



SCHOOL OF ECONOMICS
AND MANAGEMENT
Lund University

When in Poland...

**Effects of foreign direct investments on
corruption in Poland**

by

Izabela Siergiejew

Supervisors:
Hans Landström
Maria Aggestam

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Abstract

Corruption has been around for centuries. Cross-border direct investments just for decades. Recent empirical research has found, that countries with rising corruption witness a decline in foreign direct investments. Poland is a paradox in this matter as both corruption and foreign investments are rising. This paper tries to find an answer to that question through examining the relationship between these phenomena in Poland. The findings suggest, that corruption, at least in the case of Poland, could be also understood as a transfer of culture. Most major foreign investors come from economies or cultures, where corruption has been recognized, and even promoted, for years. Thus, based on theoretical literature, published surveys and numerous interviews with experts and practitioners, I conclude, that foreign investors have not only went along with corrupt activities in Poland but they could also be seen as contributing to the sustained levels of corruption. The paper explains that phenomena through a model, that combines the quality of foreign investments, the number of companies using it and the level of corruption in Poland. Increasing the share of investments with high technological sophistication can contribute to the fight against corruption in Poland.

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We trained hard...but every time we formed up teams we would be reorganized. I was to learn that we meet any new situation by reorganizing. And a wonderful method it can be for creating the illusion of progress while producing confusion, inefficiency and demoralization.

Petronius Arbiter, 210 bc

1. INTRODUCTION

In the following chapter the background and the purpose of the thesis are introduced. Furthermore, the limitations of the study and the structure of the thesis with the short descriptions of all the chapters included in the thesis are presented.

1.1. Background

According to Grant (1998), profound understanding of the competitive environment of a company is one of the prerequisites for a successful corporate strategy. Creation of a strategic fit between the firm, its implemented strategy and its environment is possible only if all these components are understood thoroughly. In a competitive, well functioning market they are relatively easy to assess, whereas in markets in transition, that until recently were centrally planned, fundamentally different patterns can be witnessed. These markets exhibit characteristics that are uncommon to market economies and therefore create much more uncertainty and risk for companies used to well-established systems.

One of those countries, that decided to transform its market from central planning to fully functioning market economy, is Poland. On January 1st, 1990, after the breakdown of the Soviet-dominated communist bloc, the first post-communist Polish government introduced an unprecedented economic reform plan known as the Economic Transformation Program. This plan was designed to stabilize the economy, promote structural reforms, and put the country on the right path to becoming a market economy. Furthermore, the transition also included the creation and development of new democratic political institutions and a cultural liberation with deep changes in habits, norms and values (Mygind, 1994).

The dissolution of the old system took place in a rather short period. However, building up new links, new products, new production methods demanded huge resources in form of time, capital and human qualifications. Consequently, reforms to modernize economy and society were very slow. Bureaucracy, inefficiency and the lack of knowledge about the mechanism of modern economy made it very difficult for foreign investors to run their business in the country. Additionally, unpredictable changes created a high risk environment for investments (Hare and Hughes, 1992).

According to OECD (2002), over ten years after launching an ambitious program of economic transformation, Poland has established itself as one of the most successful

transition economies. Consequently, over the last years output has expanded vigorously, inflation has declined and living standards have improved. Poland's robust economic growth reflects large inflows of foreign direct investment (FDI) and the dynamism of small private enterprises.

According to official statistics, annual foreign direct investments increased from 89 million in 1990 to USD 10,6 billion in 2000. In 1998 alone, Polish economy attracted 40 percent of all FDI inflows to Central and Eastern Europe. By the end of 2002, accumulated inflow of FDI to the Polish economy had reached over USD 65 billion. The number of enterprises with foreign participation increased from 429 in 1989 to 46258 by 2001. With its 39 million inhabitants, Poland has become the center of attention for foreign investors (PAIZ 2003).

Despite vigorous economic growth and significant inflow of foreign investments to the economy, Poland has been struggling with corruption that according to the World Bank (1999) and the European Commission (2002) threatens democracy and economic development. Furthermore, corruption in Poland is one of the highest among both West and East European countries, being surpassed only by Latvians, Czechs and Slovaks in CEE.

Given the high number of foreign investors in the country, they are all deeply affected by that phenomena that can be viewed as an inheritance of the past. Corruption has created the perception of unstable environment where investments are associated with high risks and unpredictability. Furthermore, the barriers of market entry are much higher than in other countries and also competition is directly influenced by the phenomena. As stated by Rose-Ackerman (1999) in the corrupt environment the winner is not the most efficient or productive investor but the one that can pay the highest bribes. Companies can behave either in a passive way, i.e. to engage in corruption and remain silent about it, or in an active way, i.e. to raise the question of corruption in all the levels accessible to root out that phenomena. Although being active has clear benefits, so does remaining passive. This is not a characteristic of only the Polish market but can be applied to most of the countries in the world, including also developed countries.

As stated by Weiner (1990), to contend that the West is ethical in all its dealings, and the East is unethical, is naive and completely self-congratulatory. It does not require a great leap of logic to conclude that in a cut-throat market, many companies, both Western and Eastern, abandon ethics for quick profits. However, the driving forces behind active participation in corruption activities may vary between Poland and Western countries. In the case of Poland, bureaucratic burden and delay are exogenous. An individual firm may find bribes helpful to reduce the effective "red tape" it faces. Consequently, the "efficient grease" hypothesis asserts that corruption can improve economic efficiency and that fighting bribery would be counter-productive (Rose-Ackerman, 1999).

It has to be pointed out that in the Western world, companies are spending a great deal on lobbying. The emphasis could be to influence governments to, for example, change or "kill" legislation that essentially decreases profits. The fact that the Western Europe functions much more efficiently on a day to day basis, does not necessarily mean that it is no less populated by individuals who do not crave

unethically derived privileges. Human nature is not all that different in different spots on this earth. What seems to be different are such things as the degree of power held by people over others, the feedback and control mechanisms to keep abuse of power in check, greater transparency of governments' actions, a greater sense of responsibility and discipline inculcated by the industrial revolution, and other similar differences (Khera, 2001).

By this day, Polish government, in cooperation with international organizations and institutions, has adopted several legislative acts to fight corruption. Unfortunately the effects are either negligible or non-existent. In the light of the upcoming membership in the European Union, persistently high levels of corruption have attracted a lot of attention by the international and local media, foreign governments and most importantly for the purposes of this paper, of companies willing to set up a branch, subsidiary or a joint venture in Poland.

1.2. Problem

For companies, corruption creates additional risks, uncertainties and costs in both establishing a company on the market and running it on a day-to-day basis. The essence of corruption in the business sector is that it does not allow the allocation of resources in the most efficient way. The incentives of the decision-makers are influenced by bribes or non-monetary measures to favor one company over another based on subjective criteria.

This has led a number of researches to address the issue of the effect of corruption on the inflow of foreign direct investments and economic growth. In both cases, findings have shown that corruption has a negative, although insignificant, effect. In the case of Poland, surprisingly, both the level of corruption and the level of inflows of foreign direct investments is growing.

To my knowledge and also confirmed by experts interviewed during different phases of work, this subject has not been studied before. There seems to be a contradiction with the theories indicating negative correlations between the levels of corruption and FDI and the theories predicting that increased levels of FDI also contribute to a more open and transparent society, i.e. lower corruption.

The case of Poland is nevertheless "special". Several factors contribute to the existence of both high levels of corruption and increasing inflows of foreign investments. Many of these have been studied before and are included in this paper. There is nevertheless one aspect of research that, to my knowledge, has not been covered ever before. That is the effect that foreign investors can have on the levels of corruption in a country.

It has to be emphasized that the findings of this paper, whether negative or positive, should not be seen as applicable in an unmodified way to other countries.

1.3. Purpose

The purpose of this paper is to find out if and how foreign investors influence the level of corruption in Poland.

1.4. Limitations

The thesis will be limited to the study of foreign direct investments in Poland from 1989 and corruption from 1995. As stated in the background and problem statement, the case of Poland has been identified as anomalous in the light of existing theories. Due to the in depth approach taken, it is not possible to conduct a comparative study with other countries on the pages of this paper.

The limitation to the period for FDI from 1989 onwards is driven by several motivations. First, the FDI inflow to Poland was not significant before 1989. Secondly, reliable data can be obtained only from that period forward. Thirdly, 1989 signifies the year of the collapse of the previous Soviet-driven regime and thus can be seen as a milestone in the development of the economy.

Corruption has been studied systematically only since 1995 and therefore there are no prior numerical indicators that could be used for examining the change in corruption over years.

Furthermore, the paper does not make any distinction between horizontal and vertical foreign direct investments as they are irrelevant to study of corruption. A thorough analysis of these two types of FDI can be found for example in Helpman (1984), Helpman and Krugman (1985) or Hill (2002).

It has to be emphasized that the paper does not attempt to add to the studies on the effects of corruption on foreign direct investments as these have been conducted before, although not specifically for the case of Poland. These effects are examined only up to the level perceived necessary for better understanding of the purpose of this paper.

1.5. Structure

To find out and exhibit in a clear way the effects of foreign direct investments on corruption in Poland, the paper is structured into three general parts – theoretical, empirical and analytical.

Figure 1 provides a visualized picture of the structure by providing a brief note for each chapter in the paper

Figure 1: Structure of the paper

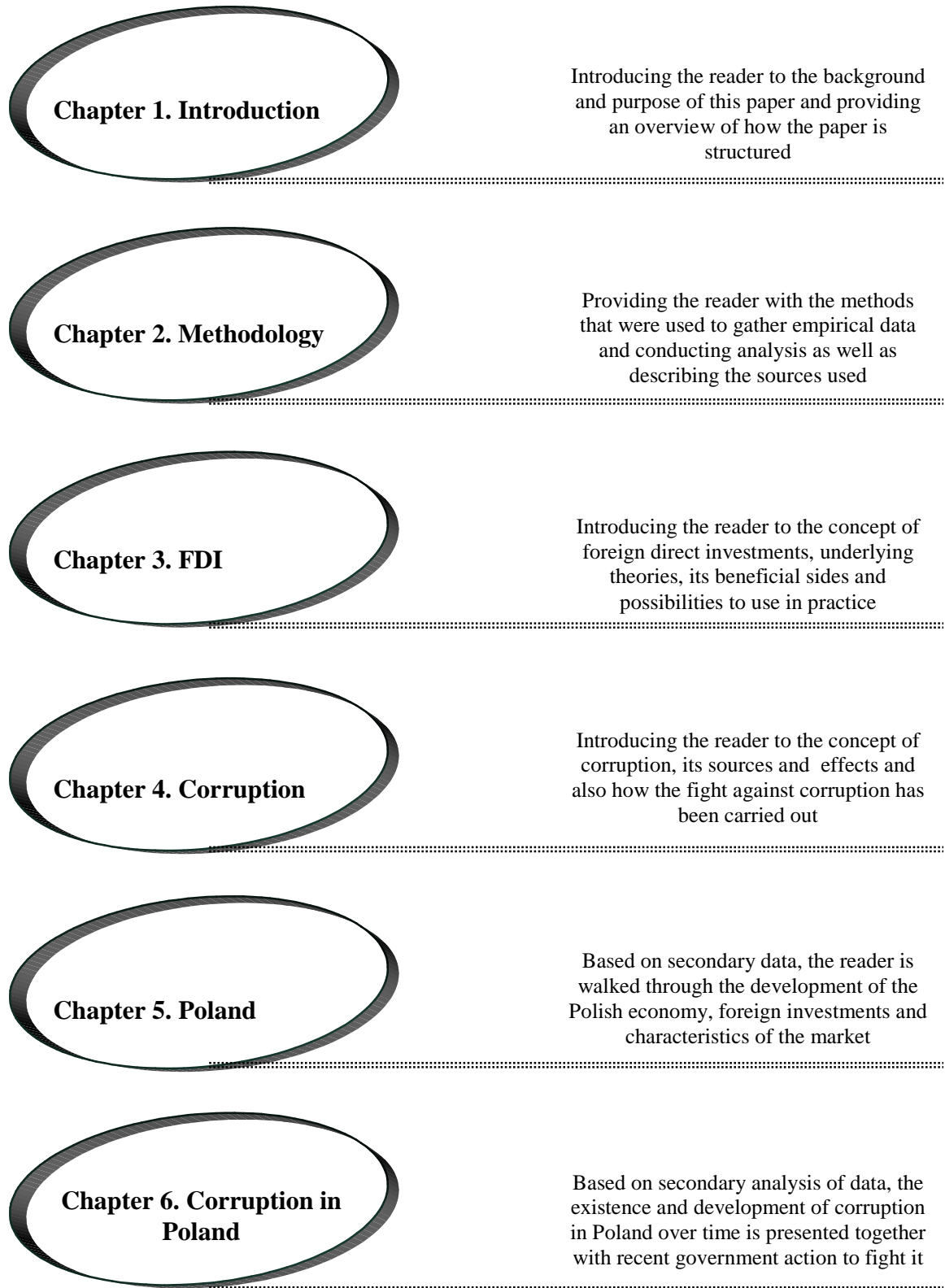
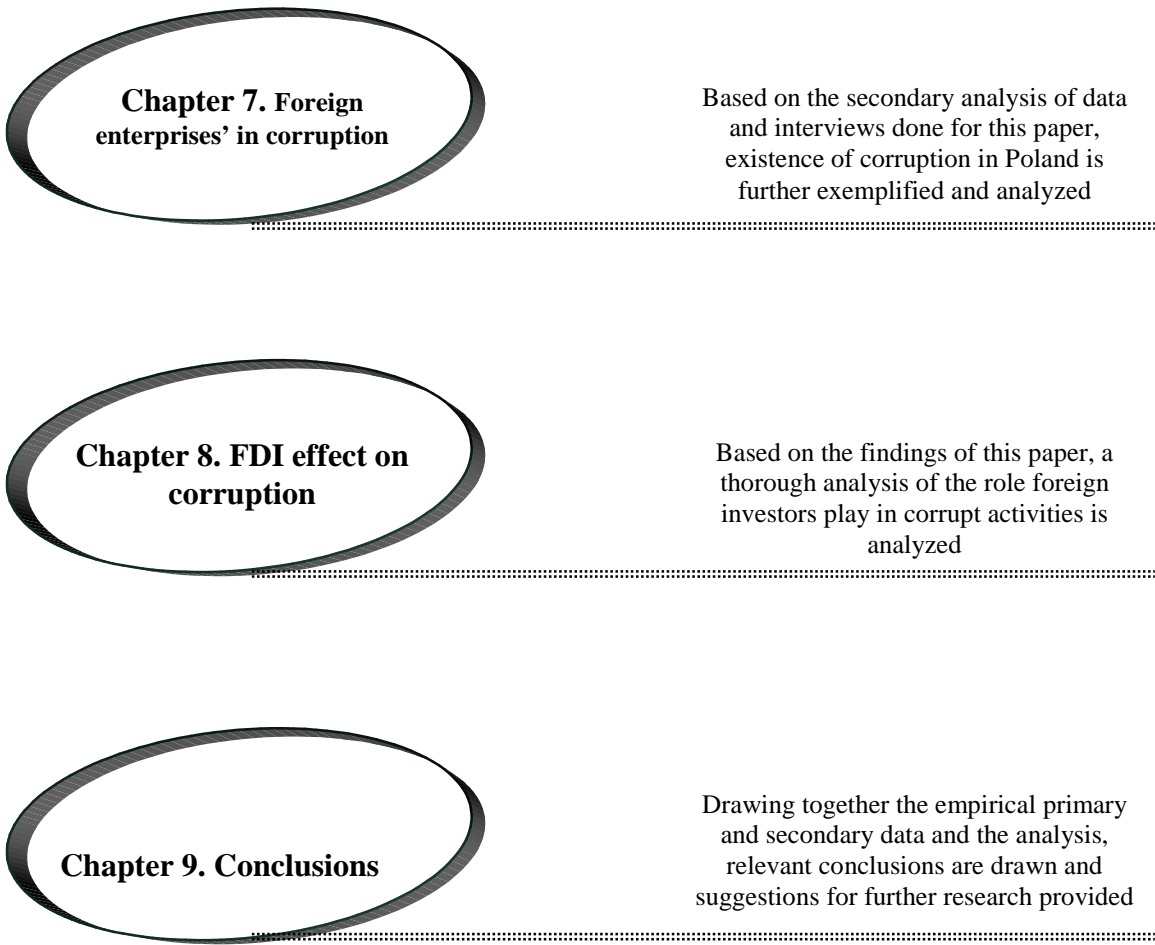


Figure 1: Structure of the paper (continued)



Every chapter commences with a brief introduction and, starting from Chapter 3, concludes with a brief summary.

Nothing has such power to broaden the mind as the ability to investigate systematically and truly all that comes under thy observation in life.

Marcus Aurelius 121-80 AD

2. METHODOLOGY

The following chapter explains the methods used for gathering data and conducting the analysis. In addition to secondary data, numerous interviews were conducted with companies and experts in this field. The chapter also provides a critique of both the data and the existing research in the field of corruption.

2.1. Choice of topic

The idea of this thesis was born when I visited Poland in December 2002. The biggest corruption scandal up to date had been just revealed and I realized that my knowledge about this fascinating issue is very limited. Considering, that my educational background is in strategic management and leadership, which deals a lot with the motives and processes for companies to expand both domestically and across borders, the choice of focusing on the role of foreign investors seemed to be natural.

I am also grateful to my supervisor, who encouraged me not to settle with a topic that has been studied in numerous ways by hundreds of students before me, but to be bold and seek to answer also provoking questions. Furthermore, since there is no thesis on the subject of corruption in Poland in the School of Economics and Management in Lund University, the choice of topic became clear.

2.2 Strategic approach

To choose and describe what method has been used in the study, is of vital importance since it will effect the result and the problem statement. According to Wiedersheim and Eriksson (1991), Patel and Davidsson (1994) , every study has a research design. The strategy one uses when conducting a study depends on how much knowledge the researcher has about the problem and what his point of departure is. There are three strategic approaches; explorative, descriptive and explanatory.

As the working process on the thesis began, I had basic knowledge about foreign direct investments from previous studies. However, the knowledge about corruption was very limited. As I did not have any knowledge about the correlation of these two factors, an explorative approach of the study was used. Consequently, while identifying the problem and formulating hypotheses, unexpected areas were met that were not taken into consideration from the beginning.

In the process of gathering and studying the data, knowledge on the field of study was obtained. Further facts had to be clarified and the correlations between foreign direct investments and corruption identified. Consequently, the descriptive approach was used since the study became of a descriptive nature while simultaneously the issue was investigated in depth.

After wide knowledge about the subject was obtained, the explanatory approach was applied to study the cause-and-effect connection between foreign direct investments and corruption.

2.3. Scientific approach

According to Bryman (1988), a term like “scientific” is inevitably vague and controversial but in the minds of many researchers and writers on methodology it entails a commitment to a systematic approach to investigations, in which the collection of data and their detached analysis in relation to a previously formulated research problem are minimal ingredients.

To choose and describe a method is a very important element of any study. This paper has not been exceptional and the choice had an impact on the results and problem statement.

2.3.1. Deductive and inductive approach

According to Wiedersheim and Eriksson (1991), a study can either be deductive or inductive. What distinguishes between the two approaches is normally the character of the problem statement itself.

The approach chosen in this paper is a deductive one since a problem was found by exploring existing theories.

2.3.2. Rationalism and empiricism

According to Mårtensson and Nilstun (1988), there are two different scientific approaches that strive to systemize the process of searching and analysis, namely rationalism and empiricism. Rationalism views logical thinking as the most important source of knowledge. Empiricism claims that knowledge is only built upon experience.

In the thesis the rationalism perspective is a dominant one. Since the research on corruption has its limitations, I had to find correlation, through rational thinking, between existing data and theories, which allowed me to postulate my own hypothesis developed on the pages of this paper.

2.4. Data collection

The collected data, that is the base for the study, can be classified as either primary or secondary (Halvorsen, 1992). In this thesis the primary data should be treated as complementary to the secondary data.

2.4.1. Secondary data

The data collection included mostly secondary data in the form of, for example, books that are available at Lund University libraries. While there is a great deal of literature about foreign direct investments, the literature on the corruption studies is very limited. As there were no books available in the library for the case of corruption in Poland, the internet resources had to be used in the process of gathering further secondary data.

Collection of secondary data through the internet was crammed with difficulties. Many relevant web pages require access codes or subscription fees prior to entering the site. The internet database provided by Lund University was therefore very helpful by providing free access to web pages of for example Social Science Research Network and National Bureau of Economic Research. I have also used ELIN and Westlaw International databases that are free of charge for Lund University students¹.

Through the use of internet, existing studies and examinations on corruption were collected. The information was gathered from e.g. :

- The Organization for Economic Co-operation and Development (OECD)

Since the OECD is one of the few organizations that actively fights against corruption, the information included on their web pages was relevant to the study. Furthermore, the studies that include comparison of the member countries of the OECD were gathered.

- Polish Agency for Foreign Investment (PAIZ)

PAIZ was established in 1992 to promote the FDI inflow to Poland. It is a governmental institution that helps foreign investors to establish businesses in the country. Statistics and surveys provided by the agency are of high quality and, as PAIZ cooperates directly with investors, I assumed that their knowledge is of great value for the study.

In the thesis I used a survey by PAIZ that was carried out in February 2003. It included the study of the biggest foreign investors in Poland and their opinions about business climate in the country.

¹ Westlaw International is available only to the students of the law faculty

- The Open Society Institute (OSI)

The Open Society Institute in Budapest is a private operating foundation that develops and implements a range of programs in civil society, culture, education, legal and economic reform. The organization carried out studies on corruption in Central and East Europe in 2002. The information provided by the Open Society Institute were very helpful.

- The World Bank

Almost all the information reported in this site is derived, either directly or indirectly, from official statistical systems organized and financed by national governments. The World Bank, in collaboration with many other agencies, provides the best data on corruption studies. Furthermore, information provided by the World Bank is free of charge.

In the thesis I used the World Bank survey from 1997 on 4500 companies from Central East European countries of which around 260 were foreign owned companies in Poland.

The survey might seem to be “out of the date”, but since they are very few surveys available the study was included in the thesis. However, the aim was not to base the knowledge on this survey, but to use it as an example that corruption is an issue in Poland or to compare it with other studies that were carried out after 1997.

Another, very important study that was carried out by the World Bank is the Corruption Report. The report was prepared by the World Bank in 1999 on a request from the Polish Government. As of May 2003, this is the only source that recognizes and defines the phenomena specifically for Poland. Since the report can be treated as a unique source, I decided to use it extensively in the thesis.

It has to be emphasized that many international organizations like IMF, OECD, EU often refer to the studies carried out by the World Bank.

- The Prince of Wales, International Business Leaders Forum (IBLF)

IBLF is a non-profit organization, headquartered in the United Kingdom, that has been active in Poland since 1993. The main approach of IBLF is to promote and support business activities in the field of Corporate Social Responsibility and to support sustainable socio-economic development in local communities.

In 2002 this organization carried out a survey on 500 of the biggest foreign investors in Poland. The aim was to study investors’ attitudes toward corruption in the country. The results of the survey have been included in the thesis.

- The European Bank of Restructuring and Development (EBRD)

In October 1999, the EBRD published a survey that included a study on foreign investors’ involvement in the corruption practices. The survey was conducted on 303

Polish companies with foreign ownership. Relevant results of the study have been included in the thesis.

It has to be emphasized that I also carried out a secondary analysis of the data. The method is based on the examining the data which have already been collected and analyzed by the creator of the database (Bryman, 1988). The purpose was to consider an alternative interpretation of a set of data than the original researcher. Furthermore, I assumed that the data e.g. the World Bank Report on Corruption in Poland, offered the potential for analyses, that the original researcher did not report.

Finally, it has to be pointed out that except surveys I tried to gather all available theoretical contributions on the correlation between foreign direct investments and corruption. However, it has to be taken into consideration that the access to some studies was denied.

Transparency International Index

Transparency International (TI) is the only international non-governmental organization that is devoted to combating corruption. Since 1995 TI has produced and published Corruption Perceptions Index, Corruption Bribe Payers Index and other indexes that measure corruption from a variety of perspectives.

The Transparency International Corruption Index is the only index that is used in the thesis. The index pools together information from several existing indexes by averaging or using other statistical extraction methods.

The index measurement is based on the scale from 0, that indicates a high rate of corruption, to 10 that indicates a low right of corruption. Since the author decided to show corruption rate in the form of graphs, the measurement of the TI index has been reversed. Consequently 10 indicates a high rate of corruption and 0 a low rate.

Furthermore, the TI index has been also used to compare corruption rate in different countries and to determine the average corruption rate in the EU.

There were three different methods to determine it. The most common measure is the arithmetic mean. This is derived by adding together the values of the items in the set and dividing the total by the number of items. There is an implied assumption in the arithmetic mean that the values from which the mean is calculated are more or less of the same order of magnitude. Since the corruption rate between particular EU countries differs greatly, the author decided not to use this method.

The second method in determining the average measurement is a mode. In the method the “most popular “ value in a set of numbers is chosen. Considering the fact that corruption rates varies among the EU countries, the aim was not to derive “the most popular value”, but the average value representative for the Community. Furthermore, the mode is used mostly for averaging statistical data for large number of data sets. In the case of corruption, the number of observations is limited to the number of countries, which , in the case of the EU, is only 15.

Therefore median was chosen that avoids the problem of extremes and the problem of choosing the “most popular” rate. Median indicates the value for which there is an equal value of observations below it as well as above it. The method is less affected by extreme values and will be less than the arithmetic mean where the items include an extreme high value and will be higher than the arithmetic mean where there is an extreme low value (Dictionary of Economics, 1992).

2.4.2. Complementary data

Since corruption is punishable in almost all countries in the world, companies are not willing to cooperate with the researcher. According to Bryman (1995) further problems may arise in connection with field studies of companies. Many organizations are resistant to being studied, possibly because they are suspicious about the aims of the researcher. Further, persons who act as “gatekeepers” between the researcher and the organization are likely to be concerned with the amount of their own and others time that is likely to be consumed by the investigation thus creating costs for the company. Firms may refuse access for a variety of other reasons: it may be company policy not to co-operate, they may not approve the specific project, the researchers assurances may not assuage worries about the amount of time that is taken up, the firm may just have been involved with another organizational researcher, and so on.

Furthermore, since the author is just a student and not a researcher or a professor of a well known organization, her authority could have been questioned by the companies. However, few interviews that are the base for primary data were carried out.

Primary data was gathered using unstructured interviews. The kind of interviewing normally carried out by qualitative researchers differs considerably from the one associated with a survey interview. Whereas the latter tend to be structured, often with closed-ended questions, and standardized, qualitative research interviews are relatively loosely structured. The aim is to elicit respondents’ ways of thinking about the issues with which the qualitative researcher is concerned, so that there is usually a preference for minimizing ed. the degree to which they are constrained (Merriam, 1998).

Unstructured interviews are not guided by pre-existing schedules; at most, interviewers use an aide-mémoire which reminds them of the topics they want to cover, while giving respondents considerable latitude over what they want to say and how they say it. The interview is often started by some general questions, and the aide-mémoire topics are activated only to ensure that everything is covered (Bryman, 1995).

- Personal interviews

The goal was to find companies that have been established in Poland since early 90s. The historical dimension is very important since the market has been developing successively. It was assumed that these companies could provide information not

only about changes of FDI but also about the changes of administrative barriers and corruption. Furthermore, the aim was also to find companies that could freely talk about these issues.

Several companies were chosen and contacted. The direct question about companies participation in the corruption activities was never asked. However, it was emphasized that the author wanted to gather information about Polish market and administrative barriers. Companies were also offered to participate in the interviews anonymously. As assumed before, the actual number of companies willing to participate was small.

Two companies agreed to participate in the interviews under the condition of remaining anonymous. The persons did not agree to be recorded, but under the interviews notes were allowed to be taken. Furthermore, the author had to guarantee that no leading information to these companies will be used in the thesis.

A week before the personal interviews, a list of “possible questions” was sent to the companies. That gave time for persons to prepare and gather all the relevant information. Both interviews took place on the 12th of May, 2003 and lasted for a little over an hour. Annex 6 provides examples of questions asked from the companies.

The interviewed persons, Mr. Carsson and Mr. Svensson (the names have been changed) were very involved in the interview process and freely discussed the subject. Furthermore, it was decided by the persons if they want to use the word “corruption” or the synonyms. For example synonym used by the persons was “tools to speed up things”.

- Telephone interviews

A number of telephone interviews were carried out. Taking into consideration the time limit of the thesis and that most of the telephone interviews had to be prearranged, the aim was to reach the persons that are perceived as experts. Annex 6 provides sample questions asked during the telephone interviews with the following persons:

Name of the interviewed person	The date
Adrian Grycuk	the 17 th of April, 2003
Grazyna Czubek	the 16 th of May, 2003
Jarek Polak	the 22 nd of May, 2003
Alfred Gubczak	the 22 nd of May, 2003
Rafal Szakalis	the 23 rd of May, 2003
Beata Smarzyńska	the 23 rd of May, 2003

- Adrian Grycuk, senior researcher at PAIZ, provided general information about the Polish market, foreign investors and corruption’s perception in Poland.

- Grazyna Czubek is the coordinator of the Batory Foundation that is one of the few organizations in Poland dedicated to fight against corruption. Ms. Czubek provided general information about corruption in Poland.
- Jarek Polak is the coordinator of The Prince of Wales International Business Leaders Forum in Poland. Since IBLF conducted in 2002 one of the biggest surveys considering foreign investors and corruption in Poland, I assumed that the interview with the coordinator of the organization might contribute significantly to the quality of the thesis.
- Shell is one of the very few companies in Poland that implemented anti-corruption measures in the organization. I found that very interesting and therefore decided to contact the company. The interviewed person was Alfred Gubczak, the spokesman of Shell in Poland
- Since the European Union's dimension is mentioned in the thesis I found it important to contact the representative who would provide the information about the importance of the EU accession for Poland. Furthermore, since corruption is mentioned in the reports of the European Commission about Poland I assumed that the representative would talk freely about it and could provide important information. The interviewed person was Rafal Szakalis, the representative of the European Commission Delegation in Poland
- To contact Ms. Beata Smarzynska at the World Bank was of a great importance. Firstly, she is an expert on corruption issues. Secondly, in the thesis I referred very often to her studies. Furthermore, since there were questions about the theories promoted by Ms. Smarzynska, the clarification was needed.

The most important aspect of the conversation with Ms. Smarzynska was the explanation of the particular elements of the model that I used in the thesis (sector 4.5.2.) For better understanding of the theory, I was allowed to do modifications of that model.

The findings from all of these interviews are presented in the analyzing part of thesis

2.4.3. Reliability and validity

Reliability refers to the extent to which research findings can be replicated. The reliability of research is high if a repetition of the research would lead to the same empirical findings and conclusions. The goal of the method is therefore to minimize errors and misinterpretations in the research and document how the study has been conducted (Yin, 1994). In order to obtain reliable results, researchers need to be objective, their measurements have to be accurate and their studies should be exhaustive (Boyd et al. 1981).

The ability to measure what a researcher intended to measure is called validity (Zigmund, 1989).

To increase reliability and validity of the thesis I have chosen to use literature provided by known, international organizations. Furthermore, the aim was to avoid a literature that would only include subjective perceptions.

The interviewed persons are considered to be experts and therefore, it can be assumed that the information provided by them are reliable. Moreover, I believe that since two of the interviews were anonymous, I was able to gather information that would not have been available otherwise. Therefore additional contribution to validity and reliability of the thesis was made.

However, since corruption is often based on opinions that can not be really measured as mathematical forms, some subjectivity might have been included in the studies. Furthermore, corruption usually involves feelings and perceptions that can not be always explained and therefore not measured. Therefore, it can be concluded, that though I aimed to achieve as high reliability and validity as possible, the study is based on subjective opinions of experts.

2.5. Critique of sources

2.5.1. Critique of secondary data

One of the biggest disadvantages of secondary data gathering is that some information could not have been accessed and thus there is a possibility that certain relevant information was missed. It has been also noticed that in some cases, data provided by the international organizations was in contradiction with each other. Therefore, the author had to decide, which data was the most relevant one consequently creating subjective evaluation problems.

Furthermore, there is a great deal of literature about corruption. The disadvantage of the studies is that they often did not contribute with any new perspectives or information. Instead, authors were referring and repeating findings from previous studies.

On some occasions authors were also referring to their “own findings” but as it was found out, they were merely replications from earlier studies by other researchers. To decide reliability of some sources, even if they were provided by the respectful international organizations, was not an easy task.

To increase the reliability and validity of the study, a great amount of publications was gathered and analyzed. The aim was to avoid using articles from daily newspapers, especially those included in the Polish newspapers. The author assumed that subjective opinions could have been included in the information provided by the media. Since it could influence the quality of the thesis, the author decided to exclude these sources .

The Transparency International Indexes also raised some questions. The advantage of this index is that since it is a “survey of surveys”, more complete and wider perception about corruption is identified. Moreover, this index might be treated as

being the best representative indicator for corruption since it exclusively focuses on corruption. However, since TI index is a survey of surveys the question is how the errors are avoided and if the criteria taken into consideration are all over the world the same. Furthermore, the TI indexes are not prepared by one person but by many. Since the corruption measures are based on subjective opinions there is a risk that individuals that are engaged in the process of indexes creation have different opinions about a scale of corruption. Finally, the scale used by TI also rises questions. As “0” means a high corruption, “10” means no corruption. However, there are problems while interpreting other numbers as 6, 7, 8 etc. since these measures do not reveal the sources of corruption. Therefore, it can be difficult to compare different countries and sources of corruption.

2.5.2. Critique of primary data

There exists a risk that the persons that were interviewed were willingly hiding the information, simply did not want to answer them or some important aspect could have been missed both by the interviewee and the interviewer. Furthermore, it has to be also taken into consideration that the base for corruption’s perception is subjective opinion. Therefore, persons that were interviewed could have not consider the facts objectively while expressing their opinions.

One can also question the reliability of the two interviews that were conducted anonymously. However, it has to be taken into consideration that corruption is punishable. Therefore there is a risk that no companies would agree to be interviewed if the author did not guarantee anonymity.

Finally, it has to be emphasized that my background could have also influenced the study since it is very difficult to sustain unbiased when writing about corruption.

2.6. Analytical procedure

Gathering empirical data and studying existing theories allowed to commence with the analytical process. The aim was to be as precise as possible by not introducing the reader to any new concepts and theories. Nevertheless, information from personal and telephone interviews to support the analysis next to the facts presented in the previous sections of the paper is used.

A significant portion of the analysis is based on the pre-existing model developed by Smarzynska and Wei in 2002 (section 4.5.2.). The model is novel and therefore there is no empirical testing of its applicability. Due to that, Mr. Smarzynska was contacted in person to clarify the logic and facts behind the theory.

Furthermore, the analytical process demanded applicability of rational approaches where the facts about foreign direct investments and corruption were connected with each other and new theories, through the deductive method, were constructed – namely the “butterfly theory” and the theory about fixed cost of corruption.

I am solely responsible for any misinterpretations of the empirical data. This applies also to interviews and translations of text from foreign languages.

Those who do not know the plans of competitors cannot prepare alliances. Those who do not know the lay of the land cannot maneuver their forces. Those who do not use local guides cannot take advantage of the ground."

Sun Tzu, The Art of War

3. FOREIGN DIRECT INVESTMENTS

The following chapter introduces the concept of foreign direct investments, determining factors for choosing a specific country, different entry modes available to companies and benefits of FDI. All of these are a part of the corporate strategy to enter a foreign market for which a thorough understanding of the corporate environment is essential.

3.1. Significance of corporate environment

No company can function without taking into consideration the environment in which it operates. According to Grant (1998), profound understanding of the competitive environment of a company is one of the prerequisites for a successful corporate strategy. Creation of a strategic fit between the firm, its implemented strategy and its environment is possible only if all these components are understood thoroughly.

Competitive advantage within an international environment is determined by three sets of factors – firm resources and capabilities, the industry environment and the national environment – which together form the core of the competitive advantage for the company. The national environment comprises of national resources and capabilities, domestic market conditions, government policies, exchange rates and related/supporting industries.

The significance of the external environment of the company cannot be over-emphasized. Not only is the company subject to the changes in it but the environment affects all the constituencies with whom the corporation interacts – its suppliers, customers, competitors, creditors, employees and also rivaling substitute industries.

Increasing internationalization of the world economy, a well-established fact for the last two decades, has significantly reformed the environment in which companies operate. One of the most significant features of that has been the increase in trade (United Nations, 1998). This has not occurred only between developed economies, but also within and between different regions and between developed and developing countries (Feenstra, 1999). This has been possible through elimination of trade barriers and harmonization of market factors.

Based on those, companies have increasing opportunities to enter foreign markets either through transactions (such as exporting, franchising or licensing) or through direct investments. In this framework, direct investments bring with them a close

interaction with the environment where the company is established. As such, the company is no longer a passive player following the rules established before it, but becomes active, influencing its surroundings.

3.2. Defining foreign direct investments

One of the most elaborated definitions of FDI is provided by the Organization for Economics Cooperation and Development (OECD). By their definition FDI is “a category of international investment made by a resident entity in one economy (direct investor) with the objective of establishing a lasting interest in an enterprise resident in a economy other than that of the investor (direct investment enterprise)”.

This involves both the initial transaction between the two entities and all subsequent capital transactions both between them and among affiliated enterprises, whether incorporated or not (OECD, 2002).

”Lasting interest” implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence by the direct investor on the management of the direct investment enterprise.

A “significant degree of influence” relates closely to the definition of “direct investment enterprise” implying that the direct investor is able to influence, or participate in, the management of an enterprise. Absolute control is not required.

“Direct investment enterprise” is an incorporated enterprise in which a foreign investor owns 10 percent or more of the ordinary shares or voting power (for an incorporated enterprise) or an unincorporated enterprise in which a foreign investor has equivalent ownership. Ownership of 10 percent of the ordinary shares or voting stock, directly or indirectly, is the guideline for determining the existence of a direct investment relationship.

Voting stocks are equity/shares that give voting rights to the holder. These can either be “listed voting stocks” (that is, equity/shares that are listed on an official stock exchange), or “unlisted voting stock” (that is, equity/shares that are not listed on a official stock exchange (OECD, 2002)

The International Monetary Fund (IMF) defines FDI, somewhat similarly but with less details, as “a *direct investment being the category of international investment that reflects the objective of a resident entity in one economy obtaining a lasting interest in an enterprise resident in another economy*” (IMF, 1993).

3.3. Economic integration and FDI

A large body of literature, both theoretical and empirical, analyses the effects of economic integration on FDI. As recognized by Markusen and Venables (1996),

economic integration can be defined as a reduction in transaction costs between countries' goods and factors of production and also as international harmonization of national legislation on trade and investment. Reduction of international transaction costs, in their view, can be achieved by political choice (e.g. when tariffs and non-tariff barriers are reduced) or by technological change (e.g. reduction of communication costs through the use of internet).

Economic integration involving liberalization and harmonization of national rules and regulations concerning foreign investment is seen by Blomström and Kokko (1997) to lead to higher world income and larger markets. Being aware of the positive consequences of the economic integration both governments and investors take actions to accelerate the process.

Given this, economic integration takes place also on a regional level. Almost every country in the world belongs to, or considers joining, a regional integration arrangement. Around 55 to 60 percent of world trade now occurs within such trading blocs (Schiff and Winters, 1998). Some of the most important agreements are the European Economic Area (including the European Union (EU) and European Free Trade Association (EFTA), North American Free Trade Association (NAFTA), Association of South East Asian Nations (ASEAN), Southern Common Market (MERCOSUR) and Southern African Development Community (SADC).

Blomström and Kokko (1997) effectively show that regional integration agreements significantly increase FDI flows into the participating countries. This is achieved through the reduction of intra-regional transaction costs that increases the effective market size of the region, which in turn makes it a more profitable area for foreign investment inflows. Furthermore, regional integration might involve an increase in trade barriers to the regions that are excluded from the amalgamated area. Consequently, from this tariff-jumping argument, investments between the included regions are expected to increase.

Many regional agreements feature also explicit dispute resolution mechanisms. If effective, these should stimulate both FDI and trade. Increase in FDI is nevertheless not likely to be evenly distributed among the participating countries. As Blomström and Kokko acknowledge, countries with the strongest locational advantages are likely to attract most investments.

3.3.1. EU integration

Among regional integration agreements, the EU deserves special attention. Progressive evolution of the EU, and especially the European Community (EC), has had a direct and profound influence not only on the economy of Member States but also on third countries (Molle, 1994).

Economic integration in the EU can be interpreted in two senses. In a dynamic sense, it is the process whereby economic borders between member states are gradually eliminated. In a static sense, it is the situation in which national components of a larger economy are no longer separated by economic frontiers, but function together as an entity.

Two main parts are distinguishable in these processes. The first applies to the integration of the markets of goods, services and the production factors (labor, capital, entrepreneurship), whereas the second part concerns integration of policy matters.

Integration of markets and different areas of economic policy follow in practice a sequence through a hierarchy of market forms as argued by Steiner and Woods (2000). The basic element is the free movement of goods and services, permitting a wider choice and lower price level for the consumers. Another basic element partly resulting from the first one – the free movement of production factors – allows optimum allocation of labor and capital.

These are followed by the integration of policies, aiming to create a common framework that would be a platform for equal conditions for the functioning of the integrated parts of the economy. These thoughts are shared also by Molle (1994), who perceives the strive for a common market being motivated by the hope that the freedom of capital and labor to move from activities with a low marginal product to those with a higher one, will lead to a more efficient allocation of resources.

3.4. Determining factors for foreign investments

According to Grant (1998) companies choose to go abroad for two reasons: first, to exploit market opportunities in other countries, and second, to exploit production opportunities by establishing production activities wherever they can be conducted most efficiently.

A number of surveys (for example Lankes and Venables, 1996), case studies (Boros-Torstila, 1999, Resmini 2000) and economic studies (Wang and Swain, 1995, Halland and Pain, 1998), next to theoretical papers (for example Grant, 1998), have discussed factors determining the choice of the target country for foreign investment. It is widely agreed that foreign direct investments take place when three sets of determining factors exist simultaneously in the target country (Dunning, 1993).

- *Ownership specific advantages* arising from firm's size and access to markets and resources, firm's ability to co-ordinate complementary activities, such as manufacturing and distribution, and the ability to exploit differences between countries.
- *Internalization incentive advantages* arising from exploiting imperfections in external markets. These include the reduction of uncertainty and transactions costs in order to generate knowledge more efficiently; and the reduction of state-generated imperfections such as tariffs, foreign exchange controls and subsidies.
- *Location specific advantages*, which include differences in country's natural endowments, transport costs, macroeconomic stability, cultural factors and

government regulations. These help to determine which countries are hosts to multinational enterprises foreign production.

If only the first condition is met, firms will rely on exports, licensing or the sale of patents, to service a foreign market. In the presence of internalization incentives (e.g. protection from supply disruptions and price hikes, lack of suitable licensee and economies of common governance) FDI becomes the preferred mode of servicing foreign markets, but only if location-specific advantages are present. Within the trinity of conditions for FDI to occur, locational determinants are the only ones that host governments can influence directly (World Investment Report, 1998).

Whereas it has not been possible to arrange firms' locational-specific decisions into a uniform theoretical pattern so far, the literature cites a large number of very different factors that impact on business potential and the risks associated with individual locations. They can be grouped into three broad categories: (i) national policy framework for FDI, (ii) business facilitation, and (iii) economic motives.

The most important determinants for the location of FDI are economic considerations. They come into full play once an enabling FDI policy framework is in place. Following from the principal motivations for investing in foreign countries, economic determinants can be grouped into three clusters: (i) resource-seeking, (ii) market-seeking, and (iii) efficiency-seeking.

Availability of natural resources, cheap (unskilled or semi-skilled) labor, creative assets and physical infrastructure promotes resource-seeking activities. Labor-seeking investment in this category is usually undertaken by manufacturing and service multinational enterprises from countries with high real labor costs. These enterprises set up, or acquire, subsidiaries in countries with lower real labor costs to supply labor-intensive intermediate or final products. Frequently, to attract such production, host countries have set up free trade or export processing zones (Dunning, 1993).

Market-seeking determinants, known as market factors, are market size, in absolute terms as well as in relation to the size and income of its population, and market growth. In the most general sense, the long-run monetary benefits of doing business in a country are a function of the size of the market, the present wealth (purchasing power) of consumers in that market, and the likely future wealth of consumers.

While some markets are very large when measured by number of consumers, low living standards may imply limited purchasing power. (Hill, 2002). For firms, new markets provide a chance to stay competitive and grow within the industry, as well as achieve scale and scope economies.

The motivation for efficiency seeking FDI is to rationalize the structure of established resource- and/or market - seeking investment in such a way, that the investing company can gain from the common governance of geographically dispersed activities.

Furthermore, the intention of the firms is to take advantage of different factor endowments, cultures, institutional arrangements, economic systems and policies,

and market structures by concentrating production in a limited number of locations to supply multiple markets. In order for the efficiency seeking foreign production to take place, the macroeconomic and political situation has to be stable and cross-border markets must be both well developed and open (Dunning, 1993, Rugman, 1998).

By definition, multinational firms must consider a variety of basic macroeconomic variables (inflation, budget deficit, balance of payments, etc.) across countries. As such, volatility of macroeconomic policy creates both problems and opportunities for international firms, requiring them to manage the risk inherent in volatile countries, but also presenting the opportunity of moving production to lower cost facilities (Baniak et al., 2002).

Lensink and White (1998) tested the significance of different macroeconomic factors and found the level of per capita gross domestic product (GDP), GDP growth, financial development and openness of a country explain whether a country is able to attract enough private capital to become independent of foreign aid. Similar study done by Wang and Swain (1995) found that the level of GDP, GDP growth, and wage rates have a significant positive effect on FDI.

Although important, macroeconomic variables cannot be the sole determinants for FDI. Market size and infrastructure are just a few of the additional characteristics that are of significance. Mello (1997) acknowledges that also institutional features, the degree of political stability and the existence of property rights legislation, affect foreign ownership. Lee and Mansfield (1996) emphasize the weakness of property laws as negatively influencing FDI. Furthermore, property and profit tax systems have been found to be important determinants.

To this, one must add the policy-based incentives given to foreign firms to locate operations in a particular country. Also uncertainty in the investor's home market could serve as a motive for investing abroad.

A reverse side of FDI is connected with the fact that unstable economic situation may result in adverse selection of investors, i.e., it may happen that only firms interested in short run speculative transactions, taking advantage of unstable exchange rates and marginal production costs, are ready to invest in the host country.

The same question can be approached also via the level of risk aversion that different companies possess. The likelihood of investment in the country is inversely related to the degree of risk aversion of the potential investor. Consequently, it may happen that the value of the expected utility from future profits could be too small for serious long-term investors (characterized by high risk aversion), but it could be satisfactory for less risk averse firms (or risk loving firms), which are more interested in speculative buying/selling transactions than in long term investment (Hill, 2002).

Somewhat opposing view to all of the above is expressed by Cukrowski and Aksen (2002). They claim that FDI does not need to be explained by any specific factor such as location advantage or ownership advantage, but it is a natural process driven

by rational behavior of perfectly competitive firms operating in uncertain environment.

3.5. Choice of entry mode

Unique features of FDI transactions are 1) that the investor is interested in obtaining ownership and 2) having an effective choice in the management of the enterprise. To achieve this, investors can use several different entry modes, some of which were mentioned in Section 3.2.

Generally, entry modes represent a continuum from the lowest to the highest investment and concomitant risk-return potential. In choosing a particular strategy, a company must find a fit between its internal corporate risk “comfort level” and the externally-perceived risk level of the target entry market (Cateora and Graham, 1996). According to Grant (1998) entry barriers to the market as compared to the firms’ existing resources and capabilities are one of the most significant factors determining the choice of the entry mode the company takes.

Categorization of FDI entry modes can be done by a checklist of inclusion and exclusion criteria. As acknowledged by OECD (2002), an investment can be considered under an entry mode of foreign direct investment in the following cases:

- *Acquisitions, mergers and disposals.* Defined as a purchase of more than 50 percent (majority acquisitions) or less than 50 percent (minority acquisition) of the shares of both public and private companies through public offers, open market purchases, stock swaps, going-private deals, reverse takeovers, share placements, recapitalisations and buy-outs aimed at establishing control. This also includes privatization.
- *Acquisitions of assets.* Acquisition of assets without accompanying acquisition of shares covers purchases of business divisions and operations. Such acquisitions include for example restaurants, pubs, hotels, casinos and other leisure industry assets, shopping centers, newspapers and periodicals, airports and ports, telephone, cellular and wireless licenses, pharmaceutical distribution rights and hospitals, nursing homes and other medical care facilities.
- *Stake purchases.* Given that it is of strategic importance, all stake purchases of 5 percent or above in both public and private companies are included wherever possible.
- *Spin-offs, split-offs and equity carve-outs.* This refers primarily to de-mergers, including partial privatisations.
- *Share buy-backs.* Share buy-backs are included in the form of public tender offers, buy-backs as divestments and buy-backs employed as a defensive technique. Other buy-back programs are covered if they include the repurchase of stakes greater than 10 percent or, lastly, if the value of the program is greater than USD 50 million.

- *Joint ventures.* This covers transactions, where existing assets or businesses are being acquired by, or merged into, a joint venture. As a rule, the creation of new companies, to pursue joint venture interests, is not covered under this heading.
- *Greenfield.* This entry mode is based on establishing a new productive facility in the host country and includes creation of a new company.

The same source clearly indicates also entry modes that are excluded from consideration as FDI.

- *Alliances or agreements.* Strategic alliances (not identified as joint ventures), including distribution, contract and customer purchase agreements and leases are not considered as direct investments. Likewise purchases by companies of products manufactured by another company are not considered. Consequently, some partnerships with the aim to reduce both the competitive pressure in the market and the costs and risks associated with R&D through strategic alliances, are not considered as alternative modes of entry (Blattner, 2002).
- *Financial instruments.* Purchases of financial instruments, such as options, rights, warrants, debt instruments (e.g. subordinated notes), private placements other than private equity transactions, and loans, are not considered as modes of entry. Placements of shares, whether primary or secondary, are not included unless they meet the criteria for divestments or privatisations.
- *Patents and copyrights*
- *Restructurings.* Restructuring transactions, such as the merger of one company's fully owned subsidiaries, are not considered as alternatives modes of entry.

The most common entry mode is a joint venture. The mode involves two companies that form a partnership under a new corporate name. Joint venturing is a low-risk market-entry strategy that is popular among successful, large, internationally oriented businesses, seeking to expand from their own maturing home markets or seeking new sources of raw materials. Strategic advantages deriving from reduced political and economic risks by combining the host-country firm's localized knowledge, skills, and systems with the foreign company's capital and technology are most notable benefits of such form. It also allows the foreign firm to operate in a market otherwise inaccessible due to trade barriers or hostility towards outsiders.

Establishment of fully owned companies (for example through acquisitions) is an entry mode characterized by high risk and high return on investment. Advantages are the ability to capitalize on low-cost labor, avoiding import taxes and transportation costs, access to raw materials and establishment of a platform for entry to other co-operative markets. Disadvantages are that company is much more vulnerable to political instability and the resulting economic sanctions by host governments (Shama, 2000)

Greenfield is an entry mode that requires more time than acquiring an existing firm. However, it can be designed and implemented to incorporate the parent company's

global strategy from the outset, thereby avoiding the challenging integration process in mergers and acquisitions. Traditionally, foreign investment policies favor greenfield investments over M&A, on the assumption that they have more immediate positive effects on capital accumulation and job creation in the host country (OECD, 2001).

The optimal entry mode thus varies from situation to situation depending on various factors. Ultimately, the choice of mode to entry must be based on an assessment of a nation's long-run profit potential. Whereas some firms may best serve a given market by exporting, as shown in Section 3.4., other firms may better serve the market by setting up a fully owned subsidiary or by using some other entry mode. Likewise, timing for entering a new market has to be taken into consideration. While the first-mover advantages might lead to high economic growth rates (Hill, 2002), they also must face higher risks. Late entrants may fall victim to late-mover disadvantages, but also witness reduced risk.

3.5.1. Protection of technology

During the last several decades, there has been a significant change in the attitudes of governments, especially those in developing countries, towards foreign direct investment. Rather than viewed as evil exploiters, foreign investors are now welcomed as a source of new technologies, better management and marketing techniques and as creators of skilled jobs.

Not all types of foreign investment, however, are perceived as equally beneficial to host countries and the participating firms. Next to greenfield investments, governments tend to favor also joint ventures (JV) over other forms of entry. They believe that active participation of local firms facilitates the absorption of new technologies and marketing skills (Beamish, 1988, Blomström and Zejan, 1991, Blomström and Sjöholm, 1998).

Theory suggests that in order to compete successfully in a foreign market a firm must possess "ownership advantages". For example, these can take the form of a superior technology, proprietary knowledge, managerial and/or marketing skills. The firm can earn rents on these assets through "arm's length" transactions (e.g., licensing, franchising, turnkey contracts) or by creating a subsidiary or engaging in a JV in a foreign country.

Firms possessing sophisticated technologies may face more uncertainty in pricing and tend to prefer fully owned projects to the JV or "arm's length" transactions. A fully owned company might be preferred to shared ownership in order to guard against leakage of sensitive information. For example, a foreign investor may be concerned that, in the case of a JV dissolution, the local partner will remain in possession of the technology acquired from the multinational and become a competitor both in the home country and also on third markets.

Additionally, the local partner may use proprietary information obtained from the multinational in its own fully owned operations, thus hurting the JV and the foreign

partner (Gomes-Casseres, 1989). Firms differentiating their products through advertising may also seek full ownership to assure the quality of their products and prevent debasing of their trademarks (Stopford and Wells, 1972; Gatignon and Anderson, 1988; Gomes-Casseres, 1989; Asiedu and Esfahani, 1998).

Smarzynska (2001) provides empirical evidence indicating that industry structure affects the choice of entry. Joint ventures in manufacturing sectors tend to be undertaken by foreign investors possessing fewer intangible assets than their counterparts involved in fully owned projects. These effects are present in higher R&D industries but not in low technology sectors.

Relative endowment of intangible assets may affect firms' choice of entry mode in two opposing ways. On the one hand, technological and marketing leaders in an industry may have a greater bargaining power in negotiations with local firms and authorities and may be able to secure more favorable terms of JV agreements. On the other hand, if the gap between foreign and domestic firms does not guarantee protection against dissipation of intangible assets, industry leaders may be more averse to shared ownership than industry laggards. Full ownership allows foreign investors to retain control over the marketing strategy and eliminates the need to persuade the local partner about the optimal level and mix of marketing expenditure.

It has to be emphasized that foreign investors, that are technological and marketing leaders in their sectors, are less likely to undertake joint ventures than firms lagging behind. This effect is the most prominent in high and medium technology industries. Thus, while it is widely believed that JV with local firms is more conducive to transferring knowledge and know-how than fully owned FDI projects, the potential magnitude of transfers from JV in high R&D sectors may be smaller than that from fully owned subsidiaries.

A positive correlation between the interaction term and the probability of a fully owned subsidiary indicates, that investors in more R&D-intensive sectors and with greater intangible assets can more easily negotiate full ownership and therefore preferences are turned into this mode of entry.

FDI is nevertheless an expensive form of market entry as firms must bear the costs of establishing production facilities in a foreign country or acquiring a foreign enterprise. Furthermore, the form is risky because of the problems associated with doing business in another culture where the "rules of the game" may be very different. Still, many companies favor FDI over export or licensing, which are associated with less cost and risk (Hill, 2002).

3.6. Benefits of foreign direct investment

There is substantial evidence that FDI benefits the host countries. The most immediate benefit of FDI to recipient country is the improvement of the balance of payments as a result of the inward flow of capital.

FDI provides also new technologies, managerial know-how, and innovations in products and production techniques as shown before. Access to foreign knowledge helps to promote domestic economic development and human capital formation and enhances, through spill-over effect, the productivity (and thus the profitability) of local firms. FDI flows are therefore important forces behind the heavier competitive pressure that is expected to encourage local producers to adopt efficiency-enhancing strategies (Meier, 1995).

As recent research shows, firms with foreign equity participation are more likely to export than firms with purely domestic capital. Similarly, the probability that a firm commences exporting is two and a half times higher for firms with foreign equity participation than for firms without foreign capital (Kraay et al. 2000). Becoming part of a production and distribution network of a multinational corporation (MNC) offers a “cheap way” of marketing products. Firms do not incur marketing cost, which are usually quite significant for newcomers (Roberts and Tybout 1998).

Foreign direct investment allows firms to realize economies of scale and leads to the growth of intra-industry trade. The advantage of this trade vis-à-vis inter-industry trade is that it is less vulnerable to swings in domestic business cycle and it does not produce such significant inequalities in regional development and income distribution.

FDI has also clear macroeconomic benefits. It is important to point out that, for a given economy, the nature and the degree of FDI impact is determined by the stage of country's economic development, economic policy and general business environment. Due to the obvious differences in these features, the impact and benefits of FDI to the domestic economy are likely to vary substantially from country to country.

In a closed economy with restrictions on capital mobility, the level of domestic investment is constrained by domestic savings. An inflow of foreign capital relaxes this constraint and hence allows an increase in the level of domestic investment. Thus, FDI may serve as a stimulus to additional domestic investment in the recipient country. This has been also empirically proven by Bosworth and Collins (1999), who found a strong link between long-term FDI and domestic investment.

This “crowding in” may be due to positive spill-over of foreign investments to domestic firms in terms of new technology or the need for local suppliers for foreign investors. FDI may also facilitate the expansion of domestic firms through complementarity in production. There is also considerable scope for the initial FDI to attract further foreign capital through the recognition of a substantial customer basis by competing or supplying foreign firms (Altenburg and Meyer-Stamer, 1999).

Rising standards of living is another perceived benefit of FDI. As acknowledged by Meier (1995), FDI it can accrue to domestic labor in the form of higher real wages and to consumers by way of lower prices. These views are also shared by Hill (2002), who claims that if FDI is vertical, then multinationals reduce absolute wage differences across countries and alter relative wages within countries. If FDI is horizontal, then multinationals may raise income in each country without necessarily changing its distribution.

An increase in total real wages may, in fact, be one of the major direct benefits of the inflow of foreign capital. One percentage points increase in FDI (measured in proportion of GDP) leads, according to Bergsman and others (2000), to an extra 0.8 percentage point increase in per-capita income. Furthermore, by increasing consumer choice, foreign direct investment can help to increase the level of competition in national markets, thereby driving down prices and increasing the economic welfare of consumers.

For economies of transition, the inflow of direct investment may not only raise the productivity of a given amount of labor, but also allows the employment of a larger labor force. If shortage of capital in relatively poor countries limits the employment of labor from the rural sector into the advanced sector, where wages are higher, an inflow of foreign capital may make it possible to employ more labor in the advanced sector.

Although FDI influences economic growth, the physical investment alone cannot be viewed as a source of long-term sustainability. It should be seen as a source of growth in the transition to a long-run path. Transition economies, by definition, have a low capital/labor ratio and thus investment, involving increased inputs of capital, would temporarily bring high growth (Easterly, 2001).

The benefits of FDI are greater than its cost especially for countries where capital and well skilled labor are limited. Active penetration of markets by foreign investors leads to the openness of economy and creation of competition there both producer and consumer benefit. Furthermore, FDI stimulates economic growth that leads to creation of democratic societies. Therefore, inflows of direct investments are of the greatest importance especially for developing countries.

Last but not least, Baniak (2002) argues that foreign direct investments could also contribute to the decrease of bureaucracy and the increase of market's transparency since foreign companies are not engaging in the local networks where competition is based on the "rule of gentlemen". In a similar manner Wei (2000) argues that global trade, investment liberalization and technological advancement are ingredients of globalization that potentially can raise every country's "natural openness" and reduce corruption.

3.7. Summary of the chapter

As stated by Grant (1998), the most important and pervasive force changing and challenging the business environment over the past decades has been internationalization. Falling barriers to trade and international capital flows have opened new business opportunities while transforming the competitive structure of most industries. The driving force for internationalization, both trade and direct investment, is twofold: first, to exploit market opportunities in other counties, and, second, to exploit production opportunities by establishing production activities wherever they can be conducted most efficiently.

The choice of a specific entry mode depends on the resources the company possesses, the duration of the investment and the specificities of the market. Companies wanting to minimize risks choose an entry mode with lower transactions (export, licensing) and those wanting to maximize long-term profits, choose a mode of direct investment.

The specific action that the company takes is also highly influenced by intangible resources of the firm. If the company wishes to protect for example its know-how and/or brand name, it is more likely to choose an entry mode where the control over the established company is maximized.

The overall attractiveness of a country as a potential market and/or investment site for an international business depends on balancing the benefits, costs and risks associated with doing business. These costs and risks are typically lower in economically advanced and politically stable democratic nations and greater in less developed and politically unstable nations. Therefore the choice of entry mode depends also on macro-economical variables of the host country. Markets that do not provide sufficient safeguards for protecting intangible assets of a company are more likely to witness higher share of fully owned undertakings, than those with stronger protection.

Engagement in foreign direct investments benefits both investors and the host country. Foreign investors might take advantage of the market factors in the host country and by this obtain competitive advantages against competitors not only in the country of origin but also in the global market.

Foreign direct investments benefit a host country in form capital, technology and know-how transfer. Moreover, foreign enterprises might contribute to reduction of bureaucracy, increase in standards of living and decrease of unemployment. Therefore it is highly important for the host country to create an environment that would attract foreign investments.

In ancient societies man had a religiously rooted reverence for his social superiors, to whom he felt he ought to bring propitiating "gifts", as he did to gods, spirits, and demons. The "blessings" of civilization have dismantled this traditional network, replacing it with rootless bureaucracy...that what has changed is not the mentality of bribery, but the amounts involved, which have increased.

Molnar, 1986

4. CORRUPTION

The following chapter introduces the concept of corruption that should be understood as one of the factors influencing foreign enterprises decisions. Corruption is defined and the factors that determine the phenomena recognized. Furthermore, corruption is exemplified through administrative barriers and the impact of the phenomena on doing business in a country is presented. In the final part of the chapter, measures to fight corruption will be presented.

There has been an essential rise in corruption studies during the last decade (Lambsdorff, 2002). Empirical research has brought to the surface completely new dimensions of the phenomena, that has been acknowledged for thousands of years. The study of corruption by scholars and policy makers has drawn closer attention on the tension between self-seeking behavior and public values (Rose-Ackerman, 1999). Increasing interest in the subject has led to the establishment of international organizations that carry out cross-country studies that contribute to better understanding of the phenomenon.

Passes (1997) acknowledges, that the momentum of democratization and economic liberalization processes fosters attitudes strongly opposed to discrimination and market distortions caused by corruption. Higher awareness of the problem and lower tolerance, combined with expected increases of corruption incidences, account for the intensity of debates and the large number of initiatives against this scourge. It is assumed that the extent of negative consequences of corruption is known with certainty. Therefore, fighting against corruption has become a high priority for many nations.

Viewed via Porter's five forces (Grant, 1998), corruption can be interpreted as a part of government and legal barriers that are included in the "threat of entry". However, for a single company that wants to expand internationally, corruption is a barrier that influences not only entry mode but also all investments decisions. Therefore corruption is a factor that can influence also other four forces acknowledges by Porter: industry rivalry, buyer power, threat of substitutes and supplier power. Since the risks and costs associated with doing business in the corrupt environment are significant, a company can not afford to ignore it.

4.1. Defining corruption

Corruption is a term carrying many different and complex interpretations. Derived from the Latin *corruptio*, meaning depraved condition, state of decay or bribery, corruption has traditionally been associated with moral decadence (Nationalencyklopedin, 2000). The Oxford Reference Dictionary (1986) defines being corrupt as being “morally depraved, wicked; influenced by or using bribery”. In social science terms corruption, according to the Collins Dictionary of Sociology (1995), is “the abandonment of expected standards of behavior by those in authority for the sake of unsanctioned personal advantage”.

There are also other definitions of the phenomena that are widely spread. Introduced by the World Bank (1999), corruption is defined as the abuse of public office for private gain. While this definition does not make specific note of private sector corruption, it does include the interface between private and public sectors without which much private sector corruption could not occur. The presented examples are:

Bribery

- purchasing government contracts, benefits, licenses, and judicial decisions
- evading customs duties, taxes and other regulations

Theft

- misappropriating budgetary funds and public assets

Patronage

- Nepotism (favoritism based on kinship), cronyism (favoritism based on informal networks)

Influence peddling

- Election or party financing in exchange for influence.

The last presented example is also a cause for further confusion, as it is often mixed and integrated with the term that has received much less negative attention than corruption. Encyclopaedia Britannica (2003), defines the term “lobbying” as any attempt by individuals or private interest groups to influence the decisions of government.

Passes (2002) recognizes that from the perspective of the bribe giver, the purpose of corrupt practices is to inappropriately shape an enterprise's "task environment". It occurs when illicit payments are made in order to influence societal actions that affect competition, clients and official controls. At the political level, the aim is to thwart regulations and policies with negative impact and to promote those which are expected to benefit one's business.

Despite many definitions of the term, all researchers agree that it has damaging effects upon democracy and economical progress. Consequently, existing views acknowledging positive outcomes of corruption, are not included in any available definition of corruption.

4.2. Measuring corruption

Corruption, by its very nature, is difficult to measure precisely. A researcher trying to develop quantitative measures of corruption has to struggle with a question of what will be included in such a measurement, and then try to value something that those, who know about it, are trying to hide. Despite these difficulties, there are several measures available, but each of them includes subjective perceptions (Smarzynska and Wei, 2002).

There are three types of indices for measurement. The first is based on surveys of individual “experts” (typically every country is rated by one expert). Popular examples of this type include the Business International (BI) Index & International Country Risk Group (ICRG).

The second type is based on surveys of firms. Typically multiple firms per country are surveyed and the average answer for each country is used as the value of corruption index for that country. Relative to the first type, these indices reduce the impact of the idiosyncratic errors of individual respondents. Most popular indices of this type include the Global Competitiveness Report (GCR) index by the World Economic Forum and the World Development Report (WDR) index by the World Bank.

The third type of indices pools together information from several existing indices by averaging or using other statistical extraction methods. Most widely known index of this type is the one compiled by the Transparency International (TI).

There appears to be a high degree of stability of corruption over years as measured by these sources. Correlation between various measures tends to be very high, providing some support for the contention that survey data on corruption may provide reliable estimate of the real phenomenon (Arvind 2001).

4.3. Determinants of corruption

According to Arvind (2001), existence of corruption requires the co-existence of three elements. First, someone must have discretionary power that would include authority to design regulations as well as to administer them. Second, there must be economic rents associated with this power. Moreover, the rents must be such that identifiable groups could capture those rents. Third, the legal/judicial system must offer sufficiently low probability of detection and/or penalty for the wrongdoing. In an extension of Becker’s (1968) “crime and punishment” argument, the first two elements are combined together to create incentives for corruption whereas the third acts as a deterrent.

The characteristic of the economic rents is that the higher the rents are, the greater the incentives to pay bribes. Moreover, the amount of bribes will be higher when the incentive to avoid regulations is greater. Parties, engaged in the corruption acts, must believe that the utility of the income from corruption is worth the inconveniences

caused by the risk of being detected and punished. Besides the risk managing, players have to also solve problems of information asymmetry and uncertainty (Larrain and Tavares, 2000).

The rent seeking behavior can be understood through the resource allocation model². These applications are based on the premise that the actors attempt to “...escape the invisible hand of the market” and to redirect policy proposals for their own advantage. Extensions of the model follow at least two routes. Application of game theory shows how firms will behave when there is competition for rent seeking or when they can co-operate with each other (Linster 1994). Generally, the extent of aggregate rent-seeking is determined by the rent available to capture and the number of players in the game. High competition for limited rents leads to higher amount of the bribery. Thus, when the players cooperate with each other, corruption can be limited.

The second route was developed by Shleifer and Vishny (1992) through a model of petty bureaucratic corruption that was first proposed by Rose-Ackerman (1978). The model takes into account the cost, demand and supply functions faced by the bureaucrats. Costs from bureaucrats include costs of providing the services (usually borne by the government) and consideration of whether the bribe-revenues have to be shared with others. Demand refers to the competition between the bribe givers. On the supply side, the bureaucrats may have a monopoly over the service or may compete with other bureaus or other services. Furthermore, given the nature of a deal, it is difficult for the parties to ensure that contracts are enforced. A bureaucrat may accept a bribe but may refuse to provide the contracted service without further payments.

As acknowledged by Shleifer and Vishny (1993), corruption arises from the weaknesses of central government, which allows various governmental agencies and bureaucracies to impose independent bribes on private individuals seeking complementary permits from these agencies. Furthermore, corruption can be reduced if the element of competition, in the form of new authorities, will be introduced into the services that agencies provide. Similarly, political competition opens up the government, decentralizes it and reduces secrecy, which in turn reduces corruption.

4.3.1. Corruption in East and West Europe

There appears to be a widespread consensus that corruption in Central and Eastern European³ (CEE) countries is a more serious problem than in other countries of the OECD, including existing EU member States. Smith Brandon Ltd. (2003) argues that corruption that has been socially integrated, hand in hand with communist rule, has flourished Central and Eastern Europe.

² Alternative theories where rent-seeking behavior is used for example transaction cost economics and the agency theory

³ With Poland these are Slovenia, Estonia, Hungary, Lithuania, the Czech Republic, Latvia and the Slovak Republic

This phenomenon can be treated as an inheritance of the past where communist systems employed corruption as a means for consolidating power. Moreover, economic systems relied on corruption for their very survival, and – at least in the later stages of their history – ended up as kleptocracies where high-level corruption and embezzlement were the norm. Offering favors and paying bribes were ways to over-ride a stagnant bureaucracy and acquire a relatively comfortable standard of living, despite recurring shortages and repeated political disruptions.

Post-communist states inherited bureaucracies that lacked many of the regulatory institutions necessary for a democratic state and economy, as well as efficient mechanisms of accountability, to function. Nowadays, bureaucratic officials who anticipate losing their jobs due to government restructuring, feel obligated to earn a living by any means possible. Furthermore, government officials, politicians, judges, lawyers and doctors may accept payments to compensate for low salaries. Consequently, there is little incentive to expose corruption. Furthermore, the norms passed from the communism are still priorities and by the Western standards, the degree of tolerance for corruption is high (Open Society Institute, 2002).

According to Khera (2001), advanced countries often take a stereotypical view of the governments, organizations, business, and institutions in developing countries as being corrupt, uninformed, incompetent, and just plain ignorant, while their views of their own businesses, governments, institutions, etc., are those of hardworking, knowledgeable, ethical, well-governed, efficient, productive, etc.

However, to contend that the West is ethical in all its dealings, and the East is unethical, is naive and completely self-congratulatory. It does not require a great leap of logic to conclude that in a cut-throat market, many companies, both Western and Eastern, abandon ethics for quick profits (Weiner, 1990).

The driving forces behind active participation in corruption activities may vary among Eastern and Western countries. In the case of East Europe, bureaucratic burden and delay are exogenous. An individual firm may find bribes helpful to reduce the effective “red tape” it faces. Consequently, the “efficient grease” hypothesis asserts that corruption can improve economic efficiency and that fighting bribery would be counter-productive (Rose-Ackerman, 1999).

In the Western world, companies are spending a great deal on lobbying that can become corruption. The emphasis could be to influence governments to, for example, change or “kill” legislation that essentially decreases profits. The fact that the Western Europe functions much more efficiently on a day to day basis, does not necessarily mean that it is no less populated by individuals who do not crave unethically derived privileges. Human nature is not all that different in different spots on this earth. What seems to be different are such things as the degree of power held by people over others, the feedback and control mechanisms to keep abuse of power in check, greater transparency of governments’ actions, a greater sense of responsibility and discipline inculcated by the industrial revolution, and other similar difference (Khera, 2001).

While studying corruption’s frequency and its actual incidence, it has been noticed that there is a self-fulfilling equilibrium of corruption. Spread of (dis)information

that everybody is corrupt creates an atmosphere of corruption. People who believe they are living in a climate of corruption get corrupted themselves (Bardhan, 1997: 1334). Moreover, the reputations of individuals and the groups they are part of (collective reputation) are inter-linked, and bad reputation of past generations may explain persistence of corruption in the present ones (Tirole, 1996).

4.4. Administrative barriers as a source of corruption

Administrative procedures exist in all countries. Indeed, it is legitimate for governments to control or even screen for some activities and investors who are going to establish on their territory. Yet, administrative costs vary greatly across countries and it can take up to two or three years to establish a new business in many developing countries. Governments impose regulations significantly influencing the location of multinational firms and their resulting productivity (Dollar, 2001). Although beneficial on some occasions, it could also lead investors to lose money and decide to locate elsewhere or cancel their investment projects (de Soto, 1999).

Administrative procedures have been classified by Morisset and Lumenga (2002) into the three groups: entry approvals; access to land - site development, and utility connections; and operational requirements. In each of these stages different separate core administrative procedures are included (Annex 4). The length of time and costs for the fulfillment of all procedures vary and depend on the quality of governance, degree of openness, public wages and other fundamental features of the country. The most important barriers appear to be the delays associated with securing land access and obtaining building permits. The officials thus act as "gatekeepers", allowing access to resources to only those that are "suited" for it ⁴.

Rose-Ackerman (1999) recognizes that all states, whether benevolent or repressive, control the distribution of valuable benefits and the imposition of onerous costs. The distribution of these benefits and costs is generally under the control of public officials who possess discretionary power. Firms that want favorable treatment may be willing to pay to obtain it. Payments are corrupt if they are illegally made to public agents with the goal of obtaining a benefit or avoiding a cost. Institutions designed to govern the interrelationships between the citizen and the state are used instead for personal enrichment and the provision of benefits to the corrupt parties.

Further, the level of corruption or the lack of good governance is expected to influence the administrative costs as bureaucrats and politicians are more likely to capture the extra rents. In this case, corruption can be both the cause and the consequence of high administrative barriers. Along the same lines, it can be argued, the degree of political freedom affects the capacity of bureaucrats or incumbent enterprises to exploit rents derived from administrative procedures. Furthermore, low paid bureaucrats are more likely to capture extra rent by raising administrative costs.

As a consequence of these practices, it is easier for the government to reduce or remove administrative procedures than to alter the extent of corruption in the

⁴ It has to be noted that there is a lack of empirical research on this matter in East Europe due to obstacles obtaining accurate information

country. Reformers could nevertheless face resistance from both the middle-level bureaucrats and incumbent enterprises. The former wish to preserve their captured rents, whereas the latter consider high administrative costs to discourage new entrances thus lowering competition (Hoekeman, Kee, Olarreaga, 2001).

As Morisset and Lumenga (2002) proved, the level of administrative barriers is positively correlated with corruption incidence and exhibits a negative correlation with the quality of governance, degree of openness and public wages. These correlations suggest that administrative reforms need to be incorporated into the broader agenda for reforms such as trade and financial liberalization, the fight against corruption and public sector administration.

Excessively complex administrative procedures required to establish and operate a business, discourage inflows of foreign direct investment (Morisset, Lumenga, Neso, 2002).

4.5. Economic impact of corruption

When the word corruption is used in social science, it is usually in connection with the view that the phenomenon has negative consequences for the society. Indeed, political scientist Carl Fredirch (1989) argues that historical definitions of corruption do have a common thread: that of focusing on corruption's dysfunctional impact on the political system. Moreover, empirical research shows that corruption has also a negative effect on economic growth, institutional performance and the legitimacy of the political systems (see e.g. Médard 1986, Mauro 1995, Rose-Ackerman 1999). Furthermore, Grey and Kufmann (1998) acknowledge, that corruption undermines the proper functioning of markets.

It is possible to argue that corruption affects the distribution of rents within a society (Kurer 1993, Rose-Ackerman 1997). It can affect income inequality through overall growth, biased tax systems, and poor targeting of social programs as well as through its impact on asset ownership, human capital formation, education inequalities, and uncertainty in factor accumulation. Moreover, corruption is the cause of both poverty and increased income inequality (Grupta et al., 1998).

Priks (2002) recognizes that when officials are corrupt, so are often the central authority and the judiciary. Understanding the interdependence of the central authority, lower lever officials and the judiciary helps to explain how the institutional design of corrupt governments is created and how it affects corruption. When power is divided among officials, the judiciary and the central authority, no agent will be able to create large rents and thereby reduce total corruption.

In the corrupt environment resources are being wasted, the inequity in resource distribution increases and the greater distrust of government occurs. Even relatively petty or routine corruption can rob government of revenues, distort economic decision-making and impose negative externalities on the society (Elliott, 2002).

4.5.1 Impact on business environment

In the decision-making calculus of outside investors, the country's corruption introduces additional elements of uncertainty and risk into the investment climate that can affect the way private firms do business. The corrupt nature of the deal may give the firm a short – run orientation or drive them out of their business since the incentives to take/pay bribes to underpaid administrators are higher (Arvind, 2001).

Furthermore, a corrupt bureaucracy will not necessarily provide service and purchase contracts to the most efficient producer. There exists a risk that the actor, that is able to pay the most in bribes, will get a contract and not the one that is the most efficient. The entrance of new actors can be also prevented through the exploitation of existing (corrupt) relationship between the enterprise and bureaucrat. The new entrant, that faces uncertainty about the level of corruption, is especially exposed to the barriers. A newcomer might hesitate to discuss bribery, therefore, bureaucracy will favor “those with no scruples and those with connections over those who are the most productively efficient” (Rose-Ackerman, 1999).

Additionally, as acknowledged by Smarzynska and Wei (2002) corrupt officials, seeing the financial benefits of accepting bribes, frequently have the discretion to redesign their activities. They may create scarcity, delay, and “red tape” to encourage bribery. Furthermore, Gupta et al. (2000), indicates that once bureaucrats recognize the potential for enhancing their income through corruption, they enact regulations that require increased interaction between the managers and the bureaucracy and refuse to provide “free” services without a fee. Corruption rarely exists in a vacuum and small payments often lead to demands for larger payments.

Companies, in their turn, justify payoffs as a way to avoid greater harms. According to Arvind (2001), it is argued that corruption helps to overcome bureaucratic rigidities and helps to maintain allocation efficiency when there is competition between bribers, but not, interestingly, between officials. Enterprises might therefore assume that small side payments to officials could speed up bureaucratic processes.

Thus, as Rose-Ackerman (1999) pointed out, multinational companies face a dilemma when dealing with corrupt regimes. Each firm believes it needs to pay bribes, but each knows that most of them would be better off if nobody paid. Furthermore, enterprises have choices when dealing with bribes creating a situation similar to “prisoners’ dilemma”. Decision has to be made whether to participate actively in the act of corruption or to refuse it. Another option is to rapport corruption to local authorities and to those in the outside world.

Unfortunately, multinationals often justify bribes and decide to keep quiet. That option is probably the worst one since the firm not only loses business, it has also done nothing to change the underlying situation for the better. Revealing corrupt demands can have an impact, if the pressure of international public opinion affects both corrupt public officials and bribe-paying business firms.

Further, as Rose–Ackerman (1999) states, multinational businesses have not generally considered the impact of their behavior on the long-term prospects of the

countries where they invest and trade. One still hears expressions of cynicism and resignation from business leaders and their advisors. However, in an international environment with no effective means of regulating inefficient behavior, large firms have an obligation, and may have a long – term interest, in behaving responsibly.

4.5.2. Corruption's impact on foreign direct investments

There is a reasonable assumption that corruption influences negatively foreign direct investments. As corruption increases, the risks associated with making investments also increases, e.g. by lowering the security of property rights. Theory predicts that corruption will have a clear negative impact on the ratio of investment to GDP.

The first investigation on the impact of corruption on investment in a cross- section of countries was undertaken by Mauro (1995). The author finds that, in a sample of 67 countries, the phenomena negatively impacts the ratio of investment to GDP. Consequently, one–standard-deviation increase of corruption activities causes investment drop by 5 percents of GDP and overall growth to decline by 0,5 percent per year (Sarkar and Hasan, 2001; Lambsdorff, 2002; Larrain and Tavares, 2000). Similar results were obtained by Keefer and Knack (1995), who combined corruption with other explanatory variables into one single index of "institutional quality".

Criticism of the results by Mauro has been voiced by Wedeman (1996) who argues, that while the correlation between corruption and the ratio of investment to GDP might be strong for countries with little corruption, it loses power for countries with higher levels of corruption. He therefore concludes that certain kinds of corruption might have more significance for investment decisions than the overall level of corruption as such.

Another contribution to the study of correlation between corruption and FDI has been undertaken by Sarkar and Hasan (2001). These authors recognize that corruption reduces both the volume and efficiency of investments. Resources will be allocated in an inefficient way from potentially productive sectors to unproductive sectors thereby decreasing the overall output. Bribes, similarly, increase the cost of production, which ultimately gets reflected in a higher output price and reduction in demand.

As pointed out in Becker and Stigler (1974), Pashigian (1975), Pauly (1979) and Rose-Ackerman (1975, 1978), the essential aspect of corrupt behavior is an illegal or unauthorized transfer of money or an "in-kind" substitute. In particular, investors certainly incur set-up costs that are sensitive to corruption. The underlying assumption is that all foreign investors have to pay a fixed bribe to obtain an operation permit or license as indicated by Romer (1994), Rose-Ackerman (1975) and Shleifer and Vishny (1994).

Recently, Smarzynska and Wei (2002) contributed a new factor to the corruption studies. These authors stated that corruption influences FDI's entry mode. The phenomenon makes local bureaucracy less transparent and hence increases the value of local joint venture partner to a foreign investor. This entry mode decreases the risk

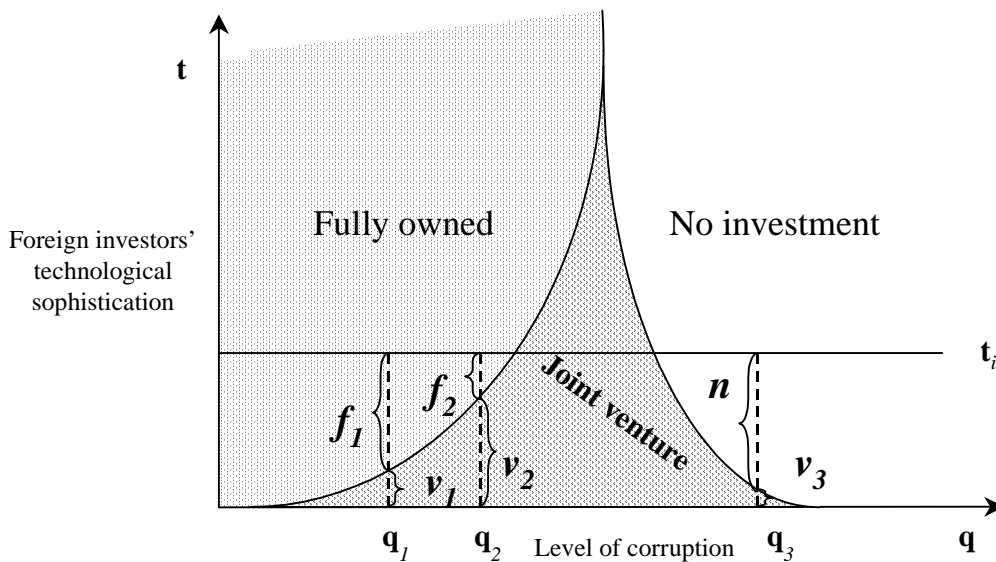
associated with establishment of the company and also lowers transaction costs (e.g., the cost of securing local permits). On the other hand, if investors possess sophisticated technology, fully owned companies will be favored. Further, Smarzynska and Wei argue that joint venture creates risk of technological know-how leakage. The high level of corruption in the host country increases costs for local permits and the risk of leakage.

The study is presented in Figure 2 on the following page, where the investment decision is mapped out in a two-dimensional space along the level of corruption in the host country (q) and the level of technological sophistication of the investing firm (t).

Holding foreign investors' technological sophistication constant at t_i and given that the corruption in the host country is at the q_1 level, foreign enterprises have a choice between joint venture and fully-owned company. The preferred entry mode will be the latter one since the transaction costs and risks created by the corruption are low ($f_1 > v_1$).

Given that technological sophistication is constant level at t_i , corruption increase from q_1 to q_2 will induce greater transaction costs and risks. Foreign investors will thus prefer joint ventures over fully owned companies to reduce their direct exposure ($v_2 > f_2$). If corruption in the host country reaches very high levels (from q_2 to q_3), transaction costs and risks become so high that almost no company is willing to enter the market and those few that do, choose a joint venture with a local company ($n > v_3$). Others, given that trade barriers are sufficiently low, choose export.

Figure 2: Entry mode decision as a function of local corruption and firm's technology



Source: Smarzynska and Wei (2002)

Arguments of Larrain and Tavaré (2000) can be seen as a contribution to the Smarzynska and Wei's theory. Authors acknowledge that investments projects have some element of a "hostage relationship". Before the investment is actually made it

is impossible to foresee perfectly all contingencies that may affect its performance. This fact provides public officials with an opportunity to collect bribes after the investment is made. For several reasons, foreign-owned firms may be particularly prone to be involved in corruption. First, average income disparity between the typical investor and host countries makes even a small bribe, from the point of view of the investor, go a long way in influencing the behavior of the corrupted official. Moreover, if the foreign investor obtains market power, she/he may be willing to bribe officials since the cost will be recovered through higher prices charged from consumers.

4.6. Fighting against corruption

Initiatives have been taken by the single countries to fight corruption, but without international support, the effects of these initiatives are limited. As international organizations dealing with corruption emphasize – the fight has to be multi-fronted. While laws and law enforcement are of essential importance, countries serious about fighting corruption should also pay attention to reforming the role of government in the economy, particularly those areas that give officials discretionary power which are “hot beds” for corruption (Wei, 2000).

Furthermore, in the fight against corruption a collective response by businesses in a single sector may be particularly effective. Although the role of legislators and pressure groups should not be underplayed, the enabling environment for promoting transparent business transactions requires multifaceted approaches. Such approaches include regulation and oversight, voluntary codes and guidelines, awareness-raising campaigns, training of practical management systems and internal controls, sanctions and incentive schemes to ensure that corruption is monitored and reported throughout company operations (Global Corruption Rapport, 2003).

So far, OECD and the European Union (EU) institutions are the main actors engaged in the fight against corruption. These institutions cooperate with each other to create anti-corruption measures that, when applied, will enhance good corporate governance. Furthermore, the principles created by the EU mostly apply to the Member States, but they can also serve as examples of anti-corruption measures that should be applied world wide.

Yet, despite the efforts made by the EU, there is no binding anti-corruption framework for all of the EU Member States. Efforts to promote the "harmonization" of anti-corruption standards and policies across existing Member States has been a difficult and fragmented process. However, Commission is in the process of developing a broad “good governance” framework, notably since the publication of the White Paper on Governance in July 2001.⁵ Measures that have emerged since then include a Code of Conduct for members of the European Parliament and efforts to formulate a code for Commission officials.

⁵ The White Paper lays down or reaffirms principles of subsidiarity and, in particular, the objective of making the policy process more open and transparent

In addition to the above measures, since the early 1990's the EU has adopted several anti-corruption instruments. As of May 2003, Community legislation in this area consisted of the following:

- The 1995 Convention on the Protection of the European Communities' Financial Interests;
- The First and Second Protocols to the above Convention, stipulating that Member States should take effective action to punish bribery that involves EU officials and damage to the Communities' financial interests;
- The 1997 Convention on the Fight against Corruption involving Officials of the European Communities or Officials of the Member States of the European Union;
- The Joint Action on Corruption in the Private Sector. Approved by the EU Council of Ministers in December 1998, this is intended to align national legislation on passive and active corruption in the private

However, as of mid-2003 none of these conventions had secured enough ratification by member States to come into force. By this day, only eight of the 15 Member States have fully ratified the 1995 Convention, and the Commission considers it unlikely that the ratification process will be completed for some years (UK National Audit Office, 2002).

Furthermore, there also exist "soft" anti-corruption acquis that is of a similar nature to the EU instruments mentioned above, although they go further in certain areas. Moreover, this acquis, once ratified by all Member States, will automatically become part of the overall Community acquis. Additional legislation comprises of:

- The Council of Europe Criminal Law Convention on Corruption
- The Council of Europe Civil Law Convention on Corruption
- The European Convention on Laundering, Search, Seizure and Confiscation of the Proceeds from Crime
- The OECD Convention on Combating Bribery of Foreign Public Officials

The latter is considered, due to its enforcement mechanisms – monitoring and peer pressure –, to be one of the most effective tools in combating international bribery and corruption. The most important elements of the implementing act are the criminalization of active and passive bribery of foreign public officials, the administrative responsibility of legal persons, and the exclusion from public tenders of companies having been found to have committed bribery.

In addition to the conventions on corruption, the Council of Europe's Committee of Ministers approved a broad framework of "Twenty Guiding Principles for the Fight Against Corruption" in 1997. Although the principles are not binding for any State, they serve as a potential framework for developing anti-corruption strategies in the broadest sense.

The principles encompass not only anti-corruption legislation but also measures to prevent and fight corruption, including promotion of public awareness, independence of the prosecution and judiciary, limitation of immunity for public functionaries, public administration reform (including transparency), codes of conduct for elected

representatives, regulation of political party financing, and freedom of the media to seek and publish information.

In 1998 the Council authorized the creation of a Group of States Against Corruption (GRECO) to facilitate international cooperation. GRECO, which has 34 members, organizes peer monitoring of fulfillment of the Guiding Principles by Member States. (Open Society Institute, 2002).

The EU anti-corruption framework remains diffuse and largely non binding. There are probably two main reasons for this. First, the extent and nature of corruption appears to differ widely across Member States, reflecting different national traditions and historical legacies. Second, to date the Commission has not seen or framed corruption as a concern for the ability of member States to implement EU directives. For this reason there has been no immediate need to pressure or criticize existing Member States on the grounds of corruption. Finally, even if the Commission would criticize the Member States for corruption, they remain powerful enough to oppose any proposed EU directives on how to clean up their polities.

Fighting against corruption is a long-term process where the engagement of society, government and businesses has a crucial signification. For a successful struggle with this phenomenon all these actors must be aware of the negative impacts that corruption leads to. Probably, it is impossible to completely reduce the phenomena but the goal of a nation should be to at least reduce it to the level where democracy could freely develop and a competitive, open market be created.

4.7. Summary of the chapter

Corruption is not a new phenomena and its neither concentrated to only one geographic location. According to Arvind (2001), existence of corruption requires the co-existence of three elements. First, someone must have discretionary power that would include authority to design regulations as well as to administer them. Second, there must be economic rents associated with this power. Third, the legal/judicial system must offer sufficiently low probability of detection and/or penalty for the wrongdoing.

An individual firm may find bribes helpful to reduce the effective “red tape” it faces. Consequently, the “efficient grease” hypothesis asserts that corruption can improve economic efficiency and that fighting bribery would be counter-productive (Rose-Ackerman, 1999). In countries were fight against corruption is effective, companies resort to lobbying, which might create grounds for corrupt activities in countries with less effective supervisory authorities.

When in investing in corrupt country, companies face additional elements of uncertainty and risk. Moreover, corruption reduces both the volume and efficiency of investments. Therefore, the corrupt nature of the deal may give the firm a short-run orientation or drive them out of their business.

A new theory to corruption studies was introduced recently, according to which corruption influences foreign investors' entry mode. Corruption makes local bureaucracy less transparent and hence increases the value of local joint venture partner through which both risks and costs are reduced. This is compared to the level of technological sophistication of the foreign investor. If it is high, fully owned companies are favored to avoid "leakage" or companies resort to low transaction cost entry modes such as exporting. Generally, corrupt countries witness an increased share of investments into sectors with low technological sophistication.

Companies have a choice of participating or not participating in corrupt activities. Even though foreign companies are aware of the negative impact of corruption, still, they justify corruption as a way to avoid greater harms. Each firm believes it needs to pay bribes, but each knows that most of them would be better off if nobody paid. Thus a situation similar to "prisoners' dilemma" arises. Another option is to rapport corruption to local authorities and to those in the outside world if the perceived effects are beneficial for the company.

This would not be the case if the penalizing system in the country would be inefficient. Fight against corruption has become an important approach for many nations and international organizations. In case of the European Union, which Poland will join in May 2004, the anti-corruption framework has remained diffused and largely non binding. The fight against corruption becomes even more difficult when governments and businesses justify corruption activities.

There is nothing more difficult to carry out, nor more doubtful of success, nor more dangerous to handle, than to initiate a new order of things. For the reformer has enemies in all who profit by the old order, and only lukewarm defenders in all those who would profit from the new order. The lukewarmness arises partly from fear of their adversaries who have law in their favor; and partly from the incredulity of mankind, who do not truly believe in anything new until they have had actual experience of it."

Niccolo Machiavelli, 1513

5. POLAND

The following chapter gives an overview of the economic development of Poland since the break-down of the Soviet-dominated economy. The focus is on the development of foreign investors penetration of the Polish market and their incentives to invest in Poland. Also the different entry modes of foreign investors and the benefits of foreign investments are covered.

More than ten years ago, after breaking out of the Soviet-dominated communist bloc, Poland took a chance and decided to transform its inefficient centrally planned economy into a market economy. On January 1, 1990, the first post-communist Polish government introduced an unprecedented economic reform plan known as the Economic Transformation Program. This plan was designed to stabilize the economy, promote structural reforms, and put the country on the right path to becoming a market economy.

The years 1993-1997 were the period of rebound from the bottom with growth rates of GDP reaching annual levels of 6-7 percent. Furthermore, the barriers, which in time of the PRL⁶ limited the possibilities of creation of new enterprises, were eliminated. Consequently, the sudden - yet expected by reformers - increase of number of companies occurred. Private sector started growing intensively contributing to the increase in the GDP, which was 20 percent higher in 1999 than in 1989 (Zienkowski 2000 a.).

Over ten years after launching an ambitious program of economic transformation, Poland has established itself as one of the most successful transition economies. Consequently, over the last years output has expanded vigorously, inflation has declined and living standards have improved. According to an economic survey published by the OECD, Poland's robust economic growth reflects large inflows of foreign direct investment (FDI) and the dynamism of small private enterprises.

In 1998 Poland attracted 40 percent of all FDI flows to Central and Eastern Europe (CEE) countries despite the slowdown of global economy. According to the Polish Agency for Foreign Investment (PAIZ) (2003), accumulated inflow of FDI to the Polish economy had reached over USD 65 billion by 2002. Even though the country witnessed a downward trend in the inflow of foreign direct investment, FDI allocation to Poland reached USD 3,23 billion in the first half of 2002.

⁶ Polska Rzeczpospolita Ludowa, Poland's name during the communist era

Poland also enjoys a high degree of integration with the EU. Two-thirds of Polish foreign trade is with the Union and most of its direct investment flows come from the West European block (PAIZ, 2003). Poland's upcoming membership in the European Union is considered to be a final adjourn from the communist regime.

5.1. Transformation

Before 1989, the Polish economy struggled through a decade of mounting political and economical problems mainly due to the effects of central planning and ideological constraints by the Communist Party. Planning became largely a personalized bargaining process of the “vanguard party” which degenerated into personality cults and abuses of position by the nomenclature (Balcerowicz, 1995). Moreover, wide informal relations of negative character were common in the communist system: corruption, client-protector relations, and bribes on every level (Zienkowski, 2002 a,).

The economy was constantly threatened with economic crisis of smaller or greater scale that usually occurred in the mid of the so called five-year-plans. It was a rule that, on the one hand, permanent shortages appeared (the most common were shortages of consumer goods - proverbial empty shelves in shops, coupons for goods, and privileges for party and economic elite), and on the other hand, what is equally important, there occurred an overuse (in comparison to well functioning economy) of factors of production – raw materials, labor (hidden unemployment), materials and capital (Zienkowski, 2002 b,).

Decades of bureaucratic allocation created serious distortions, with some sectors massively overbuilt and others severely repressed. Relative prices diverged greatly from market patterns, leading to massive explicit or implicit subsidies among sectors. Pervasive shortages allowed firms to operate in sellers' markets and reduce incentives to improve quality. With near complete state ownership, enterprises lacked the defined property rights that spur work-effort and profit making in market economies. Firms had little reason to use inputs efficiently and strong incentives to hoard both labor and raw materials. Moreover, many firms added negative value. At world prices the cost of their inputs would have exceeded the value of their output. Consequently, the economy was also far from the mainstream of international developments in R&D, lagging behind the leading technological developments and therefore not competitive (Du Pont, 2000).

With the background of communism ideology, the process of modernizing Polish economy began. The political revolution in 1989-91 initiated comprehensive transformations of the economic institutions in the transition from command economies to market economies and of a fundamental restructuring of production and the process of production. Furthermore, the transition also included the creation and development of new democratic political institutions and a cultural liberation with deep changes in habits, norms and values (Mygind, 1994).

The dissolution of the old system (break up of most economic networks between enterprises and between countries and steep cuts in production) took place in a rather

short period. On the other hand, building up new links, new products, new production methods demanded huge resources - time, capital and human qualifications. Lack of these resources caused bottlenecks for the transition process. (Hare and Hughes, 1992).

As history has shown, reforms to modernize economy and society were very slow. Bureaucracy, inefficiency and the lack of knowledge about the mechanism of modern economy made it also very difficult for foreign investors to run their business in the country. Additionally, unpredictable changes created a high risk environment for investments.

Furthermore, the barriers for the development of the new political system could be found in the risk that the old elite converts its political power to new forms in the new system and in the lack of democratic traditions and experience. An important barrier is the overwhelming burden of consolidation of the democratic institutions in a period where new legislation was needed in almost all areas. Many political decisions were made without knowing the effects of the policies because of the high uncertainty in the early years of transition (Mygrind, 2000).

Summarizing, Poland benefited from the difficult but effective introduction of truly market-driven mechanisms into the economy and became the first country in the region to rebound from transformational recession. In accordance to principles of market economy, fiscal and monetary policy gained key importance (Balcerowicz, 2000).

Since the beginning of the 90s the business environment has changed radically. For the last decade, the country tried to reduce the economical gap between its own and Western economy. Important approach was to become a member of a global integrated economy. Through joining OECD in 1996, a new level of quality in procedures and regulations began to be applied to foreign investors. Most significant was the right to equal treatment on par with domestic companies. In March 1999, the country also joined North Atlantic Treaty Organization (NATO) and the process of joining the European Union in 2004 is driving much of Poland's current economic agenda (www.export.gov, 2002). Nowadays, the European Commission regards Poland as a functioning market economy, able to cope with the competitive pressures and market forces, which becoming a full Union member will undoubtedly bring with it.

5.1.1. Privatization

Moving to a market economy is intimately linked with the privatization of state-owned property and the restructuring of production processes. The first reform government in power, after the political breakthrough of 1989, aimed to reduce the ability of the state to influence economy. Facing budgetary shortages, that administration preferred commercial methods of privatization and wanted to establish new majority owners in the privatized companies. Furthermore, privatization played a key role in attracting FDI inflows to the country in the early 90s

and became a determinant factor that changed the structure of Polish economy and contributed to the success of the transformation.

The experience of the past 10 years demonstrates the basic soundness of the underlying principle that has guided Polish privatization from the start: to find and choose the best possible investors for different types of enterprises being privatized. This approach has meant adopting individualized, market-oriented and time-consuming methods of privatization rather than massive and quick privatization schemes (Blaszczyk, 1999).

Privatization was being proceeding along three main routes. The first, under the heading of direct privatization or liquidation, covered small and medium-sized enterprises. The second route, usually referred to as indirect or capital privatization, concerned larger firms and involved open sales of shares and the search for strategic outside investors. The third route, mass privatization, was meant to distribute ownership rights to all citizens. By the end of 1995, privatization or commercialization had been completed in less than 20 percent of cases.

Furthermore, direct privatization has followed two tracks. The assets and liabilities were often leased to insiders as the first step towards an eventual purchase. Through this method the control of the enterprise by workers and management was strengthened. The second form concerned capital privatization that was the main source of revenues for the budget, even though it concerned a much smaller number of firms. Mainly foreign buyers were engaged in this process and accounted for two-thirds of the total revenue from capital privatization in 1995 (Du Pont, 2000). Moreover, a large number of enterprises in poor financial condition were liquidated and the assets were sold mainly to private entrepreneurs.

From the start of the privatization process in late 1990 until the end of 1998, 6129 (72,6 percent) of a total of 8441 state-owned enterprises were partly or fully privatized. If the 1654 rural enterprises (19,5 percent) taken over by the Agency of Agriculture Property of the State Treasury for restructuring and privatization under a separate program are excluded, the number of enterprises participating in the privatization process as of end-1998 total 4475. This means that only 53 percent of state owned enterprises had been privatized.

The number of enterprises completely privatized reached 2454 or 29 percent of total state-owned enterprises, while partially privatized 2021 companies stood for 24 percent.

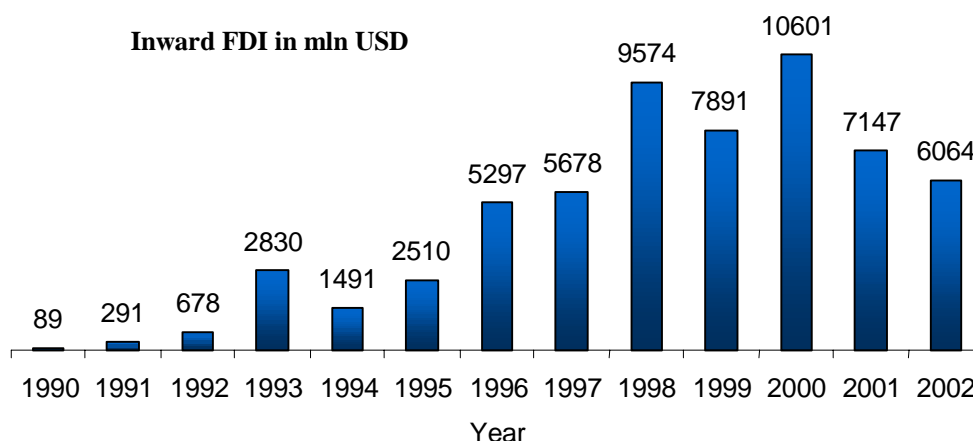
Polish private sector has expanded rapidly since 1989 and now dominates almost every sector of the economy. The state has remained majority owner for companies in sectors such as coal, steel and public utilities. Private sector is estimated to employ over two-thirds of Polish labor force and to produce over 70 percent of GDP.

5.2. Foreign direct investments

Up to 1989, foreign investments into Poland were negligible, whether measured in terms of the number of projects or dollar value. The changes, initiated with the collapse of centrally planned economy, created a new market that was not competitive and served by a small number of companies. A great number of firms realized the possibilities for future development. In 1990, after the introduction of the liberalization program, foreign investors slowly started entering the Polish market.

During the initial period, FDI inflows were of USD 0,1 billions in 1990 and USD 1,5 billions in 1994. The cumulative inflow between 1990 and 1994 amounted of USD 5,3 billions. Thus, the number of registered companies with foreign capital grew impulsively, investors did not penetrate market actively. Instead, it was preferred to locate capital in the more stable economies of Hungary and Czech Republic.

Figure 3: FDI inflows to Poland 1990-2002



Source: PAIZ, April 2003.

After 1993, a shift in the pattern of FDI emerged. In 1991 the FDI stock⁷ came to the amount of USD 380 millions, in 1992 USD 1,304 billions and in 1993 to USD 2,9 billions. Also, strong increases occurred in the capitalization of firms as well as increases in the inflow of foreign capital by the largest firms. The largest 29 foreign investors in Poland accounted for 55,8 percent of all investment and 55 percent of all investment commitments.

The most striking feature of this development was a steady rise of the equity share of foreign investors, from 2 percent in 1989 to 87 percent in 1995. This observed trend signifies, that foreign investors were changing their investment strategy and began to acquire higher shares. Investment became more factor-endowments-driven in skill-intensive industries. Furthermore, the average FDI per firm rose from USD 50000 in 1989 to USD 820000 in 1996. That indicates change in investment strategy to a more

⁷ FDI stock is the value of the share of their capital and reserves attributed to the parent enterprise, plus the net indebtedness of affiliates to the parent enterprise. (World Investment Report UN, 2000)

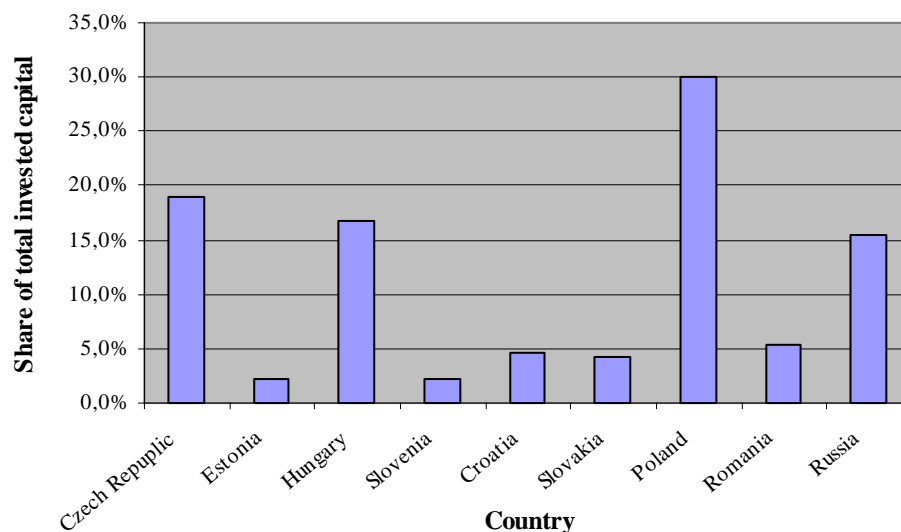
long – term involvement, less affected by the short – term prospects of a temporary tax holiday (Du Pont 2000).

Following the agreement with the London Club⁸ in 1995, FDI started to flow into the Polish economy. In 1995, the value of FDI inflows into Poland surged to USD 2,8 billion which amounted to around 50 percent of the aggregate value of FDI inflows over 1990-94 and was almost double of the value in 1994. Measured as a share of GDP, the volume of FDI was equal on average to around three percent over 1995-97 and five percent in 1998-99 (Smarzynka, 2001).

According to PAIZ, the level of FDI in Poland at the end of December 1996 was USD 13,186 billion. The increase of the FDI value in Poland was due to both an increase in investments of firms present on the Polish market and new investors. Over two-thirds of the total investment came from the largest foreign investors that contributed at least USD 1 million each. The share of foreign firms in total investment outlays increased from 20 percent in 1994 to 33 percent in 1996 and 40 percent in 1997. In manufacturing, this share is significantly higher and amounted to 56 percent of the total in 1997 (Smarzynska 2001).

About 48 percent of the value of total FDI inflows over 1990-99 came to Poland in 1998 and 1999. During these years Poland accounted for almost half of the total inflows to Central and Eastern European countries. Furthermore, in 2000 FDI reached the record number of USD 10,6 billion boosted by the 35 percent stake sale of the national telecommunications operator Telekomunikacja Polska SA to France Telecom for USD 4.3 billion (PAIZ, 2003). Since then, direct investments have started diminishing, following the slowdown of world economy.

Figure 4: Comparison of accumulated FDI inflows 1990-2001



Source: OECD (2002)

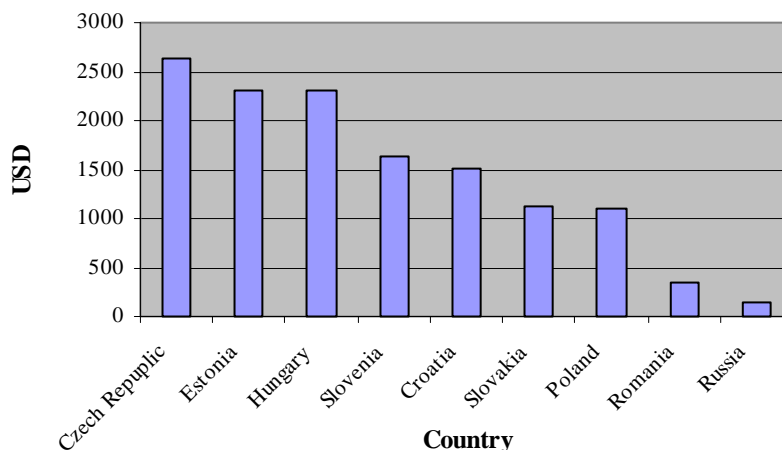
According to the 2002 annual research by PAIZ, foreigners invested in Poland USD 6,064 billion that year. Furthermore, the total foreign capital invested in Poland in 1990 – 2002 reached the USD 65,11 billion that emphasizes the attractiveness and

⁸ Group of developed countries that act as creditors for developing economies

potential of Polish market. As far as investments over USD 1 million are concerned, FDI stock by the end of the year amounted to USD 61,45 billion (Annex 3)

Moreover, Poland is the unquestioned leader in attracting FDI among CEE countries having attracted 30 percent of total as compared to 19 percent of the Czech Republic and 17 percent of Hungary.

Figure 5: Accumulated FDI per capita 1990-2001



Source: OECD (2002)

In considering accumulated FDI inflow per capita, Poland nevertheless loses its dominant position to most of the East European countries. Therefore, it can be suggested that market has not reached its saturation point and there are plenty of business opportunities still existing.

5.2.1. Major foreign investors

The number of registered foreign companies was rising systematically and increased over 85 times between 1989 and 1998. Highest relative annual increase took place between 1989 and 1993 as is evident from the table below, but, as been shown before, these investments were not significant in value. Thus, it could be assumed that the initial period was used mainly for registration purposes without active market penetration. The intensity of foreign direct investments fell to the period after 1993. Although the relative numerical increase was not as significant as before, most capital inflows occurred during that period.

Year	Number	Year	Number
1989	429	1996	28622
1990	1645	1997	32942
1991	4796	1998	36850
1992	10131	1999	40910
1993	15167	2000	44229
1994	19737	2001	46258
1995	24086		

Source: De Broeck and Koen, 2000 and Foreign Trade Research Institute, 2002

The “List of Major Foreign Investors in Poland” (Annex 2), appeared in the early 90s and included 93 companies that had made investments over USD 1 million. For the last nine years, the number of enterprises with the participation of foreign capital has been growing rapidly. By the end of 1995 there were 362 investors who had invested over USD 1 million, whilst at the end of July 1996 the number had already risen to 492. In 2002 the list included the names of 920 companies.

The largest group of investors, 212 companies, comes from Germany and the second largest from the United States – 126 companies. Other significant countries are France with 89 companies, the Netherlands with 76 and Italy with 59 companies that have made noticeable investments into Polish economy.

Most of the same countries also emerge in considering the total FDI stock. By these figures, French companies are the biggest investors being responsible almost 20 percent of the value of all foreign investment into Poland. Frenchmen are followed by the United States (14 percent), Germany (13 percent) and the Netherlands (10 percent).

Furthermore, 52 percent (479) of the total number of companies registered on the “List of Major Investors ” and 66 percent (USD 40,1 billion) of accumulated foreign direct investments during the period of time 1989 to 2002 came from the EU.

5.2.2. Sectoral composition

In the early 1990s, Poland did not have clear policy for attracting FDI. Investments were mostly attracted by industries which could bring high and quick returns. During the second half of 1994, the government announced industrial policy priorities for FDI and adjusted its investment policy to co-align with this new direction. It was expected that FDI would flow to those areas where Poland had a strong comparative advantages (Du Pont 2000).

The analysis of the pattern of foreign direct investment reflects a continuing tendency towards diversification. Most of the direct investment into Poland have been made to the traditional sectors of the national economy. The greatest interest of foreign investors, and thus also the greatest benefactors from foreign investments, has been towards the manufacturing sector (Annex 3).

Although the development of that sector has been stable, its share in the accumulated value of direct investments, in annual comparison, has been gradually declining. In 1997 its share in the overall investments amounted to 62,4 percent, declining to 58,3 percent in 1998 and to 49.2 percent in 2000. In 2001, the share of the manufacturing sector in the accumulated value of direct investment was 41,7 percent and dropped to as low as 36,9 percent in 2002.

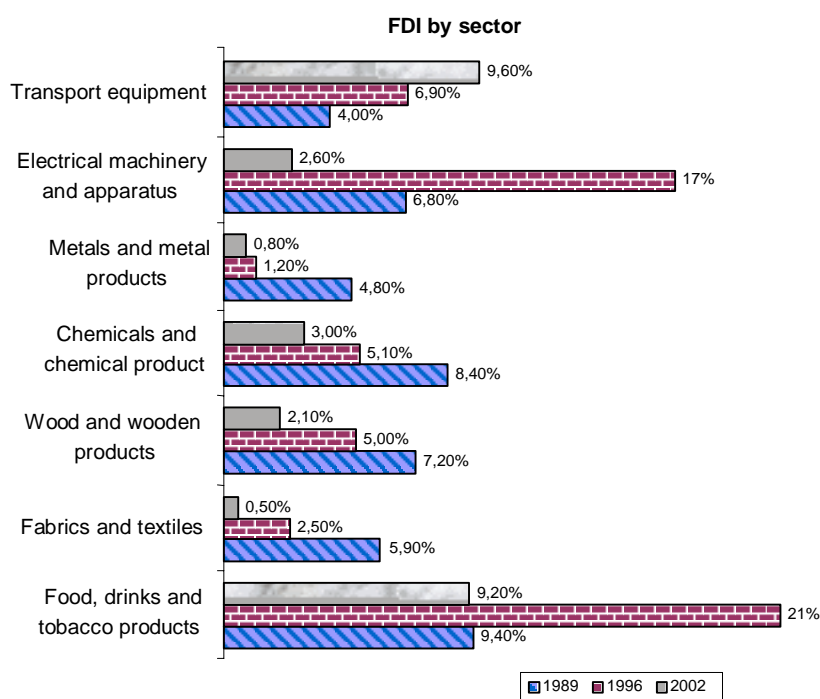
The second largest sector of the economy in terms of the inflow of foreign direct investments is taken by financial services. The accumulated value of investments recorded in that sector at the end of 2002 amounted to almost USD 14 billion or 20,6 percent of total capital invested up to that point. Trade, transport and communication

together form the third block with an aggregate share of 21 percent of total accumulated capital investments.

These changes can nevertheless be considered positive, as they indicate a gradual shift away from labor intensive sectors towards capital intensive sectors, in line with the tendencies observed in highly developed countries. Furthermore, new investment projects, carried out by foreign companies, have increased the amount of capital involved in the services sector.

A changing pattern in the sub-sectoral distribution of FDI of the manufacturing sector in comparison of the shares in total accumulated investments up to years 1989, 1996 and 2002 can provide additional insights.

Figure 6: Sub-sectoral breakdown of accumulated investments into the manufacturing sector



Source: Constructed by the author based on PAIZ (2003) and Du Pont (2000)

In such a comparison, the share of motor and transport equipment sector has slowly increased from 4 percent in 1989 to 6,9 percent in 1996 to 9,6 percent in 2002. As such, the total accumulated investment into that sector in 2002 was USD 6,2 billion.

Food industry, together with tobacco and drinks, was by far the largest sector by 1996 witnessing a remarkable rise from 9,4 to 21 percent. By now, its share has nevertheless decreased substantially reaching “only” 9,2 percent. Investment outlays registered for this sector reached USD 5,98 billion and placed it second after the transport sector.

As a third example, I look at the electrical machinery and apparatus sector, which has followed a similar path to food sector. 17 percent share in 1996 has dropped to a meager 2,6 percent in 2002 being even lower than the 6,8 percent level in 1989.

Investment outlays for this sector reach USD 1.67 billion ranking it fifth in 2002 after chemicals and other non-metal goods according to EKD classification.

The shares of these three sectors taken together in the total stock of FDI amounted to 45 percent of all the capital invested in 1996 but only 21 percent in 2002. Similar developments occur also in other sectors presented on the graph above. With the exception of the three sectors mentioned above, the share of all others has decreased constantly over the years. With the exception of the transport sector, all sub-sectors off the manufacturing sector have decreased as compared to the 1996 level.

5.2.3. R&D spending

One area, where foreign investors are not yet active is research and developments (R&D). Spending on R&D has remained relatively low and research and development intensity, as measured by the ratio of business R&D expenditures to value added, was at a level of 0,92 percent in 1999. For the whole manufacturing sector the average R&D intensity during 1995-1999 was even lower reaching only 0,74 percent.

The Polish manufacturing industry is nevertheless following patterns in R&D allocation similar to developed countries by focusing primarily on machinery, electrical machinery and motor vehicles. The gap can be found in the amount of R&D spending relating to production. R&D investment efforts in Poland are carried mainly by domestic firms. Foreign firms accounted for only 14 percent of the total technology stock in manufacturing in 1999.

Statistical data from 1998 shows that level of technology stock is very low. Poland has managed to generate about 6 percent of the Dutch technology stock and only about 0.1 percent of the US R&D stock. The gap between Polish and developed economies' technology stocks is nevertheless narrowing, indicated by higher growth rate of Polish R&D spending (Central Statistic Office, 2003).

Access to simple services like internet have been highly limited in Poland.

	1996	1997	1998	1999	2000	2001
EU	6712	12418	19450	36935	56932	99090
Poland	250	500	800	1581	2100	2800

Source: Eurostat (2003)

According to Eurostat's statistics (2003) the number of individuals having access to computers is very limited and the access to internet is very low in comparison to the EU countries. According to PAIZ (2003), the cost of access to internet in Poland is one the highest in the world having a price level almost equal to Japan, which is considered as the most expensive. Consequently, access to information is very costly and limited.

5.2.4. Trade orientation

Export is a basic indicator for successful internationalization of an enterprise. FDI-based firms have undoubtedly been the engine of export growth over the period and there is a close correlation between the growth of exports and the share of foreign firms in them.

Since 1990, the development of exports has been accompanied by substantial changes in commodity composition. Structural changes in Polish exports were related to the readjustment towards the EU markets after the collapse of the communist regime and the decline of traditional industrial goods markets. The changes confirm that the export drive was led by labor-intensive industries, but that new trends were and are emerging (Du Pont 2000).

Ratio of exports to imports	1994	1995	1996	1997	1998
Foreign owned firms – exports	3609	7770	9267	11047	13528
Locally owned firms – exports	13577	15084	15120	14644	14661
Foreign owned firms – imports	7101	10758	15674	21120	25122
Locally owned firms – imports	14331	18260	21418	21133	21878
Foreign owned firms – share in total exports	21	34	38	43	48
Locally owned firms – share in total imports	33	37	42	50	53

Source: Kaminski and Smarzynska (2001)

Foreign owned firms have shaped the dynamics of Polish trade on both export and import sides. Aggregate statistics in reflect the growing importance of firms with foreign participation in Poland's international trade. In 1994, such firms accounted for 21 percent of Poland's total exports. This figure increased to 38 percent in 1996 and 48 percent in 1998. Thus, these firms are now responsible for almost half of Polish exports.

Between 1994 and 2001 the value of their exports increased more than three-times from USD 3,6 billion to USD 25,4 billion. Considering the significant increase of FDI over 1997 to 2001, the share of foreign owned firms in total exports is likely to expand. On the import side, this share was larger than that of exports in each year over 1994-01, although it recorded lower growth rates. Foreign owned firms account for over half of Polish total imports in 2001 (PAIZ, 2003).

For this reason, many observers accuse foreign owned firms of having an adverse effect on the balance of trade because of their allegedly excessive imports. Indeed, exports by foreign firm were lower than their imports in 1994-98. The same critique has to be nevertheless extended also to domestic firms.

Export orientation of foreign owned companies is also indicated by the fact, that they have already firmly established themselves among the largest firms and the largest exporters in Poland. Among the 500 largest enterprises in Poland there were 144 firms with foreign capital (or 29 percent of the total) accounting for 46 percent of exports of that group in 1999. The average export revenue earned by a firm with foreign capital was equal to USD 224 million, as compared to USD 97 million for a locally owned company. On average, a firm with foreign capital increased its export

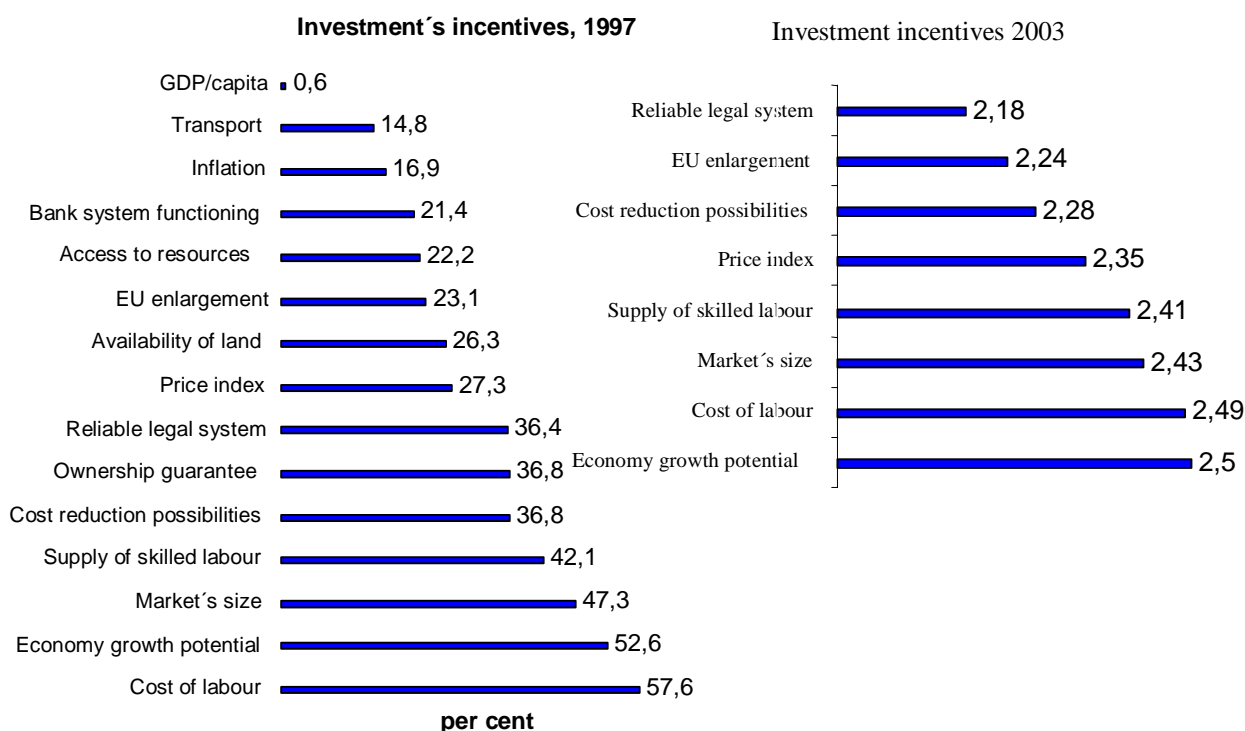
earnings by 14 percent between 1998 and 1999, while for domestic firms the corresponding figure was only 2 percent. Moreover, firms with foreign capital were on average more export oriented, shipping abroad 27,5 percent of their output as compared to 17 percent for locally owned firms.

To summarize, foreign investors have contributed to the development of the trade between Poland and the rest of the world. This process brings with it also higher integration with other markets. On the one hand, overlarge import that is heavily stimulated by the foreign owned enterprises, contributes to the creation of the trade deficit. At the same time, intensive market penetration by foreign companies forces domestic companies to be more competitive. The characteristic of the foreign investments in Poland is that are intensive on both horizontal and vertical level.

5.3. Investment incentives

Two thorough studies on investment incentives for Poland have been carried out. The Office for Marketing Research in Warsaw study in 1997 and a study by PAIZ in 2003. The results of these studies suggest that, although the economic environment in the country has changed, motives for investment have remained almost unchanged. Cost of labor, economic growth potential, market size and supply of skilled labor are continuously the main determinants. Other investment incentives might be suggested taking into consideration specialties of the Polish market, but these are of secondary importance and were therefore not presented in the studies mentioned above.

Figure 7: Incentives to invest in Poland in 1997 and 2003



Source: Office for marketing research, Warsaw 1997

Source: PAIZ, 2003

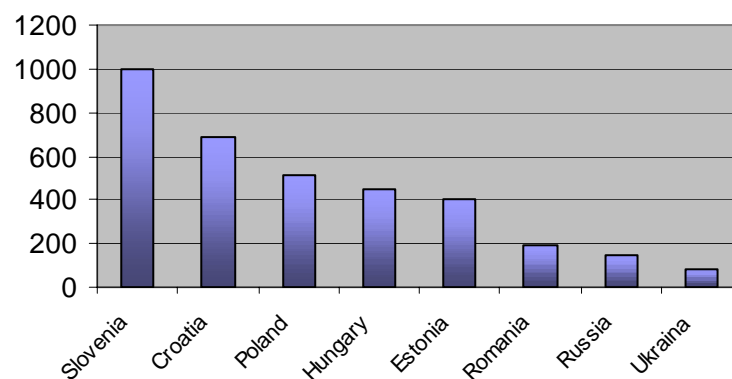
5.3.1 Cost of labor and labor productivity

In both surveys, foreign investors stated that the cost of labor is one the most important investment incentives ranking first in 1997 and second in 2003. This factor is an important locational advantage particularly for firms seeking to transfer or establish manufacturing to supply worldwide markets. Given the labor cost differences, foreign investors were expected to utilize factor cost differences and to build export oriented production in Poland.

Furthermore, the projects undertaken by foreign enterprises typically required more capital transfer than pure sales operations therefore low labor costs were crucial for attracting FDI. Additional determining factor is the constant increase in productivity (Bevan et al., 2000).

According to PAIZ, (2003), Polish labor force is very cheap. It costs just USD 2,6 an hour (including social security contributions) to employ a skilled manufacturing worker. This is twice the rate paid to workers in the early 1990s but still significantly lower than the USD 19 and USD 22 paid to skilled workers in France and Germany respectively. Furthermore, labor is almost twice as cheap as in Slovenia and 25 percent cheaper than in Croatia

Figure 8: Estimated average monthly cost of labor in 2001 (in US dollars)



Source: IMF, 2000

The development of labor cost over time is best represented by the rise in the average gross salary presented in Table 4.

1996	1997	1998	1999	2000	2001
324,2	323,7	354,8	354,8	442,7	513,8

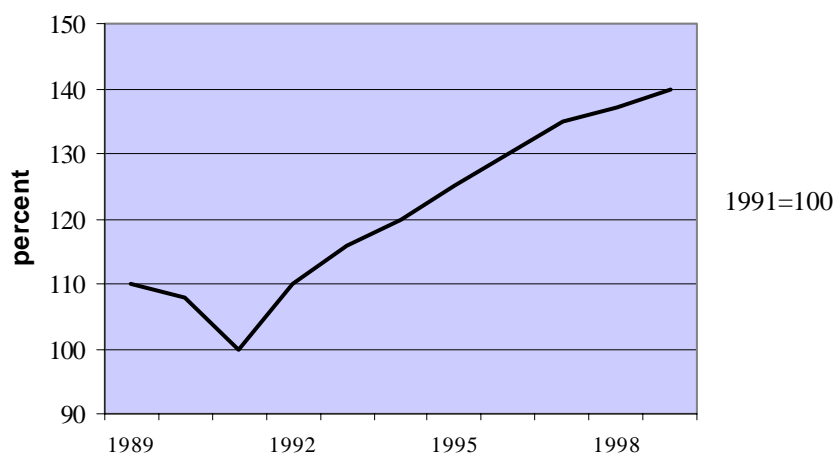
Source: Polish Statistics Office (2003)

The average gross salary has increased by nearly 60 percent from 324 USD in 1996 to 523 USD in 2001. Yet, the increase was not significant to have a visible effect on foreign investments. According to Ministry of Economy (2003), wages in Poland are still several times lower than in the European Union countries. In industrial sectors

they are approximately 6 times lower than in Germany, Denmark, Sweden and France and approximately half the level of Portugal and Greece

At the same time, industrial sectors' average salaries were approximately 7 percent higher (549 USD) than the average gross salary for the entire country. It has to be noted though that although manufacturing witnessed the biggest inflows of FDI, the average salaries were lower than both the industrial sector and country average and reached 500 USD (PAIZ 2003).

Figure 9. Labor productivity growth in Poland



Source: IMF, 2000

Polish labor productivity has been developing intensively through the 90s. Labor productivity is nevertheless higher in Slovenia and Croatia than in Poland. Hungary, with cheaper labor, exhibits also lower productivity. The difference between these countries may not be significant on the macroeconomic level, but for investors it may have crucial importance. Although low labor costs are preferred, the accompanying low productivity may eliminate the beneficial effect in the long run (IMF, 2000).

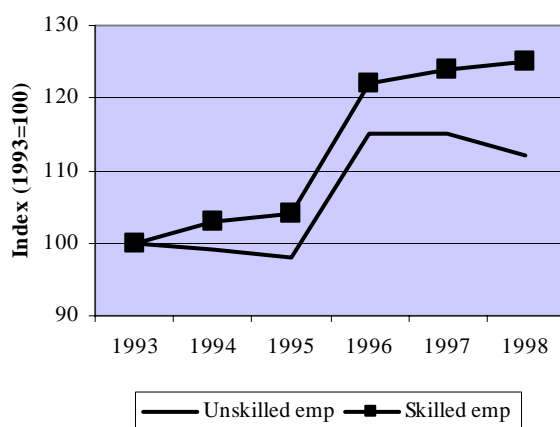
5.3.2. Supply of skilled labor

Cost of labor as an investment incentive cannot be looked upon separately. A closely connected motivation, which ranked fourth in both the 1997 and 2003 studies, is the supply of skilled labor. As investments are developing toward service sectors, the demand for skilled labor is rising.

Labor supply is very high in Poland. There are 39 million people in Poland, which, together with an 18 percent unemployment level, creates a strong demand for jobs. As the supply of new working places is limited, foreign investors, that applied resource-seeking and particularly labor-seeking strategies, have considerable bargaining power in hiring workforce.

Poland is also one of the youngest countries on the continent – 35 percent of Poles are under 25 years of age. For companies this means a working force of about 14 million young and educated people. The level of education of Polish workforce is relatively high in both skilled and unskilled sectors. In 2001 there were over 1,7 million university students in Poland, and 4 times more graduates than a decade before (www.poland.pl)

Figure 10. Employment by skills



Source: Polish Central Statistics Office, 2002

As it is visible from the graph above and table below, in the period of 1994 to 1998 employment rose fastest for persons with higher education (by 29,1 percent) and for those with secondary vocational education (by almost 17 percent). Employment of persons with primary or incomplete primary education fell significantly (up to as much as 33.5 percent). A downward trend is visible also for graduates from post-secondary schools (a drop by 14,5 percent). The share of population with the lowest education level in aggregate employment fell from 25,7 percent to 16,9 percent in the period under review.

Education level	1992	1993	1994	1995	1996	1997	1998
Higher	1542	1552	1643	1688	1746	1836	1989
Post-secondary	614	477	546	558	523	520	525
Secondary vocational	3426	3288	3466	3565	3743	4892	4006
Basic vocational	4768	4758	4845	4948	5139	5286	5300
Primary and lower	3886	3667	317	3130	3048	2839	2586

Source: International Labor Office, 2002

Unemployment rate has been nevertheless rising systematically from 10,3 percent in 1997 and by 2003 it is predicted to reach 19 percent. Furthermore, 34 percent of registered unemployed are in the age of 15-19, 21 percent in the age of 20-24, 11,1 percent 25-29 and 10,1 percent between 30 and 34. Consequently, overwhelming majority of registered unemployed are young people.

The transformation of the Polish economy has been also accompanied by significant changes in the sectoral structure of employment, mainly by a decrease in the number of jobs in traditional sectors (agriculture, mining) and expansion in the services sector. It must be emphasized that the role of skilled working force has been growing

rapidly. The largest increase in employment were recorded by the financial services (73 percent) and hotels and restaurants sectors (47,3 percent) (International Labor Office, 2002).

Furthermore, rising importance of skilled labor was effected by the shift in factor content of Poland's EU-oriented exports towards skilled labor intensive products.

Table 6: Export Specialization							
	1993	1994	1995	1996	1997	1998	Growth in 1998
Exports to the EU (million of US dollars)							
Natural Resource Based	3,820	4,567	5,336	4,641	4,800	4,862	1.3
Unskilled Labor	2,967	3,473	4,496	4,657	4,460	5,115	14.7
Capital intensive	1,268	1,607	2,475	2,680	2,914	3,372	15.7
Skilled Labor	1,760	2,269	3,479	3,520	3,971	4,847	22.1
Composition of Poland's exports to the EU (in percent)							Index 1998, 1997=100
Natural Resource Based	38.9	38.3	33.8	29.9	29.7	26.7	90
Unskilled Labor	30.2	29.1	28.5	30.0	27.6	28.1	102
Capital intensive	12.9	13.5	15.7	17.3	18.0	18.5	103
Skilled Labor	17.9	19.0	22.0	22.7	24.6	26.6	108

Source: Smarzynska, 2001

Although Poland's exports of unskilled labor intensive and natural resource based goods have been steadily increasing in absolute terms, there is a trend for reduction in relative terms. As expressed by the Export Specialization Index, the gap between export of unskilled labor products and skilled ones was significant during 1993 and 1994 but has decreased significantly since then becoming almost marginal in 1998. Therefore, considering also the increase in labor cost, it can be assumed that the export oriented foreign producers of unskilled labor intensive products (e.g., textiles) have been moving production to countries with lower labor costs (Smarzynska, 2001).

Economic transformation in Poland has caused significant changes in the demand for labor according to skills and educational qualifications. Demand fell for unskilled employees and rose for skilled ones. This is correspondingly reflected in Polish exports, which shows a higher importance of skilled labor products.

5.3.3. Economic growth potential

Economic growth potential is another investment incentive that has been recognized as very important both in the 1997 and 2003 surveys. The size and potential of the Polish market are the seen as one the most important determinants. The reason, as acknowledged by Du Pont (2000), is very simple – firms want to grow. Given the constraints of a saturated and only slowly growing domestic market in the Western Europe, enterprises are driven to sell their products abroad. Development of the Polish economy goes hand in hand with the demand for companies' products.

Table 7: Basic macroeconomic indicators								
	1995	1996	1997	1998	1999	2000	2001	2002
GDP (% change)	6,9	5,9	6,8	4,8	4,1	4,0	1,1	1,1
GDP USD bln	126,6	142,8	143,1	157,5	154,1	158,8	176,4	187,7
GDP per capita	3280,8	3697,7	3702,4	4073,3	3986,6	4108,2	4559	4881
GDP purchasing power parity /per capita USD	6780	7100	7,320	8167	8600	9440	9900	N/A
Inflation rate	19	19,9	14,9	11,8	7,3	10,1	5,5	2,0
Unemployment rate %	14,9	13,2	10,3	10,4	13,1	15,1	17,4	18,6

Source: PAIZ, 2003 and Polish Central Statistics Office

The years 1993-1997 were a period of rebound from the bottom. GDP growth rates were at annual levels of 6-7 percent. Labor productivity grew dynamically and new companies, attracted by the market potential, were establishing themselves on the market (Orlowski, 2001). Besides the effects of the reforms and the balanced macroeconomic policy promoting market rules, the “managerial dynamism”, which appeared in private sector, influenced the positive results of the economy and contributed to the high GDP growth.

The GDP per capita has been also growing slowly but systematically. Per capita income has increased from 31 percent of the average EU level in 1993 to 40 percent in 2002 (Commission of the European Union, 2002). This has brought with it also an increase in aggregate demand for goods and services, which foreign companies are readily willing to supply.

Pace of economic growth has declined since 1998. The main factors include slower economic growth in Western Europe and Russia, high domestic interest rates and a strong Polish zloty. In 1998, the growth rate slipped to 4,8 percent, in 1999 to 4.1 percent and in 2000 to 4.0 percent. Since 2001 economic growth sustained on the low level of 1,1 percent.

For foreign investors this dramatic decline in economic growth has damaging effects since demand for products and services decreased. At the same time it is counterbalanced by significantly lower levels of inflation which allows easier long-term planning. Therefore, it is not surprising that in the 2003 survey, investors considered economic growth to be the most important investment’s incentive.

5.3.4. Market size

Closely related to economic growth, the market size has been placed as the third important investment determinant in both 1997 and 2003. With its 39 million consumers, Poland is the largest economy in Central Europe having a market larger than those of the Czech Republic, Slovakia and Hungary combined. Increase in GDP per capita is accompanied with an increase in the purchasing power parity per capita (PPP). Between 1995 and 2001 the PPP increased with nearly 50 percent as visible from Table 7.

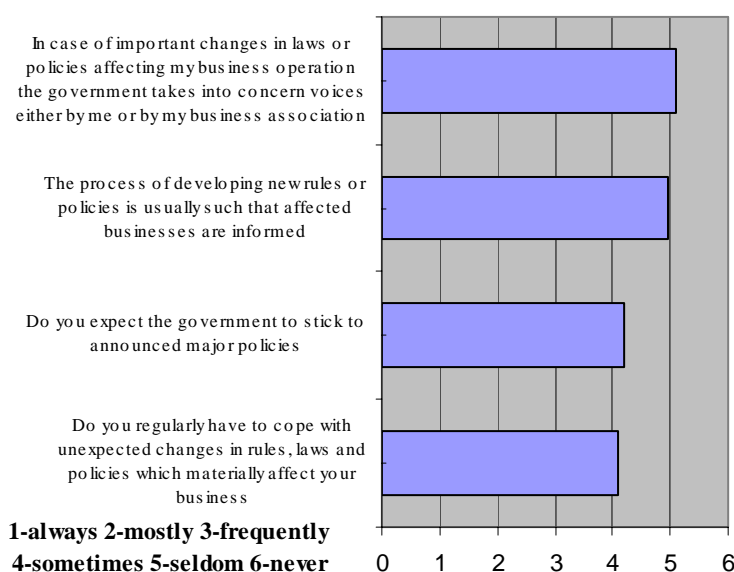
That means that Polish consumers have more disposable income to afford a wide range of consumer goods and services. Additionally, the preferences of Polish consumer are changing. Price is still an important lock-in factor but as in the Western

Europe, consumers are willing to pay more for high quality products (www.poland.pl).

5.3.5. Secondary investment incentives

As investors stated, ownership guarantees and reliable legal system are also important determinants for investments. Additional survey conducted by the World Bank in 1997 showed that foreign investors have faced serious problems in dealing with Polish legal system. Investors stated, that changes in legal system are frequent and that the government does not take into consideration opinions of the business sector. Furthermore, the biggest problems arise from the fact that investors are not informed about upcoming or, in some cases, also past changes. Therefore the credibility of the government is questioned or, as a respondent stated, “government sometimes stick to announced major policies”.

Figure 11: Enterprises perception of the government



Source: World Bank, 1997

Indeed, Polish legal system has been in the process of continuous change since 1989. The period can be divided into two – beginning to the 1990s can be seen as laying the foundation for a new legal system, whereas the subsequent periods have tried to develop the system further and simplify it.

One of the important factors, that foreign companies often consider, is the change in the tariff system. Tariff rates are generally revised at the beginning of each year and, according to the law, suspensions can be “introduced or lifted at any time”. This policy has been often exercised by the Polish government and legislation in the area is therefore very fragile from the investors’ point of view. It has to be pointed out

that Poland signed an Association Agreement with the European Union in 1992, which lowered investors' exposure for tariff changes.

Whereas the U.S.A. does not have an explicit agreement on tariffs, it has negotiated more favorable rates for some product categories. Despite that and membership in the World Trade Organization (WTO), investors coming from EU and U.S.A. have to cope with constant tariff changes. Moreover, many U.S. products are at a disadvantage compared to EU competitors since due to lower protection, U.S. investors are more exposed to changes.

Other areas to be regulated are standards and certifications. Poland has developed its own extensive system that is not harmonized with the international ones. Many product standards are mandatory and must be certified by an accredited Polish testing agency. Furthermore, since 1994 safety certificate for imports and domestically produced goods has been provided by the company on request. Poland does not automatically accept the EU "CE" mark or other international product standards, nor self-certification by manufacturers.

Testing procedures can be long and expensive, although official regulations specify that the process should not take more than three months. However, the workload of testing institutes is large, and as a result, many are not able to meet the three-month deadline. Furthermore, the system that is already complicated goes through constant changes and modifications that are unpredictable for investors (www.export.gov).

One of the most important legislative changes, from the foreign investors point of view, was established as late as in 2001. As of January 1st, 2001, business activities conducted by non-residents in Poland are subject to the Law on Commercial Activity of 19 November 1999 and the Commercial Companies Code of 15 September 2000. The law states that "Subject to meeting certain conditions, foreign entities and physical persons may operate in Poland in accordance with the general principles applicable to domestic entrepreneurs. The formation of a company with foreign participation takes place without the necessity of obtaining a permit from any state administration organ".

In all aspects, foreign owned Polish registered companies are treated on the same basis as Polish owned companies. Furthermore, foreign investors may receive or acquire shares in companies already existing in Poland. Shares may be acquired in public sales, through the Stock Exchange or, if the company is not listed on the Stock Exchange, through individual negotiations with the existing owners⁹.

The new law also changed the scope of obtaining permits. In many cases where the previous law provided for the necessity of a license/permit being obtained, the new law has changed this obligation to the requirement of having a permit. In accordance with the legislation, "a positive decision concerning the granting of a permit solely depends on complying with appropriate statutory conditions".

⁹ Further reading about recent changes in legislation can be obtained in "How to do business in Poland" prepared by Investment and Technology Promotion Office, Warsaw, 2002

Prior to the adoption of the given legislative act, the issuance of the permit was dependent on the decision of the respective authority. After the law, the permit has to be granted if the applicant fulfils clearly set criteria.

This eliminates the arbitrariness of decisions passed in respect of granting commercial activity permits¹⁰. Furthermore, the new legal system gives protection to the interests and rights of foreign investors as well as their property (Investment and Technology Promotion Office, 2002)

Polish accession to the European Union will bring further changes in legislation that are going to be harmonized with the EC law. Trade barriers between Poland and EU will be removed and the principles of free movement of goods, labor, services and capital will be applied. Through these measures more favorable investment environment will be created (<http://www.tradepartners.gov.uk>).

5.4. Entry modes

The expansion of foreign enterprises into Poland involved very high risks, including political instability, social unrest, fluctuating exchange rates, poor infrastructures, governmental bureaucratic barriers, differing language, norms, religion and almost nonexistent legal system. These risk were taken into consideration and consequently less hazardous entry modes were chosen. The most common entry forms were joint ventures, greenfield and acquisitions.

5.4.1. Joint ventures

Joint ventures (JV) were especially favored in the initial stages of market transformation. Through this form companies could reduce both the risks and the transaction costs (Meyer, 2000). The number of established joint ventures was great but the active participation of the foreign investors was limited as presented in the table.

	1989	1990	1991	1992	1993	1994
Joint ventures registered	867	2799	4796	10131	15393	20222
JV operational	241	1119	2207	5740	7935	N/A.

Source: PAIZ (2003)

The Polish partner typically contributed land, distribution channels and access to the market. The foreign partner contributed capital, technology and the knowledge of modern economy (Meyer, 2000).

¹⁰ Among others, this relates to such services as manufacturing of tobacco products, detective services, courier services, customs agency services and organization of tourist events. The new law does not regulate certain spheres of business activity, such as the processing industry, trading in non-ferrous metals and market place services, regulated previously.

5.4.2. Fully owned companies

As the political and economical situation in the country stabilized, and the knowledge of the market rose, the goal of many foreign owned companies was to buy out the joint-venture partner and transform the local firm into a fully owned subsidiary as a full-member firm with voting privileges and revenue distribution. This integrated the foreign operation into a multinational enterprise and eliminated the need to accommodate the interests of a local partner (Meyer 2000).

- Greenfield

After 1993 a new shift in the pattern of FDI emerged. A strong increase occurred in the capitalization of firms as well as increases in the inflow of foreign capital by the largest firms. During that time foreign investors were changing their investment strategy and began to take higher shares. Investment became more factor-endowments-driven in skill-intensive industries. Their typical investment option shifted from joint venture with foreign capital minority participation, towards the fully – owned subsidiary with a majority holding by a foreign partner. This may have signaled a change in investment strategy toward long-term involvement (Du Pont, 2000). In 1996 the number of firms with foreign participation reached 29000. One-third of these established projects were fully-owned by foreign investors in form of greenfield or direct acquisitions (PAIZ, 1997).

Year	Greenfield		Joint Ventures		Direct acquisition		Total	
	USD mln	%	USD mln	%	USD mln	%	USD mln	%
1989	26 514	27.5	54 399	56.4	15 500	16.1	96 423	100
1990	72 992	35.7	91 266	44.6	40 200	19.7	204 458	100
1991	180 666	42.5	126 796	31.4	105 300	26.1	403 646	100
1992	320 272	47.1	9 712	1.4	335 000	51.5	679 984	100
1993	692 092	50.3	4 934	0.4	678 903	49.3	1 377 929	100
1994	923 034	56.4	1860	0.1	430 450	43.5	1 355 349	100
1995	1 280 500	59.4	720	0.1	380 452	40.5	1 661 672	100
Total	3 496 070	54.6	590 076	8.3	2 000 805	37.1	5 496 875	100

Source: Du Pont (2000)

There has been an impressive increase in the role of greenfield investments. In 1989 only USD 26 million worth of investments were made in new companies. By the end of 1995 these investments were six times larger and constituted more than half of all FDI inflows. This increase is the best indicator of the increase in the trust in the Polish market and the growing willingness to start new establishments (Du Pont, 2000). Furthermore, greenfield was a favorable form of ownership for companies that aimed to obtain first-mover advantages. Yet, they faced considerable establishment costs, as local bureaucracies were slow and problems emerged with local contacts while integrating into business networks (Meyer, 2000).

- Acquisitions

A second clearly observable phenomenon is an increase in the receipts from direct acquisitions, going hand in hand with deregulation and an increase in privatization.

The process transfers the ownership of state property into the hands of private individuals, frequently by the sale of assets through an auction. The method was recognized by the Polish state as a way to unlock gains in economic efficiency by giving new private owners powerful incentives. Furthermore, privatization was seen as a FDI policy tool through which the state maximized revenues and ensured that the new owner was a respected international investor interested in the long-term development of the acquired firm (Hunya, 2000).

Between 1990 and 1993, FDI inflows through fully owned companies into Poland were mainly privatization-driven. In 1989 only USD 15,5 million was received from privatizing state owned firms, constituting 19,7 percent of all inward investments. In 1994 the receipts from privatization were more than 15 times higher and constituted 49,3 percent of all inflows. To a large extent due to privatization, Poland has attracted the largest amount of foreign direct investment among the Central East European Countries. The accumulated amount of inflows that were privatization-driven between 1989 and 2000 reached 36 billion euro (Central Statistic Office in Poland, 2003). It means that almost 50 percent of all FDI inflows into country were attracted through privatization process¹¹.

A trend among market entrance strategies can be noticed. As the economic regime became liberalized, the gradual shift from joint ventures to fully-owned investments occurred. To summarize, as Smarzynska (2000) acknowledges, companies with 100 percent foreign ownership accounted for 40 percent of FDI projects in Poland in 1993, 45 percent in 1995 and 50 percent in 1998.

5.5. Benefits of foreign direct investments

Positive development of Poland is, according to both economic theory and empirical evidence, closely correlated with FDI. It helped to cover current account deficit, fiscal deficit (in privatization-related FDI) and supplements inadequate domestic resources to finance both ownership change and capital formation. Furthermore, foreign investments are positively correlated with the GDP growth, as acknowledge by Smarzynska (2001), and contribute to the general macroeconomic stability in the country (Blattner, 2002).

According to Schmidt (1995), the importance of FDI inflow for Poland is of great importance since without massive inflows of foreign capital, successful transition (from planned to market economies) would have been unlikely. Foreign investors, as the new owners of formerly state-owned enterprises, had the skills and ability to induce corporate restructuring. The transfer of Western technology and know-how occurred in this process.

The transformation was based on the “deep strategic restructuring” of the acquired companies in two parts. Since foreign investors had strong advantages concerning access to capital, management expertise, new technology and established international networks, this process could have been carried through only by them.

¹¹ According to PAIZ the accumulated inflow of FDI between 1989 and 2002 is USD 61 billion which corresponds approximately to the same amount in euros

The first part, restructuring, involved building up a new structure of production with development of new products, new production methods and new technologies. Furthermore, since foreign investors created new market for their products, new methods of marketing were introduced and new networks of suppliers were build.

The second part of the “deep strategic restructuring” was based on the transfer of knowledge. Serious foreign investors (usually large multinational firms) played a vital role in training and educating individuals. Firstly, all employees working on the production level were retrained. The aim was to introduce new working methods that increased productivity and efficiency. Secondly, new management skills had to be developed through training of both old and new managers in strategy, accounting, marketing, organizational behavior etc. (Mroczkowski and Linowes, 2002; Barrell and Holland, 2000).

Moreover, foreign investors transferred to employees not only valuable business know-how and technical expertise, but also exposed them to a certain work ethic, business practices, standards and codes of conduct. Committed foreign investors almost universally paid taxes, were concerned about complying with all laws and regulations, implemented environmental standards that were generally higher than those mandated by local law and exposed the local market to sophisticated types of business transactions and legal documentation. Foreign investors contributed also to the creation of new business culture. According to Triandis (1995), Polish business environment is “converging” to Western practices with an accompanying shift of values from collectivism to individualism.

According to Mroczkowski and Linowes (2002), foreign investors have been successful in inculcating values and modifying behaviour for certain reasons. Since MNCs paid generally considerably higher salaries than most of the local companies or government agencies, population desired to work for foreign investor. Secondly, foreign investors offered the possibility to study and work abroad and to improve one’s foreign language skills. Thirdly, the demand for change was extremely high: employees, wanting to obtain the coveted job, were willing to change and act in a manner that was decided by the employer.

According to Kaminski and Smarzynska (2001), the activities of MNCs in Poland have been of crucial importance for country’s entrance in the rapidly growing global production and distribution network. Since foreign investors are export oriented, Polish products could have been introduced to the Western’s markets. Moreover, FDI helps local enterprises to expand into foreign markets due to the increased competitiveness occurring through the transfer of technology and know-how from the foreign to local enterprises (Kroska, 2001).

Since Poland has received substantial inflow of FDI, foreign companies have influenced the shape of the Polish market and contributed to the creation of private sector that has become a driving force in developing the economy. MNCs are also the most dominant actors in the private sector within which the competition has been created.

The role of competition is significant since its contributes to the increase of productivity and efficiency. It has to be also emphasized, that competition on the

Polish market is very intensive and involves both foreign owned companies and the domestic ones. Consequently, competition has contributed to the growth of the economy since more productive enterprises have become to dominate the market (Barrell and Holland, 2000).

To conclude, foreign investments have had a great impact on the development of Polish economy. Nevertheless, one can not forget that the main goal of companies investing in Poland was not to rebuild or create a new society. As acknowledged by Hewko (2002), multinational enterprises' expansion to Poland and other CEE countries was stimulated by the existence of real business opportunities. Furthermore, foreign enterprises were not passive spectators in the legislative and institutional reform process but the dynamic force in the forefront of the push for a change and agents for such reform. Thus, their interest may not always coincide with those of society as a whole or with those of domestic investors.

As acknowledge by Du Pont (2000), foreign investors entering the Polish market followed two different generic investment strategies: import – substitution FDI and export-oriented FDI. First type of companies focused on local markets and allowed production of simple products and commodities with uncomplicated technology to avoid import barriers. The second type of investors strove to develop firm's specialization for the production of products to the world market on an integrated basis. Investment were made to achieve a competitive advantage through lowered taxes, a favorable geographical location, access to resources and/or low labor costs.

Furthermore, different strategies were used by different foreign investors. Investors from Italy, France, Holland and Switzerland chose market-seeking strategies with a strong emphasis on supplying the local market and the cost of labor. Investors from the USA, Germany, Canada and the UK, on the other hand, were mostly motivated by strategic reasons and chose strategic asset-seeking FDI and exploitation of cheap labor was not their main aim. The emphasis was more on export-oriented FDI.

5.6. Summary of the chapter

Up to 1989, foreign investments into Poland were negligible, whether measured in terms of the number of projects or dollar value. The changes, initiated with the collapse of centrally planned economy, created a new market that was not competitive and served by a small number of companies. A great number of firms realized the possibilities for future development. By 2002 Poland had become the unquestioned leader in attracting FDI among CEE countries with accumulated FDI stock exceeding USD 65 billion.

The internationalization of the Polish market offered increased investment and marketing opportunities to companies, it also, as stated by Grant (1998), meant increased intensity of competition. The number of registered foreign companies increased over 85 times between 1989 and 1998. Largest investors to Poland over that time were from Germany, the U.S., France, the Netherlands and Italy.

In examining the target sectors of foreign investments, clear trends are visible. Despite the continuing prevalence of the manufacturing sector, investments inflows there are decreasing on aggregate. The financial sector is playing an important role creating foundation for further growth. Trade and communication is also becoming increasingly significant. It is evident that the market structure is changing and it can be predicted that following these trends will lead to a more diverse inflow of foreign investments.

Yet, foreign investors are not active in research and development (R&D) where spending has remained relatively low. Also investments in internet based sectors have remained very limited. Technology and know-how created by foreign R&D investments and transmitted into domestic manufacturing industries enhancing growth of domestic industries has remained on low levels. Multinational companies tend to concentrate on developing production and distribution platforms exclusively for their existing product lines, rather than on improving region's innovative capacity.

Summarizing this chapter it can be stated that Poland represents a mix of different types of investments with varying investments strategies and motives. Therefore, it is impossible to categorize investments made as being determined by a single, dominant factor. Poland is thus moving away from the status of a transition economy, where investments are determined by few dominating factors such as labor or natural resources. The country is moving closer to the developed economies of the West Europe, where relative mix of different factors is determining the overall attractiveness.

Too bad ninety percent of the politicians give the other ten percent a bad reputation.

Henry Kissinger

6. Corruption in Poland

The following chapter provides an overview of the development of corruption in Poland, its impact on doing business in the country and Polish government efforts to fight the phenomena.

As was stated before, corruption is a general phenomenon – it can be found in most places at most times. Yet its features are also specific to the time and place of occurrence. According to cross-national research, corruption in Central and Eastern Europe of which Poland is a part, is among the worst. The nature of corruption in transition economies, and the difficulty of finding solutions, are closely linked to their history and to specific institutional features of the transition. As acknowledge by Krastev (2000), “the argument that communism by its nature is less corrupt than democracy, is a theoretical speculation”.

Poland is emerging from a communist system in which legislative, executive, judicial and enforcement powers were centralized. Corruption was rife, transparency low and negative attitudes to the state were widespread (World Bank, 1999). Significant for this system was its overabundant selection of regulations and permissions, that consequently created great margins for discretion for public officials. Excessive bureaucracy became the ideal precondition for corruption. The government, cognizant of the problem that finally arrived, “took care” of the public unawareness but did not aspire to apply any measures to change the extant practices. Thus, in the late 1980s, governments and general public perceived communism as corrupt and the lack of free press both suppressed and fuelled the circulation of corruption stories.

As expressed by Ledeneva (1996), communism was a system of favors, mysteries and prosaic practices that called “*zalatwic sprawy*”¹², corresponding to the Russian term “*blat*”. The foundation of that system was the use of personal networks and informal contacts to obtain goods and services in short supply and to find a way around formal procedures. Thus, the process relied on gift giving not monetary bribes. Consequently, it can be suggested that “*zalatwic sprawy*” was a socially acceptable form of corruption that increased the social equality and the “fairness” of the communist society.

The phenomena was a dominant, widespread form of corruption drenched with favors exchanging in circular patterns. Due to “rhetorical friendship” embedded in the patterns, passiveness led to being considered as asocial. Consequently, communist “network of favors” is considered to be the most massive form of corruption so far.

The end of the economy of shortage and the emergence of “real” money changed the pattern. The “*zalatwic sprawy*” became a monetarized system replaced by bribes. For the majority of people, the transition from communism to post-communism was a changeover from “do me a favor society” to a “give me a bribe society”.

¹² A rough translation would be “do make things done”

Vulnerability to corruption was particularly great during the transitional period, as the former coercive power of the state was been relaxed and the formal and informal institutions that controlled and organized corruption in the past were in decline or had been eliminated. Meanwhile, new institutions underpinning new democratic politics, the market economy and the rule of law had not yet been created or were in their infancy.

Furthermore, the emerging free press overproduced corruption stories shaping public opinion and producing a feeling of an overwhelming presence of corruption in public life.

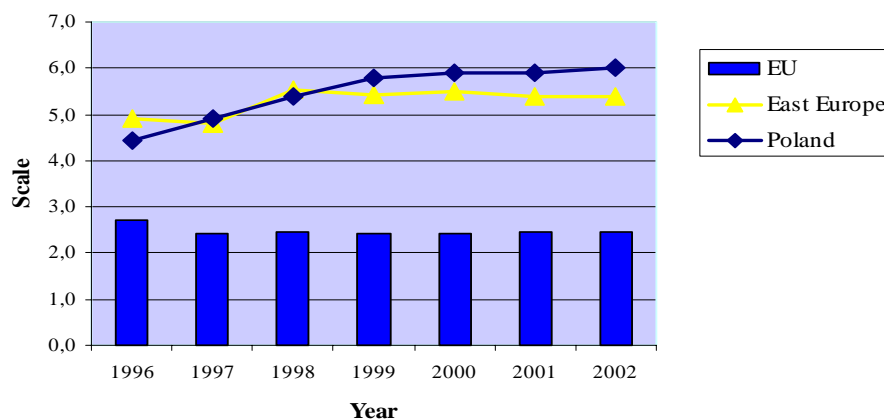
Over 10 years after the fall of the communist party, the legacy of the past is still powerful. Consequently, politicians and public servants are mistrusted and the credibility of the state is low. Furthermore, as acknowledged by the World Bank (1999), as links between political and economic spheres are very tight, the incitements to manipulate market mechanisms are high. In the public administration and public services, the vacuum created by the loss of old rules and controls has not yet been filled by new mechanisms of accountability and habits of work.

Nowadays, corruption is a general phenomena found in all places and all times. It applies to politicians, judges, police officers, doctors, teachers, businessmen etc. Corruption has reached alarming levels in Poland, both in the public and the private sector. Furthermore, the phenomena is progressing and getting worse.

On the basis of police statistics alone, bribery and corruption-related offences have doubled between 1992 and 1998. While some of this increase may reflect improvements in policing, it is unlikely that this factor could account for more than a small part of the increase. This view is supported by other sources including the Ministry of Interior report to the Parliamentary Commission on Internal Affairs and Administration of April 1999.

6.1. The level of corruption

Figure 12: Comparative change in corruption



Source: Own calculations based on data provided by TI

According to Transparency International (TI), the level of corruption in Poland has been rising systematically through the 90s reaching a certain level of stability since 2000. In 1996, on a scale of 0 to 10 with 10 being the highest, the obtained level for corruption in Poland was 4,4 points. In 2002 it had already reached 6 points increasing by over 35 percent. Furthermore, the level of corruption has been significantly higher than the average level of EU countries and since 1999 it also exceeded the average level of the CEE block. In 2002 only three other CEE countries obtained level of corruption higher than the average: the Czech Republic, Latvia, the Slovak Republic (Annex 1).

According to the Polish Central Office for Society Research, the level of corruption has been rising consistently through the 90s. 93 percent of 964 individuals, questioned in 2001, acknowledged corruption as being a “big problem”. It can be also noticed, that in 1991 “only” 71 percent found corruption to be a “big problem”. Therefore, a generalization can be made that the society becomes much more concerned with the problem of corruption, as compared with the communist era. It is also clearly evident that the public is much more aware of the problem. The share of people who could not form an opinion about the significance of corruption or who considered the phenomena to be of little significance has decreased substantially since 1991.

Question asked from respondents: How significant is the problem of corruption?	VII 1991	II 1992	VII 2000	VIII 2001
	PERCENT			
Very big	38	37	40	25
Rather big	33	49	46	68
Rather small	15	8	6	2
Very small	2	1	0	1
Difficult to say	12	5	8	5

Source: Polish Central Office for Society Research, 2002

Furthermore, according to the research, Poles are convinced that corruption applies mostly to the politics’ sphere (84 percent responses) and that most of the public officers are abusing their positions (70 percent). This is also visible when examining the sectoral breakdown of corruption by Transparency International found in Tables 2 and 3 of Annex 5. Sectors with highest involvement of public offices are on the top of the list.

Similar views were expressed by survey of the International Business Leader Forum (IBLF) in 2002. Out of 500 biggest foreign companies in Poland 81 percent responded to a question about the occurrence of corrupt activities in their line of business that they had come across the problem. At the same time, most of them (63 percent) did not consider it to be a “big issue” and it is comparable to the levels of corruption in the EU.

The case of Ryvin exemplifies further the scale of corruption. As expressed by to the Wall Street Journal Europe (2003), “Poland has produced Europe’s most bizarre, fascinating and confusing corruption scandal of the new year”. One of the most successful film producers, Lev Ryvin¹³, offered in June 2002 the editor of Poland’s major daily newspaper, Gazeta Wyborcza, 17,5 million USD so that he would use his

¹³ Co-producer of Steven Spielberg's Schindler's List

influence in the Polish Parliament (Sejm) to pass a law in favor of Ryvin's personal interests.

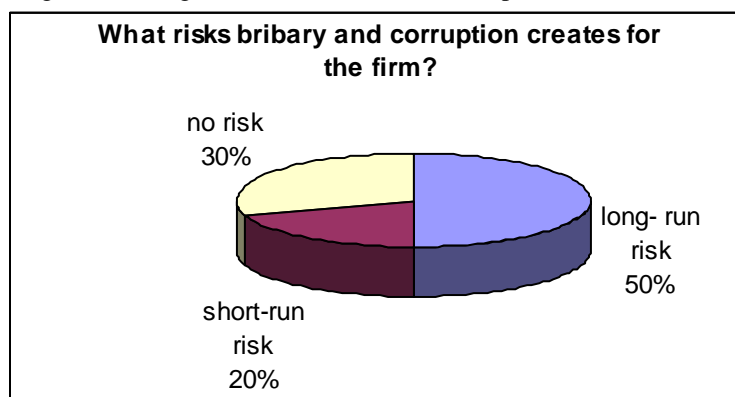
Given the close relationship between public and private sector, the following inquiries by the prosecutors' office have involved Polish president, prime minister and several other high ranking government officials. The story came out only in December, allegedly to avoid the influence it might have had on the Copenhagen Summit during the same month where Poland received an official confirmation for joining EU in 2004. Actual costs of corruption are not possible to measure with certainty. The examples above point towards the scale and scope of the issue.

6.2. Corruption's impact on businesses

There are no surveys that study empirically the effect that such activities have on the level of foreign direct investments. There are nevertheless a few recent surveys available that consider the influence of corruption on business activities in Poland. Open Society Institute (2002), the IBLF (2002), EBRD (1999) and PAIZ (2003) researches point towards a possible negative correlation between these two.

53 percent of responders to the IBLF survey stated, that the level of corruption has not been changing for the last 5 years. The level of corruption is considered to create risks in the long term in the opinion of 50 percent of responders and 20 percent of responders believe that the phenomena creates risks in short run. 30 percent of answers indicated that corruption does not create any kind of risk.

Figure 13: Long and short term risks of corruption



Source: IBLF, 2002

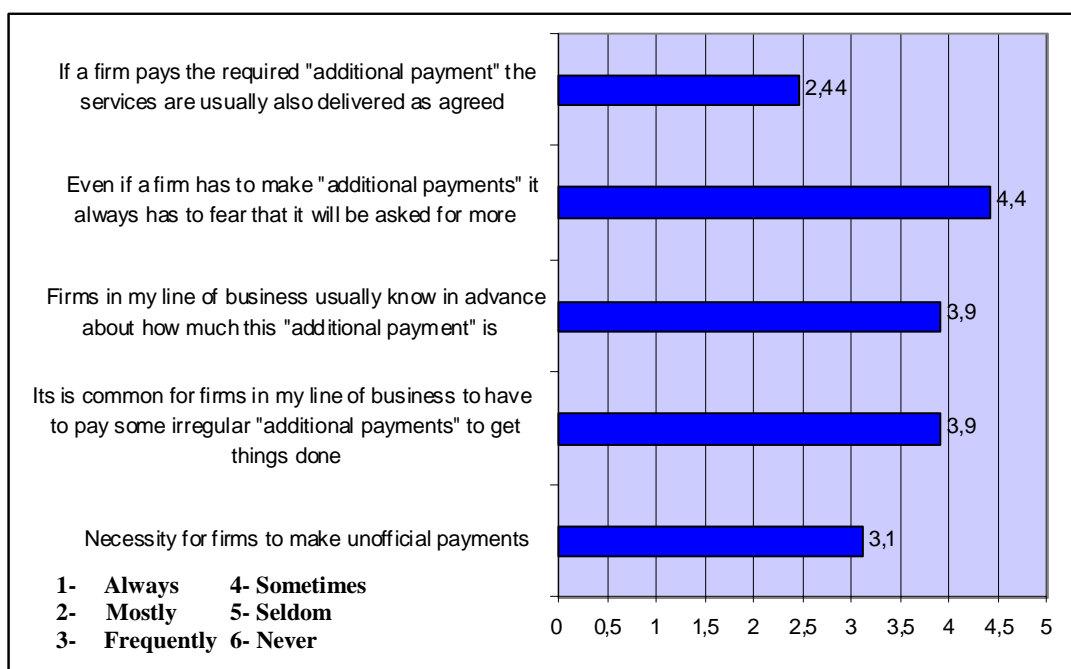
According to the results of the survey by the OSI, foreign enterprises pay on average 1,6 percent of their annual revenues in unofficial payments to public officials. A recent survey by PAIZ from February 2003 furthermore shows, that companies pay approximately 1,2 percent of their annual revenues by means of corruptive acts.

On average, what percentage of revenues do firms like yours pay in unofficial payments per annum to public officials?							
Country	0	<1	1-2	2-10	10-12	13-25	>25
Poland	0	59	21	14	7	0	0

Source: OSI, 2002

The World Bank (1997) survey asked enterprise managers also whether and to what extent their company is affected by the purchase of various kinds of “decisions”. Almost 20 percent of companies said to be affected by corruption in the passage of legislation and in financing of political parties. Furthermore, respondents stated that they frequently pay “unofficial payments” that are very common in most of the business activities. The responses also showed that after the “additional payments” had been made, firms are not often requested to increase the amount of it and the service is usually delivered as agreed.

Figure 14: Perceptions of corruption



Source: World Bank, 1997

From the survey prepared by the EBRD in 1999 on 300 foreign firms in Poland, 19,3 percent claim that they make unofficial payments for licenses and 8 percent of the respondents stated that they had to make payments for “protection” to organized crime groups¹⁴.

According to EBRD (1999), countries with inefficient regulatory environments and a great deal of corruption have “unofficial market activity” in excess of 40 percent of GDP. Significant association was also found between under-reporting of sales and bribing of corrupt officials.

6.3. Fighting against corruption

During the last years, Poland has implemented measures to fight against corruption. One of the most important events was the ratification of the OECD Convention on

¹⁴ The level is not comparable to Russia and Ukraine where, respectively, 92,9 and 88,8 percent of respondents stated the same

Combating Bribery of Foreign Public Officials in International Business Transactions. The implementing legislation entered into force in February 2001.

Furthermore, Polish government, aware of the magnitude of the problem, prepared an anti-corruption strategy in September 2002. It is not possible to talk about the success or the failure of this program since the measures are still in the process of implementation.

In addition to legislation, corruption is also fought at the level of international and national organizations. One of the best known ones in Poland is the Foundation Batory. Co-operating with a government, it aims to raise social awareness about the importance of corruption and the need to combat it through individual initiatives. To that one has to add also international organizations such as the IBLF, EBRD, OSI, World Bank and the OECD, that are all active in Poland.

Poland has also made a lot of progress towards creating of a functioning system of state's financial control. In particular, the Supreme Audit Chamber (NIK) is the most effective control and supervisory institution of any EU candidate country and has contributed extensively to revealing corruption and the legislative and institutional defects facilitating corruption.

Yet, according to the Open Society Institute (2002), Poland does not yet have a coordinated anti-corruption strategy and the will of the government to create one is doubtful. Since 1997 a number of legislative and other measures have been proposed against corruption, notably an Act on Access to Information, a new Electoral Act, to tighten regulation of political party financing, and important changes to bribery legislation. However, none of these initiatives originated from nor were discussed by the government.

Even the ratification of international anti-corruption conventions has not been done to the fullest extent. As of April 2003, legal entities were not criminally liable for bribery to public officials nor was bribery in the private sector criminalized. Non-material benefits provided to third parties were not yet classifiable as bribes and the definition of a public official remained insufficiently clear.

Since there are no specialized anti-corruption government agencies, although special units exist within the police for fighting corruption, the process of limiting the phenomena can take decades and can eventually turn to be inefficient. Furthermore, the ability of prosecutors' office to fight against corruption appears to be undermined by a lack of specialized capacity, as well as a lack of independence underpinned by the political nature of the office of Prosecutor-General.

6.4. Summary of the chapter

To summarize, corruption has reached alarming levels in Poland both in the public and the private sector. Statistics on general levels of corruption is gathered and available but data on corruption specifically in the private sector is much harder to collect and thus also to measure. It is unclear if adopted anti-corruption legislation

will bring any real changes. Further, limiting corruption should be a clear priority especially for Poland that is going to join European Union.

Despite government efforts to fight corruption, there has been little to no effect on the occurrence of the phenomena. On the contrary, the level of corruption has been rising constantly affecting every aspect of doing business. Surveys indicate, that companies spend up to 12 percent of their annual revenues for bribery or other forms of corruption. On average, this number is 1,6 percent, which constitutes a significant portion of the firms' resources. To a large extent companies seem to have learned to cope with the phenomena with only half of the companies perceiving it to create long term risks.

Corruption has a considerable effect on our lives because it is all around us. The emphasis on making money is so great, the emphasis on getting rich, no matter how, is so tremendous, that it influences virtually every aspect of our society.

Lawrence Ritter

7. Foreign enterprises' engagement in corruption

The chapter presents the findings on the engagement in corruption in Poland for foreign businesses based on primary data and compares that to previous findings of the World Bank from 1999. A further step is taken to examine the level of corruption in the home countries of the major foreign investors.

As has been exhibited, the level of corruption in Poland is relatively high. Simultaneously, the country is continuously attracting high levels of foreign direct investments. As was shown in Section 4.5.2., empirical research on markets other than Poland have found a clear negative correlation between the level of corruption and the inflow of foreign investments and consequently also economic growth.

To clarify precise locations and magnitude of corruption and to find further evidence on the effect it has on foreign companies' activities, a number of interviews were conducted in a manner explained in Chapter 2. Results from the interviews were compared against a study made by the World Bank in 1999 identifying possibilities for corrupt activities in Poland. The World Bank study did not focus specifically on the interaction between foreign investors with local officials. Thus, the findings can also be viewed as an extension to that study. The following section summarizes those findings.

7.1. Administrative barriers

The World Bank, in response to a request from the government of Poland, carried out a study in 1999 that helped to identify areas which could act as serious grounds for corruption and in which measures to reduce corruption are likely to be most productive.

7.1.1. Company registration

According to the World Bank, administrative procedures are one of the main areas where corruption is likely to occur. As I have discovered and as has been stated in the national legislation, the procedures applicable to domestic companies are to a large extent applicable also to the foreign investors. This was confirmed by all interviewees, who stated clearly, that administrative barriers are very high in Poland.

As discussed in the section 4.4. and presented in Annex 4, administrative procedures have been divided into 3 groups. In each of the group particular procedures are

included. According to Morisset and Lumenga (2002) there are on average 26 operations that the company has to cope with while registering a company. As stated by Mr. Polak, the procedures are much complex in Poland. Instead of 26 operations he suggested that there are around 50 depending on the industry the company is going to operate in.

According to Mr. Grycuk, it should take around 50 days and around 4000 PLN (USD 1000) to officially register a company in Poland. The Business Activity Law of November 19th 1999 sets clear obligation on companies wishing to start operations in Poland. Although registration for different entry forms varies, the general principles are the same. I considered the case of a limited liability company, which is the most common form of entry for middle size and large foreign enterprises. The box below presents a highly simplified registration process.

A few steps in company registration in Poland
<p>As the first step, the articles of association must be authorized by a Polish notary, which may charge a fee up to 5000 PLN. The second step is entry into the Court Register for which a fee 1000 PLN may be charged. Within 14 days after the entry into Register of Entrepreneurs in the National Court Register, the company must obtain a registration number from the Statistics Office. This must be done by the representative of the company in person and the filing is for free.</p>
<p>Next, the company must open a bank account, which is done for a fee, and must give notice of that fact to the applicable Revenue Office. Registration in the Revenue Office, to obtain the Taxpayer's Identification Number (NIP), must be done within 14 days after the registration of the company which includes also opening of a bank account and costs officially 152 PLN.</p>
<p>Registration of the bank account, on the other hand, requires a presentation of all the original documents of company registration including the presentation of NIP. Apparently the only way around this paradigm is not to do any business activity prior to the registration thus also avoiding the requirement of opening a bank account. Additional registration at the Revenue Office is required if the company intends to pay value added tax (VAT) – prior to any transaction – and/or corporate income tax – at least on the day of filing the first tax return.</p>
<p>The company is also required to register, in person, with the Social Security Office. Registration has to be done no later than 7 days after employing the first person.</p>
<p>Source: Business Activity Law of November 19th 1999 and various publications</p>

This presentation covers only 5 steps and, considering Mr. Polak's statement about 50 procedures, includes a meager 10 percent of the number of total tasks to be completed before the company can become operational. Furthermore, Mr. Grycuk emphasized that the situation is much more complex, if a foreign company wants to operate in the construction industry.

Since the time schedule to register a company is limited and the time for obtaining all the permissions, licenses etc. is very long, companies have to go through the procedures ***at least*** once. Since companies cannot specify, as it is requested in the registration forms, their exact scope of future activities, they have to repeat some of the registration procedures after they get permits and can actually start operating. Therefore, as Mr. Svensson stated, it is impossible to register company during these

50 official days and the costs are much higher as the companies use different “speed up” tools.

As Mr. Svensson and Mr. Carlsson stated, they had to go personally to all offices mentioned above and leave documents there. The “speed up tool” had to be used or else nobody could guarantee that the company will be registered in the nearest future.

The World Bank recognized the problem by stating that the “registration of companies and land transactions was cited many times as a problem area. The situation appears to be worse in Warsaw, where there is only one court to service 35000 companies which need to register or to obtain extracts from court documents to prove registration... Facilities including reading rooms are too small, which creates control rights over access, and document search is slow because registries are not computerized. Lawyers and other parties with legal interests frequently find they must bribe to obtain access to the reading rooms and to registry documents that should be on open files”

According to Mr. Gubczak and to Mr. Grycuk computers are in almost all offices in Poland. The problem is, that they are not connected with each other or, even worse, are not used to store data. Even if registers are placed in the computer files, uncertainty about their accuracy means, that everything has to be double checked manually. For companies it means complications already in the initial stages of registration, that is supposed to be the easiest and the fastest one.

7.1.2. Access to land and privatization

Another problem area was identified in the second group of administrative procedures concerning access to land, site development and utilities. As recognized by the World Bank “Municipal ownership of large amounts of land and real estate aggravates the situation and adds to the opportunities and incentives for corrupt behavior... For instance, Gmina Centrum in Warsaw owns one million square meters of commercial space...”.

Access to the land for foreign investors is very limited since many local governments own large amounts of land and real estate. The law passed six years ago, forbidding elected representatives from entering into contracts with the city or doing business with city council’s assets, is not followed in practice. Approximately half of the Warsaw city councilors or members of their families are reportedly involved in business activities using municipally owned land. According to Ms. Czubek, it is very difficult for foreign investors to get access to the land since “privileged” groups are prioritized.

As stated in the World Bank rapport, and confirmed by Mr. Svensson, special conditions for sale of land and real estate for foreign investors have been created. Proprieties could be sold only to those who, at the time of acquisition, are leasing these proprieties or only at an “authorized” price or transactions take place on the day of announcement so that only those in pre-existing knowledge can participate.

Problems occur also while buying property from the private individuals. Before the property can be bought there is a need to find out the owners of the real estate or the land. A certified layer has to go through all the records, that are not collected in any systematic order, manually. This is also consistent with the findings about the use of computerized databases or more precisely about the lack of them.

First of all, according to Mr. Svensson, it is very difficult to find a lawyer that can speak foreign languages and that has special privileges to the “reading books” in the court. Secondly, when the process of negotiation for acquisition begins, additional owners “miraculously” appeared. In the case of Mr. Svensson’s company there were three owners to one property and, as he stated, foreign investors faced this problem constantly. The World Bank states further, that it is not uncommon that “papers are getting lost and are later re-found”.

Privatization of the state owned properties has been another alternative for obtaining land and property. According to the Polish government and as exhibited in previous sections of this paper, Poland has attracted the largest amount of foreign direct investment in the Central East European Countries and nearly 50 percent of accumulated FDI inflow were generated through the privatization process.

The World Bank states that “widespread nepotism, cronyism and other forms of corruption are reported in appointments to privatization commissions and selection committees. It appears that some Ministry representatives and their connections are appointed in order to ensure particular outcomes of the privatization process, to ensure that funds are channeled back to particular individuals or political parties, to contribute to a complex network of traded favors, and/or to manipulate prices downwards”.

As has been repeatedly shown, foreign investors were important participants in the privatization process. The biggest companies, once owned by the state, were acquired by multinational companies. As foreign companies had wider access to capital than local investors, their participation was even considered to be highly favorable. Given these and the fact that privatized companies were often the most attractive parts of the national economy, it is logical to conclude that foreign investors were also engaged in corruptive practices within the privatization process. I do not wish to generalize on this matter and to claim that all the privatisations of state enterprises to foreign owners were conducted through corrupt practices.

Mr. Svensson nevertheless acknowledges, that his company was involved in the corruption practices while acquiring a company in the privatization process. When asked about the reasons he stated “that is the way foreign companies were doing business in Poland. Since the Polish state did not mind, neither did investors”.

The way Poland carried through privatization, also supports Rose-Ackerman’s (1999) theory that in the corrupt environment individual that has the best connections and is willing to pay the highest bribe will win against the most productive and efficient ones. Similarly, the World Bank reported: “significant abuses occur before the tender is issued. Bribes, to ensure early access to information on the technical requirements and the specification of criteria for the points system, were frequently cited as a decisive factor. Conditions can be constructed in such a way as to favor

one particular bidder, and are sometimes subject to change after bidding has started... In some cases, competing tenders are informed of the lowest bid so that they can adjust their prices and inducements accordingly”

7.1.3. Permits and licenses

After getting access to the land or properties, different permits and licenses are usually required. As acknowledged by Ms. Smarzynska, in this stage corruption practices are rather common. In a similar manner, the World Bank states that “...the local governments’ exercise of control over zoning decisions, licenses and permits for economic activity, contracts for construction works, goods and services, property rent controls and other distortions in setting tariffs, furnish ample opportunities to extract bribes and trade favors... The consequences are inefficient allocation of resources, delay in investments, a sub-optimal level of economic activity, and potential damage to public health and safety...”

Practices, similar to privatization, are implemented when issuing permits and licenses. It is not the most effective investor who obtains the permits, but the one that has connections and can pay the highest bribes. As stated by Mr. Grycuk, the time for getting licenses or permits through official channels is very long. In Mr. Polak’s opinion, every foreign company in this stage paid bribes, otherwise there was little chance for the firms to start operating. It has to be emphasized, that lately the new law concerning permits and licenses has been implemented. But, according to Mr. Czubek and Mr. Szakalis at the Delegation of the European Commission in Poland, there are serious concerns about the execution of these laws.

According to Mr. Gubczak, despite obtaining needed permits and licenses, companies are hindered in starting operating. Possibilities of financial gains through bribes have been recognized by individuals that established “pseudo-ecological” organizations. Such organizations have obtained a permit to issue “independent” evaluations concerning the historical and/or ecological aspects of location and practices.

These organizations are, for example, at liberty to stop the processes of building. Through such protests, that are on many occasions unjustified, the investments are indefinitely halted. Mr. Svensson, stated that his company could not start the building process of a new factory in Poland because of a tree that was standing on the property. According to the “pseudo-ecological” organization, the tree could not have been removed since it had a “special historical value” for Polish society. After the company had paid a bribe, the tree “lost its value”, the protests were redrawn and the company could continue to build the factory.

Generally, companies have a choice to pay the bribe and start activity or to turn to the court. According to the rapport of the World Bank “...Respondents also noted the slowness, lack of efficiency, and lack of credibility of the courts, which are overwhelmed by cumbersome procedures, and are subject to long delays, sometimes of years. Many judges reportedly sit short hours often from 10am to 1pm, three days

a week...for that reasons, a number of private sector respondents said they did not try to take legal action...”

As Mr. Gubczak stated, the case of Shell against “pseudo-ecological” organization was in court for over a year. According to Mr. Polak, the loss of time also means a loss of money and therefore the bribe is a cheaper alternative. It has to be emphasized that not all foreign investors are engaged in corrupt activities directly. As Mr. Carlsson stated, the company hired a Polish agent that was, from the beginning to the end, responsible for all administrative procedures. “Extraordinary” expenses in this process were to some extents justified and not questioned.

7.1.4. Operational requirements

The third group included by Morisset and Lumenga (2002) in the administrative procedures are operational requirements.

According to Mr. Svensson and Mr. Carlsson, inspections are very common in Poland. The country has developed a system of frequent and varying inspections especially for foreign owned companies. As stated by the respondents, there is no doubt about the purpose of these inspections. According to Mr. Svensson, if the company did not offer a “favor” to the inspector, the visits would have been much more frequent and more detailed. Furthermore, the inspector could have reported defects that, although not significant and common in practice, would have been required more money to repair than the amount paid as a bribe.

Since Mr. Carlsson’s company mostly focuses on import and export of goods, he found the biggest problems occurring on the border. Firstly, Polish product standards are very detailed and differ from those adopted by the EU. Subsequently also the incentives for bribery are high. According to the rapport of the World Bank “...the existence of ad hoc and temporary exemptions and duty suspensions aggravates the potential for corruption. There is a hierarchy of corrupt transactions, from “clear jobs”, or bribes of up to around PLN 200 to enable queue jumping, to “black jobs”, which are more serious activities such as turning a blind eye to falsified documents or invoices or being complicit in smuggling of illegal and dangerous goods”.

Tariffs between EU and Poland have, despite bilateral agreements, remained on certain agricultural products. According to the respondent, these change frequently. Therefore, to avoid the costs related to the changes in tariffs, it is wise to have a contact person that would, on time, inform about these changes. It can only be assumed, that this person has to be a public official that has inside access to the information. Certainly, the person has to be motivated somehow for his efforts.

To summarize, growing number of foreign enterprises in Poland are facing a substantial array of administrative procedures and practices. At the same time they have found ways by which to remove or reduce possible obstacles deriving from them and are able to carry on business without significant problems. It is possible to make a reasonable assumption that a significant part of foreign companies are facing the problems highlighted by the World Bank report and the research for this paper.

Consequently, it is also appropriate to assume that majority of these companies have found means to cope with these problems. Although there is knowledge about the incentives for foreign companies to invest in Poland, there is no data about the number of companies that have left the Polish market or that have considered but not entered it. Thus it is not possible to say for certain, to which extent corruption affects their operations. According to Mr. Grycuk, there is a possibility that in the future such studies will be carried through.

7.2 Foreign investors in Poland

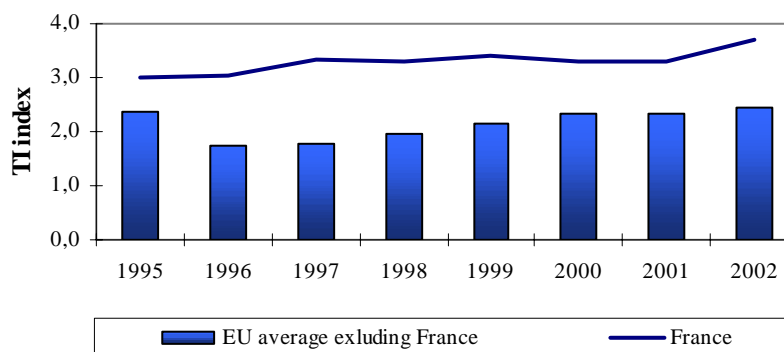
As mentioned in section 3., researchers agree that foreign investors transfer not only capital, but also know-how, technology and culture. As was shown in the previous section, foreign investors engage in corrupt activities in Poland. I assume that if the investor comes from the country where the corruption level is on a significantly high level, he also has the knowledge and experience of dealing with corruption in the host country's corrupt environment. It is thus proper to examine the level and culture of corruption in the source countries of the biggest investors.

The five biggest investment countries included in the analyze are based on the "List of Major Foreign Investors" (See section 5.2.1. and Annex 2). These are France, the USA, Germany, the Netherlands and Italy. Four of these countries are members of the EU. Therefore, in considering the significance of their level of corruption, I compare them to the average corruption level in the EU. In computing that average, the country under observation is excluded.

7.2.1. France

According to PAIZ (2003) French investors are most active on the Polish market. After examining the relative level of corruption in France, I conclude that, according to the measures considered, corruption level is much higher than the EU average.

Figure 15: Corruption in France



Source: Own calculations based on Transparency International, various years

French investors could thereby also be seen as adopting faster to the levels of

corruption in Poland, since understanding for bureaucracy and corruption practices has already existed in the country of origin.

Moreover, the French word “société” means both “company” and “society” leading, as expressed by Pastre (1998), to the company pursuing goals of its own, rather than those of only the shareholders, management, employees or other constituencies. The chairman of a French company is, as indicated by Groenewegen (2000), consequently sometimes considered to act in the name of the company as an entity corresponding to the concept of French individualism known as “la logique de l’honneur¹⁵”

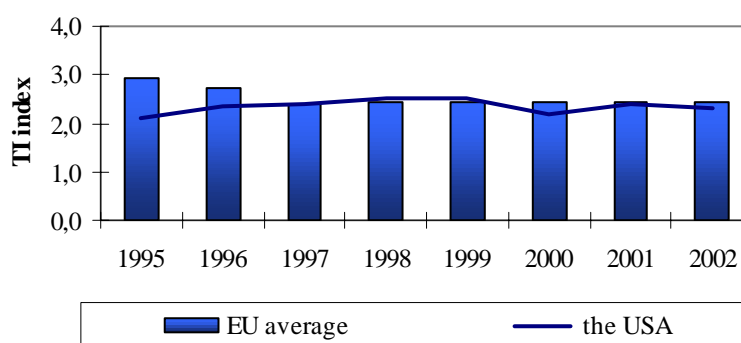
Applying the rule in Poland, it can mean that French companies act in the best interest of themselves using all means possible to expropriate rents from others in the corporate environment. A catchy phrase, that is applicable not only to France, but to all foreign investors states that “Ce n’est pas pecher que de pecher en silence”¹⁶. In other words, sinning is not sinning if no one hears about it.

Assumption about the willingness of Frenchmen to engage in corruptive activities is furthermore endorsed by their high position in the Transparency International Bribe Payers Index 2002 (in Annex 5, table 1) which indicates the likelihood of companies from a given country to offer or receive bribes to win or retain business in foreign countries.

7.2.2. The U.S.A

The second biggest source country for large foreign direct investments into Poland, according to the “List of Major Foreign Investors”, is the U.S.A.

Figure 16: Corruption in the USA



Source: Own calculations based on Transparency International, various years

According to the Transparency International, corruption in the U.S.A is on a relatively low level. Comparison with the EU average indicates similar levels in both regions.

¹⁵ “logic of honor” according to which a person is accountable only to his own conscience and beliefs

¹⁶ The locution was created by the classical French comedy playwright - Molière

According to Ms. Smarzynska, American companies have focused on developing good governance practices prioritizing high morality. Fight against corruption in the U.S.A is thus very successful. Furthermore, the U.S. managers operating abroad they are held accountable at home for their actions.

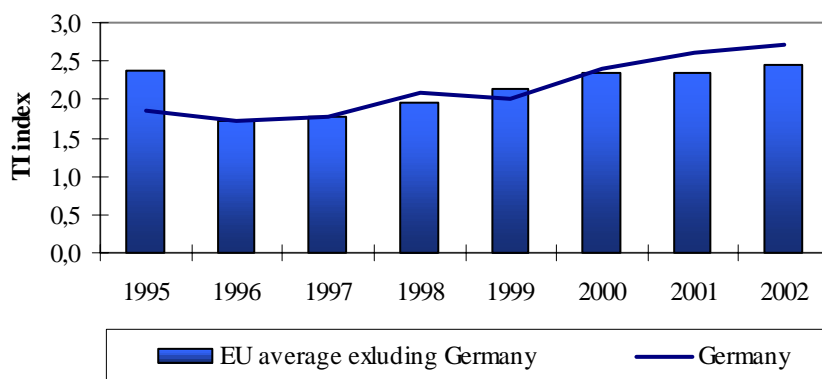
On the other hand, according to the Transparency International Bribe Payers Index (2002) (In Annex 5, table 1), the U.S. companies are just after Italians most likely to pay or offer bribes to win or retain business in the host country. Confronted with this fact, Smarzynska acknowledged, that when the U.S. companies invest abroad they follow the principle of “when in Rome, do as the Romans do”. That would also indicate, that when American companies invest in the country where corruption is widespread, they do not fight against it but, become engage in corrupt activities themselves.

Further, although the U.S. managers are responsible for their actions abroad at the home, the philosophy of “what’s out of sight, that’s out of mind” is highly applicable. This belief may be all the stronger if a host market environment has a poorly developed or poorly policed legal environment that allows shirking and low transparency. In this instance, it may well be tempting to try to “sin in silence”.

7.2.3. Germany

The third biggest group of investors comes from Germany. According to Transparency International, corruption level has been raising in Germany since 1999 but is still on the level of EU average.

Figure 17: Corruption in Germany



Source: Own calculations based on Transparency International, various years

Furthermore, the country is ranked as a fifth on the list of Bribe Payers. The interesting feature is that until 1999 bribery was tax deductible in Germany. The country was also one of the last one to ratify OECD conventions.

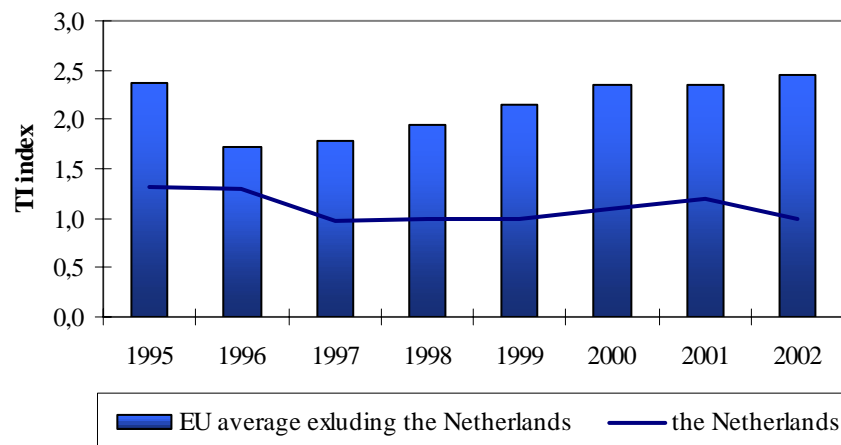
As such, it can be assumed that corruption in Germany until very recently, was widely accepted and practiced. A low level might indicate, that corruption is not considered in its negative shading, emphasized by the fact that it was allowed (and it can even be claimed that promoted) on the government level through tax incentives.

Therefore, I can assume that German investors coming to Poland did not find the levels of corruption to be alarming nor were they seen as significant obstacles.

7.2.4. The Netherlands

The Netherlands is one of the few countries in the EU where corruption level is lower than the EU average. Country has been very successfully in fighting against corruption and creating transparency and high morality in the companies.

Figure 18: Corruption in the Netherlands



Source: Own calculations based on Transparency International, various years

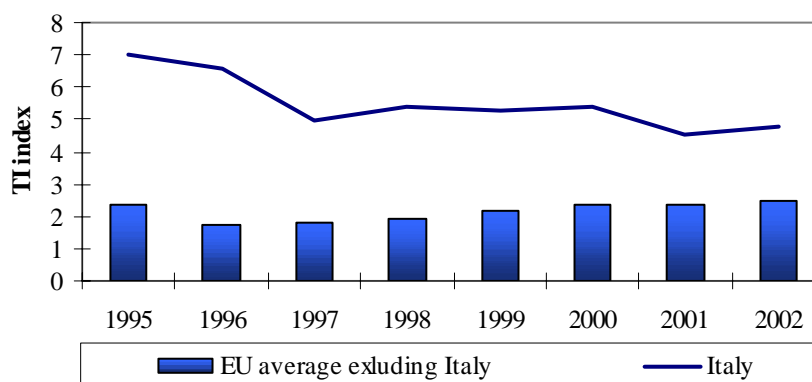
But, similarly to Germany, bribery was officially tax deductible for Dutch companies. Therefore, I can assume that investors from the Netherlands were also used to bribes and corruption, although at a lower level than Germans.

According to the TI Bribe Payers Index (2002) (Annex 5: Table 1) the Dutch are nevertheless not likely to pay or offer bribes to win or retain business in the host country.

7.2.5. Italy

While the Netherlands represents a country with a low rate of corruption within the EU, Italy represent a country with unusually high level of corruption. According to the Transparency International corruption within the EU is higher only in Greece and Italian companies are most likely, out of all the investigated countries, to offer or pay bribes to win or retain business in the host country. Italy is also one of the biggest investors in Poland.

Figure 19: Corruption in Italy



Source: Own calculations based on Transparency International, various years

A lot has been written about corruption in Italy. Bringing forth the main aspects are therefore sufficient. As Aganin and Volpin (2003) acknowledge, the Italian system of ownership is a combination of networks, favors and loyalty. Most well known of those is the notorious Italian organized crime – the mafia. Italian system of network building is based to a large extent on a system similar to the “blat” in soviet times or cronyism as defined by the World Bank.

Yet there are several differences. Control over the networks is strong with a long tradition of rules and codes of conduct. Consequently also individual opportunism, that tries to take advantage of the system, is highly discouraged. These networks, not necessarily only mafia, have expanded over the centuries to cover practically every aspect of Italian economy.

Therefore, I conclude, for Italian companies the risk associated with corruption in investing into Poland is somewhat negligible. Investors had prior knowledge about corruption mechanisms and, I assume, that they also knew how to act in a corrupt environment.

It is evident, that none of the source countries of the biggest investors are totally free of corruption. Furthermore, it is clear that foreign companies do not enter the Polish market for any other reason than to make money. Quoting Ms. Smarzynska from the telephone interview, “foreign investors are not charity organizations, they go abroad to do profitable business”.

It is also clear, that companies adopt relevant strategies to better cope with possible problems that they might face in new markets. The problem in Poland is widespread corruption. According to Mr. Polak all foreign companies are involved or at least were involved in corruption. This statement seems to contradict the low level of corruption evidenced in some countries.

One possible explanation is found in the fact, that companies do not apply the same standards in foreign countries as they do in their home country. Companies from countries with effective enforcement of anti-corruption legislation might thus adopt more lenient approaches in Poland, where, despite recent changes, corruption is not strongly punished. It may also be that companies are not, according to their definition, actually engaging in corrupt activities.

7.3. Summary of the chapter

The level of corruption is very high in Poland comparing to other CEE or EU countries. Simultaneously, the country is continuously attracting high levels of foreign direct investments. There is a possibility that the corruption level in Poland discouraged some investors that initially planned to invest from pursuing their plans. As there is no data available on the subject, this statement can so far be treated only as speculative. However, it is evident that correlation between corruption level and the inflow of foreign direct investments into Poland is not negative.

According to Morisset and Lumenga (2002) there are on average 26 operations that the company has to cope with while registering a company. As stated by Mr. Polak, the procedures are much complex in Poland. Instead of 26 operations he suggested that there are around 50 depending on the industry the company is going to operate in. According to the World Bank, administrative procedures are one of the main areas where corruption is likely to occur. Since bureaucracy barriers are very high, and there is no computerization of the offices, foreign investors use different “speeding up tools” that can save time and costs.

Furthermore, according to the World Bank corruption was very common in the privatization procedures and nearly 50 percent of investors were attracted by this process. As foreign companies had wider access to capital than local investors, their participation was even considered to be highly favorable. Given these and the fact that privatized companies were often the most attractive parts of the national economy, it is logical to conclude that foreign investors were also engaged in corruptive practices within the privatization process.

In the chapter, it has been also taken into consideration that foreign investors transfer their culture with the company. The assumption was made that if investor come from the country where the corruption level is on a significantly high level, he has also the knowledge and experience of dealing with corruption. The examination of the biggest investors showed that of five, three investors came from the country where corruption is noticeable. Therefore it can be concluded that investors knew how to behave in the corrupt environment in Poland and they could have also influenced it.

It is likely, that foreign companies took corruption into consideration prior to investing in Poland. Therefore the entry modes chosen by the investors were those that reduced exposure to risks and limited cost. As was shown before, investors concisely chose low investments in R&D and in sectors that require higher technological sophistication. Incentives to invest in these sectors were low since business environment was unstable and foreign companies seemed to pursue low-cost strategies in Poland, taking advantage of mainly low labor cost.

Furthermore, the characteristic feature of corruption in Poland is that it does not apply only to the relationships between investors and government officials but also between actors in the private sector. Therefore, through the application of Porter’s five forces it can be stated that corruption is a barrier that occurs not only in the “threats of entry” but also in other forces that include competition, suppliers and buyers.

Few relationships are as critical to the business enterprise itself as the relationship to government. The manager has responsibility for this relationship as part of his responsibility to the enterprise itself. To a large extent the relationship to government results from what businesses do or fail to do

Peter Drucker

8. Foreign investments' effect on corruption

The following chapter analyzes thoroughly the effects that foreign investors have on corruption in Poland by pointing out the choices to utilize both lobbying and corruption. The analysis is further developed to show that by maintaining a long-term presence on the Polish market and facing corruption in every step of the way, the uncertainty included in corruption disappears. Finally a model is developed to show the effect foreign companies have or can have on the level of corruption in Poland.

8.1. Corruption vs. Lobbying

As presented in section 4.1., the definition of corruption by the World Bank states, that it is an "...abuse of public office for private gain...". Although seemingly clear, such a definition cannot be considered encompassing all activities that may lead to corruption.

In the same rapport I read " ...unconstrained lobbying is also an issue. Reportedly, the bribes paid by lobbyists have risen markedly. Such lobbying, reinforced by the private interests of ministers....". As is visible, lobbying has become a powerful alternative to direct corruption. The difference between those two activities can be very vague and, in some circumstances, lobbying may transform into corruption and corruption may become lobbying.

Both activities involve direct contacts between the buyer, that wishes to receive a certain resource, and the seller, that possesses monopoly over the given resource. Both activities are, in essence, manipulations of the seller's incentives by the buyer. Both activities also witness a high degree of competition between the buyers and in both cases the most efficient party is not necessarily the one who receives the monopolized resource.

It is possible to perceive lobbying as advertising activity in a perfect monopoly situation. Without any superior controlling power, the monopolist is at liberty to choose its customers. As such, lobbying includes a provision of incentives to the monopolist to modify his preferences towards providing his product to the customer. It is highly common, that promoters of consumer goods use "gifts" to create a picture, that the customer receives superior deal to other competitors. This may take forms from simple provision of information to actual products. Offers like "buy two, get one for free" and "two for the price of one" are highly common.

If similar parallels would be drawn with corruption, the picture would not look a lot different. As such, corruption is seen as a contract between the public official and the private company. The official provides a service, in the form of information or decision, for payment. No definition of corruption, nevertheless, stipulates that such payment has to be in the form of monetary payments, which leads to the conclusion, that payments may take the form of gifts and favors similar to the “zalatwic sprawy” known before the collapse of the Soviet-system.

The line separating corruption from lobbying becomes thereby extremely thin. Both of them may take the form of gifts and favors. However, main distinction between these two activities lies in the fact, that corruption is punishable in practically in all the countries of the world, whereas lobbying is not only legal, but in some countries also highly recommended.

8.2. Foreign investors’ choices

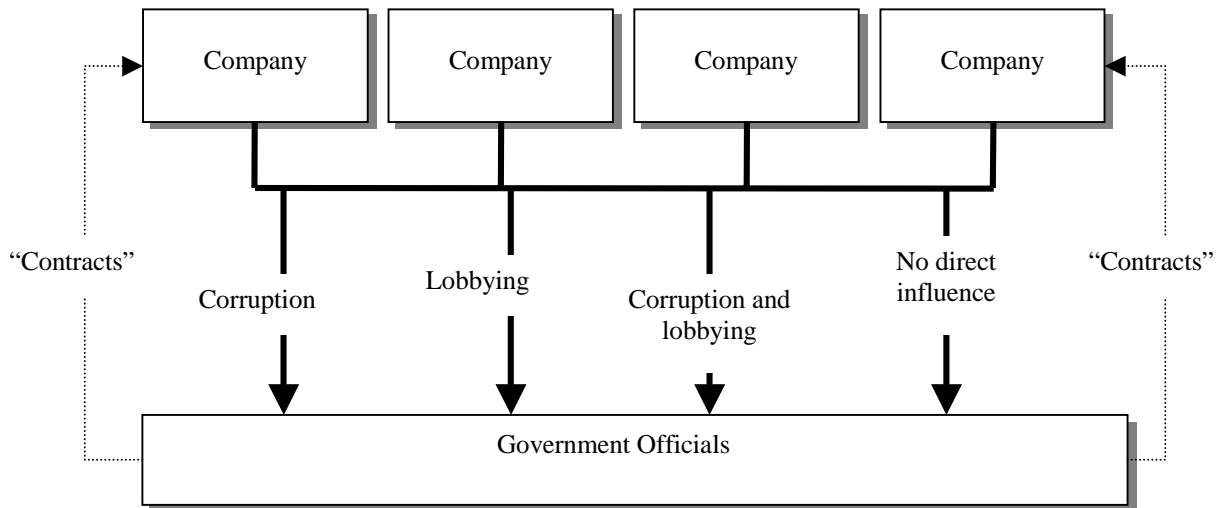
Foreign companies active in Poland, could perceive their activities as falling under the category of lobbying and not corruption. Although monetary payments are common in the market entry phase, companies that have passed that rely much more on building long term relationships and networks. Recall Mr. Carlsson’s comments on having an “inside” person in a public body that would provide early information on upcoming changes in the tariff system. Such information is needed constantly and therefore the relationship has to be based on mutual trust and loyalty – rather similarly to the Italian network systems.

There is also another significant distinction between lobbying and corruption. Consider once again the parallel between lobbying and advertisement and corruption and contracts. Advertisement never leads to a guaranteed outcome. Companies may spend huge amounts on publications and broadcasts achieving only limited effects on sales. At the same time, explicit contracts almost always result in an exchange of money for goods, services or similar.

As such, lobbying may require much more resources from a company and result in a much lower likelihood of a positive outcome than direct bribery. Companies have thus a choice between four options while considering either an entry to the market or day-to-day operations.

They can choose to remain passive and not to engage in direct manipulation of the provider of the monopolized resource, i.e. public official. They can choose to hold regular meeting with them, promoting their company, offering lunches, arranging trips to factories in foreign countries with the accompanying week or two in a full-service beach resort – all expenses paid of course. They can also choose to provide the decision-maker a fixed sum of money, car, TV or an electrical toothbrush depending on the scale of the counter-service wished for. And they can choose a mix of the last two by providing both immediate benefits and long-term gains. These choices are expressed visually on the figure below.

Figure 20: Corporate choices



Source: Author

Each of these choices has its advantages and disadvantages. Remaining passive does not create any extra costs for the company and would be the preferred choice, if the company had significant bargaining power vis-à-vis the official or if there would be an effective system for providing the needed services. At the same time, the official has the least incentives to act in favor of the company.

Even if the necessary processes would be completed, there is no guarantee that they would be done so within reasonable time. Given that time is an important factor for most business decisions, the passive approach could in fact lead to high total costs. According to Mr. Svensson, competition between both existing firms and those trying to enter the market, is high. Thus waiting is not really an option to be considered seriously.

The choice of lobbying is much more expensive but at the same time does not provide any guarantees about the final outcome. Given high competition in the demand side of monopolized resources of the public official, benefits provided by different firms would, on average, be equal. The official has thus no incentive to prefer one company over another and may just choose one randomly or, which would be even more striking for the lobbyists, make a choice based on objective criteria.

In such a way all the expenses incurred by the company would have been for nothing. A choice based on objective criteria could have been achieved also by remaining passive. Lobbying nevertheless increases the awareness of the official about a particular company and thus may be a preferred choice given competition between passive and lobbying firms. Lobbying does not, however, eliminate the time factor. If there is high competition between the potential recipients, the official may choose instead to prolong the process to benefit from continuing preferential treatment.

The third choice of providing an immediate benefit for the official is thus perhaps much more feasible from the point of view of the investor. Bribes, given the similarity with contracts, pose immediate obligations upon the receiver of the bribe. Similarly, “entering into contract” with one company effectively eliminates all other

competitors. Assuming that the corrupt official is not engaging in such activities for the first and the last time, he has incentives to honor his part of the contract expecting another contracts in the future. If the official would accept bribes from all the participants in the contest and eventually choose only one, his credibility in the eyes of the losers would disappear and they would be reluctant to engage in subsequent transactions.

Corruption, although possibly involving higher “one-time” payment, could also be considered as the cheapest way for the company to obtain what he wishes. Firstly, he does not have to bear the prolonged costs of lobbying. Secondly, providing a payment to the official does not entitle the company not only to receive the service in question, but also to impose certain time limits on the “owner” of the service. Termed “grease money” or “speed up tool”, it lowers considerably the risks faced by the company both in terms of not obtaining the necessary permits/licenses and obtaining them in time.

The final choice of a combination of corruption and lobbying is definitely the most costly of these four in terms of real expenses. The company has to take care of both immediate benefits and provide the official also continuous gains. This choice has one clear advantage over others. It is the one that guarantees the best outcome in the long-run. It has the benefit of providing confidence for the public official that he is continuously appreciated as well as rewarded. Thus, for example in the case of an official that is in charge of privatisations, he favors the paying company during the bid (corruption) but would also provide him information about possible future bids (lobbying).

The official has thus been successfully “acquired” by the company and, as the relationship continues, the dependency of the official on the benefits provided by the company increases. In such a manner, the bargaining power of the company increases and he may use it to extract either lower future payments or to increase his benefit from using that “source”. In case of an influential company, he may start to direct the official towards more profitable areas within his sphere of activity. Consider a case of a health inspector, who is “owned” by the company. By providing him with occasional success stories with high glamour but low actual damage, he may provoke for example a promotion for the official thus considerably increasing both his and also the company’s influence.

Such reasoning, supported also by empirical findings presented before, points towards a self-evident fact. As corruption is perceived to be the most efficient way of carrying out day-to-day business activities and lobbying is most efficient when accompanied with corruption, firms that wish to remain competitive in the market that depends on the “monopolized” resources of public officials, must also start using corrupt activities. Ms. Smarzynska’s personal comments confirm simple business logic – investors cannot ignore the biggest market in Central and Eastern Europe.

8.2.1 The fixed cost of corruption

At present, all theoretical and empirical studies find a negative but insignificant correlation between corruption and the volume of foreign investments. In the case of Poland, the situation seems to be reversed. Higher volumes of foreign investments are accompanied with increasing levels of corruption.

Although that positive correlation is subject to investment incentives discussed before, no study, to my knowledge, has ever found that these two occur simultaneously.

Based on empirical findings from recent studies, the level of corruption, that companies have to pay, is 1,2 to 1,6 percent of their annual revenues (OSI, 2002 and PAIZ, 2003). These numbers should nevertheless not be interpreted literally. As Smarzynska stated, bigger firms pay usually higher percentages whereas smaller firms pay less. The amount is also dependant on the public official receiving the bribe.

Foreign managers of companies operating in Poland have a tendency to form social networks within nationalities and industries. The following exchange of information includes also details about the levels of corrupt activities their firms have faced. This allows comparison and possibly also selection of officials with whom to do business in the future. From networks in the host country, the information spreads to networks in the source country. Thus it is reasonable to assume that companies about to enter the market or already extant there, do not consider corruption as an uncertainty but only as a risk¹⁷.

Such an explanation would also be consistent with the fact, that less than half of companies both in the PAIZ survey (2003) and in the IBLF (2002) survey considered corruption to be a problem. Furthermore, the responses of IBLF show clear patterns common to risk and not uncertainty. Recall that 50 percent of responses indicated that corruption is a risk in the long run and only 20 percent viewed it of being a risk in the short run. Assuming that the survey did not make a distinction between uncertainty and risk, the prevalence of long term risk points towards the existence of uncertainty. In a similar manner, short term risk and no risk is associated with the levels of risk.

As risks are predictable, the significance of corruption decreases considerably. Corruption is no longer considered as a barrier but simply extra cost, that can be calculated by reasonable certainty before actually engaging in corrupt activities. In this manner corruption can be viewed as a fixed cost that is subject to conventional risk management techniques. This is indirectly supported also by Mr. Polak, who stated that all foreign investors view corruption as a cost they have to calculate.

Consequently, as the uncertainty associated with corruption has decreased and the level of payments to be made to officials has become known, corruption for foreign

¹⁷ Uncertainty is a state in which the number of possible outcomes exceeds the number of actual outcomes and when no probabilities can be attached to each possible outcome. It differs from risk, which is defined as having measurable probabilities.

companies is becoming or has already become an additional cost in array of others. This explains also the lack of negative correlation between corruption and inflows of FDI. As Mr. Svensson stated “the best thing about risk is that you can calculate it”

The role of foreign investors must be re-examined in the light of these findings. Firstly, although corruption is not widespread in all the Western countries, lobbying is. Given the thin invisible line drawn between these two phenomena, it can be claimed that companies involved in lobbying are also willing to cross that line, if they do not suffer from immediate punishments. Adding to that the fact that enforcement of anti-corruption practices in Poland is not effective and that corruption can be perceived as the most efficient way of doing business, it can be concluded that foreign companies are not only willing to go along with, but also actually promote corrupt activities. As Mr. Svensson stated: “Bribes make things go faster and since time is money, it reduces cost. Furthermore, everybody does it so why would I like to make an exception?”

A remedy against such behavior, as stated, could be found in more effective law enforcement. Despite the passage of the law criminalizing bribes and foreseeing the punishment of both bribe givers and takers in Poland, there have been no cases in the court of law against public officials on the grounds of corruption. This was also confirmed by both Ms. Czubak and Mr. Szakalis.

8.3. A proposed novel approach

I propose that government action is not the only possible way to regulate the levels of corruption. I assume, that the quality of investments could have influenced the level of corruption in Poland.

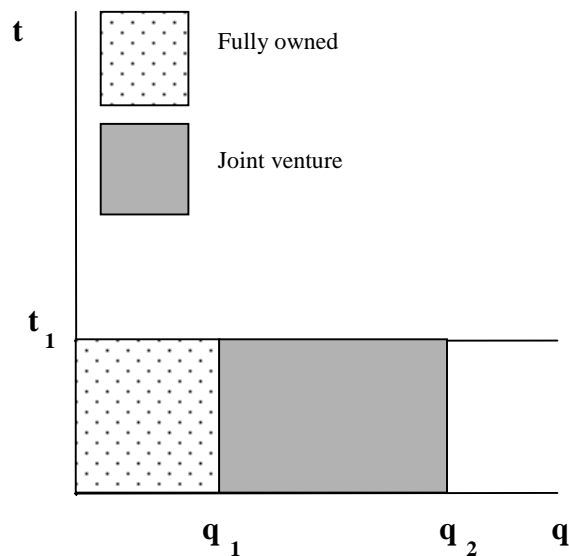
As was shown in Chapter 5, the main incentive for foreign investors during the 1990s was cost of labor. Investors, according to Mr. Svensson, had a short to medium term strategies aiming to take advantage of the growing market. Subsequently, labor intensive industries attracted most of the investments. The situation has remained unchanged also in the early years of the 21st century. Investments into industries using more sophisticated technology and R&D have not been significant.

Existing studies view increased flows of FDI into the country as increasing transparency and subsequently also decreasing corruption. This has not occurred in Poland.

Another set of studies establishes, that higher levels of corruption have an insignificant negative effect on the level of foreign direct investments. This effect in the case of Poland could be seen as a reduction in the growth rate of foreign investments. Due to obstacles in obtaining empirical data, this cannot be tested in the case of Poland and thus has to be either accepted or rejected merely on a theoretical level. The fact that FDI is increasing does not necessarily indicate the existence of a positive correlation, as the growth rate of FDI could be higher without corruption.

I choose to explain the findings of this paper through the modification of the theory developed by Smarzynka and Wei in 2002 explained in Section 4.5.2. To repeat briefly, these authors showed that the choice of entry mode is determined by the level of technological sophistication and the level of corruption in the target country. They

Figure 21: Corruption's effect for a single company



Source: Modified from Smarzynska and Wei 2002

took technological sophistication as a constant for a given firm and showed that at different levels of corruption each company faces a choice between fully owned, joint venture and no direct investment. Figure 21 shows these effects for one single company, whereas Figure 2 can be seen as an aggregate theoretical explanation for the entry choice in general.

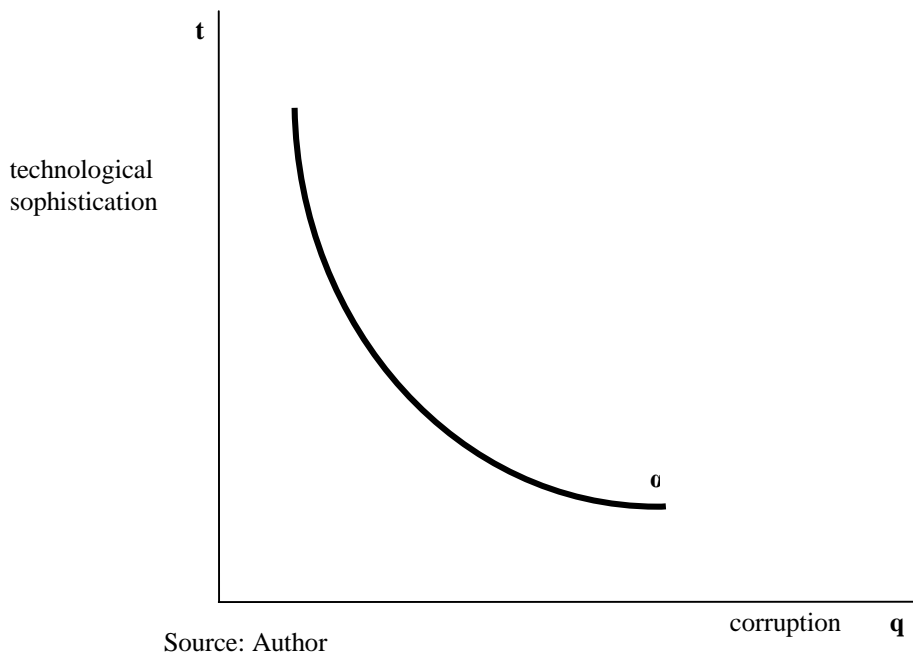
If the level of technological sophistication for the company is at t_1 then up to corruption level q_1 in the country the preferred choice of entry mode will be a fully owned company. If corruption in the country is at the level of q_2 , then the company will prefer a joint venture with a local partner to lower the risks and costs. If corruption exceeds q_2 , then the company chooses not to engage in direct investment but either to avoid any business dealings with the country at all or rely on a low interface entry mode such as export.

The limitation of that approach is that it perceives both technological sophistication and the level of corruption in the country to be constant. At its original form it is also used to describe the moment of entry into the market. I propose, that it is possible to use the same elements of the model to describe also how corruption is changing or can be changed.

8.3.1. The butterfly theory

Based on the findings of this paper, I claim that if companies use direct investments with higher technological sophistication, it will lead to a reduction in the level of corruption. The same logic tells, that if companies rely continuously on low level technological sophistication, the level of corruption shall remain unchanged or, in the worst scenario, will even increase. To explain that, I have developed the butterfly theory modifying the Smarzynska-Wei model with the permission of these authors. The butterfly theory aims to explain the relationship between corruption and foreign investments. The theory is explained through figures 22 and 23 below.

Figure 22: The framework for the butterfly model



I do not perceive neither corruption or technological sophistication to be constant but changing. The figure above presents the general framework on which the theory is built.

As in the original model, x-axis (**q**) represents the level of corruption in the country. The y-axis (**t**) is the average level of technological sophistication for all the investments made into the economy. **α** represents the sensitivity line of the corruption to the technological sophistication. The shape of the line is determined by the level and type of technological sophistication and the number of the companies engaged using that technology as a fraction of total number of companies that could use these activities.

In the figure 23, at any given point of technological sophistication, the nature of it also determines the level of corruption.

$$(1) \quad q = \alpha * t$$

Consider a situation in which the level of technological sophistication increases from t_1 to t_2 expressed as $\Delta t = t_2 - t_1$ and the level of initial corruption in the country is at q_1 on Figure 23 below. Given that the nature of the technological change follows the characteristics of α_1 , for example insignificant improvement in a sector of the economy using already highly sophisticated technology and followed by only a few companies, the subsequent change in the level of corruption will be $q_1 - q_2 = \Delta q$.

$$(2) \quad \Delta q = \Delta t * \alpha_1$$

In the other case, the nature of the technological change (α_2) is highly significant and there are a number of companies following such a change. Subsequently, the level of corruption changes to $\Delta q'$.

$$(3) \quad \Delta q' = \Delta t * \alpha_2$$

As is visible, the change in the level of corruption $q_1 - q'_2 = \Delta q'$ is significantly larger than the change in the first case.

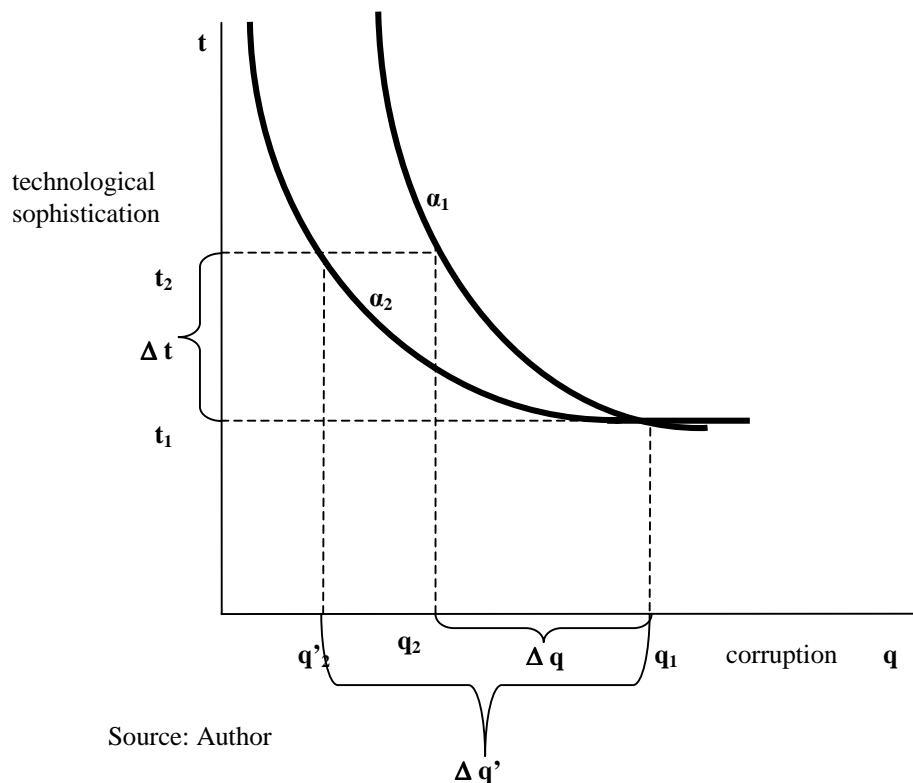
$$(4) \quad \Delta q' > \Delta q$$

or by substituting that with the equation (1) we get

$$(5) \quad \Delta t * \alpha_2 > \Delta t * \alpha_1$$

It is clear that the level of the change is highly dependent on α or in other words on the number of companies engaging in the increase of technological sophistication and the preexisting level of technological sophistication.

Figure 23: The butterfly model exemplified



Source: Author

The theory can be seen as applying both to a single company that either enters the Polish market or is already active there and to the general level of foreign investments. In the case of a single company the level of corruption should not be viewed as that of the country but only the level of corruption to which the company is subject to. As the technological sophistication of the company increases, it is subject to less interaction and/or more transparent interaction with corrupt parties. This would not necessarily mean only those parties that are extant on the government level but also private companies with whom the company has to do business.

If applicable to the entire country, the size of α should be seen as the average of all the α 's for all the sectors and companies in the economy. Expressed as α' it would be

$$(6) \quad \alpha' = \sum_{n=1}^{\infty} \alpha_n / n$$

where n is the number of sectors exhibiting a unique sensitivity of corruption to technological sophistication.

As was shown before, access to information in Poland is a significant problem. This is caused mainly due to archaic systems of storing information and the concentration of power in the hands of the people controlling that information. Given that the level of technological sophistication in the country would rise, it could also lead to improved access to information. Once again it must be stressed that technological sophistication is to be understood in the context of the Polish market. Internet and computerized databases, as was exhibited, are to be considered already as exceeding the level of sophistication in the country on average.

At present the situation on the Polish market, for example for providing internet services, seems to be like a “vicious circle” – companies do not come to the market because there are too few customers, the number of customers does not increase because the prices for using internet are too high, the prices are too high because there is not sufficient competition among providers.

Thus, if any of the links in that circle would be broken, it would create a virtuous circle that would consequently increase the access to information and eliminate the powers of the “gatekeepers” that have been continuously described as the main sources of corruption. In a similar manner it would allow the information about corrupt officials, companies and practices to spread, creating a pressure on the government to fight against the phenomena. It could be argued, that the change would be negligible, as the public in Poland is already aware of the significance of the problem. This argument is nevertheless inadequate.

The government is not subject to the opinion of only its electorate. Especially in the case of Poland, the international community plays an important role in directing the policy of the government. This would be especially so after the enlargement of the EU in May 2004. Higher transparency and wider access to information would not only be available to locals but also on the international level. It is doubtful, if it would have been possible to keep the case of Ryvin from appearing on the front pages of newspapers until after the Copenhagen summit.

It can also be argued, that providing more transparency does not eliminate the “gatekeepers” and thus does not effect the level of corruption. While it is true that the gatekeepers will remain in certain occasions, it is not true that their number will not decrease. Consider for example the case of company registration in Sweden, where most of the necessary formalities can be done in a single location through a computerized system. Firstly, it has the effect of eliminating some gatekeepers and secondly, creates a single more powerful gatekeeper. It would be wrong to see the latter as increasing corruption. Providing concentrated power to a single “gatekeeper” brings with it, in a transparent system, also increase supervision by the “customers” of that official. As the work of other offices depends highly on the efficiency of the first link in the chain, also peer pressure by others is increased.

A second critique that might arise is why it has not happened already. To answer that, I have to come back to the vicious circle from the foreign investors viewpoint. Polish market does not have high technological sophistication. It’s main strength, as recognized by the investors themselves, is access to cheap labor. Thus a certain “reversed prisoners dilemma” is created. If one company engages in investments with higher technological sophistication, he risks that the employees who have received the training and know-how, shall be “bought” by rivals.

The company would also face the environment where the training of employees would not result in the perceived effects, as other companies – its business partners, suppliers, customers – do not possess that knowledge. Thus the company chooses not to engage in investments with higher level of technological sophistication. The increased risk accompanying investments with a high level of technological sophistication is substituted with low risk investments that, correspondingly, also require lower levels of capital.

This is also one of the problems extant in applying the butterfly model to a single company. It does reduce the level of corruption temporarily but by subjecting the company to a lower access to resources owned by the corrupt officials, it also reduces the competitiveness of the company vis-à-vis its competitors.

Therefore, for a single company to initiate the change, it would mean the necessity to embrace all the actors in this specific products life cycle. If all the parties from suppliers to processors to distributors to sales and service would have to adopt these mechanisms, the effects would increase efficiency and also transparency thereby reducing the impact of corruption for the company.

Thus the company would be worst of if it would engage in such activities alone, it would be better of (as it saves the expenses) as it does nothing, and he would gain the most (in the long run) if the system in which he is a part, would adopt the same technology. Due to the fact that the level of purchasing power and cost of labor have remained low in compression with West Europe, companies have no incentives to take on projects for the sake of increasing transparency.

Thirdly, the question arises, why would this theory be directed towards foreign companies. As was indicated, investments with high technological sophistication are unreasonably expensive in Poland. Foreign investors do, in general, possess more capital than local firms. They would be thus the first ones to be able to “break the

circle” and start providing low cost services. There are naturally also Polish companies that do not lack the necessary resources but the “reversed prisoners dilemma” still applies. The choice of foreign companies as the first movers is also motivated by the fact, that a lot, if not the most, of “high” technology non-existent in Poland is common and widely used in the developed economies where the investors come from. They thus simply possess the necessary know-how and experience which to use on the Polish market.

Local companies, in order to achieve the same effect, have to first acquire that knowledge from abroad. If foreign investors would come to the market with investments with higher level of technological sophistication, it would also create a “spill-over” effect. Local companies, witnessing the effect of technology, would be more willing to start using it. They would also have easier access to that knowledge.

The spill-over of sophisticated technology from foreign investors would also occur to the public sector. As such, it would bring with it standardization of bureaucratic procedures. This cannot be achieved solely through the transfer of technology but would have to be accompanied with other driving factors. I argue that bribes for public officials are a method to compensate for low incomes relative to the private sector, thus there is a need for unification of the income levels. This has to be done simultaneously with the effective penalization of corruption – something that has been lacking in Poland. Without that, the rise in income and higher technological sophistication of companies would cause only marginal changes in the level of corruption for public officials.

Increased technological sophistication, rise in income of public officials and effective execution of an anti-corruption legal framework must be seen as complementary in the effective fight against the corruption.

9. Conclusions

The most important and pervasive force changing and challenging the business environment over the past decades has been internationalization. Falling barriers to trade and international capital flows have created new business opportunities. Many of such opportunities were created by the collapse of the Soviet-dominated economies in the Central and Eastern Europe (CEE). Foreign companies started quickly to reap the benefits of those markets by establishing branches, subsidiaries and joint ventures with local companies. In entering those markets, companies had to take into consideration the peculiarities of the corporate environment, which is one of the prerequisites for a successful corporate strategy. Creation of a strategic fit between the firm, its implemented strategy and its environment is possible only if all these components are understood thoroughly.

Poland has been one of those countries in the CEE that took the path of reforming its centrally planned economy into a fully functioning market economy. In this process, the country was highly successful in attracting foreign investors. Up to 1989, foreign investments into Poland were negligible, whether measured in terms of the number of projects or dollar value. By 2002 Poland had become the unquestioned leader in attracting foreign direct investments (FDI) among CEE countries. Also the number of registered foreign companies increased over 85 times between 1989 and 1998 with the largest investors coming from Germany, the U.S., France, the Netherlands and Italy.

The inflow of foreign investments had a great impact on the development of Polish economy. Next to clear macroeconomic benefits and transfer of capital, foreign investors brought with them new know-how and technology. New production methods and management practices have increased the efficiency of not only foreign owned companies but have contributed to the evolvement of the entire economy through spill-over effects. Increasing presence of foreigners has also augmented the need for skilled labor, as witnessed by the growing importance of financial and service sectors.

Dynamism and structure of investments made into Poland have changed considerably over the past decade. The “quick-profit-seeking” investors of the early 1990s, using the low labor costs are slowly being replaced by investors seeking long term presence on the market. Consequently, also a shift from labor intensive sectors to capital intensive ones is occurring. Investment incentives are further likely to change after Poland becomes a full member in the European Union. The intensified cohesion process will bring with it a rise in labor costs that has been the prime investive for investments so far.

A peculiarity of the Polish market in which foreign companies operate, has been the continuous persistence of high levels of corruption. Based on the assessment of

international organizations dedicated to fight corruption, the level of that phenomena has reached alarming levels in Poland. Existing theories state, that high levels of corruption cause a decrease in the inflow of foreign investments and that high levels of foreign investments increase transparency and reduce corruption. Neither of those theories seem to be applicable for the case of Poland without modification.

I do not claim, that there is a positive correlation between foreign investments and corruption in Poland. There is a possibility that without corruption, foreign direct investments would be event more significant. This does not nevertheless change the fact that both corruption and foreign investments have been rising throughout the 1990s.

According to existing views, foreign companies, investing in a corrupt environment, face increased uncertainty and risks. Corruption is seen as reducing the efficiency of investments and promoting short-run orientation in corporate strategies. As such, corruption is clearly a phenomena that deserves consideration as a part of the corporate environment from the viewpoint of both potential and extant investors.

This paper explains the somewhat anomalous co-existence of growing inflow of foreign investments and corruption in Poland through multiple approaches. One of those is connected with the transfer of corporate culture that foreign companies possess and bring with it to Poland. The assumption is made that if the investor comes from the country where the corruption level is on a significantly high level, he has also the knowledge and experience of dealing with corruption.

The examination of the biggest investors shows that out of five largest groups of investors, three came from countries where corruption is noticeable. Furthermore, most of investors came from the EU zone. Despite the fact that these countries have adopted anti-corruption measures suggested by the EU institutions, the rate of corruption has not witnessed any significant drops and has, in some cases, seen an increase. Therefore it can be concluded that investors knew how to behave in the corrupt environment prior to coming to Poland. This assumption is also supported by the fact, that the biggest investors come from the countries that Transparency International recognized as “the most common bribe payers/givers/”. Given that, it is also likely that companies continued to operate in Poland using corrupt activities thereby contributing to the continued existence of corruption.

Moreover, considering the size of the Polish market, no investor could consider it as insignificant. Competition in the market has increased rapidly. This has in turn led to extensive rent seeking by individual companies striving to appropriate the limited resources available in the country. There has been little incentive for companies to act differently, as engagement in corrupt activities substantially increased the chances to be profitable and to reduce both costs and risks. Bribes effectively reduce the “red tape” the company is facing and following the “efficient grease” hypothesis, corruption can improve economic efficiency and fighting bribery would be counter-productive.

In a similar manner, there has been also no incentives for the proprietors of those limited resources – the public officials – to refrain from accepting bribes. Their private gains outweighed any risks stemming from penalizing corruption as a

criminal offence. Common claims that the superiors to corrupt officials should monitor their subordinates and punish them do not apply if the superiors themselves are not cleared from corrupt activities.

Also, the line between corruption and lobbying has proven to be vague. Thus companies performing what they perceive to be lobbying, can turn out to be corruption and similarly, companies that knowingly engage in corruption can justify it as being lobbying. As the effectiveness of government action to fight corruption in Poland is questionable at best, the lack of clear line between these activities allows companies to use both of them to secure maximum benefits for their businesses from public bodies.

The mutual system of benefits has become a new standard for the Polish market. Corruption has become a part of everyday business and is not considered to be hindering activities to a substantial level. Corruption still remains an extra cost but it can no longer be considered as unpredictable and therefore of high influence on day-to-day operations. As such, risks, associated with the corruption in establishment process of the company, decrease.

I do not suggest that all the foreign companies entering or operating on the Polish market use corrupt activities to speed up the processes or to gain advantages over competitors. However, since the existence of corruption, in an environment not effectively enforcing measures against it, creates strong incentives to use it, it is likely that many companies followed that path.

I do believe that that foreign companies took corruption into consideration prior to investing in Poland. The choice of a specific entry mode depends on the resources the company possesses, the duration of the investment and the specificities of the market. Companies wanting to minimize risks chose an entry mode with lower transactions (export, licensing) and those wanting to maximize long-term profits, chose a mode of direct investment.

The theory authored by Smarzynska and Wei relating the level of corruption to the technological sophistication of the company and the entry mode, can be seen as applicable in Poland. It has been established that most investments into Poland are in the form of low technological sophistication and investments into R&D intensive sectors have remained low. According to the theory, the preferred entry mode should therefore be a joint venture with a local company, which has been also proven by facts. It can be argued that incentives to invest in sectors requiring higher technological sophistication have remained low due to the unavailability of resources in the country.

In this paper, I take a step further in developing this theory. Certain technologies contributing to the wider access of information, such as the internet, are relatively easy to use and do not create substantial costs for the users if their number is significantly high. Providing that increased transparency and exchange of information will result also in the increase of choices a person/company can make, it could lead to the reduction in the level of corruption. Therefore if investors choose to transfer technologies with higher technological sophistication, which will have clear

impacts on the level of transparency, they may contribute to the decrease of corruption.

According to the “butterfly theory” developed on the pages of this paper, foreign investors can contribute to the development of corruption and they can also contribute to the fight against it. The theory claims, that if companies consciously choose to invest in higher technological sophistication, they contribute to the reduction in the level of corruption. This can be seen as applicable to both single companies and the entire economy. For single companies a problem nevertheless arises, if they are not able to use that technology due to the fact that there is nobody that would follow the same development.

Technology transfer into Poland has so far been focusing on increasing productivity and efficiency of manufacturing sectors. Thus, the choices made by foreign enterprises so far could be seen as having led to the sustainability of corruption as the investments in high technological sophistication sectors were limited.

This process could occur without any direct intervention. As the competition on the market increases and the relative gap between labor costs decreases, companies will find it harder to achieve their goals by extracting higher rents from the labor to cover the ones appropriated by public officials through corruption. Relatively low FDI per capita and underdeveloped high-tech industries in Poland seem to provide wide opportunities for further development. Such movements are starting to occur for example in the finance sector, which is attracting an increasing share of the total foreign investments made into Poland. Consequently, more risky entry modes will be chosen by the foreign investors.

Finally, it has to be emphasized that investments in the non-corrupt environment are more secure. Therefore it should be in the interest of all private companies to fight against the phenomena. By this day, despite government efforts to fight corruption, there has been little to no effect on the occurrence of the phenomena. On the contrary, the level of corruption has been rising constantly affecting every aspect of doing business. Surveys indicate, that companies spend up to 12 percent of their annual revenues for bribery or other forms of corruption. On average, this number is 1,6 percent, which constitutes a significant portion of the firms’ resources. To a large extent companies seem to have learned to cope with the phenomena with only half of the companies perceiving it to create long term risks.

It is clear that integration of the Polish economy into the Common Market of the European Union will bring changes. The period of explicit demands by the EU institutions to root out corrupt activities seems to be limited up to May 2004 when Poland will become a full member in the Union. After that, any extant privileges of those bodies will disappear and shall be replaced with a simple non-binding expression of concern.

Conventions and laws punishing wrongdoers are ratified by most of the EU countries and yet the level of corruption has not seen any significant decrease. It is thus appropriate to seriously question the effectiveness of existing anti-corruption measures. On the other hand these anti-corruption measures are necessary and, combined with the efforts made by a single country, can bring some positive results.

I believe that the successful fight against corruption is a combination of many factors. Firstly, the proper legislation has to be implemented and executed. Secondly, further efforts has to be made by the Polish Government. I have no doubt that the “Ryvin scandal” will provide motivation for these actions resulting in higher awareness of the negative impacts of corruption among the society and the government. Thirdly, the role of the foreign investors is of a great importance as they act as a “motor” for changes. Therefore, investors should be more aware of the consequences of their actions. The principle of “when in Rome, do as the Romans do” should not be applicable in Poland. Instead the principle of “when in Poland, do not do as the Polish do” should apply. Investors should act responsibly and promote, as in own countries, high business moral.

9.1 Suggestions for future research

Since the studies on corruption have began relatively recently, there are many possibilities for the future research. Firstly, the cultural dimension should be examined more closely since there is still very little knowledge about foreign investors influence on corruption’s rate through the transfer of corrupt practices. Cross-country studies should be carried out for the purpose of comparison that would allow to test the validity of the theory. Secondly, there is also a question if the “butterfly theory” can be applied in other countries or if its only applicable in Poland. Thirdly, corruption is a very complex phenomena. There are still unanswered questions about all the factors that influence the emergence and continuation of the phenomena. Furthermore, all the areas influenced by corruption are not likewise defined and explored in detail.

Therefore, there is no doubt that further studies on the subject can be carried out and a person, willing to do a research, will come across many interesting and exiting areas.

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ANNEXES

Annex 1: Transparency International Corruption Perception Index 1995-2002

Rank	Country	1995	1996	1997	1998	1999	2000	2001	2002
EUROPEAN UNION									
1	Finland	9,1	9,1	9,5	9,6	9,8	10,0	9,9	9,7
2	Denmark	9,3	9,3	9,9	10,0	10,0	9,8	9,5	9,5
3	Sweden	8,9	9,1	9,4	9,5	9,4	9,4	9,0	9,3
4	Luxembourg	6,9	-	8,6	8,7	8,8	8,6	8,7	9,0
5	Netherlands	8,7	8,7	9,0	9,0	9,0	8,9	8,8	9,0
6	United Kingdom	8,6	8,4	8,2	8,7	8,6	8,7	8,3	8,7
7	Austria	7,1	7,6	7,6	7,5	7,6	7,7	7,8	7,8
8	Germany	8,1	8,3	8,2	7,9	8,0	7,6	7,4	7,3
9	Belgium	6,9	6,8	5,3	5,4	5,3	6,1	6,6	7,1
10	Spain	4,4	4,3	5,9	6,1	6,6	7,0	7,0	7,1
11	France	7,0	7,0	6,7	6,7	6,6	6,7	6,7	6,3
12	Portugal	5,6	6,5	7,0	6,5	6,7	6,4	6,3	6,3
13	Italy	3,0	3,4	5,0	4,6	4,7	4,6	5,5	5,2
14	Greece	4,0	5,0	5,4	4,9	4,9	4,9	4,2	4,2
15	Ireland	8,6	8,5	8,3	8,2	7,7	7,2	7,5	6,9
	Average	7,1	7,3	7,6	7,6	7,6	7,6	7,5	7,6
	Average reversed	2,9	2,7	2,4	2,4	2,4	2,4	2,5	2,4
ACCESSION COUNTRIES FROM CENTRAL AND EASTERN EUROPE									
16	Slovenia	-	-	-	-	6,0	5,5	5,2	6,0
17	Estonia	-	-	-	5,7	5,7	5,7	5,6	5,6
18	Hungary	4,1	4,9	5,2	5,0	5,2	5,2	5,3	4,9
19	Lithuania	-	-	-	-	3,8	4,1	4,8	4,8
20	Poland	-	5,6	5,1	4,6	4,2	4,1	4,1	4,0
21	Czech Republic	-	5,4	5,2	4,8	4,6	4,3	3,9	3,7
22	Latvia	-	-	-	2,7	3,4	3,4	3,4	3,7
23	Slovak Republic	-	-	-	3,9	3,7	3,5	3,7	3,7
	Average incl. Poland	4,1	5,3	5,2	4,5	4,6	4,5	4,5	4,6
	Average reversed	5,9	4,7	4,8	5,5	5,4	5,5	5,5	5,5
	Average reversed Poland		4,4	4,9	5,4	5,8	5,9	5,9	6,0
	Average exc. Poland	4,1	5,1	5,2	4,4	4,6	4,5	4,6	4,6
	Average reversed	5,9	4,9	4,8	5,6	5,4	5,5	5,4	5,4

Source: Transparency International, various years, own calculations

Annex 2: Source country breakdown of foreign direct investments into Poland as of 2002.12.31 and the “List of Major Foreign Investors”

	<i>Country</i>	<i>Capital invested (USD million)</i>	<i>Investment plans (USD million)</i>	<i>No of companies on the PAIZ List of Major Foreign Investors</i>
1	France	11,503.0	1,975.5	89
2	USA	7,985.2	2,389.0	126
3	Germany	7,444.57	1,290.86	212
4	The Netherlands	4,976.05	563,7	76
5	Italy	3,701.1	1,272.7	59
6	Great Britain	2,899.1	349.5	40
7	International	2,803.3	913.5	18
8	Sweden	2,653.7	963.8	57
9	Belgium	1,649.05	127.0	23
10	South Korea	1,621.8	20.0	4
11	Denmark	1,331.0	241.5	38
12	Russia	1,286.4	301.0	2
13	Ireland	1,039.7	N/A	2
14	Cyprus	911,7	175.0	1
15	Switzerland	904,7	338.5	21
16	Austria	843,4	79.2	41
17	Norway	599,3	173.9	14
18	Japan	598,7	111.0	13
19	Spain	536,2	N/A	9
20	Greece	501,5	4.0	2
21	Portugal	493,1	66.6	4
22	Finland	424,4	122.8	19
23	Canada	205,3	241.5	14
24	Croatia	173	16.0	2
25	Turkey	100,1	58.0	4
26	Luxembourg	85,7	10.2	8
27	Australia	67	4.0	2
28	Czech Republic	60,7	N/A	4
29	Israel	55,4	120.0	4
30	China	45	45.0	2
31	South Africa	35	95.5	2
32	Slovenia	35	27.0	2
33	Liechtenstein	31,9	27.0	4
34	Taiwan	5,7	200.0	1
35	Hungary	3,5	N/A	1
	Investments over \$ 1 million	57,610.3	12,323.3	920
	Estimated investments under \$ 1 million	3,990.1		
	Total	61,600.4		

Source: PAIZ, 2003

Annex 3: Breakdown of FDI stock in Poland by sectors as defined by European Classification of Activities (EKD) as of 2002.12.31

No	ECS (EKD)	Capital invested (USD million)	% of total stock
1.	Manufacturing:	24,053.7	36,9%
2.	Transport equipment	6,219.4	9,6%
3.	Food, drinks and tobacco products	5,984.0	9,2%
4.	Other non-metal goods	3,383.4	5,2%
5.	Chemicals and chemical product	1,925.0	3,0%
6.	Pulp and paper, publishing and printing	1,728.1	2,7%
7.	Electrical machinery and apparatus	1,678.1	2,6%
8.	Wood and wooden products	1,339.6	2,1%
9.	Rubber and plastics	647.9	1,0%
10.	Metals and metal products	548.1	0,8%
11.	Machinery and equipment	524.4	0,8%
12.	Furniture and consumer goods	452.3	0,7%
13.	Fabrics and textiles	308.8	0,5%
14.	Leather and leather product	14.6	0,0%
15.	Financial intermediation	13,393.2	20,6%
16.	Trade and repairs	7,586.3	11,7%
17.	Transport, storage and communication	6,251.4	9,6%
18.	Construction	3,274.8	5,0%
19.	Power, gas and water supply	2,272.2	3,5%
20.	Community, social and personal services	1,825.7	2,8%
21.	Real estate and business activities	1,174.2	1,8%
22.	Hotels and restaurants	652.6	1,0%
23.	Quarrying and mining	218.5	0,3%
24.	Agriculture	44.8	0,1%
25.	Investments over USD 1 million	61,447.4	
26.	Estimated investment below USD 1 million	3,667.2	
27.	TOTAL	65,114.6	

Source: PAIZ, 2003 and own calculations

Annex 4: Administrative procedures faced by a newly establishing firm in theory

	CATEGORIES
A	ENTRY APPROVALS
1	Company registration
2	Investment Code Registration
3	Initial Bank Deposit
4	Residence and Working Permit
5	Tax Office Registration
6	Foreign Investment Licensing
7	Business and Trading Permit
8	Statistical Office Registration
9	Existence, Conformity, Opening Reporting
10	Health Care & Pension Plans
11	Social Security Registration
B	LAND, SITE DEVELOPMENT, UTILITY
12	Access to Land (State Land)
13	Town Planning Certificate
14	Site Inspections and General Approvals
15	Building Permits
16	Electricity and power connection
17	Telephone and Telex
18	Water and Sewerage
19	Post, Box and Private Bag
C	OPERATIONAL REQUIREMENTS
20	Import-Export Intention and Permits
21	Import-Export Clearance Process
22	Foreign Exchange Controls
23	Fiscal Situation Certificate (Quitus)
24	Health and Safety Inspections
25	Labor Inspections
26	Social Welfare Plan Payments

Source: Morisset and Lumenga, 2002

Annex 5: Potential international bribe payers. Sectoral breakdown and size of bribes

Table 1. How likely companies from the following countries are to pay or offer bribes to win or retain business ?

Total sample	2002	1999
	835	779
Australia	8,5	8,1
Sweden	8,4	8,3
Switzerland	8,4	7,7
Austria	8,2	7,8
Netherlands	7,8	7,4
Belgium	7,8	6,8
United Kingdom	6,9	7,2
Germany	6,3	6,2
Spain	5,8	5,3
France	5,5	5,2
USA	5,3	6,2
Italy	4,1	3,7

Note: The question related to the propensity of companies from leading exporting countries to pay bribes to senior public officials in the surveyed emerging market countries.

A score of 10,0 shows low propensity to pay bribes; score of zero indicates high propensity.

Information for the Transparency International Bribe payers index 2002 was gathered in 15 emerging market economies (including Poland) by Gallup International Association. The questions relate to the propensity of companies from 21 leading exporting countries to pay bribes to senior public officials in the surveyed countries.

Tables 2 and 3: Levels and sizes of bribes in general

Bribery in business sector	
Total sample	2002
	835
Public works/construction	1,3
Arms and defence	1,9
Oil and gas	2,7
Real estate/property	3,5
Telecoms	3,7
Power generation/transmission	3,7
Mining	4,0
Transportation/ storage	4,3
Pharmaceuticals/medical care	4,3
Heavy manufacturing	4,5
Banking and finance	4,7
Civilian aerospace	4,9
Forestry	5,1
IT	5,9
Fishery	5,9
Light manufacturing	5,9
Agriculture	5,9

Note: The scores are mean figures from all the responses on a 0 to 10 basis where 0 represents very high perceived levels of corruption, and 10 represents none

Bribery in business sector-by size of bribe	
Total sample	2002
	835
Public works/construction	46%
Arms and defence	38%
Oil and gas	21%
Banking and finance	15%
Real estate/property	11%
Pharmaceuticals/medical care	10%
Power generation/transmission	10%
Telecoms	9%
IT	6%
Forestry	5%
Mining	5%
Transportation/ storage	5%
Heavy manufacturing	4%
Agriculture	3%
Fishery	3%
Civilian aerospace	2%
Light manufacturing	1%

Note: The results reflect the percentage of respondents who mentioned the particular Sector

Annex 6: Samples of interview questions

Interviews

All the interviews were conducted in the form of discussion. Therefore it is not possible to provide exact questions asked from each respondent. Questions presented below should serve only as a rough guideline for establishing a general view of the direction the interviews took.

Personal interviews and sample questions

The interviews with Mr. Carsson and Mr. Svensson the 12th of May, 2003

<ul style="list-style-type: none"> ➤ When did you establish your company in Poland? ➤ What kind of investment incentives were taken into consideration while investing in Poland? ➤ Did the investment incentives change through the years? ➤ What kind of entry mode was chosen? ➤ Why did company chose this entry mode? ➤ What market strategies were used? ➤ How did the strategies changed through the years? ➤ How has the Polish market changed (consumers preferences, competition etc.)? ➤ Is Polish market attractive to invest in?
<ul style="list-style-type: none"> ➤ Did the company have any problems while establishing in Poland? ➤ Are there any administrative barriers? ➤ How have the administrative barriers changed? ➤ Are there any trade barriers? ➤ How have the trade barriers changed through the years? ➤ How did the company cope with these problems? ➤ Did the company used any “speeding up” tools while coping with barriers? ➤ Can foreign company influence administrative barriers in Poland?
<ul style="list-style-type: none"> ➤ What are factors of success for Polish market? ➤ What changes do you expect after Poland joins the EU?

Telephone interviews and sample questions

- Adrian Grycuk senior researcher at PAIZ, the 17th of April, 2003
 - Grazyna Czubek, coordinator of the Batory Foundation, the 16th of May, 2003
 - Jarek Polak, coordinator of The Prince of Wales International Business Leaders Forum in Poland, the 22nd of May, 2003
 - Alfred Gubczak, the spokesman of Shall in Poland, the 22nd of May, 2003
 - Rafal Szakalis, the representative of the European Commission Delegation in Poland, the 23rd of May, 2003
 - Beata Smarzyńska, the researcher at the World Bank, the 23rd of May, 2003
-
- Is Polish market attractive for investors?
 - How are investors influenced by the regulations?
 - Are there any trade barriers?
 - How have the trade barriers changed through the years?
 - Are there any administrative barriers?
 - Do these barriers influence foreign investors?
 - How do foreign investors cope with administrative barriers?
 - Can foreign investors influence administrative barriers?
 - What is corruption?
 - Who is engage in corruption activities?
 - In your opinion what is the reason for it?
 - Can foreign investors influence corruption in Poland?
 - What action and by whom taken can contribute to decrease of corruption in Poland?
 - What changes are expected after Poland’s joining the EU?