

## Articles

# Law and the Regulation of Foreign Direct Investment: The Experience from Central and Eastern Europe

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*Foreign direct investment can play a key role in stimulating the economies of developing states. The effect of the domestic legal regime on foreign direct investment is often neglected. Using the states of Central and Eastern Europe as examples, this Article analyzes the ways in which domestic legal regimes have affected foreign direct investment. The authors argue that legal rules influence investment by affecting factor prices, transaction costs, and the allocation of risk in developing economies.*

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## I. INTRODUCTION

Five years ago private enterprise was scarce if not actually illegal in many of the Central and Eastern European (CEE) states.<sup>1</sup> Isolated behind regulations imposed by their communist governments and Western bans on trade, these states were largely cut off from the world economy. Rarely in economic history have changes been as rapid and dramatic as those which have occurred in the CEE states since 1989.

One of the most remarkable developments during this period has been the opening of the region to foreign direct investment (FDI).<sup>2</sup> Foreign investment in CEE states climbed from minuscule amounts in 1989 to almost \$10 billion by the end of 1993.<sup>3</sup> Legal reform has been central to this process. All CEE states have enacted new laws on foreign investment as well as legislation in related areas such as company law, taxation, and bankruptcy law.<sup>4</sup>

After briefly outlining the importance of foreign investment to the region, this paper describes the efforts at legal reform in CEE countries and attempts to assess their impact on investor motivation to commit to foreign investment. All of the countries have made major strides in opening their economies and establishing a supportive legal framework for FDI. They now need to concentrate on deeper institutional reforms in the domestic legal environment that will allow them to dismantle FDI legal "enclaves" and thus put foreign and

1. For purposes of this article, the states of Central and Eastern Europe include Bulgaria, the Czech Republic, Hungary, Poland, Romania and Slovakia.

2. All discussion of foreign investment in this paper refers to foreign direct (as opposed to portfolio) investment. Direct investment generally involves a measure of direct control through outright ownership of assets or the control of a majority share of outstanding stock.

3. BANK OF INTERNATIONAL SETTLEMENTS, 63RD ANNUAL REPORT 90 (1993); 44 ECONOMIC COMMISSION FOR EUROPE, ECONOMIC BULLETIN FOR EUROPE at 97, U.N. Sales No. E.93.II.E.2 (1992); THE WORLD BANK, unpublished data on file at the World Bank.

4. Czechoslovakia, for example, passed a new Commercial Code, effective January 1, 1992. Act No. 513/1991, The Czechoslovakia Commercial Code of 1991, *reprinted in English in* DAVID E. BIRENBAUM, 2 BUSINESS VENTURES IN EASTERN EUROPE AND RUSSIA, app. C-1.1 (2nd ed. 1992) [hereinafter Czech Commercial Code]. The Czech Foreign Exchange Act covers foreign exchange, including regulations on profit repatriation. Act 528/1990, Coll. on Foreign Exchange, *reprinted in English in id.* at app. C-6 [hereinafter Czech Foreign Exchange Act]. The Czech Law on Bankruptcy and Settlement sets out basic regulations for bankruptcy. Act 328/1992, Law on Bankruptcy and Settlement of July 11, 1991, *reprinted in English in* CENTRAL & EASTERN EUROPEAN LEGAL MATERIALS, binder 2 (Czechoslovakia), § Corporate Law.

domestic investors on an equal footing. The paper concentrates on the role of foreign investment law *per se*, although reference may occasionally be made to other aspects of the legal framework that apply to both domestic and foreign investors.<sup>5</sup>

## II. THE IMPORTANCE OF FOREIGN INVESTMENT TO THE REGION

A report issued in 1992 by the United Nations Centre on Transnational Corporations labeled transnational corporations and the investments they make as "engines of growth."<sup>6</sup> In the second half of the 1980's, foreign investment worldwide grew three times faster than domestic output, and for many countries it is a stronger tie to the world economy than trade.<sup>7</sup> In 1991, over 37,000 transnational corporations invested approximately \$149 billion in the world economy.<sup>8</sup> Developing and transitional countries, including the CEE states, captured about 26% of this—some \$39 billion.<sup>9</sup> By 1992, transnational corporations had raised the cumulative global stock of foreign direct investment to roughly \$2 trillion. The global flow of investment in 1992 alone was approximately \$180 billion.<sup>10</sup>

5. For a survey of underlying legal frameworks for private sector development in CEE, see Cheryl W. Gray et al., *The Legal Framework for Private Sector Development in a Transitional Economy: The Case of Poland*, 22 GA. J. INT'L & COMP. L. 283 (1992); Cheryl W. Gray et al., *Romania's Evolving Legal Framework for Private Sector Development*, 7 AM. U. J. INT'L L. & POL'Y 617 (1992); Cheryl W. Gray & Franjo D. Süblar, *The Evolving Legal Framework for Private Sector Activity in Slovenia*, 14 U. PA. J. INT'L BUS. L. 119 (1993); Cheryl W. Gray & Peter G. Ianachkov, *Bulgaria's Evolving Legal Framework for Private Sector Development*, 27 INT'L LAW. 1091 (1993); Cheryl W. Gray, Rebecca J. Hanson & Michael Heller, *Hungarian Legal Reform for the Private Sector*, 26 GEO. WASH. J. INT'L L. & ECON. 293 (1992); Cheryl W. Gray, *The Legal Framework for Private Sector Activity in the Czech Republic*, 26 VAND. J. TRANSNAT'L L. 271 (1993).

6. U.N. DEP'T OF ECON. & SOCIAL DEVELOPMENT, TRANSNATIONAL CORPORATIONS AND MANAGEMENT DIVISION, WORLD INVESTMENT REPORT 1992: TRANSNATIONAL CORPORATIONS AS ENGINES OF GROWTH at 4, U.N. Doc. ST/CTC/130, U.N. Sales No. E.92.II.A.19 (1992).

7. *Id.* at 1, 2.

8. U.N. CONFERENCE ON TRADE AND DEVELOPMENT, PROGRAMME ON TRANSNATIONAL CORPORATIONS, PROGRAMME ON TRANSNATIONAL CORPORATIONS, WORLD INVESTMENT REPORT 1993: TRANSNATIONAL CORPORATIONS AND INTEGRATED INTERNATIONAL PRODUCTION at 1, 45, U.N. Doc. ST/CTC/156, U.N. Sales No. E.93.II.A.14 (1993).

9. *Id.* at 45, 56.

10. *Id.* at 1, 13. The economic literature measures FDI in a variety of ways. FDI can be measured as both an annual flow into the host country, and as the stock of foreign investment to date—i.e. the sum of yearly flows. In addition, some sources measure flows amounts committed by a foreign investor, while other sources measure actual flows received by the host. This article will use both flows and stocks.

Figure 1 illustrates the changing nature of FDI in the late 1980's and early 1990's.<sup>11</sup> First, it is important to note that while the vast majority of FDI occurs between the industrialized nations, flows have slowly been increasing to the developing regions of Asia, Latin America and Eastern Europe. Second, while the growth of investment in the CEE states has been impressive, the absolute size of the flows is still relatively small.

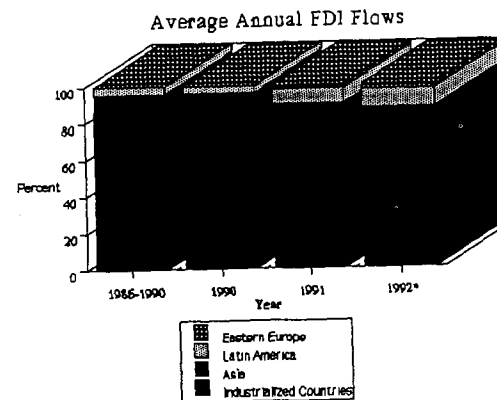


Figure 1

Since abandoning central planning and turning toward market based economies in 1989, the CEE countries have sought the capital, technology, and management skills offered by foreign investors. Foreign investment in CEE countries has grown from insignificant levels, and now constitutes about 7.5% of total FDI flows to developing and transitional countries. (Figure 1).<sup>12</sup> Recent figures, although quite rough, show steady growth in both the number of direct investments and their cumulative value across the region.<sup>13</sup> Hungary has emerged as the leader among the CEE countries both in total FDI and FDI per capita. (Figures 2 and 3).<sup>14</sup> Several studies forecast that, in the 1990's, the countries of CEE and the former

11. BANK OF INTERNATIONAL SETTLEMENTS, *supra* note 3, at 90.

12. *Id.*

13. It is very difficult to obtain accurate data on foreign investment commitments and flows. Data are not readily comparable across countries because of different accounting methodologies and even within a single country different sources give highly variable figures. Figures 2-4 show the authors' best estimates, compiled from various sources. They should be treated as rough indicators only.

14. ECONOMIC COMMISSION FOR EUROPE, *supra* note 3, at 97.

Soviet Union (FSU) could attract as much as \$75-100 billion in foreign investment.<sup>15</sup>

Despite this auspicious entry into the world economy, the level of foreign investment in the CEE region is only a tiny fraction of what is needed to turn around CEE economies, which until recently were suffering from a production decline that surpassed that of the industrialized countries during the great depression of 1928-32. Substantially more foreign capital is needed to finance privatization and restructuring of state owned enterprises. For example, Jaroslav Prochazka, the former director of foreign relations at the Ministry of Industry of the Czech and Slovak Federal Republic (CSFR),<sup>16</sup> estimated that restructuring in 1992 alone would require between \$1.8 billion and \$US 2.2 billion, and that domestic sources could cover only 40% of the total.<sup>17</sup> 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."<sup>18</sup> In 1992, the Russian Deputy Prime Minister, Alexander Shokhin,<sup>19</sup> declared that the Russian government would seek \$5 billion in foreign investment by mid-1995. That amount is more than double the total foreign investment in Russia from 1987 to 1992,<sup>20</sup> but it is very little in the context of Russia's great need for restructuring and new investment. In comparison, in the first two years after reunification, Germany poured over \$100 billion into its eastern half.<sup>21</sup>

While the need for foreign investment is up sharply in CEE and the FSU, it has become more difficult to attract such investment for two reasons. First, while absolute flows of foreign investment continue to grow, the sluggish economic growth in the United States, Japan, and Western Europe in the early 1990's caused the rate of increase of such investment to fall. In 1991, total flows declined for the first time since 1982.<sup>22</sup> Increases in direct investment by Japanese corporations provided much of the growth in foreign

15. U.N. DEP'T OF ECON. & SOCIAL DEVELOPMENT, *supra* note 6, at 32.

16. The CSFR split to become two separate countries, the Czech Republic and Slovakia, on January 1, 1993.

17. J. Prochaza, *Unfreezing the Flow of Capital to the Czech Republic*, CENT. EUR., Jul.-Aug. 1992, at 34.

18. *Id.*

19. Shokhin is currently the economics minister, having replaced Yegor Gaidar. David Hearst, *Finance Minister Quits Yeltsin Team*, THE GUARDIAN, Jan. 21, 1994, at 21.

20. Agence France Presse, Jul. 17, 1992, available in Lexis, Nexis Library, NEWS file.

21. L. Gay, *Point of No Return*, THE ATLANTA J. & CONST., May 24, 1992, at G7.

22. U.N. CONFERENCE ON TRADE AND DEVELOPMENT, *supra* note 8, at 13.

investment flows in the 1980's.<sup>23</sup> From 1986 through 1990 Japanese corporations increased their foreign direct investment at an average annual rate of 32%.<sup>24</sup> However, in 1991, Japanese outward flows of FDI fell 36% from the previous year, and in 1992 flows declined an additional 48%.<sup>25</sup>

Second, just as direct investment began to grow more slowly, competition for investment funds increased as a new group of countries attempted to attract FDI. New players, such as Laos and Vietnam in East Asia, India in South Asia, and Cuba in the Caribbean, have revised regulations restricting foreign investment, and opened their economies to increased flows of foreign funds.<sup>26</sup> Moreover, well-established players, such as the countries of the Association of Southeast Asian Nations (ASEAN), have become even more competitive targets of FDI, as their economies continue to expand and their investment climates become even more favorable.<sup>27</sup>

As mentioned above, the strongest magnet for foreign investment in the CEE region has been Hungary, attracting almost one-half of the investment in the region since 1989. But when levels of investment in other successful developing states—such as the special economic zones of China and some of the more recent entrants into the global economy, India and Venezuela—the competition that CEE states face in attracting investment becomes clear. (Figure 1).

23. BANK FOR INTERNATIONAL SETTLEMENTS, 63RD ANNUAL REPORT 90 (1993); U.N. CONFERENCE ON TRADE AND DEVELOPMENT, *supra* note 22, at 16.

24. U.N. CONFERENCE ON TRADE AND DEVELOPMENT, *supra* note 8, at 16.

25. *Id.*

26. Marita Van Oldenborgh, *Riding the Big Pacific Rim Boom*, INT'L BUS., Feb. 1992, at 36-42; F. J. Contractor, *Ownership Pattern of U.S. Joint Ventures Abroad and the Liberalization of Foreign Government Regulations in the 1980's: Evidence from the Benchmark Surveys*, J. INT'L BUS. STUDIES 21, 55-73 (1990); U.N. CENTRE ON TRANSNATIONAL CORPORATIONS, UNCTC CURRENT STUDIES, GOVERNMENT POLICIES AND FOREIGN DIRECT INVESTMENT, at 3, Series A, No. 17, U.N. Doc. ST/CTC/Ser. A/17, U.N. Sales No. E.91.II.A.20 (1991); ERT Working Group North-South, *Survey on Improvements in Investment Conditions in the Developing World*, unpublished draft report, The World Bank, Jan. 12, 1992, at 1 (on file at the World Bank).

27. ERT Working Group North-South, *supra* note 26, at 1.

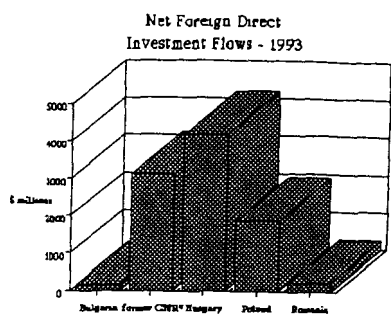


Figure 2

In sum, the CEE countries face a daunting challenge. Their need for foreign capital and know-how to repair their economies and stimulate growth is immense. Yet the expansion of global investment has slowed, and competition for foreign funds, technology and management skills is tighter than ever.

An important question, then, for the CEE states is

what type of legal framework might be most conducive to attracting FDI. However, before turning to the legal framework, we take a brief look at investor motivation, because designing an appropriate legal framework conducive to foreign investment requires a basic understanding of what motivates investors.

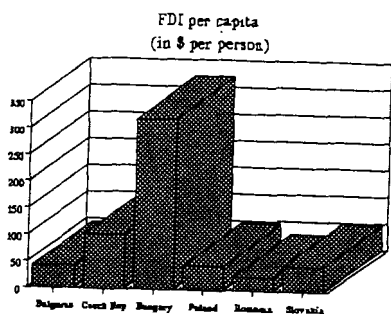


Figure 3

### III. WHY DO FIRMS INVEST ABROAD?

Since the early 19th century and the work of David Ricardo, theoretical explanations of international economics have focused upon trade rather than foreign investment.<sup>28</sup> Starting with Ricardo, the underlying assumption of orthodox international trade theory is that factors of production, labor and capital, are relatively immobile.<sup>29</sup> The static nature of labor and capital gives rise to the notion of nationally based "comparative advantages" in the costs of the production of goods. These comparative advantages are the well-

28. David Ricardo, *On the Principles of Political Economy and Taxation*, cited in John H. Dunning et. al., *The Theory of International Production: Some Historical Antecedents*, in *MULTINATIONALS: THEORY AND HISTORY* 30 (Peter Hertner & Geoffrey Jones eds., 1986).

29. *Id.*

spring of international trade, as countries move to increase their welfare through specialization and the exchange of goods.<sup>30</sup> The classical theory of international trade holds that states will trade those goods that they can produce comparatively more cheaply than can other states,<sup>31</sup> and that comparative advantage stems from differences in factor prices.<sup>32</sup> If states are free to trade, and goods require differing amounts of two stylized factors, capital or labor, patterns will develop in which countries rich in capital, export capital intensive goods, and countries rich in labor, export labor intensive goods.

Contrary to theories of trade, theories of foreign investment depend upon an opposite assumption—that capital in the form of finance, technology, or management skills may move across borders. Foreign trade and foreign investment are really alternative decisions taken by firms. The theoretical problem is to discover the factors which cause a firm in one case to manufacture at home and export to foreign markets, yet in another case to invest abroad in the construction of new facilities to manufacture in those same markets.<sup>33</sup> Why do firms choose to invest instead of trade? Despite patterns of international production which extend back to the end of the 19th century, theoretical studies of foreign direct investment are relatively recent.<sup>34</sup>

Modern direct investment theory holds that under certain conditions multinational firms possess advantages over their domestic

30. See generally RICHARD E. CAVES & RONALD W. JONES, *WORLD TRADE AND PAYMENTS: AN INTRODUCTION* (6th ed. 1993); DELBERT A. SNIDER, *AN INTRODUCTION TO INTERNATIONAL ECONOMICS* 19 (1979).

31. CHARLES P. KINDLEBERGER, *FOREIGN TRADE AND THE NATIONAL ECONOMY* 26 (1962).

32. The classical theory of trade based upon differences in factor prices has come to be known as the Heckscher-Ohlin-Samuelson model. See E.F. Heckscher, *The Effect of Foreign Trade on the Distribution of Income*, *ECONOMIST*, 1919, at 497-512; Ohlin, W.F. Stolper & P.A. Samuelson, *Protection and Real Wages*, *REV. OF ECON. STUD.*, 1941, at 58-73.

33. Mark Casson, *General Theories of the Multinational Enterprise: Their Relevance to Business History*, in *MULTINATIONALS: THEORY AND HISTORY*, *supra* note 28, at 43.

34. The pathbreaking study of Raymond Vernon is considered a classic in the field. See Raymond Vernon, *International Trade and International Investment in the Product Cycle*, 80 *Q. J. OF ECON.*, 190-207 (1966). But see John H. Dunning et al., *The Theory of International Production: Some Historical Antecedents*, in *MULTINATIONALS: THEORY AND HISTORY* 19, 19-41, *supra* note 28 (arguing that modern theories of international production contain insights which can be traced back to 19th century economics). For a useful historical overview of American multinational business, see MIRA WILKINS, *THE EMERGENCE OF MULTINATIONAL ENTERPRISE: AMERICAN BUSINESS ABROAD FROM THE COLONIAL ERA TO 1914* 3-32 (1970); MIRA WILKINS, *THE MATURING OF MULTINATIONAL ENTERPRISE: AMERICAN BUSINESS ABROAD FROM 1914 TO 1970* 3-45 (1974).

rivals that exceed the additional costs of foreign investment and that make the multinational firms the cheapest producer.<sup>35</sup> John Dunning argues that these advantages can be separated into two broad classes: location advantages and ownership advantages.<sup>36</sup> Location advantages involve those factors which reduce the cost of organizing production in a host country relative to the costs of exporting the product from the home country of the investor.<sup>37</sup> A common explanation for foreign investment—lower wage costs in other countries—is a form of location advantage, as are lower transport costs and generally favorable tax and regulatory regimes.<sup>38</sup>

An investment in 1991 in Poland by the American firm Gerber provides an example of a CEE “locational” advantage. The Gerber division of H.J. Heinz committed \$25 million to acquire a 60% stake in Alima SA, a leading baby food and fruit juice maker in Poland.<sup>39</sup> Alima was an attractive target for investment because of its relatively modern machinery and its location near suppliers of fruit and packaging and near growing markets (in CEE as well as Western Europe). According to one analyst, purchasing Alima and shipping throughout Europe costs Gerber one-tenth as much as attempting to service the European market from plants in the United States.<sup>40</sup>

Location advantages help explain why a firm chooses state A over state B as the site for a new factory, but not why the firm from state A can outcompete the indigenous firms from state B. After all, they are both subject to the same general factor prices. Theories of

35. See RICHARD E. CAVES, *MULTINATIONAL ENTERPRISE AND ECONOMIC ANALYSIS* 36-45 (1983); John H. Dunning, *The Determinants of International Production*, in 25 OXFORD EC. PAPERS 289 (1973).

36. Dunning, *supra* note 35, at 35. For a broad overview of theories of foreign direct investment, see John Cantwell, *Theories of International Production*, in *THE NATURE OF THE TRANSNATIONAL FIRM* 16, 16-63 (Christos N. Pitelis & Roger Sugden eds., 1991). See also Robert Grosse and Jack N. Behrman, *Theory in International Business*, in *TRANSNAT'L CORP.*, Feb. 1992, at 93-126.

37. Dunning et. al., *supra* note 34, at 20.

38. EMENA TECHNICAL DEPARTMENT, INDUSTRY AND ENERGY DIVISION, *ATTRACTING PRIVATE INVESTMENT*, 1992, at 8 (arguing that survey data shows a general correlation between low taxes and high rates of FDI); *But see* U.N. CENTRE ON TRANSNATIONAL CORPORATIONS, *THE DETERMINANTS OF FOREIGN DIRECT INVESTMENT*, at 42-43, U.N. Doc. ST/CTC/121, U.N. Sales No. E.92.II.A.2 (1992) (arguing that special tax and other fiscal incentives for FDI are rarely determinative of a foreign firm's decision to invest).

39. Tom Redburn, *Eastern Europe Piques Appetite of U.S. Firms*, *INT'L HERALD TRIB.*, Jul. 28, 1992, available in LEXIS, News library, Arcnws file; Bill Vlasic, *Gerber Gobbles Up Big Polish Baby Food Firm*, *DETROIT NEWS*, Oct. 4, 1991, at E-1.

40. Interview with official from Department of Commerce, in Washington D.C., (Jul. 28, 1992) (release of name would be violation of trust).

direct investment utilize ownership advantages to explain this paradox.<sup>41</sup> Ownership advantages generally fall into two categories: intangible assets possessed by the foreign firm that enable it to outcompete its host-country rivals, and internalization advantages.<sup>42</sup> Intangible assets that may lead to an advantage for foreign firms include superior technology, management, and marketing skills. For example, in the mid-1920's, General Motors expanded into Germany by purchasing the leading German manufacturer of automobiles, Opel.<sup>43</sup> The logic behind this expansion appears to have been that the introduction of General Motors' advanced production methods would give the U.S. firm a competitive advantage.<sup>44</sup>

The second category of ownership advantages, internalization advantages, is somewhat more difficult to conceptualize. Domestic firms may have transaction cost advantages over their foreign rivals which lead to foreign investment rather than trade.<sup>45</sup> A firm in state A with a strong distribution system in its home market may be able to provide goods more cheaply by combining manufacturing in state B with domestic distribution. Yet it may still be more efficient for the firm in state A to bring the transactions inside the organization than to contract with suppliers in state B through arms-length trade.<sup>46</sup> Thus, to return to the example of Gerber, it is not just that wage, input, and transport costs are lower in Poland. Polish firms also operate with these same factor prices. Gerber, however, possesses some specific advantages: ownership advantages, in that it has a recognized brand name that differentiates its product, and internalization advantages, in that its combining of manufacturing, marketing and distribution in a single corporate structure lowers costs and increases efficiency.

Modern theories stress that foreign direct investment must be explained as one of several possible courses of action. Direct investment is not always efficient. Where location or ownership advantages cannot be asserted, firms may turn to trade or licensing to increase their profits.<sup>47</sup>

41. Dunning et. al., *supra* note 34, at 20.

42. *Id.*

43. WILKINS, *MATURING OF THE MULTINATIONAL: AMERICAN BUSINESS ABROAD FROM 1914 TO 1970*, *supra* note 34, at 73.

44. *Id.* at 74, 75.

45. See Jean-François Hennart, *The Transaction Cost Theory of the Multinational Enterprise*, in *THE NATURE OF THE TRANSNATIONAL FIRM*, *supra* note 36, at 81-115.

46. Casson, *supra* note 33, at 44.

47. Wilkins notes that, in the 1920's, Coca-Cola abandoned direct investment in

#### IV. THE EFFECT OF LEGAL RULES ON THE INVESTMENT DECISIONS OF FOREIGN FIRMS

In recent years, there has been a renewed interest in the economics of growth and the relationships between growth and government policies.<sup>48</sup> A nation's legal system is in large part a reflection of government policy. As such, a legal system can alter the incentives of foreign investors in three ways: it can alter factor prices; it can alter transaction costs; and it can determine the types and amounts of risks that investors must bear. Legal systems that raise factor prices, increase transaction costs, or force foreign investors to bear risk discourage flows of foreign direct investment by hampering location or ownership advantages. This article will examine each of these factors individually.

##### A. Factor Prices

As noted above, basic theories of foreign investment suggest that a significant motivation behind foreign investment is the search for lower factor prices.<sup>49</sup> Factor prices are the price of capital, labor, or technology and can be positively or negatively affected by the background rules embedded in the legal system. For example, the real costs of labor to a foreign investor in a country in which the hourly wage rate is comparatively low may actually be significantly higher due to legal rules that place limits on the employer's ability to hire or fire workers or that require significant tax contributions to employee welfare programs.

Similarly, the cost of capital to a foreign investor is raised in countries in which the capitalization requirements necessary to form a domestic corporation are relatively high, or in countries with high corporate tax rates. The cost of capital inputs in the form of technology will also differ across countries with different legal systems. If intellectual property is not sufficiently protected by patent or copyright law, the cost to foreign investors of supplying technology may increase. The impact of the legal regime upon factor prices

manufacturing soft drinks in France in favor of licensing the process to French firms. Apparently the location and ownership advantages were insufficient to sustain the greater costs of direct investment. WILKINS, *THE MATURING OF MULTINATIONAL ENTERPRISE: AMERICAN BUSINESS ABROAD FROM 1914 TO 1970*, *supra* note 34, at 51.

48. Robert E. Lucas, Jr., *On the Mechanics of Economic Development*, 22 J. MONETARY ECON. 3-42 (1988). For an analysis of the role of government policy, see U.N. CENTRE ON TRANSNATIONAL CORPORATIONS, *supra* note 26.

49. See *supra* note 32 and accompanying text.

is fairly obvious, and despite its importance we will not devote a great deal of time to its analysis.

##### B. Transaction Costs

Factor costs are not the only costs which influence flows of FDI. Transaction costs are also an important determinant. According to Thrainn Eggertsson, "transaction costs are the costs that arise when individuals exchange ownership rights to economic assets and enforce their exclusive rights."<sup>50</sup> Much of the commercial law in developed countries has been created to reduce transaction costs by defining and enforcing property rights and by creating a system of binding contracts.<sup>51</sup> States that fail to create these legal underpinnings for exchange raise the cost of transacting and the cost of FDI.

Transaction costs fall into two broad categories: *ex ante* and *ex post*.<sup>52</sup> *Ex ante* transaction costs, the costs associated with setting up the venture, include negotiation costs and all of the costs incurred in obtaining government approval for the transaction.<sup>53</sup> Where the legal system requires a procedure of registration and licensing for foreign investment, the costs of shepherding an investment through a tangle of government bureaucracy can be significant and can discourage firms from entering the market. *Ex post* costs arise in policing the original agreement and settling disputes. Legal regimes with established rules for enforcing contracts deter opportunistic behavior and reduce *ex post* transaction costs.

##### C. Risk Allocation

In addition to influencing factor prices and transaction costs, legal regimes can also raise or lower the costs of foreign investment by determining the types and degree of risk that the foreign investor must bear. Often the issue of risk allocation is quite obvious. For example, one issue that has arisen repeatedly in the CEE states is to

50. THRAINN EGGERTSSON, *ECONOMIC BEHAVIOR AND INSTITUTIONS* 14 (1990). For the classic discussion of transaction costs see Ronald H. Coase, *The Economics of the Firm*, 4 *ECONOMICA* 386-405 (1937). See also Carl J. Dahlman, *The Problem of Externality*, 22 *J. OF LEGAL STUD.* 141-62.

51. ROBERT COOTER AND THOMAS ULEN, *LAW AND ECONOMICS* 94-116, 228-33 (1988).

52. R.C.O. Matthews, *The Economics of Institutions and the Sources of Growth*, 96 *ECON. J.* 906 (1986); OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* 20-22 (1985).

53. WILLIAMSON, *supra* note 52, at 20.

what degree foreign investors should be liable for as-yet-unidentified environmental damage caused by the previous owners of newly acquired firms.<sup>54</sup>

Risk allocation problems, however, can be much more subtle. Commercial law in the developed economies has created a wide variety of institutional structures that attempt to allocate risk. The limited liability joint-stock corporation is the most basic legal structure. Many areas of the law are relevant to an allocation of risk. Contract law, the law of secured transactions, bankruptcy law, anti-trust, and tort law all influence the allocation of risk between foreign investors, host-country partners and governments, and the public in the host country. The interplay between these areas of law must be taken into account when planning FDI. Of course, these different areas of the law intersect, and, when planning FDI, one must take into account the interplay between these rules. An ambiguous or uncertain regime of contract enforcement subjects foreign investors to the risk of counter-party default in any transaction within the host country. A foreign investor in manufacturing machinery, for example, bears the risk that host country suppliers may default on their agreements to supply basic inputs. To reduce these transaction costs caused by an uncertain contracting regime, the foreign investor may attempt to organize hierarchically and integrate production backward to include basic inputs. If, however, the host country legal regime contains strict antitrust provisions, the foreign investor may be forced to bear the costs of an increased risk of default or forego investment altogether.

## V. LEGISLATING FOR FOREIGN INVESTMENT

Prior to the first World War and continuing until the great depression of the 1930's, foreign investment was a prominent feature of the regional CEE economy.<sup>55</sup> The legal codes in these countries generally supported foreign investment by keeping the real costs of factor prices undistorted, and by lowering both transaction costs and

54. John Lindquist and Charbel Anderson of the Boston Consulting Group argue that uncertainty over environmental liability is responsible for the relatively low level of foreign investment in the CEE chemical industry. Charbel Ackermann and John Lindquist, *Acquiring in Eastern Europe: The Record to Date*, M & A EUROPE, May/June 1992, at 40. See also Judy Dempsey, *Inheriting the Earth—Western Investors Moving to Eastern Europe May Face Environmental Liability*, FIN. TIMES, Mar. 18, 1992, at 12.

55. Rudolf Nötel, *International Credit and Finance*, in THE ECONOMIC HISTORY OF EASTERN EUROPE II, 1919-1975 170-295 (M.C. Kaser, ed., 1985); ZBIGNIEW DOBOSIEWICZ, FOREIGN INVESTMENT IN EASTERN EUROPE 20 (1992).

the degree of risk which foreign investors had to bear.<sup>56</sup> As a result, many of the major industries in the region were built by foreign entrepreneurs.<sup>57</sup> The communist governments that came to power after the second World War effectively limited foreign involvement in the region's economies to co-production agreements or the purchase of turn-key manufacturing plants.<sup>58</sup> By the end of the 1970's, there was an awareness throughout the Eastern bloc that the technology gap with the West was growing larger, and that the old methods of purchasing technology—rather than opening their doors to foreign investment—were not effectively raising the technological level in the region.<sup>59</sup> Trade was viewed as an ineffective method of transferring technology and the skills necessary to use it efficiently. As a consequence, an interest in attracting foreign direct investment began to surface. In 1971, Romania began to change its regulations governing foreign investment in the hope of attracting technological change.<sup>60</sup> Other CEE states slowly followed suit, but given restrictions on foreign ownership, lack of currency convertability, and a host of other roadblocks, Western investment remained negligible through the 1980's.<sup>61</sup>

56. In CEE, many old laws that technically governed foreign investment remained on the books throughout the Communist period, although they were overruled or replaced in practice by government decrees and regulations. In the post-communist period many of these old laws have come back to life. The commercial code of Poland, for example, is basically the law of the 1930s. ROMAN FRYDMAN ET. AL., THE PRIVATIZATION PROCESS IN CENTRAL EUROPE 158, 163 (1993).

57. Foreign investment was especially significant in the core industries of metallurgy, power generation, and mining. *Id.* at 282. For example, in Poland, the U.S. based firms Jersey Standard and the Anaconda Corporation owned investments in petroleum refining and coal production, respectively. WILKINS, THE MATURING OF MULTINATIONAL ENTERPRISE, *supra* note 34, at 85, 107.

58. DOBOSIEWICZ, *supra* note 55, at 21; Philip Hanson, *The Soviet System as a Recipient of Foreign Technology*, in INDUSTRIAL INNOVATION IN THE SOVIET UNION 415-52 (Ronald Amann & Julian Cooper eds., 1982). Hanson argues that even when foreign technology was licensed, it tended to be several years after the technology had been utilized by other Western firms. Hanson, *supra*, at 424.

59. Kazimierz Poznanski, *The Environment for Technological Change in Centrally Planned Economies*, WORLD BANK WORKING PAPER No. 718 (The World Bank, Washington D.C.), 1990, at 4-28. In 1980 the number of computers in all of Eastern Europe was estimated at 8,000, while Brazil possessed approximately 10,000 systems. *Id.* at 44.

60. DAVID GRANNICK, ENTERPRISE GUIDANCE IN EASTERN EUROPE 79 (1975); DOBOSIEWICZ, *supra* note 55, at 24.

61. Hungary first allowed FDI in 1972. DOBOSIEWICZ, *supra* note 55, at 42. The Polish government issued a decree in 1976 which allowed foreign nationals of Polish ancestry to open small businesses. *Id.* at 45. Bulgaria first permitted FDI in 1980. *Id.* at 49. The Czech government did not allow FDI until 1986 and only permitted direct investment through joint ventures. *Id.* at 46. Although some FDI no doubt took place, the Bank of International Settlements records no foreign investment in Eastern Europe until

After the dissolution of communist power in 1989, these states began to change their investment climates in a concerted effort to attract foreign investment.<sup>62</sup> Nonetheless, political constraints continued to exist. At the beginning of the post-communist period, the CEE legal regimes governing foreign investment had a somewhat schizophrenic quality. Leaders were keenly aware of the need for investment, yet they had to remain sensitive to political charges of "selling out" to foreigners.

On a state visit to Britain in the spring of 1991, Lech Walesa, President of Poland, sought to drum up investment.<sup>63</sup> In an interview with the Financial Times he said: "You in the West have over-production. You can make money out of our shortages and our stupidity—and we have plenty of that. . . Come and set up a factory here. Make money."<sup>64</sup> Yet, as encouraging as Walesa's remarks sounded, the Polish investment law in force at that time allowed foreign enterprises to repatriate only 15% of the profits they earned in Poland.<sup>65</sup> The remaining 85% of the profits had to remain in Poland, and thus were unavailable to the parent company for multinational investment or dividend payments.<sup>66</sup>

Even as Gross Domestic Product (GDP) levels continued to decline across the region in 1992 and 1993, foreign investment remained a target for some opposition politicians. For example, although the Czech and Slovak Federal Republic pushed ahead with legal reforms and attracted reasonable amounts of investment in 1991 and 1992, Zbynek Kozel, deputy international secretary of the Social Democratic Party, charged in 1992 that foreign investment was "a dangerous sellout."<sup>67</sup>

Much of the anti-foreign sentiment which surfaces from time to time in the CEE states has resulted from the separate and often privileged treatment that has been granted to foreign investors.<sup>68</sup>

1986. BIS ANNUAL REPORT, 90 (1993). Dobosiewicz notes that in 1988, total foreign investment in Eastern Europe was still under \$1 billion. DOBOSIEWICZ, *supra* note 55, at 24.

62. FRYDMAN ET. AL., *supra* note 56, at 12, 50, 107-08, 158-59, 219-20.

63. *Visionary Seeks an Equal Chance*, FIN. TIMES, Apr. 23, 1991, at 19.

64. *Id.*

65. United Nations Economic Commission for Europe, *Law on Companies with Foreign Participation*, 14 June 1991, 9 EAST-WEST JOINT VENTURE NEWS 5 (Oct. 1991).

66. Gray et. al., *The Case of Poland*, *supra* note 5, at 17.

67. Robert Cohen, *Czechoslovakia's Wall Street Brigade*, N.Y. TIMES, June 21, 1992, at D1.

68. For example, the Hungarian government's decision to ease import duties for the Ford Motor Company sparked protests from Hungarian importers and charges by the director

Recognizing that inadequate legal regimes can deter foreign investment by distorting factor prices, increasing transaction costs, and increasing the risks borne by foreign investors, the reform governments have created different rules for foreign investors than for domestic investors, resulting in an "enclave" of special legislation.<sup>69</sup>

The enclave typically serves at least three purposes. First, it provides an important information—or "signaling"—function to potential investors by showing that the government is serious in its efforts to create a market based economy. Second, it provides a limited sphere in which legal development can proceed more rapidly, and thus bypass many of the hurdles to legal and institutional development in the economy at large. Third, in recognition of the costs the present institutional structure may impose on foreign investors, an enclave allows for incentives targeted at foreign investors to offset such costs. All three purposes apply also in developing countries to some extent. However, the rationale for such measures is particularly strong in the CEE context, because of the magnitude of the systemic changes required to meet the needs of foreign investors.

Yet while these purposes may be valid, the enclave approach entails major costs for the host country, as discussed later, that must be weighed against its benefits. It may discriminate against domestic investors, retard the development of domestic institutions, and create a political backlash. The sooner a country can move to dismantle the enclave, address the fundamental institutional weaknesses that increase investment costs, and provide equal treatment for domestic and foreign investors, the better. Two ways to dismantle the enclave and to address these institutional weaknesses are to convince foreign investors of the security of their investment and to develop a separate legal framework for foreign investors.

of the government's competition office that customs regulations had been drafted to meet Ford's needs. See *Government Begins Investigation of Alleged Favoritism Toward Ford*, 1 Eastern Eur. Reporter (BNA), at 552-52 (July 6, 1992). The Hungarian government continues to face accusations of "giving away" domestic industries to foreign investors. *Hungary: Privatisation as Politics*, EAST EUROPEAN MARKETS, Mar. 4, 1994, available in LEXIS, News Library, EEM File.

69. The laws favoring foreign investment are found in separate foreign investment legislation in most countries. For a review of the pertinent legislation, see BUSINESS VENTURES IN EASTERN EUROPE AND THE SOVIET UNION: THE EMERGING LEGAL FRAMEWORK FOR FOREIGN INVESTMENT (P-H) § 3.04 (1990) (the Hungarian foreign investment regime) [hereinafter BUSINESS VENTURES]; *id.* § 4.03 (the Polish foreign investment regime); *id.* § 5.04[b] (the Czech foreign investment regime). See also Cheryl W. Gray, Rebecca J. Hanson and Peter G. Ianachkov, *supra* note 5, at 638 (the Rumanian foreign investment regime).

## A. Signaling Potential Investors

A valuable and often overlooked function of a special law for foreign investment is to send a strong, positive signal to potential investors. The passage of clear and supportive foreign investment legislation conveys the message that investment is welcome.<sup>70</sup> Recognizing the important signaling effects of changes in the legal regime governing foreign investment, all of the CEE countries took steps early in the transition to communicate the security of foreign investment to potential investors. New or amended foreign investment laws, changes in the tax regimes applicable to foreigners, and bilateral investment treaties with investors' home countries soon followed.<sup>71</sup>

It does appear that the passage of legislation which shows that the government is serious about encouraging and protecting investment is an important first step toward attracting FDI.<sup>72</sup> Foreign entrepreneurs recognize the risk inherent in investing in any reforming economy, yet they also recognize, as one businessman noted, that "if you wait for the risk to disappear, the opportunity will also disappear."<sup>73</sup>

70. For an example of the importance investors place upon legal guarantees, see Dirk W. Damrau and John F.H. Purcell, *Discovering Investment Opportunities in Eastern Europe: A Framework*, Salomon Brothers, Sovereign Assessment Group, 1990, at 16-17 (on file with authors).

71. See Law on Economic Activity of Foreign Persons and on the Protection of Foreign Investment (1992) (Bulg.), *discussed in* Gray and Ianachkov, *supra* note 5, at 1103 [hereinafter Bulgarian Foreign Investment Law]; The Commercial Code No. 513/1991, part II, ch. III, § 25 (Czech.) (mandating full compensation for expropriation), *translated in* BUSINESS VENTURES, *supra* note 69, at app. C.-1.3-1.4; Investment by Non-Residents in Hungary Law XXIV/1988, ch. I, art 1, cl. 2 (Hung.) [hereinafter Hungarian Foreign Investment Law] (full compensation in the event of expropriation or nationalization), *translated in* BUSINESS VENTURES, *supra* note 69 at app. H-1.1; Law on Companies with Foreign Participation, ch. 3, art. 22 (1991) (Pol.) (full compensation in the event of expropriation), *translated in* BUSINESS VENTURES, *supra* note 69 at app. P-1.9; Law Concerning Foreign Investments No.35/1991 (Rom.), *discussed in* Gray, Hanson and Ianachkov, *supra* note 5, at 638 [hereinafter Romanian Foreign Investment Law]; *Senate Ratifies Investment Treaties with Five Nations of Ex-Soviet Bloc*, 3 Eastern Eur. Reporter (BNA) No. 24, at 861 (Nov. 22, 1993) (discussing the United States' bilateral investment treaties with Armenia, Bulgaria, Moldova, Kyrgyzstan, and Romania, which guarantee U.S. investors "the better of most-favored nation or national treatment.")

72. Damrau and Purcell, *supra* note 70, at 16-17.

73. Interview with official from Department of Energy, Washington, D.C. (Aug. 4, 1992) (release of name would be a violation of trust).

## B. Developing the Legal Framework

Interviews with multinational firms consistently indicate that legal uncertainty is a deterrent to investment in the CEE region.<sup>74</sup> Firms are often not familiar with the legal regimes or potential joint venture partners, and getting such information is costly. Thus a second challenge for CEE governments is to quickly provide a predictable legal framework for foreign investors. Reform-minded governments are aware of the costs imposed on foreign investors by inadequate legal structures. The enormity of the task has led them to develop legal and institutional reforms targeted at foreign investors and designed to rationalize factor prices, lower transaction costs, and reduce risk exposure. Despite this first step, firms face continued uncertainty in the broad legal regime governing foreign investment in the region as the laws in many areas remain in flux. Some areas of particular continuing uncertainty include real property rights, such as the rights of former landowners to recover title, the rules on liability for previous environmental damage, and the regulations governing the financial sector.<sup>75</sup>

## 1. Rationalizing Factor Prices

## a. Hiring and Firing Workers

Labor relations are a potentially explosive issue for companies making foreign investments in CEE. Decades of central planning and the lack of hard budget constraints on CEE firms led to significant overstaffing in many cases.<sup>76</sup> Western companies, as either sole owners or joint venture partners, want the freedom to restructure the work force to make these CEE firms competitive in global markets; however, CEE political leaders are concerned that high levels of unemployment will quickly sap support for reform.<sup>77</sup>

74. ENEMA Technical Department, *supra* note 38, at 20 (survey of foreign investors citing lack of legal clarity as a constraint on investment).

75. See *infra* notes 148-164 and accompanying text (discussing changing tax environment); *supra* note 54 (discussing environmental liabilities). On the problems of general corporate control and financial infrastructure, see Roman Frydman et al., *Needed Mechanisms of Corporate Governance and Finance in Eastern Europe*, in 1 ECONOMICS OF TRANSITION 171-207 (1993); Carol Holmes, *Global Strategies in the Transition*, in 1 ECONOMICS OF TRANSITION, *supra*, at 471, 482 (discussing problems of clear title hindering foreign investment).

76. Holmes, *supra* note 75, at 485. For a general overview of the relationship between incentives under socialism and economic performance, see JÁNOS KORNAI, *THE SOCIALIST SYSTEM: THE POLITICAL ECONOMY OF COMMUNISM* (1992).

77. See John Pomfret, *Czech Reform: A Two-Edged Sword; Nation Employing Free*

CEE legislation has not restricted the rights of foreign companies to hire, train, or fire local workers, although foreign firms must comply with existing social security legislation and pay social security taxes defined by statute.<sup>78</sup> In a number of cases, as part of specific privatization agreements, Western companies have committed themselves to a moratorium on reducing the work force in plants they control.<sup>79</sup> Given the sensitivities involved, an *ad hoc* approach developed through privatization negotiations is likely to be preferable to an across-the-board rule.

Foreign subsidiaries often want to hire employees from their home offices to help transfer firm-specific knowledge and techniques, and thus reap specific ownership or internalization advantages. CEE countries have been fairly accommodating to this need, although foreign employees must often pass through a maze of regulations to obtain work permits and find housing.<sup>80</sup> Romania is the only CEE state that specifically restricts the types of positions foreigners can hold.<sup>81</sup> Rumanian law allows foreigners to work only as managers or as other specialized employees.<sup>82</sup>

#### b. Obtaining Rights to Real Property

Rules on land ownership by foreign parties continue to evolve across the region. In Hungary, the Czech Republic, Poland and Slovakia, the general pattern is to prohibit foreign individuals or firms from owning land, but to permit foreign-owned firms incorporated in the host country to own land.<sup>83</sup> In Romania, foreign firms are not

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*Market Benefits, but Tumble Appears Imminent*, WASH. POST, Oct. 30, 1993, at A18 (discussing the risk of "large scale layoffs [as an] . . . inevitable downside of the changes."); Merrill Goozner, *Poland Struggles with Unemployment*, CHI. TRIB., Mar. 25, 1991, at 1.

78. For example, the Bulgarian Foreign Investment Law No. 47/1991, art. 12, cl. 4 (1991), requires that foreign employees working for foreign-owned businesses be insured for "labor incapacitation," and requires that the insurance premium equal at least 20% of the employee's gross monthly salary.

79. Interview with official from International Finance Corporation, Washington, D.C. (July 21, 1992) (release of name would be a violation of trust).

80. For example, if a Czech firm wants to appoint a foreign manager, it must obtain a residence permit from the Ministry of Interior, which in turn requires a police statement showing the clean criminal record, a medical certificate showing the absence of infectious disease, and a signed and notarized lease agreement (and, in the case of a sub-lease, a certificate from the owner that the tenant has the right to sublease).

Gray, *The Legal Framework for Private Sector Activity in the Czech Republic*, *supra* note 5, at 289.

81. Rumanian Foreign Investment Law, *supra* note 71, art. 32.

82. *Id.*

83. See Gray, *The Legal Framework for Private Sector Development in a Transitional*

permitted to own land, but there are indications that this prohibition is short-lived.<sup>84</sup> In Bulgaria, the constitution prohibits foreign citizens and legal persons from owning land.<sup>85</sup> In addition, domestically-incorporated companies in which foreigners have a stake greater than 50% may not own agricultural land, forests or water resources.<sup>86</sup> In the Czech Republic and in Slovakia, foreign citizens domiciled abroad may not own land, but Czech or Slovak business entities, even if wholly foreign-owned, are granted full rights to real property.<sup>87</sup> Prices paid by foreigners must be approved by the Czech or Slovak Ministry of Finance.<sup>88</sup> In Hungary, foreign individuals may own land, but only with the consent of the Ministry of Finance.<sup>89</sup> Wholly or partially foreign-owned firms incorporated under Hungarian law may acquire land for business purposes without restriction or the need for prior approval.<sup>90</sup> In Poland, foreign natural and legal persons are permitted to acquire land upon the approval of the Minister of Internal Affairs.<sup>91</sup> Romania has the tightest restrictions on land ownership. Foreign investors can own real estate, but not land, only if it is "auxiliary to an investment," or if they are partners in a joint venture with a Rumanian company and the Rumanian partner contributes real estate to the joint venture.<sup>92</sup>

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*Economy: The Case of Poland*, *supra* note 5, at 292; Gray, *Hungarian Legal Reform for the Private Sector*, *supra* note 5, at 306-7, 333.

84. Rumanian Foreign Investment Law, *supra* note 71, art. 1(d) (prohibiting land ownership by foreign investors). *But see Rumanian Government Planning Steps to Boost Level of Foreign Investment*, 3 Eastern Eur. Reporter (BNA) No. 23, at 824 (Nov. 8, 1993) (discussing Government plans to reverse its position and end the prohibition on land ownership by foreign investors).

85. DURZHAVEN VESTNIK [Constitution] art. 22 (2) (Bulgaria); see also Michael Wyzan, *Bulgarian Law Lowers Foreign Investment Barriers*, RFE/RL RESEARCH REPORT, v. 1, no. 13, Mar. 27, 1992, at 41-43.

86. Bulgarian Foreign Investment Law, *supra* note 71, Art. 5; see also Wyzan, *supra* note 85, at 42.

87. Czech Foreign Exchange Act, *supra* note 4, art. 25 (prohibiting foreign citizens domiciled abroad from owning land); Czech Commercial Code, *supra* note 4, Art. 21(1) (granting foreign individuals the same commercial rights as Czechoslovak individuals, subject to other laws).

88. Czech Commercial Code, *supra* note 4.

89. 1987 Law on Lands, *cited in* FRYDMAN, ET. AL., *supra* note 56, at 114.

90. Hungarian Foreign Investment Law, *supra* note 71, art. 19 (granting rights to acquire property for business purposes).

91. Law on Land Administration and Real Estate Expropriation (amended December 1990). Frydman, et. al., *supra* note 75, at 168.

92. Rumanian Foreign Investment Law, *supra* note 71, art. 1.

It was initially feared that foreign investment might be obstructed by domestic disputes over property rights,<sup>93</sup> as CEE states passed laws providing for restitution of property to pre-communist-era owners.<sup>94</sup> In most cases, this fear has not materialized. State-led sales of property combined with mass privatizations in some countries are slowly moving to establish a property market and a workable system of property rights,<sup>95</sup> although restrictions, as discussed above, and uncertainties remain.

### c. *Protecting Intellectual Property*

Foreign firms often invest abroad to exploit technological advantages they hold over their rivals. Technology is an asset and a key to competitiveness—a major “ownership” advantage. Investors are less likely to invest in countries that do not safeguard intellectual property, just as they are hesitant to invest where there is a danger of expropriation of physical assets.<sup>96</sup>

Recent reforms in the intellectual property legislation of most CEE countries, taken in part under pressure from the U.S.<sup>97</sup> and

93. Anna Gelpem, *The Laws and Politics of Reprivatization in East-Central Europe*, 15 U. PA. J. INT'L BUS. L. 315, 323 (1993) (citing concern by policy-makers in Eastern Europe that legislation favoring property restitution to dispossessed owners would generate uncertain property rights and discourage foreign investment).

94. Bulgaria, the Czech Republic, Romania and Slovakia have restitution laws in place. Gelpem, *supra* note 99, at 360, notes that Proctor & Gamble's 1991 purchase of the detergent maker Rakona ended up being reviewed by a Czechoslovakian court over charges that the government had sold the firm prior to the deadline for previous owners filing restitution claims. P & G's acquisition was ultimately approved, but the case illustrated the risks to many foreign investors of unsettled property rights.

95. This does not imply that the CEE states have all followed the same path. The substance of the various privatization programs greatly varies. For a useful overview, see Frydman et. al., *supra* note 75.

96. The problem of protecting intellectual property can be significant. According to Waldemar Sielski, the general manager of Microsoft in Poland, the ratio of legal to illegal copies of Microsoft's products in Poland is approximately 1 to 10. *Poland Set to Pass IP Law*, Bus. Eastern Eur. vol. 23, no. 7, at 6 (Feb. 14, 1994). The U.S.-based International Intellectual Property Alliance estimated that in 1992, lax Polish laws caused U.S. firms to lose over \$190 million in royalty payments. *Copyright Law Approved by Sejm, Expected to be Signed by Walesa*, 4 Eastern Eur. Reporter (BNA) No. 2, at 49 (Jan. 17, 1994). According to one survey of investors active in the region, intellectual property protection was a crucial issue in their decision to invest. See Holmes, *supra* note 75, at 482-83.

97. United States Trade Representative Mickey Kantor charged both Poland and Hungary with failing to protect the intellectual property of U.S. investors. *New Copyright Law Finally Takes Effect*, 4 Eastern Eur. Reporter (BNA) No. 12, at 453 (June 6, 1994); *U.S., Hungary Sign Broad Agreement Strengthening Protection of Rights*, Eastern Eur. Reporter (BNA), vol. 3, no. 20, at 699-700 (Sept. 27, 1993). Kantor singled out Hungary's pharmaceutical industry as the “world-wide source of copied pharmaceutical products.” *Id.* at 700.

other Western countries, have generally brought the legal protection of intellectual property up to international norms.<sup>98</sup> Patent protection has typically been extended to previously-excluded products, such as drugs, chemical compounds, and plant or animal varieties.<sup>99</sup> Copyright protection has been extended to computer software.<sup>100</sup> The terms of patent and copyright protection have typically been lengthened to the international norms of 20 and 50 years, respectively.<sup>101</sup> All of the CEE countries are signatories to the major international conventions on intellectual property, including the Paris Convention for the Protection of Industrial Property,<sup>102</sup> the Madrid

98. Hungary's parliament enacted a new law on intellectual property which came into force on July 1, 1994. *Changes to Hungary's IP Law*, 4 Eastern Eur. Reporter (BNA) No. 6, at 244-45 (Mar. 14, 1994). Poland's new copyright law came into effect on May 23, 1994. Eastern Eur. Reporter, *supra* note 97, at 453. In March 1993 new patent legislation came into force in Bulgaria. *New Patent Legislation*, Bus. Eastern Eur., at 7 (May 10, 1993). In addition, a series of bilateral trade agreements and investment agreements between the CEE states and the U.S. offer additional assurances of intellectual property protection to U.S. investors. See Agreement on Trade Relations, U.S.-Bulg., Apr. 22, 1991, reprinted in MICHAEL A. EPSTEIN ET AL., 2 INTERNATIONAL INTELLECTUAL PROPERTY: THE E.C. AND EASTERN EUROPE 18-53 (1991); Agreement on Trade Relations, U.S.-Czech., Apr. 12, 1990, reprinted in EPSTEIN ET AL., *supra*, at 16-101; Treaty Concerning Business and Economic Relations, U.S.-Poland, Mar. 21, 1990, reprinted in EPSTEIN ET AL., *supra*, at 15-73; Agreement on Trade Relations, U.S.-Rom., reprinted in EPSTEIN ET AL., *supra*, at 17-77. The United States has secured additional protection through the negotiation of bilateral investment treaties which commit the signatories to adhere to most major international treaties on intellectual property. Treaty Concerning Business and Economic Relations, U.S.-Pol., Mar. 21, 1990, S. TREATY DOC. NO. 18, 101st Cong., 2d Sess. (1990) [hereinafter Poland BIT]; Treaty Concerning the Encouragement and Reciprocal Protection of Investment, U.S.-Bulg., Sept. 23, 1992, S. TREATY DOC. NO. 3, 103d Cong., 1st Sess. (1993) [hereinafter Bulgaria BIT]. The Czech and Slovak Republic separated into two States, the Czech Republic and the Slovak Republic, effective January 1, 1993, with the result that the Czech and Slovak Republic BIT has been succeeded by two treaties, one with each Republic. Treaty Between the United States of America and the Czech and Slovak Federal Republic Concerning the Reciprocal Encouragement and Protection of Investment, Oct. 22, 1991, S. TREATY DOC. NO. 31, 102d Cong., 2d Sess. (1992) [hereinafter Czech and Slovak BITs]; Treaty Concerning the Reciprocal Encouragement and Protection of Investment, U.S.-Rom., May 28, 1992, S. TREATY DOC. 36, 102d Cong., 2d Sess. (1992) [hereinafter Romania BIT]. Differences between the U.S. and Hungary over issues of intellectual property protection have thus far precluded a bilateral investment treaty with Hungary.

99. Chemical products and pharmaceuticals were given patent protection under the previous Hungarian law. See Patent Law No. 2 on Patent Protection of Inventions (Apr. 26, 1969), as amended through Sept. 2, 1991, by Law No. 38 of 1991, at § 613(a), reprinted in EPSTEIN ET AL., *supra* note 98, at 14-57. The new law will extend patent protection. See *Changes to Hungary's IP Law*, Eastern Eur. Reporter (BNA), *supra* note 98, at 244-45.

100. *New Copyright Law Finally Takes Effect*, Eastern Eur. Reporter (BNA), *supra* note 97, at 49-50.

101. See, e.g. the Bulgarian Law on Patents of Mar. 18, 1993, reprinted in 1 CENTRAL AND EAST EUROPEAN LEGAL MATERIALS (Vratislav Pechota ed., 1992) [hereinafter CEELM].

102. Paris Convention for the Protection of Industrial Property, Mar. 20, 1883, amended

Agreement Concerning the International Registration of Marks,<sup>103</sup> and the Berne Convention.<sup>104</sup>

Enforcement capacity is an issue in all areas of intellectual property law. Although a registration procedure exists, the critical question is whether a holder of intellectual property rights can actually protect those rights if another person infringes on them. In the socialist states, this was not much of an issue because most rights—particularly in the case of patents and trademarks—were held by the state. Enforcement of intellectual property legislation in CEE countries will emerge as a critical issue as the private sector and foreign investment grow. Giving true meaning to these rights requires a strengthening of the registration agencies and the courts to insure that infringements can be identified, halted, and punished as appropriate and that the aggrieved party can be adequately compensated.

#### d. Repatriating Profits

Factor price advantages will not attract foreign investment unless profits can be repatriated to the investor's home country. Indeed, profit repatriation is consistently cited by studies of investor motivation as being among the highest concerns of potential investors.<sup>105</sup> Foreign exchange was scarce in the early period of reform, and CEE governments reacted to this scarcity by limiting the rights of foreign investors to repatriate profits.<sup>106</sup> Lack of currency convertibility made it relatively easy to enforce these restrictions. All domestic investment had to take place in local currency, and foreign firms were required to convert hard currency at a state-controlled bank. In Romania, for example, limits on profit repatriation ranging from 8-

July 14, 1967, 21 U.S.T. 1583, 828 U.N.T.S. 306; UNITED STATES DEPARTMENT OF STATE, TREATIES IN FORCE: 1991 at 327-28 (1992).

103. Madrid Arrangement Concerning the International Registration of Marks, Apr. 14, 1891, 828 U.N.T.S. 389. The Madrid Agreement has been revised a number of times, most recently in 1967.

104. Berne Convention for the Protection of Literary and Artistic Works, Sept. 9, 1886, revised July 24, 1971, S. TREAT. DOC. NO. 27, 99th Cong., 2d Sess. (1986); TREATIES IN FORCE, *supra* note 102, at 295.

105. EMENA Technical Development, *supra* note 38, at 37.

106. BUSINESS VENTURES, *supra* note 69, at 3-61 (commenting on the inconsistencies created by Hungary's policies on profit repatriation and a regime of limited currency convertibility); see Hungarian Foreign Investment Law § 32 (1); Mark Trevelyan, *Poland Changes the Rules to Attract More Foreign Investors*, Reuters Libr. Report, Jan. 23, 1991, available in LEXIS, Nexis library, NEWS file (noting the liberalization of profit repatriation in Poland).

15% were established depending upon the type of investment involved.<sup>107</sup>

Improvements in the balance of payments environment helped lead to changes in the law.<sup>108</sup> Full repatriation of profits is now allowed in all CEE countries.<sup>109</sup> Romania, the last to lift its limits, finally allowed full repatriation in May 1992.<sup>110</sup> All of the CEE countries permit full repatriation of wages of foreign employees except Hungary, which limits wage repatriation to 50%.<sup>111</sup>

## 2. Reducing Transaction Costs

### a. Making New Investments

In addition to rationalizing factor prices, the CEE states have recognized the need to introduce legal reforms that reduce transaction costs for foreign investors. Most countries in the region have reduced *ex ante* transaction costs by easing the process of establishing new, or "greenfield," investments. All CEE countries allow foreign firms to set up wholly-owned subsidiaries, thus eliminating the requirement of finding domestic partners and negotiating joint venture arrangements.<sup>112</sup> While all countries in the region prohibit foreign investment in specific sectors (defense, energy, domestic telecommunications and banking being the most common),<sup>113</sup> the process is now

107. Law Concerning the Status of Foreign Investment, Mar. 29, 1991, Art. 16, (hereinafter Rumanian Foreign Investment Law), *reprinted in* CEELM, *supra* note 101.

108. 54 OECD ECONOMIC OUTLOOK 116-7 (tables 23, 25, 26) (1993).

109. For the provisions permitting repatriation of profits, see Law on Economic Activity of Foreign Persons, Jan. 16, 1992, Art. 13 (2), *reprinted in* CEELM, *supra* note 101 [hereinafter Bulgarian Foreign Investment Law]; Act No. 513/1991, THE CZECHOSLOVAKIA COMMERCIAL CODE OF 1991 [hereinafter Czech Commercial Code] Section 730, 733; Unified Text of Act XXIV of 1988 Regarding Investments by Non-Residents in Hungary with Subsequent Amendment and Supplementals (hereinafter Hungarian Foreign Investment Act), *reprinted in* BUSINESS VENTURES, at app. H-1.1, § 33; Law on Companies with Foreign Participation, June 14, 1991 [hereinafter Polish Foreign Investment Law] *reprinted in* BUSINESS VENTURES, *supra* note 69, at app. P-1.1, Art. 25 (2); Law Concerning the Status of Foreign Investment, March 29, 1991 [hereinafter Rumanian Foreign Investment Law] *reprinted in* CEELM, *supra* note 101, art. 16.

110. Rumanian Foreign Investment Law, *supra* note 71, art. 9(c).

111. Hungarian Foreign Investment Act, *supra* note 69, § 33.

112. See Bulgarian Foreign Investment Law, *supra* note 71, art. 3(1); Rumanian Foreign Investment Law, *supra* note 71, art. 1(a); Hungarian Foreign Investment Law, *supra* note 71, § 9(2); Polish Foreign Investment Law, *supra* note 71, art. 1, ¶ 2; Czech Commercial Code, *supra* note 4, §§ 21, 24.

113. See Bulgarian Foreign Investment Law, art. 4 (requiring permission from the Council of Ministers for foreign investments in the arms industry, banking, insurance and natural resources); Rumanian Foreign Investment Law, art. 1(a) (restricting foreign

quite easy in other sectors, typically very similar to that applicable to domestic firms.

Hungary led the way in streamlining the procedures necessary for government approval of foreign investments. In 1990, Hungary amended its Investment Act and eliminated the need for prior government approval of foreign investments, including wholly-owned foreign investments.<sup>114</sup> Firms now must meet incorporation requirements applicable to all firms and register within thirty days of the adoption of their articles of incorporation.<sup>115</sup> Poland followed suit in new foreign investment legislation enacted on June 14, 1991,<sup>116</sup> and CSFR did the same in the enactment of its new Commercial Code that went into effect January 1, 1992.<sup>117</sup> The Bulgarian foreign investment law that went into effect on February 1, 1992 drops the previous minimum investment of \$50,000 and requires prior government permission only for investments in natural resources, defense, banking, and insurance.<sup>118</sup> Of all the CEE countries, only Romania continues to require prior government approval of all foreign investment, but even in Romania, approval is deemed granted if no decision is rendered in 30 days.<sup>119</sup>

#### b. Acquiring Ongoing Businesses

The CEE countries have also reduced transaction costs by making it easier to acquire ongoing businesses. While accurate figures on the relative number of greenfield investments are not available, it appears that they are outnumbered by joint ventures or buy-outs of existing host country firms.<sup>120</sup> Foreign firms generally

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investment in activities which affect national security and defense or are harmful to public order); Hungarian Foreign Investment Law, § 34 (requiring foreign investors to be subject to the same licensing requirements as domestic firms); Polish Foreign Investment Law, art. 4.1 (requiring a permit for foreign investment in the management of seaports and airports, in the defense industry, in wholesale trade and in the provision of legal services); Czech Commercial Code, *supra* note 4, §§ 21, 24 (permitting foreign investors the same commercial opportunities as domestic investors).

114. Hungarian Foreign Investment Law, *supra* note 69, § 9(1).

115. *Id.*, § 3; Act VI of 1988 on Business Organizations in BUSINESS VENTURES, *supra* note 69, at app. H-5.1, art. 19-24.

116. Law on Companies with Foreign Participation, §§4, 5 and 43 (1991) (repealing previous legislation).

117. See Czech Commercial Code, *supra* note 4, §§ 21-26.

118. Bulgarian Foreign Investment Law, *supra* note 71, art. 3(2).

119. Rumanian Foreign Investment Law, *supra* note 71, art. 20 (requiring foreign investors to apply for permission), art. 23 (decision to be made by the Rumanian Development Agency within 30 days).

120. *The Race to Invest*, EAST EUROPEAN, Fall 1983, at 16-25.

prefer to operate through joint ventures or acquisitions, because working with domestic firms or acquiring their assets is easier than starting from scratch. Domestic managers often possess valuable knowledge of local markets, familiarity with established suppliers and customers, and contacts within the government that are difficult for the foreign firm to duplicate. Only when a foreign firm is introducing a new product is greenfield investment generally more advantageous.<sup>121</sup>

Unfortunately, from the perspective of foreign firms, investing in an ongoing enterprise in CEE generally draws those firms into the quagmire of privatization regulations. Although the details of the privatization programs differ in each country, there is direct government intervention in the process in all CEE countries. While this is understandable, given that governments are the "sellers" of the firms being privatized, the direct involvement of the government in the selection of foreign partners and the required approval of privatization proposals has caused confusion and uncertainty for many foreign investors. In our view, administrative law remains one of the least developed areas of law in the CEE countries. Regularized procedures for official decision making are often lacking, and there are few established channels for public input into the process. Those turned down in the privatization process are generally given neither a statement of cause nor any opportunity to appeal the decision.

The experience of McDonnell Douglas in Poland illustrates the frustration felt by many foreign firms in the wake of what appear to be arbitrary procedures. In June, 1991, following a decision by a special government commission, McDonnell Douglas signed a letter of intent with LOT, the Polish airline, to deliver nine MD 80 aircraft.<sup>122</sup> The letter of intent contained an "offset" clause in which McDonnell committed itself to invest \$85 million in Poland's aircraft industry.<sup>123</sup> Then in August, the Polish government reversed itself and gave authority to LOT to choose its supplier directly. Over the objections of the Solidarity trade union, LOT picked McDonnell's competitor, Boeing, despite the fact that Boeing had

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121. For example, Levi Strauss has committed \$20 million over four years to manufacture Levi's jeans in Poland. The venture includes not only a greenfield manufacturing plant, but also integration forward into retailing. The cost of converting local garment plants to modern manufacturing was prohibitive, and franchising retail outlets was impractical due to lack of domestic capital.

122. Miroslaw Glogowski, *New Boeings for LOT*, WARSAW VOICE, Sept. 22, 1991, available in LEXIS News library, Curnws file; Christopher Bobinski, *Polish Aircraft Workers Near Strike over Boeing Order*, FINANCIAL TIMES, Sept. 20, 1991, at 3.

123. Glogowski, *supra* note 122.

only promised offsets of \$30 million.<sup>124</sup> McDonnell claimed it had started to produce the airplanes and stood to lose several millions of dollars. Although there could have been justifiable reasons for the reversal, no official government explanation was given.<sup>125</sup>

Experiences like the one McDonnell Douglas suffered are common throughout the region. In Hungary, the State Privatization Agency rejected Colgate-Palmolive's bid for a Hungarian cosmetic firm.<sup>126</sup> After acknowledging that Colgate's bid was the "most serious" it had received, SPA refused to give a reason for the rejection. Noting the 18 months Colgate had spent on the proposal, a Colgate official complained, "It was lengthy, it was expensive, it was involved, and it was unsuccessful. The chapter is closed."<sup>127</sup> Similar experiences have occurred in Hungary involving PepsiCo and R.J. Reynolds.<sup>128</sup> One American attorney observed that experiences like these have caused some U.S. firms to pull out of the market completely.<sup>129</sup>

The lack of established procedures for the inclusion of foreign investment in privatization may also open the door to corruption in the host country. This may lead not only to economic losses, if projects are given approval on the basis of side payments rather than economic efficiency or feasibility, but also to political losses. Charges of bribery and corruption can easily erode popular support for economic reform in general, and foreign investment in particular.

Despite its having been the highest bidder, Gerber's investment in the Polish firm Alima has been criticized in the Polish press as tantamount to theft, because the decision process was largely hidden from public view and comment.<sup>130</sup> There are growing signs that governments in the region are increasingly sensitive to the need to maintain political support for the reform process, even at the expense of foreign investment. The Hungarian Minister in charge of privatization before the 1994 elections, Tamas Szabo, recently announced that

124. Bobinski, *supra* note 122, at 3.

125. Glogowski, *supra* note 122.

126. Ken Kasriel, *Hungary's Troubled Business Ties*, CHRISTIAN SCI. MONITOR, July 7, 1992, at 2.

127. *Id.*

128. *East-West Trade: Hungary Remains Attractive to Investors Despite Frustration over Privatization*, Int'l Trade Rep. (BNA) No. 9, at 1402 (Aug. 12, 1992).

129. Interview, Washington, D.C. (Aug. 17, 1992) (release of name and firm would be a violation of trust).

130. Patricia Koza, *U.S. Seeks Smoother Path for Investment in Poland*, UPI, June 3, 1992, available in LEXIS, News Library, Arcnws file.

domestic bids would now be preferred in the privatization process over similar foreign bids.<sup>131</sup> Price alone would no longer determine ownership.<sup>132</sup> This change of policy may have little practical effect, given the lack of domestic capital, but it does send a signal which may create further uncertainty in the minds of foreign investors.

The transaction costs of making an investment overseas can be significantly more than those of domestic transactions.<sup>133</sup> The enclave strategy has reduced some of the transaction costs facing foreign investors, but the CEE states should continue to reduce transaction costs to all investors—both foreign and domestic. The issue of national economic sovereignty will continue to be important. The CEE states can best guard against opposition to foreign ownership by establishing clear, reviewable procedures that are transparent to both the interested public and the relevant foreign firms. In this way the public can be protected from bureaucratic corruption and the firms can be assured that their efforts to invest will be fairly evaluated.

### 3. Allocating Risk

#### a. Protecting Against Government Expropriation

The most severe risk borne by foreign investors and the most extreme threat to any foreign investment is government expropriation. All of the governments in the region have moved swiftly and effectively to deal with this concern. First, governments have sought to extend protections in their domestic legislation by providing guarantees of compensation in the event of nationalization or expropriation.<sup>134</sup> Second, and more significantly from the viewpoint of American investors, Poland, the former CSFR, Romania, and

131. *New Privatization Measures*, EAST EUROPEAN BUSINESS LAW, June 1992, available in LEXIS, NEWS Library, Arcnws file.

132. *Id.*

133. According to some analyses, these costs are responsible for the regional clustering of direct investment by the industrialized countries. The United States is more likely to invest in Latin America, and Japan prefers south east Asia, because cultural similarity and past experience cause their firms to have relative advantages in reducing the transaction costs that accompany investment. This may be one reason for the predominance of German and Austrian investments in CEE. U.N. CENTRE FOR TRANSNATIONAL CORPORATIONS, *supra* note 26, at 2.

134. Economic Activity of Foreign Persons and Protection of Foreign Investment Law (Bulgaria), *supra* note 78, art. 10(7); Czechoslovakia Foreign Investment Act, *supra* note 71, § 22(2); Hungarian Foreign Investment Law, *supra* note 71, § 1(2); Polish Foreign Investment Law, *supra* note 71, art. 22(6); Rumanian Foreign Investment Law, *supra* note 71, art. 5.

Bulgaria have signed bilateral investment treaties with the United States, and a treaty with Hungary is also being negotiated.<sup>135</sup> The investment treaties outline the procedures to be used in determining compensation in the event of nationalization or expropriation. European investors may take comfort from the associate status of the several CEE states in the European Union (EU). EU association requires similar treatment of all nationals.<sup>136</sup> Third, fears of expropriation without compensation have been further reduced by the former CSFR, Hungary, and Poland having joined the Multilateral Investment Guarantee Agency (MIGA).<sup>137</sup> MIGA, formed in 1988 as an independent self-supporting member of the World Bank Group,

135. The United States has bilateral investment treaties in force with the Czech Republic, Slovakia, Romania, and Hungary. The Hungarian agreement, however, dates back to 1978. The United States and Hungary have been unable to come to terms on a new treaty, chiefly due to differences over the protection of intellectual property. Treaties with Bulgaria and Poland have been ratified, but are not yet in force. *U.S. Expects Major Problems Enforcing Trade Pacts with Ex-Communist States*, Int'l Trade Daily (BNA) (May 14, 1992), available in LEXIS, Nexis library, Allwld File (citing Peter Allgeir, U.S. Trade Representative for Europe and the Mediterranean commenting on the problems with Hungary's protection of intellectual property); Interview with official from Department of Commerce (release of name would be a violation of trust), Eastern Eur. Bus. Info. Center, U.S. Dep't of Com., (Apr. 5, 1994). Investment Incentive Agreement, Oct. 22, 1991, U.S.-Czech. (entered into force on Dec. 19, 1992). *U.S.-C.S.F.R. Bilateral Agreement on Investments to Take Force Dec. 19, 1992*, Int'l Trade Rep. (BNA) No. 9, at 2105 (Dec. 9, 1992); *U.S. Signs Bilateral Investment Treaties with Armenia, Bulgaria*, Int'l Trade Daily (BNA), (Sept. 25, 1992) (signed Sept. 23, 1992, ratified by the U.S. Senate Nov. 17, 1993, not yet entered into force); Agreement on Trade Relations, Mar. 17, 1978, U.S.-Hung., 29 U.S.T. 2711, T.T.A.S. No. 8967; Treaty Concerning Business and Economic Relations, U.S.-Pol., signed Mar. 21, 1990, reprinted in 4 CEELM, *supra* note 101; *Senate Foreign Relations Approves Eight Bilateral Investment Treaties*, Int'l Trade Daily (BNA), Sept. 15, 1993, available in LEXIS, Nexis library, Allwld file (noting treaty with Poland has been ratified but not yet entered into force). Treaty Concerning the Reciprocal Encouragement and Protection of Investment, U.S.-Rom. (signed May 28, 1992), reprinted in 5 CEELM, *supra* note 101; *U.S., Romania Exchange Notes on Bilateral Investment Treaty*, Int'l Bus. & Fin. Daily (BNA), Dec. 17, 1993, available in LEXIS, Nexis library, Allwld file (noting instruments exchanged Dec. 16, 1993, with treaty in effect 30 day later).

136. The CEE states are in various stages of association with the European Union (EU). As a condition of association, they are to provide investors from EU countries with national treatment. Poland and Hungary have been associate members of the EU since February 1, 1994. Hungary applied for EU membership on April 1, 1994, and Poland followed on April 8, 1994. The Czech Republic, Slovakia, Romania and Bulgaria are awaiting EU ratification. See, John Palmer, *Nervous Poles Apply for EU Membership*, The Guardian, Apr. 8, 1994, at 10. *Eastern European Countries line up for EU membership*, Agence France Presse, Apr. 2, 1994, available in LEXIS, Nexis library, Allwld file. See also European Commission Assent 18/93 and Assent 19/93 (assent given by the Council of Europe to establish an association between the member states and Hungary and Poland), available in LEXIS, News library, Allwld file.

137. See MULTILATERAL INVESTMENT GUARANTEE AGENCY, 1991 MIGA ANNUAL REPORT 10 (noting Hungary, Poland, and Czechoslovakia as members).

offers insurance covering currency transfer restrictions, expropriation, war and civil disturbance, and breach of contract to private firms doing business in member states.<sup>138</sup>

In sum, the fear of unanticipated costs due to expropriation has been greatly diminished through this interlocking set of guarantees provided by domestic legislation, bilateral treaties, and insurance.

#### b. Enforcing Agreements

The difficulty of enforcing contracts can be a significant impediment to foreign investment, particularly in developing countries where formal legal systems are weak. The CEE states have made significant progress in this area, using a combination of external and internal institutions. Bilateral investment treaties play an important role in reducing *ex post* transaction costs by providing guarantees of third party arbitration.<sup>139</sup> Most CEE foreign investment laws also permit third-party arbitration.<sup>140</sup> The availability of arbitration helps to alleviate the concerns of many investors that the host country legal system may not be capable of predictable and timely contract adjudication. Yet arbitration does not substitute completely for a well-functioning judicial system, because it will be effective only if local judicial institutions are willing and able to recognize and enforce arbitral awards as needed.

The opportunity for arbitration is expanded still further through participation in the Convention of the International Centre for Settlement of Investment Disputes (ICSID).<sup>141</sup> The former CSFR, Hungary and Romania have signed and ratified the ICSID convention.<sup>142</sup> The convention provides a mechanism for arbitration

138. In 1991, MIGA extended protection to Bering Netherlands B.V., a Dutch company investing in Poland. *Id.* at 14. In 1992, MIGA insured a \$25 million investment by Coca-Cola in Poland. See MULTILATERAL INVESTMENT GUARANTEE AGENCY, 1992 MIGA ANNUAL REPORT.

139. See *supra* note 135. But see *U.S. Expects Major Problems Enforcing Trade Pacts with Ex-Communist States*, *supra* note 135 (noting that bilateral investment treaties will still face significant enforcement barriers).

140. See, e.g., Czechoslovak Commercial Code, § 760; Law VI of 1988 on Business Societies, Associations, Companies and Ventures, para. 18 (hereinafter Hungarian Company Act); Bulgarian Decree No. 56 on Economic Activity of January 1991, art. @3(2).

141. ICSID was created by the Convention of the Settlement of Investment Disputes between States and Nationals of Other States, Mar. 18, 1965, 17 U.S.T. 1270, 575 U.N.T.S. 159 (hereinafter the ICSID Convention). ICSID's goal is to provide a depoliticized forum for the resolution of investment disputes. See INTERNATIONAL CENTRE FOR SETTLEMENT OF INVESTMENT DISPUTES, ICSID BASIC DOCUMENTS, intro. (1985).

142. INTERNATIONAL CENTRE FOR SETTLEMENT OF INVESTMENT DISPUTES, 1991 ICSID ANNUAL REPORT 12-14.

between private investors and host governments.<sup>143</sup> ICSID's goal is to provide a depoliticized forum for the resolution of investment disputes and CEE countries further assure foreign investors by having become parties to the ICSID convention.

In our view, CEE domestic courts are increasingly willing to follow established global business practices and uphold common Western interpretations of contract law. In 1990 a dispute arose in Hungary between the American firm Pratt & Whitney and the Hungarian state airline Malév.<sup>144</sup> Pratt alleged that Malév had entered into a binding contract for the purchase of aircraft engines by returning a letter of acceptance. In January, 1992, a Hungarian court ruled in favor of Pratt, applying the Vienna Convention for International Sale of Goods.<sup>145</sup> The Pratt case is important because Hungarian courts moved quickly and effectively to resolve the dispute despite Hungary's lack of a bilateral investment treaty with the U.S. The application of the Vienna Convention in Hungary is a positive signal to Western firms that the Hungarian courts will apply commonly recognized standards of conduct in adjudicating business disputes.

Similarly, CEE countries are looking to Western norms as they design their commercial legislation. For example, the new commercial code of the former CSFR, which took effect on January 1, 1992, parallels parts of the U.S. Uniform Commercial Code, especially Article 2 governing contracts.<sup>146</sup>

Efficient conflict resolution is essential for the allocation of risk between foreign and host-country firms. Creating the institutional mechanisms for resolving conflicts among contracting parties is a complex task, but thus far, the CEE states have achieved reasonable success. Given the developing domestic legal system and the growing acceptance of third party arbitration, it appears that dispute

143. Because of the high level of government involvement in the privatization process, the government is often a party to investment contracts. In contrast to ICSID, most third party arbitration mechanisms do not allow for arbitration when one of the parties to the contract is a government. ICSID treaty, 17 U.S.T. 1270, 575 U.N.T.S. 159.

144. F. Angela Flaes, *Pratt & Whitney's Dispute with Malév Continues*, 20 BUS. EASTERN EUR. 349-50 (1991).

145. Keve Papp, *Hungarian Court Rules for Pratt & Whitney*, 21 BUS. EASTERN EUR. 53 (1992).

146. *C.S.F.R.'s New Commercial Code Praised, Compared to U.S. Laws by Commerce Official*, 9 Int'l Trade Rep. (BNA) No. 20, at 854 (May 13, 1992) (Linda Wells, director of the Commercial Law Development Program for Central and Eastern Europe, argues that the Czech Commercial Code follows parts of the U.S. uniform commercial code, the model corporate code, the model partnership code, and the unfair trade practices code).

resolution may be receding as a major impediment to investment in the region.

### C. Providing Special Incentives

A final aspect of the "enclave" strategy is to offer special incentives to attract foreign investment. The primary incentives used in CEE are tax-related. While statutory tax rates applicable to all taxpayers are relatively high (Table 1), tax incentives typically result in much lower effective tax rates for foreign investors.

Table 1: Comparative Tax Rates in 1993<sup>147</sup>

Country	Corporate	VAT	Excise	Withholding	Employer payroll/social security	Income
Bulgaria	30 <sup>2</sup> -70	18	40-70	0, 10, 15	35-50	20-52
Czech Republic	45	5, 23 <sup>1</sup>	<sup>3</sup>	10-25	36 <sup>4</sup> , 13.5 <sup>4</sup>	15-47
Hungary	40	10, 25	<sup>3</sup>	10-40	52.4 <sup>4</sup> , 12 <sup>4</sup>	25-40
Poland	40	7.22 <sup>1</sup>	<sup>3</sup>	20	48	20-40
Romania	30, 45	9, 18	<sup>3</sup>	115-200, <sup>3</sup> others	6-45	5-40
Slovakia	45	6, 25 <sup>1</sup>	<sup>3</sup>	25	38 <sup>4</sup> , 50 <sup>4</sup> , 12 <sup>6</sup>	15-47

<sup>1</sup> Beginning with the lowest positive rate.

<sup>2</sup> Standard rates: 30% and 40%.

<sup>3</sup> Employer contribution.

<sup>4</sup> Employee contribution.

<sup>5</sup> Amount is based on weight or product category.

<sup>6</sup> State employer contribution.

A 1992 study by the Foreign Investment Advisory Service (FIAS, part of the World Bank group)<sup>148</sup> estimated the effective tax rates on typical foreign investments in manufacturing in mid-1991 to be between 6 and 22% (see Table 2).

147. Corinne Yee, *East European Taxes*, 22 BUS. EASTERN EUR. 7 (1993).

148. J. M. Mintz and T. Tsiopoulos, *Corporate Income Taxation and Foreign Direct Investment in Central and Eastern Europe*, 4 FOREIGN INVESTMENT ADVISORY SERVICE OCCASIONAL PAPER 15 (1992).

Table 2: Comparative Effective Tax Rates, 1991

Country	Effective Tax Rate (%)
Bulgaria	10
CSFR	22
Hungary	6
Poland	8
Romania	12

Of course effective tax rates vary from investment to investment, both because different projects have different cost characteristics that affect the definition of taxable income, and because tax regimes themselves often vary by investment. Tax regimes have often been specifically negotiated between foreign firms and host governments as part of the overall foreign investment package.<sup>149</sup> In general, the CEE states offer tax "holidays"—a period of years in which no taxes are due—or significant tax reductions to foreign investors<sup>150</sup> (see Table 3). Tax incentives are often restricted to significant investments or specific economic sectors and may require government approval. They are generally not available to domestic investors.<sup>151</sup> Investment can be re-classified into categories that qualify for tax

149. See Rumanian Foreign Investment Law, *supra* note 71, art. 17 (which grants the Rumanian Development Agency the authority to design additional investment incentives); see also Karoly Okolicsanyi, *Tungstram: A Case Study*, in 1 RFE/RL RESEARCH REP. 25 (1992) (noting that the U.S. firm General Electric negotiated a five-year tax holiday and an exemption from import duties on raw materials).

150. For examples see Hungarian Foreign Investment Law, *supra* note 69, § 3.04 (the Hungarian foreign investment regime) and Hungary Act LXXXVI of 1991 on Company Tax, as amended (hereinafter Hungarian Company Tax Law), art. 12(1)(a) (establishing a five-year grace period for foreign ventures in specified industries), *reprinted in CEELM, supra* note 101, Binder 3A, at 30; Polish Foreign Investment Law, Art. 23(1), *reprinted in CEELM, supra* note 101, Binder 4, at 13 (granting a tax holiday if approved for certain minimum foreign investment in specified sectors).

151. To qualify under the Polish Foreign Investment Law, *supra* note 150, art. 23(1), a foreign venture or a joint foreign-Polish venture may apply for a tax holiday if the foreign contribution to the venture is more than two million European Currency Units (ECU) and (1) operates in a region of the country with high structural unemployment; or (2) facilitates the introduction of new technology; or (3) exports at least 20% of its product. Generally, the Ministry of Finance disapproves only on the grounds of "significant economic reasons." *Id.* art. 23(2).

holidays, and the length of the holidays can also be extended.<sup>152</sup> This discretion is in fact a characteristic of the enclave approach.

Table 3: Tax incentives for FDI in CEE in 1993<sup>153</sup>

Country	Minimum investment for special status	Minimum foreign participation	Tax holiday (years)	Period of additional tax reductions (years)	Tax reduction offered	Other incentives
Bulgaria	\$100,000+	49%	None in general; Tax exemptions (up to 100%) in high-tech, agriculture, food-processing	unlimited	10% <sup>1</sup> (effective rate, 30%)	5 year carry-forward for losses; other tax exemptions (up to 100%) in high-tech; agriculture; food-processing
Czech Republic	None	None	None	None	None	5 year loss carry-forward
Hungary	Fl 50m+ and other conditions <sup>2,3</sup>	30%	None	First 5 years Second 5 years	60% 40%	Reduction of tax payable for reinvestment of 1993 profits;
	Fl 50m+ and other conditions <sup>4</sup>	30%	None	First 5 years Second 5 years	100% 60%	5 year carry-forward of losses; some cases of indefinite loss carry-forward; dividends may be re-remitted abroad without withholding taxes.
Poland	ECU 2m+ <sup>5</sup>	None	None	Indefinite	Exemption with conditions—cannot exceed value of the transaction.	3-year loss carried forward in equal installments since February 15, 1992; loss may be offset against future income from any source; Financial year can be other than calendar year.
Romania	\$10,000+	None	2-5 years <sup>1</sup>	Up to 5 years	Up to 50%	Losses may be carried forward for 2 years. Annual deductions of 5% of profit before taxation. Tax holidays may be extended with government approval.
Slovakia	DM1m+	30%	2 years <sup>1</sup>	None	None	Losses may be carried forward for 5 years. Tax incentives for operating in cities in East Slovakia.

<sup>1</sup> reduction on profits.

<sup>2</sup> manufacturing sector only.

<sup>3</sup> for first-time qualifiers before December 31, 1993.

<sup>4</sup> more than half of turnover comes from priority fields.

<sup>5</sup> must either be conducted in regions with high structural unemployment; introducing new technology; or to enable the export of at least 20% of total output.

152. See Rumanian Foreign Investment Law, *supra* note 71, art. 17 (which grants the Rumanian Development Authority discretion in providing investment incentives).

153. Corrine Yee, *Tax incentives for EE investment*, BUS. EASTERN EUR., July 5, 1993, at 6-7.

Hungary was the first CEE country to offer tax incentives, and its incentives are still generous.<sup>154</sup> It is tempting to look to Hungary's low estimated effective tax rate and conclude that preferential tax treatment is behind the large share of foreign investment that has flowed into Hungary. Such a conclusion, however, is doubtful. Tax rates may affect short-term profits, but the evidence that they dominate or even significantly affect the investment decision of foreign entrepreneurs is decidedly mixed.<sup>155</sup> The majority of larger firms are investing in CEE for the long term.<sup>156</sup> Tax rates are important, and investors will be deterred if taxes are set at exorbitant levels, but it is not likely that the complex packages of reduced rates and tax holidays currently in place in CEE will tip the balance for many prospective investors. Many investors cannot even use the tax holidays they are offered. If exemptions from taxes on profits are to attract foreign investors, profits are a necessary first step. Many of the investments in CEE firms are long-term projects which will not show profits for many years. For example, General Electric's \$150 million purchase of 50% of the Hungarian lighting manufacturer Tungsram occurred in 1989. Because Tungsram did not show a profit until 1994, its tax holiday was of little use.<sup>157</sup>

The emphasis on incentives has uncertain benefits, but many clear costs, as has been noted in analogous discussions of tax incentives throughout the developing world. A first obvious cost is in government revenue, and this is important given the fiscal problems throughout the region. Another cost is uncertainty. In their effort to fine tune the incentives in the tax codes, the CEE countries

154. Until the end of 1993, the Hungarian Company Tax Law permitted an enterprise with an initial capitalization of at least 50 million forints, at least 30% of which was contributed by a foreign investor, earning at least 50% of its annual income from an activity of "special importance" as defined by the Hungarian government, to pay no corporate tax for the first five years of its existence, and a 60% tax reduction during the following five years. Hungarian Company Tax Law, *supra* note 150, § 12(1)(b). See *New Law Cuts Corporate Tax Rate*, 3 Eastern Eur. Rep. (BNA) No. 25, at 893 (1993). These reductions are no longer available for firms investing in 1994, although the newly-elected government has announced its desire to expand incentives. *Hungary's New Government Said likely to Offer Tax Breaks to Lure Investors*, East Eur. Rep., vol. 4, no. 11, at 411 (1994).

155. For a summary of the literature pro and con, see World Bank, *Attracting Private Investment: Capitalists' Perceptions of the Investment Climate in Europe, the Middle East and North Africa*, in EMENA Technical Department, *supra* note 38.

156. Holmes, *supra* note 75, at 475.

157. The FIAS study noted above concluded that the tax rates of Bulgaria and Romania may be so high that they would deter investment in the absence of tax holidays. The tax regimes in Hungary, Poland, and CSFR would be unlikely to deter investment even in the absence of special incentives. See UNCTC CURRENT STUDIES, *supra* note 26, at 26.

have changed their tax regulations frequently.<sup>158</sup> This has created much confusion among foreign investors and compounded their already difficult task of estimating future profit flows.

Moreover, the administrative costs of incentives are high. Complicated tax codes demand sophisticated bureaucracies to administer them. Preferential tax systems that grant benefits to foreigners must set administrative criteria to define "foreign" investment. Investments have to be screened to see if they meet the minimum levels of investment needed to qualify for preferential treatment. Monitoring mechanisms must be established to audit joint ventures to ensure that foreign participation is genuine and not just an illusion to escape corporate taxes. All CEE governments suffer from a shortage of skilled administrators. Diverting personnel to administer complex incentives of questionable worth is unlikely to be an efficient use of scarce resources.

The creation of tax incentives also creates loopholes and ambiguities in the law which firms can use to their advantage, leading to further revenue loss, creating further uncertainty, and demanding further bureaucratic intervention to control them. For example, many of the investment laws in the region allow for credits for re-investment of profits or for research and development costs.<sup>159</sup> Expenses can be easily re-categorized to fit the tax-exempted classes. Firms can also manipulate the date they "start" operations to extend the tax holiday beyond the normal number of years. Furthermore, firms are adept at transferring income into and expenses out of the holiday period to minimize tax liability after the holiday expires.

Finally, preferential tax codes for foreign investors may also exacerbate political tensions in the region, both internally and externally. As noted above, charges repeatedly surface throughout the

158. CEE tax laws are in a continual state of flux. At any given time CEE governments may be considering any one of a number of changes. See, e.g., *Cabinet Proposes Tax Breaks for Large Foreign Investments*, 4 Eastern Eur. Rep. (BNA) No. 7, at 261-62 (1994); *Poland to Extend Term of Tax Holidays for Investments in Certain Sectors*, Eastern Eur. Rep. (BNA), vol. 3, no. 23, at 823. *Czech Plan Will Exempt from Duties Some Imports by Foreign Joint Ventures*, Eastern Eur. Rep. (BNA), vol. 3, no. 22, at 781. See also Holmes, *supra* note 73, at 485 (noting that changing tax regulations are foreign investors' single largest complaint about the CEE investment environment).

159. See, e.g., Hungarian Foreign Investment Law, *supra* note 69, § 3.10[a] (exempting reinvested profits from the corporate profits tax); Rumanian Foreign Investment Law, Law Concerning Foreign Investments, as amended, art. 15(a), *reprinted in* CEELM, *supra* note 150, binder 5, at 5 (allowing a 50% reduction in corporate taxes for reinvestment in specified sectors).

region that politicians are "selling out" to foreign interests.<sup>160</sup> A clear tax code, with reasonable rates equally applicable to domestic and foreign firms, may not only be more efficient, but may remove a potentially troubling issue from the political agenda.<sup>161</sup> Furthermore, as the CEE states begin to enter into associate membership with the European Community,<sup>162</sup> their preferential treatment of foreign investors may complicate the process. In the spring of 1992, the EU protested a decree by the Hungarian government that gave customs preferences to the Ford Motor Company in return for domestic investment.<sup>163</sup> The Hungarian government agreed to repeal Ford's preferential treatment, and a Ford official responded by noting that "[t]here are easier places in the world to do business than Hungary."<sup>164</sup>

Rather than focusing on tax incentives, which are of questionable utility in attracting foreign firms, the CEE countries should follow the lead of the Czech Republic and harmonize the domestic and foreign investment tax regimes. They should also exert more effort to reduce the transaction costs faced by firms seeking to identify opportunities and make investments. Tax incentives work against the goal of rationalizing factor prices. They act, in effect, like subsidies. Instead of constantly changing tax rates in an effort to optimize locational incentives, these states should concentrate upon creating stable, transparent environments in which foreign entrepreneurs can more easily calculate the costs and benefits of investing and make the actual investments with a minimum of time and effort.

## VI. CONCLUSIONS

Specialized foreign investment laws play a useful role in the initial period of transition to a market economy. They send a strong signal to foreign entrepreneurs that the host country is serious about economic reform and is willing to work with investors to establish a mutually beneficial legal regime. These laws tend to create investment "enclaves" that not only serve this signaling function but are

160. See *supra* note 68 and accompanying text.

161. In CSFR, public protest was voiced against tax concessions demanded by Mercedes Benz in return for foreign investment. 2 EUROPEAN BANK FOR RECONSTRUCTION AND DEVELOPMENT, EBRD WATCH No. 4, at 4 (1992).

162. See *supra* note 136 and accompanying text.

163. Nicholas Denton, *Hungary Accused on Van Tariff*, FINANCIAL TIMES, May 30, 1992, at 2.

164. Kasriel, *supra* note 24, at 2.

also often used to target special incentives to foreigners and create an "island" of legal development that may differ from—and sometimes outpace—development in the rest of the domestic legal framework.

Yet to the extent the enclave separates foreign from domestic investors, it can quickly outlive any initial usefulness. The incentives it fosters not only bleed domestic treasuries, but they lead to bureaucratic structures that may unnecessarily complicate the investment environment and raise information and transaction costs for foreign investors. As quickly as possible, the transforming economies should dismantle the enclave and put domestic and foreign investors on an equal footing.<sup>165</sup> This may well mean that foreign investment laws are no longer needed; indeed, CSFR was the first CEE country to abolish specific foreign investment legislation in favor of a broad commercial code covering all investors in the economy.

Furthermore, if an enclave does exist, policy makers should try to focus on the concerns critical to foreign firms. In the design of investment laws to date, the CEE countries have perhaps paid too much attention to preferential tax schemes while ignoring other costs faced by foreign investors. Policy makers in reforming economies should focus primarily on reducing uncertainty and transaction costs through clear and simple legislation, dismantling unnecessary bureaucratic intervention, improving contract enforcement, supporting arbitration and other alternative dispute resolution mechanisms, strengthening protection of property rights, and engaging in active efforts to disseminate information on the legal framework and on business opportunities. Complex regulations not only increase investor uncertainty, but they divert bureaucratic resources that the host country cannot afford to squander.

The CEE states have shown remarkable willingness to restructure their legal environments to attract investment. They are paying ever increasing attention to lowering transaction costs for foreign investors. In early 1992, for example, Poland announced the creation of a new investment agency whose goal is to disseminate information and provide help to foreign investors in navigating investments through the bureaucracy. Adopting and implementing these and similar measures in the CEE states, while continually pushing to create a simple, fair, and well-enforced legal framework, will further

165. Similar conclusions are embodied in the Guidelines on the Treatment of Foreign Direct Investment, recently published by the World Bank Group. WORLD BANK GROUP, LEGAL FRAMEWORK FOR THE TREATMENT OF FOREIGN INVESTMENT, VOL. II: GUIDELINES (1992).

improve the overall investment climate and place them in a more advantageous position in the growing worldwide competition for scarce investment capital.

## Non-Appearance before the International Court of Justice

Stanimir A. Alexandrov\*

*This Article argues that the raison d'être of Article 53 of the Statute of the International Court of Justice is to allow the Court to carry out its function whenever one of the parties does not appear in a contentious case before the Court. It shows that Article 53 applies at any time in the proceedings when the respondent state chooses not to appear. The Article analyzes the Court's practice in dealing with the phenomenon of non-appearance and in satisfying itself that a particular claim is well founded in fact and in law. It identifies the advantages and disadvantages of non-appearance and explains why states may decide not to appear in a specific case. Finally, the Article considers whether non-appearance affects the binding character of the Court's decisions and their enforcement, as well as whether it is to be expected that non-appearance will lead to non-compliance.*

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