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Regionalization in Central and Eastern Europe
The Impact of Investment Frameworks on
Economic Integration and Institutional Reform

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Outlook

- International Investment Frameworks
 - Core-Element of Economic Partnership Agreements (EPA)
 - Tool for Structural Reforms, Capacity Building, Reg. Integration
- Scope and Effectiveness
 - Regional Competition vs. International Cooperation
- Evidence from Extreme Cases: EU Enlargement
 - FDI Promotion and Institutional Reform
- Results for EU & Asia
 - Competition of Policies
 - Governance Reform
 - Harmonization of Frameworks

Investment Frameworks

- Domestic Investment Frameworks (Competitive)

- Historically Grown Complexity
- “Structural Reform” Limitations
- Industrial Policy Distortions
- Investment Promotion Costs

- Countries Do Not Compete: Little Progress

- International Investment Frameworks (Cooperative)

- Next Step after FTAs
 - Globalization
 - Production Networks
 - Service Investment

- Negotiation Complexity & Commitment: Little Progress

- Best Practice: Policies of General Liberalization & Deregulation?

- Policy Options

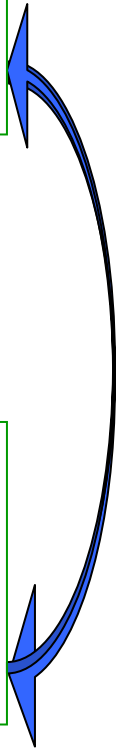
- Investment Promotion (Competitive)

- Protection/Incentives
- Economic Reform

- Policy Options

- Regionalization (Cooperative)

- Protection/Standards
- Institutional Reform



Determinants of FDI Flows

Globalization Forces

Globalization, Regionalization

- Country Size matters Less
- International Strategies More

Technology Spillovers

- Technology Cycles Fastened
- “Staying in Touch” Important

Int. Production Networks

- Country Risks matter More

Complementary, High-grade Locational Assets

- Knowledge-intensive Capabilities
- Supportive and transparent Commercial and Legal Infrastructure
- Government Policies favoring Globalization and Innovation
- Selective Sectoral and Regional Incentive Policies

Classic Locational Assets
(Resource-, Market-,
Efficiency-Seeking FDI)

Improving Economic Fundamentals

- Growth, Stability
- Skilled Labor, Infrastructure

Improving the Investment Environment

FDI Policy Options

Improving the Investment Environment



Competitive Policy

Reduction of Transact. Costs, Risks, Taxes

- Tariffs
- Tax Holidays
 - Export Support, Signaling Device
- Cash Incentives
 - Effect on Specific Industries, SMEs
- Tax Regimes

Cooperative Policy

International Agreements

- BITs (Non-discrimination, Dispute Settlement)
 - Focus on Diplomacy, Weak Institutions
- Tax Treatise (Double Taxation, Harmonization)
 - For Established Investment Relations
- Multilateral WTO
 - Break-down of OECD-MAI Top-Down Approach, Slow on Bottom-Up Negotiations; Differences of Developed and Developing Country Interests
- Multilateral EPAs
 - Competition for Investment; Support for Industrial Policy and Spillovers

Framework Example: Japan-Singapore Agreement

Trade++ Issues

- “New-Age Economic Partnerships”
 - Mutual Recognition Procedures
 - Rules of Origin
 - Intellectual Property Rights (IPR)
 - E-Trade
 - Investment Facilitation
 - Service Sector Liberalization beyond WTO
 - Financial Services
 - Human Resources Development
 - Science and Technology
 - Small and Medium Enterprises
 - ICT & Broadcasting

State of Affairs

- NAFTA (Investment Liberalization)
 - Negative List Approach
 - Limited Institutional Reform
- ASEAN (Investment Cooperation)
 - Investor Guarantees
 - No Strategic Investor in Group
- EU Acquis (Investment Competition / Institutional Cooperation)
 - Not Developed as an Investment Framework
 - Slow Impact on Core Sectors (Agriculture/Transport/Finance)
- EU Enlargement Acquis
 - Acquis gets Investment Framework Focus
 - Governance & Institutional Reform
 - Different Approaches (Czech: Top Down / Poland: Bottom Up)
 - Limited Impact on Investment Protection (BITs and International Arbitration Superior?)

EU Integration: The “Aquis” Evolves

- Free Movement of Goods, Persons, Services, Capital
- Customs Union, Taxation (mostly VAT), EMU
- Agriculture, Fisheries, Transport, Energy Policy
- Environment, Consumer and Health Protection
- Telecommunications and Information Technologies



Market
Integration



Governance
Reform

- Company Law, Competition Policy
- Justice and Home Affairs
- Financial and Budgetary Control and Provisions
- Statistics, Industrial Policy, SME

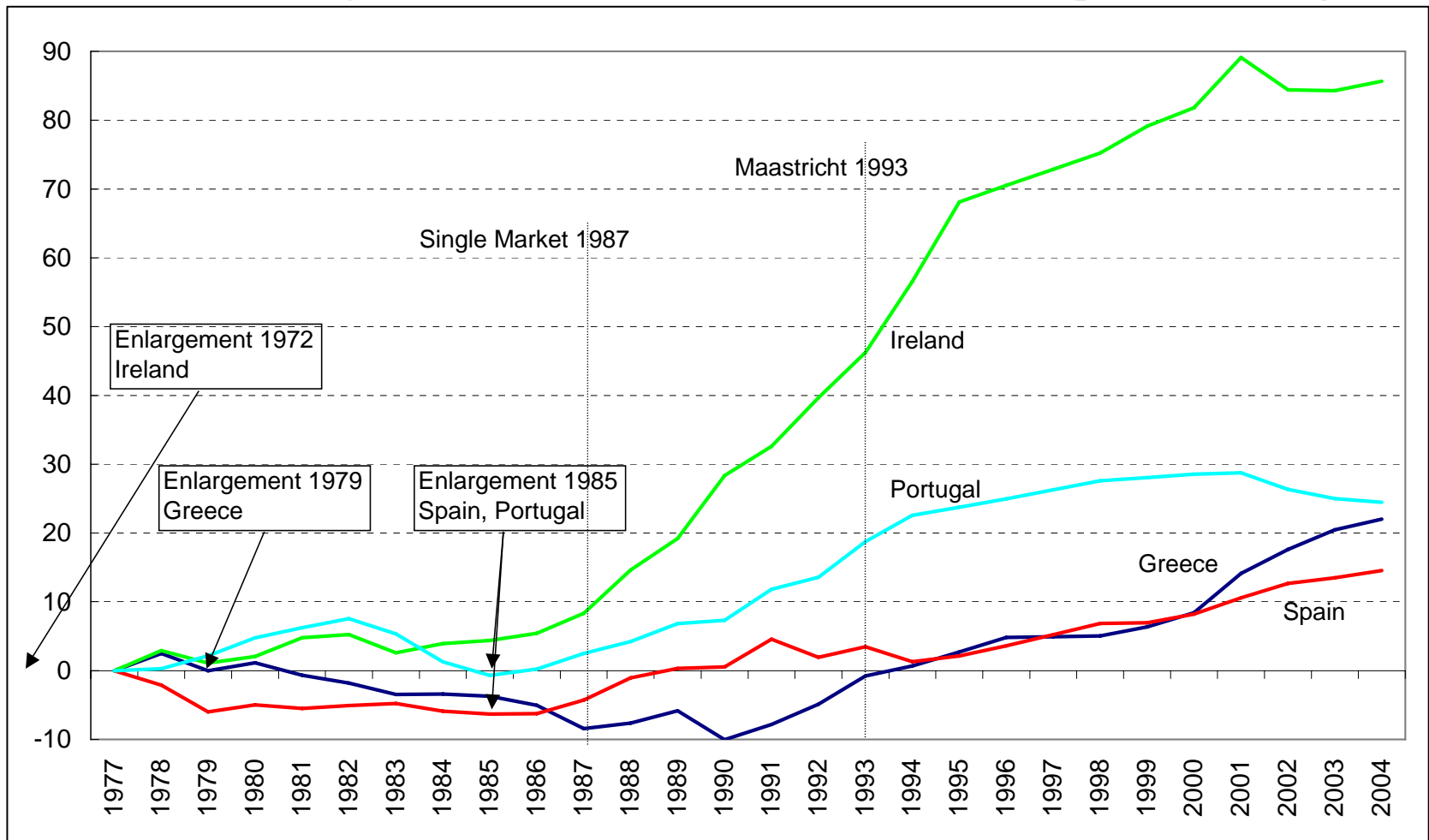
- Common External Relations and Security Policy
- Science and Research, Education and Training
- Regional and Structural Policy
- Social Policy and Employment
- Culture and Audio-Visual Policy



Set-back on
“Policy” Issues

EU Common Market: Impact Depends on Framework Reforms

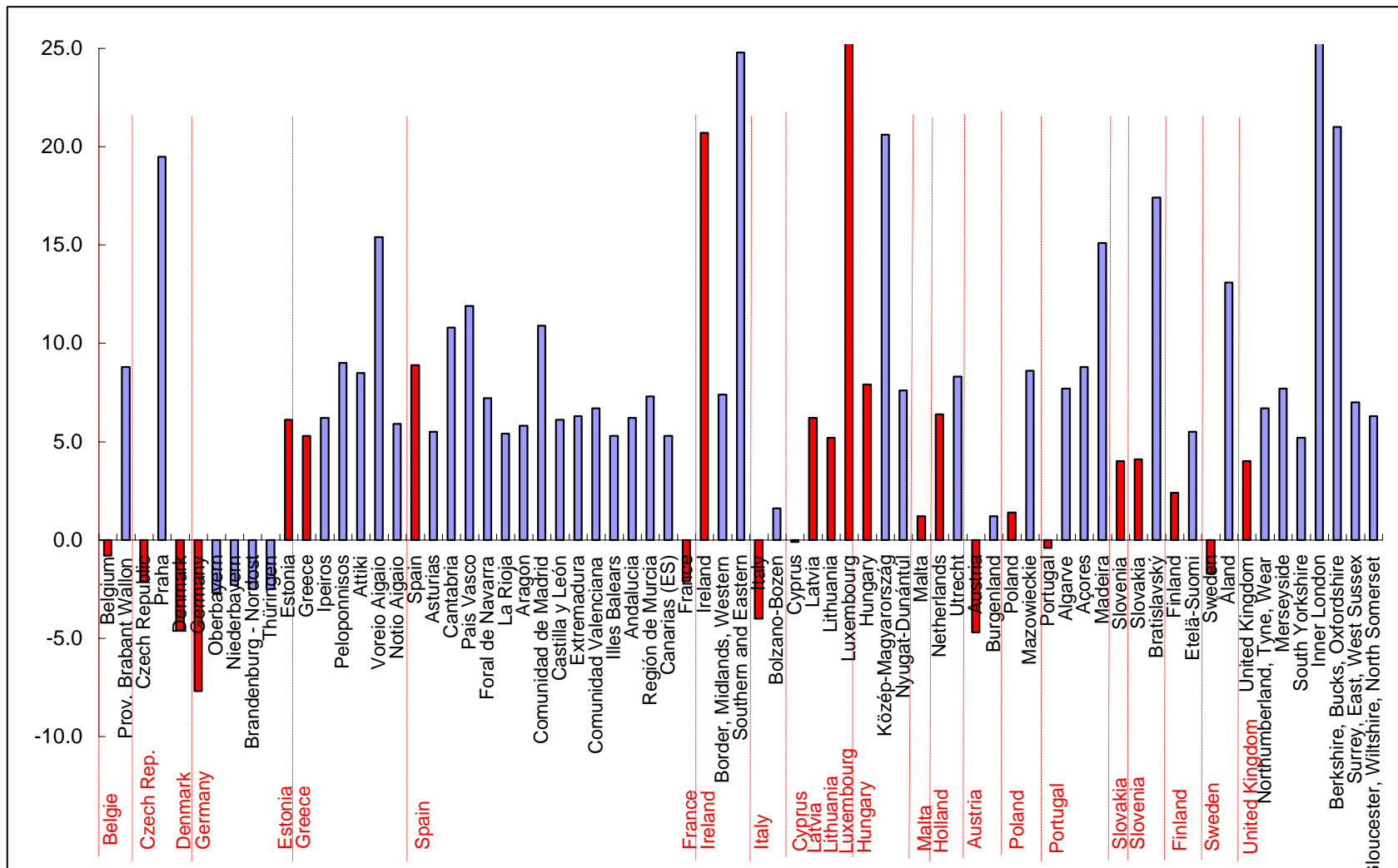
Accession Country GDP Out-Performance (Ireland, Greece, Spain and Portugal)



Note: Growth rates are plotted as PPS per capita as % of the EU15's average. Percentage point changes therefore mark strong growth on top of EU-15 growth in real per capita terms. Source: © FRI 2005. Data from EuroStat (2005).

Outperformance: National Policy, Market Size Matter

Regional GDP/Capita Out-performance above 5% of the EU-25 or National Index (1997-2002)



Remark: Above 5 (percentage) points change relative to the EU-25 GDP (PPP) per capita index average (=100) or to the national index position.

Source: © FRI 2005. Data from Eurostat Inforegio (2005).

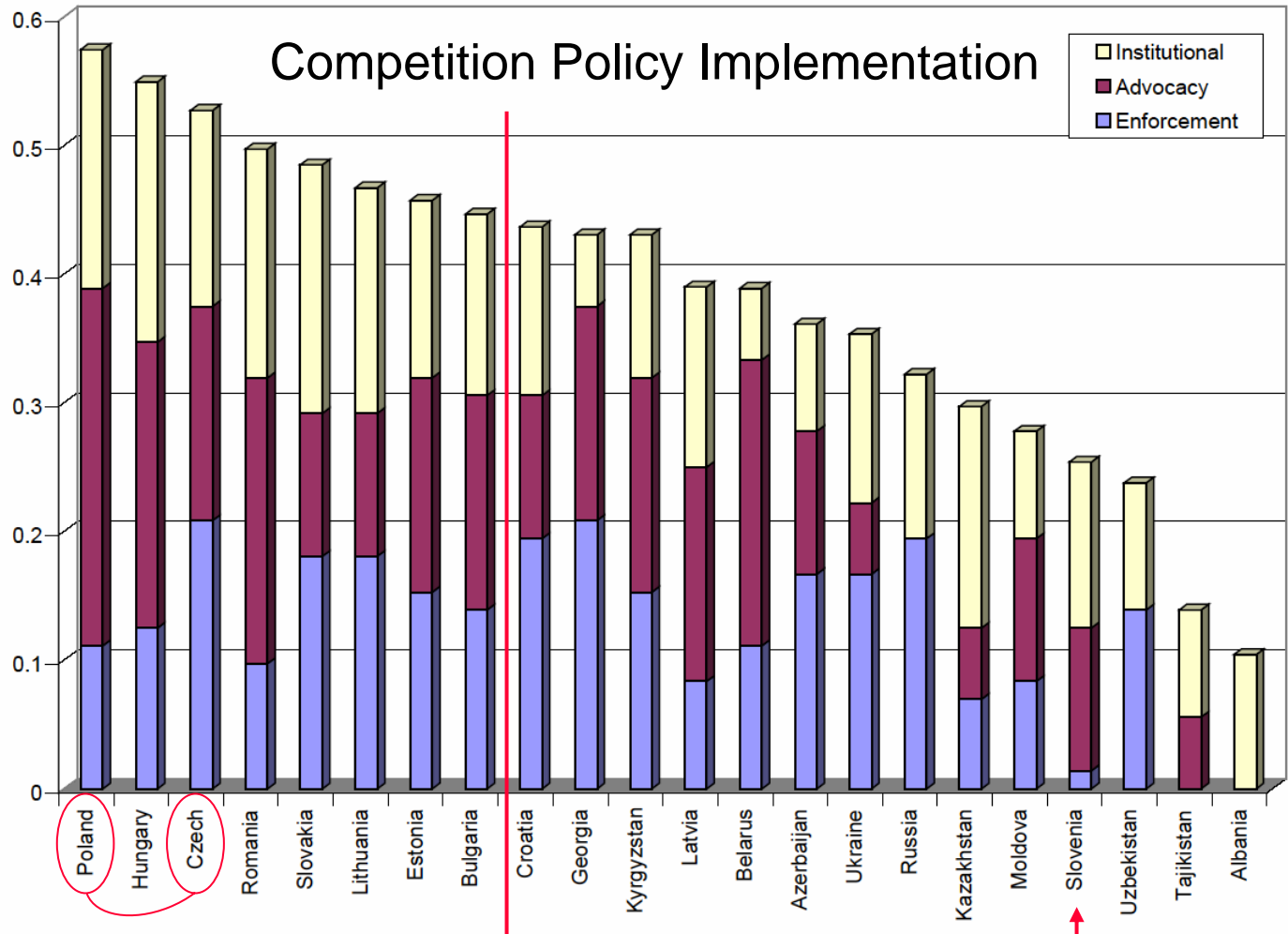
CEE Regional Integration Experience

- Strong Impact of Globalization from EU Single Market
 - Pressure for Privatization, Structural Reform, and Internationalization
- Strong Need for Finance and Services
 - Unsuccessful “Closed-Shop” Transformation led to Financial Reforms and FDI Promotion
- Strong Advantage in Wages and Engineering
 - Fitting into EU-wide Production Networks
 - Promoting Manufacturing and Supply-Chain Development
- Taking Chances with EU EPA and Accession
 - EU-Focused Structural Reforms and Capacity Building
- Taking Advantage of Support and Development Frameworks
 - Structural Funds and ODA for Capacity Building

Competition Policy Enforcement through Accession Negotiations

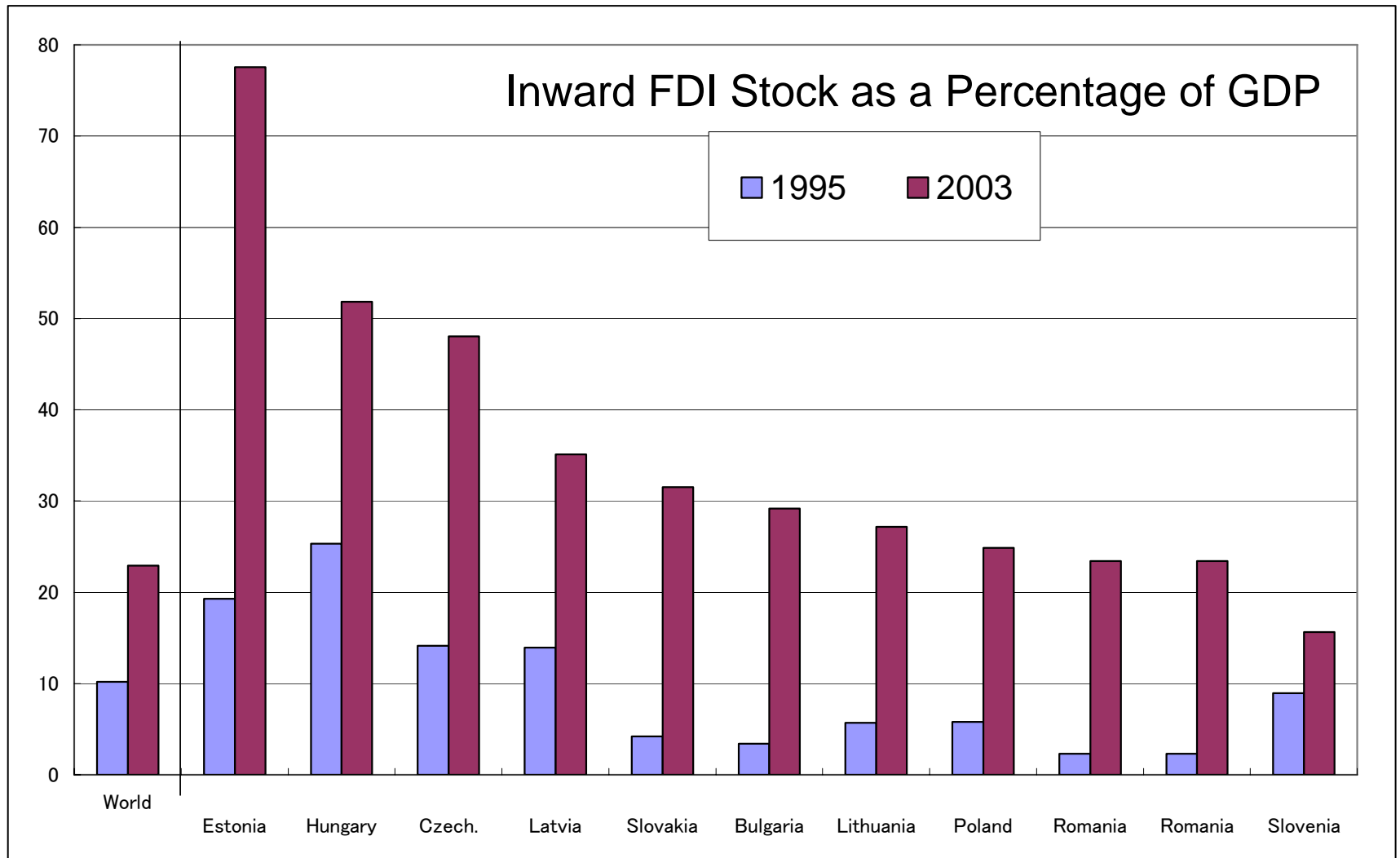
● Competition Policy (especially Anti-Trust and State-Aid Control)

- Law Enforcement (Cases and Fines)
- Competition Advocacy (Additions, Comments, Objections in Legislation and Regulations)
- Institutional Effectiveness (Agency Independence, Transparency, Appeals based on Economic Content)



Source: Vagliasindi (2001).

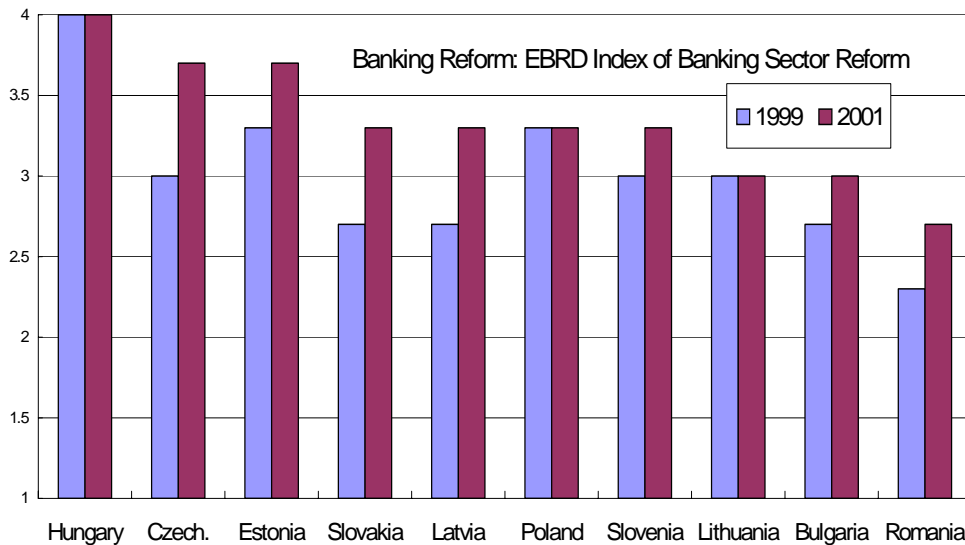
Driving Force of Market Reform: FDI



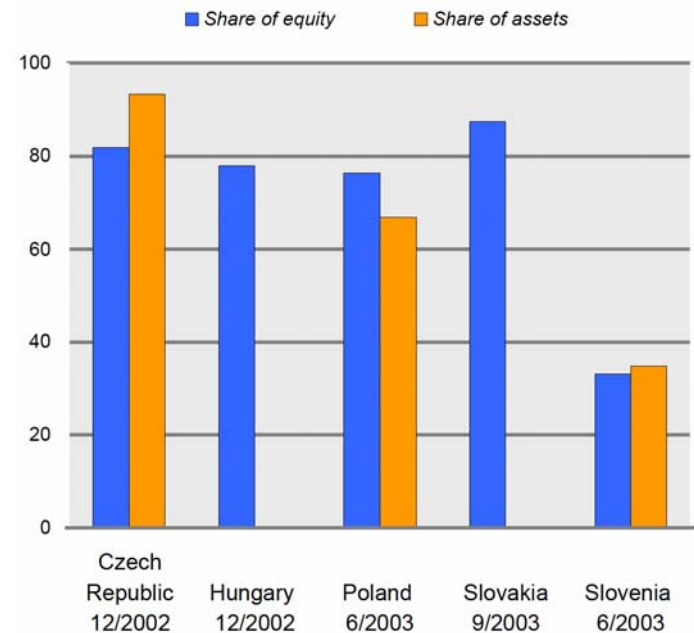
Source: © FRI 2005. Data from UNCTAD (2005) – World Investment Report 2004.

Regional Reforms: CEE Financial Reform

CEE Financial Reform



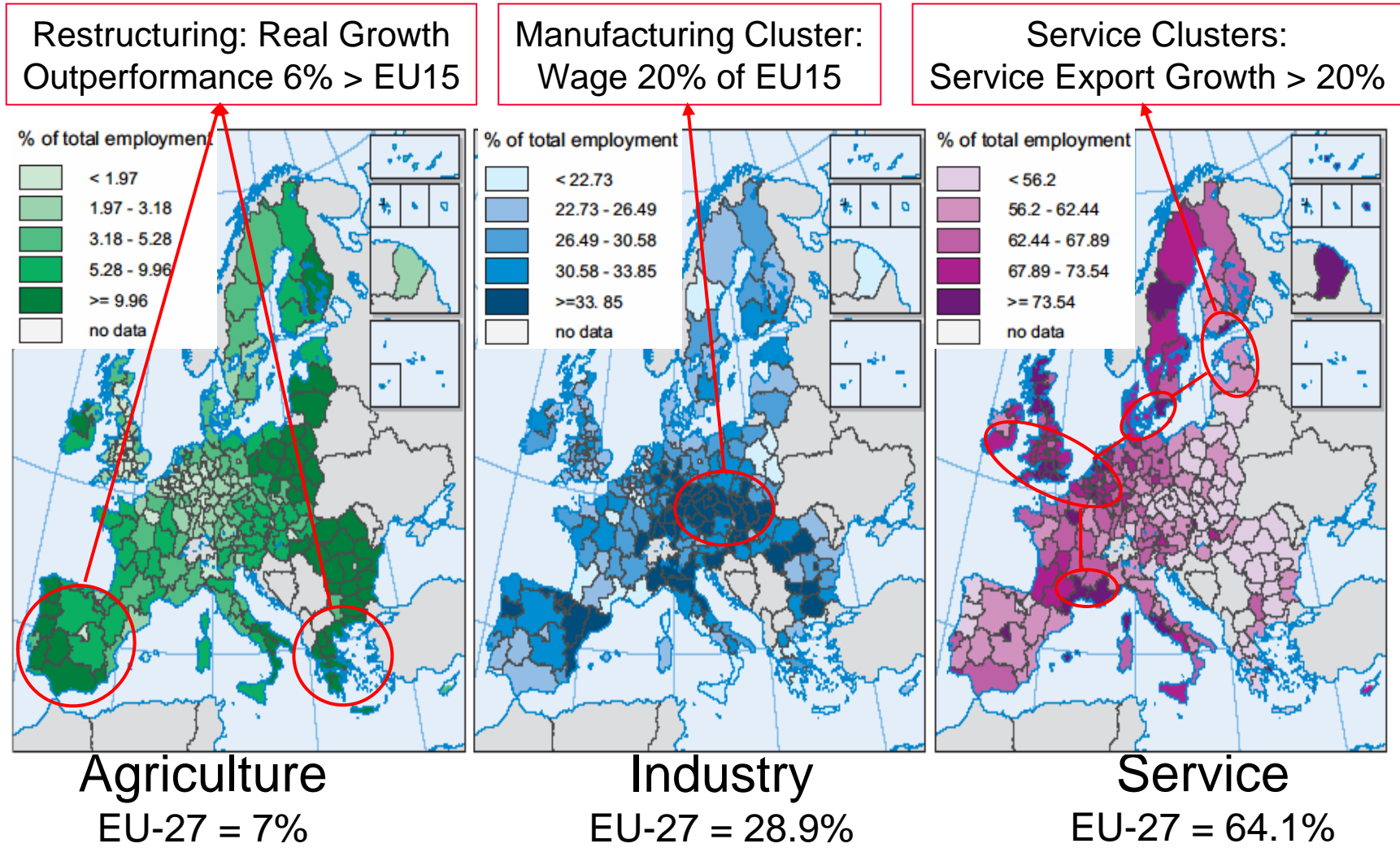
CEE Foreign Bank Ownership



Source: EBRD (2003) and UNECE (2004) – Economic Survey of Europe.

Regional Potentials & Production Network Chances

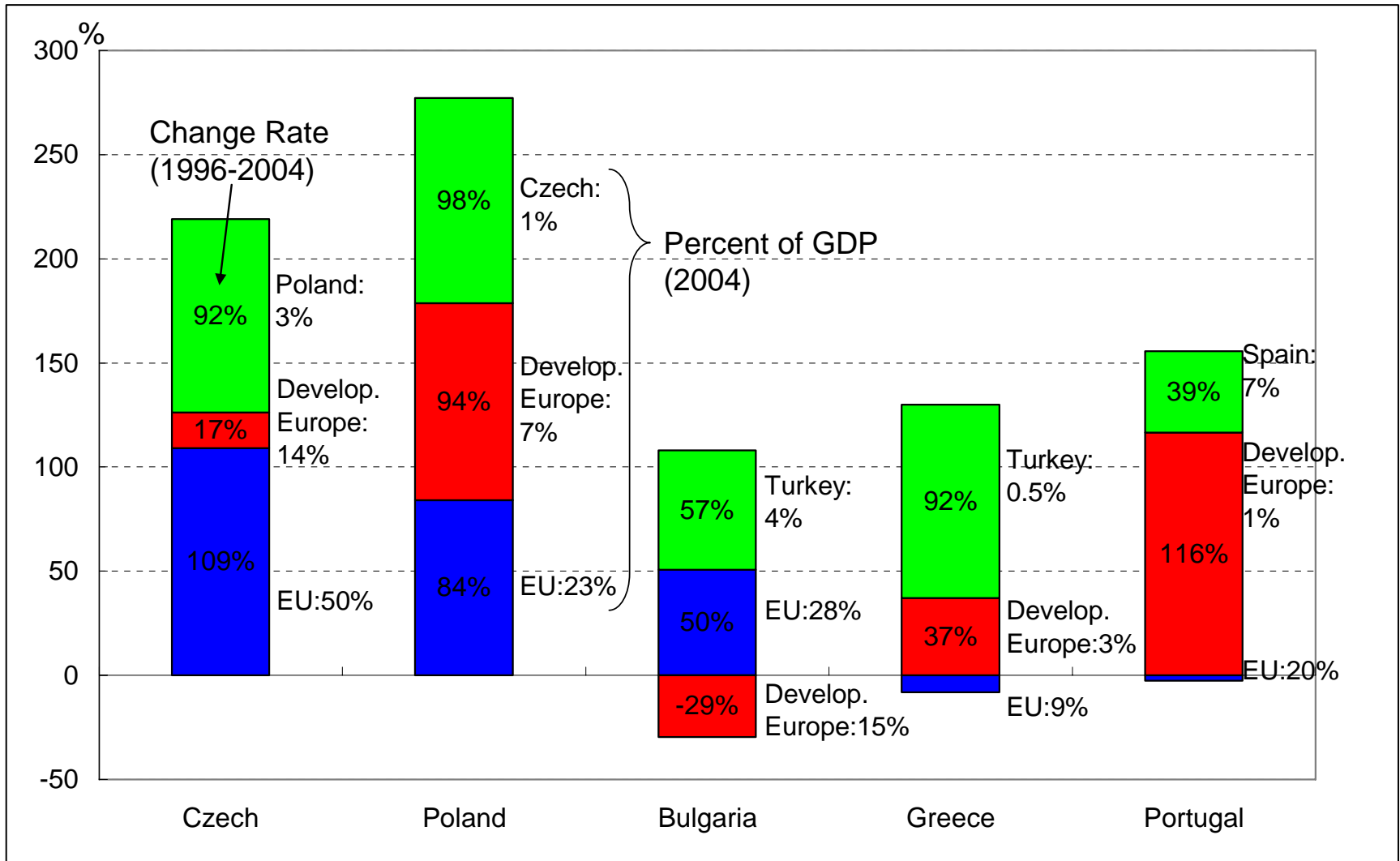
Regional Employment by Sector



Remark: Percent of sector of overall employment. Source: Eurostat Inforegio (2004): Third Report on Economic and Social Cohesion.

EU Hegemony Blocks Regional Integration?

Trade Integration ((Ex+Im)/GDP*2*100) Change Rate (1996-2004) and as Percent of GDP (2004)



Note: GDP on US Dollar basis; calculated on basis of average Forex rates of calendar year.

Source: © FRI 2006. Data from IMF (2005): Direction of Trade Statistics; IMF (2006): IFS.

Domestic Market Reform: Investment Agencies Impact

➤ Role

- Improve FDI Quantity, Quality
- Increase Project Competition
- Improve the Investment Environment

➤ Tasks

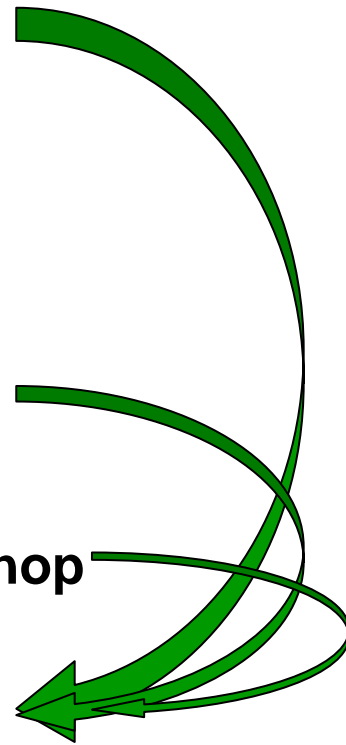
- Marketing with Product, Promotional, and Pricing Strategies
- Screening Investment Proposals
- Monitoring Foreign Investment
- Intervening to solve Problems

➤ Scope

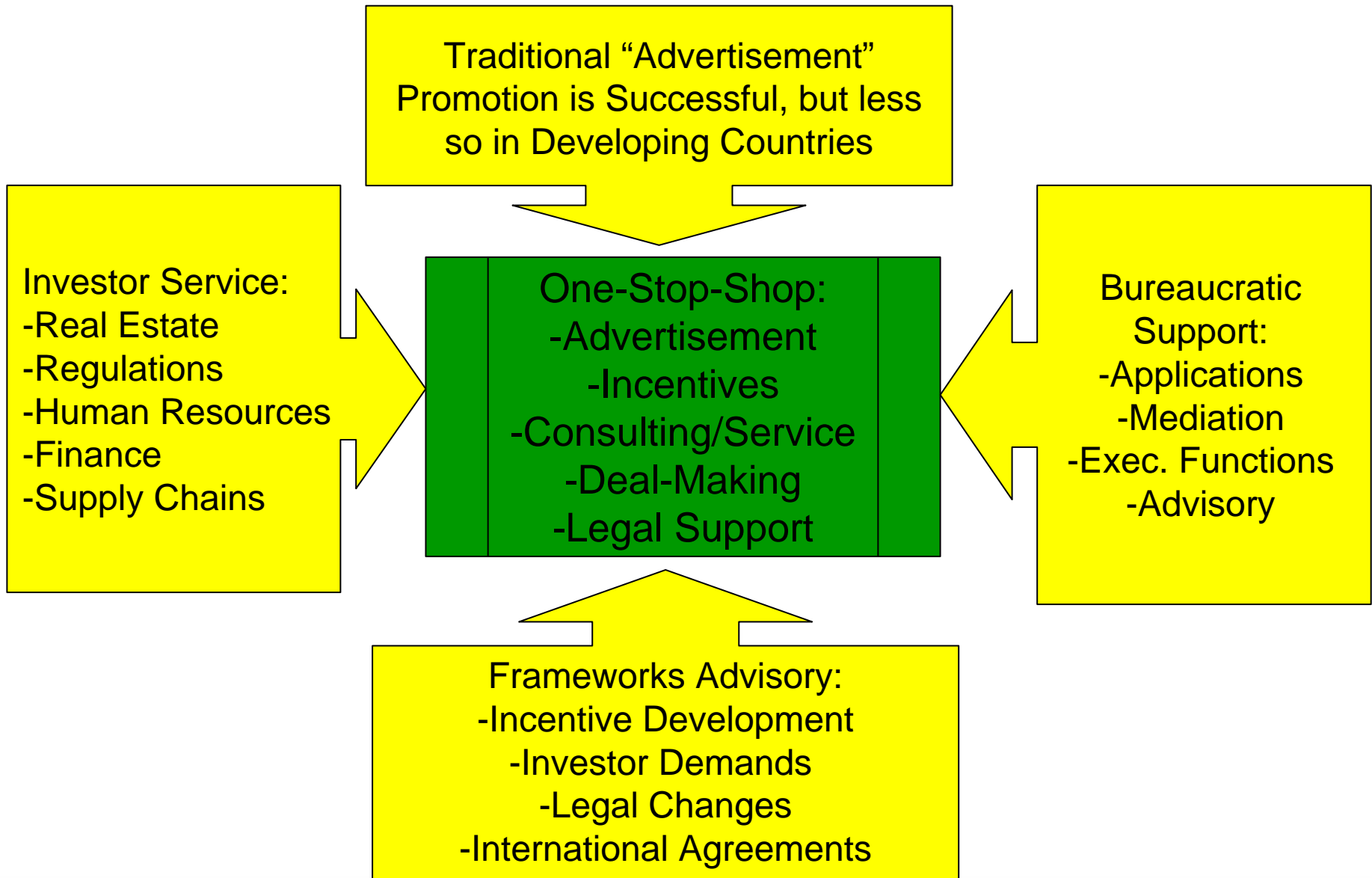
- From Information Center to Executive One-Stop-Shop

➤ Type

- Best Results with Quasi-Governmental Agencies

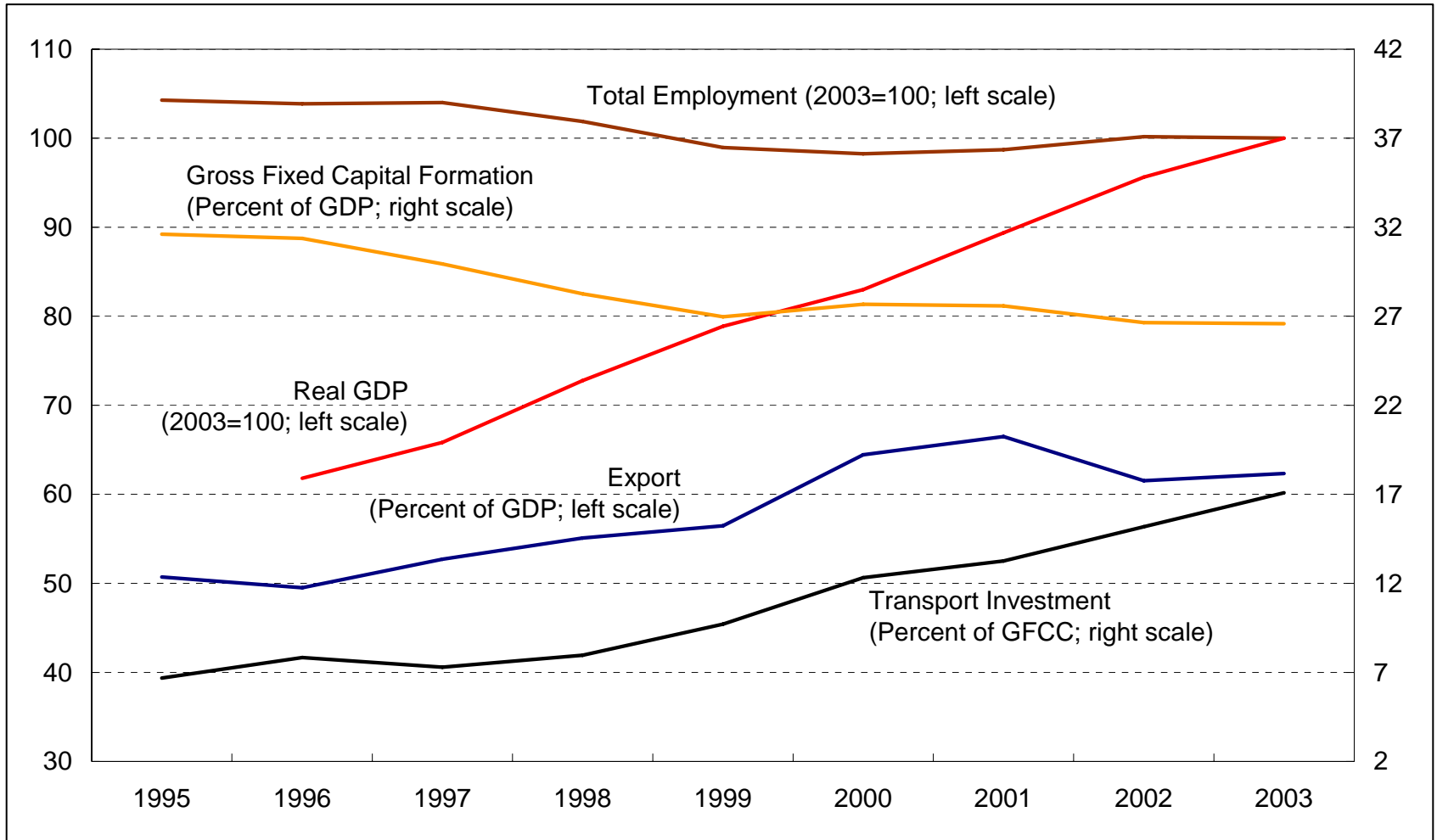


Czech Republic: One-Stop-Shop Investment Agency



Czech Production Focus: Autos & Export

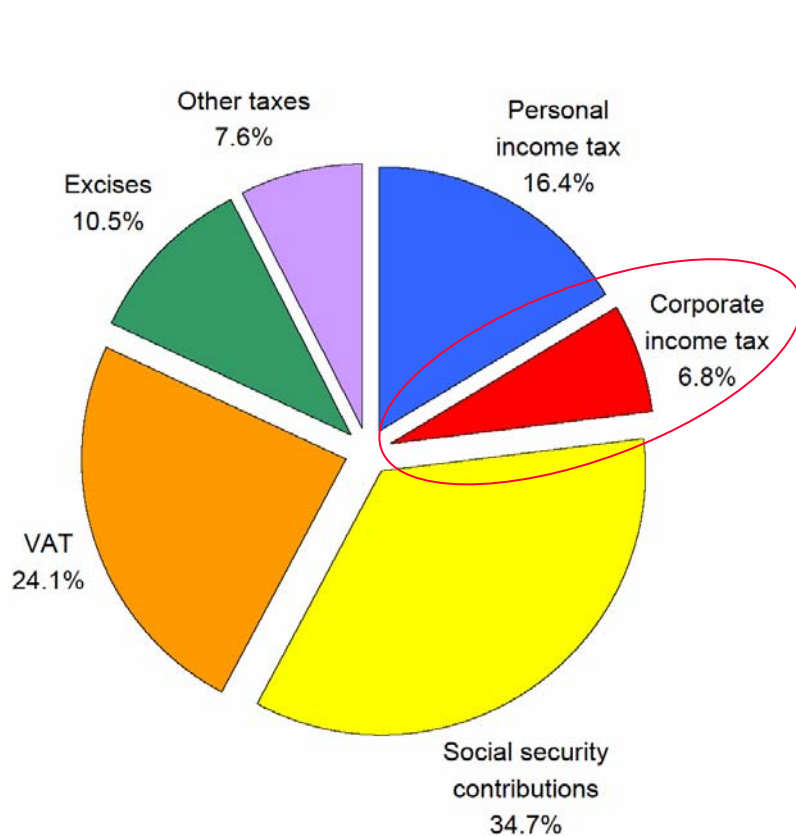
But Employment & Domestic Investment Stagnant



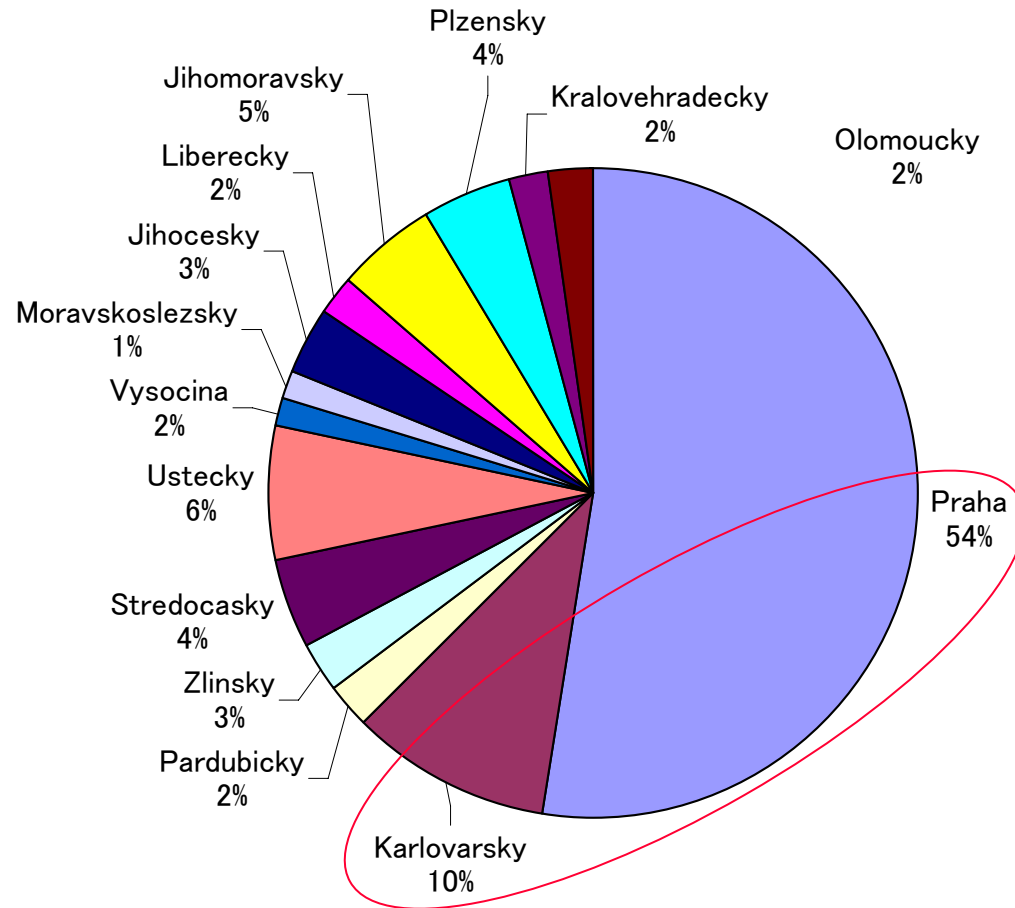
Source: © FRI 2005. Data from Czech Statistical Office (2005) – National Accounts.

Limitations of “Classic” FDI Promotion: Tax Breaks and Special Economic Zones


CEE Tax Revenue Composition

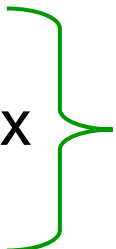


Czech Regional FDI Composition



Regional Structural Reforms: Slovakia Tax Reform

- 1995: Tax Rates Among Europe's Highest
 - Tax Share: 37% of GDP
 - Social Security: 50% of Taxable Income
- Until 2004: Regional Tax Competition
 - Following Ireland and the Baltic Countries
 - Corporate Tax Rate Reduction : 40%  25%
- 2004: Comprehensive Tax Reform
 - Corporate Tax
 - Personal Income Tax
 - VAT

 **19% Flat-Tax**

Reverse Integration: Strong Enlargement Impact

EU Outlook after Enlargement

- Less Policy-Coordination
 - No Tax Harmonization, more Tax Competition
 - No “United States of Europe”
- Less Top-Down Decision Making
 - Intergovernmental Negotiations lost Credibility
 - Step-wise Reform of Majority-Voting
- More Regional Initiatives
 - EU cannot Implement or Enforce Structural Reforms
 - Regional Governments Drive Structural Reform
- More Economic Union
 - Increasing Market Size, Competition, Differentials
 - “Economic Enlargement” through Association Agreements

Frameworks in Europe and Asia

EU

- Free Trade, Internal Market, Harmonization
 - Investment Focus
 - Institution Building
 - Structural Development Programs
- Investment Framework
 - Strong FDI Competition
 - General Tax Competition
 - Competition Policy
 - Governance Standards
 - EU Court
 - EU Executive (Commission)

ASEAN

- Trade Frictions, Investors Outside the Region
 - Trade Harmonization
 - Transparency, Inf. Sharing
 - Technical Cooperation
- Investment Framework
 - Harmonization
 - Minimum-Tax-Breaks to Attract FDI as a Region
 - Special Economic Zones
 - BIT Arbitration

Competition



Harmonization

Results for Asian Integration Plans (ASEAN+X)

- Integration of Major Investors Japan, Korea, China (+3)
- Competition of Tax and FDI Policies
- FDI-focused Governance Reform
- Limiting Harmonization and Integration Goals
 - Mutual Recognition of Standards
 - Fixed Exchange Rate Regimes are Insufficient
Coordination and Enforcement Mechanisms
 - Currency Unions work as a strong Coordination and
Enforcement Mechanisms, but require Political
Integration
- Focus on a Core-Sector: Finance
(Old-EU: Steel & Coal = Military; New-EU: Finance)
- International Institutions can Support Structural Reforms
- Effective Arbitration, Cooperative Structural Support
Schemes, Capacity Building