

# a Comparative Analysis of FOREIGN DIRECT INVESTMENT ATTRACTION



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## ABSTRACT

After the collapse of the Soviet Union over a dozen states had to learn how to adapt both their economies and their political systems. One crucial aspect of growing their new independent economies was attracting investment from other states. This paper analyzes the different strategies utilized for foreign direct investment by Czech Republic, Uzbekistan, and Moldova. The Czech Republic has been very open to foreign direct investment as they have joined the EU, and due to this openness it has had great success in attracting investment and growing their economy. Uzbekistan, a state plagued with corruption, has failed to reach the same high levels of investment resulting in a more poverty-stricken economy. Finally, Moldova has attempted to be more open than Uzbekistan through pursuing investment strategies in the 21st century, but it too has been afflicted with heavy levels of corruption. Through identifying the internal problems of each of these nations it becomes more clear how they can garner future investments to help further develop their young economies.



A crucial element in transitioning a command economy into a market economy with global trading partners is through developing relationships by attaining foreign direct investment. Countries have exploited a plethora of strategies to beckon investment. The four main areas that investors have appeared to focus on when determining the viability of their investment in foreign nations have been marketing factors, trade restrictions, cost factors, and investment climate. The marketing factors consist mainly of market size and growth, closeness to customers, and export potential. The trade restrictions boil down to trade barriers and the ethnocentricity of consumers. Cost factors include labor costs, transportation costs, technology and capital, access to raw materials and incentives provided by the government. Finally, the investment climate relates to political stability, attitudes towards FDI, and structures of the tax system.<sup>1</sup> This paper will evaluate and compare the effectiveness of three Post-Soviet nations; Czech Republic, Moldova, and Uzbekistan in providing the best overall environment for investment and how these four major categories have been addressed by the various nations, the extent to which they have affected the levels of investment, and suggest strategies countries could pursue to stimulate greater investment.

In order to become a globalized nation with a heavy foreign trade presence, a country

must open up. This means allowing foreign investors, extensive trading, and promoting cooperation between nations. The Czech Republic went through this processing of opening up when it joined the EU. The EU opened many doors of opportunity for this small planned economy to allow it to develop into a market economy. There were many driving factors for this development, but one of the most important was foreign direct investment (FDI). Over the past twenty years the Czech Republic has amassed between 2 and 14 billion US dollars in FDI year to year. (Appendix B). The centrally planned economy left over from the Soviet legacy was highly inefficient and lacked capital to grow, foreign direct investment acted as a major remedy for this. One of the desirable characteristics of the Czech economy was that it had a labor-centric economy, it simply lacked enough investment in capital and equipment. This allowed countries both in the EU and out to provide heavy levels of investment to help get it the capital it needed to help grow its economy and allow the labor force to be highly productive. In addition once the Czech Republic joined the EU and had countries invested in it and working in collaboration with it, it was able to lower the trade deficit because it had greater access to international sales networks and was able to increase its exports exponentially.<sup>2</sup> One of the major reasons that the Czech economy

was able to more effectively develop in the EU trade relationship versus its old COMECON relationships with Soviet nations is because of the stronger economies of its trading partners. European nations overall had much more expansive economies with greater levels of products, with greater amounts of capital, and more advanced technology. Trading partners that have access to greater levels of resources granted the Czech Republic more ability to expand and allowed its economy to explode to a much greater extent when it began to adopt the Western market framework. All of these developed traits that came about from joining the EU made the Czech economy not only enticing to fellow EU members, but to other Western countries i.e. the United States as well. The Czech products continue to grow in competitiveness as is displayed by the rising levels of exports specifically in high value commodities, one major example of this is in the automobile industry.<sup>3</sup> The joining of the EU paved the way for many different opportunities for the Czech Republic and made them more desirable for foreign direct investment allowing the planned economy to transition into a market economy. One major example of the types of opportunities foreign direct investment generates is International Joint Ventures (IJVs).

An international joint venture is essentially a contractual agreement between multiple parent companies, both local and foreign, that

cooperatively creates, manages, and owns a firm. This type of model is desirable because it allows high levels of collaboration between two countries, and it allows the investing countries, in this case Western countries, more control over the business. The Western countries are more inclined to invest when they have greater control because this mitigates their concerns about an economic transition like the Czech Republic's transition from planned to market economy. The IJV framework allows for successful organizational identities and business practices to be adopted from the Western economies while retaining the cultural knowledge of the local managers. An example that displays a joint venture in Czech Republic is through the Deutsche-Motor and AutoDil Joint Venture (DAJV). The parent company of Deutsche-Motors from Germany helped to modernize AutoDil by giving them more innovative technology that helped to increase productivity and helped prepare them for the global economy. It is more than likely that without this joint venture, AutoDil would not have been competitive in the world economy. The DAJV ended up dissolving due to different visions and a concern by AutoDil that Deutsche had ulterior motives relating to power, these fears can be partially attributed to cultural differences and past interactions between Germany and Czech Republic. The dissolution however does not mean that the ven-



ture was a failure as the organizational identity of Autodil had been permanently altered, and the senior managers whom were the pushers for ending the relationship admit that Deutsche's business insights helped prepare them for the world economy. "The post socialist enterprise advanced closer to a capitalist corporation through the acquisition of a very 'efficient philosophy'." <sup>4</sup> This is simply one major example of how opening up to direct investment has allowed the Czech economy to adopt Western market economy practices resulting in higher levels of growth and an ability to compete in an increasingly globalized world.



Foreign direct investment from both EU and non-EU Western market economies helped to develop the Czech economy into a more efficient machine, and FDI success in the country is due to three main factors; its EU membership, Czechinvest, and agglomeration. The Czech Republic becoming a member of the EU granted it a network of trading partners, who had a vested interest in the development of the country. In addition to the lifting of tariffs and trade barriers,

countries have a higher stake in their fellow EU members meaning that they promote a collective success that the Czech Republic was now a contributor to. Another crucial element was Czechinvest, essentially an institution that promotes trade and investment into the Czech Republic from other countries. Its main functions include information provision, incentive handling, and infrastructure development. CzechInvest acts as an international marketer by placing itself in various locations around the world to help promote relationships with foreign investors and breed excitement about opportunities in the Czech Republic. They are then able to act as an intermediary between companies internally and abroad with their knowledge of the local area and the relationships they have developed with foreign investors. It has placed its offices strategically to promote areas where it believes Czech Republic can thrive. Examples include their Chicago office, which is meant to attain investments for manufacturing, and its Silicon Valley office, meant for investments in advanced technology. CzechInvest displays Czech Republic's willingness to open its gates to investors, instead of passively waiting for it. CzechInvest markets the skill of the Czech workforce and helps energize investors about the many opportunities present in the Czech Republic. Finally, a vital factor for success of FDI in Czech Republic has been agglomeration. Agglomeration means

placing a large number of firms close together in a type of cluster. This strategy is pursued mainly by Non-EU countries, as the close proximity allows the firms to develop and share local knowledge so as to better get to know the workforce overall. Agglomeration minimizes marketing and cost factors by allowing for ease of exchange of information between various firms.<sup>5</sup> Foreign direct Investment has been crucial in turning the Czech economy around, and it did not just come naturally, but was due to active engagement with many foreign entities and fostering of relationships all around the globe.

The Czech Republic has displayed a heavy openness to investments, and this has paid off as displayed through numerous case studies of firms ranging from industrial gas to breweries to automobile manufacturing. Investors in the Czech Republic have emphasized some of the major reasons they have chosen to bet on the Czech Republic; the skills of its workforce, its location, and the government's openness and willingness to cooperate. As stated before the Czech Republic workforce is considered to be of high quality, which was discovered by Germany's firm Linde who chose to invest in Technoplyn, an industrial gas company in the Czech Republic. This relationship allowed Technoplyn to build a new facility, helped Linde to gain an entirely new market and credited the effectiveness of the Czech workforce as a major contributor to the

decision of the enterprise. The other major decision factors noted by Linde was Technoplyn's enthusiasm for a foreign partner and the strong distribution networks of the company. There are numerous examples of success stories in these types of joint ventures, and in all the examples the investors have credited the effectiveness of the workforce and the Czech peoples' ardor for advancing the economy to become a modern global market player. In addition companies are interested in the Central Eastern European area because many of its neighbors contain large economies including Germany and Austria and the distribution networks in these countries. This makes it a highly viable location for trade with all of Europe, and Germany although it has historically been intrusive upon Czech Republic sovereignty, has in recent years dedicated investment towards its ascension into the global economy. The final piece that these case studies all have in common is that the government has been clear and transparent, one advantage Czech has over other post-soviet nations is its free media, which provides accurate information enabling firms to gauge successful opportunities more clearly.<sup>6</sup> The Czech Republic has proven to be a nation willing to adapt, work with outsiders, and provide quality work all attractive qualities for an investment.

Overall the Czech Republic has been effective in gaining high levels of investment



from foreign firms and nations as it has marketed itself around the world through CzechInvest, and it has a strong closeness to customers due to its central location in Europe. It has minimized trade restrictions by adopting the open and collaborative structure of the EU. The labor force has been proven to be effective and overall their access to resources, although lower than some countries, has not been a heavy deterrent from investment. Even though it lacked advanced technologies, through help from investors they have successfully implemented innovation across their economy as displayed through the automobile industry. Finally their political stability and relatively welcoming attitude towards FDI has made them a strong candidate for investment.



Moldova, a country stuck in between Asia and Europe has struggled since the dissolution of the Soviet Union, unable to adopt an effective hybrid form of Western or Eastern market models or its own form. Moldova is one of the poorest countries in the world and one of the poorest of the Former Soviet Union, meaning

that it has a necessity for foreign direct investment. Over the past twenty years Moldova has only been able to accumulate around 100 to 700 million USD year to year in investment, a dismal number. FDI has the advantages of providing advanced technology, innovative business knowledge, global trading partners and more, making it vitally important for Moldova to grow its stagnant economy. Moldova's major reforms in order to attract greater levels of FDI have been focused on improving the investment climate. Moldova in the past has been plagued with high levels of corruption, it has lacked a strong regulatory framework, and these factors contribute to a lack of political stability and display no willingness to attract FDI. (CPI attached in Appendix) Due to high corruption in particular it has been difficult for Moldova to attract attention from Western investors such as the United States or European Union members, whom primarily trade with countries more akin to their lower levels of corruption. Moldova's primary investor has therefore been Russia, a country with similar levels of corruption, but Moldova wishes to expand its diversity of investors.<sup>7</sup> In an interview when discussing the levels of foreign direct investment in Moldova, an IMF representative stated the following, "Competitiveness and political stability are needed to for higher FDI inflow. Foreign investors need to feel comfortable, to have the opportunity to

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work here without worrying about political factors” (Tokhir Mirzoev)<sup>8</sup>, Corporate Wire Newspaper. Moldova’s deteriorating economy has made it acutely aware of this structural problem and has been working hard to amend it.

Over the past decade Moldova has sought out new ways of attracting foreign investment, it adopted a strategy in 2006 to turn its investment climate in a whole new direction. The main goal was to increase exports and begin to produce commodities that would attract investors. The first part of the newly adopted strategy focused on developing free economic zones and building industrial parks. The purpose of these free economic zones is to incentivize firms who are generally concerned with trade barriers and restrictions when determining investments; these free economic zones alleviate concerns over higher costs from trading with Moldova and help to bring in fresh investments. The industrial parks can help promote agglomeration, a key factor in successful direct investment because when firms are located in close proximity, the development is much more rapid as they are able to exchange information, not only about technologies and business acumen, but also local culture. The second part of the strategy has to do with setting high goals for themselves and instituting a civil police whom will oversee the attainment of those goals, as well as ensure that Moldova is adhering to all proper economic practices. The setting of

goals displays Moldova’s drive and ambition to grow, attractive qualities for investors. The civil police grant Moldova a more respectable image repairing their previous appearance as a corrupt nation.<sup>9</sup> The investment climate of a nation is a heavy determinant of whether or not outsiders wish to invest valuable resources, and Moldova although in the past has been deemed a corrupt nation, making investment a risky venture, it has been pushing new strategies to ensure investors a level of stability and make Moldova a country worthy of investing in.

In addition to regulatory strategies and a commitment to decreasing corruption, Moldova also seeks other means of attracting foreign direct investment through decreasing their cost factors. One effective means of enticing large corporations is through offering them tax incentives. Moldova after its transition sought tax policies that it hopes will make it a more desirable location for investment. Some of these tax policies include a 50% tax reduction for the first five years for foreign companies if the foreign company’s share is valued over 250,000 USD. This type of tax incentive intrigues larger corporations who get a break in the short term, and can then grow their business more quickly in Moldova as they do not have to pay heavy taxes during their first few years of business. A complementary tax policy that promotes long-term growth is Moldova’s low capital gains tax



rate of only 9%. Since generally a capital gains tax seeks to value money more heavily now than in the future, a low capital gains tax renders a commitment to long-term growth, and induces higher levels of investment.<sup>10</sup> These tax policies help decrease foreign corporations' cost factors therefore making Moldova a haven-like area for taxes, and this will help them to attract investment for both the short and long term.

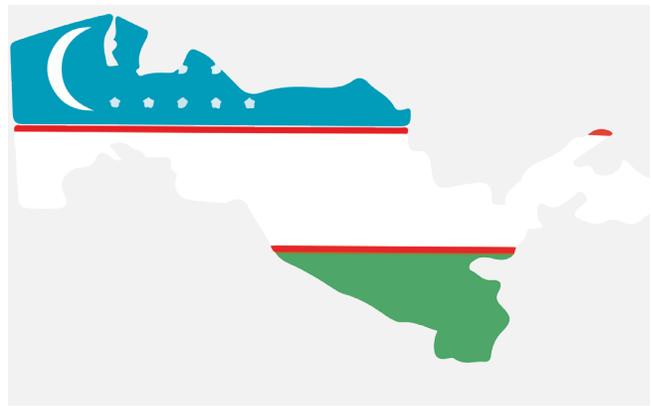
Another area where Moldova has had serious issues is human capital. Human capital is crucial in long-term economic growth, and overall an educated and skilled workforce is minimal in Moldova. As displayed in the Czech Republic, having a skilled and motivated workforce is an important factor for firms because it ensures that their costs will be minimized and production will be efficient and of high quality. One way that Moldova can overcome this problem of developing human capital is through developing relationships with foreign institutions and gaining FDI in higher educational universities at a local level. Moldova is not a physical resource rich country, therefore, developing high levels of human capital is essential to growth. Then, through an educated workforce it can employ strategies that utilize its central location, which is one of its major attractive attributes being geographically located directly between the Eastern and Western worlds. Moldova also needs a greater marketing strategy and one possibility would be

merging the Investment Attraction Team and the Moldovan Export Promotion Activities Coordination Council, this merging will create better coordination between these two separate teams and bring the goal of attracting and working with investors all under one roof. Finally, the regulatory regime in Moldova is still relatively ambiguous and restructuring it could help to induce investment by developing more financial incentives for investment and devising a transparent tax system.<sup>11</sup> It appears Moldova has a large number of possible strategies it could undergo to improve its investment situation, but it needs to implement them officially to help spur economic growth.

Moldova has indeed been making strides toward the future to turn their economy around by welcoming foreign direct investment, however it needs to garner great support nationwide. Research displays that the press in Moldova tends more to highlight the disadvantages of foreign direct investment such as loss of autonomy and foreign access to resources, rather than the major advantages including access to global markets and sharing of business knowledge. The negative attitude displayed in the press trickles down to the people of Moldova, as the press in any society tends to form and portray the opinions of the people. A negative view on FDI will not promote collaboration with various countries and makes Moldova less desirable of

an investment as a whole.<sup>12</sup> This cultural opposition and apathy towards investment is not desirable and must be addressed if Moldova wants to attract the same level of capital inflows as its Western neighbors.

Moldova has been able to attract some level of foreign direct investment, but it has remained relatively minimal over the last two decades. This is partially because in the past it has been deemed as not viable because of its corrupt nature, therefore, it did not contain the desirable investment climate. Moldova lacks the same competent workforce of the Czech Republic, but this obstacle can be overcome through greater emphasis on education. Moldova has not granted high levels of financial incentives in the past besides the advantages of free economic zones, however they do have a strong location therefore market growth displays great potential. Overall Moldova appears to have a poor investment climate that is undergoing promising reform, its cost factors are higher due to low levels of human capital, trade restrictions do not appear high, but could be more favorable, and finally their market size is small, but has high potential for growth due to its location. Moldova appears to have a strong capacity to be a good candidate for investment if it is able to fully repair their previous corrupt frameworks, improve their workforce, and place a heavier emphasis on FDI as a nation overall.



Uzbekistan, a nation in the middle of Central Asia, a part of the infamous “Stanland” is another example of a nation struggling with the economic transition and has faced many problems in attracting foreign direct investment. Uzbekistan has been able to attract only around 200 million to a peak of about 1.5 billion year to year over the past two decades, numbers almost as low as Moldova. Uzbekistan is also a country that has faced massive problems with corruption and a lack of strength in the rule of law. These are two major conditions that tend to deter investors, as they do not wish to put their assets at risk when the investment climate is unsuitable, as it is in Uzbekistan. Foreign investment in Uzbekistan has been low for many reasons including low access to resources and an unstable environment. Foreign investors have stated that Uzbekistan poses unacceptable risks to investors, and unless significant changes are made, it is an unviable place for investment. Other concerns of investors include that Uzbekistan tends to utilize their resources for domestic purposes



almost exclusively squandering any potential for outsiders to use those resources. It is an understandable decision to make for Uzbekistan as it has gone through a difficult transition over the past twenty years, and the domestic problems have forced it to focus primarily on itself. This is a problem that is often faced in economics because consumption in the present allows for the people to live a sustainable lifestyle, unfortunately for growth to occur a certain level of resources must be sacrificed for investment. This creates a huge problem for a country with limited access to resources because although it would like to have cooperative relationships with foreign investors who could employ its resources, this comes at the cost of a lack of resources for its general population.<sup>13</sup>

Another huge roadblock investors have stated is Uzbekistan's lack of legislation progress, specifically in the negotiation of contracts. Uzbekistan although seeking investment, does not welcome investors as it is not willing to allow outsiders in on the decision making progress. This lack of collaborative willingness is highly problematic for investors as they require some levels of control, and in particular this impedes the opportunities for joint ventures, as those require working in concert throughout the process. Uzbekistan in addition has a paucity of clear tax incentives. It offers tax vacations, that provide a few years of no taxes to excite investors, but it

makes certain exceptions for various enterprises including trade and food services. This problem of unclear tax codes boils down to its overall dearth in the rule of law, these kinds of distinctions and absence of uniform codes makes the investors less inclined to do work in Uzbekistan. Overall Uzbekistan has failed to reform economically to make it a desirable area for investment, as it has a hazy tax system, it has imposed import tariffs and excise duties, and requires monotonous contract registration. Uzbekistan is a country of high levels of domestic problems including scarce resources, corruption, and low rule of law, this causes investors to be incredibly wary as they fear for the stability of the government, and Uzbekistan does not soothe investors' worries by blocking their control over specific matters.<sup>14</sup>

Uzbekistan although lacking in large investments into their infrastructure due to their unstable political environment has been able to gain some levels of investment into their private businesses. Through the use of the Export-Import Bank foreign investors are able to minimize their risk of doing business in a country like Uzbekistan by conducting sovereign lending. Uzbekistan has not defaulted once on a payment from this sovereign lending framework allowing for many private business firms to garner international financing through the public sphere of the US Export-Import Bank essentially just

an intermediary that evaluates risks and helps finance loans and provides a level of insurance. Unfortunately the conducting of business in the country between various private institutions has done little to improving Uzbekistan infrastructure as a whole. In order to fully take advantage of assets foreign direct investment brings to the table, Uzbekistan will need to adopt more market-style reforms that change their banking system, tax system, and improve their overall investment climate.<sup>15</sup>

One area of particular interest for Uzbekistan involves its gas and oil resources that are not being fully utilized under its current system. China has expressed great interest in this area and over the past decade has invested in large-scale projects that will build pipelines to help ease the transportation of the gas, a major problem currently facing Uzbekistan. The countries of Central Asia have a large amount of gas and oil resources, the issue is that they are not evenly distributed and the countries have failed to cooperate and create effective trading networks. Uzbekistan's biggest issue is transporting the oil through Russian pipelines, but hopefully through China's investment in larger scale projects it is able to solve this infrastructure problem. Central Asian countries have failed to utilize comparative advantage, a key strategy for collective success. If the Central Asian states are able

to put aside their ethnic differences and begin to collaborate the way the European Union does there is high potential for strong trade in the region that would help to redistribute the resources so that everything is being used most efficiently.<sup>16</sup>

A final key for Uzbekistan to promote greater levels of investment will be to provide both financial and non-financial incentives. Financial incentives will come in the form of reforming its tax system as it has done in previous years so as to make the five year tax holiday a policy for all joint ventures with greater than 50% foreign ownership which produce consumer goods (a market that have very little stake in currently, but wish to focus on in the future). This sort of incentive and other reformations of its tax and trading policies will help clarify the system for the investors. In the past due to the ambiguous nature of their financial systems and laws, investors are wary that they will be cheated by a country with such a poor record for rule of law, but focusing on economic reforms to present a fully realized tax and trading policy could help attract greater levels of interest into Uzbekistan. The other type of incentive Uzbekistan can offer investors comes in the form of non-financial incentives, which are somewhat discretionary policies that promise monopolies or grant exclusive rights.<sup>17</sup> One example of Uzbekistan already employing

this strategy and showcasing its tax holiday is through the investment of BAT into UZTABAK. BAT is a UK enterprise primarily focused in the financial services and tobacco, they invested into UZTABAK, a very poorly run aging tobacco manufacturing plant. The funds supplied by BAT helped to modernize the plant and in return they received a tax holiday and other tax incentives, but most importantly exclusivity in the manufacturing of tobacco. Although this did not grant them a monopoly as Kazakhstani brands were very popular, but by creating an excise tax and allowing BAT to produce a national brand known as Saraton they were able to corner the tobacco market. These sorts of excise taxes and policies had to come from the very top of the Uzbek government, and although it is not completely clear the role incentives played in BAT's choice of investment, the policies of the Uzbek government created a lucrative environment where everybody internally profited. The Uzbek government must continue to provide financial and non-financial incentives to help attract business, and the government's overall firm grip on society could be advantageous as displayed in the BAT case where they were able to manufacture a monopoly on tobacco even with the heavy presence of the Kazakhstani brands.<sup>18</sup>

Uzbekistan is known for its lack of rule of law, similar to most Central Asian States. This makes the negotiation of contracts, the tax

system, and overall trading with the country an onerous task, therefore turning many investors away. Uzbekistan also fails in the area of collaboration, as it often demands control over what occurs domestically impeding the ability of investors to help modernize the nation's industries. Uzbekistan has begun to provide greater levels of financial and non-financial incentives but even these lack high levels of clarity making it still a strenuous candidate for investment. The country requires a transparent tax system, the lowering of trade barriers, and greater relationships with its neighbors, but even these changes may not be enough for it to overcome its biggest problem, the lack of rule of law.

Foreign Direct Investment has been present in all three countries during their transition from a command economy to a market economy, but the extent has varied dramatically. This is due to their different levels of addressing the four categories mentioned throughout. The marketing factors have been much higher in Czech Republic, and although Moldova displays potential due to its location it does not currently have a large market, Uzbekistan has a tough location because its neighbors are highly unfriendly, and this limits its market potential. Trade restrictions are minimal in the Czech Republic due to its membership of the EU, while Moldova does not have extensive barriers, they could be reduced. Uzbekistan faces transportation

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problems that contribute to trade barriers. Czech Republic has low cost factors and has provided strong financial incentives, as has Uzbekistan although the incentives have been unclear at times. Moldova requires greater focus on creating a better labor force and providing greater financial incentives. Finally investment climate has probably proven to be the greatest factor as Czech Republic contrary to the other two nations has relative political stability, a positive attitude towards FDI, and a clear tax system. Both Moldova and Uzbekistan have serious problems of corruption both in the present and the past heavily contributing to wariness by investors, the tax systems are also somewhat ambiguous and the two countries do not appear to understand the vitality of gaining FDI as Uzbekistan in particular has not granted enough power and influence to their investors, wishing to do everything its own way. It is crucial to make these comparisons because of the vital nature foreign direct investment has in turning an economy around and developing a nation. By looking at these various factors countries can determine what they truly need to focus on and what is inhibiting them from attracting investment. It appears investment climate may be the most important factor and clearly has acted as a strong inhibitor for both Uzbekistan and Moldova. Both countries have been making strides towards a more stable climate, however due to their political systems and corrupt past

it will be a difficult obstacle to overcome. All three countries have potential for greater levels of investment, and if they are able to effectively identify their internal problems, FDI can help to solve them through external influences.



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