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Foreign Direct Investments and Business Climate in the Southeast European (SEE) Countries in comparison with the 8 New Member States (NMS8)

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Introduction

As a result of the transition process, the former Eastern bloc and Yugoslavia divided into three groups of countries. The first group is comprised of the front-runner transition countries such as the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia, or eight of the ten so-called New Member States. In the second group one can find the CIS countries, which include 12 former Soviet Republics1. The third group constitutes the Southeast European countries, consisting of Albania, Bulgaria, Bosnia-Herzegovina, Croatia, the Former Yugoslav Republic of Macedonia (FYROM), Romania and Serbia and Montenegro.

Certainly these groups are not homogeneous; however, the three groups are distinguishable. Each group has its own characteristic which differentiates itself from the other groups. In case of the NMS, the relatively successful restructuring and transition process, the more advanced market economy, or the EU membership, while in case of the CIS countries, the slower progress in transition, the less developed economy, or the fact that these countries have slight chance to be a member of the EU in this or next decade, are all special features which characterise the given group.

Actually, the third group is quite interesting. In this group one can find countries which are not members of the EU but there are several official acceding and candidate countries, such as Bulgaria and Romania or Croatia, while the rest of the group is potential candidate country. Regarding the performance of their transition process, these economies were not as successful as the NMS; however the dynamism of the progress advanced significantly in the last few years. Nowadays, it seems most countries in the SEE region aim to close the gap between itself and the front-runner transition countries by implementing important measures similar to those adopted in the NMS, or even more significant.

One of the most important lessons from the economic transition process of the NMS is that foreign direct investment played and important role in restructuring the former centrally planned economies into market economies, integrating the national economy into the world economy and increasing the competitiveness of the economy. Besides privatisation which was a necessary consequence of the transition, these countries aimed at becoming more and more attractive for foreign investors by improving their business climate to draw more and more foreign capital into the economy. Nowadays, privatisation process is basically over and green-field investments constitute the majority of foreign direct investment inflows.

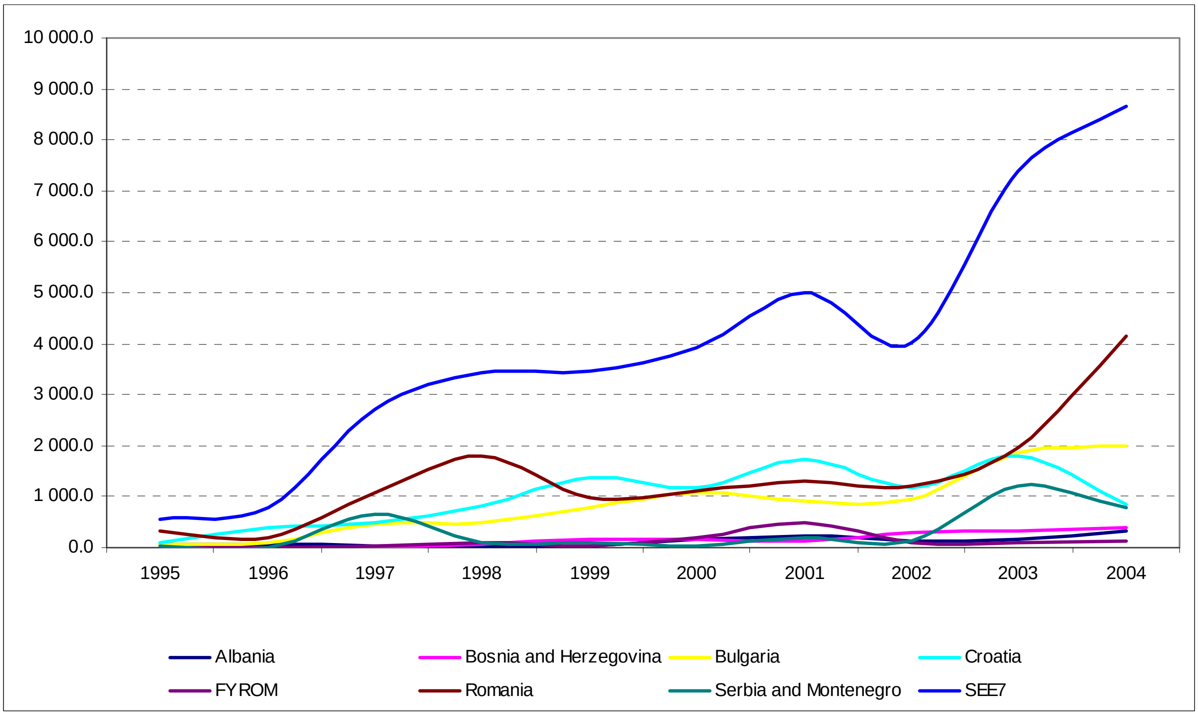
In the SEE countries this development started later, privatisation is still an ongoing process while the increasing competition for foreign direct investments is an exogenous factor to every country in the region. The main aims of this paper are to analyse the foreign direct investments inflowed into the SEE economies and to examine the business climate improvements in these countries in comparison with the eight New Member States.

[1] In fact, the CIS is a confederation of 11 former Soviet Republics, namely Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan, Ukraine, and Uzbekistan. Turkmenistan is not a permanent member of the CIS since 26 August 2005 but is an associate member.

I. Foreign Direct Investments

As it was mentioned earlier the SEE economies were less attractive for foreign investors during the first 10 years of transition, namely in the 1990s. It was the consequence of several factors, such as the wars fought between the countries in the Western Balkans after the disintegration of Yugoslavia and the slower progress in economic and political reforms. Regarding the foreign direct investments inflows one can see that the annual average amount of FDI inflowed into the SEE region was quite low in the last decade. The total annual FDI remained under EUR 4 billion in every year in that period, which is quite low considering the population of the region (the SEE region's population is close to 55 million). The FDI inflow started to grow in the new millennium and the dynamism of this growth is significant. In the 2003-2004 period the FDI inflows reached EUR 16 billion which is remarkable.

Graph 1. - Evolution of FDI in the SEE countries, 1995-2004 (millions of euros/ECU)



Source: UNCTAD

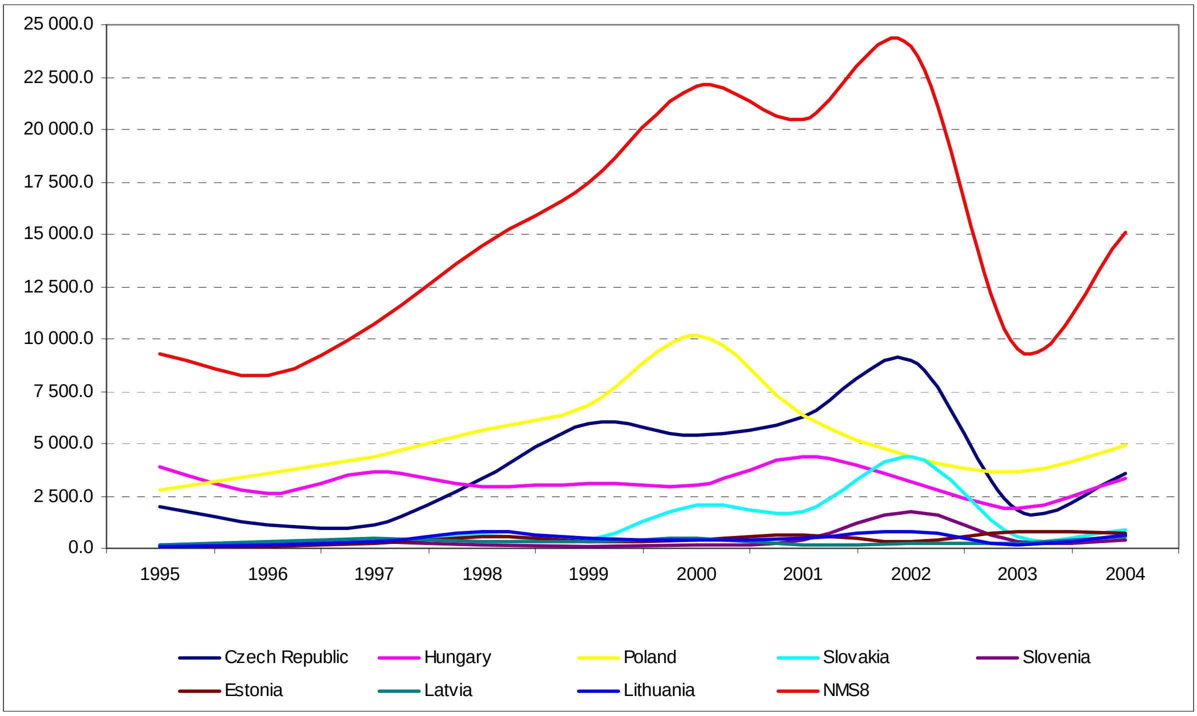
It is observable in the graph above that the foreign investors' primary targets were Romania, Bulgaria, Croatia and Serbia and Montenegro in the last few years. These four "large" countries account for about 90% of FDI inflows in the region. Accordingly, it means the "small" countries (Albania, Bosnia-Herzegovina and the FYR of Macedonia) were not really attractive for foreign investors; their share in population reaches 18% which is significantly higher than that in FDI inflows.

Nowadays, Romania is the most attractive target in the region. In the last two-year-long period the foreign direct investments increased by approximately EUR 6 billion or nearly 38% of the FDI inflowed into the SEE region chose Romania as the place of investment. In fact it is not a surprise that Romania accounted for the largest part of FDI in the last years considering the country's size.

On the other hand, the performances of Croatia and Bulgaria are both significant, their annual FDI inflows averaged around EUR 1-2 billion in the last years. Besides that Serbia and Montenegro is worth mentioning because its annual inflows increased to around EUR 1 billion in 2003 from almost zero. Though, it is true that this positive process is mainly due to the launch of privatisation in Serbia and Montenegro and the FDI inflows were linked to some large sales in that period.

During that period, the path of FDI inflows in the NMS was similar to a rollercoaster. In 2002 the FDI inflows into NMS-8 reached its peak (EUR 24 billion) and it decreased sharply (to EUR 9.5 billion) in the very next year. It means that these economies were more influenced by the weakening performance of the world economy. On the other hand, the privatisation revenues also decreased due to the fact that privatisation is almost over in that region, the largest sales were concluded. Accordingly, green-field investments accounted for a significant part of the FDI inflows.

Graph 2. - Evolution of FDI in the NMS8 countries, 1995-2004 (millions of euros/ECU)



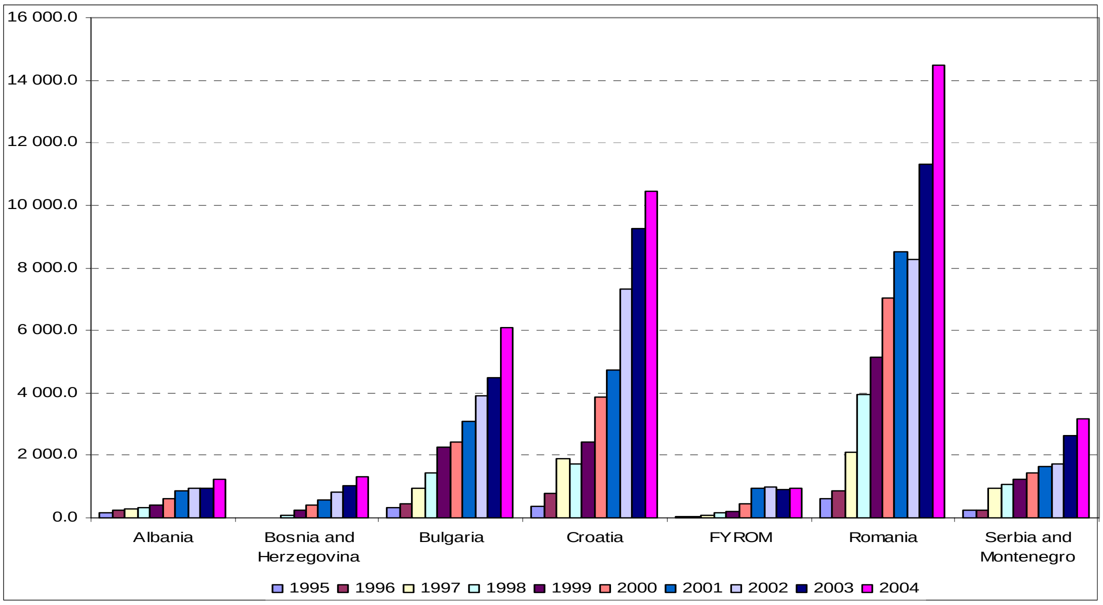
Source: UNCTAD

In case of the eight NMS, the same concentration of targets is observable as in case of the SEE countries. In the four "larger" countries, or the so-called Visegrad countries (the Czech Republic, Hungary, Poland and Slovakia) account for almost 90% of FDI inflows in the region which is mainly explainable by the size of these countries. The share of these countries in the population of the region is around 87.5%. Thus, it is a difference between the SEE countries and the NMS, namely the small countries are not under-represented in the FDI pattern.

Regarding the stock figures, the aforementioned factors are underpinned, the most important investment targets were Romania, Croatia, Bulgaria and Serbia and Montenegro between 1995 and 2004 in the SEE region. In that group the amount of FDI stock exceeded EUR 10 billion only in Romania and Croatia. In Bulgaria this figure was EUR 6 billion, while in Serbia and Montenegro it reached almost EUR 3.2 billion at the end of 2004. In these four economies the

In the other three "small" economies FDI stock was around EUR 1.0-1.3 billion in each. In case of these countries the evolution of FDI stock was mainly influenced by some larger-scale privatisation deals, the best example is the FYR of Macedonia where the privatisation of the national telecom company in 2001 resulted in a significant jump of FDI stock.

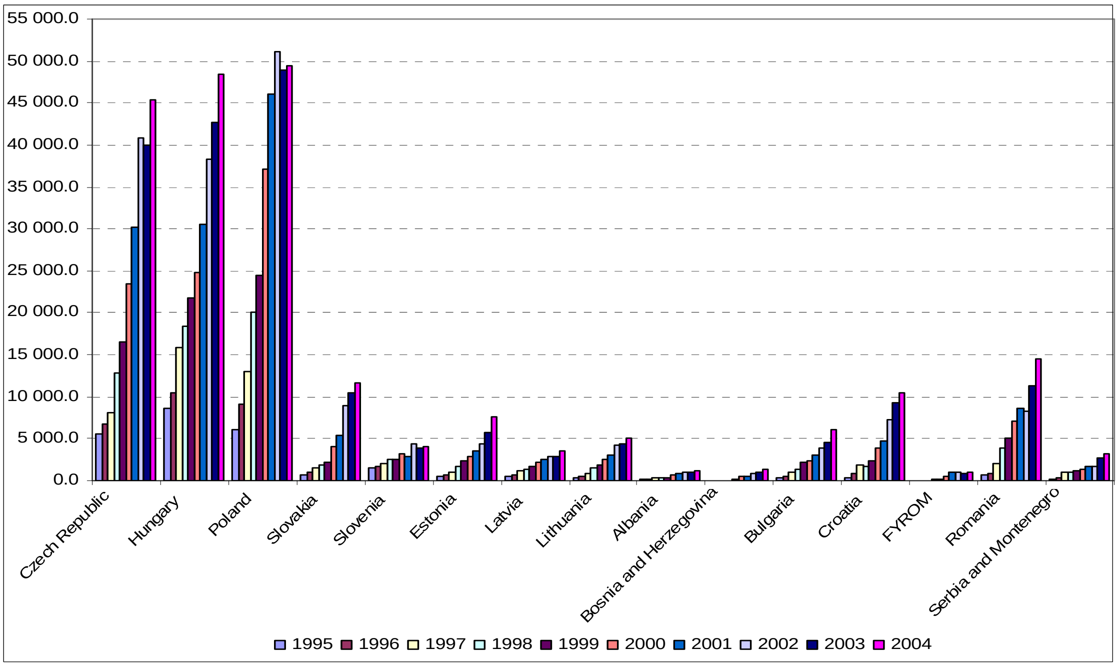
Graph 3. **-** FDI stock in the SEE countries, 1995-2004 (millions of euros/ECU)



Source: UNCTAD

If one compare the FDI stock figures in the SEE region and in the eight New Member States it is easily observable that even those countries which have higher FDI stock figures greatly lag behind the front-runner NMS countries, namely the Czech Republic, Hungary and Poland. In these three economies the FDI stock figure is between EUR 45 and 50 billion which is threefold-fourfold higher than that of the best performers (Romania and Croatia) in the SEE region.

Graph4. - FDI stock in the SEE and the NMS8 countries, 1995-2004 (millions of euros/ECU)



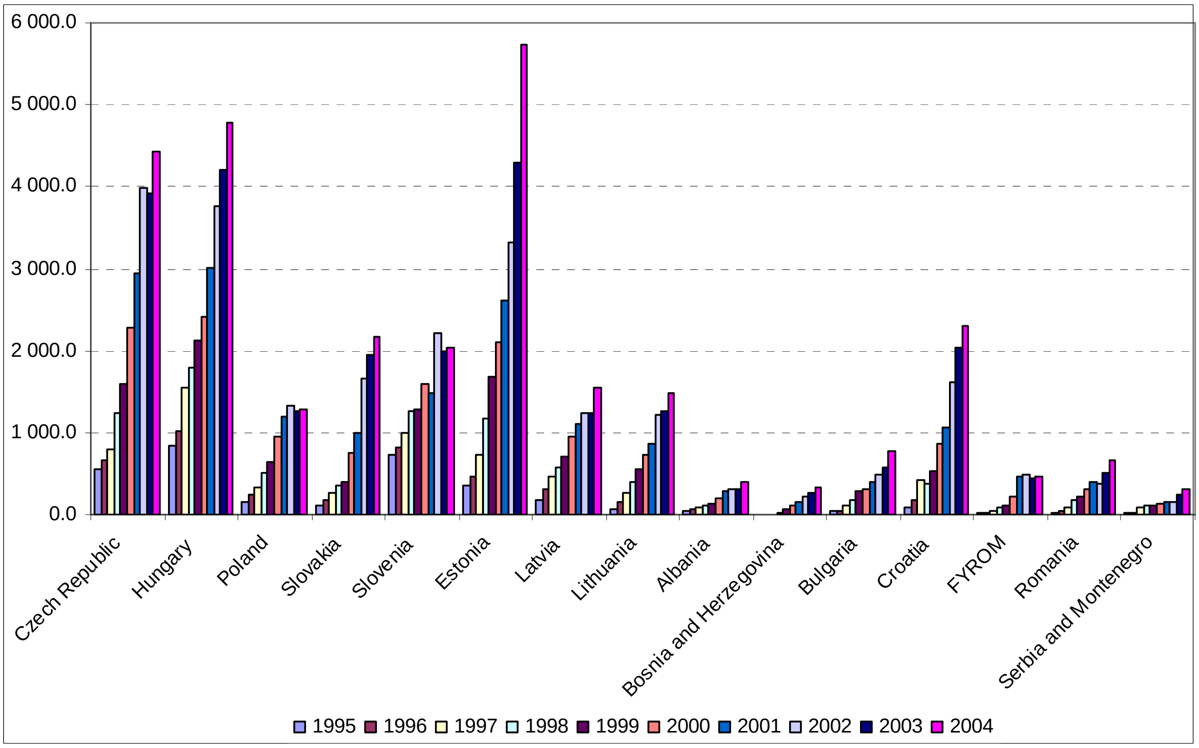
Source: UNCTAD

The figures of these best performers in the SEE region is rather comparable with that of Slovakia or Estonia from the NMS, however, the population of these countries are significantly lower than that of the aforementioned NMS countries.

Certainly, it is worth comparing the per capita stock figures which reflects a clearer picture on the FDI stocks in these countries. It was expectable that the levels of per capita FDI stocks of the Czech Republic and Hungary are significantly higher than that of Poland due to the difference in population, while Estonia has the highest per capita FDI. Generally, the per capita FDI exceeds EUR 1000 in every New Member States.

The figures of the SEE countries are really low, in most cases the per capita FDI stock level is less than EUR 1000. Romania, the best performer in total FDI is only the third in the region after Croatia and Bulgaria, in this respect. The per capita FDI is less than EUR 700. In the other four countries the figure is only between EUR 300 and 500.

Graph 5. - FDI stock/capita in the SEE and the NMS8 countries, 1995-2004 (millions of euros/ECU)



Source: UNCTAD

It seems only the figure of Croatia is comparable with that of the NMS, the per capita FDI exceeded EUR 2000 at the end of 2004. This is the same level as in Slovakia and Slovenia, while higher than that of Poland, Latvia or Lithuania.

Regarding the most important investor countries in the SEE region, one can find that mainly the neighbouring developed countries are the major foreign investors in the region. The largest investors in the SEE region are Austria, Germany, Greece, Italy and the Netherlands.

In the larger countries the shares of the largest investor country is between 13% and 26% which is not high and represents a relatively diversified investment portfolio (mainly in case of Bulgaria and Romania).

TABLE 1. - TOP 5 INVESTORS IN SOME SEE COUNTRIES

	ALB		BIH		BUL		CRO		ROM	
1	**2**	**3**	**2**	**3**	**2**	**3**	**2**	**3**	**2**	**3**
1	ITA	47.9	CRO	15.5	GRE	13.3	AUT	25.7	NED	15.5
2	GRE	34.2	SLO	13.6	AUT	11.8	GER	20.7	AUT	12.2
3	MKD	2.2	AUT	13.4	NED	9.0	USA	14.7	FRA	11.1
4	USA	2.0	KUW	9.9	GER	8.7	HUN	6.0	GER	8.0
5	TUR	2.0	GER	9.2	BEL&LUX	8.4	LUX	5.9	USA	6.5

Source: Southeast Europe Investment Guide 2005; 1- Rank, 2- Investor Country, 3- Investor's share (%)

In the smaller countries the concentration of the foreign investors is higher, which is the consequence of the less investments. Thus, one can find such an "exotic" investor like Kuwait in

Bosnia-Herzegovina which reflects well that the major European investor countries avoided these small countries as an investment target.

II. Business Climate

In this chapter we compare the business climate of the Southeast European economies by examining the key tax rates (such as the corporate tax rates and VATs) and the main indicators of the labour market in these countries. In this paper we focus on these two factors to describe the business climate.

Regarding the tax regimes it is an interesting fact that there are nine tax regimes in seven countries. Obviously, it is understandable considering the fact that Bosnia-Herzegovina is a constitution of two entities (Republika Srpska and the Federation), while Serbia and Montenegro is the union of the two former Yugoslav republics, Serbia and Montenegro.

In the SEE region one can see that the corporate profit tax (CPT) rates are in a large range, between 10% and 30%, while the typical corporate tax rate is around 10-16%. The smallest rates (10%) are adopted in Republika Srpska and Serbia which are among the lowest not only in the region but also in Europe. On the other hand, the corporate tax rates in the other countries can also be considered as low, accordingly the business climate is relatively good in view of profit tax rates. Only Albania and the Federation part of Bosnia-Herzegovina are the exceptions in this respect.

TABLE 2. - TAX RATES IN THE SEE COUNTRIES (2005)

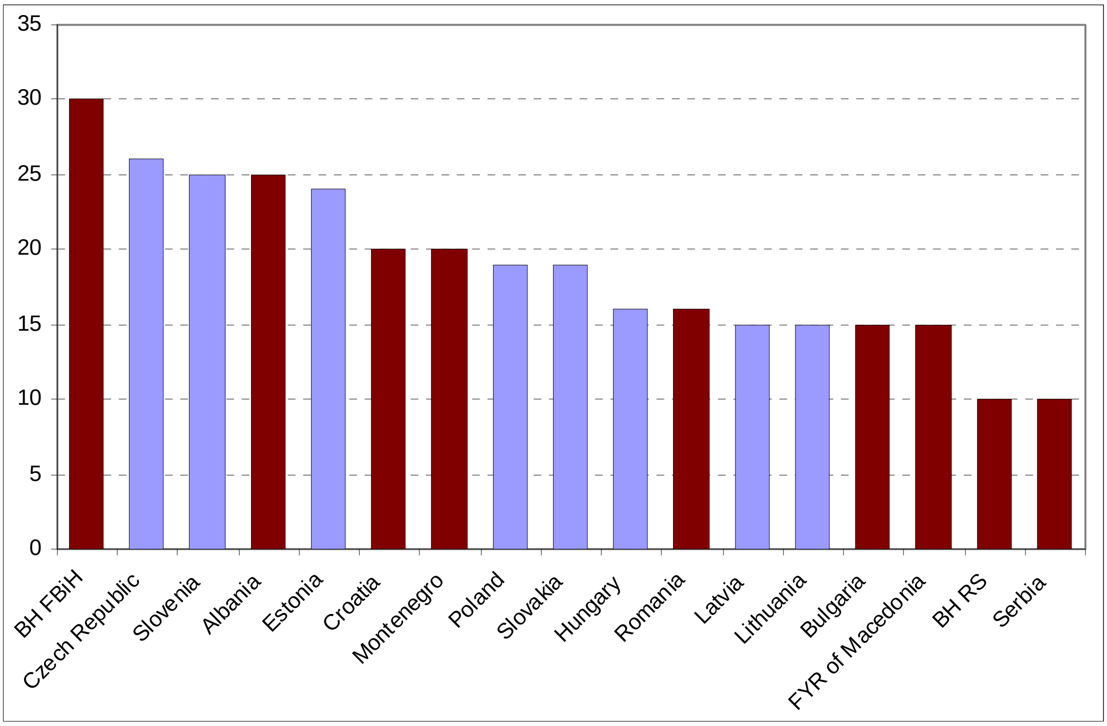
	CPT (%)	Dividends (%)	Interests (%)	VAT (st. rate, %)
Albania	25	10	10	20
Bosnia-Herzegovina				
Republika Srpska (RS)	*10*	-	-	*17*
Federation (FBiH)	*30*	-	-	*17*
Bulgaria	15	7	15	20
Croatia	20	15	15	22
FYROM	15	0	0	18
Romania	16	15	15/5	19
Serbia and Montenegro				
Serbia	*10*	*20*	*20*	*18*
Montenegro	*20*	*15*	*5*	*17*

Source: Ernst and Young

Regarding dividends and interests, in most countries these incomes are taxed and the rates are usually normal. In case of VAT, the adopted standard rates are in a small range, between 17% and 22%. It means there are no large differences among the countries from this aspect.

If we compare the corporate tax rates in the SEE region and in the eight New Member States, it is observable that the corporate profit taxes are generally lower a bit in the SEE countries than in the eight NMS. Between the 10-20% range one can find seven tax rates from the SEE region and 5 from the NMS8. Besides that, 5 out of the 8 lowest tax rates are belonging to SEE countries.

Graph 6. - Corporate Profit Tax Rates in the SEE and the NMS8 countries (2005)



Source: Ernst and Young; Blue – member of NMS8; Red – member of SEE

If we try to group the countries of the two regions, there are three different groups:

- 10-15%: Bulgaria, FYROM, Latvia, Lithuania, Republika Srpska and Serbia,
- 15-20%: *Croatia*, Hungary, *Montenegro*, Poland, Romania, Slovakia
- 20-30%: *Albania*, Czech Republic, Estonia, *Federation of BIH*, Slovenia.

It means the corporate profit tax rates are a bit lower in the SEE region than that in the eight NMS, however, the differences are not large. On the other hand, the reduction of profit taxes are planned in several NMS where CPT is relatively high (such as in the Czech Republic or Estonia).

Regarding the labour market, in several countries in the SEE region, high unemployment and low employment rate characterises the economy. It means that the outstanding economic growth has not generated sufficient new jobs for unemployed persons. This is one of the main differences between the two regions' (SEE and NMS) labour market developments.

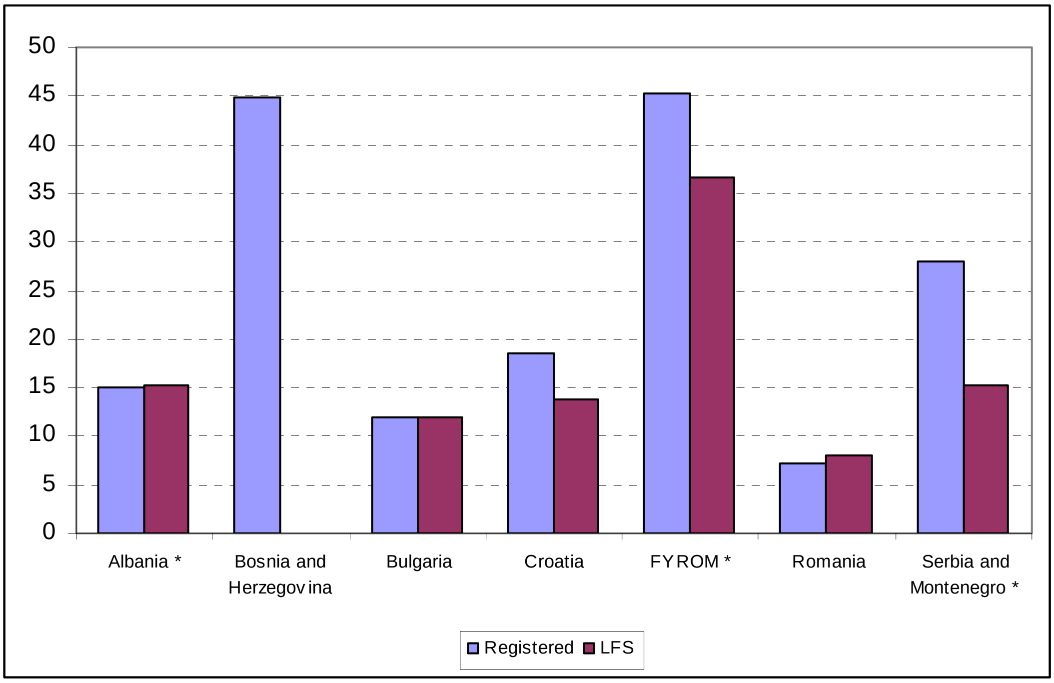
Decreasing employment rate and rising unemployment became a problem after transition. Regarding employment rate, this figure has sunk to between 60 and 80% of 1990 level, at the end of the last decade, while for example in most Central European NMS, employment never went under 80% of 1990 (Hungary is the only exception). It also means that the number of employed persons declined by 4.8 million or by 21% in the SEE region in the nineties.

In the new decade the number of employed persons decreased further in five out of the seven SEE countries. Thus, employment rate reached a very low level in these economies. In Bosnia-

Herzegovina and the former Yugoslav Republic of Macedonia, the employment rate is less than 20% which means that every fifth-sixth person has a registered job, regarding the population aged between 15 and 64. In Albania, Croatia and Serbia and Montenegro, the employment rate is not so low as in case of the earlier economies, however, it can be considered as low (between 40% and 50%). In Bulgaria and Romania, employment rate is close to the NMS, in both cases the figure slightly exceeds 60%.

Due to the low employment rate, unemployment is high in almost all SEE countries. There are three groups regarding the status of unemployment. Bosnia-Herzegovina, the former Yugoslav Republic of Macedonia and Serbia and Montenegro shape the first group. In these three economies official unemployment rate exceeds 25% and in the last several years the unemployment rate increased. In the second group there are Albania, Bulgaria and Croatia where unemployment is still double digit but it is less than 20%. In these economies unemployment reached its peak a few years ago and since then the figure is improving gradually. Romania forms the third "group" where unemployment is not a significant problem; the figure is less than 10%.

Graph 7. - Registered and LFS Unemployment rate in SEE Countries, 2004 (%)

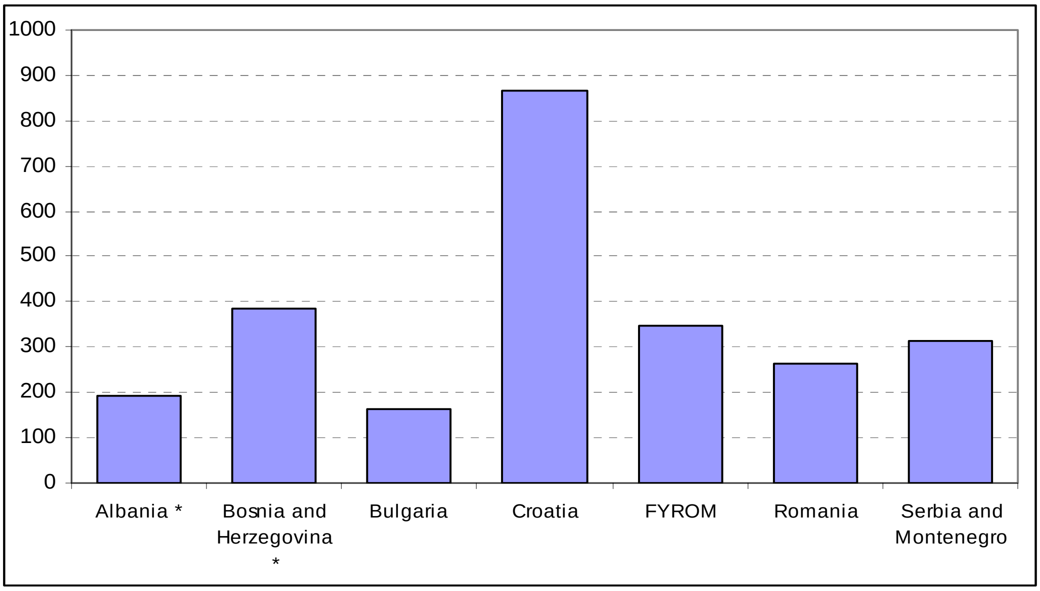


Source: UNECE, ILO; * 2003 figures

The aforementioned data are statistically reported figures, which reflect the registered unemployment rate. However, in some cases these data do not reflect appropriately the real situation, especially in case of the first group. The other method which is used to measure the rate of unemployment is the so-called labour force survey (LFS). Regarding the LFS unemployment figures, the unemployment rate in Serbia and Montenegro is "only" 15.2%, while that in the former Yugoslav Republic of Macedonia is 37.2%. In case of Bosnia-Herzegovina there is no LFS unemployment figure but the other two economies' example reflects that the number of registered unemployed persons is not equal to those who are really not employed anywhere. According to some estimation, the real unemployment rate is approximately the half of the registered one. Naturally, it reflects the high share of informal sector in these economies. On the other hand, the difference between registered and LFS unemployment rate is partly due to the fact that there is a large amount of persons who are registered as unemployed to benefit from social security system but they are not seeking work at all.

Regarding the average gross monthly wages in the region, there are significant differences among the countries. Wages are the highest in Croatia where wage level (EUR 870) is similar to or even higher than that of the NMS countries. Majority of the Western Balkan countries (Bosnia-Herzegovina, the former Yugoslav Republic and Serbia and Montenegro) form the second group where the average gross monthly wages are between EUR 300 and EUR 400, while Albania, Bulgaria and Romania are in the third group with less than EUR 300. Obviously, these seven countries are not exactly competitors of each other since their developments are not the same. Naturally, Croatia and Albania will not compete for the same foreign investors. However, the wage levels in Bulgaria and Romania are relatively lower than that of the second group (the three Western-Balkan countries), thus, the two EU candidates are relatively more attractive considering the wage levels and productivities.

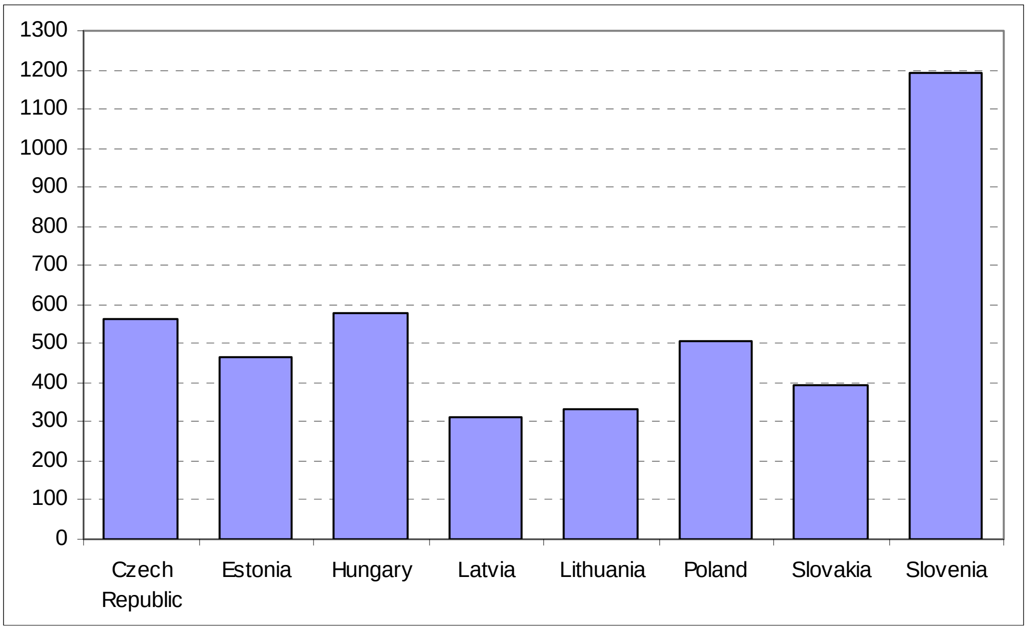
Graph 8. - Average gross monthly wages in SEE countries (2005 June/July)



Source: national statistics institutes; * 2004 figures

In terms of average gross monthly wages the NMS-8 countries are far less attractive than the SEE states (not counting Croatia). Here we can also make three groups. The first one contains only one country, Slovenia, with a wage level of almost EUR 1200. The second group of NMS-8 countries consists of Hungary, the Czech Republic, Poland and Estonia, with average gross monthly wages falling in the EUR 400-600 range. The third group (consisting of Latvia, Lithuania and Slovakia), with average gross wages between EUR 300-400 per month, can only compete in this respect with the Western Balkan countries, but not with the low wage level EU candidates, Bulgaria and Romania.

Graph 9. - Average gross monthly wages in NMS-8 (2004)



Source: WIIW

Minimum wages in the SEE countries (excluding Croatia) are significantly lower then in the NMS8. The minimum wage in Latvia, the country with the lowest minimum wage in the latter group is almost 25% higher than in Romania, where the minimum wage is around the average of the SEE states. Average minimum wages of SEE countries (not counting Croatia) match the minimum wages experienced seven years earlier in Hungary.

TABLE 3. - MINIMUM WAGES (IN EUROS)

Minimum wages	
Southeast European Countries	
Albania	86
Bulgaria	77
Croatia	285
Romania	91
Serbia	73
New Member States	
Czech Republic	238
Estonia	172
Hungary	232
Latvia	121
Lithuania	159
Poland	208
Slovakia	163
Slovenia	514

Source: Federation of European Employers

The World Bank's Doing Business and the World Economic Forum (WEF) Growth Competitiveness Index (GCI) are synthetic indices. The Doing Business index indicates the quality of the business environment of a country, while the GCI contains information about competitiveness. With the exception of Bulgaria, all the SEE countries rank behind the worst ranking NMS-8 country (Slovenia) with respect to the Doing Business index. However, in the GCI ranks all SEE countries are behind the NMS-8. Among SEE countries Bulgaria occupies the most favourable place in case of both indices.

TABLE 4. – RANKINGS OF THE SEE COUNTRIES AND NMS

	Doing Business	GCI
	Southeast European Countries	
Albania	117	100
Bosnia-Herzegovina	87	95
Bulgaria	62	58
Croatia	118	62
FYR Macedonia	81	85
Romania	78	67
Serbia & Montenegro	92	80
	New Member States	
Czech Republic	41	38
Estonia	16	20
Hungary	52	39
Latvia	26	44
Lithuania	15	43
Poland	54	51
Slovakia	37	41
Slovenia	63	32

Source: World Bank Doing Business, WEF Competitiveness Index

It is not surprising that the ranks of the SEE countries are lower than that of the New Member States, however, it is worth examining the improvement in the positions that these countries made. In the last years several SEE countries were able to improve their rank year by year. Their business climate improved significantly in the last few years and the FDI inflows also increased dynamically. In conclusion, we can state that several countries in the SEE region will become competitors of the NMS, not in short term but rather in medium or long term.