THE COST OF CORRUPTION

ATTRACTING MORE FOREIGN INVESTMENT TO SOUTHEAST EUROPE REQUIRES INSTITUTIONAL REFORM

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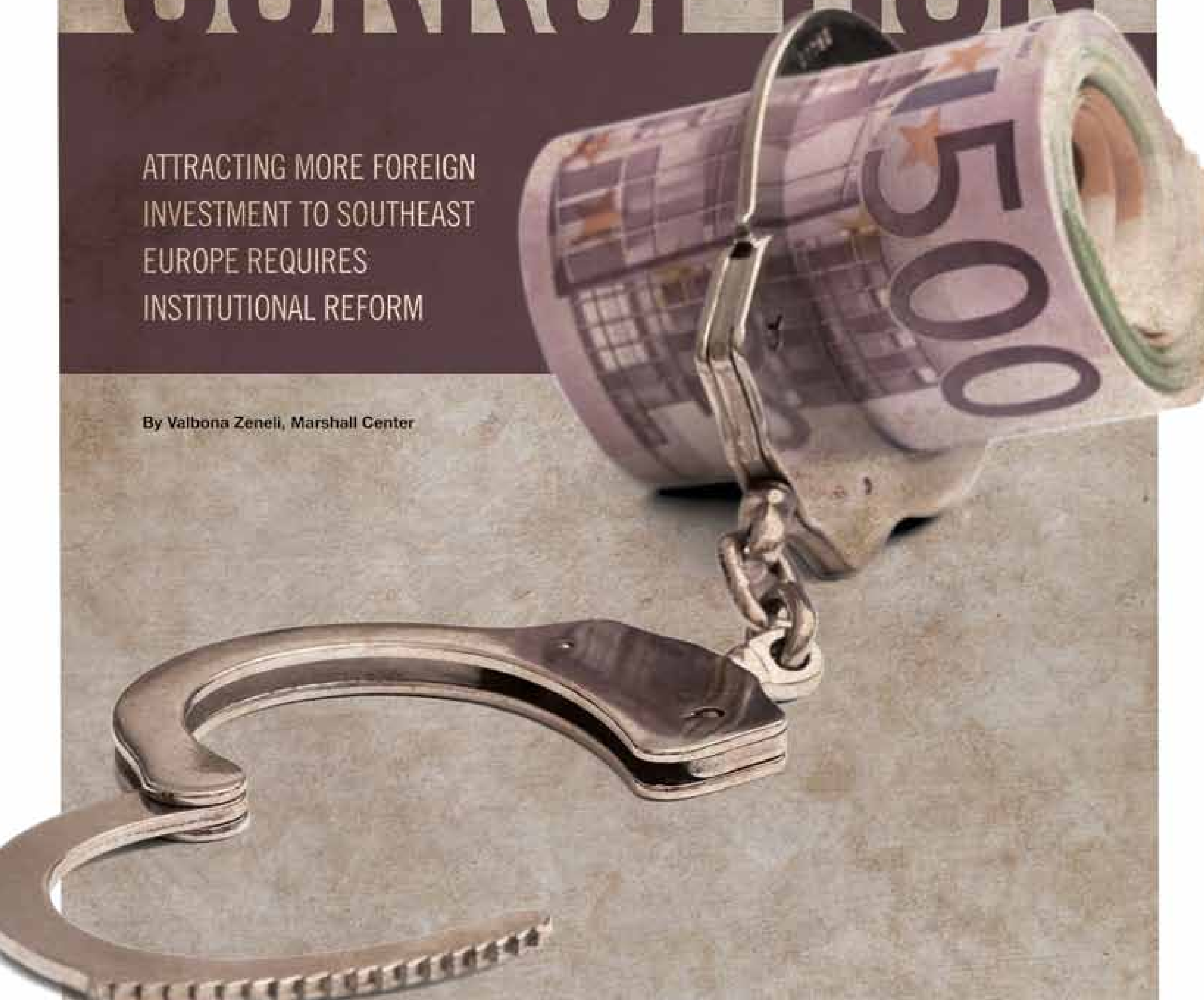

PER CONCORDIAM ILLUSTRATION

[Corruption[1] is one of the main diseases that have plagued Southeast Europe in the last 20 years. This phenomenon is perceived as an impediment to the development of these countries by: weakening the legitimacy and effectiveness of institutions, undermining economic growth, jeopardizing foreign direct investment (FDI), threatening democracy and undermining the well-being of the population.]

Research on the political and international economy has yielded important insights on the relationships between corruption, the quality of institutions, FDI and economic growth. Still, there are few systematic and comprehensive studies of corruption trends and consequences. For this purpose, an analytic study was conducted[2] using recent econometric methodologies[3] in Southeast Europe[4] to research and understand the relationship between FDI and the quality of institutions, since this issue has recently become a major item for the security of the region.

Corruption and organized crime have also been identified by the European Union as major problems in Southeast Europe and have been considered main obstacles to the very-much-aspired-to integration of these countries into the EU.

Corruption is a widespread phenomenon and governments will never be able to totally defeat it, but not all corruption is the same. The level of corruption and the consequences it brings to society are different.

Studies show that the entire Southeast European region has high levels of corruption, particularly "grand corruption." The practice is most devastating politically, undermining development, the market economy and democracy itself. It is like a cancer that destroys people, societies and future development. This common disease in the region is attributed to the existence of weak state institutions and strongly connected to the troubled history of these countries.

After the fall of the Iron Curtain in the 1990s, all the countries of Southeast Europe embraced open trade and investment regimes, but economic and social liberalization were not easy. It was a big shock[5] for countries such as Albania, Romania and Bulgaria, though the situation was a little different with the countries of the former Yugoslavia since they were more integrated with Western countries through trade.

Since the beginning of transition, the main objective of these countries seemed to be integration into the global economy, and according to Western liberal economists, this could be achieved only by large inflows of FDI.[6] The rapid growth in Central and Eastern Europe over the last years to a large extent has been accredited to the successful transition from centrally planned economies to market economies and also to the inflows of foreign investment into the region.

Since FDI was supposed to play a critical role in growth and development, governments in all the countries of Southeast Europe encouraged foreign investors to invest and take part in the privatization process, believing this would also be beneficial for faster integration[7] into the EU. During the last two decades, this was one of the main objectives for these transitioning countries.

FDI is an important indicator of global economic health and stability, and scholars and economists consider it to be a major catalyst for development, particularly in developing and transitioning economies. It's a strong channel for direct economic growth (increasing employment, exports, income), one of the main sources of private capital to replace outdated capital in scarce economies, a vehicle of modernization and technology diffusion, and a driving force for sustainable development.

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But history and econometric research have shown that this positive effect of FDI in the development of the host countries is very complex and does not lead automatically to development, but rather depends on certain policy conditions such as human resources,[8] development of the financial market,[9] level of openness to trade,[10] and, more importantly,[11] the quality of the institutions[12] and rule of law in host countries.

There are different theories[13] on the main determinants for the attraction of FDI. The volume and the distribution of foreign investment are influenced by location-specific attractiveness, political and economic stability, the property and profit tax system, market size and labor composition, geographic proximity and financial markets.

Today there is more evidence that the geographic distribution of FDI is strongly influenced by the host country's political and institutional quality, reflecting foreign investor confidence in the local investment environment. Some studies[14] even argue that efficient institutions contribute to economic growth more than trade or location. This is even more important for the countries of Southeast Europe since almost all of them have experienced instability during the transition process.

The region offers unique opportunities for investors in terms of size of markets, strategic position, proximity to Western Europe, natural resources, flexible and well-educated labor, and investment policies, to name a few. But annual FDI inflows remain low in the global context, although there has been a big increase since the 1990s.

Foreign investors did not see much attraction in Southeast European countries.[15] (The situation was totally different with the Eastern and Central European countries, which had high levels of FDI and sustainable economic growth.) Reasons varied, but included the political and economic instability of the region; underdevelopment of the economy in places where communism was especially harsh, such as Albania; transformational recession in Bulgaria; wars, political disintegration and ethnic conflicts in the former Yugoslavia; and high levels of corruption in most of these countries.

The unfinished transition process is not favorable to foreign investors because of the gap between formally adopted laws and the inability of the institutions to fully enforce them. Poor infrastructure, problems with property rights, administrative barriers, nontransparent privatization processes, weak results in fighting corruption and the thriving

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Far left: A woman strolls through an IKEA furniture store in Sofia, Bulgaria, one of many foreign companies lured to the Balkans after governments there promised to crack down on corruption that hindered economic development.

Left: Supporters of former Hungarian Prime Minister Ferenc Gyurcsány protest in Budapest in October 2011. Gyurcsány was charged with abuse of power, but supporters claim the accusation is politically motivated.

informal market continue to discourage foreign investors. At the same time, this also undermines the implementation of good development reforms.

The transition from communist regimes to market economies created unique opportunities for illicit profiteering and high levels of corruption. This was a moment of great opportunity, which improved economic flexibility and freedom of movement of goods, people and capital. Fast private gains are attractive when societies face the difficulties of transition, increasing incentives for corruption at all levels of the society. Financial wealth also becomes a symbol of social status.

Recurrent problems affecting corruption include the persistence of high-level corruption, poor fiscal leverage, a nonefficient judicial system, corruption in public administration related to low wages and economic control from the shadows.

Measuring this phenomenon is almost impossible because of the illicit nature of the activities, but the cost of corruption, according to different studies, exceeds by far the damage caused by any other single type of crime. The World Bank has calculated that more than $1 trillion is paid in bribes every year worldwide, and the damage and harm of this phenomena is even greater.

Statistical data[16] also indicate that foreign investments are distributed unevenly through the countries of Southeast Europe, and it is interesting to research the main factors contributing to this. Economic and political factors and the geographic position of these countries strongly influence corruption. The transitional period from centralized to market economy has created massive opportunities for the appropriation of rents. Lack of transparency in the privatization process and lack of legal instruments for control have created various illegal activities, such as smuggling, tax evasion, organized crime, financial fraud and a gray economy that resulted in enormous illicit gains for individuals in a short time.

Corruption negates growth and development in several ways by representing an additional cost to the economy, distorting market competition, generating monopolies and eliminating regular and transparent market mechanisms, leading to wrong decision making, poor allocation of resources, loss of legitimacy, less foreign investment or at least attraction of "nonqualitative" FDI.[17]

Ethnic conflict in the region distracted governments from the implementation of real economic reform. Old elites remained in power and their mentality, bad economic policy implementation and nonfunctioning "check and balance" systems resulted in fragile democratic institutions and weakness of the state to fight petty and political corruption seriously. Transition mostly takes place in a weak and highly politicized framework. For this reason, efficient and high quality institutional reforms are very important for these countries.

To verify the hypothesis that institutional quality and FDI strongly correlate with each other in Southeast Europe, an empirical analysis was conducted[18] using recent econometric methodologies[19] and data from the last two decades (1992-2009) for eight countries (Albania, Bulgaria, Romania, Croatia, Serbia, Montenegro, Macedonia, and Bosnia and Herzegovina). To measure the quality of institutions, European Bank for Reconstruction and Development indicators[20] were used in this analysis. The other potential explanatory determinants that we used include both traditional gravity factors, such as market size, GDP growth, human capital, natural resources and tariffs, but also other factors such as the presence of foreign banks and the agglomeration model.

The results confirmed a very strong positive and significant relationship between the quality and performance of institutions and the attraction and distribution of FDI in the region. (Croatia had the highest FDI per capita and Albania the lowest.) The same study also confirmed that the positive effects of foreign investment in the countries under consideration are stronger where the institutional framework is more efficient and less corrupt.

Another important point of our research was to check the relationship between the level of corruption (using Transparency International data) and the attraction of FDI. The analysis showed a significant negative relationship between the level of corruption in the host country and the attraction of foreign investments.

We can declare (even based on statistical studies) that there is a strong causal relationship between the quality of the institutions in the host country and the interest of important

Slovenian prosecutors prepare for a bribery trial in September 2011. A former prime minister and two former military officers were among those accused of giving preferential treatment to a company that landed a major defense deal.

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foreign businesses to invest in it. What seems difficult to understand, rather, is the direction of this relationship. Better institutions and enforcement of the rule of law may attract more FDI in transitional countries, but good institutions might result from the presence of serious multinational companies in these countries.

FDI can help by reducing corruption and generating sustainable development. Thus, a crucial task for the governments of Southeast Europe is developing their institutions and reducing corruption. The institutional environment must facilitate business and promote development. If state institutions are corrupt, EU law cannot be implemented and enforced, and development through foreign investment cannot be achieved.

Consistent political stability, strong enforcement, healthy monetary and fiscal policies, and strong anti-corruption reforms contribute to attracting "qualitative" foreign investments,[21] and also to their positive effects on growth and development. Countries that have implemented transition policies successfully have been granted relatively speedy membership into the EU, which has further accelerated FDI, generating still more growth and development. (Bulgaria and Romania are already EU countries and Croatia plans to join in 2013.)

Countries of Southeast Europe fulfill what is called "first nature geography"[22] with their strategic position and natural resources, but to be competitive in the global economy have to fulfill "second nature geography," the interaction between economic agents in a strong institutional environment. The countries of the region have to be careful in their policies and institutional reforms to provide good outcomes in the future. Creating a good business environment and high quality institutions is essential. Fighting corruption by all means is necessary. □

Euros fill a cash box at a store in Pristina, Kosovo. Balkan nations aim to eradicate corruption in the hopes of attracting investment from the eurozone.

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