production to water management.

In the initial phases of transition, FDI inflows represented a relatively small part of the CEE states’ GDP. Governments of the CEE countries, however, realized that FDI could improve domestic economic prospects through the development of permanent trade relations, the introduction of new industries, and the integration of the region into the world economy, (Holland and Pain 2000). By the mid to late-1990s, the pace of investment had picked up considerably and the
role of FDI in economic growth demanded the broadening of the theoretical framework used to explain why the CEE countries were able to attract unprecedented levels of investment.

The literature on determinants of FDI has evolved substantially in the fields of both economics and IPE. Dunning's seminal work on the eclectic paradigm and OLI-Framework describes three principal factors that motivate companies to invest abroad: ownership advantages, location advantages, and internalization advantages, (Dunning 2008). In their study of FDI determinants in transition countries, Bevan and Estrin consider factors such as host market size, unit labor costs, gravity factors, and country risk, (Bevan and Estrin 2000). Other research considers the impact of the initial starting conditions in a transition country and the types of incentives offered by the host government, (Brenton et al. 1999, Resmini 2000). Natural resources can also be a decisive factor for businesses that rely heavily on their availability and low cost, (Campos and Kinoshita 2008).

While all of these determinants of FDI are taken into consideration for the analysis conducted in this study, particular attention is given to two factors: EU membership and corruption. The literature on the impact of EU membership on both FDI inflows and levels of corruption has expanded in recent years to address the period of transition in the CEE region and the circumstances surrounding the 2004 and 2007 eastern enlargements. One of the principal requirements for EU membership is the adoption of political reforms that would solidify democratic rule in the post-communist candidate countries. It has been
argued, therefore, FDI tends to flow to democratic countries because they are more likely to protect property rights, guarantee the independence of the judiciary, and minimize overall investor risks, (Olson 1993; Feng 2001; Pastor and Hilt 1993; Li and Resnick 2003). The EU’s strict enforcement of democratic criteria for admission contributed to an improvement in the business climate by increasing investor confidence in the region.

The reputational effects of EU accession have been instrumental in attracting FDI, according to most of the scholarly research that has attempted to assess its overall impact. External incentives in the form of conditionality and social learning prompted the CEE candidates to respond to EU requisites, (Schimmelfennig 2006). Additionally, the growth of FDI in the region has been a reflection of the process of deepening and widening carried out by the EU in the CEE, (Carstensen and Toubal 2004). Preferential trade agreements, the implementation of legal and judiciary reforms, the adoption of the *acquis communautaire*, and the demonstration of the will to cooperate with the EU’s standards would all aid in guaranteeing investor security. In essence, the EU provides investors with a “seal of approval” that would allow the CEE countries to be approached as stable locations for long-term investment, rather than volatile transition markets, (Gray 2009). The implications of EU membership for investment are numerous and wide-ranging and, for the purpose of this study, are considered to have a significant impact on FDI inflows.

The impact of corruption on FDI inflows, however, remains a contested factor both from a theoretical perspective, as well as in terms of policy-making. It
is widely accepted that corruption is not a desirable feature of any system—this is neither the focus of the research, nor is the validity of this statement disputed in any of the claims presented in this study. What this study attempts to assess, rather, is whether or not corruption levels in a particular country are a significant determinant of foreign investment. The literature on corruption and FDI has seen a noteworthy expansion in recent decades and scholars in the fields of IPE and economics remain polarized it terms of offering concrete explanations for the role that corruption plays in patterns of investment.

Corruption, or the abuse of public office or funds for private gains, exists at a variety of levels and can take on many different forms. From grand, systemic, or high-level corruption to petty, opportunistic, or low-level corruption, the secrecy and illegality that often characterize bribery and the exchange of favors result in difficulties in measuring this complex and ever-changing phenomenon, (Bardhan 1997, 2001; Kaufmann 1997; Rose-Ackerman 2006; Jain 2001). At an institutional level, corruption can lead to state capture or rent-seeking in which states pass laws and implement policies that will make regulations burdensome enough to generate rents, (Hellman, Jones, and Kaufmann 2000; Tullock 1996; Ades and di Tella 1999). Added to these challenges is the fact that what is considered to be illegal activity in one country might be an accepted or customary behavior in another.

The juxtaposition of perceptions and laws concerning corruption between the post-communist CEE countries and western European states, for instance, has often been an issue of cultural relativism. People in the CEE countries had
become accustomed to paying government officials to expedite paperwork, bribing doctors in state-run hospitals for specialized medical attention, and offering monetary gifts or other goods in exchange for preferential treatment in universities. Just as there are a variety of factors that influence the direction of FDI flows, there are also many determinants of corruption outlined in the literature. These range from discretionary power and economic rents to poor regulatory quality and cultural values, (Jain 2001; Lambsdorff 2006; Miller, Grodeland, Koshechkina 2001). While it is important to understand what motivates people to engage in corrupt behavior, this study seeks to find out just how influential perceptions of corruption are on foreign investors’ decisions to establish business in particular countries.

There are two main theoretical arguments that have been developed to explain the impact of corruption on FDI. According to experts, corruption can exist either as “sand” or “grease” in the wheels of FDI. Acting as “sand”, corruption hinders economic development through reduced FDI, excessive government spending, limited efficiency of state projects, distorted economic growth, and discretionary regulation, (Wei 2001; Kaufmann 1997; Mauro 1995). The negative consequences of corruption are, in turn, perceived by foreign investors as risks to their medium and long-term projects for a particular country or region, leading them to reexamine their investment strategies.

Some scholars have researched these deterrents expecting to assess their negative impact on foreign investment, but have instead found weak or insignificant empirical correlations linking a host country’s risk factors to FDI
inflows, (Wheeler and Mody 1992; Hines 1995). Perhaps the difficulty in
establishing an adverse relationship between corruption and FDI stems from the
problems associated with measuring corruption in the first place. Based on the
perceptions and surveys of business and government experts, these measures
are both subjective and relative. The trouble with quantifying perceptions is that it
makes the collection of reliable and accurate data a challenging task for social
scientists.

The counterargument in the IPE and economics literature is that
corruption acts as “grease” in the wheels of FDI. “Speed money” or “useful
corruption” can reduce red tape, expedite licensing, and decrease bureaucratic
rigidity, (Karklins 2005). It can even promote economic growth by maximizing
efficiency and tipping the cost-benefit balance in favor of those investors who are
willing to bribe government officials to enter into a market, (Tullock, 1996; Leff
1964; Nye 1967). Studies have found that the effects of corruption on FDI have
actually declined in recent years because other factors, such as market size and
potential growth, have become more significant determinants, (Egger and Winner
2005, 2006). In fact, corruption might be tolerated in many countries because it
contributes to a reduction in transaction costs, the stabilization of institutions, and
the predictability of agent behavior (Colombatto 2003). In other words, “grease”
payments can actually facilitate the entry of foreign investment into a particular
market or country. Findings that corruption does not hinder or is not a significant
determinant of FDI inflows have been empirically substantiated for many years
by academics and experts in a variety of disciplines.
A parallel argument to those that examine the impact of corruption on foreign investment is the claim that levels of corruption tend to increase during periods of economic development. Several studies have uncovered evidence that corruption is higher in countries undergoing privatization, particularly post-communist countries undergoing a transition to a market economy, (Ades and di Tella 1997; Sandholtz and Taagepera 2005). The countries included in this study have been characterized by the conditions outlined in the IPE and economics literatures, making them ideal cases for closer examination to determine the extent of the impact of corruption on FDI. Despite high levels of corruption in the CEE region, “inflows of FDI in the 1990s that rivaled or even exceeded those of similarly sized but wealthier and more institutionally developed capitalist neighbors,” (Brada, Kutan, and Yigit 2006, 651). The circumstances surrounding transition, negotiations for EU accession, and economic development in countries with a remarkable potential for growth all contribute to explaining why investors were less concerned with corruption and far more interested in the future economic prospects of the region.

Research Design and Methods

To analyze the wide range of factors affecting FDI inflows in the CEE region, it is valuable to combine quantitative and qualitative methodological approaches. The reasoning behind this combination is that neither one of these approaches can effectively answer the complex questions posed in this study independently of the other. Preliminary observations of patterns of inward FDI
from 1998 to 2008 showed a marked increase, while perceptions of corruption in the region remained relatively unchanged throughout this time period. Providing adequate evidence to challenge traditional theories in the IPE and economics literatures, namely those that claim that corruption hinders FDI, calls for the development of a two-pronged research design capable of delivering a comprehensive analysis of findings. The quantitative method in this study relies on government records and survey data collected from various reputable international sources, while the qualitative approach gathers information from specific cases and personal interviews.

Quantitative statistical analysis will be conducted to evaluate the impact of both traditional and transition-specific factors on FDI inflows, (Carstensen and Toubal 2004). The purpose of this section is to find out whether or not corruption and EU membership are significant determinants of FDI in the post-communist CEE countries admitted to the EU in 2004 and 2007. Two hypotheses will be tested as part of the study: 1) corruption is not a significant determinant of FDI; and 2) EU membership is a significant factor in attracting FDI. A multivariate linear regression will be performed to assess the various factors’ significance, and subsequent models will be derived to further explain the data should there be any bias resulting from collinearity among the independent variables. The regressions will be carried out using Ordinary Least Squares (OLS) and Fixed Effects (FE) models to provide a comprehensive analysis of those variables that have a significant effect on inward FDI.
The case selection for quantitative analysis is based on a most-similar design to facilitate comparison. The ten CEE countries in the study share a similar historical background, have recently undergone a transition to democratic rule and a free market economic system, and are all currently members of the EU. The cases include: Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia. Models in a regression are better able to predict particular outcomes with a sizable number of data points, or large N. As a result, information about the ten cases was analyzed over a period eleven years, from 1998 to 2008. In addition, evaluating which of the factors affecting FDI are more significant than others requires a comparative research design, including independent variables from various groups of FDI determinants.

The dependent variable is FDI as a percentage of GDP and the independent variables are placed in four broad categories of determinants: market size, factors and cost, privatization and economic openness (including EU membership), and governance indicators (including corruption). The limitation of bias in the selection of cases, collection of data from reliable sources, and design of the regression models are expected to provide a reasonable degree of accuracy and establish the predictive power of the model. While the quantitative portion of the research can paint a broad picture of those factors that chart the course of FDI inflows, a qualitative investigation of specific cases is an effective way to compensate for any of the limitations that the statistical analysis of a wide range of data might have.
The specific case of Romania is an interesting case to examine using a qualitative approach for a number of reasons. It has among the highest levels of both FDI inflows and corruption in the CEE region; it began accession negotiations for EU membership in 1995 and became a member in 2007; and it underwent a massive privatization of state-run industries, attracting investors from all over the world. In contrast to the quantitative analysis, the qualitative section explores a small number of cases, chosen on the basis of a most-similar design to ensure objectivity and replicability. The goal of this thorough look into the privatization of some of Romania’s most important national industries, from petroleum refineries to water utilities, is to show that bribery and influence peddling involving both Romanian government officials and foreign investors have not deterred corruption. In addition, much of the privatization period in Romania coincided with EU accession negotiations, making it an attractive destination for FDI.

Qualitative data for this portion of the research design will be obtained from government records, official government agency reports, national news agencies, international financial publications and, perhaps most importantly, from a series of personal semi-structured interviews. The interviewees, who shall remain anonymous given the delicate nature of the subject being discussed, are EU officials, representatives of the EU in Romania, Romanian government officials, agents of regional or international organizations, and members of the Romanian business community. Measures of corruption, such as Transparency International’s CPI and the World Bank’s Control of Corruption Index, are all
based on perceptions. The perceptions, in turn, are converted into indices designed to give academics and policy-makers a better understanding of the level of corruption in a particular country. While these indices are informative, they are still based on personal opinions. To offset the subjectivity of the indices in the quantitative section, the interviews provide valuable insight by offering details and an in-depth understanding of the circumstances surrounding privatization that no index could provide. This is precisely why a combination of qualitative and quantitative research methods will provide the most comprehensive assessment of the impact of corruption and EU membership on FDI in the CEE region more broadly and in Romania more specifically.

Organization of the Chapters

The impact of corruption and EU membership on inward FDI in the CEE countries will be assessed throughout a series of chapters that will present the historical background, theoretical perspectives, research design, methods, and findings that help to explain this relationship. These are summarized in the introductory chapter of the study. The second chapter provides a historical background of the CEE countries, including a brief look at the political, economic and social legacy of the communist state. The fall of communism, process of democratization, and the transition to a free market economy is examined in relation to levels of corruption. A detailed description of the inflows of FDI is included for the individual cases being examined in this study to offer a better understanding of patterns of foreign investment in the region. An overview of the
negotiations to join the EU, the subsequent mandatory reforms, and the opening up of untapped markets to foreign investment is also provided.

Chapter 3 outlines the various theoretical perspectives and detailed arguments on both sides of the corruption debate. It surveys the theories and frameworks that seek to address the various determinants of FDI, including corruption and EU membership. Definitions of terms used throughout the study are elaborated on and specific issues, such as the difficulties associated with measuring corruption through perceptions, are addressed. Most importantly, a thorough discussion of the theories about the impact of corruption and EU membership on inward FDI is also included.

Chapters 4 and 5 focus on the technical discussion of the quantitative and qualitative research, respectively, conducted to test the claims of the dissertation. Chapter 4 comprises the quantitative research design. It explains the selection of ten post-communist CEE countries that recently joined the EU for a quantitative comparison of determinants of FDI inflows, including perceptions of corruption and EU membership, among a wide range of factors that are also considered. A multivariate regression analysis is used to study the data and determine the relationship among the factors affecting inward FDI from 1998 to 2008.

Chapter 5 discusses Romania as a specific qualitative case study. The privatization of previously state-run industries involving corrupt activities is provided to establish the weakness of corruption as a determinant of FDI. Personal interview design methods, the selection of interviewees and questions, and an in-depth discussion of the responses in regards to the central claims of
this study and the specific case of Romania are described. Lastly, the legal, political, economic, and social implications for Romania are discussed.

The final chapter of the dissertation is an overview of the puzzle, hypotheses, theoretical perspectives, and results of the quantitative and qualitative data analysis. It then proceeds to evaluate and interpret the quantitative and qualitative findings to determine the validity of the arguments presented throughout the project. Caveats, challenges stemming from the interpretation of the data, and suggestions for future improvements to the research design will also be considered. Contributions to the literature are discussed and questions for future research are posed. With corruption still regarded as one of the most important issues that the EU faces in the CEE member states, the issues discussed in this study remain a subject of great academic interest and real-world consequence. The open-ended nature of the conclusion will hopefully lead to fruitful discussions about the impact of corruption on FDI inflows not only for the current EU member states, but also for those whose goal it is to join this exclusive club in the future.
Chapter 2: Prospects and Challenges of Transition

In the mid-1990s many of the Central and Eastern European countries submitted their formal applications for EU accession. Policymakers, academics and citizens in the region demonstrated widespread support for EU accession in the hopes that membership in this exclusive club would smooth out the challenges associated with the transition from communist regimes to democratic, capitalist states. According to Eurobarometer surveys of support for EU membership conducted from 1996 to 2006 in both the member states and candidate countries, more than half of the respondents indicated that membership was a good thing, between 20 and 30 percent responded that it was neither a good nor a bad thing, and about 15 percent believed it would be a bad thing, (Eurobarometer, 2006). While formal negotiations for the Eastern enlargement were being carried out, concerns were mounting in Brussels as to whether or not the CEE countries would successfully fulfill the requirements for membership by the accession dates. Foreign investors, equally anxious to learn of the status of the candidacy of the CEE states, were beginning to evaluate the potential economic growth in the region. Many investors recognized the need for reform, especially in areas of property rights and dispute resolution mechanisms, but FDI began to trickle into the region in the early 1990s despite these apprehensions. By the mid to late 1990s, the concerns raised by the EU were beginning to take a back seat to the potential for economic development generated by transition and privatization.
Among the most problematic issues surrounding the Eastern enlargement were policy reform, economic performance, political stability, agricultural sector reform, and border security. In addition to this broad range of concerns, there were also many country-specific issues that had to be dealt with, notably corruption. The EU’s explicit intolerance of corrupt activities warrants an examination of both the rampancy of corruption in the CEE states during the communist era as well as the justice system reforms and fight against corruption that were spurred by the accession negotiations. “During the communist era, many citizens had a marked sense of ‘them’ and ‘us’, and often turned to private relations as a way of coping with the fact that they had little impact on their often incompetent and corrupt institutions,” establishing a culture of corruption that would be very difficult to change even after the collapse of communism, (Holmes 1997, 17).

In the post-communist era, this mentality persisted and bribes continued to be a part of everyday activities involving government agencies, healthcare providers, and now business transactions. As a result, the European Commission laid out a series of guidelines, reforms, and measures whose implementation would be compulsory prior to accession—the CEE countries would have to clean up their act if they were serious about joining the EU. Just one year after the 2007 accession, however, The Economist reported that, “For corrupt officials in central and eastern Europe, life has seldom been better. Joining the European Union has produced temptingly large puddles of public money to steal. And the region’s anti-corruption outfits are proving toothless, sidelined or simply
embattled," (The Economist, May 22, 2008). Would the path to EU membership, therefore, represent a symbolic cure for corruption in the CEE countries or would it simply mask its effects until the accession was complete?

Corruption in the CEE countries has taken on many different forms over the years, from high-level graft to petty bribes, often dependent upon the nature of the communist regimes and the degree to which corrupt activities could effectively resolve logistical matters. The organizational structure of communist governments gave rise to both need-based and opportunistic forms of corruption. These forms of corruption have often been categorized as “need-based” and “greed-based” by some scholars, (Arora and Goyal 1996, 618; Gupta 2003, 148). They distinguish between need-based corruption motivated by poverty and lack of resources, such as bribes given to healthcare providers, and greed-based corruption that occurs unsystematically as opportunities for enrichment present themselves, as in the case of the old communist elites’ control of privatization.

Giving and accepting bribes would, therefore, become engrained in the cultures of the CEE states, making it increasingly difficult to shake the bad habit that the EU would so adamantly refuse to tolerate. In addition, trends in corrupt behavior have also been affected by the period during which they occurred, from the rigidity of central planning and tight government controls of the communist regimes to the rampant corruption that arose during the period of transition and privatization of the past two decades. To understand how corruption developed into a systematic occurrence in this region, it is important to examine the nature of corruption in the communist era, the challenges associated with the transition
to democratic rule and the establishment of a free market, as well as the steps taken by the CEE countries to combat corruption in an effort to meet the requirements for EU membership.

The purpose of this study is to determine whether or not corruption is a significant determinant of inward FDI. The discussion of the evolution of corruption from the communist era to the transition period is a prelude to the wider description of the various factors that affect foreign investment. A comprehensive analysis of the transition, as part of the consideration of the determinants of FDI, will also describe the FDI inflows into the ten cases selected for further investigation in this study. A case-specific evaluation of inward FDI will provide an informative background on the patterns of investment and will shed light on the role that corruption and EU membership play in the economic growth in the region from 1998 to 2008.

The Nature of Corruption in the Communist Era

The nature of corruption in the communist countries can be attributed to a variety of historical, cultural and circumstantial factors. Miller, Grodeland, and Koshechkina argue that the “culture of corruption” in the CEE states is the result of several models of historical influence: the ‘dead hand of history’ model; the ‘irrelevance of history’ model; the ‘fading legacy’ model; and the ‘escape from domination’ model, (Miller, Grodeland, and Koshechkina 2001, 18-22). The ‘dead hand of history’ is a deterministic model that suggests that corrupt practices are a result of the continuity of traditional ways of thinking, while the ‘irrelevance of
history’ model negates the deterministic significance of history and argues instead that current patterns of behavior reflect conditions in the present, (Miller, Grodeland, and Koshechkina 2001, 18). In an effort to reconcile the differences between the ‘dead hand’ and ‘irrelevance’ of history models, the ‘fading legacy’ model attempts to account for the influence of both conditions of the past and those of the present on current explanations of corrupt behavior. The fourth model, the ‘escape from domination’, predicts that corrupt behavior is subject to immediate change under the specific circumstances of an ‘escape’ from the constraints of a historic domination, notably the communist regimes.

The authors evaluate the effectiveness with which these models are able to explain the particular brand of corrupt behavior associated with the CEE countries and conclude that, “there is a critically important difference between rampant corruption that results from a long-term and immutable historical-cultural tradition and rampant corruption that results from the chaos of transition,” (Miller, Grodeland, and Koshechkina 2001, 21). In other words, the last two models provide considerable insight into the nature of corruption that characterized pre- and post-communist Europe.

Miller, Grodeland and Koshechkina also make it a point to differentiate between the ‘climate of corruption’ that existed throughout the communist period and the ‘season of corruption’ that emerged during the transition period in the 1990s. The ‘climate of corruption’ emerged as a result of the rigidity of centralized planning, the politicization of state affairs, and the inefficient allocation of goods that characterized most of the CEE countries during
communist rule. One of the greatest economic hurdles in the socialist era, therefore, was supply and, “because of the shortages, it was customers who had to be innovative, relying on interpersonal networks to get what they needed. A second economy—the production, consumption, distribution, and exchange of goods outside state regulation—developed, contributing to the consolidation of two distinct spheres, the official and the nonofficial,” (Bandelj 2008, p. 33). The development of this ‘second economy’ coincided with the increasing use of public office and official position for private gain. In fact, “a considerable part of this unofficial regime entailed the “second economy,” but another part consisted of the growing tolerance of officials’ corrupt actions such as neglect of office and bribe taking for cutting red tape,” (Karklins 2005, 76). In many communist regimes, it had become standard operating procedure to bribe party officials or government functionaries in exchange for preferential treatment, access to scarce goods, or even the timely access to basic government services.

The extent of corrupt activity in the CEE states also depended on the nature of the socialist regime in place in each particular country, some of which regulated economic transactions more closely than others. The contradictory nature of administrations was evident in all aspects of their operations, from economic regulation to welfare services, and this generated the opportunities for corruption. In the centrally planned economies and rigid government structures of the CEE countries, “informal practices and the personalization of power that they create are both parasitic and functional: they reduce the amount of wealth in society directly by theft and indirectly by lowering trust and willingness to invest
but at the same time they provide means of negotiating around an inefficient administrative system so that it ‘works’," (Robinson 2007, 1218). In other words, bribing government officials with the goal of cutting red tape made agencies function more efficiently than they would have otherwise. Manufacturing facilities were common locations of bribes or private deals, usually in the form of goods or favors, to secure access to materials needed by an enterprise in order to ensure the achievement of its production targets.

The various forms of corruption that characterized the period of communist rule in the CEE countries can be categorized as either petty and need-based or high-level, greed-based, opportunistic corruption. As part of the “second economy” or black market, corruption served as a compensatory mechanism in the CEE countries—petty bribes made up the discrepancy between a public official or civil servant’s actual salary under the communist regime and the salary they would have needed to earn to prevent them from taking bribes in the first place. While this disparity in earnings was a very serious issue, the difficulties associated with inadequate pay were made light of with jokes like “we pretend to work and they pretend to pay us.” Receiving a bribe often made the difference between having the incentive to do one’s job or not being compensated enough to bother. One of the inherent flaws of the communist system was the fact that it created too few incentives to motivate workers. In addition, its widespread occurrence could not be denied because most people were well aware of the bribes and needed to engage in corrupt activities to have access to better government services. It is not surprising,
therefore, that petty corruption flourished and developed as the most representative part of the “second economy.”

Bribes as petty corruption in the CEE countries, often called blat by the Soviets, “articulated private interests and ‘human’ needs against the rigid constraints of the State order, allowed people to meet harsh conditions, to maintain their social comfort and enjoy and sense of ‘beating the system’,” (Ledeneva 1998, 46). Maintaining this ‘social comfort’ took on many different forms, including access to scarce supplies, the ability to obtain legal documents or government services quickly, the right to buy foreign consumer goods at special stores, admission to the most desirable universities, medical care at exclusive hospitals, and vacations at private resorts reserved primarily for the upper echelons of the communist party. In contrast to the petty corruption and blat that characterized everyday, need-based transactions, the kind of corruption that occurred at the higher levels of the communist party was often opportunistic in nature, usually to serve the personal interests or enrichment of the party leaders.

Empirical studies on corrupt behavior suggest that the “individual behaviors depend on the size of rents available, the expected probability that corrupt behavior is detected and punished, and the level of punishment,” (Lederman et al. 2001),” (Hallagan 2010, 29). Officials who occupied higher-level positions in the communist party were not only seldom punished for engaging in corrupt behavior, but also rarely held accountable, and the general consensus at this level was to simply look the other way when it was taking place. For instance,
party elites had access to special tourist shops where widely sought-after goods, like foreign liquors, cigarettes, cosmetics and clothes, could be purchased only by those who had access to dollars. The allure of such hard-to-come-by goods made them ideal for bribes and payoffs, especially at the administrative level. In addition, corruption was so prevalent among communist party members that it would have been counterproductive to denounce corrupt practices when such a large proportion of the high-level officials were benefitting from them. Maintaining limited trade openness and strict control of planned economies gave party officials a clear advantage over citizens in the CEE countries and did so at their expense.

The opportunistic nature of high-level corruption is interesting to note because officials were both regularly engaged in corrupt behavior and prepared to seize opportunities to profit from public office should they arise unexpectedly. In fact, “the longer corruption persists at the elite level, the greater the likelihood that the mass of the electorate will become indifferent to dishonesty, or decide that the only way to deal with a corrupt state is to benefit from law-breaking oneself, whether in the form of avoiding taxes, smuggling, or corruption of civil servants and elected representatives,” (Rose 2001, 105). State involvement in nearly all aspects of society coupled with arbitrarily enforced rules, restricted media coverage, and a lack of political competition or public accountability made corruption in communist regimes inescapable.

Corruption was, therefore, both a means to survive in socialist systems as well as a means of getting rich. While elites and party members profited from
bribes and kickbacks, or greed-based corruption, they were often careful to hide their transgressions so as not to arouse too much suspicion among less successful party members or citizens in socialist societies where everyone was supposed to, in theory, have access to the same goods and services. If the ‘culture’ and ‘climate’ of corruption were pervasive during the forty-year period of communist rule in the CEE countries, they would become decreasingly relevant when compared to the kind of corrupt activities that took place during the transition period to follow.

*The Challenges of Transition and Privatization*

The dramatic images of the fall of the Berlin Wall in November of 1989 marked one of the most hopeful and liberating experiences in the recent history of Central and Eastern Europe. Several countries, including Hungary and Poland, had been in the process of negotiating a transition to a more economically competitive and open market system for several years. Anti-communist movements, like Solidarity in Poland, also helped to undermine the communist regimes and played an important role during the period of widespread change of the early 1990s.

The disintegration of virtually all of the communist regimes of the CEE countries was characterized by largely peaceful transitions, except in the case of Romania. During the Romanian Revolution, violent protests and fighting broke out in the streets of Bucharest and Nicolae and Elena Ceausescu were captured, tried and executed. For most people in the region, the collapse of the communist
regimes heralded a period of long-awaited change. Ironically, this highly anticipated change would take many years to implement and, in many cases, would be circumvented altogether by the restructuring of the previous government and the reappointment of the same officials. In other words, the changes were often theoretical or nominal, but not real or effective. The lack of substantive administrative change following the collapse of the communist regimes is one of the many reasons why the 'season of corruption' emerged within countries that already had a 'climate of corruption' to begin with.

There were two major areas of transformation in the CEE countries in the early 1990s: the transition to democratic rule and the shift from planned to free market economies. Of course, such changes would have widespread spillover effects into society and people’s everyday lives. Along with the exhilaration of the end of communism came the uncertainty associated with the newfound freedoms. Now that the state had collapsed, who would employ workers? Who would pay for healthcare and education? What would happen to the countries’ industries? Would foreign countries step in to help? Countless questions arose during this unpredictable period in the history of the CEE countries.

While finding new ways to address the challenges of transition was definitely a priority for the emerging administrations in the region, some issues, such as the first free elections in over forty years, required immediate attention while others, like corruption, would be set aside and dealt with later. “The collapse of communist regimes altered the structure of opportunities that promoted corruption, but it could not eliminate those opportunities. New
bureaucracies could not be created from scratch, so many administrative practices—and many of the personnel—carried over,” (Sandholtz and Taagepera 2005, 115). Dismantling an entire government structure and its civil service overnight was unrealistic and, as a result, the emerging leadership simply began changing its name or party affiliation so as to distance itself from the highly unpopular communist government of the past. Communist party members became “ex-communists” and proclaimed their newfound commitment to democratic leadership, economic freedom, and social justice. Paradoxically, the same “ex-communists” who had been in power under the previous regimes were now also controlling the transition, giving rise to a whole new set of opportunities to profit from their positions in government.

Liberal economic policy recommendations, both from the West and within the CEE countries themselves, suggested that the natural course of the transition to a free market economy and trade openness required the privatization of both state-owned industries and property. In many cases, the old nomenklatura would be responsible for the implementation of privatization policies with few of the constraints of a functioning judicial system to check their activities. “The transition from the exploitation of power and access to goods and special perks to the unchecked appropriation of wealth for private use was facilitated by the previous regime’s philosophical insistence that capitalism and the free market were lawless and corrupt at their core. Bring thrust into the free market as inadvertent capitalists, many bureaucrats and citizens felt no cultural imperative to discourage the unbridled pursuit of wealth by any means,” (Kaufmann and
Siegelbaum 1996, 424). Not only was corrupt behavior not discouraged, but it had also developed into a way of carrying out transactions quickly and effectively in many cases. The new democratic governments lacked the legal and administrative tools and resources to meet all of the demands of the fast-paced economic transition. Offering bribes to obtain licenses or permits or to prepare legal documents in a timely manner had come to represent the cost of doing business in the post-communist CEE states.

The idea that transition periods are often fraught with corruption is not new. Several studies conducted by the World Bank suggest that, “faster economic growth may exacerbate state capture in the short run,” (Anderson and Gray 2006, 29). There are many differences, however, between the opportunistic form of corrupt behavior during the transition period and the kind of corruption that characterized the communist regimes. During the communist era, bribes and kickbacks often came in the form of personal favors and access to foreign consumer goods. Party officials and mid-level bureaucrats had limited access to cash and hard currency bribes and usually settled for scarce goods and “perks, such as access to dacha houses in the outskirts of the capital and to the better schools, vacations in preferred sanatoriums, ‘study tours’ abroad…and patronage for jobs in public enterprises,” (Kaufmann and Siegelbaum 1996, 423). In fact, much of the corrupt activity that took place during the communist era could be more adequately characterized as petty corruption, grease payments, or blat. The onset of Perestroika, or economic and political restructuring, and the implementation of drastic measures to meet the challenges of an emerging free
market economy culminated in the “spontaneous privatization” of state-owned industries, factories, and property in several of the countries in the region and these, in turn, gave rise to high-level corruption.

There was no doubt that the denationalization of entire sectors of the CEE states’ economies would be a complex process riddled with uncertainties surrounding its implementation. Nevertheless, policy experts from the West, influenced by the neoliberal thinking of the Washington Consensus, suggested that “shock therapy” and rapid reform was the least painful way to approach the transition. Some analysts, such as Joseph Stiglitz, have “suggested that those who were a part of the “Washington Consensus” coerced these client governments into ill-advised programs that they were not prepared for,” (Lieberman and Kopf 2008, 26). Whether the spontaneous mass privatization process and the reforms prescribed by the Washington Consensus, including stabilization, liberalization, privatization and deregulation, were the most effective way of transitioning into a free market remains a subject of debate. What is more difficult to dispute, however, are the significant consequences of this approach.

One of the most profound consequences of the “shock therapy” approach to privatization was that ‘ex-communists’, who remained in power for the most part, were now responsible for selling off the state’s wealth, providing ample opportunities to profit from both denationalization transactions and the lack of legal consequences for engaging in corruption. While petty corruption continued after the collapse of the communist regimes, it was coupled with the rent-seeking notion of state capture, ‘high-level’ corruption that took place on a 'grand' scale.
The pervasiveness of corruption during the post-communist transition period can be attributed to a number of factors associated with the privatization and denationalization of industries and property. With the state, and the old nomenklatura in particular, still making the vast majority of post-communist economic decisions, the frequency of corrupt transactions contributed to the emergence of the ‘season of corruption’. The more drawn out the process of privatization became, the more time officials responsible for carrying out the transactions had to secure bribes and kickbacks from buyers. In essence, the pace of privatization conspired against the acquisition and exercising of the control rights of rent-seeking public officials, (Kaufmann and Siegelbaum 1996, 426-428).

The high level of administrative discretion and relative lack of transparency and independent administration of the privatization programs allowed public officials to extract rents without having to face any real legal consequences. The trends of both petty and high-level corruption would continue throughout the period of privatization, but many policy reformers were hopeful that stabilization measures would soon start to take effect and that the ‘season of corruption’ would eventually come to an end. What was discovered, however, is that old habits die-hard and changing the modus operandum would prove more difficult than previously anticipated.

The long-term success of the transition and privatization processes depended on the combination of stabilization measures with economic depoliticization and institution-building, as well as effective judicial and legal
reforms. Johnson, Kaufmann and Shleifer’s analysis suggests that “stabilization may, indeed, not be sufficient for growth, and that the building of market-supporting institutions is a separate and crucial requirement of a successful transition. The EBRD’s 1997 Transition Report takes this point of view as well,” (Johnson et al. 1997, 163). One of the most effective tools to combat both petty and high-level corruption is the implementation of functioning institutions, capable of distributing government services to the public and discouraging reliance on personal favors or networks to obtain them. Establishing institutions or restructuring existing government agencies to provide government services proved to be quite a challenge for many of the CEE countries. Many elites and ‘ex-communists’ who retained power were aware that the role of such institutions would be to regulate and manage government discretion, which would in turn limit their capacity for rent-seeking and corrupt behavior.

The establishment of a free market economy in the CEE countries would be dependent not only on economic reforms, foreign investment and trade openness, but also on the restructuring of the state and political system. The notion of discretion, or the flexibility to make decisions that are still bound by the checks and balances of formal institutions, is particularly important when describing institutional evolution because it varied from state to state. Political actors negotiated varying levels of discretion into the design of institutions: 1) they could fail to design institutions altogether, which increases rent-seeking opportunities; 2) they could devise “winner-take-all” institutions that reinforced existing privileges; 3) they could set up symbolic institutions that were lax and
unenforced; or 4) they could move quickly to set up institutions designed to combat state inefficiencies, (Grzymala-Busse 2004, 3).

While highly efficient economic and political institutions represented the best-case scenario, most of the institution building that took place incorporated a high-level of elite discretion. Market actors often “consider only a small set of government policies when deciding how to allocate their assets. Therefore, governments face pressures to adopt market-pleasing policies in aggregate policy areas but retain “room to move” in many other policy areas,” (Mosely 2000, 737). Discretion and “room to move” were, consequently, some of the deciding factors in the evolution of state institution building in the CEE countries. The pace and nature of this process was also closely linked to the levels of corruption that characterized a particular system—the more inefficient the institutions, the higher the likelihood that corrupt activities would continue unchecked and unpunished, especially among elites.

The process of institution building was challenging and required the passage of many economic and political reforms, but most of the CEE countries have been able to establish adequate formal institutions, such as securities and exchange commissions, property law enforcement mechanisms, and decentralized regional and local governments. Corruption, however, remained widespread throughout the transition period, but political change has turned out to be equally susceptible to corrupt activities as economic and institutional change. As the shift to democratic rule was taking place all throughout the region, each state would have to learn the rules of the democratic game quickly
and with relatively little previous experience. The old system would be restructured, new constitutions were drafted, candidates for new positions emerged, and citizens grappled with the idea that the government would now depend on their votes to carry out the ‘will of the people’.

Some aspects of the political transition were more susceptible to rent-seeking than others, including the selection of government representatives. Corruption occurred while politicians were seeking office—illegal campaign finance, vote buying and electoral fraud took place at the local, regional, and national level, (Kunicova 2006, 148-152). Once candidates had been elected, corruption then continued while they were holding office. Whatever point in the democratic process at which corruption occurs, Linz and Stepan point out that the old nomenklatura’s attempt at establishing legitimacy though the new electoral process coincided with its efforts to maintain control of state enterprises and bureaucracies, leaving considerable “room for corruption.” In fact, they argue that, “the members of the former nomenklatura through their networks extending over management, administration, and even security services can assure themselves a privileged position in the emerging capitalist economy and with it substantial political influence,” (Linz and Stepan 1996, 69-70). At this point in the transition, the boundaries of corruption that occurred within the political and economic spheres had become completely blurred, making it difficult to distinguish between them and creating a complex web of interrelated illicit activities that would persist well into the future. The issue that this raises for the purpose of this study is, therefore, how the challenging political transition,
negotiations and accession to the EU, and rampant corruption would ultimately impact inward FDI in the CEE region.

*European Union Membership*

It has been argued that democratization and the establishment of a free market contributes to a decrease in opportunities to engage in corruption when corresponding increases in transparency, accountability, and competition accompany political and economic transitions, (Ades and Di Tella 1999; Kaufmann 1997). By the mid-1990s, both internal efforts and external pressures had succeeded in spinning the wheels of transition in the CEE countries and foreign investors showed signs of optimism about the direction of change through a growing influx of investment. In addition, geographic and cultural proximity to Western Europe and historic ties to the U.S. and other global economic powers represented important factors in the course of the transition.

Close and improving relationships with powerful actors were reflected in the negotiations to join NATO, the European Free Trade Association (EFTA—whose members have since joined the EU), the Council of Europe, the World Trade Organization (WTO), and other organizations. In addition, aid was offered by the World Bank, the International Monetary Fund (IMF), the EBRD and other financial institutions looking to stabilize the economies of the region and open up new markets to world trade. Perhaps no other single factor, however, would have as significant an impact on the course of the transition, as well as on both FDI and corruption, as the opening up of negotiations to join the EU.
Once the CEE countries were able to show that they were well on their way to establishing functioning democracies and free market economies, the EU agreed to enter into negotiations with those countries that had expressed their aspirations for membership. In 1994, the EU agreed to “produce a set of criteria to be met by intending members… This led to the adoption by the EU in May 1995 of a 300-page White Paper that spelt out certain prerequisites for membership,” (Holmes 1997, 320). There would be a long list of reforms to be implemented and requirements that the CEE countries would have to meet in a timely manner in order to be seriously considered for future membership.

Initially, most of the CEE countries signed Association Agreements and Trade and Economic Cooperation Agreements with the EU, an indication that they were, indeed, deeply committed to making the necessary changes. The European Commission’s Directorate General (DG) on Enlargement took a resolute step toward the next wave of enlargement by issuing the Copenhagen Criteria. According to the agenda of the Copenhagen European Council, the criteria for membership require that the candidate country must have attained: 1) the stability of domestic institutions capable of guaranteeing democracy and the implementation of the rule of law, human rights, and protection for minorities; 2) the establishment of a functioning market economy able to effectively deal with competitive pressures and EU market forces; and 3) adherence to political, economic, and financial goals, from an agreement to do away with the death penalty to accepting the conditions for future monetary union, (European Commission Enlargement DG 2010).
In December of 1995, the conditions for membership were expanded to include criteria set forth at the Madrid European Council, such as the reform of administrative and judicial structures. The candidate countries would also have to agree to abide by and implement the *acquis communautaire*, the EU’s body of laws, policies, and objectives. The accession criteria would continue to evolve over subsequent years of negotiations to address issues that might not have come up when the initial phases of talks took place. Meeting the accession criteria would prove to be challenging for all the candidate countries, but the benefits of membership heavily outweighed any potential costs. In addition, the member states of the West had at least as much, and in some cases more, to gain from the eastern enlargement and wider regional integration as their CEE counterparts.

Regional integration, like the broadening of the EU, has long been associated with economic growth as trade barriers are decreased, specific investment rules are set, incentives are created, and the cost of doing business goes down. The adoption of the rules set by widely respected international institutions can help to regularize expectations, reduce uncertainties and transaction costs, and stabilize patterns of behavior among member states, which is one of the core arguments of neoliberal institutionalism, (North 1991, 98). In addition, “regional integration offers “insider firms” incentives to invest more locally, by reducing transaction costs and thereby increasing the rate of return on capital. At the same time, it creates motives for outsider firms to become insider firms,” (Buckley 2004, 35).
Foreign investors were motivated by the potential for profit in the CEE markets and the move to expand European integration eastward would further assure that their investments would be safeguarded by the EU’s strict rules and standards. While EU accession negotiations were a promising sign for most investors, some feared that the economic conditions of membership would create a “Fortress Europe,” characterized by protectionist measures. Those fears were eventually assuaged as it became increasingly evident that the CEE candidate countries would soon be granted the EU “seal of approval.” This “seal of approval” “can mean big drops in risk such that countries essentially go from being treated as emerging markets to stable OECD countries, even if their previous levels of development remain more or less unchanged,” (Gray 2009, 932).

The process of rebuilding the post-communist political and economic systems of the CEE countries would be pushed along by the carrots and sticks offered by the EU. The carrots came in the form of developmental aid, such as PHARE and structural funds, as well as opportunities for employment, travel and study abroad and future EU citizenship and monetary union, among others. Some of the sticks included pushing back the accession date and the reduction or suspension of funds if the accompanying conditions were not met or reforms were not effectively implemented. On the one hand, the carrots would boost investor confidence and trigger considerable inflows of FDI. On the other hand, the sticks would punish those candidate countries that did not institute the administrative, judicial, and legal reforms needed to combat the corrupt activities
of political officials looking to hijack the transition process for their own personal gain. The EU accession negotiations would, therefore, determine not only when and under what circumstances the candidate countries would be admitted, but also the course of their economic and political future.

From the mid-1990s to the 2000s, the CEE candidate countries worked tirelessly to implement and enforce the reforms, policies, and laws necessary to meet the requirements for EU membership. Some countries, such as Hungary, Estonia and Slovenia, were better able to effectively tackle corruption and simultaneously attracted unprecedented levels of foreign investment. Having satisfied the EU conditions for membership, eight CEE countries’ candidacies were approved in 2004: the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia. Romania and Bulgaria’s entry, however, was postponed until 2007 as the EU expressed concerns about both countries’ ability to successfully fulfill the economic and political criteria for membership.

Among the most fundamental of these concerns was corruption. Monitoring reports that scrutinized the candidate countries were issued for Romania and Bulgaria. According to Romania’s report, one of the most pressing issues was that of corruption: Romania “has adopted key legal acts to sustain the on-going reform of the justice system and the fight against corruption. Investigations into allegations of high-level corruption have increased in number without prejudicing their quality. Furthermore, two national campaigns have been started to raise awareness among the public, and civil servants in particular, of the negative consequences of corruption,” (European Commission Enlargement DG 2010).
Analysts and policymakers were optimistic that the effects of democratization, free market competition, and external pressure from the EU would eventually help to reduce levels of corruption over time and bring both the “culture” and “season” of corruption to an end in the CEE countries. As Sandholtz and Taagepera explain, “cultures change. But they change relatively slowly. Where cultural orientations are concerned, there are no quick fixes. The former communist countries will probably be wrestling with comparatively high levels of corruption for decades. Creating the proper incentives is crucial,” (Sandholtz and Taagepera 2005, 127).

The fight against corruption will remain an important issue on the CEE political agendas, with some countries required to make more progress than others. Nevertheless, the period of post-communist transition and that path to EU membership were marked not only by the challenges of privatization, corruption, and reform, but also by the economic optimism of inflows of FDI and substantial economic and political development. Political leaders, EU officials, and representatives of international organizations were closely monitoring the pace of reforms in the region. Foreign investors, having realized that the protection and privileges of EU membership were only a matter of time, were more interested in the economic opportunities that privatization, the development of new industries, and the opening of relatively untapped consumer and labor markets would provide in the CEE.
Foreign Direct Investment in Transition

FDI refers to long-term investment strategies of foreign assets into domestic businesses, structures, equipment and organizations. With the free market replacing the economic decisions once made by the state in communist countries, foreign investors immediately understood the potential to profit from the opening up of new markets. Large multi-national corporations (MNCs), medium-sized firms, and even small-time investors hastened to develop plans, gather funds, and quickly establish themselves in the post-communist countries in order to get a piece of the pie. According to the European Bank for Reconstruction and Development (EBRD), the motivating factors for FDI inflows in the 1990s were three-fold: 1) resource-seeking; 2) market-seeking; and 3) efficiency-seeking, such as local labor costs, (Viezzoli 2006, 10). The CEE countries had much to offer in the way of all three—many of the CEE countries are resource rich, possessing both oil and mineral resources; previously state-controlled markets were recently opened up to trade and investment, with millions of potential consumers just waiting to tap into the wealth of goods and services that are associated with free market transactions; and labor in most of the post-communist countries was usually highly skilled and relatively inexpensive when compared to labor costs in western Europe.

Just as much of the privatization occurred within a short period of time, so too did much of the foreign investment. Foreign investors, however, weighed out a number of factors before making the decision to invest in the CEE countries. Some of these included determining whether a firm would have a greater
advantage as an investor over a local firm; the potential profitability of expanding a corporate structure rather than franchising or licensing production and sales; the cost of building factories or opening up stores; the price of real estate; the skill level and cost of labor; the availability of discretionary tax breaks and investment incentives; and transportation costs and relative proximity to the markets where the goods and services would be consumed, among many others. Of course, it was equally important for foreign investors to consider some of the potential disincentives to investing in the CEE countries immediately following the dismantling of the planned economies.

Among the potential disincentives to FDI were geographical, market, legal, taxation, political, macroeconomic, infrastructural, cultural, environmental, and many other potential constraints, (Bitzenis 2009, 99). Market constraints, in particular, were characterized by such obstacles as high levels of bureaucracy, corruption, bribery, kickbacks, lack of entrepreneurship and managerial skills, and technological backwardness. Foreign firms were, therefore, under pressure to make hasty decisions about whether or not to offer bribes or kickbacks to corrupt government officials, many of whom controlled the privatization process. On the one hand, foreign investors had to weigh the legal consequences of engaging in corrupt activities against the potential profits to be made by the advantages of entering the CEE markets with the backing of the government officials who had been paid off. On the other hand, there was no guarantee that property rights and laws governing business transactions would be respected or enforced given the relative inefficiency of the legal system following the collapse
of the communist states. Economic uncertainties in the early 1990s abounded, but just a few years later, the number of foreign firms that had invested directly in the CEE countries had grown considerably.

Foreign direct investment, along with portfolio and other forms of investment, have often been regarded as being among the most substantial engines of growth in countries undergoing economic transition. The impact of the FDI inflows would vary from case to case in the CEE countries after 1989, particularly because each country in the region had a different economic and political starting point. Some countries had already begun implementing gradual changes to their economic structures several years before the collapse of communism, while others lagged behind considerably and had to work much harder to catch up by taking the ‘shock therapy’ route. Regardless of the economic strategy pursued, it soon became clear that the potential for growth would increase exponentially with an influx of funds, technology, and know-how from abroad.

In the early 1990s, many MNCs, like Coca-Cola and McDonald’s, were among the first to open up manufacturing plants and franchises in the CEE region. The establishment of such companies was a preview of the economic openness to come, but more importantly, access to such goods gave citizens of the CEE region a taste of the West and of a newfound freedom that they had been longing for. Almost immediately following the collapse of communism, the EU, U.S., and developed countries from around the world began negotiating trade agreements that would reduce barriers to trade and facilitate foreign
investment. Several CEE countries established Most Favore

d Nation (MFN) trading status with the U.S. and others became members of the IMF and WTO, while the EU worked quickly to sign Association Agreements with states that it would soon consider for membership.

The removal of trade barriers was an important step in ensuring that foreign companies would be able to make different types of investment: greenfield FDI would chart new economic waters in the CEE; brownfield FDI would reinvent state-owned enterprises; real estate and construction ventures would increase the value of land in the region; and mergers and acquisitions, joint ventures, and licensing agreements would open the doors to countless economic opportunities. The extent to which FDI would spur economic growth in the transitioning countries of the CEE would depend on a variety of factors, ranging from individual states’ willingness to open their markets up to foreign investment to foreign investors’ perception of opportunities in the region. In order to evaluate the impact of FDI in CEE, it is important to look more closely at each country’s experience with foreign investment and how it affected its economic outcomes.

An In-Depth Look at Inward FDI in CEE: Bulgaria

The extent of Bulgaria’s economic dependence on the structure of the Council for Mutual Economic Assistance (CMEA/COMECON) became apparent in the early 1990s when the collapse of communism left the country with a massive vacuum in foreign trade. To begin the process of integration into the
global economy, Bulgaria joined the IMF in 1990 and it became a member of the WTO in late 1996. It also signed an Association Agreement with the EU in 1993, which would be a key factor in launching the membership negotiations beginning in 2000. Economic liberalization and the privatization of hundreds of state-owned enterprises would also give rise to opportunities for foreign investment. The Bulgarian government did not hesitate to take considerable measures to make its market as attractive to foreign investors as possible, including policy changes, corporate tax breaks, government subsidies, and various economic incentives. In fact, the government established the Invest Bulgaria Agency (IBA), formerly known as the Bulgarian Foreign Investment Agency, to encourage foreign investors to explore investment opportunities and carry out investment projects (mainly greenfield FDI).

The IBA’s efforts and government policies to attract FDI, along with Bulgaria’s membership in international trade organizations and negotiations to join the EU, all contributed to a gradual increase in FDI from the 1990s onward. According to UNCTAD FDI Statistics, FDI inflows into Bulgaria increased from $112 million in 1990 to almost $44 billion in 2008, (UNCTAD STAT 2012). From 2000-2009, FDI inflows “as a percentage of gross fixed capital formation ranged from a low of 39% in 2001 to a peak of 105% in 2007. Economic growth in the first decade of the new century and a strong market potential have enhanced Bulgaria’s ability to attract international investors. This is a remarkable development, since Bulgaria used to be a laggard in transition to a market economy for most of the 1990s,” (Bitzenis 2012, 1-2).
Some of the most influential factors in the increase in FDI in Bulgaria include large-scale privatization of state-owned industries, the decision to fix its currency value to the Deutsche Mark in the 1990s and later to the Euro in 1999, incentives for greenfield investors, competitive labor and real estate costs, and the EU accession process. The economic outcome for Bulgaria was significant: the UNCTAD IFDI Performance Index ranked Bulgaria 92\textsuperscript{nd} from 1990-1992 and it rose to a place among the top ten in the period from 2004-2007, (UNCTAD 2007, 62). While Bulgarian economic growth continues to depend heavily on FDI, accession to the EU in 2007 has contributed to the maintenance of economic attractiveness to foreign investors even in the most recent challenging economic times.

\textit{Czech Republic}

Unlike other states that, after the collapse of the planned economies, turned almost immediately to foreign investment to spur economic growth, the Czech Republic sought to conduct the privatization of state-owned industries domestically, offering few or no incentives to foreign investors and encouraging domestic ownership instead. The country’s geographic proximity to developed Western states, its previous experience with market reforms, and the implementation of a more measured privatization process all contributed to a more stable economic environment in the early 1990s that allowed Czech enterprises to grow. In addition, the Czech Republic also joined the IMF in 1993,
implementing some of its “shock therapy” measures, and the WTO in 1995, accepting terms that would reduce barriers to international trade and investment.

Domestic growth was promising until 1996, when a lack of modernization, a rise in wage costs, increasing inflation, and a growing account deficit contributed to an economic recession that the Czech economy was ill prepared to withstand. As a result, the Czech government introduced a series of FDI incentive schemes in 1998 that would attract an influx of foreign investment to help pull the country out of its deepening economic recession. This move proved to have positive consequences for the Czech economy as “studies [Evenett and Voicu 2001; Hanousek et al. 2004] have indicated that enterprises receiving foreign investment, or under foreign ownership, outperformed their domestic counterparts…the low productivity growth prior to 1997, in which the Czech Republic lagged behind both Hungary and Poland, can be associated with a relative lack of foreign investment,” (Kay 2007, 3-4).

The surge of FDI inflows into the Czech Republic from 1999 onward, prompted in part by fiscal incentives to foreign investors and a government stabilization package, would allow the economy not only to play catch-up, but also to surpass the levels of economic growth of other countries in the region. According to the UNCTAD STAT measures, FDI inflows increased from about $14 billion in 1998, when incentives for foreign investors were initially introduced, to over $113 billion a decade later, (UNCTAD STAT 2012). In 2004, the Czech Republic joined the EU and eventually became one of the largest recipients of FDI in the CEE region, with over 80% of inflows coming from Germany, the
Netherlands, and the U.S. The experience of an isolated and primarily domestic privatization process in the early 1990s provide the Czech government with a valuable economic lesson and its decision to open up its market to and incentivize foreign investment proved both rational and beneficial for the Czech economy in the long term.

Estonia

Throughout the communist era, the Soviet Union played a large part in restructuring the Estonian economy so as to ensure its dependence on trade with the CMEA. When this system collapsed, however, Estonia remained largely unprepared for the task of economic reform and financial independence. As a result, it looked to its experienced capitalist neighbors, primarily Finland and Sweden, for help with the establishment of a free market economy and a stable banking system. In 1992, Estonia joined the IMF, but it would not become a member of the WTO until 1999 (unlike many other CEE countries that joined in 1995). In the early part of the transition process, from 1990-1992, several other CEE countries were implementing the IMF’s recommended “shock therapy” measures, but Estonia continued to have difficulties passing reforms and it initially lagged behind in economic growth.

The challenges Estonia faced in the early stages of economic reform would soon be reversed with inflows of FDI that changed the course of market decisions. Sweden and Finland began heavily investing in Estonia, accounting for more than two-thirds of FDI inflows into the country. While much of the
investment in Estonia was in the banking industry, manufacturing, communications, retail trade, communications, and transport also received substantial capital inflows. The government established the Estonian Investment Agency, similar to the one created in Bulgaria, to seek out domestic opportunities for foreign investors and encouraging both greenfield and brownfield FDI. By the mid-1990s, Estonia also entered into negotiations to join the EU, creating a perception of economic and political stability that would contribute to its rise as one of the most desirable recipients of foreign capital and investment.

The implementation of economic reforms, stabilization of the political system and banking industry, the geographic and cultural proximity to the capitalist Scandinavian countries, and the launch of the EU accession negotiations resulted in some of the highest levels of per capita FDI inflows in the CEE region. This tremendous growth explains in large part why, “according to the Ministry of Finance Pre-Accession Economic Programme of April 2001, the essential factor in attracting foreign investments into the country is Estonia’s further integration with the EU,” (OECD 2001, 6). UNCTAD STAT records indicate that FDI inflows in Estonia rose from $92 million in 1992, to $10 billion in 2004 when it joined the EU, and upward of $16 billion four years later, (UNCTAD STAT 2012). While some of the other CEE countries, such as the Czech Republic, initially hesitated to encourage FDI, the fact that Estonia embraced foreign capital as a source of future economic growth right from the beginning of the transition process demonstrates both the foresight it had and the benefits it achieved as a result of this important decision.
**Hungary**

Hungary’s economic experience both before and after 1989 differs noticeably from other CEE states because it was one of the most liberal and advanced economies of the communist bloc. With agricultural subsidies causing its foreign debt to rise and seeing a need for loans to implement modernization programs, Hungary joined the IMF in 1982, a decade before most other countries in the region. In part because it obtained loans from the IMF, Hungary began instituting economic reforms that would lead to a gradual transition to a market economy in the 1990s. While Hungary did not adopt a full-fledged “shock therapy” strategy, it did become apparent that, even with the slow and steady reforms that had been passed for several years, there was much work to be done in very little time if the Hungarian economy was to become competitive in the global market.

By the mid-1990s, it had become clear that Hungary would benefit from the inflow of foreign capital and FDI began pouring in. Rather than selling off state-owned industries and providing Hungarian citizens with vouchers and other forms of compensation, the Hungarian government looked instead to foreign investors that would infuse the capital necessary to spur new growth or revamp the existing industries. Foreign investors also took the opportunity to invest in Hungary seriously early on and, by 1992, Hungary was already receiving more than $3 billion worth of FDI in greenfield and brownfield investments.

In 1995, Hungary became a member of the WTO and by the end of the 1990s, the EU accession negotiations were well under way. Throughout the
1990s, however, FDI inflows had grown moderately each year, from $2 billion to $23 billion over the period of a decade (averaging an increase of $4 billion per year), (UNCTAD STAT 2012). As soon as Hungary made the official announcement that it had entered into negotiations to become a EU member state, FDI inflows began to increase considerably. FDI inflows went from $22.8 billion in 2000 to $61.5 billion when it joined the EU in 2004, at an average increase of $10 billion per year, (UNCTAD STAT 2012). Car manufacturers, like Audi and Mercedes for instance, have built some of the largest plants in Europe in Hungary because of the geographic proximity, low cost of transport, and highly skilled and low wage work force.

After it joined the EU in 2004, FDI inflows continued to increase, albeit not at the rapid rate that they had in the late 1990s and early 2000s. Since Hungary had begun implementing reforms much earlier on than the majority of the CEE countries, its investment peak also occurred before other states in the region had even reach the half-way point in their reforms. “Dominance of Hungary as FDI recipient in the first half of 1990s diminished steadily over the last years. While FDI inflows in Hungary reached the peak already in 1995, big privatization projects pushed FDI inflows in Poland and the Czech Republic to their highs as recently as in 2000 and 2002 respectively,” (Torlak 2004, 9). As a result, the process of privatization also ended earlier in Hungary and foreign investors began to seek opportunities in neighboring states where much room for growth and modernization still existed. Hungary remains one of the largest recipients of FDI inflows in the CEE, but as the processes of transition and privatization are
nearing completion, it has begun to take measures to find its niche in the global economy that will ensure its competitiveness in the future.

**Latvia**

Just as in the case of its neighbors, Lithuania and Estonia, Latvia’s geographic location between developed states of the EU and the former communist bloc had a significant impact on its economic performance. Trade in Latvia had been heavily dependent on the CMEA for several decades and the collapse of the Soviet Union left behind a financial and trade vacuum that it would have great difficulty filling initially. In fact, the first few years after the fall of communism were characterized by painfully slow reforms and an unsustainable current account deficit. The legacy of communism had left behind a popular expectation that the state would provide services that, in its present reality, it was no longer able to fulfill; hence an increase in its deficit spending.

To overcome these economic challenges, the Latvian government created the Latvian Development Agency in 1993, renamed the Investment and Development Agency of Latvia ten years later. The agency’s purpose is to provide foreign investors with opportunities to establish greenfield investments, joint ventures, and buyouts that would strengthen the Latvian economy. Latvia also joined the IMF in 1992, which has provided the state with considerable loans throughout its membership period, signed a EU Association Agreement in 1995, and became a member of the WTO in 1999.
FDI inflows into Latvia were very moderate throughout the 1900s, ranging from $176 million in 1992 to $1.7 billion in 1999, (UNCTAD STAT 2012). Major foreign investments came from Estonia, Sweden, Denmark and Germany. The process of privatization was gradual, but effective, and some industries (especially in the energy, oil and telecommunications sectors) remain state-owned or managed. By the end of the 1990s, the official EU accession negotiations were well underway, a factor that contributed significantly to Latvia’s economic growth in the 2000s. In fact, FDI inflows went from about $2 billion in 2000 to more than double in 2004 at $4.5 billion, coinciding with the year in which Latvia became a EU member state.

Perhaps more than any other country in the region, Latvia’s entry into the EU sparked a burst of foreign investment that it had not experienced up until that point: FDI inflows tripled, from $4.5 billion in 2004 to $11.5 billion in 2008, averaging an increase of almost $2 billion per year in a four-year period—the annual increase from 2004-2008 was greater than the inflows of FDI in the 1990s combined. While this kind of economic growth proved almost impossible to sustain in the long-term, the extent to which FDI inflows have changed the course of the Latvian economy in the second half of the 2000s will have a lasting impact on the country’s economic future.

Lithuania

Of the three Baltic States, Lithuania’s economy is the largest in terms of market size, GDP, and output. Its economic history is similar, if not identical in
many ways, to those of Estonia and Latvia. The Lithuanian economy had come
to depend so heavily on trade with the communist bloc, that the collapse of the
CMEA and the Soviet Union made the lack of industrial modernization and
financial reform painfully obvious. FDI inflows had begun to gain momentum in
Estonia and Latvia in the early 1990s, but Lithuania lagged behind its neighbors
as a result of the slow process of privatization of state-owned enterprises and
large-scale infrastructure. The challenges associated with making improvements
to the Lithuanian infrastructure represented one of the obstacles to greenfield
investments in the 1990s and, consequently, the Lithuanian government focused
much of its energy and resources on this sector to attract FDI in the medium and
long term. In 1992, Lithuania joined the IMF and, by the mid-1990s, it had caught
up to the other two Baltic States in terms of FDI inflows.

As talks of EU membership became more serious, Lithuania developed a
medium term economic strategy in 1999 that would ensure the harmonization of
its laws and reforms with those standards set by the EU in the accession
agreement. Lithuania became a member of the WTO in 2001, but competition for
global FDI had become considerable at that point and Lithuania would have to
show investors that its specialized industries could not only compete, but also
lower costs of production and wages. Electrical engineering, laser research and
development, textiles, furniture, software, and the energy and oil sector would all
prove very attractive areas for investors, (OECD 2000, 9-10). Major investors in
Lithuania by the end of the 1990s were Sweden, the U.S., Finland, Denmark, and
Germany.
Foreign investors from these countries would continue to pour capital into Lithuania’s economy and its membership in the EU in 2004 would cause FDI inflows to increase at a rate unseen in Lithuania up until that point. Throughout the 1990s, FDI inflows had increased from $107 million in 1992 to $2.3 billion in 2000. As the EU harmonization reforms intensified, FDI inflows shot up from $2.6 billion in 2001 to $6.3 billion in 2004, the year that it became a EU member, and it reached its peak at $15 billion in 2007, (UNCTAD STAT 2012). FDI inflows after 2007 would begin to taper off, but economic growth and foreign investment in Lithuania is far from over.

Poland

In terms of both territory and population, Poland is the CEE region’s largest country. This also translates into the fact that Poland’s market size and growth potential has long been of considerable interest to foreign investors, particularly during the period of post-communist economic and political transition. In mid-1989, Poland was the “first country to embark on a program of fundamental market reform under a noncommunist government… the aim was to end hyperinflation and create the legal, institutional, and economic basis for a market economy,” (Lipton et al. 1990, 77). Poland was among the first countries in the CEE region to join the IMF, in 1986, instituting its “shock therapy” reforms just a few years later. By the mid-1990s, trade with the CMEA had seen a notable decrease, while trade with EU member states increased to represent more than two-thirds of Poland’s trading volume. The “shock therapy” approach
to economic reform advocated by the IMF and some Western states remains a subject of intense debate, but some scholars have argued that it is the reason why Poland’s transition to a free market economy progressed more smoothly and quickly than other countries in the region. On the other hand, some CEE countries instituted a more gradual approach to the economic transition and the results were similar, indicating the complexity of the factors used to explain various economic outcomes in the region.

While it might have begun the process of economic transition earlier than other countries in the region, Poland still had to tackle many of the same issues, including the lack of modernization of industry and agriculture, the challenges of privatization, and the need to become competitive on the global market. Unlike other countries in the CEE that wanted to minimize the role of foreign investors in the process of privatization of state-owned industries and enterprises, the Polish government welcomed foreign capital almost immediately. Given the sheer size of its economy and the number of industries in need of modernization, the Polish government considered the impact that FDI would have on the development of a free market economy by offering tax incentives, low real estate costs, and offering fast-track investment opportunities. In 1992, the State Foreign Investment Agency (PAIZ) was created to promote FDI investment and make foreign investors aware of the significant number of economic opportunities that had arisen in Poland. The PAIZ eventually merged with the Polish Information Agency (PAI) in 2003, forming the Polish Information and Foreign Investment Agency. In 1995, Poland also joined the WTO.
With over 5,000 enterprises in need of modernization and the infusion of capital and a market of almost 40 million consumers, FDI inflows in Poland began to take off in the mid to late 1990s. EU accession negotiations in the late-1990s also spurred foreign investment, both in greenfield and brownfield investments. FDI inflows went from $1.3 billion in 1992, to $34 billion in 2000 when it began harmonization with EU standards, to over $86 billion when it joined the EU four years later in 2004, (UNCTAD STAT 2012). French, German, Dutch, Luxembourghian, Nordic, and US investors, among other countries, took advantage of the relatively low cost of entry into the Polish market, coupled with the investor-friendly environment created by the Polish government, to establish themselves in the Polish market. FDI inflows into Poland almost doubled in a period of four years, from $86 billion in 2004 to $164 billion in 2008, and it has continued to increase, albeit at a decreased rate, (UNCTAD STAT 2012). Poland was selected to host the European Soccer Cup in 2012, spurring massive foreign and domestic investment in infrastructure and various industries, notably the tourism industry, which will help Poland continue on its path of rapid economic development well into the 2010s.

Romania

Romania is one of the largest and most populous countries in Central and Eastern Europe, but foreign access to its markets has historically been a challenge. Throughout the communist era, Romania had one of the strictest dictatorships in the region under Nicolae Ceausescu and foreign investment was
very limited as most industries and enterprises were tightly controlled by the state. The pervasive role of the state in every aspect of economic and social life in Romania also contributed to the difficult circumstances surrounding the collapse of the communist system in December of 1989. Unlike most of the countries in the CEE region, Romania did not experience a smooth transition to democratic rule. Demonstrations in Timisoara spread to Bucharest, where a bloody national uprising eventually led to the capture and execution of Ceausescu and his wife, Elena. In addition, reforms that had been gradually implemented in countries like Hungary and the Czech Republic and that had served to ease some of the transition pains were only beginning to be introduced in the early 1990s. Wrought with political instability caused by various parties and emerging leaders vying for power, Romania was not the ideal candidate for FDI in the initial stages of the transition process.

In 1990, the head of the National Salvation Front and a former communist party member, Ion Iliescu, was elected president, after a short campaign based on the promise to rebuild Romania after Ceausescu. The surge of nationalist sentiment that characterized the transition process in other CEE countries, such as Slovenia, also arose in Romania. The ‘our country is not for sale’ mentality prompted state leaders to enact legislation that favored domestic ownership in the privatization of state-owned enterprises and industries. While Romania had joined the IMF in 1972 and signed the Trade and Cooperation Agreement in 1991, these moves did not facilitate the entry of foreign investors into the Romanian market. In fact, Romania did not develop a strategy to attract FDI
inflows until it signed the Europe Agreement in 1993 and began working on its application for EU membership, submitted two years later.

The combination of a domestically-oriented privatization scheme and the lack of a strategy to attract foreign investment undoubtedly contributed to a slow start to FDI among other countries in the CEE region. During Iliescu’s presidency, FDI inflows were relatively minimal, increasing from $44 million in 1990 to just over $1 billion in 1996, (UNCTAD STAT 2012). The mid- and late 1990s, however, would see a significant increase in foreign investment as the country’s political structure and approach to economic reform underwent substantial changes.

The 1996 election of Emil Constantinescu, an intellectual who represented a genuine departure from the communist *nomenklatura*, prompted the implementation of democratic and free market reforms on an unprecedented scale. While Romania had joined the WTO in 1995 and submitted its formal application for EU membership in the middle of that same year, it was not until the late 1990s that the effects of reforms and new laws would produce tangible results. In 1996, the Romanian government set up the Romanian Foreign Trade Center (RFTC), which was eventually renamed and restructured several times, establishing the Romania Trade & Invest Agency in 2009. The investment agency’s goal was to provide potential investors with information about investment opportunities in Romania as well as professional services and the government also adopted new strategies to increase FDI inflows.
Many of the barriers to privatization set up by the Iliescu administration were removed under Constantinescu and foreign investors were now offered incentives to enter the Romanian market. Among these were tax breaks and exemptions for foreign firms, especially within the first five years of the establishment of greenfield investments; few restrictions on the acquisition of property and real estate; access to state and regional investment grants; fiscal incentives for new job creation; and the implementation of a major tax code reform that would set up a 16% flat tax.

In 1999, the European Commission accepted Romania’s application for admission and formal accession negotiations were opened by the Helsinki European Council the following year. The Romanian government had already begun the process of harmonization with EU standards by the late 1990s, but the privatization of major state-owned industries and enterprises had not yet occurred at the same pace or on the same level as most of the other CEE countries. In the early 2000s, a substantial increase in FDI inflows was the “result of major privatizations (the sale of the national oil company Petrom, and the sale of gas and some electricity distribution companies) as well as a rise in greenfield projects (large European retailers continued their expansion in Romania and more automotive spare-parts producers were relocating their production here), and the increased subscribed share capital for major Romanian companies,” (Price Waterhouse Coopers 2005/2006, 158). With more than a dozen large-scale investment projects, the EBRD is the largest foreign investor in Romania, but many other MNCs have entered the Romanian market in the agriculture,
automotive, construction, oil and gas, retail, telecommunications, food, IT, and distribution sectors of the economy.

Once the process of privatization took off in the late 1990s, opportunities for foreign investors abounded as new doors were opened for entry into the second most sizeable market in the region, after Poland. Some of the most significant privatization deals concluded in recent years include the sale of the Romanian car manufacturer, Dacia, to French Renault; the sale of Sidex, a massive steel mill, to LNM Ispat in 2000; the sale of two major banks, the Romanian Development Bank and the Agricultural Bank, to French Société Générale and German Raiffeisen Bank, respectively; the privatization and sale of regional utility, gas and electricity distribution companies to Italian Enel, French Gaz de France, and German Ruhrgas, among others; and Austrian OMV’s acquisition of 33% of the largest domestic oil company, Petrom, (Larive Romania 2005, 37).

Privatization and brownfield investments have been extremely important for the expansion of the Romanian economy, but greenfield investments have a longer-term outlook given that privatization opportunities are limited, while the type and number of new foreign investments and business are limitless. For instance, British Vodafone and French Orange telecommunications giants have firmly established their dominance over the Romanian cell phone and telecommunications market in the past decade. Foreign retail stores and food chains have also been very successful in recent years: German Kaufland, French Carrefour, and other retailers such as Metro, Cora, Selgros, and XXL have all
opened new stores and benefited from tax and government incentives as well as from the increasing purchasing power of the Romanian market.

Most FDI inflows into Romania have come from the Netherlands, Austria, France, Germany, Italy, Greece, and the US, but new investment is being generated by MNCs from many other parts of the world. In 2004, Romania joined NATO, became a non-permanent member of the UN Security Council, and completed EU accession negotiations that would allow Romania to be an official member on January 1, 2007, along with Bulgaria. The historical circumstances of the mid-2000s had an important globalizing effect on the Romanian economy, causing FDI inflows to jump from $12.2 billion in 2003 to $20.4 billion in 2004, (UNCTAD STAT 2012). Romania’s entry into the EU boosted foreign investor confidence to unprecedented levels and, after Poland, the Czech Republic, and Hungary, Romania came in as the fourth largest recipient of FDI inflows in the CEE region in 2004.

The manufacturing sector continues to attract more than a third of FDI stocks and both the IMF and World Bank have recently signed off on substantial loans to the Romanian government for business development, infrastructure improvement, and projects to modernize various industries and manufacturing plants. Romania’s “catching-up process accelerated from 2004, with net inward FDI flows as a share of GDP exceeding the inflows recorded in both the eight central and eastern European countries which joined the EU in 2004…Over the past four years, Romania has benefited from record FDI inflows, thanks to macroeconomic stabilization, strong GDP growth, large-scale privatizations and
the prospect [and actual] EU membership,” (Pauwels and Ionita 2008, 1). In 2008, FDI inflows into Romania had reached a record $67.9 billion and, while the process of privatization has slowed considerably, there remain state-owned or controlled companies that will continue to attract foreign capital in the future. Wages remain lower than in most other countries in the CEE region, attracting job-creating FDI projects, and opportunities for foreign investors are far from being exhausted. The sheer size of the Romanian market, combined with its advantageous location and EU-generated investor confidence, will ensure its capacity to attract FDI well into the future.

Slovakia

Following the collapse of communism in the CEE region, Slovakia dealt not only with transitioning to a democratic political system and a free market economy, but also struggled to generate support for the type and pace of reforms being carried out in the Czech Republic. Just as the “Velvet revolution” to dissolve the communist government had preceded it, the “Velvet divorce” to acquiescently split up the two states took place in 1993. The Czech Republic had sought to conduct its privatization process with a domestic focus, initially offering no incentives to foreign investors and strategically maneuvering to ensure that state-owned enterprises would be transferred into the hands of Czech nationals. While Slovakia had relatively low levels of foreign investment from the early to late 1990s, these numbers were reflected not only by the government efforts to keep privatization local, but also by political disagreements that caused the
country’s economy to experience a developmental lag and few or no incentives for foreign investors. Slovakia joined the IMF in 1990 and the WTO in 1995, but notable economic growth began after political issues were resolved in the late 1990s.

In 1998, Prime Minister Dzurinda implemented macroeconomic policy reforms that would stabilize the economy and aid in successfully completing the process of privatization. Incentives, such as tax breaks, grants, and low-cost real estate, were introduced in 1998 and, combined with measures to increase their transparency, they had a significant impact on the growth of the Slovakian economy. In addition, labor was about 30% cheaper in Slovakia than in the Czech Republic, but productivity was comparable, encouraging many investors to switch their sights. The sale of state-owned industries in the telecommunications, energy supply network, and manufacturing sectors spurred an influx of foreign capital into Slovakia that it had not experienced until that point in its economic transition. Car manufacturers, like Peugeot and Kia, have opened up state-of-the-art plants in Slovakia, motivated in part by improvements to infrastructure and incentives such as new highways leading to their locations.

Throughout the 2000s, there was a significant increase in greenfield FDI and the boundary between “privatization and greenfield investments has disappeared in many privatization operations when good profitability attracted additional investments. [As a result] the penetration rate of FDI is now very high and it has become the prime engine of capacity and output growth,” (Štefániková et al. 2006, 1). Slovakia established the Slovak Investment and Trade
Development Agency in 2001 to attract foreign investors by presenting them with investment opportunities in different parts of the country. Slovakia’s negotiations to join the EU were also an important economic consideration, as the country’s economy had gone from not qualifying for entry in 2004 to implementing EU harmonization standards that enabled it to join the first Eastern enlargement.

The accession negotiations and entry into the EU also had a considerable impact on the inflows of FDI into Slovakia. In 1993, FDI inflows represented only about $642 million, but after the passage of reforms in the late 1990s, inflows had risen to $4.7 billion in 2000, (UNCTAD STAT 2012). By the time Slovakia joined the EU in 2004, FDI had reached $21.8 billion and continued to rise until about 2008, when FDI inflows peaked about $52 billion, (UNCTAD STAT 2012). While the “Tetra Tiger”, as it is sometimes referred to, would not be able to sustain this level of foreign investment indefinitely, it has certainly put the investment it has received to work for economic growth that is expected to last well into the foreseeable future.

Slovenia

For much of the CEE region, the collapse of communism not only left behind a political and economic vacuum, but it also pushed each country to reevaluate its identity separate from that of a member of the Soviet-controlled communist bloc. In the former Yugoslavia, the resurgence of nationalist sentiment escalated into one of the most violent periods in recent European history. In other parts of the region, nationalist sentiment translated into the
implementation of protectionist economic measures, as in the case of Slovenia. In the early stages of the transition to a free market economy, the Slovenian Privatization Agency handled the transfer of ownership of state-owned enterprises to the private sector.

Foreign investors were looking to enter into the Slovenian market in much the same way they had in other CEE countries. In Slovenia, however, “wholly foreign-owned companies were not permitted in the military equipment field, rail and air transport, communications and telecommunications, insurance, publishing and mass media, (Dunning and Rojec 1993, 34). These are activities where protecting national ownership could be considered crucial for maintaining control over strategic assets. Moreover, the Slovenian privatization scheme favored domestic owners…” (Bandelj 2003, 379). The breakup of the former Yugoslavia in the early 1990s, therefore, had a significant impact on the inflows of FDI into Slovenia.

Perhaps traumatized by the dissolution of the former Yugoslavia and the violence that ensued, Slovenia implemented economic reforms and policy measures that would protect domestic assets and, in some instances, make it so difficult for foreign investors to circumvent the rules that they stopped being interested altogether. This explains, in large part, why FDI inflows represent such a small portion of the GDP in Slovenia throughout the first decade of transition. Slovenia did join the IMF in 1992 and the WTO in 1995, while EU accession negotiations began in the late 1990s.
Increasing pressure from foreign companies and the parallel reception of FDI in neighboring CEE countries prompted the Slovenian government to take a closer look at the potential benefits of FDI for long-term economic performance. The government established the Public Agency of the Republic of Slovenia for Entrepreneurship and Foreign Investments (JAPTI), charged with the task of matching foreign capital with domestic opportunities. The strategy used by JAPTI was a ‘FDI Co-Financing Grant Scheme’, passed in 2000 to lower the cost of entry for foreign investors interested in greenfield investments in Slovenia, (Burger, Jaklic, and Rojec 2012, 1). After initially being reluctant to allow foreign investors into the country, the grant scheme represented the new outlook of the Slovenian government on FDI and the results over subsequent years indicated that it was a sound financial decision.

After 2000, the Slovenian government would continue to provide incentives to foreign investors and remove some of the barriers to entry into the market. These types of reforms coincided with the increasing intensity of EU accession negotiations, which allowed Slovenia to be a part of the first wave of the Eastern enlargement process in 2004. In fact, FDI inflows into Slovenia grew at a disproportionately low rate when compared to other countries in the region throughout the 1990s, going from $1.8 billion in 1992 to slightly over $2.8 billion in 2000 (UNCTAD STAT 2012). The government’s policy shift towards incentivizing FDI and EU accession negotiations might be among the various factors that contributed to the increase in FDI inflows in the 2000s: FDI rose from $2.5 billion in 2001 to $7.5 billion in 2004 to $15.6 billion in 2008 (UNCTAD STAT
2012). Whether domestic or external forces influenced trends in FDI inflows more significantly is a subject of debate. What has become apparent, however, is that the policy shifts and economic reforms of the late 1990s and early 2000s would provide foreign investors with greater opportunities in Slovenia than ever before.

Corruption, EU Membership, and FDI

A detailed outline of the FDI inflows in the post-communist CEE countries provides not only a description of these trends throughout the transition period, but also serves as a backdrop for the inquiries of this study. Foreign investment has seen a remarkable increase from the early 1990s to the late 2000s, with traditional and transition-specific incentives for investment representing the bulk of the motivating factors for inward FDI. Many of the states in the region created government agencies that would be responsible for attracting FDI and offering incentives to investors. This would encourage businesses to consider opportunities to invest in the privatization of previously state-run industries and, perhaps most importantly, to establish new companies. From supermarkets and restaurants to furniture and clothing stores, the availability of goods and services was highly anticipated by consumers in the CEE.

The potential for growth was unparalleled and many companies that ventured into the markets in this region early on have been handsomely rewarded over the past two decades. Some of the largest MNCs, from food and beverage producers to telecommunications and retail giants, were willing to enter into the uncharted territory of the post-communist markets in the early 1990s,
often taking greater risks. In fact, property rights had not yet been codified, dispute resolution mechanisms were still evolving, and law enforcement was slow and inefficient in many of the CEE states in the initial stages of transition.

This changed in the mid-1990s, however, as one particular group of FDI incentives began to stand out among the others: the process of regional integration and the path to European Union membership. Negotiations to become part of the WTO and the IMF, EU accession treaties, and the establishment of Most Favored Nation status are some of the avenues that the CEE countries took to reintegrate into the world economy.

The process of integration eliminated trade barriers and facilitated investment. It signaled a new era of economic openness and potential for unparalleled growth. The scramble to implement reforms and meet deadlines for membership requirements was also well underway. Improvements in the business climate, institutions, and judicial system sent a strong message to investors around the world that CEE would be the next hot spot for investment.

All of this positive change was taking place, however, during the ‘season of corruption’ that characterized so many of the states in the region. Privatization deals were sealed with bribes and favors to elites and the old nomenklatura in charge of the process. Investors established new companies by paying off government officials to circumvent burdensome licensing and regulations. As FDI inflows increased in the transition, so too did the levels of corruption.

This is precisely the paradox that this study seeks to examine in depth, with the aim of providing an explanation for the course of events and trends that has
characterized the economic and political history of the post-communist CEE countries in the past two decades. With this scope in mind, it is essential to review the literature and arguments that investigate these issues of foreign investment, corruption, and EU membership, as well as the theoretical frameworks proposed to organize them.
Chapter 3: Sand or Grease in the Wheels of FDI?
A Theoretical Overview of Corruption and EU Membership

Corruption has recently attracted unprecedented attention among academic, political, and business circles, as well as international organizations and the media. This new focus can be attributed to a number of different factors: 1) the end of the Cold War; 2) the lack of information and focus on corruption in centrally planned economies that is now being replaced by a flood of data; 3) the transition in the CEE to democratic governance and a free and active media; 4) the frequent contact among people from different countries that has resulted from globalization; 5) the growing role of international organizations’ efforts to make people aware of the impact of corruption; 6) a greater reliance on free market transactions; and 7) the role played by the EU, U.S., and international institutions, like the OECD and the World Bank, in the fight against corruption, (Tanzi 1998, 560-561). This increase in attention to corruption has also raised a number of important questions about the circumstances under which it occurs, its direct and indirect impact on inward FDI, and its short term and long term consequences.

Over the past several decades, a number of theories have been proposed to explain the impact of corruption on foreign direct investment. Does it have as significant an influence on FDI inflows as scholars have claimed? More recently, theories that examine the link between European Union membership and levels of corruption and investment have also been formulated. The scope of this study is to determine whether or not corruption and EU membership are significant
determinants of FDI from 1998 to 2008 in the CEE countries more generally and Romania more specifically. With this in mind, it is essential to investigate the theoretical perspectives and bodies of literature that have sought to address the relationship between these components.

Many economics theories claim that corruption acts like “sand in the wheels” of FDI, while others argue that corruption can actually serve to “grease” its wheels by providing opportunities that might not have been previously accessible. In addition, several other significant determinants of FDI also need to be considered, including (but not limited to) the role of political interests, the restructuring of government institutions, and economic factors such as market size, access to skilled inexpensive labor, geographic proximity, and the reputational effects of joining the EU. A thorough analysis of theories and determinants will help to provide a better overall picture of the impact that corruption has had on patterns of inward FDI from 1998 to 2008.

**FDI and Economic Development: Determinants of FDI Inflows**

The level of economic and political restructuring in the CEE countries following the collapse of communism was unprecedented and it coincided with an influx of foreign funds and an increase in local entrepreneurs, all of whom were prepared to take risks to enter the region’s newly-accessible markets. Political and business leaders in the CEE countries, often coached by their Western counterparts, understood that one of the most efficient ways of achieving economic development was to institute policies and promote incentives that
would make the region attractive to FDI. Bitzenis explains that there are five basic entry modes into the economic activities of a foreign country: trading (imports and exporting directly or indirectly); foreign direct investment (FDI); portfolio or indirect investment; collaboration or strategic alliances between MNEs; and entry modes that do not involve the transfer of money, but include licensing agreements, franchising, management or turnkey projects (Bitzenis 2009, 75-78). Of these five entry modes, FDI is the mode that requires the greatest degree of long-term commitment since companies that build equity in a foreign country are less likely to withdraw their capital, facilities or resources on short notice or at the slightest sign of economic or political instability.

FDI has been defined in a number of different ways by various institutions. In the IMF’s *Balance of Payment Manual* (IMF, 1993), FDI is defined as “a category of international investment made by a resident entity in one economy (direct investor) with the objective of establishing a lasting interest in an enterprise resident in an economy (host country) other than that of the investor (direct investment enterprise). ‘Lasting interest’ implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence by the direct investor on the management of the direct investment enterprise,” (Bitzenis 2009, 79). Most definitions of FDI either specify or allude to the idea that the investment is ‘lasting’ and that the investor has ‘a significant degree of influence’ over operations in the host country. These elements of FDI are precisely what make the decision to invest all the more complex. In an effort to avoid negative long-term consequences and establish the
most profitable and stable business abroad, investors and corporations are hard-pressed to do extensive research about the economic, legal, political and social conditions in the country or region they are entering.

Direct investment in a foreign country can generate opportunities for tremendous economic growth and profitability, but may also be accompanied by great risk. Weighing the prospective benefits and potential risks of entering into a host country’s economic activities can help a company determine whether or not a particular venture is lucrative and worthwhile. This kind of evaluation produces a long list of factors that influence company motivations and barriers to FDI. “Most investors further emphasize that their goal is to invest in countries with large markets and promising growth prospects. At the same time, investors with efficiency-seeking investments prefer low labor force costs, while those engaged in extractive activity note that foreign investments will be driven largely by the availability of natural resources,” (Bitzenis 2009, 89).

Dunning (1988) and Bitzenis (2003) outline both the incentives for FDI, as well as the barriers or obstacles associated with FDI. The following are some of the motivating factors for FDI according to their content (Bitzenis 2009):

1) **Market seekers**: market size, prospective market growth, access to new markets

2) **Market seekers from a strategic point of view**: meeting local needs or tastes, perceived lack of competition in the host market, opportunity for a joint venture, advantages from either horizontal or vertical integration
3) **Factor seekers:** availability or low cost of natural resources, access to high technology, low cost of human resources, managerial, organizational, marketing, and entrepreneurial advantages

4) **Efficiency seekers:** economies of scale or scope, diversification of risk

5) **Locational seekers:** geographic or cultural proximity, climate, infrastructure

6) **Exploiting ownership advantages:** strong brand name, product innovation, marketing expertise, existing business links, multinationality

7) **Financial benefits seekers:** tax relief, financial advantages

8) **Political motivation:** special government treatment, specific population as target market

9) **Other motivating factors:** overcoming market imperfections, emergence of last-minute opportunities

In contrast, these represent some of the barriers or disincentives of FDI (Bitzenis 2009):

1) **Country/geographical/location constraints:** lack of raw materials or natural resources, high crime rate, social instability, lack of security, lack of tourist opportunities

2) **Business environment/market constraints:** bureaucracy, corruption, bribery, lack of entrepreneurship, managerial skills, or skilled labor, high competition, social instability, technological backwardness, low labor productivity
3) **Legal constraints:** unstable legal framework, lack of laws, imprecise property rights, ineffective or discriminatory law enforcement

4) **Taxation constraints:** high taxation or VAT, profit repatriation constraints

5) **Political/governmental constraints:** political or governmental instability, high government intervention, blockage of fund transfers, takeovers, inefficiency in reform implementation

6) **Macroeconomic constraints:** exchange rate volatility, high inflation, low per capita income

7) **Infrastructure constraints:** lack of infrastructure or financial intermediaries, technological backwardness

8) **Cultural constraints:** local skepticism about FDI, lack of knowledge of local business mentality

9) **Religious constraints:** religious opposition to FDI

10) **Environmental constraints:** health and safety laws, product safety laws, social constraints that determine consumer buying patterns, ecological constraints like avoiding pollution

11) **External constraints:** war, domino effect of an economic crisis

12) **Other disincentives:** lack of future prospects for economic growth, lack of participation in regional initiatives or international organizations, lack of favorable bilateral treaties, etc…

The incentives and barriers to FDI inflows in the CEE countries are, for the most part, part of the extensive list compiled by Bitzenis, Dunning, and many
other scholars. They can, however, be categorized to show how multinational corporations (MNCs, or MNEs) chose to invest more heavily in some parts of the region than in others. Dunning provides a theoretical framework that combines elements of institutionalism with his Ownership, Location, and Internalization (OLI) approach to investigate the decisions made by MNCs to invest in foreign countries. The OLI paradigm seeks to categorize recent analytical and empirical research on FDI, taking into consideration at such determinants as ownership advantages, production and transaction costs, competitive advantages, entry mode, and location, (Dunning 1993, 2008, 2009). He then looks more closely within MNCs, examining their internal decision-making structures, to determine if their motivation to invest are transaction and resource-based or knowledge and incentive structure-based, (Dunning and Lundan 2008, 576).

A thorough consideration of the incentives and barriers that determine the course of FDI is part of a broader analysis of the economic climate in a particular host country. In his article on “How to Analyze Foreign Investment Climates,” Stobaugh proposes four techniques that investors and multinationals can use to determine whether a country’s investment climate is hospitable. A “go—no go” approach looks at desirable and undesirable aspects of a country’s economic performance; the “premium for risk” method means investors will only take certain economic risks if the return is higher than usual; and the “range of estimates” and “risk analysis” techniques provide analytical tools for measuring risk, (Stobaugh 1969, 107-108). Whatever the incentives to invest in the CEE countries may have been following the collapse of command economies in the
region, many of the influential political and business leaders responsible for carrying out economic reforms have regarded FDI as one of the best ways to improve prospects for economic growth, both in the short and long-term.

**FDI in the CEE Economic Transition**

The transition of the CEE countries to a free market economy gave rise to unprecedented incentives and market opportunities for foreign investors. The implementation of privatization and its associated economic reforms were heavily influenced by the World Bank, the International Monetary Fund (IMF), the European Bank for Reconstruction and Development, and the European Union, among many others. In fact, the “EBRD was established primarily by Western states in April 1991 explicitly to help most of the post-communist countries with their economic transitions; after a rocky start, the bank was by the mid-1990s playing a useful role in the privatization and economic development programs of these states,” (Holmes 1997, 323). Most of these organizations had developed policy prescriptions and aid conditionality that were designed to push certain reforms and open up markets. Accordingly, the goals of privatization were three-fold: 1) to diminish the state’s influence over the economy and business transactions to spur competition and increase efficiency; 2) to increase cash flow and financing for business through foreign direct investment (FDI), capital market access, and deregulation; and 3) to reduce fiscal deficits, increase tax revenue, and streamline state budgets, (Lieberman and Kopf 2008, 11-12). FDI would play a significant role, as mentioned in the second goal, because it would facilitate the
transition process by helping to build the infrastructure of the CEE countries, provide much needed employment, and stimulate economic growth and competition.

As MNCs from the West invested more heavily in long-term projects in the CEE countries, the hopes and projections for the success of FDI in contributing to economic growth were shared by the public and private sectors alike. FDI, therefore, was expected to accomplish a wide range of economic goals that involved spending foreign capital on both introducing and setting up branches of MNCs or new firms, and on restructuring or selling off parts or entire formerly state-owned industries and means of production. According to Barrell and Holland (2000, 478-479), FDI would improve economic prospects by, but not limited to, the following:

- Establishing permanent commercial relations in the CEE countries
- Making improvements to the local infrastructure
- Introducing new industries, often by building new plants or factories with modern technology
- Restructuring former state enterprises, often by subdividing existing state firms into more manageable sizes
- Accelerating technological convergence
- Providing many of the tools needed for the modernization of equipment and means of production
- Bridging ‘idea’ gaps with the help of new technologies, management techniques, distributive networks, and marketing practices
• Replacing the existing capital stock that was obsolete
• Supplementing domestic savings and increasing the total level of capital investment
• Integrating the region into the world economy so that the CEE economies would be open to free-market competition and trade
• Participating in the process of privatization to increase government revenues
• Transferring knowledge and helping to customize production
• Increasing labor productivity and providing employment opportunities that were once created by the state

These are just some of the many expectations that CEE countries had from FDI inflows. It remains the subject of heated debate whether or not FDI inflows spurred economic growth, or if the states could have achieved similar results by implementing bottom-up reforms and relying less heavily on foreign investors for economic stimuli. In fact, even after an extensive discussion of the role of FDI in the CEE transition and the impact of the OLI approach and MNCs on the course of the economic reform, Barrell and Holland conclude that, “the existing evidence is inconclusive regarding the role of FDI in the process of transition,” (Barrell and Holland 2000, 479). The extent to which FDI fulfilled all of the domestic expectations for economic growth remains to be determined, but what is more difficult to refute is the fact that it was occurring at an unprecedented rate, quickly
changing the structure of both the political and economic systems in the transition countries.

*Privatization and Economic Development*

Of the rapidly occurring changes in the political and economic structures of the CEE region, perhaps one of the most fundamental was the process of privatization. Privatization refers to the transfer of ownership of state-owned economic sectors from public to private owners. Parallel to privatization is the process of marketization, in which the legacy of the planned economy would be "replaced by the price mechanism, in which economic decisions and the direction of the economy are determined by the response of individuals and firms to changes in relative prices. Beyond these economic reforms is the far more demanding challenge of creating a new civic culture of public virtue as well as a national sense of social responsibility," (Gilpin 2001, 336). The difficulty in creating this sense of "public virtue" and "social responsibility" is that opportunities to engage in gray area or illegal activities during the process of privatization for personal enrichment were abundant and there was little in the way of political, economic, or judicial mechanisms to prevent or disincentivize people from engaging in them. On the one hand, there were many benefits of privatization and marketization in the process of economic transition because, according to the liberal tradition, they placed the bulk of the economic decision-making into the hands of the private sector, which was arguably more efficient at maximizing positive economic outcomes than the communist state. On the other
hand, many challenges and unexpected situations arose from privatization and marketization that the newly established political and economic institutions of the 1990s had a difficult time addressing.

The process of privatization in CEE had no precedent in history—no other mass, regional transition from a communist to capitalist system had ever taken place. While there are some similarities that can be drawn from individual cases, such as the privatization of hundreds of industries in Chile under Pinochet during the 1970s and 80s, a shift of such proportions remained exceptional. Policy-makers scrambled to develop the most efficient mechanisms to avoid the complete political, economic, and social destabilization of the region. The result was two fundamental approaches to privatization: ‘shock therapy’ and ‘gradualism’ (Holmes 1997, 206-207). Economists like Jeffrey Sachs championed the minimization of negative effects associated with the quick and painless ‘shock therapy’ approach, which was applied in countries like Poland, the Czech Republic and Russia with varying degrees of success. Supporters of the ‘gradualist’ approach, however, argued that the risks of destabilization could be curtailed if changes were implemented less quickly and more methodically. Countries like Romania and Hungary underwent a less hasty privatization process, in which the results of the gradual reforms were equally varied.

To understand how privatization affected the economic development of CEE, it is important to look at why privatization and marketization were considered by most economic analysts as the best solution to fill the void left behind by the failed command economic systems. Lieberman discusses six
major factors in the primacy of privatization during times of economic transition: 1) the successful economic performance of Japan and the Asian Tigers after implementing competitive, free market policies; 2) the failure of command economies and the prescription of the import-substitution model in Latin America; 3) the emergence of the ‘fourth industrial revolution’ in which traditional smoke-stack industries were increasingly being replaced by information-based and technologically advanced industries; 4) the proven inefficiency of state-owned enterprises (SOEs); 5) strong ideological commitments to private enterprises by influential Western powers, such as the United States and the EU; and 6) privatization as a means to achieve a market-economy end, (Lieberman and Kopf 2008, 3-6). While these factors serve to explain why privatization was implemented to achieve the economic goals of transition, the extent to which this process was either successful or challenging depended upon the way in which it was implemented in each CEE country.

Mass privatization in the CEE countries took on a variety of forms, depending on the kind of industries and properties being auctioned off or offered for sale. Multi-track privatization strategies included voucher-based, mass privatization; trade sales and international tenders; “loans-for-shares” programs; initial public offerings (IPOs); management and employee buyouts (MEBOs); and liquidation, (Kaufmann and Siegelbaum 1996, 426-428). The process of privatization itself was so complex that it required new institutions, such as privatization agencies, and new public regulation mechanisms to carry it out. Paradoxically, rather than the deregulation of economic transactions and the
contraction of the role of the state as part of the establishment of a liberal, free market economy, the regulatory mechanisms of the centrally planned economy were simply adjusted to carry out privatization. The nature of the state’s economic control had been transformed, but in the initial stages of the transition, it continued to play a significant role.

The restructuring effects of privatization varied from case to case in the CEE because each country relied on a different privatization recipe, with a broad range of approaches making up the ingredients of individual economic transitions. While each approach to privatization differed in scope, execution, and subsequent outcomes, the most common methods for privatization included the following, (Lieberman, Kessides, and Gobbo 2008, 14):

- Spontaneous privatization
- Small-scale privatization
- Restitution
- Management/employee buyouts (MEBOs), leasing and management contracts
- Mass (voucher) privatization
- Trade sales (foreign/domestic strategic investors)
- Public offerings (IPOs)
- Residual share sales
- Privatization through restructuring or liquidation

The sheer number of privatization methods discussed above is a testament to the complexity of the process of economic transition. It is also one of the reasons
that the CEE transition faced many challenges and often turned to foreign investors to guide, plan for, and carry out significant parts of the privatization process.

One of the most important ingredients of the privatization recipe was the inflow of foreign direct investment. The influx of foreign capital and know-how, especially in the more permanent form of FDI, provided an impetus for economic growth that could, arguably, be achieved less efficiently domestically. In an article about the impact of FDI on economic transition, Jensen points out that many countries in transition tend to view FDI as a ‘panacea’ for achieving rapid economic growth, (Jensen 2006, 881). Holland and Pain (1998) also found that very high inflows of FDI into the CEE coincided with the peak of the implementation of the privatization programs in the region: the higher the private sector share of industry in a country, the more likely it was to attract FDI. In addition, the “one-off opportunities offered by the transfer of state monopolies into the private sector, particularly of public utilities, give a strong incentive for strategic investments,” (Holland and Pain 1998, 6). This incentive stems from the idea that privatization provides a unique entry-mode into the emerging markets as a result of the advantages of the direct participation in and the impact of influential decision-making on the entire process. Foreign investors would subsequently take on partial responsibility for providing results when it came to improvements to infrastructure, access to capital, selection of competent management, and filling in knowledge-gaps.
Jensen argues, however, that dependency on foreign capital to bring about domestic economic growth and reform has significant consequences. She explains that “many developing and transition countries face the fundamental problem that they have few alternatives to the outside injections of capital, knowledge, and network resources that FDI provides… [While] situations where FDI is directly detrimental economic growth are rarely found… FDI should not be considered a panacea for the fundamental problems of economic growth in transition countries,” (Jensen 2006, 882-884). Instead, FDI could represent a provisional patch to the much deeper political and economic reforms that domestic institutions would undergo. If the economy were growing, it would be possible to shift focus away from the institutional challenges of the transition process and onto the influx of capital and business opportunities from abroad. Eventually, the inflows of FDI would reach their peak and then begin a gradual decrease as MNCs and investors crowded out the market, bringing attention back to the role of domestic institutions not only in the transition process, but also in the economic future of the countries of the CEE region.

*FDI and Political Institutions: Domestic Political Economy, Institutionalism, and the Role of the EU*

The impact of interests and institutions on the economies of the CEE countries has been the subject of research and debate due in part to the unprecedented levels of investment flowing into transitioning economies. To understand the political and economic links among inflows of FDI, the role of
institutions, and the impact of corruption warrants a closer examination of the underpinnings of the liberal tradition in International Political Economy (IPE) literature. Two approaches will dominate the discussion in examining these links: the domestic political economy of foreign economic policy and institutionalism.

In recent years, IPE has become increasingly recognized among scholars whose work focuses on explaining what drives and what accounts for events in the world economy, particularly because of the explanatory power of its theoretical and analytical approaches as a bridge between politics and economics. Some of the most compelling arguments, such as the public choice approach, contend that the roles of individuals and interests groups within a state, as well as both domestic and international institutions, serve as the factors that shape domestic-international interaction. With these factors in mind, it is possible to construct a theoretical framework based on the domestic political economy of foreign economic policy to explain the policies that have been implemented to attract FDI and promote economic growth in the CEE countries since the early 1990s. In other words, the domestic-level decision-making by both individual politicians and state institutions has determined not only the economic course, but also the resulting economic outcomes in recent years.

To further the domestic analysis of political economy in the CEE countries, three analytical steps may be identified: 1) determine the economic interests at stake; 2) examine how these interests are organized; and 3) explore how these interests are arranged into political institutions, (Frieden and Martin 2003, 126). This type of analytical framework makes it possible to distinguish between
special interests and broad public policies, as well as between policies that are
driven by either domestic or international pressures. In addition to the broader
theoretical discussion, it is equally important to review the literature on
determinants of FDI inflows and the theories on corruption, situating both within
the framework to trace their linkages, or lack thereof.

*The Domestic Political Economy of Foreign Economic Policy*

The political and economic environment in the CEE countries after the fall
of the Berlin Wall was rife with uncertainty and competition for political influence.
Politicians were confronted with pressures stemming from both concentrated
interests and the broad public, emphasizing the demand side of self-interested
socioeconomic actors viewed through the perspective of rent-seeking, state
capture, or directly unproductive behavior, (Frieden and Martin 2003, 127). The
transition to a free-market economy and a democratic form of governance was
guided by international actors, like the EU and the US, and was characterized by
the liberalization of trade policies and the implementation of economic reforms. In
theory, policy preferences are often based on the most influential interests at any
given time and place, whether they stem from concentrated interest groups or
public pressure for government to respond to certain situations. During the period
of transition in CEE, policy preferences were based on a combination of
interests: governments had a responsibility to enact reforms quickly in order to
jump-start economic growth, while politicians were driven to gain as much
political influence as possible to fill the initial power vacuum that resulted from the democratic transition.

The transition to democratic governance in the CEE countries was a difficult process and each country in the region approached it differently. Most CEE states had had little or no experience with democratic rule, yet they were expected to implement drastic reforms within a short period of time. According to the analytical framework outlined to examine domestic political economy of foreign economic policy-making, it is essential to explore both the political and economic interests at stake.

The Impact of Regime Type, Interests and Institutions on FDI

The transition period in the CEE countries marked an important turning point in their history not only because of the political and economic changes taking place, but also because new interests were now being articulated and organized into emerging institutions. Wettersten asks an important question when trying to assess how rational thought and action affect the behavior of individuals as well as states: how do institutions steer events? (Wettersten 2006). The answer to this question is complex and, within the field of IPE, institutionalists have attempted to provide an explanation that accounts for the increasing role of institutions in determining the political and economic path followed by any one state. Institutions are also closely related to regime type—the nature of the political system shapes the development of institutions.
The institutional approach of IPE assumes that states are rational actors and that they interact with other states through institutions to maximize utility within the constraints of global markets and politics. These institutions either aggregate interests or delegate decision-making to achieve their purpose and to resolve collective-action problems. North explains that, institutions are established to “create order and reduce uncertainty in exchange. Together with the standard constraints of economics they define the choice set and therefore determine transaction and production costs and hence the profitability and feasibility of engaging in economic activity,” (North 1991, 97). Institutions are, therefore, efficient solutions to organizational problems within a competitive framework, (Williamson 1985).

When applied to the study of patterns of FDI inflows, institutions that carry out bureaucratic, judicial, legislative and other functions play a significant role in determining whether or not foreign investors are attracted to the opportunities in a particular country. If property rights are not accompanied by adequate enforcement mechanisms, FDI might not be the right option for an MNC because it risks losing control or ownership of its investment. In the early 1990s, much of the CEE region underwent democratization as part of a natural process of moving away from its communist past. The democratic regimes that replaced the old system were accompanied by the promise and hope of both citizens within the region and neighboring democratic states.

The shift to democratic regimes in the CEE region represented a political step forward, but in terms of the ability to attract foreign investment, the regime
type that is most likely to increase FDI inflows is still a subject of intense debate. In the 1990s, in light of the wave of democratization taking place around the globe, Mancur Olson and other scholars argued that democracies tend to do a better job of guaranteeing property rights, ensuring the independence of the judiciary, and minimizing electoral challenges—all necessary, or at least desirable, for attracting foreign investment, (Olson 1993; Feng 2001; Pastor and Hilt 1993; Pastor and Sung 1995). Similarly, Jensen argues that countries with democratic political institutions are associated with higher levels of FDI inflows, (Jensen 2003, 588). He explains that, “material benefits of FDI [such as foreign exchange, employment, and the development of local industries] force governments into a competition for scarce international capital,” (Jensen 2003, 589). To spur economic growth and facilitate the transition to a free-market economy, many of the CEE countries turned to foreign investors to jump-start the process of market liberalization.

To determine the impact of democratic rule on inflows of FDI, Li and Resnick conducted research on whether or not increased democracy leads to more FDI inflows into less developed countries (LDCs). They postulate that, if “deepening democratic governance enhances a country’s ability to attract FDI, then democratization helps to deliver the economic benefits from foreign capital. The stakes for the leaders in the LDCs are high given the potential consequences,” (Li and Resnick 2003, 176). On the other hand, they consider the possibility that, if higher levels of democracy actually hurt a country’s chances of attracting FDI, countries undergoing political and economic transitions must
choose between lower levels of FDI or democratization. The economic and political stakes are high in either situation.

In contrast to arguments that champion democratic systems in their ability to attract FDI, O'Donnell and Haggard argue that foreign investment is actually more likely to occur in countries where autocratic governments facilitated entry into the market by shielding foreign firms from certain rules, taxes, and domestic pressures, (O'Donnell 1978; 1988; Haggard 1990, 258; Huntington and Dominguez 1975). In One World, Ready or Not, Greider also questions whether or not FDI might be more successful in countries where democratic rules do not constrain economic activities. He points out that, “the promise of a democratic evolution requires special skepticism if the theory is being promoted by economic players who actually benefit from the opposite conditions... A corporation that has made strategic investments based on the cost advantage offered by repressive societies can hardly be expected to advocate their abolition,” (Greider 1997, 38).

In fact, the argument that MNCs are actually hurting economic growth in less developed regions of the world often goes hand in hand with the theory that FDI actually prefers autocratic regimes that protect them from constraining rules or their enforcement.

This is precisely the question that Harms and Ursprung seek to answer in their study of the impact of regime type on inward FDI. They challenge the argument that civil and political repression may actually boost FDI and found that the influence on per capita FDI of political and civil repression is negative. They conclude, however, that while the “globaphobic world view is simply not
supported by comprehensive scholarly investigations into these complex issues, the contrasting results that “more liberal regimes attract a larger volume of foreign direct investment is much sharper than the rather inconclusive evidence provided by the empirical literature on democracy and growth,” (Harms and Ursprung 2002, 660-661). There remains some disagreement among scholars as to the extent of the effect of regime type on a country’s ability to attract FDI. For the purpose of this study, the implications of the arguments put forth by Olson, Jensen, Li and Resnick, among others, linking democratic regimes to higher levels of FDI inflows, will be considered a foundational element in the construction of the theoretical framework on domestic political economy.

While there were many different forms of foreign investment that took place in the CEE countries after the fall of communism, FDI was perhaps the form of investment that was most sensitive to the nature and rules of the domestic political system and the emerging democratic regime. FDI involves significant investments in serving domestic markets, building local infrastructure, and setting long-term goals. In times of economic crisis, portfolio investors could easily pull out of a country, but FDI is built into the domestic economy and very difficult to extract on short notice, given that it usually takes the form of physical structures. As the CEE governments began articulating their policy preferences in the early 1990s, they had to take FDI into serious consideration because many politicians were counting on it to save domestic economies from collapse related to inexperience, slow reform, or global uncompetitiveness.
The restructuring of formal institutions was one of the most critical elements of the transition to democracy in the CEE, but a reformed bureaucracy with newly hired government officials would take time to establish. As a result, informal networks and groups often stepped in to reorganize market institutions and generate new opportunities. In fact, “informal systems have shaped—and continue to help shape—many of the crucial economic, political, and societal developments in Central and Eastern Europe and the former Soviet Union, including the distribution and management of resources; patterns of privatization and ownership; structures of influence and governance; and perhaps the very nature of the state,” (Wedel 2003, 140). Capital raised by informal networks was, therefore, a key driver of both economic development and institutional reorganization in the CEE. Many of these networks worked alongside government institutions, proposing strategies that would make foreign investors aware of the region’s prospects for growth.

Both political and economic interests, principal among the various elements of the analytical framework, clearly favored policies that would make CEE countries attractive to FDI: tax relief, access to public procurement contracts, special government treatment, and other economic incentives. In addition, many of the multinational corporations that carried out FDI were based in highly developed Western countries with sound free-market economies. Countries in the CEE differed in levels of economic development, social pressures, and the extent to which leadership was determined to implement reforms, but their goals converged around the need to spur economic growth,
establish efficient institutions, and stabilize the domestic political economy. Policy preferences were, therefore, geared towards the economic actors who had the best or greatest means of influencing domestic economic outcomes.

Economic development in the CEE countries in the 1990s and 2000s was desirable on a number of different levels, from creating employment that would maintain domestic stability to ensuring that leaders who emerged during the transition period would remain in power. As part of the transition process, new specific interest groups were constantly emerging, each characterized by the goals they were pursuing and the group of people who comprised them. This leads to the discussion of the second element of the analytical framework of the domestic political economy of foreign economic policy: the organization of interests in the CEE countries and their role in influencing both policy preferences and the way institutions would come to be structured.

Arguably, the most influential interest group that emerged was the *nomenklatura*, communist wolves dressed in democratic sheep’s clothes. In an attempt to reinvent themselves, former communists began speaking favorably about the importance of economic development and the policies that they intended on implementing to achieve it as quickly as possible. The benefits were twofold: 1) the passage of economic reforms and the attraction of FDI would help the economy grow, making politicians look attractive to their constituents and assuring they would be reelected in the recently established system of free elections; and 2) government officials would be in a position to enrich themselves as opportunities arose from foreign investors looking to buy up government
industries (whose sale the *nomenklatura* would also control) and to enter new, promising markets. In time, other interest groups also emerged: political parties, trade unions, business interests, and eventually class-based movements as the income gap among various groups began to widen.

The organization of policy preferences at the state level naturally occurred with the formation of political parties during the period of democratic transition, among other specific interest groups. In most of the CEE countries, variants of the same major political parties emerged: Socialists and Social Democrats; Liberals; Christian Democrats; Agrarians; Greens; ethnic minority and religious parties; and fringe parties, such as right-wing parties and Communists. While the process of democratization contributed to the unprecedented development of political parties, the transition to a free-market economy in the CEE countries led to the organization of labor movements and trade unions, business and management interests. The organization of many of the interests that emerged in the CEE in the 1990s often occurred on class or sectoral lines, but policy preferences are subject to change when these interests converge under less predictable circumstances. For instance, there have been cases where automotive trade unions and business interests set aside class politics in favor of sectoral forms of association to protect both companies and their employees from competing economic threats.

Whether policy preferences are organized along political, class, sectoral, or other lines, the third element of the analytical framework applied to the domestic political economy is the way in which interests, more generally, are
arranged into political institutions. As a democratic political system responds to pressures from concentrated interests as well as the broad public, institutions that either aggregate interests or delegate decision-making authority often emerge. North argues that economic “incentives are a function of the institutional structure of society. Institutions are the rules of the game of a society composed of the formal rules, the informal constraints, and the enforcement characteristics of each. Together they define the way the game is played…Efficient markets are structured by institutions to have low transaction costs and to provide incentives for the players to compete through price and quality,” (North 2005, 2). Some of the most influential institutions that emerged during the transition process in the CEE countries were the electoral, legislative, bureaucratic, and judicial institutions. Each of these institutions played a significant role not only in shaping policies, but also in enforcing them and ensuring that democratic and free-market ideals upon which they were based would be formally engrained into the post-communist societies of the region.

The arrangement of policy preferences into formal institutions remains, however, the subject of some debate. While North suggests that institutions can structure markets efficiently so as to make them competitive and reduce their transaction costs, Przeworski asks the question, “institutions matter?” (Przeworski 2004). He examines the historical and political role of institutions more broadly to determine whether, or if indeed, they actually matter. The Washington consensus champions the ‘third generation of reforms’, in which efficient institutions are established to carry out all of the functions necessary to
implement political and economic reforms in LDCs. Przeworski challenges the theory of ‘new institutionalism’ within IPE because he not convinced by either of its two main assumptions, notably: “1) ‘Institutions matter’: they influence norms, beliefs, and actions; therefore, they shape outcomes; 2) ‘Institutions are endogenous’: their form and their functioning depend on the conditions under which they emerge and endure,” (Przeworski 2004, 527). While Przeworski does concede that, “politics does matter,” he and Limongi believe that institutions that facilitate optimal government responses but that prevent government discretion in the face of group pressures simply do not exist, (Przeworski and Limongi 1993, 65). For the CEE countries, the emergence of a wide variety of institutions in a relatively short period of time calls into question their efficiency, ability to deal with domestic as well as international pressures, and their ability to resolve collective-action problems effectively.

*Rent-Seeking and State Capture*

The organization of policy preferences and interests into functioning democratic and free-market institutions during the transition period in the CEE countries was a complex and difficult process. The fact that these countries liberalized economic policies and underwent privatization of major state industries in a short period of time inevitably gave rise to unchecked, discretionary decision-making carried out by politicians who emerged as part of the new democratic leadership. Domestic political decision-making in the initial stages of the transition period was extremely influential because it would
determine the course of the economic and political reforms to come. This also represents the stage of the transition that might have been, arguably, most susceptible to rent-seeking and state capture.

In the CEE countries, “the fear of the leviathan state [gave] way to an increasing focus on oligarchs with the power to “capture the state” and shape policy-making, regulatory and legal environments to their own advantage, generating concentrated rents at the expense of the rest of the economy,” (Hellman, Jones, and Kaufmann 2000, 1). In fact, Tullock points out that many corrupt public officials “actually write laws with the intent of being bribed to permit people to avoid carrying out the law. This is rent seeking,” (Tullock 1996, 8). Many states in the region struggled to resolve collective-action problems through the development of institutions, but ended up first having to deal with the most basic of transition tasks: establishing competent and accountable leadership.

The collapse of the command economies in the CEE was regarded as a significant historical event with widespread political and economic effects. In reality, however, the shift to a market economy was slow and sometimes incomplete, given the extent to which business practices, production, and labor had to be reformed and reorganized. The degree to which communist party leaders and organizations had captured the state for decades is difficult to measure, but it certainly does speak to the fact that wherever rents could be extracted with little or no consequence, they were. In her study of the political economy of rent-seeking, Krueger describes rent-seeking as a competitive activity to which resources are constantly devoted.
The competition for and allocation of resources can characterize many different types of institutional functions, from acquiring business licenses, to obtaining public procurement contracts with the state, to being hired for government positions. As Krueger explains, “some means of influencing the expected allocation—trips to the capital city, locating the firm in the capital and so on—are straightforward. Others, including bribery, hiring relatives or officials or employing the officials themselves upon retirement, are less so…In the latter case, government officials themselves receive a part of the rents,” (Krueger 1974, 292). As such, corruption is one form of transfer payment, subject to competitive pressures from both the public and private sectors, that takes place within a rent-seeking government structure.

Ascertaining how rent-seeking and state capture affect inflows of FDI requires the consideration of both domestic and international determinants. On the one hand, scholars generally examine preferences, the organization of institutions, enforcement mechanisms, institutional quality, transparency, and other factors to explain why MNCs choose to invest in certain countries. On the other hand, it is equally important to look at the way in which powerful international actors have shaped the development of domestic rules and institutions in transition economies, such as those of the CEE countries.

In a “capture economy,” firms tend to conspire with public officials to extract benefits and heavily influence government decision-making related to the economy. Given the instability of institutions following the collapse of communism, regulatory and legal framework weaknesses were often sensed by
firms ready to pay up to enter into newly emerging markets with a high likelihood of profitability. Therefore, “when the state underprovides the public goods needed for entry and competition, “captor” firms purchase directly from the state such private benefits as secure property rights and removal of obstacles to improved performance…[They achieve this through] state capture (firms shaping and affecting formulation of the rules of the game through private payments to public officials and politicians), influence (doing the same without recourse to payments), and administrative corruption (“petty” forms of bribery in connection with the implementation of laws, rules, and regulations,” (Hellman, Jones, and Kaufmann 2000, 1).

Political and economic liberalization may have contributed to a greater degree of insecurity of property rights, transparency, accountability, and legitimate channels of influence, allowing “captor” firms to compete for entry into regional markets. The reform and strengthening of judicial institutions and enforcement agencies were a challenge in the initial stages of transition, rendering them inefficient in many cases and generating opportunities for corrupt activities. According to Ades and di Tella, the fewer firms competing for domestic state influence, the greater their rents will be and, subsequently, the more politicians and public officials who have some degree of control over these firms stand to gain from engaging in malfeasant behavior.

The argument suggesting less competition and higher rents seems clear, but there is a parallel that must also be considered: the “general idea that rents may foster slack…ignores the interaction of competition with the bureaucrat’s
incentive scheme. Higher rents also imply that the public would be keener to rewrite the bureaucrat's contract and to spend resources trying to control him. Since the equilibrium amount of bribes is determined by this contract, it is possible that less competition implies less corruption,” (Ades and di Tella 1999, 982). While some doubt may exist about the positive connection between rent-seeking and corruption, most of the literature that addresses the two areas of study suggests that the links are undeniable and that, further, rents foster corrupt practices.

*International Organizations and Inward FDI: Regional Integration and Reputational Effects of EU Membership*

The political, economic, judicial, and other types of institutions that emerged during the transition process in CEE became the foundation of both domestic governments and the regionally integrated EU structures. The goal of these institutions was, in large part, to facilitate the political shift to democracy and economic growth that would allow the region to become competitive in the global economy. Scholars have elaborated on the impact of factors such as market size, trade openness, levels of risk, resource availability, skilled labor, geographic proximity, state subsidies, and financial incentives on the ability of the CEE states to attract FDI. One of the most important determinants of FDI inflows into this region, however, is EU membership. In fact, it is now very difficult to separate the analysis of determinants of FDI inflows in general from the impact of the negotiations to join and membership in the EU over the past two decades.
In his study on *The Uniting of Europe*, Haas defines regional integration, from the neofunctionalist perspective, as “the process whereby political actors in several distinct national settings are persuaded to shift their loyalties, expectations and political activities to a new center whose institutions possess or demand jurisdiction over the pre-existing national states,” (Haas 1958, 16).

Regional integration scholars have presented and applied classical theories of integration, including, but not limited to, neofunctionalism and liberal intergovernmentalism. While the neofunctionalist view has been exhausted, according to some academics, the institutionalist and liberal intergovernmentalist perspectives emerged to interpret the “success of the subsequent stages of the EU from the Treaty of Rome to Maastricht” by explaining the “cooperation of governments,” (Roy 2008, 6). Similar to the arguments put forth in the public choice theoretical framework, regional integration can be considered a type of collective-action agreement among countries attempting to achieve a specific set of related goals. As such, regional integration, such as that of the EU, involves various forms of collective decision-making that can constrain national actors from independent action, which takes place through a deepening and widening of institutional integration.

The institutionalist perspective, with regard to the process of European integration, emerged in the 1980s to explain the ways in which international organizations and institutions facilitate issue-linkages, foster cooperation, and promote reciprocity, (Axelrod and Keohane 1985; Martin 1992; Simmons 2000). Institutionalists who have studied how EU institutions affect the decision-making
process argue that “institutions are not simply the facilitators of efficiency gains in
the process of regional integration; they also provide focal points—precedents
and symbols around which actors’ behaviors converge—that help determine
particular choices made at critical decision points,” (Genna in Roy 2008, 21). One
of these critical decision points came after the collapse of communism in the
CEE as the EU member states at the time were developing a road map for the
future of the EU, taking into consideration the political, economic, and social
implications of eastern enlargement.

The Eastern enlargement and implementation of the associated reforms
represented a step in the right direction and reflected a diffusion of norms and
policies from the EU level to the individual state level. Schimmelfennig describes
two basic models of international rule promotion: external incentives and social
learning. The external incentives model posits that the “relevant strategy of the
European international organizations is political conditionality: these
organizations set their liberal democratic norms as conditions that the Eastern
European countries have to fulfill in order to receive rewards specified in
advance. These rewards consist of assistance and institutional ties ranging from
trade and cooperation agreements via association agreements to full
membership,” (Schimmelfennig 2006, 30). This system of carrots and sticks,
while it continues to contribute to scholarly debate about the effectiveness of
conditionality, has led to the implementation of liberal economic policies that
have prevented a range of interventions in the market that might have had
negative effects on FDI inflows into the CEE countries.
The costs of EU regional integration in the CEE region would be great, but the potential economic, political, security, and social advantages were projected to outweigh them heavily. The benefits of enlargement and EU membership for transitioning CEE states, as well as for the founding EU member states, have been noted through a wide range of issues, notably the opening up of markets to free-market exchanges. Investment in the CEE countries took place in a number of different forms, from local entrepreneurship to portfolio and foreign direct investment. Given the relative inexperience of the CEE countries with free-market economics and the shortage of domestic capital needed to spur economic growth and competitiveness, FDI emerged as one of the dominant forms of economic influence coming out of the EU and other developed countries, like the U.S. and Japan. Following the collapse of the command economies in the late 1980s and early 1990s, the CEE countries began engaging in competition for foreign investment, offering financial and political incentives for MNCs from the West to buy out formerly state-owned firms, establish new industries, contribute to improvements in local infrastructure, and create opportunities for trade and growth.

The long-term and semi-permanent or permanent nature of FDI gave rise to a different set of circumstances for economic decision-making by MNCs. Domestic conditions and motivating factors for FDI were carefully and painstakingly analyzed to ensure the best possible outcomes, especially because the economic stakes for both the MNCs and the CEE states were very high. “The countries of Central and Eastern Europe are in the midst of earnest attempts to
attract an equilibrium level of FDI stock. Such inflows have been shown to promote economic growth in the region, allowing these states to catch up with the moving target offered by the more advanced countries to the west of the former Iron Curtain,” (Hall in Oxelheim and Ghauri 2004, 375).

Of course, the most developed of the EU member states, and MNCs originating in these countries, also stood to gain from closer economic and political ties with CEE countries. Bevan and Estrin’s study on FDI flows from market to transition economies within the EU shows that there are several determinants of FDI inflows into CEE countries: country risk (including private sector development, industrial development, government balance, reserves and corruption), unit labor costs, host market size and gravity factors. Although all of these determinants play a key role in investors’ decisions to make long-term greenfield and brownfield commitments, the ultimate measure of FDI inflows has been affected by the prospect and process of EU membership. They find that “an announcement about timetables for admission to the EU increases levels of FDI to the prospective members,” as “reintegration into Europe [symbolized by EU membership] is an important political and economic symbol as Mayhew (1998) contends,” (Bevan and Estrin 2004, 776-777).

Other authors make similar claims in regard to the impact of EU membership on FDI inflows. Carstensen and Toubal examine both the traditional and transition-specific determinants of FDI. They explain that many CEE countries have been or are in the process of being commercially integrated and that “FDI flows to Eastern Europe may now reflect a deeper phase of integration,”
 Increases in levels of FDI inflows are reflective, however, of a wider EU integration process and the long list of membership requirements. In fact, research has been carried out to examine the impact of joining the EU on patterns of FDI inflows into the CEE countries to determine why the mere announcement of such a significant step, as Bevan and Estrin suggest, would provide foreign investors with some sort of security about their decision to invest in the region.

The reputational effects of EU membership on FDI inflows has been of particular interest to IPE scholars because of their implications for the process of regional integration as well as for the analysis of the domestic political economy of the individual member and candidate states. Following the collapse of communism in the CEE, the EU responded almost immediately by providing aid and offering preferential trade agreements. One such agreement was a generalized system of preferences (GSP), followed shortly by a series of European association agreements. Both types of agreements aided in the deepening of policy-induced integration, which would eventually progress into accession negotiations for full membership by the mid-1990s. Convergence with the EU *acquis communautaire*, the ultimate goal of the accession process, would ensure that the political and economic institutions of the CEE states would resemble, if not imitate, those institutions of the established member states. The CEE states’ institutional alignment with the EU archetype would consist of institutional measures such as “laws on competition, company law, company accounts and tax regulations, banking laws, laws on mergers and state aid,
intellectual property law, rules of indirect taxation, and transport and environmental laws,” (Kaminski 2001, 4). A commitment to such extensive policy reforms would, therefore, contribute to the enhancement of credibility of commitment to improved CEE market access and liberal economic policies.

As barriers to trade were lifted incrementally, the outcome of these reforms would manifest itself through “increased flows of trade as well as of direct and portfolio investments as investors face lower institutional and policy risks due to an improvement in a country’s business climate… Access to FDI combined with business climate favorable to private sector development has shaped the dynamics of industrial restructuring. In this way, the accession process appears to have had significant impact on structural reforms and FDI inflows,” (Kaminski 2001, 4-5). While the CEE countries showed either willingness or eagerness to cooperate with the conditions of the integration process, domestic changes took place more quickly on paper than they did in reality. This leads to a series of important questions: what part of the regional integration process contributed, either directly or indirectly, to the increase in FDI flows into CEE? Was it the mere announcement of EU candidacy, as Bevan and Estrin have suggested, that prompted investors to enter markets in the region early on? Did the passage of institutional reforms help to mitigate some of the economic or political risks associated with FDI? Or were the reputational effects of EU membership, as posited by Julia Gray, enough to put the EU “seal of approval” on potential investments?
To answer such questions, it helpful to examine some of the theories on the impact of regional integration and institutions on FDI inflows. While many of the studies linking FDI inflows and the transition period in the CEE countries focus primarily on the determinants of FDI, such as the OLI paradigm, research has recently begun to emphasize the importance of announcements about EU membership. Bevan and Estrin’s (2004) findings about the political and economic symbols of reintegration having a positive influence on FDI inflows opened the door for a number of similar studies showing a correlation between EU announcements and the reaction of private firms. Clausing and Dorobantu examined the ability of the CEE countries to attract FDI in the context of EU integration. They found that “EU announcements had statistically significant and quantitatively important effects on foreign direct investment in the CEE states,” (Clausing and Dorobantu 2005, 78).

Interestingly, in her study of the EU’s ability to reduce perceptions of default risk, Gray discovered that “markets pay less attention to the actual path of reform that to the EU pronouncements on it,” (Gray 2009, 932). In other words, the simple declaration of an agreement to comply with EU standards, with the ultimate goal of such compliance being full membership, might be enough of a motivational factor for foreign investors to put aside their fears of political and economic uncertainty and proceed with their investments. As these studies imply, however, reforms were often not complete, and in some cases had only just been passed, but many investors were nevertheless willing to take a leap of economic faith. Conversely, foreign firms were ready to invest in the CEE even though the
EU could make no guarantees that these reforms would actually be carried out, especially because the enforcement mechanisms of the accession agreements were more rigorous during the process of accession negotiations than they were after candidate states had become full-fledged members.

In similar research, Gray analyzes quantitatively the investment risk associated with various stages of the EU accession negotiations, from key announcements about the process to the actual implementation of reforms. After comparing data from countries that have recently joined the EU, she finds that investors tend to take risks at all stages of negotiations, after the initial application process has begun, (Gray 2006, 5). The idea that institutions guarantee or provide some level of certainty is not new, but for the transitioning countries of the CEE, the best option seemed to be to import the constraining international institutions of the EU. Rather than attempting to build such political and economic institutions from scratch in countries with little experience, domestic institutions in the CEE were created based on the structure and policy recommendations of those in the developed EU member states. In essence, Gray found that the development of strong and effective domestic institutions played a significant role in mitigating and reducing the level of risk associated with foreign investment. Substantial reforms during transition, such as institution building, help to translate “uncertainty into risk, and risk into opportunity. As Root (2005) puts it, “transforming uncertainty into risk is how countries [and individuals] grow rich,” (Gray 2006, 4).
While the accumulation of wealth in an open economic system was definitely one driving factor in the transition and privatization processes, the relatively rapid expansion of stable institutions speaks to the importance of institutions in periods of economic development. Along with unimpeded access to the EU’s common market and growing momentum for domestic policy reform, the parallel improvement in institutional quality also provided a greater degree of legal and regulatory certainty. As the concept of institutional quality became more engrained in the governments and citizenry of the CEE states, the focus slowly began to shift from institution building to the actual implementation of the reforms that these institutions were created to devise. In fact, the development literature emphasizes a shift “from the urgency of so-called “first-generation” economic reforms, such as liberalization, stabilization, budget constraints, and privatization, to a new focus on institutions and governance. The “type two” or “second-generation” reforms aimed at reducing corruption, improving regulations, ensuring independence of monetary and fiscal institutions, and strengthening the judiciary,” (Gray 2005, 3). In order to understand just how effective the “second-generation” reforms have been in the CEE countries, it is important to look at the way in which EU-style domestic institutions, such as regulatory mechanisms and the judiciary, have addressed the challenges of transition and privatization, most notably in the area of corruption.
Corruption and FDI in Central and Eastern Europe: The Challenge of Defining Corruption

Numerous attempts have been made to define the concept of corruption, some of which emphasize a parsimonious approach to its study and others that seek to differentiate among its various forms and purposes. One of the most common and concise definitions put forth, with slight variations in word choice, is ‘the misuse or abuse of public office for private gain,’ (Bardhan 1997; Jain 2001; Kaufmann 1997; Tanzi 1998). In other work, corruption is referred to as the ‘sale of government property for private or personal gain,’ (Aidt 2009). While these definitions have overlapping components, many scholars have argued that the concept of corruption is difficult to define because of its blurred parameters. In his attempt to define pornography in a 1964 case, United States Supreme Court Justice Potter Stewart explained that he might not be able to provide an intelligible definition, but he declared, “I know it when I see it,” (Lambsdorff 2007, 16). Similarly, Wei explains that “like pornography, corruption is difficult to quantify, but you know it when you see it,” (Wei 2001, 4). Insofar as defining corruption is concerned, the list of corrupt behaviors and activities is seemingly endless. Much like criminal law, laws written to combat corruption are constantly being updated and changed to address new forms of corrupt behavior that lawmakers were unaware of in the past.

To complicate the matter of defining corruption, what is considered corruption in one country might be permissible in another, making it difficult to distinguish between illicit, gray-area, and legal activities. Bribery, extortion, fraud, and embezzlement that involve public officials, the misuse of public office,
which threaten the public interest are usually considered different forms of corrupt behavior. In some countries, offering a bribe is often perceived as a simple payment for the rendering of a necessary service, such as a medical visit or the procurement of legal documents. In fact, “moral codes of different societies vary in the extent to which activities that eventually lead to corruption are accepted as ‘normal behavior,’” (Jain 2001, 83). In the United States, lobbying, gift-giving, and campaign contributions have been known to teeter on the edge of legality and could be considered illegal if carried out in other countries. On the one hand, “the political culture in the United States permits the creation of political action committees to influence legislators, a practice that people in other democratic societies see as being close to legalized corruption,” (Jain 2001, 83). On the other hand, ‘guanxi’, the practice of building long-term political and business relationships through the exchange of favors in some East Asian countries, is considered a form of corruption that is legally punishable in most Western countries.

There is also the issue of confining the definition of corruption to the public sector, when it has been shown that private sector and corporate corruption also exists and can have significant consequences. This is precisely why Rose-Ackerman acknowledges that while much of her work “concentrates upon the classic relationship in which a private individual attempts to corrupt a government bureaucrat in order to obtain a government contract, the analysis may be generalized to include situations in which ‘private, non-governmental’ officials are the recipients of bribes and others in which one government bureaucrat bribes
another," (Rose-Ackerman 1975, 187). Furthermore, “the rare but real phenomenon of “noble cause corruption” suggests that corruption is not strictly and universally for private gain, despite selfish motives often being involved,” (Hodgson and Jiang 2077, 1044). While private sector and ‘noble cause’ corruption should definitely be taken into account, the majority of corruption definitions focus on the public office, public power, and public interest elements of the concept because of its pervasiveness in these areas.

The different interpretations and categorizations of corruption also make it challenging to generate a comprehensive definition that scholars and practitioners from all over the world can agree upon. For the purpose of this study, Bardhan’s understanding of corruption will be used as the foundation for the ever-evolving definition of the term: “the use of public office for private gains, where an official (the agent) entrusted with carrying out a task by the public (the principal) engages in some sort of malfeasance for private enrichment which is difficult to monitor for the principal,” (Bardhan 1997, 1321). In addition, elements of Rose-Ackerman’s explanation of the concept of corruption will also be incorporated: “monetary payments to agents (both public and private) to induce them to ignore the interests of their principles and to favor the private interests of the bribers instead… [Corruption] represents the illicit use of willingness to pay as a decision making criterion,” (Rose-Ackerman 2006, xiv, xvii). Having established a basic framework for the definition of corruption, including the acknowledgement that this definition is not necessarily limited to the public
sphere or always carried out for private gain, it is equally important to outline its various forms and levels.

The wide array of corruption categories is a testament to the broad nature of the concept and extent to which it affects transactions and relations among people all over the world. Rose-Ackerman distinguishes between "low-level opportunistic payoffs, on the one hand, and systemic corruption, on the other, that implicates an entire bureaucratic hierarchy, electoral system or overall government structure from top to bottom," (Rose-Ackerman 2006, xvii). Low-level, often referred to as ‘petty’, corruption usually occurs in situations where public benefits are scarce or difficult to attain, officials are responsible for exercising their own discretion, or where the bureaucratic process is riddled with red tape and delays. Systemic corruption, also known as ‘high-level' or ‘grand' corruption, affects the public sector through rent-seeking and rent-extraction, a corrupt electoral system, and corrupt public procurement project dealings. These categories have been further expanded upon and other, new distinctions among the different forms of corruption have also been put forth.

In his seminal review of corruption, Jain identifies three types of corruption in democratic societies. He looks primarily at democratic societies so as to establish a degree of comparability among certain aspects of the definition of corruption, such as the nature of the public sector. According to his research, corruption can be categorized as grand, bureaucratic, and legislative, (Jain 2001, 73-75). ‘Grand corruption’ refers to the way in which political elites exploit their power to create or change economic policies. ‘Bureaucratic corruption’ involves
the corrupt activities of appointed bureaucrats vis-à-vis their superiors or the public. ‘Legislative corruption’ refers to the way in which and degree to which legislators’ voting behavior can be influenced, such as ‘vote-buying’, bribes by interest groups, or campaign contributions. Jain, along with most corruption scholars, is careful to distinguish between bribes and gifts, where bribes imply reciprocity and gifts do not. It is equally important for scholars to differentiate between corruption and criminal acts, such as tax evasion, racketeering, money laundering, or black market activities.

Among the most comprehensive reviews of the concept of corruption is an article written by corruption scholar Bardhan, who examines the close relationship between corruption and development. Bardhan acknowledges both the damaging consequences and possible redeeming, or ‘efficient’, features of corruption in a variety of contexts. One of the first definitional issues he addresses is tendency for the difference between political and economic corruption to be blurred, especially in situations in which political power and economic gain go hand in hand. In communist countries, such as China, centralized corruption is often a specific feature of one-party rule and command economies. The state is often considered to be a “stationary bandit” engaging in “lump-sum” corruption, (Bardhan 1997, 1325). In contrast, decentralized corruption, found in countries like India, is characterized most often by “roving bandits” and petty corruption. The nature of the political system may be linked to the type of corruption that is most prevalent in a country, but there remains to be research conducted in this area to determine the robustness of the links.
In his discussion, Bardhan also focuses on the various forms of corruption that exist within the state, including corrupt rent-seeking behavior, crony capitalism, influence peddling, kinship-based or clan-based corruption, and public procurement corruption. Rent-seeking behavior, as analyzed early on by scholars like Krueger, is an attempt to extract economic rent by imposing restrictions on competition or manipulating the political or social environment through corruption, bribes, smuggling, or black market activities, (Krueger 1974, 291). Rent-seeking is found both in democratic countries, as politicians are bribed to ensure that a specific policy is implemented; and in autocratic countries, where rulers like Mobutu sese Seko in Zaire and Ferdinand Marcos in the Philippines sought to extract rents to prevent or support certain economic agendas. ‘Crony capitalism’ often characterizes governments and economies in transition, such as the Central and Eastern European countries after the collapse of the communist system. As the transition economies move from state-controlled to market control pricing and state-owned industries undergo privatization, public officials frequently receive bribes or kickbacks by ‘crony capitalists’ looking to enter these markets for less than their worth.

People are motivated to engage in corrupt behavior for a number of different reasons, from economic gain to political power. There are many cases in which corruption is linked to kinship or clan, representing one of the important social aspects of corruption. As Bardhan points out, “it is widely recognized that in developing countries gift-exchange is a major social norm in business transactions, and allegiance to kinship-based or clan-based loyalties often takes
precedence over public duties even for salaried public officials,” (Bardhan 1997, 1330). This is a central element of patrimonial political systems, as Fukuyama notes in detail in his study of *The Origins of Political Order*, (Fukuyama 2011). Ironically, there are often double standards when it comes to officials who publicly condemn corruption and shady public procurement bids, but who would not hesitate to support pork-barrel politics that benefit their own constituents. This kind of corruption brings up the question not only of legality, but also of morality and norm-based condemnation of corruption. Banfield coined the term “amoral familialism” in 1958 to describe the tendency of families from the southern part of Italy to look out for their immediate families, while neglecting to invest in the society at large. While “amoral familialism” remains a subject of debate for scholars like Putnam, the persistence of corruption in any given society may also be linked to the behavior of previous generations. As Fukuyama shows, this is a central element of all patrimonial societies, of which tribalism is a widespread variant, and not likely to be eliminated in a short period of time such as the post-communist transition.

Whether a ‘culture’ or ‘tradition’ of corruption exists in a society is not empirically clear, but policy positions have evolved over time to address its persistence in some regions more than others. On the one hand, Bardhan discusses the position of the “moralists,” who “emphasize that without fundamental changes in values and norms of honesty in public life—a kind of ethnic cleansing through active moral reform campaigns—no big dent in the corrosive effects of corruption is likely to be achieved,” (Bardhan 1997, 1335). An
example of this kind of campaign is the “Demasca Spaga” (‘Expose Bribery’) campaign launched in Romania in 2006 to inform the public that not only is corruption morally inacceptable, but it is also punishable by prison sentences. The “fatalists,” on the other hand, “are more cynical, that we have reached a point of no return in many developing countries, the corruption is so pervasive and well entrenched that for all practical purposes nothing much can be done about it,” (Bardhan 1997, 1335). While the ‘moralists’ and ‘fatalists’ have differing policy prescriptions, finding the best approach to combating corruption will depend in large part on its clear definition and categorization and on laws tailored to address its complexities.

As corruption has attracted increasing attention in recent years, Tanzi, former Director of the IMF’s Fiscal Affairs Department, sought to simplify the categorization of corruption by offering a concise list of what it could be:

- Bureaucratic (or “petty) or political (or “grand”); for example, corruption by the bureaucracy or by the political leadership;
- Cost-reducing (to the briber) or benefit-enhancing;
- Briber-initiated or bribee-initiated;
- Coercive or collusive;
- Centralized or decentralized;
- Predictable or arbitrary; and
- Involving cash payments or not

Tanzi goes on to say that, “undoubtedly, other classifications could be added to this list,” (Tanzi 1998, 565). While some of these classifications overlap with the
work of other scholars, it is worth noting that each definition and categorization add a different and valuable dimension to the general understand and definition of the concept of corruption.

Another important contribution to the definition and classification of corruption is provided by Aidt in his economic analysis survey of corruption. He distinguishes among four different analytic approaches to corruption that focus on the theoretical analysis of the concept. In developing these four analytic approaches, he considers the degree to which governments (the ‘principal’) are willing to implement policies and establish institutions to address corruption as well as institutional and historical determinants of corruption levels. Based on these considerations, Aidt's four categories are: 1) Efficient corruption: to facilitate beneficial trade and promote allocative efficiency; 2) Corruption with a benevolent principal: a cost-benefit analysis in which a benevolent principal provides a non-benevolent agent with decision-making capacity; 3) Corruption with a non-benevolent principal: non-benevolent government officials engage in rent-seeking behavior; and 4) Self-reinforcing corruption: the incidence of corruption depends on history and strategic complementarity, (Aidt 2003, F633). Aidt’s classifications of corruption, along with the definitions and categorizations put forth by other scholars and practitioners, help to clarify the concept of corruption and make both government officials and the public aware of its consequences.
Determinants of Corruption

Having reviewed the various definitions and classifications of corruption, it is equally important to examine its causes if effective policies to combat it are to reflect both its consequences and its sources. Corruption is a very complex phenomenon that can take place in an endless combination of circumstances. As a result, many scholars have attempted to list the reasons why corrupt acts may seem or actually be more attractive for the parties involved than transparent activities. Much like the discrepancy that exists among the elements that define corruption, its sources and determinants are also varied, particularly because it differs from one country to another and may change its form depending on the circumstances in which it is taking place.

Aidt accepts the standard definition of corruption as the misuse of public office for private gain, adding that it also goes against the rules of the game. As such, Aidt explains that there are at least three clear conditions that must be present in order for corruption to arise and persist, (Aidt 2003, F633). The first condition is “discretionary power,” where public officials must possess some kind of discretionary power to implement or change policies and regulations, allowing them in turn to abuse this power for the benefits of a corrupt transaction. The second condition is “economic rents” because parties in a corrupt transaction must be able to extract rents to make their deal profitable. The third condition that must exist is “weak institutions,” which are often staffed by officials who are willing to risk or exploit their discretionary power to collect rents that materialize from corrupt transactions. In his review of corruption, Jain also lists discretionary
power and economic rents as two of the most important determinants of corruption, but he expands upon the third condition. Institutional weakness, according to Jain, signifies that the "legal/judicial system must offer sufficiently low probability of detection and/or penalty for the wrongdoing. In an extension of Becker's (1968) 'crime and punishment' argument, the first two elements combine together to create incentives for corruption and the third acts as a deterrent," (Jain 2001, 77). It is, therefore, important to understand that determinants of corruption are a combination of both incentives and deterrents.

Lambsdorff points out that the determinants of corruption are often closely linked with its consequences, contributing to a vicious feedback cycle that makes it difficult to distinguish among the different factors at play. He lists several possible causes of corruption that have been widely discussed in recent literature: 1) size of the public sector; 2) regulatory quality; 3) lack of economic competition; 4) government structure; 5) forms of democracy; 6) voting systems; 7) decentralization of government authority and structures; 8) culture, including the role of religion; 9) values and traditionalism; 10) role of social structure, including gender and ethnicity; and 11) geography and history, (Lambsdorff 2007, 4-19). Most of the factors behind corrupt acts that Lambsdorff and other academics discuss have political or economic motives behind them. Social factors, like familial ties and culture, along with geographic or historical factors also play a role in determining the type and frequency of corrupt transactions that take place within a country.
Corruption in the CEE countries, for example, had their own brand of corruption due in large part to the shared political, economic, and social circumstances that were in place under communist rule, as well as to their geographic and cultural proximity. Miller, Grodeland, and Koshechkina present two ideal-type models of the type of corruption that characterized this particular region: the ‘culture of corruption’ model and the ‘victims of circumstances’/‘corruption despite culture’ model, (Miller, Grodeland, Koshechkina 2001, 15). In the latter, a “culture of mutual favors” is firmly rooted in society and “both sides justify the practice, perhaps even morally justify it, and neither feels that they are acting under duress,” (Miller, Grodeland, Koshechkina 2001, 15). In the former, however, both sides are uncomfortable with the practice, but feel as though there is little that can be done to avoid it. This ‘culture of corruption’ can be attributed, in part, to historical circumstances. As Karklins suggests, “corruption in one-party systems and under a state-administered command economy had a distinct profile, and the profile of corruption in the post-communist region is rooted in its political history,” (Karklins 2005, 74). The shared political and economic experiences of the CEE countries also meant that their institutions evolved to reflect the relationship between the government and the governed.

Institutions, according to North, are “consist of both informal constraints (sanctions, taboos, customs, traditions, and codes of conduct), and formal rules (constitutions, laws, property rights)... [They were devised to] create order and reduce uncertainty in exchange,” (North 1991, 97). In the CEE countries, the informal constraints were not compelling enough to prevent corrupt acts from
taking place, given that many ordinary citizens accepted the notion of ‘culture of corruption’ to some extent. The promise of jobs or promotions, along with bribes and gifts, had become commonplace occurrences that were paid little attention to by the authorities because they were often most involved in such dealings. The formal rules against corruption were either too weak or completely unenforced by communist authorities. As Karklins explains, “formal rules and law were further undermined by the informal rule that party interests superseded law for the sake of the smooth functioning of the system,” (Karklins 2005, 76). While the public condemnation and private acceptance of corruption characterized the CEE countries, the complete disregard for elite corruption in many African countries has led to serious political instability and a complete degradation of the rule of law. Ironically, while many of the citizens of African countries live in dire poverty, the private assets of presidents, generals, and other political leaders are often worth millions or hundreds of millions of dollars, if not more. Whether these corrupt trends are a result of a ‘culture of corruption’ that exists in African states, geographic proximity, shared historical experiences, or simply a lack of efficient institutions has become blurred. What is clear, however, is that the abuse of power and public office have often gone unpunished and contributed to a worsening of the political, economic, and social situation not only in Africa, but also in many other parts of the world.

Phrases like the ‘misuse of public office’ or the ‘abuse of discretionary power’ accompany many of the descriptions of corrupt behavior. Corruption often involves representatives of the state and its institutions, making certain
governmental activities particularly susceptible to bribes and other forms of corruption. Tanzi explains why some of these activities are fertile ground for corruption. His discussion of factors that directly contribute to corruption begins with regulations and authorizations, such as licenses, permits and various types of authorizations. In essence, “the existence of these regulations and authorizations gives a kind of monopoly power to the officials who must authorize or inspect the activities,” (Tanzi 1998, 566). As a result of this discretionary authority, some individuals become ‘middlemen’ or ‘facilitators’, promising to help circumvent certain rules or expedite the process of procuring licenses in exchange for a fee. In India, this type of ‘facilitator’ is commonly referred to as a “license raj,” (Tanzi 1998, 566). Bribing government officials in charge of implementing regulations and giving authorizations is a widespread phenomenon in developing and transition countries, where entrepreneurs and enterprises are attempting to enter into the market as quickly and cheaply as possible.

In addition to regulations and authorizations, Tanzi’s discussion also focuses on the rampancy of corruption in what is arguably the most significant government activity, taxation. Tax and customs administrations are affected by corruption when: laws are difficult to understand; there is frequent contact between taxpayers and tax administrators; tax administrators’ wages are low; tax administrator corruption is concealed, ignored, or goes unpunished; there is a lack of transparency and/or tax administrations are not closely monitored by the state; tax administrators wield discretion over important decisions; and state controls are generally weak, (Tanzi 1998, 567). Public expenditure represents
another government activity that is often affected by corruption, particularly because this type of spending is subject to the discretion of state officials who may or may not be willing to accept compensation for choosing one bid over another. Investment projects, procurement spending, and extrabudgetary accounts are all forms of public expenditure that have been known to involve the selection of contracts that may offer the highest commission to public officials rather than provide the most efficient proposal.

Government provision of goods and services at below-market projects, such as disability pensions, public housing, and healthcare, are also a known source of corruption due to “limited supply, rationing or queuing,” (Tanzi 1998, 569). In fact, most discretionary decisions made by government officials can be fertile ground for corruption because of the potential to be bought with a “temptation price”. These decisions may include the provision of tax incentives, use of private and government-owned land, authorization of major foreign investments, sale of public sector assets, privatization of state-owned enterprises, and monopoly power over a specific export, (Tanzi 1998, 570). In the CEE countries, the sale of public sector assets and privatization of state-owned enterprises were particularly affected by corruption because the opportunities for bribery and embezzlement were widespread and the judicial system was ill equipped to charge or punish such activities.

While transition and privatization have been known to provide opportunities for corruption, democratic states face similar issues when it comes to the financing of political parties. Opportunities for bribery and extortion abound
as political parties as well as private groups are often willing to do ‘whatever it takes’ to ensure campaign funds and support for party candidates. Political corruption can take on many different forms, from outright ‘vote buying’ to the promise of tax breaks, jobs or contracts in exchange for financial contributions to a political campaign. Historically, the spoils system in the United States was a patronage system that rewarded political supporters with jobs, contracts, and political power. It was eventually replaced with the civil service system to award government positions on the basis of merit, but there is no doubt that elements of these ‘spoils’ continue to underlie some government decisions and the institutionalization of corrupt practices.

Today, the practice of lobbying one’s political representatives is considered legal when it abides by strict guidelines. In other democratic countries, however, such persuasion tactics would be considered forms of bribery, especially when favors or material benefits are involved. Ironically, “the use of material benefits by political elites is considered legitimate on the collective level, [however], it is considered increasingly illegitimate as one moves down to the individual level, where it usually contravenes accepted rules of the democratic process and falls under the heading of ‘political corruption’,” (Etzioni-Halevy 1989, 234). In other words, while democracy is “widely believed to have a constraining effect on political corruption,” it also provides many opportunities to engage in corrupt activities in areas such as campaign financing and support for the passage of legislation that benefits a specific group, (Kunicova 2006, 140).
Regulation, authorization, public expenditure, government provision of goods and services, transition and privatization, and campaign financing are some of the most significant factors that contribute directly to corruption. There are, however, a number of indirect causes of corruption that should also be expanded upon. One of the most important indirect causes is the quality of state institutions and bureaucracy. Przeworski points out that, in theory, “institutions prevent people from doing what they would have otherwise done or induce them to do what they otherwise would not have done,” (Przeworski 2004, 528). In reference to corruption, it seems that the more efficient an institution is, the less likely civil servants and government officials are to engage in corrupt activities. The “absence of politically motivated hiring, patronage, and nepotism, and clear rules on promotions and hiring,” along with higher wages, strict penalty systems, institutional controls, transparency of laws, and examples by leadership are all factors that contribute to the quality of a bureaucracy, (Tanzi 1998, 571).

Hiring government workers on the basis of qualifications and merit and paying them a reasonable living wage are some ways to improve the quality of government functionaries and combat corruption at the bureaucratic level. In countries, such as communist states, where civil servants are underpaid or lack benefits, many are tempted to accept bribes as a compensatory mechanism—the bribe serves as compensation between what a government official is actually paid and what he or she should be paid. In fact, “there appears to be a lower threshold below which corruption income becomes acceptable and an upper threshold above which it becomes unacceptable. In most countries where there
is at least some corruption, there seems to be an acceptance of the ‘petty’ corruption by which lower level administrators supplement their income,” (Jain 2001, 81). The theory that civil service workers who are paid a ‘fair wage’ are less likely to engage in corruption lacks strong empirical evidence because it is difficult to differentiate among the various determinants of corrupt behavior—greed, opportunity, need, and many other factors may also play a role in a civil service worker’s decision to engage in corrupt activities. Motivating factors for corruption, whether on an individual or institutional level, are empirically difficult to determine.

In Kaufmann, Kraay, and Mastruzzi’s seminal article on governance, the authors survey perceptions of governance in 199 countries to determine the traditions and institutions by which authority in these countries is exercised and how effective the governments’ performance is perceived to be. They examine six clusters or dimensions of governance: 1) voice and accountability; 2) political stability and absence of violence; 3) government effectiveness; 4) regulatory quality; 5) implementation of the rule of law; and 6) control of corruption, (Kaufmann, Kraay, and Mastruzzi 2004, 254-255). They argue that, whether the corruption is petty or grand, the corruption itself is often a manifestation of the corruptor and corrupted’s lack of respect for the rules that govern their interaction. Government institutions are founded on legal and political traditions, but they are often shaped by norms. For instance, while it might not be illegal to influence a politician’s decisions in a particular country, doing so would contravene the rules of the game and give the person or group doing the
influencing an unfair advantage over others who follow the rules. In other words, illegality is not the only determinant as to whether or not engaging in corrupt behavior is right or wrong. Such nuanced interpretations of corruption are precisely one of the reasons that it is so challenging, if not impossible as some argue, to measure its occurrence as well as its impact on areas such as development, investment and governance.

*Measuring Corruption*

When investigating the impact of corruption on the ability to attract foreign investment or on political stability, among other areas, one of the most significant questions is: can corruption actually be measured? Measuring the extent of corruption and its impact is tricky because “corruption costs can seldom be accurately assessed,” (Rose-Ackerman 1975, 202). In other words, aside from the difficulties associated with defining corruption and establishing its determinants, there is the problem of measuring such an amorphous concept. Most attempts to measure corruption have focused on perceptions of the various types or how much corruption is taking place. Due to its clandestine nature, “a researcher trying to develop quantitative measures of corruption has to struggle with the question of what will be included in such a measurement, and then try to measure something that those who know about it are trying to hide,” (Jain 2001, 76). The challenge of measuring corruption also makes it difficult compare its various forms in different countries, to test hypotheses, and to develop comprehensive theories.
Over the years, a variety of case studies, polls, and surveys have been carried out by academic and research organizations to develop a method for measuring corruption. One challenge that anyone attempting to measure this concept faces is *reification*—using an operational measure of corruption as if it were the concept itself, (Babbie 1995, 116-118). Another significant challenge is asking all the right questions needed to develop an accurate assessment of the pervasiveness of corruption. Should it be measured by how frequently the term ‘corruption’ is used in the media? By the number of indictments, trials, and convictions that take place in the legal system to punish those who engage corrupt activities? By the extent to which elections are undermined or votes are bought? By the amount of the bribe itself or the portion of the total benefit that a bribe represents? By the extent of the political or economic influence that an individual or group gains from offering a bribe? By using subjective or objective data, or a combination of the two?

While the most widely used measures of corruption today are composite indices, incorporating a variety of questions, most feature the perceptions of individuals or groups whose assessment of corruption in a particular country is considered accurate within a reasonable margin of error. Two broad “categories of sources are used: polls of experts and surveys of businesspeople or citizens...Polls of experts are designed to provide comparable results across countries through elaborate benchmarking...Surveys typically draw on the responses of large numbers of respondents with direct knowledge of local conditions,” (Kaufmann, Kraay, and Mastruzzi 2004, 257). This does not suggest
that subjective, perceptions-based data are, in fact, accurate. On the contrary—
“perceptions-based questions about governance can be vague and open to
interpretation… A well-crafted question on corruption asks firms for the estimated
share of bribes in the annual spending of firms like theirs. By contrast,
generalized opinion questions…are less informative for constructing aggregate
indicators of governance,” (Kaufmann, Kraay, and Mastruzzi 2004, 272). The
emphasis for measuring corruption as accurately as possible lies, therefore, on
asking specific questions and incorporating a wide range of indices.

There are, of course, some academics who are convinced that current
corruption indices are fundamentally flawed from their very construction. The
problem with trying to measure corruption “is an attempt to measure something
which is not quantifiable…[and] currently popular strategies for measuring
corruption do not serve any useful purpose. [It] is merely an illustration of a
confused thought process, and a desire to imitate science,” (Zaman and Ur-
Rahim 2009, 118-119). There remains considerable room for debate on the
efficacy with which corruption can actually be measured, but this should not
discourage attempts to quantify or study its spread and consequences. In fact,
even those who argue that it is almost impossible to measure corruption offer
some “rules for constructing useful and valid measures of special types of
corruption: R1) the target of a proposed measure must be, in principle,
measurable; and R2) the goal (or goals) of measurement must be specified,”
(Zaman and Ur-Rahim 2009, 119). No one measure or index is completely
accurate, but there exist study, survey, and research designs that can give
academics and practitioners alike a better idea of the causes and consequences of corruption.

Despite the challenges associated with measuring corruption, a variety of academic, legal, political, and international organizations have attempted to assess its frequency and different forms. Perhaps the most widely used of these measures is the Transparency International Corruption Perceptions Index (CPI). As the creator of the index, Lambsdorff explains that “the CPI is a composite index, using the assessments by risk agencies and surveys carried out among elite businesspeople. While perceptions should never be confused with reality, the given consensus provides some confidence that the perceptions gathered are informative on actual levels of corruption,” (Lambsdorff 2007, 20). The index was first published in 1995, but Lambsdorff recently announced that the CPI’s 2010 edition would be his last. After 15 years of fruitful study of global corruption, he conceded that there were some inherent flaws in the methods and research design of the CPI, but also seemed hopeful that his index would either be improved upon or replaced by another (and perhaps more accurate) measure of corruption. While the CPI is currently undergoing some methodological improvements, other studies and surveys continue to provide data for academics and practitioners who investigate perceptions of corruption.

One such study is the index measuring corruption and other institutional variables published by Business International, a private firm whose index is now incorporated into The Economist Intelligence Unit. For 20 years, the BI index has used information collected and analyzed by a network of analysts and
correspondents to rank countries on the perception and monetary measurement of corruption. The BI index is sold to banks, multinational corporations, and global investors who are interested in knowing more about the business environment in which they seek to enter. Using the BI index in his work on corruption and economic growth, Paolo Mauro argues that its measures are relatively accurate and that BI “assessment reports undergo further checks…to ensure accuracy and consistency of the results…All BI indices are positively and significantly correlated, even controlling for GDP per capita,” (Mauro 1995, 683-685). Ades and di Tella, as well as Kaufmann and others, have used a similar index in their work, the World Competitiveness Report (WCR) published by the World Economic Forum foundation in Geneva (Ades and di Tella 1997; Kaufmann 1997). In addition to the WCR, Ades and di Tella have drawn on the data assembled by Peter Neumann and his collaborators in the German business publication Impulse. The WCR gives out grades from 1 to 100, 100 being the most corrupt, to countries all over the world, while Neumann’s approach consists of a series of interviews with businesspeople from Germany and other countries to evaluate their experiences with bribery and corruption.

As a result of its lending capacity and practices, the World Bank has also sought to measure a number of Governance Indicators, among which Control of Corruption was one of the most important, to gauge the likelihood of funds being used appropriately. The six primary indicators are used by businesses and researchers alike, but the World Bank does concede that there are “measurement challenges. Margins of error are not trivial, and caution in
interpreting results is warranted—i.e., countries cannot be precisely ranked. But these margins of error have declined, and are substantially lower than for any individual measure of corruption,” (Kaufmann 2005, 83). The World Bank’s indicators go beyond measures of corruption to consider accountability, political stability, and other areas of government effectiveness. The International Country Risk Guide (ICRG), published by Political Risk Services, also includes a corruption index, among other factors, in its assessment of the level of political risk in any particular country.

Tanzi and Davoodi have used the ICRG index in their work, as well measures provided by the Transparency International CPI and Global Competitiveness Report, (Tanzi and Davoodi 1997, 2000). Additionally, Tanzi and Davoodi incorporate data from the Business Environment and Enterprise Performance Survey (BEEPS). BEEPS is “a survey of 3,000 enterprises across 20 transition economies, conducted jointly for the European Bank for Reconstruction and Development (EBRD) and the World Bank, [in which] enterprises were asked to assess the major impediments in their business environment in terms of competition, corruption, taxes and regulations, inflation, financing, and infrastructure,” (Tanzi and Davoodi 2000, 7). According to the BEEPS surveys carried out over a period of several years, concentrating mainly on the CEE countries, corruption and anti-competitive practices appeared to be the primary impediments for start-up firms in those countries.

Other important sources of data on corruption, and more generally on governance indicators, are compiled and published by a variety of international
organizations and academic institutions. Some of these include the Hong Kong Political and Economic Risk Consultancy; the EBRD’s annual Transition Report; the Heritage Foundation/Wallstreet Journal Economic Freedom Index; Global Insight/Mc-Graw Hill DRI Country Risk Review; the World Bank’s Country Policy and Institutional Assessments; Kaufmann, Kraay and Zoido-Laboton’s aggregate measure of probity, bureaucratic quality, and rule of law; Hall and Yago’s ‘opacity’ index; and UN Corruption/Integrity surveys aimed at business environment, judicial, and police practices in specific countries and sectors.

Despite all the research and statistical efforts to compile accurate data, it is apparent that no one survey or index is complete or entirely capable of explaining the sources and consequences of corruption. To date, almost every measure of corruption is based in part, if not primarily, on the perceptions of businesspeople, international organizations, research institutions, and even experienced individuals. Corruption, much like other forms of criminal activity, is especially difficult to evaluate because of its clandestine nature—it can only be measured when those people or organizations doing the measuring are aware of its existence. Corruption is like an iceberg: the tip represents what is known, but the much larger portion that lies below the surface symbolizes everything that we are unaware of or that cannot be accurately measured.

Framing Corruption: The Principal-Agent Model

Measuring corruption has and will continue to pose a challenge for researchers who are interested in studying and developing theories to explain its
pervasiveness in various political, economic, and social environments. Corruption has a wide range of determinants as well as consequences, and it is important to consider both its incentives and deterrents when developing an analytical model. In his review of corruption, Jain proposes that, since players must deal with issues of uncertainty, risk, and information asymmetry when it comes to corrupt transactions, there are two predominant approaches to modeling, each of which explains a different type of corruption. “An agency model seems to best explain grand corruption and legislative corruption. Although bureaucrats are also agents, a resources allocation model that views corruption as a cost within a supply-demand framework seems to best explain petty corruption,” (Jain 2001, 85). While the relationships between public office or discretionary power and inflows of foreign direct investment are often characterized by grand and legislative corruption, several models also address the impact of petty corruption.

Generally, a corrupt act consists of an exchange of favors between an agent (usually the corrupted) and a client (usually the corruptor). The agent is entrusted with a certain level of discretionary power by his or her superior, known as the principal. The principal then sets the rules as to how certain tasks designated to the agent are to be carried out. Subsequently, “the agent is supposed to serve the client in accordance to these rules. Bribery, extortion, embezzlement, and fraud in the public sector are variants of corrupt behavior, amounting to the agent “defecting” from [the] rule-bound behavior” established by the principal, (Lambsdorff 2007, 18). In this type of game, the agency model examines changes that both incentives and deterrents have on the decisions of
public officials or legislators. If the principal does not give the agent the necessary incentives or fails to enforce the rules that would deter the agent from defecting, the agent might engage in corrupt activities with a client. Conversely, if the corrupting client makes the agent a deal so tempting that the agent might be willing to forego the principal's incentives or risk being punished under the system of established rules, then the agent might also engage in corrupt activities despite the influence that the principal might exert over him or her.

The agency model, or the principal-agent model—terms often used interchangeably—has been used by a number of academics and researchers to explain why government officials engage in corrupt activities. One of the first academics to apply this model to the study of corruption was Rose-Ackerman, who used it to establish three of the most significant determinants of corruption: 1) ‘the existence of narrowly focused favors available for distribution’; 2) ‘the ability of wealthy groups to obtain these benefits legally’; and 3) ‘the temporal stability of political alliances’, (Rose-Ackerman 1999, 132). While favors, wealth, and political stability are all significant determinants, political, economic and social imbalances of all types can contribute to corrupt activities. Johnston’s agency model, which contrasts imbalances between economic and political opportunities, produces four levels or types of corruption: interest group bidding, patronage machines, elite hegemony, and fragmented patronage, (Johnston 1997, 68). These opportunities contribute to both grand and petty corruption, indicating the importance of the agent’s role in determining the path of corrupt activity in which he or she and the client will be engaged.
In his study on corruption and economic growth, Mauro relies on an agency model to determine whether corruption slows economic growth by affecting the decision-making capacity of government institutions, (Mauro 1995). Similarly, Tanzi and Davoodi use the agency model to show that corruption has a negative impact on the allocation of public funds, (Tanzi and Davoodi 1997).

Aidt’s principal-agent model explanation includes examples such as corruption in tax collection, efficiency wages that are theoretically supposed to minimize corruption, and institutional controls and legal remedies that are designed to punish an agent’s defection from the principal’s rules, (Aidt 2003, 636-638). There is a general acceptance of the notion that the agent, the corrupt government official, has some property rights or decision-making capacity over the government resources he or she is allocating.

*The Resources Allocation Model*

The resource allocation model has traditionally been used to explain petty corruption, but has also been applied to grand and legislative corruption. This model has also been incorporated to explain the supply and demand functions with which bureaucrats are faced when deciding whether or not to engage in corrupt activities. As part of this model, it is assumed that the agent has the authority to restrict a government good, thereby affecting the supply of this good. Examples include tax collection, the procurement of an import license, or access to a government road. If the agent can collect bribes to make the restricted good become more easily available and if he or she runs a low risk of being detected,
it is like that this type of behavior will become systematic. In addition, most
corruption occurs with theft, creating competition between agents and clients.
Maximum bribes are collected when there is competition among agents and cost-
reducing corruption occurs when there is competition among clients. Ironically,
the theory of supply and demand applies to the allocation of government
resources in corrupt environments much in the same way that it applies in non-
corrupt environments.

To determine whether “grease money” speeds up or slows down the
wheels of commerce, Kaufmann and Wei use a form of resources allocation
model known as a Stackleberg game. Using this particular game, they find that “if
one allows regulation, tax, and bureaucratic red tape and their discretionary
enforcement to be endogenously chosen by rent-seeking officials, the officials
may charge according to the firm’s “ability to pay” by raising the nominal
harassment sufficiently,” (Kaufmann and Wei 2000, 5). In other words, their
model indicates that the higher the demand for bribes, the less effective the
bureaucracy becomes. Similar relationships using the resources allocation model
have been the subject of economic studies of corruption. The “ability to pay”
argument is taken up Bliss and di Tella in reference to firms who have the ability
to offer greater bribes than others seeking the same government services or
goods. Gupta, Davoodi, and Alonso-Terme argue that “corruption distorts the
government’s role in resource allocation” and leads to increased income
inequality and poverty, (Gupta, Davoodi, and Alonso-Terme 2002, 23). Rose-
Ackerman investigates the correlation between cost, supply, and demand in petty
corruption transactions involving bureaucrats, (Rose-Ackerman 1978). Both the resources allocation model and the principal-agent model, therefore, contribute to a more comprehensive understanding of the circumstances under which corruption occurs and its complex web of consequences.

A Theoretical Overview of Corruption and FDI: Sand or Grease in the Wheels of FDI?

While the principal-agent and resources allocation models help to explain the circumstances under which corruption takes place, establishing a theoretical framework can explain the assumptions, motivations, and expectations associated with corrupt behavior and patterns of FDI inflows. In both the IPE and economics bodies of literature, there exist competing theories about the impact of corruption on FDI inflows. Many scholars and economists claim that corruption has a negative impact and acts as “sand in the wheels” of FDI. In contrast, several proposed theories claim that corruption can actually provide incentives and opportunities for foreign investment, serving to “grease the wheels” of FDI.

Corruption remains, however, only one of many determinants of FDI, which is why it is equally important to examine other influences, incentives and barriers to investment. One such significant influence that needs to be investigated more closely is the role of EU accession negotiations and subsequent EU membership on levels of corruption in the CEE and how these, in turn, influenced the inflows of FDI. What has become evident in the literature, however, is the value of analyzing these issues in the context of the transition process and the usefulness of considering their inextricable linkages.
Corruption Is Sand in the Wheels of FDI

"Public procurement represents about 15 percent of the GDP in the European Union. If one applies this average to the ex-communist new members of the EU and calculates that about 10 percent of procurement moneys represent kickbacks and other illicit payments, one can say that between 1 and 2 percent of the GDP is spent on corruption in procurement alone," (Karklins 2005, 9). Much of the literature that deals specifically with corruption in a political and economic context posits that corruption either acts like “sand” in economic transactions or has negative, long-term consequences for economic growth. Several international organizations and academic institutions, from the UN and the World Bank to the Harvard Center for International Development, have adopted this argument as part of their policy prescriptions for political and economic actors.

The dichotomy between ‘sand’ and ‘grease’ in the wheels of FDI appears as part of the title of a 2001 article by Wei, called “Corruption in Economic Transition and Development: Grease or Sand?” Wei collected evidence that showed people who accept or give bribes are not necessarily made better off from their exchange and that the overall effect of corruption on FDI inflows is negative. He explains that there are “several channels through which corruption hinders economic development,” (Wei 2001, 29):

- Reduced domestic investment
- Reduced foreign direct investment
- Overblown government expenditure
• Distorted composition of government expenditure away from education, health, and the maintenance of infrastructure

• Less efficient but more manipulatable public projects

In response to Wei’s comparison, Kaufman explains that the ‘grease’ argument falls through because “instead of corruption being the grease for the squeaky wheels of a rigid administration, it becomes the fuel for excessive and discretionary regulations. This is one mechanism whereby corruption feeds on itself,” (Kaufmann 1997, 2). The evidence that Wei gives for these deterrents is perhaps less convincing than his theoretical argument and he does concede that inherent conditions of transition might alter the robustness of his findings. It is possible, for instance, that Wei’s findings are not a definitive consequence of corruption, but that they are the result of poor governance, political instability, lack of property rights enforcement, or a number of other deterrents of FDI.

Rose-Ackerman explains that “corruption costs can seldom be accurately assessed” and, with this in mind, policy-makers and academics have often relied on empirical studies, indices that measure risk perception and qualitative data that demonstrate the negative impact of corruption on transition countries’ ability to attract FDI, (Rose-Ackerman 1975, 202). Mauro’s findings in “Corruption and Growth” provide statistical evidence supporting this argument with a thorough examination of the Business International indices on corruption, red tape and judicial system efficiency for 70 countries, (Mauro 1995).

The negative correlation between corruption and FDI can affect not only a country’s ability to attract investment inflows initially, but also the efficiency of the
investments in the medium and long-term. As Sarkar and Hasan (2001) describe it, corruption is, therefore, a ‘double-edged sword’ when it comes to investment efficiency. First “corruption distorts the sectoral allocation of investible resources by diverting resources from potentially productive sectors to unproductive sectors and thereby decreasing the overall output-generating capacity of the investment;” then, corruption drives up “the cost of production which ultimately gets reflected in a higher output price increase and reduction in demand,” (Sarkar and Hasan 2001, 112). In simpler terms, the quality of an investment can be reduced when funds are diverted toward corrupt activities instead of the investment at hand.

While it is important to examine the impact of corruption on a transitioning country’s ability to attract FDI, it is equally important to look at investment determinants and the way in which perceptions of risk are measured. Wheeler and Mody’s study on “International Investment Location Decisions: The Case of U.S. Firms” and Hines’ work on “Forbidden Payment: Foreign Bribery and American Business After 1977” both suggest weak or insignificant empirical correlations between inflows of FDI and a host country’s risk factors, which includes perceptions of corruption as one of the main determining factors, (Wheeler and Mody 1992; Hines 1995). The transition process taking place in the CEE countries has motivated economists and political scientists alike to reexamine this weak correlation and refine the quantitative measures included in studies that focus on investor perceptions of risk.

Wei also explores this indeterminately weak correlation between risk indicators and levels of investment in developing countries and reassesses the
impact of corruption “on a broad panel of bilateral FDI data with a more comprehensive list of control variables,” (Wei 2000, 2). One of the interesting questions that he asks is, if China is considered by various measures to have rampant corruption, why then has it been able to attract the largest amount of FDI of any host country in the world for several years? He concludes, contrary to previous findings of insignificant correlations like those of Wheeler and Mody, that increases in levels of corruption have in fact been demonstrated to have a negative effect on and significant statistical correlation with a reduction in inward FDI. While his findings suggest a negative correlation between corruption and FDI, whether or not it hinders it in actuality remains elusive in his research. This study, along with many others conducted by American, European and Asian scholars, would nevertheless compel academics, policy-makers and leaders of international organizations to account for corruption when measuring levels of economic progress and when prescribing certain policies or reforms for developing countries.

The most recent literature on the effects of corruption on FDI inflows into the CEE countries has tended to scrutinize the determinants of FDI inflows and the extent to which these determinants, including corruption, have affected economic growth and development. In fact, Velkova outlines some of the most important reasons why foreigners have not wanted to invest in South Eastern European countries: path dependence, small local markets, monetary considerations, internally-oriented privatization and company restructuring, an unfinished transition process, administrative barriers, problems in acquiring
industrial locations, biased labor legislation, relatively rigid labor markets, and a state-oriented policy in promoting FDI, (Velkova 2006, 18-20). In his study of “FDI Inflows to the Transition Economies in Eastern Europe: Magnitude and Determinants,” Johnson echoes some of the same concerns of international investors described by Velkova. He argues that “large differences in the volume of FDI that individual European transition economies have attracted” can be accounted for by ‘traditional’ as well as ‘transition-oriented’ determinants, (Johnson 2006, 2).

Firm-level evidence provided by Smarzynska and Wei also confirms Johnson and Velkova’s work. They contend that, “the extent of corruption in a host country affects a foreign direct investor’s choice of investing through a joint venture or through a wholly owned subsidiary. Corruption reduces inward foreign direct investment and shifts the ownership structure toward joint ventures,” (Smarzynska and Wei 2000). In light of the recent EU enlargement to countries such as Romania and Bulgaria, this argument is particularly relevant. Other investment deterrents that make up investor perceptions of risk in the CEE countries include slower private sector development and industrial development, a relatively inefficient judicial system, weak law enforcement in the domain of corruption, and actual levels of corruption, among many others. With so many investment deterrents to consider, it is not surprising that most firms choose joint, rather than independent, ventures to enter the CEE markets. This way, foreign corporations can rely on local firms to carry out business plans, obtain licenses and permits, and deal with government officials directly. Most scholars, according
to the literature reviewed in this section, would agree that, ultimately, corruption costs investors more than it benefits them. There is, however, an equally important flip side to this seemingly convincing argument.

**Corruption Can Grease the Wheels of FDI**

Although the argument that corruption has a negative impact on inflows of FDI and economic development has contributed to the adoption of anti-corruption legislation, a wide array of reforms and a focus on transparency and integrity, the case of corruption as “speed money” or “grease money” continues to spark debate among both academics and policy-makers. While corruption may not be desirable for economic growth, it is important to point out that “empirical studies have not always found a consistent negative relationship between corruption and FDI. Hines (1995) reported non-significant relationships between corruption and incoming FDI,” (Habib and Zurawicki 2001, 689; 2002, 293). In fact, “some analysts speak of “useful corruption” when it cuts red tape and reduces bureaucratic rigidity; it can also provide people with a sense of control over their lives and in this sense humanize the interaction between the population and public officials,” (Karklins 2005, 8). While scholars like Mauro and Wei may argue that the benefits of such “useful corruption” are usually short-lived and narrow in scope, this line of reasoning has been the subject of investigation by analysts and practitioners in the past.

In 1964, Leff presented the rather controversial idea that corruption may actually help to raise economic growth in developing countries by allowing
businesses to circumvent cumbersome government regulations through bribery. He argues that corruption is “an extra-legal institution used by individuals or groups to gain influence over the actions of the bureaucracy,” and “if these groups are more likely to promote growth than is the government, then their enhanced participation in policy formulation can help development,” (Leff 1964, 8). Although his more recent work seems to reflect an evolution in his position on the issue of corruption and investment, Nye engaged Leff’s claim in his 1967 work on “Corruption and Political Development: A Cost-Benefit Analysis.” In an effort to address the debate between the “moralists” and the “revisionists”, Nye suggests that while corruption may be more costly in the long run, “under some circumstances Mandeville is right that private vice can cause public benefit,” (Nye 1967, 417).

The circumstances under which private vice can prove beneficial to the public may not appear obvious, but they might increase bureaucratic efficiency. Engaging in corrupt activities is generally accompanied by a certain level of secrecy not only because the participants might suffer legal consequences, but perhaps more so because of the negative political and social implications of being a corrupt agent or politician. In fact, Tullock explains that, “most people who object to corruption probably do so on moral grounds without considering the practical effects…This brings us to the Becker-Stigler (1974) theory of corruption. They pointed out, quite truthfully, that simply selling various government privileges at auction, would put the privileges in the most efficient hands,” (Tullock 1996, 7-8).
This efficiency-maximizing characteristic of corruption stems from the notion that corrupt transactions represent pure transfers and a less wasteful alternative for rent-seeking. Tullock “considers the selling of government positions, which can just be another type of corruption, to be a pure transfer of assets which is not equivalent to waste, since the money increases utility or production elsewhere,” (Lambsdorff 2002, 105-106). In addition, Wellisz and Findlay determine that “paradoxically, maximum waste is likely to occur if the licensing system is absolutely ‘fair’ and if it brings no benefits to the licensor…Graft and corruption reduce economic costs,” (Wellisz and Findlay 1984, 149).

Egger and Winner agree with the conclusion that corruption can help to reduce the economic costs of doing business. In their comparison of data testing the ‘grabbing hand’ and ‘helping hand’ theories of corruption, they find that there is a “positive short run impact of corruption on FDI, which supports a “helping hand” interpretation… because it accounts for an equalization effect on the international distribution of real inward FDI shares,” (Egger and Winner 2005, 934). In subsequent research, Egger came to a similar conclusion: the impact of corruption on FDI has declined in recent years and other economic factors, such as market size and growth, are now considered to be more significant than corruption, (Egger and Winner 2006). In developing countries, corruption is often tolerated and even considered desirable because it “reduces transaction costs, makes agents’ behavior predictable, and stabilizes the institutional environment…as long as corruption fulfills the role of making conduct
predictable, and the party system is strong enough to guarantee stability, it is not intolerably harmful,” (Colombatto 2003, 370).

In 1977, the United States Congress passed the Foreign Corrupt Practices Act (FCPA), which sought to reduce the frequency and amounts of bribes paid by American firms to gain entry into or conduct business in foreign markets. Despite its goal of preventing corruption abroad by setting legal consequences domestically, the results of the act’s passage were to cause a decline in U.S. business activity in countries whose public officials normally accepted bribes as a matter of routine transactions, (Hines 1995, 1). Eventually, the fine print of the act was changed to allow for some ‘grease’ payments to be made without domestic legal consequences, implying that these types of payments would not only be tolerated, but also accepted as part of the efficient operation of MNCs abroad.

The flow of FDI “may be considered another factor that, through making a country richer, can improve financial institutions despite political and financial corruptions,” (Kholdy and Ahmad Sohrabian 2008, 495). Put simply, FDI will flow inward despite corruption. In his seminal work on Political Order in Changing Societies, Huntington argues that “the only thing worse than a society with a rigid, over-centralized, dishonest bureaucracy is one with a rigid, over-centralized and honest bureaucracy,” (Huntington 1968, 386). He contends that bribing government officials in countries with inefficient bureaucracies might help to speed up the process through which corporations acquire licenses and conduct business transactions. The possibility remains, according to Nye and Huntington, that engagement in corrupt practices by top-level political officials might
eventually produce a desirable economic outcome for the public as well. The
corruption as ‘grease money’ argument has several points worth taking into
account. It has difficulties, however, in explaining a wide range of negative
correlations in the empirical evidence on the impact of corruption on economic
growth in developing countries. It is important, however, to put the ‘grease the
wheels’ argument into the context of the economic and political transition that
took place in the CEE countries.

Corruption in Transition

Whether corruption helps economic development is the subject of intense
debate, but one correlating argument that may be more difficult for ‘sand in the
wheels’ proponents to refute is the widespread statistical findings that corruption
does not hurt FDI inflows. The argument that corruption increases during periods
of economic or political transition has been addressed in much of the transition
and privatization literature in the CEE region. In her book, The Best System
Money Can Buy, Warner makes two substantial claims: (1) the integration
process in the EU has actually contributed to corruption in Europe; and (2) that
the establishment of a free market economy does not necessarily root out
corruption, (Warner 2007). She explains that “corruption continues to serve the
interests of some EU member-state politicians, parties and firms because it
allows those involved to beat their competition… because it allows flexibility that
formal rules and regulations do not; because it is a tool in the economic and
political struggle for power; and because the various dynamics of
decentralization, export-oriented policies, and campaign and party finance allow for and provide incentives for it,” (Warner 2007, 11). For many years, the argument that corruption has the potential to ‘grease the wheels’ of economic activity lay dormant, but Warner’s recent examples of significant corruption cases all throughout Europe have demonstrated not only that the debate is ongoing, but also that the less ‘principled’ argument has the potential to make both academics and investors reevaluate their assessment of corruption and its real impact on inward FDI.

Is an increase in corruption, therefore, an inevitable part of the transition process? To answer this, Ades and di Tella find “evidence suggesting that corruption is higher in countries pursuing active industrial policy,” (Ades and di Tella 1997, 1040). To correlate to these findings, Robertson and Watson (2004) also uncovered a pattern in relation to the rate of FDI inflows and corrupt practices: the faster FDI inflows enter a host country, the greater the potential for increases in corrupt practices. The ‘shock therapy’ approach to the transition process that was implemented in many of the CEE countries, therefore, contributed either directly or indirectly to an increase in corruption. The privatization of industries during the transition process created unprecedented opportunities to engage in corrupt exchanges because the largest bribe often picked up a state-owned enterprise for a fraction of its worth or beat out companies that offered smaller or no bribes for a lucrative government procurement contract. In addition, the CEE states’ long-standing culture of corruption that existed under the communist system would continue well into the
transition period. Whether the opportunity for corrupt exchanges occurred as a result of cultural inertia or structural opportunity, Sandholtz and Taagepera “expect reforming communist and post-communist countries to experience higher levels of corruption than otherwise similar countries. Empirical analysis confirms this proposition,” (Sandholtz and Taagepera 2005, 110).

The accompanying political transition in the CEE countries often ensure that the old nomenklatura would remain in power, albeit with ‘former-communist’ labels. In their study of corruption and privatization in transition, Kaufmann and Siegelbaum found that the “transition from the exploitation of power and access to goods and special perks to the unchecked appropriation of wealth to private uses was facilitated by the previous regime’s philosophical insistence that capitalism and the free market were lawless and corrupt at their core,” (Kaufmann and Siegelbaum 1996, 424). As a result of this skewed view of capitalism, bureaucrats, citizens, and entrepreneurs had very little incentive to discourage the pursuit of wealth by any means that had characterized the communist system. The transition process occurred in a series of stages, each with various levels of privatization. Immediately following the collapse of communism, ‘spontaneous’ privatization was implemented in certain economic sectors to accelerate desperately needed capital inflows and prevent economic destabilization. This “particularly corrupt form of spontaneous privatization was taking place informally through the blatant theft of state assets and diversion of revenues from state enterprises by their managers,” (Kaufmann and Siegelbaum 1996, 424).
Some studies have shown that economic transition and political instability can hinder FDI inflows, and that corruption is just one of many factors that are a part of the experience of the CEE countries. In fact, it has been posited that the “conditions created by transition [such as increases in levels of corruption] have been a barrier to FDI, but some of the transition economies had inflows of FDI in the 1990s that rivaled or even exceeded those of similarly sized but wealthier and more institutionally developed capitalist neighbors,” (Brada, Kutan, and Yigit 2006, 651). In other words, despite increases corruption, FDI was pouring into the CEE countries at unprecedented rates throughout the transition process. This is precisely why the paradox of the effects of corruption and transition on FDI inflows is so substantial.

In simplest terms, corruption arguably hinders FDI, but inflows of FDI reached their peak during the transition process that was characterized by the highest levels of corruption. FDI flowed into this region despite corruption because the market-seeking determinants of investment have much more explanatory power than any of its disincentives. While FDI entered CEE markets despite corruption, the long-term consequences of deeply engrained graft and bribery would have to be addressed. High levels of corruption in transition might have been tolerated or advantageous in transition, but both domestic political and economic institutions of the CEE countries and the international and regional organizations that they were seeking to join would eventually have to devise a long-term strategy to reduce the frequency and extent of corrupt practices as part of the consolidation of democracy and capitalism.
EU Membership and Corruption

Much of the recent literature on international organizations, regional integration, and institutions posits that “the more a country is tied into international networks of exchange, communication, and organization, the lower its level of corruption is likely to be,” (Sandholtz and Gray 2003, 762). Sandholtz and Gray argue that international factors affect domestic practices through both economic incentives and social integration and the transmission of values and norms. They do agree, however, that there are other determinants of corruption, besides integration into an international organization, that should be taken into consideration: low wages or average incomes, state control of economic resources and a painstaking privatization process, the nature of a country’s political leadership, and social values, among others, (Sandholtz and Gray 2003, 774). The study conducted by Sandholtz and Gray compared the cases of 150 countries whose corruption perception levels were measured by Transparency International’s CPI. Though the focus of this study is not as broad as Sandholtz and Gray’s analysis, the implications are still both significant and relevant.

While this literature has traditionally had a broader focus and attempted to explain the complex series of preferences and policies that have spurred integration processes, it also has the potential to explain why the newly admitted EU member states have implemented anti-corruption legislation, reform and policies. Of course, as previously mentioned, there remains an important disconnect between the introduction of legislation and its execution. So few of the
corruption cases brought to court have actually resulted in convictions, rendering such legislation ineffective.

There are several EU institutions that have stressed the importance of the fight against and prevention of corruption as an integral part of the EU’s internal and external policies. From an internal perspective, the fight against corruption represents the fulfillment of the requirements of the *acquis communautaire* and respect for existing member states. Externally, anti-corruption efforts are considered an essential component of the EU’s approach to international affairs and of its security policy. The Commission distinguishes between active and passive corruption. Active corruption is “to promise, offer or give, to a person or entity, directly or indirectly, an undue advantage, for the person himself or herself or another person or entity, in order that the person act or refrain from acting in the exercise of his or her duty,” (Felfoldi, European Commission Publication). Passive corruption signifies “to solicit or accept, directly or indirectly, an undue advantage, for oneself or another person or entity, in order to act or refrain from acting in the exercise of his or her duty,” (Felfoldi, European Commission Publication). Along with the understanding of corruption, it is equally important to examine what policies and efforts the EU has taken to combat its existence.

According to the European Commission, there is a correlation between good governance, economic development and the fight against corruption and organized crime. The Commission’s Directorate-General of Justice, Freedom and Security has adopted instruments to address a variety of issues, including the protection of the EC’s financial interests, corruption among officials of the EU or
of member states, private sector corruption, and problems such as money-laundering, public procurement, and organized crime. The Commission has put forward a number of communications, ranging from the proposal of a comprehensive EU Policy against Corruption to the development of a Strategic Concept on Tackling Organized Crime, as well as an Action Plan for the implementation of the Hague Programme, passed in 2005. In addition, the EU Council of Ministers also adopted a resolution criminalizing bribery in December 1994 and followed suit, in 1995, with a Protocol requiring member states to punish bribery related to the European Community’s affairs. In 2005, Council Resolution 6902/05 on a comprehensive EU policy against corruption called on the European Commission to adhere to GRECO recommendations on the implementation of anti-corruption policies and to develop a monitoring mechanism to evaluate candidate countries’ progress. It was not until 2011, however, that the EU anti-corruption periodic assessment mechanism was established as part of the Communication on Fighting Corruption in the EU.

Some scholars have argued that the “EU has been a follower in the anticorruption movement”, rather than a leader (Sandholtz and Gray 2003, 772). In an era of economic, political and security concerns, however, this role is slowly changing to include more proactive measures to combat corruption.

*Between Theory and Practice*

The theoretical framework linking corruption, EU membership, privatization, and transition is wide ranging and accounts for a variety of findings.
Some studies argue that the impact of corruption on inward FDI is significantly negative, while others that consider many of the same factors come to diametrically opposed conclusions. Perhaps the reason for the disconnect between theory and practice in many of these studies is the selection of cases used to analyze perceptions of corruption. In addition to the fact that corruption is measured solely on the basis of perceptions, it is also important to consider differences among the countries and transitions being examined. An investigation of corruption requires some factors to be controlled for: the selection of countries with a similar communist background; the extent of the privatization of state-run industries; cultural and geographic proximity; and an increasing level of integration into the EU, among many others. The focus of this study will, therefore, turn to both quantitative and qualitative evaluations of case studies in the CEE region. The goal of a comprehensive analytic approach is to put the theories elaborated on here to the test and assess how well they hold up in specific cases.

Are corruption and EU membership, among other traditional and transition-specific determinants, significant factors in the CEE region’s ability to attract FDI? The following chapter provides a quantitative analysis of the significance of a series of independent variables on FDI inflows. The regression model developed in the following section can help to develop a quantitative explanation for the increase in foreign investment that characterized the region throughout the 1990s and the 2000s. The quantitative explanation, however, is not sufficient in describing the actual relationship between corruption, FDI, and
EU membership. For this reason, Chapter 5 of this study will provide an in-depth analysis to understand this relationship through a qualitative analysis of large-scale privatization transactions in the specific case of Romania. A combination of these methodological approaches will produce a more accurate and wide-ranging investigation of the effects of corruption and EU membership on inward FDI.
Chapter 4: A Quantitative Examination of FDI Inflows to the CEE Region

In 2004 and 2007, the European Union underwent a series of substantial enlargements when it admitted several candidate countries from the Central and Eastern European region. This expansion, from an economic standpoint, would provide unprecedented financial opportunities for FDI inflows, the expansion of businesses and entrepreneurial ventures, access to new and emerging markets, and the chance for a once divided continent to unite in its pursuit of capitalist goals. While most of the CEE countries had little or no recent experience with a free enterprise economic system, businesses in many Western EU member states anticipated the potential to enter virtually unexplored markets and establish themselves abroad, still benefitting from the protection of the EU’s legal framework. As members of the EU, the CEE countries would have to modify their legislative code and implement wide-ranging reforms in areas such as the protection of private property, contract enforcement, and market regulation. The enforcement of legislation to combat corruption in the CEE countries would pose a far greater challenge given the culture of corruption and obstacles to economic development that had characterized the region for decades during the communist era.

Initial observations of the inflows of FDI into the CEE region have revealed that the amount of FDI channeled into the region after the collapse of the communist systems began to pick up in 1995 continued to increase significantly throughout the end of the 1990s and well into the 2000s. As Figure 1 shows,
although the levels of FDI vary from country to country and within each country from year to year, the general trend for the region shows a notable increase from 1998 to 2008. In fact, Romania and Bulgaria both received substantial amounts of foreign investment, especially in the period from 2003 to 2008.


Observations about FDI inflows prompted a closer examination of levels of corruption to have a better idea of the types of trends that characterized this region during the period from 1998-2008. Figure 2 traces corruption perceptions scores among the CEE countries based on data collected by Transparency International’s Corruption Perceptions Index. Most countries’ levels of corruption showed minimal fluctuations, either slightly above or slightly below the average score. What is interesting to note is that Romania and Bulgaria both have the lowest CPI averages and among the highest levels of FDI inflows in the region.
Given the theoretical explanations about corruption’s negative effects on FDI inflows, how is this possible? To explain this pattern, it is essential to look at determinants of FDI more generally to discover which of these are more significant than corruption in directing the path of FDI inflows.

FIGURE 4.2: Transparency International’s Corruption Perceptions Index for the CEE Region, 1998-2008

The countries being examined in this study are now all members of the EU and have been directed to implement a series of reforms to tackle corruption. The time period from 1998 to 2008, however, was characterized by a substantial increase in FDI in the region, but levels of corruption remained virtually
unchanged, either improving only slightly or even deteriorating in some cases. This set of circumstances runs contrary to what much of the traditional literature on corruption expects will happen to FDI in corrupt countries; namely that elevated levels of corruption will prevent MNCs and other firms from investing in this area. These special cases have, therefore, prompted a series of questions that will be addressed from a quantitative perspective.

In an effort to determine the real impact of corruption levels on the inflows of FDI, it is useful to investigate a set of quantitative cases among the member states that joined the EU in 2004 and 2007. The research in this chapter attempts to address a series of questions that are relevant both to academia and to policy-making. Which traditional and transition-specific determinants of FDI have had a significant impact on FDI inflows? Have elevated levels of corruption prevented the inflow of FDI into the CEE countries? What impact has EU membership had on FDI inflows to CEE countries struggling with corruption? To what extent did the post-communist economic transition in the CEE countries affect both levels of corruption and FDI inflows?

Research Design

The aforementioned questions have been the subject of inquiries carried out by a number of academics and international organizations. This study, however, aims to answer one question more specifically: Is corruption a significant determinant of FDI in the post-communist CEE countries that have recently joined the EU? The available data on both FDI inflows and levels of
perceived corruption have led to the formulation of a postulation about the relationship between these two variables. Two parallel hypotheses were tested in this study: 1) Corruption is not a significant determinant of FDI in the post-communist CEE countries that have recently become EU members; and 2) EU membership and market size are significant determinants of FDI in this region.

Statistical analysis was conducted to examine the link between corruption, foreign investment, and EU membership, among a wider range of determinants of FDI. The significance of the impact of a series of factors that affect FDI inflows is assessed using a mixed methods approach: the application of quantitative methods is developed in this chapter and the qualitative, in-depth investigation of the specific case of Romania is the focus of the following chapter. The combination of methods allows for both theory testing, designed to quantitatively explain the validity of this study’s claims, and theory generation, a qualitative search for a common explanation, to provide a comprehensive analysis of the impact of both corruption and EU membership on FDI in the CEE region.

The quantitative examination of a large number of cases can be beneficial for analysts and policy makers alike in that it offers valuable insight into the extent to which certain determinants chart the course of FDI. Several studies have been conducted to uncover the effects of corruption on FDI, but none has examined its impact on the specific combination of CEE transition countries that have recently joined the EU. In addition, statistical analyses tend to paint a broad picture of the effects of various determinants on FDI inflows. This can cause many of the underlying factors and details of a study to be overlooked or
underrepresented. It can also lead to inaccuracies in the representation of the extent of the issue’s complexity. To offset some of the limitations that a large sample size can produce in the context of a study where corruption measurements are difficult to begin with, the following chapter offers an in-depth examination of the case study of Romania. The blend of quantitative and qualitative approaches is designed to compensate for the inaccuracies in the explanations that either approach might produce independent of the other.

Another important aspect of this study’s research design that is addressed by the combination of quantitative and qualitative approaches concerns the difficulties associated with the measurement of corruption. Data on FDI inflows, market size, population, corporate tax rates, and other figures is fairly accurate within a small margin of error. In fact, data collected by international organizations with extensive survey resources and access to government records, such as the World Bank and the UN, are often compared to one another in order to ensure the reliability of their figures.

Corruption scores, as elaborated in this study’s literature review, are measurements based on perceptions and surveys of business people and experts. The corruption survey participants’ expertise is not challenged here, but it is worthwhile to note that perceptions are subjective and may vary from one individual to the next. It is, therefore, imperative to keep in mind that such scores are not the result of an exact science and require at least basic, if not extensive, interpretation to substantiate findings. Nevertheless, as this chapter will demonstrate, analyzing the effects of corruption, EU membership and several
other determinants of FDI is useful in explaining a wide range of complexities associated with attracting investment in the post-communist CEE region.

The objective of a multivariate linear regression is to establish and explain the relationship between a series of independent, or predictor, variables and a dependent variable. Traditional FDI determinants and corruption variables will be included in a cross-country regression that takes a series of independent variables into consideration to determine the extent to which of these affect the inflows of FDI into the selected CEE economies. The objective in the selection of independent variables is to collect value neutral data using a passive and objective approach so as to produce a reliable reductive data analysis, as well as valid conclusions and possible generalizations.

The selection of cases analyzed in this study is based on a most-similar design to allow for a greater degree of comparability among the determinants of FDI inflows. The ten cases include: Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia. To avoid systematic bias in case selection, all ten countries are located in the CEE region and share a common historical background. These former communist countries have recently undergone a period of substantial transition, including democratization and marketization. In addition, all ten countries applied for and were admitted as members to the European Union in either 2004 or 2007. Other member states that joined the EU during the 2004 enlargement, notably Malta and Cyprus, do not share the political and economic experiences of the cases selected for the purpose of this study, namely the transition from communist
governments and command economies, and were therefore excluded from the analysis. Former East Germany was also omitted because its transition period differed from other CEE countries given its reunification with West Germany.

The data for the regressions covers the period from 1998 to 2008 and these specific years were chosen for a number of reasons. First, and most importantly, many corruption indices that were compiled prior to 1998 are characterized by a lack of information. While the difficulties associated with measuring graft continue to affect the accuracy of corruption indices, the methods used to collect such data have continued to evolve and improve, producing more consistent data over time. Second, the selected years reflect the time period during which the ten CEE countries were in the process of either negotiating or being admitted into the EU. By 2008, all ten countries had joined the EU, allowing for the regressions to adequately reflect the impact of EU membership as a determinant of FDI inflows. Finally, the regressions assessing the relationship between determinants of FDI and FDI inflows were not carried out beyond 2008 because the impact of the 2008 global economic crisis would have skewed the results of the analysis as FDI flows slowed significantly worldwide for a period of several years.

**Variables**

The dependent variable in this study is the natural logarithm of FDI inflows as a percentage of the individual countries’ GDP, LN(FDI%GDP). In the CEE cases, FDI inflows are indicative not only of economic development, but also of
the pace of the transition process and the success of the implementation of reforms. A country’s ability to attract FDI can help to shape other countries’ and investors’ perceptions of economic performance and market potential, just as EU membership can act as a guarantor of political and economic stability. FDI statistics are generally consistent and reliable, making them good sources of data for the purpose of analysis in this study.

Data on the dependent variable, LN(FDI%GDP), was generated for the specific set of CEE countries using the World Bank’s Data Bank on World Development Indicators, (WDI). The IMF defines foreign direct investment as “a category of international investment made by a resident entity in one economy (direct investor) with the objective of establishing a lasting interest in an enterprise resident in an economy (host country) other than that of the investor (direct investment enterprise),” (Bitzenis 2009, 79).

To compute FDI as a percentage of GDP, the World Bank’s Development Indicator database uses the measure of FDI as the “sum of equity capital, reinvestment of earnings, other long-term capital, and short-term capital as shown in the balance of payments. This series shows net inflows (new investment inflows less disinvestment) in the reporting economy from foreign investors, and is divided by GDP,” (World Bank WDI 2013). The World Bank’s data on GDP are based on World Bank and OECD national accounts data files. GDP is calculated as “sum of gross value added by all resident producers in the economy plus any product taxes and minus any subsidies not included in the value of the products. Data are in current U.S. dollars. Dollar figures for GDP are
converted from domestic currencies using single year official exchange rates,” (World Bank WDI 2013). Several studies use FDI as a percentage of GDP as their dependent variable (Walsh and Yu 2010; Campos and Kinoshita 2008; Wilhelms 1998; Buthe and Milner 2008) as it produces a relatively reliable measure of the rate of economic development in a particular country or region.

An important distinction should be made between those determinants of FDI that are a measure of finite amounts, such as GDP or population, and those factors that are measures of perceptions, including government effectiveness, corruption, and political stability. The World Bank Governance Indicators attempt to evaluate governance quality by surveying enterprise, citizen and expert respondents in both industrial and developing countries. Data is gathered from survey institutes, NGOs, think thanks, international organizations, and private sector firms (World Bank WGI Data Sources 2012).

The goal of the indicators is to allow for cross-country comparisons over time, but there are definitely some methodological issues that should also be taken into account given the difficulty associated with producing accurate measurements. In fact, these “concerns question the extent to which perceptions data adequately capture the relevant reality... that there are various systematic biases in perceptions data on governance, [and] the possibility that subjective assessments of governance are driven by factors other than governance itself, such as the level of development or recent economic performance of a country,” (Kaufmann, Kraay, and Mastruzzi 2010, 19). Given the subjectivity and potential biases of the collected data, the measures of the World Bank indices are not
meant to provide hard evidence of corruption or government effectiveness, but instead highlight the degree to which these perceptions have changed over time, allowing for useful comparisons of governance among countries in this study.

Included as variables in the regression models of this study are two separate measures of corruption. Transparency International’s CPI is a composite index that considers assessments of risk by various agencies and business expert surveys. It provides insight into the changes in patterns of perceptions of corrupt activities over time and for more than 150 countries. The CPI uses an average of percentile ranks of countries on the individual indicators of perceptions of corruption. Alternatively, the World Bank’s Control of Corruption index is developed with the unobserved components methodology that places data in common units, provides a natural framework for rescaling units based on relative precision, and aggregates measures, all while considering the standard errors, (World Bank WGI 2012). In essence, Transparency International's data is generated using a simpler, more straightforward methodology and the World Bank’s Control of Corruption relies on a more complex approach to reduce the margins of error. The research design of these indices must account for biases and subjective interpretations, but taken together, they can complement each other in providing a more balanced representation of the perceptions of corruption in a given country over a specific period of time.

The independent, or explanatory, variables are drawn from a number of studies that outline both traditional and transition-specific determinants of FDI inflows, (Carstensen and Toubal 2004). While the theoretical background on
patterns of FDI inflows outlines a long and complex series of determinants, those explanatory variables that were most relevant for this study have been organized into categories according to the nature of the determinants.

The natural logarithm of a series of variables was calculated in order to simplify and linearize the relationship between the variables, especially since some of the data is interpreted as percentage changes in the dependent variable. This type of measure also addresses the issue of heteroscedasticity. Had the actual value of some of the determinants been used, this might have resulted in the residuals of the regression having a skewed distribution. The calculation of the natural logarithm aids in attaining an approximate degree of homoscedasticity in the data and is expected to improve the predictive power of the model.

**Market Size**

Dunning (1988) and Bitzenis (2003), among other scholars, focus on market size as one of the most important determinants of FDI. The size of the market, the potential for market growth, entry into new markets, and opportunities for joint ventures and horizontal or vertical integration have all been widely described as having a significant impact on the location of FDI inflows.

**Annual GDP growth (GDPGROW):** This measure is the value of the annual percentage increase of the total value of a country’s GDP compared to the previous year. It reflects the growth of the market size over time and can therefore be used by MNEs and other firms to forecast future market size. It is
expected that an increase in the percentage of annual GDP growth will coincide with an increase in FDI. (World Bank WDI 1998-2008).

**GDP per capita (LN(GDPCAP))**: This variable represents the sum of the gross value added of the GDP divided by the midyear population of a particular country. This measure is particularly useful in comparing countries with different population sizes, providing a comparable measure of the GDP from one case to another. It is also an indicative measure of market wealth and purchasing power. This variable was selected more specifically to allow for the normalization of the data among the various cases. It is expected that GDP per capita will have a significant impact on FDI inflows. (World Bank WDI 1998-2008).

**Population (LN(POP))**: This value represents the total number of inhabitants of a given country as of January 1st of the year in question. Population is a useful measure of market size independent of any other economic indicators of market size. (Eurostat 1998-2008).

*Factors and Cost*

Foreign investors consider costs associated with FDI in an effort to maximize efficiency. These include the availability or low cost of natural resources, trade costs, access to high technology, low cost of human resources, as well as managerial, organizational, marketing, and entrepreneurial advantages, (Dunning 2008; Bandelj 2002; Bitzenis 2003). In addition, a well-
educated and relatively low-cost labor force has been one of the most attractive features of the CEE countries. Simply put, when costs are low in a particular region, it becomes more attractive for FDI.

**Natural resources rents (NATRES):** Total natural resources rents are calculated as a percentage of GDP in order to reveal the role that natural resources play in a particular economy. Several of the CEE countries have substantial oil reserves and the mining industry, after a much-needed period of modernization, is also producing considerable revenues. Given the profitability of natural resources and the industries generated by their availability, this variable should be a significant determinant of FDI independent of other variables. (World Bank WDI 1998-2008).

**Corporate tax rate (CTR):** As a percentage measure of the corporate tax rate, often set as an incentive offered by a host government to businesses looking to enter into a market in the long term, the corporate tax rate is a good indicator of economic openness and of the annual cost of establishing a business abroad. The lower the corporate tax rate, the more attractive a host country appears to foreign investors. (Data from 1998-2003: Huizinga, Laeven and Nicodeme 2008; Data from 2004-2008: KPMG Corporate and Indirect Tax Rate Survey 2007).

**Purchasing power parity conversion factor (PPPEX):** This conversion factor for GDP measures purchasing power by comparing the number of units of a country's currency needed to purchase the same amounts of goods and services
in the domestic market as one US dollar would buy in the United States. This index provides foreign businesses with information that goes beyond a simple measure of the currency exchange rate between two countries because it also incorporates the relative costs of a fixed basket of goods and services. The lower the PPP conversion factor, the less it costs a foreign company to purchase identical goods and services. (World Bank International Comparison Program database 1998-2008).

**Labor costs as monthly minimum wages (LABOR):** Monthly minimum wages in Euros, with measurements from years prior to the adoption of the Euro in 2002 converted to Euros, provides foreign businesses with information to determine which countries have the lowest cost of labor. A low-cost labor force should be a significant determinant of FDI because it lowers production costs in the host country. (Eurostat Database 1999-2008).

*Privatization and Economic Openness*

The extent to which previously state-run companies have been privatized is highly indicative of the economic progress that has taken place throughout the transition period. The gradual decrease in state involvement in economic areas that may be more efficiently operated by the private sector has been the goal of the CEE countries. This goal was established not only by public and private officials working together to advance the privatization process, but also by the EU as part of a short and long-term economic development plan.
Privatization revenues as a percent of GDP (PRIREV): The collapse of communist rule and of the command economies in the CEE region, among many other countries once in the Soviet sphere of influence, gave way to a period of rapid and widespread privatization. From national utilities to automobile manufacturing, state-run companies were being sold to both domestic and foreign investors on an unprecedented scale. The calculation of cumulative privatization revenues as a percent share of GDP offers foreign investors a clearer picture of the role they might play in a transitioning economy. Privatization is particularly attractive to FDI as investors are able to buy out or enter into a joint venture with a state-run company undergoing privatization, generating the potential for huge profits. The PRIREV factor developed in this study considers government revenues for the cash sale of previously state-run enterprises. (EBRD Transition Reports 1998-2008).

EU Membership (EUMEM): This is a binary value that represents EU membership as 1 or 0—1 signifying EU membership and 0 indicating non-membership. As members of the EU, the CEE countries belong to one of the most, if not the most, extensive regional trade agreements in the world. Member states are required to implement economic reforms, eliminate barriers to trade with other EU member states, and adopt regulatory measures. EU membership is expected to signal international competitiveness and guarantee a certain level of economic stability, making it a significant determinant of FDI inflows. (European Commission 1996-2008).
<table>
<thead>
<tr>
<th>Description</th>
<th>Mean</th>
<th>Std. Deviation</th>
<th>N</th>
</tr>
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<tbody>
<tr>
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<tr>
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<tr>
<td>LABOR</td>
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<td>Mean</td>
<td>Std. Deviation</td>
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<tr>
<td>Description</td>
<td>Mean</td>
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</tr>
<tr>
<td>PROPRI</td>
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<tr>
<td>Description</td>
<td>Mean</td>
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</tr>
<tr>
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<td>Description</td>
<td>Mean</td>
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<td>Description</td>
<td>Mean</td>
<td>Std. Deviation</td>
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</tr>
<tr>
<td>POLSTB</td>
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<tr>
<td>Description</td>
<td>Mean</td>
<td>Std. Deviation</td>
<td>N</td>
</tr>
<tr>
<td>GOVEFF</td>
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</tr>
<tr>
<td>Description</td>
<td>Mean</td>
<td>Std. Deviation</td>
<td>N</td>
</tr>
<tr>
<td>REGQUAL</td>
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<tr>
<td>Description</td>
<td>Mean</td>
<td>Std. Deviation</td>
<td>N</td>
</tr>
<tr>
<td>RULAW</td>
<td>.46231390</td>
<td>.402049460</td>
<td>104</td>
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<tr>
<td>Description</td>
<td>Mean</td>
<td>Std. Deviation</td>
<td>N</td>
</tr>
<tr>
<td>CTRCORR</td>
<td>.27026254</td>
<td>.400193669</td>
<td>104</td>
</tr>
</tbody>
</table>
Property rights index (PROPRI): This is index is a rating that assesses individuals’ ability to accumulate private property that is secured by clear laws, which are enforceable by the state. The score also takes into consideration the chances that private property will be expropriated and the efficiency and independence of the judiciary system. Scores range from 0 to 100, with 100 being the best possible and indicating that private property is absolutely guaranteed by the state. Traditional determinants of FDI include measures of private property protection because FDI is a long-term endeavor and investors are looking for a guarantee from the state that their property will not be threatened. (Heritage Foundation Index of Economic Freedom 1998-2008).

Governance Indicators

The World Bank defines governance as “the traditions and institutions by which authority in a country is exercised. This includes the process by which governments are selected, monitored and replaced; the capacity of the government to effectively formulate and implement sound policies; and the respect of citizens and the state for the institutions that govern economic and social interactions among them,” (World Bank 2012). While the efficiency with which a government operates is one measure of governance, it is equally important to consider factors such as levels of corruption, the accountability of the government to its people, the transparency of its institutions, the quality of its legal and regulatory framework, and the overall stability of the political system. These considerations provide a backdrop for the type government and political
environment that a company will be dealing in the long-term if it decides to make greenfield or brownfield investments in a country.

**Transparency International’s Corruption Perceptions Index (TICPI):** The perceptions index developed by Transparency International (TI) attempts to measure the degree to which a country’s public sector, including administrative and political institutions, is perceived to be corrupt. TI carries out a series of surveys in each country, gathering data on perceptions of corruption from business people and country experts. Scores range from 0 to 10, with 0 being the most corrupt and 10 being the least corrupt. TI acknowledges that the CPI does not tell the complete story of corruption in a particular country and that the index is limited in scope because “there is no meaningful way to assess absolute levels of corruption in countries or territories on the basis of hard empirical data,” (TI 2012). Given the difficulty, or impossibility, of accurately measuring the pervasiveness of secretive and frequently illegal activities, the scores given by TI are not expected to be significant for FDI. (Transparency International Corruption Perceptions Index 1998-2008).

**Voice and Accountability (VOIACC):** Voice and accountability is a perceptions index that measures the extent to which citizens of a country participate in the selection of their government and representatives, as well as attitudes regarding basic freedoms of expression and association and an independent media. Scores range from -2.5, worst, to 2.5, best. Of note is the fact that the highest
scores, among which the Scandinavian countries are found, generally do not exceed 1.5 or 1.6, thereby making a score of 2.5 difficult to attain. (World Bank Worldwide Governance Indicators 1998, 2000, 2002-2008).

**Political Stability and Absence of Violence (POLSTB):** Political stability and absence of violence is a perceptions index that measures the probability that a government will be threatened or overthrown by the use of violence or unconstitutional means. It also accounts for the use of terrorist tactics and politically-motivated violence. The score ranges from -2.5 to 2.5, with -2.5 being the lowest and 2.5 the highest. The more stable a government and the more consistent its ability to address violent threats, the more likely firms will be to contribute to FDI in the long term. (World Bank Worldwide Governance Indicators 1998, 2000, 2002-2008).

**Government Effectiveness (GOVEFF):** Government effectiveness captures perceptions about the overall quality of the institutions of a government. It measures the quality of public and civil services, the degree to which the government is independent from political pressures, and the level of commitment to policy development and enforcement. If a government is able to effectively address political, economic and social challenges, this is a potentially significant determinant of FDI. (World Bank Worldwide Governance Indicators 1998, 2000, 2002-2008).
Regulatory Quality (REGQUAL): Regulatory quality is an index that describes perceptions about the government’s ability to establish and implement effective policies that promote the development of the private sector. Policies that are favorable toward the private sector and that facilitate investment, along with government incentives such as tax breaks, can play a significant role in attracting FDI. (World Bank Worldwide Governance Indicators 1998, 2000, 2002-2008).

Rule of Law (RULAW): Rule of law is a perceptions index that summarizes the degree of confidence that agents have in the rules set by a particular society. This index measures the quality of contract and property rights enforcement, the effectiveness of the police and court system, and the extent to which violence and crime are likely to affect the political, economic, or social interaction within a country. It is expected that respect for rule of law will have a positive effect of limited significance on FDI inflows. (World Bank Worldwide Governance Indicators 1998, 2000, 2002-2008).

Control of Corruption (CTRCORR): Corruption perceptions, while difficult to assess, attempt to measure the degree to which public office, institution, and civil service are influenced or driven by private gain. This index accounts for both petty and grand corruption and for the extent of state capture by private interests and influential government leaders. While much of the traditional literature on corruption claims that it has a significant impact on inflows of FDI, corruption in the CEE countries is expected to be of minimal importance among the

*Specification of Regression Models: Ordinary Least Squares and Fixed Effects Models*

The multivariate regression in this study is comprised of a series of linear models, each one formulated to complement the others in determining the statistical significance of traditional and transition-specific determinants on FDI inflows in ten EU member states in the CEE region. The use of panel data, collected from a variety of sources over an 11-year time period, provides more information, increases the degrees of freedom, and addresses the omitted variables problem. The program used to carry out the regression analysis was IBM’s Statistical Package for the Social Sciences v20 (SPSS) and two types of models were run, one with a Pooled Ordinary Least Squares (Pooled OLS) regression and the other with a Fixed Effects (FE) regression.

The collinearity diagnostics were automatically computed by the SPSS program for the Pooled OLS regression. The Durbin-Watson statistic option was selected to test the regression residuals for serial correlation. The casewise diagnostics were set up in such a way that outliers three standard deviations outside of the mean would be noted. A constant was also included in the equation and any cases that had missing values were excluded in a listwise manner and were subsequently removed.
FDI inflows in the Pooled OLS model are described as a linear function of their determinants:

\[ \ln(Y) = \alpha + \beta X + \epsilon \]

where \( Y \) is the dependent variable, \( \alpha \) is the constant, \( \beta \) is the coefficients matrix, \( X \) represents the independent variables matrix, and \( \epsilon \) is the error of the model. Results are based on the Pooled OLS modeling to explain the effect of various determinants on FDI inflows.

In addition to the OLS regression, a Fixed Effects (FE) regression was performed on the data to allow for a comparison between the results of both models. The FE model is useful for analyzing the influence of variables that change over time. The Pooled OLS model requires that certain assumptions about the data be met, including homoscedasticity or no serial correlation in the data, which might impose some restrictions. The FE model might solve the omitted variable bias caused by the Pooled OLS regression, but it might also cause loss of information and a reduction in the degrees of freedom. Given the fact that Pooled OLS and FE regressions each has different benefits, including both models will aid in strengthening the overall explanatory power of the results of this study.

FDI inflows in the Fixed Effects model are described by the following equation:

\[ \ln(Y_{it}) = \alpha_i + \beta_1 X_{it} + F_i + \epsilon_{it} \]

where \( Y_{it} \) is the dependent variable, \( i \) is the entity, \( t \) represents time, \( \alpha \), is the unknown intercept for each entity (constant), \( \beta \) is the coefficient for a particular
independent variable, \(X\) represents one independent variable, \(F\) is the fixed effect, and \(\epsilon\) is the error term of the model.

In preparation for the analysis of the panel data, some average values were calculated in order to account for missingness in the data set and ultimately increase the sample size. These years include 1999 and 2001 for the World Bank Governance Indicators for all countries, the TI CPI scores for Latvia and Slovenia in 1998, and the labor statistics for 1998. Other cases with missing data for specific independent variables were excluded listwise, meaning that all values for that entire case were removed from the sample set.

In the analysis, \(\text{LN}(\text{FDI}\%\text{GDP})\) is written as a linear function of the determinants of FDI and the general form of the equation is:

\[
\text{LN}(\text{FDI}\%\text{GDP}) = \alpha + \beta_1(\text{GDP}\%\text{GROW}) + \beta_2(\text{LN}(\text{GDPCAP})) + \beta_3(\text{LN}(\text{POP})) + \\
\beta_4(\text{NATRES}) + \beta_5(\text{CTR}) + \beta_6(\text{PPPEX}) + \beta_7(\text{LABOR}) + \beta_8(\text{PRIREV}) + \\
\beta_9(\text{EUMEM}) + \beta_{10}(\text{PROPRI}) + \beta_{11}(\text{TI_CPI}) + \beta_{12}(\text{VOIACC}) + \beta_{13}(\text{POLSTB}) + \\
\beta_{14}(\text{GOV_EFF}) + \beta_{15}(\text{REGQUAL}) + \beta_{16}(\text{RULAW}) + \beta_{17}(\text{CTR_CORR}) + \epsilon
\]

where \(\alpha\) is the constant, \(\beta_i\) is the coefficient or estimate of the determinant, and \(\epsilon\) is the error of the model.

**Pooled OLS Regression Analysis**

In the first phases of the Pooled OLS modeling, determinants of FDI inflows were added in steps and significance values and collinearity were recorded. The first model looks at determinants that fall into the broader categories of market size and factors and cost, which are generally considered to be among the traditional determinants of FDI. The results of this first regression
indicate that the LN(GDPCAP), CTR, and LABOR determinants are significant. In the second model, the third category of transition-specific determinants, privatization and economic openness, was added to the first two. The most significant determinants in this regression mirrored the results of the first regression, with LN(GDPCAP), CTR, and LABOR being significant, but adding PPPEX and EUMEM as significant FDI determinants as well. In fact, it is interesting to note the high level of significance of EU membership when it is added to the model as a factor.

The third model consists of all four categories of determinants, as the governance indicators were also included. This reflects the general form of the linear equation discussed in the model specification and the greatest number of determinants of the five models. This model also produced the highest $R^2$ value, which might be a result of the expanded sample size. Here, LN(GDPCAP) increased in significance and other significant determinants were NATRES, PPPEX, TICPI, POLSTB, and REGQUAL. At this point in the regression, it was important to devise a way to trim the model so as to determine which of these factors had the most significant impact on FDI inflows.

Once all of the determinants were incorporated into the regression model, the next step was to analyze the collinearity among the variables. The systematic removal of independent variables based on collinearity diagnostics, using Variance Inflation Factor (VIF) values, contributed to an improvement of the model’s descriptive power and ensured the elimination of inflated results. In the fourth model, those determinants with a strong collinearity were removed and
those determinants that were significant included LN(GDPCAP), PPPEX, PRIREV, EUMEM, and POLSTB.

The fifth model was comprised of a combination of determinants with the most significant impact on FDI inflows, generated by the previous models. In the last reduction of independent variables, it was discovered that GDP%GROW was not significantly different than zero and was therefore removed from the regression. This produced the final model with significant coefficients for PPPEX, EUMEM, and POLSTB at or below the .01 significance level.

Table 2 highlights the findings of the five regression models, including the coefficient ($\beta$), the standard error, and the significance level of the coefficients within each cell. Significance is indicated by (*) as 10%, (**) as 5%, and (***) as 1%. In Model 1, the $R^2$ value is 0.451 and in Model 2, as more variables are added to the regression, the $R^2$ decreases slightly to 0.402. When all of the variables are added in Model 3, however, the $R^2$ value increases once again to 0.572. After the multicollinearity (VIF) analysis and the removal of some of the strongly correlated variables, it was discovered that the $R^2$ actually decreased to 0.451 in both Models 4 and 5. Observations about the identical values of $R^2$ in Models 1, 4, and 5 indicate that market size is a strong indicator and that using only GDP%GROW, LN(GDPCAP), LN(POP), NATRES, CTR, PPPEX, and LABOR as determinants of FDI in the regression model produces a relatively good fit for the data.
TABLE 4.2: Results of Pooled OLS Multivariate Regression Analysis

<table>
<thead>
<tr>
<th></th>
<th>Model 1</th>
<th>Model 2</th>
<th>Model 3</th>
<th>Model 4</th>
<th>Model 5</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP%GROW</td>
<td>0.005 (0.024)</td>
<td>-0.020 (0.025)</td>
<td>0.005 (0.027)</td>
<td>0.001 (0.026)</td>
<td></td>
</tr>
<tr>
<td>LN(GDPCAP)</td>
<td>0.205 (0.112)</td>
<td>0.255 (0.131)</td>
<td>0.615 (0.148)</td>
<td>0.26 (0.121)</td>
<td>0.258 (0.117)</td>
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<tr>
<td>LN(POP)</td>
<td>-0.037 (0.071)</td>
<td>-0.082 (0.076)</td>
<td>0.055 (0.093)</td>
<td>-0.11 (0.089)</td>
<td>-0.110 (0.089)</td>
</tr>
<tr>
<td>NATRES</td>
<td>-0.061 (0.067)</td>
<td>-0.067 (0.079)</td>
<td>-0.134 (0.080)</td>
<td>-0.036 (0.075)</td>
<td>-0.036 (0.074)</td>
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<tr>
<td>CTR</td>
<td>-0.038 (0.013)</td>
<td>-0.025 (0.015)</td>
<td>0.001 (0.015)</td>
<td>-0.01 (0.014)</td>
<td>-0.01 (0.013)</td>
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<tr>
<td>PPPEX</td>
<td>0.047 (0.854)</td>
<td>-2.636 (1.048)</td>
<td>-3.036 (1.040)</td>
<td>-3.508 (0.839)</td>
<td>-3.512 (0.831)</td>
</tr>
<tr>
<td>LABOR</td>
<td>-0.004 (0.001)</td>
<td>-0.003 (0.001)</td>
<td>-0.001 (0.001)</td>
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<tr>
<td>PRIREV</td>
<td>0.002 (0.011)</td>
<td>-0.001 (0.012)</td>
<td>0.02 (0.009)</td>
<td>0.020 (0.009)</td>
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<tr>
<td>EUMEM</td>
<td>0.745 (0.229)</td>
<td>0.362 (0.224)</td>
<td>0.658 (0.224)</td>
<td>0.661 (0.218)</td>
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<tr>
<td>PROPRI</td>
<td>-0.006 (0.007)</td>
<td>-0.005 (0.011)</td>
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<tr>
<td>TICPI</td>
<td></td>
<td></td>
<td>0.45 (0.151)</td>
<td>0.137 (0.126)</td>
<td>0.137 (0.125)</td>
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<tr>
<td>VOIACC</td>
<td></td>
<td></td>
<td>-0.956 (0.786)</td>
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<tr>
<td>POLSTB</td>
<td></td>
<td></td>
<td>-0.929 (0.312)</td>
<td>-1.195 (0.312)</td>
<td>-1.190 (0.296)</td>
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<tr>
<td>GOVEFF</td>
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<td>-0.291 (0.503)</td>
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<td>REGQUAL</td>
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<td>1.478 (0.483)</td>
<td>0.321 (0.293)</td>
<td>0.322 (0.290)</td>
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<td>RULAW</td>
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<td>-0.492 (0.600)</td>
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<tr>
<td>CTRCORR</td>
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<td>-0.666 (0.480)</td>
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<tr>
<td>R^2</td>
<td>0.451</td>
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<td>0.572</td>
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<td>N</td>
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</table>

Coefficients are the first value
Standard errors are in parenthesis ( )
Significance is indicated by (*) as 10%, (**) as 5%, and (***) as 1%.
Reliability in a regression model depends in large part on the selection of independent variables that have a statistically significant impact on the dependent variable. One way that the reliability of the model can be affected is through the presence of outliers. Throughout all the models, there were no outliers outside of three standard deviations flagged by the SPSS software. According to the three-sigma rule for a normal distribution, 99.73% of the data should lie within three standard deviations of the mean and, since no points were found to be beyond three standard deviations in the data, it can be assumed that outliers are not influential in the models.

Another factor that should be taken into consideration when attempting to improve a regression model's reliability is collinearity, or multicollinearity in this case. Multicollinearity creates an undesirable situation in which independent variable correlations are strong and the variables essentially express the same information. The problems that arise from multicollinearity are: 1) the standard errors of the coefficients may increase; and 2) increased standard errors may cause the coefficients for one or more of the independent variables to be insignificantly different from 0. This results in a distorted or misrepresentative inflation of the standard errors and makes it difficult to determine which of the independent variables has a significant impact on the dependent variable. Multicollinearity can cause some variables to appear to be significant when they are not otherwise, or vice versa, and can reduce the explanatory power of the model.
Detection of multicollinearity is possible through the analysis of variance inflation factors (VIF). Having included all of the independent variables in Model 3, collinearity diagnostics were performed and a strong correlation was established among LN(GDPCAP), TICPI, LABOR, PROPRI, PPPEX, REGQUAL, VOIACC, CTRCORR, GOVEFF, and RULAW. In order to ascertain which variable should be eliminated from the model, every independent variable with a VIF over 5 was removed one at a time.

The regression was performed as an iterative process, each with one independent variable omitted, and the $R^2$ value was noted. The model with the highest $R^2$ was used to ascertain which independent variable should be permanently excluded from future iterations. A total of five iterations were carried out as part of the methodology in the removal of subsequent collinear independent variables. The iterations progressed until all determinants with a VIF value over 5 were subsequently removed and the model’s reliability improved.

The collinearity diagnostics revealed that the CTRCORR determinant was collinear with the other World Bank governance indicators. It was omitted during the iterative process of the multicollinearity analysis because its VIF was over 5. This is likely to be the result of the fact that the CTRCORR index was compiled as part of the same World Bank Governance Indicators data source. It was therefore determined that all of the government indicators would be best represented by POLSTB and REGQUAL, the remaining variables that had weaker collinear relationships.
TABLE 4.3: VIF Sample Size Reduction Data

<table>
<thead>
<tr>
<th>Iteration</th>
<th>GDP%GROW</th>
<th>LN(GDPCAP)</th>
<th>LN(POP)</th>
<th>NATRES</th>
<th>CTR</th>
<th>PPPEX</th>
<th>LABOR</th>
<th>PRIREV</th>
<th>EUMEM</th>
<th>PROPRI</th>
<th>TICPI</th>
<th>VOIACC</th>
<th>POLSTB</th>
<th>GOVEFF</th>
<th>REGQUAL</th>
<th>RULAW</th>
</tr>
</thead>
<tbody>
<tr>
<td>Iteration 1</td>
<td>2.046 (0.840)</td>
<td>6.632 (0.000) *0.486</td>
<td>2.914 (0.561)</td>
<td>3.661 (0.098)</td>
<td>3.33 (0.973)</td>
<td>8.032 (0.004) *0.530</td>
<td>6.995 (0.451) *0.569</td>
<td>4.22 (0.903)</td>
<td>3.897 (0.110)</td>
<td>7.635 (0.639) *0.571</td>
<td>6.685 (0.004) *0.528</td>
<td>11.495 (0.227) *0.565</td>
<td>3.922 (0.004)</td>
<td>14.663 (0.564) *0.571</td>
<td>9.064 (0.003) *0.526</td>
<td>19.234 (0.415) *0.569</td>
</tr>
<tr>
<td>Iteration 2</td>
<td>1.866 (0.979)</td>
<td>6.216 (0.000) *0.482</td>
<td>2.728 (0.487)</td>
<td>3.096 (0.133)</td>
<td>2.931 (0.835)</td>
<td>6.685 (0.004) *0.528</td>
<td>6.092 (0.378)</td>
<td>3.748 (0.771)</td>
<td>3.877 (0.118)</td>
<td>6.335 (0.639)</td>
<td>6.333 (0.002) *0.519</td>
<td>11.455 (0.221) *0.562</td>
<td>3.656 (0.002)</td>
<td>11.455 (0.227) *0.565</td>
<td>7.813 (0.003)</td>
<td>13.181 (0.137) *0.569</td>
</tr>
<tr>
<td>Iteration 3</td>
<td>1.743 (0.674)</td>
<td>5.311 (0.000) *0.482</td>
<td>2.644 (0.663)</td>
<td>3.032 (0.085)</td>
<td>2.808 (0.601)</td>
<td>6.516 (0.008)</td>
<td>5.842 (0.231)</td>
<td>3.113 (0.724)</td>
<td>3.746 (0.191)</td>
<td>6.328 (0.002)</td>
<td>5.319 (0.052)</td>
<td>9.676 (0.052)</td>
<td>3.459 (0.000)</td>
<td>9.676 (0.052)</td>
<td>7.813 (0.011)</td>
<td>15.181 (0.137) *0.559</td>
</tr>
<tr>
<td>Iteration 4</td>
<td>1.738 (0.723)</td>
<td>5.217 (0.000) *0.482</td>
<td>2.542 (0.839)</td>
<td>2.823 (0.145)</td>
<td>2.638 (0.815)</td>
<td>4.433 (0.000)</td>
<td>5.842 (0.231)</td>
<td>2.642 (0.375)</td>
<td>3.746 (0.188)</td>
<td>5.697 (0.003)</td>
<td>5.056 (0.056)</td>
<td>8.689 (0.015)</td>
<td>3.345 (0.000)</td>
<td>8.689 (0.015)</td>
<td>7.813 (0.011)</td>
<td>15.181 (0.137) *0.559</td>
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<tr>
<td>Iteration 5</td>
<td>1.566 (0.851)</td>
<td>4.345 (0.000) *0.467</td>
<td>2.541 (0.822)</td>
<td>2.755 (0.230)</td>
<td>2.449 (0.480)</td>
<td>4.371 (0.000)</td>
<td>4.355 (0.038)</td>
<td>2.38 (0.140)</td>
<td>3.639 (0.109)</td>
<td>4.345 (0.015)</td>
<td>4.345 (0.015)</td>
<td>5.941 (0.000)</td>
<td>3.307 (0.000)</td>
<td>5.941 (0.000)</td>
<td>7.813 (0.011)</td>
<td>15.181 (0.137) *0.559</td>
</tr>
<tr>
<td>Iteration 6</td>
<td>1.56 (0.956)</td>
<td>3.724 (0.034)</td>
<td>2.214 (0.219)</td>
<td>2.677 (0.630)</td>
<td>2.448 (0.481)</td>
<td>4.355 (0.038)</td>
<td>4.355 (0.038)</td>
<td>2.38 (0.140)</td>
<td>3.229 (0.004)</td>
<td>3.868 (0.280)</td>
<td>3.868 (0.280)</td>
<td>4.711 (0.001)</td>
<td>3.27 (0.000)</td>
<td>4.711 (0.001)</td>
<td>7.813 (0.011)</td>
<td>15.181 (0.137) *0.559</td>
</tr>
<tr>
<td>Iteration 7</td>
<td></td>
<td>3.494 (0.029)</td>
<td>2.214 (0.216)</td>
<td>2.633 (0.631)</td>
<td>2.18 (0.441)</td>
<td>4.321 (0.000)</td>
<td>4.321 (0.000)</td>
<td>2.289 (0.037)</td>
<td>3.098 (0.003)</td>
<td>3.864 (0.278)</td>
<td>3.864 (0.278)</td>
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<tr>
<td>ACTION TAKEN</td>
<td>REMOVED GOVEFF AND PROPRI</td>
<td>REMOVED RULAW</td>
<td>REMOVED LABOR</td>
<td>REMOVED CTRCORR</td>
<td>REMOVED VOIACC THE ONLY IV WITH VIF&gt;5</td>
<td>REMOVED GDP% GROW BECAUSE SIG WAS HIGH - 0.956</td>
<td>FINAL MODEL</td>
<td></td>
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<tr>
<td>CTRCORR</td>
<td>12.219 (0.169) *0.563</td>
<td>11.705 (0.118) *0.557</td>
<td>11.453 (0.074) *0.542</td>
<td>11.37 (0.092) *0.537</td>
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</table>

VIF values are the first term
Significance values are in parenthesis ( )
* denotes the R^2 value of the linear model when the IV is removed.

TICPI, however, was retained as part of the model because it was necessary to account for at least one corruption indicator as part of the analysis of the independent variables. In the final model, TICPI had a weak significance and the coefficient for this variable has very limited accuracy in its predictability of FDI. In other words, TICPI was the least significant variable among the remaining determinants after those with a strong collinearity were removed. A more comprehensive analysis of the impact of corruption on FDI would also include a qualitative study that might account for aspects where a quantitative study could potentially have limitations.

*Pooled OLS Regression Results*

The statistical analysis performed in the final model revealed that the most significant determinants of FDI inflows in the CEE region are the natural logarithm of GDP per capita (LN(GDPCAP)), purchasing power parity (PPPEX), privatization revenues as a percentage of GDP (PRIREV), EU membership (EUMEM), and political stability (POLSTB). These findings are similar to previous studies about the role of market size, economic openness, and transition in
attracting FDI to particular regions. The coefficient of LN(GDPCAP) was significant in all the models and, accordingly, a 10% increase in the GDP per capita measure would result in a 2.58% increase in FDI as a percentage of GDP. The size of a host country’s market, represented by a measure such as GDP per capita, is a reliable determinant of the direction of FDI inflows. It also supports the second hypothesis outlined earlier in this chapter, notably that market size plays an important role in FDI inflows.

In terms of factors and cost, foreign companies often consider investing in countries or regions with favorable currency exchange rates (PPPEX). When materials, resources, and the cost of services are low in the host country, this motivates investors to build factories, set up offices, and fund projects in the long-term. Purchasing power parity is a measure that goes beyond currency exchange and also considers the costs of materials, resources, and services in the host country. A PPPEX value close to 1 reveals that the costs of goods and services in the host country are on par with those of the domestic market, which might lead investors to stay home. The closer the PPPEX value is to 0, however, the more likely a company will be to establish an economic presence abroad and take advantage of the low operational costs. The negative coefficient for PPPEX describes the inverse relationship, where FDI increases as the purchasing power parity increases towards the maximum theoretical value of 1.

The period of political and economic transition in the CEE region produced a substantial movement to privatize many state-run industries, such as utilities and oil companies. The result of this massive privatization was an unprecedented
flow of FDI that picked up in the mid to late 1990s and continued increasing through the 2000s. The measure of privatization revenues in the model supports this trend with high levels of significance in Models 4 and 5. The regression brings to light just how influential a factor privatization is when a 1% increase in privatization revenue could theoretically produce a 2% increase in FDI as a percentage of GDP.

Among all of the significant determinants of FDI inflows, the second hypothesis was most strongly supported by the findings related to EU membership. The strict criteria for joining the EU and the requirement that countries implement a broad range of political and economic reforms have undoubtedly contributed to an improvement in investor confidence in the region. In fact, the model predicts that EU membership is the single most significant factor in charting the course of FDI in the CEE region. The rapid growth in FDI after countries have joined the EU is reflected by the coefficient of 0.661. This means that EU membership, represented in the data as a value of 1, will increase FDI inflows into a new member state by 66.1% of the GDP. Figure 1 also illustrates a similar trend, where FDI increased significantly in the years after a country joined the EU.

While it was not expected that governance indicators would accurately model FDI inflows, the regression uncovered that the World Bank perceptions measure of political stability does have a considerable impact on foreign investment. Although the correlation suggests that as political stability increases, FDI decreases, this phenomenon can be explained by cases where measure of
this factor were low or had a negative value, but levels of FDI remained high or even increased. The fact that the coefficient of POLSTB is strongly correlated to the dependent variable suggests that a better understanding of this relationship would be beneficial.

To address findings related to the first hypothesis, notably that corruption is not a significant determinant of FDI inflows, it is important to look at the results of the TICPI coefficient in the regression. The coefficients were significantly accurate for most of the independent variables, but the coefficient for TICPI was not found to be as significantly accurate as the other determinants. This could be a result of the fact that its measurement is a value based on perceptions and that it is illegal and secretive by nature, generating difficulties in accurately measuring corruption itself. Based on the $\beta$ value for TICPI, a 1-point increase in the index would only produce a 13.7% increase in FDI as a percentage of GDP. To achieve a 1-point increase, however, a country would have to substantially reduce actual levels of corruption, which has proven to be unrealistic in practice. In addition, this decrease in the actual levels of corruption would have to be accompanied by the acknowledgement by perception indices that this reduction had taken place. In other words, while it is important to account for corruption as one of many determinants of FDI inflows, it may be less significant than the traditional literature on corruption’s negative consequences for FDI has suggested.

To summarize, Model 5 of the statistical analysis appears to be a reasonably accurate predictor of FDI inflows. The $R^2$ value achieved in the
modeling is within an acceptable range for the social sciences, but this regression is simply a reference point from which to develop a more comprehensive analysis of the impact of the determinants considered as part of this quantitative study. As a continuation of the analysis of the panel data collected in this study, a Fixed Effects regression was also carried out using the same set independent variables. This two-model approach allows for a greater degree of comparability among the effects of the independent variables on inward FDI in the CEE countries over time.

_Fixed Effects Regression Analysis_

The second model included in this study is the Fixed Effects (FE) regression, which examines the link between the predictor and outcome variables within a particular entity. Each entity, in this case the years, has its own set of specific and individual characteristics that could have a potential effect on the predictor variables. An example of this type of effect would be the election of a government administration that introduces policies to encourage trade, resulting in an increase in GDP. The FE model is designed to control for those entity characteristics that could bias the predictor or outcome variables. “FE remove the effect of those time-invariant characteristics from the predictor variables so we can assess the predictors’ net effect,” (Torres-Reyna 2012, 9). When the research design is based on panel data, the FE model is used to analyze the impact of variables that change over time.
The FE and Pooled OLS models are both multivariate linear regressions, but one difference worth noting between the two is the rigidity of their assumptions. On the one hand, Pooled OLS models assume that there is no heteroscedasticity or correlation among the data. If these conditions are met, then the Pooled OLS model is strong in terms of its explanatory power. The FE model, on the other hand, takes the difficulties of meeting these assumptions into consideration by accounting for biases in the individual entities being investigated.

The Pooled OLS model does not account for the changes in the data for each year from year to year, which is why the FE model was conducted to allow for a more thorough analysis. The setup of the FE model in SPSS is similar to that of the Pooled OLS regression and the panel data used in the second model was parallel to that used for the first model. In the FE model, dummy independent variables are created to account for years. More specifically, when a particular year is being investigated, it is assigned a value of 1 and all other years receive a value of 0 to provide a more accurate statistical interpretation about what the impact of the independent variables is in the year and country in question.

While the FE model is useful in the analysis of change over time, the results from the Pooled OLS also provide valuable information for the purpose of this study. For instance, after performing the Pearson correlation analysis as part of the first model, it was determined that four of the six World Bank governance indicators had high levels of correlation. The two variables with the lowest levels
of correlation, Political Stability and Regulatory Quality, were therefore included in the FE model as well. The high correlation of the World Bank governance indicators for Control of Corruption (CTRCORR) with Transparency International’s CPI (TICPI), as well as the World Bank governance indicators, explains why it was not included in the FE model.

Using the variables from Model 5 of the Pooled OLS regression allowed for the selection of independent variables with the highest significance and the lowest levels of correlation. This informed the decision to use the following variables in the FE model: natural logarithm of GDP per capita (LN(GDPCAP)), natural logarithm of the population, natural resources (NATRES), corporate tax rate (CTR), purchasing power parity conversion factor (PPPEX), privatization revenues as a percentage of GDP (PRIREV), EU membership (EUMEM), Transparency International’s CPI (TICPI), political stability (POLSTB), and regulatory quality (REGQUAL). The actual regressions were carried out by SPSS in much the same way as the regressions were performed for the Pooled OLS model. In the FE regression, five models were generated, each one containing fewer independent variables as those that had low levels of significance were systematically removed. The removal of these statistically insignificant independent variables increased the predictive power of the model, as shown in Table 4.
TABLE 4.4: Fixed Effects Regression Model

<table>
<thead>
<tr>
<th></th>
<th>FE 1</th>
<th>FE 2</th>
<th>FE 3</th>
<th>FE 4</th>
<th>FE 5</th>
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<tr>
<td>GDP%GROW</td>
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<td>0.293</td>
<td>0.304</td>
<td>0.314</td>
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<td></td>
<td>(0.093)</td>
<td>(0.093)</td>
<td>(0.091)</td>
<td>(0.090)</td>
<td>(0.077)</td>
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<tr>
<td></td>
<td>***</td>
<td>***</td>
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<td>***</td>
</tr>
<tr>
<td>LN(GDPCAP)</td>
<td>-0.215</td>
<td>-0.194</td>
<td>-0.208</td>
<td>-0.216</td>
<td>-0.204</td>
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<tr>
<td></td>
<td>(0.073)</td>
<td>(0.071)</td>
<td>(0.067)</td>
<td>(0.066)</td>
<td>(0.060)</td>
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<td>***</td>
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<td>***</td>
</tr>
<tr>
<td>LN(POP)</td>
<td>-0.069</td>
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<tr>
<td></td>
<td>(0.059)</td>
<td></td>
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<td>NATRES</td>
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<td>0.034</td>
<td>0.035</td>
<td>0.034</td>
<td>0.030</td>
</tr>
<tr>
<td></td>
<td>(0.013)</td>
<td>(0.012)</td>
<td>(0.012)</td>
<td>(0.012)</td>
<td>(0.011)</td>
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<td>***</td>
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<tr>
<td>CTR</td>
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<td>PPPEX</td>
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<tr>
<td>LABOR</td>
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</tr>
<tr>
<td>PRIREV</td>
<td>0.009</td>
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<td>0.009</td>
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<td>(0.008)</td>
<td>(0.007)</td>
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<td>EUMEM</td>
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<td>-0.230</td>
<td>-0.246</td>
<td>-0.907</td>
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<td>(0.256)</td>
<td>(0.257)</td>
<td>(0.254)</td>
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<tr>
<td>PROPRI</td>
<td>0.047</td>
<td>0.060</td>
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<td></td>
<td>(0.104)</td>
<td>(0.104)</td>
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<td></td>
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<td>TICPI</td>
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<td>VOIACC</td>
<td></td>
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</tr>
<tr>
<td>POLSTB</td>
<td>-1.027</td>
<td>-0.917</td>
<td>-0.865</td>
<td>-0.907</td>
<td>-0.908</td>
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<td></td>
<td>(0.281)</td>
<td>(0.265)</td>
<td>(0.248)</td>
<td>(0.244)</td>
<td>(0.226)</td>
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</table>
Results of Fixed Effects Regression

In FE1, the following independent variables were included: LN(GDPCAP), LN(POP), NATRES, CTR, PPPEX, PRIREV, EUMEM, TICPI, POLSTB, and REGQUAL. Those independent variables that were insignificant in the Pooled OLS model or had a high level of correlation were not included as a means of fine-tuning the FE model from its very inception. In FE2, the NATRES variable was removed because of its low level of significance. As a Factors and Cost variable, natural resources may play a role in attracting inward FDI in some countries and for some foreign companies, but the model describes it as statistically insignificant because its importance as an FDI determinant perhaps because it is not applicable across all countries and all years.

Coefficient estimates are the first term
Standard errors are in parenthesis ( )
Significance is indicated by (*) as 10%, (**) as 5%, and (***) as 1%.
Bayesian Information Criterion (BIC)
When the NATRES variable was removed, it was noted that the significance of several of the other variables improved. Even though TICPI had a lower level of significance than NATRES, TICPI was not removed because it is part of the primary focus of this study and to find out if the removal of NATRES would improve the significance of TICPI in the subsequent model. When it was determined that TICPI became less significant in FE3, it was finally removed as an independent variable. Just as in the Pooled OLS model, the impact of corruption on inward FDI according to the FE model was also insignificant. This is not to say that it does not play a role in investors’ decisions, but statistically, it appears to represent a less influential factor. For example, the government incentives, like a low corporate tax rate (CTR), and effective dispute resolution mechanisms (REGQUAL) in a particular country might be more important considerations for inward FDI.

FE4 was characterized by an insignificant EUMEM variable, which was subsequently removed. This result stands in contrast to the high level of significance of EU membership that was part of the Pooled OLS models. The difference in the influence of EU membership in the two regressions could be caused by setup of the actual models. The FE model is designed to investigate the impact of the independent variables over time, in this case from 1998 to 2008. Eight of the CEE countries did not join the EU until 2004, six years after the 1998 start of the panel data. Romania and Bulgaria did not become members until 2007, nine years after the 1998 start of the panel data. Given the reduced amount of information available—only five years of data are available for eight
countries and 2 years of data are available for the other two—the FE model might not be best suited to assess the impact of EU membership on inward FDI over time, especially a limited period of time.

In FE5, PRIREV was eliminated for consistently low significance. Finally, those independent variables that remained as part of FE5 were: LN(GDPCAP), LN(POP), CTR, PPPEX, POLSTB, and REGQUAL. FE5 includes those variables with the highest levels of significance and the greatest degrees of freedom. It is interesting to note, however, that the Bayesian Information Criterion (BIC) for FE5 is actually the highest of all of the models. The BIC score introduces a penalty term into the FE model to reduce the number of explanatory variables. In other words, the lower the BIC, the fewer explanatory variables might be included in a description of determinants of inward FDI and the better the overall fit of the model. As the BIC score increases in FE4 and FE5, the potential problem of over-fitting is taken into consideration. The BIC score for FE3 is the lowest, indicating that this model provides the best fit for all of the FE model’s parameters, and interestingly enough, includes EUMEM.

The results from the FE3 regression are similar to those in Model 5 of the Pooled OLS regression. Some of the coefficients and significance values are very close to one another, often within one-one-hundredth of a coefficient or significance value. Other results show similar trends, while some are seemingly disjointed. The FE model supports the Pooled OLS model’s findings, and thus validates the first hypothesis of this study, that corruption is not a significant determinant of FDI. In contrast, the FE model finds that EU membership does not
play as an important role in charting the course of inward FDI, seemingly rejecting the first part of the second hypothesis. It is important to note that FE3, including EUMEM, has the lowest BIC. It does, however, report that LN(GDPCAP) and LN(POP), both factors included in the Market Size categorization, are very significant, supporting the second part of Hypothesis 2. Perhaps a longer period of EU membership as a time consideration would have resulted in a shift in the FE model, contributing to the overall significance of joining the EU for inward FDI. This remains to be addressed in future research as more data on the role of EU membership in the economic development of the CEE countries becomes available.

Statistical analyses in the social sciences are based on a number of measures that might not be as accurate or stand up to mathematical or physical science standards. This is important to consider when interpreting the results of regression models such Pooled OLS, Fixed Effects, and many others. The goal of these regressions is to provide a better idea, a starting point for inferences that can be made about cases and what influences them over time. In the regression models performed in this study, the results are similar to other empirical data collected and analyzed in the field. Considering the challenges associated with accurately measuring corruption from a quantitative perspective, as well as other determinants used in this study, it is essential to examine its degree of influence on FDI inflows through a series of specific cases. The significant relationship between FDI inflows, EU membership, and corruption, therefore, will be the focus of the in-depth qualitative study carried out in the following chapter.
Chapter 5: The Link Between Corruption and FDI in Romania
A Qualitative Case Study Selection

Statistical analysis of ten CEE countries performed in the preceding chapter of this study revealed that some of the most influential determinants of FDI are market size, economic openness, EU membership, and political stability. Contrary to the ‘sand in the wheels’ theories, corruption plays an insignificant role in charting the course of foreign investment. These findings offer valuable support for explanations that downplay the role of corruption in MNCs and international investors’ decisions to make long-term commitments in the CEE region. The data used in the regression models was obtained from reliable sources, such as the UN and the World Bank. The results, however, do not tell the whole story about the links between corruption and foreign investment because they do not take many of the details of specific privatization deals into consideration. Numbers cannot possibly describe the personal understandings between investors and government officials or quantify the way in which negotiations are carried out, often under a veil of secrecy. This is precisely why a wide-ranging analysis of corruption as a determinant of FDI would benefit from a combination of quantitative and qualitative methods.

EU members in the CEE region have had different experiences in transition, in terms of both their ability to attract FDI and their perceptions of corruption. Foreign investment in Romania and Bulgaria in the 1990s, for example, was initially off to a painfully slow start. Part of the reforms and conditions for EU membership, however, required that state-run companies be
privatized, allowing the private sector to control the market and correct for the inefficiencies that had plagued economies in the region throughout the communist era. Attracting foreign investment became one of the primary goals of the countries that most desperately needed capital for economic development. By the time they had concluded their accession negotiations to join the EU, FDI had begun pouring in despite little improvement, and deterioration in some cases, of perceptions of corruption in the region.

Romania, among other CEE countries, experienced a spike in FDI beginning in the late 1990s and increasingly throughout the 2000s. During this period, state-run industries and firms were being privatized, through both domestic and international investment. Perceptions of corruption, however, fluctuated between moderate improvement in some years and periods of deterioration, its average measure remained relatively unchanged. As one of the most corrupt countries in the region and one of the most desirable locations for foreign investment, therefore, the case of Romania stands out and demands further attention.

The debate about the extent to which corruption affects the inflows of foreign direct investment in the CEE region, and Romania more specifically, continues both in academia and in the real world of policy-making. IMF, World Bank, and EBRD loans have been and continue to be conditional on Romania’s ability to privatize successfully and impose austerity measures to reduce its fiscal deficit. The EU, however, has raised concerns about the difficulties associated with the administration of developmental funds and the extent of the
implementation of judicial reforms to combat political corruption. Privatization, however, has been inextricably linked to corrupt activities in countries undergoing economic and political transition. The case of Romania is particularly interesting to examine and was chosen for a more comprehensive analysis because of its recent entry into the EU and its elevated levels of both corruption and FDI inflows. The link between the corruption of government officials and Romania’s ability to attract foreign investment can be understood better by examining a series of qualitative cases in which privatization and corruption have gone hand in hand.

This qualitative chapter discusses, at length and in detail, several cases in which allegations or convictions of the corruption of government officials were part of the privatization process of major national industries. The small-N design is useful for this section’s purpose of qualitative analysis because it allows for an in-depth investigation of some of the most well-known and well-documented cases in recent Romanian history. Cases were chosen with a most-similar design in mind to meet standards of objectivity, clarity, unit homogeneity, and replicability. One of the goals of small-N research is to identify the causes of a positive outcome and, in this study, the positive outcome of increasing FDI inflows over a period of a decade in Romania creates a puzzle of exceptional interest. The cases were, therefore, selected as exemplars of this positive outcome in that they highlight the theoretical claim that corruption does not hinder foreign direct investment, and in some cases, bribe-taking and political influence have even served to speed up the process of allowing FDI to enter the
Romanian market by removing bureaucratic obstacles and streamlining licensing and permitting procedures.

Judicial convictions did not result in all of the examples outlined here and the cases cover a wide range of national industries, from petroleum refineries to water utilities. The political players are also different from case to case, but the nature of the relationship between their public office and the private business interests of foreign companies is quite similar. Another aspect that these cases have in common is that media exposure of bribe taking or influence peddling for private gain has brought significant attention to the issue of corruption in the general public. In many of these instances, the court of public opinion has found government officials guilty of corruption where the judicial system has lacked either the authority or the evidence to issue a conviction. As Tullock points out, “most people who talk about corruption are thinking not about a congressman who votes for crop restrictions because he thinks that will win elections but about somebody who actually takes bribes,” (Tullock 1996, 11). In fact, these cases demonstrate that corruption takes on a variety of creative forms so that participants avoid penalization, raising awareness about all of the various types of corruption that take place in an economic system undergoing privatization regardless of the industry in which it is taking place.

Assessing the extent to which the selected cases provide evidence that corruption does not always hinder FDI and can actually grease its wheels in some situations benefits from the qualitative aspects that only personal interviews can provide. Tullock explains that, “most people who object to
corruption probably do so on moral grounds without considering the practical effects,” (Tullock 1996, 7). These “practical effects" of corruption are precisely what twenty personal interviews with EU officials, officials of other regional and international organizations, representative of the EU in Romania, Romanian government officials, and members of the Romanian business community were designed to uncover. The interviews took place in Belgium, France, and Romania from June to August of 2009. As per the requirements of the University of Miami’s Human Subject Research Office and the IRB, the sensitive nature of the questions involved the strict anonymity of the interviewees. In addition, the interviewees requested that their statements be recorded as personal opinions and not as the official position of their organizations or institutions.

The qualitative data collected from these case studies originated from media outlets, such as national news agencies and international financial publications, as well as from the aforementioned personal interviews. The sources include a combination of case study narratives based on media reporting, documented evidence from government investigations, official government agency statements, and supporting data provided by the anonymous interviewees. Questions posed during the interviews touched on a wide range of issues: perceptions of the extent to which corruption affects FDI; factors that determined business investments; the role of EU membership and of other international or regional organizations on levels of corruption; the impact of judicial reforms and judiciary action to combat corruption; obstacles to investment and long-term economic opportunities in Romania and the CEE region. The
overall responses provided in the course of the interviews were both informative and supportive of the claims put forth in this study. Due to the difficulty in measuring levels of corruption with scientific accuracy, the qualitative methods and case studies provided in this chapter will give a more in-depth analysis of the relationship between corruption and FDI, more specifically in terms of the privatization of some of Romania’s most important national industries.

*Privatization in Romania*

Romania's membership in organizations such as the EU and NATO, as well as offers of development aid, was contingent upon the implementation of a series of specified political, legal, economic, and social reforms. CEE countries undergoing democratization and marketization had little or no choice about whether to privatize state-owned industries, but they did have some choices about how to carry out the privatization process. Much of the literature on privatization in times of corruption concedes that “an increase in corruption coincided with the process of privatization,” but that does not necessarily suggest that “this increase was actually caused by the privatization process,” (Kaufmann and Siegelbaum 1996, 428). Powerful elites with inside information about privatization deals, access to financing, and the ability to conduct negotiations far removed from public scrutiny partnered with foreign firms looking for emerging markets, cheap skilled labor, and natural and strategic resources. The number of cases in which representatives of foreign firms looking to invest in Romania have
been associated with Romanian government officials in corrupt transactions is staggering.

Ironically, however, widespread corruption and relatively poor rankings in corruption indices since 1989 have not been successful in deterring foreign investment. In fact, the *Financial Times* recently reported that, “they may no be celebrating on the streets of Bacau or Brasov but Romania has been doing pretty well as of late… Chuck Movit, IHS Global Insight’s economist for Romania is cautiously bullish [and] argues the future also looks positive. Strong foreign investment flows through much of the previous decade have helped improve competitiveness dramatically. Hence, provided Western Europe returns to growth by 2013, demand for Romanian exports and incoming FDI will again be on the rise,” (Eddy, September 18, 2012).

Some theories suggest that levels of corruption in the privatization era were closely associated with the degree to which bureaucrats and politicians retained control rights over the economic activities in the CEE countries, among other factors, (Kaufmann and Siegelbaum 1996, 429). In fact, even today bureaucrats and politicians have continued to influence the region’s economic activities to a large extent. Romania’s Social Democratic Party (PSD), currently part of a three-party alliance known as the Social Liberal Union, is “populated by a worrying number of prominent politicians and businesspeople who are suspected of corruption, abuse of office, or crime… [including] oil magnate and billionaire Dinu Patriciu, who has successfully withstood years of investigations into allegedly corrupt privatization deals,” media mogul and former Securitate
employee Dan Voiculescu, and recently sentenced former Prime Minister and PSD leader Adrian Nastase, (Verseck, July 17, 2012).

The Oil Sector and Energy Industry: The Case of Petrom

One of the foundations of European integration, beginning with the European Coal and Steel Community (ECSC), is the cooperation among member states in areas of energy, natural resources, and war-making capacities. The reform of the Romanian energy sector, therefore, has been an instrumental part of the accession process, particularly because of the country’s abundance of oil products and an extensive distribution network touching other parts of Europe. Spurred by neoliberal policy prescriptions and the upcoming EU accession in 2007, one of the most critical aspects of market reform was increasing the efficiency and improving the management of the Romanian oil and energy industry. This would be achieved, in large part, through a privatization process that was often inadequately regulated and administered by agencies, such as the Authority for State Assets Recovery (AVAS) and the National Agency for Privatization, that were subject to political influence and private interests. One of the largest such privatizations took place in 2004, when 51% of PETROM’s share capital was acquired by the Austrian oil company, Österreichische Mineralölverwaltung (OMV). The transaction was negotiated for several years before the changes were implemented, leaving ample time and room for profit-driven private interests and politically motivated influence peddlers to insert themselves into the process.
In 2001, the EBRD approved a pre-privatization syndicate loan of $150 million USD to Romania to ensure the timeliness and efficiency of the privatization process. After Petrom seriously considered seven offers, OMV Austria was selected in 2004 and preparations for the transition began immediately. This privatization scheme also ensured that Petrom would continue to receive EBRD, IMF, EU development, and other loans, totaling well over $1 billion Euros, for exploration, development, construction of new drilling facilities, research, and environmental and energy efficiency investments. From an economic standpoint, the privatization of Petrom and its 51% acquisition by OMV represented a crucial step in the development and future profitability of the company. Meanwhile, a national debate was brewing about the transparency of the privatization process and the extent to which the government had the authority to sell off the country’s national resources.

With the election of Traian Basescu to the presidency in December of 2004 and a shift in the governing coalition, the Romanian government decided to scrutinize Petrom’s privatization after the mass-media publication of many months worth of critiques and accusations of corruption surrounding the contract. This represented part of Basescu’s campaign platform, in which he declared that combating corruption in the Romanian government would be one of his priorities as president. One critique, voiced both by the media and by public opinion, was that the contract’s sale price was too low, hinting at the idea that those in charge of the negotiations had taken substantial bribes in order to ensure the low sale price. Other complaints stemmed from the fact that the transaction was carried
out with a lack of transparency by the administration of former Prime Minister Adrian Nastase, who was more recently convicted of corruption charges and sentenced to a two-year prison term. In addition, OMV enjoyed benefits such as ecological tax and reinvestment profit tax exemptions, as well as significant royalties associated with the sale. Major Romanian newspapers (*Evenimentul Zilei, Adevarul, and Ziarul Financiar*) and weekly financial publications (*Capital*) accused the consultants who prepared the privatization contract of having purposely undervalued Petrom’s market value to serve their own personal interests.

The accusations of corruption linked to the sale of Petrom continued to escalate, prompting the Basescu administration set up an investigatory commission in the Romanian Senate to dissect the sale of SNP Petrom. The commission was headed by Senators Carol Dina and Marius Marinescu. It found that several of the features of the sale contract could have adverse and unforeseen implications for the Romanian state over the next fifteen to thirty years, (*Romanian Senate Investigative Report 2007, 8*). As part of the contract, the Romanian government would be responsible for compensating the seller, OMV, for a period of fifteen years for environmental degradation that took place before the sale of Petrom and for a period of 30 years for the abandonment or removal of outdated Petrom drilling facilities. This type of open-ended compensation package with no financial restrictions (“despagubiri fara o limita valorica”) was heavily contested because there was no way of accurately calculating the impact of such degradation or removal expenses, and even more
difficult to determine their true cost, putting the Romanian government at a significant disadvantage in the deal.

The value of Petrom’s land holdings would also come into question as part of the Senate commission’s investigation of the circumstances surrounding the sale to OMV. The commission found that the price of the property sold to OMV by the Romanian government was significantly underestimated. In addition, much of the transferred property was located in urban centers, where real estate analysts predicted that the value of the land would increase exponentially in the coming years. The aspect of the Petrom sale that sparked the most controversy in the media and that was most heavily scrutinized by the Senate commission was the final sale price of the Petrom company. According to the contract, the sale price was negotiated to include the debts held by Petrom at the time of the sale to OMV. A large portion of these debts was paid off by the Romanian government, however, before the sale took place, but the price was not adjusted to reflect these payments. In fact, the commission found that some information generated by the formulas and software used to assess the actual value of the Petrom company was deliberately concealed and even omitted by the consulting agencies carrying out the appraisal, (Romanian Senate Investigative Report 2007, 14).

Without access to all of the relevant information and influenced by the personal interests of the politicians and businesspeople closest to the deal, the Romanian government was inadequately prepared to negotiate a fair price for Petrom. The Commission’s report goes on to mention that Petrom’s net profits in
2006 alone exceeded 671 million Euros, a value that surpassed the entire amount of 668 million Euros paid by OMV. In the end, the Senate commission issued a series of recommendations and presented their findings to the Romanian parliament in an effort to recuperate some of the losses associated with the sale of Petrom. While the claims outlined by the Senate commission were debated, it appears that the pace of privatization, coupled with the fact that the deal with OMV had already been concluded, made it very difficult to make any retroactive changes and the sale remained final.

From an analytical standpoint, what makes the case of Petrom interesting to study is the fact that the sale of the company was finalized despite the significant concerns raised by the Senate investigative commission and the media’s allegations of corruption against members of Adrian Nastase’s administration and consultants who were hired to carry out the negotiations. To complicate matters, just a few hours after the contract was signed, the headlines of major Romanian newspapers ran Nastase’s announcement at the Victoria Palace in Bucharest: “he who directs Petrom controls the Romanian economy, and he who controls the economy also controls Romanian politics,” (Trefas 2004, 1). OMV’s president, Wolfgang Ruttenstorfer, immediately refuted the prime minister’s comment by stating that his company had no intention of meddling in Romanian politics, leaving “politics to politics and economics to economics,” (Trefas 2004, 1). In essence, the lack of transparency surrounding the negotiations raised many flags about why the sale price of the company was so low if none of the government officials who participated were extracting some
type of payoff. This only served to fuel the allegations of corruption surrounding the deal.

Nastase’s announcement sparked a nationwide debate about his real intentions and those of his administration: was the Petrom sale in the best interest of the country or in the personal interest of those who participated in the negotiations? Nastase’s controversial comment also reflected the way that transactions were often carried out under the communist system, when paying off officials to close deals was commonplace. While allegations of corruption surrounding the Petrom deal were not pursued by the Romanian judiciary, public polls showed that people have still been inclined to believe that most business transactions do not take place in Romania without being characterized by some form of corrupt activity. According to the ideal-type models of corruption outlined by Miller, Grodeland, and Koshchkina, the Petrom deal would fall under the categories of both a ‘culture of corruption’ model and a ‘corruption despite culture’ model. The former represents a practice of corruption deeply embedded within the Romanian political system and society in which little can be done to avoid the giving and taking of bribes. The latter corresponds to a situation in which both the corrupted and the corruptor may justify the practice as part of the political setting in which business is regularly conducted.

Theoretically, therefore, corruption did not represent a significant deterrent to OMV’s investment and other factors, such as market size and the potential for economic growth, played a far more important role in the decision to finalize the Petrom deal, (Egger and Winner 2006). Additionally, OMV’s initial investment
capital would be reimbursed within one or two years given the projected profits of the company, making a long-term investment opportunity in Romania very appealing. Since allegations of corruption in Romania seldom produce convictions, the extent to which negotiations to privatize companies or set up foreign businesses within Romania are affected by corrupt practices remains a matter of perception rather than hard evidence. This is precisely why the data from well-documented sources, such as Transparency International's CPI, the International Country Risk Guide (ICRG), and the BEEPS survey, are composite indices that still rely on measures of perception drawn from polls of experts and surveys of businesspeople and knowledgeable citizens.

In the case of Petrom, the theory that corruption helped to speed up or ‘grease the wheels’ of the company’s privatization and transfer to OMV, avoiding the inefficiencies of a drawn-out negotiation, holds more explanatory power than the theory that corruption hinders FDI. In fact, the importance of the OMV investment and others like it can serve as a boost to the Romanian economy, “making a country richer…despite political and financial corruptions,” (Kholdy and Sohrabian 2008, 495). According to comments made during interview with an official of the Representation of the European Commission in Romania in 2009, the Petrom sale was a “strategic deal to sell Petrom to Austrian investors in exchange for Austrian support for Romania’s entry into the European Union. As a result, corruption in Romania is more of a political problem than it is an economic problem, but it has certainly not prevented investment from taking place,”
During an interview later on that same day, an investment expert from the BRD (Banca Româna de Dezvoltare), a Romanian bank bought out by the French Société Générale, expressed a similar position: "the price paid for Romania to join the EU included selling off some of its most important state assets, including banks and top producing industries. ERSTE Bank’s purchase of BCR (Banca Comerciala Româna) and OMV’s purchase of Petrom are both examples of sales that had very favorable terms for the Austrians in exchange for their support of Romania’s entry into the EU," (Anonymous interview, BRD in Bucharest, July 8, 2009). In other words, FDI will continue to flow into Romania despite the corruption that may characterize the negotiations to allow foreign companies to enter into its market because the potential far outweighs the risk.

This trend has held especially true for multinational corporations and companies with access to considerable sums of investment capital. As some scholars point out, most investors are market, factor, locational, or efficiency seekers who tend to invest in countries with large markets, preferably with low labor costs, that promise future economic growth, (Dunning 1998, Bitzenis 2003). The Petrom deal in Romania met most of the aforementioned conditions, thereby making it an ideal candidate for a foreign buyout despite the corruption, or alleged corruption, surrounding its sale. In fact, some analysts have argued that, had the consultants and politicians who worked out Petrom’s sale not undervalued the price of the company and its land holdings, OMV might not have
so readily agreed to the purchase price and the negotiations could have continued for some time, raising concerns about Romania’s ability to repay its massive development loans.

The conditionality of IMF and EBRD loans to Romania applied significant pressure to privatize inefficient government-owned and operated industries as quickly as possible in order to prevent further losses. The fact that some of the consultants and politicians involved in the deal were able to profit personally from the sale in the form of bribes and favors was not enough to hinder its finalization. In the end, the Petrom deal was concluded despite corruption in Romania and this speaks to the importance of the investment and the future profitability of one of the largest oil companies in Central and Eastern Europe.

The Case of Rompetrol

While the sale of Petrom to OMV Austria was surrounded by suspicion and allegations of corruption, the case of Romania’s second largest petroleum refining company, Rompetrol, was mired in scandals that would take such accusations to a new judiciary level. Rompetrol was established in the mid-1970s as one of the largest operators of the Romanian oil industry under the Ceausescu administration. As part of the wave of privatizations that took place in the early 1990s, Rompetrol was privatized as a MEBO in 1993. While the management and employee buyout form of privatization helped to steer the company away from previous inefficient government control, capital and technological investments in the company remained limited, as did its profits. In
1997, the oil industry giant Shell altered Rompetrol’s bargaining power by “conferring exclusive access to the oil and gas properties within the country. These benefits granted by the key stakeholders tended to increase the value of the SOE’s [state-owned enterprise] resources and thus increase their bargaining power,” (Brouthers and Bamossy 1997, 297). Rompetrol, therefore, became increasingly attractive to both domestic and international investors, including Romanian businessman Dinu Patriciu and Texas native G. Philip Stephenson of International Equity Partners LP.

In 1998, Dinu Patriciu, Philip Stephenson, and other investors acquired a controlling share of Rompetrol, which was turned over the following year to a Dutch-based multinational holding company, Rompetrol Group N.V. The Rompetrol Group (TRG) is registered and headquartered in the Netherlands, but is active primarily in Romania and has bought out several oil field operators and refineries since 1999. Its operations and investments in Romania’s oil industry, therefore, constitute foreign direct investment and make the TRG case particularly interesting for the purpose of this study’s examination of the link between FDI and corruption.

In 2001, TRG “bought the government’s stake in Romania’s largest oil refinery, Petromidia, for about $50 million… But the deal’s success drew the attention of the government. Government officials say Rompetrol did not live up to its commitments when it bought the Petromidia refinery and did not pay all the taxes it owed, in effect ripping off the Romanian government,” (O’Hara 2005, 2). As a result, the acquisition of the Petromidia refinery sparked a lengthy and
politically charged investigation led by the Anti-Corruption Directorate (DNA) into corrupt activities and irregularities associated with the sale, including fraud, money laundering, and tax evasion. TRG claimed that the investigation was “abusive, politically-motivated, and unfounded,” and it retaliated against the Romanian government by mounting suit following the DNA’s anti-corruption inquiry, (Peterson 2008, 8). The Romanian government, in turn, raised objections that the “Dutch company, The Rompetrol Group N.V., was a mere shell company used by Romanian interests so as to qualify as “foreigners” entitled to sue the Romanian state under international law,” (Peterson 2008, 8). The World Bank’s International Center for Settlement of Investment Disputes (ICSID) tribunal, however, upheld the ‘foreign’ status of TRG and allowed the suit to continue, further politicizing the case in the Romanian media.

Political connections have played a very important role in the accumulation of wealth in the democratizing states of the CEE, but as Patriciu’s acquisition of Petromidia demonstrated, businesspeople cannot always count on such connections to facilitate their transactions. Patriciu’s “allegiance to the Liberal party came under question when he obtained the Petromidia privatization” during the Nastase administration when he was investigated by the Romanian Anti-corruption Agency, finding himself in the center of a “political fight between President Basescu and Prime Minister Tariceanu, accused of guiding liberal party policy from the shadows, (Nicu et al. 2007),” (Young 2008, 30).

At the same this ‘political fight’ was being waged, it was also discovered that Tariceanu wrote a letter to President Basescu asking him to ‘speak’ to the
prosecutors of Patriciu’s case in an effort to ensure a favorable outcome of the DNA investigation, (The Bucharest Diplomat, May 2007). Apparently, Patriciu’s decision to become involved in politics while attempting to build his oil empire would have serious legal consequences that he was not prepared to face. Complications in the case abounded: Patriciu was a senior National Liberal Party (PNL) member; a close friend (and reportedly the former employer) of former Romanian Prime Minister Calin Popescu-Tariceanu; and a political rival of President Basescu, whose election platform consisted of the implementation of a strict anti-corruption agenda.

After lengthy investigation into the acquisition of the Petromidia refinery, which started in 2006, Romanian newspapers and newspapers around the world announced on August 29th, 2012, that Patriciu, Stephenson, and eleven other businessmen were acquitted of “defrauding the state of $85 million (€ 68 million) by laundering money and illegally manipulating markets to financially benefit an oil company… Prosecutors charged that from September 1999 to November 2001, Patriciu siphoned off money using a network of insiders and a former government minister and transferred it to his company funds,” (International Herald Tribune, August 29, 2012). Ironically, Patriciu’s longtime political ally and friend, Adrian Nastase, was not as fortunate as he was—Nastase is now serving a two-year prison sentence after he was convicted of engaging in corrupt activities. The prosecutors in the highly publicized case have not issued specific comments on the acquittal, but they reserve the right to appeal the ruling in an attempt to eventually bring Patriciu to justice.
The magistrates of the Romanian court dismissed all charges against Patriciu, Stephenson, and their associates; however, they did not present the arguments for their decision. Patriciu declared that he had maintained his innocence all along, but his acquittal only served to raise more suspicions about the possible ties between Patriciu, the wealthiest man in Romania, Rompetrol and the legal system. In fact, in January 2010, judicial experts examined the composition of Patriciu’s legal team in regards to “whether it was proper for counsel to participate in a case. Particularly well-known [is the] Rompetrol v. Romania case where objections to the participation of a counsel were based on the relations between the counsel for one of the parties and a member of the arbitral tribunal,” (Malintoppi 2011, 328). In addition, not long after the DNA’s investigation into the allegations of corruption began to intensify, a 75% stake in TRG was sold to the Kazakh gas company, KazMunaiGaz, in 2007. The move was perceived by some as a strategic move away from a precarious situation for Patriciu, and perhaps even as an indication that he did indeed have something to hide. With his fortune stretching well beyond the billion-Euro mark, many Romanians are still convinced that it was Patriciu’s ties to the legal system that produced his acquittal.

Despite accusations of corruption and extensive investigation into charges of money laundering, fraud, and other corrupt activities, Rompetrol’s profits have increase considerably since its acquisition by the Dutch-based TRG. In fact, the negotiations for the sale of 75% of Rompetrol to KazMunaiGaz took place amidst the Petromidia scandal. With one of the highest yielding and most technologically
advanced oil refineries in the Balkans at Petromidia, the sale was successfully completed even as the legal proceedings continued.

The Rompetrol case is, therefore, another significant example of the fact that the internal flow of FDI was not only unhindered, but also not slowed down by problems of corrupt activities. In an interview with Stephenson discussing the charges facing Rompetrol, the American businessman offered the following remarks about foreign investment in Romania: “Stephenson said Rompetrol’s case has some similarities to that of Yukos, the private Russian oil company that oil executive Mikhail Khodorkovsky bought on the cheap in the 1990s, only to be sentenced to nine years in a Russian prison earlier this year. But, he added, Romania is not like Russia,” (O’Hara 2005, 2). He also commented on the nature of business transactions in countries close to Romania, including Bulgaria, the Ukraine, and Russia. "In five years here, I've never been personally threatened. Your opponents may write bad things about you and convince the government to investigate you, but there are no business killings here. He also expressed confidence that he and Rompetrol will be cleared of any wrongdoing," and that the Romanian judiciary would effectively implement the rule of law, (O’Hara 2005, 3). While Stephenson’s remarks are based on personal experience, it is interesting to note that his belief in the Romanian judiciary’s ability to respect the rule of law is one of the reasons that he invested the majority of his personal wealth in Romania.

Just as in the case of OMV Petrom, TRG’s incentives to invest in Romania heavily outweighed any of the risks that corruption might have posed. According
to Dunning’s OLI paradigm, substantial benefits in the Romanian oil industry have included ownership advantages, low production and transaction costs, and competitive advantages, (Dunning 1993, 2008, 2009). In addition, both TRG and OMV Petrom were active market, factor, locational, resource, and low labor-cost seekers, (Bitzenis 2009). While much of the literature on the impact of corruption on FDI claims that corruption, such as fraud and bribery, has a negative impact on the ability of a country to attract foreign investment, this argument merits a thorough reexamination.

Scholars who have argued that corruption is ‘sand in the wheels’ of FDI have also conceded that there are some limitations to this position. Susan Rose-Ackerman explains that, “corruption costs can seldom be accurately assessed,” (Rose-Ackerman 1975, 202). If this is the case, it is equally difficult to pin the failure of a country or a company to attract foreign investment solely on corruption. There are a number of other factors that might carry far more weight in a foreign firm’s decision not to make a long-term investment: legal or taxation constraints, lack of infrastructure, high government intervention, and many other disincentives, (Bitzenis 2009). In fact, in response to claims made by Shang-Jin Wei in his seminal article on the negative impact of corruption on FDI, he admits that “Wei’s results might have absolutely nothing to do with corruption, but rather have to do with some other aspect of low institutional quality, such as poor security of property rights or poor quality of the judiciary,” (Wei and Shleifer 2000, 349). Such concessions are at the heart of the criticisms by the body of literature that claims that corruption is not enough of a disincentive to prevent a foreign
firm from investing in a country like Romania. Given the tremendous economic opportunities, low cost of skilled labor, access to natural resources, and market potential, FDI in Romania is unlikely to stop as a result of corruption alone.

Johnson & Johnson Enters the Romanian Pharmaceutical Market

Corrupt practices have often been perceived as compensatory mechanisms by which government officials accept bribes and gifts as a means of supplementing their income, (Jain 2001, 81). Among the groups that engage in such practices in Romania are professors and teachers, government administrators working in a wide array of agencies, and health care professionals. Throughout the communist era, “o mica atenție” (a small attention to deal or a little gift) was not only commonplace during a doctor’s visit or hospital stay—it was standard operating procedure. Patients understood that the quality of their healthcare was directly dependent upon the amount of their gift or bribe to the doctors, nurses, technicians, pharmacists, or other healthcare professionals treating them. As a result, bribing healthcare professionals became a part of both the culture of corruption in Romania as well as the accepted price for receiving treatment. While the communist system was dismantled in late 1989, corruption in the healthcare industry is arguably just as engrained in Romanian society and healthcare professionals today as it was in the previous era.

In an interview conducted at the American Embassy in Bucharest, the official explained that American companies are often frustrated with the way that
foreign and domestic companies tend to conduct business in Romania. The general attitude that some American firms have is “we lost [the bid] so the other side must have bribed,” (Anonymous interview, U.S. Embassy in Bucharest, Romania, July 9, 2009). While bribing government officials might have permitted some firms to gain significant advantages over others, it seems that even those companies from countries with strict anti-corruption legislation have been tempted to engage in the same activities in the name of economic competition. In fact, a recent “report from Consumers International (CI) says that self-regulation by the multinational drug giants has failed, citing drug adverts by companies such as Glaxo-SmithKline, Wyeth, Novartis and Pfizer [and] the heavy promotion by all companies of products to doctors,” (Boseley, The Guardian, October 30, 2007).

The U.S. Congress passed the Foreign Corrupt Practices Act in 1977 in an effort to reduce the frequency and amounts of bribes paid by American firms to gain access to foreign markets. Ironically, the results of the act’s passage were to cause a decline in U.S. business activity in countries whose public officials normally accepted bribes as a matter of routine transactions, (Hines 1995, 1). When investing abroad or trying to enter into markets where the potential for profits is very high, even the legally-bound American firms have found it difficult to resist the temptation to engage in corrupt activities in countries where bribery and gift-giving have been acceptable means of market entry in the past.

In April of 2011, the U.S. Securities and Exchange Commission (SEC) charged Johnson & Johnson with foreign bribery in violation of the FCPA. The SEC alleged that “since at least 1998, subsidiaries of the New Brunswick, N.J.-
based pharmaceutical, consumer product, and medical device company paid bribes to public doctors and hospital administrators in Poland and Greece, and public doctors in Romania to prescribe J&J pharmaceutical products” and purchase medical equipment used at government funded or government-run facilities, (Scarboro, April 8, 2011). The corrupt practices in which Johnson & Johnson was involved consisted of employees and agents from its CEE subsidiaries making a wide range of “improper payments to publicly-employed healthcare providers in…Romania in order to induce the purchase of medical devices and pharmaceuticals,” (U.S. Department of Justice, April 8, 2011). As part of the settlement negotiated with the SEC and the U.S. Department of Justice, Johnson & Johnson agreed to pay a $21.4 million penalty for the violation of the FCPA. To perpetuate the cycle of corruption in Romania and other CEE countries, there must be willing participants on either end of any deal.

In the case of Johnson & Johnson, corrupt practices might have simply facilitated the firm’s entry into the Romanian pharmaceuticals market if the bribery had not been uncovered by American legal investigators. As it stands, the $24.1 million penalty is more of a slap on the wrist for a company with over $24.4 billion in pharmaceutical sales alone and over $16.3 billion in profits in 2011, (Johnson & Johnson, January 24, 2012). Johnson & Johnson’s subsidiaries have been bribing Romanian doctors and other healthcare providers throughout the CEE at least since 1998. Those are the charges that the SEC has been able to substantiate with evidence. Most scholars of corruption would agree that the actual amounts of the bribes (cash, goods, services, trips, etc.) probably far
exceed the SEC’s conservative estimates because it is difficult to accurately assess their value or determine their frequency given the high degree of secrecy.

Johnson & Johnson’s employees conducted a simple cost-benefit analysis in terms of the bribes: while the consequences were costly and brought on negative publicity, economic analysts might argue that the vast amount of sales in the CEE encouraged by the bribes grossly surpassed the SEC fines. As Carolyn Warner explains, “corruption continues to serve the interests of some... firms because it allows those involved to beat their competition or at least gain resources to try to do so; because it allows flexibility that formal rules and regulations do not; because it is a tool in the economic and political struggle for power,” (Warner 2007, 11). In other words, getting caught was inconvenient, but the situation forced Johnson & Johnson to reexamine the situation and pose a fundamental question: was it worth it?

Over a 13-year period, Johnson & Johnson not only effectively established itself in the Romanian and other CEE markets, but it also became one of the region’s industry leaders and top-grossing companies. While it might be difficult to accept, its success in the region might be, in part, attributable to the decision to bribe the very doctors who made sure that their products were sold everywhere. Factors such as market size, high demand, the potential for profit in emerging economies heavily outweighed the risks associated with engaging in corrupt behavior. Perhaps Nathaniel Leff’s theory that corruption can be beneficial merits a reexamination and gains new applicability in the case of Johnson & Johnson, (Leff 1964).
Veolia and Apa Nova Bucuresti: Is Corruption in the Water?

The incentives for investing in the long-term in Romania have played a significant role in the process of privatization of previously state-owned enterprises that has taken place over the past two decades. Under the communist regime, the state was responsible for managing the water supply in cities and towns throughout the country. When the state government collapsed in 1989, however, it immediately became apparent that the water supply system in place would have to be modernized to meet the demands of a growing infrastructure. Much like other SOEs, negotiations began for the privatization, sale, or foreign management of most of the utilities and service-oriented industries in Romania, from oil companies to energy suppliers, and waste management to the water supply system. As a result, the capital city of Bucharest opened up its water supply management under the RGAB, a municipal water utility, to bidding from foreign firms with experience in water and sewer operations and repairs of aging pipelines.

In April of 2000, the French water management company Veolia (known as Vivendi at the time) won a 25-year tender to manage the Bucharest Water Services via concession, including its rehabilitation and administration. Ownership of the water supply assets would be divided between the Veolia Water Group (84%) and the Bucharest Municipality (16%), while its management would be supervised by The National Regulatory Authority for Public Utilities, (European Commission’s “WaterTime” Project 2005, 9, 14). Apa Nova Bucuresti, owned and operated by Veolia, would aim to improve water and sewer coverage
and water quality, as well as repair aging, leaking, and inefficient pipelines and treatment plants. The World Bank and the EBRD, along with the German government’s finance corporation DEG and private investments by Veolia, provided over €100 million in loans to ensure the success of the project and of the privatization process.

While improvements to the Bucharest water utility were undoubtedly necessary, the Romanian government did not provide Apa Nova with subsidies and the consumers absorbed the vast majority of the cost of the project. In fact, “before the concession the average combined water and sewage wastewater tariff in Bucharest was around US$0.18 per cubic meter. By 2009 the combined tariff had reached US$1.08. In local currency terms the real price increase over the period averaged 11 percent a year,” (Earhardt, Rekas, and Tonizzo 2011, 2). World Bank analysts have maintained that the increase in the tariffs has been tied to improvements in water supply services and that such increases would have taken place over time regardless of which company was managing the utility.

The EU and the World Bank have maintained the need for the privatization of utility and electric companies in Romania and other countries in the CEE to ensure their future efficiency and profitability. The privatization of water utilities has had mixed results in different cities, but apparently the case of Bucharest is a model for success, according to the World Bank: “All the evidence points to the concession contract as the root cause of the improvements in service and efficiency in Bucharest’s water and wastewater services,” (Earhardt, Rekas, and
Tonizzo 2011, 4). The World Bank credits the privatization team in charge of the project, as well as the invitation of a “Romanian adviser with strong reform credentials who was known and trusted by senior officials in the government. His role was to ensure that the advisory team’s technical expertise could be effectively communicated to the right people in the government and to stay on top of the management of the complex and fluid transaction process,” (Earhardt, Rekas, and Tonizzo 2011, 4). Having knowledgeable advisers during a complex transaction involving high stakes definitely proved advantageous for Veolia.

Legal and political “influence has also been achieved through bribery: executives and politicians in France, Italy and the US have been convicted of corruption involving subsidiaries of Suez and Veolia. Another form of political influence-building is in ‘advisory’ connections developed between the companies and political authorities in cities,” (Hall 2005-2006, 183).

Political influence may take on many different forms, depending on the nature of the situation or transaction, the people involved, the type of government in power, and the culture of doing business or agenda setting in a particular country. For instance, “the political culture in the United States permits the creation of political action committees to influence legislators, a practice that people in other democratic societies see as being close to legalized corruption… moral codes of different societies vary in the extent to which activities that eventually lead to corruption are accepted as ‘normal behavior’,” (Jain 2001, 83). In the case of the privatization of the Bucharest water utility, the reliance on advisers to ensure government cooperation could also be perceived in a different
light. When the privatization process was initiated, it was the former mayor of the city of Bucharest, Viorel Lis, who signed the 25-year tender with Veolia, known at the time as Vivendi, in March of 2000. The bidding process was relatively transparent and based solely on price, with Veolia offering a lower price than both its French competitor, Suez Lyonnaise des Eaux, and the UK’s International Water. While the bidding process might have been open and transparent, many Bucharest residents felt that the terms of the contract were unfavorable to the city and that the profit margins were disproportionate in comparison to the rise in the cost of water and sewage over the next several years.

In a private interview with the former director of one of the largest foreign-owned companies that operates extensively in Romania, it appears as though the former Bucharest mayor, Viorel Lis, took an undisclosed amount of bribes and gifts from Veolia’s representatives in exchange for his influence in ensuring the acceptance of the contract by the municipality. “Veolia has a complete monopoly, is making millions in profits, and has not respected its obligations under the contract because it has not even started improvements or repairs in many places where the price of water has already increased four or five times what it was just a couple of years ago,” (Anonymous interview, Bucharest, July 10, 2009). Six months after Lis signed the initial documents accepting the Veolia deal, it was current president Traian Basescu, Lis’ successor as the mayor of Bucharest, who approved the final version of the contract. When the final contract was made public and began to raise doubts as to its benefits for the residents of Bucharest, Lis declared that the final version of the contract signed
by Basescu was different from the one he had originally approved. The penalty for withdrawing from the contract was over €5 million, so Basescu’s strategy became making sure the terms of the contract were enforced and that work on the water supply and sewage systems began right away. Ironically, the transparency of the bidding process and low cost of the Veolia contract would eventually be clouded by the problems with the actual restructuring.

The wide-scale and long-term foreign direct investment by Veolia in the Bucharest water utility was deemed a success by World Bank, EBRD, and EU analysts. After heavy rains and flooding caused significant damage in the capital city in July of 2002, however, consumers and some members of the local government began voicing concerns that led to a probe into the execution of the Veolia contract. The National Regulatory Authority for Public Utilities, Consumer Protection Association, and the former vice-mayor Ioan Radu asked that the Apa Nova contract be examined for compliance with its City Council contract, frequent and unjustified price increases, consumer bill overpricing, use of Mayoral assets, lack of transparency in its operations, and refusal to engage in a dialogue with consumers, (Bojin 2003, 2-3).

The disagreements between Apa Nova and the Bucharest Municipality continued to escalate and eventually prompted the Romanian prime minister’s office to launch a formal investigation. The investigatory team “identified irregularities in the execution of the lease contract which transferred management of certain assets to Apa Nova, with assets transferred which had not been on the list approved by the city council, and which did not relate to
water and sewage services. The team also said that assets which had been provided in 2000 by the city of Bucharest towards its share of the new company had not been properly accounted for,” (Hall, Lobina, and de la Motte 2003, 14). In essence, the investigation uncovered fraudulent payments and bribes for which no Apa Nova or Bucharest Municipality employees were ever tried or convicted. While the Apa Nova contract represented one of the most profitable ventures for the Veolia Water Group and one of the most successful utility privatizations according to the World Bank, once more a major FDI project unhindered by consequences of corrupt practices was carried out in Romania.

Veolia’s involvement in corrupt practices and scandals is not limited to the discoveries of the prime minister’s office in Romania—media attention to bribes and fraudulent transactions carried out by officials at all levels in the Veolia Water Group span the entire globe. Currently, “the private water sector is dominated globally by two French multinationals, Suez and Veolia, who hold over two-thirds of global private water operations,” (Hall 2005-2006, 179). This means that these two companies are constantly competing against one another for international influence and using whatever means necessary to achieve their goals. In fact, the Veolia Group “makes money managing privatized water utilities and it is in their interest to influence governments and institutions to privatize public services,” (Chandra, Girard, and Puscas 2005, 2). It does not come as a surprise, therefore, that a significant number of cases have resulted in the Veolia Group being “charged with corruption, bribery and anti-competitive business
practices” in places such as New Orleans, Connecticut, Houston, Milan, and France (Chandra, Girard, and Puscas 2005, 2, 26-27).

While corruption cases involving Veolia abound, both domestically and internationally, this has not prevented Veolia from privatizing water utilities in many different parts of the world, including Bucharest. One possible explanation for this is that the privatization of the Bucharest water utility was a “first-generation” reform, required by the EU as a condition of membership and vital to the stabilization of governance in Romania, while dealing with corruption in such cases remained a “type-two” or “second-generation” reform, (Rodrik 2004; Gray 2005). Corruption as part of the Veolia deal in Bucharest could even be perceived as a negligible side effect of the urgency of privatizing and repairing the water utility. Given the culture of corruption that had characterized Romania under communism and throughout the transition, the mutual favors exchanged by Veolia and Bucharest municipality public officials could be perceived as having greased the wheels of FDI. In this case, “both sides [justified] the practice, perhaps even morally [justified] it, and neither [felt] that they [were] acting under duress,” (Miller, Grodeland, Koshechkina 2001, 15). Advisers to the deal and public officials accepted bribes and gifts as part of what was most likely deemed a normal form of interaction between a large, powerful, and wealthy international corporation with the means to influence the local government in exchange for pressure and aid in ensuring that the company was awarded the privatization contract.
The privatization of the Bucharest water utility was an important step in the establishment of Western-style management of previously state-owned and run utilities and has also been an extremely profitable venture for the Veolia Water Group. The Bucharest municipality officials with authority to push the deal through and Veolia’s advisers with the ability to influence these officials acted as “‘middlemen’ or ‘facilitators’, promising to help circumvent certain rules or expedite the process of procuring licenses in exchange for a fee,” (Tanzi 1998, 566). While those who claim that corruption hinders FDI might argue that the cost of bribing public officials heavily outweighs the benefits that any foreign company could provide, Veolia was able to offer the lowest cost bid even though there have been allegations and investigations of bribes. In other words, bribing the local officials in Bucharest did not raise the cost of Veolia’s investment and made their behavior predictable. As Colombatto suggests, “as long as corruption fulfills the role of making conduct predictable, and the party system is strong enough to guarantee stability, it is not intolerably harmful,” (Colombatto 2003, 370). Not only was the Veolia privatization a success according to the World Bank, but it also increased efficiency and kept prices low in comparison to neighboring European countries—this foreign investment flowed into Romania despite the involvement of Veolia employees and Bucharest municipality officials in corrupt activities.

ArcelorMittal and the Galati Steel Works (Sidex) Case

The time frame of the privatization of state-owned industries in Romania often coincided with the Nastase administration, which was in power from 2000
to 2004. Just as in the cases of Petrom and Rompetrol, the sale of the Sidex Galati steel plant to ArcelorMittal represented the privatization of one of Romania’s most important national industries. The Galati Steel Works Company (Combinatul Siderurgic Galati), as it is called now, is located in Galati, a city in the Danube delta region of southern Romania. It remains the largest steel mill in the country and specializes in the production of sheet metal. Construction on the mill began under Gheorghe Gheorghiu Dej in 1963 and was completed in 1966, soon after Nicolae Ceausescu’s accession to power. The Sidex steel mill employed tens of thousands of workers in the Galati region and was designed to be an agent of economic growth for the Romanian economy, providing steel for the manufacturing of Dacia cars, Aro trucks, agricultural machinery, and several other steel-intensive industries.

By the late 1980s, however, the Sidex mill’s processing plants and technology were outdated and the pollution of the ground water, air, and soil in the region reached alarming levels. Romania’s application to join the EU, submitted in 1995, also required the privatization of inefficiently run state-owned industries and that factories meet certain environmental standards. Arrears in tax and social security fund contributions by Sidex and were coupled with the non-payment of debts and utility bills amounting to over $360 million, driving the World Bank, IMF, and EBRD to push for the plant’s privatization. Sidex was at the top of the list of the most problematic state-owned industries, “as in 2000 it was responsible for 80% of the losses to the Romanian state budget. The government at the time was a difficult coalition of center-right parties… Plagued
by corruption it had earlier promised to curb and by the often incompetent handling of reforms, including privatization, the government found itself under a variety of pressures,” (Sznajder 2008, 221). Some of these pressures included the upcoming national elections of 2000 and the insistence by the EU that the implementation of economic and political reforms be carried out more rapidly.

In order to restructure the Sidex steel mill, the Romanian government would have had to make significant investments that it could not commit to given its decreased revenues in the late 1990s. As a result, the government turned to foreign direct investment as the strategic and only feasible option in the privatization of the Sidex plant. Two bids were on the table as of February 2001: 1) LNM Holdings, part ArcelorMittal, and a consortium headed by Usinor of France and 2) Germany’s Salzgitter and Turkey’s Erdemir. Just a couple of months later, the French consortium headed by Usinor appeared as though it was prepared to back out of the deal, leaving LNM Holdings as the primary bidder. In July, however, Usinor decided to reenter the bidding process and representatives met with Romanian government officials to convince them that Sidex should be bought out by a European company, and not by India’s ArcelorMittal. The scandal that followed the bidding process for Sidex’s privatization would make headlines from Bucharest to London.

In late July of 2003, British Prime Minister Tony Blair drafted and sent a letter to Romanian Prime Minister Adrian Nastase congratulating the Romanian government for carrying out the privatization deal with a ‘British’ company. In the letter, Mr. Mittal is referred to as a “friend” of the Prime Minister, a controversial
label according to a Downing Street official. The letter read: “I am particularly pleased it is a British company which is your partner,” (Telegraph 2002, 2). While Lakshmi Mittal and his son live in London, LNM Holdings is a Dutch-based company with only about 100 of 80,000 worldwide workers employed in Britain, hardly categorizing it as a British company. The influence of Prime Minister Blair on the deal was indisputable and it is “possible to see the sequence of events: a deal about to be finalized comes under threat; Mr. Blair smoothes matters with the Romanians; the deal is done,” (Telegraph 2002, 2). That Mittal called in a favor to the British Prime Minister after donating more than £125,000 to Blair’s Labour Party is a commonplace occurrence in politics—what raised flags, however, was the fact that Blair used his political influence to ensure the sale of a Romanian industry to an Indian and Dutch-based firm with few ties to Britain.

The letter to Adrian Nastase also commended the Romanian privatization efforts and “noted that is has the potential to “set Romania even more firmly on the road to membership of the European Union”… The rub was that…UK steelworkers, and their supporters in Blair’s own party, were angered that Blair would help a foreign firm build up capacity in Romania to compete against UK steel…The corruption problem was in the timing,” (Warner 2007, 48). In other words, the conclusion of the Sidex sale would promote Romanian interests in the UK in its efforts to become a member of the EU. The sale of an outdated steel factory represented only a part of what was at stake in the Sidex—ArcelorMittal deal.
The nature of the sale of Sidex to ArcelorMittal also raised suspicions about other aspects of the deal. In Britain, "Tory leader Iain Duncan Smith said the disclosures about the EBRD loan underlined the need for an independent inquiry into the whole affair. "This is something that I would never have assumed could have actually happened, that another department was involved in apparently assisting Mr. Mittal to achieve his aim of purchasing this steel firm…I think there are some very serious questions now outstanding"," (Daily Mail October 10, 2009). Such questions were in fact raised, both in the UK and in Romania. In Britain, the Parliament called for an official inquiry into the contributions made by Lakshmi Mittal to the Labour Party and the letter Blair wrote to Romanian Prime Minister Adrian Nastase. The inquiry would investigate whether “billionaire Lakshmi Mittal's deal to acquire Sidex, a Romanian steel plant, was tainted by corruption… Mittal allegedly paid bribes to Romanian officials to consummate the deal,” (Radu 2007, 3).

Allegations of bribes given to Romanian officials to ensure the finalization of the Sidex privatization surfaced in the UK, forcing the Romanian judiciary to begin its own formal investigation into the matter. Like many allegations of corruption that emerged throughout Nastase’s leadership, however, the ones against the officials in charge of the Sidex privatization were quickly silenced, and certainly not for lack of evidence in the case. In essence, “competition, rather than disrupting corruption, is absorbed into the prevailing system of business and politics…Firms entering markets where corruption is the prevailing mode of conducting business find that to compete, they must participate, not run to the
judiciary. They learn the informal market arrangements,” (Warner 2007, 49).

ArcelorMittal was certainly no stranger to bribe and gift-giving before it entered into the Romanian market and found it easier to maneuver through the privatization procedures by paying off Romanian government officials than by playing by the rules that might have delayed the deal’s conclusion. As the head of one of the EU’s representative agencies in Romania explained, “foreign businesses have often had to go through hoops and ladders to enter into the Romanian market, raising questions about the link between politics, businesses, and issues of corruption. The case of the buyout of Sidex by the Indian ArcelorMittal is a good example,” (Anonymous interview, Bucharest, July 8, 2009).

The Sidex case has raised some interesting questions in regards to the effect that corruption has on the inflows of FDI. Studies have been conducted to determine what uncovers, and subsequently reduces, instances of corrupt behavior. The results seem to point more clearly in the direction of a haphazard discovery or information uncovered and used for blackmail, rather than in the direction of firms filing complaints of uncompetitive practices with national or EU authorities. In fact, upon further scrutiny, several corruption cases in recent years indicate that “competitive pressures were not the reasons the case came to light; more often, it was routine tax inspections, personal vendettas, a jilted lover, or suspicious deaths,” (Warner 2007, 51). Had Tony Blair not written to Nastase and raised suspicions about the Sidex deal in both Britain and Romania, it is debatable whether allegations of corruption and bribe-giving would have turned
into a media frenzy and forced investigations by the UK Parliament and the Romanian judiciary.

The reality of this situation and many others like it is that, “corruption persists even under economic competition and various areas are nearly impervious to competition. Firms resort to corruption when doing so is less costly than losing business, and politicians and bureaucrats enable it by asking for bribes to exercise their discretion in a manner favorable to specific firms,” (Warner 2007, 52-53). A simple cost-benefit analysis would have produced the same results: it was in the best interest of ArcelorMittal representatives to bribe Romanian officials in order to finalize the Sidex sale because the profitability of the deal far surpassed any amount of bribery. This does imply that corruption is justified or morally acceptable—it simply points to the fact that, as in so many cases, corruption can heavily grease the wheels of foreign direct investment.

Summary of Findings

The cases selected for the purpose of in-depth qualitative examination cover a wide range of business interests, including the sale of the largest petroleum refineries in Romania and the privatization of water utilities. What these cases have in common, however, is that they represent privatization deals that were successfully conducted despite accusations or actual convictions of acts of corruption. What OMV saw in the Romanian market’s potential was far greater than any obstacle that might have been posed by having to bribe certain government officials to ensure the finalization of a very beneficial deal. The same
can be said for Veolia, a company who has routinely engaged in corrupting public officials to conclude privatizations of major cities’ water utilities. The international political economy literature on determinants of FDI outlines factors such as market size, low labor costs, highly skilled workers, and the potential for future profitability. Not only are many of the privatized Romanian industries very profitable long-term investments, they also serve a large and growing market in a country with years worth of untapped potential.

The literature on corruption remains somewhat divided on the extent to which bribery and political influence affect Romania’s and other CEE countries’ ability to attract FDI. Despite hundreds of examples of cases in which the privatization of companies was carried out with substantial levels of corruption, many scholars continue to argue that corruption hinders FDI. In practice, however, buying into the privatization of many national industries has proven to be a wise business move for international firms looking for new markets. Romania is representative of the fact that “some of the transition economies had inflows of FDI in the 1990s that rivaled or even exceeded those of similarly sized but wealthier and more institutionally developed capitalist neighbors,” (Brada, Kutan, and Yigit 2006, 651). Despite increased corruption, FDI was pouring into Romania and other CEE countries at unprecedented rates throughout the transition process because the market-seeking determinants of investment have a greater explanatory power than any of its disincentives. In simplest terms, corruption arguably hinders FDI, but inflows of FDI reached their peak during the transition process that was characterized by the highest levels of corruption.
This puzzle was answered, in large part, by the valuable insights provided by the interviewees who participated in this study. Their contribution was to personalize and analyze what the quantitative data on FDI inflows in periods of high levels of corruption could not. Several of the interviewees pointed to the cultural aspects associated with corruption—some countries regard corruption as something unacceptable and even insulting, while others have institutionalized it both in their government structures and their culture. In fact, a publication entitled “The Corruption Handbook” is published in Romania annually and is available for download on the internet. The guidebook outlines what the customary payment is for various services, whom the payment should be given to and how the payment should be provided.

Members of the business community in Romania echoed some of the comments and observations made by EU officials. One high-ranking official in a foreign automobile manufacturing company explained that it has been customary to bribe both high-level and low-level politicians to allow certain business plans or infrastructure-building projects to be carried out. In fact, some of these projects may never have been completed had it not been for the kickbacks and bribes paid at the ‘right’ time to the ‘right’ people. A high-ranking representative of the EU in Romania also explained that while corruption may have negative long-term effects, it was not one of the significant determining factors in patterns of inward FDI. FDI would have flowed to the CEE countries as a result of the business opportunities and the EU’s eastward expansion, regardless of the levels of corruption in the region. While the qualitative data collected from case studies
and interviews supports the claim that corruption plays a much smaller role as a determinant of FDI than previous economic literature has suggested, studies that examine these trends in the long-term might be able to provide a more accurate picture of the effects of this complex relationship.
Chapter 6: Does Corruption Really Matter for FDI?

In 2007, the Romanian government launched a campaign known as “E.U. nu dau si nu iau spaga”, which translates to “I do not give or receive bribes.” What is lost in translation, however, is the fact that the word for “I” in Romanian is “eu”, the abbreviation for the European Union in English. The play on words in this campaign suggests that the Romanian government is relying in large part on the EU for help in the fight against corruption. The campaign’s flyer is a fake Romanian currency bill that warns: on the front, “Are you itching to give something? Better think twice!” and on the back, “Are you itching to get something? Oh, you’re going to get it alright!” Combatting corruption is an important concern of the legal, judicial, and political systems of the CEE region. The goal of governments throughout the region, therefore, has been to reduce corruption while continuing to attract the levels of foreign investment that have contributed to substantial economic growth.

From 2003 to 2004, Romania’s inward FDI more than tripled, from US$1.8 billion to US$6.4 billion, (World Bank WDI 2003). Its perceptions of corruption score according to Transparency International’s CPI, however, remained largely unchanged: Romania’s score went from 2.8 to 2.9, but it fell in the overall ranking from 83rd place to 87th place. In 2005, FDI jumped from US$6.8 billion to US$11.4 billion in 2006, (World Bank WDI 2005). Again, its CPI score underwent little change, from 3 to 3.1, while its rank went from 85th to 84th place. New manufacturing facilities, retail stores, restaurant and hotel chains,
telecommunications companies, and foreign-based supermarkets have opened their doors throughout the country. Many state-run industries have been privatized and many plants that were once closed or operating inefficiently have been modernized, restructured, and reinvented to make them profitable again. The impact of foreign investment is not only a numerical measure included in the assessment of economic progress, but also a visible and undeniable sign of a promising transition. All of this progress, however, has occurred in spite of high levels of corruption perceptions in Romania and several other CEE states. This is precisely the contradiction that this study has sought to address: Is corruption a significant determinant of inward FDI?

The period of the 1990s and 2000s was characterized by change in most aspects of political, economic, and social life in the CEE region. Corruption, however, has remained a widespread phenomenon despite EU, international, and domestic efforts to eliminate it. In fact, the continued existence of economic crime and corruption “throughout the Western world is evidence that they will never disappear altogether,” (Holmes 1997, 223). Slush fund allegations and campaign fraud are among the recent accusations of illegal party financing surrounding a well-known member of the Spanish Popular party, Mariano Rajoy, (Gardner, Financial Times, February 6, 2013). In fact, fifteen prominent Spanish business owners are currently being investigated for making questionable donations to Rajoy’s party. The Rajoy scandal has led one journalist to ask the question: do we deserve these politicians? (Cruz, El Pais, January 30, 2013). Cruz goes on to explain that the general public is partly responsible for what
happens in the political realm because public servants are democratically elected. More recently, the son-in law of King Juan Carlos of Spain, Inaki Urdangarin, was also officially charged in a corruption case. It has been almost thirty years since Spain joined the EU in 1986 and it is certainly not the only long-time member to struggle against corruption.

One of the founding members of the EU, Italy, has been plagued by corruption scandals in high-level politics for many years. The European Commission has reprimanded some CEE member states, such as Romania and Bulgaria, for the handling of certain corruption cases and the leniency of sentencing. In the case of Silvio Berlusconi, former Italian prime minister, the Italian courts sentenced him to four years in prison after convicting him of fraud and tax evasion in 2012. Berlusconi remains free, paid only a relatively small fine of 10 million Euros, and cannot run for public office for three years. The difference between the original four-year prison sentence and the penalty he has actually paid is impressive. If Italy, a founding EU member state and established democracy, is still grappling with the deep-seeded problem of corruption, it is not surprising that CEE states emerging from a substantial political and economic transition are having similar issues. Perhaps it will take more than democracy, a free-market economy, and EU monitoring and conditionality to cure the CEE region of its corruption ills.

Bribery and unscrupulous behavior are not desirable features of any system, but the legacy of communism and the culture that developed to facilitate graft will take both time and a substantial shift in public attitudes to reduce its
pervasiveness. Given the paradox between the extent of corruption and the unparalleled levels of economic growth of the 1990s and 2000s, however, this relationship has been the subject of close theoretical and policy-oriented debates.

The bodies of IPE and economics literature that address the “impact of corruption per se on international business had not emerged as a separate topic for empirical studies until the early 1990s. Earlier, corruption was implicitly lumped together with other factors in the composite index of political stability,” (Zurawicki and Habib 2010, 2). Most research on the impact of corruption on inward FDI has been conducted within the past two decades, leaving many aspects of this relationship either underexplored or unaddressed altogether. Some of the most challenging aspects of studying this secretive, and often illegal, behavior have been: 1) the development of a comprehensive definition that highlights its purposes and its various forms; 2) the ability to measure a non-quantifiable concept based on perceptions; and 3) the formulation of theories that can adequately explain its influence on political and economic development. The classic definition of “the misuse or abuse of public office for private gain” has been generally accepted in the literature, however, the concept itself is far more complex than any definition is able to capture, (Bardhan 1997; Jain 2001; Kaufmann 1997; Tanzi 1998).

As one of the many vestiges of the communist era, the culture of corruption evolved over half a century’s time to compensate for the inefficiencies, shortages, and inequalities of the oppressive regimes of the Soviet bloc and to
enable those in power to gain from their positions of authority. In this context, private gain could take the form of monetary compensation, as well as personal favors or political advantages. Today, corruption continues in the form of both high-level payoffs and petty bribes in the CEE region. It exists as both a need-based and opportunistic means of accomplishing bureaucratic tasks, accessing services, and personal enrichment. While academics and policy-makers have come to a general agreement about what corruption is, there remains some discrepancy about how it is measured and outright disagreement about its impact on foreign investment.

Measuring corruption is inherently difficult because of the nature of the phenomenon. It involves secrecy, discretion, and the ability to operate under the legal radar. Indices such as Transparency International’s Corruption Perceptions Index and the World Bank’s Control of Corruption are based on perceptions of levels of corruption. Surveys and interviews with business experts, risk agencies, and local officials are used to generate data that is, in turned, transformed into scores and values that can be used for measurement and comparison purposes. As a subjective source of information, corruption indices can give researchers a general idea of the climate of corruption within a particular country, but their accuracy and ability to provide concrete information about how much corruption is actually going on will be a permanent source of debate. When it comes to quantifying corruption, therefore, it is only possible to truly know what has been uncovered or disclosed. In addition, corruption takes on a variety of forms and
the relationship between the principal, the agent, and the corruptor can be vastly
different from country to country or from culture to culture.

The difficulties associated with collecting empirical data on levels of
corruption make it equally challenging to determine its real impact on foreign
investment. For this reason, the theories that have emerged to describe its
influence on inward FDI have been wide ranging. On the one hand, many
scholars argue that corruption acts as “sand in the wheels” of FDI and dissuades
companies from investing in countries where corruption is pervasive, (Wei 2001;
Mauro 1995; Rose-Ackerman 1975, 2006). On the other hand, there have been
several studies that have shown corruption to be more like “grease in the
wheels” by allowing bribes to help companies circumvent burdensome
regulations and licensing procedures, (Wellisz and Findlay 1984; Colombatto
2003; Egger and Winner 2005; Kholdy and Ahmad Sohrabian 2008).

Research on the impact of corruption perceptions on FDI has also
produced results that lie somewhere in between these two theoretical extremes.
Some scholars have approached corruption as having a negative impact on
investment in their research design, only to discover that it is actually an
insignificant determinant of FDI, (Wheeler and Mody 1992; Hines 1995). In other
words, corruption matters very little or not at all to companies that are ultimately
interested in making a profit in the long term. An analysis of theoretical
explanations that seek to explain whether corruption is a significant or
insignificant determinant of FDI has constituted the primary purpose of this study.
To analyze the role of corruption in charting the course of FDI, it was also essential to review the literature on the traditional and transition-specific determinants of FDI. Dunning’s OLI paradigm (Ownership, Location, and Internalization) accounts for many of the traditional factors that motivates companies to invest abroad. These include, but are not limited to: market size, access to new markets, availability of natural resources, low cost and skilled labor, cultural proximity, tax incentives, and the potential for long-term economic growth. Other important considerations for foreign investors involve transition-specific factors, such as privatization opportunities, demand for greenfield and brownfield investment, host government incentives, political stability, protection of private property rights, and effective dispute resolution mechanisms. From a theoretical standpoint, the consideration of these factors determines whether or not an investor perceives an economic opportunity worth pursuing. In reality, however, the decision to make a greenfield or brownfield investment or to establish a joint venture or wholly owned subsidiary abroad is often influenced by many other variables that are specific to each company and each investor and may not be predicted by the OLI paradigm or any other theory of FDI determinants. Whether or not corruption is, more generally, one of these determinants is the question built into the research design of this study.

Summary of Research Design

Assessing whether or not corruption has been a significant determinant of inward FDI in the CEE countries required, first and foremost, a thorough analysis
of patterns of investment in the ten cases included in the study. These cases are: Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia. All of these countries share several important characteristics and were specifically chosen to allow for a great degree of comparability: they are located in the CEE region; have similar communist backgrounds; have undergone democratization and marketization; and have all recently become EU member states. In addition to a comparison of these ten countries, the specific case of Romania was examined more closely to provide concrete examples of the corruption and FDI trends throughout this time period.

One of the initial observations of inward FDI into the region was that it grew substantially in the mid to late 1990s and throughout the 2000s. If the “sand in the wheels” literature was right, then corruption levels should have experienced a noticeable decline during this period in order to help account for the unprecedented FDI inflows. The perceptions of corruption, however, showed little or no improvement in most of the CEE countries. The “grease the wheels argument” was, therefore, equally unconvincing at a glance because levels of corruption did not show a remarkable increase to account for the increase in inward FDI. These observations led to the formulation of a more fundamental question concerning the “sand or grease” links developed in the IPE and economics literature: Does corruption really matter for FDI?

While the question seemed rather simple, the research design to answer it was complex and involved testing many factors. A mixed methods design was developed to provide a more comprehensive approach to determining what link,
if any, existed between measures of corruption perceptions and levels of inward FDI. The quantitative method was used to analyze panel data collected from a variety of sources, from the World Bank and UNCTAD to Transparency International and Eurostat. The period from 1998 to 2008 was chosen because data on corruption and other determinants was becoming more widely available in the late 1990s; this period was marked by negotiations and entry into the EU; and the financial crisis of 2008 would have skewed results considerably if the included period had been extended. Since the ten countries had all become members of the EU in either 2004 or 2007, two parallel hypotheses were formulated and tested: 1) Corruption is not a significant determinant of inward FDI in the ten cases; and 2) EU membership and market size are significant determinants of inward FDI.

The reasoning behind the formulation of two hypotheses was that it was not enough to simply test whether corruption was a significant determinant of FDI—it was equally important to come up with an explanation for other factors that were potentially significant considerations for investment, hence the selection of EU membership and market size. To test the hypotheses, first a cross-country, multivariate linear regression was performed using an Ordinary Least Squares (OLS) approach. In addition to the OLS regression model, a Fixed Effects (FE) regression was also performed. Independent variables were categorized into: 1) market size; 2) factors and cost; 3) privatization and economic openness (including EU membership); and 4) governance indicators (including corruption perceptions). Each regression model has its own set of
advantages, as well as some weaknesses that were taken into consideration. By including both models, however, it was possible to compare their results and provide a more complete picture of the quantitative impact of corruption on inward FDI.

Many similar studies that examine the role of specific determinants in FDI inflows report their findings, but do not provide a comprehensive explanation about why some factors are important and why others are not. Often, quantitative data analysis leaves out details about specific cases and is unable to capture the intricacies of investors’ decisions and motivations that cannot be measured by values or indices. The shortcomings of quantitative data were, therefore, addressed in the qualitative analysis of specific cases in Romania, each of which represented a major recipient of FDI and either suspicion or proof of corrupt activity. The five cases selected for analysis had an important element in common: they represent privatization deals that were successfully conducted despite accusations or actual convictions of acts of corruption.

Study Findings

The Pooled OLS and Fixed Effects regressions performed to analyze whether or not corruption was a significant determinant of inward FDI each provided valuable insight into what factors investors take into consideration. After running all five Pooled OLS models, it was revealed that those determinants that affect FDI inflows with noteworthy levels of significance were the natural logarithm of GDP per capita (LN(GDPCAP)), purchasing power parity (PPPEX),
privatization revenues as a percentage of GDP (PRIREV), EU membership (EUMEM), and political stability (POLSTB). In real terms, this means that the size of the host country market’s economy is an important consideration for investors. MNCs are attracted, as much of the economics literature suggests, to countries where the size of the market is an indication of the potential success of an investment. Throughout the period analyzed in this study, from 1998 to 2008, the level of economic growth in the CEE countries was unprecedented. GDP, as well as many other measures of development, were constantly on the rise from year to year. Additionally, purchasing power parity and privatization revenues signaled that the region was ready for the kind of long-term investment that would reward those companies that seized the available opportunities.

According to the Pooled OLS statistical model, there were two other important considerations: EU membership and political stability. Where quantitative findings are concerned, it is generally accepted that correlation is not necessarily causation. Taking this into account, it is still possible to suggest that conditions imposed as part of the accession negotiations for EU membership had a considerable impact on the improvement of the economic and political climate of countries in the region. In order for candidates to be allowed to join, the reforms and requirements outlined in the *acquis communautaire* and the accession treaties had to be met. The process of democratization involved the stabilization of the political system, including free and fair elections and an effectively functioning bureaucracy. For investors, the long-term benefits of investing in countries closely monitored by Brussels offered peace of mind. They
were not dealing with rogue countries where governments could arbitrarily expropriate their property, but instead with governments that had to meet very stringent standards to join one of the most influential, economically and politically sound regional organizations in the world.

The findings of the Pooled OLS model, therefore, supported both the first and second hypotheses of the study—notably, that corruption is an insignificant determinant of inward FDI, but EU membership and market size are influential factors. The results of the second regression, the FE model, were similar to those of the first regression, although some discrepancies also emerged. Those determinants that were found to have a significant impact on FDI in FE5, the fifth and final model of the regression, included: GDP per capita (LN(GDPCAP)), population (LN(POP)), corporate tax rate (CTR), purchasing power parity (PPPEX), political stability (POLSTB), and regulatory quality (REGQUAL). In terms of the hypotheses, therefore, the FE model also supported the claim that corruption is not a significant consideration. It did not, however, find that EU membership was an important factor, but did point to the impact of market size. The FE model supported the second model only partially, consequently leaving room for the interpretation of all the results.

From a statistical standpoint, it is interesting to note some of the similarities and differences between the Pooled OLS and the FE models. On the one hand, GDP per capita, purchasing power parity, and political stability were revealed to be important considerations in both models. Countries with increasing economic development, low costs for starting businesses, and
democratic values are, according to both regressions performed in this study, attractive features of FDI host countries. On the other hand, the models also showed some variation in the analysis of the factors that foreign investors consider. While the Pooled OLS model pointed to additional determinants, such as privatization revenues and EU membership, the FE model uncovered the importance of population, corporate tax rates, and regulatory quality. The variations in the findings are a result of the differences in the regression models, but each one made valuable contributions to the overall analysis of FDI determinants.

What is perhaps more important than what the Pooled OLS and FE models found is what they did not find. Neither model revealed corruption to be a significant determinant of FDI in the CEE countries. The levels of statistical significance were consistently low, which is precisely the underlying argument of this study. In other words, perceptions of corruption are not among the most important considerations made by investors. Those factors that did show statistical significance in the models are, therefore, part of the many possible explanations for the findings on corruption, especially because FDI flowed into these ten case studies at an unparalleled rate from 1998 to 2008.

The quantitative findings of this study are informative for the general explanation of significant determinants of inward FDI in the CEE countries. They are not, however, designed to look at the complexities of specific cases or analyze the details of transactions that took place throughout the transition period. The purpose of the qualitative analysis was to supplement the findings of
the quantitative research by examining five of the most important privatization transactions carried out in Romania in the 1990s and 2000s. These five privatization deals were selected for an in-depth analysis because they were all successfully conducted despite accusations or actual convictions of acts of corruption.

The privatization of Petrom and Rompetrol, the two largest state-run oil companies in Romania, was carried out as part of the wider plan to transfer control of key industries into the hands of the private sector. The private sector would, according to scholars and policymakers, run these industries more efficiently than the state. Ironically, this efficiency would be achieved in part with bribes, purposeful undervaluation of assets, and a commitment to secrecy by those involved in the negotiations. In fact, it not only Romanian politicians and officials who committed economic crimes, but also representatives of those companies looking to enter into the host country market under the most favorable conditions. This was the case of Johnson & Johnson, which was later found guilty and financially penalized for engaging in corrupt practices, and the French water utility giant, Veolia. Representatives of MNCs are often just as much to blame for perpetuating the cycle and culture of corruption that continues to exist in Romania and other CEE countries.

Discussion of Research

The U.S. Ambassador to Romania recently “urged authorities to sell off the country’s state-owned energy companies in order to uproot corruption and
cronyism,” (AFP, April 1, 2011). Romania’s Black Sea oil reserves and shale gas exploration have proven to be a very attractive investment opportunity for MNCs like OMV, Chevron, and many others. While the privatization of inefficiently run companies might address the issue of corruption in the long-term, the weak enforcement mechanisms in some of the CEE countries have made it possible for negotiations to be concluded with the help of grease payments offered to political officials. Loan conditionalities imposed by the IMF, the World Bank, and EU membership requirements, among others, have stipulated that the CEE countries must engage in an active privatization process as part of the requirements for market reform. Ironically, “the growth of privatization itself, encouraged by the World Bank and others, places far more lucrative contracts and concessions on offer - and so companies have more frequent, and greater, incentives to offer bribes,” (Hall 1999, 11). The temptation to engage in corrupt activities when the potential for personal enrichment is present is difficult to ignore.

The privatization of state-run industries has been at the heart of the political and economic transition of the CEE region. Many companies have been sold off to private and foreign investors, however:

The privatization process itself can create corrupt incentives. A firm may pay to be included in the list of qualified bidders or to restrict their number. It may pay to obtain a low assessment of the public property to be leased or sold off, or to be favored in the selection process …firms that make payoffs may expect not only to win the contract or the privatization auction, but also to obtain inefficient subsidies, monopoly benefits, and regulatory laxness in the future. (Rose-Ackerman 1996).
These represent just a few of the issues associated with privatization, but case after case shows that they have not prevented foreign investors from entering into the CEE countries’ markets.

The incentives to invest in countries in transition, many of which possessed untapped economic potential, have been very real. While the quantitative studies, for instance, did not suggest natural resources are an important determinant of FDI more generally, the case of Romania might contribute a different perspective on this issue. “Central and eastern Europe are thought to hold some of the continent’s most promising shale reserves, prompting enthusiasm in recent years that the region could repeat North America’s shale gas “revolution” of the past decade,” (Buckley, February 5, 2013). In addition, if the EU is able to become increasingly energy independent by exploring new sources in the CEE region, especially by decreasing its reliance on the volatile supply and prices of the Russian energy giant Gazprom, it will have considerable security implications in both the short and long term.

The development of the oil and energy industries of the CEE region represents just one of the many potential areas for economic development and foreign investment. For foreign investors and MNCs that have taken advantage of the opportunities in Romania and other CEE countries, “investments are the expression of long-term confidence in a relationship,” (Leffler, March 1, 2013). FDI is one of the ultimate economic manifestations of this type of long-term confidence since commitments made through greenfield and brownfield investments are lasting, physically tied to the country in which they are located.
In times of financial crisis, for instance, portfolio investors can pull out of a market relatively quickly, while FDI must be prepared to weather economic storms because the removal of tangible assets is either difficult or impossible. The degree of involvement associated with foreign direct investments warrants a thorough cost-benefit analysis and careful consideration of the economic and political conditions in the host country.

Much of the focus on corruption as a potential deterrent of FDI has centered on the behavior of government officials in the CEE countries and their willingness to accept bribes that would facilitate companies’ market entry and subsequently contribute to their personal enrichment. What is interesting to note about this dynamic is that much of the bribing being carried out in the CEE region originates from MNCs and representatives of foreign companies. Foreign companies often look for support from their home country governments because they can promote their MNCs in “bidding for major contracts [and provide] diplomatic and legal representation in case of problems. These interests are likely to dominate over other considerations which are less central to the country’s own interests, such as opposition to corruption, a critical approach to privatization, or a commitment to development,” (Hall 1999, 13). As a result, corruption has become an issue with a double-edged sword.

It has proven challenging to eliminate corruption in countries that have an extensive history of economic crime and companies from foreign countries that have strict penalties for bribery have been known to contribute to the very cycle that critics like the U.S. Ambassador Gitenstein believe they should help to stop.
He expressed that he “was impressed by Romania’s efforts to reform the state and end corruption but stressed that “the drive for reform should be coming from inside the country and not be imposed from the outside”,” (AFP, April 1, 2011).

Complications arise when some multinationals are part of the problem instead of the solution. Regardless of where it originates, of quantitative findings that it is insignificant for inward FDI, and qualitative cases showing that it happens even in successful privatization negotiations, corruption is not a desirable aspect of any transaction. As a result, the EU has continued its efforts to curb corruption, as well as all forms of economic crime, for the long-term political and economic stability of the organization and its members.

Since the period of EU candidacy, emphasis in the CEE region has been placed on the impact of democratization and marketization on the recovery process, particularly since the region’s proximity to the industrialized West has political and economic, as well as foreign security implications. German reunification, free and fair national elections, and newfound personal freedoms were just some of the ways that the CEE countries were initially able to demonstrate their dedication to long-term progress. The opportunity to develop new trade relationships, secure eastern borders, and maintain political stability throughout Europe would also attract the interest of the EU. Part of the candidates’ path to membership involved the implementation of market reforms and a commitment to the fight against corruption.

While the EU, international organizations, and even domestic anti-corruption agencies have demonstrated their commitment to the fight against
corruption, changing deeply engrained patterns of behavior is a painstaking and
drawn out process. As the trends throughout the late 1990s and 2000s would
show, passing laws against corruption and enforcing them were not necessarily
one and the same. One of the issues is that:

Communism created structural incentives for engaging in corrupt
behaviors, which became such a widespread fact of life that they
became rooted in the culture in these societies _ that is, the social
norms and practices prevailing in communist societies. The
transitions toward democracy and market economies have not yet
erased this culture of corruption. In addition, the process of
privatization itself has opened myriad of opportunities for
corruption. (Sandholtz and Taagepera 2005, 1).

The prescription of broad reforms has been approached with commitment and
determination by the recently admitted EU states, but it has become apparent
that the economic environment in which such restructuring would be carried out
varied significantly from one country to another. The EU’s cooperation and
verification mechanisms were designed to tackle issues needing reform and
impose penalties when certain conditions were not met. In Romania and
Bulgaria, these mechanisms are still in place, much to the dismay of both
governments, because neither country has been able to address the EU’s
concerns about the continuation of widespread corrupt practices.

Expectations for the CEE countries have been high because newly
admitted member states would receive economic aid and guidance throughout
the transition period from the more seasoned EU member states. In many CEE
countries, EU and other foreign economic policy-makers approached the
transition process as a system to which a series of capitalist formulas could be
applied and from which fast-paced economic growth would result. The EU has played and continues to play a leading role in the economic development of the CEE region and yet, despite its efforts, the fight against corruption has been riddled with obstacles. Although “there is a need for a major cultural shift… this can never occur overnight, whatever the culture,” (Holmes 1997, 265).

The Evolution of the Fight Against Corruption

The EU members in the CEE have been making progress in fighting economic crime, but the issue of corruption is one that is globally widespread and historically engrained in the culture of the region. “It is estimated that globally the money lost to corruption adds up to approximately 5 percent of the world economy, and an even higher percentage in countries with high levels of corruption. Nevertheless, comparatively little money is used to investigate and prevent corruption,” (Karklins, pp. 8). The argument that corruption is not desirable for economic growth has been widely acknowledged and transformed into policy. The United States Congress implemented the Foreign Corrupt Practices Act in 1977, making it illegal for U.S. corporations to bribe foreign political officials. This remained the strictest piece of anti-corruption legislation in international transactions and organizations for almost two decades. During this period, the U.S. government continued to pressure the OECD and several other international organizations to adopt similar legislation and more stringent conditionality measures.
In an attempt to better coordinate the fight against corruption, Transparency International was founded in Germany by Peter Eigen in 1993. On the non-governmental organization’s website, the description reads as follows: “Transparency International, the global civil society organization leading the fight against corruption, brings people together in a powerful worldwide coalition to end the devastating impact of corruption on men, women and children around the world. The mission is to create change towards a world free of corruption,” (Transparency International). While the NGO’s mission is somewhat idealistic in nature, its goals of creating global networks, monitoring levels of corruption and spurring anti-corruption activism within civil society are gradually receiving attention from academics, politicians and investors alike. In fact, the Corruption Perceptions Index incorporated in the quantitative models of this study is also widely used in academic and economic studies because of the information it provides on over 150 countries.

In 1994, the OECD passed the “Recommendation on Bribery in International Transactions” and called for the prohibition of bribery of foreign officials in international transactions. The Recommendation was eventually transformed into a Convention against corruption in 1997 that would be ratified by all 30 OECD member states at the time. The same type of anti-corruption measures would become a part of the lending conditionality of the World Bank and the International Monetary Fund, each threatening developing countries with the possibility of withholding loans if anti-corruption reforms were not implemented. Other IOs would follow suit, including the United Nations
Development Program (UNDP), the World Trade Organization (WTO), the Organization of American States (OAS), the World Customs Organization (WCO), and most importantly for the purpose of this study, the EU and other European organizations.

The EU has adopted similar measures and, additionally, issued a series of anti-corruption communications designed to address problems such as bribery and state capture at both the highest level of government as well as at the societal level. Corruption has consistently been referred to as one of the most pressing issues affecting the CEE countries and the EU’s regular evaluations of new member states’ fulfillment of the Copenhagen criteria have served to validate this concern. On the one hand, “the Commission has been able to require the CEE countries to put in place anti-corruption policies. However, its task has been seriously limited by the fact that the EU itself largely lacks an anti-corruption framework, beyond conventions that are narrowly focused and not ratified by a large proportion of member States, and therefore not yet in force,” (EUMAP 2005). Unfortunately, the lack of consistency and of a coherent approach on the part of the EU has yielded results that leave much to be desired. In many CEE countries, anti-corruption legislation has been adopted but seldom enforced, indicating a significant disconnect between policy and practice.

Monitoring and reducing corruption is one of the goals of the EU because of its effects on the ability of recently admitted member states to implement the *acquis communautaire*, the functioning of the single market, and the consolidation of democratic governance. The EU has therefore established
strong partnerships with the Council of Europe, the Open Society Institute’s EU Monitoring and Advocacy Program (EUMAP), other regional organizations, in addition to coordinating policy with international anti-corruption movements. In 1994, the Council of Europe established the Multidisciplinary Group on Corruption and, just a few years later, in 1997, the Group of States Against Corruption (GRECO) was created. Both oversight committees worked to make sure that the Council of Europe’s Union Policy Against Corruption, which criminalizes all bribery even outside of Europe, was properly implemented. This policy was similar to the far-reaching authority of the FCPA and established a model for the EU to replicate.

Along with the OECD and the Council of Europe, the Open Society Institute (OSI) has helped the EU to initiate the fight against corruption through a number of legal instruments. OSI’s European Union Monitoring and Advocacy Program (EUMAP) has issued several reports on corruption policy and judicial capacity in an effort to bring corruption-related problems to the attention of EU officials. The oversight committees, policies, reports, and legal instruments of the OECD, Council of Europe, EUMAP and other organizations have all served to demonstrate the negative impact of corruption on all facets of politics, economics and society. The EU has made progress in ensuring that transition countries are working to fulfill the criteria for membership and that they are taking all the proper measures and implementing vast legal, political and economic reforms that would reduce levels of corruption. Nevertheless, the process of reducing corruption remains a complicated one and, insofar as the CEE countries are experiencing
economic growth and foreign investment, it will be difficult to tackle this complicated issue.

Future Research

The period following the collapse of communist rule in the CEE region was marked by both uncertainty and hope. On the one hand, the countries that were once part of the Soviet bloc had deep political and economic scars, including an extensive culture of corruption, resulting from years of oppression and control under the communist regimes. On the other hand, historical ties to the West, a relatively educated workforce, a resource-rich geography, and prospects for future growth contributed to the region’s appeal. The opening up of the CEE markets and the promise of EU membership signaled a wealth of opportunities for foreign investors and multinationals. The purpose of this study has been to determine whether or not such opportunities for inward FDI have been hindered by perceptions of corruption.

This study has not sought to provide a normative evaluation of corruption because it has been conceded that corruption is an undesirable feature of any system. The quantitative and qualitative findings suggest that corruption is not a significant determinant of FDI, but that by no means implies that governments, regional organizations, and NGOs should not do everything in their power to continue the fight against corruption. On the contrary—if the results and logic developed throughout this study were applied to policy-making, they would
suggest that because corruption is an insignificant determinant of FDI, there should be no objections to its reduction.

The fight against corruption is now built into the legal, judicial, and enforcement mechanisms of the CEE countries. While its success might not predict how much inward FDI countries receive, reducing economic crime will contribute to the overall political and economic advancement in the region. This study’s focus was on the significance of corruption as a determinant of FDI in the period from 1998 to 2008. As more data becomes available, future research will be able to provide a cross-country analysis of the effects of corruption on FDI over a longer period of time, giving a better idea of longitudinal trends. What is known about corruption in the CEE region is based on perceptions and only represents a small part of what is actually occurring on a daily basis.

Perhaps more reliable measures of corruption will also contribute to the improvement of research methods designed to investigate such a complex phenomenon. Other studies might also include different quantitative or qualitative models, independent and dependent variables, or measures or indices to collect information. One of the challenges of future research will be the incorporation of events such as the 2007-2009 global economic crisis or the eventual slowing of the process of privatization as most state-run companies are sold.

While the scope of studies that will take place in five, ten, or twenty years is interesting to consider, what is far more important is measuring the strides that the CEE countries will have made in actually reducing corruption in the long-term. Ideally, EU membership, the enhancement of the rule of law and
enforcement mechanisms, and the domestic commitment to the fight against corruption will eventually lead to a substantial reduction. The passage of laws and reforms is limited, however, by forces for which measures and indices have had difficulty accounting: the culture of corruption. It will take several generations to erase this aspect of the collective memory of the CEE countries, but a continued commitment to anti-corruption will undoubtedly contribute to an improvement in governance and investment climates throughout the region in the long run.


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### Appendix 1: Pearson Correlation Table

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<th>LN(GDPCAP)</th>
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<th>CTR</th>
<th>PPPEX</th>
<th>LABOR</th>
<th>PRREV</th>
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