Foreign Direct Investment in the Black Sea Area

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Introduction

The Black Sea is a region of vital interest to the foreign investor. This study examines the six countries that border it (Russia, Ukraine, Georgia, Turkey, Romania, Bulgaria) and presents the financial outlook and the foreign direct investment performance of each state. The main focus is on the analysis of the legislation related to the promotion and protection of investments. This is done with the aim of providing information about the opportunities and pitfalls of doing business in the area. The main conclusion is that the Black Sea presents great opportunities that remain largely unrealized. The reasons for this are mainly administrative barriers and the lack of legal certainty and enforcement.

The Challenge of FDI

The countries of the Black Sea region occupy a strategic position for the foreign investor. The area is rich in natural resources, lies at the crossroads of continents and civilizations and has a large untapped domestic market. These elements in combination create a highly attractive outlook for Foreign Direct Investment (FDI). Further, the region is undergoing a period of transition. The term transition refers to the process of transformation of political, economic and legal institutions from a communist system operating in a command economy to pluralistic democracy embracing market capitalism. Russia, Ukraine and Georgia are newly independent states emerging from more than seven decades of communist rule. Bulgaria and Romania are experiencing democracy and capitalism for the first time since the beginning of the last century. Turkey is currently striving to be accepted as a European state economically and politically. The Black Sea presents great challenges both for the states surrounding it and the foreign investors.

The process of investing in a foreign country is qualitatively different from investing in one's home state. A private investor will not become involved in a foreign venture unless he has adequate assurance that he will be treated in an equitable way and that at least some of the basic privileges he enjoys in his home jurisdiction will be respected in the host state. The investor will have to consider not only the normal commercial risks that may befall any venture but he will have to weigh a number of additional factors. He will have to face a number of dangers that are largely remote in the national context. Some of the problems that do occur involve requisitioning, breach of contract, nationalization, expropriation, and destruction of property.

In such cases the position of the investor is perilous because local legal remedies may be inadequate or non-existent. Where the changed circumstances result from a fundamental change in host country policy, revolution or war, contractual protection through the local court system may be unavailable. In any case the investor will be reluctant to place the fate of his venture in the hands of the local judges especially where the host state is a less developed country. In seeking greater security the investor will attempt to find redress for his loss through other means. Diplomatic protection by the home government will be an obvious option in the case of large multinationals investing in less developed countries. Further, a number of legal mechanisms have evolved which may come to the assistance of an investor in distress.

Capital exporting and capital importing countries alike try to improve the global investment climate by offering assurances and by building mechanisms that will protect and facilitate foreign investment. Even in developed countries the aim of attracting investment has become standard in political proclamations. The modern international investment protection framework consists of multilateral, regional and bilateral instruments. Further, each country has enacted specific legislation directed to the attraction and protection of FDI. For the host country, increased levels of FDI are seen as the best way to achieve development. The challenge is how to utilize FDI to help create a functioning market economy and achieve sustainable development.

The countries of the Black Sea region present many common elements in their investment outlook. Even though each country is at its own stage of development and has a different historical and economical background it is useful to try and see the similarities between them. As is often the case, international investors do not choose one country in a region as a target for investment to the exclusion of its neighbors. An attractive investment climate in some of the countries creates favorable conditions for the attraction of FDI in the region as a whole. Especially in the field of infrastructure development, telecommunications and transportation of energy supplies, a regional approach is taken by the multinational enterprises that engage in these activities. The 6 countries in this study can be roughly separated in three categories according to the financial and legal reforms taking place and their progress towards a market economy. It is advisable to include the former soviet republics of Russia, Ukraine and Georgia in one category. As transitional economies with a similar past they share the same political and economic background and even though their FDI performance is not the same, their advance towards a market economy is comparable. Further, the pace of legal reform and the effectiveness of their investment regime share many elements. On a second group we can place the Balkan countries of Romania and Bulgaria. Their difference from the first group lies in the prospect of EU accession and in the lack of a Soviet past, which has allowed them to modernize more effectively. In the third group we can place Turkey by itself. Turkey can no longer be called a transitional country and due to historical reasons does not share much with the economies of Eastern Europe. However, as a still developing country it follows an investment policy comparable to the rest of the region.

Financial Outlook

A general observation about the countries in our study is that their progress towards a market economy has not been steady. In the transitional countries the pace of legal reform has followed a pattern that betrays varying levels of commitment to a market economy. The political powers have not been always pro reform and local interests have often captured the political initiative in an effort to protect the status quo. In our first and second group of countries the general economic situation was characterized by sharp deterioration after the collapse of communism.

Russia (Russian Federation) and the Ukraine have not fared so well in their progress towards democratic reform and capitalism. In the market sector there has been a move more towards wild capitalism than European free market economics. Lately, the situation seems to be improving. Russia appears to be coming out of the economic slump and political turmoil of the mid nineties. After the collapse of the USSR in 1991 the Russian economy contracted for 5 years and was hard hit by the global financial crisis of 1998. The low point in the economy was in August 1998, which saw the ruble depreciate, the government default on its loan obligations and the large majority of the population suffer a sharp deterioration in their living conditions[1].

Ukraine is the second largest state in the former Soviet Union in economic terms and substantial in geographical size. Though energy dependant on Russia (it needs to import over 85% of its annual energy supplies), the Republic of Ukraine has a very promising agricultural sector and in Soviet times had a diversified heavy industry, which was of strategic importance to the region. Unfortunately it has not been so successful after the break up of the USSR. Even though, shortly after independence in 1991, the government embarked on a reform program, liberalizing prices and setting up a privatization framework, the impetus for change soon stalled.

As a result of a deadlock between a pro-reform government and a conservative parliament, Ukraine is the only eastern European country that witnessed a decline in its GDP and gross erosion of living standards during the entire 1990s. Only in 2000 the economy witnessed signs of a recovery. The collapse of the Soviet regime and the downturn in the formal economy, in conjunction with the political and regulatory vacuum that followed, gave birth to a substantial shadow economy that was estimated at 50-70% of official Gross Domestic Product (GDP) in 2000. After 10 years of independence, reforms to establish a functioning market economy and solidify the rule of law are still in an embryonic state.

In both countries new governments are proving a crucial element in making the reform effort a priority. This has resulted in a brighter economic outlook. In Russia the situation picked up in 1999 and since the election of current president Vladimir Putin there is hope that a new momentum towards reform is being built and that a new era of political stability will help push forward economic reform. Conditions improved significantly in the period 1999-2002 with increased industrial output and progress in structural reforms. Russia's financial standing has also improved and now receives a B

rating from rating agencies. Similarly in the Ukraine after the re-election of President Kuchma in November 1999 there is renewed hope that the strengthening of the president's position and a pro reform majority in parliament will push trough the much needed reforms. Since 1999 industrial output has recovered, in early 2000 most commercial debts have been rescheduled and important legislation on privatization, taxation, and land reform has been submitted to parliament[2]. The economy continued to expand in 2001 as real GDP rose by 9%.

The economic situation and the problems of transition in Georgia have been similar. Georgia attained its independence from the Soviet Union in 1991. The road to a market economy and democratic reform has been difficult due to the financial and political situation in the country and the Caucasus region. Civil conflict and political unrest have hampered the modernisation effort to a considerable extent. After the first turbulent years of independence, stability begun to return in 1994 despite continuing internal and regional conflicts. In 1995 the country witnessed economic recovery and introduced its national currency, the Lari[3]. The Georgian economy traditionally revolved around tourism, agriculture (32% of GDP), mining, and a small industrial sector. The country is heavily dependant on energy imports. The effects of the Russian economic crisis have been particularly hard on Georgia. As official bilateral trade plummeted and illegal trade bypassed the Georgian banking system a serious currency shortage ensued. To make matters worse 1998 were one of the driest years in the county's history, which resulted in reduced agricultural output. Currently the economic outlook is slowly improving as a result of the central bank's strong and prudent monetary policy in accordance to the instructions of the IMF and the World Bank. The Lari is the most stable currency in the region.

The Balkan countries of Romania and Bulgaria, which form the second grouping of countries in this study, followed the same pattern of a sharp economic downturn and deterioration of living standards after the collapse of communist rule. Fortunately lately they have shown signs of recovery and a willingness to introduce pro market reforms. In the decade of change so far, the results have been mixed. Romania witnessed a drop in economic activity and living standards for the majority of the population since the collapse of communism. In the 1990s the country was governed by two administrations that marked two stages of development in the reform process. The first one from 1989 to 1996 saw the gradual reform of economic and political institutions. The second one from 1996 to 2000 saw the acceleration of economic reforms and privatisation. However, both phases did not deliver the required results and were marked by recession.

Bulgaria is a good example of the devastating effects of the process of transition from a command to a market economy in the absence of determined pro-market policies. After the end of communism in 1989, elections failed to produce a parliamentary majority with a definite reform agenda. Thus, the market reforms were introduced in a haphazard and reluctant way. The result was near total collapse in 1996-1997. However, as the situation prior to 1997 is an example of failure of politics, the period after 1997 is a tale of the success of proper reform in turning around a difficult situation.

As in the former Soviet republics, new political balances have brought about a sea change in reform policies. Since 2000 a coalition government under the Prime Minister Adrian Nastase governs Romania. The government has made it its priority to speed up the pace of reform. It has pledged to improve the economy by offering tax incentives to businesses, combat corruption, reduce bureaucracy, stabilize the political environment and increase social protection.

Overall, the economic situation seems to be improving. However, the macroeconomic fiscal position remains vulnerable. One of the major problems in the economy is the level of state involvement. Even though the private sector accounts for 62% of GDP and around half of employment, many of the major industries and the utility sector remain under government ownership and control.

Similarly in Bulgaria a result of early elections in the spring of 1997 in Bulgaria a clear reform majority was elected. The government embarked immediately on a radical reform program aimed at stabilization and the establishment of a functioning market economy. Some of the most important policies were the implementation of a currency board, privatization and structural reforms. The current government under Simeon Saxe-Coburg-Gotha is continuing the reform effort with the aim of acceding to the EU, with which negotiations begun in 2000. The country cooperates closely with multilateral institutions and receives considerable assistance from the IMF and the World Bank. Prudent economic management resulted in strong fiscal consolidation, low inflation, low interest rates and rising foreign

exchange reserves. The improved policy performance and successful reforms provided the basis for the return of economic growth. The European Commission notes (2002) that Bulgaria is close to being a functioning market economy and that it should be able to cope with competition within the EU in the medium term, provided that the reform effort continues to remove persistent difficulties. Bulgaria and Romania are expected to join the EU in 2007.

Turning now our attention to Turkey we need to distinguish it from the rest of the countries in the study. Turkey has not experienced communism and although it often has been far from a fully functioning democracy, it has always been pro western and pro capitalist. This fact, along with its strategic position, makes it a unique place as a destination of foreign investment. Two-thirds of its economy are already globally integrated and that percentage is rising through its close ties with the EU[4]. Turkey combines modern industry and commerce with traditional industries like agriculture that still takes up to 40% of employment. The private sector is well developed and operates according to international market conditions. However, the state still has a controlling hand over basic industries, banking, transport and telecommunications.

Turkey is a country with a vibrant economy, which usually entertains high growth rates. However, due to political and structural problems the situation has not been one of sustained growth. Although the country often enjoys high GDP growth rates (in excess of 6%) it has suffered sharp declines in 1994 and 1999.

One of the major distortions in the economy is the considerable public sector deficit. This is due to the need to service loans whose interest rate repayments reach 40% of central government spending. The country is also plagued by high inflation. As a result of the latest financial crisis the IMF closely supervises the country's economy and the government has been implementing an IMF backed reform program since June 1999. The program focuses on reform in various sectors of the economy and the social security system, banking reorganization, budget control and privatisation. It is hoped that it will bear fruit and there are already some promising signs of recovery despite the dismal condition of the stock exchange market.

Investment in the Black Sea Area

The Black Sea region is characterized by low levels of foreign investment. The locational advantages of this area should make it a prime target for FDI. However, inward investment in all the sectors of the economy is very low by international standards. It is a standard theme in this work that it is not the failure of the legislative framework that hinders FDI but the failure in its enforcement. It is the practical difficulties in investing in this part of the world that deter FDI. Looking at our first group of countries, Russia can provide a good example of the situation at hand.

Even though on the increase, for an economy the size of Russia, the amounts of FDI are minimal and correspond to an unimpressive 2% of GDP[5]. FDI statistics are similar in Ukraine. There is evidence of increased flows of FDI in recent years but overall they remain low. This can be explained by the reluctant and haphazard way in which market oriented reforms have proceeded in the years following independence until very recently. Unfortunately the willingness to attract FDI on the part of the government has not been coupled with the necessary legislation to encourage it.

Foreign investors are not free to enter every sector of the economy and foreign participation is often restricted to 49% or less. Further, most equity investments, joint ventures and share acquisitions need approval by the anti-monopoly commission, which involves a lengthy and costly procedure. Also, although privatization has progressed to some extent (almost fully for small and medium sized enterprises), more than 200 large enterprises accounting for about 70% of industrial output are still state controlled and receive significant subsidies by the government. In the area of capital markets development Ukraine has fared better in reforming and modernizing its banking sector by utilizing international assistance, but it still has to extend the use of international accounting standards to other sectors.

Similarly, Georgia is a country that has many opportunities for attracting FDI, but like Russia and Ukraine, it has many deeply routed problems, which result in low levels of investment. Georgia has preferential market access to the EU and it is in a prime position for the transportation of oil and gas from Russia and the Caucasus. Further, the country combines low labour costs with a highly skilled

workforce. There are opportunities for investment in natural resources and agribusiness sectors, infrastructure development, telecommunications and energy.

Our second group of countries offers an investment climate that is comparable but arguably more attractive to FDI than the previous former Soviet republics. The EBRD recognizes that the investment climate in Romania improved under the previous administration and continued to improve since 2000. In the period 1999-2000 a number of measures were adopted to address the issues of corruption, red tape and to improve the effectiveness of the regulatory system. In 1999 the government changed the system of discretionary investment incentives in an effort to create a level playing field for investment. In order not to discriminate against the foreign investors who benefited from the incentives, general tax cuts were introduced.

FDI inflows play an important part in Romania's move towards modernization and reform. However, the levels of incoming investment are very low. The European Commission in its annual report on Romania's progress to accession (2002) notes that significant progress is being made towards establishing a functioning market economy, and the country in the medium term should be able to cope with competition from external market forces.

Romania offers a large domestic market (22 million), a wide range of natural resources (reserves of oil, gas and minerals), a diversified industrial structure, and an employment force that combines skill with low costs. Opportunities exist in oil exploration, in the automobile industry, banking and finance, telecommunications, construction and development, tourism, consumer products and retail sales. The future levels of FDI will be determined by the government's success in proceeding with privatisation and in creating a stable and reliable investment climate.

The FDI profile of Bulgaria is also gradually improving. Its borders with Greece (an EU country) offer easy access to the European market. Bulgaria presents opportunities for investment in consumer related activities such as finance, trade and services. These sectors attract the bulk of FDI and some of the biggest investments are made in the financial sector. Also large investments have been made in the petroleum and chemical's sectors.

Due to the sluggish pace of reform till the mid nineties and the crisis of 1997 FDI levels in Bulgaria were some of the lowest in the region. However, the return of economic growth has market a sea change in the attitudes of foreign investors. FDI levels rose sharply since 1997 as the international markets saw the Bulgarian economy with renewed optimism. In 2000 Bulgaria ranked first in terms of FDI among Balkan countries and it is rapidly narrowing the gap between itself and the other central and eastern European countries. This effort is assisted by one of the most investor friendly and liberal foreign investment regimes in the region.

Finally, we consider Turkey. Perhaps due to the unhealthy state finances Turkey has been under performing in attracting FDI. US investment in Turkey is primarily concentrated in the manufacturing, banking and petroleum sectors[6]. There has been reform and there are still coordinated efforts to improve the investment climate of the country. Turkey has FDI laws conducive to investment and the rights of foreign investors are protected in a non-discriminatory way. In Turkey the rule of law and the sanctity of contract are maintained and despite the lack of a liberal political environment, the economic environment is one that offers stability to the foreign investor. Turkey has some advantages that are unique in the region. It has a cheap and well qualified labour force which is reliable and hard working, it possesses a large domestic market which offers opportunities for retail trade, it has a mature economic and industrial infrastructure and it offers competitive incentive packages to foreign firms. Further, there are large development projects operating in Turkey that offer unique opportunities for the foreign investor.

The investment barriers in the Black Sea area are common for all counties, even though there are differences of degree for different problems. Despite a number of much needed legislative changes, there are structural deficiencies in the counties' economies and the state in general that harm investor confidence. While there is a fundamental commitment to a free market economy the outdated administrative and regulatory systems, the lack of enforcement of laws and regulations, the widespread confusion as to the appropriate procedures, red-tape, hostile attitudes by officials and debilitating corruption in multiple levels in the state mechanism in many situations act to nullify the locational advantages the Black Sea region offers as a recipient of foreign capital. Further, the area suffers from

an underdeveloped banking system, poor communications networks, a burdensome and frequently changing tax structure, severe crime, limited and non transparent privatization schemes, an almost total lack of enforcement mechanisms for the protection of Intellectual Property Rights (IPRs), complex certification procedures and a weak legal system. All of the above combine to create a hostile environment to FDI. However, the situation can be remedied through proper reform and there is evidence of the political will to carry it through.

Foreign Investment Legislation

One of the basic aims of economic policy in the countries under consideration is the attraction of foreign capital. FDI is seen as the most appropriate method of injecting funds into the economy and it is sometimes the only means to fund necessary infrastructure development. This is because the capital basis of the region is limited and without adequate levels of incoming investment, domestic capital cannot fund transition, even with the aid of international institutions. All the states in this study have specific foreign investment legislation. FDI laws aim to consolidate investment legislation and assist in creating a welcoming environment for foreign businesses.

All countries offer national (application of national regulations to foreign investors) and Most Favored Nation (MFN) treatment (the most favorable level of treatment offered to investors from a specific state, is extended to all) to foreign investors and some provide for security against future legal changes detrimental to the investment. However, a number of restrictions to national treatment exist in the investment laws (see below). Russia enacted an investment code as early as 1991 in an effort to create a legal framework conducive to foreign investment. According to the legal instruments the investors' rights and interests are fully protected and there is a guarantee of compensation for losses through illegal or negligent actions of government authorities and officials. Investments are protected from expropriation and there is provision for compensation for nationalization according to international standards.

The legal framework for investment in the Republic of Ukraine is based on the Law on the Regime of Foreign Investment of 1996. The Law provides for the equal treatment of foreign and domestic enterprises but does not correspond to the Bilateral Investment Treaties (BITs) signed by Ukraine since it imposes restrictions on national treatment. By a total of 27 provisions it gives precedence to domestic legislation and in theory protects foreign investors against discrimination vis-à-vis domestic ones only to the extent that no discriminatory provision is found in generally applicable legislation[7]. Even though Ukraine generally welcomes foreign investment, there are sector specific restrictions on FDI in banking, insurance and telecommunications. Other sectors such as armaments, and alcoholic spirits are completely closed to FDI. Investment subject to license is possible in agricultural chemicals, pharmaceuticals, medicines, cosmetics and hygiene products. However, the restrictions on investment are gradually being lifted.

Georgia does not have an incentives regime for foreign businesses and operates a "level playing field" policy for domestic and foreign investors. The investment law defines investments as referring to every kind of property, tangible and intangible, including intellectual property, invested and used for possible generation in an entrepreneurial activity. The investment policy is liberal and provides, in summary, for unlimited tax-free repatriation of capital and profits and no limitations on foreign currency accounts. The Lari is not freely convertible in international markets but internally has been stable and easily exchangeable.

A very interesting feature of the investment laws of these three countries is the inclusion of a commitment (known as a 'grandfather clause') that any subsequent legislative act that changes the legal framework to the detriment of investments already made in the country, shall have no effect. The period of protection is 10 years in Georgia and Ukraine and 7 in Russia. During this period the investment will be governed by the laws and tax regulations as they stood at the time of establishment.

Bulgaria has one of the most liberal foreign investment laws in the region. The Law on Foreign Investment (LFI) of 1997 outlines the conditions for making investments, the relevant procedures, the protection offered and the conditions and procedures for effecting priority investment projects. The current exceptions to national treatment relate to the acquisition of land and real estate; limitations on purchase of real estate by foreigners in border regions for reasons of national security; non-applicability of national treatment for nationals and companies of states that discriminate against

Bulgarian nationals and business entities; and privatization. The last exception is currently being withdrawn. Till now Bulgaria offered preferential treatment to certain categories of nationals in privatization procedures. Subject to new legislation however, this discrimination is to be eliminated.

Turkey has a long tradition in facilitating foreign investment. The regulations in general can be characterized as transparent and streamlined. The 1980s saw sweeping reforms in the economic and social structure of the country. One of the major reforms was the adoption of liberal and flexible foreign investment policies. In reflecting these changes and modern needs, the foreign investment law was substantially modified and liberalized.

The main features of the FDI legislation are as follows. Turkey operates a screening procedure for foreign investment that is formal and non discriminatory. The fact however, that there is no such screening for domestic investors in theory represents a violation of the national treatment principle. The screening requirement does not hinder FDI since it only serves to block small investments usually having to do with retail trade. Turkey welcomes investment in most sectors, but there are participation limitations in some areas. Establishment in the financial and petroleum sectors requires special permission and the equity participation ratio of foreign investors is restricted to 20% in broadcasting and 49% in aviation, telecommunications and maritime sectors. There are some restrictions in the energy sector. The state still has a dominating presence over energy production and distribution, even though private enterprises were given the right to invest, operate and trade in the electricity sector in 1985 with the abolition of the state monopoly. There is a minimum capital requirement of $50.000 (US) for incoming investment but the transfer of profits, dividends and capital shares is free (subject to the deduction of appropriate tax) in the domestic and foreign currencies. Portfolio investments are not subject to prior permission.

Incentives

In their effort to attract FDI, many countries originally (the former eastern block counties after the fall of communism and independence) operated investment schemes that provided various incentives to foreign investors. The effectiveness of incentives schemes has been doubted and now most of the countries aim to create a “level playing field” for foreign and domestic investors. Instances of positive discrimination in favor of the foreign investors are few and in specific sectors. Some countries now operate free trade zones as opposed to general incentives schemes.

The Ukraine and Turkey are examples of an active incentives policy. In the first case it takes the form Special Economic Zones (SEZs) and in the second it is a comprehensive scheme. The Ukraine originally operated a system of investment incentives for foreign investors, mainly based on tax holidays. These however have been reduced since 1996 and now only some import duties and taxes exemptions remain for imports of capital goods. The aim of the Ukrainian government is to create a level playing field for investors, foreign and domestic. This is considered a move in the right direction since investment incentives are usually costly and often fail to deliver the intended benefits. Further, they result in distortions in competition between domestic and foreign firms and between foreign firms themselves, and are a breeding ground for corruption. There are 21 SEZs in Ukraine and the typical incentives offered include exception from customs duty (and even VAT) on imported goods and services, lower taxes, lower social security payments and exception for profits in foreign currency from mandatory currency sale to Ukrainian banks. The SEZs are open to investment for large enterprises, which use local labor. The government in 1999 pledged to avoid creating any new SEZs as a result of criticism from abroad.

Turkey operates a comprehensive incentive scheme, which is divided into general incentives and incentives for Small and Medium Enterprises (SMEs). The benefits of the scheme are awarded to domestic and foreign investors on a non discriminatory basis and according to the most favored nation principle, as is enshrined in the Foreign Investment Law and in BITs. As part of the general incentive scheme the country is divided into 3 types of regions (developed, first priority and normal regions) that offer different incentives according to their development needs. In order to qualify for the investment incentives, the foreign investor needs to obtain an incentive certificate from the General Directorate of Foreign Investments (GDFI). The incentives include exceptions from corporate taxes and VAT, custom’s fees and duties and provide for soft loans for R&D projects. The incentive regime is currently under review to conform to EU standards as part of the legislative reform in preparation for Turkey’s accession to the EU.

Along with the incentive scheme, Turkey has 10 Free Zones that were established in 1985. The Free Zones are special areas deemed to be outside the customs border and where regulation of trade, financial and economic activities is not applicable in the same manner as in the rest of the country. They are open to a wide range of activities including manufacturing, storage, packaging, trading, banking and insurance. Imports and exports from and to the outside are not subject to duties and income generated within the zone is not subject to income tax. However, import to turkey itself from the Zones is treated as import from abroad and is subject to relevant regulations.

Development Agencies

One of the most common recommendations of the international institutions is the establishment of a foreign investment agency to assist entrepreneurs and multinational enterprises that wish to invest in the country. Most countries have a special government department or a governmental agency entrusted with attracting foreign capital. The examples of Bulgaria and Romania are illustrative. With the help of the EU, development agencies have been set up in both countries. In an effort to attract FDI and assist foreign investors in the pre and post establishment phase, the Bulgarian government has set up the Bulgarian Foreign Investment Agency. The Agency assists companies in the investment process by providing up to date information, legal advice, information on local partners and by coordinating the activities of different institutions. Similarly, the Romanian Development Agency is charged with attracting foreign investment and operates as a gateway to incoming investment. Its responsibilities include identifying local partners for investors, pre and post establishment consultation, and assistance to SMEs for expansion and development.

In Russia the Ministry of Economic Development and Trade set up the Russian State Investment Agency to implement its FDI policies. One of its main functions with particular interest to the foreign investors is the protection of their legal interests from abuse in the sphere of public administration, coordination of activities by different authorities concerning the rights of investors and collection of data on violations of those rights.

Legal System, Corporate Governance, Corruption

The function of the overall legal system in the transitional countries is of doubtful effectiveness. This is the result of the change from a communist to a democratic system of governance and the transformation of a network of laws and regulations geared to a command economy to one aimed to serve a market economy. Ten years of transition have not been enough to complete the process of legislative change and in many instances the laws are inadequate to deal with modern needs. Even when the legal framework is up to date however, many laws are not enforced or are not enforced properly. In all the countries in our study there is a problem of corruption in all areas of business and official activity. Although there are variations as to the degree of corruption encountered, the entire area suffers levels of corruption unheard of in the west. The example of Ukraine helps to illustrate these points.

The legal system in Ukraine is a patchwork of pre and post independence legislation, which creates uncertainty for the foreign investors. Old Soviet law is still in force unless repealed by subsequent legislation. This creates many problems since foreign investors have to comply with a very complex and burdensome volume of administrative procedures often in contradiction to each other. New legislation seldom improves the situation because it is being adopted in a piecemeal fashion to achieve specific legislative objectives without due regard to the coherence of the system. Further, there is little coordination between different government departments at different levels of government and even within the Ukrainian parliament itself. To make matters worse, most legislative acts are framework acts dependant on secondary directives for specification, and secondary legislation is not usually publicly available. The one major legislative act already in force is the passage of the new Constitution of June 1996. All other major legislative reforms are still pending.

The muddle of legislation described above seriously jeopardizes the investment climate. It is difficult for the foreign investors to keep up with a regulatory system that combines elements from two completely different market philosophies and keeps changing constantly. However, the major trend is for reforms in favour of free market policies which correspond to the suggestions of the international financial institutions.

As far as corporate law in Russia is concerned there is an attempt to redraw company legislation and in particular address the issue of corporate governance, which is of vital importance to investors. A Corporate Governance Code was adopted in 2001. This, along with a number of other changes demonstrates the will of the Russian government to create transparent conditions of corporate governance and enhance minority shareholder protection. Transparency and effective protection of shareholder rights can serve to make the Russian market much more attractive to foreign capital.

The problem of inconsistent interpretation and enforcement of laws and regulations is significant in the Black Sea region. It is important to point out that new firms find it difficult to enter into the market not only because of the corruption of officials, but also due to the lack of personal contacts. It is noted that personal contacts are often the only way to overcome administrative barriers. Further, due to the lack of resources, many government agencies in Russia institutionalize their personal dealings with investors by officially offering ‘consultancy services’.

All the countries studied are facing high levels of corruption and are trying to remedy the situation. In Romania widespread corruption and the existence of an underground economy result in a significant shortfall in government revenues and in unfair treatment for law-abiding enterprises that honour their tax obligations. In 2000 a new law was introduced on preventing and uncovering corruption in the public administration and banking system. It is hoped that it will be more effective than previous initiatives. Similarly, Bulgaria has ratified the OECD anti-bribery convention and passed a law against money laundering in 1996. As we have noted above, political and economic considerations sometimes affect official decisions but this does not occur to such a level so as to make investors particularly inconvenienced.

The problem of corruption is related to the inefficiency of the judiciary. Georgia created an anti-corruption commission in September 2000, which has the task of developing measures to combat corruption across the board of government activity. In addition to this initiative there is an ongoing effort to implement judicial reform. The impartiality and independence of lower courts has come into question as a result of the handling of disputes of foreign investors with local partners. The government has attempted to tackle this by conducting open inquiries in cases involving investment disputes. Judges have been required to pass exams to retain their posts and the government has been implementing a World Bank programme to improve the functioning of the legal system through the development of new court administration, improvement of court infrastructure and dissemination of information on the role of the judiciary. A similar program is under way in the Ukraine.

In Turkey, similar problems poison the investment climate, but to a lesser degree. Sometimes foreign firms complain about inadequate tender procedures in government procurement. It needs to be noted that Turkey is not a signatory to the WTO Government Procurement Agreement. Government practice is often complicated, time consuming and expensive for foreign tenders. Further, this is the area most often plagued by corruption. Turkey has a network of laws, regulations and penalties against corruption but enforcement is uneven. Turkey is a signatory to the OECD Convention Combating Bribery. However, the situation is relatively mild and does not constitute a serious investment barrier.

Evaluation

The main theme of this evaluation is the disparity between legislation and its enforcement. The former eastern block countries have still a long way to go in completing their transitional phase. Renovating the legislative framework is a necessary procedure but it does not automatically guarantee the set up of an attractive investment climate. Most of the investment barriers that inhibit FDI in the region are caused by pragmatic problems. For these to be overcome these countries need a fundamental change in the attitudes of officials, decision makers and the business community, along with the modernization of the law and the overhauling of the administrative and judicial system.

Taking the example of Russia, one can point out that, the problematic investment climate stems basically form the lack of effective enforcement of the legislation that is already in force. Low levels of FDI bear witness to the unwillingness of foreign investors to commit themselves in a country with lax law enforcement, overburdening bureaucracy, uncooperative elites and rampant corruption. A study by the Foreign Investment Advisory Service of the IFC and the World Bank into administrative barriers to investment in the Russian federation[8] found that there is over regulation of private business

activity though complicated procedures that seem to serve no legitimate government purpose. There is no legal certainty with regulations changing constantly and their interpretation and enforcement based on the whim of officials, usually seeking illicit remuneration for their services. In comparison with other transition economies Russia fares worse in these areas.

Ukraine and Georgia are also plagued by under investment. For the time being Ukraine is one of the most underdeveloped of the Eastern European countries. Its investment needs are huge and FDI is one of the most appropriate vehicles for rapid development. However, despite the government's commitment to the attraction of FDI the policies pursued are lacking in vigor and efficiency. One of the difficulties is the absence of a centralized investment promotion agency. Recently in 2000 several institutions charged with promoting FDI were integrated into the ministry of economics in an attempt to coordinate their efforts and enhance their efficiency. Lack of transparency and insecurity constitute a much greater investment barrier than any flaws in the laws relating to foreign investment.

The legal system in the Ukraine is changing rapidly in a free market direction and since 2000 it can be said that the change has the full-hearted support of the country's political institutions. One of the changes that are deemed necessary by the foreign institutions and the investors is the alignment of the FDI legislation to the obligations imposed by the BITs Ukraine has signed. Even though international treaties are directly applicable and override national legislation, the elimination of conflicts will help increase investor confidence. The move from a system of discretionary incentives to the creation of a level playing field for investors both foreign and domestic is a commendable change. However, it should be noted here that the state in its effort to attract FDI should not neglect domestic firms, because no matter what the levels of FDI will be in the future, the main force of the economy is its domestic potential. A level playing field policy that promotes both incoming and domestic investment is the best solution for sustainable development.

Georgia has a liberal investment regime that complies with the international norms on investment promotion and protection. As a result of its accession to the WTO and closer cooperation with international institutions, Georgia can claim to have an up to date investment regime. Unfortunately however, the levels of FDI in the country are very low and there is not much optimism that they will pick up in the immediate future. The problem is once again one of enforcement of the legislative framework and the extent of illegal activities. Georgia is a country with an outdated administrative and judicial system and is plagued by crippling corruption on all levels of state and business activities.

The Romanian investment climate and level of development and institutional reform is more akin to the former soviet republics (for example Russia, Georgia and the Ukraine) than the central European countries (like Poland, Hungary and the Czech Republic)[9]. There are a number of general points that help explain the low levels of FDI in Romania. The most serious problem that faces the foreign investor is the unstable and unpredictable investment framework. Governments do not seem to follow a consistent investment promotion strategy. The frequent changes in the incentives regime have lead to foreign investors being disadvantaged and undermine their confidence. Furthermore, even though FDI is recognized as a basic element for development, it has not been the focus of the government's economic policy in the last few years. This is explained by the influence exerted by domestic interests on government decision-making. These groups are not in principle against the notion of foreign capital in the economy, but prefer to do without outside competition. Even foreign institutions like the World Bank and the IMF have not been too diligent in promoting FDI friendly policies. The EU funded the Romanian Development Agency with €5 million during 1991-1996 but has not monitored the use of these funds[10]. The Commission's findings point to major difficulties in the path of development. Romania suffers from serious economic imbalances with high inflation and a widening current account deficit in a difficult social environment. The muddled legal environment, the poor administration and the fragile macroeconomic environment hinder the development of the private sector.

In assessing the prospects for FDI development in the region, Bulgaria and Turkey seem to be the most likely candidates to succeed in attracting the bulk of investments. Bulgaria has made great progress since 1997. The reform has been to a great extent a success both in modernizing the legislative framework and in streamlining the economy. However, such a short period of time cannot be an absolute guide for future development and, as is the case in many transitional countries, the political determination to keep up the pace of reform cannot be taken for granted.

In general terms, Turkey seems to offer the most stable and reliable legal investment climate in the Black Sea region (of the countries studied). Thanks to a great extent to its close relations to the EU, Turkey can offer a combination of the advantages of a developing country (cheap labor force, untapped large domestic market, investment promotion schemes) and the modern legal framework of a European state. The current economic situation however is not highly conducive to the attraction of FDI. Due to the two financial crises that have shaken the country, Turkey has been unable to make progress towards achieving a fully functioning market economy. The economic crises halted economic recovery and stopped the preexisting stabilization programme. The vulnerabilities of the economic sector and the extensive government intervention into many sectors of the economy were the reasons for the collapse. As a result, macroeconomic stability has been shaken and the imbalances in the economy have reappeared. The main aim of the stabilization programme currently under way is to achieve lower inflation and short-term macroeconomic stability. However, the European Commission suggests a wider focus on planning for medium term economic recovery and insists on reforms in banking, agriculture, and state enterprises. Further it is required that the country in general improves its public education, health, social services and infrastructure in its effort to approximate European standards.

Conclusion

Despite the significant administrative barriers, inadequate regulation and enforcement that currently poison the investment climate in the Black Sea, there is reason for optimism for the future. The locational advantages that make this region an attractive destination for FDI have already been explained. The element that will probably make the difference in this decade is the realization on the part of the governing elites, in the countries under consideration, that growth can only be achieved through vigorous reform. A lot of progress has been made in the past decade and more needs to be done now in order to realize the potential for FDI. It is hoped that the political determination to push forward the needed reforms that we see today will be maintained. FDI is one of the main vehicles for the development of the region and local policy makers should rise to the challenge.

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