Political Competition and the Regulation of Foreign Direct Investment

by

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Dissertation submitted in partial fulfillment of
the requirements for the degree of Doctor
of Philosophy in the Department of
Political Science in the Graduate School
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2010

ABSTRACT

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Abstract

This dissertation examines the variation of foreign direct investment (FDI) regulations. Why do some countries restrict the entry and operations of MNEs while others permit and even seek inward FDI? What factors determine the choice of FDI regulations and what conditions are likely to bring about their reform? This study identifies the political dynamics leading to the improvement or deterioration of investment climates in transition economies and beyond.

I argue that FDI policies depend on the level of political competition and the anticipated distributional implications of FDI liberalization for the main constituencies that back the government in office. Democratic governments, which derive political power from domestic workers who benefit from investments by foreign firms, liberalize FDI regulations. By contrast, non-democratic leaders, who fear that FDI would upset the balance of domestic economic power and undermine the privileged position of domestic industrialists who support the regime, continue to restrict foreign investment.

I examine the choice of FDI regulations using a newly constructed database of FDI regulations in 28 transition economies between 1989 and 2008, an index of investment freedom available for a worldwide sample starting in 1994, and the evolution of FDI policies in three complementary case studies. The statistical analysis reveals that higher levels of political competition are associated with greater openness to

FDI. The case study research shows that both increases and decreases in the level of political competition lead to the revision of FDI regulations. Democratization has brought about more liberal FDI policies, whereas the consolidation of authoritarian regimes has been followed by the adoption of more restrictive FDI regulations.

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1. Introduction

1.1. Introduction

Companies investing overseas encounter a diverse set of policies that regulate their entry and operations. Some countries provide equal treatment to foreign multinational enterprises (MNEs) and domestic investors, while others restrict foreign ownership, impose cumbersome administrative procedures on foreign firms, and legally mandate or sanction other forms of discriminatory treatment. In countries such as Turkmenistan, Venezuela, Eritrea, and Zimbabwe, policies and practices that discriminate against foreign investors have persisted for decades or more; in contrast, countries such as Latvia, Costa Rica, Colombia, and Botswana that historically limited foreign ownership are now among the most active in their efforts to attract foreign direct investment (FDI) (World Bank Group Advisory Services: Investment Climate 2009). These are but a few examples; other countries that have liberalized restrictive FDI policies since 1990 include Armenia, Georgia, Ireland, Madagascar and South Korea, while restrictive policies remain in place in countries as diverse as Angola, Bangladesh, Belarus, Cuba, Iran and Sri Lanka.

The removal of FDI restrictions in some countries but not in others is surprising. On the one hand, political economists argue that reform is difficult to accomplish because entrenched groups that benefit from protectionist policies oppose policy

initiatives that might erode their privileged position (Przeworski 1991; Nelson 1992; Geddes 1994; Haggard and Kaufman 1995). Yet the policy changes of the past two decades show that policymakers in many countries have surmounted such domestic opposition to relax or eliminate restrictions on FDI. On the other hand, a more recent stream of research suggests that market-oriented reforms are likely to be adopted widely as governments respond to or emulate other governments' policy choices (e.g., Simmons and Elkins 2004; Henisz et al. 2005). While the number of countries that adopted some form of market-liberalization reforms in the past two decades is indeed impressive, the extent of reform and the records of implementation vary considerably among reform adopters, leading to questions about the limits of policy diffusion.

This dissertation examines the variation in the choice of FDI regulations. Why do some countries restrict the entry and operations of foreign MNEs while others permit and even seek inward FDI? What factors determine the choice of FDI regulations and what conditions are likely to bring about their reform? This study identifies the political dynamics leading to the improvement or deterioration of investment climates in countries around the world, deepening our understanding of a core source of political risk faced by virtually all MNEs.

I argue that FDI policies depend on the level of political competition and the distributional implications of FDI liberalization for the main constituencies that back the

government in office. Governments that derive political power from supporters who benefit from investments by foreign firms liberalize FDI regulations, whereas leaders who fear that FDI would upset the balance of domestic economic power and undermine their supporters' privileged position continue to restrict foreign investment. FDI inflows have distributional implications for domestic factors of production: they benefit domestic workers and tend to hurt domestic firms. Anticipating these distributional effects, democratic governments, who draw their political support from domestic workers, choose policies that allow FDI and may even make an effort to promote it. Non-democratic regimes, whose survival in power depends on the support of wealthy domestic elites (the owners of domestic capital), choose restrictive FDI policies.

The argument mirrors theories of trade policy adoption and financial liberalization. Quinn and Inclan (1997) show that governments deciding on national regulations of international finance take into account the economic consequences of these policies for their main political constituencies. A vast literature on the politics of trade proves that distributional implications of trade liberalization play strongly in governments' decisions to remove or maintain tariff and non-tariff barriers to trade (Mayer 1984; Rogowski 1987; Dutt and Mitra 2002; Hiscox 2002). With notable exceptions (Pinto 2005; Kobrin 2005; Pandya 2007), scholars have paid less attention to the policies governing the entry and operations of foreign firms. This project seeks to

explain the variation in national policies on FDI and, in line with studies on trade and capital account reforms (Quinn 2002; Milner and Kubota 2005; Eichengreen and Leblang 2008; Milner and Mukherjee 2009), it suggests a close relationship between political competition and the liberalization of FDI regulations.

This introductory chapter sets the stage for the arguments developed in the dissertation. I first highlight variations and changes in FDI policies around the world in recent years and illustrate the differences in openness noted above (Section 1.2). In the following two sections, I discuss the existing studies on the political economy of FDI regulations (Section 1.3) and the broader theoretical and practical relevance of the dependent variable (Section 1.4). I explain the focus on FDI regulations in transition economies in Section 1.5, and conclude the chapter with a roadmap for the dissertation.

1.2. FDI inflows and FDI regulations around the world

Annual global FDI inflows have increased from $17.7 billion dollars in the first half of the 1970s to a high of almost $2 trillion in 2007 (UNCTAD 2009). Global FDI stock, which was roughly $750 billion in 1980, has reached $1.9 trillion in 1990, $5.7 trillion in 2000 and $15 trillion in 2008.[1] For the past two decades, FDI has grown at an

[1] United Nations Conference for Trade and Development (http://www.stats.unctad.org/FDI/).

average of 14.7 percent per year,[2] or twice as fast as exports and three times as fast as gross fixed capital formation. Some 82,000 MNEs controlling over 800,000 foreign affiliates are engaged in FDI (UNCTAD 2009). By a rough estimate, production by foreign-owned companies had reached over ten percent of total world output in 2000 (Lipsey 2002). Today, foreign direct investments represent both the largest share and the most stable type of global capital flows.

A number of factors have contributed to the growth of foreign direct investment. Advancements in communication technologies have increased the speed and decreased the costs of working across borders. Transportation costs have declined steadily over time making it possible and sometimes quite appealing for companies to relocate segments of their value chains in different parts of the world in order to take advantage of cost and institutional differences. The reduction of trade restrictions further lowered the costs of organizing operations in a multinational network.

The impressive increase in foreign direct investment can also be attributed to the removal of stringent regulations governing the entry and operations of foreign firms. Until recently, FDI restrictions were ubiquitous in developing countries and sometimes endured in developed countries as well (Golub 2003). They impeded the free flow of FDI

[2] I calculated the FDI growth rate using UNCTAD FDI inflows data. The rates of FDI inflows growth for the different decades are even more impressive: 16.8 percent in the 1970s, 16.5 percent in the 1980s, 22.9 percent in the 1990s. The overall average growth rate is lower because of the steep decline since 2000.

around the world (Nicoletti et al. 2003), and affected the entry decisions and performance of multinational companies (R. D. Robinson 1976; S. E. Guisinger 1985; Gomes-Casseres 1990; Contractor 1990).

For the past two decades, many governments have chosen to liberalize the laws restricting the entry of foreign companies. Developing countries began to reduce or eliminate restrictions on FDI during the 1980s. The trend became more pronounced in the 1990s, when much of the former communist world transitioned to open-market economies and countries in Latin American and East Asia moved away from development strategies based on import-substitution industrialization. In 1991, the UN Conference on Trade and Development counted a total of 82 changes in FDI regulations in 35 countries. In 2004, for example, 270 new policy reforms were implemented in just over 100 countries around the world (Table 1.1). Changes in FDI regulations where observed in both developed and developing countries and across all regions of the world. Egypt, for example, eased the acquisition of land by foreigners and allowed the expansion of new investments in tourism. Ghana and Mali simplified and centralized the admission procedures for foreign investors in so-called "one-stop-shops" (UNCTAD 2006). Even during the recent financial crisis, when many feared a possible rise in investment protectionism, governments continued to lower barriers to multinational investments and moved toward increased openness to FDI (UNCTAD 2009). In 2008, 55

countries introduced 110 new FDI-related policy changes, most of them favorable to FDI (see Table 1.1).

Reversals of liberalization were also observed in recent years. About one fifth of the policy changes recorded by UNCTAD in 2005 and 2006 were intended to increase FDI restrictions. The government of Eritrea closed down the investment promotion agency, suspended private import-export licenses and introduced limits on the transfer of foreign exchange. Bolivia and Venezuela nationalized their oil, gas and telecommunications sectors, while Zimbabwe continued its "indigenization program" by requiring all foreign-owned companies to sell a 30 percent stake to local businesses within a 10-year period. In March of 2006, the Russian Federation announced that FDI would be completely or partially restricted in 39 strategic sectors, including defense-related activities, aviation, and natural resources. That same year, China enacted a policy to protect "critical industries and enterprises" from foreign acquisitions to ensure that they remain under Chinese control (UNCTAD 2006).

Table 1.1 National FDI regulatory changes, 1991-2006

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Number of countries that introduced changes in their investment regimes	35	43	56	49	63	66	76	60	65	70	71	72	82	103	92	91	58	55
Number of regulatory changes	82	77	100	110	112	114	150	145	139	150	207	246	242	270	203	177	98	110
more favorable to FDI (a)	80	77	99	108	106	98	134	136	130	147	193	234	218	234	162	142	74	85
less favorable to FDI (b)	2	0	1	2	6	16	16	9	9	3	14	12	24	36	41	35	24	25

Source: UNCTAD database on national laws and regulation. Reported in UNCTAD (2009).

(a) includes liberalizing changes or changes aimed at strengthening market functioning, as well as increased incentives

(b) includes changes aimed at increasing control, as well as reducing incentives.

1.3. The (limited) political economy of FDI regulations

Very few studies have analyzed the origins of FDI regulations. Wint (1992) provided a qualitative evaluation of FDI policies in ten developing countries and concluded that their governments adopted more open FDI regulations, but have nonetheless been reluctant to eliminate screening processes. Kobrin (2005) examined a number of determinants of FDI policy changes to evaluate the weight of explanations that emphasize rational decisions based on an assessment of the "opportunity costs of closure" (Garrett 2000) vis-à-vis explanations proposing external pressures to adopt neoliberal reform as an important determinant of FDI liberalization. Looking at the UNCTAD dataset on FDI regulatory changes, Kobrin finds support for the "rational decision" explanation and only limited support for the external influence thesis. However, this dataset, which represents one of the first attempts to capture FDI policy reforms around the world, records when a policy change was enacted but does not measure a country's openness to FDI or the magnitude of the reform. Because the data is constructed this way, Kobrin's research is limited to the analysis of a count of FDI policy changes and cannot provide an investigation of FDI openness across countries and across time.

Pinto (2005) analyzes FDI regulations in OECD countries and argues that partisanship can explain much of the enduring variation among advanced economies.

Left-leaning governments, which favor labor, adopt policies that promote investment flows, whereas right-leaning governments, which favor owners of capital, restrict these flows. The present dissertation complements Pinto's study by extending the research beyond advanced industrial democracies, and proposing that, more generally, governments that depend on broad constituencies (labor) are more likely to be open to FDI than those who rely only on the support of selected elites controlling domestic industries.

Finally, research by Pandya (2007) suggests that countries are more likely to restrict FDI in industries in which foreign firms are in competition with local producers. Her theory suggests that sector-level variations endure because FDI has different effects in different industries, depending on whether multinationals invest to gain access to the local markets or to take advantage of lower production costs. Pandya argues that "FDI designed to compete in product markets reduces the income of both labor and capital owners, making it more likely to be regulated. By contrast, FDI designed to exploit lower productions costs creates new jobs and has few negative repercussions" (2007: 3). I argue that the distributional effects of FDI are more pronounced along factor lines: owners of labor benefit from FDI and owners of domestic capital are hurt by it. Empirical studies assessing the impact of MNE investments (discussed in Chapter 3)

report that these effects can be observed across industries, across countries, and across time.

This dissertation, itself limited in several ways, aims to advance our understanding of FDI policies by proposing that the political economy of FDI regulations differs in democratic and non-democratic regimes. Democratic governments, which cater to the policy preferences of broad electorates, are likely to choose policies that open the economy to the entry and operations of MNEs, because their investments provide new and better jobs for vote-rich, capital-poor constituencies (workers). By contrast, authoritarian governments choose to protect the interests of political elites who control domestic industries by limiting the level of competition from foreign firms in the domestic economy.

1.4. The relevance of FDI regulations

The investment climate—the national policy framework and the stability of the political and institutional environment—influences the location decisions of multinational firms. The national policy framework defines the legal rights, obligations and guarantees offered to investors and the extent to which policy-makers can use existing policies to extract rents from them. Institutional structures that impede arbitrary policy changes assure investors that the risk that governments will opportunistically

alter policies in order to expropriate firms' profits or assets is low (Henisz and Zelner 2001; Henisz 2002).

The investment climate is particularly important to multinational investors because their bargaining leverage declines after the investment is realized. Investors have strong bargaining power over governments seeking scarce capital or access to technology, and can use it to obtain favorable contract terms (Vernon 1977; Poynter 1982). However, once resources that were mobile *ex ante* are sunk in the ground, the bargaining power shifts to the government (Fagre and Wells 1982; Lecraw 1984; Kobrin 1987). As a result, foreign investors become exposed to political risk, including the risk of outright expropriation (Kobrin 1980, 1984) and the possibility of government-initiated changes in the original terms of contracts awarded to foreign investors (Zelner et al. 2009).

Investor surveys confirm the importance of national policies and institutions for multinational investments. In a 2002 survey of firms engaged in FDI, respondents revealed that social and political stability and the ease of doing business are among the most important concerns in site selection. Investors ranking the top five location factors identified market access as the top priority (77 percent of respondents), followed by the stability of the social and political environment (64 percent), the ease of doing business (54 percent), and the reliability and quality of infrastructure and utilities (50 percent)

(MIGA 2002). A recent survey by the Foreign Investment Advisory Service (FIAS) shows that business executives interested in investing in South and Eastern Europe rank political stability and economic regulations as the most important two factors affecting the attractiveness of investing in the region (2007).

By specifying the terms and conditions under which foreign firms are allowed to invest, FDI regulations are likely to affect MNEs' location and mode of entry decisions. Nicoletti, Golub, Hajkova, Mirza, and Yoo (2003) have shown that FDI restrictions are a significant determinant of FDI levels in OECD countries and conclude that "aligning FDI restrictions on those of the most liberal country would increase significantly the OECD-wide inward FDI" (2003: 71). Research in international business has highlighted the impact of FDI restrictions on the entry decisions and the performance of foreign companies (R. D. Robinson 1976; S. E. Guisinger 1985; Contractor 1990; Gomes-Casseres 1990).

Yet, studies in economics and political economy analyzing the determinants of FDI flows largely overlooked the effect of government policies on FDI. Studies assessing the relative impact of economic determinants of FDI emphasize the importance of market size and trade costs, the availability of relatively skilled labor, distance from major markets, export orientation, and the abundance of natural resources (see Navaretti and Venables 2004 for a review of the determinants of FDI). National policies governing

the entry and operations of FDI have received surprisingly little attention in this literature. The same way tariff and non-tariff barriers affect trade costs and shape the global trade map, barriers to FDI such as mandatory joint venture requirements and screening and approval procedures alter the costs, benefits and risks of investing, thus affecting investment decisions.

More recently, studies have also highlighted political institutions as important determinants of FDI. Investors seeking to minimize political and contractual risks prefer policy stability, which is greater in countries with more checks and balances (Henisz 2004). Jensen (2003, 2006) argues that democratic governments are more successful in attracting foreign direct investment because they can make a credible commitment to preserving a market-friendly environment for multinationals. He notes that "democratic governments, unlike authoritarian governments, offer mechanisms for multinationals to influence policy and 'punish' policy makers for taking positions that would harm multinationals" (2006: 51).

Li and Resnick (2003) disagree in part with Jensen's conclusion and argue instead that democratic institutions have conflicting effects on FDI inflows. They claim that, on the one hand, democracies have a negative effect on FDI inflows because they constrain elected officials from offering generous fiscal and financial incentives and from allowing MNCs to maintain monopolistic or oligopolistic positions, while also empowering a

broad range of interest groups, including labor movements and local business, to lobby the government for protection. On the other hand, democratic institutions have a positive effect on FDI inflows because they ensure a better protection of property rights. As a result, “the net effect of democratic institutions on FDI inflows to the developing countries is contingent on the relative strength of these two competing forces” (2003: 177).

What remains unclear, however, is the actual level of openness to FDI in different types of regimes. Is it the case that more democratic countries offer investors less favorable conditions, but FDI comes in anyway because these same regimes offer better protection of property rights, as Li and Resnick's study suggests? Or is it possible that, on the contrary, FDI policies are more open in more democratic countries, and investors are happier to go where both the policies are more welcoming and the protection of property rights is stronger? Are FDI regulations more favorable in democratic or in authoritarian regimes?

The level of FDI openness in different political regimes can be assessed empirically. This dissertation sets out to do this by constructing a new database of FDI regulations in 28 transition economies between 1989 and 2008. Empirical results presented in later chapters show that democracies are more open to FDI than non-

democratic regimes, suggesting that studies looking at regime type as a determinant of FDI might have overlooked an important intervening variable: FDI regulations.

1.5. Studying FDI policy changes in transition economies

The post-communist region of the world offers a quasi-experimental setting to analyze policy choice. Following the fall of the Berlin Wall and the disintegration of the Soviet Union, 28 countries embarked on the transition from socialist to market economies. From the onset of the transition, however, there was considerable variation among the types of political regimes that would head the economic reforms. With only few exceptions—specifically, Azerbaijan, Belarus, Croatia, Kazakhstan, Romania, Serbia, and Tajikistan—the regime type of the first half of the 1990s is indicative of the level of democracy achieved by these countries in the post-1989 era (Figure 1.1). For example, from the very beginning of the 1990s, Hungary and Slovenia held free and fair elections that brought to power political forces opposing former communist elites. In contrast, in Kazakhstan, Nursultan Nazarbayev, the leader of the hard-line communist party, maintained power by asserting the continuation of Soviet-style rule even after all attempts to prevent the fall of the Union failed.

Studying policy choices in this region allows for important controls. First, these countries' economic transformations took place roughly at the same time, placing all countries in the same international context. All the former communist countries

embarked on the process of post-communist economic transition at roughly the same time (1988-1992), when the world economy had already gathered some momentum toward globalization and new ideas about the merits of market liberalization were spreading throughout the developing world.

Second, all former communist countries started with similar economic characteristics inherited from the planned economy. Among these, an important feature is the limited availability of domestic capital and the concentration of property under state control. Consequently, these countries had to rely heavily on international capital—FDI, loans, and aid—as the main source of investment. Foreign capital was needed to finance the privatization and restructuring of state-owned enterprises. Jaroslav Prochazka, the former director of relations at the Ministry of Industry of Czechoslovakia, estimated that in 1992 domestic sources could cover only 40% of the total funding required for planned restructuring. Prochazka noted that "foreign investment is one of the essential conditions for the effective restructuring of industry and also of the future prosperity of the country" (quoted in Gray and Jarosz 1995: 6).

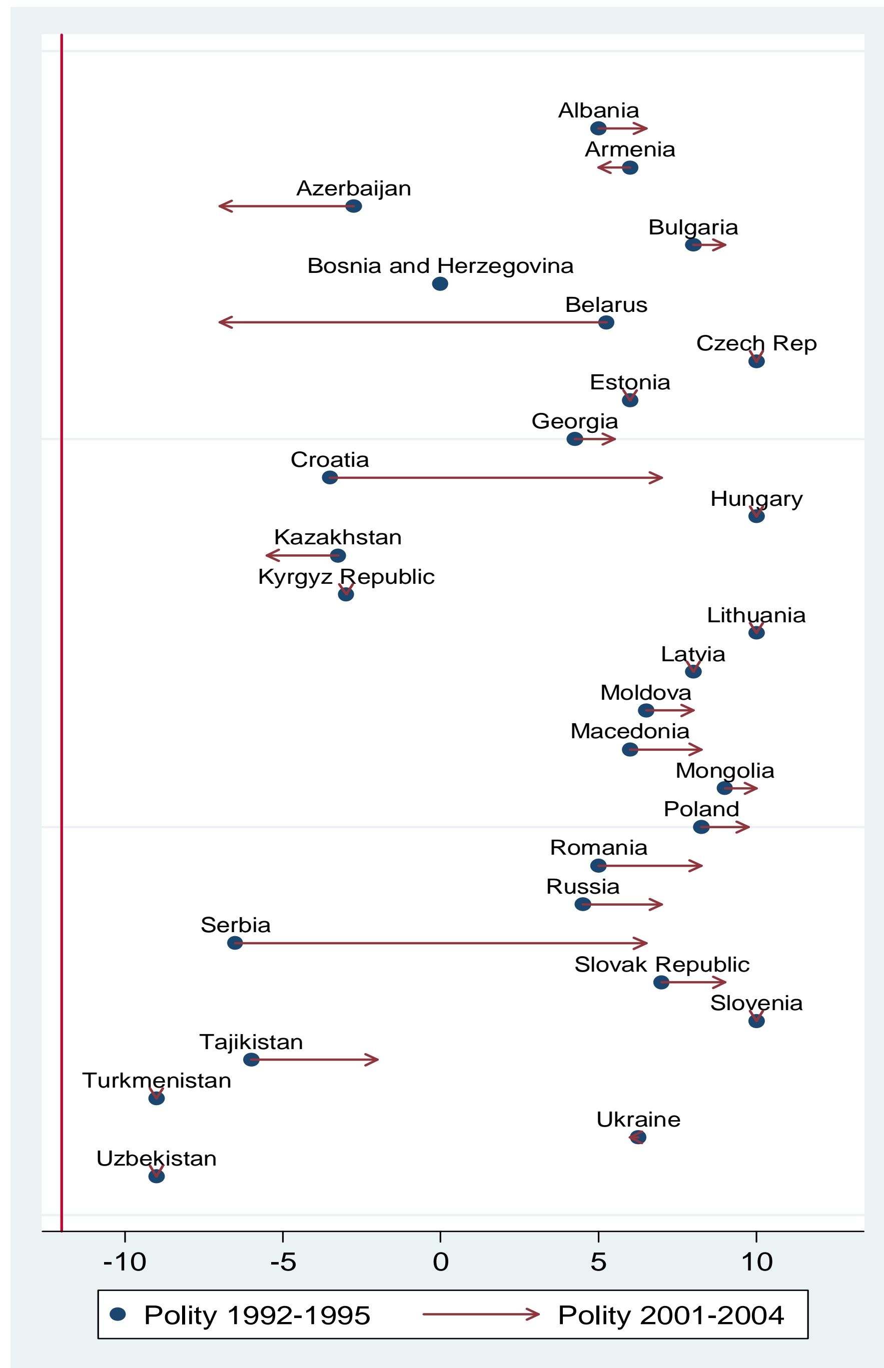

Figure 1.1 Political competition and transitions in post-communist countries

Many economic advisors and policy-makers believed that multinational investments could help former countries recover faster from the dramatic contraction of output that resulted from the sudden rejection of economic planning and the breakdown of trade patters across the Soviet bloc. Multinationals could bring not only much needed investments, but also new technologies and managerial and technical knowledge that could be emulated by other domestic firms. Speaking in 1995, the U.S. Ambassador to Hungary said, "I have often been asked why there isn't a new Marshall Plan to help Central and Eastern Europe. Well, there is—it is here—and it is called private foreign investment… Foreign investment creates jobs, enhances productivity, generates economic growth, and raises the standard of living. It brings new technology, new management techniques, new markets, new products, and better ways of doing business" (quoted in Gowan 1995: 10).

While perhaps not a panacea for economic recovery, the anticipated benefits of FDI for transition economies were great. Several governments recognized that the legal and institutional environment could deter foreign investors and created special legislation on FDI. These FDI codes were meant to signal to foreign investors that the government was serious about allowing multinational investments, and to create "enclaves" of special legislation which could be easily adjusted to respond to foreign investors' concerns (Gray and Jarosz 1995).

The regulation of foreign direct investments was an important policy dimension in the economic reform strategies of all post-communist countries. Nonetheless, as this study will show, there was wide variation among the FDI policy choices made by post-communist governments. At the end of the 1980s, all communist countries banned or severely restricted FDI. Since then, some countries have proceeded to eliminate restrictions on FDI and even replaced them with incentives for foreign investors, while others have chosen to maintain policy barriers on the entry and operations of multinational companies. This dissertation proposes a possible explanation for why this has been the case.

1.6. Roadmap

The study is organized in five additional chapters. Chapter 2 starts with an overview of the literature on economic reform, which makes a compelling case for considering the distributional effects of policy changes. These studies, however, frequently lump together policies as diverse as price liberalization, privatization, and foreign exchange controls under one heading, making it difficult to disentangle the causal mechanisms and to identify the exact coalitions supporting or opposing reform. I argue in favor of conceptual disaggregation, and propose to focus on a narrow set of policies that target FDI, much in the same way that streams of research on the political economy of trade policy and capital account liberalization have done with these two

types of economic reforms. I advance a theoretical framework that builds on a combination of political incentives in different regimes and the distributional implications of FDI for two factors of production: domestic labor and domestic capital. In the second part of Chapter 2, I discuss the anticipated effects of FDI on domestic wages and firms, and develop the theoretical argument of this dissertation. I end the chapter with empirical illustrations of the theoretical dynamics from a number of transition economies.

Chapter 3 provides a history, a measurement and an empirical assessment of FDI policy developments in transition economies. At the end of 1980s, all former communist countries banned or severely restricted multinational investments. Less than a decade later, foreign investors were welcome in much of the region, but not everywhere. Chapter 3 describes the evolution of FDI policy frameworks in former communist countries and introduces a new dataset of FDI regulations in the 28 transition economies that captures policy development between 1989 and 2008. The second half of the chapter offers an empirical assessment of the theoretical argument on the basis of the new dataset and one alternative measure of FDI openness available for a worldwide sample.

Chapter 4 presents a refinement of the theoretical argument on the basis of a simple formal model which shows that even non-democratic regimes have incentives to open to FDI, but only to a limited extent. The supporters of authoritarian regimes –

owners of domestic capital – can benefit from allowing some FDI in the economy and capturing the gains from output growth away from labor. Allowing too much FDI in the economy, however, may tilt the balance of economic power away from the supporters of the authoritarian government and put its grip on power at risk. To play it safe, non-democratic governments open only *partially* to FDI. The chapter shows empirically that while democracies have opened quickly and completely to FDI, non-democratic regimes have done so gradually and partially by choosing a mix of stringent entry regulations and relatively low restrictions on other policy dimensions.

In Chapter 5, I trace the effects of political competition on FDI openness and the causal mechanisms at work in three complementary case studies: Croatia, Kazakhstan, and Romania. In each case I examine variation over time (or in a single unit diachronically). I selected these three countries because they have experienced important political changes in the post-1992 period. Following Franyo Tudjman's death in 1999, the party he founded and led was defeated in parliamentary and presidential elections by a pro-democratic coalition. The regime change was followed by a series of reforms, including the adoption in 2000 of an important law on investment promotion. Romania underwent a similar political change three years earlier, when the 1996 elections brought to power for the first time a political coalition not affiliated with the communist regime. In Kazakhstan, a number of constitutional referenda passed since

the mid-1990s have paved the way for Nursultan Nazarbayev's lifetime presidency and the consolidation of his autocratic rule. As the regime strengthened, the government reversed earlier policies that de-regulated the entry and operation of foreign firms.

I end in Chapter 6 with a review of the argument and the key findings, a brief discussion of the theoretical implications for FDI policy reforms in other regions, and a few thoughts on possible theoretical extensions for future research that can address some of the limitations of the present study.

2. A Theoretical Framework of FDI Policy Choice

> *One should bear in mind that there is nothing more difficult to execute, nor more dubious of success, nor more dangerous to administer than to introduce a new system of things: for he who introduces it has all those who profit from the old system as his enemies and he has only lukewarm allies in all those who might profit from the new system.* (Niccolo Machiavelli, The Prince IV)

2.1. Introduction

In recent years, countries around the world have revised their national policies governing foreign direct investment (FDI). Today, some countries provide equal treatment to multinational enterprises (MNEs) and domestic investors, while others restrict foreign ownership, impose cumbersome administrative procedures on foreign MNEs, and legally mandate or sanction other forms of discriminatory treatment. In countries such as Turkmenistan, Venezuela, Eritrea and Zimbabwe, policies and practices that discriminate against foreign investors have persisted for decades or more. In contrast, countries as diverse as Latvia, Costa Rica, Colombia and Botswana that historically limited foreign ownership are now among the most active in their efforts to attract foreign direct investment (World Bank Group Advisory Services: Investment Climate 2009).

This dissertation examines why some countries persist in restricting the entry and operations of foreign MNEs, while others allow and even seek inward FDI. The argument presented in this chapter highlights the effect of political competition on the

openness of different countries to FDI. I argue that FDI restrictions tend to be lower in democratic countries because political participation and electoral contestation create incentives for policy-makers to weigh more heavily the welfare of domestic workers, who benefit from FDI. Conversely, non-democratic regimes rely for their power on the support of a select few, who tend to be the wealthier members of society who control domestic economic resources. To prevent their welfare being negatively impacted by direct competition with foreign firms, closed political regimes choose to restrict the entry and operations of foreign firms.

In developing this project, I address important questions of political economy pertaining to the relationship between democracy and development and the dynamics of economic reform in developing and transition countries. First, this study examines empirically a common assumption in the study of regime change—that "democracy, which is generally a situation of political equality, looks after the interests of the majority more than nondemocracy, which is generally dominated by an elite and is more likely to look after its interests" (Acemoglu and J. A. Robinson 2006: 18; see also Boix 2003). Second, the project advances the study of government policies as important intervening variables between political systems and economic performance. Policies are the main output of government—the result of preference aggregation by politically motivated leaders—and an important determinant of economic outcomes. In contrast

with studies that analyze the direct relationship between political regimes and FDI flows, I focus this research on understanding the choice of policies that shape the opportunities for foreign direct investment in different types of political regimes. Finally, this research contributes to the burgeoning literature on the political economy of trade and investment liberalization, which has closely examined the link between policy preferences and policy reform. Studies in this stream of research have analyzed trade barriers and capital account controls, but not the policy barriers to FDI. The present study fills this gap by placing the specific policies governing the entry and operations of FDI at the center of analysis.

This chapter is organized into five additional sections. Section 2.2 provides a broad overview of theoretical accounts of the relationship between democracy and economic reform and then zooms in on the political economy of trade and investment liberalization. Distributional implications of policy changes have been at the center of many debates in these earlier investigations. They are also a critical theoretical component of the present study. Section 2.3 discusses the distributional effects of FDI and the relevant empirical evidence from economics. Section 2.4 presents the main argument of this study, which builds upon a combination of the distributional effects of FDI and the political incentives of policy makers in different political regimes. To illustrate the dynamics proposed in the theoretical framework, Section 2.5 discusses FDI

regulations in a few transition economies, where post-1989 political transformations have brought about substantial changes in national policies on FDI. Further qualitative evidence regarding the ways in which political incentives affect the choice of FDI regulations is provided in subsequent chapters.

2.2. Political competition, policy reforms and economic performance

One of the most important and challenging questions addressed by social science is why some countries prosper more than others. There is no question that the world's wealthiest nations are democracies, but whether this is the result of democracy enhancing growth opportunities or prosperity bringing about democracy remains a subject of scholarly debate. In this section, I first review the scholarship that relates political competition to development and economic reform, and argue that the conceptual aggregation common across much of this literature is one of the reasons for the lack of consensus to date. In contrast with studies on economic reform, broadly defined, the research on trade and investment liberalization has focused on explaining a narrow set of government policies. I review this work in the second half of this section.

In development economics, almost every decade since Solow's (1956) theoretical contribution to the study of economic growth has been marked by the rise and decline of a new explanatory variable (Easterly 2001). Parallel research in political science,

stimulated in part by Lipset's (1959) revelation of a strong correlation between democracy and development and in part by impressive economic growth in non-democratic countries around the world, has proposed a variety of hypotheses relating regime type and economic performance.

Scholars who argue that democracy facilitates growth emphasize political stability and policy credibility (Feng 1997; Rodrik 2000), institutions for the protection of property rights, and contract enforcement mechanisms that constrain political leaders from plundering (North and Weingast 1989; North 1990; Olson 1993; Przeworski and Limongi 1993; Clague 1997; but see Przeworski 1991). On the other side of the debate, scholars have argued that democracy inhibits development. Their theoretical arguments underscore citizens' preferences for government consumption over investment (Huntington 1968), interest group pressures for particularistic privileges that damage the economy (Olson 1982; but see Remmer 1990), and higher demands for the redistribution of wealth (Meltzer and Richard 1981; Alesina and Rodrik 1994), which undermine the security of property rights and the incentives to invest (Przeworski and Limongi 1993). In this view, only governments that are sufficiently insulated from such pressures can choose policies that enhance economic performance (Amsden 1989; Haggard 1990; Wade 1990; Evans 1992, 1995). Since state autonomy from societal pressures is maximized under authoritarian rule, these studies predict higher growth in

non-democratic regimes. Finally, there is also the possibility that democracy has a hump-shaped effect on growth (Barro 1997), or that no causal relationship exists between regime type and economic performance (Przeworski et al. 2000).

Despite the proliferation of studies, more than two decades of research on the impact of political regimes on economic performance have failed to generate a scholarly consensus. At the theoretical level, models and hypotheses with great intellectual merit lead to diametrically opposed predictions. The issues have yet to be resolved through empirical research, which has failed to produce any robust findings and is mired in controversies over basic issues of measurement, sampling, and statistical methodology (Krieckhaus 2004).

Perhaps more fundamental, however, existing research has failed to resolve outstanding questions regarding the nexus between democracy and economic growth because it has not devoted adequate attention to government policies—the key variables that mediate between political regimes and economic performance. With the notable exception of studies that attempt to separate policy choice and economic outcomes and to provide adequate measures for both (e.g., Remmer 2002; Mulligan et al. 2004), research on the political economy of development routinely ignores national policy choice. Ultimately, policy is the main tool in the hands of strategic leaders who use it intentionally to affect outcomes and the relative welfare of different groups in their

societies. Different policy choices may well explain why some regimes perform better than others or why a particular country's growth accelerates or slows down. Within a country, policy outputs and economic performance are characterized by higher temporal variance than political institutions. Moreover, policy choices in one arena may undercut policy choices in another, or have differing consequences for particular dimensions of economic performance. Understanding the variation in economic outcomes that may be the result of competing forces requires finer-grained theoretical approaches that disaggregate key concepts such as market reforms and economic performance.

Conceptual aggregation is the norm in many studies of economic reform, which frequently lump together policies as diverse as macroeconomic stabilization, privatization, trade liberalization and the removal of capital account controls under the heading of "economic liberalization." As Brooks and Kurtz point out, it is "analytically inappropriate to lump free market reforms together as part of a package by assumption, and thus to presume that the political dynamics that characterize reform efforts are necessarily similar across policy arenas" (2007: 704). The likelihood of reform adoption depends on the timing, certainty and the distribution of expected benefits and costs across different economic groups, all of which are likely to vary depending on the type of reform in question. For instance, privatization programs across Eastern Europe and Latin America produced highly concentrated benefits for a small group of domestic

entrepreneurs, while the costs of privatization have been long-term, diffused, and hard to ascertain. By contrast, the removal of restrictions on foreign direct investment are expected to have long-term diffused benefits at the expense of a limited number of domestic industrialists who lose from increased competition in the home market. Similarly, banking reform undermines the economic privilege of insiders who control bank resources and those with easy access to soft credit, but is likely to generate long-term benefits for a wide range of economic actors, including consumers and small and medium-size enterprises. It is unlikely, then, that different types of economic reforms will result from the same configuration of political and economic conditions.

Much of the research on the determinants of market-oriented reforms nevertheless overlooks these nuances. Starting with the assumption that the benefits of reform are generally long-term, diffused, and uncertain, whereas the costs are immediate, concentrated, and definite, several studies have predicted that reforms would be blocked by those who are negatively affected (Przeworski 1991; Nelson 1992; Geddes 1994; Haggard and Kaufman 1995; Jensen 2003), or by those who benefit from arbitrage in a partially reformed economy (Hellman 1998; but see Schamis 1999). Guided by insights from theories of collective action (Olson 1965), these studies converge on the understanding that the preferences of concentrated groups prevail in policy decisions at

the expense of diffuse groups, which lack information and the capacity to mobilize in opposition.

Machiavelli's five century old insights into the challenges of implementing change resonate well in this literature: "adjustment measures by their nature arouse considerable opposition and win few immediate friends" (Nelson 1990: 325). The adoption of reforms such as policies of macroeconomic structural adjustment that tend to decrease growth in the short-term (Blanchard et al. 1994; Blanchard 1997; Clague 1997; Greskovits 1998) involves a very high political risk. Even when policy-makers expect reform to follow a J-curve trajectory—economic decline in the short run followed by long-term recovery (Przeworski 1991)—mustering political support for policies that sacrifice short-term individual welfare and promise only delayed and uncertain benefits is a daunting political task. In many instances, governments that introduced economic reforms were punished in subsequent elections (Remmer 1991; Bunce 1999).

Even reforms which promise few adjustment costs and widely spread benefits receive only lukewarm support prior to their adoption. (Fernandez and Rodrik 1991) argue that uncertainty about the distribution of gains and losses from reform enhances the "status quo bias." They show mathematically that "there are reforms which, once adopted, receive adequate political support but would have failed to carry the day ex ante" (1147). For example, trade policy reforms enacted in many countries (including

South Korea, Taiwan, Chile and Turkey) were initially strongly opposed by the private sector, which later became a strong defender of trade openness and outward orientation.

For these reasons, students of political economy expressed deep skepticism about the ability of democratic governments to enact "inherently unpopular, politically hazardous" neoliberal reforms (Remmer 1998: 3). Democracy inhibits the election of politicians promising to address economic woes through wide-sweeping policy changes, and creates incentives for those already in power to delay the adoption of reforms for fear of electoral punishment (Alesina and Drazen 1991; Roland 2000). It also empowers coalitions of special interests, who can mobilize opposition to reform and lobby the government to continue on a path of protectionism. By contrast, authoritarian governments do not come under electoral pressures and are insulated from the pressures of interest groups that oppose reform (Haggard 1990; see also Wintrobe 1998; Brooker 2000; Acemoglu and J. A. Robinson 2006). Consequently, the argument goes, non-democratic regimes are in a better position to enact unpopular economic reforms, for which democratic policy-makers are likely to be ousted from office.

This theoretical view, however, falls short of addressing many of the theoretical questions it raises. For instance, why would strong and relatively autonomous authoritarian leaders want to pursue "inherently unpopular" reforms, especially if these hurt much of the economy, including their own interests? Only extreme economic

circumstances could induce self-interested politicians to go ahead with neoliberal reforms. And even then, why would those controlling and benefiting from a strong and autonomous state use its might to advance economic reforms designed specifically to diminish the role of the state in the economic sphere? Paradoxically, many prior studies on the political economy of economic reform are better positioned to explain the stickiness of the *status quo*, or lack of reform, than the conditions and dynamics that bring about policies of structural adjustment and market liberalization.

More importantly, this stream of literature is at odds with developments in many developing countries over the past two decades. In countries across Latin America, Eastern Europe and the former Soviet Union, democratic governments embraced market-oriented reforms with greater enthusiasm and ambition than their authoritarian counterparts. Perhaps the costs of economic reform were not as concentrated as some of these studies suggest, those who were negatively affected did not have the power to mobilize in opposition to reform (see, for example Crowley 1994), or their opposition did not translate into derailment of reform (Geddes 1995). It is also possible that changes in government brought about by increased political competition among domestic groups put in power leaders with preferences for policy change.

Contrary to what was previously "conventional wisdom" in the scholarship, democratic politics could be conducive to economic reform (Weyland 2002; Fidrmuc

2003). Democratic elections make governments more accountable to their citizens, creating incentives for policy-makers to select policies that are good for most of society (Olson 1993, 2000; see also Bueno de Mesquita et al. 1999, 2003). But democracy also gives voice to coalitions of special interests, who oppose reforms that hurt them (Grossman and Helpman 2002a, 2002b). The question then becomes: are electoral incentives powerful enough to motivate politicians to overcome the power of special interests when the latter's interests are in opposition to those of society at large?

During the past two decades, democratization led to the adoption of market-oriented reforms in many developing countries, suggesting that increased political competition can be a powerful motivating force that drives policy adoption at the expense of the concentrated interests opposing it. Episodes of political liberalization were accompanied by economic reform across much of Eastern Europe (Bunce 2001; Fidrmuc 2003), Latin America (Teichman 2001; Gans-Morse and Nichter 2008), and parts of Africa (Bienen and Herbst 1996).

Democratization creates "windows of opportunity" for reform by "undermining established sociopolitical forces and by allowing new or previously excluded actors, who are dissatisfied with the status quo, to enhance their influence" (Weyland 2002: 60). It reduces the political clout of interest groups who benefited the most from the old policy model. As Geddes points out, "in many countries the biggest, and certainly the

most articulate and politically influential losers from the transition to a more market-oriented economy are government officials, ruling-party cadres, cronies of rulers, and the close allies of all three" (1995: 68). At the same time, democratization enhances the political weight of previously marginalized groups who prefer a different allocation of economic resources and who have little to lose from economic reform (Bienen and Herbst 1996). Thus, recent studies challenge many of the conclusions of research on the political economy of economic reform and propose a positive relationship between regime type and the enactment of market-oriented policies.

The evolution of scholarship on democracy and economic reform carries important lessons for political economy research. First, the distributional effects are important considerations in the calculus of policy reform. Economic policies are a means of allocating scarce resources across different groups. Policy changes inevitably generate winners and losers. The devil is always in the details and it is highly unlikely that economic reform, defined broadly to encompass a range of macroeconomic and market-oriented policy changes, has clear effects on well-defined economic groups. Conceptual aggregation, while attractive because of its theoretical scope, can undermine the power of causal mechanisms and the validity of empirical verification. The separate examination of specific policy reforms can be a more productive avenue to theoretical consensus. Studies examining the liberalization of trade and investment policies,

discussed below, have built in this direction. In a similar way, this dissertation focuses on a narrow set of economic policies that deal specifically with the entry and operations of foreign firms.

Second, this review also suggests that studies of political economy need to combine an understanding of how policy changes affect different groups with theories about which groups matter most in the policy-making process. In every polity, the government decides how to weigh the economic costs and benefits accruing to different constituencies. The formula is rarely one that maximizes social welfare. Rather, political leaders motivated by strong individual incentives decide which economic policies to enact. They do not necessarily adopt market-oriented policies simply because they have the ability to overcome opposition to reform, as some of the earlier studies suggested. They have to want to do so—that is, to find it in their own interest to go down the reform path. In both democratic and non-democratic regimes, those in power depend on the support of particular political groups, whose preferences are likely to influence policy choice. Political competition determines to a large extent whose interests are represented. In this research, I focus on understanding how political competition affects the choice of policies that permit or restrict foreign direct investment.

2.2.1. The political economy of trade and capital account liberalization

For many years following World War II, developed and developing countries had in place trade and capital account restrictions. These measures, many believed, were necessary for quick economic recovery in the aftermath of the war. In developing countries, the prevailing economic model of import-substitution industrialization required barriers to trade and capital flows as a means to stimulate the growth of national industries. In time, however, the costs of protectionism became apparent and many governments shed their restrictive regulations in favor of policies that encouraged trade and financial integration in the global economy. The impressive number of developing countries that abandoned their protectionist trade policies since the 1980s led Rodrik to describe the phenomenon as a "rush to free trade" and a "genuine revolution in policymaking" (1994: 62). Why, after years of protectionism, would so many countries concurrently introduce trade policy reform?

Much of the research aiming to explain trade policy and the "rush to free trade" carefully examines the domestic preferences for protection (Milner 1999). Two theoretical models shape the debate about trade preferences and policies. The so-called factoral model assumes that economic factors of production, such as labor and capital, are mobile in the economy. It builds on the Stolper-Samuelson theorem (1941), which shows that when factors can move among sectors, free trade increases the income of

factors of production that are relatively abundant in the economy and lowers the income of factors that are relatively scarce. According to this model, relatively abundant factors favor free trade, while scarce factors favor protectionism. Rogowski (1989) used these insights to provide one of the first accounts of trade policy formation. He argued that, depending on a country's relative factor endowments, preferences for trade policy translate into class conflict when the interests of labor diverge from those of the owners of capital and land, and into urban-rural cleavages when the owners of land have interests opposing those of capital and labor. Later studies provide additional empirical support for the factoral model of trade preference formation (see, for example, Midford 1993; Scheve and Slaughter 1998).

The theoretical alternative to the factoral model is the sectoral model, which assumes that factors are sector-specific, as in the Ricardo-Viner model. Under this assumption, trade benefits the factors specific to export-oriented industries and decreases the income of factors specific to import-competing sectors. Factor specificity (or low factor mobility) implies that owners of the same factors of production employed in different industries can have divergent preferences for protectionism. Thus, political coalitions are likely to form along industry lines represented by strong special interests (Magee et al. 1989; Frieden 1991; Irwin 1994, 1996; Gourevitch 1986). The conflict between them increases with global interdependence, which accelerates the growth of

export-oriented industries and the decline of sectors competing with imports (Frieden and Rogowski 1996).

The level of factor mobility across sectors is critical to deriving expectations from the two models (Alt et al. 1996). When factors can move easily in the economy, political coalitions demanding more or less trade protection align along factor lines; when factors are sector-specific, preferences for trade policy form along sector lines. More recently, Hiscox (2001) has argued that the level of factor mobility can be observed (rather than assumed) across time and countries. He offers a theoretical account that combines insights from both models of trade policy formation and shows that "trade issues divide societies along very different lines when substantial variation exists in levels of factor mobility" (2001: 4).

But preferences for trade openness and trade protection rarely translate directly into economic policy. Political institutions determine whether majority preferences translate into trade regulations and the extent to which special interests can influence the policy process. Mayer (1984) builds a model of tariff formation in which trade policies are determined by the underlying factor-ownership distribution, voting eligibility rules and participation costs, and shows formally that tariff policies are sensitive to changing voter eligibility rules and voter participation costs under majority voting. His insights suggest that, *ceteris paribus*, tariff rates in representative democracies are different than

those in political regimes that exclude much of the electorate from the policy-making process. A number of empirical studies support the view that democracies are more likely to promote free trade (Verdier 1998; Milner and Kubota 2005; Eichengreen and Leblang 2008).

Within democracies, specific institutional designs can further affect the extent to which policy-makers respond to demands for protectionist policies. Some institutions tend to give special interests greater access to the policy process (see Ehrlich 2007). Other institutions insulate policy makers from such demands, allowing them greater flexibility in choosing tariff rates. For example, institutional configurations that increase the number of veto players reduce the likelihood of trade protectionism in response to declining economic conditions (Henisz and Mansfield 2006). Electoral systems with proportional representation also enhance the chances of free trade because they insulate decision makers from the sway of special interests (Rogowski 1987; Mansfield and Busch 1995; Persson and Tabellini 2000).

Interest group models provide rich explanations of cross-national differences in trade policy preferences, but are not equally well equipped to explain why trade policies change over time. One possibility is that the preferences of domestic groups change as a result of exogenous trends, such as changes in the level of factor mobility brought about by technological innovation and industrial restructuring (Hiscox 2001), or the rapid

growth of the international economy that alters the costs and benefits of protectionism (Frieden and Rogowski 1996; Garrett 2000). But such developments take time and affect economies differently, and thus are unlikely to engender concurrent changes of domestic preference that could explain "the rush to free trade" across the developing world.

Another possibility is that political developments have changed the relative power of different economic groups to influence trade policy. If, as Mayer (1984) argued, trade policies are more open in democracies than in non-democracies, democratic transitions are likely to enhance the prospects for more trade openness. Recent studies find empirical support for this claim across Latin America (Stokes 2001; Weyland 2002), developing countries (Milner and Kubota 2005), and samples of both developed and developing countries (Dutt and Mitra 2002; O'Rourke and Taylor 2006). O'Rourke and Taylor (2006) argue that because democracies are more sensitive to the preferences of the electorate, democratization leads to more liberal trade policies in countries where workers stand to gain from free trade, and to more protectionist policies in countries where they benefit from the imposition of tariffs and quotas. The other studies mentioned here assume that in labor-abundant, capital-scarce developing countries, trade reforms benefit large sections of society and hurt only a small group of capital owners. Because democratization weakens the power of the latter and empowers large

groups that were formerly excluded from the political process, the spread of democracy across the developing world can explain the widespread enthusiasm for trade openness.

The distributional implications of capital account liberalization are not as well defined as they are in the case of trade policy reform. The main benefit of financial openness is that it enables governments and domestic firms to borrow money on international markets at competitive rates. In the long-run, economists argue, capital mobility should increase the efficiency of the national financial sector and the competitiveness of businesses, and ultimately generate economic growth (Eichengreen et al. 1998; but see Rodrik 1998). At the same time, however, increased capital inflows and outflows can induce high exchange-rate volatility, larger interest-rate changes, and increased instability of the banking sector (Eichengreen 1999; Brooks 2004; Wibbels 2006). Large inflows of capital lead to the appreciation of the real exchange rate, which implies higher prices for consumers and declining profits for exporters. A large outflow of capital means decreased investment, which can hurt growth, but also the depreciation of the national currency, which can help consumers and exporters.

In short, there are considerable risks associated with capital account liberalization, both if it attracts too much capital and if it fails to attract enough capital or to contain capital flight (Quinn and Inclan 1997; Brooks 2004). Because the potential benefits of financial integration seem to be outweighed by the costs resulting from

problems of asymmetric information in financial markets, Garrett argues that "the case is at best weak that there are clear economic benefits to financial market integration, and that these have increased in recent years" (Garrett 2000: 965). In this light, the spread of financial liberalization across both developed and developing countries is surprising.

Studies that examine the extent and timing of capital account openness emphasize both domestic and international determinants, but there is little agreement among them. Some of the earlier research on this topic suggested that financial liberalization was the result of successful lobbying by interest groups representing the owners of mobile capital, such as financial intermediaries and multinational companies (Frieden 1991). The studies that followed highlighted international interdependence and balance-of-payments crisis (Frieden and Rogowski 1996; Haggard and Maxfield 1996), but also partisanship (Quinn 1997; Quinn and Inclan 1997; Kastner and Rector 2003, 2005; Brooks and Kurtz 2007) as important drivers of financial liberalization. More recently, scholars have argued that the removal of capital account restrictions not only in developed but also in many developing countries could be the result of international diffusion processes (Simmons and Elkins 2004; Quinn and Toyoda 2007; Brune and A. Guisinger 2007), or the effect of the democratization that swept the globe during the last two decades (Brune et al. 2001; Quinn 2002; Eichengreen and Leblang 2008; Milner and Mukherjee 2009).

The cacophony of arguments and theoretical mechanisms proposed is perhaps not surprising when we consider that there is little consensus about the complex macroeconomic and distributional effects of capital account liberalization (Bhagwati 1998). To advance the debate, scholars needs to build on a clearer understanding of the distributional consequences of financial market liberalization, and then examine how and under what conditions these affect the policy-makers' decisions. To do this, research may have to unpack financial market liberalization further and examine separately the regulations targeting different types of investment flows. This dissertation takes a step in this direction and provides an analysis of government policies on the entry and operation of FDI.

2.3. Foreign direct investment and the welfare of domestic workers and capital

Foreign direct investments have long-lasting distributional implications for the host economy. Multinational companies tend to be large industry players with deep pockets, considerable competitive advantage, and often with enough weight to influence the rules of the game even in mature industrial economies. Their entry into developing countries can visibly alter the industry landscape by attracting the most qualified labor, employing the most competitive suppliers, working their way into or even restructuring distribution chains, and providing more competitive goods and services in the product

markets. Domestic companies competing head-to-head with multinationals are likely to see their margins decline following the entry of foreign companies. By contrast, workers employed by multinational corporations or by local companies competing with them are likely to see their wages go up as a result of increased competition in the labor market and higher emphasis on labor productivity.

This section discusses the effects of FDI on wages and local firms, and reviews the empirical research examining them. The discussion pays particular attention to what the impact of MNE investments was expected to be in former communist countries.

2.3.1. Multinationals and domestic workers

Public controversy regarding the treatment of workers by multinationals in developing countries has renewed interest in understanding how FDI affects domestic labor. Economists comparing the experience of workers in multinational subsidiaries to that of workers employed in local firms find that foreign affiliates pay higher wages and tend to provide better conditions than their local counterparts. In an extensive survey of host- and home-country effects of FDI, Lipsey (2002) concludes:

> It is rare to find a study of FDI and wages that does not find that foreign-owned firms pay higher wages, on average, than at least privately-owned local firms. That is not only in developing countries, where most of the research has taken place, but also in developed, high-wage countries. To some extent, the differential can be explained by the industry composition of FDI, weighted toward relatively high-wage industry sectors. However, the differential exists within industries, in most industries, and in most countries. (20)

For instance, in Morocco, wages in foreign subsidiaries are 70 percent higher on average than in locally owned firms, and 30 percent higher when adjusted for firm size (Haddad and Harrison 1993). Between 1975 and 1999, wages in Indonesian manufacturing industries were between one and a half to three times higher in foreign-owned than in domestic private plants (Lipsey and Sjöholm 2004). Statistically significant differences between wages in foreign-owned and domestically-owned plants have been reported in Cote d'Ivoire, Morocco and Venezuela (Harrison 1996), Mexico, Venezuela and the United States (Aitken et al. 1996), Cameroon, Ghana, Kenya, Zambia and Zimbabwe (te Velde and Morrissey 2003), and Brazil, Indonesia, Portugal, Germany and the United Kingdom (OECD 2008).

The presence of foreign-owned firms may also have an indirect positive effect on wages in domestic firms. This can happen because the employment activities of foreign-owned firms affect the local labor market or because the productivity advantage of multinationals spills over to local firms. (Feenstra and Hanson 1997) argue that in the northern Mexican regions where many multinationals invested, growth in FDI can account for over 50 percent of the increase in the skilled labor wage share that has occurred since the late 1980s. Using a cross-section of worker-level data, Lipsey and Sjöholm (2004) also find that FDI is positively associated with average wage levels in domestic firms.

In Eastern Europe in particular, the transition from a state-controlled socialist economy to market-based capitalism was not kind to the region's labor force. Real wages fell quickly and life savings evaporated due to inflation. Many state-owned enterprises were paralyzed by the new system and wages were months or even years overdue. Restructuring called for the elimination of excess labor, and 20-30 percent unemployment rates became common in countries where socialist governments once guaranteed full employment. Where jobs survived, working conditions were nothing to boast about: little protective equipment, poor ventilation and low lighting. There was little hope that conditions in nearly bankrupt local firms would change. When foreign firms set up shop next to the old socialist factories, the differences were striking and many jumped at the opportunity for better work.

In a recent account of the impact of multinationals on the economic transformation of Eastern Europe and the former Soviet Union, Lewis observes that Westerners find it "hard to appreciate the humiliations that workers in much of Eastern Europe and the former Soviet Union have suffered. For them, the arrival of an employer with an international reputation, introducing better health and safety standards, and offering both higher pay (on time) and modern training, must have seemed little short of a miracle" (2008: 45). When multinationals started investing in the former communist countries, people queued for job interviews like they used to queue for bread a few

years earlier. “Every time a multinational announced a hire, CVs poured in and people lined up in front of the building. Everyone wanted to work here” (personal interview, July 2007).

Great hopes regarding the benefits that multinational investments can bring to the host economy, including expectations for better pay and working conditions, were mixed with fears that takeovers by multinationals would be followed by significant layoffs. State-owned enterprises, whether sold to foreign or to domestic investors, required considerable restructuring in order to survive. Multinationals had the means to implement dramatic re-organization more quickly and more effectively than domestic investors, and many feared that their investments would be at the expense of hundreds, or even thousands of jobs.

Fears about dramatic job losses were partly assuaged by governments who negotiated no-layoff guarantees as part of privatization agreements. Aware of the impact massive layoffs would have on regional or even national economic and political stability, governments had strong incentives to ensure that investors agreed to a delayed, gradual reorganization of labor. The multinationals agreed. Cost savings could be made in other areas and companies typically wanted to avoid mass layoffs that would give the company a very bad image in the local community from the outset. For example, in Romania, when Sidex-Galati, a steel giant which still employed 28,000 in

1996 (down from 45,000 in 1989), was sold to LNM Mitall, the investor agreed not to make mass redundancies for five years. In Tula in Russia, when Procter & Gamble acquired the overstaffed local detergent maker Novomoskovskbytkhim, the company retrained part of its employees to set up firms that would provide auxiliary services such as transportation and cleaning to the P&G plant (Lewis 2008: 53).

Moreover, studies show that when multinationals acquire local enterprises, wages increase in subsequent years. In Indonesia, foreign takeovers resulted in average wage increases of 10 percent for low-skilled workers and 21 percent for high-skilled workers (Sjöholm and Lipsey 2006). A recent OECD study provides further evidence that in both developed and developing countries, foreign takeovers of domestic firms tend to raise average wages relative to increases that would have occurred in the absence of takeovers. The effects range from 5 percent in the U.K. and 8 percent in Portugal, to 11 percent in Brazil and 19 percent in Indonesia (OECD 2008).

Statistical evidence suggests that domestic workers benefit from both greenfield and cross-border M&A multinational investments in their countries. The picture is more mixed with regard to the effect of FDI on domestic capital.

2.3.2. Foreign direct investment and domestic firms

Economists tend to agree that the entry of foreign companies hurts domestic investors. Foreign companies increase competition in both the product and the labor

market. Downward pressures on prices in the product market and upward pressures on wages in the labor market result in lower margins for domestic producers (Navaretti and Venables 2004). Caves (1996) argues that the entry of multinationals reduces the market share of domestic incumbents – a "market stealing" effect (Aitken and Harrison 1999) – and can even lead to the exit of domestic firms.

Anecdotal evidence across industries and geographical locations supports this argument. Multinational companies from emerging markets expanded abroad in response to intensified competition in their home markets following the entry of foreign competitors. Cemex, the Mexican leader in cement, saw its profits decline quickly when its home market position was challenged by the entry in the mid-1980s of global industry leaders Holcim and Lafarge. To remain competitive, Cemex responded by acquiring operations in Spain. More recently Haier, the leader in home appliances in China, saw its profitability decline after the entry of global industry leaders Whirlpool and Electrolux, who invested billions in production and distribution facilities in China. Haier believed that competing with large multinationals in its home market alone would be a losing strategy and it decided to invest in its own expansion in the U.S., Europe and India.

It is harder to say whether the effects of increased domestic competition following foreign entry are balanced by positive spillovers in the economy.

Multinationals have higher productivity than local firms in both developed and developing economies (Lipsey 2002; Gorg and Greenaway 2004). In transition economies, for example, the European Bank for Reconstruction and Development (2005) reports that productivity is considerably higher among foreign-owned firms than domestic firms. Foreign firms have 39 percent more sales per worker and a 42 percent higher total factor productivity relative to state-owned enterprises. New private firms have 18 percent more sales per worker and 23 percent higher total factor productivity, while privatized firms have 10 percent more sales per worker and 10 percent higher total factor productivity than state-owned firms (EBRD 2005).

What remains unclear is whether the entry of foreign companies helps increase the productivity of domestic firms. As Rodrik points out, "Today's policy literature is filled with extravagant claims about positive spillovers from FDI but the evidence is inconclusive" (1999; see also Blomström et al. 2001; Gorg and Greenaway 2004). A number of studies examining whether the presence of foreign firms affects the productivity of domestic firms in the same sector find little evidence of such spillovers in developing countries (Haddad and Harrison 1993; Aitken and Harrison 1999; Kathuria 2000; Lopez-Cordova 2002). Studies assessing these effects in transition economies find either evidence of negative spillovers (e.g., Djankov and Hoekman 2000) for the Czech Republic, Zukowska-Gagelmann (2000) for Poland, Konings (2001) for

Bulgaria, Poland and Romania, and (Damijan et al. 2003) for Bulgaria, Czech Republic, Estonia, Hungary, Poland, Romania, Slovakia, and Slovenia), or no evidence of positive effects (Kinoshita 2000; Bosco 2001).

Multinationals may not be willing to share technologies and know-how with their local competitors, which would explain the absence of horizontal spillovers, but they have incentives to encourage technological upgrading in local firms that provide intermediate inputs. Javorcik (2004) argues that spillovers from a multinational presence are more likely to take place through such backward linkages and provides evidence based on the analysis of firm-level data from Lithuania. Her study also shows no evidence of either horizontal spillovers to domestic firms competing with multinationals or forward spillovers to firms buying inputs from multinationals. This suggests that even when the presence of multinationals is associated with positive spillovers to local businesses, these effects are limited to a small subset of firms (Lin and Saggi 2005; Javorcik and Spatareanu 2005).

Overall, the empirical evidence suggests that multinational investments hurt the position of domestic firms by increasing competition in local product and labor markets. Positive spillovers, if present, are mostly limited to a small number of local firms. Consequently, local firms have incentives to oppose the removal of barriers to FDI. (Chari and Gupta 2008) argue that when the Indian government proposed the

liberalization of foreign entry in 1991, a number of industries lobbied in opposition. They show that as a result, the government allowed FDI in only 46 of 96 industrial categories, and provide evidence that liberalization was limited in industries with high concentration and high state-ownership, and especially in industries with profitable state-owned firms. As their study shows, the liberalization of foreign direct investment is likely to evoke considerable opposition from domestic firms because they expect foreign entry to result in lower profits.

2.3.3. Anticipated effects and FDI policy preferences

A final question must be resolved before the different pieces of the puzzle can be put together in the theoretical framework I propose. Are these anticipated effects reflected in expressed preferences for FDI? Do publics support multinational investments, and do capital owners oppose them? Are policy-makers and their supporters in agreement about the necessity to allow or restrict the entry and operations of foreign firms?

It is important to note that *ex ante* recognition of the benefits of FDI among voters is not a necessary condition for the liberalization of foreign direct investment. Even if workers are not aware that attracting multinational investment is a fast way to provide better wages and working conditions, policy-makers are likely to eliminate barriers to FDI in order to achieve these benefits for their supporters. Democratic leaders need only

believe that voters will be aware of the benefits *ex post* and that they will reward politicians for their policy choices.

Scholars have often questioned the ability of voters to understand the costs and benefits of complex economic policies. With regard to capital account liberalization, Brooks and Kurtz argue that "The average citizen is in a difficult position to evaluate the likely consequences of the freer movement of investment across international borders, and most typically is not aware of such reforms prior to their adoption" (2007: 708). The effects of multinational investments are more visible and therefore easier to appreciate. However, there is almost no systematic analysis of FDI preference among different publics.

In Latin America, a region with a long history of foreign investment, the translation of economic benefits into preferences for FDI is easy to observe. Using individual-level survey data provided by Latinbarometer data for 18 Latin American countries, Pandya (2010) shows that labor supports investments by foreign firms. The effect is stronger for highly skilled workers, whose skills are in high demand in multinational enterprises.

No similar study has tested these effects for former communist countries, but I believe that the results would be even stronger, especially if one controlled for the timing and mode of privatization. Where privatization started early and involved

foreign investors from the outset, opponents of FDI question the legitimacy of policies that allowed multinationals to take over the "family silver." But where privatization favored political insiders, the public demand for FDI was high. Even a former communist activist working in Slovakia's steel giant, VSZ Kosice, accepted multinationals as legitimate economic participants, noting that "They have been good for us, and good for the country. I have no problems with them" (Lewis 2008: 44).

Throughout the 1990s, the most vocal opponents of FDI stressed that foreign ownership would lead to widespread unemployment and the surrender of national economic sovereignty (Stark and Bruszt 1998). Proponents of FDI emphasized multinational investments as an important channel for economic recovery and integration into the world economy. They argued that allowing foreign investors to participate in national economies would have great economic benefits (Artisien-Maksimenko and Rojec 2001).

Some of the public shared these democratic leaders' belief that foreign investment is beneficial for the local economy. Using survey responses from the early 1990s, Rohrschneider and Whitefield (2004) show that individual-level support for foreign ownership is best explained by ideological orientation, especially a commitment to the principles of a free-market economy versus state interventionism. Interestingly, support for foreign investment during these first years of the transition was lower

among the public in more democratic regimes. This is very likely because in these countries the issue of foreign ownership was salient from the onset of economic reforms. Political debates highlighted the potential benefits of FDI, but also played to fears of losing control of critical domestic enterprises and surrendering national economic sovereignty. The survey data analyzed by Rohrschneider and Whitefield (2004) reveal that support for foreign investment was moderate in the first years of the transition, ranging from a low of 24 percent in Hungary in 1993 to 64 percent in Lithuania in 1993.

In many countries, opposition to FDI peaked during debates over the privatization of the most competitive domestic enterprises, which were very attractive to foreign investors but also considered by many to be the "family silver" that should remain under local control. The lack of panel survey data does not allow us to establish this fact empirically, but regional analysts and observers agree that concerns over the role of FDI surfaced only when foreign investors were portrayed as "taking over" national industries during privatization deals (personal interviews; see also Bandelj 2007; Sinn et al. 1997). In Slovenia, for example, people were afraid that wealthy Western Europeans would buy everything in their economy. "If they have enough money they can buy whatever they want and we don't have the power to stop them," argued Mira Puc, a managing director of the Agency for Privatization in the early 1990s (Sinn et al. 1997: 206).

But after the privatization process was complete and multinationals could only invest in greenfield projects, support for FDI increased. A 2006 survey conducted in Poland by the Public Opinions Research Center shows that about 60 percent of Poles viewed FDI in Poland as beneficial, while only thirteen percent have a negative view of FDI (PAIZ 2006). Similarly, a 2006 European Bank for Reconstruction and Development study reflecting individual sentiments about life in transition shows that most people have a positive attitude toward foreign investors. The survey asks respondents about the extent to which they trust foreign investors, so responses do not reflect the respondents'' beliefs about the economic benefits of FDI, or their preference to see more or less foreign investment in their economies. It is nonetheless worth noting that with few exceptions, citizens in transition economies trust foreign investors (see Table 2.1).

Table 2.1 Levels of trust in foreign investors in transition economies, 2006

COUNTRY	Distrust FDI	Do not distrust FDI	Difficult to say
Albania	28.90	65.86	5.24
Armenia	24.20	66.10	9.70
Azerbaijan	22.80	55.60	21.60
Belarus	30.06	49.60	20.34
Bosnia	43.44	52.55	4.00
Bulgaria	44.40	34.30	21.30
Croatia	52.50	36.80	10.70
Czech Republic	25.10	57.80	17.10
Estonia	20.10	51.10	28.80
Fyrom	40.40	51.00	8.60
Georgia	26.00	53.50	20.50
Hungary	42.70	42.20	15.10
Kazakhstan	30.40	49.60	20.00
Kyrgyzstan	27.10	58.00	14.90
Latvia	22.20	58.40	19.40
Lithuania	22.40	58.80	18.80
Moldova	26.50	48.50	25.00
Mongolia	21.20	49.10	29.70
Montenegro	28.40	62.80	8.80
Poland	29.90	52.70	17.40
Romania	37.20	53.30	9.50
Russia	42.60	31.50	25.90
Serbia	43.23	48.65	8.12
Slovakia	36.06	51.25	12.69
Slovenia	25.03	56.18	18.79
Tajikistan	9.50	66.10	24.40
Ukraine	39.80	40.90	19.30
Uzbekistan	16.80	54.80	28.40
Total	30.68	52.04	17.29

Note: Distrust FDI reflects percentage of respondents who expressed complete or some distrust towards foreign investors. Do not distrust FDI reflects the percentage of responders who answered that they have complete or some trust in foreign investors, or that they neither trust nor distrust FDI.

Reporting on political changes in Slovakia following the removal from power of Vladimir Meciar and his cronies, Lewis recalls an unusual episode, at least by Western standards, of industrial action in the country's capital. In 1999 Slovak workers marched to the government offices in Bratislava, demanding better wages, more secure jobs and improved working conditions. Their battle cries might have sounded unfamiliar to trade unions in the West; the Slovaks wanted their government to do more to attract big multinational companies to the country. The marchers believed that they had more chance of achieving their goals by working for the subsidiary of a major western corporation than by taking industrial action against local employers. In effect they were saying to the government: bring us jobs – but good ones (2008: 44).

Such calls were not uncommon in former communist countries. Workers might have marched to their own government offices across the region, had political action been allowed everywhere.

2.4. Political competition and FDI regulations

Across the world, foreign investments were and continue to be a means of redistributing economic resources among politically important groups. The anticipation that foreign direct investment benefits labor and hurts owners of domestic capital shapes these groups' preferences regarding FDI regulations. Owners of domestic capital, who expect to see their profits decline as a result of increased competition, favor greater

restrictions on multinational companies. By contrast, owners of domestic labor prefer the liberalization of FDI entry. Which group gets its way depends on the country's political regime.

In democracies, the right to vote is deemed to be a fundamental human right. All citizens above the voting age are entitled to participate in the selection of government leaders and their votes are weighted equally. Representatives of different groups compete for elected office and incumbents face a fair probability of being removed from office through elections. An inclusive and competitive selection process ensures that democratic regimes draw their support from broad electoral bases. Public policies, especially economic policies with significant redistributive consequences, need to address the interests of broad constituencies.

In stark contrast to the openness of political participation in democratic countries, the selection of political leadership in non-democratic regimes is restricted to a small group of powerful members of society. This happens either formally—by managing the selection of leadership within the ranks of the dominant political organization, or informally—through electoral fraud, manipulation, or intimidation. The group which determines the selection of political leaders—"the *selectorate*" in Bueno de Mesquita et al.'s terminology (1999, 2003)—includes only a subset of the population in authoritarian systems. It includes the elites in control of enough instruments of power

to determine the leaders' survival in office (*e.g.*, domestic industrialists, military leaders, and members of the dominant party). Economic power translates into political sway, so the *selectorate* in non-democratic regimes encompasses most of the wealthiest members of society.

Foreign investment flows are an important channel for redistributing economic resources among political constituencies. As discussed in the previous section, FDI is expected to increase the welfare of domestic workers and hurt the income of owners of domestic capital. Democratic governments are likely to choose policies that welcome the entry and operations of foreign firms because these bring better jobs and better pay for domestic workers, who form the majority of the electorate in democratic countries. Conversely, non-democratic countries restrict foreign direct investment because wealthy elites, who own or manage domestic capital, anticipate losses from increased competition in their local markets. In short, I argue that democracies allow the free entry and operation of multinational enterprises, while non-democratic regimes restrict FDI.

In non-democratic regimes, the equilibrium of political support and survival is a delicate one. Leaders need the support of powerful elites, which are critical to their survival and the consolidation of their regime. At the same time, those who support the leader depend to a large degree on his power to continue to enjoy their special privileges, including access to government resources and contracts, and to positions of

influence. Policy innovations threaten to upset this delicate balance. They introduce uncertainty over the level of political advantage and economic rents channeled to regime supporters, and the latter's response to the new institutional arrangement. At the same time, changes in institutions, especially economic reforms with strong redistributive effects, may enrich competing groups, increasing the threat to the incumbent leader and his close supporters. As Acemoglu and Robinson argue, "political elites will block beneficial economic and institutional change when they are afraid that these changes will destabilize the existing system and make it more likely that they will lose political power and future rents" (2006: 115). To preserve their political support and ensure survival in office, non-democratic governments use economic policies to protect the interests of loyalists who control domestic enterprises. Thus, they continue to restrict FDI in order to shelter domestic firms from increased competition in the local market.

Democratization shifts the center of political control. It weakens the influence of former elites and expands the *selectorate* to incorporate previously excluded constituencies. Democratization involves a change in the position of the median voter, who no longer represents resource-rich, vote-poor political insiders but rather the interests of resource-poor, vote-rich constituencies (i.e. domestic labor). Previously excluded groups gain influence and their policy positions enter into policy calculations. At the same time, as Weyland suggests, "Democratization reduces the political clout of

the vested interests that benefited the most from the old development model, such as protectionist business sectors and the military" (2002: 60). Thus, political liberalization redefines the constituencies to which the government responds, and therefore the incentives behind economic policy-making.

To ensure their own survival, governments in new democratic states must find ways to reward those who helped bring down the old regime, to appeal to broad sections of the electorate, and to reduce the sway of politically active representatives of the old regime. In many developing countries, FDI inflows can help governments achieve at least the last two of these three objectives. To appeal to a broad electorate, whose welfare depends on wages, governments need to create new and better jobs, and FDI can do this. To weaken the economic position of domestic industrialists who supported the old regime, governments need to increase competition in the local economy, and FDI can do this, too. Consequently, governments in new democratic countries have strong incentives to attract FDI. I argue that episodes of political liberalization are likely to be closely followed by government decisions to eliminate enduring FDI restrictions and create institutions that help promote multinational investments.

As previous sections have highlighted, democratization has been a powerful force behind economic reforms across the developing world. New governments which

must take into account the preferences of "new" constituencies have to look for ways to shift the allocation and distribution of resources. They have done so through a number of market-oriented reforms, including the liberalization of trade (Milner and Kubota 2005; see also Garrett 2000) and capital account controls (Quinn 2002). This study makes a very similar argument with regard to FDI policy changes. To illustrate the dynamics proposed in this theoretical framework, the following section discusses FDI regulations in transition economies, where post-1989 political transformations have brought about substantial changes in national policies on FDI.

2.5. What took them so long?

In the eyes of Gabriel Eichler, a Slovak émigré who had been brought in to salvage VSZ Kosice (a giant steelworks in Eastern Slovakia) and to manage its sale to the U.S. Steel Corporation, the question is not why foreign companies came, but what took them so long (Lewis 2008). For foreign investors, the answer is simple: discriminatory government policies and practices suggesting high political risk. Thus, the question may be more appropriately directed to the Slovak leaders: Why did FDI liberalization take them so long?

Following Slovakia's independence in 1993, the rule of Vladimir Meciar and his party was marked by the concentration of political and economic power in the hands of loyal allies, much to the dismay of the country's Western allies. As Innes remarks,

“Meciar went quite publicly for the clan-economy, the placing of party men in crucial industrial, bureaucratic, educational and media positions, and the clientelistic distribution of state assets to loyal followers, signaling clearly that to be a ‘party man’ was once again the way to get ahead” (2001: 270). During the Slovak privatization program, most of the country’s largest companies were sold, usually at laughable prices, to a small circle of political supporters. VSZ Kosice is a case in point. In 1994, Meciar approved the decision to sell 15 percent of VSZ to a shell company set up that same day by Alexander Rezes, the minister of transport and a close friend of the prime minister (Lewis 2008). Rezes, who soon became the country’s richest man, did little to upgrade VSZ or find it new markets, and by 1998 the steel giant was running more than $250 million in yearly losses.

During Meciar’s authoritarian rule, the government repeatedly expressed concerns about foreign ownership of Slovak companies (USCS 1999). To build and maintain a crony-capitalist system based on a powerful governing party and its leader, foreign investors had to be excluded from the privatization program. As Lewis notes,

> By creating an inner circle of multi-millionaires who owed their entire fortune to prime ministerial patronage, Meciar was attempting to build an impregnable power base from which to manipulate or control all other institutions of state. Foreign multinationals, with their deep pockets, global reach and independence, were clearly not so easily pushed around and were therefore largely excluded from privatization. Despite the fact that Slovakia, like most of the region, was crying out for western expertise and capital, only seven out of nearly 800 companies sold in 1995-96 involved any foreign investment. (2008: 168)

Meciar's rule was ended by defeat in the parliamentary and presidential elections of 1998-99. The new democratic government of Mikulas Dzurinda made the promotion of foreign direct investment one of its top priorities. Bringing in foreign companies was critical to curtailing the economic power of Meciar's oligarchs, linking the Slovak economy to the West, and ultimately consolidating the democratic institutions that brought them to power. Finding a foreign investor to rehabilitate VSZ—Slovakia's largest industrial group, employing 25,000 people in an area impoverished by Meciar's slow economic reforms, and also the centerpiece of Rezes' empire, and the "iron fist" who sponsored the ruling party (Anderson 2000)—would accomplish these goals. The new government believed that "selling VSZ to a Western firm would send a message to Meciar and his allies that crony capitalism in Kosice was a thing of the past, and would show western governments and investors that Slovakia had ridded itself of a particularly nasty case of it" (Lewis 2008: 170). In 1999, US Steel bought VSZ for almost $500 million and committed to invest $700 million more. The American company soon turned things around and made the Kosice steelworks the company's most profitable operation. But "from the Slovak point of view, the deal was not only about business, but also a means to help preserve the country's newly won democracy" (171).

Slovakia's story is not unique. In Croatia, Franjo Tudjman's strategy of consolidating his authoritarian grip on government through the economic

empowerment of loyal supporters mirrors Meciar's. Tudjman reportedly affirmed that Croatia's economic transition must be achieved through the creation of "two hundred Croatian capitalists" who would own and run the most important businesses in the country (personal interview, 2005). During the privatization process, his cronies were granted favors, including monopolies, licenses and generous loans (Brcic 2000), while interested foreign investors were kept away. According to a top advisor in Tudjman's HDZ party, the government "used the privatization process to create a new elite, the same as in other transition countries" (J. Smith 2000). Tapes released by the democratic coalition that defeated the HDZ following Tudjman's death in 1999 revealed conversations in Tudjman's office (recorded at his request) about the financial schemes under which the president and his allies would gain control over some of the country's most valuable economic assets.

The crackdown on Croatia's tycoons through criminal investigations and indictments was a clear effort by the new government to put an end to the economic and political power of Tudjman's supporters. Croatia's first foreign investment code was passed by parliament less than six months after Tudjman's death and the Trade and Investment Promotion Agency was established soon afterwards.

The privatization process was tainted by stories of corruption in every transition economy in the former Soviet bloc, but the extent to which foreign investors were

invited to participate is an indicator of each government's desire to strengthen or weaken political insiders. In Hungary, for example, where democratic political groups defeated the former communist party in the country's first democratic election in 1990, the government emphasized the participation of foreign investors in the privatization of Hungarian state-owned enterprises. Hungary enacted one of the region's first foreign investment laws that eliminated limits on foreign equity in most sectors. In 1993, the government also established the Investment and Trade Development Agency (ITD Hungary), which is often praised as one of the most active and effective institutions for FDI promotion in the world (World Bank Group Advisory Services: Investment Climate 2009).

By contrast, FDI liberalization has been very slow in Belarus and the Central Asian republics. The Belarus president, Alyksandar Lukashenka, who came to power in 1994 by playing on people's fear that the deterioration of Soviet structures would bring about chaos and impoverishment, consolidated his authoritarian grip on power through controversial referenda in 1996 and 2004, and was re-elected in 2006 for a third consecutive term in office. He has repeatedly expressed his disdain for foreign investors "who like cockroaches penetrate every hole and crack" (quoted in USCS 2005) and never fails to emphasize that his government maintains strict control over foreign companies. Interested investors are carefully screened and granted approval only if they can

persuade the government that their project has positive implications for the Belarusian economy and people.

Further east, the governments of Kazakhstan, Uzbekistan, Tajikistan and Turkmenistan also restrict the entry and operations of foreign companies. In Kazakhstan, Nursultan Nazarbayev, who has been in office since 1989, has built a strong presidential regime by allowing an inner circle of close family, friends and business associates to exert formal and informal influence over valuable economic resources and political positions. In the 1990s, Nazarbayev skillfully reorganized the country's political and economic structures to gradually weaken the powerful Russian elites making up most of the country's bureaucratic apparatus, and to replace them with loyal cronies who owed their welfare to himself.

To orchestrate this elite replacement without an open conflict between the Russian and Kazakh ethnic groups, Nazarbayev allowed Western companies to acquire industrial interests managed by Russians, including those in its oil, gas, mining and steel sectors. As the threat of Russian dissent was avoided and his power consolidated through constitutional amendments that eventually granted him a lifelong term in office, Nazarbayev turned against the same foreign investors. The government claimed that the deals it had granted foreign investors at the beginning of the 1990s were unfair to the Kazakh people, and insisted on renegotiating production-sharing agreements to

give shares to local firms and to ensure that sufficient inputs were sourced from local firms controlled by his own allies. The Kazakh government continues to screen all foreign direct investments through a slow and opaque process that involves negotiations with the almighty State Investment Committee that was established in 1996.

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Across the region, foreign investments were and continue to be a means of redistributing economic resources among politically important groups. In countries where democratic governments came to power soon after the demise of the communist regimes, allowing foreign companies to build new enterprises or to acquire aging industrial groups was both a way to consolidate electoral support and an effort to prevent old elites from siphoning off the assets of state-owned enterprises. In sharp contrast to the speedy FDI liberalization in newly democratic regimes, FDI reforms were delayed in countries where former communist elites survived in power and were lukewarm at the prospect of foreign investment undermining the economic resources of their power base. When democratic forces eventually gained power in the mid or late 1990s, FDI restrictions were removed, while they continue to endure in the least democratic regimes of the region.

3. FDI Regulations in Transition Economies: History, Measurement and Assessment

3.1. Introduction

At the end of the 1980s, most countries that were about to shed decades of communist governance still banned foreign direct investment. Soon after new democratic governments came to power in the region, barriers to FDI started to come down and were replaced by policies that aimed to attract multinational investments. This dissertation argues that the liberalization of FDI policies is the result of deliberate choices by democratic governments who saw foreign investment as a means to create new and better jobs. In contrast, enduring non-democratic regimes maintained FDI restrictions to safeguard the welfare of regime cronies, which would have been negatively affected by increased competition with foreign firms.

This chapter provides a history, a measurement and an assessment of FDI regulations in the 28 former communist countries. Section 3.2 presents a brief account of the evolution of FDI regulations in these countries, starting with the provisions for foreign investment at the end of the 1980s and highlighting the main policy developments across the region since 1989. Section 3.3 discusses the methodology used for creating policy measures that allow comparisons of FDI regulations across countries and across time. Section 3.4 tests the theoretical argument developed in Chapter 2 using

the new data that captures FDI openness in transition economies between 1989 and 2008, as well as an alternative index of FDI freedom available for a worldwide sample starting in 1994.

3.2. A brief history of FDI regulations in former communist countries

Before the fall of the Berlin Wall, investments by foreign enterprises were banned or severely restricted in all countries of the Eastern bloc. By 1985, only Yugoslavia, Romania, Hungary, Poland and Bulgaria had removed complete bans on foreign investment to allow limited foreign participation in joint ventures. Nonetheless, substantial restrictions, including foreign equity limits, strict approval requirements, and controls on the repatriation of profits, amounted to significant barriers to FDI. While foreign investment restrictions were revised in several countries in the late 1980s, significant FDI policy changes were not enacted until after the fall of communist regimes. Furthermore, several former communist countries delayed the liberalization of FDI legislation until the late 1990s or beginning of 2000s, while a few continue to restrict foreign investment on their territories.

This section discusses some of the most important policy developments in the former Eastern bloc. It highlights that even where legislation was changed to permit foreign investments in joint ventures during the communist regimes, remaining

restrictions severely limited the entry and operation of foreign companies. Important policy changes were enacted throughout the region since the end of the communist rule, but there is considerable variation in the timing and extent of FDI liberalization in these 28 transition economies.

3.2.1. FDI regulations at the beginning of the 1990s

Yugoslavia was the first communist country to allow limited foreign investments. Regulations enacted in 1967 allowed foreign investments the right to participation in management and profit sharing, but not in the ownership of factors of production. Foreign investors possessed contractual rights, but not an equity interest in the joint venture, and were allowed to remit up to one half of their net annual earnings (Jadach 1985). The right to establish wholly owned enterprises and to acquire equity in joint ventures was granted to foreign investors at the end of 1988 (Dobosiewicz 1992). Restrictions were maintained in a small number of economic sectors, including telecommunication, air transport, publishing, and broadcasting.

Since 1971, Romania also allowed foreign companies to hold up to 49 percent equity in joint ventures with state-owned enterprises. However, foreign investors were required to consult with various planning committees and ministries, and to demonstrate that the investment can bring significant economic benefits such as new technologies and increased exports in order to obtain the approval of the Council of

Ministers (Jadach 1985). Foreign investors were further asked to submit one-year and five-year plans to the government to facilitate economic planning, while also being required to keep their accounts and negotiate all contracts in convertible currencies. In practice, these requirements discouraged foreign investors and the flows of foreign capital were insignificant during the communist years.

In Hungary, the complete ban on foreign investment was removed in 1972, but even at the end of the 1980s foreign companies were allowed to operate in Hungary only as partners in joint ventures with domestic enterprises and only as long as their equity holding did not exceed 40 percent (Dobosiewicz 1992). As a result, FDI flows were almost negligible. New FDI legislation introduced in 1988 simplified the formalities required to set up a joint venture but maintained restrictions on the repatriation of profits, which were limited to the enterprise's hard currency earnings. Drastic legislative changes were introduced in 1990-1991, when the government agreed to eliminate approval requirements for FDI, to allow foreign investors to establish wholly-owned enterprises and to repatriate earnings without limitations, and guaranteed market-value compensation in the event of government expropriation (Gray and Jarosz 1995; OECD 2000).

In Poland, foreign investment was permitted under strict and often contradictory regulations since 1976, but mostly in small businesses established by foreign nationals of

Polish decent (so-called “Polonia” firms) (Gordon 1990; Dobosiewicz 1992). The legislation on foreign investment was revised in 1989 to allow the establishment of limited liability and joint stock companies with up to 100 percent foreign equity (Gordon 1990). However, foreign investors could only remit 15 percent of the profits realized in Poland, needed special permission from the Ministry of Internal Affairs for any land purchases, and were required to formally apply for approval at the Foreign Investment Agency. At the beginning of 1990, the legislation was widely criticized by both foreign investors and Polish officials, including the Foreign Investment Agency and the Ministry of Foreign Economic Relations, which agreed that the rules needed change (Dobosiewicz 1992).

In March 1980, Bulgaria became the fifth country in the Eastern bloc to authorize foreign investment. Throughout the 1980s, the government adopted what was seen at the time to be a very liberal FDI policy framework. It allowed the creation of wholly-owned foreign subsidiaries as well as joint enterprises, and did not restrict the fraction of profits that could be repatriated (Jadach 1985). Nonetheless, remittances had to be made out of export earnings and the president and managing director of the enterprise had to be Bulgarian nationals. Furthermore, all foreign investments required the approval of the Council of Ministers (Jadach 1985; Dobosiewicz 1992). Restrictions on the entry and operations of foreign companies were eased starting in 1989, when

formalities for setting up joint ventures were simplified and most of the restrictions on profit repatriation were removed (Dobosiewicz 1992).

In Czechoslovakia, the door to foreign investment was not opened until 1986, and even then foreign participation in joint ventures was limited to 49 percent and profit transfers were regulated by permits issued on a case-by-case basis. Income tax was set at 50 percent and an additional 25 percent was imposed on hard currency remittances. Furthermore, all key management positions had to be filled by Czechoslovak citizens (Dobosiewicz 1992). These restrictions involved significant costs for foreign investment, which was negligible in the 1980s.

Further east, the Soviet Union banned FDI altogether until 1987, when a Decree on Joined Enterprises was enacted to allow joint ventures with foreign companies for the first time since the 1930s (Frenkel and Sukhman 1993). The decree limited foreign participation at 49 percent and required joint enterprises to submit for approval a set of "foundation documents," including a feasibility study for the proposed venture. Approval was required from the administrative authority overseeing the Soviet state entity, as well as from the Ministry of Finance. While the law provided for duty-free import of equipment and material, as well as a two-year tax break for joint ventures, foreign investors had little guarantees that any profits generated could be repatriated since the ruble was not freely convertible at the time.

In October 1990, a Presidential Decree on Foreign Investment proclaimed for the first time that foreign companies were welcome in the Soviet Union in any form allowed by domestic laws. Legislative drafts, including the Draft of the USSR Law on Foreign Investment in the Soviet Union (October 1990) and the Fundamentals of Law on Investment Activity (December 1990), paved the way for an investment regime that granted foreign investors the right to invest in all sectors of the economy and guaranteed the protection of foreign investments. However, the ideological struggle between Communist apparatchiks and reformers, which translated into a "war of laws" between the central and republican governments and into fighting for the right to have priority in legislative and regulatory matters, stalled the liberalization of foreign investment legislation (Frenkel and Sukhman 1993). A USSR Foreign Investment Law was enacted on July 4, 1991, but the collapse of the Soviet Union at the end of 1991 opened a window for republican governments to adopt their own laws on FDI.

3.2.2. FDI regulations since the early 1990s

Across the region, there has been significant variation both in terms of the timing and the extent of FDI liberalization following the fall of communist governments. Table 3.1 highlights the evolution of FDI codes—both the year of the first FDI law and the year when foreign investors were formally granted equal treatment with local investors (or

national treatment)—and the establishment of investment promotion agencies (IPAs) across all 28 transition economies.

Table 3.1 Time of first foreign direct investment laws and the establishment of investment promotion agencies in transition economies.

Country	First FDI law after 1988	National treatment introduced in law	Investment Promotion Agency
Albania	1990	1994	2006
Armenia	1994	1994	1998
Azerbaijan	1992	1992	2003
Belarus	1991	1991	No IPA
Bosnia & Herzegovina	1995	1998	1999
Bulgaria	1991	1992	1997
Croatia	No FDI law	1995	2006
Czech Republic	No FDI law	1995	1993
Estonia	1991	1991	1994
Georgia	1995	1995	2002
Hungary	1988	1989	1993
Kazakhstan	1994	1994	1998
Kyrgyz Republic	1991	1991	No IPA
Latvia	1991	1991	1993
Lithuania	1990	1991	1997
Macedonia	1993	1993	2007
Moldova	1992	1992	1998
Mongolia	1990	1993	1993
Poland	1990	1996	1991
Romania	1991	1991	2002
Russia	1991	1991	2001
Serbia & Montenegro	2002	2002	2001
Slovak Republic	No FDI law	1993	2001
Slovenia	1988	1991	1996
Tajikistan	1992	1992	No IPA
Turkmenistan	1992	1993	No IPA
Ukraine	1993	1993	2005
Uzbekistan	1991	1994	2007

Recognizing that in former communist countries outdated legal regimes and the prospects of significant policy reforms can deter foreign investors, most governments in transition economies chose to create a specific set of rules for foreign investors. Gray and Jarosz referred to foreign investment codes as "enclaves of special legislation," and argue that these served three important objectives (1995: 17). First, they sent a signal to foreign investors that the government was serious about changing the conditions under which foreign companies could invest in their economies. Second, FDI codes allowed the reform of the legal regime governing the entry and operations of foreign companies to proceed more rapidly. And third, they allowed governments to compensate for risks associated with the broader institutional structure by providing special incentives for foreign investors to offset such risks.

Hungary was the first former communist country to promptly put in place a favorable legislative environment for foreign investors. The governments that came to power as a result of Hungary's transition away from communist rule strongly favored the entry of foreign companies . They argued that FDI was good for the country because foreign companies contributed to job creation, the import of new technologies, and to an accelerated integration of Hungary in the global economy though exports. The FDI legislation was modified in January 1991 to eliminate required government approval, allow foreign companies to establish wholly-owned subsidiaries and repatriate earnings

without restrictions. The laws also guaranteed market-value compensation in the event of government expropriation (Dobosiewicz 1992; OECD 2000).

Furthermore, unlike other countries in the region, which chose some form of mass or voucher privatization that severely limited the opportunities for foreign investors to purchase entire companies, Hungary encouraged foreign strategic investors to participate in competitive tender procedures. Privatization in Hungary involved substantial foreign participation, including in the sale of large stakes of key sectors such as utilities, telecommunications and financial services (OECD 2000). For example, the 1993 sale of the Matav Telecommunications monopoly to a consortium of German and American firms was one of the first large-scale privatization deals in the former communist region. That same year, the government established the Hungarian Investment and Trade Development Agency (ITD-Hungary) to assist foreign companies interested to invest in Hungary.

In Poland, a new law on foreign direct investment was enacted on July 7, 1991, waiving all restrictions on the remittance of profits, dividends, and capital gains. Under the 1991 law, foreign investors were no longer required to obtain the approval of the state to invest, investments greater than $2.6 million were granted three-year tax holidays, and the Foreign Investment Agency was transformed from a state bureau responsible for screening FDI into an information office with the mission of assisting

foreign companies interested to invest in Poland (Dobosiewicz 1992; Gray and Jarosz 1995).

As mentioned earlier, in 1986, Czechoslovakia replaced the complete ban on FDI with very strict regulations on foreign ownership, profit repatriation and the nationality of top managers. After a government formed by non-communist forces assumed power in December 1989, an intense policy debate started between the government, who publicly expressed its interest in attracting foreign investment, and supporters of gradual reform, including the former deputy prime minister Valter Komarek, who advocated limited rights for foreign investors. Despite opposition, the government passed a law on enterprises with foreign participation in May 1990, which allowed foreign investors to establish wholly-owned subsidiaries and to buy existing Czechoslovak companies and land. The law also simplified, but did not eliminate, approval procedures, and kept in place restrictions on the repatriation of profits and other foreign currency transactions (Dobosiewicz 1992).

Following the disintegration of Czechoslovakia, FDI legislation diverged considerably in the two countries. With its accession to the OECD in 1995, the Czech Republic agreed to meet (with a small number of exceptions) the OECD standards for equal treatment of foreign and local investors (USCS 1999; UNCTAD 2003a). This implied the elimination of foreign equity limits, FDI approval requirements, and any

restrictions on the repatriation of funds, access to government procurement, and privatization programs. In practice, foreign companies were excluded from the voucher-based privatization program of the early 1990s, but encouraged to participate in subsequent privatization efforts that targeted large state-owned enterprises. In fact, most state-owned companies have been privatized with foreign participation (USCS 2002a).

Moreover, in 1992, the Czech government established CzechInvest, the first investment promotion in the region, to act as a "one-stop shop" for potential foreign investors. The agency provided information, including sector-specific data, processed incentive applications, and helped identify potential production sites, potential partners and suppliers, and facilitated contacts with national and local institutions (UNCTAD 2003a). By 2001, CzechInvest employed more than 50 investment officers, coordinated six overseas offices and 15 local representatives in all regions of the country (OECD 2001).

At the time of independence, Slovakia already had in place FDI legislation that eliminated screening procedures, foreign equity limits, and restrictions on the repatriation of profits. However, the government that came to power in 1994 following the election of Vladimir Meciar expressed reservations towards the impact of foreign investment and the foreign ownership of Slovak companies. Between 1994 and 1998, there was an "unwritten preference" for Slovak entrepreneurs in the privatization

program, and almost none of the 950 companies privatized during this period involved foreign participation (USCS 2002b). After Meciar and his party were defeated in parliamentary and presidential elections in 1998-1999, the new government rescinded the previous government's law on strategic privatization, which prohibited the privatization of a broad range of state-owned enterprises in several sectors, including banking and insurance, power and gas, and telecommunications. This move paved the way for a number of privatization deals that involved foreign investors, including the sale in 2000 of a 51 percent stake in Slovenské Telekomunikácie to Deutche Telekom. In 2001, the government also established a Slovak investment promotion agency, SARIO, and approved successive packages of investment incentives designed to attract FDI to Slovakia (USCS 2008).

In Romania, legislative changes introduced in 1990 allowed foreign investors to establish wholly-owned subsidiaries in all sectors of the economy, but continued to require that they register with the Romanian Development Agency (a *de facto* screening procedure) and to restrict their ability to transfer profits and repatriate earnings (Dobosiewicz 1992; Gray and Jarosz 1995). Foreign participation in privatization programs was formally permitted, but limited in practice by the preference of the first Romanian governments for privatization methods involving vouchers and management buy-outs. Direct sales to foreign investors became predominant after 1996 and were

reflected in a jump in FDI flows (OECD 2004). An investment promotion agency was not established until 2002 (RFTC 2003; ARIS 2004).

Yugoslavia's move towards an open foreign investment regime was brought to a halt by bloody ethnic and political struggles that marked its disintegration. Serbia emerged from the break-up of Yugoslavia with a relatively oppressive political regime under the rule of Slobodan Milosevic and inward-looking economic policies. For most of the 1990s, Serbia was isolated through economic sanctions. The inflow of foreign capital was almost suspended (only Serbian Telecom was privatized with foreign participation), and international trade and financial flows were largely discontinued (OECD 2003).

After Milosevic was forced out of power in the fall of 2000, the new democratic government put in place an accelerated reform program. In 2001, it adopted a comprehensive program to improve the legal environment in the country. A new Foreign Investment Law enacted in January 2001 aimed to encourage foreign investment by extending to foreign investors the same status, right and duties that are granted to domestic investors (i.e. national treatment) and allowing them to acquire real estate property for business use under conditions of reciprocity. A new Privatization Law passed in June 2001 replaced the 1997 Law on Ownership transformation which strongly favored company insiders, and opened tenders to the participation of foreign investors (OECD 2003).

Croatia never passed a separate law on foreign investment, effectively making foreign investors subject to the same rights, obligations, and legal status that apply to domestic investors (USCS 1997). However, while equal treatment was always provided under the law, in practice foreign investors faced different types of discrimination. During the 1990s, "the former regime under Franjo Tudjman went out of its way to obstruct foreign investors and award spoils of industry to political cronies" (USCS 2002). Following Tudjman's death in December 1999, a coalition of democratic forces defeated his party in parliamentary elections. The new government led by Ivo Sanader passed a law on investment incentives, revised privatization legislation to increase transparency and facilitate the participation of foreign investors, reduced payroll and corporate taxes, and revised banking and foreign exchange legislation. It also established in 2001 a special task force to work towards the elimination of administrative barriers to investment (USCS 2005a), and created in 2005 the Croatian Trade and Investment Promotion Agency.

Slovenia maintained restrictive foreign investment policies in the 1990s. Deals involving foreign investors were subject to the approval of the Slovenian Privatization Agency. Complete foreign ownership was not allowed, and in many strategic sectors, company directors had to have Slovenian citizenship (Bandelj 2004). FDI policies were amended in 1997 to permit the repatriation of profits and capital and to allow foreign

companies to own land. An FDI promotion program was started in 2001, and in July 2004 the parliament voted to transform the Slovene Trade and Investment Promotion Authority (known today as JAPTI) into a stronger and more independent investment promotion agency with greater power to grant benefits for investments that create jobs (USCS 2005b).

In Albania, foreign direct investment was banned by the constitution until 1990 (Dobosiewicz 1992). In late 1990, the constitution was amended and new regulations allowed foreign participation of up to 90 percent in joint ventures with an Albanian state-owned enterprise. Remaining restrictions on foreign equity and screening requirements were eliminated at the end of 1993, when the government passed a new law on foreign investments (USCS 2000). The law also provided guarantees against expropriation and allowed for the unrestricted transfer of profits after tax and debt obligations have been met (USCS 2000, 2002). The Albanian Investment Promotion Agency (ANIH), which is operational since 2002, is responsible for attracting foreign investors in greenfield, privatization and infrastructure projects, and for offering information and professional services to potential and existing investors (OECD Investment Compact 2006).

Following the disintegration of the Soviet Union, the Russian government promulgated its own version of the USSR Foreign Investment Law, which permitted

foreign investment in most sectors of the Russian economy in all forms allowed by national legislation, provided legislative protections against nationalization and expropriation, and the statutory foundation for "national treatment" of foreign investments—that is, the guarantee that foreign investors will be treated no less favorably than domestic investors (USCS 1999). However, government approval continued to be required for a wide range of foreign projects, including investments in ventures in which the foreign share exceeds 50 percent or in new enterprises using assets of existing Russian enterprises, investments in the exploration of natural resources or defense industries, or large investments over 50 million rubles[1] (USCS 1999). Moreover, the right of foreign investors to participate in Russian privatization programs was frequently undermined by controversy and discriminatory practices, while remittances of investment returns were generally delayed (USCS 2001).

After declaring its independence, Ukraine adopted a series of laws that liberalized the foreign investment regime. Legislation passed in 1993 allowed foreign investors to register without prior government approval, provided guarantees against expropriation and legislative changes, and granted the right to prompt remittance of their profits (OECD 1993). The Foreign Investment Law passed in April 1996 also guaranteed formal equality of treatment for national and foreign companies. In practice,

[1] About US$ 1.7 million at current exchange rates.

however, foreign investors regularly reported that laws were not applied equally and that the government discriminated against foreign companies in privatization bids, procurement contracts, and the recognition of contractual provisions for international arbitration (USCS 1999, 2004). According to one assessment, the legislative and regulatory apparatus put in place during Leonid Kuchma's regime (1994-2005) was "designed to protect existing enterprises from domestic competition and foreign ownership" (USCS 2007). After Victor Yushchenko's election in December 2004, the government halved the number of business regulations and established an investment promotion agency, InvestUkraine, in August 2005.

In the Baltic republics, laws on foreign direct investment were enacted in late 1990 or early 1991, shortly after obtaining independence from the Soviet Union. The first Lithuanian law on foreign investment was adopted on December 29, 1990 (OECD 2001a). The Foreign Investment Act in Estonia and the Law on Foreign Investments in Latvia were passed in 1991 (OECD 2001b; UNCTAD 2003b). These laws granted foreign investors the rights to establish a company, to receive the same treatment accorded to domestic investors, to terminate the investment and repatriate profits after the payment of taxes, and to be protected from expropriation or nationalization. Investment promotion agencies were established in 1993 in Latvia (UNCTAD 2003b), in 1994 in Estonia (USCS 1999; OECD 2001a), and in 1997 in Lithuania (OECD 1998).

Belarus officially welcomed foreign investors in the 1990s, although the actions and statements of government officials tended to reflect distrust and discrimination against profit-seeking enterprises. Foreign investors were required to register with the State Committee for Foreign Economic Relations and to obtain the consent of the local council of deputies (OECD 1994). Although at the end of the 1990s the government made an effort to simplify the registration procedures (UNCTAD 2003c), in recent years it decided that foreign investments are no longer unconditionally welcome in the country. A senior official in the Ministry of the Economy admitted in 2005 that priority is always given to domestic investors, while foreign investors have "to persuade the government that the project is necessary for the country and the people" (quoted in USCS 2005). In practice, the government screens all foreign investment proposals and approves them on a case-by-case basis after considering its effects in terms of the number of jobs created and competition with existing domestic producers (USCS 2005).

In Central Asia, Kazakhstan passed a number of legislative acts on FDI. A 1994 foreign investment act provides guarantees about compensation in the event of expropriation, sets out the basis on which disputes can be settled by international arbitration, and guarantees the right to apply the provisions of the law in effect at the time a contract was signed for a period of ten years, even if the law is subsequently altered, or for the duration of the contract between an authorized state agency and a

foreign investor (OECD 1998a). In 1997, the government enacted the Law on State Support for Direct Incentives, which provided tax concessions, customs waivers and state grants to a number of designated priority sectors. The State Investment Committee, a government agency established in 1996, was responsible to determining the amounts, procedures, and terms of concessions on a case-by-case basis, a practice that was repeatedly criticized by international agencies (OECD 1998a).

In 2003, a new Law on Investment replaced both the Law on Foreign Investments and the Law on State Support of Direct Investments to establish an equal legal regime for domestic and foreign investors. This law significantly limited many of the guarantees provided in previous legislation (McGuire Woods 2006). Since its inception, the State Committee on Investment screened all foreign investment proposals through procedures that have been deemed highly bureaucratic and non-transparent. Residents and non-residents are allowed to hold foreign exchange accounts, but most capital transactions, including the repatriation of profits, are subject to quantitative limits and strict documentary requirements (USCS 2005).

In the Kyrgyz Republic, Askar Akayev's government has opened most of its economy to foreign investment since June 1991, when the parliament passed a foreign investment law that allowed the establishment of local enterprises with foreign ownership, secured the right to repatriation of profits, provided guarantees against

expropriation and policy changes, and allowed foreign investors to bid in privatization programs. The 1997 Law on Foreign Investments extended national treatment to foreign companies (OECD 1998b), and in 2003, a new FDI law provided guarantees against policy changes and the right to appeal directly to the International Arbitrary Court in case of investment disputes involving the state (UNCTAD 2003d). There is little evidence of discrimination against foreign investors (USCS 1999). In recent years, the government has pledged to make foreign direct investment a priority and to implement far-reaching regulatory and tax reforms. However, "there is a great deal of uncertainty regarding the ability of any government to pursue this approach, as domestic opposition to the sale of state assets is strong, and investors are wary because of the poor business environment" (EIU 2007).

In contrast, in Uzbekistan, while the country's FDI code no longer restricts foreign ownership since 1994, the government strongly favors joint ventures with local partners (UNCTAD 1999). Makhudjon Askarov, the Minister of Foreign Economic Relations, emphasized in an interview that the Uzbek government seeks 50-50 joint ventures between foreign investors and national partners because it "views the significant equity stake for the national partner as ensuring full participation and acquisition of skills for the national partner" (quoted in UNCTAD 1999: 15). The Uzbek government also screens every foreign investment proposal to ensure that the entry and

incentives are granted only to investments the government deems appropriate. According to the U.S. Commercial Service, "[t]he government does not have a standard and transparent screening mechanism, and the legislation is designed to protect domestic industries and limit competition from abroad" (USCS 2007).

Reports suggest that the business environment has worsened considerably since 2006, when the government rescinded indefinite tax exemptions to foreign investors and announced that Russian companies would be favored in any future tenders (USCS 2008; EIU 2007). These changes were applied retroactively to a number of projects, including the Zaraftan-Newmont gold-mining company, forcing it into bankruptcy in 2006, and to a British-Uzbek joint venture, Amantaytau Goldfields (EIU 2007).

Thus, the scope of FDI reforms varies greatly across space, time, and policy type. Countries as diverse as Poland, Kyrgyzstan, and Mongolia, removed most restrictions on FDI in the 1990s, while Croatia, Kazakhstan, and Uzbekistan did not. Reforms started as early as 1988 in Hungary, but were delayed by more than a decade in Serbia, its southern neighbor. Restrictions on foreign equity ownership were eliminated in most countries, while significant variations endure in the extent to which governments use screening and approval requirements to control the flow of foreign investments. To capture the full extent of these variations, I constructed a new dataset of FDI regulations

in transition economies. The next section describes the methodology used to collect and code the data.

3.3. A dataset of FDI regulations in transition economies

To capture the variation of FDI policies across post-communist economies and the change across time, I constructed the *FDI Regulations in Transition Economies* dataset. I coded the foreign investment regimes in the 28 post-communist countries from 1989 until present. Information was collected on more than 20 policy variables grouped along four dimensions: (1) Entry and establishment; (2) Operations and repatriation; (3) Guarantees on investment and dispute settlement; and (4) Promotion of foreign investment. Table 3.2 shows the variables included in each of the four dimensions. The information for the database was collected from multiple sources, including the United States Commercial Service country commercial guides, OECD investment surveys and investment policy reviews, UNCTAD World Investment Directory, Economist Intelligence Unit country reports, as well as various articles by legal scholars and investment climate assessment reports by business and legal consulting firms.[2] The information was codified independently by two coders and discrepancies were

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[2] A detailed appendix including descriptions of the data sources and a matrix of sources available for each country-year is available from the author upon request.

discussed and resolved jointly. To quantify all information for the 28 countries over 20 years and 20+ policy variables, each coder made over 11,000 judgments.

Table 3.2 Variables coded in the *FDI Regulations in Transition Economies* dataset

FDI Regulations in Transition Economies Dataset
(1) Entry and establishment
Screening and approval of foreign investment
Foreign ownership limits
Licensing of foreign investors (*)
Restrictions on foreign participation in privatization
Restrictions on foreign participation in government procurement contracts (*)
Restrictions on foreign ownership of land (commercial and agricultural land)
(2) Operations and Repatriation
National treatment
Performance requirements
Repatriation of funds (currency convertibility and transfers)
(3) Guarantees on investment and dispute settlement
Protection against expropriation
Protection against legislative change
Access to international arbitration
FDI insurance programs (MIGA)
(4) Promotion of foreign investment
Investment Promotion Agency
Incentive programs (*)
Free trade and special economic zones (*)
Bilateral Investment Treaties (*)
Double Taxation Treaties (*)
Corporate Income Tax (*)

Note: Variables marked (*) are not included in the FDI Openness index.

The new FDI regulations data makes possible the comparison of policies in the 28 post-communist countries starting from the beginning of the transition process. Existing

indicators of investment climate, including the Heritage Foundation Index of investment freedom also used in this chapter, are available starting in 1995 or later and therefore miss policy reforms enacted by these countries in the first years of their transition to open-market economies.

Other efforts to collect data on foreign investment policies are limited to advanced industrial nations, cover only a small subset of policy variables, or do not extend over time. More specifically, the Australian Productivity Commission collected data on FDI restrictions in APEC countries (Hardin and L. Holmes 2002, 1997); Golub (2003) used a variant of their methodology to carry out a similar study for OECD countries; and UNCTAD (2005) provided a cross-national assessment of the most recent information available at the time on foreign ownership restrictions, screening and notification procedures, and management and operational restrictions in a number of services industries. Because none of the available measures are sufficiently broad in scope and time coverage to allow for the testing of the hypotheses derived from the theoretical model, I assembled a complete panel of FDI regulations in former communist countries that starts in 1989 and covers a wide range of policy choices.

The data collection effort described is subject to several limitations. First, policies on FDI are diverse and complex and therefore not easily quantifiable even when they are known. Investment incentives, for example, are of different types (tax breaks, custom

duty exemptions, government grants, access to credit), extend over different lengths of time, and may be granted only to investors meeting a set of conditions. Second, descriptions of FDI policies are not readily available for the early 1990s and for some of the countries in the data (*e.g.*, Tajikistan and Turkmenistan). Although a special effort was made to obtain reliable information for the entire set of countries and period of time, occasional gaps remain in the data. Third, the focus of the data is on policies that discriminate between foreign and domestic investors. As a result, regulation of labor and product markets, requirements for registering a business and other policies defining a country's business environment are not included.

The *FDI Regulations in Transition Economies* dataset includes a wide range of policy variables that were selected following existing policy guidelines on international investment. For example, the World Bank published in 1992 the "Guidelines on the Treatment of Foreign Direct Investment" which recommend that countries put in place an investment regime that offers open admission (subject to a restricted list of investments that are either prohibited or require screening and licensing); national treatment that prohibits the discrimination of foreign investors; protection and security of investments, including "prompt, adequate, and effective" compensation in case of expropriation; permission to conduct investment-related currency-transfers, without

undue delay; and the settling of disputes between the State and foreign investors through arbitration.

The data collection effort started with the methodology proposed by (Hardin and L. Holmes 1997, 2002) and amended by Golub (2003) which consider (1) restrictions on entry—i.e. foreign equity limits and screening and approval procedures, and (2) input and operational restrictions. I expanded the scope of the data collection to include two additional dimensions: (3) guarantees on investment, including access to international arbitration and guarantees against expropriation, and (4) investment promotion. The coding of the different policies in the *FDI Regulations in Transition Economies* dataset and the methodologies on which it builds are described in Table 3.3. Variables are coded on two-, three-, or four-point scales to reflect gradations in government practices. Higher values indicate greater levels of openness to FDI.

Table 3.3 FDI policies and the FDI Openness Index

Type of policy	FDI Openness Index	Weight Hardin and Holmes (1997)	Weight Golub (2003)
<u>**Restrictions on market entry**</u>			
Screening and approval procedures			
investors required to demostrate economic benefits	0	0.1	0.2
approval granted unless investment contrary to national interest	1	0.075	0.1
notication by foreign investor required (pre or post)	2	0.125	0.05
same registration procedures as domestic investors	3	0	0
Foreign equity limits			
no foreign equity permitted	0	1	1
less than 50 per cent foreign equity permitted	1	0.5	0.3 - 0.6
more than 50 per cent and less than 100 per cent foreign equity permitted	2	0.25	0.1 - 0.2
100 per cent foreign equity permitted	3	0	0
Foreign investor participation in privatization programs			
no foreign participation allowed	0	0.5	
foreign investors allowed, but discriminating practices in place	1	0.25	
foreign investors allowed under equal treatment	2	0	
Access to commercial land			
foreign investors not allowed to purchase or lease land	0		
foreign investors allowed to lease but not purchase land	1		
foreign investors allowed to lease land or purchase it under specific conditions	2		
foreign investors may lease and purchase land	3		

Table 3.3 (cont) FDI policies and the FDI Openness Index

Type of policy	FDI Openness Index	Weight Hardin and Holmes (1997)	Weight Golub (2003)
<u>**Restrictions on post-entry operations**</u>			
National treatment			
not included in national legislation	0		
included in national legislation, but discrimination in practice	1		
included in national legislation, no discrimination	2		
Performance requirements			
performance requirements are preconditions to operation in the country	0	0.2	0.1
no performance requirements	1	0	0
Repatriation of funds			
government controls transfer of funds and currency convertibility transactions	0		
transfer of funds is unrestricted but difficult because of controls on currency convertibility	1		
no restrictions on transfer of funds currency convertibility	2		

Table 3.3 (cont) FDI policies and the FDI Openness Index

Type of policy	FDI Openness Index	Weight Hardin and Holmes (1997)	Weight Golub (2003)
Guarantees on Investment			
Protection against expropriation			
not provided in existing legislation	0		
provided in existing legislation, but breached in practice	1		
provided in legislation and practice	2		
Protection against legislative change			
no guarantees against legislative change	0		
investors may apply old law if legislative changes are unfavorable	1		
Access to international arbitration			
no international arbitration allowed	0		
international arbitration allowed, but difficult to have decisions recognized	1		
international arbitration decisions are recognized and enforced by local courts	2		
FDI insurance program			
no investment insurance programs are active	0		
MIGA offers investment protection	1		
Promotion of foreign investment			
Investment promotion agency			
No investment promotion agency in place	0		
Investment promotion agency established and operational	1		

3.3.1. Restrictions on entry and establishment.

Screening and approval procedures vary widely in stringency from simple notification or automatic approval unless contrary to national interest to convoluted procedures of government approval typically granted on a case-by-case basis. The most liberal regimes have eliminated all screening and approval procedures and foreign investors must follow the same procedures domestic investors go through to register a business. At the opposite end, foreign investors must try their luck in a convoluted and non-transparent screening process.

For example, in Tajikistan, there is no foreign investment body empowered to deal with foreign investors directly, and there are no established criteria to screen investment proposals. Instead of working with a dedicated agency, a potential investor has to go through a lengthy screening process by all concerned government agencies. In practice, foreign investors must submit a statement describing the proposed project to the Government of Tajikistan, which circulates it among the relevant government offices and ministries with instruction to review and express their formal opinion. If a ministry objects to the proposed investment activity it sends an official note to the government (USDS 2006). In 1990, all former communist countries screened foreign investments. Today, only Azerbaijan, Belarus, Kazakhstan, Kyrgyzstan, Russia, Tajikistan, Turkmenistan and Uzbekistan continue to screen FDI.

Restrictions on foreign ownership specify the maximum foreign equity participation allowed. This can range from a complete ban on foreign investment to no restrictions on the establishment of wholly-owned foreign subsidiaries. In Albania, for example, FDI was banned by the constitution until the second half of 1990, when the constitution was amended to allow foreigners to own up to 90 per cent equity in an Albanian commercial entity (Dobosiewicz 1992). This restriction was also removed in 1993, paving the way for wholly-owned foreign enterprises to operate in the country.

Restrictions on foreign participation in privatization capture the extent to which governments restrict the acquisition of state-owned enterprises by foreign investors. Although *de jure* restrictions on foreign investment in privatization programs were rare, governments' preference for privatization methods that did not involve direct sales (i.e. mass/voucher privatization and managerial/employee buy-outs) effectively limited the participation of foreign companies in the privatization of many domestic firms. In Hungary, which limited the scope of mass privatization and opted instead for direct sales, foreign companies played a big role in the privatization and restructuring of a large number of local enterprises. In contrast, in the Czech Republic, Slovakia, Russia, Romania, Bulgaria, and Armenia, among other countries, foreign investors were only involved in large-scale privatization programs reserved for the prominent industrial

complexes (*e.g.*, in automotive, steel, and pharmaceutical industries) and the former state monopolies in infrastructure industries (energy, utilities, and telecommunications).

Restrictions on foreign ownership of land indicate whether foreigners are allowed to buy or only to lease land. For instance, in the early 1990s, foreign-owned firms incorporated locally were allowed to own land in Hungary, the Czech Republic, Slovakia and Poland, but not in Romania and Bulgaria (Gray and Jarosz 1995). Restrictions on foreign ownership of land were relaxed in 1997 in both Bulgaria (Braykov 1997; USCS 2005), and Romania (USCS 1998). However, significant restrictions remain in place in countries such as Tajikistan and Uzbekistan (USCS 2003, 2005).

3.3.2. Restrictions on operations and repatriation.

National treatment refers to the degree of discrimination between national and foreign firms in conducting business. Governments that embrace the principle of national treatment in their legislation promise to accord enterprises incorporated on their territory but owned and controlled by nationals of another country, "treatment under their laws, regulations, and administrative practices […] no less favorable than that accorded in like situations to domestic enterprises" (OECD 2001). While most transition economies have formally adopted this principle (see Table 3.1), they differ considerably in their efforts to ensure that it is reflected in the day-to-day practices that affect the activities of foreign investors.

In Georgia, for instance, post-1995 legislation has not discriminated between foreign and local investors. However, foreign investors were affected by informal practices involving corruption and even criminal pressures that ultimately determined multinationals to sell out their ownership (USCS 2002). Some of these practices have been curbed since 2004, when the new government of the "Rose revolution" made considerable efforts to improve the investment climate through a number of institutional reforms, including the restructuring and downsizing of government ministries and agencies, and the streamlining of regulations, licensing requirements and customs formalities (USCS 2005).

Performance requirements refer to conditions imposed on foreign firms that want to establish, maintain or expand an investment, *e.g.* the requirement to use a certain amount of local inputs (local content requirements) or to export a certain percentage of output (export requirements). Such conditions were frequently imposed on multinational investments in the 1970s and 1980s, when many countries in Latin American and Asia pursued industrial policies of import-substitution industrialization (Gereffi and Wyman 1990; Haggard 1990). In recent years, however, very few countries continue to demand that multinationals source their inputs locally or export most of their production. Governments have renounced such practices after recognizing that they represent an important deterrent for FDI, especially for multinationals that have

extensive supply chains around the world and prefer to work with imported parts from their own suppliers rather than with locally produced inputs.

Repatriation of funds codes the difficulty of accessing foreign exchange and transferring earnings abroad. This variable is coded as 'open' only if the government imposes no limits on the repatriation of profits and the local currency is easily convertible into foreign exchange. Limits on currency convertibility existed in most former communist countries at the beginning of the 1990s, when governments were pursuing programs of macroeconomic adjustment to address inflation and gain control over the money supply. While most currencies in Central and Eastern Europe were freely convertible by the second half of the 1990s, access to foreign exchange is still limited in some of the countries in Central Asia and the Caucasus. Similarly, restrictions on the transfer of funds were in place in most countries at the beginning of the transition and gradually removed throughout the 1990s. In Romania, for example, the 1991 FDI code imposed profit repatriation limits ranging between 8 and 15 percent, but these limits were removed in May 1992 to allow full repatriation (Gray and Jarosz 1995: 25).

3.3.3. Guarantees on investment and dispute settlement.

Legislation on foreign investment usually contains guarantees against expropriation. To alleviate fears of expropriation, which are not negligible in countries that have only recently shed an ideology that justified the state control of all property,

many governments have adopted strong language emphasizing that expropriation can be allowed only under exceptional circumstances and with immediate and fair compensation (Sornarajah 2004). *Protection against expropriation* is strongest when national legislation prohibits arbitrary expropriation and no recent incidents raise doubts about the government's commitment to respect private property.

Guarantees against legislative change are another important safeguard for foreign investors. The government promises that in the event of policy changes unfavorable to foreign investors, these can operate for a number of years under the legislative framework that was in place at the time of the investment. For example, under Article 6 of the 1994 Foreign Investment Law of Kazakhstan, foreign investors were guaranteed that no adverse changes in the legal regime would affect their projects for a period of ten years (USCS 1994). However, in 1997, the government amended Article 6 to withdraw the guarantee with respect to changes in laws related to the importation, production, or sale of excise goods, and laws related to the importation of finished products, contradicting the very premise of the original 1994 law which guaranteed that investors would be protected from any adverse regulatory changes (USCS 1997).

The foreign investment legislation of many states also guarantees access to third-party *international arbitration*, which can be very important to foreign investors when they lack confidence in the ability of the local court system to resolve investment

disputes in a timely and fair manner. The availability of arbitration helps to alleviate the concerns investors may have with regard to predictable and timely contract adjudication in the local courts, but will be effective only if local judicial institutions are willing and able to recognize and enforce arbitrary awards. The opportunity for arbitration is particularly important in the context of disputes between private investors and host governments, which can be adjudicated at the International Center for the Settlement of Investment Disputes (ICSID). The data codes the foreign investors' rights of access to international investment dispute settlement mechanisms on the basis of the country's membership to the ICSID convention; legislative clauses that allow business entities to opt out of the host state's court system and pursue their rights before a neutral arbitration tribunal; and the ease of having arbitration decisions recognized and enforced in the host country.

In addition, most governments have allowed the Multilateral Investment Guarantees Agency (MIGA) to provide foreign investors with *investment insurance* against non-commercial risk in order to reduce fears of expropriation without compensation or adverse treatment of FDI. Country membership in MIGA is required before foreign investors can sign insurance agreements that protect their investments in that country. While none of the former communist countries was a MIGA member in 1990, all except Tajikistan had signed up by 2000.

3.3.4. Promotion of foreign investment.

The presence of an investment promotion agency that markets investment opportunities in a country and helps foreign investors obtain the necessary registration and approvals for operations is a strong signal that the government is committed to attracting FDI. The *Investment Promotion Agency* variable reflects the existence of such a government body in a given year. While investment promotion agencies were set up in 24 of the 28 transition economies, some agencies were established as early as 1993, while others only in the mid 2000s (see Table 3.1 for years of establishment). Short of more nuanced measures reflecting the size and level of competence of these investment promotion agencies, the timing of their establishment conveys the most information about the government's real commitment to attracting FDI.

The policy variables in the *FDI Regulations in Transition Economies* data are coded on two-, three-, or four-point scales to capture nuances in national legislation and government practices across the region. Higher values indicate greater levels of openness to FDI. The detailed coding scale is described in Table 3.3 and the summary statistics for the different policies are in Table 3.4.

Table 3.4 FDI Policies summary statistics

Policy variable	Number of observations	Mean	Standard deviation	Min	Max
Foreign equity limits	560	2.729	0.691	0	3
Screening and approval	556	1.516	1.375	0	3
Access to privatization	560	1.225	0.770	0	2
Access to land	540	1.965	1.107	0	3
National treatment	557	1.363	0.819	0	2
Performance requirements	533	0.867	0.340	0	1
Repatriation of funds	560	1.211	0.729	0	2
Grandfather clause	560	0.325	0.469	0	1
International arbitration	560	1.211	0.777	0	2
Expropration protection	560	1.671	0.707	0	2
FDI insurance	560	0.784	0.412	0	1
Promotion agency	560	0.432	0.496	0	1

3.4. Political competition and FDI regulations: An assessment

I investigate the relationship between political competition and FDI policies using the newly created dataset of FDI regulations in transition economies described in the previous section. I supplement this with an analysis of a worldwide sample using the Index of Economic Freedom, which codes FDI restrictions (but not promotion) since 1994.

The *FDI regulations in transition economies* data capture FDI policy changes in the 28 former communist countries starting in 1989. The scores for the different policy dimensions are aggregated into an indicator of *FDI openness* and re-scaled to range from

0 (closed) to 100 (open). In 2008, the countries with the highest FDI openness indicator in the *FDI Regulations in Transitions Economies* dataset were Bulgaria, Estonia, Georgia, Hungary, Macedonia, and Slovakia, while Belarus, Turkmenistan, and Tajikistan, maintained stringent restrictions on the entry and operation of foreign companies.

I also use the *Index of Economic Freedom* to assess variation across a worldwide sample of countries. This index quantifies the restrictiveness of government policies along ten economic dimensions, including restrictions on foreign investments, for 182 countries for the period 1994-2008. The investment freedom indicator ranges from 10 (not free) to 100 (free).[1] A country is coded to have a liberal investment regime if it encourages FDI by treating it the same as domestic investment (a principle often referred to as "national treatment") and providing simple and transparent foreign investment legislation. There are no restrictions in sectors related to national security or real estate and no expropriation is allowed. Both residents and non-residents have easy access to foreign exchange and international payments. Capital transactions, including the repatriation of capital, face no restrictions (Miller and K. R. Holmes 2009).

A score of 50, representing both the mean and the median of investment freedom scores in 2008, implies that foreign investments face restrictions in a number of sectors,

[1] In older editions, the Index of Economic Freedom scored countries from 1 (not free) to 5 (free). I have re-coded the recent data, which uses a scale from 0 (not free) to 100 (free), to reflect the original scale.

including real estate, utilities, natural resources, and national security. The foreign investment code is somewhat non-transparent and foreign investors face bureaucratic impediments. Transfers of capital are subject to obvious restrictions, and residents and sometimes non-residents face restrictions on access to foreign exchange and find it difficult to conduct international payments. A score below 50 reflects even more stringent restrictions on foreign direct investment, including outright prohibition of FDI in some sectors, a discriminatory foreign investment code, restrictions on purchases of real estate, and strict controls on access to foreign exchange and international capital transactions.

The 2009 Index of Economic Freedom, which describes the investment policies in effect in 2008, reveals that no countries ban foreign direct investment altogether. Eight countries—Burma, Cuba, Eritrea, Iran, North Korea, Turkmenistan, Venezuela, and Zimbabwe—rank at the bottom of the list with a score of 10, which implies that foreign direct investment is discouraged through severe restrictions in many sectors, a discriminatory and difficult to understand foreign investment legislation, and an opaque and corrupt approval process. Foreign investors may not purchase real estate and the government controls or prohibits most international payments, transfers, and capital transactions.

The correlation between the two dependent variables is 0.7, a fair score considering that the FDI Regulations in Transitions Economies dataset goes beyond the policies assessed in the Index of Economic Freedom (IEF) to include government guarantees and investment promotion efforts. In the analysis presented here I use the FDI openness indicator for 28 transition economies to examine policy changes that have been adopted and implemented since 1989, when all these countries had outright bans on foreign investments. I complement this analysis with an investigation of the IEF investment freedom score to assess cross-sectional and temporal variation in a larger sample of 127 countries between 1994 and 2008.

3.4.1. Independent variables: Determinants of FDI liberalization

This paper argues that competitive political regimes are more likely to allow the free entry of foreign direct investments, *ceteris paribus*. To measure political competition and the openness of political participation, I rely on political regime variables from the Polity IV dataset (Jaggers and Gurr 1995; Marshall and Jaggers 2000). The widely used polity score ranges from -10 to 10 and aggregates data on five different indicators that capture institutional differences between democratic and non-democratic regimes: (1) the competitiveness of executive recruitment, (2) openness of executive recruitment, (3) executive constraints and decision rules, (4) the regulation of political participation, and (5) the competitiveness of political participation. I specify models relying on the

aggregate polity score (*regime type*) as the key independent variable, as well as alternative models that capture political competition and the openness of the political process (selectorate size) using three of the categorical indicators, specifically, the *competitiveness of political participation*, the *competitiveness of executive recruitment*, and the *regulation of executive recruitment*.

The factors that shape FDI regulations are discussed by Kobrin (2005), who suggests two possible sets of determinants. Kobrin argues that FDI liberalization is either the result of a cost-benefit analysis by rational decision-makers evaluating the "increasing opportunity cost of closure" (Garrett 2000) or the response of policy-makers to external coercive pressures to adopt neoliberal polices (Cohen 1996). He analyzes eleven possible determinants of FDI liberalization, including country size, level of development, growth of GDP, trade openness, human resource capabilities, and democracy to address the first hypotheses; and dependence on the US, dependence on international institutions, FDI penetration, growth of FDI and resources dependence to account for the "external pressures" explanation. His analysis shows that only determinants from the first set are correlated with changes in FDI policy. While timely and insightful, the study is limited by the nature of the dependent variable, which represents a count of annual policy changes recorded by UNCTAD starting in 1992 and does not measure the level of FDI openness or the magnitude of a policy change.

The size of the economy and level of development are likely to determine the extent to which governments, even those facing similar political incentives, decide to open their economies to foreign direct investment. One of the strongest conclusions of empirical research on the determinants of FDI location points out that FDI seeks to locate in large economies (see, for example, Nunnenkamp and Spatz 2002). Economies that are both large and open to FDI are priority targets for multinational companies seeking new markets and promising production locations abroad. Even governments motivated to allow FDI to benefit those whose welfare depends on labor may be wary of the effects of a sudden increase in foreign direct investment levels following FDI liberalization and the resulting changes in the domestic economic landscape. Market size gives big economies greater bargaining power relative to foreign investors and allows them to keep in place FDI restrictions even when smaller economies liberalize. *Country size* is measured as the natural logarithm of GDP, lagged one year.

The effect of the level of economic development is expected to work in the opposite direction. Scholars have argued that the impact of FDI on domestic firms and industries is contingent on the characteristics of the host economy (Moran 1998; Moran et al. 2005). The probability that FDI has positive spillover effects depends on the "absorptive capacity" of the host economy, which in turn depends on the level of economic development, the degree of competition in the domestic market, the quality of

local human capital, and the level of private-sector sophistication (UNCTAD 1999; Lipsey and Sjöholm 2005). Thus, in countries with high levels of development, FDI liberalization can be justified both in the terms of its wage increases and positive spillover effects. The measure for the *level of development* is GDP per capita, lagged one year.

Proponents of foreign direct investment have often suggested that FDI leads to economic growth by providing much needed capital to developing economies where capital is often scarce. Countries with low domestic savings levels may have stronger incentives to allow foreign direct investment in order to increase overall domestic investment, *ceteris paribus*. In the empirical model, *domestic savings* are measured as a percentage of GDP and lagged one year.

Perhaps equally important is the sectoral profile of the domestic economy. The relative concentration of GDP in agriculture, industry, and services, is an indication of the level of domestic protectionist pressures. Countries with larger agriculture and industry sectors are more likely to have strong domestic pressures opposing FDI liberalization. Measures of the value added in *industry* and *agriculture* as a percentage of GDP, lagged one year, are included as controls. Moreover, the size of the natural resource sectors may also be associated with restrictions on foreign direct investment. A

measure of *resource exports* combining oil, gas, coal and minerals, lagged one year, is included also as a control.

The argument presented in this paper builds extensively on the distributional implications of foreign direct investment. I argue that labor benefits from FDI entry while domestic firms fear that increased competition in the domestic markets lower their returns. If domestic companies have already been exposed to competition from imports in the product markets, however, they have less to be concerned about. Or, if they are exporting in international markets, their products are competitive and their organizations well-equipped to thrive despite increased competition at home. Economies that are already integrated in the global market through high levels of trade are less likely to keep in place restrictions on FDI. *Trade (X+M)/GDP* measures trade openness as exports plus imports as a percent of GDP, lagged one year.

The choice of policies governing the entry and operations of foreign companies may also be shaped by participation in international organizations and agreements. The OECD has overseen the commitment of member governments to adhere to the principles of the 1976 Declaration on International Investment and Multinational Enterprises and by improving their investment climates and reducing barriers to FDI. A number of non-OECD countries, including Argentina, Brazil, Chile, Egypt, Peru, and Eastern European countries that later joined the EU, have also subscribed to the

Declaration. In doing so, they committed to offer multinational companies national treatment, minimize the imposition of conflicting requirements on multinational enterprises, and make their investment incentives and disincentives as transparent as possible.

If adherence to the OECD Declaration provides incentives to lower barriers to FDI, membership in the organization or subscription to the Declaration should be associated with higher levels of FDI openness. A more likely scenario, however, is that governments have subscribed to the OECD Declaration only after the political incentives to lower FDI restrictions were already in place. In this case, no empirical effect should be observed. *OECD Declaration* is a dummy variable constructed to reflect OECD membership or a commitment to the principles of the OECD Declaration.[2] Statistics for the dependent and independent variables in the two samples are summarized in Table 3.5 and Table 3.6.

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[2] It is important to note that for transition economies in Eastern Europe the *OECD Declaration* dummy also captures EU accession, a region-specific phenomenon that perhaps created incentives for EU candidates to remove FDI restrictions. Instead of differentiating EU candidates, OECD members and other adherents to the OECD Declaration on International Investment and Multinational Enterprises, I use one dummy to highlight governments' declared commitment to a common goal.

Table 3.5 Summary statistics, worldwide sample

	Obs	Mean	Std. Dev.	Min	Max
IEF Investment freedom	2,300	3.10	0.98	1	5
Market size (GDP)	2,147	23.63	2.10	19	30.07
Economic development	2,009	7.59	1.56	4.55	10.91
Domestic savings (% GDP)	2,059	18.13	14.75	-71.82	86.86
Agriculture, value added (% GDP)	2,013	16.89	13.96	0.06	67.26
Industry, value added (% GDP)	2,011	31.19	11.52	8.65	94.26
Export resources (% GDP)	1,495	21.90	26.53	0	99.67
Trade (Exports + Imports)/GDP	1,761	0.85	0.50	0.13	4.56
OECD Declaration	2,484	0.20	0.40	0	1
Regime type (Polity)	1,786	3.00	6.70	-10	10
Competitiveness of political participation	1,745	3.30	1.34	0	5
Regularity of executive recruitment	1,745	2.51	0.56	1	3
Competitiveness of executive recruitment	1,745	2.02	1.07	0	3

Table 3.6 Summary statistics, transition economies

	Obs	Mean	Std. Dev.	Min	Max
FDI Openness	560	64.13	25.69	4	100
Market size (GDP)	479	23.06	1.43	20.52	26.71
Economic development	465	7.29	0.98	4.94	9.40
Domestic savings (% GDP)	477	16.63	15.51	-71.82	60.75
Agriculture, value added (% GDP)	473	17.78	12.17	2.53	65.86
Industry, value added (% GDP)	471	34.50	8.72	10.29	68.82
Export resources (% GDP)	273	20.84	20.94	0.67	91.96
Trade (Exports + Imports)/GDP	339	0.95	0.32	0.29	1.73
OECD Declaration	560	0.15	0.36	0	1
Regime type (Polity)	397	3.20	6.51	-9	10
Competitiveness of political participation	391	3.28	1.20	1	5
Regularity of executive recruitment	391	2.41	0.49	2	3
Competitiveness of executive recruitment	391	2.10	0.85	1	3

3.4.2. Estimation and results

I analyze the effect of the variables described above using the two alternative indicators of FDI openness. I evaluate the FDI policies of 28 transitions economies in Eastern Europe and the former USSR using the FDI openness indicator I constructed using the policy variables included in the FDI Regulations in Transition Economies database. The *FDI openness* indicator is continuous, ranges from 0 (restricted) to 100 (open), and measures openness to FDI between 1989 and 2008. Empirical models of FDI policies in transition economies are estimated using time-series cross-sectional analysis with random effects. The results are presented in Table 3.7.

The *IEF investment freedom* captures FDI restrictions between 1994 and 2008 in 182 countries. For part of the period, this index was constructed on a 5-point scale, with 1 indicating high FDI restrictions, and 5 low FDI restrictions. The methodology was changed in recent years to allow for a more refined 10-point scale, ranging from 10 to 100 and increasing in increments of 10. The variable used in the analysis was re-coded for the entire time period to reflect the original 5-point scale. Because the dependent variable is an ordinal categorical variable, I analyze the sample using a multi-level random-intercept proportional odds model with an ordered probit link. The results are shown in Table 3.8 and predicted probabilities are depicted in Figure 3.1 and Figure 3.2.

Table 3.7 Political competition and FDI regulations in transition economies, 28 countries

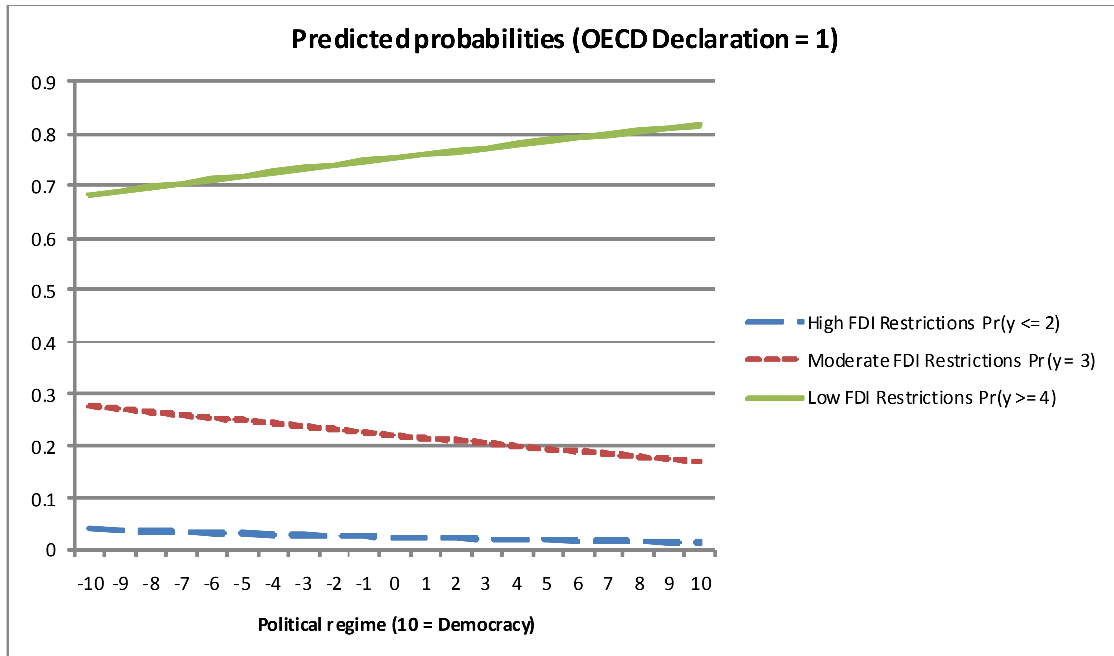
	FDI Openness			
	(1)	(2)	(3)	(4)
Country size (GDP)	-3.450	-3.688	-4.404	-3.985
	(-1.49)	(-1.46)	(-1.63)	(-1.59)
Economic development (GDP/capita)	7.272*	9.332**	8.794*	7.836*
	(2.24)	(2.71)	(2.49)	(2.30)
Domestic savings	-0.0237	0.00541	0.115	0.0414
	(-0.25)	(0.06)	(1.26)	(0.46)
Agriculture, value added	-0.766***	-0.714***	-0.672***	-0.710***
	(-5.07)	(-4.68)	(-4.48)	(-4.64)
Industry, value added	-0.765***	-0.768***	-0.758***	-0.759***
	(-5.30)	(-5.49)	(-5.58)	(-5.38)
Resource exports	0.243**	0.255***	0.218**	0.231**
	(3.26)	(3.37)	(2.91)	(3.10)
Trade (X+M)/GDP	9.099**	8.754**	7.846**	8.635**
	(2.98)	(2.89)	(2.64)	(2.85)
OECD Declaration	1.023	0.450	0.883	1.106
	(0.72)	(0.32)	(0.65)	(0.78)
Regime type	0.645**			
	(3.07)			
Competitiveness of political participation		3.011***		
		(3.30)		
Regularity of executive recruitment			7.881***	
			(4.32)	
Competitiveness of executive recruitment				4.909**
				(3.27)
Constant	121.0**	102.4*	113.1*	119.7*
	(2.64)	(2.07)	(2.20)	(2.46)
Observations	237	235	235	235

t statistics in parentheses; * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

Table 3.8 Political competition and FDI regulations, 127 countries

	Investment Freedom				
	(1)	(2)	(3)	(4)	(5)
Country size (GDP)	-0.360**	-0.351**	-0.398***	-0.373**	-0.384**
	(-3.19)	(-3.03)	(-3.38)	(-3.16)	(-3.28)
Economic development (GDP/capita)	0.991***	0.997***	1.121***	1.129***	1.103***
	(5.25)	(5.03)	(5.69)	(5.70)	(5.61)
Domestic savings	0.0244*	0.0272*	0.0258*	0.0258*	0.0265*
	(2.31)	(2.54)	(2.40)	(2.40)	(2.47)
Agriculture, value added	0.0128	0.0264	0.0249	0.0228	0.0251
	(0.78)	(1.52)	(1.42)	(1.29)	(1.43)
Industry, value added	-0.0420**	-0.0389*	-0.0428**	-0.0436**	-0.0419*
	(-2.61)	(-2.38)	(-2.62)	(-2.66)	(-2.57)
Resource exports	-0.0109*	-0.00960	-0.0108*	-0.0121*	-0.0114*
	(-2.16)	(-1.85)	(-2.08)	(-2.33)	(-2.20)
Trade (X+M)/GDP	-0.178	-0.151	-0.279	-0.251	-0.258
	(-0.61)	(-0.50)	(-0.93)	(-0.83)	(-0.86)
OECD Declaration	0.168	0.145	0.230	0.222	0.197
	(0.67)	(0.57)	(0.91)	(0.87)	(0.78)
Regime type	0.0395*				
	(2.18)				
Competitiveness of political participation		0.324***			
		(3.33)			
Openness of executive recruitment			0.230**		
			(2.66)		
Regularity of executive recruitment				-0.0149	
				(-0.09)	
Competitiveness of executive recruitment					0.160
					(1.56)
Constant (_cut11)	-6.836*	-5.451*	-6.196*	-6.425*	-6.398*
	(-2.55)	(-1.98)	(-2.23)	(-2.30)	(-2.32)
Constant (_cut12)	-3.932	-2.300	-3.085	-3.324	-3.295
	(-1.48)	(-0.84)	(-1.12)	(-1.19)	(-1.20)
Constant (_cut13)	-1.565	0.0864	-0.706	-0.954	-0.924
	(-0.59)	(0.03)	(-0.26)	(-0.34)	(-0.34)
Constant (_cut14)	1.870	3.554	2.758	2.510	2.529
	(0.70)	(1.29)	(1.00)	(0.90)	(0.92)
Constant	1.569***	1.615***	1.643***	1.654***	1.632***
	(11.91)	(11.97)	(12.01)	(11.94)	(11.91)
Observations	1153	1146	1146	1146	1146

t statistics in parentheses; * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$



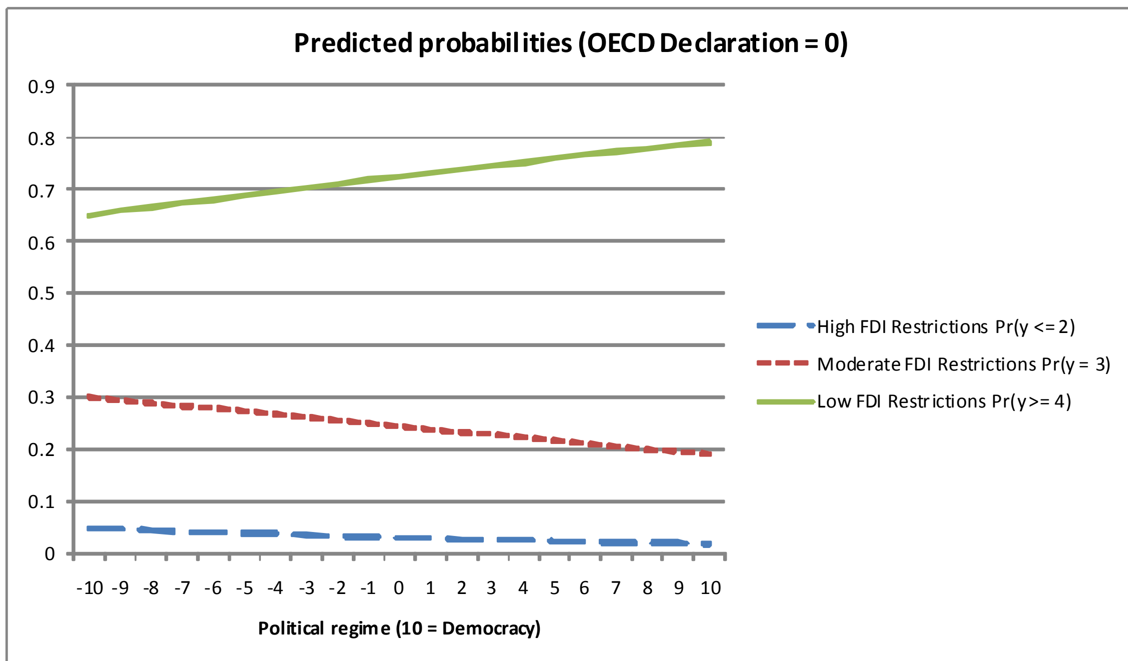
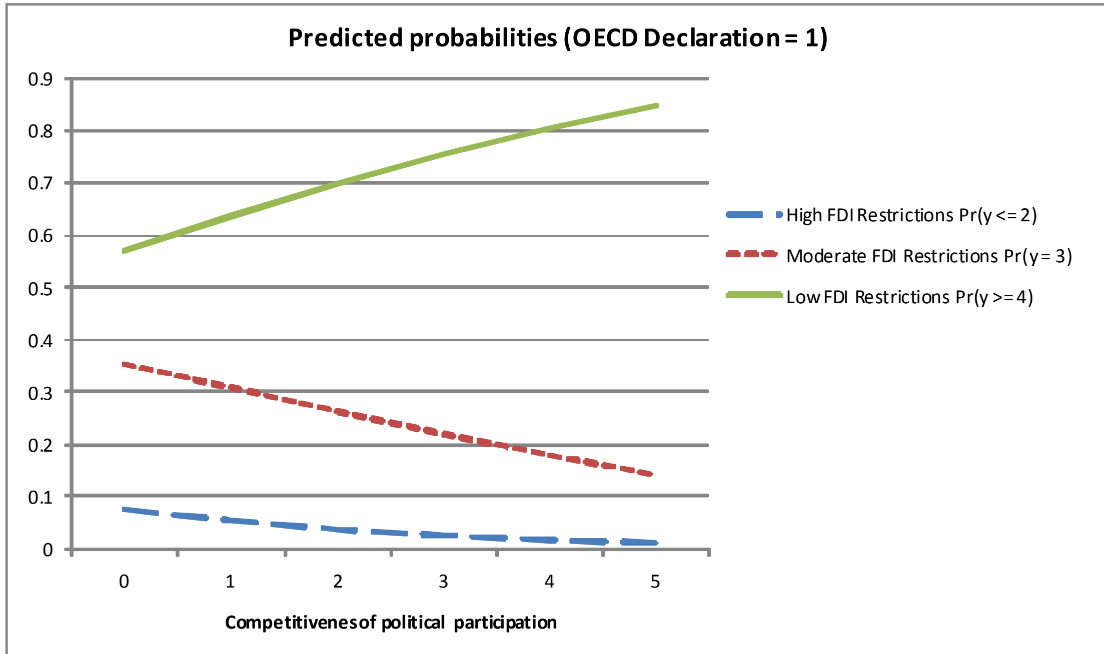


Figure 3.1 Predicted probabilities: Political regimes and FDI openness



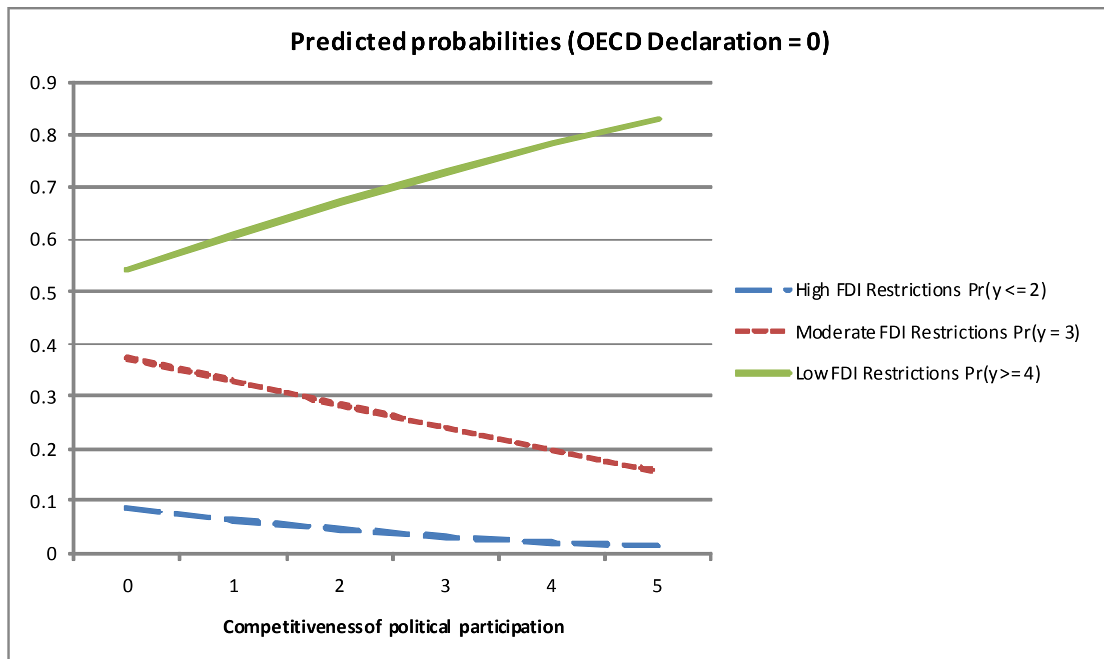


Figure 3.2 Predicted probabilities: Competitiveness of political participation and FDI openness

Both analyses show that democratic regimes are choosing policies that are less restrictive to foreign direct investment than non-democratic regimes. Regime type has a positive and significant coefficient both for the subset of transition economies (1989-2008) and for the large cross-national sample (1994-2008).[3] Moreover, in both samples, an increase in the competitiveness of political participation is associated with an increase in FDI openness. Two other measures of political competition—the competitiveness and regularity of executive recruitment—are associated with higher FDI openness in transition economies, but not in the larger cross-sectional sample.

Predicted probabilities generated by the ordered probit models shown in Table 3.8 suggest that, when holding all continuous variables at the mean, the probability of having open FDI policies (i.e. low restrictions on FDI) increases when we compare less democratic to more democratic regimes (Figure 3.1). The probabilities of having high or moderate restrictions on FDI decrease when the level of democracy increases. Figure 3.2 depicts that similar dynamics define the relationship between the competitiveness of political participation and FDI openness. Increasing the level of democracy increases the probability of having lower restrictions on FDI, when continuous variables are set at their means. For example, the difference between the probabilities of Tudjman's Croatia

[3] The coefficients in the two tables cannot be compared directly because they have been estimated using two different models—a non-linear ordered probit and a linear estimator, respectively.

(1991-1999) and democratic Croatia (2000-2008) having open policies on FDI is roughly 11 per cent.

The analysis also indicates that smaller economies and those at higher levels of development are more likely to be open to FDI. These results seem sensible, considering that throughout history small economies have always sought greater integration in the world economy than their larger counterparts (Katzenstein 1985). Advanced economies are more open to FDI, which is not surprising when considering that the effect of foreign direct investment on local economies is likely to be contingent on the capacity of local factors to compete with and "learn" from multinational companies. Since developed countries are more likely to gain from FDI, they tend to be more welcoming to it, too.

Economies with larger agriculture and industry sectors have higher restrictions on FDI. I interpret the size of the agriculture and industry sectors as rough indicators of the overall strength of pressures for continued protectionism. In the two samples, the level of value added in industry as a percent of GDP is negatively correlated with investment freedom and openness to FDI, respectively. Value added in agriculture is negatively correlated with openness to FDI only in transition economies.

As expected, results in the large sample (Table 3.8) show that resource exports are negatively associated with FDI openness. The effect is reversed for transition economies, suggesting that it may be contingent on industry-specific or contextual

factors. Resource rich transition economies made an effort during the 1990s to attract foreign direct investment to upgrade their outdated extractive sectors, and later re-instituted restrictions on foreign companies. The experiences of foreign oil companies in Russia and Kazakhstan, for example, attest to the fact that the honeymoon of the early 1990s was short-lived.

Finally, adherence to the OECD Declaration on International Investment and Multinational Enterprise does not have an impact on FDI openness. Despite efforts to coordinate national policies towards foreign direct investment in a way that mirrors what the GATT and WTO achieved for trade, every attempt to put in place a general framework on international investments, including the Multilateral Agreement on Investment, have ended in failure (Graham 2000). For the time being, policies on foreign direct investment are decided by national governments with little consideration for multilateral frameworks. Significant differences in the national policies on FDI endure despite the advancement of globalization.

To assess the robustness of these results, I lag the political competition variables by two and three periods (Table 3.9). The results do not change. In the sample of transition economies, different lags of political competition have the expected positive and significant effect on FDI openness. While this suggests that the effect of political competition on FDI regulation endures, the magnitude of the coefficients decrease with

time. This is not surprising: while countries often adopt new FDI legislation immediate after the change of the regime, some of the provisions take immediate effect while others take longer to implement. For instance, the democratic government that came to power in Croatia immediately following Tudjman's death at the end of 1999 adopted a new set of FDI laws that liberalized the entry condition for foreign companies shortly after the election. However, the adoption of an incentive program and the establishment of an investment promotion agency took several years.

I also estimate an empirical specification than includes a time trend. In the sample of transition economies, there is an observable move towards increased FDI liberalization across time. Several studies have suggested that economic liberalization is the result of the diffusion of global ideology (Simmons and Elkins 2004; Simmons et al. 2006; Quinn and Toyoda 2007). They argue that as ideas spread around the world, countries are more likely to adopt open economic policies. I include a time trend as a proxy for the diffusion of ideas. Even when a time trend is included in the analysis, the effect of political competition remains strong (Table 3.10). A similar set of results was obtained using the worldwide sample (results are available from the author).

Table 3.9 Political competition and FDI regulations in 28 transition economies: Alternative lags

	FDI Openness					
	(1)	(2)	(3)	(4)	(5)	(6)
Country size (GDP)	-3.450	-3.958	-3.943	-3.985	-4.861	-4.633
	(-1.49)	(-1.67)	(-1.68)	(-1.59)	(-1.90)	(-1.84)
Economic development (GDP/capita)	7.272*	10.51**	10.60***	7.836*	11.15***	11.36***
	(2.24)	(3.27)	(3.29)	(2.30)	(3.33)	(3.43)
Domestic savings	-0.0237	0.00888	0.0388	0.0414	0.0433	0.0800
	(-0.25)	(0.10)	(0.46)	(0.46)	(0.51)	(0.98)
Agriculture, value added	-0.766***	-0.682***	-0.659***	-0.710***	-0.655***	-0.616***
	(-5.07)	(-4.56)	(-4.45)	(-4.64)	(-4.37)	(-4.29)
Industry, value added	-0.765***	-0.636***	-0.606***	-0.759***	-0.612***	-0.560***
	(-5.30)	(-4.49)	(-4.33)	(-5.38)	(-4.40)	(-4.21)
Resource exports	0.243**	0.212**	0.190**	0.231**	0.203**	0.178**
	(3.26)	(3.08)	(2.80)	(3.10)	(2.96)	(2.68)
Trade (X+M)/GDP	9.099**	7.930**	8.090**	8.635**	7.526*	7.596**
	(2.98)	(2.69)	(2.78)	(2.85)	(2.57)	(2.67)
OECD Declaration	1.023	0.141	-0.0598	1.106	0.348	-0.384
	(0.72)	(0.11)	(-0.04)	(0.78)	(0.26)	(-0.29)
Regime type (lag 1)	0.645**					
	(3.07)					
Regime type (lag 2)		0.585**				
		(2.85)				
Regime type (lag 3)			0.397*			
			(2.27)			
Competitiveness of exec recruitment (lag 1)				4.909**		
				(3.27)		
Competitiveness of exec recruitment (lag 2)					5.114***	
					(3.68)	
Competitiveness of exec recruitment (lag 3)						4.698***
						(3.97)
Constant	121.0**	105.2*	103.8*	119.7*	111.4*	103.4*
	(2.64)	(2.26)	(2.24)	(2.46)	(2.25)	(2.13)
Observations	237	256	252	235	253	250

t statistics in parentheses; * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

Table 3.10 Political competition and FDI regulations in 28 transition economies: Time trend

	FDI Openness			
	(1)	(2)	(3)	(4)
Country size (GDP)	-3.288	-3.497	-4.102	-3.669
	(-1.44)	(-1.37)	(-1.54)	(-1.48)
Economic development (GDP/capita)	4.196	5.250	4.768	4.440
	(1.28)	(1.47)	(1.30)	(1.28)
Domestic savings	-0.0604	-0.0409	0.0610	-0.00663
	(-0.66)	(-0.47)	(0.68)	(-0.07)
Agriculture, value added	-0.527***	-0.452**	-0.450**	-0.483**
	(-3.31)	(-2.80)	(-2.83)	(-2.99)
Industry, value added	-0.447**	-0.416**	-0.457**	-0.453**
	(-2.75)	(-2.59)	(-2.91)	(-2.82)
Resource exports	0.124	0.143	0.122	0.121
	(1.57)	(1.80)	(1.56)	(1.53)
Trade (X+M)/GDP	3.048	2.591	2.617	2.954
	(0.91)	(0.79)	(0.81)	(0.89)
OECD Declaration	-0.882	-1.413	-0.792	-0.780
	(-0.60)	(-0.99)	(-0.56)	(-0.53)
Time	0.920***	0.973***	0.872***	0.898***
	(3.88)	(4.04)	(3.55)	(3.67)
Regime type	0.519*			
	(2.52)			
Competitiveness of political participation		2.683**		
		(3.04)		
Regularity of executive recruitment			6.660***	
			(3.68)	
Competitiveness of executive recruitment				3.693*
				(2.47)
Constant	124.9**	111.7*	123.5*	125.0**
	(2.78)	(2.26)	(2.44)	(2.61)
Observations	237	235	235	235

t statistics in parentheses; * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

Table 3.11 Political competition and FDI regulations in 28 transition economies: Lagged dependent variable

	FDI Openness			
	(1)	(2)	(3)	(4)
Country size (GDP)	-0.167	0.00333	-0.366	-0.514
	(-0.37)	(0.01)	(-0.69)	(-1.04)
Economic development (GDP/capita)	1.914*	1.509	1.859*	2.064*
	(2.46)	(1.81)	(2.28)	(2.55)
Domestic savings	-0.0721	-0.0256	-0.0104	-0.0321
	(-1.38)	(-0.49)	(-0.20)	(-0.62)
Agriculture, value added	0.138	0.134	0.128	0.130
	(1.87)	(1.72)	(1.63)	(1.70)
Industry, value added	0.148*	0.123*	0.112	0.118*
	(2.54)	(2.04)	(1.87)	(1.99)
Resource exports	0.0375	-0.00292	-0.00456	0.0127
	(1.65)	(-0.14)	(-0.22)	(0.59)
Trade (X+M)/GDP	1.126	0.555	-0.538	-0.215
	(0.70)	(0.33)	(-0.32)	(-0.13)
OECD Declaration	-0.681	-1.088	-0.918	-0.648
	(-0.70)	(-1.08)	(-0.91)	(-0.64)
FDI Openness (Lag 1)	0.856***	0.908***	0.908***	0.881***
	(28.59)	(32.04)	(32.61)	(29.89)
Regime type	0.360***			
	(4.11)			
Competitiveness of political participation		0.617		
		(1.49)		
Regularity of executive recruitment			1.310	
			(1.59)	
Competitiveness of executive recruitment				1.652**
				(2.94)
Constant	-6.816	-10.40	-4.289	-1.439
	(-0.48)	(-0.70)	(-0.27)	(-0.10)
Observations	236	234	234	234

t statistics in parentheses; * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

In addition, I re-estimate the results with a lagged dependent variable to account for the fact that policy choices are "sticky" and FDI regulations at time *t-1* predict regulations at time *t*. In this specification, regime type and the competitiveness of executive recruitment continue to have positive and statistically significant effects on FDI openness (Table 3.11).

3.4.3. Alternative measures of political competition

Following Schumpeter (1942) and more recently Przeworski et al. (2000), many scholars have defined democracy as a regime in which the executive and legislative are selected through a process of contested elections. Contestation implies that incumbents face a fair probability of losing elections because multiple political groupings compete for a number of political positions. Although a tremendous amount of effort has been devoted to measuring the level of democratic political completion, most scholars agree that none of the indicators available is a perfect measure of the underlying concept.

Munck and Verkuilen (2002) argue that no existing measure of democracy simultaneously identifies the appropriate attributes of democracy, provides a well-conceived scale for the measurement of each attribute, and aggregates properly the individual indicators without loss of information. For instance, in the widely used Polity IV data, different coding patterns generate the same Polity score which do not reflect the variation across the underlying dimensions (Gleditsch and Ward 1997). To address this

shortcoming, in the analysis presented above I rely both on the composite Polity score and on its component indicators.

In addition, I re-estimate the results using a number of alternative measures of democracy (Table 3.12: Transition economies and Table 3.13: Worldwide sample). Specifically, I use the Freedom House political rights and civil liberties data, a measure that combines Freedom House and Polity IV scores, a dichotomous measure of regime type provided by (Jose Antonio Cheibub and Ghandi 2004), measures of contestation and inclusiveness proposed by (Coppedge et al. 2008), Vanhanen's indicator of competition, and the voice and accountability measure included in the World Bank Governance Indicators.

The Freedom House measure of political rights reflects the extent to which people are allowed to participate freely in the political process, including the rights to vote, to compete for public office, to join political parties and organizations, and to elect representative who have an impact on public policies and are accountable to the electorate. Freedom House's measure of civil liberties refers to freedoms of expression and belief, associational and organizational rights, and personal autonomy from the state. Both original measures were re-coded to reflect an increase from 1 (least free) to 7 (most free). As shown in column (2) of both Tables 3.9 and 3.10, the measure of political

rights has a positive and significant effect on FDI openness. The civil liberties coefficient is not significant.

I also rely on a measure that averages the Freedom House and the Polity indicators after both have been transformed to a scale 0-10. (Hadenius and Teorell 2005) argue that this average index performs better both in terms of validity and reliability than its constituent parts. The results in column (3) show that the Freedom House - Polity average has the expected effect on FDI openness in both the sample of transition economies and in the worldwide sample.

The results shown in column (4) use a dichotomous measure of regime type. The original data provided by (Jose Antonio Cheibub and Ghandi 2004) was re-coded to have democracy = 1. A regime is considered a dictatorship if the chief executive is not elected, the legislative is not elected, there is no more than one party, or there has been no alternation in power (Przeworski et al. 2000). As shown in Table 3.12, former communist countries have more open policies on FDI, *ceteris paribus*. The dichotomous democracy variable, however, is not significant for the worldwide sample.

Table 3.12 Political competition and FDI regulations in 28 transition economies: Alternative measures of democracy

	FDI Openness							
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Country size (GDP)	-3.924	-4.090	-4.273	-3.911	-1.979	-2.070	-3.492	-3.673
	(-1.75)	(-1.94)	(-1.95)	(-1.71)	(-0.99)	(-0.81)	(-1.60)	(-1.55)
Economic development (GDP/capita)	7.692*	7.285*	7.093*	6.677*	2.506	4.550	6.768*	7.244
	(2.52)	(2.38)	(2.32)	(1.96)	(0.76)	(1.17)	(2.09)	(1.95)
Domestic savings	0.104	0.107	0.0821	0.0309	-0.129	-0.0793	-0.000448	-0.00361
	(1.25)	(1.22)	(0.96)	(0.31)	(-1.09)	(-0.64)	(-0.00)	(-0.04)
Agriculture, value added	-0.805***	-0.867***	-0.804***	-0.848***	-0.693***	-0.813***	-0.809***	-0.662***
	(-5.76)	(-5.87)	(-5.61)	(-5.31)	(-3.68)	(-4.21)	(-5.17)	(-3.34)
Industry, value added	-0.695***	-0.840***	-0.714***	-1.012***	-0.949***	-1.145***	-0.910***	-0.348
	(-5.27)	(-6.20)	(-5.28)	(-7.08)	(-5.57)	(-6.79)	(-6.41)	(-1.86)
Resource exports	0.241***	0.171*	0.223**	0.236**	0.0641	0.0503	0.231**	0.149
	(3.54)	(2.47)	(3.25)	(3.10)	(0.70)	(0.49)	(3.05)	(1.85)
Trade (X+M)/GDP	6.715*	7.663*	7.432*	3.030	4.740	5.448	7.867*	9.285*
	(2.29)	(2.48)	(2.50)	(0.96)	(1.20)	(1.36)	(2.42)	(2.21)
OECD Declaration	0.981	0.910	1.017	2.496	2.784	1.908	2.198	0.619
	(0.75)	(0.65)	(0.76)	(1.39)	(1.23)	(0.83)	(1.37)	(0.39)
Freedom House: Political rights	3.053***							
	(4.80)							
Freedom House: Civil ciberties		0.902						
		(1.22)						
Freedom House - Polity average			1.908***					
			(3.89)					
Cheibub & Gandhi: Democracy (0/1)				13.36***				
				(4.00)				
Coppedge: Contestation					7.578***			
					(3.84)			
Coppedge: Inclusiveness						2.712		
						(0.73)		
Vanhanen: Competition							0.130*	
							(2.46)	
WB Gov Indicators: Voice & Accountability								4.960*
								(2.11)
Constant	115.5**	139.5**	130.6**	143.1**	132.8**	131.3*	129.0**	116.5*
	(2.61)	(3.27)	(3.00)	(3.11)	(2.97)	(2.51)	(2.89)	(2.36)
Observations	258	258	258	170	125	125	215	167

t statistics in parentheses; $^{*}p < 0.05$, $^{**}p < 0.01$, $^{***}p < 0.001$

Table 3.13 Political Competition and FDI Regulations in 127 countries: Alternative measures of democracy

	Investment Freedom							
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Country size (GDP)	-0.375***	-0.403***	-0.412***	-0.347*	-0.385	-0.424	-0.330**	-0.264**
	(-3.72)	(-3.90)	(-3.77)	(-2.21)	(-1.74)	(-1.84)	(-2.87)	(-2.71)
Economic development (GDP/capita)	0.866***	0.966***	0.985***	1.186***	1.022*	1.385***	0.977***	0.378
	(4.93)	(5.32)	(5.34)	(4.25)	(2.56)	(3.36)	(4.92)	(1.92)
Domestic savings	0.0330***	0.0319***	0.0289**	0.0328*	0.0368	0.0247	0.0323**	0.0270*
	(3.47)	(3.33)	(2.98)	(2.13)	(1.69)	(1.13)	(2.90)	(2.36)
Agriculture, value added	0.0146	0.0117	0.0170	-0.00679	-0.0324	-0.0222	0.0118	-0.00577
	(0.93)	(0.74)	(1.07)	(-0.28)	(-0.91)	(-0.59)	(0.67)	(-0.31)
Industry, value added	-0.0451**	-0.0494**	-0.0439**	-0.0511*	-0.0405	-0.0358	-0.0477**	-0.0449**
	(-3.03)	(-3.28)	(-2.87)	(-2.20)	(-1.25)	(-1.08)	(-2.78)	(-2.58)
Resource exports	-0.0124**	-0.0144**	-0.0130**	-0.0107	-0.0225*	-0.0271**	-0.00949	-0.0117*
	(-2.72)	(-3.13)	(-2.69)	(-1.51)	(-2.21)	(-2.59)	(-1.86)	(-2.37)
Trade (X+M)/GDP	-0.463	-0.556*	-0.518	0.0433	0.197	0.331	-0.177	-0.0598
	(-1.76)	(-2.10)	(-1.93)	(0.10)	(0.27)	(0.49)	(-0.55)	(-0.21)
OECD Declaration	0.194	0.232	0.186	0.229	0.530	0.680	0.199	0.135
	(0.83)	(0.98)	(0.80)	(0.60)	(0.93)	(1.16)	(0.71)	(0.47)
Freedom House: Political rights	0.207***							
	(3.86)							
Freedom House: Civil ciberties		0.0637						
		(0.86)						
Freedom House - Polity average			0.0979*					
			(2.41)					
Cheibub & Gandhi: Democracy (0/1)				0.359				
				(1.23)				
Coppedge: Contestation					0.893**			
					(2.84)			
Coppedge: Inclusiveness						0.572		
						(1.81)		
Vanhanen: Competition							0.0142**	
							(2.79)	
WB Gov Indicators: Voice & Accountability								1.050***
								(5.59)
Constant (_cut11)	-7.400**	-8.274***	-7.741**	-8.110*	-11.78*	-10.26	-6.012*	-9.372***
	(-3.02)	(-3.31)	(-3.01)	(-2.10)	(-2.07)	(-1.78)	(-2.14)	(-3.69)
Constant (_cut12)	-4.494	-5.403*	-4.863	-3.345	-5.914	-4.292	-3.114	-6.416*
	(-1.85)	(-2.18)	(-1.91)	(-0.88)	(-1.07)	(-0.76)	(-1.11)	(-2.56)
Constant (_cut13)	-2.138	-3.055	-2.535	0.159	-1.892	-0.260	-0.513	-4.150
	(-0.88)	(-1.24)	(-1.00)	(0.04)	(-0.34)	(-0.05)	(-0.18)	(-1.66)
Constant (_cut14)	1.242	0.335	0.819	4.828	4.837	6.660	3.259	-1.037
	(0.51)	(0.14)	(0.32)	(1.26)	(0.87)	(1.16)	(1.16)	(-0.42)
Constant	1.536***	1.590***	1.542***	2.406***	3.040***	3.208***	1.749***	1.307***
	(12.22)	(11.97)	(11.88)	(10.73)	(8.67)	(8.59)	(12.15)	(10.87)
Observations	1262	1262	1224	887	663	663	1101	794

t statistics in parentheses; * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

Coppedge et al. (2008) argue that two principal components of most commonly used democracy indicators — contestation and inclusiveness — capture 75 percent of variation in these indicators and measure Robert Dahl's two dimensions of polyarchy. The two measures are used to estimate the results in columns (5) and (6). Contestation has a positive and significant effect on FDI openness in both samples.

A different index of democracy (Vanhanen 2000) also includes a measure of political contestation. Competition is measured the percentage of votes not cast for the largest party and is calculated by subtracting from 100 the percentage of votes won by the largest party in parliamentary elections or the party of the successful candidate in presidential elections. The results obtained using this measure, shown in column (7) of each table, suggest that higher political competition—i.e. a lower percentage for the largest party—is positively associated with FDI openness.

Finally, I rely on one of the components of the World Bank Governance Indicators, which are computed on the basis of several hundred individual variables measuring perceptions of governance (Kaufmann et al. 2008). An unobserved component model is used to construct six aggregate governance indicators, including voice and accountability, which I use to estimate the results in column (8). The 'voice and accountability' measure includes a number of indicators which measure the extent to which citizens are allowed to participate in the selection of governments and

indicators measuring the independence of media. As the results in column (8) show, countries which allow their citizens more voice and accountability are also more open to FDI.

3.5. Conclusion

Multinational companies are not welcome in every corner of the world, but many countries have removed most barriers to the entry and operations of foreign firms. This dissertation argues that where political developments have brought about more democratic politics, changing political incentives account for the liberalization of foreign investment policies. New governments, often brought to power by the votes of previously marginalized groups, have found it in their best political interest to allow the entry of foreign companies whose investments promised to bring about better jobs and higher wages. With the expansion of political participation through democratization, political incentives to provide better employment for domestic workers seem to override political pressures to protect domestic firms from increased competition. I show empirically that democratic regimes have adopted policies that are more welcoming to foreign direct investment than their non-democratic counterparts.

Furthermore, this chapter shows that political considerations of the distributional consequences of FDI affected reforms not only in transition economies, which had complete bans or very strict restrictions on FDI during the communist regimes and had

received almost no FDI before 1989, but also in other developed and developing countries, where the presence of foreign MNEs might have engendered nationalist reactions against foreign companies. While nationalist and populist rhetoric has been present in political debates about FDI liberalization in some countries (Bandelj 2007), empirical observation shows that most democratic governments have overcome nationalist opposition and lowered or eliminated barriers to FDI.

More democratic countries adopt and implement policies that open their markets to the international economy. This seems to be true in the case of trade policy reform (Milner and Kubota 2005) and capital controls liberalization (Quinn 2002). I complement this research and argue that democratization in the last decades of the twentieth century also brought about policy reforms that involved the removal of strict restrictions on the entry and operations of foreign firms and, in some cases, the replacement of restrictions with generous incentive and promotion programs to attract FDI. Countries that became more democratic during this time opted to open their doors to foreign companies, while non-democratic regimes continued to restrict the entry of foreign firms.

4. FDI Liberalization in Transition Economies: The Degree, Mix, and Timing of Policy Changes

4.1. Introduction

In the previous chapters, I argue that political competition is an important determinant of FDI regulations. I propose that democracies are more likely to be open to foreign direct investment than non-democratic regimes and use data from transition economies as well as a broader sample of developed and developing countries to support this hypothesis. The theoretical rationale takes into account both the distributive consequences of FDI entry and the political incentives of leaders in power. Because FDI is a complement for domestic labor and a substitute for domestic capital, higher levels of FDI benefit domestic labor (through upward pressures on wages) and hurt domestic capital (through downward pressures on the returns to capital in the economy). As a result, democratic governments – who draw their legitimacy from the support of the majority – opt to remove barriers to FDI in order to increase the welfare of their supporters though higher wages. By contrast, non-democratic regimes keep in place barriers to FDI because their political survival depends on the support of small groups of elites who own or control domestic capital and whose welfare would decline with increased competition from foreign firms.

This chapter extends the previous argument and empirical analysis in several ways. In Section 4.2 I present a formal model that builds on the existing theoretical rationale to show that under certain conditions even non-democratic governments remove some of the barriers to FDI in order to open *partially* to investment by multinational companies. To derive the model, I apply the framework developed for coordination games by Morris and Shin (2000) following the intuition described by Atkeson (2000), and show that it is in the best interest of non-democratic governments to allow FDI up to a certain threshold, but not above.

In Section 4.3, I discuss the observable implications that can be derived from the formal model and test them in Section 4.4. I show that while both democratic and non-democratic regimes have removed barriers to FDI, democracies have removed them completely and non-democracies only in part. This partial openness to FDI in non-democracies is not due to limited liberalization on each of the different policy dimensions, but rather to a mix of low restrictions on some dimensions and high restrictions on others. I argue that even non-democracies remove many of the barriers to FDI if they can keep in place a number of policies that allow them to maintain tight control over the level of FDI inflows.

4.2. Political survival and FDI liberalization: A model of FDI policy choice

A fundamental difference between democratic and non-democratic regimes is the size, and implicitly the composition, of the group who participates in the selection of political leaders. This is "the selectorate", following the terminology of (Bueno de Mesquita et al. 1999, 2003). In a democracy, the selectorate is part of the population that is eligible to vote. In a non-democracy, the selectorate is a small group of elites who control enough instruments of power to ensure the leaders' survival in office. These are most likely the wealthiest members of society who either own or control domestic capital. In market-oriented economies, they own or operate industrial conglomerates, banks, and real estate. In state-controlled economies, they are involved in the management of large state-owned enterprises or utility companies. Since their welfare is a function of the returns on domestic capital, they oppose any policy change that increases competition in the domestic economy and therefore reduces the returns on the capital they own or control. By contrast, people whose welfare depends on wages – domestic labor – are the majority of a democratic government's constituency. For simplicity, I will refer to a non-democratic government as being controlled by domestic capital and to democratic government as being controlled by labor.

The model considers an economy with two factors of production: labor L and capital K. The output of the domestic economy is a function of the two factors $Y = F(K, L)$, where K is the sum of domestic and foreign capital invested in the economy, $K = K_d + K_f$. Both the labor force L and the domestic capital K_d are in fixed supply. Wages represent the marginal productivity of labor $w = \frac{\partial F(K,L)}{\partial L}$, and the returns to capital are the marginal productivity of capital $r = \frac{\partial F(K,L)}{\partial K}$.

If the government allows the unrestricted entry of FDI, foreign capital enters until returns to capital in the domestic economy are the same as in the rest of the world, or r_{world}. At this point domestic output is maximized, given the fixed labor and domestic capital supply. However, at this point the return to domestic capital r_{open} is considerably lower than the return the owners of domestic capital get if there were no foreign investment. By contrast, wages are higher than in an economy closed to foreign capital. Every new unit of foreign capital depresses returns to domestic capital and increases the returns to labor. In short, the entry of foreign capital has both growth implications and strong redistributive effects. While the output is at its highest level in a fully open economy and so are wages, returns to capital are considerably lower than in a closed economy.

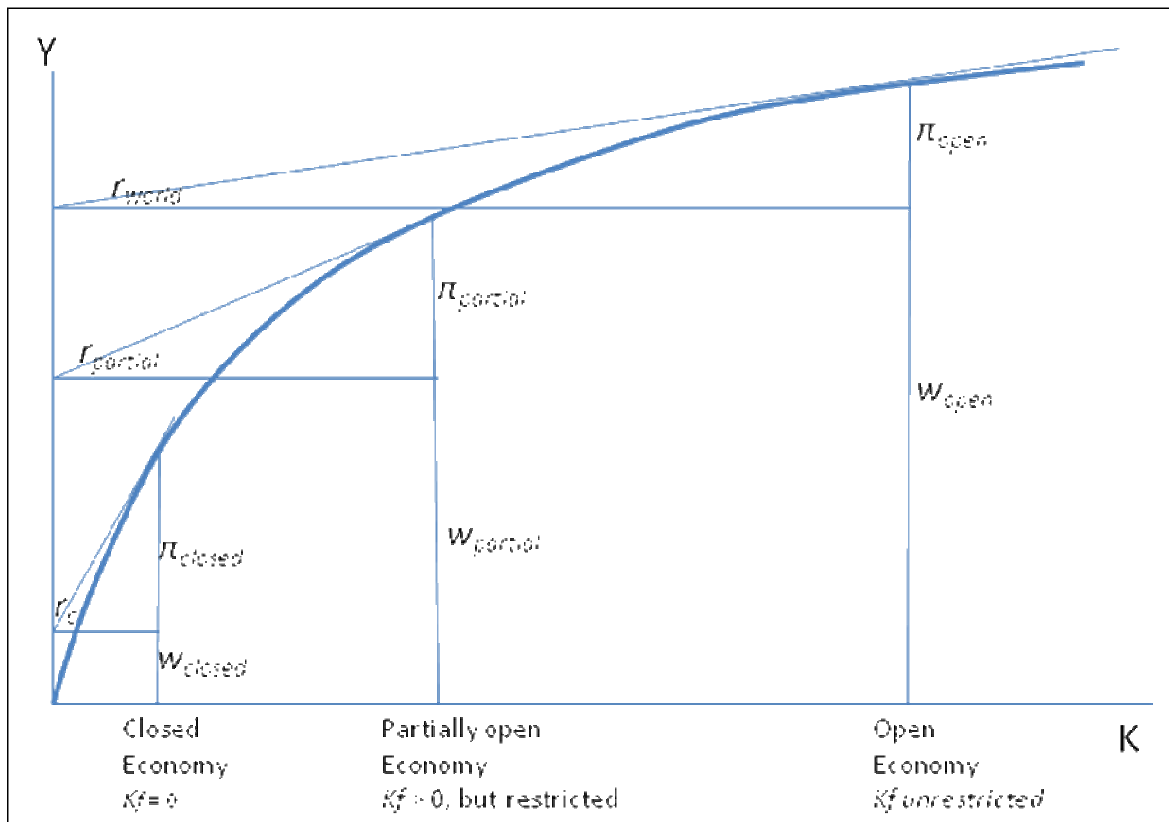


Figure 4.1 FDI openness and redistributive effects of FDI entry

Figure 4.1 illustrates this graphically. In a closed economy, returns to capital are r_{closed}. Profits are π_{closed} and wages w_{closed}. As the government allows the entry of some foreign capital in a partially open economy, return to capital in the domestic markets decrease to $r_{partial} < r_{closed}$. Consequently, profits $\pi_{partial}$ are a lower proportion of the total output and wages $w_{partial}$ are a higher proportion than in a closed economy. In addition, profit $\pi_{partial}$ is split between domestic and foreign firms operating in the economy. Total output has increased as a result of FDI entry, but domestic firms get only

a smaller percent of the total than before and therefore lose relative to labor. The balance of economic power shifts slightly from the powerful elite of capital owners to labor.[1] If the government opens to FDI completely, foreign capital enters up to the point where returns to capital in the domestic economy are the same as in the rest of the world, $r_{open} = r_{world}$. At this point, domestic capital is in a weaker position relative to labor than in a partially open economy, and obviously than in a closed economy. By contrast, domestic labor is best off in an open economy both in term of absolute gains and relative to domestic capital.

A government that is controlled by labor has a very easy choice – to open to FDI by removing all possible barriers on the entry and operations of foreign firms. If barriers on FDI entry were the only available policy tool, a government controlled by or aiming to protect the interests of domestic capital would also have an easy choice – to keep the economy closed to FDI – because any change to allow openness would directly hurt domestic capital owners. Policy barriers to foreign capital make it more expensive for foreign firms to invest in the domestic economy. Such barriers are the equivalent of tax p on foreign capital K_f, which will now enter only as long as $(1-p)r \geq r_{world}$, or

---

[1] The magnitude of the relative gains π_d / w depends on the exact form of the production function $Y = F(K, L)$.

$r \geq \frac{r_{world}}{1-p}$. Notice that the return on domestic capital r increases as p increases. Therefore, a government controlled by domestic business interests will set the tax at the highest level, essentially keeping all foreign investment out.

Alternatively, the same government can allow some foreign capital, impose a tax on domestic labor's higher income and use the tax revenue to compensate domestic capital owners for their depressed profits due to increased competition from foreign companies. The government chooses policy barriers $p_{partial}$, which results in foreign capital in the amount of $K_f(p)$ and a return to capital of $r_{partial}$.[2] The output is profits plus wages, but the profit must be split between domestic and foreign investors: $Y_{partial} = \pi_d + \pi_f + w_{partial}$.

In order to be able to compensate domestic capital for their profit loses, the government imposes a tax on the higher income of labor. A government interested exclusively in the welfare of domestic capital owners collects as tax any income above w_{closed}. The tax revenue collected, $w_{partial} - w_{closed}$, is transferred to domestic capital. In this arrangement, labor gets only w_{closed} and the owners of domestic capital get $\pi_d + (w_{partial} - w_{closed})$.

---

[2] $K_f(p)$ is such that $(1-p_{partial})r_{partial} = r_{world}$. Simply put, foreign investors come in only a long as their returns after taking into account the policy barriers are at least as high as capital returns in the rest of the world.

If taking away all of labor's income that is above w_{closed} were costless and without risk, even a non-democratic government controlled by domestic capital would choose to open to FDI completely because in an open economy $\pi_d + (w_{partial} - w_{closed})$ is the highest. However, labor would not endure such a gruesome tax and would rebel if (1) it stood to gain a lot by refusing to pay the tax and (2) it believed that it could win against a government trying to coerce it into paying the tax. A successful rebellion would result into the overthrow of the business-controlled government and the coming to power of a regime controlled by labor, which would eliminate the tax on labor and the transfer to owners of domestic capital. Clearly, a government controlled by domestic business interests wants to avoid such an outcome at any costs. It therefore uses its position of power to ensure that the two conditions conducive to rebellion are not simultaneously met.

The decision of labor to rebel or not is a coordination game between workers. In the current scenario, each worker receives wage $w_{partial}$ and must pay tax $(w_{partial} - w_{closed})$. If workers rebel and win, each worker keeps $w_{partial}$ regardless of whether she rebelled or not. If workers rebel and lose, those who rebelled get $w_{closed} - \varphi < 0$, where φ is the punishment for rebellion. Those who did not rebel, continue to get w_{closed}.

The government strength to quell a rebellion is a function of the capital owners' revenues, and therefore a function of returns to capital r. I assume here, as one would in a one-short game, that the government starts with no savings, so that in the event of a rebellion it can only use the ruling class' income to subdue its opponents. Police strength is increasing in income, but other factors matter as well; hence, policy strength, denoted by θ, has a stochastic component. Workers do not know the state of the world θ – the strength of the police – but start with a common prior that θ is a function of the returns to capital and a stochastic component that is normally distributed with mean 0 and variance $\frac{1}{\alpha}$ (precision α). That is, $\theta = f(r) + \varepsilon$, where $\theta \approx N\left(0, \frac{1}{\alpha}\right)$. Each worker receives an idiosyncratic signal $x_i = \theta + \varepsilon_i$ of the state θ, where ε_i is normally distributed with mean 0 and variance $\frac{1}{\beta}$ (precision β). For every state of the world θ, $a(\theta)$, a strictly increasing function of θ, is the fraction of labor that must rebel in order to overcome the police.

In coordination games with no uncertainty – i.e. the state of the world θ is common knowledge – there are multiple equilibria in a region of the state space and the outcome depends on the players' expectations of what other players will do and not on the underlying state of the world. By introducing uncertainty, Morris and Shin (2000) eliminate the multiple equilibria problem. They show that if agents perceive a noisy

signal of the true state of the world and thus have some uncertainty over what every other agent knows about the coordination game they are playing, then these games have a unique equilibrium corresponding to each underlying state of the world. The game presented here is similar to the street riot game proposed by Atkeson (2000) as a direct application of the Morris and Shin's innovative insight into solving coordination games. Atkeson proposes a solution based on the iterated elimination of dominated strategies. The iterative procedure puts tighter and tighter bounds on equilibrium strategies which converge to common limit points, x^* and θ^*.

Following Atkeson, I use x^* and θ^* to denote the limit points of the equilibrium strategies. All workers who receive signals $x \leq x^*$ rebel, and all workers who receive signals $x > x^*$ choose not to do so. The rebellion is successful for all states $\theta \leq \theta^*$ and fails in all states $\theta > \theta^*$, where the fraction of labor necessary to overwhelm the government strength is $a(\theta^*) = \Phi\left(\frac{\alpha}{\sqrt{\beta}}(\theta^* - f(r)\right) - \frac{\sqrt{\alpha+\beta}}{\sqrt{\beta}}\Phi^{-1}\left(\frac{\varphi}{w_{partial} - w_{closed} + \varphi}\right)$.

In other words, all workers who perceive the government as weak rebel, while those who perceive a stronger government do not. The workers' rebellion is successful if the government is indeed weak – the true state of the world θ is lower than the threshold θ^* – and fails when the government is strong.

Because the equilibrium is unique, the government can survive a rebellion only if its strength is higher that the equilibrium threshold θ^*. To maintain its strength θ above this level, it must ensure that $f(r) > f(r^*) \equiv \theta^*$. Therefore, there exists a threshold $r^* = f^{-1}(\theta^*)$ such that $r > r^*$. To maintain its strength above the threshold level, the government must ensure that the return to domestic capital does not fall below r^*. In order to do so, it must keep the level of foreign capital below a certain threshold K_f^* by keeping in place policy barriers to FDI above a level p^*. For levels of foreign capital below K_f^* returns to capital in the domestic economy are above r^*, the government is perceived as strong by a large percent of the workers and its police strength is sufficient to overwhelm a workers' rebellion. For levels of foreign capital above K_f^*, the government strength decreases below the threshold θ^* because of the decline in return to domestic capital r and a rebellion by the workers would be successful. A government concerned by its survival in office can only lower policy barriers to the level p^* in order to ensure that the entry of foreign capital does not exceed K_f^*. This partial reform equilibrium is stable because powerful constituencies who benefit in this status quo block further economic reform (Hellman 1998). By allowing increased FDI liberalization, they risk to lose not only their economic gains, but also their control of the government.

4.3. FDI liberalization: Observable implications

Using the theoretical foundations of the model presented above, we can derive expectations about the policy choices of different regime types, policy convergence and divergence across the space of policy tools, and the timing of policy reforms. In terms of the degree of liberalization, I expect democracies to be open to FDI *(H1)*. The benefits to labor are maximized in an open economy, so governments that cater to the interests of labor choose to remove all barriers that restrict the entry and operations of foreign firms. I also expect non-democracies to open partially to FDI, but not completely *(H2)*. Since democracies are open and non-democracies only *partially* open to FDI, democracies are likely to be more open to FDI than non-democracies *(H3)*.

Governments use an array of policy tools as barriers to FDI. For examples, they can screen foreign investment proposals with convoluted approval procedures, place upper limits on foreign equity, restrict the access of foreign investors to land, limit their participation in privatization programs and their ability to repatriate funds. While the model does not differentiate among different policy tools, it highlights that non-democratic governments are concerned with maintaining control over the *exact* level of FDI in their economy for fear that the entry of foreign capital will tilt the balance of economic power away from their supporters.

In the simplified world presented by the model, the government uses a straightforward tax on foreign investors' earnings to control the amount of foreign capital coming in. In reality, however, the exact effect of some policies on the level of foreign capital is very difficult to determine. Such policies are of little use to governments who want to have strict control over the level of foreign capital. By contrast, policies such as the screening of every foreign investment proposal are very instrumental in keeping the level of FDI under control. As long as non-democratic governments keep in place policies that are effective means of managing the level of foreign capital in the economy, they can eliminate additional barriers to FDI.

Thus, partial liberalization is achieved through a mix of policies that give governments control over entry and policies that allow the unrestricted operations of foreign companies once they passed the "entry test." This mix serves both as a mechanism to attract FDI and to control its inflow levels. Consequently, democratic and non-democratic regimes are likely to have different levels of openness on policies that are instrumental for the regulation of FDI entry and similar levels of FDI openness on policies that apply to post-entry operations (*H4*).

Another implication of the model is that the speed of liberalization is different in democratic and non-democratic regimes. For a government controlled by labor, the

policy choice is simple – in order to maximize the benefits to labor it must open to FDI completely. Democracies are therefore likely to remove all barriers to FDI quickly.

By contrast, non-democratic regimes can only open gradually since it takes time and successive trials to figure out the precise effect of FDI entry on the redistribution of economic power in the country and to choose the optimal policy level that maximizes the benefits to those in power without allowing a successful rebellion by workers to bring about changes in government. If they liberalize too much, FDI inflows could undermine the economic power of political supporters while enriching regime opponents (i.e. labor). Too many barriers to FDI, however, keep all multinationals out and do not allow the government to get the spoils from a higher output. Finding the optimal level of restrictions takes time. Since overshooting can be fatal for non-democratic regimes, they are likely to liberalize gradually. As a result, non-democratic regimes are more likely to take longer than democratic regimes to reach certain levels of FDI liberalization (*H5*).

In sum, we expect to observe variation among democratic and non-democratic regimes not only in the degree of liberalization, but also in terms of the policy mix they choose and the timing of policy reforms. I test these hypotheses using new data on FDI regulations in post-communist countries described at length in Chapter 3.

4.4. The level, type and timing of FDI liberalization: An empirical assessment

According to the model presented above, I expect democracies and non-democracies to have different *levels* of FDI restrictions, different *mixes* of FDI policies, and different *timing* of FDI liberalization. Specifically, democracies are likely to be open to FDI and non-democracies are likely to be partly open. Partial openness to FDI in non-democracies is the result of a mix of low restrictions on some dimensions and high restrictions on others, rather than partial liberalization on each type of FDI regulation. Moreover, democracies are likely to remove restrictions on FDI fast, while non-democratic governments liberalize gradually.

I test these hypotheses using the *FDI Regulations in Transition Economies* dataset described in Chapter 3. The key independent variable is the type of political regime that best describes a country's government rule at time *t*. The data come from the Polity IV project and the Freedom House. I use three different indicators of regime type. First, I rely on the widely used index constructed by (Jaggers and Gurr 1995) that combines data on five factors to capture the institutional differences between democracies and autocracies: (1) the competitiveness of executive recruitment, (2) the openness of this process, (3) constraints on chief executive's decision power, (4) the regulation of political participation, and (5) the competitiveness of political participation. Two 11-point scores

are created using this data to reflect a country's democratic and autocratic characteristics. The difference between the two indices yields a summary measure of regime type (*polity)* ranging from -10 for highly autocratic regimes to 10 for highly democratic ones.

Second, to check for sensitivity to measurement of regime type, I also use Freedom House ratings which score countries on three types of political rights and four types of civil liberties on a scale from 1 to 7, where 1 represents the most free. Each pair of political rights and civil liberties ratings is averaged to determine an overall status of "free" (if the average rating is between 1 and 2.5), "partly free" (3 to 5.5) and "not free" (5.5 to 7). Finally, using the two data sources, I construct a dummy variable (*democracy)* that is one if *polity* if greater than 5 and *freedom house* is "free". This double condition ensures that only countries that are evaluated as democratic in both the Polity and the Freedom House data are grouped in the 'Democracies' category. The countries that meet this condition are listed in Table 4.1.

Table 4.1 Countries evaluated as democracies, if *polity* > 5 and *freedom_house* = "free"

Country	Period
Bulgaria	1991-2007
Czech Republic	1990-2007
Estonia	1991-2007
Croatia	2000-2007
Hungary	1990-2007
Lithuania	1991-2007
Latvia	1991-2007
Mongolia	1992-2007
Poland	1991-2007
Romania	1996-2007
Serbia	2002-2007
Slovakia	1990-1995, 1998-2007
Slovenia	1991-2007
Ukraine	2005-2007

To evaluate whether democracies are open to FDI (*H1*) and non-democracies partially open to FDI (*H2*), I use a series of one-sided *t*-tests for every year since 1989 using the *democracy* dummy to separate the two groups. The means and *p*-values for these tests are shown in the first two columns of Table 4.2. The results show that indeed, both democracies and non-democracies have eliminated some barriers to FDI. Column (3) of Table 4.2 shows that democracies are more open to FDI than non-democracies, as emphasized in the discussion and empirical evidence presented in Chapter 3.

Table 4.2 T-tests for regime type means and difference of means

Year	H1 FDI_dem > 0	H2 FDI_nondem > 0	H3 FDI_nondem - FDI_dem < 0
1989		0.21***	
		(0.000)	
1990	0.53**	0.24***	-0.30***
	(0.005)	(0.000)	(0.000)
1991	0.53***	0.29***	-0.24***
	(0.000)	(0.000)	(0.000)
1992	0.56***	0.40***	-0.16*
	(0.000)	(0.000)	(0.010)
1993	0.71***	0.46***	-0.25***
	(0.000)	(0.000)	(0.000)
1994	0.73***	0.49***	-0.24***
	(0.000)	(0.000)	(0.000)
1995	0.76***	0.52***	-0.25***
	(0.000)	(0.000)	(0.000)
1996	0.80***	0.56***	-0.24***
	(0.000)	(0.000)	(0.000)
1997	0.85***	0.57***	-0.27***
	(0.000)	(0.000)	(0.000)
1998	0.86***	0.62***	-0.24***
	(0.000)	(0.000)	(0.000)
1999	0.88***	0.62***	-0.26***
	(0.000)	(0.000)	(0.000)
2000	0.88***	0.62***	-0.25***
	(0.000)	(0.000)	(0.000)
2001	0.89***	0.65***	-0.25***
	(0.000)	(0.000)	(0.000)
2002	0.89***	0.67***	-0.22***
	(0.000)	(0.000)	(0.001)
2003	0.90***	0.67***	-0.22***
	(0.000)	(0.000)	(0.001)
2004	0.90***	0.68***	-0.22**
	(0.000)	(0.000)	(0.001)
2005	0.89***	0.69***	-0.20**
	(0.000)	(0.000)	(0.002)
2006	0.91***	0.72***	-0.19**
	(0.000)	(0.000)	(0.002)
2007	0.91***	0.74***	-0.17**
	(0.000)	(0.000)	(0.006)

Notes: p-values in parentheses, *** significant at 0.1%, ** at 1.0%, * at 5.0%.

I rely on the policy components coded in the *FDI Regulations in Transition Economies* data to investigate whether democratic and non-democratic regimes choose similar or different mixes of FDI regulations. To establish whether the two types of regimes adopt similar or different policies, I run a series of one-sided *t*-tests for each of the twelve policy variables described in the dataset. As Table 4.3 shows, non-democracies adopt policies that are very similar to those of democracies on policy issues relating to limits on foreign ownership of commercial entities, performance requirements, and FDI insurance programs provided by international agencies such as MIGA.

On other dimensions, the policies of the two types of regime are significantly different for the entire period under analysis. While democracies have eliminated screening and approval procedures on the entry and establishment of foreign companies, non-democracies continue to keep in place procedures that allow them to control the inflow of foreign investment. At the same time, only democracies have established investment promotion agencies to help foreign companies navigate through the changing legislative environment and bureaucratic procedures, obtain permits and registration in a timely fashion, and find industrial locations and business partners in the country.

Table 4.3 T-tests for difference of means on FDI policy variables

Year	Entry and establishment			
	Screening and approval of FDI	Foreign ownership limits	Restrictions on participation in privatization	Restrictions on foreign ownership of land
1990	0.23	-0.97	-0.54	-2.17**
	(0.812)	(0.054)	(0.063)	(0.005)
1991	-1.35**	-1.18***	-0.49	-0.88*
	(0.001)	(0.001)	(0.051)	(0.030)
1992	-0.78	-0.25	-0.13	-1.40***
	(0.060)	(0.242)	(0.356)	(0.000)
1993	-1.63***	-0.40	-0.18	-1.04**
	(0.001)	(0.092)	(0.309)	(0.008)
1994	-1.67***	-0.22	-0.31	-0.93*
	(0.000)	(0.146)	(0.157)	(0.015)
1995	-1.87***	-0.11	-0.14	-0.86*
	(0.000)	(0.233)	(0.314)	(0.021)
1996	-1.44**	-0.11	-0.19	-0.69*
	(0.002)	(0.233)	(0.259)	(0.050)
1997	-1.64***	-0.11	-0.38	-0.64
	(0.001)	(0.233)	(0.081)	(0.056)
1998	-1.67***	-0.12	-0.19	-0.77*
	(0.000)	(0.216)	(0.222)	(0.024)
1999	-1.67***	-0.12	-0.28	-0.95**
	(0.000)	(0.216)	(0.129)	(0.006)
2000	-1.81***	-0.13	-0.44*	-0.80*
	(0.000)	(0.198)	(0.022)	(0.015)
2001	-1.90***	-0.13	-0.31	-0.80*
	(0.000)	(0.198)	(0.053)	(0.015)
2002	-1.85***	-0.13	-0.37*	-0.39
	(0.000)	(0.181)	(0.026)	(0.156)
2003	-1.85***	-0.13	-0.37*	-0.32
	(0.000)	(0.181)	(0.026)	(0.175)
2004	-1.71***	-0.13	-0.38*	-0.32
	(0.000)	(0.181)	(0.019)	(0.175)
2005	-1.57***	-0.14	-0.29	-0.42
	(0.000)	(0.163)	(0.062)	(0.113)
2006	-1.57***	-0.14	-0.29	-0.64*
	(0.000)	(0.163)	(0.062)	(0.025)
2007	-1.56***	-0.14	-0.27	-0.48
	(0.001)	(0.173)	(0.080)	(0.073)

Notes: p-values in parentheses, *** significant at 0.1%, ** at 1.0%, * at 5.0%.
- For "Protection against legislative change" the alternative hypothesis is Ha: Policy(non-democracies) - Policy(democracies) > 0. For all other variables, Ha: Policy(non-democracies) - Policy(democracies) < 0.

Table 4.3 (cont) T-tests for difference of means on FDI policy variables

	Operations and repatration		
Year	National treatment	Performance requirements	Repatriation
1990	-0.67**	-0.57*	0.45
	(0.002)	(0.035)	(0.947)
1991	-0.71*	-0.07	-0.07
	(0.013)	(0.213)	(0.367)
1992	-0.19	-0.12	0.28
	(0.320)	(0.166)	(0.901)
1993	-0.48	-0.12	-0.10
	(0.116)	(0.166)	(0.312)
1994	-0.33	-0.07	-0.13
	(0.166)	(0.213)	(0.269)
1995	-0.32	-0.07	-0.47*
	(0.138)	(0.213)	(0.038)
1996	-0.37	-0.07	-0.44
	(0.092)	(0.213)	(0.065)
1997	-0.37	-0.13	-0.28
	(0.092)	(0.123)	(0.170)
1998	-0.35	-0.13	-0.49*
	(0.057)	(0.120)	(0.043)
1999	-0.53**	-0.13	-0.49*
	(0.005)	(0.120)	(0.043)
2000	-0.42*	-0.13	-0.50*
	(0.022)	(0.101)	(0.039)
2001	-0.42*	-0.13	-0.44*
	(0.022)	(0.101)	(0.050)
2002	-0.32*	-0.14	-0.36
	(0.026)	(0.085)	(0.088)
2003	-0.32*	-0.14	-0.36
	(0.026)	(0.085)	(0.088)
2004	-0.26	-0.21*	-0.29
	(0.053)	(0.041)	(0.137)
2005	-0.21	-0.29*	-0.21
	(0.075)	(0.016)	(0.192)
2006	-0.21	-0.29*	-0.14
	(0.075)	(0.016)	(0.281)
2007	-0.21	-0.29*	-0.19
	(0.088)	(0.019)	(0.222)

Notes: p-values in parentheses, *** significant at 0.1%, ** at 1.0%, * at 5.0%.
- For "Protection against legislative change" the alternative hypothesis is Ha: Policy(non-democracies) - Policy(democracies) > 0. For all other variables, Ha: Policy(non-democracies) - Policy(democracies) < 0.

Table 4.3 (cont) T-tests for difference of means on FDI policy variables

Year	Guarantees on investment and dispute settlement: Protection against expropriation	Protection against legislative change	Access to international arbitration	FDI insurance programs (MIGA)	Promotion: Investment promotion agency
1990	-0.70	0.22	-0.45	-0.25	-0.67***
	(0.118)	(0.195)	(0.116)	(0.113)	(0.000)
1991	-0.07	0.02	-0.19	-0.14	-0.30**
	(0.420)	(0.447)	(0.255)	(0.139)	(0.008)
1992	-0.15	0.35	-0.30	-0.13	-0.38**
	(0.327)	(0.028)	(0.152)	(0.263)	(0.001)
1993	-0.35	0.50	-0.68**	-0.08	-0.45**
	(0.100)	(0.006)	(0.008)	(0.327)	(0.002)
1994	-0.39	0.51	-0.72**	0.09	-0.50***
	(0.064)	(0.004)	(0.005)	(0.731)	(0.000)
1995	-0.39	0.57	-0.77**	0.09	-0.50***
	(0.064)	(0.001)	(0.003)	(0.731)	(0.000)
1996	-0.44*	0.57	-0.71**	0.14	-0.70***
	(0.044)	(0.001)	(0.004)	(0.874)	(0.000)
1997	-0.44*	0.51	-0.59*	0.14	-0.90***
	(0.044)	(0.004)	(0.011)	(0.874)	(0.000)
1998	-0.35	0.50	-0.43*	0.03	-0.64***
	(0.055)	(0.004)	(0.039)	(0.621)	(0.000)
1999	-0.47*	0.50	-0.43*	-0.06	-0.58***
	(0.032)	(0.004)	(0.039)	(0.216)	(0.001)
2000	-0.44*	0.48	-0.44*	-0.06	-0.50**
	(0.038)	(0.004)	(0.036)	(0.198)	(0.004)
2001	-0.50*	0.48	-0.46*	-0.06	-0.46**
	(0.022)	(0.004)	(0.028)	(0.198)	(0.007)
2002	-0.40*	0.52	-0.37		-0.52**
	(0.031)	(0.001)	(0.063)		(0.001)
2003	-0.53*	0.46	-0.44*		-0.46**
	(0.015)	(0.004)	(0.035)		(0.004)
2004	-0.53*	0.39	-0.44*		-0.46**
	(0.015)	(0.011)	(0.035)		(0.004)
2005	-0.57**	0.43	-0.29		-0.43**
	(0.009)	(0.005)	(0.096)		(0.005)
2006	-0.57**	0.43	-0.29		-0.36**
	(0.009)	(0.005)	(0.096)		(0.006)
2007	-0.57*	0.42	-0.34		-0.21*
	(0.012)	(0.008)	(0.062)		(0.041)

Notes: p-values in parentheses, *** significant at 0.1%, ** at 1.0%, * at 5.0%.
- For "Protection against legislative change" the alternative hypothesis is Ha: Policy(non-democracies) - Policy(democracies) > 0. For all other variables, Ha: Policy(non-democracies) - Policy(democracies) < 0.

For most of the remaining variables, the policies of the two types of regimes converge for part of the time period and diverge for the rest. Restrictions on participation in privatization programs are higher in non-democracies only since 2000, a result which must be interpreted keeping in mind the timing of privatization reforms across transition economies. By 2000, most Eastern European countries had completed their privatization programs, and restrictions on foreign acquisition of state-owned enterprises were no longer meaningful. Restrictions on foreign ownership of land were significantly higher in non-democracies in the 1990s, but as some of them have been removed, the policies of the two types of regimes converged.

National treatment provisions are significantly higher in democratic regimes since mid-1990s, as most democratic countries incorporated this principle in their national legislation and tried to eliminate bureaucratic practices that discriminated against foreign investors. Similarly, they also adopted strong language promising to allow the expropriation of property "only exceptionally and for public interests, in cases and ways determined by law and with full, unconditional and immediate indemnification" (Constitution of Hungary, Article 13(2)) and to recognize and enforce international arbitration decisions in domestic courts. By contrast, non-democracies continued to discriminate against foreign companies even after incorporating the national treatment principle in their foreign investment codes, allowed sporadic

instances of expropriations, and made it very difficult for foreign investors to have international arbitration decisions recognized in the local judiciary system.

Lastly, and perhaps not surprisingly, non-democracies offer, on average, more guarantees against legislative change than democratic regimes. Unlike the other hypotheses, the difference of means test for this variable implies that non-democracies have higher levels of guarantees than democratic countries and the results show the difference to be statistically significant for every year since 1992. This finding is consistent with the argument that only countries with poor rule of law need to provide additional guarantees and incentives to foreign investors (Li 2006).

I examine the differences in the timing of liberalization along the twelve policy dimension using survival analysis regression. Table 4.4 shows the results obtained using maximum likelihood estimation for parametric regression Weibull survival-time models. The results show that democracies are more prompt to remove restrictions relating to the screening and approval of FDI, foreign equity limits, participation in privatization, to grant foreign companies national treatment and protection against expropriation, and to establish investment promotion agencies that provide information and administrative assistance to foreign investors. At the same time, there are no significant differences between democratic and non-democratic regimes in terms of the

timing of policy changes that affect access to land, repatriation of profits, access to international arbitration and the availability of MIGA insurance programs.

These simple tests support a nuanced story of FDI liberalization in transition economies. Both democracies and non-democracies are likely to remove regulatory restrictions on multinational investments, but democratic governments do so faster and to a greater degree than non-democratic regimes. Democratic governments have strong incentives to attract multinational investments and do so by removing all barriers to FDI and replacing them with guarantees and promotion efforts that facilitate FDI. Non-democratic governments fear that FDI will destabilize the political system by changing the allocation of economic gains. As a result, they choose to maintain restrictions that allow the government to control the distributive effects of FDI (e.g., strict screening and approval requirements), to remove some of the other barriers to FDI and to limit their FDI promotion effort.

Table 4.4 Political competition and the timing of FDI liberalization in 28 transition economies

	Screening and approval of FDI		Foreign ownership limits		Restrictions on participation in privatization		Restrictions on foreign ownership of land	
	(1)	(2)	(1)	(2)	(1)	(2)	(1)	(2)
Regime type	0.293**		0.102*		0.117*		0.0374	
	(3.01)		(2.19)		(2.42)		(0.77)	
Freedom House: Political rights		0.883***		0.407*		0.333*		0.0738
		(4.63)		(2.58)		(2.53)		(0.5)
Constant	-4.096***	-7.172***	-2.019**	-3.203**	-3.668***	-4.067***	-3.393**	-3.038**
	(-3.86)	(-4.99)	(-2.80)	(-2.91)	(-4.13)	(-4.05)	(-3.15)	(-2.68)
ln(p) constant	0.0206	0.229	0.337	0.266	0.243	-0.014	0.178	-0.0716
	(0.08)	(0.92)	(1.34)	(1.08)	(0.97)	(-0.05)	(0.55)	(-0.21)
Observations	221	246	53	58	216	236	192	225

	National treatment		Performance requirements		Repatriation		Investment promotion agency	
	(1)	(2)	(1)	(2)	(1)	(2)	(1)	(2)
Regime type	0.108*		0.0848		0.0546		0.186**	
	(2.24)		(1.36)		(1.5)		(2.79)	
Freedom House: Political rights		0.322*		0.0971		0.132		0.470***
		(2.46)		(0.45)		(1.23)		(3.43)
Constant	-2.326***	-3.211***	-2.417**	-2.204	-5.310***	-4.687***	-6.014***	-8.075***
	(-3.41)	(-3.44)	(-2.63)	(-1.89)	(-4.83)	(-4.43)	(-4.88)	(-5.74)
ln(p) constant	-0.0565	-0.0996	0.996***	0.829***	0.691**	0.42	0.683**	0.852***
	(-0.22)	(-0.39)	(3.76)	(3.41)	(3.29)	(1.91)	(3.1)	(4.82)
Observations	162	170	17	18	252	281	254	272

Table 4.4 (cont) Political competition and the timing of FDI liberalization in 28 transition economies

	Protection against expropriation		Protection against legislative change		Access to international arbitration		FDI insurance programs (MIGA)	
	(1)	(2)	(1)	(2)	(1)	(2)	(1)	(2)
Regime type	0.226*		-0.140**		0.0572		0.0000574	
	(2.11)		(-2.92)		(1.3)		0	
Freedom House: Political rights		0.687*		-0.593**		0.223		0.0242
		(2.03)		(-3.28)		(1.7)		(0.23)
Constant	-3.123**	-6.550*	-1.686*	0.149	-3.916***	-4.044***	-2.610***	-2.647***
	(-2.90)	(-2.42)	(-2.02)	(0.19)	(-3.76)	(-3.64)	(-4.34)	(-3.44)
ln(p) constant	0.295	0.848*	-0.294	-0.281	0.319	0.095	0.529**	0.508**
	(1.08)	(2.42)	(-0.72)	(-0.88)	(1.14)	(0.33)	(3.12)	(2.85)
Observations	33	23	198	247	236	260	94	90

This chapter presents a theoretical model of FDI policy choices in democratic and non-democratic regimes and tests some of the observable implications derived from the model using the new *FDI regulations in transition economies* dataset. It shows that while both democratic and non-democratic countries have removed some of the barriers to FDI they had in place in 1989, democracies have done so to a greater extent than non-democratic regimes. According to the model, non-democracies have strong incentives to allow some FDI in their economies because their supporters are better off in a partially open economy if they can capture most of the output growth. They can only do so if they maintain tight control over the level of FDI inflows and do not to allow the balance of economic power to shift too much away from their constituencies. For this reason, non-democratic regimes keep in place very restrictive screening and approval procedures and, as long as they do so, they can remove many of the other restrictions on the operations of foreign companies. Thus, partial liberalization of FDI policies in non-democracies can be explained as a mix of tight control on FDI entry and relatively low restrictions on other policy dimensions.

The theoretical model can be used as a foundation for the derivation of additional observable implications. In the model presented here, the strength of a non-democratic regime is a strictly increasing function of returns to domestic capital. More realistically, however, government strength also depends on factors other than domestic

capital earnings. If we allow non-democratic governments to differ in terms of their sensitivity to changes in the balance of economic power between domestic capital and labor, we can expect more stable non-democratic regimes to be able to open more to foreign investment than weak or unstable regimes.

5. Political Transition and FDI Policies in Croatia, Romania, And Kazakhstan

5.1. Introduction

This dissertation argues that changes in the level of political competition bring about FDI policy changes. Former communist countries such as Hungary and the Czech Republic that institutionalized democratic competition at the onset of their transition have soon thereafter chosen to liberalize the regulations on the entry and operation of foreign companies. But, as this chapter will show, democratic transitions that were delayed by the grip on power of former communists or authoritarian political leaders in countries such as Croatia, Romania and Slovakia, were also followed by the removal of FDI restrictions. At the same time, the consolidation of authoritarian regimes in countries such as Kazakhstan and Belarus resulted in higher restrictions on foreign companies.

This chapter takes a closer look at political and FDI policy developments in three of these countries to show that changes in the level of political competition and FDI liberalization are causally related. The econometric analysis presented in previous chapters shows a strong correlation between the two variables, but falls short of establishing causation. I rely on in-depth case studies to demonstrate that this

correlation is not spurious; instead, changes in the level of political competition have a clear causal effect on the choice of FDI restrictions.

To show the causal link between political developments and policy choice, I analyze variation *within* units over time. I selected three countries that underwent important political transformations in the post-1990 period *after* the initial transition that took place with the fall of the Berlin Wall and the Soviet Union. Croatia was ruled by the authoritarian hand of Franjo Tudjman until his death in late 1999, when a landslide electoral victory by opposition parties started what is often referred to as the country's "second transition." Croatia's democratization was sudden and fast, and it was followed by important changes in the government's policy and attitude toward FDI. Romania, where mid-level members of the communist apparatus retained power in 1989 and delayed political liberalization, is a case of more gradual democratization. However, with the increase of political competition came a steady liberalization of the FDI regulations.

Finally, Kazakhstan presents a fascinating story of authoritarian consolidation following an initial episode of political competition and FDI liberalization in the early 1990s. The country's leader, Nursultan Nazarbayev, strengthened his position in power through a series of institutional changes that culminated with the removal of term limits on his presidency and the empowerment of a close circle of family members and friends.

Almost every move that led to the consolidation of his regime was followed by policy changes that resulted in the deterioration of the investment climate for foreign investors.

The chapter is organized around these three cases. For each case, I first describe the political developments and highlight the degree of variation in political competition across time, and then discuss the changes in the FDI policies before and after the episodes of democratization in Croatia and Romania, and the process of authoritarian consolidation in Kazakhstan.

5.2. Croatia

Croatia's first decade of post-communist transition was marked by the rise to power of nationalist president Franjo Tudjman, ethnic war following its independence in 1991, and a gradual process of economic liberalization and restructuring. In free multi-party elections organized in 1990, the Croatian Democratic Union (HDZ) emerged as the largest party in parliament and elected its leader, Franjo Tudjman, as the first Croatian president. Throughout the 1990s, Tudjman consolidated his authoritarian regime by empowering close supporters and allowing them to divert state resources toward personal gain. Following Tudjman's death at the end of 1999 and the electoral defeat of the HDZ in January 2000, Croatia embarked on a second transition that involved a great degree of democratization and economic liberalization. This chapter shows that while formal restrictions to FDI were always low in Croatian legislation, Tudjman's emphasis

on benefiting domestic economic interests were a de facto barrier to foreign investments. Since 2000, however, Croatian governments have made visible efforts to eliminate enduring administrative barriers to FDI and put the country on the map of foreign investors.

5.2.1. Tudjman's semi-authoritarian regime

During the communist regime, the question of Croatian nationhood defined an almost constant struggle to gain greater autonomy within the Yugoslav federation. After Tito's break with Stalin in 1948 and economic reforms in the 1950s and 1960s that considerably distanced Yugoslavia from the socialist model practiced by other countries in the Soviet bloc, a Croatian movement known as the "Mass Movement" (*Maspok*) or the Croatian Spring (*Hrvatsko Projlece*) emerged as a popular force that sought increased independence from Belgrade and the broadening of the regime's social base. The movement, which was partly driven by Croat nationalist leaders, threatened the supremacy of the League of Communists in Yugoslavia (LCY) and the political stability of the federation. Fearing similar reactions across the country, Tito decided to quell the movement by purging nationalist elements from the League of Communists of Croatia and enforcing a long period of "Croatian silence" (*Hrvatsko Sutnja*). Among the party members pushed aside was communist general Franjo Tudjman, who later rose to become the leader of the HDZ and the first president of independent Croatia.

The Croatian silence ended only in December 1989, when the newly elected leadership of the League of Communists of Croatia expressed official support for governance reforms (Ramet 2002). The party changed its name to the League of Communists of Croatia–Party of Democratic Change (SKH-SDP) and organized multi-party elections in April 1990. This period of political liberalization provided a window for previously marginalized nationalist leaders to return to the political scene. The 1990 elections resulted in a landslide victory for the HDZ led by Franjo Tudjman, whom parliament (the *Sabor*) elected president. Under his leadership, the HDZ restored Croat national symbols paving the way towards declaring independence in June 1991.

The first years of independence were marked by violent ethnic conflicts in Croatia and Bosnia-Herzegovina. On the domestic political front, Tudjman and his party continued to mobilize nationalist support and used the war to strengthen their political positions. Elections for parliament that were scheduled for August 1996 were held one year early to capitalize on military advancements and changes to the electoral law that significantly reduced the chances of opposition parties to win parliamentary representation (see Table 5.1). As a result, the 1995 parliamentary elections stalled the development of a multi-party system and effectively installed HDZ as a dominant party with enough seats in parliament to rule on constitutional issues alone (Kasapović 1996).

Table 5.1 Croatia: Timeline of political events and FDI liberalization

April 1990	The Croatian Democratic Union (HDZ) emerges as the largest party after the first free parliamentary election in forty years. Parliament elects the leader of the HDZ, Franjo Tudjman, as president of Croatia.
April 1991	The Law on the Transformation of Socially Owned Enterprises is enacted, paving the way for the first wave of privatization.
June 1991	Croatia declares independence from Yugoslavia.
January 1992	After a six-month war, Croatia achieves international recognition.
August 1995	Following a successful assault on western Slavonia, Croatian military launch "Operation Storm" on Serb areas in the Krajina.
October 1995	HDZ wins the election to the lower house of parliament.
June 1997	Tudjman wins a second term as president.
1998	A few local banks enter bankruptcy, opening questions about the stability of the Croatian banking sector.
December 1999	Tudjman dies on December 10th.
January 2000	Six moderate parties win a landslide victory in the parliamentary elections.
July 2002	*The Law on Investment Incentives is passed.*
February 2000	A political moderate, Stipe Mesic, wins the presidential election.
October 2001	Croatia signs a stabilization and association agreement with the EU.
July 2002	The Croatian Social Liberal Party (HSLS) leaves the coalition.
March 2003	Croatia submits application for EU membership.
June 2003	*The Trade and Investment Promotion Agency (APIU) is established.*
November 2003	A parliamentary election results in defeat for the SDP-led coalition and the formation of a new government led by Ivo Sanader's HDZ.
June 2004	Croatia is accepted as a candidate for EU membership.
January 2005	Stipe Mesic is re-elected for a second presidential term, defeating the ruling HDZ's candidate in a second run-off.
November 2007	Parliamentary elections end in a narrow victory for the center-right HDZ of the incumbent prime minister, Ivo Sanader. The party subsequently forms a multiparty coalition government.

Despite the end of the war in 1995, Tudjman tightened his grip on power. He transformed Croatia into a semi-presidential political system and assumed the power to appoint and dismiss ministers, to dissolve parliament and to veto the appointment of local officials. His tremendous influence on the HDZ implied that he could exert his power even further through the parliament. In practice, he ruled through informal structures around the presidential office and used state institutions, including the judiciary, to achieve political ends (author interviews, May 2007; EIU 2000). As one observer points out, "throughout Tudjman's years as president, parliament was controlled by his party and the government was his personal fiefdom; even kindergarten principals and hospital directors were appointed by party officials" (J. Smith 2000: 5). In 1997, he won a second term as president in an election that was characterized by the OECD as "free, but not fair" primarily because the extensive control of the HDZ on the national television and radio networks, which severely limited the access of opposition candidates to the mass media (Freedom House 1998).

During the early 1990s, Tudjman used his party, the HDZ, to unify nationalist factions around the goal of Croatia sovereignty. This common ambition was powerful enough to bring together strange bedfellows. On the one hand, the HDZ was the party of nationalist dissidents pushed aside by Tito during the 1971 purge. On the other, the party also relied on the support of a number of ethnic Croats from the ranks of the

Communist party personnel who joined the HDZ in the months leading to the April 1990 elections. As a result, the list of HDZ candidates standing for election in 1990 was a mix of reformers who had been purged from the Croatian communist party during the Croatian Spring, technocrats and managers of domestic enterprises who were primarily interested in maintaining control of their companies, and ardent nationalists with authoritarian and ethnic chauvinistic inclinations (Gagnon 2004: 141). Tudjman was willing to listen to everyone's input in order to sustain the unity of the party, but towards the end of his regime, he allowed hardliners to assert their influence over the party at the expense of more moderate voices (author interviews, Zagreb, May 2007).

In addition, Tudjman used his control over the state apparatus to build a base of support for his regime. The first stage of privatization (1991-1996) allowed enterprise managers and employees to gain shares in their own company at a discount on book value, but any unsold shares were transferred to the Croatian Privatization Fund, owned by the state (EIU 2000). The second privatization stage (1996-2000) involved a small-scale voucher privatization program designed to benefit the victims of war, but as in many other countries beneficiaries chose to place their vouchers with the privatization fund. Consequently, existing management retained full control over the enterprise and oversight over their actions declined. There was almost nothing keeping managers from taking advantage of ample opportunities for asset stripping enhanced by easy access to

loans. They and other politically connected insiders used existing assets to gain access to credit and purchase shares from others who were willing to sell.

The process led to the economic empowerment of the so-called Croatian tycoons, many of them very closely connected to the president and the HDZ. One example is Miroslav Kutle, who rose from bartender to clerk in the privatization agency, and then went on to acquire 170 businesses, including the largest Croatian grocery store chain, all with little money of his own (J. Smith 2000). In exchange for payoffs to party officials, Kutle was allowed to take out large amounts of credit to finance the acquisition of state-owned companies, which he then "drained" by pocketing profits while refusing to pay suppliers. In 2000, the US ambassador to Croatia said Kutle almost bankrupted the country and used him to illustrate Tudjman's view that "anybody who helped build [the party] deserved to have all the riches this country had to offer" (quoted in J. Smith 2000).

Not surprisingly, corruption often involved Tudjman himself, his family and very close associates. Tapes recording conversations that took place in Tudjman's office—the recordings were secretly ordered by the president himself—were made public after 2000 and revealed the schemes the president and his men employed to plunder billions of dollars from the treasury. For example, when the government agreed to sell a large portion of the national telephone operator to Deutsche Telecom, about $100 million of the proceeds were deposited in an Irish Bank account controlled by the

president and some of his top advisors (J. Smith 2000). Through several similar deals, Tudjman enriched himself, his family and his allies, creating a close circle of loyal cronies who were willing to use their newly acquired power and wealth to safeguard the regime and their privileged positions (author interviews, May 2007).

The tycoons were able to carry out their operations—financing takeovers with loans obtained through political connections—because Tudjman's regime saw no need to rush the strengthening of bank regulations (EIU 2000). The level of non-performing loans, liquidity problems and bad management led to the collapse of several banks in 1998, including Dubrovacka Bank and Glumina Bank, the latter owned by Miroslav Kutle. Fearing that worse would follow, Tudjman's government adopted a set of banking reforms, including the sale of loss-making companies and banks to foreign bidders (author interviews, May 2007). By then, however, privatization deals that created incentives for communist-era managers and politically protected tycoons to siphon enterprise resources, and the lack of new investments to restructure enterprises accelerated the decline of industries already hit hard by the loss of the Yugoslav market and almost half a decade of war. The combination of bank closures that left many families strapped and slow economic recovery brought Croatia on the verge of crisis in the late 1990s (author interviews, May 2007).

Tudjman's second terms as president was curtailed by his death in December 1999. One month later, an opposition coalition led by the Social Democratic Party (SDP) and the Croatian Social Liberal Party (HSLS) won a landmark victory in parliamentary elections (see Table 5.2). They promised to transform Croatia into a liberal democracy after almost a decade of HDZ's domination, and to end the country's international isolation and the plight of those who had lost out during the transition. The economic situation, including the banking crises and controversies over the handling of the privatization process, as well as squabbling among Tudjman's top aides who fought to succeed him, contributed to HDZ's electoral defeat (Pickering and Baskin 2008: 533).

Table 5.2 Election results, seats in the lower house

	August 1992	October 1995	January 2000
Social Democratic Party of Croatia (SDP)	3	10	46(a)
Croatian Democratic Union (HDZ)	85	74	46
Croatian Social Liberal Party (HSLS)	13	12	25
Croatian Peasant Party (HSS)	3	10	16
Others	34	21	18
Total	138	127	151

(a) Including three deputies standing for the SDP's regional affiliates, the Primorsko-Goranski alliance and the Croatian Party of Slavonia and Baranja
Source: Economist Intelligence Unit 2000.

The parliamentary victory of the SDP-HSLS coalition marked the beginning of Croatia's "second transition." By 2000, the SDP, whose roots can be traced directly to the League of Communists of Croatia, transformed itself into a coherent political grouping on the center-left. The party seemed committed to the principles of liberal democracy

and vowed to strengthen the role of parliament, break the HDZ control over the media, and press forward with much needed economic reform. The new government adopted a number of constitutional amendments to reduce the power of the president and restore the balance of power in favor of the parliament, and Croatia has progressed as a liberal parliamentary democracy since then (Doric 2009).

The new government also unveiled many of the abuses committed during Tudjman's years in government. The former president's tapes exposed the type of deals that were made with backing from the highest level of government. Subsequent investigations revealed the level of corruption that was perpetrated at the time and the extent of damages incurred as a result (author interviews, May 2007). Although the new government pursued a number of high profile indictments for corruption, including that of Tudjman's daughter, it could do little to correct the wrongdoings of the Tudjman regime.

Moreover, the financial situation the SDP-HSLS-led coalition inherited in 2000 required a number of harsh economic reforms, including a set of austerity measures that secured a stand-by agreement with the IMF. Unpopular economic policies and frequent political infighting between coalition members paved the way for HDZ's return to parliament in 2003. However, by then the country has made an important step toward political liberalization and a strong commitment to economic reform and the goal of EU

membership. Croatia was on its way to being considered a "credible candidate" to the EU, and there was little choice for its different parties, including the HDZ, but to converge on a set of principles that furthered the goal of European integration (Vachudová 2005).

5.2.2. Another breakthrough: Opening to FDI

The Croatian government never passed any special legislation on FDI until July 2000, when a Law on Investment Incentives was passed by the SDP-HSLS government. While other countries in the region were enacting FDI codes to signal policy liberalization and clarify the conditions that applied to foreign investors at a time when other policies were in constant flux, Croatia did not adopt any special FDI legislation. Foreign investments were regulated by the 1995 Law on Commercial Companies, the Constitution, and relevant legislation that governed domestic economic activities (OECD 2003). As a result, foreign investors had the same rights, obligations, and legal status as domestic investors, if conditions of reciprocity were met in the multinational's home country (USCS 2004). In practice, however, during the 1990s foreign investors faced a series of difficulties, and in some cases even open hostility (USCS 2004).

As one interviewee put it, "until 1999, Croatia was not interested in FDI." Instead, Tudjman mentioned in one of his speeches that his plan was to create a capitalist society by having "200 real Croatian families" as the country's leading

capitalists (author interview, Zagreb, May 2007). Admittedly, Tudjman's regime was quite successful in accomplishing this goal: the corruption and patronage used by the president and his HDZ party created many opportunities for well-connected political allies to amass impressive wealth by diverting state resources and bank loans toward their private gain. Privatization of state-owned enterprises was mostly a means of distributing economic spoils to political favorites rather than a strategy for restructuring. Consequently, there was little interest in attracting foreign investors.

Because the government never adopted an FDI code, the status and conditions offered to foreign investors were always interpretable and barriers to FDI were mostly administrative or informal. Politicians and bureaucrats followed Tudjman's lead and gave preference to domestic businesses over foreign ones. National companies were favored in government tenders and contracts, received direct or indirect subsidies, and were the only ones consulted, often only informally, before the adoption of legislation and regulations (author interviews, May 2007). Moreover, some local governments have repeatedly and openly expressed opposition to foreign investments in the tourism sector along the Dalmatian coast (USCS 2004; author interviews, May 2007).

In addition, the choice of privatization methods and the government's strategy when carrying out tenders did not create any opportunities for foreign investment. During communist times, most Yugoslav companies were organized as socially owned

enterprises to limit state ownership in favor of employees. At the beginning of the 1990s, the law on the transformation of socially owned enterprises allowed for their case-by-case sale with preferential treatment and generous discounts awarded to current and retired employees. In 1993, Tudjman's government modified the law to limit employee purchases to 50 percent of a company to "avoid discrimination against other domestic investors" (OECD 2003: 126) and then in 1996, it passed a new privatization law which focused on speeding up the process for remaining assets, including shares that were transferred to the state portfolio in the earlier phase. The government pressed forward with a small-scale voucher privatization that was intended to benefit population groups that were most affected by war—in practice, many believe that political connections dictated access to vouchers as well—and with the selling of shares held by the Croatian Privatization Fund below face value (author interviews, May 2007; OECD 2003). All in all, the privatization methods combined with insufficient or ineffective regulatory and institutional constraints created a space for tremendous insider deals and provided no opportunities for foreign takeovers. With only two exceptions—the sale of Pliva pharmaceuticals in 1998 and of 35 percent of Hrvatski Telekom to Deutsche Telekom in 1999—all other privatization deals were completed during Tudjman's rule without foreign participation.

The electoral defeat of the HDZ after Tudjman's death and the increase in political competition that followed brought about a significant change in the government's attitude towards FDI. A special law on investment incentives was adopted in July 2000 and offered considerable tax exemptions for large investments that create new jobs. The law also provided one-time government grants of approximately $1,800 for each new employee, while additional funding for employee re-training could also be obtained upon request (USCS 2001).

Moreover, the new administration organized a third stage of privatization that encouraged foreign participation starting in May 2000. The government first conducted a comprehensive inventory of assets that remained under state ownership and merged them under the management of the Croatian Privatization Fund. According to observers, this measure enhanced transparency, eased the completion of the privatization process, and helped the government attract the interest of foreign firms (OECD 2003).

Despite the governments' effort to attract FDI, powerful local interests that gained control over major Croatian businesses in the 1990s continued to oppose foreign investments, including acquisitions, even in recent years. One such example is the opposition to the 2007 sale of Dukat, Croatia's largest dairy manufacturer, to Lactalis, a family-run group from France. To stall the acquisition, Konzum, Croatia's largest

retailer, suspended the distribution of Dukat products in its stores (author interviews, May 2007).

Such opposition is even more frequent when considering proposed foreign acquisitions of tourism-related assets along Croatia's coastline on the Adriatic Sea. The general sentiment that coastline properties should remain under domestic ownership provides an easy justification for local interests to mobilize opposition to foreign investments. "It is very easy to portray FDI as a scary thing—you just have to say that foreign companies will buy all our houses on the coast and that we will become cooks and cleaners in hotels owned by foreigners, and everyone will nod along," one interviewee noted. "For a while, even after Tudjman was gone, [politicians] were speaking about the need to attract investments, but were avoiding the world 'foreign;' everyone knew they meant FDI, but they still would not say it" (author interviews, May 2007).

But Ljubo Jurcic, a leading Croatian economist and the SDP's candidate for the office of prime minister before the 2007 parliamentary elections, emphasized that the government can go a long way toward assuaging these fears by showing with concrete examples that foreign investors can help establish technologically advanced enterprises that create good jobs. Jurcic noted that FDI has become more important in recent years and that all the candidates lining up for the elections were mentioning FDI and the

Croatian investment promotion agency. When I spoke to him during the summer leading to the electoral campaign, Jurcic was involved in refining the SDP's economic strategy and was travelling abroad to meet with managers of foreign companies which were, in his view, a perfect match for Croatia's economic endowments and industrial profile (author interviews, May 2007).

Perhaps ironically, because the SDP is the clear successor of the League of Communists in Croatia, the party's economic strategy and its emphasis on FDI openness has placed the issue on the country's policy agenda. In recent years, all governments have made visible efforts to remove enduring administrative barriers to FDI. In 2001, the SDP-led government asked the Foreign Investment Advisory Service of the World Bank to conduct an assessment of administrative barriers to FDI in Croatia (FIAS 2002). In 2006, the government launched *Hitro*, an initiative that aims to simplify the country's laws and regulations and to increase the use of on-line interfaces to complete a wide range of administrative procedures. The program not only shortens the time required for such procedures—for example, business registration can be done on-line and takes only four days—but also eliminates bureaucratic discretion (USDS 2007).

The Trade and Investment Promotion Agency of Croatia (APIU) was established in 2003 and buttressed with new leadership and a larger budget in 2006. In 2007, APIU had 39 employees (roughly around the average staff size for investment promotion

agencies around the world) and a budget of 2.2 million Euros. The agency remains subordinated to the government and according to two of its employees, it "cannot do much without its support." The president was politically appointed and instead of formulating a medium or long-term investment strategy, it was using the agency's resources to respond to the government's requests for FDI assistance or promotion. However, the government's intention to place competent people in the agency and use it to attract important investments into Croatia was apparent in its choice to make APIU the best paid government agency in the country (author interviews, May 2007).

* * *

Croatia is a clear example of political liberalization delayed by an authoritarian president who used his position and state resources to strengthen his power and benefit those loyal to his regime. His death precipitated political liberalization and brought to power a coalition of parties who opposed Tudjman's rule. To legitimize their mandate and amass continuing electoral support, the new government pressed forward with a set of economic reforms, including policies to stimulate foreign direct investment that would create new and better jobs. Although these measures were not enough to keep the government in power for another mandate, the policy changes enacted put Croatia on the path of FDI liberalization that subsequent governments have upheld.

5.3. Romania

Romania's transition to democracy has been gradual, and so has the evolution of its FDI investment climate. Popular uprisings that contributed to the demise of Nicolae Ceusescu's communist regime opened a window of opportunity for little known mid-level members of the nomenklatura to step up and fill a political vacuum created by the outlawing of the Romanian Communist Party (PCR) and the lack of an organized anti-communist movement. The dominance of former communists on Romanian politics in the early 1990s stalled democratization and economic reform until November 1996, when a coalition of opposition parties first came to power in a landmark election. The new government considerably improved the FDI policy framework, although its efforts to ensure a competitive investment climate were often derailed by opposition from economic elites who had benefited from insider privilege during the first years of the transition. Nonetheless, increased political competition after the 1996 election created incentives for subsequent governments to maintain liberal FDI policies.

5.3.1. Former communists delay democratization in the early 1990s

Among the countries in Eastern Europe, Romania was one of the last to put an end to communist rule. In mid-December 1989, thousands of people mobilized on the streets of Timisoara in western Romania, and later in Bucharest and other cities, demanding the end of communism and the removal of its totalitarian dictator, Nicolae

Ceausescu. The days of violent clashes between demonstrators, the security forces loyal to the regime, and the army, which ultimately sided with those asking for change, came to be known as the December 1989 Revolution. But the popular uprisings in Timisoara and elsewhere were followed by an internal coup which precipitated the end of the regime and forced Ceausescu to flee. A group of political insiders, loyal to communist ideology but marginalized during Ceausescu, successfully "hijacked" the December revolution and used it as an opportunity to oust Ceausescu's regime and step in top positions of political power. As a result of behind-the-scenes political maneuvers, about which incredibly little is known even today, Romania's political and economic transition was stalled by the survival in power of former communist activists until they were defeated in national elections in the fall of 1996.

During the anti-communism revolution, a group of political figures gained access to the TV station and for the first time in decades, unfamiliar faces addressed the nation. Among them were Ion Iliescu, Petre Roman, and Virgil Magureanu. Ion Iliescu, who went on to become Romania's first president from 1990 to 1996, was the minister of youth and secretary of the party's central committee on ideology until 1971, but was demoted to lower posts when his rapid ascension in the communist party was perceived as a possible threat to Ceausescu's leadership (Tismaneanu 1992: 225). Petre Roman was a university lecturer in the late 1980s and the son of Valter Roman, a member of the

Central Committee of the Romanian Communist Party (PCR) and the director of the party's publishing house, Editura Politica (Tismaneanu 1993: 331). When Iliescu won the presidency in May 1990, Roman was appointed as the country's first prime minister. Virgil Magureanu, whose past hides links to the Romanian secret service, the Securitate, became the head of the domestic intelligence service (the SRI), an institution organized in part with cadres from the old network of informers (Gallagher 2005: 113; Watts 2007). Like them, many others who served or where closely tied to mid-level communist bureaucrats or members of the *Securitate*, went on to become the political elite who led Romania in the first years following the fall of Ceausescu's regime.

Iliescu and his followers formed the National Salvation Front (FSN), a political organization that re-united former political insiders who supported the overthrow of Ceausescu's personal rule but had little interest in fundamental political reform. They adapted their rhetoric to resonate with the revolutionary movement demanding profound changes in Romania's political system—hence the widespread accusation that they "hijacked" the revolution—while also positioning themselves to fill the vacuum left by the dismissal of Ceausescu's top political figures and the outlawing of the communist party. The FSN took over the old structures of the PCR and established political presence in every county, town and commune, just as the PCR had done for decades before. By enlisting members of the PCR bureaucracy who feared replacement or

demotion, FSN gained control of state resources, including physical facilities, printing presses and the national radio and TV station. Before long, the FSN was the strongest and most extensive post-communist organization, and the most visible political force in the country.

Romania did not lack movements that genuinely supported political reform and the institution of open political competition from the onset of the transition. Political parties that pre-dated the entrenchment of the communist rule—the Peasant's Party and the National Liberal Party—reappeared in the political arena at the end of 1989. Representatives of the revolutionary movement in Timisoara and communist dissidents were calling for a radical departure from the structures of the past, the exposure of communist party membership lists and more importantly, the publication of the so-called "*Securitate* files" which contained detailed individual records of political activity during Ceausescu's regime. In a public document that came to be known as "*Declaratia de la Timisoara*" (the Timisoara Declaration), released on March 11, 1990, they demanded that leaders of the Communist Party and members of the *nomenklatura* and the *Securitate* be barred from running for public office in the first three elections (Gallagher 2005: 90). However, none of these emerging political groupings were potent enough to rival FSN's political reach (Pop-Eleches 2008).

Despite the popular support for the revolutionaries' claims and the rapid reinstitution of the 'historic parties,' the FSN representatives dominated the political scene after 1989. Iliescu called for "national unity" and portrayed the FSN leadership as the caretaker who would ensure the organization of free and fair elections, without participating in them. However, only weeks later, FSN broke this pledge and registered as a political party in February 1990. This move and the increasing realization that Iliescu's intent was to limit rather than ensure political reform led to almost continuous protests by revolutionaries and students who opposed the ideology and the dominance of the FSN.

The first post-communist elections were held in May 1990. Iliescu was elected president with 85.1 percent of the vote, while the FSN won 66.31 percent of parliamentary seats. The Hungarian minority united their votes behind the Democratic Union of Hungarians in Romania (UDMR) and obtained 7.2 percent of the votes for parliament. Those opposing the FSN split their votes between the National Liberal Party and the Peasants' Party (Gallagher 2005: 94).

Following the elections, political protests against Iliescu and the FSN intensified. Students camped for weeks in Bucharest's University Square and were only dispersed when in mid-June 1990 thousand of miners from the Jiu Valley descended in the capital to clash with the demonstrators, and ransack the offices of opposition parties and

revolutionary civil groups. When order was restored in the capital, Iliescu thanked the miners for their support, but he continues to deny having called upon them on any of the three occasions when thousands made the day-long trip to Bucharest to take a political stance.

Iliescu's strong preference for limited reform became even more apparent when he distanced himself from Petre Roman, the first prime minister he appointed, after Roman declared his aim to transform Romania into a market economy through a program of extensive economic liberalization. Roman's tenure ended in September 1991, when miners came to Bucharest again, this time to protest the prime minister's program for economic reform, which incorporated, among other items, the restructuring of the largely outdated and loss-making mining sector. The disagreement between Iliescu and Roman, and their respective visions for Romania's future mirrored a rift within the FSN. The party later split in two factions: Iliescu's Democratic National Salvation Front, later re-named the Romanian Social Democratic Party (PSD), and Roman's FSN, which later became the Democratic Party (PD).

The tensions at the top and the mounting evidence that Iliescu was not ready to do anything about Romania's declining economy translated into low electoral support for the FSN in the 1992 local elections. By then, the opposition parties have agreed on putting forward a united front, formed an electoral alliance known as the Romanian

Democratic Convention (CDR), and received strong political support in western Romania. In central Romania, the nationalist Party of Romanian National Unity (PUNR), which positioned itself as a political counter-force to the Democratic Union of Hungarians in Romania (UDMR), was also gaining political momentum.

Although Iliescu's victory was less impressive in the September 1992 national elections than two years earlier, it nonetheless revealed his enduring dominance on Romania's post-communist politics. He won 47.34 percent of the vote in the first round of presidential elections and defeated in run-offs CDR's presidential candidate Emil Constantinescu, who received 31.24 percent in the first round. Iliescu's party, the PSD, won the largest share of parliamentary votes, 27.71 percent, followed by the CDR with 20.16 percent and Petre Roman's FSN with 10.18 percent (Gallagher 2005: 105). The opposition's candidates won more than 50 percent support in western Romania, but Iliescu was able to compensate by drawing resounding victories in the east and south.

Iliescu's and his party's overwhelming 1990 victory and their re-election in 1992 were a reflection of their ability to capitalize on the remnants of the communist party and its extensive resources and organizational structures. They also showed their inclination to use to their political advantage Romanian people's nationalism and their fear that too much change could lead to the disintegration of society, the loss of stability and the little privilege some of them enjoyed. By contrast, historical parties were

perhaps out of touch with the reality of a people exhausted by almost five decades of communist rule (a point repeated by Iliescu throughout the campaigns), and used as political credentials their personal hardships as communist dissidents and their ties to the pre-World War II past, which many Romanians associated with an externally imposed monarchy and the rule of landed lords and rich industrialists.

Romania's slow progression away from its communist past is the result of the combination of a weak opposition with little base on which to mobilize political support, and a strong FSN which built on enduring political networks of communist party members, vouched to protect their positions, and appealed to people's fears of change. Vladimir Tismaneanu observed in 1993, "Iliescu's ability has been to cater precisely to the fears, neuroses, and phobias among Romania's industrial workers and peasants, to persuade them that the transition would be less painful if effected gradually by 'true patriots' like him, rather than the oppositional Westernizers, allegedly intent upon restoring big landed estates and 'selling out the country' to multinational corporations" (Tismaneanu 1993: 314). But ultimately, he writes, "the hallmark of Romania's transition is a blend of authoritarianism, demagogy, and pseudo-political process that keeps the bureaucracy in positions of economic and institutional power and reduces the opposition to the status of powerless marginality" (Tismaneanu 1993: 312).

The bureaucrats Iliescu protected by allowing them to continue in positions of privilege at a time of little oversight over the dealings of state employees benefited greatly from limited reform. To consolidate his party's political base and its political machine, Iliescu allowed managers of state-owned enterprises, union leaders, and local political activists to use state resources for their own enrichment. They were allowed to live in or purchase state-owned housing at nominal prices, to set up private companies that supplied goods and services to state-owned enterprises at above-market prices, to be among the first entitled to receive land in the process of restitution, and benefit in other ways from the use of state property. For a long while at the beginning of transition, economic transactions were just a means to divert state resources toward the political supporters of the Iliescu regime.

Large state-owned banks and enterprises were particularly instrumental for exchanging economic benefits for political support. One often-cited example is the relationship between Iliescu's government and the state electricity monopoly, *RENEL*. At a time when *RENEL* was still accruing impressive losses that needed to be covered by the state budget and when the payment of state-funded pensions and salaries was lagging behind, the salaries of *RENEL* employees were possibly as high as 1 percent of Romania's GDP (Gallagher 2005: 115). In exchange for such largesse, the government expected *RENEL* to hire its most loyal supporters, tolerate late payments or even write-

off the debt of companies enjoying the government's favor, and harass those who did not enjoy such privilege.

Similarly, the government appointed in well-paying positions in state banks people who were willing to use bank loans to reward political insiders and undermine sympathizers of the opposition. One of the state banks, Bancorex, had as much as 70 percent of its portfolio in non-performing loans when it was liquidated in 1999 because until 1997 the directors "were able to sign off on $10 million loans with one signature—their own" (Cook 1999). Bancorex was in no way an exceptional case; other banks were also allowing the government to facilitate preferential access to credit for politically connected firms and individual entrepreneurs. As a result of such abuses, only members of the Communist Party and the *Securitate*, which remained part of Iliescu's political apparatus, were able to prosper during the early years of the transition period.

Even today, a number of oligarchs who laid the foundations of their business empires during those years continue to be strongly connected with Iliescu's PSD party. In the most recent presidential election, the close relationship between PSD's candidate, Mircea Geoana, and some of Romania's notorious oligarchs might have cost him the election after it was publicly revealed that Geoana made a house call to one of them the night before the final presidential debate.

5.3.2. Opposition parties win power

Iliescu's reign was temporarily ended in the November 1996. The growing inequalities between privileged insiders who were looting state assets and others who had to endure the hardships of prolonged economic crisis, the indefinite postponement of government measures for economic recovery and restructuring, and a hard winter during which energy shortages left many without heating for days at a time persuaded many more voters to support Iliescu's opponents. The CDR's presidential candidate, Emil Constantinescu, defeated Iliescu in presidential elections and the CDR won 30.17 percent of the parliamentary vote, followed by PSD with 21.52 percent and PD with 12.92 percent.

International observers hailed the 1996 elections as Romania's much waited for proof that it was committed to democracy. Without a doubt, the elections brought fresh air in Romania's politics and inspired many to believe that better times were ahead. However, although the CDR won the presidency and had a plurality of seats in parliament, it could not form a government on its own. To govern, it decided to join forces with the Democracy Party (PD, Petre Roman's faction of the FSN) which was formed largely by younger members of the *nomenklatura*, who joined the Communist Party to advance professionally, achieve status or personal gains rather than for ideological reasons.

During its time in power, however, the CDR-PD coalition was often paralyzed by power sharing disputes which undermined its ability to govern. Moreover, the implementation of a broad program of economic reforms promised during the campaign was constantly challenged by economic elites who prospered during Iliescu's rule. A year after the election, Constantinescu declared, "In November 1996 we won the elections, but we did not conquer power, because a large part of the economic power belonged, and still belongs in good measure, to a mafia-type web of interests which had no connection with the national interest" (quoted in Gallagher 2005: 165). What the president did not say was that some of these powerful economic interests had re-aligned themselves and were blocking government initiatives from the inside. For example, the government's campaign to expose acts of corruption and patronage were curbed by members of the PD who were in power before they split with Iliescu's party and feared that investigations might reveal too much. Petre Roman, Iliescu's first prime minister and one of the top figures in the PD, lived in a state-owned "protocol" house until after the 1996 elections paying symbolic rent. Like him, many members of PD benefited from their positions of influence at the beginning of the 1990s and were using their new access to power to maintain or enhance these benefits.

In 2000, popular disappointment with the CDR government translated into increased electoral support for Iliescu and PSD, and since then, Romania has mostly

alternated between PSD and PD-led governments, the two factions of the FSN which succeeded, albeit unofficially, the communist party. The high degree of political polarization—one of the highest among the former communist countries—may explain the slow pace of reform and economic recovery (Frye 2002). Perhaps not surprisingly, but disappointing nonetheless, governments spend most of their time undoing institutional arrangements that benefited the opposition and establishing their own. Institutional re-organization and leadership changes followed every election, compromising policy continuity and slowing down economic reform. With polarization, however, also came a high degree of political competition and a focus on reforms that would gain the approval of the electorate. FDI liberalization was one such reform.

The intense political competition between two parties that succeeded from the communist party organization is perhaps unique to Romanian politics (Pop-Eleches 2008). In 2004, the frontrunners for presidential elections were Adrian Nastase, the outgoing PSD prime minister, and Traian Basescu, the mayor of Bucharest and the PD candidate, leading Basescu to ask in one of their televised debates what curse has brought the people of Romania to choose between two former communists. As Pop-Eleches (2008) points out, "after almost two decades of democratic elections the Romanian political scene has come full circle" with the two former FSN factions

competing against each other for every position of influence, the PSD on the center-left and the PD on the center right.

The alternation in power of two political parties that descended from the communist organization is most certainly not what many Romanians envisioned as defining their democratic future. However, the genuine political competition that resulted from the ideological differences and the rivalry between these two parties has been exactly what paved the way for democratic competition in Romanian politics. The transition has been gradual and marred with numerous episodes of political deadlocks and infighting, and so has the process of economic reform. The importance of patronage in building both of these organizations explains why economic liberalization has been at times lukewarm; nonetheless, the intense political competition between the two factions has pushed them toward policy choices, including the removal of barriers to FDI, that are needed to accrue electoral support.

In short, Romania's post-communist transition is defined by the political dominance of Ion Iliescu and his PSD party from December 1989 to the end of 1996, followed by intensified competition and almost perfect alternation in power of center-right coalitions and the center-left PSD. The November 1996 elections marked a critical moment in Romania's recent history by strengthening its democratic institutions and enhancing political competition. The theory proposed in this dissertation suggests that

following such political liberalization, the government would increase its openness to FDI. The following section describes the evolution of FDI regulations in Romania and shows that indeed Romania's FDI policies have been considerably more open since 1996.

5.3.3. The evolution of FDI regulations

Romania has allowed foreign investment since the beginning of the 1970s, but the conditions were always extremely strict. Foreign companies could not own more than 49 percent of joint venture with a state-owned enterprise, transfers of profits could not exceed the joint venture's hard currency earnings, and bureaucratic conduct and state planning agendas were a strong deterrent for any efficiency-driven enterprise (Dobosiewicz 1992: 48). As a result, foreign direct investment was practically negligible at the end of the1980s.

Following the demise of Ceausescu's regime, the legislation on foreign investment was changed frequently. A government decree passed in March 1990 removed limits on foreign equity participation in all sectors of the economy, but the government continued to require foreign companies to obtain approval before investing. A year later, the government led by Petre Roman passed the Foreign Investment Law in April 1991. The law guaranteed the investors' right to transfer profits and eased registration procedures for foreign firms, but continued to require that they obtain approval from the Romanian Development Agency. The 1991 law also offered a limited

number of tax incentives for investments that exported more than half of their output, acquired more than half of their inputs in the domestic market, and created at least 50 new jobs (Lutan 2006: 264). However, neither law provided national treatment to foreign investors or access to international arbitration. This is in contrast to countries such as Hungary, who provided such conditions for FDI early on, and also had more democratic political systems.

The government did little else to encourage foreign companies to invest. Until 1996, the privatization of state-owned companies, which put some of the other Eastern European countries on the map of foreign investors, was carried out through management and employee buyouts and widely distributed vouchers (mass privatization). The first method clearly favored insiders, which acquired a very large share of their companies (about 65 percent on average), while companies privatized through mass privatization ultimately ended up under the control of the enterprise managers or investment funds run by various regime insiders (OECD 2005). Direct sales did not start until 1996 and sales to strategic investors did not become a government priority until 1998.

Following the 1996 election, the government placed great emphasis Romania's integration into the world economy and particularly on foreign investments as a means to create jobs, access new technologies, and restructure the domestic industry (author

interviews, Bucharest, July 2007). The CDR-PD coalition government revised Romania's economic reform program, including the legislation on FDI. In June 1997, it adopted an executive decree that increased the rights of foreign investors and the scope of FDI incentives. Most importantly, the decree (which was adopted into law a year later) improved the FDI framework by specifying that foreign investors should receive equal treatment with domestic investors and by guaranteeing access to alternative mechanisms for the resolution of investment disputes, including international arbitration courts that could mediate between foreign investors and the Romanian state (Lutan 2006: 266). The government also implemented new regulations that liberalized foreign exchange markets and eliminated procedures that were delaying in the processing of capital outflows (PRS 2008).

But perhaps the most important breakthrough in terms of opening the Romanian economy to FDI has been to revise the government's privatization strategy and proceed with privatization through sales that encouraged the participation of foreign investors (OECD 2005). This strategy was reflected in a jump in FDI flows (Figure 5.1) and also paved the way for the privatization of some of the largest state-owned enterprises such as Sidex-Galati later on.

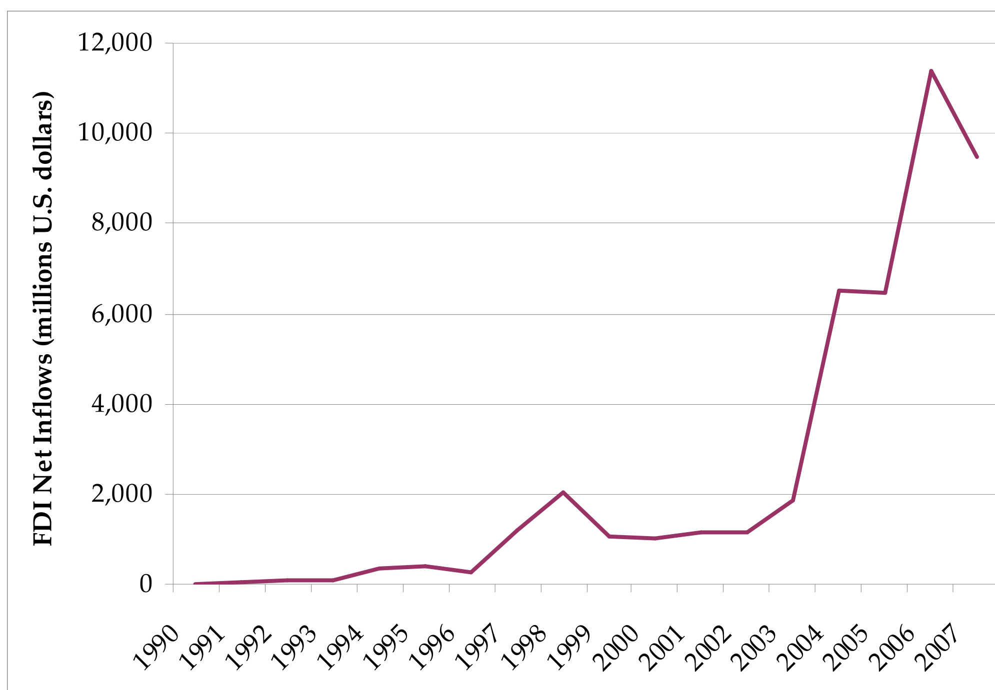


Figure 5.1 FDI inflows in Romania (millions of U.S. dollars)

After 2001, when a new parliamentary coalition led by center-left PDSR formed the government, there have been both positive and negative developments in the FDI policy framework. Investment incentives were eliminated or drastically reduced, a policy change that may be explained by Romania's preparation to join the European Union. The accession negotiations, launched in February 2000, involved more than 30 chapters. Chapter 4 on the free movement of capital and Chapter 6 on competition were negotiated and closed by 2003 and 2004, respectively (Permanent Representation of Romania to the European Union 2010). The conclusion of these chapters brought Romania's state support polities closer to the provisions of European competition law,

but also precluded the government from extending fiscal incentives to investors. However, the process offered a venue for the negotiation of exemptions, and many observers believe that the government did not try hard enough to retain some tools for attracting FDI, like other candidate countries did (author interviews, July 2007). Moreover, to abide with the commitments made during these negotiations, the government suspended a number of investment incentives already granted to foreign investors, a decision that has been subsequently challenged by investors in international arbitration courts.

A positive development has been the establishment of a dedicated government agency to deal with foreign investments of all types. As the following section shows, Romanian governments have tried a number of institutional structures that were intended to assist interested foreign investors but only established a special foreign investment agency in 2002.

5.3.4. A long road to institutionalized FDI promotion

The institutions designed to interact with foreign investors also changed frequently over the past two decades. In March 1991, the government re-organized the Romanian Agency for the Promotion of Foreign Investment and Economic Aid that functioned under the communist regime and was in charge of screening and approving FDI projects. In its place, the government established the Romanian Agency for

Development (ARD) and entrusted it with ensuring among other things that foreign-led investment projects are compatible with the government's economic reform program by screening investments and channeling foreign capital towards the restructuring and development of priority sectors in the Romanian economy. For the first year, ARD was subordinated to the government and had a special department dealing with foreign investments. Starting in 1992, ARD was re-organized as an autonomous government agency employing between 100 and 128 people; however, its management was appointed by the prime minister for five years, and its budget was partly run by the state (Lutan 2006: 174).

After a coalition of opposition parties defeated Iliescu and his PSD party presidential and parliamentary elections at the end of 1996, ARD was shut down, replaced for a few months with a newly established Department for the Promotion of Foreign Investments in the Ministry of Privatization, and then re-established in 1998. The new ARD had an equally broad mandate that included the assistance and promotion of FDI among other development objectives, depended entirely on the state budget for funding, and employed over 150 people organized in four departments, only one of which was responsible for assisting foreign investors. However, the agency operated only until 2000. While some of its local development responsibilities, including FDI promotion at the local level, were delegated to the National Agency for Regional

Development, the closing of ARD left an institutional void in terms of a nationwide coordinated effort to assist and promote foreign investments in Romania.

To fill part of this void, the government established in 2001 a Department for Foreign Investor Relations that was part of the government secretariat and a Department for the Promotion of Foreign Investments as part of the Ministry for Development and Prognosis. The first institution was responsible for developing, coordinating and implementing a government strategy for the promotion of foreign investments exceeding $10 million. The department employed up to 15 people and did not have a separate budget. The second institution that functioned as part of the Ministry for Development and Prognosis had similar responsibilities, but was working with foreign investments between $1 and $10 million dollars. The combination of the overlap between the responsibilities of the two departments, the lack of coordination between them, and their limited scope and institutional autonomy rendered them ineffective. The government decided to re-organize the state institutions dealing with FDI again, and in 2002 it replaced these departments with the Romanian Agency for Foreign Investment (ARIS).

ARIS is a separate agency that continues to be subordinated to the government. In 2004, ARIS employed 33 people (including staff) and had a budget of almost 0.5 million Euros. In its first two years of activity, ARIS spent two-fifths of its budget on

foreign investment promotion activities and assisted 50 projects totaling more than 3 billion Euros (Lutan 2006: 176). In 2008, the agency's budget was 0.53 million Euros and roughly the same number of people were working there (ARIS 2008). Since then, ARIS assisted with the development of more than 86 projects, with an estimated investment value in excess of 8 billion Euros and more than 37,000 new jobs expected to be created (see Appendix 5.1).

* * *

Romania's political transition is perhaps uniquely defined by the emergence of two strong parties whose roots can be traced back to the old communist party. Political strategy at the beginning of the 1990s, which focused on preserving the bureaucratic and *Securitate* networks and using them to build new political machines, established a new system of patronage that perpetuated the privilege of old and new political insiders. While the game of patronage endures to a large degree, increased political competition after 1996 has brought considerable advances to Romania's policies on foreign investment.

Table 5.3 Romania: Timeline of political events

December 1989	Political uprisings in Timisoara, and later in other Romanian cities, create an opportunity for mid-level communists to instrument Ceausescu's ousting. Him and his wife flee the capital but are caught by the army, convicted in a hasty military trial, and executed on December 25, 1989.
March 1990	*Government decree removes foreign equity limits.*

Table 5.3 Romania: Timeline of political events

May 1990	Romania holds its first election. Ion Iliescu and his party, the National Salvation Front, win an overwhelming victory.
June 1990	Post-election protest movements challenging Iliescu's electoral victory are quelled with the help of miners from the Jiu Valley.
March 1991	*The Foreign Investment Law is enacted and the Romanian Development Agency (ARD) is entrusted to approve FDI projects.*
September 1991	Petre Roman, Romania's first prime minister, steps down following ideological disagreements with President Iliescu. His resignation leads to a split of the FSN into two political groupings, known later as the Romanian Social Democratic Party (PSDR, Iliescu's faction) and the Democratic Party (PD, Petre Roman's faction).
September 1992	Iliescu wins presidential elections and his PSDR party is the largest political group elected to parliament. Structural reform proceeds very slowly.
November 1996	The Romanian Democratic Convention (CDR) wins landmark election and its presidential candidate, Emil Constantinescu, become Romania's first democratic president.
January 1998	*ARD is shut down, replaced for a few months with a newly established Department for the Promotion of Foreign Investments in the Ministry of Privatization, re-established at the end of the year, and shut down again in 2000.*
November 2000	Iliescu wins a new presidential mandate and his party, the PSD, wins the largest number of seats in parliament.
January 2001	*The government establishes the Department for Foreign Investor Relations in the government secretariat and a Department for the Promotion of Foreign Investments in the Ministry for Development and Prognosis.*
June 2002	*Romanian Agency for Foreign Investments (ARIS) is established.*
November 2004	Traian Basescu is elected as president and a pre-electoral coalition that brought together the Democratic Party (PD) and the National Liberal Party (PNL) forms the new government.
November 2008	The PD wins a plurality of parliamentary seats and continues to govern in coalition with PNL.
November 2009	Traian Basescu is re-elected president.

5.4. Kazakhstan

Perhaps one of the most fascinating cases of FDI policy choice is Kazakhstan. At first glance, Kazakhstan's story contradicts the argument of this dissertation, since this authoritarian regime chose a relatively welcoming climate for foreign investors at the beginning of its economic transition. A closer look, however, reveals a rather astute political leader who attracted Western companies to take over state-owned enterprises in order to diminish the economic power of Soviet-era elites who were likely to challenge his regime. However, this honeymoon period was short-lived. As political and economic power grew increasingly concentrated in the hands of Nursultan Nazarbayev's family and close associates, the investment climate for foreign companies deteriorated and the government started to screen and interfere with the activities of foreign investors in order to safeguard the economic privilege of the regime's supporters.

This chapter describes Kazakhstan's story in five sections. A brief introduction to Kazakhstan's position at the end of 1980s highlights its dependence on the Soviet Union's economy and the delicate balance between the Kazakh and Russian populations at home. The following section depicts Nazarbayev's strategy of creating an independent state in conditions that many deemed ripe for ethnic conflict and tension

with Russia. I next discuss the critical role played by foreign investments at the beginning of the 1990s in shifting the balance of economic power toward the supporters of Nazarbayev's regime, and the consolidation of his rule through a succession of institutional changes that enhanced the power and tenure of the president. I finish the study with a discussion of the evolution of FDI policies in Kazakhstan, which when overlaid on top of the political story paint a convincing case of authoritarian consolidation leading to the reinstitution of restrictive FDI regulations.

5.4.1. Leaving the Soviet Union

Kazakhstan, a country of 15 million people but five times the size of France, or roughly one-third the area of the continental U.S., has been part of the Russian Empire and later the Soviet Union for more than 250 years. Endowed with vast lands and abundant natural resources—some say the country could export the entire periodic table—Kazakhstan was part of the agro-industrial backbone of the Soviet economy. The country became independent for the first time in December 1991, after all efforts to re-define the union among Soviet republics had failed, and since then has been led by Nursultan Nazarbayev, the First Secretary of the Kazakh Communist Party since 1989.

Nazarbayev was one of the most forceful advocates of the preservation of the Soviet Union. When the union dissolved after an abortive political coup in mid-1991, he pushed for an economic union between Russia, Kazakhstan, Kyrgyzstan, Ukraine and

Belarus. When this also failed, Kazakhstan was the last republic to declare its independence, days after Russia, Belarus and Ukraine withdrew from the U.S.S.R. (Olcott 2002: 35).

Nazarbayev's preference for the continuation of a political and economic union with Russia and some of the other former Republics was linked to his keen awareness of the potential perils of an independent Kazakhstan. The Kazakh and Russian economies were highly interdependent as a result of socialist economic planning that did not take into account the administrative boundaries between the republics. As late as 1994, when the IMF first reported such statistics, Kazakhstan was sending 60 percent of its exports to Russia and imported 47 percent of needed goods from Russia (Olcott 2002: 46). Many believe that the interdependence between the two economies was even greater in earlier years. Russia was purchasing Kazakhstan's entire aluminum, iron and chromium output, and was providing more than half of Kazakhstan's energy needs. The pipeline system built during the Soviet times did not link Kazakhstan's oil and gas reserves to the refineries on its territory, but rather to ones in Russia. Moreover, the refineries in Kazakhstan were ill-equipped to process the natural riches of the country. To avoid the potential economic collapse that could ensue from severing economic ties between the two countries, Kazakhstan maintained the ruble until 1993, when tensions over the pace

of price liberalization, monetary policy and the payment of government debts led Kazakhstan to re-orient its economic strategy.

Another factor that influenced Nazarbayev's preference for continuing within a political and economic union with Russia was the ethnic composition of the republic. Kazakhstan was the only former Soviet republic in which the titular ethnic group did not represent the majority. At the time of independence, 39.7 percent of the population was Kazakh, 37.2 percent was Russian, and the remaining were other ethnic minorities (Dave 2004). For Kazakhstan, the Russian ethnic population was its "Achilles' heel" (Olcott 2002). It was large enough to claim dominance. It also accounted for the majority of workers in the country's factories and mines, which were the most likely to be affected by a decline in economic relations with Russia. Moreover, the boundaries of the republic had been artificially created by administrative decree during the Soviet era and there was no historical or natural border to separate it from Russia. Any tension between the Russian and Kazakh populations was expected to aggravate Russia and to lead to the severance of economic ties, or worse, to violent conflict.

5.4.2. State-building in the 1990s

Although Nazarbayev may have preferred that Kazakhstan remain within a reconfigured union, the events of the last half of 1991 left him in a very advantageous position to become the leader of Kazakhstan. He ran for the presidency unopposed in

December 1991, and has successfully consolidated his grip on power since then. He first placed a strong emphasis on the formation of Kazakh nationhood and implicitly on the marginalization of Russians in positions of influence, while also enabling the empowerment of a new and loyal group of elites through patronage. At the same time, he built on his people's fear of political instability and economic decline, to increase the executive's powers at the expense of the parliament, which today does little more than rubberstamp the president's policies into legislative acts.

In the initial years following Kazakhstan's independence, Nursultan Nazarbayev's government was preoccupied with the building of a new state through a process that required a skillful balancing of power between the Kazakhs and Russians. According to the last Soviet census, in 1989 the population of Kazakhstan consisted of two-fifths Kazakh, two-fifths Russian, and one-fifth other ethnic groups (Pomfret 2005). But the politics of state-building have sent strong signals to the Russian population about their new status in the country. Throughout the 1990s, the government emphasized the "Kazakhstaness" of the state by asserting Kazakh as the official language, denying dual citizenship, and using Kazakh cultural symbols to represent the country. In response, many Russians living there chose to emigrate. According to some reports, more than one quarter of the country's Russian population left in the 1990s (see Olcott 2002: 270).

The emphasis on introducing Kazakh as the language of government was one of the most powerful means of effecting elite replacement and the consolidation of the regime. While the dominant language was and continues to be Russian, the official language of the state has been Kazakh since September 1989, a few months after ethnic conflict in the southwest of the country led to Nazarbayev's appointment as the First Secretary of the Communist Party of Kazakhstan (Pomfret 1995). The 1995 constitution, which laid the foundation for the new state, established Kazakh as the official language and Russian as the language of inter-ethnic communication, and also requires that the president of the country be fluent in Kazakh. According to the 1999 census, while practically all Kazakhs speak Russian, only 15 percent of the Russians living in Kazakhstan speak Kazakh and 27 percent are trying to learn the state language (Dave 2004). Even today, Russians underline language requirements as the main barrier to government positions and contracts, and thus as the main source of discrimination and discontent (author interviews, Almaty, June 2007).

In a grand gesture of state-creation, the country's capital was moved from Almaty to Astana (*'capital'* in Kazakh) in December of 1997. The new capital, which used to be a Russian dominated town, is strategically and symbolically located between the predominantly Russian northern and western provinces and the mostly Kazakh southwest. The relocation was announced during a visit by the Russian prime minister

at the time, and was interpreted as an expression of confidence in an independent Kazakhstan and the determination of Nazarbayev's government to rule over both Russian and Kazakh dominated provinces from a capital that is centrally located. At the same time, the relocation also provided an opportunity to distance the institutions of government from previously powerful elites that still had some sway in Almaty, and also from sources of popular opposition (author interviews, Almaty, June 2007).

As a result of the government's state-building strategies, today Kazakhstan is a country that brings together newly empowered Kazakhs and those considerably less influential Russians who chose to stay. As Olcott notes,

> For all the talk of a multi-ethnic Kazakhstan, it is the Kazakhs who now dominate in the republic. They are the country's most prominent political and economic leaders, and for the first time, it is the Russians who must take their cues from them. The former colonists find themselves in a difficult position, and the figures for outmigration eloquently speak to the difficulties that ethnic Russians are having accommodating themselves to the situation. (2002: 58)

Nowhere is this more evident than in the distribution of economic spoils, which from the very beginning were channeled to Nazarbayev's family and (mostly Kazakh) friends. As in the other former republics, the collapse of the Soviet Union placed Nazarbayev in control of millions of dollars of Communist Party property. These properties, including public buildings, hotels and residences, offered tremendous opportunities for patronage. To ensure that state assets could become personal ones in case independence was short-lived, Nazarbayev placed trusted family and friends in

positions of power and legitimized the consolidation of power in the hands of new elites of Kazakh origin in terms of the restoration of Kazakh nationhood (Olcott 2002).

5.4.3. Economic decline, reform and recovery

In the first years following independence, economic policy was driven by Nazarbayev's belief that maintaining close economic ties with Russia was necessary to avoid an economic collapse, which could be fatal for the new country and the emerging political elite. With time, however, the government realized that the heavy dependency on the Russian economy would hamper its ability to establish the regime and act independently. Thus, economic policies in the second half of the 1990s were used to decrease this dependency, and to shift economic influence from the Russians living in Kazakhstan, who were running many of the country's state-owned enterprises, toward Nazarbayev's political supporters. Privatization through sales to foreign investors rather than managerial buy-outs was critical to achieving this end, and explains the government's emphasis on attracting foreign direct investment in the 1990s.

Like most transition economies, Kazakhstan suffered an economic decline in the aftermath of the Soviet Union's demise. The early 1990s were characterized by high inflation and falling output levels. Because Kazakhstan maintained the ruble for almost two years after becoming independent, inflation tracked mostly that of Russia, reaching four-digit levels in 1992. GDP fell by 30 percent between 1991 and 1995 as a result of the

disruption of trade among the former Soviet republics (see Table 5.2). Nonetheless, Kazakhstan's post-independence decline was perhaps not as dramatic as in other Central Asian republics because it enjoyed the continuation of privileged economic relations with Russia and an improvement in its terms of trade as a result of the shift from Soviet to world prices (Pomfret 1995: 86).

Among the Soviet republics, Kazakhstan was one of the most tightly integrated into the larger economy of the Soviet Union (Olcott 2002; Pomfret 1995). Its many single-town enterprises, which were built to process its rich mineral ores, were integrated into production chains with suppliers and smelters in other parts of the Soviet Union, and were selling most of their output to Russia. Its oil and gas industries were underdeveloped and dependent on Russian pipelines and refineries. At independence, Kazakhstan was producing only about 6 percent of the Soviet Union's total oil and 1 percent of its gas, and most of the country's reserves were unexplored, particularly in the offshore sites on the Caspian, where most of the country's natural wealth was believed to lie (Jones Luong and Weinthal 2001). Kazakhstan's own major refineries in Pavlodar and Shymkent were linked by pipeline to Siberian oilfields (Pomfret 2005: 861) and were ill-equipped to process the oil and gas extracted in the country (Olcott 2002: 47). Consequently, the energy sector required considerable investment before Kazakhstan could export a lot of its own oil and gas without relying on Russia.

Table 5.4 Kazakhstan macroeconomic indicators 1990-2008

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
GDP, GDP growth, and GDP/capita										
GDP (millions of constant 2000 US$)	26,348	23,450	22,207	20,164	17,623	16,178	16,259	16,536	16,221	16,659
GDP growth (annual %)	..	-11	-5	-9	-13	-8	0	2	-2	3
GDP per capita (constant 2000 US$)	1,612	1,425	1,351	1,235	1,095	1,023	1,044	1,078	1,076	1,116
GDP per capita growth (annual %)	..	-12	-5	-9	-11	-7	2	3	0	4
TRADE										
Exports (constant 2000 US$, millions)	12,487	11,363	10,057	9,373	8,342	8,759	8,934	9,041	7,965	8,204
Imports (constant 2000 US$, millions)	27,143	19,190	14,911	11,153	10,529	8,433	6,991	7,516	6,974	7,016
FOREIGN DIRECT INVESTMENT										
FDI, net inflows (current US$, millions)	..	..	100	1,271	660	964	1,137	1,321	1,151	1,587
FDI, net inflows (% of GDP)	..	..	0	5	3	5	5	6	5	9

	2000	2001	2002	2003	2004	2005	2006	2007	2008
GDP, GDP growth, and GDP/capita									
GDP (millions of constant 2000 US$)	18,292	20,761	22,796	24,916	27,308	29,957	33,162	36,114	37,269
GDP growth (annual %)	10	14	10	9	10	10	11	9	3
GDP per capita (constant 2000 US$)	1,229	1,397	1,534	1,671	1,819	1,978	2,166	2,332	2,378
GDP per capita growth (annual %)	10	14	10	9	9	9	10	8	2
TRADE									
Exports (constant 2000 US$, millions)	10,354	10,167	11,855	12,744	14,133	14,289	15,218	16,587	16,761
Imports (constant 2000 US$, millions)	8,981	8,846	9,120	8,427	9,674	10,884	12,201	15,312	16,681
FOREIGN DIRECT INVESTMENT									
FDI, net inflows (current US$, millions)	1,283	2,835	2,590	2,092	4,157	1,971	6,278	10,189	..
FDI, net inflows (% of GDP)	7	13	11	7	10	3	8	10	..

In the mid-1990s, the government shifted its focus from economic policies of stabilization that followed closely the policy developments in Russia to implementing its own privatization strategy. The first stage of large-scale privatization involved vouchers which citizens could use to buy shares in Investment Privatization Funds (IPFs), which themselves bought shares in state enterprises. The distribution of vouchers favored the Kazakh population by allocating 100 vouchers to urban residents and 120 vouchers to rural residents, who were disproportionately of Kazakh origin (Pomfret 1995: 90). The voucher privatization also created opportunities for the managers of newly established

investment funds to accumulate impressive personal fortunes. Many of them, who perhaps not coincidentally were ethnic Kazakhs, went on to form Kazakhstan's new economic elite and later occupied important positions in Nazarbayev's government. One such example is Mukhtar Ablyazov, the manager of Astana Holdings, who in 1998 became the Minister of Energy, Industry, and Trade, but later fell out of favor with the president after he founded the Democratic Union of Kazakhstan as an alternative political movement (Afzal 2004). At the same time, many Communist-era legislators who were still serving in Kazakhstan's parliaments were denied private gains in the privatization process and began to publicly criticized the government for the deals it was making (Olcott 2002: 138).

Yet, Nazarbayev pressed on with privatization and appointed a new prime minister, Akezhan Kazhegeldin, to oversee the case-by-case sale of the country's large state-owned enterprises. Privatization proceeded at impressive speed during 1995-1996 and involved many sales to foreign investors (see Table 5.3 for selected examples). Many accused the government of selling the country's most profitable enterprises at unreasonably low prices to harvest short-term gains in a process that lacked any transparency (Jones Luong 2000; Olcott 2002). One such deal was the sale of Karaganda Metallurgical Complex (Karmet), where Nazarbayev had held his first job. The steel plant, which was one of the largest steel mills in the world, had an estimated

replacement cost of $1 billion, and accounted for 10 percent of Kazakhstan's 1995 GDP when working at half capacity, was sold for a reported $50 million cash payment to Ispat (Mittal Steel) at the end of 1995 (Olcott 2002: 140).

Table 5.5 Privatization by sales (millions of US dollars), 1995-1996, selected examples

Enterprise	Date	Buyer	Basis	Value
Pavlodar Aluminium	September 14, 1995	Whiteswan	50%	169.6
TNK Kazchrom	October 15, 1995	Japan Chrome	52%	582.6
Karaganda Metallurgy	November 15, 1995	Ispat International		838.6
AO Zheskazganskii GOK	December 8, 1995	Novaresources SG	40%	45.4
AO Sokolovo-Sarbaiskoe GOPO	February 13, 1996	Aivedon International	49%	124.7
AO Torgaiskoeboksitovoerudoupravlenie	April 5, 1996	Whiteswan	51%	13.2
AO Krasnootyabrskoeboksitovoerudoupravlenie	April 5, 1996	Whiteswan	51%	29.2
AO Keregitas	April 5, 1996	Whiteswan	51%	19.7
Karagandiskaya TES 2	April 17, 1996	Ispat Karmet	Property	42.5
AO Ermakovskaya GRES	May 2, 1996	Japan Chrome	53%	259.7
AO Zheskazgan Svetmet	May 24, 1996	Samsung Deutchland	40%	351.2
Karaganda Shakta Ugol	June 18, 1996	Ispat Karmet	Property	195.0
Ekibastuzskaya GRES 1	June 26, 1996	AES Suntree Power	Property	554.0
Almatyenergo	July 31, 1996	Tractebel	Property	358.4
Shymkent oil refinery	July 1, 1996	Vitol Munay	94%	230.0
Pavlodarskaya TES 1	August 8, 1996	Whiteswan	Property	113.7
Zheskazganskaya TES	August 8, 1996	Samsung	Property	107.2
Zambylskaya GRES	August 27, 1996	Vitol Munay	Property	124.1
GAO Yuzhneftgaz	August 28, 1996	Hurricane Hydrocarbons	89.50%	930.0
AO Sary-Arka Pollimetall	September 19, 1996	Nakosta	39%	28.6
Razrez Vostochnyi + 34% of Rasrez Spepnoi	September 25, 1996	Japan Chrome	Property	317.6
Razrez Bogatyr + 66% of Razres Stepnoi	October 18, 1996	Access Industries, Inc	Property	801.1
Razrez Severnyi	October 18, 1996	Sverdlovenergo	Property	233.5
AO Lisakovskii GOK	October 24, 1996	AO Esil	51%	46.0
Karagandiskaya GRES 2	October 1, 1996	Independent Power Corp, Plc	Property	418.8

Note: Value includes all buyer liabilities, including guaranteed investments, guaranteed future contributions to the state budget, bonus, debt payments, wage arrears, budget and non-budget arrears, royalties, etc.
Source: Kalyuzhnova 1998, p.79-83.

The government headed by Prime Minister Akezhan Kazhegeldin also decided to accelerate the development of Kazakhstan's energy sector by attracting foreign investment as quickly as possible. Between June 1996 and July 1997, the government sold the bulk of its shares in a number of oil and gas enterprises to foreign investors,

despite tremendous opposition from the "oil barons" managing those companies. When the government put up for tender shares in Kazakhstan's major oil companies, the oil barons, most of whom were Russian and had been in top positions since the Soviet era, opposed what they claimed to be the surrendering of their enterprises to foreign investors (Bird 1997a). Prime Minister Kazhegeldin told diplomats and journalists that "the heads of oil enterprises do not want to go ahead with privatization" (Bird 1997b) and the head of the State Property Committee, Sarybai Kalmurzayev, declared that "there is a group of people who are afraid that they will lose everything if the oil-wells are torn from their control." He singled out as one of the main opponents of oil sector privatization Mendesh Salikhov, who headed Kazakhstan's largest oil company, Mangistaumunaigaz, located in the western part of the country and the producer of one-third of its oil output (Solovyov 1997). The government eventually overcame the oil barons' opposition and pushed through with the planned sales by dissolving Kazakhstanmunaigaz, the state holding company which controlled the nation's oil and gas sector (Solovyov 1997).

Kazakhstan's decision to involve foreign investors in the privatization of the energy sector is in sharp contrast to the choices made by the other oil-rich former Soviet republics. Uzbekistan and Turkmenistan maintained state-control of their energy companies; Azerbaijan did the same but also involved foreign companies in the

development of oil projects; and Russia proceeded with privatization in its oil sector but limited the involvement of foreign investors (Jones Luong and Weinthal 2001). Kazakhstan's choice is also puzzling because new countries are often reluctant to release state control over the oil and gas reserves that offer the promise of economic growth and vast opportunities for patronage. Yet Nazarbayev's government proceeded with the rapid sale of state-owned oil enterprises. I argue that his strategy offered a means not only to reduce the country's dependence on Russia for oil refining and transportation, but also to decrease the economic sway of Soviet-era economic elites, many of whom were Russian, opposed Nazarbayev's regime, and supported nationalist forces in the predominantly Russian northern and western provinces which hold the vast oil and gas reserves.

Thus, Kazakhstan's development strategy focused on balancing good economic relations with Russia and with Western investors, which helped Nazarbayev assert the economic independence of his country from Russia. At the same time, by allowing foreign investors to purchase state-owned enterprises and oil companies which were mostly controlled by Russian managers, the government was able to marginalize Russian elites that did not support Nazarbayev's regime and to empower his own political supporters.

Thus, the liberalization of FDI was a critical play in the government's strategy to shift power and privilege from Russian to Kazakh elites in order to ensure the independence and stability of the regime. Restrictions on FDI (discussed in detail below) were relaxed in the mid-1990s. Clauses related to the promotion of trade and foreign direct investments were even incorporated in the 1995 Constitution that established the founding principles of the State of Kazakhstan (Dosmukhamedov 2002). It was only after Nazarbayev had successfully strengthened his grip on power that the investment climate and the conditions offered to interested investors began to deteriorate.

The involvement of foreign investors in the development of the country's oil and gas industries paid off in the middle-run. Kazakhstan has enjoyed a swift economic recovery since the beginning of this decade, primarily due to increased exports from the new oil fields developed by major foreign companies, many of which came into production just as oil prices rose (Pomfret 2005: 872). A negative side-effect of this focus on the development of natural resource extraction, however, was the neglect of most other economic sectors, including agriculture and manufacturing, which suffered deep crises in the 1990s and have been slow to recover since then. Foreign direct investment has been negligible in these sectors despite the fact that the government has proposed a long-term development strategy designed to diversify the economy beyond natural resources and heavy industries. Nazarbayev's plan "Kazakhstan 2030" outlines some of

these objectives, and the government established the Development Bank, the Investment Fund, and the Fund for Innovation to provide financial support to accomplish them (Nazarbayev 2008). However, development in new economic areas has been limited to date, and it is unclear whether the government will be able to stimulate the diversification of the Kazakh economy by presidential decree (author interviews, July 2007).

5.4.4. Stronger in power: the consolidation of Nazarbayev's regime

Kazakhstan's political history since independence can be described as a sequence of skillful maneuvers that contributed to the entrenchment of the country's first president, Nursultan Nazarbayev, and culminated with the removal in 2007 of any presidential term limit, which effectively made him the country's leader for life. As president, he repeatedly invoked the importance of political and economic stability to legitimize institutional changes that enhanced the power of the executive and weakened the parliament and the role of political parties. These changes also restricted the ability of opposition groups to organize, access media channels, and gain political representation. At the same time, the political spectrum was gradually reduced to one party, Nur Otan, which bears the president's name.

Nursultan Nazarbayev has yet to be confirmed in a free and fair election. Nazarbayev's political career began within the ranks of the Communist Party of

Kazakhstan, which he was selected to lead in September of 1989. When Kazakhstan became independent, he ran unopposed and received 98 percent of the vote in a popular election in December 1991 to become the country's first president. His first term was renewed through a national referendum held in the spring of 1995, shortly after he dissolved parliament. The presidential election scheduled for December 2000 was held almost two years early to eliminate the incentive and opportunity for opposition movements to mobilize politically. Nursultan Nazarbayev won the election held in January of 1999 after former Prime Minister Akezhan Kazhegeldin, his most serious challenger, was barred from running. He was then re-elected in December of 2005, with 91 percent of the vote, after presidential elections were once again brought forward to cut short the election campaign. Finally, in May of 2007, the Parliament passed a constitutional amendment that lifted the two-term limit on the "First President" of Kazakhstan. Nazarbayev was now president for life.

The Constitution, which was adopted through a national referendum in September 1995, conferred great powers to the executive over the legislative and judiciary. Subsequent amendments to the Constitution further enhanced executive power, granted immunity to the "First President," and established that he will appoint a successor to whom he will be a special advisor (Dave 2005). The president chooses and dismisses the prime minister, his cabinet and other top officials. He appoints a third of

the members of the Senate and nine deputies to the lower house, the Majilis, and has the power to dissolve the Parliament at any time. He selects all regional and district governors, the *akims*, and has resisted demands to allow these positions to be filled through sub-national elections. He has the right to ban political parties if he deems this appropriate and appoints three of the seven members of the Central Election Commission, which oversees electoral campaigns and elections.

Nazarbayev has deftly used his presidential prerogatives to consolidate his position over time. When the 1994 parliament became an institution through which various clan notables and pro-democratic representatives voiced opposition to the president and gained access to state resources, he dissolved it and hastily organized a national referendum that enhanced executive power and extended his term in office for another five years (see Figure 5.3 for a timeline of political events). He later introduced a number of amendments to the laws on elections and political parties, in order to strengthen pro-government groups and decrease the number of representatives of the Russian population and rival Kazakh clans.

Table 5.6 Kazakhstan: Timeline of political events, 1989-2010

September 1989	Nursultan Nazarbayev is appointed the first secretary of the Communist Party of Kazakhstan.
December 1991	Kazakhstan is the last republic to claim its independence from the USSR. Nursultan Nazarbayev runs unopposed in popular elections and becomes the country’s first president.

Table 5.6 Kazakhstan: Timeline of political events, 1989-2010

December 1993	Nazarbayev asks for the dissolution of the Soviet-era Parliament.
March 1994	Legislative elections produce a Parliament that is not as pliant as expected, leading to its dissolution a year later.
December 1994	*The Law on Foreign Investment is enacted.*
March-April 1995	Nazarbayev dissolves the Parliament and renews his mandate as president through a national referendum.
September 1995	The Constitution of Kazakhstan is adopted through national referendum. It confers unlimited power to the president and subordinates the legislature and judiciary to the executive.
February 1997	*The Law on State Support for Direct Incentives is adopted. It establishes the State Committee on Foreign Investments.*
July 1997	*Nazarbayev introduces amendments to the 1994 Law on Foreign Investments, which eliminate guarantees for a subset of foreign investors.*
January 1999	Nursultan Nazarbayev wins presidential elections, after former Prime Minister Akezhan Kazhegeldin, the most serious challenger, is barred from running.
December 1991	Nazarbayev removes the outspoken *akim* of Pavlodar, Galymzhan Zhakiyanov. In response, several ministers resign to form a reform group called Democratic Choice. The main leaders of the group, including Zhakiyanov, were later sent to jail on various indictments.
June 2002	The Law on Political Parties raises minimum party membership from 3,000 to 50,000.
February 2003	*A new Law on Investment supersedes and consolidates previous legislation on FDI.*
June 2003	Daniyal Akhmetov is appointed prime minister.
April 2004	The Law on Elections is amended to restrict political rallies and discourse during electoral campaigns.
Sept.-October 2004	Parliamentary elections are faulted by international observers for serious shortcomings. Ten of the twelve parties which participate in the elections are pro-regime and win 59 out of the 77 seats in the Majilis; independent candidates that are closely connected to the regime win another 17 seats. Moderate opposition party Ak Zhol wins one seat and renounces it in protest.

Table 5.6 Kazakhstan: Timeline of political events, 1989-2010

November 2005	Zamanbek Nurkadilov, a prominent leader of the opposition, is killed.
December 2005	Presidential elections are held early. Nursultan Nazarbayev wins an overwhelming majority, with 91 percent of the vote.
February 2006	Altynbek Sarsenbayev, another prominent leader of the opposition, is killed, fuelling speculation that their deaths had been organized at the highest level of the state.
July 2006	President's Otan Party and his daughter's Asar Party merge, after his daughter is believed to have fallen from the grace of the President for making public a family conversation about the killing of opposition leader Altynbek Sarsenbayev.
Deember 2006	Otan Party changes name to Nur Otan, and incorporates within its ranks Kazakhstan's second largest party, the Civil Party, and the Agrarian Party.
January 2007	A cabinet reshuffle promotes Karim Masimov to the post of prime minister.
February 2007	Rakhat Aliev, the president's son-in-law is sent to Austria as ambassador. Soon afterwards he is accused by authorities of involvement in the abduction of two officials from Nurbank, a bank in which he held a stake.
May-June 2007	Parliament approves constitutional amendments that appear to broaden the powers of the legislature and lift the term-limit on the first President of Kazakhstan, Nursultan Nazarbayev.
June 2007	President Nazarbayev dissolves the Majilis, the lower house of parliament.
August 2007	Parliamentary elections for the Majilis return only deputies from Nur Otan, Nazarbayev's political party, while the opposition fails to win a single seat.
November 2007	The Organization for Security and Co-operation in Europe (OSCE) votes to award Kazakhstan the chairmanship of the body in 2010.
January 2008	Rakhat Aliev, by now the president's *former* son-in-law, is convicted, in absentia, on a range of charges, including theft and abduction. He receives a 20-year prison sentence, and then in March is sentenced to a further 20 years on charges of seeking to overthrow the state.

Source: Freedom House 2009; Economic Intelligence Unit 2008.

As a result, whereas in the first two parliamentary elections, Soviet-era elites and various clan notables won a majority of the seats at the expense of pro-government parties, in the 2004 parliamentary elections only one seat was not awarded to one of the ten parties openly supporting Nazarbayev's rule. Zharmakhan Tuyabai, the Speaker of the outgoing parliament and a Deputy Chairman of Otan, decried the 2004 elections as a "farce" and joined the opposition parties. Two years later, Kazakhstan's major pro-regime parties, including Dariga Nazarbayeva's Asar Party, the Civil Party, and the Agrarian Party, all merged with Otan, which also changed its name to Nur Otan in recognition of the country's leader (Pannier 2006). In the August 2007 parliamentary elections, Nur Otan received 88.5 percent of the votes and was awarded all parliamentary seats because none of the other participating parties were able to reach the 7 percent threshold introduced by the 2004 Law on Elections (Dave 2009).

The enhancement of authoritarian power was a gradual process that combined institutional reform with the concentration of political and economic power in the hands of a close group of associates and family members. In a speech at the end of 2004, Nazarbayev deplored the fact that "ten megaholdings in the country control almost 80 percent of its gross domestic product" (quoted in Dave 2005). What the speech did not say was that members of his family, his government and the main pro-regime parties

owned or ran these business conglomerates, extending their influence over oil, gas, and industry assets, as well as major retail and media outlets. Prominent financial groups include: a conglomerate run by Timur Kulibaev, the president's second son-in-law and a close ally of Prime Minster Karim Masimov; the Eurasia Group, a major industrial conglomerate run by Alexander Mashkevich, Alijan Ibragimov and Potokh Shodiev, some of Kazakhstan's most prominent billionaires; and the Kazakhmys Group controlled by the country's richest man, Vladimir Kim (Dave 2009: 254).

The handling of the privatization process and other means of patronage also allowed Nazarbayev's family and close supporters to gain control over the media. In the early 1990s, Dariga Nazarbaeva, the president's eldest daughter, was appointed the head of the state-controlled news agency Khabar. Together with her husband, Rakhat Aliev, she later bought a majority share in the agency and used it as a platform to build Kazakhstan's largest media conglomerate, which includes a number of newspapers and TV and radio stations. Rival local media outlets are controlled by Nazarbayev's second son-in-law, Timur Kulibaev, and by the Euroasia Group (author interviews, July 2007). Although the different media outlets compete among themselves for audience, they are all closely affiliated with the regime and support the president and his government. In 2007, Reporters without Borders ranked Kazakhstan's media freedom 131 out of 167, below neighboring Kyrgyzstan and Tajikistan (RSF 2007).

Over time, critics of the government have found it increasingly difficult to express or mobilize opposition to the regime. Their voices have been and continue to be limited by *de facto* regime control over the media, which is owned by the President's family and associates. Moreover, the ability of political forces to mobilize was gradually restricted by institutional reforms. The Law on Political Parties passed in 2002 requires all *existing* political groupings to show that they have support from a minimum of 50,000 members (with at least 300 supporters in each of the country's administrative units) before they can register with the Ministry of Justice. Parties which could not produce this evidence were barred from participating in two consecutive elections (New York Times 2002; Dave 2005). Furthermore, the Law on Elections and its amendments severely restrict the right to political discourse, rallies and demonstrations during electoral campaigns, and gatherings organized around the announcement of election results (OSCE 2004; Dave 2005).

As a result of this steady authoritarian progression, Kazakhstan today has a president for life and a parliament consisting of representatives of the Nur Otan party, which bears the President's name and his leadership. These developments have prompted observers to draw parallels between Kazakhstan's regime and the institutions of the Soviet Union. As the Bhavna Dave writes,

> Kazakhstan's political system is a hybrid of Soviet-era institutions and practices overlaid with some formal and cosmetic elements of Western democratic systems

> and models of governance. Prominent among the reconstituted Soviet-era institutions and practices are the consolidation of a one-party system under Nur Otan, a party bearing the name of the president, who is its supreme leader; the mobilization and co-optation of youth through the youth wing Zhas Otan, which resembles the Soviet-era *Komsomol*; the steady removal by the Parliament of all constitutional provisions that limited the president's term in office; and the granting of special status to the "First President." The capture of formal institutions through a steady concentration of power and authority in the president and his close circle of kin, clients, and friends—who may or may not hold vital government posts but have amassed considerable wealth and influence and form a protective shell around him—has conferred enormous power of patronage upon Nazarbayev. (2009: 252)

On all dimensions considered by the Freedom House—electoral process, civil society, independent media, national and local governance, judicial independence, and corruption—Kazakhstan scores worse today than it did during the 1990s (see Table 5.7).

Table 5.7 Kazakhstan: Nations in Transit ratings and averaged scores

	1991-2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Electoral Process	6.00	6.25	6.25	6.50	6.50	6.50	6.50	6.50	6.75	6.75
Civil Society	5.00	5.00	5.50	5.50	5.50	5.50	5.75	5.75	5.50	5.50
Independent Media	5.50	6.00	6.00	6.25	6.50	6.50	6.75	6.75	6.75	6.50
Governance*	5.00	5.00	5.75	6.25	6.25	-	-	-	-	-
National Democratic Governance	-	-	-	-	-	6.50	6.75	6.75	6.75	6.75
Local Democratic Governance	-	-	-	-	-	6.25	6.25	6.25	6.25	6.25
Judicial Framework and Independence	5.50	5.75	6.00	6.25	6.25	6.25	6.25	6.25	6.25	6.00
Corruption	6.00	6.25	6.25	6.25	6.50	6.50	6.50	6.50	6.50	6.50
Democracy Score	5.50	5.71	5.96	6.17	6.25	6.29	6.39	6.39	6.39	6.32

* Starting with the 2005 edition, Freedom House introduced separate analysis and ratings for national democratic governance and local democratic governance to provide readers with more detailed and nuanced analysis of these two important subjects.

Note: The ratings reflect the consensus of Freedom House and its academic advisers. The ratings are based on a scale of 1 to 7, with 1 representing the highest level of democratic progress and 7 the lowest. The Democracy Score is an average of ratings for the categories tracked in a given year.

Source: Freedom House 2009.

5.4.5. FDI regulations in Kazakhstan

With the consolidation of Nazarbayev's power came a series of policy changes on FDI. At the beginning of the 1990s, the government sought to attract foreign investments as a means to re-orient economic benefits from the Soviet-era elites who controlled domestic economic assets toward members of his own clan and entourage. Western companies were allowed to take over state-owned companies in the oil, gas and heavy industries, despite tremendous opposition from the managers of domestic enterprises. Once the privatization was complete and potential challengers to the regime effectively marginalized, the government took a somewhat different position toward foreign investors. Its rhetoric emphasized the need to correct some of the imbalances created by the concession contracts signed at the beginning of the 1990s, when Western investors could take advantage of a young and "naïve" government. In recent years the legislation on FDI has become increasingly disadvantageous for foreign investors and the governments has taken a series of steps to increase the share of pro-regime business interests in some of the country's most profitable oil and gas projects.

The evolution of Kazakhstan's FDI legislation reflects this trend. Following the dissolution of the Soviet Union, the Kazakhstani legislature validated the laws of the USSR and decided they would be in effect until new laws were enacted to replace them (Dosmukhamedov 2002: 59). The result was an overlap between Soviet laws and the

legislation enacted at the republican level before and after independence. The ensuing legal confusion created a need for more drastic legal reform, and in 1994 Nazarbayev initiated a state program on legislative reform. By the end of that year, a new Law on Foreign Direct Investment had been adopted.

The 1994 FDI law provided a national regime for the treatment of foreign investors and incorporated a number of guarantees that signaled the government's inclination to attract foreign investments. Perhaps most importantly, it guaranteed the stability of the legislation by giving investors the right to continue under the provisions of the law in effect at the time the contract was signed for a period of ten years, or for the duration of the contract signed between the authorized state agency and the foreign investor. It also provided guarantees against expropriation and against the interference by state agencies, and guarantees for the free use of dividends and the unrestricted transfer of currency abroad. Moreover, the law set out a basis on which disputes could be resolved through international arbitration (OECD 1998a; Dosmukhamedov 2002: 102).

Although the 1994 Law on Foreign Investment fell short of eliminating all sources of political risk for foreign investment, it was clearly designed to attract FDI. For example, certain provisions included in the legislation undermined the national treatment regime for foreign investors. The law also did not specify clear legal

mechanisms for "prompt, adequate and effective compensation" in case of expropriation (Dosmukhamedov 2002: 110). Nevertheless, the FDI policy framework was one of the most welcoming to foreign investors in the former Soviet republics at the time and the most permissive FDI legal regime in Kazakhstan since independence.

Following the adoption of the 1995 constitution, which considerably enhanced the power of the executive, in February 1997 the government proposed a Law on State Support for Direct Investments. The law was presented as a new step toward enhancing the investment climate through investment incentives and the creation of the State Committee on Foreign Investments, a one-stop-shop to assist interested investors. However, despite its name, the law successfully established a regime in which every foreign investment proposal had to be reviewed and approved by the State Committee on Foreign Investments, effectively introducing a screening mechanism that gave the state a powerful tool to negotiate the terms of multinationals' entry. The level of tax concessions, custom-waivers, and government grants was decided on a case-by-case basis by the State Committee in contracts signed with the investors (OECD 1998a). Although the case-by-case determination of concessions was criticized repeatedly by international agencies, the same procedures are in effect today and investors cannot sidestep this negotiation phase (author interviews, July 2007).

The 1997 law undermined the openness of the previous FDI policy framework in several ways. Most importantly, it introduced an effective screening mechanism, which allows the government to review all investment proposals and select the ones it likes by signing a special agreement between the state and the investor. According to Dosmukhamedov, "the right to initiate such an agreement belongs solely to the State Committee: the Committee itself unilaterally selects a 'proper' foreign investor, defines the terms of the contract, controls its execution and applies sanctions where appropriate" (2002: 118). Clearly, this new framework contradicted the 1994 guarantee against interference by state agencies, and reverted to a model of institutionalized state intervention in the activities of foreign investors through a process that is highly dependent on executive discretion. Furthermore, the law departed from the principle of national treatment by mandating that the State Committee must decide on the specific terms of entry and operations for different investors.

Moreover, the Law on State Support for Direct Investments was followed by a set of amendments to the 1994 Law on Foreign Investment, which singled out investors who import, produce, or market excised products (alcohol, tobacco, luxury goods, automobiles, crude oil, weapons and others) and deprived them of any guarantees provided in the 1994 law. The amendments were described as a means to protect the interests of well-connected business entrepreneurs that were close to Nazarbayev's

regime, who perceived that increased competition in the retail market for excised goods was detrimental and unnecessary (author interviews, Almaty, July 2007). Interesting, not only did the guarantee against legislative changes fail to protect these investors, but the government insisted on the retroactive application of these legislative amendments (Dosmukhamedov 2002: 121).

Since 1997, the government has continued to alter the investment framework in ways that seemed to privilege domestic companies at the expense of foreign investors. Following cabinet changes at the end of 1997, the privatization strategy was revised to limit the access of foreign investors. The President and the new Prime Minister, Nurlan Balgimbayev, declared that previous privatization deals did not take into account the potential of domestic investors, and that they would be given priority in any new contracts (USCS 1999; Olcott 2002). Later, in June 2002, the Prime Minister signed a decree that mandated domestic content requirements, forcing investors in a number of sectors (primarily extractive industries) to contract with Kazakhstani service providers to purchase Kazakhstani equipment, goods and raw materials, and to obtain approval for all tender commitments from a designated government body. In 2003, the U.S. Commercial Services noted a "growing tendency to challenge contractual rights, to legislate preferences for domestic companies, and to created mechanisms for

government intervention in foreign company operations, particularly procurement decisions" (USCS 2003).

A more recent Law on Foreign Investments was passed in 2003. It replaced the 1994 Law on Foreign Investments and the 1997 Law on State Support of Direct Investments with legislation that "is clearly less advantageous than the old one for foreign investors" (Cutler 2003). The law eliminated a number of guarantees included in previous legislation, and opened up questions about the access to international arbitration in case of investment disputes. This has been particularly problematic, since in the last decade many of the Western firms operating in Kazakhstan found themselves under pressure from the state or from domestic interests, including their joint-venture partners, to agree to new contractual terms. While the specific circumstances vary from case to case, observers agree that in recent years the government has often re-interpreted contracts signed with foreign investors when there seemed to be opportunities to benefit domestic interest groups, especially those closely connected to Nazarbayev, by enhancing their access to certain markets or oil development projects (author interviews, July 2007).

The government continues to screen foreign investments, sometimes at the highest levels, by requiring that all investors sign agreements with the State Committee on Foreign Investments. By many accounts, including those of lawyers working closely

with foreign investors in Kazakhstan, the investment framework is unnecessarily vague, leaving room for the government to interpret the law as it deems appropriate. Most frequently it interprets the law to protect the interests or directly benefit those closely connected to the political leadership (author interviews, July 2007).

Moreover, in recent years the government's efforts to promote foreign investments have been limited. The natural riches of the Caspian Sea have attracted a significant level of FDI in the oil and gas sector without the need for government promotion. The State Committee on Foreign Investments was established as a designated government agency on FDI, but one where foreign investors have to stop to obtain approval rather than assistance. An investment promotion agency, Kazinvest, was established as a state enterprise in May of 1998, but its scope and ability to help foreign companies overcome some of the challenges of operating in Kazakhstan remain extremely limited (author interviews, July 2007). The poor office location and facilities are a clear sign of the agency's position on the periphery of the institutional structures dealing with FDI, and recent visits to the agency's website (www.kazinvest.kz) revealed that the English version of the web page has been suspended (author observation, March 2010).

* * *

There is no doubt that FDI has contributed to Kazakhstan's economic recovery in the transition period. The country has experienced a period of impressive economic growth since the beginning of the 2000s, when oil prices increased just as new oil fields came into production and oil transport problems began to ease. But despite the impressive levels of FDI in Kazakhstan's oil and gas industry and to a lesser extent in some of its heavy industries, FDI in other sectors remains low and most foreign investment projects have yet to result in significant new jobs or higher income for most Kazakhstanis. What is unquestionable, however, is that a small number of political insiders have benefited and continue to benefit personally from foreign investors' interest in the country's natural reserves.

Moreover, it is important to recognize that Nazarbayev used foreign investors for more than just the enrichment of his family and a few close associates. At a time when his political fate as the first president of Kazakhstan was not yet decided, he invited Western companies to take over state-owned enterprises, including many companies in the natural resource sector, in order to weaken the enduring Soviet-era economic elites that might have challenged the his rule. But after this short "honeymoon" period in which foreign investors were allowed to invest without restriction, Nazarbayev reinstated a set of restrictions on FDI, including a strict approval procedure that empowered his government to screen all foreign investments and determine the terms

and conditions for each one's entry and operation. These regulations allow the government to control all FDI coming in and to ensure that the economic interests of those supporting the president are not at stake.

Appendix 5.1 Romanian Agency for Foreign Investments project portfolio, 2008-2009

No.	COMPANY	LOCATION	INDUSTRIAL SECTOR	INVESTMENT VALUE (€ Mililion)	NO. OF JOBS	COUNTRY OF ORIGIN
1	VOESTALPINE (Intention)	Constanta	Steel Industry	5000	5000	Austria
2	RENAULT TECHNOLOGIE	Titu	Automotive	450	3000	France
3	GRAELLS & LLONCH	Prejmer Brasov	Industrial Parc	300	1000	Spain
4	SELGROS	Bucuresti si alte orase	Retail trade	250	4800	Germany
5	RENAULT MECHANIQUE	Pitesti	Automotive	226	650	France
6	EGGER	Suceava	Wood processing	210	700	Austria
7	TENGELMAN	Bucuresti si alte orase	Retail trade	200	3000	Germany
8	PIRELLI	Slatina	Automotive	190	1250	Italy
9	INA SCHAEFFLER	Brasov	Fine mechanisc	180	1200	Germany
10	HOLZINDUSTRIE SCHWEIGHOFER	Suceava	Wood processing	170	500	Austria
11	SAINT-GOBAIN	Calarasi	Float glass production	120	200	France
12	CALSONIC KANSEI	Ploiesti	Automotive	120	1050	Japan
13	REAL INTERNATIONAL HOLDING GmbH	Bucuresti si alte orase	Retail	105	1000	Germany
14	DELPHI DIESEL	Iasi	Automotive	100	1000	USA
15	CELESTICA	Bors – Bihor	Electronics	84	1000	Canada
16	GENERAL ELECTRIC	Bucuresti	Services	80	170	USA
17	PROCTER & GAMBLE	Ploiesti	FMCG	70	300	USA
18	SNR ROULEMENTS	Sibiu	Automotive	60	1000	France
19	NOKIA	Cluj	Electronics	60	500	Finland
20	BIOMART – MARTIFER	Lehliu Gara Calarasi	BIO-DIESEL production	55	250	Portugal
21	HOLZINDUSTRIE SCHWEIGHOFER	Sebes-Alba	Wood processing	54	320	Austria
22	HEWLET PACKARD	Bucuresti	Services	50	1200	USA
23	BEARBULL SAS	Bucuresti, Iasi, Cluj, Constanta	Retail trade	50	200	France
24	GROUP SOUFFLET	Buzau	Food industry	46	40	France
25	NATUZZI	Baia Mare	Furniture	40	880	Italy
26	PIRELLI/CONTINENTAL	Slatina	Automotive	40	350	Italy/Germany

No.	COMPANY	LOCATION	INDUSTRIAL SECTOR	INVESTMENT VALUE (€ Mililion)	NO. OF JOBS	COUNTRY OF ORIGIN
27	SINOROMA	Buzau	Tobacco industry	36	120	China
28	HONSEL	Slatina	Automotive	36	900	Germany
29	ANCHOR MALL GROUP	Bucuresti	Retail trade	35	2200	Turkey
30	SAINT-GOBAIN ISOVER	Ploiesti	Construction materials	35	220	France
31	YAZAKI	Arad	Automotive	30	500	Japan
32	COINDU	Curtici-Arad	Automotive	30	300	Portugal
33	BAMESA	Topoloveni	Automotive	30	120	Spain
34	MICHELIN	Zalau	Automotive	25	300	France
35	COFICAB	Arad	Automotive	25	200	Tunisia
36	SW UMELTTECHNIC	Corbenii Mari Dambovita	Construction materials	25	400	Austria
37	ANCHOR MALL Development	Bucuresti	Real estate	25	50	Turkey
38	MAKITA	Branesti ilfov	Portable tools	25	300	Japan
39	PIRELLI AMBIENTE ECO TECHNOLOGIE	Gorj	Automotive	25	1200	Italy
40	TMD FRICTION	Caransebes	Automotive	24	100	Germany
41	MONSANTO CORP.	Sinesti Ialomita	Agriculture	23	20	USA
42	MARQUARDT SCHALTSYSTEME	Sibiu	Automotive	23	500	Germany
43	WIENERBERGER	Gura Ocnitei - Dimbovita	Construction materials	20	80	Austria
44	BYD	Cluj	Electronics	20	2000	China
45	FB&C HANDELS – ROMPLY	Calarasi	Wood processing	17	400	Austria
46	JOHNSON CONTROLS	Ploiesti	Automotive	16,6	800	USA
47	LA FESTA	Valenii de Munte-Prahova	Beverages	16	300	Poland
48	UCO TEXTILES	Giurgiu	Textile industry	15	200	Belgium
49	ANCHOR MALL GROUP	Bucuresti	Retail trade	15	100	Turkey
50	KARELIA CORP.	Baia Mare	Wood processing	15	200	Finland
51	OPTIBELT	Maramures	Automotive	15	200	Germany
52	YAZAKI	Ploiesti	Automotive	14	1900	Japan
53	MICROSOFT EMEA	Bucuresti	Technical support center	13,1	750	USA
54	YKK	Bucuresti	Light industry	10	100	Japan
55	SW UMELTTECHNIC	Timisoara	Construction materials	10	400	Austria
56	AIRLIQUID	Calarasi	Industrial gas production	10	20	France

No.	COMPANY	LOCATION	INDUSTRIAL SECTOR	INVESTMENT VALUE (€ Mililion)	NO. OF JOBS	COUNTRY OF ORIGIN
57	SCHLEMMER	Satu-Mare	Automotive	10	80	Germany
58	LIBERTY COMODITIES	Calarasi	Metallurgy	10	150	India
59	ERT GRUPO	Arad	Automotive	10	100	Portugal
60	WILLY KREUTZ	Timisoara	Electrical components	8	100	Germany
61	XELLA INTERNATIONAL	Ploiesti	Construction materials	8	40	Germany
62	MEDISYSTEM	Bucuresti	Medical services	7,5	200	Holland
63	HUTCHINSON	Brasov	Automotive	7	700	France
64	CAUCHO	Sibiu	Automotive	6	200	Spain
65	GREENFIBER	Buzau	Petrochemical	6	50	Switzerland
66	SOL-PLUS	Timisoara	Plastic materials	5	125	Japan
67	WEIDMULLER	Baia Mare	Electrotehnics	5	200	Germany
68	ZUMTOBEL	Arad	Electrical components	5	100	Austria
69	MANUFACTURA MODERNA DE METALES	Turda	Automotive	5	260	Spain
70	WINPRO	Bucuresti	Call center	5	400	India
71	STALMOT	Arad	Furniture	5	300	Belgium
72	DESLEE CLAMA	Sibiu	Textile industry	4	60	Belgium
73	INFINEON	Bucuresti	R&D in microelectronics	3,1	200	Germany
74	HOLCIM	Ploiesti, Oradea	Construction materials	3	100	Switzerland
75	T&K DESIGN	Mizil – Prahova	Textile industry	3	1200	Turkey
76	CAPGEMINI	Iasi	Service center	3	2000	Great Britain
77	HAELVOET	Salaj	Furniture	3	100	Belgium
78	UNILEVER	Ploiesti	Food industry	2,5	30	Holland
79	GEDEON RICHTER	Tg. Mures	Pharmaceutical industry	2,3	30	Hungary
80	HALVOET	Jibou-Salaj	Furniture	2,2	100	Belgium
81	SAMSUNG	Targoviste	Metallurgy	2	50	South Korea
82	HIRSCHMANN	Tg. Mures	Automotive	2	350	Germany
83	ETA SpA COMO	Alba Iulia	Mechanics	1,5	100	Italy
84	DOMART	Focsani	Metallic constructions	1	150	China
85	ERICSSON TELECOMMUNICATIONS	Bucuresti	Global services center	Not disclosed	500	Sweden

Appendix 5.2 List of interviews

CROATIA

Zagreb, May 2007

Marijana Badun, Professor, Faculty of Economics

Josip Bohutinski, Journalist, business.hr

Ana Maria Boromisa, Institute for International Relations

Drago Čengić, Professor of Sociology, Social Science Institute

Tamara Depolo-Petrovic, Journalist, Wirtschafts Blatt

Tonko Dolezal, Senior Adviser, Trade and Investment Promotion Agency

Vojimir Franičević, Professor, Faculty of Economics

Bubravka Garić, Diplomat, Austrian Trade Commission at the Austrian Embassy

Ljubo Jurčić, Former Minster of the Economy, Professor, Faculty of Economics, and SDP candidate for prime minister in the 2007 election

Evan Kraft, Advisor to the Governor, National Bank of Croatia

Igor Maricic, Investment and Finance Consulting and former Head of the Trade and Investment Promotion Agency

Katarina Ott, Director, Institute for Public Finance

Nino Prstec, Senior Adviser, Strategic Planning Division, Trade and Investment Promotion Agency

Nikola Vrdoljak, Senior Adviser, Strategic Planning Division, Trade and Investment Promotion Agency

Goran Vuksić, Institute of Public Finance

KAZAKHSTAN

Almaty, June 2007

Daniyar Akishev, Director, Research and Statistics Department, National Bank of Kazakhstan

Botagoz Alimbayeva, Kazakhstan Investment Promotion Center, KAZINVEST

Saule Dissenova, Senior Consultant, Deloitte & Touche

Dinara Jarmukhanova, Attorney, McGuire Woods

Arman Kashinbekov, Executive Director, Kazenergy, Kazakhstan Association of Oil & Gas and Energy Sector Organizations

Mukhtar Kazhibekov, Ernst & Young LLP

Bakhyt Ospanov, Chief Financial Officer, Syrymbet Mining Company

Bakhyntur Otarbayeva, Vice-rector, International Relations Department, Kazakh Economic University

Victoria Simonova, Attorney, Denton Wilde Sapte

Olga Taimova, Head of Infrastructure Support, Agency of the Republic of Kazakhstan on Regulation of Activities of the Regional Financial Center of Almaty City

Interviewee who requested to remain unidentified, Professor, Kazakh Economic University

Interviewee who requested to remain unidentified, Program Adviser, Investment Fund of Kazakhstan

ROMANIA

Bucharest, July 2007

Doina Ciomag, Executive Director, Foreign Investment Council in Romania

Irina Dumitriu, Romanian Chamber for Industry and Commerce

Maria Grapini, President of Board of Administration, Pasmatex Group; President of Business-Government Consultation Group on Manufacturing

Margareta Dumitru, Counselor, Strategy and Inter-Institutional Relations Division, The Chamber of Commerce and Industry of Romania

Bogdan Grigore, Counselor, Strategy and Inter-Institutional Relations Division, The Chamber of Commerce and Industry of Romania

Iustina Lutan, Investment Officer, Romanian Agency for Foreign Investments (ARIS)

Radu Nicosievici, Chairman, The Advocacy Group

Ion Pop, Director, Strategy and Inter-Institutional Relations Division, The Chamber of Commerce and Industry of Romania

Miruna Vitcu, Director, Human Resources and Communications, Regional Development Agency, West Region

OTHER LOCATIONS

Geneva, March 8-9, 2007 - World Association of Investment Promotion Agency Annual Meeting

Branislav Bugarski, Deputy Director, Vojvodina Investment Promotion Fund, VIP

Qemal Balliu, Executive Director, Business Development Foundation, Albania

Pavel Cernansky, Head of SARIO Information Center, Foreign Trade Section, Slovak Investment and Trade Development Agency (SARIO)

Judit Czako, Consultant, Investment Promotion Directorate - Business Intelligence, Hungarian Investment and Trade Development Agency, ITD-Hungary

Ralfs Dakters, Head of Division, Investment and Trade Promotion Department, External Relations Division

Olena Hantsyak-Kaskiv, Deputy Director, Ukrainian Center for Foreign Investment Promotion InvestUkraine

Eva Jaksikova, Marketing Executive, Czech Invest – Investment and Business Development Agency

Slavica Korica, Executive Director, Foreign Investment Promotion Agency of Bosnia and Herzegovina

Iustina Lutan, Investment Officer, Romanian Agency for Foreign Investments (ARIS)

Marek Magi, Director, Foreign Investment and Trade Promotion, Enterprise Estonia

Zuzana Mikulasova, Head of Direct Marketing Department, Foreign Direct Investment Section, Slovak Investment and Trade Development Agency (SARIO)

Robert Pilous, Investment Development Manager / Automotive and Aerospace, Czech Invest – Investment and Business Development Agency

Ivanna Polyeshchuk-Dribna, International and Local Events Manager, Information and PR Department, Ukrainian Center for Foreign Investment Promotion InvestUkraine

Gregor Rozman, Project Manager, Public Agency of Republic of Slovenia for Entrepreneurship and Foreign Investments (JAPTI)

Viktor Skarshevsky, Deputy Director, Ukrainian Center for Foreign Investment Promotion InvestUkraine

Aleksander Stojkov, Deputy Director, Vojvodina Investment Promotion Fund, VIP

Isabelle Strauss, Advisor to CEO, Albanian Business and Investment Agency (AlbInvest)

Monika Szmetana-Garai, Director of Hungarian External Representation in Switzerland, Hungarian Investment and Trade Development Agency, ITD-Hungary

Paris, January 29, 2007

Anthony O'Sullivan, Head of the Investment Compact for South East Europe, OECD

6. Conclusion

6.1. Summary of argument and key findings

In recent years, many governments have decided to remove policy barriers that had restricted the entry and operation of foreign firms for decades. For instance, today multinationals can establish wholly-owned subsidiaries in countries where not long ago they were required to form a joint venture with a local firm. They can choose to import equipment and inputs in places where minimum use of local content used to be a requirement for operation. Governments that not long ago were imposing restrictive conditions on the entry and operations of MNEs are now promising treatment no less favorable than that received by national companies. And some countries have established investment promotion agencies with the special purpose of attracting FDI and helping foreign companies navigate the local administrative procedures and business environment. Yet not all countries have gone down this path. Instead, a number of countries continue to or have decided to restrict FDI after having a more liberal investment climate in place. As a result, the map of FDI openness is perhaps as colorful as ever.

The variation of FDI policy choices—across countries, across time, and across different types of regulation—is a fascinating phenomenon. To explain part of this variation, the theoretical framework proposed in this dissertation starts with the

consideration of the distributional consequences of FDI for two local factors of production—domestic workers and domestic capital. Foreign capital complements labor and thus carries the prospect of increasing wages and creating new jobs. At the same time, FDI competes with domestic capital and drives down its returns.

Anticipating these effects, governments select policy choices that favor the constituencies from which they derive most political support. Democratic governments, whose political success depends of the electoral appeal to broad constituencies, seek FDI as a means to provide new and better jobs. By contrast, governments that retain power through the support of a restricted group of elites, whose welfare depends on economic power in the domestic market, are unlikely to choose national policies that facilitate investments by foreign companies. However, as I argue in Chapter 4, even these governments open partially to FDI, but only as long as they can effectively redistribute the gains that accrue from multinational investments to their political base. Because non-democratic governments are concerned with maintaining command over the distribution of the economic benefits among domestic groups, they use strict entry procedures to control FDI inflows.

The logic underlying the theoretical framework suggests that regime changes bring about the revision of FDI policies. A transition to democracy increases the size of those who have a say in government policy decisions, while countries that become less

democratic increasingly focus on re-orienting economic benefits toward a small group of key domestic elites. Therefore, in countries that democratize, where the preferences of previously excluded groups become a more important part of the political equation, governments choose to remove restrictions on FDI. When countries become less democratic, however, the investment climate deteriorates as a result of the government's effort to enhance the privilege of those backing it.

In order to test these hypotheses, I constructed a new dataset of FDI regulations for the 28 transition economies between 1989 and 2008. Perhaps more than in any other part of the world at any other point in time, this group of countries had at the beginning of the 1990s very similar FDI restrictions approximating a complete ban on FDI. As a result, the levels of FDI at the time were negligible. Moreover, the nature of the political regimes that would govern over economic reforms was largely determined at the beginning of the 1990s. Although important institutional developments have defined the political transition of these countries, most of them have in place today a level of political competition not very different than the one they embraced at the onset of their post-communist era. The exceptions include late democratization in countries such as Croatia, Georgia, Romania, Slovakia, and Ukraine, and the consolidation of authoritarian rule in Azerbaijan, Belarus, and Kazakhstan.

The dataset on FDI regulations in transition economies combines information on a wide range of policy dimensions, ranging from restrictions on entry and operations to investment guarantees and FDI promotion. The construction of the dataset allows for the comparison of policies across countries and across time, as well as the investigation of the mix of policies that governments use to regulate the flow of FDI. The dataset is the first to code FDI regulations in transition economies, as well as the first systematic effort to bring together the restriction and promotion side of FDI regulation.

Multi-method empirical tests using two alternative measures of FDI openness and three complementary case studies provide support for the theoretical framework. Empirical models utilizing the newly constructed database of FDI regulations show that political competition is an important determinant of FDI liberalization. Statistical analysis relying on an alternative measure of investment freedom available for a larger number of countries confirms these results. A number of robustness checks including, among other specifications, a number of alternative measures of political competition provide additional support.

I complement the econometric analysis with three case studies—Croatia, Romania, and Kazakhstan—in order to capture some of the informal dimensions of the policy environment and to allow for a careful assessment of causal mechanisms. To test the validity of the theoretical framework's dynamics, I examine variation over time, or

"in a single unit diachronically" (Gerring 2004). The three cases are therefore chosen to reflect a wide variation on the key explanatory variable—political competition—over time. Among the post-communist countries that experienced visible regime changes subsequent to the transition away from communism, Croatia is a case of dramatic democratization at the beginning of the 2000s, Romania reflects a more gradual increase in political competition throughout the 1990s, and Kazakhstan is a clear case of authoritarian consolidation.

In Croatia, following Franjo Tudjman's death at the end of 1999, the party he founded and led was defeated in parliamentary and presidential elections by a pro-democratic coalition. The regime change was followed by a series of reforms, including the adoption in mid-2000 of the country's first law on investment promotion. Romania represents a case of less dramatic, but nonetheless a significant increase in political competition after Iliescu and his party were defeated in the November 1996 elections, leading to the formation of the first government which incorporated parties standing for a radical break with the communist structures of the past. The new government emphasized publicly the importance of FDI for the restructuring of the Romanian economy and the participation of foreign companies in the privatization process.

In Kazakhstan, Nursultan Nazarbayev, who has been in office since 1989, has built a strong presidential regime by placing an inner circle of close family, friends and

business associates in key political positions and allowing them to exert formal and informal influence over the country's economic resources. In the 1990s, Nazarbayev gradually re-oriented economic power from Russian elites making up most of the country's bureaucratic apparatus toward loyal cronies who owed all their privilege to the president. To orchestrate this elite replacement without an open conflict between the Russian and Kazakh ethnic groups, Nazarbayev allowed Western companies to acquire industrial interests managed by Russians, including those in the oil, gas, mining and steel sectors. After the threat of Russian dissent was avoided and the president's power consolidated through constitutional amendments that paved the way for his lifetime presidency, Kazakhstan became less open to FDI. The government claimed that the deals it signed with foreign investors in the early 1990s were disadvantageous to the country, and renegotiated a number of production-sharing agreements to transfer shares to local interests and to ensure that sufficient inputs were sourced locally. The Kazakh government continues to screen all foreign investment projects through a slow and non-transparent process.

In each of these cases, the link between political and policy developments suggests a causal relationship between changes in political competition and the revision of FDI regulations. Moreover, in each instance, political change—whether brought about by electoral results or institutional reform—preceded the modification of FDI policies.

Visible increases in political competition in Croatia and Romania have been quickly followed by new legislation to eliminate enduring restrictions or introduce new incentives for FDI. By contrast, in Kazakhstan, political moves and institutional reforms that steadily contributed to the consolidation of Nazarbayev's authoritarian regime resulted in the deterioration of the FDI investment climate.

Across the region, foreign investments were and continue to be a means of redistributing economic resources among politically important groups. In countries where democratic governments came to power soon after the demise of the communist regimes, allowing foreign companies to build new enterprises or to acquire aging industrial groups was both a way to consolidate electoral support and an effort to prevent old elites from siphoning off assets from state-owned enterprises. In sharp contrast to the speedy FDI liberalization in newly democratic regimes, FDI reforms were delayed in countries where former communist elites survived in power and were lukewarm at the prospect of foreign investment undermining the economic resources of their political base. When democratic forces came to power a few years later, FDI restrictions were removed, while they continue to endure in the non-democratic countries in the region.

6.2. Beyond the post-communist world

Perhaps one of the most important questions that remain is whether the mechanisms proposed by this dissertation pertain to a broader set of countries. While the theoretical framework does not build on elements that are specific to a certain region, transition economies from the former Soviet bloc are unique because their long history of autarky was suddenly interrupted by the fall of the Berlin Wall and the USSR that opened a window for political and economic change. History rarely offers such moments and it is important to consider whether countries in other parts of the world might experience a similar connection between politics and FDI policy changes. Has the increase (or decrease) of political competition been followed by government decisions to lower (or augment) FDI restrictions in Latin America? Are we to expect greater FDI liberalization if countries democratize in Africa and Southeast Asia?

The evolution of FDI policies outside transition economies suggests that similar dynamics may be at play. Even in South Korea, a country that is often used as an example of economic liberalization preceding political changes, FDI restrictions were only relaxed after President Kim Young Sam formed the first democratic government in 1993 (Gills 1996). The economic reforms that started in the 1960s and were accelerated in the 1980s focused on increasing Korea's participation in the world economy through greater openness to trade. Kim Young Sam's government proposed a new "Program for

Globalization" that included the liberalization of FDI policies and the internationalization of Korean enterprises. Tension between these two ways of defining globalization—opening Korea to foreign enterprises and enhancing competition in the domestic market versus opening the world to Korean *chaebols*—dominated the policy debate. The government pressed forward with a program that included among other goals making South Korea "the world's best location for foreign investments," offering national treatment to foreign companies, and attracting more FDI into the country (Gills 1996).

More recently, observers have hailed China for its greater integration in the world economy through increased trade and inward foreign direct investment. It is important to note, however, that although China has attracted important levels of FDI in recent years, its government policies continue to be quite restrictive. Until 2001, wholly-owned foreign enterprises were not allowed. When these joint venture requirements were removed the government placed greater emphasis on increasing the export output of foreign companies operating in China (Long 2005). Today, although some foreign companies enjoy preferential treatment when compared to domestic firms, such conditions only apply to a subset of investments. More broadly, the government divides FDI into four categories that differentiate between foreign projects that are encouraged, allowed, restricted or prohibited (Long 2005).

The dissertation predicts that as a non-democratic regime, the Chinese government would maintain restrictions to control FDI inflows in order to minimize the risk that foreign investments alter the balance of economic power in a way that may have negative political consequence. In fact, FDI regulations in China continue to be quite restrictive. In its most recent assessment of the investment climate in China, the U.S. Commercial Service writes:

> China has a legal and regulatory framework granting it the authority to restrict foreign investment that it deems not to be in China's national interest. Key terms and standards in many regulations are undefined. China has told the United States that it wants to preserve flexibility for its regulators to approve or block foreign investment projects in response to changing circumstances. The potential restrictions that China may impose are much broader than those of most developed countries, including the national security review conducted by the Committee on Foreign Investment in the United States (CFIUS). […] China's laws and regulations give regulators significant discretion to shield inefficient or monopolistic enterprises from foreign competition. They are also often applied in a manner that is not transparent. In addition, overall predictability for foreign investors has suffered because investors are less certain that China will approve proposed investment projects. (USCS 2010)

In Latina America, Hugo Chavez's tense relations with the multinationals operating in his country and Morales' nationalization spree that included telecommunications companies and state oil and gas assets and also indicate a close link between political changes and the government's attitude towards foreign investments. In recent years, following increasing state intervention in the economy including actual or threatened expropriations, Venezuela's investment climate has become "less welcoming than its legal relatively open framework suggests" (USCS 2009a). In 2008, for

example, the government proceeded with the nationalization of important assets in the cement, steel, dairy, and banking industry, and the nationalization of more companies in the banking, petrochemical, retail, and food distribution sectors were considered.

In Bolivia, following the strengthening of Evo Morales' regime and the increased political influence of his Movimento al Socialismo that led to landslide victories in presidential and parliamentary elections at the end of 2009, the Bolivian government has focused on prioritizing Bolivian over foreign investments and undermining the legitimacy of opposition forces and their ties to foreign companies. In a recent development, three former presidents (Carlos Mesa, Jorge Quiroga, and Eduardo Rodriguez) are facing legal action from Morales' government for having violated the constitution when signing energy contracts with foreign companies (Mateos 2010). Although the country remains generally open to FDI, a provision incorporated in the 2009 constitution stipulates that Bolivian investments have priority over FDI. This provision stands in clear contradiction with the investment law, which provides national treatment for foreign firms. Moreover, the new constitution declares that all natural resources are the property of the Bolivian people and revokes contracts that violate this principle (USCS 2009b).

The most important difference between transition economies and other countries is their experience with FDI. Without a doubt, abuses and questionable deals signed

with corrupt governments have given multinationals a bad name in many places around the world. Because of the pre-1989 bans on FDI, transition economies started in the early 1990s with a "blank slate," which made the adoption of open policies towards FDI an easier political sell. By contrast, where foreign investments are associated with years of corruption and increasing inequality, democratic governments may have a harder time persuading electorates that FDI liberalization is in their best interest. Nonetheless, while these are important considerations for future research, they do not change the logic of government policy choice proposed in this dissertation. All democratic governments want to liberalize FDI policies, but they may have a more difficult task of passing such legislation in countries where multinationals are associated with a tainted past. Similarly, non-democratic governments prefer to restrict FDI, but may find it more difficult to do so where past multinational investments have contributed to economic growth and higher wages.

6.3. Future research

This dissertation is one of the first contributions to a new area of political economy research on FDI regulations. I propose that governments use FDI policies strategically to channel resources in a way that enhances their political and economic position. Governments that depend on the support of labor seek to attract multinational investments, expecting that FDI will increase wages and create new and better jobs.

Governments that stay in power through the support of a small group of wealthy elites chose to protect domestic capital by restricting FDI and selectively allowing foreign projects that do not threaten to alter the domestic balance of economic power.

Future research should focus on understanding the links between possibly different effects of FDI on domestic workers depending on their level of skill, on domestic firms depending on their position in the supply chain, and on different sectors depending on the scope of complementarities between foreign and domestic firms. In general, foreign companies make greater use of technology and production methods that require greater skill levels. It is likely that younger and better educated workers who adapt easily to new jobs will benefit more from increases in FDI flows than workers with low or highly specific skills who are not attractive candidates for multinational hires. The effect of foreign companies on domestic firms may also depend on the extent to which domestic enterprises can work with foreign companies or have to compete with them directly. This effect may vary across industries, but perhaps even more so across firms within the different industries depending on their position in the value chain. Existing research frequently differentiates between market-seeking and efficiency-seeking FDI, suggesting that higher competition with local companies is more likely to result when foreign companies come in to serve the local market then when they invest to take advantage of lower production costs and export most of their output. However,

the real picture is likely more complicated than that. Foreign investments in retailing may indeed hurt local stores, but can bring great benefits to local producers and distributors who have a wider choice of outlets for their products. FDI in export-oriented manufacturing which does not compete directly with similar firms, might nonetheless have a negative effect on them if it leads to higher wage costs or greater pressures on suppliers.

Bearing this in mind, it is important to reflect on the extent to which policy-makers have incentives to craft regulations in ways that tap these differences. It is considerably easier to identify the results of targeted patronage and protectionist policies than the effects of economic policies that are directed at broad groups of the electorate. Their level of appreciation is even harder to grasp. Not surprisingly, politicians in many countries seek to entice or reward loyal voters through clientelistic practices (Kitschelt and Wilkinson 2007). National FDI policies do not offer such opportunities because it is extremely difficult to identify those whose income rises as a result of FDI and what party they are likely to vote for. Politics may make a big difference, however, in terms of the channeling of FDI towards selected geographical constituencies. Do democratic governments strategically encourage foreign companies to invest in regions that have offered political support or are likely to provide a critical electoral edge in future elections? Do non-democratic governments encourage

competition by foreign investors in areas of the country where local businesses finance the political activity of opposition forces? Future research addressing these questions may unveil interesting links between the logic of political survival and the choice of government policies on FDI.

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Biography

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