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Foreign Direct Investments in Developing Nations:

Issues in Telecommunications and the Modernization of Poland

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I. Introduction and Summary

Globalization has produced a new model for economic modernization based on foreign direct investments (FDI). The United States and Germany in the 19th century and Japan and Korea in the 20th century all used versions of the "import substitution" approach to develop their industrial bases: In a process which often took generations, governments provided subsidies and other supports for critical young industries while protecting them from more advanced, foreign rivals until they were ready to compete. Under the new model of the last 30 years, China and other developing nations in Asia, many Latin American countries, and the transitional economies of Central and Eastern Europe have opened themselves to FDI transfers of advanced technologies, business methods and entire enterprises by the world's most advanced and competitive foreign corporations. These transfers from multinationals based in the United States, Western Europe and Japan may involve joint ventures with local companies in developing nations or the establishment of new foreign affiliates or subsidiaries. The result has been the most rapid modernization of the industrial and service bases of scores of nations, the fastest worldwide growth, productivity gains and incomes progress on record, and a new dependence on attracting these foreign transfers.

Advances in telecommunications are a hallmark of the most successful advanced economies, because they help create, knit together and integrate large national economies and provide critical infrastructure for the global networks of multinational companies.

The modernization process driven by FDI proceeds in many ways. The transfers involve not only advanced technologies and other equipment but also advanced management skills and operational knowledge, all of which can be emulated and reproduced by domestic companies. The FDI-based enterprises also stimulate the expansion of local firms or the creation of new domestic businesses to provide local goods and services for the new enterprises. Further, they create new import-export networks which local firms also use. And the incomes generated by all of these features of FDI-based modernization increase demand for other local goods and services, supporting jobs, incomes, government revenues and the broader expansion and modernization of the developing or transitional economy.

FDI in telecommunications plays a special role in this process. Advances in telecommunications are a hallmark of the most successful advanced economies, because they help create, knit together and integrate large national economies and provide critical infrastructure for the global networks of multinational companies. In these respects, the establishment of advanced telecommunications facilities in a developing or transitional economy is often a prerequisite for major FDI transfers in other areas. Since developing nations and transitional economies cannot on their own produce the advanced technologies and services required for modern telecommunications, they are particularly dependent on FDI in this area.

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Multinational companies in telecommunications and other sectors do not have unlimited resources for foreign direct investments, and so they pick and choose where to establish their new operations. Economists have studied these decisions and identified a series of criteria which largely determine where multinationals locate their FDI. Many of these criteria are traditional economic matters such as the size of the domestic market, its access to other neighboring markets, the skills, quality and wage costs of the domestic labor force, the quality and extent of the country's basic infrastructure, especially for export and import activities, the extent of tariffs or quotas, and local tax burdens.

Researchers also have identified a series of political factors which strongly influence where multinationals locate their FDI. The legal and regulatory requirements for establishing and operating a business can matter greatly, and the past two decades have seen widespread liberalization of these requirements by many nations. More generally, a country's political stability and the extent of corruption involved in government decisions affecting businesses are important issues for foreign direct investors. In that context, the reliability of the rule of law in a developing or transitional economy, and how strictly and reliably the government enforces contracts, protects property rights, and expedites the fair settlement of business disputes are often threshold issues for multinationals contemplating new FDI commitments.

Many nations have seen their flows of foreign direct investment slow sharply when they fail to maintain these political conditions. Turkey and India, countries which offer many economic conditions that should attract large-scale foreign direct investments nevertheless have relatively low levels of FDI. One of the main factors in this phenomenon is the inconsistent and non-transparent ways in which the Turkish and Indian governments often implement their laws and regulations, especially weak enforcement of contracts, as well as widespread corruption. Similarly, recent government expropriations and pervasive favoritism in government decisions affecting businesses have sharply limited FDI to Venezuela and Russia, especially outside the energy sector.

Poland, while not suffering from the systemic problems that sharply dampen FDI in those countries, still attracts less FDI as a share of GDP than the other transitional countries in the OECD, and therefore less FDI than justified by overall economic conditions. The impact of the nation's comparatively low levels of FDI is aggravated by insufficient domestic savings, which together produce levels of overall public and private investment which impede the pace of Polish modernization and growth. Nevertheless, FDI-based enterprises in Poland comprise much of the leading edge of the Polish economy, accounting for disproportionate shares of sales, fixed assets, jobs and productivity gains. In recent years, however, FDI flows in manufacturing have slowed.

Several factors help explain this slowdown. The poor state of the country's transportation infrastructure is often cited as one reason. Recent data suggest further that serious problems have arisen in the critical area of the country's telecommunications infrastructure. Poland's record in attracting FDI in advanced telecom was excellent in the 1990s. From 1990 to 2003, Poland ranked sixth among all of the world's developing nations in telecom FDI, starting with the major joint venture between Telekomunikacja Polska SA (TPSA) and the Danish Polish Telecommunications Group (DPTG) that built the fiber optic network that now stretches from the nation's Baltic northern border to the country's southern border. Yet, new inflows of telecom FDI have slowed sharply in recent years; and the quality and extent of Polish broadband service, a critical infrastructure for international business, now ranks among the lowest in Europe.

Our analysis finds that Poland's current difficulties in attracting FDI in telecom infrastructure largely reflect issues of governance, not economics. While the country boosts a sizable market and well-educated workforce, the World Bank ranks Poland next to last among the nine Central and Eastern European countries for the quality of its political institutions and the ease of doing business. Similarly, the OECD has found that stringent government regulation of new businesses and many of their economic decisions discourage FDI. The inefficiency of the Polish state bureaucracy also is often cited by international organizations, as is the accountability of its political institutions. Perhaps most critically, the World Bank notes a recent decline in Poland's reputation for providing a reliable rule of law, and the World Economic Forum recently ranked Poland near the bottom of OECD countries in terms of the clarity, efficiency and neutrality of its legal framework for firms to settle disputes. Beyond the overall flows of FDI as a share of GDP, these developments have produced a sharp slowdown in new FDI by American multinational companies and a comparatively small share of FDI to Poland in the telecom sector.

The World Economic Forum recently ranked Poland near the bottom of OECD countries in terms of the clarity, efficiency and neutrality of its legal framework for firms to settle disputes.

These issues has come together recently in the highly-publicized, decade-long legal dispute between TPSA and DPTG over payments owed to DPTG under the contract which built Poland's north-south fiber optic network in the early 1990s. The dispute has been marked by TPSA's repeated efforts to discredit the international arbitration tribunal set up to settle the dispute as set out in the two parties' original agreement. After a decade of consequent delays and wrangling, the arbitration panel found in favor of DPTG, a finding deemed final and binding under the original TPSA-DPTG contract. Now TPSA is trying to stop enforcement of the decision by asking the Polish courts to overrule it as contrary to Polish principles of public policy. TPSA also has asked Austrian courts and the Federal Economic Chamber to set aside the arbitrators' decision, again in contravention to its contract with DPTG. These steps by TPSA reinforce the impression cited by the OECD and the World Economic Forum of Poland's substandard reputation for maintaining an efficient and neutral framework to settle business disputes involving multinational foreign investors.

In nations such as India and Ecuador, in which the government is seen as complicit in legal disputes which effectively denied foreign investors' property rights, FDI inflows have slowed sharply. Until August 2010, when the arbitration panel found in favor of DPTG, the Polish government was a part-owner of TPSA; and this dispute may well have damaged Poland's reputation as an attractive location for FDI generally and telecom FDI in particular. Poland faces many challenges in restoring its reputation among foreign direct investors. One important step to restoring substantial inflows of FDI in advanced telecom, which play such a critical role in the overall modernization of transitional and developing economies, would be a public effort by the Polish government encouraging TSPA to respect the legal process set out in its original agreement with DPTG and bring this long dispute to a close.

II. The Role of Foreign Direct Investment in Developing Countries

Foreign Direct Investment (FDI) has become a central element in the modernization strategies of the world's most successful developing nations and transitional economies. In countries that can offer the right combination of domestic resources and stable institutions, these FDI transfers of advanced technologies, operational and managerial skills, international business experience, and often entire modern business organizations, have produced large benefits for their host economies. Such FDI can provide the basis not only for large and rapid gains in productivity and growth, but also the formation of new businesses and even new industries in the host country. As the developing economy matures, private domestic business investment will normally begin to exceed FDI.[2] With many variations, these dynamics have been crucial to the economic transition of Central and Eastern European (CEE) countries and former republics of the Soviet Union since the early 1990s,[3] often tied to the modernization and reform of newly-privatized state-owned industries.[4]

These transfers drive modernization in a variety of ways, both directly and through a range of indirect spill-over effects. For example, FDI transfers often proceed through joint ventures between a Western multinational company and a local company partner. The multinational provides new technologies, operational knowledge and management skills, and its network of international suppliers and customers; the local company usually can provide knowledge of the domestic market, a network of relationships with local workers, suppliers and customers, and sometimes a recognized domestic brand. Over time, skilled workers and executives from the local company acquire new operational and managerial knowledge and techniques, and sometimes use them to set up their own modern businesses. Local employees of such joint ventures or wholly foreign-owned companies also gain new skills and experience from working in a modern business enterprise, raising their productivity; and some will leave to work for other domestic companies, increasing the productivity of these companies. The technological,

[2]Guislain and Qiang (2006).
[3]Blonigen, Bruce (2005).
[4]Kalotay and Hunya (2000): cited in Boulhol and Kierzenkowski. (2010).

operational and managerial practices imported by the multinational investor also become examples that are sometimes adopted by other domestic firms.

The presence of new FDI-based enterprises may lead to the establishment of new domestic firms formed to provide local goods and services which the FDI-based enterprises require, and also to existing local firms upgrading their operations to provide them. One study of FDI in the 1980s, for example, found that each $10 of FDI led to $6 in additional domestic investment.[5] FDI also can help create new import and export networks, when some of the goods or services produced by foreign direct investments are exported to third countries over the trading networks of the multinational foreign direct investor, and when additional intermediate goods are imported into the host country to produce and assemble the finished good. In time, domestic companies typically take advantage of these new import and export networks. Finally, the incomes generated from all of these channels increase demand for other local goods and services, supporting the expansion and often the modernization of existing local businesses and the formation of new businesses. These various spill-over effects from FDI-based companies promote job creation, income growth, government revenues, and overall economic development in the host country. However, these effects don't take hold everywhere: A country's capacity to absorb or host the spillover benefits from FDI depends on economic conditions such as adequate infrastructure, a strong competitive environment, and a well-functioning financial system.[6]

Compared to portfolio investments which can enter and exit a host country quickly and easily depending on transitory financial market conditions, foreign direct investments are usually long term and can produce structural improvements in the host country. Therefore, while portfolio investments increase the vulnerability of a host country if they abruptly leave during times of economic uncertainty or difficulties, FDI usually remains stable during short-term economic disruptions.

Some countries are much more successful than others in attracting foreign direct investments. Overall, the advanced economies attract more FDI than developing countries. From 1990 to 2009, the share of FDI flowing to developing nations ranged from less than 20 percent in 1990 and again in 2000, to nearly 40 percent or more in 1994, 1997, 2004, and 2009. (Figure 1, below) In 2009, developing countries held about 30 percent of the total worldwide stock of FDI, nearly equal to their combined 29 percent share of worldwide GDP. There are also large differences in FDI flows across developing economies. In 2009, Asian developing countries held about 60 percent of the stock of FDI in all developing nations, led by China as the leading recipient of FDI to the developing world since 2000. In 2009, China held 10 percent of all developing world FDI stock and received 20 percent of all FDI flows to developing nations.[7]

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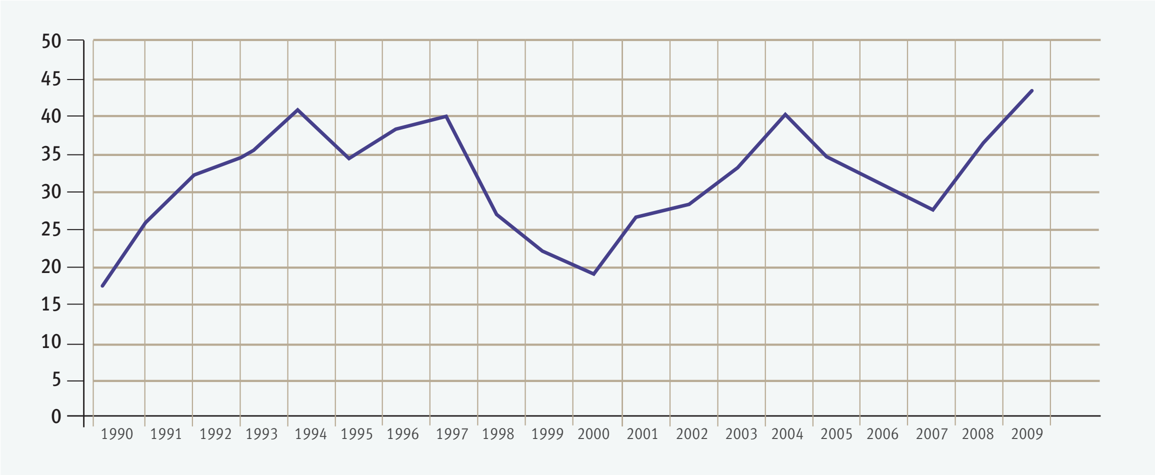
[5]Bosworth and Collins (1999): cited in Lydon and Williams (2005).
[6]World Bank (2008): Barrios and Strobl (2002): cited in Boulhol and Kierzenkowski. (2010).
[7]United Nations Conference on Trade and Development Statistics Online (2011).

Figure 1. Share of Annual FDI Flows to All Developing Nations[8]



Multinationals undertake major FDI in certain developing countries and not in others for a variety of reasons. In some cases, the investments arise from the traditional activities of exploiting the natural resources of a developing nation and then exporting them in some form. Multinationals' interest in expanding uranium and platinum mining in Mongolia or developing shale oil in Poland are current examples. In other cases, multinational manufacturers or retailers use FDI to directly serve foreign markets in fast-growing developing nations with expanding middle classes. In still other instances, multinationals undertake FDI in developing economies to take advantage of low-cost inputs, especially labor. Using large-scale FDI to shift part of a multinational's production chain to a developing market, usually the lower end of the production process, can help offset the advantages of rival domestic or foreign-based manufacturers producing within the developing country. The goods (and sometimes services) produced in this process may be shipped back home, but more commonly they are sold into the developing market or exported to third countries.[9]

Many other considerations affect FDI decisions. Macroeconomic factors are always important. The size and growth rate of a domestic or regional market for the goods or services produced in FDI-based operations are often crucial. Developing countries with high and sustained growth rates, especially large economies such as China and Brazil, attract disproportionate FDI as Western companies establish operations there to tap these fast-expanding markets. Large, fast-growing economies also may offer economies of scale that reduce a company's costs.[10] And the various costs of doing business in the host country are always important, including tax rates, the availability and price of skilled and unskilled labor, and the state of a country's energy network.[11] The quality and extent of a country's transportation and telecommunications

[8]*Ibid.*
[9]Creating a global network of FDI-based operations also enables a multinational to diversify its operations and risks in ways that reduce its exposure to regional economic downturns.
[10]Mottaleb and Kalirajan (2010).
[11]Kinda (2010).

infrastructure are almost always important as well. Decent telecommunications infrastructure in particular can contain the costs of connecting FDI-based firms with their worldwide suppliers and customers, expanding the size of the market accessible to the company.[12]

Trading costs such as tariffs or quotas on the equipment brought in through FDI also play a role, as do unusually high or low transportation costs for the products produced through FDI and bound for export.[13] High costs to export finished goods to third-country markets may induce some multinationals to shift from a production-for-export strategy to production-for-domestic consumption in the host-country market. In short, openness to trade is an important consideration in decisions about where to locate FDI; and one study found that from 1970 to 1993, one of the most important determinants of manufacturing FDI to developing countries was their "export orientation."[14] Other studies come to broader conclusions. One review of FDI from the United States, Germany, France and the Netherlands to 129 developing countries from 1995 to 2008, for example, identified as key factors a country's market size and growth, the quality of its political institutions, cultural similarities and tax burdens, as well as openness to trade.[15] However, another study of FDI to four large developing markets – Brazil, Russia, India and China, or the "BRIC's" – emphasized the importance of labor costs and the quality of the transportation and telecommunications infrastructure, as well as market size.[16]

A range of other factors often grouped as a country's "business and investment environment" also play a significant role in FDI. For example, countries where it takes relatively little time and expense to start a new business attract more FDI, relative to GDP, than places where forming a new businesses is more protracted and burdensome.[17] Similarly, the regulatory and bureaucratic barriers to operating a new enterprise also affect FDI-location decisions.[18] The business environment also includes the presence of a domestic banking system that can provide modern banking services and a network of financial market relationships.[19]

III. The Impact of Political Arrangements and Behavior on Foreign Direct Investment

While many studies of FDI focus on the range of economic factors noted above,[20] political factors also weigh heavily on these decisions, including a country's general political stability, the soundness of its economic policies and currency, government's respect for the rule of law and the strength of its contract enforcement, the security of patent and other property rights, and the

[12]Some countries, including Japan and Korea, link their foreign aid to a developing country's public investments in infrastructure; and in what is sometimes called a "vanguard effect," this linkage encourages FDI by Japanese and Korean companies to the same country. Kimura and Todo (2010).

[13]Kinda (2010).

[14]Singh and Jun (1995).

[15]Antonakakis and Tondl (2010)

[16]Vijayakumer et. al; (2010).

[17]Mottaleb and Kalirajan (2010).

[18]Mottaleb and Kalirajan (2010).

[19]Kinda (2010). These financial intermediaries can also be sources of valuable information about local conditions, potential business partners, and new opportunities and risks.

[20]See Vijayakumar et al (2010) for determinants of FDI to Brazil, Russia, India, China, and South Africa; Singh and Jun (1995) for political risk, business conditions, macroeconomic variables; Mottaleb and Kalirajan (2010) for business environment; Kinda (2010) for physical and financial infrastructure; Kimura and Todo (2010) for foreign aid.

levels of corruption.[21] Issues of political risk, the rule of law, contract enforcement and institutional stability are especially important for decisions to invest in developing and transitional economies, which often fall short in these areas. A recent survey of executives from multinational enterprises that invest in developing countries found that political risk was the most important constraint on FDI in those countries, followed by weak government institutions.[22]

Political risk includes breaches of contract by a government, adverse regulatory changes, restrictions on currency transfers and convertibility, expropriations, political violence and terrorism, and failures to honor sovereign guarantees, including sovereign debt defaults. Countries such as Venezuela or Ecuador that take steps extremely hostile to multinational investors, such as the expropriation of foreign-owned businesses, naturally suffer very sharp declines in FDI. However, the survey found that the risks that cause most concern are government interventions which threaten the viability of the investments, including breaches of contract and regulatory changes. Among telecommunications and utility companies investing in developing markets, two-thirds were particularly uneasy about regulatory changes and failures to honor sovereign guarantees, and nearly half expressed concerns about breaches of contracts.

Issues of political risk, the rule of law, contract enforcement and institutional stability are especially important for decisions to invest in developing and transitional economies, which often fall short in these areas.

Turkey is an instructive example of how important the rule of law and reliable political institutions are in attracting FDI to developing and transitional economies. Despite Turkey's economic potential and liberal laws for FDI, the country has long lagged behind other emerging markets in attracting such investments. A principal reason appears to be the government's inconsistent and nontransparent implementation of laws and regulations and its weak enforcement of contracts.[23] This is consistent with findings by the World Bank that political arrangements and factors have the largest impact on FDI decisions and flows, both directly and indirectly through their effects on the economy.[24]

Many Latin American countries also provide examples of how weak political institutions and uncontrolled executive power adversely affect FDI inflows. Countries with authoritarian, populist leaders including Argentina, Bolivia, Ecuador and Venezuela all experienced sharp declines in FDI over the years 2003 to 2007, compared to 1998 to 2002.[25] (Table 1, below) Argentina, which defaulted on its sovereign debt in 2001 and repudiated part of its debts to foreign lenders in 2005, suffered a 53 percent decline in annual average FDI from the first period to the second one. The percentage declines in average annual FDI inflows were 89 percent for Bolivia, 64 percent for Venezuela, and 39 percent for Ecuador.

[21]Kinda (2010).
[22]Multilateral Investment Guarantee Agency (2010).
[23]Dumludag (2010).
[24]World Bank (2010).
[25]Noriega (2009).

Table 1. Annual Average FDI inflows to Selected Latin American Countries (US $)[26]

Country	1998-2002	2003-2007	Percent Change
Argentina	$9,202,000,000	$4,360,000,000	– 52.6%
Bolivia	$814,000,000	$86,000,000	– 89.4%
Ecuador	$870,000,000	$530,000,000	– 39.1%
Venezuela	$3,408,000,000	$1,234,000,000	– 63.8%

Democratic political institutions generally reduce such political risks, which in turn may lead to increased FDI inflows. One researcher used the price data for political risk insurance and found that democratic political institutions reduce the premiums that multinationals pay for coverage against government expropriations and contract disputes.[27] This effect reflects the constraints which democratic institutions normally impose on executives who might be tempted to nationalize foreign assets and void contracts with foreign companies. Other analysts note that some countries with little semblance of any strict rule of law still receive FDI, but this exception is almost always limited to a country's initial stage of economic development and generally involves inflows of easily-duplicable technologies and know-how.[28] Under these conditions, foreign companies usually can claim a larger share of the revenues from their domestic partners to compensate them for potential losses – for example, if the former partner becomes a rival earlier than their contract contemplated.[29]

Many breaches of contract and governmental guarantees with multinationals in developing countries involve the intellectual property (IP) rights of the technologies and other products introduced through the multinationals' FDI. Some developing countries such as India and Brazil have argued that strong IP protections and enforcement disadvantage their economies, and regularly call for revisions in the IP rights now protected under the World Intellectual Property Organization (WIPO) and the World Trade Organization (WTO). Despite these claims, a long line of research has established that strong IP rights are important factors attracting FDI to developing nations and spurring their pace of modernization.[30]

[26]Noriega (2009).
[27]Jensen (2008).
[28]Tao and Wang (1998).
[29]Large FDI inflows also can contribute to improvements in a country's rule of law and institutional stability, which then benefits domestic companies as well as the foreign multinationals. One recent study found that FDI inflows are associated with lower costs to enforce contracts, especially when the host country carries significant foreign debt and so is highly exposed to international capital markets. Pressures from multinationals and local companies who depend on those multinationals can induce host governments to respect and enforce contracts more strictly. Ahlquist and Prakash (2010).
[30]Markusen, James R. (2001). For a review of this literature, see Shapiro and Hassett (2005).

IV. The Role of Telecom Industry Foreign Direct Investment in Modernization

Foreign direct investments on any significant scale in telecommunications are recent: They did not begin until the early- to mid-1980s, when the United States broke up the AT&T telecom monopoly and other nations such as the United Kingdom and Japan privatized their state-owned or private monopoly telecom companies. In 1988, Chile became the first developing nation to privatize its telecom system, and several multinationals quickly set up operations in the new market.[31] In 1990, FDI accounted for just 10 percent of total telecom investments in developing nations, mainly from former colonial arrangements. Since 1990, however, more than 80 developing countries have privatized their telecom incumbents, and foreign investors have paid out $57 billion to governments undertaking telecom privatization and another $137 billion to local private businesses involved in these privatizations.

A second wave of telecom FDI began in the mid-1990s with the development of low-cost mobile telephony technologies. This shift accelerated FDI transfers in telecom, involving both advanced and developing countries as hosts, because cellular networks quickly proved to be more cost-effective and less disruptive than landline systems since they involve less construction.[32] More than half of all FDI telecom projects from 1990 to 2003 involved mobile technologies; and by 2002 and 2003, mobile technology and facilities accounted for 95 percent of new projects.[33]

By 2003, 460 FDI-based telecom infrastructure projects had been initiated in 122 countries, involving investments of nearly $200 billion.[34] These investments represented 11.5 percent of all FDI flows to developing nations in this period, and 30 percent of all telecom investment in developing and transitional economies. Moreover, China did not permit FDI in telecom in this period. Excluding China from these calculations, telecom investments in 2003 accounted for 16 percent of all FDI to developing nations.[35] Average annual FDI flows in telecom began to decline in 2001 as the surge of privatization in Eastern and Central Europe subsided. Nevertheless, in 2004, half of all developing nations still maintained monopolies on at least their international telephone services, leaving room for hundreds of additional projects.[36]

Telecom FDI plays a particularly critical role in the modernization of developing and transitional economies. Advanced telecommunications encompassing fiber optics, satellite and other Internet and cellular telephony transmission routes, provide much of the basic infrastructure of the global economy. Not only are these facilities and operations the chief channel for trade in modern services; they are the means by which all large companies now integrate their domestic

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[31]Quiang and Guislan (2003).
[32]UN (2004): cited in Boulhol and Kierzenkowski. (2010).
[33]Quiang and Guislan (2003).
[34]Quiang and Guislan (2003).
[35]*Ibid.*
[36]ITU Regulatory and Competition Database (2005) cited in Guislain and Qiang (2006).

and international activities. Virtually every business of significant size depends on diverse suppliers from many countries, even large firms with entirely domestic customer bases; and modern telecommunications networks are the only efficient means to coordinate these activities. At the level of the national economy, telecom infrastructure expands market access and intensifies competition, which in turn tends to increase business investment, enhance efficiency, and stimulate innovation – all essential hallmarks of successful companies and a modern national economy.

Strong telecom foreign direct investments, especially when accompanied by market reforms that introduce competition in telecom... require a reliable legal and political environment.

Modern telecom infrastructure in developing countries, largely provided through FDI, is also an important factor in the FDI decisions by multinationals in other industries. The OECD has noted that telecom infrastructure is one of the key determinants of investment location decisions, especially for foreign investors;[37] and researchers have found that developing countries with more phone and other communication lines than predicted based on their GDP receive relatively more FDI.[38] The basic reason lies in the global networks of the multinational companies responsible for FDI. The new developing-nation affiliates or subsidiaries of a multinational investor become part of that multinational company's global network, and their efficiency depends upon the global supply chain of goods and services maintained by the parent company largely through advanced telecom facilities. As a result, robust investment in telecom infrastructure also facilitates trade in other products and services.[39] FDI in telecom infrastructure, then, helps enable FDI in other areas, which in turn enables the modernization process in developing and transitional economies.[40] That is why, as documented by many studies, there are strong links between telecom investments and overall economic growth in developing and transitional economies.[41]

Strong telecom foreign direct investments, especially when accompanied by market reforms that introduce competition in telecom, have been shown to drive the build-out of national telecom networks, enhance their quality, and drive down their costs. These developments require a reliable legal and political environment. For example, studies show that the reliability of a developing nation's legal and regulatory systems affects the value of telecom companies located there: Foreign investors will pay premiums for telecom companies in developing nations with such arrangements, providing greater capital for investment.[42] Researchers also have found that regulatory risk is a key determinant of telecom FDI.[43] The national strategies developed to attract advanced FDI by countries such as Korea, Malaysia and Ireland all include regulatory reforms designed to attract advanced FDI in telecom, along with large-scale public investments and incentives for private investment in telecom infrastructure.[44]

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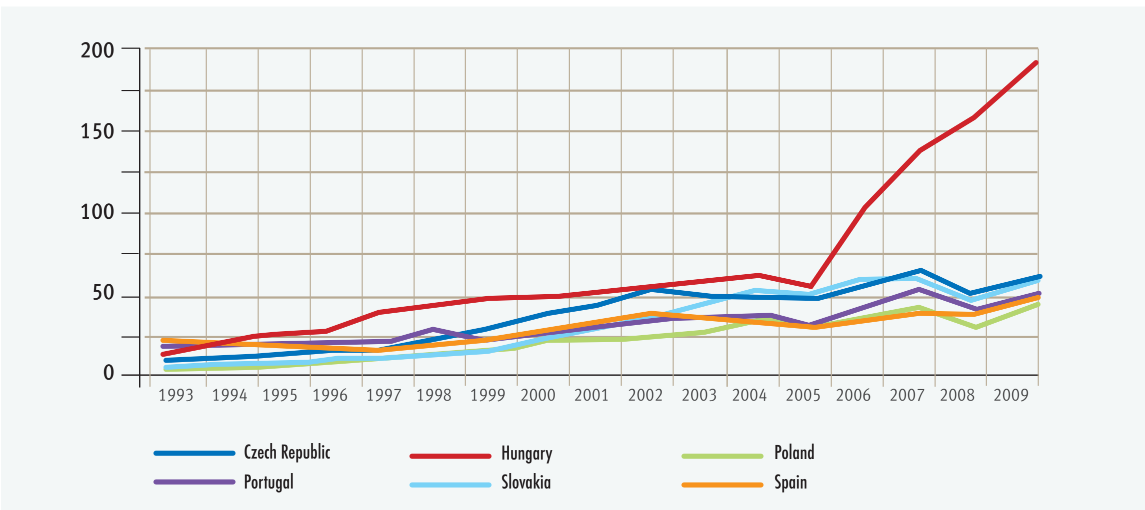
[37] OECD (2009c): cited in Boulhol and Kierzenkowski. (2010).
[38] Reynolds, et. al. (2004).
[39] Lin (2008).
[40] Berllak et. al (2010); Campos and Kinoshita (2008): cited in Antonakakis and Tondl (2010).
[41] For example, see Canning (1997 a,b); Easterly and Levine (1997), and Roller and Waverman (2001) in Reynolds, et. al. (2004).
[42] Kilpatrick, Parker and Zhang (2004): cited in Guislain and Qiang (2006).
[43] Ure (2004): cited in Guislain and Qiang (2006).
[44] Reynolds et. al. (2004).

V. The Role of FDI in Poland's Economic Development

Poland has had a persistent problem with insufficient domestic saving to finance the public and private investments required to modernize its production base, create adequate infrastructure and lay the foundations for strong growth. Poland's total investment rate has consistently lagged other transitional economies, including Hungary, the Czech Republic and the Slovak Republic, as well as the more successful Asian developing countries.[45] As a result, Polish economic modernization requires large flows of foreign direct investments. Yet, among six Central and Eastern European transitional economies in the OECD, Poland has consistently drawn the least FDI as a share of GDP. (Figure 2, below) In 2009, Poland's stock of FDI was equal to 42 percent of its GDP, barely half of the average of 81 percent of GDP for the other transitional economies. Setting aside Hungary, which has attracted extraordinarily high levels of FDI since 2005, the stock of FDI in the four other nations averaged 53 percent of GDP in 2009, or 26 percent greater than Poland.

Figure 2. FDI Stock as a Share of GDP, Six OECD Economies, 1993-2009[46]



Poland's FDI stock as a share of its economy also lags behind Portugal and Spain, two other European economies undergoing rapid modernization. (Figure 2, above) Poland's accession to the European Union (EU) increased inward flows of FDI, which rose from an average of $6 billion per-year over 2000-2003 to $16 billion per-year in 2004-2008. Nevertheless, Poland's FDI also lags compared to most of the other new EU members: In 2009, Poland's stock of FDI as a share of GDP ranked ninth out of the ten, and its FDI per-capita ranked eighth.

[45]Boulhol and Kierzenkowski. (2010).
[46]United Nations Conference on Trade and Development Statistics Online (2011).

Although Poland's store of FDI is relatively small as a share of the economy, its FDI-based enterprises play a prominent role in the economy. In 2007, 18,000 foreign-owned companies in Poland accounted for 27 percent of manufacturing jobs, 11 percent of all employment, 26 percent of all fixed assets, and 40 percent of all sales.[47] The average labor productivity of these foreign-owned companies was 80 percent higher than the average for domestic firms, and their capital productivity was 40 percent higher.[48] As a result, the average monthly gross salary of workers in FDI-based manufacturing concerns in Poland was 55 percent higher than their domestic counterparts.[49] FDI-based businesses in Poland also accounted for two-thirds of the country's total exports in 2007, up from 50 percent in 2000.[50]

However, recent FDI into Poland suggests new problems with the composition as well as the quantity of these investments. Manufacturing's share of FDI flows into Poland fell from 45 percent in the mid-1990s to 26 percent in 2006. Moreover, much of the newer FDI in manufacturing has been concentrated in lower-technology areas, with only an estimated 3 percent of recent FDI flows involving high-tech manufacturing.[51] Instead, 60 percent of recent FDI into Poland has involved services, compared to 50 percent into the Czech Republic and 40 percent into the Slovak Republic.

One factor in the relatively low levels of both foreign direct investment and domestic investment in Poland is the state of the country's infrastructure. Modern infrastructure tends to raise overall investment by generating both significant economies of scale and positive externalities or spillovers which encourage business investment. While Poland's transportation infrastructure is widely criticized as inadequate – the World Bank recently ranked Poland last among nine Central and Eastern European countries for the quality of this public infrastructure – transportation infrastructure in almost all countries is mainly the province of governments and therefore involves relatively little FDI.[52] Therefore, we focus here on the country's telecommunications infrastructure. Telecommunications has become the node where all forms of investment – private and public, foreign and domestic – intersect and interact. And as numerous studies have shown, countries with such advanced arrangements attract more FDI.[53]

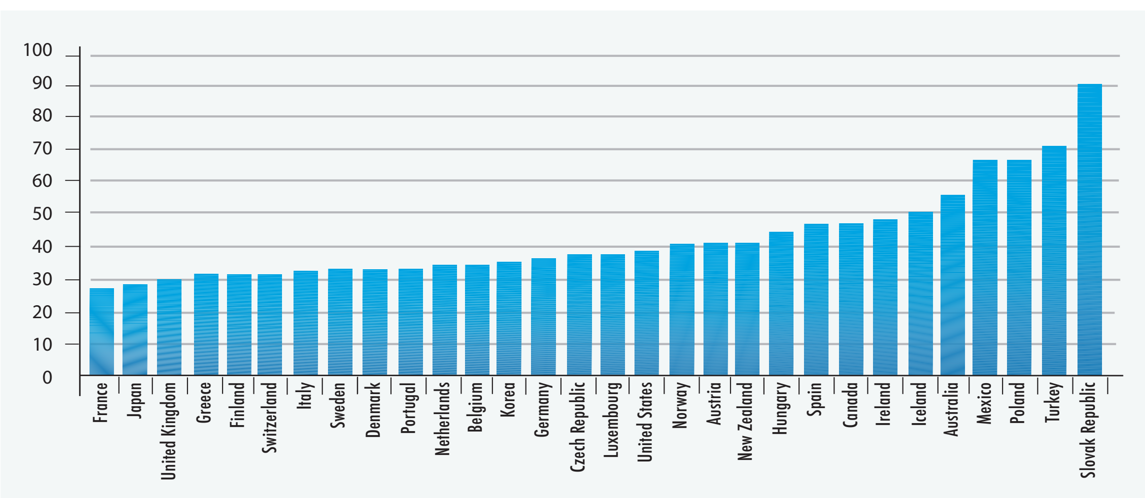
The telecommunication services in most countries were state-owned or heavily-regulated private monopolies until the mid-1980s, when advances in information technologies eroded the economic rationale for a single provider. As a result, most developed nations privatized these enterprises.[54] Among developing countries, the privatization of these services provided the

[47]Boulhol and Kierzenkowski. (2010).
[48]Zimny (2010).
[49]Zimny (2010).
[50]Zimny (2010).
[51]Boulhol and Kierzenkowski. (2010).
[52]World Bank (2010).
[53]Reynolds et al (2004); Lydon and Williams (2005).
[54]Guislain and Qiang (2006).

opportunity to both increase inward FDI flows and gain access to advanced technologies and business methods in an area that would enable the modernization process in many other sectors, especially when this privatization was accompanied by broad regulatory and tax liberalization.[55]

In the early-1990s, Poland was a leader among the new Central and Eastern European countries in accessing FDI in telecommunications, starting with the major joint venture between Telekomunikacja Polska (TPSA) and the Danish Polish Telecommunications Group (DPTG) to construct the fiber-optic system network that now reaches from the nation's northern border on the Baltic to the southern border. From 1990 to 2003, Poland ranked sixth among all developing countries in telecom FDI flows, receiving some $8 billion, mostly for 10 major projects. In recent years, however, these inflows of FDI in telecom have slowed, and Poland now is commonly seen as falling behind. In a recent study of Poland's investment climate, 30 percent of companies called the country's telecommunication infrastructure "bad" or "very bad."[56] One reason is that Poland lags in broadband, the most critical telecom infrastructure for global business. In January 2010, broadband penetration reached 13.5 percent of households and businesses in Poland, compared to an average of 24.8 percent for Europe. Polish broadband service also is comparatively slow, with 66 percent of the country's broadband users falling between 144 Kbps and 2 Mbps, compared to 15.4 percent of all European users.[57] The inefficiency of Polish broadband service is also evident in pricing: In 2008, monthly service for a medium speed connection averaged $67 in Poland, nearly 60 percent higher than the European average of $42. (Figure 3 below)

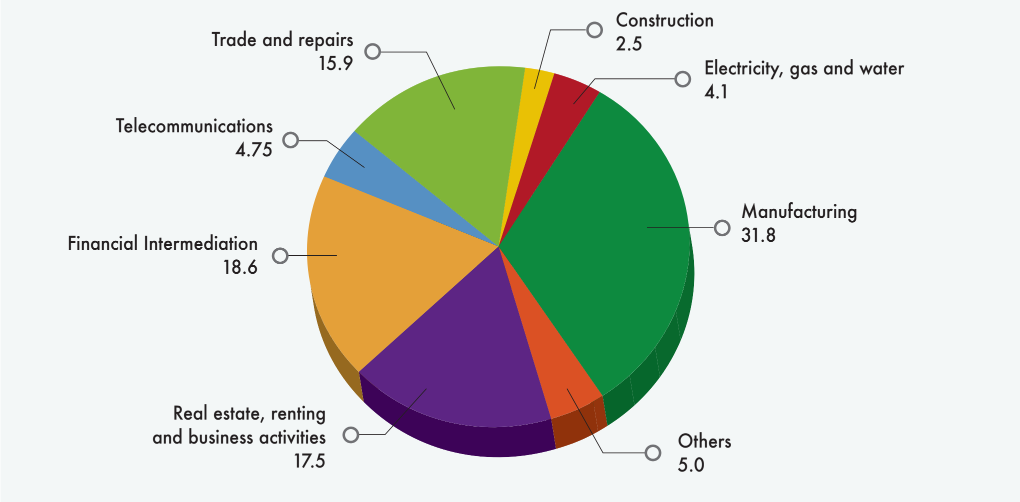
Figure 3. **Average Monthly Subscription Fee for Medium-Speed Broadband, 2008, US Dollars, Purchasing Power Parity (PPP)**



[55]Reynolds et al (2004).
[56]PAIiIZ (2008).
[57]European Commission (2010).

In accessing advanced telecom infrastructure, developing nations rely on foreign direct investments from industry leaders in the advanced economies. Yet, the telecommunications sector's share of the Polish stock of FDI is now less than 5 percent.(Figure 4 below)

Figure 4. Poland's FDI Stock by Industry, as Shares of Total FDI Stock, 2009



The question is why FDI in telecommunications into Poland has been relatively weak. Earlier, we reviewed the factors that tend to encourage or attract FDI to developing countries. The liberalization of the Polish economy over the last two decades has demonstrably improved the economy's resource allocation and created new economies of scale. In addition, the Polish workforce is well-educated and relatively inexpensive, and the culture encourages entrepreneurship. Nevertheless, the data show that Poland is not meeting its potential for FDI, both generally and in telecommunications in particular.

Much of the answer appears to lie with Polish governance. The World Bank which ranks Poland last among nine Central and Eastern European countries for its public infrastructure also ranks the country next to last for the quality of political institutions and the ease of doing business there, and below average for the quality of markets, access to technology, and corruption.[58] The brightest spot is the quality of Polish education, which ranks third among the nine behind the Czech Republic and Estonia. The OECD also gives Poland low marks for certain political and governmental factors which affect multinational companies' willingness to invest there.

[58]World Bank (2010).

The OECD reports that companies considering direct investments in Poland face stringent government regulation over many economic decisions, heavy burdens in starting a new business, and intense government involvement in, once again, the infrastructure sector.

As noted earlier, numerous studies have found that a country's political arrangements and the rule of law are often the most critical criteria in attracting FDI to developing and transitional economies. The World Economic Forum and the OECD both noted recently the inefficiency of the Polish bureaucracy, despite (or because of) an expansion of public payrolls from 160,000 employees in 1990 to 450,000 in 2010.[59] The World Bank agrees, citing Poland among all of the Central and Eastern European countries for failing to improve government efficiency from 1996 to 2009.[60] Inefficiency is not the only impediment to greater FDI. The "Management Index" issued by Bertlesmann Stiftung found recently that among Slovakia, Hungary, the Czech Republic and Poland, Poland ranks last for institutional accountability and the effectiveness of reform.[61] A recent survey by the American Chamber of Commerce in Poland and KPMG suggests how these matters may affect foreign direct investment: Among U.S. companies that have established operations in Poland, 59 percent undertook those commitments before the end of the Polish People's Republic in 1989 or from that year to 1995, another 17 percent from 1996 to 2000, 21 percent from 2001 to 2005, and only 3 percent from 2006 to 2010.[62]

Perhaps most important for attracting FDI in telecommunications and FDI more generally, the World Bank reports that Poland has declined in recent years in providing a reliable rule of law.[63] In a similar vein, the OECD has recently criticized Poland's tax system for a lack of consistency and transparency. Further, the World Economic Forum ranks Poland near the bottom of all OECD countries in terms of the clarity, efficiency and neutrality of the legal framework for settling disputes between firms.[64] Accordingly, the U.S. State Department has noted that U.S. firms are reluctant to rely on Poland's courts and typically include third-country dispute arbitration and resolution clauses in their contracts with Polish firms. However, Polish firms on occasion appeal to Polish courts to stop the enforcement of such arbitration decisions, which undermines the efforts of foreign direct investors to establish a more reliable means to settle disputes. Nearly alone among all European nations, Poland also has refused to be a party to the Washington Convention for the Settlement of Investment Disputes between States and Nationals of Other States. These conditions undermine what a long line of research has

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[59] Cited in Kowalewski and Rybinski (2011).
[60] *Ibid.*
[61] *Ibid.*
[62] Kuskowski, Sadowski, and Mariusz Strojny (2011).
[63] Kowalewski and Rybinski (2011).
[64] Schwab (2010).

identified as a principal requirement for attracting FDI in telecommunications, the consistent and reliable application of regulation and law, and the fair enforcement of contracts.[65]

VI. The Case of Telekomunikacja Polska and Danish Polish Telecommunications Group

These issues come together in the well-known, on-going legal dispute between Telekomunikacja Polska S.A. (TPSA) and the Danish Polish Telecommunications Group (DPTG). This dispute, which has involved a decade of dogged delays by TPSA, already may have discouraged FDI into Poland in the telecom sector. It is even more likely that if TPSA continues to use the Polish courts to avoid paying a judgment reached by independent international arbitrators in accordance with the contract between TPSA and DPTG, it will adversely affect Poland's attractiveness for future FDI in telecommunications on a significant scale. That outcome could impair Poland's prospects for further, rapid modernization.

The case grew out of one of the earliest and most successful instances of telecom FDI for Poland. In 1991, the General Directorate of Posts and Telecommunications of the Republic of Poland, which would become Telekomunikacja Polska S.A., formed a joint venture with DPTG to construct Poland's principal fiber optic network. The network stretched from the northern coast on the Baltic to the country's southern border. DPTG provided some DKK 127 million (U.S. $20 million) to fund the cable and all equipment, while TPSA provided an estimated DKK 110 million (U.S. $18 million) in labor, real estate and other resources. Under the agreement, DPTG was to receive a little under 15 percent of the network's net revenues for 15 years – the gross revenues, less the costs of operations, maintenance, tax and depreciation – while TPSA would retain a little over 85 percent of net revenues. The original agreement also stipulated that any disputes between the two parties would be settled by arbitration, and the award of the arbitration would be "final and binding."

In 1999, TPSA claimed that "errors in reporting" had resulted in overpayments to DPTG in previous years, so TPSA began to deduct the alleged overpayments from future payments, which it said would produce a "fair return" for DPTG. The two partners could not agree on the terms for past or future payments, so DPTG called for arbitration in June 2001. The arbitration, as stipulated under the terms of the original contract, was conducted in accordance with the rules of the United Nations Commission on International Trade Law. Under these rules and the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards, the two parties agreed to abide by the outcome, which also would be enforceable in the Polish courts. A three-person arbitration tribunal was appointed in Austria, the tribunal appointed an expert to evaluate both sides' claims, and each side named its own expert.

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[65]Guislain and Qiang (2006).

Five years into the process, as the case moved toward resolution, TPSA initiated what appeared to most observers as a concerted effort to discredit the arbitration tribunal and delay its final finding. In April 2006, TPSA challenged two of the three arbitrators for bias and then challenged the chairman on grounds that the other two arbitrators had appointed him. These claims were rejected by the President of the Federal Economic Chamber in August 2006; and three months later, the Economic Chamber also rejected TPSA's claims. One year later, in November 2007, TPSA challenged the chairman for bias again; and in February 2008, the two sides agreed that a new chairman would take over in March 2008. TPSA then called for the removal of the Tribunal's expert, which the Tribunal rejected. The slowdown in telecom FDI to Poland from 2006 onward coincided with TPSA's repeated efforts to discredit and extend the arbitration process, consistent with the report of the World Economic Forum that Poland ranks near the bottom of OECD members for the clarity, efficiency and neutrality of the legal framework for firms to settle their disputes.[66] The impact of these developments on potential investors was almost certainly aggravated by the Polish government's ownership stake in TPSA throughout this period.

Numerous studies and surveys have found that contract enforcement, respect for the rule of law and the security of property rights are important factors in FDI to developing and transitional economies, all implicated in TPSA's decade-long approach to its dispute with DPTG.

The Polish government divested itself of the final 4.15 percent stake in TPSA in August 2010, when the arbitration tribunal announced its holding. TPSA was held liable for $567 million (April 2011 exchange rates) in underpayments to its foreign partner DPTG for the period of 1994 to 2004. The award for underpayments covering 2005 to 2009, the final years of the 15-year agreement, is still under consideration.

Despite TPSA's contractual commitment to respect the findings of arbitration, it has refused to pay the award, claiming it "violates the principles of public policy in Poland." In September 2010, TPSA moved to stop enforcement of the binding award by asserting that Polish "principles of public policy" should supersede its agreement to respect the findings of the Tribunal under Austrian law. TPSA also has appealed to the Austrian courts to set aside the award and, yet again, asked the President of the Federal Economic Chamber to find the three arbitrators as a group and the chairman separately guilty of bias. The Chairman of the Federal Economic Chamber has dismissed two of the three claims of bias and the third is under consideration. After more than a decade, then, the dispute still remains unsettled.

While TPSA's appeal of the arbitration decision is not allowed under its original contract, it is permitted under Polish law; and there is no objective way to measure the precise impact of this case on other foreign investors. However, as noted earlier, numerous studies and surveys have found that contract enforcement, respect for the rule of law and the security of property rights

[66]Schwab (2010).

are important factors in FDI to developing and transitional economies, all implicated in TPSA's decade-long approach to its dispute with DPTG.[67] It also may be a factor in the World Bank's recent finding that foreign investors' view the rule of law in Poland has deteriorated.[68]

For years, foreign direct investors in Poland have complained about the use of interminable legal proceedings in Polish courts to delay payments from their partners, suppliers and clients. To be sure, Poland is not alone. Foreign direct investment fell 31 percent in India last year, and press accounts there note that problems in telecom have played an important role. A widely-publicized corruption scandal involving wireless licenses has shaken foreign investor confidence, as has an equally well-publicized dispute between Vodaphone and the Indian government. In that dispute, the Indian government is suing Vodaphone for capital gains tax associated with its purchase of an Indian company from the Hong Kong concern Hutchison. The transaction occurred outside India, and the capital gains tax falls to the seller, Hutchison, not the buyer Vodaphone – but Vodaphone operates in India and Hutchison does not, so the Indian government has tortuously bent the law to try to collect from Vodphone.

France Telecom and the French government have the ability to bring this dispute to a close; and their unwillingness to do so has harmed the reputation of Poland, not France, as a location for foreign direct investment.

Similarly, FDI flows to Ecuador, especially in the energy sector, have been harmed by a long-running dispute between private plaintiffs and Chevron over pollution in the early 1990s by Texaco, before Chevron purchased Texaco's Ecuadorian operations. The government had settled with Texaco for some $20 million and released the firm from future liabilities. Nevertheless, the government has allowed private suits against Chevron for some $45 billion in damages allegedly associated with Texaco's operations. The suits have been brought under a law enacted after the damage occurred, with no provision for retroactive relief; and there is strong evidence that the court's experts worked with the plaintiffs earlier in the case. Moreover, Ecuador's government has backed the suit, even charging with fraud the seven officials who negotiated the original agreement with Texaco and two of Chevron's Ecuadoran lawyers. The case continues under the wary gaze of other foreign direct investors considering Ecuador. The violations of contract and the rule of law are more subtle in TPSA's case; but the impact on foreign direct investment into Poland, especially for telecom, may be equally harsh.

One irony here is that with the Polish government's divestiture of its remaining ownership stake in TPSA in August 2010, the France Telecom Group became the majority shareholder with a 49.7 percent ownership share; and the largest shareholder in France Telecom is the French government, which owns 29 percent of the telecommunications giant. France Telecom and the French government have the ability to bring this dispute to a close; and their unwillingness to do so has harmed the reputation of Poland, not France, as a location for foreign direct investment.

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[67]Kinda (2010).
[68]Cited in Kowalewski and Rybinski (2011).

Poland will find itself in the world's spotlight this year. The economy, alone in Europe, avoided a recession in 2009, and growth is reasonably strong this year. The country also will assume the presidency of the European Union, host the 2012 European football championship jointly with Ukraine, and hold general elections in October. At the same time, however, the government deficit has quadrupled since 2007, and public debt is nearing its constitutional ceiling of 55 percent of GDP. Economic reforms to bolster private savings and restore strong foreign direct investment are overdue. A sound step would be a concerted effort to finally settle the decade-long, high-profile dispute between TPSA and DPTG, which has tainted the international reputation of Poland's leading telecommunications concern and the quality of Polish governance.

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