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**The University of Edinburgh**

**Business School**

**The Quality of Foreign Direct Investment Inflows  
in Post-Socialist Transition Economies**

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**Submitted for the Degree of Doctor of Philosophy**

**The University of Edinburgh**

**April 2016**

## **Statement of original authorship**

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## **Declaration**

This thesis includes as chapters and subchapters previously published papers by the author as per the following List of Publications:

1. Acc-Nikmehr, N. 2009. Multinational enterprises and bargaining power: Some critical reflections. *Journal of Risk and Governance*, **1**(4).
2. Beck, M. and Acc-Nikmehr, N. 2008. Foreign direct investment and country risk: Is there evidence of 'malign' investment in former Soviet states. *Journal of Risk and Governance*, **1**(1): 53-75.
3. Ass (currently Acc-Nikmehr), N. & Beck, M. 2005 'Blind bargaining' and the effects of foreign direct investment on recipient states: The Case of post-Soviet and Eastern European countries. In Sima Motamen-Samadian (ed.) *Capital Flows and Exchange Rate Risks in Emerging Markets*, Palgrave Macmillan: London, 61-95.

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## **Abstract**

This PhD thesis develops and tests a model of bargaining between foreign investors and domestic institutions in transition countries. For this purpose this research employs a mixed-methods research methodology combining three studies - two macro-level quantitative and one micro-level qualitative - examining various aspects of the relationships between institutional factors and the quality of inward foreign direct investment (iFDI) flows in transition economies (that is, the impact of iFDI on the host country institutional environment). Specifically, emphasizing the circular nature of the relationship between the applied variables, it attempts, firstly, to identify the impact of the institutional environment in post-Soviet and Central and Eastern European countries on the quality of FDI inflows, and, secondly, to determine whether and how this iFDI affects the quality of the host countries' institutions. The analysis of the presence, size, and direction of the impact of iFDI is pursued through the study of foreign investors' (FIs) nonmarket strategies with a special focus on political behavior.

Despite the growing role of iFDI and of companies with FDI (especially MNEs) as one of the most important rent-seeking interest groups in many economies, the analysis of the impact of iFDI stocks and flows on the host country's institutional environment has received much less attention than analysis of the impact of host country institutions on iFDI and has, moreover, produced mostly mixed results. This project is intended to fill this gap and to contribute to theory building on the relationships between iFDI quality, foreign investors' political behavior, various aspects of institutional environment (including institutional voids), and institutional changes in host countries. It finds evidence for the hypothesis that certain combinations of patterns of quality of iFDI and host-country institutional variables determine foreign investors' (FIs) political influence and political behavior and may also allow them to pursue their economic goals through manipulation of political regimes and, consequently, reshaping of the host country's institutions in accordance with their strategic goals.

The proposed model was tested quantitatively for a sample of 27 post-Socialist countries and qualitatively for the case of Ukraine. The results of all three studies

provide evidence in support of this model. In particular, both quantitative panel studies provide evidence for the existence of ‘blind bargaining’ - a model depicting the cognitive situation of a foreign investor who lacks clarity on the situation he/she is in and, as a result is bound to act in conditions of extreme uncertainty due to the high degree of non-transparency and instability of the “rules of the game” at any given moment and of their propensity for unpredictable change at any time in the future. ‘Blind bargaining’ originates from the specific state and society relationship that can be formed in neo-patrimonial host states where economic decisions are often not directed towards serving national interests, but towards supporting the personal aims of the officials in power. The first quantitative study shows and explains the attractiveness of such countries to riskier investors, who prefer relatively weak political regimes over stronger ones and who reduce their investment inputs once host states become more assertive. This model of relationships leads to the inflow of mostly ‘malign’ FDI (that is, iFDI that has a destabilizing impact on institutional competencies of recipient countries) into these economies. The second quantitative study examines the quality of iFDI flows in 12 post-Soviet states by determining the impact of attracted iFDI on local institutions, as measured by country risk indicators via a pooled regression model. The latter analysis shows that iFDI has a marginally negative effect on some individual country risk measures and a significantly negative effect on others, implying that there is a strong case for questioning the existing orthodoxy according to which the problems of transition can be overcome via increased iFDI.

Given the complexity and context-specificity of foreign investors’ political behavior and its impact on host countries’ institutional capacities, this research acknowledges the need for a more targeted analysis at lower levels of aggregation. The thesis addresses this through a qualitative analysis of the relationships between foreign investors and host states in the context of one country - Ukraine. Interviews with company representatives and various experts were conducted to explore how changes in foreign investors’ bargaining power and, as a result, in their strategic choices regarding their political involvement impact the institutional environment in Ukraine.

Based on the combination of empirical and theoretical insights described above, a 'blind bargaining' model was developed as a special case of the political bargaining model. It provides a comprehensive framework for explaining foreign investor – host state bargaining relationships in neopatrimonial transition economies and reveals several distinctive characteristics of both parties' behavior in terms of their goals, resources, constraints, the nature of the bargaining process, strategies and outcomes. However, it is suggested that further country-specific tests are necessary to test its applicability beyond the transition countries, particularly in emerging and developing countries.

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## **List of Abbreviations**

ACC	American Chamber of Commerce
BEEPS	Business Environment and Enterprise Performance Survey
BMI	Business Monitor International
CEE	Central and Eastern European Countries
CEO	Chief Executive Officer
CIS	Community of Independent States
CPA	Corporate Political Activity
CSA	Corporate Social Activity
CSR	Corporate Social Responsibility
CPI	Corruption Perception Index
EBA	European Business Association
EBRD	European Bank for Reconstruction and Development
EIU	Economist Intelligence Unit
EMF	Emerging Market Firm
ER	Economic Risk
EU	European Union
FATF	Financial Action Task Force
FDI	Foreign Direct Investment
iFDI	inward Foreign Direct Investment
oFDI	outward Foreign Direct Investment

mFDI	malign Foreign Direct Investment
FI	Foreign Investors
FIG	Financial Industrial Group
GDP	Gross Domestic Product
GI	Global Insight
GLSE	General Least Squares Estimator
HDI	Human Development Index
IB	International Business
IDP	Investment Development Path
IIA	International Investment Agreement
IMF	International Monetary Fund
ISIC	International Standard Industrial Classification
IT	Information Technology Company
IV 2SLS	Instrumental Variable 2-Stage Least Squares
JV	Joint Venture
LR	Legal Risk
LSDV	Least Squares Dummy Variables
MNE	Multinational Enterprise
OCR	Overall Country Risk
OCT	Organizational Capability Theory
OECD	Organization of Economic Cooperation and Development

OFC	Offshore Financial Center
OLI	Ownership Location Internalization paradigm
OLS	Ordinary Least Squares
PAC	Political Action Committee
PRS	Political Risk Service Group
R&D	Research and Development Company
RBV	Resource Based View
SEE	South-Eastern European States
SME	Small and Medium Size Enterprise
SOE	State Owned Enterprise
SSCU	State Statistics Committee of Ukraine
TCE	Transaction Cost Economics
TI	Transparency International
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
VAT	Value Added Tax
WB	World Bank
WMRC	World market Research Centre
WTO	World Trade Organization

## Table of Terminology

Concept	Definition
Quality of FDI inflows	<p><i>General Definition:</i></p> <p>Effects of FDI inflows on the recipient economy.</p> <p><i>Research-specific definition:</i></p> <p>Since the overall goal of this research is the analysis of the impact of iFDI flows on host countries' institutional capacities (as one of the most important location-specific advantages), the 'quality' of FDI is defined as indicating the size and direction of the impact of a unit of iFDI on changes in the institutional environment, as measured by country risk indicators, including overall country risk, political risk, economic risk, legal risk, tax risk, operational risk, and security risk within the quantitative part of this study and in terms of the direction of the impact of foreign investors' political behavior on changes in institutional environment within the qualitative part of the project.</p>
Malign FDI	<p><i>General Definition:</i></p> <p>Lower quality iFDI that has a destabilizing effect on the recipient economy, for example, "lower domestic savings and investment by extracting rents and siphoning off the capital through preferred access to local capital markets and local supplies, as well as through the repatriation of profits, drive domestic producers out of business, substitute imported inputs, produce small labour elites and cause the increase of unemployment, prevent beneficial spillovers and externalities to host economies", etc (Moran, 1998: 15-20).</p>

*Research-specific definition:*

iFDI that has destabilizing impact on institutional competencies of recipient countries.

Benign FDI

*General Definition:*

Higher quality iFDI that has positive stabilizing effect on the recipient economy, for example, “filling the gap between savings and investment, as well as between investment and foreign exchange, reinvestment in the same or related industries, increasing employments”, etc. (Moran, 1998: 15-20).

*Research-specific definition:*

iFDI that has a stabilizing impact on institutional competencies of recipient countries.

Round-tripping or  
Pseudo-FDI

iFDI by domestic businessmen who made a decision to go abroad and return to their home countries as foreign investors to evade taxes and/ or the impact of regulations, capitalizing on institutional differences between their real and pseudo home countries.

Blind bargaining

Model depicting the cognitive situation of a foreign investor who lacks clarity on the situation he is in and, as a result, is bound to act in conditions of extreme uncertainty due to the high degree of non-transparency and instability of the "rules of the game" at any given moment and of their propensity for unpredictable change at any time in the future.

Neopatrimonial states

Regimes possessing the following characteristics: high levels of personalization of power in the state, the capture of

the state by ruling clans, lack of rule of law, lack of distinction between the spheres of economics and politics, a disintegration of the state apparatus, the spread of corrupt practices in the state bureaucracy, paralyzing impact of state intervention in economic life (motivated by the personal interests of representatives of state authorities), lack of transparency and lack of consistency in all spheres of political and economic life (Eisenstadt, 1973; Zon, 2001).

Original OLI model	Static framework which includes three sets of interdependent variables: ownership-specific (O), location-specific (L), and internalization (I) advantages (OLI advantages) and serves to “explain the extent and pattern of international production, i.e. production financed by FDI and undertaken by MNEs” (Dunning, 2001: 176).
Adjusted OLI model	Dynamic framework which accounts for the changes in OLI configurations arising from the modifications of O, L, and I components caused by their interrelationships (Dunning & Lundan, 2008).
Ownership advantages	Firm-specific (‘competitive’ or ‘monopolistic’) advantages. They accommodate both tangible and intangible resources. The former include natural endowments, manpower and capital, while the latter are composed of technology and information, managerial, marketing and entrepreneurial skills, organizational systems, incentive structures and favored access to intermediate or final goods markets (Dunning & Lundan, 2008: 96).
Location advantages	Country-specific advantages which are either not available or available only partially and under poor conditions in the

firm's home country. They embrace such immobile, natural or created endowments as labor, energy, materials, components, semi finished goods, prices, quality, productivity, international transport and communication costs, investment incentives and disincentives, barriers to trade, cultural, social and political differences, spillovers, economies of scale, institutional environment and others (Dunning, 2000; Dunning & Lundan, 2008: 100-102).

Internalization advantages Context-specific configurations of O and L advantages that vary across types of value-added activities, firms, industries, regions and countries (Dunning, 2001).

Institutions “Rules of the game in a society or, more formally, the humanly devised constraints that structure political, economic and social interactions. They consist of formal rules (constitutions, statute and common law, and regulations), informal rules (conventions, moral rules, and social norms), and the enforcement characteristics of each” (FDI: 7).

Institutional voids Situation where some or all of the most important market-supporting institutions, including property rights, regulatory systems, contract-enforcement mechanisms and others, are either missing, underdeveloped or inefficient (Doh *et. al.*, 2014; Khanna & Palepu, 1997; Khanna & Palepu, 2013; Palepu & Khanna, 1998; Prokopovych, 2011; Puffer, McCarthy & Boisot, 2010).

Institutional change Change in the rules, both formal and informal, that govern institutions (Inayatullah, 2004). It can result from a centralized action, such as bargaining, lobbying or any other

political activities, supported by a collective-choice process (Kingston & Caballero, 2009).

Vested interests	Rule-making elites represented by merged political, economic and criminal powers including state officials, political and economic elites, able both to prevent institutional change and to successfully advocate the emergence and persistence of inefficient institutions (Libecap, 1989; Ostrom, 2005).
Power	“Structural element of the relationship within which parties act to influence each other” (Bachrach & Lawler, 1981: 45-46).
Power as an outcome	“Capacity of one actor to do something affecting another, which changes the probable pattern of specified future events” (Lukes, 1980: 13).
Power as a potential	“Approach assuming the necessity of distinguishing between potential and actual, or successful, use of power. From this standpoint, power is a resource that may or may not be used, and if used may or may not be effective” (Bachrach & Lawler, 1981: 45-46).
Power as a tactical action	“Approach emphasizing the active manipulative quality of power relationships and, as a result, assuming potential power and stressing the tactical use of the potential rather than the specific dimensions that define the potential” (Bachrach & Lawler: 1981: 46).
Political power	Ability of an individual, a group, or an institution to shape and control the behavior of others through the governance of



the public resources distribution and policies implementation processes for society. Political power consists of two components: de jure political power or political institutions and de facto political power. The latter is nurtured from two sources such as the group's collective action potential and the group's economic resources (Acemoglu *et al.*, 2004).

- Bargaining power “Concept implying conflict of interests over goals that no party can achieve without taking the other into account and, thus, establishing that dependence is the defining characteristic of bargaining power” (Bachrach & Lawler, 1981: 79).
- Obsolescing bargain Framework suggesting that the position of MNEs vis-à-vis host states can be significantly weakened once the foreign company has sunk investments which it cannot easily withdraw (Vernon, 1977).
- Political bargaining Model built on the assumption that MNE – state relations are repetitive in their nature. In particular, it delineates that MNEs need to continually initiate and engage in negotiations with host states over different policy issues to preserve and even strengthen their competitive positions in certain markets. The outcome of each political bargain depends on the relative potential and actual power of all parties participating in negotiations (Eden, Lenway & Schuler, 2004).
- Political behavior “(T)he acquisition, development, securing, and use of power in relations to other entities, where power is viewed as the capacity of social actors to overcome the resistance of other actors” (Boddeyn & Brewer, 1994: 120; Astley &

Sacheva, 1984: 90)

Corporate raiding	Illegal seizure of both domestic and foreign companies either independently or, most probably, through fostering alliances by oligarchs, state officials at all levels and, in many cases, criminals (Pojansky, 2014).
Bridging	Strategy assuming firms' dedication to the unconditional compliance with the requirements of its operational environment (Meznar & Nigh, 1995).
Buffering	Strategy involving corporate actions on protection of a firm's assets from all range of external pressures and on vigorous participation in activities that would lead to the improvement of a company's competitive positioning in the respective markets (Hillman, Keim & Schuler, 2004; Meznar & Nigh, 1995).



## **CHAPTER ONE: INTRODUCTION**

### **1.1 Background to the research**

This PhD thesis develops and tests a model of bargaining between foreign investors and domestic institutions in transition countries. For this purpose this research employs a mixed-methods research methodology combining three studies - two macro-level quantitative and one micro-level qualitative - examining various aspects of the relationships between institutional factors and the quality of inward foreign direct investment (iFDI) flows in transition economies (that is, the impact of iFDI on the host country institutional environment). Specifically, emphasizing the circular nature of the relationship between the applied variables, it attempts, firstly, to identify the impact of the institutional environment in post-Soviet and Central and Eastern European countries on the quality of FDI inflows, and, secondly, to determine whether and how this iFDI affects the quality of the host countries' institutions. The analysis of the presence, size, and direction of the impact of iFDI is pursued through the study of foreign investors' (FIs) nonmarket strategies with a special focus on political behavior.

Despite the growing role of iFDI and of companies with FDI (especially MNEs) as one of the most important rent-seeking interest groups in many economies, the analysis of the impact of iFDI stocks and flows on the host country's institutional environment has received much less attention than analysis of the impact of host country institutions on iFDI and has, moreover, produced mostly mixed results. This project is intended to fill this gap and to contribute to theory building on the relationships between iFDI quality, foreign investors' political behavior, various aspects of institutional environment (including institutional voids), and institutional changes in host countries. In particular, it seeks evidence for the hypothesis that certain combinations of patterns of quality of iFDI and host-country institutional variables determine foreign investors' (FIs) political influence and political behavior and may also allow them to pursue their economic goals through manipulation of political regimes and, consequently, reshaping of the host country's institutions in accordance with their strategic goals.

Interestingly, significant body of research concentrated on the search for empirical evidence on the relevance of institutions as determinants of iFDI flows. Scholars have been seeking to identify how the changes in the patterns of iFDI flows are associated with various institutional aspects. Most of the previous research in this domain was quantitative macro-level analysis on the determinants of iFDI flows into countries with different levels of development and impact of iFDI on such country indicators as economic growth (Akinlo, 2004; Alfaro & Charlton, 2007; Basu & Guariglia, 2007; Bengoa & Sanches-Robles, 2003; Borensztein, De Gregorio & Lee, 1998; Chowdury & Mavrotas, 2006; Durham, 2004; Hansen & Rand, 2006; Lee, Baimukhamedova, Akhmetova, 2010; Li & Liu, 2005; Liu, Siler, Wang, & Wei, 2000; Vu & Noy, 2008), income inequality (Basu & Guariglia, 2007; Bhandari, 2007; Franco & Gerussi, 2010), spillovers (Alfaro, Chanda, Kalemli-Ozcan & Sayek, 2004; Cheung & Lin, 2004; Hejazi & Safarian, 1999; Kugler, 2006; Liu, Siler, Wang, & Wei, 2000; Smarzynska Javorcik, 2004; Smarzynska Javorcik & Spatareanu, 2006; Van Pottelsberghe de la Potterie & Lichtenberg, 2001), and trade (Wang, Buckley, Clegg & Kafouros, 2007) among others.

Only recently, more research effort was focused on the relationships between iFDI and institutional environment in host countries (Bevan, Estrin & Meyer, 2004; Busse & Hefeker, 2007; Daude & Stein, 2007; Dunning & Lundan, 2008; Mudambi & Navarra, 2002). However, only several quantitative research projects examined impact of iFDI on host countries' institutional capacity. We differentiate two categories of research here: studies using iFDI flows and stocks as an aggregate measure of the impact of MNEs' activity and survey-based studies. The former category includes research on iFDI impact on host countries' institutional environment measured by risk indicators (Beck & Acc-Nikmehr, 2008), providing evidence that iFDI flows have overall destabilizing impact on institutional competencies (See Chapter 6); by economic transition indicators (Malesky, 2005; Malesky, 2009), demonstrating large positive influence on economic reform in transition economies; by corruption perception index (Kwok & Tadesse, 2006; Robertson & Watson, 2004), producing contradictory results; and by environmental regulations index (Cole, Elliot & Fredriksson, 2006), observing that the direction of FDI effect depends on the degree of corruptibility of local governments. The latter

category consist of studies on political influence of foreign firms (Desbordes & Vauday, 2007), regulatory advantages of foreign firms (Huang, 2005) based on the World Business Environment survey by World Bank and one study on determinants of FDI which among other results provides evidence on the impact of FDI on standards of governance in transition economies (Hellman, Jones & Kaufmann, 2002). The latter study is based on joint EBRD and World Bank Business Environment and Enterprise Performance Survey.

Contemporary research also examines various context-specific political activities that both domestic companies and foreign investors utilize to influence public policy decision-making in a way that would solidify and improve their positioning in the markets (Baron, 1995; Baron, 2006; Boddewyn, 1998; Boddewyn & Brewer, 1994; Grier, Munger & Roberts, 1991; Griffin, Fleisher, Brenner & Boddewyn, 2001; Hillman, Zardkoohi & Bierman, 1999; Lenway & Rehbein, 1991; Meznar & Nigh, 1995; Pittman, 1998; Rugman & Verbeke, 1998; Schuler, 1996; Schuler, 1999; Schuler, Rehbein & Cramer, 2002; Shaffer & Hillman, 2000; Stopford and Strange, 1991). However, Hillman and Hitt (1999) claim that the research in this field has not kept pace with the turn of events in both political and economic environments of various countries. Particularly, Vogel (1996) argues that the collapse of the Soviet Union followed by a very specific institution-building processes heavily relying on the support and participation of various domestic and international, market and nonmarket, formal and informal actors, including foreign investors, requires a new research effort to focus on better understanding of the role of all of the various types of businesses on the elaboration and implementation of public policies (Lawton, McGuire & Rajwani, 2013).

However, it is noteworthy that in spite of the obvious growth in the interest to corporate political activity, especially during the last 25 years, as to our knowledge (on August, 2014) there was no qualitative research projects examining the quality of iFDI in terms of foreign investors' political behavior and impact on institutional environment in post-Soviet transition countries.

Based on the combination of existing empirical and theoretical insights described above, including eclectic paradigm, social conflict view, the new institutional,

bargaining power, and corporate political activity theories, this thesis seeks to close the research gap and develop a ‘blind bargaining’ model - a model depicting the cognitive situation of a foreign investor who lacks clarity on the situation he/she is in and, as a result is bound to act in conditions of extreme uncertainty due to the high degree of non-transparency and instability of the “rules of the game” at any given moment and of their propensity for unpredictable change at any time in the future - will be developed as a special case of the political bargaining model. It will provide a comprehensive framework for explaining foreign investor – host state bargaining relationships in neopatrimonial host states (states where economic decisions are often not directed towards serving national interests, but towards supporting the personal aims of the officials in power) and, as a result, reveal several distinctive characteristics of both parties’ behavior in terms of their goals, resources, constraints, the nature of the bargaining process, strategies and outcomes.

The proposed model questions the dominant orthodoxy of FDI (See Fig. 1.1) which suggests that increased foreign investment will, in virtually all instances, benefit the recipient nation. This orthodoxy has an extensive academic pedigree (Balasubramanyam, Salisu, and Sapsford, 1996; Borensztein, De Gregorio and Lee, 1998; De Melo, 1999; Dyker, 1999) which loosely underpins a well established policy discourse which emphasises ‘the creation of positive investment climates’ and the need to ‘create institutions which are complementary to investment’ (Guisinger, 1985; Mudambi and Navarra, 2002). Implied in this orthodoxy is the assumption that, firstly, the failure by certain regions to exhibit sustained growth can be attributed to a lack of ability to attract foreign investment, and, secondly, that the inability to attract lasting foreign investment, itself, can be attributed to institutional deficiencies of the potential recipient country. Applied to former Soviet states, other than the Baltics, this narrative typically identifies corruption, lack of legal and institutional reforms and insufficient liberalisation as root cause for the insufficiency of economic and social development in these countries (Estrin, Hughes and Todd, 1997; Fabry and Zeghni, 2002; Bevan, Estrin and Meyer, 2004).

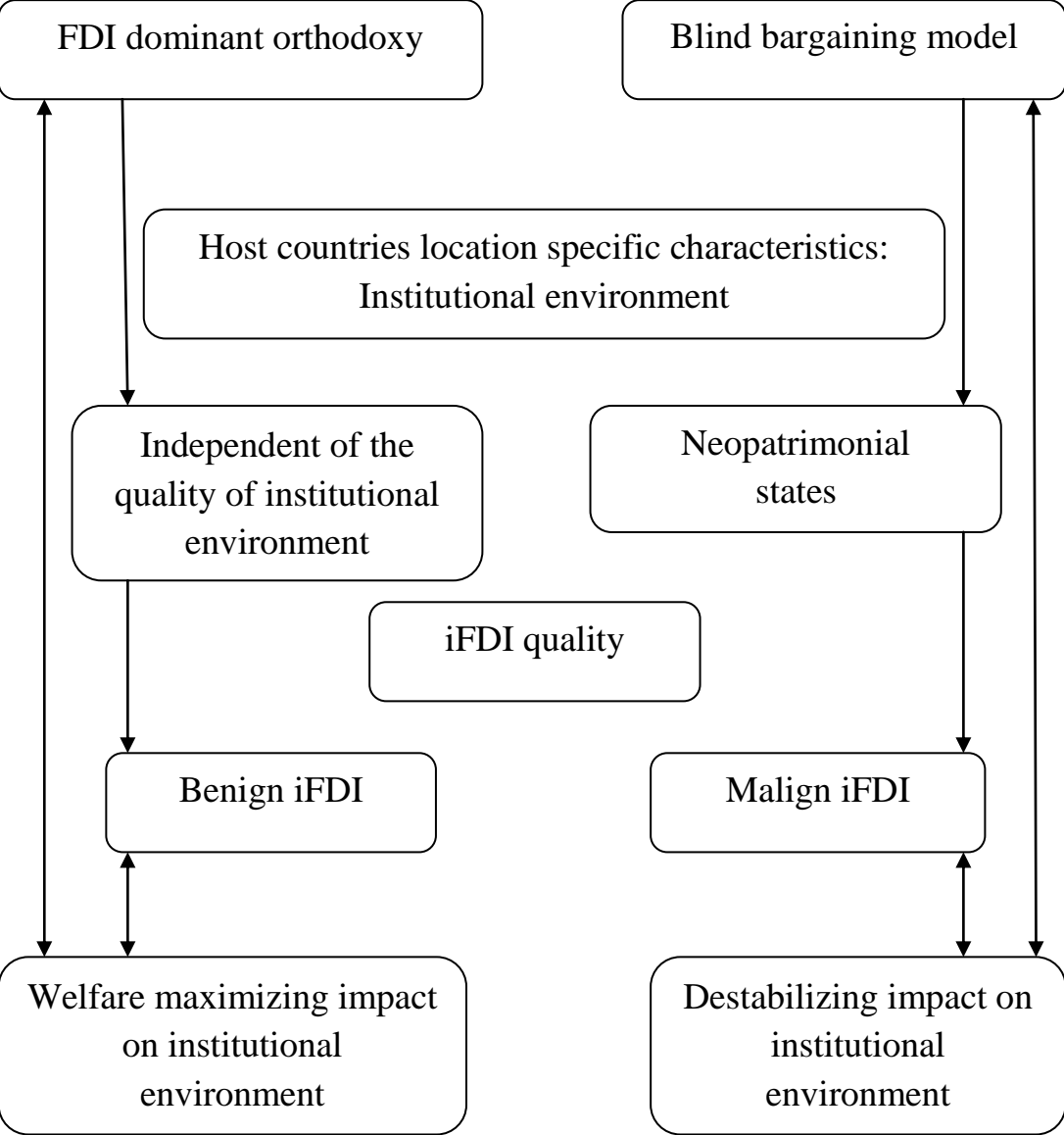
One of the obvious weaknesses of this narrative is that it oversimplifies the experiences of different countries within larger regions. Thus, there is significant

evidence that, contrary to the assumption that the entire region has been an FDI laggard, FDI in former Soviet states has been highly concentrated in a number of countries which rank, by international standards, amongst the top FDI recipients (Meyer and Pind, 1999). Moreover, there is no consistent evidence that the top FDI recipients amongst former Soviet states also rank at the top in terms of social and institutional development and/or political stability (Abbott, 2002; Abbott and Beck, 2003). Lastly, there are some, largely qualitative analyses, which suggest that some countries which have been targeted by FDI have in fact experienced a deterioration in their institutional capacities (Marriott and Muttitt, 2005).

To avoid some of the pitfalls discussed above the proposed model will be tested quantitatively for a sample of 27 post-Socialist countries and qualitatively at a lower level of disaggregation for the case of Ukraine, given the complexity and context-specificity of foreign investors' political behavior and its impact on host countries' institutional capacities.



**Figure 1.1: The relationship between quality of iFDI and institutional environment in host countries: The orthodox approach vs. the “blind bargaining” model.**



## **1.2 Quality of foreign direct investment: Definition & operationalization problems**

### **1.2.1 Introduction**

The globalization of economic production supported by the continuing liberalization of investment policies and trade regimes and increased competition among firms is reshaping the international economic landscape (UNCTAD, 2005). As a result, even in spite of the dampening effect that global financial and economic crisis had on foreign direct investment (FDI) (UNCTAD, 2009) and a significant contraction of global FDI flows in 2009 (UNCTAD, 2010), internalization of production continued to gain momentum (UNCTAD, 2010). The role of FDI and multinational enterprises (MNEs) in the world economy has been persistently increasing. Foreign affiliates of MNEs experienced notably smaller decrease in their sales and value-added as compared to the world economy (UNCTAD, 2010). Their “share in global gross domestic product (GDP) reached an historic high of 11 percent” in 2009 (UNCTAD, 2010: xviii).

Consequently, more research efforts aim to attend to the study of different aspects of FDI and MNEs activity. It is suggested that the quality of FDI is one of the primary issues to be addressed under the circumstances (Kalotay, 2010; Narula & Guimon, 2010). The investigation of the impact of FDI on the host economies is critical for both academic and policy-making purposes. Even though some countries tend to acknowledge the differences in the types of FDI projects in their national policies (Alfaro & Charlton, 2007), most of the investment promotion instruments in transition and developing countries are currently still considering the increase in the volume of inward FDI (iFDI) flows as their major goal, while neglecting the importance of the characteristics of the quality of these flows for their economies. Narula & Guimon (2010) suggest that the latter should be determined by the host state’s development aspirations and strategies.

### **1.2.2 Malign vs. Benign FDI**

The principal problem for the analysis of the quality of FDI inflows is its definition. The concept of quality is very broad and can be expressed through

multiple effects FDI inflows are capable of and expected to transfer to the recipient economy. According to Moran (1998: 15-20) among such effects are:

Transfer of capital; transfer of know-how and management; rise of efficiency and expansion of output; higher economic growth; balance of payments benefits; increase in competition and lower prices; increase in entrepreneurial spirit, help in training and education; increase in employment; help in infrastructure; improvement of living conditions in developing countries; identification, allocation, management and effective use of world material and human and financial resources; greater international unity and interdependency; ensuring a more equal distribution of income and wealth.

Moreover, recently academics acknowledged less conventional location advantages, such as institutions and institutional environment, as one of the most important immobile factors of host countries (Bevan, Estrin & Meyer, 2004; Busse & Hefeker, 2007; Daude & Stein, 2007; Dunning & Lundan, 2008; Mudambi & Navarra, 2002). As a result, academics and policy-makers also assert that FDI inflows will contribute both to the rise of the efficiency and improvement of the quality of legal, administrative and political systems and to the perfection of markets and property rights regulations (Malesky, 2005; Malesky, 2009; Smarzynska Javorcik, 2002).

As a solution for the operationalization problem of this all-embracing concept, researchers have chosen to restrict their definition of the quality of FDI to the focus of their research project. For example, UNCTAD (2006) define quality FDI in terms of its employment, skills enhancement and competitiveness effect on the host economy and its economic agents. Other researchers use the quality of FDI to indicate the impact of a unit of iFDI on growth (Akinlo, 2004; Alfaro & Charlton, 2007; Basu & Guariglia, 2007; Bengoa & Sanches-Robles, 2003; Borensztein, De Gregorio & Lee, 1998; Chowdury & Mavrotas, 2006; Durham, 2004; Hansen & Rand, 2006; Lee, Baimukhamedova, Akhmetova, 2010; Li & Liu, 2005; Vu & Noy, 2008), income inequality (Basu & Guariglia, 2007; Bhandari, 2007; Franco & Gerussi, 2010), spillovers (Alfaro, Chanda, Kalemli-Ozcan & Sayek, 2009; Cheung

& Lin, 2004; Hejazi & Safarian, 1999; Kugler, 2006; Liu, Siler, Wang, & Wei, 2000; Smarzynska Javorcik, 2004; Smarzynska Javorcik & Spatareanu, 2006; Van Pottelsberghe de la Potterie & Lichtenberg, 2001), trade (Wang, Buckley, Clegg & Kafouros, 2007) and institutional environment measured by risk indicators (Beck & Acc-Nikmehr, 2008), economic transition indicators (Malesky, 2005; Malesky, 2009), corruption perception index (Kwok & Tadesse, 2006; Robertson & Watson, 2004), and the environmental regulations index (Cole, Elliot & Fredriksson, 2006) among others.

Since the overall goal of this research is the analysis of the impact of iFDI flows on institutional capacities (as one of the most important location-specific advantages) of host countries, the ‘quality’ of FDI is defined as indicating the size and direction of the impact of a unit of iFDI on institutional environment measured by country risk indicators, including overall country risk, political risk, economic risk, legal risk, tax risk, operational risk and security risk within the quantitative part of this study and in terms of the direction of the impact of foreign investors’ political behavior on changes in institutional environment within the qualitative part of the project.

It is necessary to admit that, contrary to the anticipations of host states that FDI will always improve economic welfare, lower quality FDI can have destabilizing effect on the recipient economy, such as:

Instead of filling the gap between savings and investment, MNEs may lower domestic savings and investment by extracting rents and siphoning off the capital through preferred access to local capital markets and local supplies of foreign exchange. Instead of closing the gap between investment and foreign exchange, they might drive domestic producers out of business and substitute imported inputs. The MNE may reinvest in the same or related industries in the host country and extend its market power. The repatriation of profits might drain capital from the host country. MNEs’ use of “inappropriate” capital intensive technologies may produce small labour elite while consigning many workers to the ranks of the unemployed. Their tight control over technology, higher management functions and export channels

may prevent the beneficial spillovers and externalities hoped for in more optimistic scenarios (Moran, 1998: 15-20).

Following Moran (1998) we suggest to label iFDI as ‘malign’ or ‘benign’ depending on the direction of their impact on the host country’s institutional environment. As a result, if iFDI has a destabilizing impact on institutional competencies of host countries, we refer to it as “malign’ iFDI and, if iFDI has a stabilizing impact on institutional competencies of recipient countries, we refer to it as “benign” iFDI.

### **1.3 Research framework and research objectives**

As an alternative to the conventional views on FDI described above, this thesis suggests a new model – “blind bargaining” - and examines the possibility that foreign investment in former Soviet states has not only failed to produce the expected effects, but also may have had a discernibly negative impact on certain regions. The latter would include neopatrimonial states and states undergoing periods of radical change in institutional environment, or institutional upheaval, characterized by extreme uncertainty and ambiguity such as transition economies of the former Soviet Union and Central and Eastern Europe (CEE) have been experiencing (Roth & Kostova, 2003: 315), which makes them highly dependent on and vulnerable to pressures of any entities or groups of entities retaining control over economic resources. This research adopts an integrated approach to the study of different aspects of the entire cycle of the relationships between the quality of iFDI and institutional environment in transition economies.

The research framework of this study presented schematically in Figure 1.2 demonstrates the above described circular relationship between the quality of the institutional environment and the quality of iFDI in host countries. Combining the OLI paradigm (Dunning, 1980; 2000; 2001) and new institutional economics (North, 1990; Williamson, 1975; 1985) as a foundation for the theoretical framework, this research examines the relationship between institutions as one of the most important host country location specific characteristics and the quality of iFDI both

quantitatively for the sample of 27 countries and qualitatively for the case of Ukraine.

The first quantitative study shows and explains the attractiveness of such countries to riskier investors, who prefer relatively weak political regimes over stronger ones and who reduce their investment inputs once host states become more assertive. The following hypothesis is tested:

- Hypothesis 1: The presence of ‘blind bargaining’ in neo-patrimonial post-Soviet states results in attracting riskier lower quality iFDI.

This chapter argues that this model of relationships leads to the inflow of mostly ‘malign’ FDI (that is, iFDI that has a destabilizing impact on institutional competencies of recipient countries) into these economies.

The second quantitative study examines the quality of iFDI flows and stocks by determining the impact of attracted iFDI on local institutions, as measured by country risk indicators. The following hypothesis is tested:

- Hypothesis 2: The host countries’ risks increase (decrease) with the growth of lower quality ‘malign’ (better quality ‘benign’) iFDI flows.

This analysis provides evidence that iFDI has a negative effect on some individual country risk measures, implying that there is a strong case for questioning the existing orthodoxy according to which the problems of transition can be overcome via increased iFDI.

The qualitative part of this research explores the relationships between iFDI and the institutional environment of one country – Ukraine – with a particular focus on the iterative political bargaining that occurs amongst the relevant actors. The following questions are explored with a view to establishing which types of foreign investors actually have the leverage to affect the host country institutional environment and what resources they are able to mobilize for this purpose:

- Question 1: Does the newly developed blind bargaining model apply to companies with FDI in Ukraine? Does its relevance vary for different groups of companies with FDI? How?
- Question 2: How do the choices of companies with FDI regarding political strategies depend on their characteristics?
- Question 3: Does the level of political activity and pro-activeness vary between different groups of companies with FDI? If so, how?
- Question 4: How successful and efficient are different types of companies with FDI in their efforts to influence institutional changes? Why?

Here it is argued that the outcome of such bargains is dependent on and determined by foreign investors' bargaining power. The latter is analyzed drawing on the theories of power (Bachrach & Baratz, 1970; Dahl, 1957; Lukes, 1980), bargaining power (Bacharach & Lawler, 1981), political bargaining model (Eden *et al.*, 2004) (including obsolescing bargain [Vernon, 1971; 1977; Stopford & Strange, 1991; Stopford, Strange & Henley, 1991], political bargaining [Eden, Lenway & Schuler, 2004] and blind bargaining [Acc-Nikmehr & Beck, 2005] as a special cases) and social conflict view of institutional differences (Acemoglu *et al.*, 2004; Arrow, 1951; Knight, 1992; Olson, 1965; Stigler, 1975).

As a result, certain combinations of patterns of quality of iFDI and host-country institutional variables determine the content of bargaining between foreign investors and host states, as well as foreign investors' political influence and political behavior, and allow foreign investors (particularly the largest and most powerful ones) to pursue their economic goals through manipulation of political regimes by the means of various corporate political strategies including such tactics as lobbying, corruption (Henisz & Zelner, 2005; Mudambi & Navarra, 2002), involvement in policy-learning, policy-making processes and international diplomacy (Welch & Wilkinson, 2002), public and government relationships, relationships with mass media and non-governmental organizations (NGOs), participation in firms' alliances and associations (Boddewyn, 1988), organizing investors' coalitions and building constituencies (Lord, 2003). All of this amounts to a reshaping of the host country's

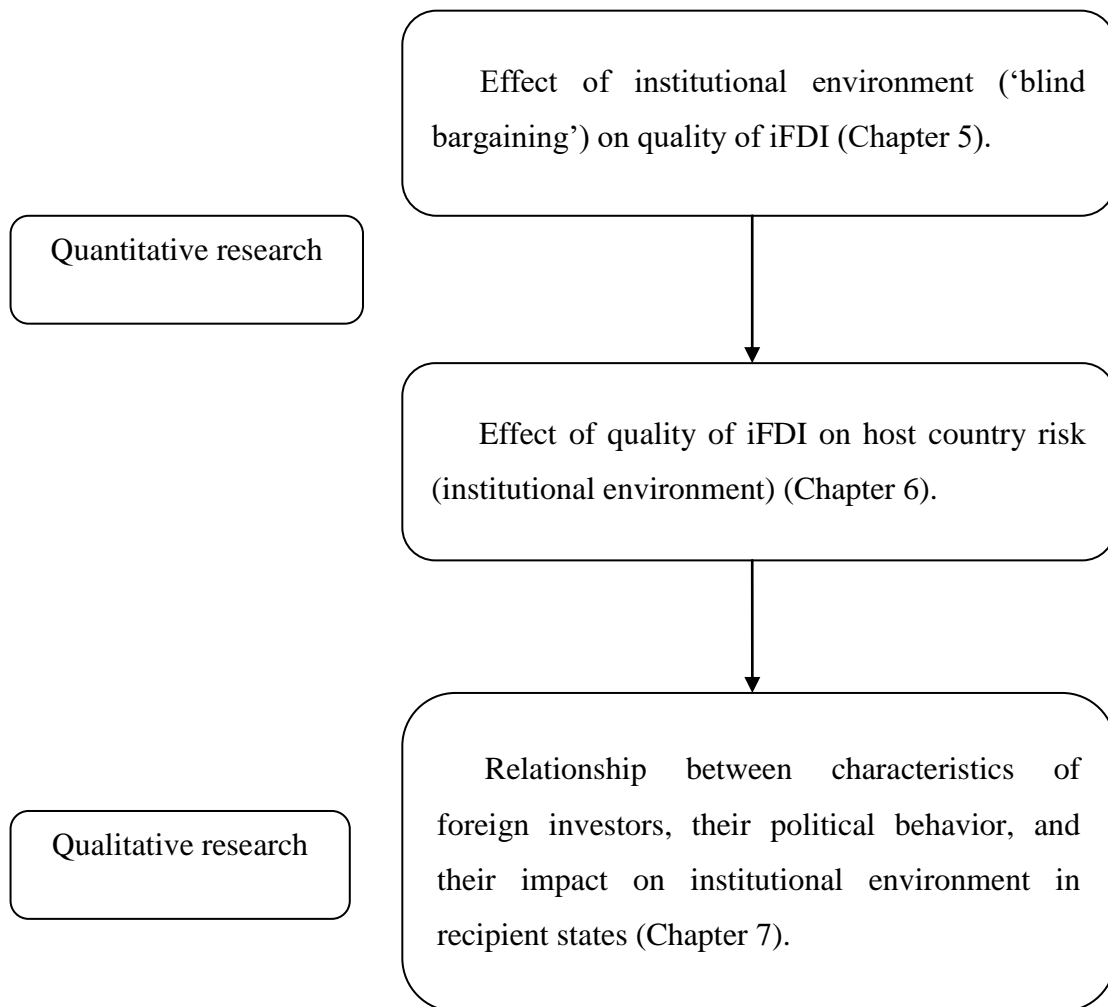
institutions in accordance with the foreign investors' strategic goals, to the extent that their de facto political power allows.

Overall, it is argued that not only do host country location-specific advantages, particularly institutions, determine the quality of FDI inflows, but also that iFDI, through the political behavior of the investors, influences the patterns of changes in the institutional environment of this host country. Political bargaining processes and outcomes are contingent on the institutional characteristics, capabilities and goals of host countries (Eden *et al.*, 2004) and on the relevant bargaining power and goals of foreign investors. The worse the initial conditions and the weaker the host country institutions the lower the quality of the iFDI enters the country: it will either fail to contribute to the development of the institutional environment or even cause negative changes.

In this context, the specific objectives of this research project are to examine all stages of the complete cycle of the above discussed relationships as illustrated in Fig. 1.2.



**Figure 1.2: Research framework**



#### **1.4 Research approach**

This study adopts a mixed methods research approach to investigate different aspect of iFDI quality in terms of the relationships between various types of foreign investors and institutional environment in post-Soviet transition countries. This research is based on a critical realism paradigm (Archer, Bhaskar, Collier, Lawson & Norrie, 1998; Bhaskar, 1978, 1989, 2011; Campbell, 1974, 1988; Cook & Campbell, 1979; Manicas, 2006; Sayer, 1992, 2000) thus aiming at avoiding the problems of objectivity by separating the transitive and intransitive objects of science and the tools for explaining reality itself. It does not reject the interpretivist position that natural and social phenomena are fundamentally different (Blaikie, 1995) and see the world as having dual actuality. One of the most distinctive and important features of realism, especially in the context of this research, is methodological pluralism (Olsen, 2004; Sayer, 2000). It predicates that realists allow the use of different methods and techniques, including both qualitative and quantitative, for the study of the same social phenomenon and its various characteristics (Carter, 2003; Danermark; 2002; Olsen, 2004; Sayer, 2000).

Through a process of retrodution this research inquires into real social structures and mechanisms searching for and suggesting new connections - antecedents which are presumed to cause the observable phenomenon and its changes (Blaikie, 1995; Olsen, 2004). Moreover, retroductive logic is also appropriate for both qualitative and quantitative methodologies (Olsen, 2004).

This study consists of three parts: two quantitative and one qualitative. The former two parts utilize econometric techniques for the analysis including conventional ordinary least squares (OLS), least squares dummy variables (LSDV) and general least squares estimator (GLSE) regression models. The latter one relies on the semi-structured interviews method to analyze complex multiple links and relationships in which foreign investors engage for the purpose of aligning the host country's institutional environment with their strategic goals. Overall fifty interviews were conducted including twenty nine confidential interviews with CEOs, directors,

or managers of relevant departments within the companies with FDI and twenty one auxiliary interviews with various experts.

This research applies a combination of directed and conventional approaches to content analysis (Hsieh & Shannon, 2005). Thus, only several principal categories are predetermined and most categories, as well as subcategories and codes, are derived directly from the data as a result of multiple in-depth reviews of interviews' records.

#### **1.4 Structure of the thesis**

This thesis consists of nine chapters. Chapter one introduces the background of this research, informs about relevant literature, summarizes available theoretical and practical evidence on quality of iFDI, focusing on the development of its definition and relevant operationalization problems, outlines the research framework and research approach, provides a list of the research hypothesis for the quantitative parts and research questions for the qualitative part of the project, and, finally, reviews the structure of the thesis.

Chapter two includes a review of an international business, management and political science literature required for the comprehensive analysis of the quality of iFDI and bargaining relationships between foreign investors and host states, their political behavior and impact on institutional change in post-Soviet transition countries. It summarizes available theoretical and practical evidence on eclectic paradigm, institutions, institutional change, and social conflict view; bargaining power with special attention to existing obsolescing and political bargain models for developing a new 'blind bargaining' model as a special case of political bargain model for neo-patrimonial transition states; corporate political activity.

Chapter three offers the justification of the choice of mixed methods research approach, critical realism paradigm, retroductive strategy and methods, including econometric OLS, LSDV and GLSE models in case of quantitative parts and semi-structured interviews in case of qualitative part of the analysis. Detailed discussion of

sampling design, researchers' performance, triangulation and data analysis procedures conclude this chapter.

Chapter four provides a brief description of iFDI distribution patterns in transition economies and of Ukrainian geopolitics and economy. The discussion of the both transition countries' and Ukraine's major characteristics, including strengths and weaknesses as a potential investment destination, with a special focus on imperfections of institutional environment, helps to understand and justify the choice of the former as a case for the quantitative research and the latter as a case for the qualitative research.

Chapter five is based on the author's publication "Blind bargaining and the effects of foreign direct investment on recipient states: The case of post-Soviet and Eastern European countries". It is a quantitative analysis examining the relationships between iFDI and institutional capacities in 28 transition economies, including Community of Independent States (CIS), South Eastern European (SEE) and Central Eastern European (CEE) countries. The results provide evidence of the negative impact on indicators of stability and policy consistency, such as economic risks, on the host countries ability to attract quality FDI inflows.

Chapter six is based on the author's publication "Foreign direct investment and country risk: Is there evidence of 'malign' investment in former Soviet states". It is a quantitative analysis of the 'quality' of inward FDI in transition countries in terms of its impact on institutional environment measured by country risk. It examines the impact of FDI on a number of country risk indicators via a pooled regression model in twelve post-Soviet states and finds either a marginally negative effect on individual country risk measures such as in the case of 'Overall Country Risk', or significantly negative effects as in the case of 'Economic Risk' and 'Legal Risk'.

Chapter seven presents the results of the qualitative part of this study based on the semi-structured interviews analysis. The findings are organized in line with the themes pursued by four research questions. The first theme includes all the evidence related to the bargaining power, quality of iFDI and institutional environment in Ukraine, and changes in foreign investors - host state relationships. The second

theme focuses on the analysis of the patterns of foreign investors' political behavior and all related issues such as relationships between foreign investors' characteristics and a choice of corporate political strategies, level of pro-activity, modes of participation and effectiveness of their actions. The third theme provides the assessment of efficiency of foreign investors' attempts in protecting their interests in Ukraine. It also summarizes the interviewees' feedback on and recommendations on the potential actions for securing the improvement of the quality of iFDI and institutional environment in the country.

Chapter eight answers to the research questions by discussing the findings of all three parts in relation to each other within the framework of the entire research project in the context of the research objectives, hypothesis and questions. It draws on the relevant theory discussed in the literature review and research framework to analyze the findings and identify contributions to the literature.

Chapter nine summarizes the implications of this study for the literature, business practice, education and public policy. Finally, the thesis concludes with the review of limitations of this project and directions for the future research.

## **CHAPTER TWO: QUALITY OF FOREIGN DIRECT INVESTMENT, INSTITUTIONAL ENVIRONMENT AND BARGAINING POWER**

### **2.1 Introduction**

This chapter builds on a comprehensive review of existing international business, political science, economics, and sociology literature instrumental in answering research questions posed within this study and developing a ‘blind bargaining’ model. Thus, to test the hypothesis posed by two macro-level quantitative projects, suggesting that, firstly, the presence of ‘blind bargaining’ attracts riskier investors who prefer relatively weak political regimes and who reduce their investment inputs once host states become more assertive; and, secondly, iFDI in former Soviet states has not only failed to generate the expected positive institutional transformation effects, but rather had discernibly negative impact on certain regions; as well as to build on the results of both of the above and of a more detailed qualitative study on the foreign investors impact on institutional environment to develop a blind bargaining model, this literature review combines multiple theories, including the analysis of eclectic paradigm, institutional, FDI, trade, and development theories, the evolution of the bargaining theory, bargaining strategies, and foreign investors’ political behaviour to meet the explanatory needs of this research project. It also explores the existing theoretical knowledge on corporate political activity. In this light, the nature of foreign investors - host state relationships is analysed in terms of iFDI quality and its impact on host countries’ institutional environment taking into account changes in foreign investors’ bargaining power and in foreign investors’ political behaviour.

### **2.2 Conventional views on FDI, trade, and development**

Since the 1970s, much of the literature on economic growth has focused on the question as to why the ‘West’ has been able to accumulate significant amounts of wealth while other regions of the world suffer from comparable poverty (Lucas, 1988). Up until the mid 1990s this issue was widely disputed, not least on account of the different disciplinary approaches which contributed to this debate. However, partly due to the influence of the World Bank, International Monetary Fund and

World Trade Organization, a new consensus formed in the 1990s which emphasized trade as a principal source of wealth, and argued that the economies of wealthy nations could be distinguished from poorer ones primarily on account of their greater participation in world trade. Implicit in this new orthodox was a barely hidden policy agenda which advocated, for various reasons, the lifting of trade barriers and the expansion of global trade. Academically the new orthodoxy was underpinned most eloquently by the works of Jeffrey Sachs and Andrew Warners, whose 1995 Brookings Paper Economic Reform and the Process of Global Integration, stated categorically that "... Countries that are open to trade ... experience unconditional convergence to the income levels of rich countries". Apart from underpinning Sachs' unquestionably disastrous role in advising the collapsing Soviet Union on matters of economic restructuring, this view formed the groundwork for a host of policy initiatives which advocated the integration of transition and developed countries in the world economy as a means of combating poverty.

While political support for this orthodoxy has been strong, it has never been fully accepted amongst mainstream economists. Thus Rodrik's (2003) review of the literature on gains from foreign trade concluded that the evidence was clear that "trade yields relatively small income gains which do not translate into persistently higher growth". In as far as evidence for the positive effects of participation in trade and foreign investment was concerned, economists found that those directly employed by foreign companies experienced some, albeit fairly limited, welfare benefits. For instance, Aitkin, Harrison and Lipsey (1996) noted that foreign firms operating in developing countries tended to pay higher wages than indigenous firms; which they attributed to the possible application of superior technology. Similarly, Budd, Konings and Slaughter's (2004) investigation of multinational firms, led them to conclude that these firms engaged in patterns of rent sharing where the greater profitability of the parent company gave rise to higher wages. However, another study by Konings (2004) concluded that the employment effects of FDI itself were generally limited, primarily because employment relocation was mainly taking place between trans-national company parents which were located in similar, high-wage, countries. A study by Pavlinek (2002) on acquisitions and joint venture agreement in Central Europe was even more pessimistic in that it concluded that these activities

did not result in improvements in employment conditions, but rather in the introduction of more effective managerial control and measures to enhance labor discipline (see also Woolfson and Beck; 2004).

While many of employment and wage effects of FDI suggest caution with regard to Sachs' proposition, it is on the level of aggregate data that the pro-trade/foreign investment hypothesis appears to suffer its greatest weaknesses. Although there is evidence of a long term, albeit inconsistent, growth in trade volumes over at least the last three decades, most historical studies of growth across regions find no evidence of an 'unconditional narrowing' of global income differentials. As one of the most comprehensive and thorough studies of long-term world income distribution, Maddison's (2001) book *The World Economy: A Millennial Perspective*, instead strikingly observes an increase in inequality, in which the positions of 'Eastern Europe and the former USSR' and 'Africa' have markedly deteriorated (see Table 6.1).

Although Maddison's classification of 'US, Canada, Australia and New Zealand' into one group is perhaps somewhat counter-intuitive, his aggregate data permit some useful comparisons (see also Berger, 2006 who discusses this data in some detail). Particularly interesting, in the light of the claim of 'unconditional convergence' are comparisons between the richest group (1) including the of 'US, Canada, Australia and New Zealand' with the three non-Western groups 'Asia' (2), 'Eastern Europe and former USSR' (2) and 'Africa' (3). Of these three groups only 'Asia' (2) experienced a significant reduction in income inequality from 14.5 to 1, to a still sizable 8.9 to 1 as compared to the richest group from the period from 1950 to 1998. 'Eastern Europe and the former USSR' (2), by contrast experienced an initial narrowing of its income differential to group (1) from 3.6 to 1, to 2.8 to 1 during the period from 1950 to 1973. From 1973 to 1998, however, the income differential of the 'Eastern Europe and former USSR' (2) group relative to the richest group more than doubled from 2.8 to 1 in 1973 to 6.0 to 1 in 1998. Although it can be reliably argued that 'Asia' experienced a massive expansion of trade during this period, the pro-trade argument breaks down when we consider that the 'Eastern Europe and former USSR' and 'Africa' groups also experienced increased trade and integration



in the world economy. On the basis of aggregate data, then, there is not only evidence of a recent increase global polarization, but also of trade having a polarizing effect on at least two regions.

That this widening of income differential is not merely a matter of academic debate and economic data is perhaps best illustrated by linking this analysis to the, by now, well known phenomenon of the Russian mortality crisis. This data is reproduced in Table 6.2, not so much to illustrate the shocking decline of life expectancy among Russian males and the still quite pronounced decline among female which had occurred by 1994, but to point to the lesser known fact that the situation had not improved significantly by 2000.

**Table 2.1. Interregional spread of per capita GDP, USD, PPP**

		1950	1973	1998
Western Europe		4,594	11,534	17,921
US, Canada, Australia, NZ	(1)	9,288	16,172	26,146
Japan		1,926	11,439	20,413
Asia (excl Japan)	(2)	635	1,231	2,936
Latin America		2,554	4,531	5,795
Eastern Europe and former USSR	(3)	2,601	5,729	4,354
Africa	(4)	852	1,365	1,368
World wide average		2,114	4,104	5,709
Ratio (1) to (2) Asia		14.5:1	13.1:1	8.9:1
Ratio (1) to (3) EE and USSR		3.6:1	2.8:1	6.0:1
Ratio (1) to (4) Africa		10.9:1	11.8:1	19.1:1

Adapted from Maddison, 2001: 126.

**Table 2.2. Life expectancy in Russia and other countries**

Country	Year	Life expectancy at birth	
		Males	Females
Russia	1991	63.5	74.3
	1992	62.0	73.8
	1993	58.9	71.9
	1994	57.6	71.2
	1995	58.3	71.7
	1996	59.8	72.5
	1997	60.8	72.9
	1998	61.3	72.6
	1999	59.9	72.4
	2000	58.8	71.7
India	1994-1997	62.4	63.4
China	1994-1997	69.0	73.0
US	1994-1997	73.6	79.4

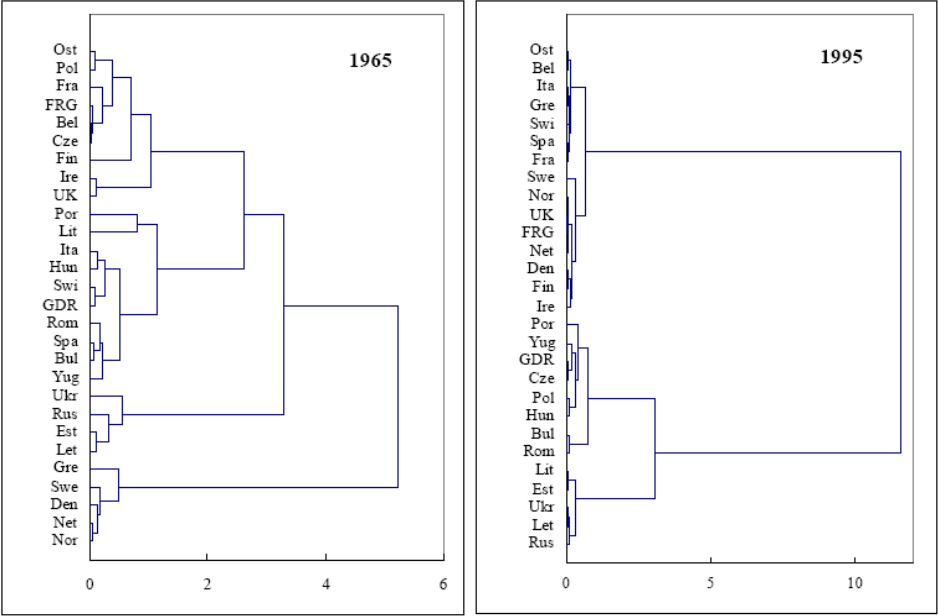
Source Goskomstat, WHO.

Adapted from Gavrilova, Semyonova & Evudkushkina, 2002: 20.

While the simultaneous occurrence of increased income inequality of the ‘Eastern Europe and the former USSR’ with the Russian mortality crisis is at least suggestive of a link, it would, of course, be difficult to draw direct causal connections. What is worth pointing out, however, is that there are several analyses which illustrate a close connection between the worsening economic position of the region post 1990 and indicators of well-being. One particularly striking study, conducted by Mesle and Vallin (2002), for instance, illustrates that, whereas in 1965 a ranking of male life expectancy included a mix of western and eastern nations, by 1995 a clear dichotomy had occurred in which the top portion of the table was

occupied exclusively by western nations, while the bottom was occupied by eastern ones (see Figure 6.1).

**Figure 2.1. Dendrograms resulting from the hierarchical analysis of male age-specific death probabilities in 28 European countries, in 1965 and 1995**



Source: Mesle and Vallin, 2002.

Taking into account these, and other, sources of evidence it is perhaps no overstatement to argue that the recent several decades of trade liberalization have brought few tangible benefits to Eastern Europe and Russia as a region. What is more difficult to answer is the question as to whether trade liberalization itself and growth of FDI inflows has damaged the region, and, if yes, by what means. To answer these questions, the following sections will, firstly, identify and justify the most appropriate theoretical frameworks for analyzing such complex phenomenon, including eclectic paradigm and neo-institutional theories. The latter will be reviewed together with some of their more radical alternatives which will help better contextualizing and understanding various aspects of the studied phenomenon. Secondly, an analysis bargaining power, various bargaining models, and political

strategies will be implemented to determine all potential loopholes and tools available for foreign investors' for achieving their business objectives.

### **2.3 Eclectic paradigm**

This part of the literature review includes a revision of the evolution of Dunning's eclectic paradigm (Dunning, 1980; Dunning, 2000; Dunning, 2001) and a validation of its choice as a theoretical framework and an instrument for the analysis of such complex phenomenon as the relationship between different components of institutional environment (as critical host country location-specific advantages) and FDI inflows. Special attention is also given to the examination of the investment development path (IDP) as a tool helping to account for the heterogeneity of FDI in terms of its impact on host country's development considering institutional inertia and path-dependent nature of policies in these countries (Narula & Guimon, 2010; Boudier-Bensebaa, 2008).

#### **2.3.1 Introduction**

The globalization of economic production supported by the continuing liberalization of investment policies and trade regimes and increased competition among firms is reshaping the international economic landscape (UNCTAD, 2005). Both the size and the role of Multinational Enterprises<sup>1</sup> (MNEs) in the world economy have continued to grow. The number of MNEs in the world had risen from an estimated 37,000 (with approximately 170,000 foreign affiliates) in the beginning of the 1990s to approximately some 70,000 (with approximately 690,000 affiliates) in 2004. Almost a half of all MNEs affiliates are now located in developing countries (UNCTAD, 2005). As a result, the nature of MNEs is becoming extremely diverse and complex.

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<sup>1</sup> "A Multinational Enterprise (MNE) is an enterprise that engages in foreign direct investment (FDI) and owns or, in some way, controls value-added activities in more than one country" (Dunning & Lundan, 2008:3). "An MNE *qua* MNE has, therefore, two distinctive features. First, it accesses, organizes and coordinates multiple value-added activities across national boundaries and, second, it internalizes at least some of the cross-border markets for the intermediate products arising from these activities. No other institution engages in both cross-border production and transactions" (Dunning & Lundan, 2008: 6).

In the light of these changes in the global economic scenario and the increasing importance of the role of the study of the MNEs phenomenon remains one of the major focuses in international economics and business research. Among the leading economic and behavioral explanations of the existence and growth of MNEs and of their foreign value-added activities are: Hymer's industrial organization theory; Vernon's product cycle theory; multinationality, organizational and risk diversification theories; capital imperfections theory; follow my leader, tit for tat theory; resource based theory; evolutionary theory; organizational (management related) theories, traditional location theories; agglomeration theories; exchange rate theories, etc. (Dunning, 2000; Dunning & Lundan, 2008; Tolentino, 2001). Most of these theories were using different units of analysis and were trying to answer different questions. None of them was trying to explain all MNEs activities (Dunning & Lundan, 2008).

Only three theories were making an attempt to offer more general explanations of the MNEs foreign value-added activities: internationalization theory, the eclectic paradigm of international production and the macroeconomic theory of foreign direct investment<sup>2</sup> (FDI) (Dunning & Lundan, 2008). However, it is "Dunning's approach to the complex phenomenon of the MNE that has proved robust and, over time, has become one of the most influential streams of thought in the international business literature" (Buckley & Nashai, 2009: 58). It should be admitted that, in spite of numerous criticisms (Buckley & Hashai, 2009; Cantwell & Narulla, 2001; Guisinger, 2001; Itaki, 1991; Tolentino, 2001), the reconsidered and adjusted eclectic paradigm retains its position as a dominant analytical framework for examining context specific and operationally testable economic theories (each of which seeks to explain a particular component of the internalization process) of foreign direct investment and international production (Dunning, 2000; Dunning, 2001, Dunning & Wymbs, 2001).

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<sup>2</sup> "Traditionally, the territorial expansion of a firm's production outside its national boundaries has been achieved by the act of a foreign direct investment" (Dunning & Lundan, 2008: 7). The latter "involves the transfer of package of assets or intermediate products, which includes financial capital, management and organizational expertise, technology, entrepreneurship, incentive structures, values and cultural norms, and access to markets across national boundaries" (Dunning & Lundan, 2008: 7).

### **2.3.2 The evolution of the eclectic paradigm**

What are the qualities that make the eclectic paradigm so unique and sustainable?

The main distinction between the eclectic paradigm and other theories seeking to explain MNEs activities and behavior is that “it does not purport to be a theory of MNE *per se*” (Dunning & Lundan, 2008: 95). It is more holistic. Moreover, Dunning suggests that it “may be considered as an ‘envelope’ of complementary and context-specific economic and business theories” (Dunning, 2001, Dunning, 2008: 108). Consequently, he states that “the purpose of the eclectic paradigm is not to offer a full explanation of all kinds of international production but rather to point to a methodology and to a generic set of variables which contain the ingredients necessary for any satisfactory explanation of particular types of foreign value-added activity” (Dunning, 2001: 177).

Interesting is the fact that this same holistic nature is to be blamed for the successes and failures of the explanatory powers of the paradigm. As Dunning himself acknowledges, on one hand, the general nature of the paradigm may limit its power to explain certain patterns of MNEs behavior and their choices for international production (Dunning, 2001; Stoyan & Filippaios, 2008). On the other hand, it is both the span and the flexibility of its general framework that allow the eclectic paradigm (if it is applied to a predefined specific context) to successfully accommodate certain criticisms and incorporate new developments in the global economy, thus preserving and advancing its potential as a valuable tool for explaining and “determining the extent and pattern of both foreign owned production undertaken by a country’s own enterprise, and that of domestic production owned or controlled by foreign enterprises” (Dunning & Lundan, 2008: 95).

### **2.3.3 The original static OLI model**

Originally the eclectic paradigm was formulated as a static framework which included three sets of interdependent variables, namely: ownership-specific (O), location-specific (L), and internalization (I) advantages (OLI advantages) and had an objective to “explain the extent and pattern of international production, i.e. production financed by FDI and undertaken by MNEs” (Dunning, 2001: 176).

Ownership advantages are firm-specific ('competitive' or 'monopolistic') advantages. They accommodate both tangible and intangible resources. The former include natural endowments, manpower and capital, while the latter are composed of technology and information, managerial, marketing and entrepreneurial skills, organizational systems, incentive structures and favored access to intermediate or final goods markets (Dunning & Lundan, 2008: 96). Initially O advantages were divided into two sub-categories, namely: asset-specific ownership advantages (Oa) embracing most of the above mentioned firm- and environment-specific tangible and intangible resources and transaction cost-minimizing advantages (Ot) shaped by the opportunities arising from the multinationality and privileges of common governance (Dunning, 2000; Dunning, 2001; Dunning and Lundan, 2008).

Location advantages are country-specific advantages which are either not available or available partially and on the worst conditions in the firm's home country. They embrace such immobile, natural or created endowments as labor, energy, materials, components, semi finished goods, prices, quality, productivity, international transport and communication costs, investment incentives and disincentives, barriers to trade, cultural, social and political differences, spillovers, economies of scale, institutional environment and others (Dunning, 2000; Dunning & Lundan, 2008: 100-102).

Internalization advantages are the result of the assessment of the value added by a certain configuration of O and L advantages. These configurations are context-specific and vary across types of value-added activities, firms, industries, regions and countries (Dunning, 2001). Such exhaustive evaluation enables firms to make cognizant internalization decisions.

So "the generalized predictions of the eclectic paradigm are straightforward. At any given moment of time, the more a country's enterprises - relative to those of another - possess desirable O advantages, the greater the incentive they have to internalize rather than externalize their use, the more they find it in their interest to access and exploit them in a foreign location, than the more they are likely to engage in outbound FDI" (Dunning & Lundan, 2008: 100).

## **2.3.4 Adjusted OLI model**

### **2.3.4.1 Dynamic OLI model**

The eclectic paradigm was facing different criticisms. While most of these critical attacks addressed its general nature (Dunning, 2001; Dunning & Lundan, 2008; Itaki, 1991) some of them, on the contrary, found that the OLI framework was comparatively static and lacking dynamism. Moreover, it was indicated that the paradigm did not account for the changes in OLI configurations arising from the modifications of O, L, and I components caused by their interrelationships (Dunning & Lundan, 2008).

Consequently Dunning added a dynamic dimension to his paradigm. He specified that “changes in the outward or inward direct investment position of a particular country can be explained in terms of changes in the O advantages of its enterprises relative to those of other nations, changes in its L assets relative to those of other countries, changes in the extent to which firms perceive that these assets (and any other it may acquire) are best organized internally rather than by the market, and changes in the strategy of firms which may affect their reaction to any given OLI configuration” (Dunning & Lundan, 2008: 100).

### **2.3.4.2 Institutional advantages**

Acknowledgement of the growing influence of institutional elements caused another adjustment within the OLI framework. Dunning admits that in the course of their activity MNEs create and transfer not only hard but also soft technology, such as codes of conduct, norms, corporate culture, organizational regimes, incentive systems, etc. The latter may induce modifications in OLI configurations and affect the host country in many different ways as a result of their interaction with its environment (Dunning & Lundan, 2008). To account for all these changes Dunning follows the North's analysis of institutions and extracts institutional assets (Oi) element out of the asset specific (Oa) component of ownership advantages.

To justify this adjustment Dunning explains that some of formal and informal institutional effects are reflected in firm's corporate culture and were accounted for



by the Oa. However, there are others which are a reflection of external norms and values. These institutional elements are shaped by human environment in which firms operate (Dunning & Lundan, 2008). As in the case of other OLI components, the composition and strength of the Oi advantages is highly contextual (Dunning & Lundan, 2008). This addition of a new unit of analysis significantly contributes to the advancement of the explanatory powers of the eclectic paradigm.

### **2.3.5 Exploratory applications of OLI model**

Plentiful research provides evidence in support of the eclectic paradigm. It has been one of the most efficient instruments for explaining different aspects of MNEs behavior. The largest part of this research explored applicability of the eclectic paradigm in terms of its capability to explain MNEs internalization decisions and choices of entry modes into foreign markets. Tests were conducted for small- and medium-sized as well as large firms representing different industries and various home and host countries.

Clear and detailed classification of ownership, location and internalization advantages, which allowed determining the original OLI configuration specific for any particular firm at any moment in time, provided MNEs with enough information for making decisions regarding externalization (export, licensing) or internalization (joint ventures, wholly owned enterprises) of their production. MNEs decisions on whether to engage in FDI or not are also confined by their strategic agenda. In other words, different entry-modes are going to be performed by firms pursuing different strategies, such as: natural resource seeking, market seeking, efficiency seeking (process or product) or strategic asset seeking strategies. So, all in all, MNEs decisions to engage in FDI and their consequent patterns of behavior in a host country will be determined by their unique OLI configuration, their underlying management and organizational strategies, and the economic, institutional and cultural specific characteristics of their host and home countries (Dunning & Lundan, 2008). Possession of such context-specific knowledge allows developing operationally-testable theories for each individual MNE or country decision-making case (Dunning, 2000).

### **2.3.6 Conclusion on OLI model**

The analysis of the evolution and explorative applications of the eclectic paradigm provides clear and strong evidence that this general framework is one of the best contemporary instruments that allows explaining the levels and patterns of foreign value-added activities of both firms and home and host countries. Plentiful research evidence demonstrated the high efficiency of the application of exclusive (for certain firm and host/ home country combinations) OLI configurations for explaining MNEs behavior. As a result of its holistic nature and flexibility the eclectic paradigm was successfully extended and adopted necessary adjustments for multiple technological, economic, socio-cultural, institutional and other changes and developments in both market and non-market environments. Thus, we assert that not only can OLI framework be used to select and explain various market strategic preferences such as, for example, choice of particular entry modes by MNEs' managers in their internalization decisions, prediction of competitors' entry mode strategies and development of innovative more efficient counter-strategies (Brouthers *et al.*, 1999), but also to examine foreign investors' non-market strategic options, particularly their political behavior and its impact on institutional changes in host countries determined by their bargaining power.

## **2.4 Institutions**

### **2.4.1 Introduction**

The neo-institutionalism theoretical framework (Acemoglu, Johnson and Robinson 2004; Dunning & Lundan, 2008; EBRD, 2009; Hall & Soskice, 2001; Henisz, 2000; Henisz & Zelner, 2005; North, 1989; North, 1990; North, 1995; North, 2003; Persson, & Sjostedt, 2009; Rodrik, 2002; Rodrik, Subramanian, & Trebbi, 2002) focuses on the study of institutions and institutional environment as critical instruments for the revelation and explanation of the variations in FDI patterns across different countries (Bevan, Estrin & Meyer, 2004; Busse & Hefeker, 2007; Daude & Stein, 2007; Dunning & Lundan, 2008), since institutions (particularly legal, political and administrative systems) are recognized as major immobile factors in a globalized market (Mudambi & Navarra, 2002). It is emphasized that the institutional diversity

and multiple potential institutional possibilities resulting from differences with regard to the choice of certain institutions and their combinations can be restricted by path dependency and embeddedness in cultural heritage of these institutions (North, 2003; Wise & Brown, 1998) as well as by characteristics, such as liberal, coordinated or transitional state of the market economies (Hall & Soskice, 2001; Roth & Kostova, 2003), and, the most important for this research project, by political power (Acemoglu *et al.*, 2004). As a result, the main objective here is to establish theoretical relationship between iFDI impact, the choices of institutional arrangements and the quality of institutions in the host countries.

What are the major catalysts and obstructs of economic development and growth? This is one of the most important, complex and controversial questions of the contemporary world. Researchers agree that it is a combination of multiple factors (such as geography, culture, different paths of factor accumulations, etc.) that determines the direction and pace of a particular country's development. However, Acemoglu, Johnson and Robinson (2004) argue that, in spite of a certain success in clarification of the development mechanisms, previous research failed to provide a fundamental explanation for economic growth. Following the North and Thomas's view there is a growing consensus among academics that differences in institutions and in their quality are the central and fundamental determinants of comparative growth (Acemoglu, Johnson and Robinson 2004; Dunning & Lundan, 2008; EBRD, 2009; Hall & Soskice, 2001; Henisz, 2000; Henisz & Zelner, 2005; North, 1989; Persson, & Sjostedt, 2009; Rodrik, 2002; Rodrik, Subramanian, & Trebbi, 2002).

As a result, the study of institutions and institutional environment is critical for the revelation and explanation of the variations in economic development of different countries, in general, and especially in case of developing and transition countries seeking to improve their performance, in particular. Moreover, Roth & Kostova (2003) emphasize that understanding institutions is even more crucial in periods of radical change in institutional environment, or institutional upheaval, which are characterized by extreme uncertainty and ambiguity. Scholars acknowledge that transition economies of the former Soviet Union and Central and Eastern Europe (CEE) are experiencing institutional upheaval accompanied not only by the downfall

of the political system, laws, regulations and financial markets, but also by the destruction of “the underlying assumptions about the purpose of economic activity” (Roth & Kostova, 2003: 315).

In this light, an analysis of the institutional environment and determinants of the institutional quality in transition countries, in particular in Ukraine, is an imperative step for the identification of the main sources of the country’s failure to achieve sustainable economic growth and for the explanation why the Ukrainian state ended up with bad institutions which do not maximize aggregate welfare.

#### **2.4.2 Institutions – definition and classifications**

“Institutions are the rules of the game in a society or, more formally, the humanly devised constraints that structure political, economic and social interactions. They consist of formal rules (constitutions, statute and common law, and regulations), informal rules (conventions, moral rules, and social norms), and the enforcement characteristics of each” (FDI: 7). The main objective of their existence is a reduction of uncertainty in the world of growing impersonal exchange and increasing specialized interdependence (North, 1989; North, 1991; North 2003).

Institutional environment of any society is generally described as consisting of three general categories of institutions: political (constitutions, laws, forms of government, the extent of constraints on politicians and elites), economic (the structure of property rights, the presence and perfection of markets) and social (marriage, education, religion) (Acemoglu *et al.*, 2004). However, different classifications of institutions are also applied by some researchers.

Thus, Rodrik (1999), in turn, builds his institutional analysis based on the classification of the same institutions according to their functional relations with the markets. He distinguishes market-supporting and non-market institutions. The latter are the institutions that perform regulatory, stabilizing and legitimizing functions, and which, in a pursuit of larger goals, such as social stability and cohesiveness, may place certain restrictions on the markets or even sometimes produce socially undesirable outcomes, for example corruption. Market supporting institutions are divided into five types: property rights, regulatory institutions, institutions for

macroeconomic stabilization, institutions for social insurance and institutions of conflict management (including political institutions).

Property rights are one of the most important determinants of the economic growth (Acemoglu *et al.*, 2004; Henisz, 2000; North, 1991; Rodrik, 1999). However, Rodrik (1999) argues that presence of formal property rights is though necessary but not sufficient condition for the creation of an attractive economic environment. They require a companionship of strong and efficient control rights embracing a combination of legislation, private enforcement and customs and traditions. A good example for the validity of this argument is Russia's failure to create an attractive investment climate in spite of its clearly defined shareholders rights versus China's success to do so without a clear definition of property rights.

Further Rodrik (1999) reasons that, as a result of the markets' failures, market economies are governed by the multiple regulatory institutions, including institutions controlling conduct in goods, services, labor, asset and financial markets. He also suggests that fiscal and monetary institutions are required for ensuring macroeconomic stabilization of the economies. Social security, unemployment compensation, public works, public ownership, deposit insurance and unions' legislation are some of the institutions for social insurance. The last but not the least type of market supporting institutions, according to Rodrik (1999), is the institutions of conflict management including the rule of law, a high-quality judiciary, representative political institutions, free elections, independent trade unions, social partnerships, institutionalized representation of minority groups and others. These institutions "tend to increase the incentives for social groups to cooperate by reducing the payoff to socially uncooperative strategies" (Rodrik, 1999: 13).

These differences in the approaches with regard to the choice of certain institutions and their combinations, attest to the institutional diversity, and, as a result, demonstrate that multiple potential institutional possibilities can still be identified. Nonetheless, some researchers emphasize that societies are limited in their ability to change their sets of institutions because the latter are path dependent, or deeply embedded in the cultural heritage of these societies (North, 2003; Wise & Brown, 1998). However, the validity of the latter argument was challenged by the

empirical evidence, as in the case of South and North Korea, demonstrating that countries with absolutely identical characteristics, including cultural heritage, can adopt contrasting sets of institutions and choose completely opposite paths of their development (Acemoglu *et al.*, 2004). Scientists suggest that the choices of institutional arrangements and the quality of institutions in countries are also restricted by certain characteristics, such as liberal, coordinated or transitional state of the market economies (Hall & Soskice, 2001; Roth & Kostova, 2003), and political power (Acemoglu *et al.*, 2004).

Thus, the quality and choice of certain sets of institutions differs across countries. Acemoglu *et al* (2004) indicate that current research distinguishes four main approaches with regard to the institutional differences:

- the efficient institutions or the political Coase theorem view claiming that societies will choose socially efficient economic institutions;
- the ideology view identifying ideological differences as a main cause of differences in economic institutions across countries;
- the incidental institutions view declaring that institutions are the choices determined by economic reasoning based on the calculations of their social costs and benefits;
- the social conflict view averring that both economic and political institutions in most of the cases are not the choices of the whole society for its benefits but of the controlling political power at the time.

We argue that the social conflict view provides the most appropriate framework for the analysis of the relationships between foreign investors and institutional environment in transition countries such as Ukraine.

### **2.4.3 The social conflict view**

Economic institutions are crucial in shaping the economic performance of the society. North emphasizes that the choice and quality of economic institutions is determined by political institutions (North, 2003). Acemoglu, Johnson & Robinson

(2004) following North, in accordance with the social conflict view of the institutions, elaborate that economic institutions condition the economic performance of the economy and determine the array of economic outcomes, including the distribution of resources in the future. Nevertheless, they emphasize that since the prosperity of different groups and individuals differs depending on the set of economic institutions performing the distribution of the resources, there will typically be a conflict over the choices of these institutions. The preferred set of economic institutions will be secured by the groups with the prevailing political power.

Political power is defined as consisting of two components: de jure political power or political institutions and de facto political power. The latter is nurtured from two sources such as the group's collective action potential and the group's economic resources (Acemoglu *et al.*, 2004). As a result, the winner will be the group outperforming the rest of the society along both dimensions of the political power.

The legitimate question to ask here is “why do the groups with conflicting interests not agree on the set of economic institutions that maximizes the aggregate growth?” (Acemoglu *et al.*, 2004: 3) and instead irrationally opt for the set of institutions leading to economic inefficiencies and sometimes even poverty (Acemoglu *et al.*, 2004). The answer is “commitment problems inherent in the use of political power. Individuals who have political power cannot commit not to use it in their best interests” (Acemoglu *et al.*, 2004: 3-4). Moreover, it is also induced by a threat to become economic and/or political losers, loose power without compensation (Acemoglu *et al.*, 2004; Acemoglu, 2006; Persson, & Sjöstedt, 2009). As a result, groups possessing both de jure and de facto political power “affect the choice of economic institutions and influence the future evolution of political institutions” (Acemoglu *et al.*, 2004: 6) in a ways that furthermore strengthen their political positions and improve their economic welfare (Acemoglu *et al.*, 2004).

Academics agree that politically powerful groups will opt for the good institutions maximizing aggregate welfare in cases when the cost of not adopting such institutions is higher than the cost of adopting the institutions improving only

their welfare (Acemoglu, 2006; Acemoglu & Robinson, 2006; Persson, & Sjöstedt, 2009). Good economic institutions “providing security of property rights and relatively equal access to economic resources to a broad cross-section of society” are also anticipated to arise “when political power is in hands of a relatively broad group with significant investment opportunities” and when power holders can obtain only limited rents from the rest of the society (Acemoglu *et al.*, 2004: 9-10). Moreover, the imposition of checks and balances on politically powerful policy-makers will reduce policy volatility and, as a result, also contribute to the improvement of the economic institutions and stimulate economic growth (Acemoglu *et al.*, 2004; Henisz, 2004).

Social conflict view provides an ideal framework for explaining the persistence of institutional voids and inefficient exploitation of institutional change in transition economies.

#### **2.4.4 Institutional voids and institutional change**

##### **2.4.4.1 Institutional voids**

Palepu & Khanna (1998) argue that it is the quality of institutional infrastructure that contributes to the success of developed and to the failure of developing, emerging and transition economies in providing secure and transparent business environment characterized by efficiently functioning markets. The authors emphasize that unfortunately very often governments in transition and emerging economies focus on the development and advancement of physical infrastructure consciously or unconsciously leaving the problem of the lack and underdevelopment of formal institutions unattended (Palepu & Khanna, 1998; Khanna & Palepu, 2013). Scholars use the term ‘institutional voids’ to define the situation when some or all of the most important market-supporting institutions, including property rights, regulatory systems, contract-enforcement mechanisms and others, are either missing, underdeveloped or inefficient (Doh *et al.*, 2014; Khanna & Palepu, 1997; Khanna & Palepu, 2013; Palepu & Khanna, 1998; Prokopovych, 2011; Puffer, McCarthy & Boisot, 2010).



Social conflict view framework (Acemoglu, Johnson & Robinson, 2004) provides a solid foundation for explaining why institutional voids and or inefficient formal institutions persist in transition countries. In post-Soviet states, particularly Ukraine, vested interests, represented by merged political, economic and criminal powers including state officials, political and economic elites, opt for preserving inefficient formal institutional structure. It is noteworthy that in this case failure to create functional institutional environment is not a result of misguided government policies (Palepu & Khanna, 1998). It is rather a barrier created by a deliberate effort of the vested interests (Khanna & Palepu, 2013) to preserve and increase their economic and political power (Acemoglu, Johnson & Robinson, 2004). Pursuit of such self-centered goals culminates in a development of various government strategies which, even if efficient, are undermined by a destructive behavior of state officials. The fear of the latter to lose their power without compensation (Acemoglu, Johnson & Robinson, 2004) leads them to establishing a governed by corruption parallel informal institutional structure feeling all the artificially created and nurtured voids in formal institutions.

Thus, this new alternative informal institutional arrangement either completely prevents or minimizes chances for any centralized, group and/or individual effort to influence efficient institutional change in transition post-Soviet states. However, the analysis of the relationships between institutional voids and institutional change (Doh *et al.*, 2014) and the assessment of a possible impact of various stakeholders on institutional change requires better conceptual understanding of this process.

#### **2.4.4.2 Institutional change**

Kingston & Caballero (2009) distinguish two basic approaches to classification of institutional change theories even though both of them acknowledge exogenous parameter change as a key catalyst of institutional change. The first approach incorporates theories based on unintentional evolutionary and the second on design-based views. The latter most vividly provides further justification of artificially maintained institutional voids hypothesis.

Design-based approach combines collective-choice theories of institutional change. According to the theories within this category, institutional change is a result of a centralized action, such as bargaining, lobbying or any other political activities, supported by a collective-choice process (Kingston & Caballero, 2009). In parallel with a social conflict view (Acemoglu, Johnson & Robinson, 2004) Libecap (1989) argues that the ability of any group to react to exogenous parameters shift by promoting institutional change is dependent on and restricted by the interests of a powerful groups with vested interests representing a rule-making elite. Moreover, both Libecap (1989) and Ostrom (2005) further indicate that powerful groups will not only be able to prevent institutional change but also to successfully advocate the emergence and persistence of inefficient institutions.

Libecap (1989) views institutional change as a path-dependent process which is constrained by a framework of responses determined by previous political agreements, political bargaining process and a set of current available alternatives of institutional arrangements. Moreover, he admits that dominated by step-by-step modifications the process of institutional changes has an incremental nature.

Ostrom (2005), based on her multi-layer nested hierarchy of rules approach identifying operational, collective-choice, constitutional and meta constitutional rules, explains that the decision on implementation of the institutional change will be issued by the decision-makers aligning the higher level rules along with their interests. This researcher also acknowledges the role of bounded rationality in effecting the institutional change.

Kingston & Caballero (2009) point out that institutional economists insist that the judiciary should be responsible for controlling institutional changes by approving it in courts or by issuing legislation. However, if the judiciary is an inefficient and faulted institution itself, as it is in case of transition economies, this process of artificial institutional selection is doomed to failure from the outset. Similar outcome is expected in case of theories investing all decision-making power into political actors who they define as autonomous rulers, such as North (1981) predatory ruler model (Kingston & Caballero, 2009).

The second approach integrates evolutionary theories of institutional change (Ayres, 1944; Hayek, 1973; Knight, 1995; Levi, 1990; Sugden, 1989; Veblen, 1899; Yong, 1996). Kingston & Caballero (2009) specify that the main difference between the two categories is the selection process of institutional differences. In the case of evolutionary theories there is not centralized institutional selection mechanism, for example, such as legislation. Here all institutional selections are decentralized, even though sometimes deliberately generated, and are outcomes of uncoordinated options.

Some theories belonging to this category consider institutional change as a secondary issue (Kingston & Caballero, 2009). For example, Kingston & Caballero (2009) argue that transaction cost economics (TCE) is based on the assumption that the goals of transaction costs minimization automatically leads to the emergence and adoption of the most efficient set of institutions. As a result, this approach fails to explain the institutional differences and persistence of inefficient institutions in societies with similar characteristics (Kingston & Caballero, 2009).

Similarly, Hayek (1973) argues that inefficient institutions will be ousted by evolutionary pressure. In his view institutions are the result of the social groups' selections. The latter are determined by the rules of conduct developed through generations based on deliberate effort and constituting a part of an overall 'spontaneous order'. He also insists that "the rules that emerge spontaneously are necessarily efficient" (Kingston & Caballero, 2009: 172).

Levi (1990) demonstrates that decentralized actions of independent individuals could lead to decentralized collective actions of, for example, disadvantages groups, and attempts to force institutional changes by withdrawing their support for certain institutions.

Evolutionary institutional approach rests on an assumption that institutional change is path-dependent. However, in contrast to the design-based theories, evolutionists claim that institutions and institutional structures change under the pressure of changing circumstances or shifts in exogenous parameters which are not caused and controlled by any systemic pressure such as legislation or political

activity. Here, the key impetus for all institutional changes is uncoordinated responses to changes in characteristics of various elements constituting this institutional environment, for example, such as population, social and physical and technologies (Ayres, 1944; Hodgson, 2004; Kingston & Caballero, 2009; Nelson, 2005).

Merging of the two above discussed approaches poses a question regarding the relationships between formal and informal institutions (Kingston & Caballero, 2009). North (1990) considers informal institutions to be a very important element of the overall institutional structure but sees changes in them as a follow up of modifications in formal rules. Roland (2004) suggests the opposite way causation in this relationships, while Ruttan (2006) demonstrates that all elements of physical and institutional infrastructures mutually affect each other.

This literature analysis shows, that so far research on institutional voids, institutional changes and relationships between formal and informal institutions has produced mixed and inconsistent results. It proves that further context-specific research is required to identify patterns of the above discussed relationships specific to singular countries or certain groups of countries, such as transition states.

#### **2.4.5 Neo-institutional vs. alternative models of trade, FDI, and development**

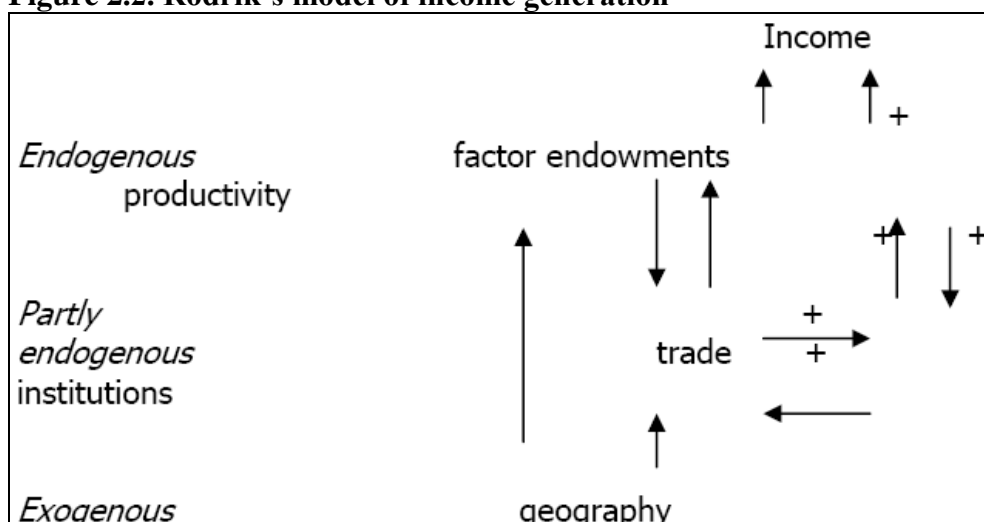
##### **2.4.5.1 Neo-institutional models of trade, FDI, and development**

The analysis of institutional theories provided above confirms that contemporary theoretical approaches to the impact of trade and investment on development no longer take an unambiguously positive role of trade and investment for granted. In particular, there is now a broader acknowledgement of the fact that institutional structures mediate the impact of trade and investment. However, within this literature a number of micro-narratives continue to suggest that trade and investment are linked to increased growth and prosperity, even to the extent of having a ‘unambiguously’ positive impact on existing institutional structures. Specifically, the literature continues to recognize three mechanisms which allegedly create benefits from trade and investment. These include, firstly, strategic modernization which describes a process where the recipient country gains access to the know-how and finance

necessary to update equipment and bring about strategic restructuring together with an imposition of efficient corporate governance (Blanchard, 1997). Secondly, trade and investment are expected to create positive externalities which extend to a process where the introduction of new products and processes by foreign firms creates spillovers for the domestic economy (Teece, 1977). Lastly, and perhaps most controversially, increased trade and investment are expected to result in hardening budget constraints, where foreign participation in firms reduces financial links of local firms with government organizations, allowing central government to impose harder budget constraints and improve performance (Dewartipont and Maskin, 1995; Roland 2000).

At their core, neo-institutionalist narratives on trade and economic growth suggest that the integration of an economy into the world market cannot alone explain growth. Rather, growth is, apart from obvious factor endowments, dependent on the interaction of three factors, namely; i) participation in trade, ii) institutional development and iii) existing productive capacity (Rodrik, 2003). According to Rodrik, the income level of a country is dependent on its factor endowments which, in turn, are determined by the availability of physical and human capital. However, the effect of these factor endowments is mediated by economies' levels of productivity. In other words, economies with similar levels of physical and human capital can differ significantly in terms of their wealth and growth potential on account of different levels of productivity. In Rodrik's model (see Figure 6.2) factor endowments and productivity are 'endogenous.' The elements which establish these endogenous levels of factor endowments and productivity include trade and institutions, which Rodrik describes as being 'partly endogenous.' In other words, the positive effect which trade is likely to have on an economy depends in part on the absorptive capacity of institutions, with institutions having a more pronounced influence on income levels than trade (see also Rodrik, Subramian and Trebbi, 2001).

**Figure 2.2. Rodrik's model of income generation**



Source: Rodrik (2003).

Ultimately, therefore, the principal source of wealth for an economy is its productivity, albeit that improvements in a country's trade position can lead to improvements in its institutional make-up, which, in turn, positive affect the crucial parameter of productivity. Lastly, both trade and factor endowments are affected by a country's geography which, as exogenous factor, can play a key role in shaping a national economy's competitive position.

In terms of its policy implications Rodrik's model represents a limited, but not insignificant, deviation from Sach's orthodoxy on at least two counts. Firstly, it suggest that trade is not sufficient to initiate growth through productivity enhancement, if institutional structures are deficient. Secondly, is an implicit assumption that trade and foreign investment are likely to have a impact on both institutional developments and only indirectly on productive capacity (see plus signs in Figure 6.2).

While Rodrik's model and similar neo-institutionalist narratives on income and growth have their appeal, particularly when compared with earlier uncritical assumptions with regard to the benefits of international trade, they have struggled to find convincing empirical support. Rodrik's own (2003) work entitled *The Search for Prosperity* purports to include case studies in support of the model's core

assumptions. Accordingly, the book includes fourteen country studies which are meant to illustrate how the interaction of institutions and trade either created, or failed to create, prosperity. Interestingly, none of these country examples include a post-Soviet country. Examples of a successful translation of trade into wealth include Australia, India, Botswana, Vietnam, Mauritius, Venezuela, Poland, China and Mexico. Examples of largely unsuccessful absorption of trade include the Philippines, Indonesia, Romania and Bolivia, with Pakistan representing an 'undecided'. While it is futile to unpick these arguments at any length, it is probably worth mentioning that Botswana's economy recently faced a near complete collapse, triggered partly by its close economic ties with Zimbabwe. Similarly, Venezuela, despite its oil wealth underwent a major economic crisis in mid 2000 which brought a socialist government to power. The Philippines, Indonesia and Romania, rather than being condemned to hopeless underperformance, meanwhile, appear to experience moderate economic growth.

The fact that applications of neo-institutionalist models of growth do not perform unambiguously well when applied to concrete case studies, needless to say, does not necessarily discredit this intellectual enterprise. What is perhaps more troubling are other issues which include the fact that, as a theory, Rodrik's model is potentially over determined. In other words, it offers an opportunity to explain the absence or presence of trade-induced growth on the basis of institutional weaknesses, while institutional stagnation or development, in turn, can be linked to the presence of absence of trade. This offers the very real possibility that virtually any event or development with regard to a country's economic fate can be explained on the basis of at least some of the elements of the model. Perhaps even more troublesome, is the fact that the model ignores a significant intellectual tradition which views, and has viewed, trade as a potentially detrimental force in as far as the institutional, social and political development of developing and transition nations is concerned.

#### **2.4.5.2 Alternative model of trade, FDI, and development**

Alternative literature voices concerns over the impact of trade and investment on lesser developed economies in connection with the, largely continental, imperialism debate of the early 20<sup>th</sup> century. At the time an intense debate took place among

leftist intellectuals who examined the instability of contemporary advanced capitalist systems and highlighted the economic role of colonialism and imperial expansionism as practiced by the main European powers and the US (see e.g., Luxemburg's *The Accumulation of Capital*, originally published in 1913 and Bukharin's *Imperialism and the World Economy*, originally published in 1916). Bukharin's work in particular hypothesized that export of capital by heavily industrialized nations would lead to the subjugation of the economic interests of the recipient country. In chapter seven of his *Imperialism and the World Economy*, Bukharin stated:

Looked upon from the point of view of the spreading of the organizational forms of modern capital, capital export is nothing but a seizure and a monopolization of new spheres of capital investment by the monopoly enterprises of a great nation or - taking the process as a whole - by the organized "national" industry, by "national" finance capital. Capital export is the most convenient method for the economic policy of finance groups; it subjugates new territories with the greatest ease.

In the 1970s a number of researchers attempted to re-examine earlier notions of imperialism within a structuralist context, with a view toward explaining the persistence of underdevelopment within certain regions. In his, at the time, widely read paper *A Structural Theory of Imperialism*, Galtung (1971) proposed a concept of 'core and periphery' in which Core, or industrialized, nations established core areas within the Periphery, or developing nations, in order to facilitate trade. According to Galtung, this core and periphery system superficially benefited both Core and Periphery nations, while, at a deeper level, sustaining a type of unequal trade and exchange which Galtung described as imperialism or structural violence. Specifically Galtung (1971: 81) noted that:

Imperialism will be conceived as a dominance relation between collectives—particularly between nations. It is a sophisticated type of dominance relation which cuts across nations, basing itself on a bridgehead which the center of the Center [sic] nation establishes in the center of the Periphery [sic] nation, for the benefit of both. ... Briefly stated, imperialism is a system that splits up collectives and relates some of the parts to each in relations of harmony of



interests, and other parts in relations of disharmony of interest, or conflict of interest.

While Galtung's analysis was primarily concerned with the role Western economic activity played in fermenting conflict within periphery nations, he attributed a crucial role to trade and foreign investment in supporting institutional structures which cemented existing relationships of exploitation and contributed to political instability.

Galtung's core and periphery theory was further developed by Wallerstein's (1979) who introduced the concept of the 'semi-peripheral state'. According to Wallerstein, semi-peripheral states played a key role in the capitalist system, on account of their ability to absorb products of richer nations. However, Wallerstein argued, there was no guarantee for the future prosperity of the nations and no evidence that these nations would benefit from a future expansion of trade. In his chapter *Dependence within and Interdependent World* (1979: 71), Wallerstein specifically argued:

In a system of unequal exchange, the semiperipheral country stands between in terms of the kinds of products it exports and in terms of the wage levels and profit margins it knows. Furthermore, it trades or seeks trade in both directions, in one mode with the periphery and in the opposite with the core. Whereas at any given moment, the more *balanced* trade a core country or a peripheral country can engage in, the better off it is in absolute terms, it is often in the interest of the semiperipheral country to *reduce* external trade, even if balanced, since one of the major ways in which the aggregate profit margin can be increased is to capture an increasingly large portion of the *home* market for its *home* products (emphasis in the original).

Wallerstein was not only reluctant to accept the assumption that foreign investment and trade will have a positive effects on the recipient economy, but went as far as to argue that foreign investment which was led primarily by the needs of the developed country was destined to be detrimental to the recipient economy.

While the structuralist analysis of inequality has ceased to attract the attention of mainstream scholarship on development, a series of more recent papers have borrowed heavily from some of the core notions of this literature. A striking example of this is the work of Moran whose notion of benign and malign foreign investment relies heavily on earlier ideas about the potentially undesirable effect on unconstrained trade. In his book *FDI and Development: A New Policy Agenda for Developing Countries and Economies in Transition*, Moran (1998: 20) argues that:

Instead of filling the gap between savings and investment, Multinational Enterprises (MNEs) may lower domestic savings and investment by extracting rents and siphoning off the capital through preferred access to local capital markets and local supplies of foreign exchange. Instead of closing the gap between investment and foreign exchange, they might drive domestic producers out of business and substitute imported inputs. The MNE may reinvest in the same or related industries in the host country and extend its market power. The repatriation of profits might drain capital from the host country. MNEs' use of "inappropriate" capital intensive technologies may produce small labour elites while consigning many workers to the ranks of the unemployed. Their tight control over technology, higher management functions and export channels may prevent the beneficial spillovers and externalities hoped for in more optimistic scenarios.

Implicit in Moran's analysis is the assumption that, rather than contributing to institutional development and productivity, certain types of FDI have the potential to undermine existing institutional growth trajectories and, in so doing, forestall future economic growth and development.

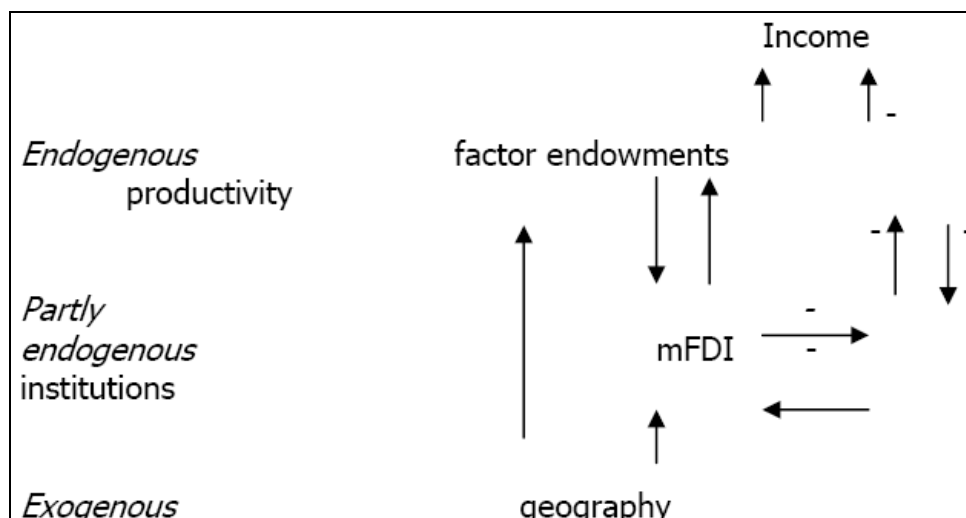
Although analyses of the type presented by Moran still represents a minority view amongst development economists, it is interesting to note that even some researchers involved in contemporary international policy making have started to adopt a critical perspective on the institutional impact of foreign investment. One example of this are the economists Hausmann and Fernandez-Arias (2000) who presented a paper to the Annual Meeting of the Board of Governors, Inter-American Development Bank and Inter-American Investment Corporation which noted that

“the view that capital inflows tend to take the form of FDI – share of FDI in total liabilities tends to be higher – in countries that are safer, more promising and with better institutions and policies was misleading”. Specifically Hausmann and Fernandez-Arias found that, while some capital flows tended to target countries that were safer, more developed, more open, more stable and had better and advanced institutions and financial markets, the share of FDI in total capital flows to these countries tended to be lower than to less stable regions. This analysis not only suggested that FDI often targeted countries that were riskier, poorer, more volatile and more closed, but also that foreign investment quite possibly contributed to regional instability.

Collectively these alternative approaches to foreign investment suggest a model of trade, investment, and development which differs radically in its outcomes from the neo-institutionalist paradigm. Applying the notion of malign investment to Rodrik’s framework, it can be argued that certain types of investment (here denoted as mFDI for malign FDI) can weaken existing institutions, while being themselves attracted to institutionally weaker environments. This potentially vicious cycle of institutional erosion and malign FDI inflows, in turn, is likely to adversely affect the domestic productive capacity of the recipient country productivity and, ultimately, its wealth (see Figure 2.3).

While there is no conclusive empirical study which documents the institution-eroding effects of malign investment, there is ample anecdotal evidence on how developing and transition countries suffered from institutional disintegration and political instability as a consequence of FDI (see, e.g., Marriott and Muttitt, 2005). This pattern appears to be particularly pronounced where these investments centre on primary and/or extractive industries at the costs of the recipient country’s secondary and tertiary sectors.

**Figure 2.3. Malign investment and the erosion of domestic capacities**



An industry and foreign investor type specific analysis is required to provide a more substantial and consistent evidence and support for the suggested model. Thus, the remaining sections of this chapter will, firstly, examine the existing bargaining models and develop a new ‘blind bargaining’ model of bargaining relationships between host states and foreign investors. Secondly, it will review the key characteristics of all potential strategic tools that foreign investors can apply for protecting their interests and initiating pursued changes in institutional environment of recipient states.

## 2.5 Bargaining models and strategies

### 2.5.1 Vanishing of ‘obsolescing bargain’

The ability of transition host states to protect themselves against the inflow of ‘malign FDI’ and their aptitude in securing the inflow of ‘benign FDI’ can be significantly reduced not only by levels of political instability, but also by shifts in bargaining power between host states and MNEs.

While Vernon (1977) and Moran (1974), referring to ‘obsolescing bargain’, assumed that the position of MNEs vis-à-vis states can be significantly weakened once the foreign company has sunk investments which it cannot easily withdraw, Vernon acknowledges that the assumption that national leaders gained greater bargaining power as a result of growing competition between the firms was false.

This has led him to suggest that “overall, the role of multinational enterprises as a class has been growing, not declining” (Vernon, 1971: 194). Similarly, Stopford and Strange (1991: 215) came to the conclusion that “governments, as a group, have indeed lost their bargaining power to MNEs as the possibilities for their collective action have diminished”. They have suggested that “intensifying competition among states seems to have been a more important force for weakening their bargaining power, than have changes in global competition among firms” (Stopford & Strange, 1991: 215). They have further argued that while “governments can maintain considerable power in their dealings with any one foreign firm” (Stopford & Strange, 1991: 215), the competition for world market shares is likely to undermine their position (Stopford & Strange, 1991: 215).

Recent research has suggested that bargaining no longer defines the MNE-host relationship, and that bargaining irrelevance is reflected in a shift from a conflictive relationship to a more co-operative one (Haslam, 2004: 2). According to this research, these movements can be explained by changes in the strategy of both MNE and governments which conditionally define an end to the era of ‘massive expropriation’ (Haslam, 2004: 3). Luo (2003:1) suggests that:

(I)n the beginning of the twenty first century, the nature of the relationship between multinational corporations (MNC) and host governments could be best described as co-competition that is a situation, where cooperation and competition simultaneously function in increasingly interdependent MNC-government relations (MGR). In this context, cooperation reflects the elements of mutual accommodation and collaboration, where joint payoffs and goal accomplishment are sought by all parties based on their interdependent activities or resources. Competition reflects the elements of bargaining where private gains are sought at the expense of the other party’s interests.

Extending this argument further, Ramamurti (2001: 23) argues that “in the last decade relations between MNEs and host governments in developing countries changed from being predominantly adversarial and confrontational to being non-adversarial and cooperative”. In addition, it has been argued that the regulative

authority of international institutions and the growth in variability of international instruments regulating relations between MNEs and host states is reducing the relevance of ‘obsolescing bargain’ (Jensen et al., 2012).

Starting from the late 1990s – beginning 2000s International Investment Agreements (IIAs) (bilateral, regional and multilateral) have been amongst the most popular international regulative instruments. IIAs have been created in order to help host countries attract FDI by ensuring more transparent, stable and predictable regulatory framework for FDI within these states and to protect foreign investors’ interests. Bilateral investment treaties (BITs) and double taxation treaties (DTTs) became some of the most important instruments at the bilateral level to protect investors already by the beginning of the 2000s (UNCTAD, 2003). In 2002 alone, 82 BITs were concluded by 76 countries and 68 DTTs by 64 countries (UNCTAD, 2003). Overall, by the end of 2002, 2181 BITs and 2256 DTTs were signed worldwide, out of which more than 700 BITs and 600 DTTs were concluded by CEE since the early 1990s. BITs and DTTs cover an estimated 22% and 57% of the FDI stock in developing and CEE countries and 7% and 87% of the world FDI stock, correspondingly (UNCTAD, 2003). Russia alone signed 54 intergovernmental agreements on promotion and mutual protection of investments with foreign countries and 80 intergovernmental agreements on avoiding double taxation (Yacheistova, 2001).

Haslam (2004) argues that, in the current neoliberal epoch, the scope for bargaining between states and MNEs has become very limited since attempts to extract more surplus from foreign firms can result in the deterioration of the host country’s reputation as a good investment climate. He also provides an example, where, contrary to the expectations of obsolescing bargaining, Chilean and Argentinean state agencies refused to renegotiate existing arrangements for the sake of preserving their reputation as safe investment environments (Haslam, 2004).

Most contemporary research argues that ‘obsolescing bargain’ has become irrelevant primarily due to the necessity of the states to create a comparatively advantageous investment climate under conditions of growing competition. In this context, it is usually assumed that the interests of the state, national goals, and state

representatives or officials responsible for making decisions coincide. In doing so, much of this research ignores the possibility of a divergence of national goals and the interests pursued by government officials. However, evidence exist that, in certain countries, state officials are directed not by national interests but rather by the private motives of personal gain. Therefore, the nature of their decision-making cannot effectively underpin their country's reputation but rather increases uncertainty.

### **2.5.2 Political bargaining**

Eden, Lenway & Schuler (2004) suggested that obsolescing bargain model remains an important component in the study of MNE – state relationships. These scholars argued that removing focus from ‘obsolescing’ and placing it onto ‘bargaining’ element of the model led them to the development of a more conceptually advanced political bargaining model which is built on an assumption that MNEs – state relations are repetitive in their nature. The authors emphasize that to preserve and even strengthen their competitive positions in certain markets MNEs need to continually initiate and engage in negotiations with host states over different policy issues (Eden, Lenway & Schuler, 2004).

The outcome of each political bargain depends on the relative potential and actual power of all parties participating in negotiations (Eden, Lenway & Schuler, 2004). The deviation between the potential and actual powers is determined by several categories of factors identified in obsolescing bargaining model including relative goals, resources and constraints of bargaining actors (Brewer, 1992; Eden, Lenway & Schuler, 2004; Grosse, 1996; Grosse & Behrman, 1992; Kobrin, 1987; Moran, 1985; Vachani, 1995; Vernon, 1971; Vernon, 1977) and “the ability of either party to limit the behavior of the other party directly through economic and political coercion” (Eden, Lenway & Schuler, 2004: 17). Political bargaining model adopts the aforementioned factors with adjustments built upon the insights from the international business and strategic management literature on liability of foreignness and legitimacy (Boddewyn & Brewer, 1994; Jones, 1985; Kostova & Zaheer, 1999; Wood, 1991), transaction cost economics (Argyres & Liebeskind, 1999; Dean *et al.*, 1998; Getz; 1997; Littlejohn, 1986; Lord, 2000; Stratmann, 1991; Wexler, 1982;

Williamson, 1985) and the resource based view (Barney, 1991; Miller & Shamsey, 1996; Teece, Pisano & Shuen, 1997).

Embracing new theoretical approaches allows Eden, Lenway & Schuler (2004) to identify several new aspects within each category of core components not accounted for in obsolescing bargaining model. Thus, they show that recent developments in international business, such as emerging market firms (EMFs), causes the evolvement of two new nontraditional FDI market entry motives: knowledge-exploitation and knowledge-seeking. Further, the scholars draw our attention to the value of organizational legitimacy in reinforcing MNEs' potential bargaining power (Eden, Lenway & Schuler, 2004).

Another very important advantage of political bargaining model is expanded coverage of host countries. Whereas obsolescing bargain model examined only the MNE - developing country relationships and relative goals, political bargaining model does not have country wise restrictions. Moreover, its authors admit the need for the development of custom made models for four distinct groups of countries, including developed, emerging, transition and developing economies. It would allow accounting for and assessing the impact of the differences in goals, capabilities and institutional environment on the quality of MNE – host state relationships and outcomes of their bargaining (Eden, Lenway & Schuler, 2004).

Both individual and collective potential bargaining power of MNEs versus host states is also highly dependent on the MNEs' ability to manipulate their tacit and relational resources within a host-country specific regulatory environment and on the contextual complementarity of both parties' resources (Eden, Lenway & Schuler, 2004; Luo, 2001). Political bargaining model also extends the list of traditional external and internal political and economic constraints acknowledged by obsolescing bargain model by pointing out to the role of supranational institutions in constraining host states' decision-making alternatives (Eden, Lenway & Schuler, 2004; Ramamurti, 2001).

Overall, political bargaining model is an excellent theoretical platform for a development of special cases, such as obsolescing bargain model, for further comprehensive country-specific analysis of different foreign investor – host state



bargaining relations, in general, and foreign investors' political behavior, in particular.

### **2.5.3 'Blind bargaining'**

While existing bargaining models provide a reasonable description of the nature of bargaining in MNE-host state bargaining relations, none of them captures the specific characteristics of bargaining in neo-patrimonial post-Soviet transition states. This research suggests that these characteristics as a special case of political bargaining model in neo-patrimonial transition countries can be summarized under the term 'blind bargaining'.

'Blind bargaining' is a model depicting the cognitive situation of a foreign investor who is lacking the clarity on the situation he is in and, as a result, bound to act in conditions of extreme uncertainty due to the high degree of intransparency and instability of the "rules of the game" at any given moment and of their propensity for unpredictable change at any time in the future. It describes the relationships between foreign investors and recipient states with regard to their ability to attract 'benign FDI' for the states where "the specific model of interaction between state and society blocking social and economic development of this state" (Zon, 2001: 72) exists. So, 'blind bargain' occurs where a "patrimonial and predatory state" (Zon, 2001: 71) has developed, such as is the case in Ukraine, in other post-Soviet states and in states with analogous characteristics and behavioral patterns. It relates specifically to the "deficiencies of these paralyzing states" (Zon, 2001: 71) and helps explain inconsistencies in the bargaining behavior of these states and their inability to attract quality FDI inflows.

'Blind bargaining' is rooted in the heterogeneity of bargaining interests of government actors in neo-patrimonial states and the incentive incompatibilities faced by officials. Neo-patrimonial states, in this context, can be defined as regimes, possessing the following characteristics: high levels of personalization of power in the state, the capture of the state by ruling clans, lack of rule of law, lack of distinction between the spheres of economics and politics, a disintegration of the state apparatus, the spread of corrupt practices in the state bureaucracy, paralyzing impact of state intervention in economic life (motivated by the personal interests of

representatives of state authorities), lack of transparency and lack of consistency in all spheres of political and economic life (Eisenstadt, 1973; Zon, 2001).

‘Blind bargaining’ reflects both the presence of a latent conflict between national and personal interests of state representatives and the inability of the existing political system to sanction individual self-enrichment. As a consequence of this situation, the decisions of neo-patrimonial host states are often directed not towards serving national interests, but towards supporting personal aims of the officials in power. This leads to bargains with these states being less stable and more unpredictable than in states which are characterized by conventional patterns of economic instability such as, for instance, lack of currency convertibility.

One of the primary implications of ‘blind bargaining’ is the absence of any distinction between spheres of economy and politics. Moreover, there is a subordination of state politics to the personal economic interests of the ruling elite.

In many post-Soviet states, the rule of political-economic clans is omnipresent and it even showing ‘dynastic’ tendencies. In October, 2003, for instance, for the first time, the rule of a post-Soviet state was passed from father to son as a result of Azerbaijan’s “democratic” presidential elections. In Kazakhstan, President Nursultan Nazarbayev’s eldest daughter, the country’s biggest media baron, is creating a new political party and is believed to be groomed for the succession of her father. There is also an assumption that the head of the major business empire in Uzbekistan, the daughter of the President Islam Karimov would replace her father if he was forced to step down. Turkmenistan’s President, Saparmurat Niyazov, is president for life. At least half of the former Soviet Republics can be considered as being predominantly governed by authoritarian rule.

Relatives of presidents are often the biggest businessmen of their countries, possessing massive economic power. The daughter of the former Ukrainian President, Leonid Kuchma, is married to one of the country’s oligarchs, a steel and media magnate. The sons of the recent president of Ukraine, Viktor Yanukovich, and of Moldova and sons of the both previous presidents of this country are all powerful business tycoons. Former Georgian President Eduard Shevardnadze’s nephews and

son-in-law are among the leaders of the country's biggest business clans (BBC News, 2003).

The presidents of Ukraine and Belarus attempted to introduce constitutional changes to satisfy their wish to seek another presidential term. Lacking judiciary independency the Ukrainian Constitutional Court ruled that Kuchma could stand for another term. In many post-Soviet Republics the body of law that exists on paper is often arbitrarily interpreted and enforced so as to serve the personal goals of the elite. Moreover, laws are sometimes applied retroactively (WMRC, 2004).

In Azerbaijan, for instance, President Aliyev is ultimately the sole guarantor of foreign investors' interests in a highly unstable socio-political situation. In late 2002, investors filed a US\$300m lawsuit against the president, his son and the former head of the country's privatization commission, over the aborted privatization of state oil company SOCAR (WMRC, 2004).

Regulatory uncertainty, the burden of bureaucracy and corruption are primary characteristics of the post-Soviet investment environment. According to Transparency International, post-Soviet states ranked among the most corrupt in the world. Interestingly all post-Soviet states were downgraded as a result of growing corruption during the years of transition. In 2003, for instance, Ukraine, Moldova and Russia were ranked as 106<sup>th</sup>, 100<sup>th</sup> and 86<sup>th</sup>, respectively (out of 133 countries), while in 1999 they had occupied the 75<sup>th</sup>, 75<sup>th</sup> and 82<sup>nd</sup> places respectively (out of 99 countries). Amongst the Central European post-Soviet countries Belarus was the most successful in reducing corruption and ranked 53<sup>rd</sup> (out of 133) in 2003. Performing even worse the Central Asian countries were ranked in the following sequence in 2003: Armenia – 78<sup>th</sup>, Kazakhstan and Uzbekistan – 100<sup>th</sup>, Kyrgyzstan – 118<sup>th</sup>, Azerbaijan, Georgia and Tajikistan – 124<sup>th</sup>, having being ranked between 80-90<sup>th</sup> in 1999 (Transparency International, 2004).

Regarding post-Soviet countries, the World Market Research Centre (WMRC) concluded that “flux in the regulatory environment and the overblown importance of bureaucracy have fuelled a high degree of corruption at different levels of the system” (WMRC, 2004: 45). Further to this it was noted that “many officials, both at different levels of government and at the enterprise level, have vested interests in the

status quo and see foreign firms as a threat and regional power groups use their influence in state agencies in order to secure as many economic benefits as possible” (WMRC, 2004: 45). The report concludes that “in the absence of transparent system, the ability to lobby and use a network contacts has become a valued commodity” (WMRC, 2004: 45).

Licensing requirements are vivid examples of flourishing corrupt practices and the maintenance of vested interests. In many sectors, such as transport and energy generation and distribution, the respective ministries are responsible for issuing licenses to private investors while at the same time enjoying direct commercial interests in these sectors (WMRC, 2004). The presence of powerful interest groups and the importance of contacts create opportunities for corruption and misuse of business relationships. More importantly there is a possibility that bargaining outcomes may come up for re-examination if contacts are dismissed or replaced at their post (WMRC, 2004).

Government attempts to fight corruption had, in many cases, more to do with politics and public image than with effective crusade for transparency (WMRC, 2004). Moreover, the lack of regulation and the over reliance on personal links combine to create opportunities for organized crime, which itself has become major concern to foreign investors (WMRC, 2004).

‘Blind bargaining’, as a concept of bargaining, is characterised by multiple layers of risk creating institutional and structural factors which jointly explain the lack of attractiveness of neo-patrimonial states to foreign investors. Additionally, the concept helps explain why post-Soviet neo-patrimonial countries serve mostly as a target of riskier and lower quality, earlier referred as ‘malign FDI’, which focuses on the exploitation of markets and resources.

Corporate raiding and round-tripping or pseudo-iFDI are two of the most important strategies nourishing ‘blind bargaining’ model of relationships between foreign investors and a state in post-Soviet transition economies.

The following analysis of both of the above mentioned strategies further contributes to the attempts on identifying various triggers and explaining their impact on the quality of FDI inflows, process of institutional change and patterns of

interactions between formal and informal institutions in transition economies. Moreover, it also provides evidence supporting the based on the social conflict view hypothesis of deliberate effort by powerful elites to fail the development of efficient formal institutional infrastructure in post-Soviet countries, particularly Russia and Ukraine.

## **2.5.4 Corporate raiding in transition economies**

### **2.5.4.1 Definition**

Corporate raiding has been gaining momentum over the years of transition in post-Soviet countries, especially in Russia and Ukraine. Fundamental systemic weaknesses create multiple incentives for oligarchs, state officials at all levels and, in many cases, criminals to seek for opportunities of corrupt enrichment and augmenting their asset bases through illegal seizure of both domestic and foreign companies either independently or, most probably, through fostering alliances (Pojansky, 2014).

In spite of the growing attention to the raiding problem, the phenomenon still remains highly under researched and poorly understood (Osipyan, 2010; Pojansky, 2013; Pojansky, 2014; Zimmerer & Khmara, 2012). Partially it can be explained by its contextual nature and complexity (Firestone, 2008; Pojansky, 2014). As a result, scholars propose different country-specific explanatory descriptions and definitions of raiding. Firestone (2008: 1207), focusing on Russia, characterizes corporate raiding as:

acts designed to give a legitimate appearance to the illegal (accomplished through illegal means) transfer to the actor or a third party of property rights, rights to the results of intellectual activity and equal rights to individualization (of intellectual rights) as well as the illegal acquisition of the rights to carry out managerial functions in a commercial or in a commercial or other organization.

Researchers who chose Ukraine as the site for their study of raiding problem identify “illegal and corrupt manipulation of Ukraine’s patchy legislation and

ramshackle institutions” (Stack, 2010: 3) as the most important instruments for transferring property rights to the assets in question. Pojansky (2014) elaborates that highly underdeveloped Ukrainian institutional environment characterized by presence of various institutional voids allows raiders to exploit the existing legal, administrative and regulatory tools in undertaking their illegal activities.

The evolvement of country-specific features of raiding modes can be explained by the differences in operational relationships between formal and informal institutional elements (Pojansky, 2014). Comparing Sakwa’s Russian ‘dual state’ approach and Hanson’s view of Ukrainian raiding enabling mechanism, Pojansky (2014) illustrates that distinctions are caused by parallel, in the former case, and combinatory, in the latter case, use of formal and informal power mechanisms. However, in spite of the above differences, omnipresent corruption and institutional deficiency and desire to gain more economic and, consequently, political power remain the main sources and driving force for raiding, respectively.

#### **2.5.4.2 Evolution**

Scholars and experts distinguish three phases and respective types of raiding, namely black, gray, and white (Gabor & Khmara, 2012; Osipyanyan, 2010; Pojansky, 2013; Pojansky, 2014), which can be identified with the evolutionary phases in the emergence and consolidation of the economic and, consequently, political elites in transition countries, particularly in the case of Ukraine.

The first black or ‘bandit’ phase of raiding started in 1991 after the dissolution of the Soviet Union. Inception of privatization within the settings of institutional upheaval generated incentives for the formation of criminal groups which targeted both small newly privatized and large state enterprises. Using criminal methods ‘black raiders’ seized and, in many cases, plundered and sold all the assets of the attacked company (Gabor & Khmara, 2012; Osipyanyan, 2010; Pojansky, 2013; Pojansky, 2014).

By the end of 1990s – beginning of 2000s raiding evolved to the next ‘gray’ stage recognized as phase of initiation and establishment of the most oligarchs’ vertical monopolies. At this point various state officials, Soviet era ‘red directors’ and

prosperous representatives of a newly formed businessmen class, or even anonymous parties commenced their pursuit for economic resources) moving away from criminal to much more sophisticated methods. Thus, to achieve their goals these representatives of a newly forming economic power elite acquired the services of various state ministries and private middlemen as well as illegally obtained court orders and forged shareholders decisions (Gabor & Khmara, 2012; Osipyany, 2010; Pojansky, 2013; Pojansky, 2014).

This period is also characterized by the transition from a criminal 'krysha', informal criminal protection institution, to a political 'krysha', new qualitatively different much more advanced and sophisticated informal protection mechanism.

The last 'white' raiding period started with inauguration of a new president in 2010 in Ukraine. Further redistribution of economic resources in a country is performed by a smaller group of powerful businessmen and state officials leading to a higher consolidation of political power around Presidential Administration in case of Ukraine (Gabor & Khmara, 2012; Osipyany, 2010; Pojansky, 2013; Pojansky, 2014). The latter is a group outperforming the rest of the society along both dimensions of political power: de jure and de facto.

#### **2.5.4.3 Raiding methods**

Pojansky (2013; 2014) suggests that a very broad specter of raiding instruments nourished on deficiencies of institutional environment in transition economies, in general, and Ukraine, in particular, can be best represented through the classification of the most popular methods, including:

- forced bankruptcy or business crises;
- corporate or minority shareholder attacks;
- civil litigation;
- extortion.

In cases of forced bankruptcy or business crises raiding agents exploiting various formal and informal institutions artificially generate situations leading to the

weakening of the targeted companies' financial positions. As a result, financially drained companies lose their assets (Pojansky 2013; Pojansky, 2014).

Corporate or minority shareholder attacks also have a very elaborate program of actions. Firstly, raiding groups gather intelligence on a targeted company. Secondly, they acquire a small share of company stocks and file a lawsuit against it with a court in a remote location. Further, they either employ criminal groups representing themselves as security companies or bribe law enforcement agencies to seize the control over the raided company (Pojansky, 2013; Pojansky, 2014).

The last but not the least is civil litigation and extortion. The former is thriving due to highly corrupt judicial and law enforcement authorities, while the latter implies primarily reliance on the regulatory authorities' support (Pojansky, 2013; Pojansky, 2014). Experts assume that extortion is the most open and direct way of raiding. Business owners are straightforwardly contacted by their intruders and warned about the consequence of their refusal to give up their businesses. In cases of owners' resistance their companies become a target of a multifaceted administrative pressure taking forms of never-ending fines, inspections, obstructions in issuance and renewal of licenses and permits, criminal cases, physical threats, etc. (Pojansky, 2013; Pojansky, 2014).

The immunity of businesses to raiding attacks can only be secured by their impeccable operational conduct and flawless reputations. This requirement is practically unattainable in realities of post-Soviet transition. Any minor innocuous misconduct becomes an invincible weapon in hands of offenders capitalizing on the deficiencies of institutional environment in transition countries, particularly selective law enforcement (Pojansky, 2013; Pojansky, 2014).

Growing economic and political power of relatively small condensed group of oligarchs and elite state officials, omnipresent corruption ensuing lack of all levels state officials' commitment to national interests and instead their commitment to promoting economically inefficient institutions, lack of control over local and regional institutions are just a few of the major factors inducing changes in



redistribution of power between multiple individual and collective economic and political actors, including foreign investors.

### **2.5.5 Round-tripping or pseudo-FDI**

Round-tripping or pseudo-FDI is iFDI by domestic businessmen who made a decision to go abroad and return to their home countries as foreign investors for escaping regulations, particularly avoiding pressure and protecting from their real home countries' institutional imperfections and voids, capitalizing on institutional differences between their real and pseudo home countries, obtaining value added services, etc... Considering its share in transition and emerging economies, it becomes extremely important for the study of iFDI quality and its impact on institutional changes to acknowledge the crucial role of round-tripping or pseudo-FDI as one of the 'foreign' investors' strategic behavior in this set of countries. However, most of the existing quantitative studies examining the impact of iFDI on host countries do not distinguish between pseudo-FDI and real iFDI. Some of the most important objective reasons for such lack of accountability for pseudo-FDI are scarcity of accurate verifiable information on genuine identity of foreign investors from tax havens and offshore financial centers (OFCs), such as Cyprus, the British Virgin Islands and others, and resulting measurement problems. Xiao (2004) suggests the absence of conceptually clear definition of round-tripping FDI is the main reason and explanation for an existing methodological void resulting in the problems with getting reliable estimates of the volumes of round-tripping FDI in any country.

Most of the literature on round-tripping FDI focuses on the incentives and determinants of outward FDI (oFDI). Xiao (2004) distinguishes two fundamental types of round-tripping FDI. He refers to the first type of this kind of investment as "round tripping for escaping regulations" and to the second one as "round tripping for value added services". In the latter case he compares the value adding process of round tripping FDI with one that financial sector follows in real economy. In the former case FDI is driven by the desire of pseudo foreign investors to avoid the pressure of and protect from their home countries' institutional imperfections and

voids. However, he fails to point out to this class of investors' ability to capitalize on institutional differences between their real and pseudo home countries.

Other researchers within this domain clearly distinguish between these two directions of the institutional environment's impact on domestic investors' decision to go abroad and return to their home countries as foreign investors. First of all, they suggest that pseudo investors are motivated by institutional support in the form of new government policies encouraging investing abroad. Such policies can include government guaranties of privileged access to raw materials and financing in China (Buckley *et al.*, 2007), government encouragement of domestic companies' pursuit of competitive advantages by acquiring new advanced technologies, managerial capabilities and other needed resources in China (Buckley *et al.*, 2007; Luo *et al.*, 2010) and in Russia (Settles, 2008).

Second of all, like Xiao (2004), they emphasize the role of institutional constraints in discouraging local entrepreneurs to invest in the status of domestic investors. Among the main institutional deficiencies they name institutional arbitrage defined as a "gap between the firm's needs and institutional environment" (Witt & Lewin, 2007: 10) caused by the desire to avoid high taxes (Gordon & Hines, 2002; Vernon, 1998), economic risk, political instability, policy uncertainty (Le & Zak, 2006), corruption, regulatory uncertainty, lack of property rights protection, and government interference (Ledyeva, Karhunen & Whalley, 2013; Luo *et al.*, 2010; Settles, 2008; Witt & Lewin, 2007).

Scholars identified several additional important country-specific incentives for round-tripping FDI in case of Russia Loungani & Mauro (2001) point to the unstable and unpredictable political situation, macroeconomic instability, a confiscatory tax system, as insolvent banking system. All of the above listed factors lead create an environment where businessmen are afraid of exposure of the information on their business projects. As a result they opt for round-tripping their investments which would, firstly, guarantee the secrecy of investors' identity, secondly, increase the security of their investment and, thirdly,

Moreover, Ledyeva, Karhunen & Whalley (2013) recognize corruption money laundering as one of the largest sources of capital flight from Russia. Relying on a Financial Action Task Force (FATF) report (2011) they suggest that Russian corrupt public officials are relying on various round-tripping schemes for legalizing their proceeds from corruption. This assumption is supported by the several other in-depth analyses of corrupt capital flows in Russia (Perez, Brada & Drabek, 2012; Shelly, 2003; Simpson, 2005).

A relevant question to ask here is: “Why do businessmen seeking to avoid imperfections of their home countries institutional environment, particularly transition economies, choose to return to their home countries rather than to invest in other markets characterized by lower risk and better quality institutions?” Scholars suggest that returning as foreign investors domestic businessmen are capitalizing on exploiting the institutional differences between two countries. This situation is defined as institutional arbitrage (Boisot & Meyer, 2008; Gaur & Lu, 2007; Huang, 2003; Ledyeva, Karhunen & Whalley, 2013). Thus, the status of a foreign investor generates several essential advantages for pseudo-investors. It increases their bargaining power (Boisot & Meyer, 2008) and puts them in a superior competitive position with regard to both domestic and genuine foreign investors since they can exploit on their privileges of foreign investor’s status and local experience and knowledge (Ledyeva, Karhunen & Whalley, 2013). As foreign investors they enjoy an access to additional resources such as foreign banking and financial expertise (Ledyeva, Karhunen & Whalley, 2013; Sutherland *et al.*, 2012), superior organization capabilities and higher security of their assets (Ledyeva, Karhunen & Whalley, 2013). As local businessmen they successfully avoid the liability of foreignness problem since they possess all required intangible assets including, for example, expertise in all aspects of local business practices and established relationship-based networks (Ledyeva, Karhunen & Whalley, 2013; Zaheer, 1995).

It is noteworthy that all of the above discussed characteristics of round-tripping FDI in Russia are intrinsic to other post-Soviet countries. However, further research effort focusing on the study of various aspects of pseudo-foreign investors’ behavior in transition countries is required to find evidence and support for existing theoretical

assumptions and identify new important elements of this phenomenon in different contexts.

Overall, very little academic effort has been devoted to the study of round-tripping FDI in emerging and transition economies to date. Moreover, the largest share of theoretical inquiries focused on China (Boisot & Meyer, 2008; Fung, Yau & Zhang, 2011; Morck, Yeung & Zhao, 2008; Sutherland *et al.*, 2010; Xiao, 2004) and Russia (Abalkin & Whalley, 1999; Buitter & Szegvari, 2002; Ledyeva, Karhunen & Whalley, 2013; Loungani & Mauro, 2001; Mulino, 2002). Only one study on regional characteristics and effects of FDI in Ukraine by Kokko and Kravtsova (2012) indirectly superficially refers to the possible absence of impact of round-tripping FDI on knowledge and technology spillovers and resulting changes in productivity and efficiency of domestic local firms. The authors particularly emphasize that round-tripping FDI is a virtually unexplored phenomenon and accounting for the role of pseudo-FDI and/or even the study of the relationship between pseudo-FDI and host countries' formal and informal institutional environment is crucial for the advancement of a suggested 'blind bargaining' model and of our knowledge on both extent and directions of real versus pseudo foreign investors' impact on all aspects of development in transition countries.

The qualitative part of this research attempts to, at least partially, close this research gap and provide an initial insight into the role of pseudo-iFDI in reshaping institutional environment and the impact of pseudo-iFDI on the quality of institutional environment in Ukraine.

## **2.6 Foreign investors' political behavior**

### **2.6.1 Evolution of research on corporate political activity**

The expansion of both corporate political activity and research on corporate political behavior gained momentum in the beginning of the 1960. Initially scholars in political science, political economy and sociology examined business-government relations in terms of distribution of power and policy outcomes (Buchanan & Tullock, 1962; Dahl, 1959; Epstein, 1969; Lowi, 1969; Olson, 1965; Stigler, 1971). Consequently, the fast growth followed by the emergence of new forms of corporate

political activity resulted in an increased interest of management and other scholars in the subject of business-government relations, in particular (Baron, 2006; Grier, Munger & Roberts, 1991; Griffin, Fleisher, Brenner & Boddewyn, 2001; Lenway & Rehbein, 1991; Meznar & Nigh, 1995; Pittman, 1998; Rugman & Verbeke, 1998; Stopford and Strange, 1991), and corporate political behavior, in general (Baron, 1995; Baron, 2006; Boddewyn, 1998; Boddewyn & Brewer, 1994; Hillman, Zardkoohi & Bierman, 1999; Schuler, 1996; Schuler, 1999; Schuler, Rehbein & Cramer, 2002; Shaffer & Hillman, 2000).

Boddewyn & Brewer (1994: 120) and Astley & Satcheva (1984: 90) define political behavior as “the acquisition, development, securing, and use of power in relations to other entities, where power is viewed as the capacity of social actors to overcome the resistance of other actors”. As a result, some scholars divide the participants of the political bargaining process into two groups such as demanders, including businesses, interest groups, individual citizens and /or public opinion, and suppliers representing nonmarket environment and including other entities or governments and actors or political decision-makers (Baron, 1995; Boddewyn & Brewer, 1994; Schuler *et al.*, 2002; Hillman & Keim, 1995).

Overall, relying on the assessment of four basic characteristics of nonmarket environment such as issues, interests, institutions and information (Baron, 2006) firms determine a range of political actions and strategies leading to compliance, evasion, negotiation, cooperation, coalition building and co-optation behaviors (Boddewyn & Brewer, 1994; Oliver, 1991).

Hillman & Hitt (2004), in their first of the two available to date fundamental attempts to systematize the existing body of literature on corporate political activity, classify this research by four categories of antecedents of corporate political activity including firm, industry, issue and institutional factors.

Lawton, McGuire & Rajwani (2013), in their most recent systemic analysis of literature on corporate political activity, develop a framework consisting of three domains within which corporate political activity has been viewed through the lenses

of stakeholder, resource dependency, resource based view, institutional and collective action theories (Lawton, McGuire & Rajwani, 2013).

The first domain explores the resources and capabilities focus based on the resource based view (RBV) and organizational capability theories (OCT) (Bonardi, Holburn & Vanden Bergh, 2006; Capron & Chatain, 2008; Dahan, 2005b; Frynas, Mellahi & Pigman, 2006; McWilliams, Van Fleet & Cory, 2002; Oliver & Holzinger; 2008; Woll, 2007) and provides valuable insight into mechanisms of integration, reconfiguration and deployment of multiple combinations of various types of resources, including political resources, in different non-market environments (Dahan, 2005a,b; Lawton, McGuire & Rajwani, 2013).

The second domain reviews the research employing institutional perspectives for the analysis of complex relationships between different institutional arrangements, businesses and governments at the country-level (Boddewyn & Doh, 2011; Deileman & Boddewyn, 2012; Deileman & Sachs, 2008; Jackson & Deeg, 2008; Khana & palepu, 2005; Peng, 2003) and firms' abilities to adapt to changes in nonmarket environment at the firm-level (Deng et al., 2010; Robertson et al.,2007; Shaffer et al., 2007; Sun et al., 2010; Tian et al., 2007; Venard, 2009; Zhang & Liu, 2010). One of the most important challenges within this domain is "to understand non-market activity in emerging economies, thus moving beyond the institutional voids perspective outlined by Khanna and Palepu (2005)" (Lawton, McGuire & Rajwani, 2013: 14).

The third domain, which can be qualified as a constituent of the second domain, focuses on the analysis of the impact of certain characteristics of political environment on the corporate political activity. In particular, Lawton, McGuire & Rajwani (2013: 9) conclude that this group of studies shows that certainty of political processes is determined by the quality of regulations, political risks and types of political systems. However, they emphasize that the largest share of these studies examines the 'hard' features of institutions, including construction, norms, formal rules and enforcement, devoting much less attention to the 'soft' aspects of institutions, including country culture, uncertainty and history (Baron, 1997; Blumentritt & Nigh, 2002; Delios & Henisz, 2003; Frynas & Mellahi, 2003; Hillman

& Hitt, 1999; Hillman, Zardkoohi & Bierman, 1999; Shaffer, Quasney & Grimm, 2000). Moreover, the authors point out that within the context of transactional approach scholars focus on the negative aspects of uncertainty failing to acknowledge the potential of positive perceptions of uncertainty for increasing the efficiency of corporate political activity in different markets. The primary challenge for the researchers within this domain is to develop a reliable and meaningful measure of political outcomes (Lawton, McGuire & Rajwani, 2013).

It is obvious that the interest to corporate political activity has grown dramatically, especially during the last 25 years. However, Hillman and Hitt (1999) claim that the research in this field has not kept pace with the turn of events in both political and economic environments of various countries. For example, qualitatively new institutional setting such as the ones developed in the state capitalist economies of China and the Gulf States caused significant changes in the business-government relations in these countries (Lawton, McGuire & Rajwani, 2013). Moreover, Vogel (1996) argues that the collapse of the Soviet Union followed by a very specific institution-building processes heavily relying on the support and participation of various domestic and international, market and nonmarket, formal and informal actors, including foreign investors, requires a new research effort to focus on better understanding of the role of all of the various types of businesses on the elaboration and implementation of public policies (Lawton, McGuire & Rajwani, 2013). Qualitative analysis of business-government relations within the context of each country, and even industry, would be the best approach for exploring this kind of relationships.

### **2.6.2 Classification of corporate political activities**

Contemporary research examines various context-specific political activities that both domestic companies and foreign investors utilize to influence public policy decision-making in a way that would solidify and improve their positioning in markets of their businesses' operations. The degree of a company's involvement in a public decision-making and its political pro-activeness as well as the choice of particular political strategies and tactics is determined by numerous combinations of various company and host-country specific characteristics.

Research on the political activities of MNEs in developed countries identifies and provides analysis and evidence on the use of the following most popular political tactics: lobbying, including direct and grassroots lobbying and coalition building, constituency building, advocacy advertizing, reporting research or public polls results, personal services, election funding and some others (Baron, 1993; Baron, 2006; Getz, 1993; Keim & Zeitaml, 1986). However, scholars focusing on the study of political activities of businesses in emerging, developing and transition economies argue that corruption, cronyism and extensive use of connections should be also classified as political strategies (Lawton, McGuire, Rajwani, 2012).

Hillmann & Hitt (1999) suggest a very comprehensive classification of these tactics according to several different characteristics. Firstly, the authors recommend establishing the nature of corporate political activity in terms of its persistence in time. Particularly, they propose to distinguish between transactional, short-tem issue-based, and relational, long-term, approaches in corporate political behavior. Secondly, they also emphasize the value of establishing the level of company's participation in political activities. A company's choice of pursuing its political interests either individually or collectively will depend on combinations of company ownership-specific and host-country location-specific characteristics and the nature of the disputed or proposed issues. Moreover, both of the participation techniques will be associated with specific residual business community reactions, such as, for example, free-riding problem in case of collective action approach (Olson, 1965). Finally, based on the type of resources companies utilize for attaining their desired projected issue outcomes, scholars divide all known political tactics into three groups of political strategic actions, namely information, financial incentive, and constituency building strategies (Hillmann & Hitt, 1999). It is noteworthy that companies, to increase the efficiency of their corporate political activity, usually use simultaneously all of the abovementioned strategies and tactics in various combinations (Hillmann & Hitt, 1999; Hillmann & Hitt, 2004; Lawton, McGuire, Rajwani, 2012).



### **2.6.2.1 Information strategy**

Information strategy builds upon a direct corporate communication of relevant information to political decision-makers with the purpose of promoting more attractive policy outcomes (Hillman & Hitt, 1999). Hillman & Hitt (1999: 834 - 835) suggest that information strategies should include the following political tactics:

- direct lobbying by both internal and external professionals and executives;
- initiating company and/or think tank led research projects and reporting research results;
- testifying as expert witnesses in hearings and/ before other government bodies;
- providing decision makers with position papers and/or technical reports.

#### **i. Direct lobbying**

Lobbying is the most popular and widely used corporate political strategy. Scholars distinguish three main forms of lobbying including direct lobbying, grassroots lobbying, and coalition lobbying. The latter two are forms of indirect lobbying and belong to and will be reviewed in the constituency building strategy section. The choice of a specific lobbying mode depends on the unique combinations of such factors as company-specific and country-specific characteristics and the nature of the issue and competition (Hillman, Keim & Schuler, 2004). In most cases foreign investors prefer not to rely on any individual form of lobbying and employ several lobbying techniques simultaneously.

Direct lobbying, due to its nature, is the most frequently adopted approach to protecting and promoting corporate interests. In this case individual lobbyists, including company representatives or executives and hired lobbyists, personally contact state officials through formal and informal meeting, phone conversations to advocate changes which would ensure improving their company's competitive positioning in the market (Johnson, 1992; Katzenstein, 1985; Murtha & Lenway, 1994a). Researchers provide evidence of the growing popularity of direct lobbying

(Lord, 2000b; Coen, 1999) even in spite of the fact that it is considered to be one of the most time- and resource-consuming practices of this sort (Schlozman & Tierney, 1986).

Analysis of lobbying activities shows that direct lobbying produces better results than any other kind of political activity in terms of an increased control over the lobbying process, firstly, because direct communication is a guarantor of a lobbyist's message and a targeted policy-maker's feedback delivery as well as more general information exchange between the advocainvolved parties; and secondly, because it supports initiation and sustenance of lobbyists – political decision-makers relations (Mack, 1989; Sachs, Cantor & Neale, 1986). However, the degree of a lobbyist's success is highly dependent on such lobbyist's qualities as communication skills, personal integrity, political ethics and professional competence (Mack, 1989).

## **ii. Researching, testifying and reporting**

Political decision-makers, particularly legislators, on a daily basis confront a very broad range of policy issues requiring a comprehensive knowledge of the relevant operational field. Unfortunately, in most cases state authorities do not have sufficient resources and cannot ensure a provision of an adequate knowledge base for their employees to be able to make informed decisions. Businesses take advantage of such opportunities by offering various state officials and legislators their expertise and filling out the existing knowledge gaps (Buchanan & Tullock, 1962; Lord, 2000a). For this purpose companies initiate their own and/or think tanks led research projects and consequently report the results of their analysis to the relevant governmental bodies. Emphasizing their command of various operational problems businesses also acquire a right to provide decision makers with position papers and/or technical reports and to testify as expert witnesses in hearings and/or before other government bodies (Hillman & Hitt, 1999; Schuler, 1996; Rehbein & Schuler, 1999).

Petitions are another very efficient instrument for addressing various existing and/or prospective problems which companies face as a result of changes in government regulations. Depending on the nature of the issues companies choose to

communicate their concerns to the policy-makers either individually or collectively (Schuler, 1996; Rehbein & Schuler, 1999).

### **2.6.2.2 Constituency building**

Constituency building is an indirect strategy aiming at altering various public policies. Instead of interacting with decision makers directly corporations using this political strategy are seeking for the support of individual stakeholders, both related and unrelated to the firm, representing such overlapping categories as citizens, voters, employees, members of labor unions, customers, suppliers, retirees, students, etc. Companies develop custom made constituency programs targeting at mobilizing, educating and stimulating active reactions of specific groups of individuals sensitive to certain policy issues having a potential of threatening their future prosperity in any ways. (Baysinger, Keim & Zeithaml, 1985; Hillman & Hitt, 1999; Keim, Zeithaml & Baysinger, 1984; Lord, 2000) Emerged, as a result of exposure to various economic and political educational programs, corporate press conferences on various policy issues and advertizing of particular policy positions by participating companies, active constituency groups intervene the public policy decision-making process by articulating their collective opinions via various means of civil and political communication (Hillman & Hitt; 1999; Keim & Zeithaml, 1986).

#### **i. Indirect lobbying: grassroots mobilization**

Grassroots mobilization is a fast developing form of indirect lobbying relying on the progress in communication technologies not supported by the relevant adequate rules and regulations (Sachs, Cantor & Neale, 1986; Wilcox *et al.*, 2003). It is a group level activity in which groups generate public pressure on various state officials, predominantly legislators, to promote their specific interests (Sholzman & Tierney, 1886; Wilcox *et al.*, 2003). For this purpose groups employ both direct and indirect techniques such as advocacy writing, phone calls and letter writing campaigns, respectively (Keim & Zeithaml, 1986; Wilcox *et al.*, 2003).

## **ii. Indirect lobbying: coalition building**

Coalition building is a form of indirect lobbying based on the use of collective power. In pursuit of their goals companies join either temporary issue-based interest groups or longer-term alliances such as trade and/or business associations, industrial organizations, chambers of commerce and others (Getz, 1997; Keim & Zeithaml, 1986). Interest groups join together to increase their resources and, as a result, bargaining power through collective actions. However, the main problem with this form of political activity is that the end product of collective action is not always a collective benefit. In many cases only certain coalition members would individually enjoy the outcome of such political bargaining (Getz, 1997). Similar to grassroots lobbying, coalitions utilize various combinations of all available types of political activities.

## **iii. Advocacy advertizing and other**

Advocacy advertizing is another indirect approach to aligning public opinion with corporate interests which would lead to the reshaping of targeted public policies and/or institutions. For this purposes companies rely on various media outlets such as, for example, various video and audio programs, publications and advertisements (Hillman & Hitt, 1999; Keim & Zeithaml, 1986; Keim, Zeitmal & Baysinger, 1984; Sethi, 1979; Sethi, 1987). All materials used for a delivery of a certain message to public can be tailored to specific characteristics of any targeted audiences. Availability and access to numerous sources of information such as, for example statistical and/or survey databases, significantly facilitates the process of advocacy advertizing (Mack, 2001). However, some scholars argue that it is important to ensure that the sources are credible and provide accurate information. Moreover, any communication with the public should be non-coercive (Kein & Zeithaml, 1981).

Other tactics within the constituency building strategy include public relations, press conferences and political education programs (Hillman & Hitt, 1999).

### **2.6.2.3 Financial incentive strategy**

Financial incentive strategy uses various financial inducements to bring about changes in public policy. Company representatives directly contact political decision-makers offering a wide specter of financial inducements for aligning public policies with private company interests (Hillman & Hitt, 1999). Hillman & Hitt (1999: 834 - 835) composed the following list of financial incentive tactics:

- financial support including direct contributions either to a political leader or political party;
- honoraria for speaking;
- paid travel expenses;
- personal services.

#### **i. Election funding**

Funding either individual political decision maker or political party has a very long history and tradition in Western democracies. For example, in the USA political action committees (PAC) are the main channels for companies' investments into the future political support of their interests. In Europe corporate prosperity is secured through election funding by trade and industrial associations (Baron, 2006). Baron (2006) identifies three primary interdependent goals for election funding. The first target is to increase the probability of electing a candidate approved by a company, the second – to ensure continuous access to and preferential treatment by incumbents at any point in time, and the third – to control lawmaking process and voting.

#### **ii. Personal services and other**

Personal services is a very efficient and, as a result, popular form of corporate political behavior. Delegating firm representatives for a work in official political positions or influential non-governmental organizations and employing current or former state officials or decision-makers relatives can be extremely beneficial for the company (Hillman & Hitt, 1999).

Inviting political decision makers as guest speakers for various social or educational events and paying inflated honoraria for their participation as well as paying their various travel expenses are several other ways to solicit their political support which ensures strengthening of a company's competitive positioning in the host market (Hillman & Hitt, 1999).

### **iii. Corruption, cronyism and extensive use of connections**

Research on corporate political activity in developed countries does not consider corruption as a manifestation of one of the forms of corporate political activity. However, recently, scholars focusing on the study of corporate behavior in countries with underdeveloped institutional systems suggested recognizing corruption as one of the corporate political tactics. Venard (2009) and Collins, Ulluenbruck & Rodriguez (2009) provide evidence that in Russia, India and other transition and emerging economies corruption is a natural response to the growing competitive pressure which is supported and nourished by institutional weaknesses and failures (Lawton, McGuire, Rajwani, 2012).

Lawton, McGuire, Rajwani (2012), based on the Khatri, Tsang & Begley's (2006) analysis, also argue that institutional voids, especially in collectivist and hierarchical societies, create incentives for consistent expansion of informal networks and other forms of informal relationships, such as cronyisms, political party affiliation, familial ties and others. Such institutional environment, characterized by prevalence of informal institutional structures, makes use of the most of the corporate political tactics irrelevant and leaves businesses with no other choice but to accept the informal rules and adopt tactics which can help facilitating the achievement of desired outcomes.

### **2.6.3 Proactive and reactive corporate political behavior**

A very important characteristic of corporate political behavior is also the nature of a firm's interaction with host-country institutional environment. Different scholars propose a number of closely related classifications of the above characteristic.

Hillman, Keim & Schuler (2004) suggest that even though above discussed classifications of corporate political activity by approach, participation level and strategy are vital for the analysis of corporate political behavior, the latter would not be complete without knowledge on the pro-activity or reactivity of firm's political actions.

Oliver & Holzinger (2008) classify pro-active and reactive strategies as influence-oriented and compliance-oriented categories, respectively. Moreover, they further divide them into two subtypes such as proactive and defensive strategies in the first case and reactive and anticipatory strategies in the second case (Oliver & Holzinger, 2008).

Meznar & Nigh (1995) and Blumentritt (2003) identify bridging as reactive and buffering as proactive manifestations of corporate political behavior and emphasize that these approaches to handling the relationships with state institutions are not mutually exclusive.

#### **2.6.3.1 Bridging**

Bridging strategy assumes firms' dedication to the unconditional compliance with the requirements of its operational environment (Meznar & Nigh, 1995). To succeed companies continuously monitor and actively adopt all the developments in the regulatory, socio-economic and political institutional contexts in a host country (Hillman, Keim & Schuler, 2004; Meznar & Nigh, 1995). Hillman, Keim & Schuler (2004: 844) compare bridging to Weidenbaum's (1980) "passive reaction" and "positive anticipation" types and Boddewyn & Brewer's (1994) "non-bargaining" behavior.

#### **2.6.3.2 Buffering**

Buffering strategy involves corporate actions on protection of a firm's assets from all range of external pressures and on vigorous participation in activities which would lead to the improvement of a company's competitive positioning in the respective markets. To meet their buffering goals on resisting, controlling and/or promoting environmental changes, companies apply all available political strategies and tactics,

such as informative, constituency building and financial, at all level of participation, namely individual and collective (Hillman, Keim & Schuler, 2004; Meznar & Nigh, 1995).

### **2.6.3 Effectiveness of corporate political activity**

The effectiveness of corporate political activity depends on the firm's ability to identify the best performance-enhancing combinations of the most potent individual political strategies. The effectiveness of the latter, in turn, is defined as a strategy that advances firm's performance and strengthens its competitive advantage to the extent required to meet the firm's objectives (Oliver & Holzinger, 2008).

Baysinger (1984) suggested that the effectiveness of a corporate political strategy is determined by the three types of issues pertinent to management, defense and maintenance domains. Thus effectiveness depends on the availability of issues that, firstly, allow a firm to pursue its goals at the expense of other businesses or society as a whole, secondly, threaten the legitimacy and thirdly, ability to pursue and meet organizational objectives.

Keim & Baysinger (1988) draw a parallel between the development of businesses' market, such as product, and nonmarket, particularly political, strategies. The choice of activities within both of the domains adjusted by their integrative effect depends on the firm's access to both internal and external environment resources. As a result, product and political strategies focus on the attainment of specific to their sphere of expertise goals, such as higher economic profits and desirable policy outcomes, respectively, in a pursuit of the overall organizational objective to maximize its competitive advantage.

Moreover, Keim & Baysinger (1988) suggest that the effectiveness of any corporate political strategy depends on such factors as potential value, ease of imitability and organizational support. Potential value refers to the ability of employees, responsible for the company's political affairs domain, to recognize arising political issues the proper management of which could enhance the organizational ability to effectively influence political decision makers. Ease of imitability indicates the probability of imitating a firm's political strategy by other



firms. The nature of organizational support is determined by available resources, supportive management, and suitable organizational structures assigned for elaborating political tactics and strategies.

Kudina & Collinson (2009) base their analysis of the effectiveness of corporate political strategies in one of the transition countries, China, on the belief that firms as rational agents would not employ any corporate political strategy without anticipating its positive effect on corporate performance.

Oliver & Holzinger (2008: 514) claim that the effectiveness of political strategies is “a function of firms’ internally and externally oriented dynamic capabilities which are grounded in knowledge and influence acquisition and use, and that their effectiveness will vary with the rate of environmental change”. Moreover, the authors suggest that increasing effectiveness of political strategies is possible to achieve by combining various dynamic political strategies. Such strategic synergies cause the decrease in the probability of imitating them and lay a solid foundation for a growth of flexibility with which firms adapt to any modifications and fluctuations in the political environment.

## **2.7 Summary and research questions**

The review of the previous theoretical and empirical multidisciplinary research effort provides evidence that existing literature is lacking a comprehensive theoretical framework for analyzing the quality of iFDI and relationships between foreign investors and institutions in transition countries. Reconciling theoretical insights from international business, political science, economics, and sociology, including eclectic paradigm, neo-institutionalism, particularly social conflict view, bargaining models, political strategies, and behaviors under the conditions of neo-patrimonialism, this study fills this gap by developing a new alternative ‘blind bargaining’ model for explaining the foreign investment patterns and the variations in impact of different foreign investors on institutional structures in neo-patrimonial host countries.

Firstly, eclectic or ownership-location-internationalization paradigm, neo-institutional, neo-patrimonial, both conventional and alternative FDI, trade,

development and bargaining theories are integrated to develop a ‘blind bargaining’ model explaining the relationship between host country- and ownership- or investor-specific characteristics in neo-patrimonial transition states. It is argued that less stable states with underdeveloped or missing institutional structures attract ‘malign’ iFDI flows that are interested in exploiting existing institutional weaknesses and voids. The following research hypothesis is suggested:

Hypothesis 1: The presence of ‘blind bargaining’ in neo-patrimonial post-Soviet states results in attracting riskier lower quality iFDI.

Secondly, an analysis of the institution-eroding effect of ‘malign’ iFDI in transition states is proposed by applying the notion of ‘malign’ iFDI to the neo-institutional Rodrick’s framework of FDI, trade, and development (Rodrick, 2003; Rodrick, Subramian, & Trebbi, 2001) and combining it with a newly developed ‘blind bargaining’ model. It is argued that political bargaining process and outcomes are contingent on institutional characteristics, capabilities and goals of host countries (Eden *et al.*, 2004) and relevant bargaining power and goals of foreign investors. The worse the initial conditions and the weaker the host country institutions the lower quality iFDI enters the country which either do not contribute to the development of institutional environment or even cause negative changes. As a result, the following hypothesis is proposed:

Hypothesis 2: The host countries’ risks increase (decrease) with the growth of lower quality ‘malign’ (better quality ‘benign’) iFDI flows.

Finally, acknowledging the limited nature of the macroeconomic results due to their lack of capacity to account for regional and foreign investors’ diversity, this thesis proposes a more focused micro-level study of foreign investors’ behavior and performance in one country. An in-depth qualitative analysis of foreign investors’ political behavior in Ukraine allows addressing multiple generalizability and diversity issues identified at the macroeconomic phases of this research project. Thus, accounting for location- or recipient country-specific and ownership- or foreign investor-specific characteristics, this part of the thesis, initially, examines if a newly developed ‘blind bargaining’ model applies to different types of companies

with FDI in Ukraine. Subsequently, combining the adopted theoretical frameworks with corporate political activity research, a ‘blind bargaining’ model is further revised and advanced building on the analysis of various groups of foreign investors’ political behavior in their respective impact on institutional changes in the host country. In this context, the following research questions are suggested:

Research question 1: Do any of the existing bargaining models (obsolescing bargain, political bargaining and or newly developed blind bargaining model) apply to companies with FDI in Ukraine? Does their relevance vary for different groups of companies with FDI? How?

Research question 2: How do the choices of companies with FDI regarding political strategies depend on their characteristics?

Research question 3: Does the level of political activity and pro-activeness vary between different groups of companies with FDI? If so, how?

Research question 4: How successful and efficient are different types of companies with FDI in their efforts to influence institutional changes? Why?

## **CHAPTER THREE: RESEARCH METHODOLOGY**

### **3.1 Introduction**

Research methodology is an overall strategy constituting a constructive framework adopted by a scholar for answering postulated research questions (Howell, 2013). Based on a comprehensive theoretical inquiry it justifies the choices of research approaches, methods, techniques and their combinations for the fulfillment of the research task (Goddard & Melville, 2004; Howell, 2013). It is noteworthy that the final decisions on the use of specific methodological elements depend on the nature of the studied phenomenon and research questions.

This research aims at providing a comprehensive analysis of different aspects of iFDI quality in post-Soviet transition countries. The accomplishment of this mission requires employing mixed method research methodology. While the first two parts of this project adopt a macro-level quantitative approach to analyze two different aspects of the quality of iFDI in post-soviet transition countries, such as the relationships between iFDI quality and host country institutional environment in the context of 'blind bargaining' model, in the first case, and an impact of iFDI on institutional capacities in transition countries, in the second case, the third section addresses the gap in micro-level research on the political behavior of MNCs and other companies with FDI (referred to hereinafter as foreign investors or companies with FDI), their relationships with state institutions, and their impact on the changes in institutional environment within the context of one country. Here, emphasizing the complexity and context-specific nature of the phenomenon of foreign investors' political behavior and their impact on host country's institutional environment, in particular, and relationships with host state institutions, in general, this research acknowledges the need for more targeted qualitative analysis at higher levels of disaggregation.

That is why the third part of this thesis is a comprehensive study of different aspects of foreign investors' political behavior in the context of one country - Ukraine. Specifically, it is the first qualitative study (to our knowledge as of 04/01/2013) which explores the complexity of relationships between host country institutions and foreign investors as well as the impact of the latter on the changes in

the host country institutional environment in post-Soviet and Central and Eastern European countries, particularly Ukraine.

This mixed methods analysis adopts the scientific realist stance recently suggested by Pawson & Tilly (1997) which admits the importance of social contexts and, as a result, builds upon the combination of elements of both Bhaskar's structuralist or transcendental (1979) and Harre's constructivist (1971) versions of realism (Blackie, 2001). A retroductive research strategy (Bhaskar, 1979; Blakie, 1995; Blakie 2001; Harre, 1971; Pawson & Tilly, 1997) is most pertinent for the inquiry into the complexity of the examined phenomenon. Moreover, the exhaustive explanation, evaluation and assessment of impacts of the latter (Blackie, 2001) would require application of exploratory, descriptive and explanatory strategies (Blackie, 2001; Easterby-Smith *et al.*, 1991) and acknowledgement of subjectivity in the perceptions of continuously changing processes of social interactions (Littlejohn, 2000). Semi-structured interviews allow us to account for the complexity and versatility of multiple links and relationships in which foreign investors and their representatives engage for the purpose of aligning the host country's institutional environment with their strategic goals.

The qualitative analysis focuses on the study of foreign investors' political behavior as determined by the quality of iFDI manifested through these companies' corporate governance practices. As a result, we explore major areas of the social, economic and political interests, political influence and relative bargaining power of foreign investors as one of the major rent-seeking interest groups and holders of de facto political power, in order to estimate their impact on the transformation of the institutional environment in Ukraine.

This chapter is organized as follows. Firstly, section 4.2 outlines and justifies the relevance of mixed methods research methodology for this research. Sections 4.3 and 4.4 discuss characteristics of quantitative and qualitative research methodologies, respectively. Sections 4.5 and 4.6 overview the research philosophy, paradigm and strategy to substantiate the appropriateness and advantages of the selected research methodology. Section 4.7 reviews the models adopted for the quantitative analysis. Finally, section 4.7 consists of the qualitative research design review, including a

detailed discussion of the research method, data collection and data analysis procedures.

## **3.2 Mixed methods research**

### **3.2.1 Objectives and advantages**

Mixed methods research is distinguished from quantitative and qualitative purists' research paradigms by its methodological pluralism (Johnson & Onwuegbuzie, 2004; Onwuegbuzie & Leech, 2005). While quantitative and qualitative purists deny the compatibility of their respective research paradigms stating that even the methods employed within each of their domains cannot and should not be mixed, mixed methods research acknowledges the value and usefulness of both of these approaches (Johnson & Onwuegbuzie, 2004).

As a result, the main objective of the mixed methods mode of inquiry is “not to replace either of these approaches but rather to draw from the strengths and minimize the weaknesses of both in single research studies and across studies” (Johnson & Onwuegbuzie, 2004: 14-15). Scholars argue that pragmatic researchers open to adopting multiple methodologies within the same research framework are not only more likely to be able to address all the problematic issues and biases specific for any singular research approach arising in the process of answering research questions but also add more complete knowledge due to their broader range of options in selecting the most appropriate and efficient combinations of methods (Johnson & Onwuegbuzie, 2004; Onwuegbuzie & Leech; 2005).

Other advantages of employing mixed research methodology that arise from the complementary use of quantitative and qualitative research methods include:

- better explanatory power;
- increased reliability due to arising opportunities to neutralize the weakness of one method by capitalizing on the strengths of another method;
- ability to obtain stronger evidence for supporting the findings;
- increased generalizability of the findings;

- ability to identify blind spots, both terms of further inquiries and understanding, inaccessible to the eye using mono-methodology;
- ability to expand the range of research questions (Johnson & Onwuegbuzie, 2004).

### **3.2.2 Disadvantages and weaknesses**

As any other research methodology the implementation of mixed method research approach also has its disadvantages and weaknesses. Firstly, from the feasibility perspective, both its critics and proponents emphasize that, in general, it is a very demanding task for a single researcher to apply different research approaches within the same research project simultaneously. A researcher needs to gain an expertise in multiple research methods which increases the amount of time required for the completion of such project and also raises the expenses. Overall, specialists argue that mixed method projects are a more feasible task for a research team. Secondly, from the conceptual perspective, experts speculate that numerous theoretical and analytical details still require careful consideration. For example, researchers still need to resolve problems intrinsic to and accompanying the process of mixing qualitative and quantitative paradigms, find the most appropriate and efficient ways for qualitative analysis of quantitative data and for interpreting conflicting results (Johnson & Onwuegbuzie, 2004).

Green, Caracelli & Graham (1989) identify five major rationales for undertaking mixed methods research. The first purpose for combining qualitative and quantitative approaches is triangulation. In other words, multiple methods are employed for examining the same phenomenon to test the convergence and corroboration of findings. Also, application of this research approach can be driven by a pursuit of complementarity. In this case different research paradigms help to add more details, illustrate and clarify their outputs. Initiation rationale is seeking to identify vague, inconsistent and conflictive issues and, based on this information, introduce relevant changes to the research question. The goal of development rationale is to communicate the evidence obtained by one method to the other one. Finally,

expansion rationale broadens research perspectives by utilizing various methods for different elements of the research project.

### **3.2.3 Types of research approaches**

Scholars distinguish several types of mixed method research approaches. In addition to the rationale, the choice of these types in each particular case depends on four factors including theoretical perspective adopted by the author of the project – explicit or implicit, priority of research strategy – equal, qualitative or quantitative, sequence of data collection implementation – qualitative, quantitative or no sequence, and the point at which the data are integrated – at data collection, data analysis, data interpretation stages or with some combinations (Terrell, 2011).

Based on the factors listed above the following major mixed method research approaches can be distinguished:

1. sequential strategy:

- explanatory – qualitative analysis is applied to provide a more detailed explanation of the quantitative results;
- exploratory – quantitatively testing various elements and generalizing qualitative findings;
- transformative – varies aligning with a theoretical perspective.

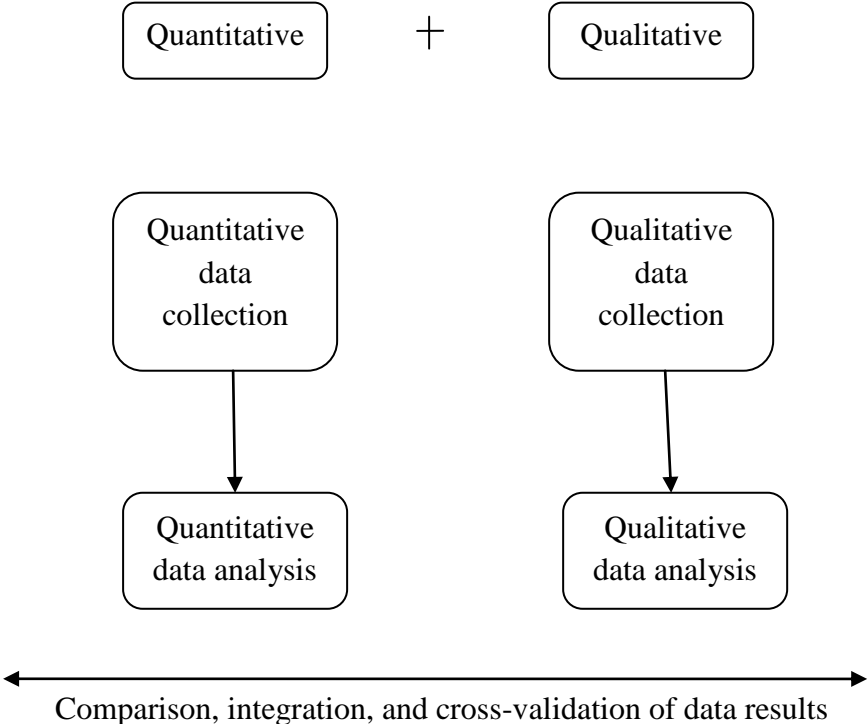
2. concurrent strategy:

- triangulation – pursues confirmation, corroboration or cross-validation of findings;
- nested – two various data collection methods are embedded within each other for achieving a better understanding of the studied phenomenon;
- transformative - varies aligning with a theoretical perspective (Terrell, 2011)



Based on the above analysis and classification of the mixed method research methodology this research adopts a concurrent triangulation strategy (Terrell, 2011), which involves three data collection stages: two quantitative and one qualitative (see Fig. 3.1). All of these strategies are given equal priority. The integration of the findings is taking place at the data interpretation stage of the research project. The main goals for employing concurrent triangulation strategy was to confirm, complement, corroborate and cross-validate the results from three parts of the research project examining different aspects of the same phenomenon.

**Figure 3.1. Concurrent triangulation strategy\***



\*Adopted from Terrell (2011: 267).

**3.3 Research paradigm**

According to Blaikie (1995: 131) “scientific research is about answering questions by means of controlled inquiry”. These questions can be categorized as follow: firstly, ‘what’ questions focusing on the description of the subject matter; secondly, ‘why’ questions inquiring into the reasons and seeking for an explanation of studied events, and, thirdly, ‘how’ questions exploring the mechanism underlying

relationships between the phenomenon under investigation (Blaikie, 1995). The study of any phenomenon with the intent to answer any set of such specific questions can be conducted in multiple ways. The choice of appropriate research approaches and methods will be guided by a belief system or research paradigm built upon the ontological, epistemological and methodological dimensions of the researcher's view on knowledge (Guba, 1990).

As a result, the cornerstone of any research project and the most fundamental point in question for a researcher are the decisions on the ways of approaching, epitomizing, elucidating and interceding the studied phenomenon (Blaikie, 1995). Several major approaches to social enquiry are distinguished by the contemporary science. Whether the methods of the natural sciences can be applied to the social science is the main question that divides philosophers into different groups representing varying views in regard to this inquiry (Blaikie, 1995). As a result of debating on this problem the following ontological responses were distinguished:

- classical responses: positivism, negativism, historicism, critical rationalism, classical hermeneutics, interpretivism;
- contemporary responses: critical theories, realism, contemporary hermeneutics, structuration theory, feminism (Baikie, 1995).

This research adopts an epistemological stance of critical realism (Archer, Bhaskar, Collier, Lawson & Norrie, 1998; Bhaskar, 1978, 1989, 2011; Campbell, 1974, 1988; Cook & Campbell, 1979; Manicas, 2006; Sayer, 1992, 2000). While positivism and critical rationalism adopt a correspondence theory of truth, according to which objectivity is achieved by the use of logical (deductive) reasoning to criticize false or bad theories, hermeneutics and interpretivism reject the existence of any objectively valid interpretation and claim that all that is possible is culturally and historically situated accounts leading to an unlimited number of interpretations. In contrast to both of these ontological positions, realism makes an attempt to avoid the problems of objectivity by separating the transitive and intransitive objects of science and the tools for explaining reality itself. Realism does not reject the interpretivist position that natural and social phenomena are fundamentally different (Blaikie, 1995). Realists see the world, in general, and social objects, in particular, have dual

actuality. On one hand, like constructivists, realists see social phenomenon as being perceived through the lens of researcher's subjective views, judgements and standpoints (Flick *et al.*, 2004; Olsen, 2004). However, on the other hand, they accept that the existence of this world and any social objects or phenomena is also independent of any subjective constructs or experiences (Blaikie, 1995; Olsen, 2004; Sayer, 2000).

One of the most distinctive and important features of realism is methodological pluralism (Olsen, 2004; Sayer, 2000). It predicates that realists allow the use of different methods and techniques, including both qualitative and quantitative, for the study of the same social phenomenon and its various characteristics (Carter, 2003; Danermark; 2002; Olsen, 2004; Sayer, 2000). Moreover, they encourage the search for, and development of, subject-specific methods (Blaikie, 1995).

### **3.4 Research strategy**

The critical realist position adopted in this research critical realism position informs the choice of research strategy for this research project.

There are four research strategies that are associated with the discussed above approaches to social inquiry, namely: inductive, deductive, retroductive, and abductive. All of these research strategies are distinct in terms of the starting point and analytical structure of the research (Blaikie, 1995). Realists find both inductive and deductive research strategies insufficient and inadequate for meeting their purposes (Blaikie, 1995; Olsen, 2004). They claim that validity of findings obtained through a descriptive induction is questionable and the causality of relations cannot be established, while also rejecting deduction based on the fundamental criticism of the hypothesis-testing method (Blaikie, 1995; Olsen, 2004).

By contrast, retroduction and abduction are acknowledged as the most appropriate research strategies by realists (Blaikie, 1995). Abduction is an analytical instrument employed in cases when the researcher is seeking to discern the inner knowledge and understand the inner traits of experiences related to the phenomenon under investigation (Olsen, 2004; Danermark, 2002). As a result, it does not possess the analytical apparatus which would allow the inquiry into macro-level topics

(Olsen, 2004). Consequently, it appears to be the research technique least compatible with quantitative research methods (Olsen, 2004).

Retroduction appears to be the most appropriate research strategy for the study of phenomenon as elusive to measurement and possibly even precise definition as institutional quality, relationships, power, and status, in general, and changes in institutional quality and in power relationships between host state institutions and companies with foreign direct investment, in particular (Olsen, 2004). According to Sayer (1992: 107) retroduction is “a mode of inference in which events are explained by postulating (and identifying) mechanisms which are capable of producing them”. Thus, retroduction inquires into real social structures and mechanisms searching for and suggesting new connections - antecedents which are presumed to cause the observable phenomenon and its changes (Blaikie, 1995; Olsen, 2004). Moreover, retroductive logic is appropriate for both qualitative and quantitative methodologies (Olsen, 2004).

This qualitative analysis adopts critical realists’ position and is embedded into interpretative or constructivist paradigm acknowledging relativism and admitting the subjectivity in perceptions of continuously changing processes of social interactions (Littlejohn, 2000). A retroductive research strategy is most pertinent for the inquiry into the complexity of the examined phenomenon. The exhaustive apprehension of the latter requires application of exploratory, descriptive and explanatory strategies (Easterby-Smith *et al.*, 1991).

We now proceed to present the research design that has been selected in view of the critical realist retroductionist approach outlined above. However, it must be also noted that the choice of the appropriate research methods has also been guided by the difficult multidisciplinary nature of the tested research hypothesis and explored research questions.

### **3.5 Overall research design**

This thesis includes three studies (Figure 3.2) serving the overall aims of this PhD project on developing and testing a model of bargaining determining the quality of FDI inflows, relationships between foreign investors and institutions, and the role

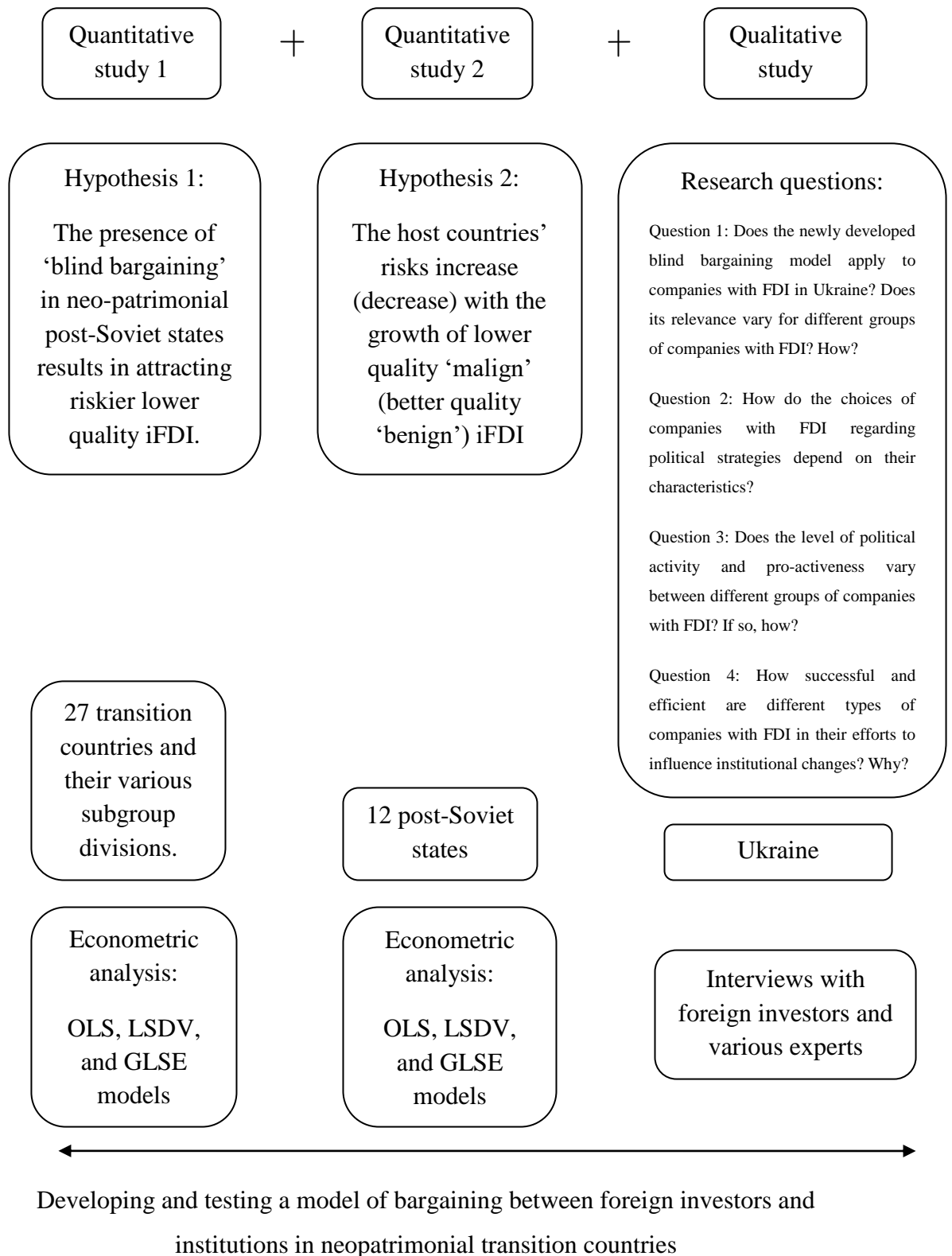
of foreign investors in institutional changes in neo-patrimonial transition countries. Each of these sub-studies analyzes and tests specific aspects of the proposed model at different levels of disaggregation.

The first quantitative study introduces a ‘blind bargaining’ model and suggests that the presence of ‘blind bargaining’ in neo-patrimonial post-Soviet states results in attracting riskier lower quality iFDI. Initially, the hypothesis is tested using Ordinary Least Squares (OLS), Least Squares Dummy Variables (LSDV), and Generalized Least Squares Estimates (GLSE) techniques for an entire group of 27 transition countries representing Central and Eastern European and post-Soviet regions, including post-Soviet states, the Baltic states, Central and Eastern European accession and non-accession countries for the five year period, 1997-2002. However, due to a high degree of the sample heterogeneity in terms of, firstly, the quality of recipient countries’ institutional environment, and, secondly, other geographic, historic, resource endowments, macro-economic and other characteristics, the sample was divided into smaller more homogenous regional clusters and the analysis was undertaken for the following groups of countries:

1. all post-Soviet states except the Baltic states;
2. Central European accession and non-accession countries and the Baltic states;
3. Central European post-Soviet states including Belarus, Moldova, Russia and Ukraine;
4. Central Asian States.

The results of this analysis confirm that ‘blind bargaining’ in neo-patrimonial post-Soviet states results in attracting riskier lower quality or ‘malign’ FDI.

**Figure 3.2. Overall thesis research design**



Based on the above results, the second quantitative study proposes an analysis of the reverse relationships between institutions and FIs for a sample of twelve post-Soviet neo-patrimonial recipient states with the strongest indications of ‘blind bargaining’ and ‘malign’ iFDI, namely the Central and Eastern European States of Belarus, Moldova, Russia, and Ukraine, and the Caucasus and Central Asian Republics of Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan. It is suggested that the host countries’ risks increase (decrease) with the growth of lower quality ‘malign’ (better quality ‘benign’) iFDI. As in the case of the first quantitative study, this hypothesis is tested using OLS, LSDV, and GLSE techniques for the nine years period, 1997-2005. The results of this analysis confirm that foreign investment may have had negative effects on institutional capacities the region. However, the generalizability of these findings is questioned due to a limited time frame and variations in investment patterns within these regions.

The qualitative study is initiated as a response to the above concerns on the validity and generalizability of quantitative findings. As a result, the qualitative investigation of interactions between FIs and institutional environment in one of the post-Soviet neo-patrimonial transition countries included in the samples from previous studies, particularly Ukraine, is proposed for testing the model at a higher level of disaggregation to address all issues mentioned above and answer additional questions on political activity and strategies of different types of FIs in the country. A number of research questions is proposed to identify the applicability of a newly-developed ‘blind bargaining’ model, as well as the role and various technical and behavioral characteristics of FIs in shaping institutional environment in Ukraine. Firstly, the study explores if the newly developed ‘blind bargaining’ model apply to companies with FDI in Ukraine as well as whether and how its relevance varies for different groups of companies with FDI. Further, this research inspects if the choices of companies with FDI regarding political strategies depend on their characteristics as well as whether and how the latter affect their level of political activity and pro-activeness. Finally, the last section of this part of the thesis examines how successful and efficient are different types of companies with FDI in their efforts to influence institutional changes and what are the main sources for any variations in such impact.

Overall, even though each individual study independently contributes to developing and testing a model of bargaining between foreign investors and institutions in neo-patrimonial transition countries, their combination is employed for satisfying triangulation requirements and helping to assure confirmation, corroboration and cross-validation of findings (Terrell, 2011). The following sections of this chapter will review in more details various methodological characteristics of all three studies.

## **3.6 Quantitative research design**

### **3.6.1 Introduction**

Quantitative research approach is based on a systemic empirical analysis of a quantifiable data to explain a particular observable phenomenon (Given, 2008; Howell, 2013). Its main objective usually is to develop models and/or theories and/or propose hypothesis which would serve as a framework for establishing relationships between a dependent and various independent variables describing a particular event or characteristic of the phenomenon (Given, 2008).

This approach is commonly associated with the positivist philosophy comparing a social observation with physical phenomenon and claiming the objectivity of social science inquiry which allows achieving time- and context-free generalizations (Johnson & Onwuegbuzie, 2004; Nagel, 1996). Thus, the main goals of quantitative purists are to “eliminate bias, remain emotionally detached and uninvolved with the objects of study, and test or empirically justify their stated hypothesis” (Johnson & Onwuegbuzie, 2004: 14)

The quality of data, dependant on the data measurement problems, is one of the fundamental characteristics for determining the reliability of this type of research. As a result, the main advantage and disadvantage of this type of research is the ability to collect data from large samples and/or to access large databases which allows generalizing the results from a sample to the entire population. However, in doing so the researcher should take into account possible measuring problems (such as in case of analysis of FDI, for example, failure to distinguish between real and pseudo-FDI, account for reinvestment of profits, differences in measurement approaches between



different countries, etc.), which could negatively impact or question the reliability and generalizability of research results (Black, 1999).

### **3.6.2 Models**

#### **3.6.2.1 Panel data**

The dataset characteristics are the starting point for a choice of specific statistical techniques in undertaking a quantitative analysis. Panel, longitudinal cross-section or time-series dataset is pertinent to macroeconomic studies. Such dataset includes a series of countries or regions specific variables recorded over a certain period of time. Depending on data availability researchers distinguish balanced and unbalanced panel dataset. The former refers to the ideal cases when datasets contain data for all elements and years of the analysis, while the latter is characterized by some missing data. As any other item of statistical or econometric analysis, using panel data has its advantages and disadvantages. The most important strength of panel data is its ability to account for individual heterogeneity or control for variables that either cannot be observed or measured, such as cultural elements, or variables that change over time but not across countries, such as policies and regulations. The most important weaknesses of panel data include data collection problems and cross-country dependency or correlation between countries (Baltagi, 2008; Greene, 2008; Stimson, 1985; Torres-Reyna, 2007).

#### **3.6.2.2 Ordinary Least Squares model**

Ordinary Least Squares (OLS) model is a basic and one of the most often used tools for the panel data analysis (Stimson, 1985). However, despite its popularity, it has multiple limitations and should be used with caution based on the results of appropriate diagnostic techniques. Firstly, standard OLS model has a single intercept and coefficient estimated for independent variables (see Equation 1).

$$Y_{it} = \alpha + \beta X_{it} + \varepsilon_{it} \quad (\text{Eq. 1})$$

where

$i$  ( $i=1\dots n$ ) is the entity/ country subscript;

$t$  is the time subscript;

$Y_{it}$  is the dependent variable (DV) for the analysis;

$X_{it}$  is an independent variable (IV) for the analysis

$\alpha$  is an intercept for all entities

$\beta$  is constant or unknown parameter to be estimated for IVs;

$\epsilon_{it}$  is the error term.

Such model is recommended to apply in cases of homogenous units' analysis featuring low levels of heteroscedasticity and autocorrelation (Stimson, 1985). Thus, treating any cross-entity data as homogenous will lead to an unobserved heterogeneity bias since this OLS does not produce unit-specific measures of heteroscedasticity (Chen, 2008; Stimson, 1985). Since the main unit of the analysis performed in both quantitative parts of this research projects, the quality of institutions, is a very country-specific and path-dependent characteristic which will vary significantly between the sample countries depending on their cultural, political, ethnical and other aspects of their historical heritage, an augmented model establishing an intercept term  $\alpha$  for each country  $i$  is suggested (see Equation 2).

$$Y_{it} = \alpha_i + \beta X_{it} + \epsilon_{it} \quad (\text{Eq. 2})$$

where

$$\alpha_i = \tau + v_i \quad (\text{Eq. 3})$$

$\tau$  is a constant element of the intercept and thus remains the same for all sample countries,

$v_i$  is a variable part of the intercept and changes for every country in the sample.

The presence of multiple regressors determined the need for the final adjustments of the model (see Equation 4).

$$Y_{it} = \alpha_i + \sum \beta_k X_{it} + \epsilon_{it} \quad (\text{Eq. 4})$$

where

$k$  ( $k=1, \dots, K$ ) is a variable/regressor subscript.

Overall, the existing research on OLS suggest that, due to the weaknesses discussed above, the genuineness of the results produced by this model cannot be confirmed without applying other statistical tools (Greene, 2008; Stimson, 1985).

### 3.6.2.3 Least Squares Dummy Variables model

The Least Squares Dummy Variables (LSDV) model is one of the techniques that can be applied for removing such sources of OLS bias as between-unit and / or between-time-point variances (Stimson, 1985). The latter can be achieved by adding dummy variables (See Equation 5).

$$Y_{it} = \sum \beta_r X_{rit} + \epsilon_{it} \quad (\text{Eq. 5})$$

where

$i$  ( $i = 1 \dots n$ ) is the entity/ country subscript;

$t$  ( $t = 1, 2, \dots, T$ ) is the time subscript;

$Y_{it}$  is the dependent variable (DV) for the analysis;

$X_{rit}$  are the  $r$  covariates

$\beta_r$  are constants or unknown parameters to be estimated for covariates;

$\epsilon_{it}$  is the error term determined as follows:

$$\epsilon_{it} = \alpha_i + \tau_t + \mu_{it} \quad (\text{Eq. 6})$$

$\alpha_i$  are fixed unit-specific effects;

$\tau_t$  are time-specific effects;

$\mu_{it}$  are effects specific to both time and unit.

Assuming that there are no additional time-specific effects, except for those included in the model, the main goals of this model is to remove the unit-specific or sample countries – specific error in case of this research project. The latter can be achieved by determining the fixed effects for each country (Stimson, 1985; Wallace & Hussain, 1969). Controlling for both country- and time-specific effects simultaneously is not recommended for two reasons. Firstly, it will result in a

significant loss of degrees of freedom. Secondly, it may cause collinearity problems between dummy and explanatory variables (Stimson, 1965).

### 3.6.2.4 General Least Squares Errors model

General Least Squares Errors (GLSE) model addresses the coefficients interpretation problem associated with fixed time effects in LSDV model. Here, it is suggested to view the fixed estimated dummy coefficients as random variables, which allows avoiding the explanatory limitations of fixed constants' individual effects due to a shift in interest towards the distribution parameters of random variables such as mean and variance (Stimson, 1985).

$$Y_{it} = \sum \beta_r X_{rit} + \epsilon_{it} \quad (\text{Eq. 5})$$

where

$i$  ( $i = 1 \dots n$ ) is the entity/ country subscript;

$t$  ( $t = 1, 2, \dots, T$ ) is the time subscript;

$Y_{it}$  is the dependent variable (DV) for the analysis;

$X_{rit}$  are the  $r$  covariates

$\beta_r$  are constants or unknown parameters to be estimated for covariates;

$\epsilon_{it}$  is the error term determined as follows:

$$\epsilon_{it} = \alpha_t + \tau_t + \mu_{it} \quad (\text{Eq. 6})$$

$\alpha_t$  are random variables;

$\tau_t$  are time-specific effects;

$\mu_{it}$  are effects specific to both time and unit.

### 3.6.3 Quantitative study 1: 'Blind bargaining' and the quality of iFDI

#### 3.6.3.1 Introduction

The first quantitative study introduces a model of bargaining between foreign investors and institutions in transition countries instrumental for determining the quality of iFDI in transition countries. It is argued that the neo-patrimonial nature of

rule in some states, in particular post-Soviet, stipulates the presence of a ‘blind bargaining’ element in the relationships between MNEs and these states. ‘Blind bargaining’, reflecting latent conflict between genuine economic goals and the private interests of the state ruling elite, creates high levels of uncertainty and instability with regard to bargaining outcomes. The higher levels of uncertainty and unpredictability which result from the personalization of power and decision-making in these states, in turn, are likely to encourage MNEs to either disengage themselves from the respective territory, or to seek conditions which are excessively biased in their favor.

‘Blind bargaining’ can be considered as one of the explanations for the failure of post-Soviet states in attracting good quality or ‘benign FDI’. Following Hausmann and Fernandez-Arias (2000) and Elo (2003) it can be argued that the risky investment profile of these countries is likely to lead to a situation where a greater share of FDI is ‘malign’. This means that investment either does not contribute to the host states’ growth, or even influences negatively the overall development of the host state.

It is argued that the presence of ‘blind bargaining’ in neo-patrimonial post-Soviet states results in attracting riskier lower quality FDI. The ‘quality’ of FDI is defined as indicating the size and direction of the impact of a unit of iFDI flows on changes in institutional environment measured by host country risk indicators, including overall country risk, political risk, economic risk, legal risk, tax risk, operational risk, and security risk.

To test the hypothesis the relationships between iFDI flows and host country risk indicators will be analyzed for the sample of 27 transition countries, including Central and Eastern European and post-Soviet countries for the five year period between 1997 and 2002. However, it is also suggested that the heterogeneity of institutional environment and other region- and nation-specific features in recipient countries may infringe the quality of results produced as a result of the regression analysis. That is why the sample is further divided into several smaller groups based on the combination of states’ regional, geographic, historic, ethnographic, institutional, resource endowment, and macro-economic characteristics. Overall, the test is conducted for the following five different groupings of countries:

1. all CEE including post-Soviet states, the Baltic states, Central European accession and non-accession countries;
2. all post-Soviet states except the Baltic states;
3. Central and Eastern European accession and non-accession countries and the Baltic states;
4. Central European post-Soviet states including Belarus, Moldova, Russia and Ukraine;
5. Caucasus and Central Asian states.

The Baltic states are excluded from the group of post-Soviet countries and included in the group of Central and Eastern European accession and non-accession states based on their stronger institutional and economic performance, as well as their historically stronger ties and national identity feelings of belonging with the European region. The post-Soviet states group is further divided into two smaller groups – four Central European post-Soviet states (Belarus, Moldova, Russia and Ukraine) and eight Caucasus (Armenia, Azerbaijan, Georgia) and Central Asian (Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan, and Uzbekistan) states - by regional, ethnographic, and resource-endowments characteristics.

This classification allows identifying potential additional sources affecting the quality of iFDI flows in specific more homogenous groups of countries and, as a result, contributes to increasing the purity and predictive capacity of research findings. Thus, it is argued, that despite the smaller size of the sample, the results can provide a clearer picture of the relationships between the iFDI inflows and the quality of institutional environment in transition states and provide evidence for a ‘blind bargaining’ model in neo-patrimonial states.

### **3.6.3.2 Variables and measurements**

#### **i. Dependent variable**

The volumes of iFDI flows as a percentage of GDP in 27 transition economies for the 5 years period between 1998 and 2002 is used as the dependent variable for testing the hypothesis on the relationship between the quality of iFDI flows and institutional environment in the sample countries. The choice of iFDI flows, as

opposed to iFDI stocks, as a dependent variable is determined by the ability of the former to capture the political-economic effect (Cole, Elliott & Fredriksson, 2006; Malesky, 2009) of the interactions between the host country's institutions and the quality of new investment flows. The dependant variable was calculated using the UNCTAD data for both iFDI flows and GDP in all countries included in the analysis. Even though the academics question the accuracy of both measuring and reporting FDI flows and stocks, the uniformity of the data source helps, at least partially, addressing and resolving this issue.

## **ii. Independent variable**

Measuring the quality of institutional environment in a country is an extremely challenging task due to a highly complex nature of the phenomenon. Academics continuously debate the relevance (Buckely, *et. al.*, 2007; Judge, *et. al.*, 2011) and question the quality of existing institutional measures (Alonso & Garcimartin, 2004). A specific focus of a research project would usually determine the choice of an appropriate institutional variable. The latter range from income per head, income distribution, the efficiency of tax system, population educational level, corruption perception (Kwok & Tadesse, 2006; Robertson & Watson, 2004), bureaucracy, infrastructure, rule of law, law enforcement and other similar indices countries (Bevan, Estrin & Meyer, 2004; Busse & Hefeker, 2007; Daude & Stein, 2007; Dunning & Lundan, 2008; Mudambi & Navarra, 2002) to such their cumulative counterparts as environmental regulations (Cole, Elliot & Fredriksson, 2006), economic transition (Malesky, 2005; Malesky, 2009), governance (Hellman, Jones & Kaufmann, 2002) and country risk indicators (Acc-Nikmehr & Beck, 2005).

For the purpose of this research, due to the data availability and access restrictions, Global Insight's country risk indicators are adopted as the most appropriate measure of recipient countries' institutional capacity and quality. Global Insight estimates its risk indicators on the basis of the following criteria:

- Political Risk (PR): institutional performance, representativeness, internal political consensus, external political consensus;

- Economic Risk (ER): degree of market orientation, policy consistency and forward planning, diversity and resilience of the economy, macroeconomic fundamentals;
- Legal Risk (LR): legislation, transparency, independence, experience;
- Tax Risk (TR): coherence, fairness, level, effectiveness;
- Operational Risk (OR): attitudes to foreign investment, infrastructural quality, labour, bureaucracy and corruption;
- Security Risk (SR): civil unrest, crime, terrorism, external security threat.

Overall Country Risk (OCR) is calculated as an aggregate of all other risk components based on the following equation:

$$\text{OCR} = \text{Square Root}(0.25 \text{PR}^2 + 0.25 \text{ER}^2 + 0.15 \text{LR}^2 + 0.15 \text{TR}^2 + 0.10 \text{OR}^2 + 0.10 \text{SR}^2)$$

All risks are rated on the scale from 1 to 5 points, where 1 is insignificant risk and 5 is extreme risk (Global Insight, 2005).

Data is collected from Global Insight's individual annual country reports for the entire research period.

### **iii. Control variables**

GDP, export, and trade balance per capita, hosts' debt as share of GDP, inflation, and unemployment are selected as control variable to account for certain country specific characteristics. GDP per capita reflects on the standards of living and purchasing power in each country (Globerman & Shapiro, 2003; Buckley, *et. al.*, 2007). Government debt controls for the intensity of the creditors' pressure (such as home countries, private banks, World Bank, International Monetary Fund, etc.) on the host state institutions. The data on government debt and GDP is accessed from Global Insight individual country annual reports. The indicator is calculated as a share of GDP. Trade balance, exports and imports control for the type of iFDI and measure the openness of the economy. The data for all of the above measures was obtained from the UNCTAD online database. Inflation reflects on the vulnerability of the economy to the deterioration in the real value of income and is measured as an annual percentage change in a consumer price index. IMF was the source for this index. Finally, the unemployment rate affects an interest of resource-seeking investors in entering the countries with large, flexible, high quality, but relatively



cheap employees' pool (Coughlin, *et.al.*, 1991). This along with most of the other control variables was obtained from Global Insight individual country reports (See Table 3.1).

**Table 3.1. Quantitative study 1: List of variables, measurements, and sources\***

Variable type	Variable name	Theoretical justification	Measure	Source
Dependent	iFDI flows as a share of GDP		Percentage	UNCTAD
Independent	Country risk	Institutions	Scale from 1 to 5 points, where 1 is insignificant risk and 5 is extreme risk	Global Insight
Independent	Political risk	Institutions	Scale from 1 to 5 points, where 1 is insignificant risk and 5 is extreme risk	Global Insight
Independent	Economic risk	Institutions	Scale from 1 to 5 points, where 1 is insignificant risk and 5 is extreme risk	Global Insight
Independent	Legal risk	Institutions	Scale from 1 to 5 points, where 1 is insignificant risk and 5 is extreme risk	Global Insight
Independent	Operational risk	Institutions	Scale from 1 to 5 points, where 1 is insignificant risk and 5 is extreme risk	Global Insight
Independent	Security risk	Institutions	Scale from 1 to 5 points, where 1 is insignificant risk and 5 is extreme risk	Global Insight
Control	GDP per capita	Market-seeking FDI	\$ US	Global Insight
Control	Government debt as a share of GDP	Market-seeking FDI	Percentage	Global Insight
Control	Exports as a share of GDP	Market-seeking FDI	Percentage	UNCTAD
Control	Trade balance as a share of GDP	Market-seeking FDI	Percentage	UNCTAD
Control	Unemployment	Resource-seeking FDI	Percentage of working-age population without employment	Global Insight
Control	Inflation	Transaction costs	Annual percentage change in a consumer price index	IMF

\*Independent variable and all control variables are in logarithmic form.

### 3.6.3.3 Empirical Model

The following analysis draws on the data, which have been arranged in a balanced panel format, listing iFDI flows, variable risk scores and other country characteristics for 27 post-Soviet and Eastern European countries for the five year period, 1998-2002. For this purpose the following equation was estimated:

$$Y_{it} = \alpha_i + \beta_1 (\text{Risk indicators})_{it} + \beta_2 X_{it} + \epsilon_{it}$$

where

$i$  is the country subscript;

$t$  is the time subscript;

$Y_{it}$  is the dependent variable for the analysis, iFDI $_{it}$  flows;

$(\text{Risk indicators})_{it}$  is an independent variable measuring institutional capacity of a country  $i$  in a year  $t$  measured by Global Insight's indicators of country risk, including overall country risk calculated as an aggregate of political, economic, legal, tax, operational and security risks.

$X_{it}$  is a matrix of control variables indexed by country and by year. The latter includes, GDP per capita, government debt as a share of GDP, exports and trade balance as percent of GDP, unemployment, inflation;

$\alpha_i, \beta_1, \beta_2$  are constants or unknown parameters to be estimated;

$\epsilon_{it}$  is the error term.

Independent and all control variables are in natural logarithmic form, which allows measuring their elasticity and contributes to minimizing skewness caused by outliers.

The Ordinary Least Squares (OLS), Least Squares Dummy Variables (LSDV), and the General Least Squares Error (GLSE) models were adopted to examine the relationship between the quality of iFDI flows and institutional environment in recipient countries controlling for some recipient markets' characteristics. Of these models, the LSDV model can be considered the most reliable since the OLS model is likely to produce overinflated t values on account of serial correlation, and the GLSE

is likely to underestimate the significance of coefficient (Stimson, 1985). A Hausman test was performed to determine the choice of an original model. OLS model was selected since the unobserved fixed effects did not bias the results.

### **3.6.4 Quantitative study 2: Evidence of ‘malign’ iFDI in former Soviet states**

#### **3.6.4.1 Introduction**

The second quantitative study is stemming from a relatively recently initiated debate questioning the direction of the causality between FDI and other variables of interest (Apergis, 2008; Balasubramanyam, Salisu, and Sapsford, 1996; Borensztein, De Gregorio and Lee, 1998; Carcovic, 2002). Moreover, it further tests a newly proposed ‘blind bargaining’ model questioning the dominant orthodoxy of iFDI (See Fig. 1.1) which suggests that increased foreign investment will, in virtually all instances, benefit the recipient nation (Balasubramanyam, Salisu, and Sapsford, 1996; Borensztein, De Gregorio and Lee, 1998; De Melo, 1999; Dyker, 1999). Thus, this empirical part of the research project consists of an exploratory statistical national level data analysis which tests the impact of institutions, as one of the most important location-specific advantages of host economies, measured by country risk indicators, on a quality of iFDI flows via a pooled regression analysis.

To test the hypothesis on the effects of the quality of iFDI flows on the recipient country’s institutional environment the data for twelve neo-patrimonial post-Soviet countries, namely the Central and Eastern European States of Belarus, Moldova, Russia, and Ukraine, and the Caucasus and Central Asian Republics of Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan, over a nine years period, 1997-2005, are investigated in terms of three models, including OLS, LSDV, and GLSE. To preserve the homogeneity of the sample, this analysis deliberately excludes the three Baltic states, whose economic development was affected relatively early on by their eventual succession to the European Union (Hunya, 2004).

### **3.6.4.2 Variables and measurements**

#### **i. Dependent variable**

As in the previous quantitative study, due to the data availability and access restrictions, Global Insight's country risk indicators are adopted as the most appropriate measure of recipient country's institutional capacity and quality. However, for the purpose of this research, these indicators serve as dependent variables. Moreover, in the following analysis, tests are conducted only for the Global Insight's variables which produced the strongest results in the previous analysis. The latter include overall country risk (OCR), economic risk (ER), and legal risk (LR). It should be noted that this analysis has excluded a fourth Global Insight's variable, which also produced strong results, namely political risk. The reason for this is that the latter variable shows a strong path dependency in the sense that the stability of democratic governance systems has strong historical determinants and appears to change only marginally over time. For the purpose of our argument regarding the potentially malign effects of FDI, both economic and legal risks appear to be the more suitable variables.

All risk indicators are estimated, rated and collected as in previous quantitative study.

#### **ii. Independent variable**

The volumes of iFDI flows as a percentage of GDP in 12 post Soviet states for the nine years period between 1997 and 2005 is the key causal variable for testing the hypothesis on the effect of the quality of iFDI flows on institutional environment in the sample countries. As in the first quantitative study, the choice of iFDI flows as opposed to iFDI stocks as a causal variable is determined by the ability of the former to capture the political-economic effect (Cole, Elliott & Fredriksson, 2006; Malesky, 2009) of the interactions between the host country's institutions and the quality of new investment flows. This variable was calculated using the UNCTAD data for both iFDI flows and GDP in all countries included in the analysis. Even though the academics question the accuracy of both measuring and reporting FDI flows and

stocks, the uniformity of the data source helps, at least partially, addressing and resolving this issue.

### **iii. Control variables**

GDP per capita, trade balance and hosts' debt as share of GDP, and unemployment are selected as control variable to account for certain country specific characteristics. GDP per capita reflects on the standards of living and purchasing power in each country (Globerman & Shapiro, 2003; Buckley, *et. al.*, 2007). Government debt controls for the intensity of the creditors' pressure (such as home countries, private banks, World Bank, International Monetary Fund, etc.) on the host state institutions. The data on government debt and GDP is accessed from Global Insight individual country annual reports. The indicator is calculated as a share of GDP. Trade balance control for the type of iFDI and measures the openness of the economy. The data for all of the above measures was obtained from the UNCTAD online database. Finally, the unemployment rate affects an interest of resource-seeking investors in entering the countries with large, flexible, high quality, but relatively cheap available employees' pool (Coughlin, *et.al.*, 1991). This along with most of the other control variables was obtained from Global Insight individual country reports (see Table 3.2).

**Table 3.2. Quantitative study 2: List of variables, measurements, and sources\***

Variable type	Variable name	Theoretical justification	Measure	Source
Dependent	Country risk	Institutions	Scale from 1 to 5 points, where 1 is insignificant risk and 5 is extreme risk	Global Insight
Dependent	Legal risk	Institutions	Scale from 1 to 5 points, where 1 is insignificant risk and 5 is extreme risk	Global Insight
Dependent	Economic risk	Institutions	Scale from 1 to 5 points, where 1 is insignificant risk and 5 is extreme risk	Global Insight
Independent	iFDI flows as a share of GDP	Institutions	Percentage	UNCTAD
Control	GDP per capita	Market-seeking FDI	\$ US	Global Insight
Control	Government debt as a share of GDP	Market-seeking FDI	Percentage	Global Insight
Control	Trade balance as a share of GDP	Market-seeking FDI	Percentage	UNCTAD
Control	Unemployment	Resource-seeking FDI	Percentage of working-age population without employment	Global Insight

\*Independent variable and all control variables are in logarithmic form.

### 3.6.5.3 Empirical Model

The following analysis draws on the data, which have been arranged in a balanced panel format, listing iFDI flows, variable risk scores, and other country characteristics for 12 post-Soviet countries for the nine year period, 1997-2005. The adopted model examines the impact of the quality of iFDI flows on institutional environment in recipient countries controlling for some recipient markets' characteristics. As in the case of the first quantitative study, this analysis includes Ordinary Least Squares (OLS), Least Squares Dummy Variables (LSDV) and the General Least Squares Error (GLSE) Models. Of these models, the LSDV model can be considered the most reliable since the OLS model is likely to produce overinflated t values on account of serial correlation, and the GLSE is likely to underestimate the significance of coefficient (Stimson, 1985). For this purpose the following equation is estimated:

$$Y_{it} = \alpha_i + \beta_1(iFDI)_{it} + \beta_2 X_{it} + \varepsilon_{it}$$

where

$i$  is the country subscript;

$t$  is the time subscript;

$Y_{it}$  is the dependent variable for the analysis, institutional capacity of country  $i$  in year  $t$  measured by Global Insight's indicators of country risk, including overall country, economic, and legal risks.

$iFDI_{it}$  is the key causal independent variable.

$X_{it}$  is a matrix of control variables indexed by country and by year. The latter includes GDP per capita, government debt as a share of GDP, trade balance as percent of GDP, and unemployment. GDP per capita reflects on the standards of living in each country. Government debt controls for the intensity of the creditors' pressure (such as home countries, private banks, World Bank, International Monetary Fund, etc.) on the host state institutions. Trade balance (exports and imports) control for the type of  $iFDI$  and measure the openness of the economy.

$\alpha_i, \beta_1, \beta_2$  are constants or unknown parameters to be estimated;

$\epsilon_{it}$  is the error term.

All independent and control variables are in logarithmic form, which allows measuring their elasticity and contributes to minimizing skewness caused by outliers.

### **3.7 Qualitative study: Research design**

#### **3.7.1 Introduction**

Qualitative research is the most appropriate and efficient approach for uncovering, exploring and describing of complex multifaceted practices, experiences, relationships, and interactions between various entities and their representatives within a specific context of certain socio-political-economic realities. A qualitative approach allows the researcher to obtain participants' reflections on the issues under investigation, including their attitudes, beliefs, feelings, assumptions, judgments and experiences within a particular socio-economic-political context. Moreover, it not only gives researchers' access to the information that cannot be obtained in any other

way by non-participants but can also reveal patterns that those taking part in the researched activity on a daily basis might not be aware of (Flick *et al.*, 2004).

As a result, qualitative research works as a unique source of insight into the complexity of any social phenomenon accounting for the multiple dimensions of interactions of contexts, settings and participants' frames of references (Marshall & Rossman, 1995; Strauss & Corbin, 1990). Hence, this research acknowledges the need for more targeted qualitative analysis at higher levels of disaggregation emphasizing the complexity and context-specific nature of the political behavior of foreign investors and their impact on the host country's institutional environment, in particular, and relationships with host state institutions, in general.

The quantitative analysis of the impact of FDI on the institutional environment in post-Soviet and Central and Eastern European countries presented in Chapters 5 and 6 allowed us to establish the signs of the impact and strength of the relationships between the quantity of FDI and variables used to measure the quality of institutions in these countries in general. However, for several reasons, including data availability and the nature of the research methods, it did not permit us to reveal and look into the unique distinctions in these relationships and their impact in different countries and industries. Qualitative analysis will therefore supplement quantitative analysis in order to identify and explore specific factors underlying the political activity for different types of companies with FDI within and different industries in a single country, Ukraine.

The inclusion of qualitative analysis is essential for the following reasons. First of all, qualitative research is inherently flexible (Miles & Huberman, 1994). Such flexibility makes it feasible for a researcher to uncover new latent issues and information and adjust the course, emphasis and depth of the study of certain focal points of a research based on the details detected by a researcher in the process of inquiry into the topic. It is particularly important in cases of examining very complex phenomenon characterized by multiple, overt and covert, traits and interactions. As a result, applying qualitative methodology increases the chances not only of detecting previously unknown attributes of a researched matter but also of ability to diagnose,



distinguish and pinpoint the core issues, explanations, interpretations and implications of analyzed interactions.

Moreover, for the study of changes in power relationships between business actors, various types of companies with FDI, and state institutions, and for the detection and assessment of the impact of the former on the later it is also very important that contextuality is a guiding principle of qualitative research (Flick *et al.*, 2004). Even though the qualitative study's transferability or generalizability to other settings sometimes is seen as problematic and considered by traditional canons as a weakness in the approach (Marshall & Rossman, 1995), inspecting multiple dimensions of both personal and impersonal interactions within a particular socio-economic-political context (Denzin & Lincoln, 1994) ideally serves the exploratory, descriptive and explanatory goals of this research.

### **3.7.2 Research method**

#### **3.7.2.1 Justification of research method**

The complex nature of the relationships between host country institutional environment and companies with foreign direct investment, the multidisciplinary character of the questions posed as a result of the definition of the problem, the sensitivity of the topic and the suggested research strategy impose special requirements and restrictions on the research design of this project.

The first and one of the most important phases of data collection for this research is a critical literature review. An analysis of public documents and information then carried out and the conclusions of this analysis are compared with those of the literature review. This allows the researcher to appropriately define the issues and identify the possible causes of problems. It also serves as means of imposing constraints on the choice of research techniques.

In this particular case because of the complexity, sensitivity and volatility of the studied phenomena the adoption of a longitudinal approach to data collection is impossible. Conducting case studies or organizing focus group discussions for

examining political behavior of companies with FDI and their relationships with various host country institutions and their representatives could produce a more holistic picture and provide the researcher with extremely important supplementary primary information on various companies approaches, strategies, tactics, behaviors and assessments of their political activities. According to Herz & Imber (1995) the analysis of political and administrative elites' activities, relationships and interactions can be most effectively pursued through employing semi-structures interviews as a research method. However, the secretive nature of and taboo attitude toward, the relevant aspects of business practices and behavior makes the information sought by the researcher highly sensitive, confidential and largely inaccessible, and that, in turn, makes it impossible to attempt the use of methods such as case studies or focus group discussions.

Thus, the best feasible research method for this study consists in semi-structured, confidential interviews with CEOs, directors, or managers of relevant departments within the companies with FDI for the purpose of gaining a historical perspective on the development and changes in power relationships between companies with FDI and host country institutions. The complex multiple links and relationships in which MNEs and companies with FDI engage for the purpose of aligning the host country's institutional environment with their strategic goals.

### **3.7.2.2 Interview**

What is an interview? Is it simply a conversation of two equal partners? Kvale (1994: 126) asserts that

The conversation in the research interview is not the reciprocal interaction of two equal partners. There is a definite asymmetry of power: the interviewer defines a situation, introduces the topics of the conversation, and through further questions steers the course of the interview.

This means that an interviewer is a leader of this deliberate conversation, structuring the interviewing procedure and defining the flow and the atmosphere of the interview (Kvale, 1994) for the purpose of detecting and exploring interviewees' views, attitudes, ideas, experiences and practices with regard to matters in question

within certain socio-political-economic settings (Kahn & Cannell, 1957; Seidman, 1998). The interviewer aims to obtain a comprehensive account of the examined phenomenon in both factual and meaning spheres of the inquiry (Kvale, 1994).

The forms of interviews range from highly structured to completely unstructured procedures. In order to meet the goals of this research project all interviews were semi-structured based on the use of open-ended questions serving as a guiding instrument for the steering of a conversation in a desired direction and probing for detailed and expanded interviewees' perceptions and perspectives (Flick, 1998). Since the targeted participants of this cycle of interviews were chief executive officers (CEOs), directors and managers of companies with FDI or MNEs subsidiaries in Ukraine, as well as state officials, journalists, and representative of various international organizations, these interviews can also be categorized as elite cross-cultural interviews – a method we will now discuss.

Elite interviews involve parties occupying posts entrusting their holders with authority, power, influence and various kinds of specialized knowledge depending on the sphere of their expertise (Gubrium & Holstein, 2002; Marshall & Rossman, 1995). Communication with representatives of the elite stratum of researched companies as well as with officials identified with other spheres of business or representing public, state and international organization exhibiting interest for this research in terms of their mutual interdependencies, impact and interactions significantly increases the chances of gaining access to the important facts, news and information not available to employees holding a lower-ranking positions. It is particularly important in the current research to explore the essence, motivations and practices of non-market and, particularly, political activity of companies with FDI and their impact on filling the institutional void and causing changes in the institutional environment of a host country.

Cross-cultural interviews are carried out with the representatives of different cultures and of various nationalities (Ryan, 2002). Conducting cross-cultural interviews generates problems, firstly, with an adequate account of, and reflection on, cultural differences in an interviewer's understanding of the information shared by an interviewee, and, secondly, for the ability to detect and understand various

linguistic nuances in interviewing non-native speakers. To avoid the former problems the researcher must ensure that he or she is acquainted with specific characteristics of cultures represented by different participants. The anticipation and elimination of linguistic problems requires a forward and back translation of the interview protocol into the languages used for interviewing.

The interviews for the current research were conducted in three languages (subject to the interviewee preference), including English, Russian and Ukrainian. To ensure the reliability and adequacy of reproducing open-ended research questions comprising the framework for the semi-structured interviews in different languages, the help of two independent professional interpreters was solicited to undertake the forward and back translations of the interview protocol originally designed in English into Russian and Ukrainian.

Another factor that influences the researchers' capability to obtain detailed information about the examined topic is the duration of the interview. Longer interviews give more opportunities to probe deeper and more exhaustively into various facets and multiple overt and covert features of the studied phenomenon.

Further, to increase the size of the sample of interviewed companies by meeting the convenience demands of some participants as well as to decrease the researcher's travelling time and costs, the researcher used three interview techniques, including telephone, face-to-face and Skype interviews. The second and third techniques allowed for accounting and assessment of not only contextual and articulate aspects but also provided access to the visual aspect of the communication process.

### **3.7.2.3 Advantages and disadvantages of semi-structured interviews**

The assessment of the advantages and disadvantages of a data collection method employed in the course of this research needs to address two aspects, differences in levels of structure and in interviewing techniques. Apart from data availability, the investigator's pursuit of a higher degree of either reliability or validity of the research is one of the main rationales governing the choice between structured and semi-structured interviews, respectively (Langley, 1987).

A higher degree of structure ensures internal consistency and comparability of the results due to the use of standardized research instrument. As a result, the data is viewed as more reliable since it can be quantified and replicated. Moreover, the fact that larger samples can be recruited further ensures that the results can be generalized. However, such precise and invariable nature of questions, usually limits the researcher's ability to ensure the validity of the analysis, since participants are restricted in their options of answers and are deprived of the chance to discuss their relevant experiences, ideas and issues not covered by the questionnaire. Besides, the authenticity of the suggested questions can also be doubted (Adler & Adler, 2002).

By contrast, semi-structured interviews can provide a researcher with access to the exceptionally detailed and genuine information (McCracken, 1988), made available thanks to the researcher's flexibility in the wording of questions and deeper exploration into both predetermined topics and those that are identified spontaneously during the course of the interview (Adler & Adler, 2002; Marshall & Rossman, 1995; Rubin & Rubin, 1995).

Nevertheless, this method has its disadvantages. Firstly, it is more expensive and time consuming. Secondly, confidentiality concerns are greater in such cases. As a result, researchers are restricted by the small sample sizes. The latter condition, in turn, imposes limitations on the analyst's ability to generalize the results of his/her study (Adler & Adler, 2002; Marshall & Rossman, 1999; Rubin & Rubin, 1995). The diversity in the content of the interviews due to differences in participants' experiences, knowledge and perceptions makes it non-replicable. Semi-structured interviews are also more susceptible to an interviewer's bias through conscious or unconscious misinterpretation of the interviewee's answers. The interviewer may also unintentionally influence or distort the respondent's comments and explanations (Adler & Adler, 2002; Marshall & Rossman, 1999; Rubin & Rubin, 1995).

With regard to the three interview techniques engaged in this study, namely face-to-face, Skype and phone interviews, the first two have certain advantages over the third one. In particular, the first can be characterized as synchronous communication both in time and space (Opdenakker, 2006). Such communication allows an investigator to both monitor and evaluate such social cues as an interviewee's

nonverbal behavior, including body language, voice, and emotional tone (Opdenakker, 2006). A comparative disadvantage of phone interviews is that they cannot provide visual access to the respondent. However, a strong advantage of this technique as compared to face-to-face interviews is that it ensures an extended geographical access to the target audiences (Opdenakker, 2006). It is also must be noted here that both of these technique could be relevantly costly. Interesting is the fact that Skype interviewing combines the advantages of both the other technique, without their disadvantages, making it the most cost-, time-, and spatial access-efficient interviewing technique.

### **3.7.3 Data collection**

#### **3.7.3.1 Sampling design**

Sampling design is a vital element of any research process (Onwuegbuzie & Leech, 2007). The researcher's ability to identify the most appropriate sampling scheme and strategy and to solicit agreement for participation from the actors representing the field of the researcher's interest is a principal requirement for the completion of any research project. The choice of sample size and of sampling procedures depends on the nature and objectives of the research project (Given, 2008), including sampling scheme, design and strategy (Onwuegbuzie & Leech, 2007).

Qualitative research is primarily based on the use of relatively small non-probability samples, in contrast with the random sampling schemes and larger size samples in quantitative research. As a result, both the data analysis techniques and approaches to generalization of findings differ significantly in qualitative and quantitative research. While quantitative researchers are restricted in their choice to one sample-to-population type of statistical generalization, qualitative researchers can interpret their findings applying any of the three types of generalization techniques, namely statistical, analytical generalization or case-to-case transfer (Firestone, 1993; Miles, & Huberman, 1994; Onwuegbuzie & Leech, 2007).

The research objectives, complexity, and sensitive nature of the studied phenomenon, namely the power relationship between companies with FDI and

institutional environment and the impact of the former on the latter, determined decision-making process of a sampling framework for this research project. The selection of participating companies was guided by the rules of a purposive sampling scheme. Within this scheme a combination of two partially overlapping kinds of purposive sampling alternatives were adopted, including criterion and theory-guided sampling (Given, 2008; Patton, 1990). So, taking into consideration the recommendations of previous theoretical and empirical research, the targeted units of analysis were identified based on the following criteria: the presence of FDI, company/subsidiary size (measured by the number of employees), and industry.

Two additional criteria, the form of ownership and the company's status in the global economy, were taken into account in the process of selecting appropriate research strategy. Here, parallel sampling design facilitated and ensured credible comparison of findings at both pairwise and subgroup levels (Onwuegbuzie & Leech, 2007). Three subgroups were recognized as important for the purpose of this research. The sample companies were grouped by industry, by characteristic representing companies' stand based on combination of form of ownership and the MNC's status in the global economy, and by company's investment decision rationale. In accordance with the previous research, the first two grouping criteria are believed to determine the bargaining power and political behavior of the companies as well as the character of their relationships with various state institutions. The author added the third dimension based on her own analysis and observations.

In addition, expert and stakeholder purposive samplings (Given, 2008) were employed to identify and recruit participants for the strategically important for the issue under consideration support or auxiliary interviews series. Thus, representatives of such subgroups as state officials, experts, journalists, potential foreign investors, domestic companies, including both small and medium sized enterprises and large domestic companies, - potential partners of existing foreign investors as well as foreign companies – potential investors were selected to increase the probability of pinpointing some new issues, discerning new contexts and, as a result, raising the potential for reaching more resonant and insightful conclusions.

The choice of research strategy imposes certain requirements on the size of a sample (Onwuegbuzie & Leech, 2007). The latter, in turn, directly determines the degree to which generalizations can be made on the basis of this research (Onwuegbuzie & Leech, 2007). As a result, Onwuegbuzie & Leech (2007) suggest that in comparisons of subgroups' each subgroup should consist of at least three cases. Moreover, it should be acknowledged that researchers can stratify the subgroups of their choice by more than one attribute, which also would cause further changes in the size of the sample (Onwuegbuzie & Leech, 2007). Overall, the sample size should ensure that data saturation and completeness (Rubin & Rubin, 1995), as well as theory saturation and information redundancy requirements are satisfied (Onwuegbuzie & Leech, 2007).

Even though a comparison of different subgroups ensures better insight into different contexts and expands the researcher's knowledge of these contexts and of their meaning for the understanding of the whole phenomenon, it is important to avoid sacrificing 'thick descriptions' and to preserve the uniqueness and complexity in depiction of each particular case (Onwuegbuzie & Leech, 2007). Hence, a balanced usage of both research techniques is an imperative for conducting a competent and efficient research producing legitimate and representative results valid for generalization (Onwuegbuzie & Leech, 2007).

### **3.7.3.2 Sample companies**

The nature and objective of the research project shaped the requirements to the sampling design, scheme, strategy and targeted population. Since the goal of the analysis was to explore the major areas and intensity of political interests (such as economic, social, legal policies, state building, etc.), as well as impact on changes in host country institutional environment of various patterns of political behavior including lobbying, firms alliances and associations, public and government relations, relationships with media, constitutions building, investors coalitions, policy-making, policy learning and international diplomacy, semi-structured interviews with chief executive officers (CEOs), directors and managers of different departments within companies with FDI or MNE subsidiaries in Ukraine were held between July and November, 2012. The original contact list for the sample of the



companies was identified based on the information contained within the Unified State Register of Enterprises and Organizations in Ukraine.

Consequently, after a review of companies' web sites the database for the initial sample of 269 companies with FDI from both developed and developing countries and more than 200 employees, representing both services and the industrial production sector, was compiled. All of the selected companies were contacted via e-mail containing a solicitation letter guaranteeing the confidentiality and compliance with the Data Protection Act (see Appendix A). To increase the chances of getting a response for an interview request the list of e-mails included all relevant available contact points for each company, including administrative company contacts, CEOs, general and legal directors, Public Relations, Government Relations, International Relations, and Advertising department managers.

The first contact round resulted in a positive reply from 17 companies. Representatives of 13 of these 17 companies asked for an interview protocol (see Appendices C and B for the English and Russian versions of the interview protocol, respectively) to gain a better idea about the essence of the research project and to prepare for an interview. However, after receiving the interview protocol containing a more detailed information on the research questions, 9 company representatives refused to participate in the study. Four of them explained that the sensitive nature of the research questions and confidentiality of this kind of information were the main reasons for their refusal. The other five participants did not provide any explanation and declined further communication by ignoring the follow up e-mails. Representatives of seven out of the remaining eight companies, who committed to their original decision on research participation, agreed to be interviewed only under the condition of strictest confidentiality and retention of a right to reject answering any question. Remarkable is the fact that by contrast, the director of the last company contacted me immediately upon the receipt of my e-mail with an offer to conduct a telephone interview right away.

The rest of the companies' agreement to participate in the research project was solicited through a lengthy process of multiple follow-up e-mail and telephone contact points. These efforts eventually culminated in an overall sample of 29

companies with FDI representing both the services and production branches of the economy in Ukraine.

Interviews were conducted with one representative from each company. Thus the overall number of interviews was equal to the number of companies participating in the study. Participating companies selected their representatives themselves. However, the nature of the research questions confined the pool of possible interviewees to the top level management category. Thus among the participants were CEOs, General and Legal Directors, Public Relations, Government Relations, International Relations, and Advertising department managers (see Table 3.3).

**Table 3.3. Summary of interviewee characteristics**

Characteristic	Title	Quantity
Position	CEO	1
	General Director	8
	Legal Director	3
	Department Managers:	17
	- Legal	2
	- International Relations	2
	- Public Relations	9
	- Public & Government Relations	3
- Government Relations & Advertising	1	
Nationality	Host country	21
	Home country	5
	Other	3
Total		29

Semi-structured interviews with open-ended questions were designed to last approximately one hour. Factually the time of the interviews varied from 48 to 131 minutes. The average length of the interviews was 68 minutes (see Table 3.4). Since among the interviewees were representatives of host and home as well as third country nationalities, interviews were conducted in three languages, subject to the choice of the respondent, including 6 interviews in English, 15 in Russian and 8 in Ukrainian languages (see Table 3.4). Furthermore, 8 interviews were audio-taped with the participants consent whereas the remaining 21 participants only agreed to

allow recording the interviews by note-taking (See Table 3.4). Finally, it is also necessary to report that out of 29 interviews 7 were administered in person, 6 via Skype and 16 over the phone (see Table 3.2).

**Table 3.4. Summary of interview characteristics**

Characteristic	Title	Quantity
Time	Minimum	48 minutes
	Maximum	131 minutes
	Mean	68 minutes
Language	English	6
	Russian	15
	Ukrainian	8
Recording method	Audio-taping	8
	Note-taking	21
Interview technique	Face-to-face	7
	Skype	6
	Telephone	16
Total		29

### 3.7.3.3 Sample subgroups identification

To ensure a better insight into different contexts and expand the researcher's knowledge of these contexts and of their meaning for the understanding of the whole phenomenon and of their impact on the shifts in tendencies and changes in relationships between various elements of the studied relationships, the researcher divided a sample into different subgroups by several characteristics. Accordingly all companies are classified by economic sector into two groups: services and production. Further these groups are broken down into several subgroups by industry type. List of industries is based on the aggregation of two-digit International Standard Industrial Classification (ISIC) divisions. Thus, the service sector cluster consists of trade; banking and financial services; construction; and other services (including logistics, engineering, etc.) subgroups. The production sector covers agriculture; food beverages and tobacco; light; chemical, and metallurgical industries (see Table 3.5).

To carry out a comprehensive analysis of the problem in question and identify the causes of variations in patterns of companies' political behavior, it is necessary to take into consideration whether the investor's home state is a developed, developing or transition country and companies' investment decision rationale (see Table 3.6). Moreover, in the process of splitting sample into groups it is also essential to account for unique combinations of such characteristics as investment decision rationale, form of ownership, investor-company status in the global economy (see Table 3.6).

**Table 3.5. Sample classification by industry**

Economic sector	Industry	Number of companies	Company names
Services	Trade	4	ST1, ST2, ST3, ST4
	Banking and financial services	3	SBF1, SBF2, SBF3
	Construction	3	SC1, SC2, SC3
	Other services	2	
	- Logistics	1	SL1
	- Engineering	1	SE1
Production	Agriculture	14	
	Food , beverages and tobacco production	3	PA1, PA2, PA3
	Light industry	5	PFBT1, PFBT2, PFBT3, PFBT4, PFBT5
	Chemical and petrochemical industry	2	PLI1, PLI2
	Metallurgical industry	2	PCP1, PCP2
	Other manufacturing	1	PM1
		2	POM1, POM2
Total		29	

**Table 3.6. Sample classification by investment decision rationale, home country's level of development, foreign direct investor's status in the global economy and form of ownership**

Characteristic	Type	Number of companies
Home country level of development	Developed countries	17
	Developing, emerging and transition economies	12
Investment decision rationale	Resource seeking	9
	Market seeking	20
	Efficiency seeking	-
	Strategic asset/ capability seeking	-
Form of ownership	1. Wholly owned foreign ventures	24
	2. Joint ventures	4
	3. Company with individual investors	1
Foreign Direct Investor's status in the global economy	1 Elite MNCs (with an exclusive status in the global economy)	12
	2. Mid-range profile foreign direct investor-company	6
	3. Low-range profile foreign direct investor-company (including Individual Investors)	11
Total		29

#### **3.7.3.4 Sampling for auxiliary interviews**

Expert and stakeholder purposive samplings (Given, 2008) were employed to identify and recruit participants for the support or auxiliary interviews. Thus, 21 representatives of such subgroups as state officials, experts, journalists, potential foreign investors, domestic companies, including both small and medium sized enterprises and large domestic companies, - potential partners of existing foreign investors as well as foreign companies – potential investors were selected to increase the probability of pinpointing some new issues, discerning new contexts and, as a result, raising the potential for reaching more resonant and unbiased conclusions (see Table 3.7).

**Table 3.7. Summary of characteristics of auxiliary interviews' participants**

Stakeholder category	Type	Number of interviewees	Stakeholder names
Experts	Total	10	
	-State officials representing Departments of International Economic Activities/	3	ESO1, ESO2, ESO3
	Regulatory entity	1	EINGO1
	-Representatives of international non-profit consulting and research organization	3	
		2	ELA1, ELA2, ELA3
	-Legal advisors	1	EA1, EA2
	-Academic experts		EJ1, EJ2
	-Journalists		
Potential partners	Total	4	
	-Large domestic manufacturing enterprise	1	PPLDM1
	-Small & medium size businesses	2	PPSB1, PPSB2
	-Research and development organization	1	PPR&D1
Potential investors	Total	4	
	Small foreign IT companies	3	PISIT1, PISIT2, PISIT3
	Foreign contractor company	1	PIFC1
Total		21	

**3.7.3.5 Pilot interviews**

Piloting is an important part of the research process that ensures the overall quality of a research project, particularly for multicultural studies such as the present one focusing on very sensitive topics. Pilot interviews serve multiple purposes. Firstly, they allow the researcher to test the original interview protocol and his or her interviewing techniques in a field environment. As a result, an interviewer obtains extremely valuable information for improving his/her research instrument and

interview technique. Both the interviewee's feedback and the interviewer's own reflections help identifying possible shortcoming or omissions in the interview protocol. The acquired experience and information allow the researcher to correct his/her interview style, technique, structure, and vocabulary, improve time management in the course of the interviewing process and, most importantly, to disclose sensitive issues of the research project, identify interviewees' attitudes and reactions to such issues and adjust the mode used for the discussion and investigation of such issues.

Two pilot interviews were conducted for this research project in June, 2012. Since the multicultural nature of the project required conducting interviews in three different languages, including English, Russian or Ukrainian, both pilot interviews were conducted in different languages. The first interview was undertaken in English. The interviewee was an expert in international business from academia. As a result of this interview, several terminological corrections and auxiliary themes were added to the research instrument. In terms of terminology, the interviewee suggested to avoid using such a strong and alarming term as "political behavior". Accordingly, the latter term was substituted with less sensitive phrases such as 'nonmarket strategies and behavior', 'your company's relationships with state institutions' and 'its impact on changes in institutional environment in Ukraine'. The expert also suggested examining, during the course of the interview, such questions as the role and impact of pseudo-FDI on the activity of real FDI in Ukraine and on their relationships with host state institutions.

The second interview was conducted in Russian. The interviewee was a director of a wholly owned subsidiary of a foreign company in Ukraine. The data obtained in the course of this interview were included in the analysis since this interview was completed in the format of an official interview followed by a discussion of the interviewing procedure. The researcher received the participant's feedback on the quality of her conduct during the interview and on the quality of the instrument, including such issues as its content, clarity, presence of ambiguities, drawbacks, and participant's recommendations. As a consequence of this interview, the researcher singled out a physical threat to assets, particularly the raiding problem, as one of the

most important sources of foreign investor's growing concern with regard to the security of their direct investments in Ukraine.

Moreover, the reflective account of these pilot interviews allowed the author to analyze her qualifications as an interviewer to assess some of her strengths and amend some of the weak aspects of her interview conduct.

### **3.7.3.6 Researcher's performance as an interviewer**

The performance of the researcher is one of the most important factors defining the quality of the interview process. Even though there are no absolute standards for interviewer's qualifications and no recipe for truly effective questions, the primary task of the interviewer, guiding his/her behavior is to maintain the ambience of an interesting conversation and the friendly and open atmosphere during the interview while steering the course of the interview (Kvale, 1994; Seidman, 1998).

The natural flow of questions from topic to topic, use of terminology and language that are familiar to the respondent, and the ability to capture the interviewee's reaction to some of the questions and to assess how successfully the interview is being conducted while it is underway depend on the interviewer's knowledge of the subject as well as his or her ability to listen, to understand the received information, to be sensitive to non-verbal cues such as pauses, body language and eye movements, to follow up on what the interviewee says and to keep him or her focused (Easterby-Smith *et al.*, 1991; Ghauri *et al.*, 2002; Kvale, 1994; Oppenheim, 1992).

Meeting all the above conditions implies that the interviewer should avoid being overly authoritative or leading, so as not to influence the direction the participant's responses will take. The interviewer's style must combine directness and precision and at the same time leave room for the respondent's freedom during the interview (Oppenheim, 1992). Moreover, the interviewer must ensure that the interviewee feels secure enough to discuss his/her experiences or feelings (Kvale, 1994).

It is also very important for the interviewer to refrain from asking multiple questions all at once. The practice of asking several questions at a time considerably



increases the complexity of respondent's task. The necessity to concentrate when attempting to memorize several questions simultaneously so as to be able to follow the flow of an interview significantly decreases the subject's ability to produce the comprehensive response for any of these questions. It simply puzzles the participant and draws his/her attention away from concentrating on being as precise and as objective as possible. The interviewee starts feeling discomfort because of his/her inability to assess all the information. It also brings into the subject's consciousness the fear of missing some information and the fear of being inadequate in his/her answers. This, in turn, induces the danger of misinterpreting the questions themselves and misrepresenting the participant's thoughts on the issue (Seidman, 1998).

How can the interviewer meet such a variety of sometimes conflicting requirements? How can the interviewer remain detached and professional in his/her attitude and yet be connected and friendly? What are the instruments and techniques that can help to become a good non-biased interviewer? According to Steinar Kvale (1994: 147):

(T)he interviewer is him or herself a research instrument. A good interviewer is an expert in the topic of the interview as well as in human interaction. The interviewer must continually make quick choices about what to ask and how; which aspects of a subject's answer to follow up – and which not; which answers to interpret – and which not. Interviewers must be knowledgeable in the topics investigated, master conversational skills, and be proficient in language with an ear for their subject's linguistic style. The interviewer should have a sense for good stories and be able to assist the subjects in unfolding of their narratives.

To guarantee the compliance with all the above discussed requirements and qualification criteria which interviewer must meet to ensure the quality of interviewing procedure and that an interview reflects the respondent's ideas and feelings in the most objective way or, in other words, to endure the most effective and competent interviewing possible the following measures were taken. First, as mentioned previously, based on the literature and document review the semi-

structured interview protocol was developed before the interviews and two pilot interviews were conducted. This helped the researcher to increase the degree of control over the interview process, refine the interview protocol, and increased interviewer's capability to react to unforeseen directions and developments in the conversations (Ghauri *et al.*, 2002).

Secondly, significant effort was invested into the development of the briefing or introduction part of the interview since it is the moment when the interviewer establishes the first contact with the participant. The quality of this first contact to a great extent determines the level of confidence and trust of the subject in the interviewer (Kvale, 1994). At this stage the interviewer is responsible for establishing of a trustworthy atmosphere and reassuring the informant about his or her concerns regarding the confidentiality of information. Successful completion of this task is a necessary - but not sufficient - condition for the further success of the interview in general (Kvale, 1994).

An interview starts with the introduction of the interviewer him/herself and of the organization or research unit he/she represents. This is followed by the indication of the research topic, the explanation of the purpose of the interview and of the implications of this research results for the development of business, changes and/or improvement of the business environment and policy making process and procedures in a particular context settings. At this point the interviewer must be as precise, open, friendly and trustworthy as possible. It is the first moment of grasping the prospective interviewee's attention and earning his confidence. Moreover, at this stage to ensure the trust the researcher must also guarantee the participants that all their names, associated companies and responses will be treated with strict confidentiality and the respondent's statements will not be associated with their companies, unless otherwise agreed.

Thirdly, all the questions were open-ended to prevent leading questions and bias both during the interviewing and interpreting stages of the research process (Easterby-Smith *et al.*, 1991). Both 'grand-' and 'mini-tour' questions were employed to get more details and ideas about interviewee's perceptions, concerns and expectations (Oppenheim, 1992). The last but not the least important structural

unit of the interview is the conclusion or debriefing. At this point it is important to provide the interviewee with a chance to express any of his/her ideas and to ask him/her if he/she has any other points to raise (Oppenheim, 1992).

### **3.7.3.7 Triangulation**

Triangulation is a very important part of social research, particularly when it has a qualitative and/or interdisciplinary nature (Olsen, 2004; Yeasmin & Rahman, 2012). It is a mechanism contributing to the increase in a probability of attaining balanced assessments of research findings and objective answers to research questions (Ghauri *et al.*, 2002; Olsen, 2004; Yeasmin & Rahman, 2012). The validity of research results is thus enhanced due to the employment of multiple research approaches and techniques ensuring the availability of various viewpoints, as opposed to the reliance on the results acquired through the use of a single source (Olsen, 2004; Jakob, 2001).

Building on the definition of triangulation and the procedures initiated, developed and applied by Campbell & Fiskel (1959) and Web (1966) (Yeasmin & Rahman, 2012), Denzin (1970, 1978) further advances the concept of triangulation. He distinguishes four types of triangulation, including data, investigator, theory and methods triangulation (Denzin, 1970; 1978). Here, data triangulation involves the use of various sources of data, while investigator triangulation requires participation of multiple researchers in the work on a given research topic (Denzin, 1970; 1978). Analogously, theory and methods triangulations demand that the study be conducted applying multiple theoretical perspectives and methods, respectively (Denzin, 1970; 1978). It is important to note that the main factor in the employment of particular types of triangulation is the researcher's philosophical stance and approach (Yeasmin & Rahman, 2012).

This study makes use of two types of triangulation. At the overall thesis level, method triangulation is applied (see Figure 3.2). Both quantitative and qualitative methods are utilized for the analysis of the relationships between FDI and host countries' institutions. In addition, the qualitative part of the project makes use of data triangulation to ensure the convergence of various perspectives on the same

issue, increase the validity of findings and to minimize the impact of bias and subjectivity in judgments expressed by the participants. At this stage interviews were conducted not only with representatives of various kinds of companies with FDI but also with state officials, experts, journalists, potential foreign investors, and representatives of domestic companies, including both small and medium sized enterprises and large domestic companies, - potential partners of existing foreign investors.

Further, the data sources triangulation helps to reinforce the reliability and objectivity of research findings. So, the research included the analysis of six important sources of data. The main source of data, interviews, was complemented with the analysis of official, private and state documents. These, in accordance with John Scott's (1990) classification of the documents, of major interest to the researcher, can be identified as follows: official state public documents (e.g., the Constitution of Ukraine, legislative and normative acts including investment and tax legislation, banking law, and others), private sector public documents (annual business reports and accounts of MNEs), consultants' reports on firms' activities, and international organizations' public documents (International Monetary Fund, World Bank annual investment reports). Moreover, data analysis also relied on public sources of information including various publications, such as newspapers, analytical magazines, etc. as well as company websites.

Triangulation of both interviewees and written data sources guaranteed a thorough verification and cross-checking of research findings, and contributed to the minimization of bias and maximization of objectivity in assessments of the data. As a result, this comprehensive analysis produced a more complete and holistic picture of the phenomenon within a certain social context (Ghauri *et al.*, 2002).

#### **3.7.4 Data analysis**

Qualitative research produces large amounts of text or narrative data (Schutt, 2012; Taylor-Powell & Renner, 2003). The form in which these data are offered depends on the choice of particular research methods (Taylor-Powell & Renner, 2003). Thus, data obtained in cases of individual open-ended interviews can be

presented mainly in the form of interviews' notes, summaries or word-to-word transcripts (Taylor-Powell & Renner, 2003).

This focus on text does not mean that qualitative data analysis is simply a descriptive representation of the data obtained in the process of research (Wolcott, 1994). On the contrary, it is a very systematic (Wolcott, 1994) and, what is even more importantly, continuous process which is an integral part of all research stages (Erlandson et al., 1993; Folkestad, 2008; Schutt, 2012), including the data collection, data reduction, data display, and conclusion drawing and verification phases (Miles & Huberman, 1994).

Since qualitative data analysis is an iterative process, examining each interview at the data collection stage allows reflecting on and, as a result, accounting for and examining any newly discovered concepts, ideas, relationships and social contexts of events in each consecutive interview (Parlett & Hamilton, 1976; Schutt, 2012). This progressive focusing approach ensures the continual refinement of the research focus at any point and stage of the study (Parlett & Hamilton, 1976).

The range of research methods applicable for the analysis of text data is very wide (Hsieh & Shannon, 2005). A list includes such techniques as grounded theory, ethnography, phenomenology, netnography, ethnomethodology, conversation, narrative, historical, comparative and content analysis (Hsieh & Shannon, 2005; Lillis, 1999; Schutt, 2012). The choice of a particular research method is determined, primarily, by the nature of the research questions and goals of a particular research project. However, the researcher's preferences, experiences and skills will also doubtlessly play an important role in this process (Schutt, 2012).

This research applies a combination of directed and conventional approaches to content analysis (Hsieh & Shannon, 2005) for the study of various aspects of foreign investor – host state relationships in Ukraine, focusing on MNEs' bargaining power and nonmarket, particularly political, behavior. While the directed approach is characterized by the use of pre-set initial categories based on the review of available theory, the conventional approach avoids such preliminary identification of general themes or categories. Here, the latter are identified in the course of the interviewing

process (Hsieh & Shannon, 2005). So, in the case of the present research only several principal categories are predetermined and most categories, as well as subcategories and codes, are derived directly from the data as a result of multiple in-depth reviews of interviews' records. Overall, the process of identifying, distinguishing and clarifying all of these categories, subcategories and codes is the most important task of qualitative research (Schutt, 2012).

This stage of a research process is referred to as a data reduction stage. It is a necessary step in the data processing and analyzing procedures. Here, all the interview materials are critically reviewed for the purposes of identifying important fragments of information and facts that further need to be grouped, compared and/or summarized according to the objectives of the research project (Folkestad, 2008; Miles & Huberman, 1994).

The extreme complexity of the nature of above procedures requires developing a coding manual to guarantee the consistency of coding (Zhang & Wildemath, 2005; Weber, 1990). Next all interview extracts are organized by topic and interviewee groups into tables or text-matrices and, in some cases, diagrams (Folkestad, 2008). It assists significantly in facilitating, managing and improving the quality of analytical procedures. Appropriately, the quality of data display eventually influences the validity and reliability of analysis (Folestad, 2008; Miles & Huberman, 1994).

Further, taking into account both the sensitivity of research topic and the complexity of coding and categorizing procedures, to ensure the validity and reliability of an elaborated system of codes and categories, it is advised to involve one or two independent experts who develop their own lists of categories. Then, all available lists are compared, and following discussion of the similarities and differences, adjustments are introduced to the original list of categories (Burnard, 1991). In this research, the author obtained the assistance of two colleagues with research experience. Certain changes were made in the categories after comparing and discussing the three lists of categories.

As discussed earlier, the data gathered in this research examined at both the individual participant and group levels. Moreover, not only was the primary sample

divided into three groups (by industry, foreign investors' status in the world economy, and level of development of the foreign investor's home country) but also a cluster of experts representing various spheres related to the work of foreign investors in a host country. Therefore, the main challenge of such highly complex analysis focusing on the investigation of very sensitive issues is accommodating the uniqueness of views of each individual participating unit, different groups and collective vision across all foreign investors, their groups and experts (Miles & Hubermann, 1994; Silverstein). Contrasting and comparing participants' views at all identified levels of data disaggregation enables the researcher to overcome this problem (Noblit & Hare, 1988).

In the final stage of analysis, conclusions are drawn. This entails assessing all previously structured information, making decisions regarding its relevance as well as the relevance and importance of various relationships between different concepts, and eventually drawing inferences and providing credible explanations about meanings derived from this analysis (Schutt, 2012; Miles & Huberman, 1994; Zhang & Wildermuth, 2008). Therefore a researcher's reasoning abilities is a critical factor determining the quality of analysis (Zhang & Wildermuth, 2008). Moreover, the researcher's analytical competences gain even more significance due to the fact that there are no generally agreed upon solid standards for evaluating and verifying the validity, reliability and objectivity of inferences in qualitative analysis (Schutt, 2012). Miles & Huberman (1994) suggest that all the conclusions need to be verified directly in the course of analysis. So, it is advised to assess the credibility of informants, recall whether the statements were made spontaneously or consideration of a particular issue was provoked by a question, test them against the experts' opinions, ensure that all possible aspects of the social contexts' influence are accounted for by comparing, contrasting and linking patterns in the data at various levels of disaggregation, and conduct multiple reviews of both interviews and other research material to evaluate the extant of consensus or disagreement among researchers within related subject areas (Schutt, 2012; Miles & Huberman, 1994).

### **3.7.5 Research protocol**

The research protocol of the qualitative part of the thesis is designed to address the complexity of the studied phenomenon to test and refine a newly proposed ‘blind bargaining’ model in the context of one country, Ukraine. The proposed outline of a semi-structured interview framework consists of four parts. The first part of the questionnaire includes the company profile questions developed to insure that all foreign investors’ ownership-specific characteristics are accounted for in the research process. As a result, this section contains questions on the investment motivation, entrance mode, length of operation, specter of activities, form of ownership, company existing and prospective growth plans in Ukraine.

The second section of the questionnaire is designed to answer the first qualitative research question probing whether a blind bargaining model applies to companies with FDI in Ukraine and whether and how its relevance vary for different groups of companies with FDI. For this purpose the following aspects of foreign investors – host state bargaining relationships are examined: comparative assessment of foreign investors’ and a recipient state’s bargaining strengths and weaknesses; the role of pseudo-FDI and ‘raiding’ in prompting the changes in real FIs’ bargaining power; FIs’ concerns with fluctuations of various country risks reflecting on respective changes in institutional environment; the main source of pressure or influence on FIs and how conflictive the demands issued by different elements of institutional structure are in Ukraine; FIs’ assessment of the problem of merging political, economic, and criminal powers in Ukraine and of its impact on their bargaining power; the role of FIs’ personal relationships with representative of various state offices in increasing their bargaining power; and, finally, overall reliability and consistency of institutional arrangements in Ukraine, as well as self-assessment of changes in the FIs’ bargaining power throughout the entire period of their operation in the country.

The third section is designed to examine second qualitative research question on the relationships between FIs’ ownership characteristics and their specific choices of nonmarket strategies and political behavior in Ukraine. This goal is pursued by exploring various FIs’ organizational structures applied to manage their political



activity in Ukraine; choices of cooperation modes, membership in local and international professional and business associations; self-assessment of efficiency of individual and collective business effort in applying different political strategies and promoting pursued institutional changes; intensity of engagement at different levels (local, regional, national) and with various branches of power (regulatory, executive, judicial); the spheres and types of recipient country policies of greatest interest for foreign investors, host authorities' interest in and responsiveness to FIs' expert opinions; and, the stages of policy cycle and channels of FIs' political involvement in Ukraine.

The forth section of the qualitative research instrument seeks to establish, firstly, whether and the level of political activity and pro-activeness vary between different groups of companies with FDI, and, secondly, how successful and efficient are different types of companies with FDI in their efforts to influence institutional changes and what causes the differences. For this purpose FIs' assess their own and overall business efficiency of political involvement in institution-building process in Ukraine; debate on the issue of potential liabilities for political ties with groups estranged from political power; assess overall quality of iFDI and business environment in Ukraine compared to other transition countries; and, finally, reveal their plans on both potential changes in their political behavior and, overall, in their presence in the country based on their assessment of changes in the quality of institutional environment in Ukraine as depicted within a newly-developed 'blind bargaining' model framework (see Appendix B for full Questionnaire).

## **CHAPTER FOUR: DATA CONTEXT**

### **4.1 Transition economies**

This section entails a brief description of iFDI distribution patterns in transition economies. Discussion of the countries' major characteristics, including strengths and weaknesses as a potential investment destination, helps to justify the choice of the sample region as a case for the quantitative research and understand an unequal regional distribution of iFDI in post-Soviet countries.

#### **4.1.1 Foreign direct investment**

Since the collapse of the Soviet Union the FDI performance of its former constituents has been patchy. Table 6.3 lists absolute figures for FDI inflows into former USSR countries from 1997 to 2005. Perhaps unsurprisingly, this data indicates a massive acceleration of FDI inflows into the Baltic countries in the run-up to their EU accession. By contrast, a number of former Soviet states with significant levels of industrial development, such as Belarus, Moldova and the Ukraine, either have experienced no significant increases in FDI inflows, or have received FDI inflows which are disproportionately low given their level of industrial development and population size; particularly in comparison with the Baltic states.

The two oil producing Central Asian countries, Azerbaijan and Kazakhstan, stand out in terms of FDI inflows and FDI growth with FDI figures for recent years exceeding all other former Soviet states, including the Baltics, with the sole exception of Russia. This contrasts dramatically with the other Central Asian countries, Armenia, Georgia, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan, which have experienced negligible FDI inflows.

**Table 4.1. FDI inflows, mil. USD**

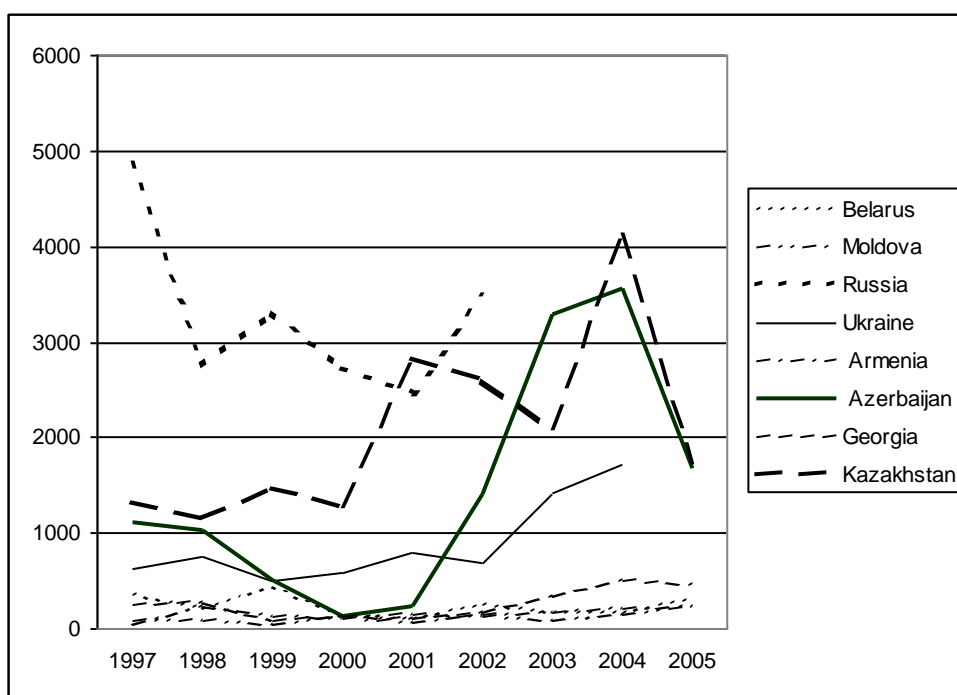
Country	1997	1998	1999	2000	2001	2002	2003	2004	2005
1. Former USSR Countries									
1.1. <i>Central &amp; Eastern Europe:</i>									
1. Belarus	352	203	444	119	96	247	172	164	305
2. Moldova	79	76	38	129	156	132	78	154	225
3. Russia	4865	2761	3309	2714	2469	3461	7958	15444	14600
4. Ukraine	623	743	496	595	792	693	1424	1715	7808e
1.2. <i>Central Asia:</i>									
5. Armenia	52	221	122	104	70	144	157	217	220
6. Azerbaijan	1115	1023	510	129	227	1392	3285	3556	1680
7. Georgia	243	265	82	131	110	165	340	499	450
8. Kazakhstan	1321	1152	1472	1283	2823	2590	2092	4113	1738
9. Kyrgyzstan	84	109	44	-2	5	5	46	175	47
10. Tajikistan	18	25	21	22	9	36	14	272	54
11. Turkmenistn	108	62	89	131	150	100	100e	-15e	62e
12. Uzbekistan	167	140	121	73	570	65	70e	1e	45e
1.3. <i>Baltic Countries/ New EU Countries:</i>									
13. Estonia	267	581	305	387	542	284	919	1049	2853
14. Latvia	521	357	347	410	164	254	292	699	632
15. Lithuania	355	926	486	379	446	732	179	773	1009

While it is obvious that in absolute figures, as well as in per capita terms, Azerbaijan and Kazakhstan, vastly outperformed other former Soviet states, it is important to note that even these countries have experienced dramatic fluctuations in terms of the amounts of FDI they have received during this period. This pronounced instability of year-by-year FDI inflows is depicted in Figure 6.4, in which recent figures for Russia and Ukraine have been excluded in order to provide a more readable scaling of the trend lines. Apparently, in as far as there has been substantial investment in former Soviet states, this has centered on a very limited number of countries, who themselves could not rely on stable and regular inflows of foreign capital.

Although there is a long history of complaints among potential foreign investors about the vagueness of government attitudes to foreign investment, the existing differences in FDI inflows can only be insufficiently explained by the attitudes and actions of these post-Soviet states. Rather, the unequal regional distribution of FDI in the post-soviet territories appears to be primarily determined by the presence, or absence, of natural resources.

Hitherto, natural resource and food industries have been the most attractive targets for foreign investment. In Russia, the fuel and food sectors lead in terms of share of total FDI inflows with 23% and 28%, respectively. They are followed by trade, transport and telecommunication. The machinery, timber and other sectors, meanwhile, have hardly received any investment at all.

**Figure 4.1 FDI inflows, mil. USD**



Large scale investments in the oil and gas sectors have included about 50 joint ventures and involved American, British, French, German, Canadian, Japanese and other companies. The scale of projects in the food sector is significant as well with foreign companies showing an interest in pastries and meat industries as well as the production of non-alcohol drinks, beer and tobacco (Yacheistova, 2001).

As an example of an industrialized state which has attracted only limited amounts of FDI, Ukraine had attracted less than 6 billion dollars in FDI by 2004, which comprised only about a seventh of the officially estimated 40 billion dollars required for restructuring its economy. A detailed analysis of FDI flows indicates that these were quite small and often used inefficiently. For example, foreign investment inflows in Ukraine during the first half of the year 2001 were 12.4% less than the

amount of FDI inflows during the corresponding period of the year 2000. As in Russia, foreign investors targeted the Ukrainian food and agricultural processing industry. The FDI share into this sector comprised 19.8% of the total investment inflows. Wholesale and sale mediation attracted 13.9% of investment. Investment into machine-building industry, finance sectors and transport were equal to 8.2%, 7.9% and 6.8% of total investment inflows, respectively (State Statistics Committee of Ukraine, 2002).

In Azerbaijan the largest share of FDI was received by the country's main industry – oil. The high level of investment in this area, however, has hardly benefited other sectors. For instance, amidst complaints about corruption and unfair practices by officials, as well as declining traffic volumes, several international airlines have abandoned their operations in the country. Specifically, during the period of 1999-2000, six different companies, Austrian airlines, Pakistan Air, British Airways, KLM, Lufthansa and Emirates have ceased operations in Baku's Bina International Airport (WMRC, 2004a).

In Kazakhstan, which, by 2004 had received seventeen billion dollars in FDI since independence, there is evidence that foreign investment had a de-stabilizing effect on the local economy, which has led to increased frictions between the states and foreign investors. Thus, a number of high profile international investors, such as TengizChevroil, Canada's Hurricane Hydrocarbons Ltd and the Carachaganak Petroleum Operating Company, have faced Environment Ministry accusations of opaque sales and environmental breaches. Moreover, a newly enacted Investment Law, approved in 2003, stipulates that new contracts negotiated with foreign companies will no longer contain a "grandfather clause" that shield the company from regulatory and tax changes. The law also prevents companies from resorting to international arbitration if the Kazakh government forbids this. Furthermore, the law eliminates preferences for foreign investors with a view towards "creating a level playing field between domestic and foreign companies" (WMRC, 2004b).

Both Kazakhstan and Azerbaijan, meanwhile, appear to suffer from a rise of governmental authoritarianism and are even showing 'dynastic' tendencies. In October, 2003, for instance, for the first time, the rule of a post-Soviet state was

passed from father to son as a result of Azerbaijan's presidential elections. In Kazakhstan, President Nursultan Nazarbayev's eldest daughter, the country's biggest media baron, is creating a new political party and is believed to be groomed for the succession of her father. These, and many other events, such as discussed below relationships between iFDI, corruption, and political instability in post-Soviet countries, are indicative of the potentially adverse effects of the newly found foreign-sponsored wealth.

#### **4.1.2 Foreign investment, corruption, and political instability**

Today, any evidence regarding the link between foreign investment and increases in corruption and political instability remains largely anecdotal. Nevertheless, as far as former Soviet states other than the Baltics are concerned it is difficult to find instances in which foreign investment appears to have had a positive impact on the recipient countries political institutions. Put simply, FDI inflows have increased in a number of former Soviet states, and where this has been the case, so typically has corruption.

Figures 6.5 to 6.7 depict scatterplots of the *Corruption Perception Index* rank and FDI inflows for the period from 1999 to 2005 (Transparency International, 2006). The *Corruption Perception Index* is collected by the international voluntary association *Transparency International* and ranks countries according to a number of criteria, including bond ratings, as those which are internationally perceived as most or least corrupt.

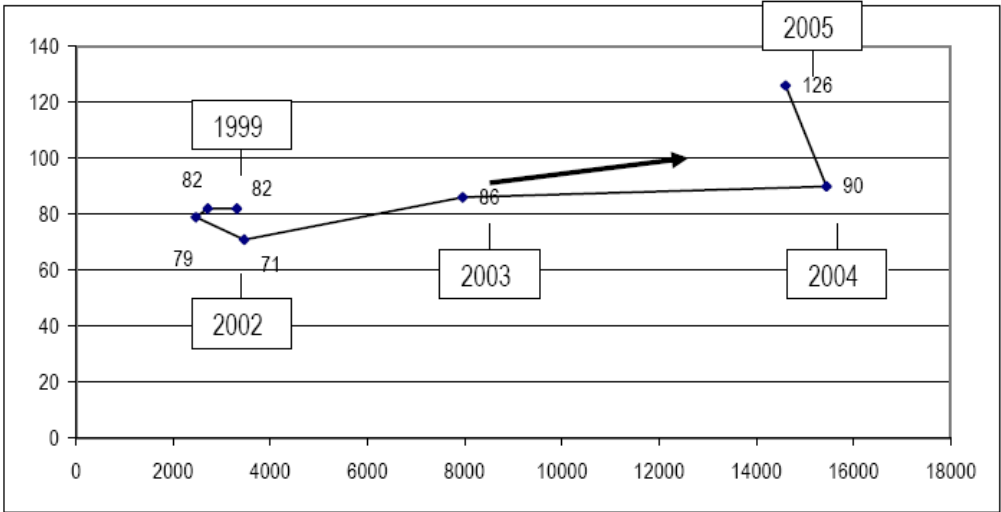
As concerns the scatterplot for Russia, it can be noted that the country experienced a small decline in its corruption ranking alongside a decline in FDI. This situation, however, changed from 2002, when a massive increase in FDI inflows was accompanied by a modest increase in the country's corruption rank. Between 2004 and 2005, lastly, a small decline in FDI inflows occurred which was accompanied by a pronounced increase in the country's corruption perception ranking.

This pattern is closely mirrored by the scatterplot for Azerbaijan. Here too an initial decrease in FDI was accompanied by a decline in the country's corruption ranking. From 2001 onwards, however, Azerbaijan experienced both a massive

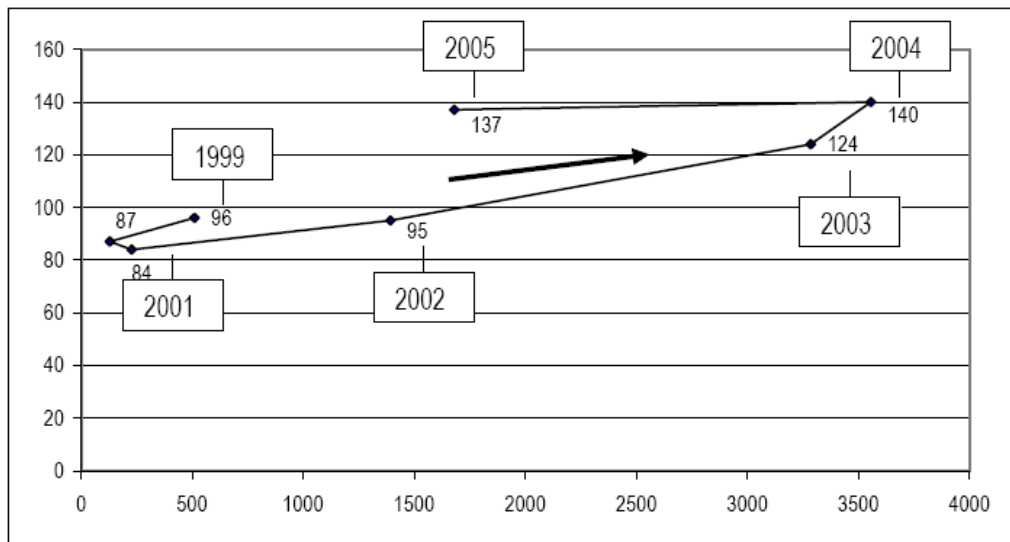
increase in FDI inflows and in its corruption ranking. This situation changed only between 2004 and 2005, when the annual FDI more than halved and the country's corruption perception ranking declined from 140<sup>th</sup> to 137<sup>th</sup>.

The scatterplot for Kazakhstan deviates from the previous two patterns in several minor respects. Initially, Kazakhstan's corruption ranking decreased alongside a decline in FDI. From 2000 to 2001, both FDI inflows and the country's corruption rank increased. This was followed by a period from 2001 to 2003, when FDI inflows decrease while the corruption rank continues to increase. Between 2003 and 2004 a massive increase in FDI inflows took place which was again accompanied by an increase in the country's corruption perception rank, this time from 100<sup>th</sup> to 103<sup>rd</sup>. The period from 2004 to 2005, lastly, saw a decrease in FDI alongside a continuing increase in the corruption index, this time to 107<sup>th</sup>.

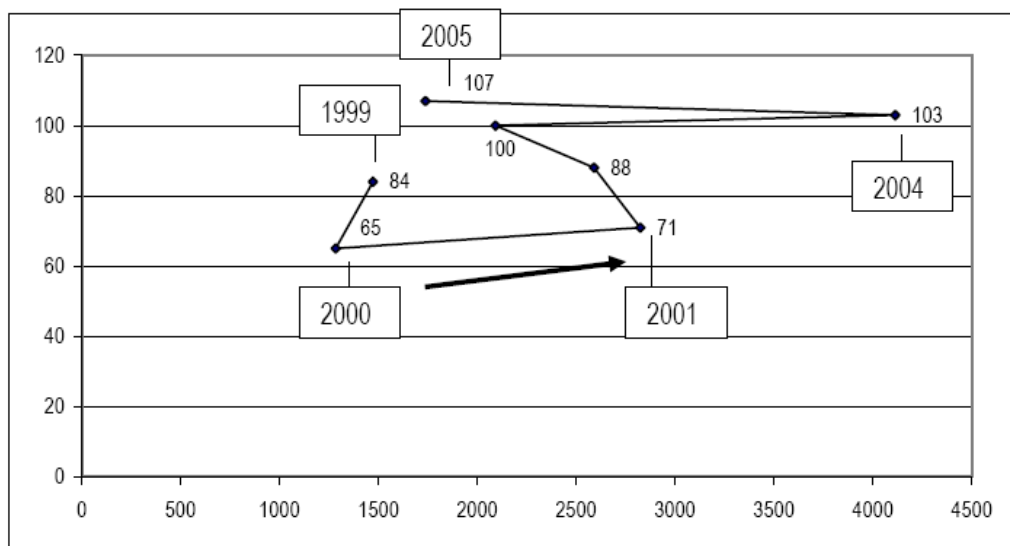
**Figure 4.2. Russia: Scatterplot of Corruption Perception Index rank and FDI inflows, 1999-2005**



**Figure 4.3. Azerbaijan: Scatterplot of Corruption Perception Index rank and FDI inflows, 1999-2005**



**Figure 4.4. Kazakhstan: Scatterplot of Corruption Perception Index rank and FDI inflows, 1999-2005**



### 4.1.3 Summary

Taken together these brief analyses of the iFDI in transition countries, and its links with corruption and political stability in post-Soviet states lend limited support to the hypothesis that increased inflows in FDI are likely to be linked to increases in corruption and possibly political instability in the recipient country. Needless to say,



the simultaneous occurrence of increased FDI inflows together with increased corruption, if this is indeed measured by this index, does not in itself imply causality. What it does suggest, however, is that FDI has not had, as previously often assumed, a corruption-reducing effect on post-Soviet recipient states. Such implications provide essential grounds for calling researchers to study the relationships between iFDI and institutional environment in recipient transition states.

## **4.2 Ukraine**

This section entails a brief description of Ukrainian geopolitics and economy. Discussion of the country's major strengths and weaknesses as a potential investment destination helps to understand and justify the choice of Ukraine as a case for the qualitative research.

### **4.2.1 Geopolitics and economy in Ukraine**

The Ukrainian geopolitical position and economy present several interesting features as far as its status both as iFDI host and as a trading partner is concerned. It is physically the second largest country in Europe with a very attractive and strategically important geographic position in terms of its access to neighboring markets. Ukraine is a critical buffering zone both for the Russian Federation and for the West in both political and economic terms. However, the country's development as a sovereign nation since 1991 has been dogged by difficulties, as internal dissension has made it impossible to develop a consensus about its geopolitical orientation and its place in the global economy, specifically the question of whether it should be aligned with Russia or the European Union (Friedman, 2010).

Ukraine's economic development potential is illustrated by the following facts:

As a market, Ukraine has a relatively large, albeit declining, population of 45.7 million (BMI, 2009). Half of its population is economically active, and the country benefits from a well-educated, skilled and low-cost labor force with a 99.7% literacy rate (BMI, 2009; PRS Group, 2008). About 70% of Ukrainians hold a secondary or higher education diploma and the country's 80 research institutes employ about

70,000 scholars which may give it potential advantages in terms of scientific and technological development (PRS Group, 2008).

In the area of natural resources, the Ukraine is said to possess 25% of the world's black soil and, as a result, has the capacity to produce large both high quality and quantities of crops such as grains, roots and flax (PRS Group, 2008). The country also has substantial reserves of oil, gas, coal and iron ore, although it faces competition in these areas in terms of the resource endowments of neighboring countries (PRS Group, 2008).

However, the country has not been able to capitalize on this potential. Due to relatively slow pace of economic development, many well-educated Ukrainians are earning relatively low incomes (PRS Group, 2008). Moreover, the education levels and the health of labor force have been deteriorating drastically in recent years due to low levels of expenditures on education, lack of specialized training facilities and programs, and the emigration of highly skilled professionals (Chobanyan & Leigh, 2006) as well as the lack of funding for health care services (PRS Group, 2008). International observers have also suggested that the Ukraine is poorly endowed in terms of capital resources and infrastructure. Specifically levels of savings have remained low, and the country does not appear to have access to sufficient domestic capital to support the investment needs of domestic industries and infrastructure (PRS Group, 2008). Foreign investors, though often interested in accessing potential Ukrainian markets, appear to have been discouraged by political uncertainty; a lack of transparency of regulatory systems; limited confidence in the court system which is related to a poorly developed rule of law; corruption; selective enforcement of tax policy; over-regulation and excessive government interference; and an underdeveloped infrastructure (PRS Group, 2008). Taken together these factors appear to have contributed to investment patterns which center on opportunistic resource- and market-seeking, lower-quality iFDI.

Notwithstanding these problems, there is some potential for a future growth of demand which rests both on the size of Ukrainian market itself and its close proximity to the large markets of Russia and the EU. Although some market segments in the Ukraine are still very immature, brand consciousness among

Ukrainian consumers appears to have been increasing (BMI, 2009). Against this stands the fact that Ukrainian disposable household income remains low, while trade barriers erected by the US and EU to protect their industrial metal and agricultural industries continue to adversely affect the Ukrainian economy (BMI, 2010).

As concerns the internal structure of Ukrainian industry it is notable that competition is weak in several areas, while firms often lack access to supporting industries. Apart from a lack of strategic outlook, some Ukrainian industries have been held back by a combination of a lack of investment in enterprise restructuring and technological upgrading, a neglect of research and development capacities, inefficient corporate governance and management systems, distorted competition, and corruption. All of these elements appear to have been aggravated by the vulnerability of the Ukrainian economy to external shock, as has been exemplified in 2009 by a 14.8% (Global Finance, 2011) or 15.1% drop in GDP (according to UNCTAD, 2011).

In terms of Porter's diamond model (1990a; 1990b), the Ukrainian economy can, by and large, be categorized as being in a factor-driven stage of national competitive development path, when it is typically assumed that a government has the greatest direct impact on economic development. Accordingly, it has been argued that government policy should focus on the "need to upgrade basic factors and to create advanced factors, particularly through upgrading the country's infrastructure, educational system and the development of technological base, which includes the acquisition of contemporary technologies and/or licenses. It has also been argued that the government should play an active role in creating developing industrial and export clusters, as well as in generating and maintaining domestic rivalry and efficient corporate governance" (Chobanyan & Leigh, 2006: 158).

Sadly, government economic policy in the Ukraine during the past decade appears to have been largely politically motivated. Thus several parliamentary factions seem to have concentrated on strengthening their own control and influence which seems to have undermined the country's overall policy-making capabilities (BMI, 2009). These developments, in turn have adversely affected the Ukraine's potential as an export-platform iFDI destination, and may have resulted in an overall

economic performance which is far below the country's potential in terms of iFDI quality and volume as well as export capacity.

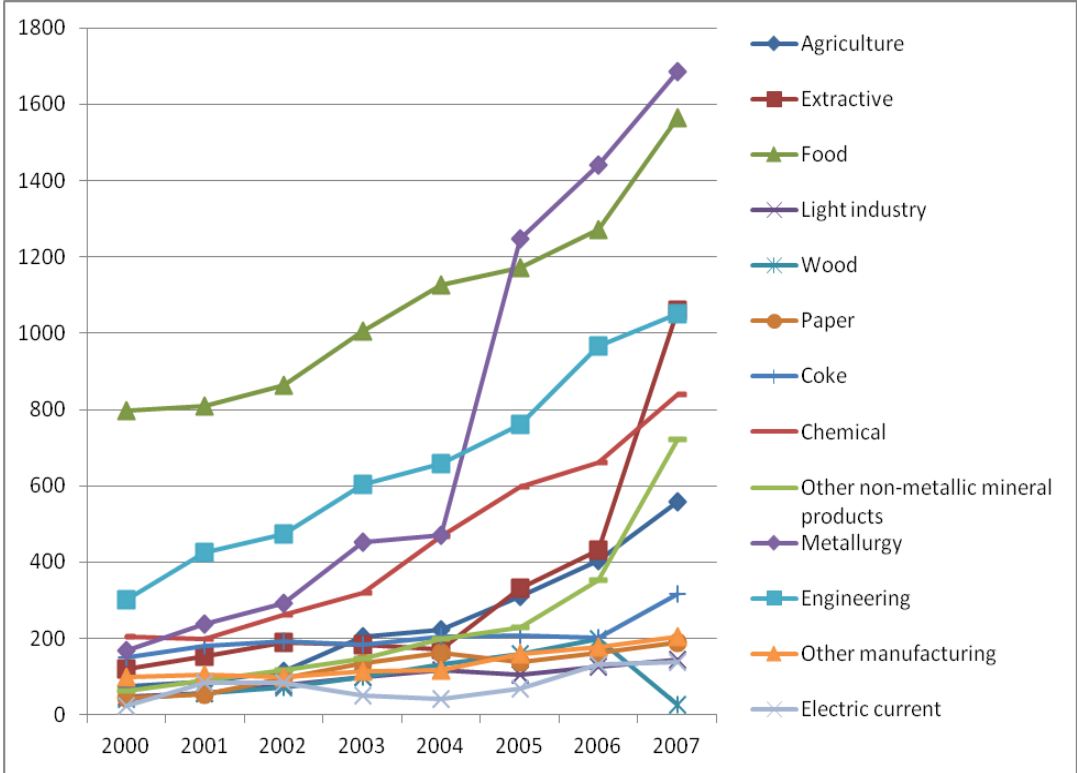
#### **4.2.2 Structure of inward foreign direct investment in Ukraine**

A surge in the share of iFDI in GDP by 6.4 percentage points took place between 2004 and 2005 - a period marked by such key political event as the Orange Revolution. These changes had been preceded by a slow increase in the share of iFDI from 0.25% in 1992 to 2.6% in 2004 and was consecutively followed by a substantial reduction from 9.1% in 2005 to 4.8% in 2009 (see Figure 4.5). Moreover, the share of merchandise iFDI stock in the total iFDI stock in Ukraine fell from 55.1% in 2000 to 22.8% in 2007, signifying the growing importance of the service sector. Particularly, iFDI in the financial, trading, real estate and construction sectors accounted for 16.3%, 10.4%, 8.7% and 5.5% of total iFDI stock in 2007, respectively.

The principal source country for iFDI in the named above four service industries in 2007 was Cyprus and the main target of its iFDI in Ukraine was finances, absorbing 25.9% of total iFDI in the service sector. The next largest investment destination was real estate, followed by trading and construction economic activities with 45.3%, 20.3% and 28.9% of total iFDI in these sectors in 2007, respectively. The runners up for the financial sector were France investing 13.8%, followed by the Netherlands – 7.2%, Poland – 6.8%, Russia – 6.1%, UK – 4.1%, Sweden – 3.5%, Hungary – 3.5%, USA – 2.9% and Luxembourg – providing 2.3% of total iFDI stock in this sector in 2007. In the trading sector the biggest investors were British Virgin Islands, UK, the Netherlands, USA, Germany and Russia contributing 12.7%, 11.5%, 9.4%, 9.2%, 4.4% and 3.5% of total iFDI in this sector in 2007, respectively. The second largest investor into the real estate sector of the Ukraine is the UK supplying 11.2% of total iFDI in this sector preceding 8.3%, 5.5%, 5.4% of the British Virgin Islands, USA and Russia, respectively. The construction sector was characterized by high levels of investment concentration. The total share of the four largest investors here equaled to 80.6% of total iFDI stocks 2007. However, in this case Cyprus lost the first place to the Netherlands by accounting for 36.4% but still came ahead of the UK (8.3%) and Russia (7%) in 2007.

The leader in merchandise iFDI stocks and exports was metallurgy and the production of finished metal products (see Figures 4.6 and 4.7). The stocks of iFDI in this industry grew by 1010% from \$166.9 mln. in 2000 to \$1685.6 mln. in 2007, while exports increased by 639.1% during the period 1995-2008; but fell by 159.5% by 2010 as a result of world economic crisis and tightening protectionist measures introduced by the US and EU. Thus, the larger share of the increase in both iFDI and exports in this industry occurred during the 2004-2008 period.

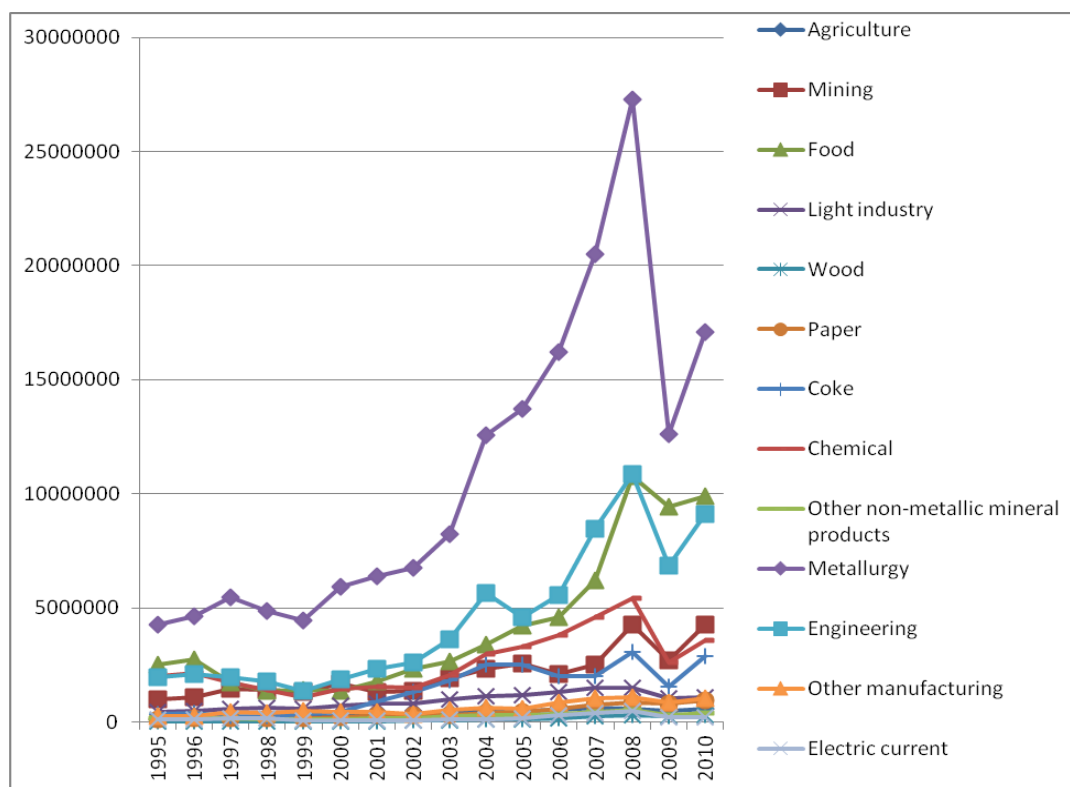
**Figure 4.5. Structure of merchandise iFDI stock in Ukraine in 2000-2007, US \$ mln**



Source: State Statistics Committee of Ukraine (2008).

The next largest recipients of investment are i) the food, beverages and tobacco production and ii) the engineering industry (including production of machinery, electric, electronic and optical equipment, transport vehicles and equipment). These sectors experienced a steady and consistent growth in iFDI stocks from \$795.7mln. and \$302.6 mln. in 2000 to \$1564 mln. and \$1049.6 mln. in 2007, respectively. Meanwhile the exports increased, though with less consistency by 425.6% and 558.7% during the 1995-2008 period, respectively.

**Figure 4.6. Structure of merchandise exports in Ukraine in 1992-2010, US \$ thousands**

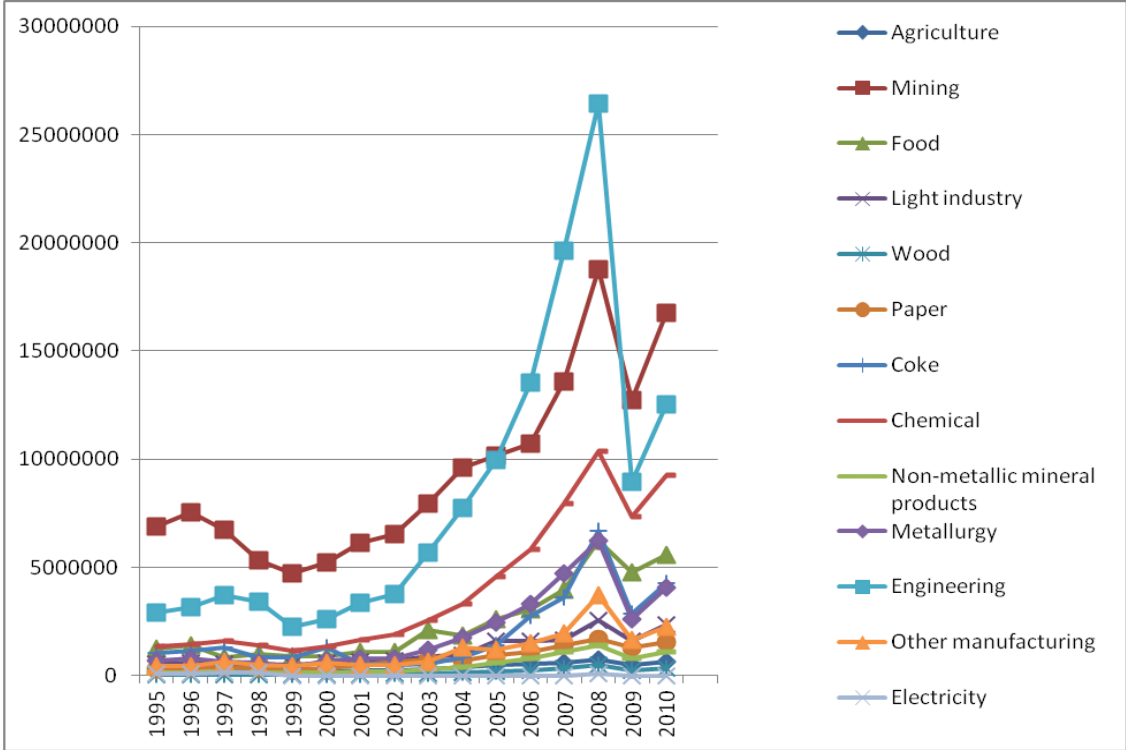


Source: UNCTAD (2011).

Cyprus tops the list of investors in extractive industry holding 60% of total iFDI stock in this sector in 2007, and comes second in metallurgy, third in food and production of other non-metallic products and fourth in chemical and petrochemical industry with shares of 27.1%, 12.9%, 23% and 10.9%, respectively. Sweden, the Netherlands and Switzerland control 36.9% out of remaining 40% of total iFDI stock in the extractive sector; which suggests a high degree of investment concentration by home countries in this sector. Germany comes ahead of Cyprus in metallurgic industries with a share of 43.3%. Further, Poland and British Virgin Islands contributed 3.5% and 2.6% of total iFDI stock in this sector in 2007. IFDI in the food, beverages and tobacco industry is led by the Netherlands with 28.3%, while the USA, UK and Sweden account for equal shares of 9% each. IFDI in chemical and petrochemical industries are also dominated by a relatively small group of home countries, including Germany, USA, Netherlands and Cyprus who together hold 65.6% of total iFDI stocks in this sector. The engineering sector is the most

diversified one in terms of home countries' representativeness. Here, the UK, Republic of Korea and USA supply 18.7%, 14.3% and 7.6% of total iFDI stock in 2007 while Switzerland, Italy, Hungary, British Virgin Islands and Canada together accommodate another 26.8% of iFDI stocks in this sector.

**Figure 4.7. Structure of merchandise imports in Ukraine in 1992-2010, US \$ thousands**



Source: UNCTAD (2011).

**4.2.3 Institutional environment in Ukraine**

Why, in spite of its great potential (as described in Section 4.2.1) for securing success on the path of socio-economic development, has Ukraine failed to achieve sustainable economic growth and create a stable efficient political and social environment? Experts agree that one of the major reasons of Ukraine’s failure is its weak low-quality market-unfriendly institutional base (EBRD, 2009; Jakubow, 2009; Tiffin, 2006; van Zon, 2001; Wise & Brown, 1998). The next logical question to ask is: “what are the main causes and determinants of the evolvement of such negative institutional environment in Ukraine?”

The social conflict view on institutional differences in combination with neopatrimonialism concept provides the best theoretical framework for explaining the evolution of the institutional environment in Ukraine and for the analysis of relationships between these institutions and MNCs. In line with this view van Zon (2001) avers that the current state of institutional arrangements in Ukraine is conditioned by the development of a predatory neo-patrimonial state characterized by “the specific model of interaction between state and society blocking social and economic development of this state” (van Zon, 2001: 72). The ascent of such a state is determined by the legacies of the past (including a preference for one man rule, plural elite governance and bureaucratic administrative control) and by the combination of dominant belief systems and social practices (van Zon, 2001), which were radically challenged as a result of institutional upheaval caused by the dissolution of the Soviet Union and the transition from central-planning to the market economy (Roth & Kostova, 2003, Tiffin, 2006).

The emerged institutional vacuum was not filled out efficiently. “No polity has been created that is a reflection of society and that could adapt political structures to changing social needs, creating preconditions for evolutionary institutional change” (van Zon, 2001: 75). Instead, “a grab-and-run process took place in which ruling clans appropriated the state and the wealth of the nation” (van Zon, 2001:75). Moreover, van Zon (2001) argues that this state, through its practices undermining its own infrastructure and governance instruments, can be defined as self destructive. Some of the main characteristics of Ukraine in this regard are the following: lack of transparency of the state apparatus, political and bureaucratic power used for private enrichment rather than for public good, diffusion of power, lack of transparency and consistency in the system of laws (laws and decrees are often ill-defined and contradictory), weak property rights, underdeveloped and inefficient enforcement mechanisms, almost non-existent contract enforcement, dominance of personal interests in the decision-making process, corruption, blurred distinction between the political and civil service aspects of government administration, overlapping competencies within the state apparatus, high discretionary power of bureaucracy, lack of trust in the society, lack of accountability (lack of horizontal differentiation and concomitant delineation of responsibilities), and corruption (Van Zon, 2001).



Collective action potential is very low in Ukraine. As a result, the state is governed by the most economically and politically powerful clans choosing sets of institutions which are going to contribute to the increase of both their de jure and de facto political power regardless of their effect on the general welfare of the nation.

As mentioned above (in section 3.1), it is a very hard task to assess and measure the quality of institutions in a country. One of the most widely available and popular instruments evaluating the institutional quality is the World Bank's indicators measuring six dimensions of governance. According to these indicators, quality of the institutional environment in Ukraine is very low and, in some cases, even deteriorating over time (see Table 3.1). The worst performing Ukrainian indicator is 'control of corruption' (measuring the extent to which public power is exercised for private gains and 'capture' of the state by elites and private interests) with its lowest level reaching -1.15 in 1998 and, after a period of improvement lasting until 2005, deteriorating to a -0.72 level by 2008. Slightly better - though still persistently poor - performance can be observed in case of a 'rule of law' indicator. Here, the quality of contract enforcement, courts and police improves from -1.01 in 2000 to -0.62 in 2008. Government effectiveness, estimating the quality of public and private services and their independence from political pressures, as well as the quality of policy formulation and implementation and the credibility of the government's commitment to these policies, improved very insignificantly from -0.72 in 1998 to -0.6 in 2008. Regulatory quality, measuring government's ability to formulate, implement and regulate private sector development policies, raises from -0.82 in 1998 to -0.39 in 2008. It is noteworthy that all four of the aforementioned indicators reached their best values in 2005, in the year after the Orange Revolution, but were unable to maintain this positive trend and deteriorated between 2006 and 2008 (Kauffman, Kraay, & Mastruzzi, 2006).

This downturn in governance indicators, accompanied by the fall of real GDP growth from 12.1% in 2004 to 2.7% in 2005 and to 2.4% in 2008 after its recovery to 7.3% and 7.9% in 2006 and 2007 respectively (PRS, 2008; EIU, 2009), shows that, in spite of certain improvements in the institutional environment, Ukraine still was not able to create conditions for sustainable economic growth.

Moreover, recently some tendencies in reversing the achieved progress were noticed. For example, the National Bank of Ukraine (NBU) introduced foreign exchange controls in response to tensions in the currency market (EBRD, 2009: 240). Elimination of free enterprise zones without accounting for the interests of true cases of foreign direct investment was a clear case of contract-enforcement failure in the country and contributed to the downgrading of its investment climate (Davis, 2005). The property rights regime, the most important economic institution and one of the most important determinants of economic growth, is still perceived to be very weak in Ukraine. Joint-stock company law, establishing property rights and rights of minority shareholders, was approved only in April 2009, almost 18 years after the declaration of Ukrainian independence (EBRD, 2009: 240). Competition and bankruptcy laws lack effective implementation while the economic and civil codes require revisions due to multiple inconsistencies. Reform of the court system is still on the emergency agenda of Ukraine; the lack of independent, impartial and efficient judges is one of the major hurdles preventing progress in economic growth (Tiffin, 2006).

**Table 4.2. Governance indicators, Ukraine**

Governance indicators (-2.5 to +2.5)	1996	1998	2000	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Control of corruption	-1.032	-1.155	-1.072	-1.022	-0.855	-0.890	-0.687	-0.679	-0.741	-0.788	-1.007	-0.975	-0.996	-1.028
Government effectiveness	-0.706	-0.917	-0.749	-0.658	-0.582	-0.538	-0.584	-0.543	-0.666	-0.708	-0.796	-0.747	-0.807	-0.583
Political stability	-0.267	-0.248	-0.504	-0.381	-0.397	-0.484	-0.274	-0.033	-0.150	0.032	-0.311	-0.024	-0.079	-0.099
Regulatory quality	-0.316	-.742	-0.523	-0.587	-0.562	-0.391	-0.497	-0.509	-0.429	-0.519	-0.571	-0.516	-0.606	-0.611
Voice and accountability	-0.499	-0.284	-0.655	-0.549	-0.581	-0.605	-0.206	-0.032	-0.035	0.061	-0.03	-0.1	-0.131	-0.288
Rule of law	-0.935	-1.115	-1.142	-0.866	-0.842	-0.753	-0.790	-0.811	-0.744	-0.693	-0.774	-0.813	-0.828	-0.795

Source: World Bank. Available at [www.worldbank.org](http://www.worldbank.org)

Dominant belief systems and social practices also prove to be very important determinants of the institutional environment and quality in transitional Ukraine. Van Zon (2001) develops and compares general Western and Ukrainian models characterizing the functioning of the states, economies and societies in accordance with their dominant belief systems (see Table 3.2). The comparison of the elements of these two models attests to the validity of the assumption that the country's failure to provide foundations for the sustainable economic growth is primarily determined by weak low-quality market-unfriendly institutional base.

This overview of the institutional environment in Ukraine provides evidence that the development of the predatory state, in which choices of the sets of institutions belong to the elites possessing political power and in which belief systems and social practices are characterized by "disdain for the public good, general passivity and lack of initiative, lack of trust, widespread cheating and lack of accountability and transparency" (van Zon 2001: 91), resulted in the evolution of a very weak low-quality market-unfriendly institutional environment. Therefore it is argued that an achievement of sustainable economic growth will require not only deep structural and institutional reforms but also changing of the belief systems and social practices in Ukraine.

#### **4.2.4 Summary**

The review of geopolitics, economics and institutional environment in Ukraine demonstrates that this country presents one of the most illustrative cases of neo-patrimonial transition states. In spite of its great potential for securing success on the path of socio-economic development, Ukraine has failed to achieve sustainable economic growth and create a stable and attractive operational environment for foreign investors. Thus, the analysis of the main causes and determinants of the evolvement of such negative institutional environment in the context of this country and its relationships with companies with FDI will be a very important contribution to the overall understating of iFDI quality and patterns of foreign investors' political behavior in neo-patrimonial transition countries.

**Table 4.3. State, Economy and Society: Western and Ukrainian Models**

	Western Model	Ukrainian Model
Economy and politics	Clear distinction between spheres of economy and politics. Sphere of economy has relative autonomy.	No distinction between spheres of economy and politics.
Law of value	Law of value should be driving force in economy (economic rationality).	Law of value rejected. Primacy of political rationality over economic rationality.  Administrative decisions should govern the economy.
Rule of law	Rule of law.	Mores are more important than laws.
Demarcation of competencies and the issue of accountability	Horizontal differentiation within and between organizations, clear demarcation of competencies. Contractual obligations are important.  Hiatus between rules and decisions (procedural rationality).	Opaque borders between and within organizations.  Wheeling and dealing. Economic transactions are based on personal trust.  No accountability.  No hiatus between rules and decisions.
Enterprises	The function of an enterprise is profit maximization.  Enterprise headed by manager/entrepreneur. Networking in and between enterprises important, social engineering through sophisticated management methods.	The function of an enterprise is to maximize output and to guarantee employment.  Enterprise headed by 'khozyain' (boss).  Top-down hierarchical management methods.
Role of state	State as facilitator, provider of basic public goods such as education.  Soft governance mechanisms are important.  State rules over citizens, with mutual rights and obligations.	State has a role to play in the organization of production.  Where enterprises fail, the state should intervene.  Rule by decree.  State rules over subject people.
Approach towards economic problems	Economic rationality, analytical approach, transparency.  Economic calculation is possible. Methodical rational acquisition.	Political rationality. Lack of transparency. Economic problems ignored.  Economic calculation very difficult. Often, external factors blamed for economic problems. Aversion against 'book-keeper's mentality'.

Source: Adopted from van Zon (2001: 84).

## **CHAPTER FIVE: FINDINGS FOR QUANTITATIVE STUDY 1: 'BLIND BARGAINING' AND THE QUALITY OF FOREIGN DIRECT INVESTMENT IN POST-SOVIET, CENTRAL AND EASTERN EUROPEAN COUNTRIES**

### **5.1 Introduction**

This chapter presents the results for an explanatory statistical national data analysis that introduces a new 'blind bargaining' model and tests it for a sample of 27 Central and Eastern European and post-Soviet states (including Estonia, Latvia, Lithuania, Bulgaria, Czech Republic, Hungary, Poland, Romania, Slovakia, Slovenia, Belarus, Moldova, Russia, Ukraine, Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan, and Uzbekistan) and several smaller groups set apart from the above sample for a five year period between 1998 and 2002. The study provides support the hypothesis that the presence of 'blind bargaining' in neo-patrimonial post-Soviet states results in attracting riskier lower quality iFDI.

### **5.2. An empirical analysis**

The analysis was performed applying Ordinary Least Squares (OLS), Least Squares Dummy Variables (LSDV) and the General Least Squares Error (GLSE) models. Of these models, the LSDV model can be considered the most reliable since the OLS model is likely to produce overinflated t values on account of serial correlation, and the GLSE is likely to underestimate the significance of coefficient (Stimson, 1985).

Column 1 of Table 5.1 lists standardized slope coefficients (with t-value) and column 2 the coefficient of determination ( $R^2$ ) for the bivariate regressions (Unrestricted OLS) of 'FDI as percent of GDP' with a series of independent variables. Taking into account problems of heteroscedasticity and autocorrelation, significant slope coefficients and substantial coefficients of variation can be detected for all of the country risk indicators, in particular, for 'Overall Country Risk', 'Political Risk', 'Economic Risk', 'Legal Risk', 'Tax Risk', and 'Operational Risk', all of which are negatively related to FDI (i. e., the greater these risks the lower is relative FDI). Significant slope coefficients (at the 0.10 significance level) can be

also detected for 'Inflation', which regresses negatively with FDI, and 'Export per Capita', which regresses positively with FDI. The variable 'Trade Balance' also produces a significant coefficient which, interestingly, indicates a negative relationship between a balance of trade and FDI, as well as 'Debt per Capita' does.

Next, the dependent variable 'FDI as percent of GDP' is subjected to a multivariate OLS regression, which includes a number of independent variables that were selected on the basis of their conceptual relevancy and a desire to avoid multicollinearity in the model. Using such constant coefficients (or pooled regression) model with panel data has a number of statistical drawbacks. However, following Stimson (1985), this model can be used as a computational basis for more efficient models such as the General Least Squares Errors (GLSE) model. Column 3 of Table 5.1 again lists standardized coefficients (with t values) and the overall coefficient of determination ( $R^2$ ) for this OLS model. This model yields significant negative slopes for the variables 'Economic Risk' and 'GDP per Capita'. Significant positive coefficients can be detected for 'Economic Risk' (albeit only at the 0.10 level of significance) and for 'Export per Capita' and 'Unemployment' (see Column 3, Table 5.1). Given the limited significance of these variables, the model yields a relatively large coefficient of determination with 25.8%. This is likely to be a reflection of a violation of statistical assumptions, which arise from the use of panel data.

Next, the same data are subjected to a Fixed Effects (or Least Squares Dummy Variable (LSDV)) model. In terms of significance of coefficients, this LSDV estimation produces much weaker results than the previous OLS models. Thus, significant coefficients can only be detected for 'GDP per Capita' which again yields a negative coefficient and 'Export per Capita', which yields a positive coefficient (see Column 4, Table 5.1). Despite this, the LSDV model produces a relatively high coefficient of determination with 58.6% of total variation being explained by the model.

Following Stimson (1985), information from the OLS and LSDV models can be used to estimate an error parameter which is then used to calculate the much more

reliable GLSE model<sup>3</sup>. Overall, the results of the GLSE model closely mirror the results of the LSDV model. Thus, a significant negative relationship can be detected for ‘Economic Risk’ and ‘GDP per Capita’, while ‘Export per Capita’ yields a positive coefficient (see Column 5, Table 5.1). Explaining 21.3% of the variation, the coefficient of determination indicates that the model fits all country samples reasonably well, with the possibility of significant heterogeneity existing between different groups of countries.

**Table 5.1. Regression models for a sample of 27 countries, 1998-2002**

Dependent Variable: FDI as percent of GDP

Models	Unrestricted OLS		Restricted OLS	LSDV	GLSE
	(1)	(2)	(3)	(4)	(5)
Overall Country	-1.924	R <sup>2</sup> =.098			
Risk	(-3.807)				
Political Risk	-1.453	R <sup>2</sup> =.073			
	(-3.229)				
Economic Risk	-1.974	R <sup>2</sup> =.121	-2.979	-0.934	-2.833
	(-4.285)		(-4.808)	(-0.402)	(-2.942)
Legal Risk	-1.907	R <sup>2</sup> =.097			
	(-3.785)				
Tax Risk	-1.915	R <sup>2</sup> =.080			
	(-3.405)				
Operational Risk	-0.989	R <sup>2</sup> =.034			
	(-2.150)				
Security Risk	-1.199	R <sup>2</sup> =.057			
	(-2.841)				
Inflation	-0.025	R <sup>2</sup> =.043	-0.011	0.007	0.002
	(-2.435)		(-1.048)	(0.564)	(0.015)
Unemployment	0.035	R <sup>2</sup> =.005	0.072	-0.059	0.064
	(0.847)		(1.795)	(-0.341)	(0.970)
GDP per Capita	0.0001	R <sup>2</sup> =.004	-0.002	-0.002	-0.002
	(0.706)		(-4.506)	(-1.981)	(-3.139)
Export per Capita	0.0004	R <sup>2</sup> =.016	0.003	0.004	0.003
	(1.469)		(3.585)	(2.004)	(2.622)
Trade Balance	-0.0001	R <sup>2</sup> =.018	-0.000	-0.000	-0.000
	(-1.566)		(-1.045)	(-0.507)	(-0.893)
Debt per Capita	-0.003	R <sup>2</sup> =.001	-0.014	-0.018	-0.013
	(-0.283)		(-1.252)	(-0.605)	(-0.815)
			0.258	0.586	0.213

T values are listed in parentheses.

Unadjusted and adjusted Coefficients of Determination (R<sup>2</sup>) are listed next to slope parameter or at bottom of column respectively.

Source of data: Global Insight.

<sup>3</sup> Stimson (1985) notes that his error components model performs well for “short (in time) and fat (in space) design” which makes ideally suited to this analysis.



The analysis based on the GLSE model is then repeated for different subgroups of countries (see Table 5.2). The first subgroup includes 10 EU Accession countries only (Estonia, Latvia, Lithuania, Bulgaria, Czech Republic, Hungary, Poland, Romania, Slovakia, Slovenia). Again, the model yields significant negative coefficients for 'Economic Risk' and 'GDP per Capita' and a significant positive coefficient for 'Export per Capita' (see Column 1, Table 5.2). This indicates that, while economic risk does negatively influence investment inflows, foreign investors are not keen to target richer, and presumably politically more assertive accession states. Analysis of ex-Soviet republics (excluding the Baltics) produces a slightly different pattern of relations. Here only the 'Economic Risk' variable gives a significant, and again, negative slope (see Column 2, Table 5.2). Another potentially significant relationship exists with 'Trade Balance' which is also negatively correlated with FDI.

For the European ex-Soviet republics (excluding Baltic States): Belarus, Moldova, Russia, and Ukraine, the same GLSE model yields an impressive coefficient of determination of 46.2%. This, however, is not reflected in terms of significant coefficients. Thus, potentially significant coefficients can only be detected for 'Debt per Capita', which yields a positive slope and 'Unemployment', which yield a negative slope. The former coefficient is indicative of the assumption on the predominance of 'malign FDI' inflows to these countries, which is debt increasing but not necessarily employment reducing (see Column 3, Table 5.2).

Lastly, the GLSE model is applied to the subgroup of ex-Soviet Central Asian republics. It produces significant negative coefficients for 'Economic risk' and 'Trade balance' and a significant positive coefficient for 'Export per Capita' (see Column 4, Table 5.2).

Taken together, these subgroup analyses suggest that the prospect of attracting 'malign' FDI is most profound in those post-Soviet European countries which are not accessing the EU (Belarus, Moldova, Russia, Ukraine). Meanwhile, among accession countries in particular, there is evidence that foreign investors are becoming more reluctant to invest into those countries which have achieved certain levels of wealth and, presumably, institutional capacity.

In this context, it can be observed that the ability to attract FDI and quality of the attracted inflows corresponds with indicators of stability in a country. Moreover, it was detected that FDI as a percent of GDP, for some groups of countries, is negatively related to per capita GDP, which can be seen as an indication that FDI is likely to shrink once certain level of prosperity is reached in a country. For certain groups of countries, mainly post-Soviet states, significant positive correlations between FDI and debt and negative correlations between FDI and trade balance can be also observed. The inference that these states mainly attract ‘malign FDI’ can be taken to particularly on account of the fact that FDI impact negatively trade balance of these recipient states.

**Table 5.2. GLSE Regression for different subgroups of countries, 1998-2002**

Dependent Variable: FDI as percent of GDP

Subgroups	EU Accession Countries <sup>1</sup>	Post-Soviet Countries (excluding Baltics) <sup>2</sup>	Post-Soviet European Countries <sup>3</sup>	Post-Soviet Central Asian Countries <sup>4</sup>
	(1)	(2)	(3)	(4)
Economic Risk	-2.185 (-2.069)	-7.411 (-2.514)	-4.324 (-1.021)	-8.233 (-1.951)
Inflation	-0.007 (-0.202)	0.006 (0.395)	0.007 (0.969)	0.008 (0.094)
Unemployment	0.115 (1.408)	-0.012 (-0.061)	-0.231 (-1.392)	-0.002 (-0.006)
GDP per Capita	-0.002 (-3.144)	-0.000 (-0.037)	0.000 (0.349)	-0.003 (-0.698)
Export per Capita	0.003 (3.076)	-0.000 (-0.047)	0.003 (0.454)	0.028 (1.904)
Trade Balance	-0.000 (-0.466)	-0.000 (-1.043)	-0.000 (-1.068)	-0.006 (-2.378)
Debt per Capita	-0.012 (-0.472)	-0.007 (-0.249)	0.078 (1.777)	-0.014 (-0.307)
	R <sup>2</sup> =0.194	R <sup>2</sup> =0.128	R <sup>2</sup> =0.462	R <sup>2</sup> =0.259

T values are listed in parenthesis.

Unadjusted and adjusted Coefficients of Determination (R<sup>2</sup>) are listed next to slope parameter or at bottom of column respectively.

Source of data: Global Insight.

<sup>1</sup> Estonia, Latvia, Lithuania, Bulgaria, Czech Republic, Hungary, Poland, Romania, Slovakia, Slovenia.

<sup>2</sup> Belarus, Moldova, Russia, Ukraine, Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan, Uzbekistan.

<sup>3</sup> Belarus, Moldova, Russia, Ukraine.

<sup>4</sup> Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan, Uzbekistan.

### 5.3 Conclusion

This chapter argues that the failure of post-Soviet states to attract the required amounts of quality FDI can be, first of all, explained by the presence of 'blind bargaining'. The latter is a model depicting the cognitive situation of a foreign investor who is lacking the clarity on the situation he is in and, as a result, bound to act in conditions of extreme uncertainty due to the high degree of non-transparency and instability of the "rules of the game" at any given moment and of their propensity for unpredictable change at any time in the future. originates from the specific state and society relationship which can be formed in neo-patrimonial host states where economic decisions are often not directed towards serving national interests, but towards supporting personal aims of the officials in power. 'Blind bargaining', which ultimately undermines the relationships between MNEs and such neo-patrimonial host states, reflects both the presence of the latent conflict between national and personal interests of the state representatives and the inability of the existing political system to sanction individual self-enrichment.

It can be argued that the subordination of state politics to personal economic interests of a ruling elite, as a main characteristic underpinning the existence of 'blind bargaining', explains the inability of many post-Soviet states to attract the required amounts of quality FDI. It also explains attractiveness of these states to riskier investors and consequently the inflows of mostly 'malign FDI' into these countries.

Our comparative analysis of the impact of these countries' risks and economic indicators on the quality of interactions between FDI and host states, conducted for 27 post-Soviet and CEE countries, supports the main argument of this paper in that it documents differential relationships between FDI inflows and other variables for different groups of countries. These include all post-soviet states except Baltic states, Central European accession and non-accession countries and Baltic states, Central European post-soviet states (Belarus, Moldova, Russia and Ukraine), and Central Asian States.

The most stable relationship that can be observed for all groupings is the strong correlation between FDI levels of economic risks. The significance and strength of

this attests to the significance of ‘blind bargaining’ context since one of the main criteria upon which Global Insight bases its rating of this type of risk is policy consistency and forward planning of the economy. The latter is, first of all, dependent on the quality and independence of a state’s economic and political system, the lack of which reflects latent conflict between genuine economic goals and the private interests of these states’ ruling elite; which, in turn, creates high levels of uncertainty and instability with regard to policies.

Interesting is also, primarily, negative (though not very significant) relationship between FDI and ‘GDP per Capita’ and, secondarily, the weak negative relationship between FDI and ‘Trade Balance’. The former supports the assumption, made on the basis of the previous research that FDI flows to European EU accession countries in particular decrease with an increase in welfare levels in these countries.

Further to this, it can be observed that a negative relation between FDI and ‘Trade Balance’, which is much stronger for the Central Asian countries, co-exists with a positive relationship between FDI and ‘Export per Capita’ for this region. This appears to indicate that resource centered FDI is likely to increase per capita export. However, these gains are wiped out by excessive public and private spending which negatively affects the country’s overall trade balance.

The relationships between FDI and some other economic indicators provide further evidence for the paper’s argument. Thus, EU accession countries are the only group for which FDI is negatively correlated with inflation. By contrast, in all post-Soviet states, FDI inflows are not associated with the reduction of the rates of inflation. Moreover, in case of the post-Soviet European states (Belarus, Moldova, Russia, and Ukraine) FDI shows a strong positive relationship with ‘Debt per Capita’, while for all other groups this relationship is weakly negative. This indicates that this region attracts riskier and lower quality debt-increasing investment.

The opposite situation can be observed for ‘Unemployment’. Here, EU accession countries are the only group for which unemployment reveals strong enough (in comparison to all other cases) positive relationship with FDI vis-à-vis post-Soviet countries where FDI is negatively related with unemployment. These finding, though contradictory to the original argument on lower FDI quality in neo-

patrimonial post-Soviet states, indicates that EU accession countries are now attracting FDI which is not contributing to the increase of employment in the region. The inference can be made that, after reaching a certain level of development by transition countries, FDI changes its quality from being unemployment reducing to not contributing to the increase in employment. Negative relationship between unemployment and FDI in case of post-Soviet European countries, in turn, can be explained by the high levels of underreporting figures on unemployment in these states.

In general, it can be concluded that this study provides quantitative evidence for the tested hypothesis on the presence of 'blind bargaining' in neo-patrimonial post-Soviet states resulting in attracting riskier lower quality iFDI flows. However, it is emphasized that further country and industry specific analyses are required to ascertain variations in relationships between countries, industries, and companies characteristics and the nature of FDI inflows. Moreover, it is also suggested that the quality of iFDI flows is associated with the quality of institutional changes in neo-patrimonial transition states. Another qualitative macro-level region-specific and qualitative micro-level country-specific study are undertaken to address these issues. A detailed findings analysis of these follow up studies is provided in the two following chapters.

## **CHAPTER SIX: FINDINGS FOR QUANTITATIVE STUDY 2: IS THERE EVIDENCE OF ‘MALIGN’ FDI IN FORMER SOVIET STATES**

### **6.1 Introduction**

This chapter presents the results for an exploratory statistical national level data analysis that tested the impact of iFDI on institutional capacities, as one of the most important location-specific advantages of host economies in twelve post-Soviet transition countries, namely the Central and Eastern European States of Belarus, Moldova, Russia, and Ukraine, and the Central Asian Republics of Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan, and Uzbekistan and nine years (1997-2005) are investigated in terms of three models. This analysis deliberately excludes the three Baltic states, whose economic development was affected relatively early on by their eventual succession to the European Union (Hunya, 2004). The relationship between country risk indicators as reported by Global Insight country reports, iFDI flows, and control variables for the above listed countries are examined.

### **6.2 An empirical analysis**

Similarly to the previous quantitative study, this analysis was performed applying OLS, LSDV, and GLSE models. In this analysis the LSDV model can be also considered the most reliable of these models since the OLS model is likely to produce overinflated t values on account of serial correlation, and the GLSE is likely to underestimate the significance of coefficient (Stimson, 1985).

The first part of the analysis utilizes Global Insight’s score for ‘Overall Country Risk’ (OCR) as dependent variable (Table 6.1). Overall this analysis performs well for both the LSDV and the GLSE variant. For the more reliable LSDV variant, 53.1% of the total variation is explained by the five independent variables, ‘FDI as % of GDP’, ‘Government Debt as % of GDP’, ‘GDP per capita’, ‘Unemployment rate’ and ‘Trade Balance as % GDP’. Of the independent variables both ‘Government debt’ and the ‘Unemployment rate’ have a significant, risk increasing, effect on overall country risk at the .05 level of significance or above. ‘FDI as % of GDP’ also

has a risk increasing effect, but here the significance is more marginal (.12 level of significance).

While it is probably not surprising that government debt and unemployment would increase the overall riskiness or decrease its overall stability, it is interesting to note that, contrary to the assumptions of the benign model of FDI, the variable 'FDI as % of GDP' also exerts a negative influence on 'Overall Country Risk'.

This pattern of a risk increasing role of FDI is confirmed for the dependent variable 'Economic Risk' which is examined in the next set of models (Table 6.2). Again this analysis performs well for the LSDV model which yields an adjusted R Square value of 46.4%. In this model, 'Government debt' and the 'Unemployment rate' have again a significant, risk increasing, effect 'Economic Risk' at the .05 level of significance or above. 'FDI as % of GDP', meanwhile also has a significant risk increasing effects, however, at the lower .01 level of significance.

Perhaps the most interesting results are gained by re-examining this model with the third dependent variable of 'Legal Risk' (Table 6.3). This variable, which assesses a country's system of legal and commercial governance, probably most strongly supports the assumptions of the previously discussed opposing models of 'benign' versus 'malign' foreign investment, as it focuses on country-specific governance competencies in terms of transparency, independence, and quality of legislation.

Again the result of these models closely mirrors those of the previous analysis, with the LSDV model performing well and yielding an adjusted R square value of 48.9%. However, in case of the dependent variable 'Legal Risk', the independent variables 'Government debt', the 'Unemployment rate' and 'FDI as % of GDP' have a significant risk increasing effect at the .05 level of significance. The significance of the 'FDI as % GDP' risk increasing effect particularly in this model lends strong support to the previously discussed hypothesis of an institution-eroding effect of 'malign' iFDI flows in terms of political stability in the context of post-Soviet states.

**Table 6.1. Overall Country Risk (OCR)**

Model	OLS	LSDV	GLSE
Indep Variables			
FDI as % of GDP .	.0295 (1.915)	.0249 (1.544)	.0065 (.858)
Gov Debt as % GDP .	.0106 (4.160)	.0197 (5.281)	.0048 (2.885)
GDP per capita .	.0003 (3.275)	.0002 (1.119)	.0001 (0.644)
Unemployment rate .	.0185 (1.279)	.0665 (2.058)	.0387 (3.249)
Trade Balance/% GDP -.	.0065 (-.965)	-.0019 (-.0168)	-.0021 (-.512)
R square adjusted 28.9	28.9	53.1	21.5

**Table 6.2. Economic Risk (ER)**

Model	OLS	LSDV	GLSE
Indep Variables			
FDI as % of GDP	.0169 (1.060)	.0314 (1.744)	.0068 (.915)
Gov Debt as % GDP	.0109 (4.150)	.0191 (4.597)	.0027 (1.592)
GDP per capita	.0003 (2.717)	.0001 (1.080)	-.0001 (-1.729)
Unemployment rate	.0300 (1.999)	.0768 (2.1297)	.0530 (4.175)
Trade Balance/% GDP -	.0112 (-1.596)	-.0037 (-.301)	-.0023 (-.558)
R square adjusted	30.0	46.4	21.6

**Table 6.3. Legal Risk (LR)**

Model	OLS	LSDV	GLSE
Indep Variables			
FDI as % of GDP	.0263 (1.494)	.0337 (1.916)	.0126 (1.552)
Gov Debt as % of GDP .	.0070 (2.408)	.0197 (4.7064)	.0031 (1.540)
GDP per capita	.0004 (3.587)	.0012 (1.494)	.0001 (1.316)
Unemployment rate	.0070 (.419)	.0363 (1.003)	.0250 (1.822)
Trade Balance/% GDP-	.0054 (-.694)	-.0047 (-.037)	.0002 (0.033)
<i>R square adjusted</i>	<i>32.0</i>	<i>48.9</i>	<i>30.1</i>



Despite the lack of more detailed data and the fact that these risk variables are based on a number of assumptions, the relationship between these variables reflecting on the changes in the quality of institutions in the country and iFDI flows is remarkably stable; with FDI having a significant positive (risk increasing) coefficient for most of the relevant LSDV model outputs.

#### **6.4 Conclusion**

The chapter has sought to question the conventional assumption of a ‘benign’ role of foreign investment and examine an opposing hypothesis of institution-eroding effect of lower quality ‘malign’ iFDI flows in the context of neo-patrimonial post-Soviet states. Although the regression analyses are inevitably affected by weaknesses in the underlying data, they strongly point to the possibility that, at least for the period during which these countries were examined, FDI was having an overall destabilizing effect on domestic institutional competencies and capacities. While this analysis does not necessarily confirm the hypothesis of a ‘malign’ effect of foreign investment, it certainly contests the conventional assumption that iFDI will positively impact the institutional structures and the stability of recipient countries.

Although our results point to the possibility that, on the whole, foreign investment may have had negative effects on the institutional environment in the region, this analysis must necessarily be interpreted with caution. Specifically some of the factors which limit the generalisability of these findings include the fact that the regression analysis covers a limited time frame during which some parts of the region, such as Georgia and Azerbaijan were, *ab initio*, characterized by involvement in conflict and instability. Secondly, during the period examined here a very large amount of foreign investment was concentrated on a small number of natural resource-endowed states, which could have a distorting effect on the overall data analysis. Thirdly, the model does not account for the endogeneity of iFDI as an independent variable.

Despite these caveats it is probably valid to note that this analysis throws doubt on the, often politically motivated, advocacy of iFDI which presupposes that the

interests of foreign investors are identical with those of recipient states. Without more concrete evidence in its support, the assumption of a 'benign' effect of foreign investment is no more than speculation, irrespective of how many international organizations pay lip service to this; and what is more, it is an assumption that needs to be very carefully and critically examined.

The micro-level qualitative study of foreign investors' performance and behavior in one neo-patrimonial country, namely Ukraine, was undertaken to further refine and test a newly-introduced 'blind bargaining' model and address the issues of generalizability and validity of quantitative findings identified above.



## CHAPTER SEVEN: QUALITATIVE RESEARCH FINDINGS

### 7.1 Introduction

The complex and very sensitive nature of both the studied phenomenon and research questions in this study determined the necessity for the analytic framework to take into account multiple aspects of working environment and characteristics of the participating companies with FDI. As a result, foreign investors' activity in Ukraine is examined by concurrent comparing, contrasting and linking patterns of their behavior in terms of their association with different contextual segments. The latter are identified based on these companies' affiliation by their status in the world economy, the home country's level of development (developed, developing, emerging or transition group), and industry.

Distinctive in case of this study is the fact that breaking the analysis into independent units focusing on isolated within- and cross-group investigations would deprive the researcher of ability to trace and show important links between various companies with FDI characteristics, their strategic choices and performance. Such limitation, in turn, would have a negative effect on the quality and, as a result, reliability and validity of both the analytic reasoning and conclusions.

Moreover, a better elucidation, interpretation and justification of various companies with FDI behavioral patterns is further achieved through broadening the analytical perspectives by acknowledging the value and scrutinizing the viewpoint, judgments and facts shared by various experts and potential foreign direct investors in Ukraine.

The findings based on the synthesis of data provided by the representatives of all of the above specified groups are exhibited at a cross group level and structured in accordance with the themes identified in the course of this research project to . These are outlined below.

1. Changes in foreign investor – host state bargaining relationships and their bargaining power in Ukraine; development of a new bargaining model.

This part of the presentation of findings includes questions on the quality of iFDI, bargaining power, and constraints for FIs' in Ukraine. It identifies the prevalent types of various companies with FDI activity in Ukraine. The discussion of the main bargaining strengths and weaknesses of both the host country's (location specific advantages) and foreign investor's (ownership specific advantages) serves as a foundation for the analysis of the changes in their bargaining power used to develop a new bargaining model specific to Ukraine and other neo-patrimonial transition and developing countries.

2. Patterns of foreign investors' nonmarket strategies, in general, and political behavior, in particular, in Ukraine.

This section addresses the issues of FI's existing and potential capacities and interest in prompting institutional changes in Ukraine. It explores various aspects of nonmarket, with the special focus on political, behavior of different companies with FDI in Ukraine. The discussion covers the following issues: its organizational fundamental, particularly its management structure at both company and subsidiary levels; the choices and efficiency of cooperation modes at different participation levels, made of individual motions and several alternatives for collective alliances; the determinants of political strategies (distinguishing bridging and buffering mechanisms); the intensity of engagement at different levels (local, regional, national) and with various branches of power (regulatory, executive, judicial); the spheres and types of host country policies of greatest interest for foreign investors, and the stages of policy cycle and channels of foreign investors' political involvement.

3. The role of different groups of foreign investors in shaping the institutional environment in Ukraine and the self-assessment of their efficiency.

This part of the research probes the nature and quality of political bargaining between different groups of foreign investors and Ukraine. It examines the host state's dedication to an encouragement of sustainable open dialog and of the active participation of foreign investors in endeavors expected to assist in modifying the institutional environment in Ukraine. It also investigates such issues as the

efficiency, degree of pro-activity and intensity of foreign investors' political involvement and, where appropriate, changes in these. The discussion of the problems of merging political, economic and criminal powers and of the estranged (from the groups representing such powers) party's potential liabilities for political ties closes the inquiry of this section. Overall, this section is seeking for evidence supporting the proposition that bargaining in Ukraine has a dual nature. In other words, FIs need to distinguish between formal and informal bargaining in Ukraine.

#### 4. The quality of foreign direct investment in Ukraine.

The final section is dedicated to the outcomes of the FIs – host states bargaining relationships in Ukraine. It briefly relates participants' reflections on the quality of iFDI in Ukraine and its determinants. For better understanding of the sources of business environment characteristics' negative impact on changes in the quality of foreign direct investment inflows in Ukraine, it also includes a summary of interviewees' assessment of their working experiences in Ukraine comparing to other post-Soviet and Central and Eastern European countries. Finally, the debate on necessary changes in the Ukrainian political system are needed closes this chapter.

Overall, combining the findings from all qualitative research sections designed to answer specific questions on the goals, resources, constraints, strategies and outcomes of FIs – host states bargaining relationships allows testing, refining, and further developing a 'blind bargaining' model for the case of Ukraine.

## **7.2 Bargaining power and changes in foreign investors – host state bargaining relationships**

### **7.2.1 Company profile**

The analysis of the data obtained in the course of this research project shows that company characteristics such as whether the investor's home state is a developed country or a developing or transition country, the motivation for the investment decision, the form of ownership and the foreign investor's status in the global economy play a major role in determining investors' pattern of behavior, bargaining power, and the degree of success of their performance.

However, this research also reveals that an important additional cluster of characteristics specific to Ukraine and some other former post-Soviet countries is hidden within this traditional set of company profile features. Both experts and foreign investors unanimously identify presence of round tripping or pseudo-FDI, the status of such companies' owners in the local economy and politics, problem of merging political, economic and criminal powers and growing raiding problem as the most crucial factors preventing an FDI inflow and even causing an outflow of higher quality 'benign' FDI from Ukraine.

As a result, the following analysis provides evidence that real foreign investors currently present or pursuing access to Ukrainian market are predominantly guided by resource- and market-seeking motivation in the industries least often targeted by pseudo-investors, which are, as a result, reasonably competitive markets. Notably, resource-seeking companies are primarily interested in physical resources while the main attractions for market-seeking companies are market size and prospects of market growth.

It is worth noting that there is a certain group of potential investors, including IT and R&D companies, interested in exploitation of Ukrainian high quality professional labor resources, and that they found a way to simultaneously avoid and, what is more important, even benefit from the inefficiencies of the Ukrainian market and institutional environment through contracting out Ukrainian professionals without actually entering the Ukrainian market.

### **7.2.2 Foreign investor's ownership-specific advantages**

Financial resources are the main ownership-specific advantage of foreign investors in Ukraine. However, all interviewees, regardless of the industry in which they operate, claimed that by itself this tangible asset cannot ensure the security of their businesses in the Ukrainian market. The latter can be achieved only in cases if the tangible financial resources are supported by the intangible relational resources component. That is why the status of foreign investors in the world economy, determined, first of all, by their exclusive access to, favored relations with and support from home and host countries' governments and supranational organizations

and institutions is the crucial asset for efficient operation and even survival of foreign investors in Ukraine. However, these relational resources are a privilege of the elite MNEs. All low- and mid-profile investors admitted that:

Any foreign business would feel much less vulnerable and insecure in Ukraine have it had guarantees of the support from its home country and international organizations (from an interview with SE1).

Elite MNEs identified advantages of common governance (Dunning & Lundan, 2008) as the second group of their ownership-specific advantages in Ukraine. The most important asset within this group of advantages for them is their exclusive access to product markets and to better quality inputs, including labor, natural resources, information, finance, and semi manufactured goods. It followed by a set of advantages arising from MNEs' multinationality, namely operational flexibility and ability to diversify and reduce risks.

Elite MNEs also considered a valuable asset their managerial, technical-technological, marketing and institution-building expertise, in general, and legal expertise, in particular. Though ST3, PFBT1, PFBT4, SBF2 emphasized that the value a host country place on various expert qualities of MNEs can change over time. A good example here is the deterioration of the Ukrainian authorities' interest in MNEs legal expertise. PFBT1 informed that, since his company was one of the first foreign investors which entered the Ukrainian market after the dissolution of the Soviet Union, during the first 10 years of the Ukrainian independence, the state authorities heavily relied on his MNEs' legal expertise in developing new Ukrainian laws. However, over the last 10 years this interest has significantly decreased.

It is noteworthy that low- and mid-profile investors do not perceive any of their ownership-specific assets as advantages for their operation in the Ukrainian market. They consider the positioning and operation of their companies in Ukraine extremely vulnerable. Further analysis of the foreign investors – host state relationships in Ukraine will provide evidence on the sources of such attitudes and help better understanding and developing several elements of a 'blind bargaining' model,



including goals, resources, and constraints determining FIs' bargaining power and relationships in Ukraine.

### **7.2.3 Ukraine's location-specific advantages and disadvantages**

#### **7.2.3.1 Location-specific advantages**

##### **i. Market-seeking iFDI**

All representatives of the food, beverages and tobacco industry have the market-seeking motives and emphasized that the most attractive Ukrainian location-specific advantage is the great potential of the Ukrainian consumers' market growth. They claimed that Ukrainian market, if compared to Western markets, has a very low degree of saturation. Moreover, an interviewee representing PFBT1 noted that in Ukraine consumption per person is much lower even in comparison with other post-Soviet countries including Russia. As a result, foreign investors in this industry see the development of their business in Ukraine as induced not only by the growth of demand and consumption but also by growth of the market itself.

The public relations director at PFBT1 also said that for that company:

Ukraine is one of the ten priority emerging and quickly developing and growing markets in the world along with India, China, Russia, Mexico, and Brazil. In Western Europe our market growth is minimal. It does not exceed 1-2% a year. In contrast, in Ukraine and some other post-Soviet countries our business growth rate is a two-digit number ranging from 15% - 20% to even 30% a year.

Likewise, all representatives of companies belonging to the trade sector (ST1, ST2, ST3 and ST4) identified the Ukrainian market capacity as a primary driving force of their investment decisions. Also, the Head of Corporate Affairs Department at ST3 recognized that sufficiently active population is another very important advantage for the successful growth of their business in the country. He also emphasized the critical role of the existing trend of development in Ukraine towards European integration.

## **ii. Resource-seeking iFDI**

Similarly, all interviewed representatives of the agricultural business community were driven into the country by its high potential and name Ukraine among the four countries possessing the highest agricultural potential, together with Brazil, Argentina and Russia.

For this reason, these companies, whose activity is directly dependent on their physical presence in the Ukrainian market, are ready to deal with imperfections of the institutional, business and investment environment in the country.

Thus, a directors at PA1 says that:

Our company has been consistently growing in Ukraine since 1991 despite political and economic instability and crisis in the country.

However, if there were a possibility to use Ukrainian resources without being physically present in the country, that would be the preferred option for many investors. For example, potential foreign investor PIFC1, representing the construction industry revealed that many foreign construction companies, including his business unit, agree to work in Ukraine, first of all, only as contractors and, second of all, only under the condition that their work is insured against nonpayment and other risks by international financial institutions.

### **7.2.3.2 Location-specific disadvantages**

Most of the location-specific disadvantages in Ukraine are similar for all types of iFDI, including market-, resource-, efficiency- and strategic-asset seeking inflows. They originate from the imperfections of institutional environment in Ukraine. All foreign investors' complaints are perfectly reflected in PA1 ranking of the major impediments for a safe and efficient operation of businesses in the country. The interviewee asserted that:

There are a lot of disadvantages for business in this 'funny country':

1. state banditism, which is driven by ruling elite, headed [at the time of the interview] by President Yanukovich and his gang;

2. endemic corruption, which is getting worse, worse and worse over the years;
3. bureaucracy;
4. discretionary law enforcement.

For example, EA1 suggested that Ukraine is potentially one of the most attractive countries for iFDI in the world because it possesses an abundance of the major factor of production, namely land resources. However, the problem is that this main strategic good is not actually a good in Ukraine. In other words, he explains that Ukraine and Belarus are the only two European countries that do not allow the free sale and purchase of agricultural land by foreigners and stateless persons. It could only be transferred to their temporary possession, i.e., leased - for not longer than 50 years in accordance with the decision of local or regional authorities (Land Code of Ukraine, Article 22).

Under such circumstances the success of foreign investors in obtaining a permit for use of certain land resources was completely dependent on their ability to come to an agreement with respective representatives of local or regional authorities. However, both experts and foreign investors emphasize here that any such decisions and agreements are subjective. Moreover, in the event of a change of power, foreign investors will have to renegotiate their deals with the new authorities and will be at risk of losing their investments.

It must be admitted that there are also multiple illegal schemes for purchase of agricultural land by foreign ventures and stateless persons in Ukraine. For example, interviewed experts ELA2, ELA3, EA2, EJ2 explained that since the Land Code of Ukraine allows non-citizens to buy non-agricultural land plots within the city limits on the stipulation that the real estate is located on the acquired lots, some foreign investors are seeking opportunities to purchase agricultural land as non-agricultural by the means of direct corrupt relationships with state officials or using intermediary entities, such as consultancy organizations, dominated by legal consultants, established for this purpose in Ukraine.

All interviewees emphasized that whether by legal lease or illegal purchase contract, a foreign company acquiring access to Ukrainian land will be taking on an extremely high risk due to political uncertainty, instability and corruption, all of which, according to the results of this research, head the list of most important deterrents for iFDI flows into Ukraine.

How do both experts and foreign investors explain the pertinence and sustainability of such an unattractive corrupt relationship-based business environment in Ukraine?

Experts assert that multiple institutional voids, most of which are deliberately preserved to serve the interests of power elites, in all spheres of Ukrainian institutional environment are definitely the main location-specific disadvantage and a vital determinant of foreign investors' decision to enter, operate or exit the country. A fundamental flaw of the Ukrainian state administrative framework is a systemic deliberate failure of all branches of power to fulfill their functional responsibilities. EINGO1 declares that overall assessment of response mechanisms to the requirements of legislative framework in the country attests to the view that:

Ukrainian legislation is prepared only for fools. In reality officials at any level are just openly and shamelessly ignoring the existing laws and courts are not taking any actions to prevent, control and bring to an end such flagrant abuses of power. To be more precise the basic guiding principle of Ukrainian officials is a selective application of impracticable laws. In other words, state representatives in Ukraine live by the rule proclaimed by the famous Spanish dictator Franco: "To friends – everything, to enemies – the law".

Naturally this very often leads to discrimination against foreign investors unless they choose to follow the existing informal rules of business conduct in Ukraine or are able to resist and overcome all unfair and illegitimate demands due to their privileged status in the world economy. However, on a general scale, it can be inferred that this lack of transparency and the prevalence of illegitimate forms of

regulating business operations prevent a predominant portion of quality iFDI from entering the Ukrainian market.

In support of this conclusion approximately 75% of our participants, equally representing all industries, single out the unlimited power of bureaucracy and frequent unpredictable and ungrounded changes of legislation as major disadvantages deterring foreign investors from entering the Ukrainian market.

As EINGO1 stated:

State officials' actions are directed not by the official formal rules but by orders to persecute a certain company or its representatives. Such orders can contain a requirement for an official to initiate a criminal case, jail and torture a manager or an owner of a certain company or simply close down this business altogether. By contrast, if an enterprise belongs to somebody who has close relationships with the ruling elite, then an agent of that business can commit any kinds of crimes ignoring all existing rules and laws absolutely without any fear of being punished for their misconduct.

Furthermore, several of the interviewed experts (EINGO1, EJ2, ELA2 and ELA3) stated that every state official in Ukraine is accountable not only to his/her official supervisor but also, more importantly, to an unofficial boss appointed by the ruling elite. The latter represents the interests of a criminal unofficial hierarchy co-existing with and dominating the official state hierarchy. These experts also believe that this specially-built criminal unofficial hierarchy is the main decision-making body in Ukraine, meaning that any state official or bureaucrat is predominantly concerned about meeting the demands of representatives of this ruling criminal structure rather than about the legitimacy of their requests and such abstract notions as integrity, honesty and justice.

Besides, all experts who participated in this research project also unanimously claimed that court system is absolutely rotten in Ukraine. They emphasized that the judicial branch is completely dependent on and under the influence of the executive branch of power in Ukraine. The consensus of interviewed experts attests to the fact that there is no separation of powers in the country.

Additionally, all experts and company representatives interviewed stated that the attitudes of general population towards business in the country are still very negative and even hostile. All company representatives also unanimously referred to the negative impact of the lack of business culture in Ukraine on the development of their businesses.

Foreign investors characterized Ukrainian market as much less competitive in comparison with the markets of Central and Eastern European (CEE) and South Eastern European (SEE) countries and developed countries, including labor market competitiveness.

This lack of competitiveness to a certain degree also determines the quality of labor force in Ukraine. Here the most important issue is the problem of the work ethic. Most company representatives interviewed claimed that a significant share of workers in Ukraine, even though highly qualified, tend to put very little effort into their work, perform poorly and deceive their employers. However, approximately 25% of the interviewees disagreed with this statement. They insist that their Ukrainian staff is meeting and even exceeding all their expectations and requirements to their employees. In support of the latter statement BPFBT1 indicated that in their company a Ukrainian subsidiary had been made the regional headquarters for all their subsidiaries in the post-Soviet states and Mongolia. Moreover, the Ukrainian team was also responsible for the development of business in the CEE and SEE regions.

Market-seeking investors, particularly in the food industry, indicated that at the moment people are not willing to spend money on consumer products and food, causing the stagnation of consumption growth in Ukraine. They suggested that this tendency was a consequence of a decline in the population's real income levels. On the other hand, both experts and interviewees representing various business sectors said that information on the extremely high and consistently increasing volumes of foreign currency exchange operations shows that people in Ukraine have money but prefer to save it in foreign currency.

The interviewees assumed that this decline of the population's confidence in the future is not an effect brought about by the economic crisis but rather a by-product of the instability and growing uncertainty about the direction of future political and economic trends and developments in the country.

## **7.2.4 Risks in Ukraine**

### **7.2.4.1. Risks as a disadvantage**

Attitudes towards various risks in Ukraine have been found to differ significantly depending on the industry, target markets of the final product and investment status of the company.

Overall both experts and representatives of companies with FDI working in Ukraine agree that country risks, in particular political, operational and legislative risks linked to the instability and unpredictability of policies and corruption of both the decision-making process and law-enforcement mechanism, are major causes for concern of businesses in Ukraine. For example, PA1 disclosed that his company developed a very large project and is ready to invest any time. However, the project is on hold because of the highly unstable and unpredictable political situation in Ukraine. The interviewee explained that:

As soon as politics change we will immediately go. However, as long as the politics stays the same the project is going to be frozen.

All foreign investors interviewed also identify financial risks, specifically spotlighting exchange rate and liquidity risks, as the second most important group of risks in the country. Grivna's devaluation by 60% and banks rejection to lend money to some of the most prospective businesses in Ukraine, respectively, are just several examples of the above mentioned risks. There are also industry specific risks such as, for example, weather for agricultural businesses.

#### **7.2.4.2 Risk as an advantage**

However, a certain group of potential investors who abandoned the idea of investing in Ukraine learned to exploit the main pitfalls in this country, namely institutional voids and growing risks.

Four potential foreign investors active in the IT and R&D industries, hailing from developed countries, and producing their products for the same (developed) group of countries were interviewed. They opt to recruit Ukrainian specialists on a private agreement or contract basis. Three of the four interviewed managers of such companies (identified in our research as potential investors PISIT1, PISIT3 and PPR&D1) revealed that their initial attempts to establish fully functional offices in the country failed as a consequence of multiple systemic drawbacks and regulatory pressures.

The director at PISIT1 confirms that:

Originally we were eager to explore the opportunities of physical presence in Ukraine. However, in no time, we realized that the costs of dealing with a broad range of regulatory authorities in Ukraine would completely undermine our competitiveness and damage our reputation. At this point, we decided to search for alternative models of working in Ukrainian market.

As a result of their search for alternative cooperation models which would relieve them from any necessity to deal with or report to any state agency in Ukraine, all of these businessmen recognized the advantages of absolutely non-obligatory cooperative relationships with independent individuals in the country. The latter could either be registered as independent entrepreneurs in Ukraine and pay taxes on their salaries or contract payments received from their foreign ‘employers’ or not. All of the interviewees admit that under this collaboration model they do not take any responsibility for their Ukrainian ‘partners’ behavior as taxpayers.

It is noteworthy that they acknowledge the positive impact of the economic crisis and political uncertainty (and associated economic, political and operational risk



factors) on their businesses. They admit that their labor expenses usually decline, or, at least, do not increase, in cases of recession, crisis and political instability. In particular, they do not need to raise salaries or the costs of any related social packages, if any are provided, and can increase the work load demands on their employees without fear of losing them.

## **7.2.5 Main sources of pressure on foreign investors in Ukraine**

### **7.2.5.1 Corruption and regulatory authorities**

There is almost unanimous agreement among all foreign investors, domestic companies and experts about the main sources of pressure on businesses in Ukraine. Representatives of both the main foreign investors and auxiliary experts, with the exception of four out of 12 representatives of the elite group of investors, claim and provide descriptive evidence that omnipresent corruption and regulatory authorities at all levels and law enforcement agencies in Ukraine hamper their operations on a constant basis. ST1 pointed out that:

At any point of time their company is facing and must respond to the demands of at least thirty control functions imposed on them by various public authorities.

The representative of ST3 explained that regulatory authorities like ministries can impact the functioning of all businesses through initiation of multiple unpredictable and ungrounded changes in existing Ukrainian legislation. The demands of local regulatory authorities are driven by the pursuit of their official representatives' corrupt interests. PA1 emphasized that:

Corruption was at the kindergarten level during the first Ukrainian President's, Mr. Kuchma's, reign in comparison to its current scale and scope. It is getting worse, worse and worse with every coming day.

Such pursuit of private corrupt interests, in turn, is possible due to the imperfections of both legislative and judicial systems' chaos that according to the interviewees, in most cases, amounts to a complete absence of any control over and/or accountability of such officials.

Local tax authorities are the primary and most frequently cited source of such pressures in Ukraine independent of industry and type of activity of the business interviewed. These allegations are further reinforced by legal advisors ELA1, ELA2, and ELA3, who also claim that the main sources of pressure on companies in Ukraine are both tax and law enforcement agencies.

Representatives of fire authorities are also frequent visitors to businesses in Ukraine. Since there are no regulations as to the limits on the number of inspections, their representatives can drop by practically on a daily basis with checkups and leave recommendations and directions for improving the fire safety of the inspected unit and/or territory, according to representatives of both the production (PO1, PO2) and service (ST1, SB3, SC1) sectors. Such recommendations include issues ranging from the fire alarm devices to the increase of the hydrant tube sizes. They explain, for example, that even if the tube diameter is in compliance with all current standards and requirements, the officials can still demand that they be replaced them with tubes of a bigger diameter. Providing the representatives of fire authorities with an approved plan according to which your enterprise is entirely compliant with all fire safety requirements is not sufficient either. Representatives of such authorities have the power to claim that three-, two- even one- year old plans need to be upgraded and modernized. Similar renewal requirements are also very often generated with regard to fireproofed varnishes and paints, and any other flammable substances.

Almost no business unit, except for representatives of the elite group, has any power to resist these authorities and protect itself from arbitrary regulatory meddling and interference. Some of the interviewed companies (ST1, SBF2, SE1, PLI2, and POM2) admitted that they had tried to protect their rights through courts but had all failed to prove their innocence in spite of the availability of all required evidence, had lost their cases and had to pay bribes to prevent being closed down.

For example, trading company ST1 was involved in a case in which the inspector claimed that two substances cannot be kept next to each other in their warehouse because they would create a fire hazard. Even though the company obtained several independent experts' conclusions that both substances were not flammable by their nature and were safe to be kept next to each other, they were still found guilty and

had either to pay bribes to the inspector to close the case or to deal initially with more follow up inspections and eventually with danger of being closed down due to non-compliance with fire safety requirements.

Generally, such corruption-related pressure cases consist of the following stages. Firstly, as a result of inspection, the representative of a tax, fire, health and safety or any other kind of regulatory authority delivers a protocol of inspection containing detailed information on multiple non-compliance issues requiring corrections. If a company cooperates and pays bribes, an inspector withdraws all unsubstantiated highly resource-consuming claims from the protocol and leaves just a couple insignificant demands for correction. If a company decides to be uncooperative, disagree with the inspector's claims and not pay a bribe, then a representative of the respective local or district regulatory authority the company is dealing with comes back at the end of a set term for corrections and modifications and orders the business to be closed down.

If a company further decides to appeal to the next higher authority (city inspections), the latter send their own inspectors, who are as corrupt as the previous ones. Their visit will result in even more demands for upgrades and correction of non-compliance issues. If company management chooses to continue their pursuit of justice, they move up to the regional and national level authorities. Eventually, the final level of their communication with inspection authorities will be determined by the availability of both tangible and intangible assets.

Due to a highly systemic organizational approach, effective management, risk distribution, and strong financial and relational resources, elite foreign investors claimed that their style and modes of operations in Ukraine are similar to those applied by other subsidiaries operating in any other country of the world. They declared that they never pay bribes and resolve all issues of this character directly at the highest (national) administrative levels. This access to the highest administrative resource ensures that they do not have problems with any agencies or authorities at local or regional levels and/or are perfectly equipped to resolve all of the issues generated by multiple institutional voids.

Both experts and elite companies' representatives themselves suggest that the latter is the only group of investors actually feeling comfortable operating in Ukraine. PFBT1 explains:

We are a very big global company with a well established reputation and a strong name. These are the major factors that determine our ability to protect our interests and operations from corruption pressures in Ukraine.

By contrast, mid- and low-range profile foreign investors who either do not possess enough resources to meet all the demands of corrupted regulatory authorities or simply want to preserve their right to keep their business clean and conduct it in a legitimate manner find themselves in a very vulnerable position. They become targets of constant pressure from various regulatory agencies mostly at local and regional levels. As a result, in most cases such foreign investors are left with no other choice but to exit the country.

ELA1 provides a very representative example of such a situation. The Director of Business Development of one of his client companies with foreign investments, a wholly-owned subsidiary of a mid-range profile company from the Netherlands working in the transportation and logistics sector, decided to exit the Ukrainian market after approximately four to five years of work there in it due to of its inability to attain operating efficiency in the local business environment. The most striking here is the fact that the company was present in several Community of Independent States (CIS), SEC and CEE markets, initially starting in Russia, expanding into Ukraine, and then moving into Romania, Turkey, Azerbaijan, Georgia, and some other post-Soviet states. Overall he managed offices in 17 transition and developing economies. Of all of them Ukraine offered the most unacceptable and unproductive environment for conducting business and was the only country he decided to exit.

The Business Development Director's main arguments concerned the low quality of business environment and the tax regime. He could not understand why he had to have extended meetings with his accountant every day. Additionally, he said that constant bribery and corruption claims were doubtlessly potentially harmful for company's reputation. The Director acknowledged that, even though it was large, the

company still did not possess sufficient resources to resolve the issues emerging at the highest regulatory levels. He insisted that as an open transparent company they could not afford to put up with this sort of pressure and assume this kind of risks.

Moreover, according to his calculations, he had to devote 32% of his work time to management of one Ukrainian business while having only the remaining 68% of his day for the other 16 offices combined. Nonetheless, he admitted that if the Ukrainian unit produced 32% of the company profits he would consider staying in the market and looking for various strategies to overcome all institutional deficiencies. However, he was absolutely confident that all the talk about the potential of the Ukrainian market was not substantiated with any realistic prospects for positive changes. In reality, he said there was a total mismatch between overall effort and outcome.

A representative of a developing country foreign contractor company, PIFC1, working in a construction industry provided further evidence of extremely unacceptable operational conditions in Ukraine for low- and mid-range profile foreign investors from developed countries which, due to their lower profile cannot count on active support and protection of their interests by their home countries and/or international organizations. He and PA1 representative explained that following the non-corrupt compliance mode of operation in Ukraine can result either in a very slow and long-lasting process of resolving any operational issues, the best case scenario, or in a complete failure of all attempts to reach authorities, get answers for their questions and resolve their problems, worst case scenario. As a result, such procrastinations and failures cause companies that do not want to put at risk their reputation eventually make a decision to withdraw their investment from Ukraine.

On the contrary, more flexible companies from developing countries, like PIFC1, which do not have access to the developed markets, have no other choice but accept 'the rules of the game' in Ukraine to maintain their competitiveness. Thus, even though trying to stick to highly responsible corporate behavior and shocked by the scale of corruption in Ukraine at the beginning, they end up adjusting their operational modes to local conditions and learn to cope with corruptive pressures.

The PIFC1 interviewee reveals that his company worked at the key state project in Ukraine. The conduct of a major international event in the country depended upon the completion of this project. However, he emphasized that even the fact that the failure to finish their work on time could result in a major international scandal and transfer of the event to a different country, which would irreparably damage already faulted Ukrainian reputation, was not helping in overcoming corruption pressures from state officials.

He stressed that on many occasions his attempts to resolve problems with representatives of various regulatory authorities, such as, for example, obtaining different permits and dealing with delays in their issuance, without resorting to corruption were unsuccessful. The most shocking for him was the fact that his explanations of the nationwide consequences, in case of the project failure, had absolutely no effect. None of the state officials cared about the country's international profile and reputation. Bribes were the only means to resolve any problem intentionally created by the state officials.

Moreover, PIFC1 further implied that the Ukrainian legal system itself prompts corruption in the country. He explains that:

The law is somehow based on this. It embeds the windows of opportunities for corrupt demands. If you try to fully (100%) obey the existing laws, your company loses any chances to progress in its work. So, anyone (I particularly emphasize - ANYONE) who makes a business in Ukraine ought to in some ways disobey the laws because the laws are serving as a source for corruption.

#### **7.2.5.2 Other sources of pressure**

Only representatives of the elite MNEs group identified their stockholders as important sources of pressure whose demands they are consistently accounting for in the course of their decision making process. Also, interviewees working for trade sector companies using direct sales operational modes identified accounting for the interests of all independent entrepreneurs working with them as one of their

priorities. Moreover, a representative of ST3 asserted that these entrepreneurs' needs are fundamental determinants of their decision-making.

Overall, experts deny that companies' employees, trade unions (except for one developed country elite MNE with partial state ownership, SC1) or any other public organizations have any influence over foreign or domestic businesses in Ukraine. They explain that the reason for this is the growing passivity of the population in the country over the more than twenty years of independence. Further, they elaborate that though, in general, Ukrainian people are not used to stand up for and protect their rights, this upsurge in passivity has its roots in the failure of the 2004 Orange Revolution leaders to fulfill to their promises. ELA2 explained that:

The 'Orange' political elite betrayed their people by continuing to focus on meeting the demands and orders of business elites rather than building a fair civil society in Ukraine.

#### **7.2.6 Behavioral inconsistency and conflict between demands of different state authorities**

Half of the respondents state that there is no problem with laws in Ukraine. They suggest that almost every single law in itself meets basic legislative standards and requirements. ELA1, ELA2 and ST2 specifically point out that the key words here are "in itself". They assert that the major problem of Ukrainian legislation is that very often the content of different laws is contradictory. Moreover, even when this is not the case, disputes arise due to a lack of co-operation between the legislative and executive branches of power.

To this we need to add the absolutely dysfunctional law enforcement mechanism. For example, according to the Law on FDI in Ukraine the company with FDI does not need any licenses to export its products. However, when PM1, one of the low-range profile metallurgical companies with foreign investment participating in this research project, tried to export without a license it was not allowed. Any attempts to prove their right given them by the law were useless. The authorities' answer was: "Who cares about this law?! We are the only ones who can tell you which law applies in your case! We command that according to a different law you need a

license and you have to get it. Otherwise you cannot export!” The fact that companies with FDI are exempt from that law on the basis of their status and need to be treated in accordance with the law on FDI in this case was meaningless for the authorities. Apparently, the latter have an infinite right to decide what laws to apply to any company in Ukraine.

Both the PM1 director and foreign investor did not want to accept such treatment and decided to defend their company’s interests by pursuing a law suit. They tried to resolve the issue at all three levels of the judicial system (local, regional and national) and finally when they got to Kiev the decision was against the company. They lost their legitimate law suit. Thus, in the end they still had to apply for a license to be able to export. As a result, both the investor and the management of the company were completely disappointed in the system. Moreover, the investor started seriously thinking about withdrawing his investments.

Similar regulatory inefficiencies, mistreatment of foreign investors and the poor-functioning of law enforcement can be observed in interactions with officials responsible for customs, nontariff trade restrictions, taxes and other regulatory issues. The law does not exist for them. No matter what relevant legislation states, they can ignore it because there is always another law or normative act they can apply in a given situation.

Contradictions between laws and the impossibility of defending one’s rights due to pervasive corruption are among the main problems hampering the work of both domestic and foreign enterprises in Ukraine. Moreover, most of the new rules are designed in a way that definitely creates more opportunities for corruption and deters real investors from entering Ukraine. All respondents unanimously affirm that corruption is rapidly and significantly growing and becoming more and more of a problem for the operation of businesses in Ukraine.

Elite MNEs with a strong status in the global economy, feeling secure in their access to high- level authorities and protected by the power of head offices and home countries, are not afraid of the pressure of corruption. They admit that they face constant demands for monetary contributions from representatives of various



regulatory authorities, but say they do not give in to those demands. There were cases when these companies succeeded in requests for the dismissal of corrupt bureaucrats from office. However, other companies - predominantly representing developed countries - which do not have such strong support and do not want to give in their corporate rules and ethics to these pressures eventually have to exit the market under the growing burden of corruption. By contrast, companies less concerned with corporate conduct and business ethics continue to enter the Ukrainian market. This situation, on one hand, leads to the deterioration of the overall quality of iFDI and, on the other hand, exacerbates the problem of the monopolistic predominance of large companies in Ukrainian economy.

There is also a pressure of a different kind. For example, the aforementioned PM1 director, representing metallurgical industry, disclosed that he was getting calls from the Presidential Administration regarding the purchase of tickets for a forthcoming concert of a famous foreign singer in the capital of Ukraine, Kiev. The Presidential Administration demanded that his company purchase a certain number (in this particular case seven) of tickets for this concert for the unimaginably high price of 30,000 grivnas which was almost an equivalent of \$4,000 per ticket at the time. The chance to socialize with famous Ukrainian oligarchs and government representatives was offered as the main incentive for the purchase of these tickets. When the director refused to buy the tickets the person representing the Presidential Administration threatened that his company would be closed down.

In response to the question about the extent of pressure on his company the same director said he felt that bigger companies that attract the higher degree of attention of powerful people are under much stronger and more contradictory pressure and admitted that:

The pressure is there but my company is just a relatively small one and there is not much that could be taken from it.

The most vivid example of the lack of not only consistency but also absence of any common sense in the activity and actions of the Ukrainian legislative authorities and the Presidential Administration is the recent discussion of the need to decrease

several different tax rates in Ukraine, in particularly to reduce the value-added tax to 12%. Nonetheless, at the same time the president signed the Law on Advance Corporation Tax. In other words, the president assured the public of his intention to cut taxes but at the same time decided to apply advanced corporation tax to companies paying dividends. Taking two such contradictory actions approved and executed by the same branch of government definitely does not add to the credibility of the Ukrainian authorities in the eyes of foreign investors.

Similar state authorities' behavioral inconsistency can be observed in a case of changes in value-added tax (VAT) in Ukraine. According to the Tax Law working in the country initially, after the dissolution of the Soviet Union, all the companies had to pay a 20% VAT which was refundable at the end of each report period. The new Tax Code abolished VAT. After a short while state authorities revealed their plans on the VAT restoration. However, in reality under the VAT disguise they introduced a new non-refundable 20% tax.

PA1 representative also revealed that, in spite of the state persistent attempts to attract his company to invest into Ukraine, the operations of the latter have been continually hindered by the same state officials at all phases of its existence. Problems with issuing and delays with obtaining of various permits, rejection to issue import licenses in time are just some of the bureaucrats' corrupt pressure on foreign investors in Ukraine.

Under these conditions of external pressure, inconsistencies and contradictions, experts suggest that, in spite of all instruments for attracting iFDI formally existing in Ukraine, foreign investors are at a disadvantage in comparison to domestic companies. The latter are much more knowledgeable about country-specific corrupt practices. This expertise is a necessary condition for successfully navigating the business environment in Ukraine. All the experts and low- and mid-range profile investors interviewed asserted that the foreign investors who feel most comfortable in Ukraine are those originating from countries with similar patterns of business – state relationships, such as Turkey, Greece, Italy, Spain, etc.

## **7.2.7 Pseudo-FDI in Ukraine**

### **7.2.7.1 Incentives for and impact of pseudo-FDI on real iFDI in Ukraine**

Pseudo-FDI or round tripping FDI are defined here as investments originated by offshore companies owned by Ukrainian elites. Experts EJ1, EJ2, EA1 and EA2 acknowledge that, on one hand, it is good for the Ukrainian economy that money is coming back to the country of its origin but also argue that, on the other hand, the presence of this kind of investment plays a crucial role in sustaining the highly corrupt institutional order and environment in Ukraine.

The prevalence and monopolistic behavior of pseudo-FDI in the country representing the interests of powerful domestic unified political and economic elite groups to a great extent explains the Ukrainian failure to create an attractive investment climate in the country and the reluctance of real foreign investors to enter, work and stay in this market.

This phenomenon was initially triggered by the provisions of the first Law on FDI in Ukraine. This law gave FDI a more privileged status in comparison to domestic investment. This created an incentive for local investors and especially local elites to seek the ways of registering their investments as FDI. Consequently, most domestic investments were awarded FDI status either as a result of their inflow to the country from offshore zones or based on fake contracts with nonexistent foreign partners from Poland, Bulgaria, Romania, Hungary and other CEE and SEE countries.

**Table 7.1. iFDI by country in Ukraine (at the beginning of the year), mln USD**

#	Country	1996	2001	2004	2005	2006	2007	2008	2009	2010	2011
	Total	896.9	3875	6794.4	9047	16890	21607.3	29542.7	35616.4	40053	44708
1	Cyprus	51.5	377.7	901.9	1101.4	1635.9	3187.5	5946.4	7646.2	9005.3	9914.6
2	Germany	156.9	240.9	451.6	653.7	5503.7	5578.1	5918.3	6393	6601.9	7076.9
3	Netherlands	46.5	362.2	459.9	637.2	919.5	1533.8	2508.8	3197.4	3954.5	4707.8
4	Russia	50	286.6	388.6	720.8	835.8	1002.1	1462.4	1847.2	2566.4	3402.8
5	Austria	16.4	124.5	252.4	361.1	1439.5	1633.8	2067.4	2443.8	2605.2	2658.2
6	France	11.3	39.9	59.2	79	87.9	830.3	1044.8	1231.2	1630.8	2367.1
7	UK	53.9	312	701.2	955.4	1174.8	1563.4	1975.5	2249.8	2307.5	2298.8
8	Sweden	19.1	77.1	103.1	120.3	134.1	137.3	986.7	1262.8	1275.8	1729.9
9	British Virgin Islands	5	192.8	367.5	582.2	736.5	806.2	1066.7	1294	1342.7	1460.8
10	USA	183.3	639.5	1060.2	1190.6	1387.4	1396.8	1430.1	1464.6	1309.1	1192.4
11	Italy	19.2	72.2	94.9	103.1	117.4	132.9	150.4	914.2	982	982.4
12	Poland	20.5	62.8	152.7	194.7	225.5	394.6	672.1	690.1	866.7	935.8
13	Switzerland	38.4	163.3	321.6	442.3	456.4	566.5	648	718	796.4	859.4
14	Hungary	20	51.9	128.7	177.3	191	370.9	411.2	595.4	711.5	723.6
15	Luxembourg	1	9.7	40.9	58.1	77.8	93.4	210.7	214.2	265.1	443.2
16	Other countries	203.9	861.9	1310	1669.8	1966.8	2379.7	3043.2	3454.5	3832.1	3954.3

Source: State Statistics Committee of Ukraine (2011).

**Table 7.2. oFDI by country from Ukraine (at the beginning of the year), mln USD**

#	Country	1996	2001	2004	2005	2006	2007	2008	2009	2010	2011
	Total	84.1	170.3	166	198.6	219.5	243.3	6196.6	6203.1	6226.3	6871.1
1	Cyprus	...*	...*	1.9	2	2.1	10.3	5825.5	5826.1	5778.5	6342.5
2	Russia	52.1	68.1	88	97.3	102.9	104	148.6	99.9	166.1	194.3
3	Latvia	...*	...*	...*	...*	...*	3.5	30.7	31.6	31.9	87.9
4	Poland	0.3	0.3	0.4	21.1	21.3	24.2	30.1	46.9	49.4	49.1
5	Georgia	...*	0.9	2.2	...*	2.2	2.9	28.5	26.9	32.4	31.1
6	British Virgin Islands	—	—	—	—	—	0.1	10.9	14.3	20.8	25.8
7	Kazakhstan	—	...*	0	0	0	0.2	0.8	26.8	27.1	25.2
8	Panama	...*	...*	...*	...*	...*	...*	...*	...*	...*	...*
9	Spain	—	...*	...*	...*	...*	...*	...*	...*	...*	...*
10	Moldova	0	...*	...*	0	0.9	1.3	26.7	26.6	15.2	15.2
11	Switzerland	8.1	6.5	4.2	4.7	4	4.3	4.6	5	5.1	9.3
12	Germany	0.2	0.2	0.4	0.4	0.3	0.4	2.5	2.6	5.2	9.2
13	Lithuania	...*	0.4	0.4	0.4	0.4	2.9	4	...*	...*	...*
14	Armenia	...*	—	—	—	—	...*	12.8	13.5	...*	...*
15	USA	1.4	0.7	5.4	5.7	5.6	5.7	5.9	5.9	5.8	5.8
16	Other countries	11.5	30.2	30.4	32	47.1	45.3	32.3	35.7	39.5	22.7

\*In accordance with the Law of Ukraine "On State Statistics" this information is confidential.

Source: State Statistics Committee of Ukraine (2011).

All three interviewed legal advisors suggested that another not less important motive for pseudo-FDI is the search for efficient forms of investment protection. They argued that the flaws of the judicial system in Ukraine lead more and more investors to seek a legal shelter for their investment overseas in offshore zones. Since the domestic judicial system does not provide equal access to justice and is not guided by the rule of law, more and more even small and medium size firm owners opt to operate in the Ukrainian market as foreign investors protected by the laws of various offshore states. This partially explains the consistent growth (especially during the last 3 years) of volumes of oFDI and iFDI to and from such countries as Cyprus, UK, the Virgin Islands, Panama, Netherlands and others (see Table 7.1 and Table 7.2). The interviewed experts insisted that even iFDI from Germany, Austria, the Netherlands and UK comes predominantly from holdings whose origins are impossible to trace.

#### **7.2.7.2 Distinctive characteristic nurturing growth of pseudo-FDI in Ukraine**

Interviewed experts argued that a certain amount of round tripping FDI is present in any developed, developing or transition country and, in spite of that, many such countries are extremely successful in terms of both creating an attractive investment climate and attracting high quality FDI. It can be explained by the fact that according to the International Monetary Fund (IMF) experts' estimates offshore companies either do not appear in the top five major investors or they account for no more than 5% of iFDI (Pryadko, 2013). However, EJ1 suggests that in the case of Ukraine there is an additional important element exacerbates the existing institutional voids, inefficiencies and corruption further preventing the country from realizing its theoretical ambitions. This element is the system of power established by the first Ukrainian president, Leonid Kuchma.

EJ1 identifies the Ukrainian system of power as comparable to the system of power in Muscovy, which is referred to as the 'feeding system'. He describes the functioning of this system in the following way:

The tsar assigns his boyars [vassals] certain territories to manage. The boyars, in their turn, reassign parts of these territories to their own

vassals, and so on. Each of them is feeding from his/her territory. As a result, the 'feeding system', which can be compared to centralization of power, emerges. However, the main difference between centralization of power and the 'feeding system' is that in the case of the latter the Tsar or the President does not have any control over the territories assigned to the boyars or regional authorities.

The Tsar's and his boyars' main concerns are receipt of money and obtaining other important preferential treatments. Nothing else is important for them. That is why when the President encourages foreign investors to invest into certain regions and promises them his and regional authorities' support he cannot actually guarantee the support of the latter. Even though officially it would look like that regional authorities are assisting investors, in reality, unless representatives of regional agencies directly control the incoming foreign business and, as a result, have their own interest in supporting its development, in most cases their help and services would actually be unproductive.

The analysis of the literature on Russian history (Ignatov, 2002; Lyubavskiy, 2000; Lyubavskiy, 2012; Granovskiy, 1868) confirms the above statement and provides evidence that the Grand Prince, later Tsar, shared his power with feudal princes, later boyars/ vassals, who had significant sovereign rights on their territories. They judged the land and "robbery" disputes, collected taxes, custom duties, tributes and other exactions, had their own Chancellery, the Boyar Duma. In general, feudal princes independently controlled all the internal affairs of their designated territories. The basic administrative units were regions that were further divided into smaller territorial units, each of which were ruled by appointed governors pursuing their own interests. Thus, administrative-territorial division lacked standardization and, due to the lack of centralization of government and control over the regions, resulted in highly diversified and archaic rent-seeking governance (Ignatov, 2002; Lyubavskiy, 2000; Lyubavskiy, 2012; Granovskiy, 1868).

Similarly, nowadays as a result of the strong pressure of regional authorities real foreign investors, even large investors and MNEs, are disappearing in many

Ukrainian regions (Korrespondent, 2013). Pojansky (2013) also specifically stresses that due to the lack of central authorities' intelligence on and control over the Ukrainian regions, the latter cultivate an environment encouraging corruptive behavior among the representatives of all dispute-resolution state authorities, namely courts, law-enforcement agencies and local administrative organs. The interviewed experts claim that the environment is a little bit more favorable in the capital due to the multiple centers of power.

#### **7.2.7.1 Crisis and pseudo-FDI**

Interestingly, experts note that due to the pseudo-FDI nature the 2008 crisis made pseudo-FDI a much popular business operation model in Ukraine. Moreover, the crisis strengthened pseudo-FDI's competitiveness and bargaining power in Ukrainian markets.

#### **7.2.8 Raiding in Ukraine**

In general, the majority of smaller joint ventures and foreign investors in the sample were thinking about either withdrawing their investments or had already lost their foreign partners due to the deterioration of the institutional environment in Ukraine and/or raiding attempts. Due to the latter the company in a chemical industry, PCPI, lost its foreign partners. After three to four years of fighting and litigation the company survived the attack owing to its impeccable business conduct and absolute transparency. However, its foreign investors, despite having a high profile and status in the world economy as well as home state support, as a result, strong bargaining power, refused to renew their partnership with the company. They explained that, they prefer to invest into countries with lower rates of political, operational and legislative risks (India in this particular case), despite the lower expertise level of skills there.

Experts indicated that some sectors are less likely to become a target of a raiding attack. For example, companies working in information technology (IT) sector usually do not have many assets. Their main asset is their employees. The risks of loosing employees as a result of an illegal forced changed of ownership prevent raiders from pursuing such companies (Pojansky, 2013). Weather risks, capital,



experience and expertise intensity makes agricultural businesses much less attractive for raiders as well (Pojansky, 2014). Thus, raiders prefer to focus on companies controlling valuable physical assets (Pojansky, 2014).

The legal advisors interviewed suggested that a sophisticated enterprise security scheme is one of the corner-stones ensuring the successful protection of any business in Ukraine. Such a scheme would need to include internal regulations, instructions, employee contracts, separation of the terms of their authority, etc. However, these experts admitted that unfortunately most businesses do not have one while the representatives of low- and mid-range profile companies with FDI insist that the chances that such sophisticated enterprise security would really help to protect their assets from illegal seizure are very slim. They believe that it would only work for companies possessing strong intangible assets, such as close relationships with power elites. As a result, they argued that the case of surviving a raiding attempt described above is an isolated one, the exception rather than the rule. There is a great deal of evidence of much less successful outcomes.

Berezhna (2008) reported that \$2 bln. out of the \$3 bln. annual volume of mergers and acquisitions (M&A) were actually raiding takeovers. Moreover, the rate of success of corporate raiding attacks in Ukraine is shockingly high. In nine out of ten cases legitimate business owners lose their Ukrainian operations due to legally backed raiders' criminal activity (Berezhna, 2008). Moreover, experts emphasize that raiders' attacks on companies with FDI have increased significantly over the time (Berezhna, 2008; Frishberg & Partners, 2012), especially after the President's Yanukovich commencement to power in 2010 (Danilova, 2012; Rojansky, 2013). Very representative are the cases of large companies with FDI raiding attacks and takeovers, such as MNE Bunge owning 94% of the Dnipropetrovsk Oil-Extracting Factory (Berezhna, 2008), 95% US owned the Zhytomir Sweets Factory (Danilova, 2012), a wholly owned foreign enterprises Aypronimpeks – Ukraine working in a service industry in Ukraine (Zaxvat.net; 2013). Four large food and beverages industry companies, namely Khibzavod, Nemiroff Holdings, Lesnoy Kiev, and Kirsanovskiy Sugar Factory were raided were raided in one month (Frishberg & Partners, 2012). EU diplomats revealed names of three Polish companies, Gorkis

Granit, Organika and Kievmetallprom, struggling to preserve their ownership rights. Moreover, they also disclosed that at the same time more than fifty other EU foreign investors reported attempts of raiding their companies in Ukraine (Rettman, 2011). Even such world number one steel titan as Arcelor Mittal had been striving with Ukrainian oligarchs over its major steel production facility in Ukraine, the Krivorozhstal (Rettman, 2001).

Such a persistent increase in deterioration of an already weak property rights regime in Ukraine is, first of all, nurtured by omnipresent corruption, mutual dependence and cooperation of administrative, judicial, economic and political elites directed by their personal financial interests, raiders' connectedness to oligarchs representing a new power elite - a product of merging political, economic and criminal powers, and, as a result, complete disregard of legitimacy of claims and state interests. An unsuccessful dispute of a large US company Vanco over its deep oil drilling project in Ukrainian courts due to its non-compliance with the interests of powerful oligarchic elite group represented by high-rank state official, in this particular case Yulia Tymoshenko (Frishberg & Partners, 2012), provides vivid evidence on insecurity of even large elite MNEs from the developed countries. Obviously, under such conditions both existing and potential foreign investors will be reluctant to associate their future business plans with this country.

### **7.2.9 Merging of political, economic and criminal powers in Ukraine**

The problem of the merging of political, economic and criminal powers in Ukraine is very acute. EJ1, EJ2, EA1, EA2, ELA1 and ELA3 alleged that currently politics is a business project. Any decisions about introduction of new reforms in all spheres of state activity or attracting new foreign investment to the country are controlled by financial industrial groups (FIGs). In other words, foreign investors' ability to enter and safely operate in the Ukrainian market, for at least certain period of time, is completely dependent on and determined by the interests of the major groups controlling all domains of power in the country.

The most vivid example of such circumstances is an investment project in the Ukrainian port industry, SL1. The analysis of this case shows that the attraction of a

major foreign direct investor was a by-product of a growing Ukrainian FIG's export appetites and, consequent need to increase their competitiveness, accompanied by their fear and, what is even more important, reluctance to make long-term investment commitments to any development projects, including improvement and renovation of port facilities in Ukraine.

Having considered all the available options based on the needs of their own businesses, representatives of FIGs came to the conclusion that they needed to change the existing legislation on the port industry.

However, apart from several singular cases of large real foreign investment projects nourished by the private interests of large businesses having strong representation in politics, experts stated that since 2010 they have observed almost no low- or mid-range profile foreign investors in Ukraine. In support of the above statement ELA1 specified that his firm registered on average 20-30 companies with FDI a year in one industry in one region between 2000 and 2010. Starting in 2010 (when Viktor Yanukovich succeeded Viktor Yushchenko as president of the country) the situation drastically deteriorated. Only one company a year was registered during the last four years.

In explaining the reasons for the decline in foreign investors' interest in the Ukrainian market all experts emphasized that the growing investment activity of FIGs, which are not interested in allowing and supporting the development of healthy competition in the Ukrainian market. Moreover, they asserted that these business groups feel very confident and secure because they have extremely strong leverage on the political sphere in the country which they successfully lobby to prevent all institutional reforms that might threaten their businesses interests.

Also, in contrast to the previous example both FIGs and other local Ukrainian businesses are, in most cases, interested in preventing foreign investors' entry into the Ukrainian market which they see as undermining their competitive advantage. Interviewees representing the service sector, including ST2, ST3, SBF1, SBF2, SC2, SC3, point out that:

Every single Ukrainian politician owns a business and, as a result, in one way or another represents his/ her own interests. Thus, the primary goal of such politicians is to provide the most favorable conditions for their own businesses. That is why all their legislative activity is not focused on the search for solutions which would contribute to the improvement of operational conditions for all businesses in industries of their particular interest. Ultimately the success in promoting the politician-businessman's personal interests depends on the support of his/ her colleagues (from an interview with SBF1).

Personal connections and relations with representatives of various relevant authorities or state officials are an important means of hindering the entry of foreign investors. Good example of this includes the failure of real foreign investors to secure participation in such projects as the reconstruction of the Odessa airport and the privatization of Odessa Portside Plant. In both cases some unknown offshore companies from Cyprus won the tenders.

Therefore, respondents said that it is not a secret that if a company has connections with powerful oligarchs and representatives of authorities, the business is going to be more or less secure; otherwise it could be in great danger.

In general, all experts unanimously agreed that politics is a business project in Ukraine; the primary motivating factor underlying all political decisions is the accommodation of the business interests of deputies and various state officials who own or act on behalf of a significant share of businesses in Ukraine.

Subsequently, ELA1 stated that in his opinion, though capable causing significant changes in individual characteristics of institutional environment, even elite group of MNEs cannot and are not really interested in politically influencing any systemic changes in Ukraine.

### **7.2.10 Scope of corruption accompanying and supporting the process of merging political, economic and criminal powers in Ukraine**

To demonstrate the scope of merging powers and corruption in Ukraine and what foreign investors are facing upon entering the Ukrainian market, we present a detailed account of a case of corruption provided by the executive director of a small domestic construction firm (PPSB2), a representative of the auxiliary group of our research sample.

All interviewed experts unanimously agreed that redistribution of the land titles is one of the most corrupted spheres in Ukraine. Moreover, even though the major phase of land redistribution, which started in 1991, was over by the 2000s, today it remains the most attractive domain for disputes of corrupted officials over their influence and ownership rights of certain territories. In this process the largest share of state land was divided between high ranking state officials practically free of charge. The following case is a vivid example of this.

A high ranking local-level state official decided to divide in to smaller pieces and sell his misappropriated 35-hectare or 35000 square meters piece of land that had previously belonged to a large industrial plant which lost its rights to it without any compensation in the mid 1990s due to high corruptive pressure on local authorities from its powerful prospective owner. Obviously it was not the only lot under the ownership of this particular boss. Other powerful persons, including local, regional and state officials, had also similarly gained control over the plots of land formerly belonging to the state. What is distinctive in this case is the fact that no titles had been officially transferred to the persons who had gained control over this land. Instead, either the plots were tacitly acknowledged as their respective possessions, or the deeds were transferred to third parties or companies based on rental agreements. In any event, the official in question decided to divide his 35-hectare plot into smaller plots and sell them.

He transferred the land into the possession of a small construction company PPSB2, in which he unofficially owned 90% of the shares. PPSB2 then divided the land into approximately 900 small lots of 32 square meters each and rented them for

\$1,500 per lot to interested parties under the provision that they acquire it for the construction of small summer houses. In reality both parties secretly agreed that this rental contract was actually a sale contract. At the time of transaction PPBS2 had no legal ownership rights to the land and could not sell it. So, the actual buyers had no ownership rights to their lots in accordance with their official rental agreements. In other words, they consciously became accessories to corruption and assumed very high risks by investing in this illegal project.

At this point more than 900 people were involved in this corrupt project managed by the top local state official.

After this state of affairs had persisted for several years almost all available lots had been 'sold' and the PPBS2 began the official process of land registration. To complete this process the company needed to obtain the legal permit for the allotment of land meaning its official transfer from the state to the company. The State Agency on Land Resources in Kiev, capital of Ukraine, is the institution responsible for the oversight of such activities. The PPBS2 representative had to pay a \$25,000 bribe to someone at this agency to issue the official transfer and entitlement document. Additionally, a further \$15,000 of bribes was distributed between other state agencies and authorities in the following proportion:

- \$7,000 paid to someone from the Health and Safety Agency in return for a permit attesting that the state of the acquired land satisfied all the requirements for the construction of small summer houses.
- \$3,000 was paid to representative(s) of the Fire Inspection Agency for a document confirming that the company territory development plan met all the standards stipulated by fire safety rules and regulations such as, for example, availability of driveways of the appropriate size, fire hydrants, etc. It is worth noting that in fact none of these conditions had been fulfilled up to the time of the interview.
- the last \$5,000 was paid to the Electric Agency for the allocation of a kilowatt limit and permission to install transformers and electric cables.

In sum the representative of PPBS2 paid \$40,000 in bribes. All the bribe money was collected from the owners of the lots. Moreover, each of the small lots' owners spent another \$10,000 on the registration of their ownership of the land. Thus, approximately \$9 mln. were distributed among various state officials as bribes. The state official who owned the land did not spend a penny out of his pocket but made approximately \$1,350,000 (900 lots x \$1500 each) of pure profit out of this illegal endeavor. Of course neither the state officials – bribes recipients nor the owner of the land declared their income and paid any taxes on it to the state.

This case is indicative of the scope and the scale of corruption in Ukraine. It provides evidence of a strong network of corruption including state official at all levels. Moreover, it demonstrates that numerous employees of various state agencies and organizations can benefit substantially from even the sale of such small plots of land. Based on this evidence it can be deduced that Ukrainian state officials are absolutely uninterested in fighting corruption in the country.

#### **7.2.10 Bargaining power**

The findings from this research provide evidence for a 'blind bargaining' hypothesis in the case of all industries and for the relevance of the political bargaining thesis in transition countries. The respondents representing industries that are strategically important for the ruling elite indicate that their bargaining power increased in proportion to these elites' reliance on their services.

All but one large MNEs with an exclusive status in the global economy declared that their bargaining power did not change or decreased slightly due to a natural course of development. Under certain circumstances, their bargaining power can increase as witnessed by SL1, one of the partially state owned MNEs belonging to the elite group in our research sample. This is usually the case when the progress of certain state policies and programs or prosperity of businesses with strong political connections is dependent on or benefits from the presence of such companies.

For example, the above mentioned transport and logistics company SL1 revealed that powerful financial industrial groups in Ukraine were interested in their presence due to their lack of relevant expertise and reluctance to risk the investment of large

amounts into projects necessary for the development of their business and the growth of their competitiveness in the world market. Here, the danger exists that upon the completion of such a project the relevant MNE can lose at least part of its bargaining power. The extent of this fall in bargaining power will depend on the company's status in the global economy and its ability to protect its rights and interests. In this particular case the subsidiary under consideration most probably will be able to secure its bargaining position due to the privileged status resulting from its partial home-state ownership, reputation and its origination from a very strong and reputable developed country actively protecting the interests of its businesses around the world.

Overall, the experts interviewed suggested that by their nature such companies possess substantial resources, international expertise and well established mechanisms of interaction with and influence on various state institutions and power. While most of the interviewees from this group of companies indicated their dissatisfaction with multiple elements of the Ukrainian business, economic and political environment in contrast to other groups of foreign investors they actually have the capacity to protect their interests.

One of the main sources of sustainable bargaining power for large-scale joint ventures and MNEs, especially from developed countries, is the support of their home state governments and embassies. An ideal example of the importance of such support can be found in the attempt to force ArcelorMittal to sell its business in Ukraine for a pittance. In spite of the company's status in the world economy it was harassed with numerous inspections. The tax authorities rejected the company's absolutely legitimate request for refund of its value-added tax. Experts are convinced that without vigorous backing of the MNE by the French government even such an industrial giant as ArcelorMittal would have to give in to the illegitimate pressure from Ukrainian authorities and sell the company on unfavorable terms.

Both experts and representatives of the companies with iFDI claimed in the interviewees that the foreign investors' pro-activeness, changes in the strength of their bargaining power and effectiveness in defending their interests to a great extent



depend on the status, experience, personality, reputation, relational resources and other characteristics of the manager or CEO.

Low- and mid-range profile foreign investors, including less developed countries' joint ventures and companies with private investors, agree that they have never possessed any bargaining power in Ukraine. The majority of such companies believe that their bargaining power was significantly higher in the 1990's as compared to the present time and point to the skyrocketing corruption and deterioration of the rule of laws as some of the main causes of these changes. It is noteworthy that the latter statement is not supported by the official data on corruption provided by Transparency International (2014). According to their assessment corruption perception index was quite stable over the discussed period. Further more detailed both qualitative and quantitative studies of such sensitive topic as corruption could help explaining this controversy.

Overall it can be inferred that elite MNEs are the only group of foreign investors' that can claim to possess a certain degree of bargaining power in Ukraine. All the rest of the foreign investors insist that they do not have any bargaining power in Ukraine.

#### **7.2.12 Summary**

This section of the qualitative study addressed the first research question on the applicability of existing bargaining frameworks, including obsolescing, political and 'blind bargaining' models, to various groups of companies with FDI in Ukraine. This analysis shows that obsolescing and political bargaining models are not sufficient for explaining and understanding FIs – host state bargaining relationships in transition countries. First of all, both models focus only on the analysis of MNEs' characteristics and bargaining behavior in recipient states. Neglecting or failing to account for other groups of FIs significantly decreases explanatory power of both tools in neo-patrimonial states. Development of a "blind bargaining" model, acknowledging that host country decisions are driven by the interests of the ruling political-economic clans for increasing their businesses' competitiveness and

distinguishing two types of FIs, such as real and pseudo-FIs, allows capturing differences in their respective goals, resources, and constraints.

This part of the study provides evidence that real iFDI, particularly middle and low-profile FIs, face multiple additional pressures and constraints in neo-patrimonial states. Primary sources of FIs' concerns in such countries include loss of competitiveness to and pressure from pseudo FIs due to their stronger tacit relational resources, local experience, and knowledge; merging political, economic, and criminal powers; behavioral inconsistency and conflict between demands of different state authorities; corruption; raiding.

### **7.3 Foreign investors' political behavior and patterns of interaction with institutional environment in Ukraine**

#### **7.3.1 Foreign investors' organizational structure of relations with host state institutions**

##### **7.3.1.1 Low- and mid-range profile foreign investors – in-house organization**

This research revealed several patterns with regards to various categories of foreign investors' perceptions and approaches to the management of their relations with host state institutions. Very distinctive are the facts that no low-profile investors and only half of mid-range profile foreign investors have a systemic vision of company government relations or perceive a potential benefit from establishing specialized units responsible for strategic interactions with Ukrainian institutions (such as, departments for corporate government relations or affairs, corporate public affairs or lobbying).

The primary reasons for this stance are a lack of financial and relational resources and the predominantly illegitimate nature of claims which representatives of state authorities impose on companies. As a result, low- and mid-range companies with FDI opt for low-profile behavior. Staying out of the spotlight of corrupt state officials helps them to protect their operations and increase the chances of their businesses' survival in Ukraine.

However, no matter how much these companies try to escape excessive intervention by the Ukrainian state authorities, as legal business entities they still have to report to multiple, predominantly regulatory, bodies on various issues. These interactions are handled by specific functional field specialists; for example, manager and certain specialists of tax departments deal with all tax-related inquiries, legal consultants are in charge of all legal and court matters, executive directors and employees of health and safety departments deal with fire, sanitary, and health and safety inspections, etc. The directors or CEOs are responsible for all general government relations issues and unresolved functional problems that are passed on to them by various departments.

#### **7.3.1.2 Elite MNEs and the higher middle-range profile foreign investors – in-house organization**

A half of the mid-profile foreign investors' and elite MNEs' organizational structure of relationship with regulatory state authorities on routine functional issues is similar to the one adopted by low- and the other half of mid-range profile foreign investors. However, in contrast to the latter group, all the interviewed elite MNEs had public, international or government affairs or relations specialist positions or specialized public relations, international relations, corporate affairs and/ or government relations departments (further referred to hereinafter as government relations departments).

Government relations departments' main objective is to ensure a favorable climate for successful development of their businesses. Respondents report that accomplishment of this goal requires performing most of the activities comprising the full cycle of issue management analysis and policy-making. The former includes environmental scanning, issues identification, issues monitoring and/ or strategy formulation, strategy implementation, and evaluation.

All interviewees declared that primary concern of their work in this domain is legislation and decisions of various state authorities that could have a negative impact on the operations of their businesses in the country. They said that the success of their mission consisted in achieving the most favorable outcome for the qualitative

growth of their businesses depends upon their efficient consolidation of two mutually supportive lines of work in reshaping institutional environment, namely persistent continuous analysis of existing and forthcoming legislation and normative acts and cultivation of trusting reputable relationships with decision-making state officials. These relationships are a critical source of MNEs' bargaining power in the process of their negotiations with state officials.

### **7.3.1.3 Subsidiary - head office interactions on the subject of relationships with Ukrainian institutions**

All respondents representing elite MNEs' subsidiaries in Ukraine claimed that they are not dependent on head office directives in their interactions with Ukrainian public institutions saying that they are only required to inform their colleagues in head offices about the results of their issue management analysis, their planned responses to any identified problems and their proactive strategic initiatives with regard to the institutional landscape in Ukraine. Their relationships with the head office and other subsidiaries' departments are of a strictly consultative nature. Moreover, 40% of these research participants emphasized that they are competent to manage not only all Ukrainian institutional dilemmas but also wider post-Soviet, CEE and SEE regional issues of this nature without referring them to head offices.

Low- and mid-range profile foreign investors, by contrast, admit that they are much more dependent on their headquarters in their host-country institution-building strategic decision-making and activities.

### **7.3.2 Branches of power and levels of foreign investor – state interactions**

A clear distinction can be seen in the patterns of low- and mid-range profile investors' and elite MNEs' involvement in relationships with various branches of power at different levels. All elite MNEs representatives declared that they are highly involved in and constantly seeking dialog with both the Ukrainian population and the authorities.

Naturally, elite MNEs are very actively building their relationships with local authorities and communities in regions where their production facilities or offices are

located. These are primarily local regulatory bodies responsible for, e.g., tax, health and safety, fire departments, and customs.

These foreign investors said that they also work a lot with local communities by investing significant resources into various projects based on the principles of corporate social responsibility. For example, PFBT1, as a leader in its sector, supports programs on healthy eating and healthy life style. In pursuit of these goals the company has built various sport facilities for the public. Additionally, to encourage the adoption of this new culture by the general population, the firm's government and public relations staff work persistently with local district, city and regional authorities. PA1 was an organizer and sponsor of book fairs and public educational lectures on various pressing and general issues.

At the national level, elite MNEs have access to, and actively cooperate directly with, cabinet of ministers, the Presidential Administration, and the parliament (Ukrainian: *Verkhovna Rada*). Interviewees emphasized that direct access to these critical decision-making centers provides them with a certain bargaining leverage and advantage over their competitors.

Public Relations Director at PFBT3 explains that:

Strong global players like our company feels much more secure in Ukrainian and similar markets due to its access to high level host, home, and international authorities.

As mentioned above, both low- and mid-range profile investors prefer avoiding any unnecessary contacts with any authorities at all levels due to a lack of resources and a fear of being noticed and, as a result, becoming victims of extortion by corrupt authorities.

### **7.3.3 Foreign investors' impact on institutional environment in Ukraine**

EJ1 suggested that to identify the impact of foreign investors on institutions in Ukraine, first of all, it is necessary to categorize investments by their status, relational resources, and scope of operations.

Three representatives of the elite group, large MNEs from developed countries that were pioneers among foreign investors in Ukraine (starting their operations there in the very beginning of the 1990s), claimed that they were very active in their attempts to contribute to the establishment of high quality institutions in the country, in general, and all rules directly affecting the activity of MNEs in the industry, in particular.

PFBT1 stated that from the very first day of the company's operations in Ukraine in the beginning of the 1990s, the company management was involved in attempts to actively influence the country's leadership through various channels and by different means including but not limited to participation in foreign investment forums, presidential foreign investment councils and boards, and collaborating and maintaining constant dialog with all authorities and officials offering various options for future development in the field.

Interestingly, the same interviewee called special attention to the fact that even though his company is still very successful in its ability to influence and reach the desired results even on extremely complex issues; recently this has required much more effort and become more difficult than was the case in the past.

All interviewees unanimously agreed that pseudo-FDI undoubtedly has a negative impact on the institutional environment in Ukraine.

Additionally, expert EJ1 insisted that foreign investment whose inflow is supported by different state institutions has a neutral or even negative impact on institutional arrangements in Ukraine because inherently such FDI cannot change the existing system of the corruption of power in the country. Due to the fact that these investors directly negotiate with the authorities whose representatives are motivated, first of all, by their personal private interests in attracting particular investors, the latter are actually becoming a part of a state protection racket system and, as a result, can be considered as an integral component of the existing corrupt system.

As a result, it can be inferred that presence of both of the last two discussed iFDI types do not improve either investment climate or institutional environment in the

country because inherently they are not real iFDI but one of the elements of existing shadow economic and political market system in Ukraine.

#### **7.3.4 Channels and instruments of influence**

Expert EINGO1 said that at the time of the interview (August 2012) the identification of the channels and means by which companies with FDI attempt to initiate some changes in the institutional environment and to fill multiple existing institutional voids in Ukraine was a very challenging task. He said that either the state system as a whole was going through a major crisis, or a crisis of the ruling elite at the time (under the presidency of both Vikto Yushchenko and Viktor Yanukovich) was underway, or Ukraine was even experiencing a crisis regarding its very nationhood originated in the failed promises of the Orange revolution in 2004. This crisis, he said, had led to a loss of responsibility for, and consistency in, decision making, resulting in a radical deterioration of trust in public officials at all levels.

These remarks have at least to some extent been borne out by the events that led to the collapse of Yanukovich's presidency in February 2014 (one and a half years after the interview), followed by the annexation of Crimea by the Russian Federation and the rise of separatist movements in eastern Ukraine.

##### **7.3.4.1 Relationships with authorities and corruption**

EINGO1 asserted that 10 years previously to reach a certain goal it was enough for both domestic companies and foreign investors to lobby their interests using economic, political, administrative, relational and corrupt channels. The choice of certain combinations of channels and relevant instruments depended on the issues, the company's ethical principles and the strength of its bargaining power determined by the company's status in the world economy.

For example, in September 1997, the large Korean automotive industry MNE Daewoo, using economic, relational and corrupt channels, was able to lobby for the passage of the law "on promotion of automobile production in Ukraine", which significantly improved its competitiveness and increased its profitability in Ukrainian market. The outcome of this company's effort was legislation remaining in force for

a long period (until now), which, not only made it unprofitable to bring used cars into the country, but also to establish favorable conditions for the lobbying company by – among other things - significantly increasing duties for its competitors.

It is noteworthy that in this case decision makers were committed to their agreements. The law remained in power even after the Korean investor left the Ukrainian market.

Nowadays, by contrast, this stability, security and long-term commitment to decisions - even those secured by corrupting state officials – have almost completely eroded. Any company, either domestic or with foreign investments, can still successfully lobby its interests. However, in contrast with practices prevailing earlier, officials receiving a better offer or an order from their official supervisors and/or unofficial bosses can override their previous decisions or issue new laws, decrees or court rulings which, though they do not annul the benefits created by the previous law provide better working conditions and leverage for competitors.

The most vivid illustration is the case of ‘Livella’, a pseudo-FDI company with FDI in oil and gas industry. This company was somehow able to obtain a court ruling that allowed it to import its products into Ukraine without import duty, excise tax and value-added tax. As a result, this company became an industry leader in Ukraine and, according to different sources, controlled approximately 40 - 50% (Auto-consulting, 2011) or even 80% (News oilru.com, 2011) of the oil market in Ukraine.

Based on this evidence seventeen out of twenty one interviewed experts conclude that at present in Ukraine personal relations and friendship with members of the ruling elite and representatives of the parallel criminal hierarchy are the most efficient channels for companies to exercise influence on the institutional environment. Respectively, this dependence on incumbents’ perception and almost absolute absence of fair mechanisms controlling the changes in institutional environment greatly decreases the confidence of all businesses, including foreign investors’, in the security of their future operations and even continued existence in the country. This, in turn, partially explains the reluctance of new foreign investors to



enter, and the growing tendency of existing foreign investors to exit, the Ukrainian market.

Under such circumstances it is also not surprising that the fear to become public and to reveal any information about them grow into the most important problem for low and mid-range profile foreign investors. Three quarters of these companies explained that very often they just literally hide from any public involvement, assuming a very passive position and, as a result, avoiding any attention. Therefore they usually do not participate in any forums, round tables and any other activities through which they could contribute to filling the existing institutional voids and to initiating changes in the institutional environment.

#### **7.3.4.2 Other channels**

The huge chasm between elite MNEs on one hand and low- and mid-range profile foreign investors on the other with respect to their ability to protect their businesses in Ukraine leads to significant differences in means at their disposal for voicing their concerns and opinions and for providing advice to officials on various institutional issues.

All elite MNEs, half of the mid-range profile foreign investors and foreign contractors working in Ukraine also identified international arbitration as an efficient means of protecting their companies' interests in Ukraine. For example, PIFC1 disclosed that at the time the interview was conducted his company was involved in international arbitration case with a state of Ukraine regarding the collection of their receivables. The company representative clarifies that initially the company tried to resolve the issue locally but due to the lack of success of such attempts and approaching a three-year term limitation to claiming the rights they had to initiate and international arbitration case.

Moreover, Director of PIFC1 reveals that:

It is not the first time we have to turn to international arbitration to receive full compensation for our work in Ukraine. We have already

completed several large state projects in the country and in approximately half of the cases we had to take the same route.

All representatives of elite MNEs also declared that their primary channel of communicating both with authorities and the public was domestic and international mass media. They stressed that their close cooperation with various media outlets enables them to reach out to very wide audiences and, as a result, ensured that their thoughts are conveyed to both authorities and the public. By contrast, due to the vulnerability of their position in Ukraine and fear to become public (as discussed above) mid- and low-range profile foreign investors completely reject mass media as an instrument for protecting and promoting their interests.

Elite MNEs representatives also pointed out the role of various international and domestic business and professional organizations including the European Business Association, American Chamber of Commerce, European Trade Chamber, Ukrainian-American Business Council, and multiple domestic industrial business associations. Foreign investors spoke in varying degrees about their confidence in the ability of representatives of such organizations to promote their members' collective interests due to collectively invested into them authority and resources have better chances.

Every foreign investor, regardless of status, country of origin, form of ownership and investment decision rationale, acknowledged the significance of informal connections as one of the most efficient means and channels for promoting its interests and resolving its problems. It is through this channel that they are able to secure the access to officials that enabled them to directly communicate their ideas and concerns in personal meetings.

Elite MNEs also identified regular communication and cooperation with officials at all levels as a very efficient instrument for strengthening the company's position in the market, reinforcing its reputation, and forming and developing a company culture of interactions with and impact on the Ukrainian institutional environment, and in particular the cultivation of relationships with state officials at all levels.

### **7.3.5 Relationships between a level of the institutional framework's development, operation and cooperation modes**

Interestingly, experts emphasized that the choice of channels, instruments and cooperation modes of companies with FDI in undertaking their political activities depends on their choice of an operation mode in Ukraine. Here foreign investors should be automatically divided into two categories: those businesses which adopt a Ukrainian operation mode and those which prefer to preserve their reputation and maintain their transparency.

The Ukrainian mode of operation in business allows businesses to minimize their costs and expenses, since in Ukraine each business has an option to decide either to pay taxes or not. In the latter case, companies do not register their real profits officially; instead, they unofficially pay a certain percentage to state officials (usually it is approximately 8-10% of company turnover) and pay very low official salaries making up the difference to their employees in envelopes distributed to them unofficially. Transparent businesses, of course, truthfully report all their transactions and profits.

Both fully and partially foreign owned companies choosing the first mode have no recourse to official legal mechanisms such as involvement of public, various media resources, investors' coalitions, home country embassies, international diplomacy, and some other resources because they are afraid of publicity, public investigations and ensuing punishments. In most cases, to achieve their goals they either work independently or organize small special interest groups by cooperating with similar domestic businesses, resorting to such unofficial means as relational resources, 'speed money', corruption, etc.

Elite MNEs admitted that even their mode of cooperation with state institutions had changed significantly in the last 7-10 years. The Head of the Public and Government Relations Department at PFBT1 said that in the 1990s most elite MNEs contributed to the improvement of the institutional environment in Ukraine through independent efforts. Foreign investors had required expertise and resources to fill the omnipresent institutional voids in the country.

However, in the mid 2000s the situation changed. Thanks largely to foreign investors' efforts, a Ukrainian institutional framework, though still highly underdeveloped, had been established. At this point independent efforts to bring about desired modifications of its elements became inefficient. Even though in certain cases the elite MNEs' status, transparent operation mode, and tangible and intangible resources would still allow them to independently address specific urgent and pivotal issues directly affecting the development of their businesses in Ukraine, in general interactions between foreign investors and the public sector regarding institutional issues transitioned from the individual to the collective domain.

According to the Head of Corporate Affairs Department at ST3, the fact that, in spite of all the available resources, most of the elite MNEs and mid-range profile foreign investors opt for collective models of promoting their interests and negotiating changes in various spheres of their operational environment in Ukraine is due to the systemic nature of the current problems that foreign investors, in particular, and all business entities, in general, face in the country. For example, he pointed out that tax reform is a systemic issue which could never be effectively addressed by the uncoordinated independent actions of individual entrepreneurs or companies.

### **7.3.6 Professional and business associations**

#### **7.3.6.1 International professional and business associations**

Mechanisms of interaction and communication between state and business are in place. However, the only efficient entities in this field are the European Business Association (EBA) and American Chamber of Commerce (ACC). These two organizations are very actively engaged in 'civilized' lobbying at the state level on a constant basis. Their work is characterized by systemic approach. The involvement of specialists from these international associations in the development of the Tax Code is a very good piece of evidence that even though high quality mechanisms of interaction between state and business such as ACC and EBA are in place they are viewed as a pure formality by Ukrainian authorities and overall, with rare exceptions, do not work.

The first draft of the Tax Code was a product of joint efforts of the Ministry of Finance and Tax Administration (Governmental Portal of Ukraine, 2009). The representatives of PFBT1, PFBT3, ST2, ST4 and SBF3 reported that the quality of the output was so low that even representatives of pro-government businesses stood up against it. In response the government formed a second committee which included representatives of pro-government large business and EBA and ACC specialists representing foreign investors' interests. This committee produced the new improved version of the Tax Code written in accordance with the international norms and standards accepted in developed countries, which seemed to satisfy all parties. However, as soon as it was adopted and came into force, an EBA poll showed that 37% of EBA members, including both foreign investors and domestic companies, were not satisfied with its quality. Only a minimal percentage of businesses were satisfied (EBA, 2012).

The reason for dissatisfaction did not lie in the content of the Tax Code itself. The problem lay rather in the fundamental institutional voids related to law enforcement in Ukraine, giving rise to omnipresent informal relations that circumvent official regulation. The effect of the Tax Code in this environment was to create more opportunities for inspections by the tax authorities, which was exactly what tax officials were looking for. Since the Tax Code was introduced they have been allowed to intrude into any company at any time at their wish and convenience without any restrictions on the number of inspections. Moreover, during their official investigations tax inspectors are not guided by formal rules. In fact, according to all low- and mid-range profile foreign investors and three fourth of experts interviewed, they completely ignore them and terrorize businesses extorting taxes from them in amounts necessary to meet both their formal officially assigned norms on tax volumes, and their informal personal corrupt needs.

One of many examples is the way in which the guidelines for calculating income tax are completely disregarded on purpose. According to the Tax Code enterprises can carry their losses forward consolidating their losses from previous years and current profit and pay the income tax on this difference. Nevertheless, all low- and mid-range profile companies with FDI testified that tax inspectors simply overlook

this rule and do not allow enterprises and businesses to apply it unless they make it worth the inspections' while. The latter is just one out of multiple examples exposing shameless tax officials' behavior which is in direct contradiction with established norms, rules and laws.

Overall the analysis of interaction between the state and such business associations as EBA, ACC, US – Ukraine Business Council, which allows membership only for American companies, and other similar organizations reveals double standards and double-cross approach of Ukrainian authorities to their cooperation. On one hand, Ukraine plays by the rules of the developed world and satisfies the requirements with regard to the norms of civilized lobbying through allowing participation in and certain degree of influence by international professional and business associations on the law-making process. On the other hand, when it comes to the final law-enforcement phase of this cycle respective authorities just cross out all the rules formalized at the previous stages and continue to play by their own informal illegal rules, for example, through discretionary law enforcement.

#### **7.3.6.2 Domestic professional and business associations**

Whereas international professional and business associations actively try to fill existing institutional voids and bring about some positive changes in the Ukrainian institutional environment, domestic industrial and professional associations are not effective in Ukraine at all in this regards. Experts stated that, first of all, policy makers pay no attention to public opinion in Ukraine even when it is expressed by legitimate public organizations. Accordingly, professional and business associations are not viewed as powerful entities capable of promoting and protecting the interests of their members.

Overall, both experts and foreign investors interviewed characterized them as passive 'pocket organizations' which are only created for show and most of which do not even try to represent business interests, especially those of smaller producers. Both FIs and experts almost unanimously claimed that:

Domestic professional and industrial organizations are highly efficient only in cases when they serve as a vehicle for achieving certain goals of powerful FIGs representing the interests of political elites.

Second, interviewed experts said these domestic organizations do not have a systemic approach to their work. Their inconsistency and absence of persistence in pursuit of their members' interests demonstrate their lack of lobbying culture. ELA1 provided an example:

In the port industry industrial associations exist but they are very passive. They do not understand that promotion of their industrial interests requires a systemic approach and work. In general, they just simply do not believe in their ability to affect any changes.

However, in line with the previous statement it must be noted that opinions of the interviewees differ depending on the industry and status of their company. The stronger MNEs are much more optimistic in their judgments of various business associations. While all elite MNEs, all mid- and half of low-range profile foreign investors named American Chamber of Commerce (ACC) and European Business Association (EBA), the most efficient organizations promoting industry and business interests, the other half of low-range profile foreign investors and all domestic actors do not believe in the operational efficiency and usefulness of any kind of associations, including the international ones.

Only representatives of the banking and financial services sector and the trade sector consider their domestic Association of Banks of Ukraine and Ukrainian Association of Direct Sales, respectively, to be efficient and helpful. All representatives of both economic sectors referred to the pro-activeness, efficiency and positive impact of the work of these professional associations on their operations in Ukraine. Meanwhile, representatives of agricultural industry insist that even though that had some minor influence on institution-building process in Ukraine the situation changed in 2010. They affirm that at the moment they have absolutely no either individual or collective power over the institutional changes in the country.

The same can be said about state investment agencies in Ukraine. Interviewed experts claimed that state investment agencies set up conferences and round tables with the purpose of attracting investors but the treatment of companies with real foreign direct investment is deteriorating in Ukraine. Only elite companies which have connections with representatives in government get preferential treatment and flourish monopolizing local markets and obstructing competitiveness of low- and middle-range profile foreign and domestic companies.

### **7.3.7 Open dialog and programs for attracting foreign investors in discussions on problems of institutional environment in Ukraine**

ELA1 asserts that mechanisms of influence and interaction between various business representatives, experts and state authorities are in place. For example, representatives of ST1, ST3, PFBT1, and PFBT2 informed that Ukrainian Custom Services were very pro-active in initiating a constructive dialog with business. The top managers were invited to participate in discussions on the changes in the Customs Code of Ukraine. All interviewees from the trade, food, beverages and tobacco, and chemical industries also reported that Ministry of Economic Development and Trade continuously encourages their participation in specialized working groups analyzing various topical issues of their concern.

However, in spite of evidence provided by these foreign investors, experts insist that in most cases business state cooperation mechanisms are pure formality. According to the Director at ST2:

The authorities rarely have intentions to take into consideration or follow recommendations developed in the course of events or programs they organized unless such recommendations, laws or any other outcomes serve their interests. Usually, for them it is just an activity to mark off their calendars.

An example of this attitude can be found in the drafting and passage of legislation serving the business interests of one of the largest and most powerful vertically integrated holdings in Ukraine. In accordance with its business development strategy this FIG was planning to undertake a certain investment



project. However, for that purpose they first needed to develop and pass a law. As a result, they addressed ELA1 as an expert in this field with a proposition to work on this law. Our interviewee agreed to participate in this project and explained that the company would need approximately a year to analyze the existing situation and legislature in this segment, work out a thorough strategy, select tactics on realization of this strategy and write up the law.

However, the client-company wanted this law to be ready within less than a month. ELA1 refused to participate in this project under such conditions because it was not feasible to produce a good quality legislative document within such a narrow time frame. Ironically, the FIG found someone else who prepared the draft legislation within a month. However, due to its overall weakness and multiple flaws this piece of legislation was passed only after one year and three months. And even then, given its very low quality, determined by the lack of thought and crudity, it could not efficiently serve even the original FIG's investment initiative.

According to legal and academic experts and journalists this state of affairs is the norm rather than the exception in most Ukrainian legislative, regulatory and administrative projects. Even all representatives of the elite MNEs group admit that, even though there is an open dialog and multiple programs for attracting companies with FDI in discussions of the problems of the institutional environment in Ukraine, the ability of such companies to gain a hearing for their concerns is weakening. They acknowledged that Ukrainian authorities and officials pay less and less attention to their recommendations and approve and implement fewer and fewer of them.

### **7.3.8 Foreign investors' participation and interests in the institutional reform process in Ukraine**

Nevertheless, all legal experts and representatives of elite MNEs interviewed declared that they are actively and continuously involved in the policy making process in all spheres related to their operations in Ukraine. Due to the omnipresence of institutional voids in the country foreign investors of this caliber are seeking to contribute to establishing new or improving existing rules and norms in domains

accommodating political, economic, social, environmental, distributive, regulatory, constituent and other miscellaneous issues.

To ensure the desired quality of outcomes of their efforts, elite MNEs cooperate with all branches of government at all levels and at all stages of policy cycle including issue identification, policy analysis, policy instrument development, consultations, coordination, decision-making, legislative, implementation and evaluation. Representatives of this group stated that they are working with in-line legislation on a constant basis. They are also independently and as members of various interest groups, business and industrial associations continually assessing the quality of new legislation and normative acts, analyzing proposals for new laws, and submitting their own proposals with accompanying documentation and analysis to the relevant parliament committees. The latter, in turn, consider these proposals and transfer them with their recommendations and corrections to the Verkhovna Rada which makes the final decision either to pass or reject them.

It is noteworthy that 5 out of 12 elite MNE subsidiaries disclosed that their market position, status in the global economy and relational resources secure them enough power to be able to influence the destiny of the legislation even at the stage of its signing by the President. In cases when the Verkhovna Rada's recommendations contradict these companies' or industry's interests, they ask for a personal meeting with the President. During such meeting they report to him the results of their analysis, their arguments and all possible negative effects on and consequences for businesses, industries and the state such as, for example, lower investment and tax revenues.

Based on the evidence presented by MNEs the President further decides whether to veto the law completely, return it to the Verkhovna Rada with his comments and recommendation for revision or approve it as is. Sometimes the outcome of these legislative negotiations both at the Presidential and Verkhovna Rada levels will depend on the presence and bargaining power of other vested interests such as political elites representing their businesses (including multiple pseudo-FDI holdings and various large domestic FIGs).

One of the most scandalous examples of this was a government attempt to monopolize the grain market by enforcing quotas on grain export. Initially there was just an informal ban on shipping the grain to all the companies except one owned by the President's friend. Later, the Ukrainian government formalized this in the form of quotas all of which were allotted to the aforementioned privileged company. In response to this discrimination on the side of foreign investors protested and eventually, after a long negotiation the quotas were annulled. Unfortunately, justice had been restored too late. By that time all the foreign investors and local business that had suffered as a result of this discrimination had lost their money (Polovec & Xeruvimova, 2011).

In contrast to the practices of the elite MNEs, interviewed representatives of the more active two low- and three mid-range profile foreign investors stated that their involvement in the policy making process is restricted to round-table consultations and the evaluation stages of the policy cycle due to their lack of resources and expertise. Meanwhile the rest nine and three passive representatives of these groups, respectively, admit that in addition to those factors, their lack of any initiative - indeed in all cases complete self-exclusion from the institution building process in Ukraine - is primarily motivated by their self-preservation instinct. As discussed above, they prefer to stay out of the spotlight to avoid the undesired attention of state officials and of politically connected businessmen.

In general, all interviewed experts pointed out that the successful involvement of foreign investors in creating a more favorable working environment through their attempts to initiate and influence institutional changes is feasible under certain conditions. First of all, it is necessary to cultivate informal relationships and making informal agreements with state officials. Second of all, if foreign investors want to preserve their reputation and sustain transparency of their business operations they need to concentrate on staying out of sight of influential and powerful figures. Getting into the sight of such hungry predators will result in significant losses for them.

### **7.3.9 Legislative changes supported by individual and collective actions of foreign investors in Ukraine**

#### **7.3.9.1 Successes and positive outcomes for businesses**

Interviewees representing elite MNEs provided evidence of their active engagement in and contribution to the filling of institutional voids and changing of inefficient elements in the institutional environment in Ukraine.

The Head of Corporate Affairs Department at ST3, for example, declared that his company along with other independent business representatives, members of various business associations, of Ukrainian Antimonopoly Committee was invited to participate in an effort on the development of an absolutely new Law on Domestic trade in Ukraine sponsored by one of the Ministry of Economics' working groups. He emphasizes that very distinctive in this particular case was the group organizer's positive attitude towards, attention and responsiveness to the input and advice of business representatives.

Among other successfully altered laws relevant to the work of elite MNEs operating in services representative of the relevant companies named the Customs Code, various technical regulations, and the Tax Code. In the latter case they emphasized their role in dissuading law-makers from increasing taxes for small and medium size enterprises (SMEs) and persuading them to actually reduce the tax burden on this group of businesses.

All interviewees representing agricultural industry, namely PA1, PA2, and PA3, disclose the success of their collective action supported by ACC and EBA in a removal of an export ban and protesting discretionary export licenses issuance to only special elite group of politically connected companies. However, they admit that their past experience taught them to distrust the promises made by Ukrainian politicians. PA1 confesses that:

Even though everything was running smooth at that moment and Ukrainian Prime Minister, Mr. Azarov, promised that the government had no intentions to reinstate export ban once again, business representative cannot

rely on his words. Unfortunately, in the past Mr. Azarov said many things which never came true. Moreover, they actually came out quite differently in reality.

### **7.3.9.2 Failures and negative outcomes for businesses**

Among the laws which were adopted without consulting with businesses and taking into account their opinions and positions; the Law on the Fundamentals of Language Policy stands out. Contrary to business interests this law included a clause which obliged companies to label their products both in state and regional languages. The first major problem was that large entrepreneurs practice pre-ordering their labels and packaging a year ahead and the law did not include any provisions determining regulations for this transitional period. The second not less significant concern for investors was that Ukraine has 18 regional languages, which meant to comply with this requirement foreign investors would have had to reissue new labels and packages in 18 languages, which would have been highly impractical and infeasible. Moreover, the need to constantly match the label languages with the respective regions to which deliveries were being made would have created enormous logistical difficulties. ST3 noted that:

The regulatory authorities did not lose any time in issuing claims for non-compliance with this law against both producers and sellers.

Another bill which passed its first reading without consultation with business was the Law on Increase of Customs Duties which proposed the increase of duties on raw materials and/or component parts not produced in Ukraine but crucial for the functioning of their businesses. Both foreign and domestic companies will be negatively affected by the resulting escalation of prices and eventually will suffer from the loss of their products' competitiveness.

### **7.3.10 Law on Lobbying**

All the legal experts and most of the business representatives interviewed expressed confidence that the adoption of the new Law on Lobbying (registered in the Verkhovna Rada of Ukraine on October 20, 2010) will not lead to any changes in

the relationships between business and state institutions in Ukraine. They asserted that the change of business culture in the country is the *condition qua non* for any new laws, no matter how perfect, to become effective.

Backing the above statement, all of the elite MNEs' representatives explained that their political behavior and lobbying practices are identical in all host countries of their operations and do not differ from their conduct in relevant domains in their home countries. They said, moreover, that the patterns of their relationships with host countries' governments and other state officials are not affected by the imperfect lobbying laws of these developing and transition states. Even in the absence of local lobbying laws the behavior of the subsidiaries of elite MNEs is in line with their home countries' laws and corporate conduct requirements.

Interestingly, only one of the fifty experts and business representatives interviewed was actually familiar with the new Law on Lobbying and was able to provide a detailed analysis of its advantages and disadvantages and its conformity with European standards.

Emphasizing that on this particular issue he was articulating his personal view rather than a company position the Head of the Corporate Affairs Department at ST3, one of elite MNEs working in the direct sales industry, explained that the Ukrainian version of the Law on Lobbying contains several clauses which drastically distinguish it from the European and American regulatory rules on lobbying. First, it sets up a very complicated framework for the mandatory annual registering and accrediting of lobbyists with the Department of Justice and ministries of their specialization, respectively. As ST 3 said,

Given the 'high quality and efficiency' of Ukrainian bureaucracy, such complex and frequently repetitive procedures are deadly for any regular organized groups of lobbyists.

This interviewee further explains that this process is very lengthy and highly complicated in comparison to the respective regulations in developed countries. For example, in the EU any lobbyist group can simply register online by openly providing required information about a newly founded organization.

The second alarming issue is that the law does not make it clear who exactly is allowed to undertake lobbying activities. In accordance with this law, representatives of companies, particularly those with FDI, are barred from directly engaging in lobbying activities. The law introduces an intermediary institution between companies and state authorities (representative of ST3, 2012; Law of Ukraine “On regulations of Lobbying activities in Ukraine”, 2010). ST3 emphasized that, given the complexity of all registration procedures, setting up such intermediaries can be expected to be very time-consuming and until this done, businesses in Ukraine will be left with no other option but either to break the law and illegally contact government authorities directly or to fold their hands and wait for the intermediaries to be set up.

Moreover, the representative of ST3 explained that, accounting for all specificities of a Ukrainian institutional setup, especially the strength of informal institutions, merging of political, economic and criminal powers and corruption, an analyst with a good imagination can assume that the new Ukrainian Law on Lobbying establishes a legal framework for overtaking lobbying activities through formalizing corruption through the provision of intermediary institutions.

EINGO1 reinforces the above discussed accounts by claiming that both Ukrainian ruling elite and those who referred to as opposition are not interested in adoption of ‘civilized’ Law on Lobbying. That is why there are very low chances that a ‘civilized’ version will be endorsed. Even if it happens it will not affect and change in any way the existing informal mechanisms of business – officials’ relations.

All interviewed experts assert that the only way to resolve this problem is to try to overcome the existent systemic conflict of interests.

### **7.3.11 Summary**

This section explores the second and third research questions on the relationships between the FIs characteristics and their choices of political strategies and intensity of political activity in Ukraine. Developing on the findings from the previous section, it uncovers several new elements of a ‘blind bargaining’ model.

In particular, it provides further evidence that FIs' access to various authorities and ability to protect their interests in the country primarily depends on their status and personal relations with state representatives. Thus, it shows that, while elite companies with iFDI have higher capacities to protect their assets and interests and officially enforce any negotiation outcomes, mid- and low-profile FIs are more susceptible to unreliability and volatility of any host country decisions due to heterogeneity of bargaining interests of government actors.

The results of this analysis lead to unveiling two new elements of a 'blind bargaining' model: the need to distinguish between formal and informal bargaining processes and between formal and actual outcomes of such bargaining. A success in formal negotiations over various public policies in industry-specific or any other issues of foreign investors' interest does not guarantee their application to every business actor in Ukrainian market. Personal relationships with authorities and corruption are two of the most important FIs' political strategies in Ukraine. As a result, informal bargaining over the safety of FIs' assets and fair law enforcement is a crucial element of a bargaining process between FIs and host state in neo-patrimonial states.

#### **7.4 Efficiency self-assessment of the foreign investors' political activity in Ukraine**

An assessment of the efficiency of the foreign investors' political activity is a very complex task, especially in the case of a very specific system of power relations that exists in Ukraine. ELA1 stated:

Executive branch of power is a parallel world which has nothing in common with the reality. To be more precise the Viktor Yanukovich's government, in comparison with the previous Viktor Yushchenko's representatives of this branch of power, these appointees at least behave as one expects from those in power to behave, but from the efficiency point of view there is no change. All their work and decisions are completely separated from reality. They exist in a parallel world.



In this light we suggest to review several aspects of foreign investors' self-reflection on the effectiveness of their political activity.

#### **7.4.1 Degree of foreign investors' pro-activeness and success in anticipating unfavorable institutional changes**

With regard to the pro-activeness and success with which companies anticipate unfavorable institutional changes, once again we observe the behavioral patterns of the representatives of elite MNEs to be completely different from those of low- and mid-range profile foreign investors.

All representatives of elite MNEs unanimously stated that they were very consistent in their routine in-depth analysis of the overall business environment, in general, and its institutional component, in particular. They insisted that this proactive approach ensures that they can anticipate possible arising problems, decisions and events that might have an adverse impact on the operations of their businesses in Ukraine. PFBT1 explains:

We very clearly analyze, anticipate and estimate the likelihood of all possible institutional scenarios' occurrence. On a constant basis we monitor all actions of all groups whose interests are strongly represented in government. We are try to prevent approval of decisions that can either hinder our business operations or do not make any sense from the point of view of either businesses or of the state. In most cases such decisions are promoted by certain members of political elites seeking to protect and promote the interests of their businesses.

The same interviewees pointed out that various business, professional and industrial associations also try to monitor and influence all relevant institutional processes and changes with varying degrees of success.

By contrast, low-and mid-range profile foreign investors are much less optimistic about the business associations' (particularly domestic industrial associations') willingness and ability to limit the political power of vested interests and prevent ratification of decisions giving unfair competitive advantages to those interests.

Moreover, they emphasized that institutional voids in Ukraine are backed and nurtured by co-existent dominating informal institutional mechanisms and arrangements. As a result, all members of low-range profile and two thirds of mid-range profile foreign investors themselves are very passive both in terms of their analytical and operational conduct, due to their fear of retaliation for their actions and to their lack of resources and faith in their ability to cause any positive changes in the existing institutional order in Ukraine.

#### **7.4.2 Buffering mechanisms**

When asked about their buffering mechanisms and strategies 90% of interviewees representing low- and mid-range profile companies with FDI acknowledged that they are just learning to adapt to the system to survive. Moreover, they admitted that they had lost any hope in their ability to cause an improvement in the existing business environment in Ukraine.

Interestingly, all interviewed state officials representing the Departments of International Economic Activity in various regions that have been successful in attracting foreign investment noted that in the course of their work they had observed evidence of different foreign investors' action modes. Academic experts EA1, EA2 and state officials ESO1, ESO2, ESO3 revealed that beginning two to three years after the "Orange Revolution" many low- and mid-range profile real foreign investors had been frequently trying to conceal their FDI by registering their businesses as domestic ones. For that purpose they enter into agreements with small and medium size Ukrainian businesses. As a result, a mirror image of round tripping FDI is created: real iFDI masking itself as domestic investment.

The same group of interviewed experts explained that foreign investors who prefer to disguise their FDI in such ways explained that by doing so they are trying to minimize their costs and expenses and, more importantly, to avoid excessive attention and attempts by various Ukrainian regulatory authorities and state officials to extort bribes.

This mechanism allows foreign investors who choose an illegal Ukrainian business mode of operation to preserve both their businesses in Ukraine and their

reputations in their home and other developed countries. Experts explain that since officially they do not have businesses in Ukraine it becomes much more difficult to trace their affiliation with illegal conduct, such as tax evasion, dual salary payments (combining officially paid low salaries and unofficially distributed salaries in envelopes), corruption and other.

Another very important reason for hiding iFDI from authorities is foreign investors' strong desire to protect their facilities from illegal physical intrusion and their assets from illegal seizure. Experts EJ2, EJ3 and ELA3 observed that arousing the interest of the various state officials can result in raiding attempts and loss of their companies for business owners. That is why, admitting their weakness in comparison with elite MNEs, low- and mid-range profile companies with FDI become very attractive targets for raiders and, as a result, some of them decide to operate through local businesses without registering their FDI.

It should be noted that almost all interviewed representatives of low- and mid-range profile companies (both domestic and with FDI) when asked about buffering mechanisms first of all named physical protection of their assets. It is clear that the real threat of raiding attacks forces those foreign investors who legally operate in Ukrainian market, as well as domestic business owners, to literally fortify their business by improving their security systems and increasing the number of their security personnel.

Overall, representatives of both the experts and foreign investors interviewed emphasized that the main reasons for deciding to operate illegally (either disguising their investments as a local businesses or choosing Ukrainian mode of operation) are multiple institutional voids including, among others, the underdeveloped and corrupt regulatory and judicial systems and ineffective contract-enforcement mechanisms. In particular, they called attention to the complete absence of a system of control over personal and business expenses. This means that it is legal in Ukraine, for example, for the director of a large multibillion dollar business to officially receive a minimal salary of \$125 and at the same time live a luxurious life spending millions on cars, yachts, and real estate, and this will not raise any public concerns or questions. Under such circumstances any person or legal entity can report a minimal income or profits

but at the same time spend millions in any currency, and nobody is going to prosecute them for fraud. The interviewed experts noted that this is practically an open invitation to operate in the shadow economy.

Moreover, interviewed experts also agreed that any other country, even developed, if adopted Ukrainian taxation system and system of control over personal and business expenses, would observe the same percentage of businesses moving into the operational bounds of shadow economy already in one year.

Experts also suggested that the use of mass media can be another effective defense mechanism for foreign investors. However, its use is only efficient and, as a result, feasible in cases when the company with FDI is transparent and ready to become the center of intense public attention. Almost all the experts and company representatives interviewed agreed that these defense mechanisms can be effectively employed virtually exclusively by the elite foreign investors possessing strong relational resources.

A legal consultant to companies with FDI, ELA1, disclosed that he advises all of his clients that there are two possible ways of managing their business in Ukraine. The first one is to hire various experts, including lawyers, auditors, accountants, and other consultants, maintain transparency, completely refrain from any transactions involving corruption and act strictly only within the legal framework. The second one is just to go with the flow and see where you end up.

He emphasized that all large MNEs representing the elite group of investors choose the first path independent of the specificities of the host country's business environment while most of mid- and low-range profile foreign investors do not consider themselves to be strong enough to fight with the existing corrupt system in Ukraine. However, according to this expert's observations, almost every company that chose the second path regretted their decision. With time all of them realized that by committing to the prevailing Ukrainian business mode of operation they trapped themselves and, as a result, deprived themselves of opportunities to use publicity and to appeal to domestic and international mass media, the international community and

organizations, their home country embassies and other public sources with requests for help.

However, it is worth noting that some contradictory evidence provided by one of the interviewees working at one of the Regional Department of International Economic Activity in Ukraine. ESO1 informed that she was aware of mid- and low-range profile foreign investors who, as a result of operating their businesses in Ukraine not only adopted the Ukrainian mode of operating their businesses in Ukraine but also, consequently, started applying either this mode of operation, in general, or some of its elements, in particular, in other countries of their operations, particularly CEE and SEE states.

Both experts foreign investors interviewed also suggested that one of the principal buffering mechanisms for companies with FDI in Ukraine, especially elite MNEs, is national embassies. Ukrainian political elites and their businesses are highly dependent on the USA and EU countries because such a large share of their savings, business assets and real estate are held and registered in those and other developed countries. EJ2 explained that

Therefore, the threat of sanctions analogous to the ones applied in Belarus or to the Magnitsky list in Russia is extremely intimidating for Ukrainian elites.

Thus, if an ambassador from one of these countries contacts a Ukrainian official in response to the raising of concerns by a business from the country that ambassador represents, the matter will be given the immediate full attention of the authorities.

The fear is, of Ukrainian elites are largely due to the fact that according to the EU countries' legislation most of their businesses are criminal. All their companies registered as offshores in Cyprus, Austria, Netherlands, UK, USA and other developed countries conduct their business in Ukraine and not in the countries where they are registered. Taking advantage of treaties on double taxation, they do not pay taxes in Ukraine; neither do they pay them in the countries where they are registered, as their business activity is not carried out there. Of course, this is highly illegal, since tax exemptions under double taxation treaties apply to those companies in

Ukraine only if they are paying their taxes in their home countries, which they are not and this makes them vulnerable to prosecution. The Lazarenko's case demonstrated home countries' power (in this particular case, that of the USA) and resulted in the conviction of a Ukrainian high-ranking politician and businessman for committing the same crime which resulted in long-term imprisonment and a loss of approximately 90% of his fortune.

All three interviewed legal advisors insisted that it is because of these leverage members of the Ukrainian political elites are reluctant to get involved in conflicts with the US or EU embassies and are always very flexible in their negotiations over sensitive issues involving foreign investors' complaints.

Overall, all interviewed company representatives agree that comparing to the beginning of the 1990s their companies need to spend much more time and significantly increase the intensity of their effort in protecting interests of their businesses in Ukraine. Moreover, they further clarify that, if ten years ago it was making up approximately 5% of involved employees' work load, nowadays coping with issues related to their companies' protection went up to 20% - 40%, depending on the issue and company characteristics, primarily such as status and industry of operation.

#### **7.4.3 Businesses' informal relations with state officials**

In general, participation of businesses in politics can be of two kinds: direct and indirect. In case of direct participation business representatives are elected as members of parliament (MPs) or Verkhovna Rada in Ukraine at the national level or as the deputies at the regional and local levels. However, this participation model is more inherent to and popular among domestic businesses. At least, foreign investors are reluctant to disclose any information about their employees' engagement in politics.

Indirect participation includes purchase of MPs', deputies' and/or other state officials' services and political investment. All interviewed foreign investors unanimously rejected their involvement in financing political parties' or individual deputies' election campaigns in Ukraine. However, all low- and two thirds of mid-

range profile companies with FDI admit that they are forced to intentionally foster personal relationships with various state officials to secure acceptable operational conditions for the survival of their businesses in the Ukrainian market. As a result, they contribute to growth of both economic and political shadow markets in the country.

Interviewed experts emphasize that in Ukraine all the relationships with state officials are cultivated in the informal operational space. As in most transition and developing countries, foreign investors in Ukraine focus their lobbying efforts on the representatives of the executive branch of power. This choice is determined primarily by the fact that law enforcement is much more important in these countries than the law itself. Moreover, the law itself has multiple referential norms for executives. In other words, after the law is adopted the Cabinet of Ministers or respective Ministries and Departments have to develop additional numerous regulations and norms. As a result, the executives have power either to further improve and support existing legislation or completely or partially distort it. In this way, in corrupt countries even a very good law becomes useless by the end of this process. Moreover, even if the quality of the law itself is preserved and complies with the existing western standards, the discretionary approach to law enforcement allows unfair treatment of less powerful foreign investors by state officials in Ukraine (Interviews, 2012; Pryadko, 2013)

That is why those foreign investors and domestic entrepreneurs emphasized that those who want to be successful seek close ties and nourish relations with executives at various levels and/or with ‘siloviki’, representatives of security and military services. The latter group often has influence over both executives and legislators. They represent purely informal structures which very often merge with criminal structures. Therefore, in general, it is very hard to figure out if a certain security or military officer is working for himself or for his criminal boss.

LA1 described that the relationships between legitimate business and officialdom / ‘siloviki’ generally operates as follows:

As a rule, representatives of the latter groups have their businesses (referred to as ‘purses’), which are usually registered to third persons and to which the parties involved in the relationships transfer their bribes in accordance with existing agreements.

Most of the positions within the executive and security sectors can be sold. The buyer of a position within an authority first pays his supervisor a onetime lump sum bribe and then makes certain monthly or any other term payments depending on and according to their agreement. The omnipresence of such practices confirms that the conflict of interests is a systemic phenomenon in Ukraine. Experts speculate that there are no honest high ranks officials in Ukraine with the exception of may be just a few isolated cases.

#### **7.4.4 Problem of potential liabilities for political ties for foreign investors in Ukraine**

Our interviewees unanimously insist that their businesses are apolitical. Without any hesitation all categories of our interviewees also agreed that businesses’ liability for political ties is very high in Ukraine. The historical review of post-electoral events in the country provides very strong evidence in support of this argument. Every change of political power, both peaceful and revolutionary, including the most recent coup, was followed by a very active purge of all politically involved businessmen from power. Moreover, their entire businesses either endured raiding attempts or were simply expropriated with the help of law enforcement agencies and transferred to the members of new political, and, respectively, economic, elite groups.

Moreover, EA1 claimed that

The risk of potential liabilities for political ties is much higher for low- and mid-range profile foreign investors than for the same group of domestic businesses.

He explained that the representatives of the latter group usually support all leading political forces in Ukraine, securing the backing and protection for their less



competitive businesses in the case of a power change. At the same time due to higher competitiveness of their business the former group is usually a more attractive target for changing political elites which might control businesses directly competing with those foreign investors. As a result, new state officials will be interested in imposing various sanctions and fines on foreign investors to reduce their competitive abilities.

In general, all interviewed experts suggested that low- and mid-range profile foreign investors in Ukraine predominantly occupied those niches which, for one or another reason, did not represent interest for domestic businesses and were not monopolized by large domestic investors. So, overall, it can be concluded that if foreign investors suggest a project that does not represent a competitive danger for domestic businesses controlled by power elites, local and regional authorities approve such iFDI.

Such mode of business – political power relationships definitely explains passiveness and desperate attempts of all low- and middle-range profile foreign investors to hide and stay out of sight of newly elected political businessmen.

#### **7.4.5 Quality of iFDI**

All experts unanimously characterize the quality of FDI in Ukraine as very low. In particular, EA1 explains that:

In Ukraine two thirds of all industrial enterprises are under the control of foreign investors. This could be a great advantage for the Ukrainian economy if it were not for one minor detail. The main problem here is that almost all of these companies with FDI are holdings which are registered in EU countries but like companies with offshore jurisdiction. For example, a lot of such companies are registered in Cyprus, Austria and other EU countries. However, they are registered as companies which are not working in those countries to minimize their taxes almost to zero level. So, the main goal of such holdings is to reduce their tax base in Ukraine via transfer prices.

The most crucial characteristic of such companies is that all of them are controlled by Ukrainian businesses that trafficked their capital abroad; they establish holdings there and then bring this money as iFDI back into Ukraine. That is why the biggest foreign investor in Ukraine is Cyprus.

Overall, all experts agree that with one exception (the food, beverages and tobacco industry) all iFDI in Ukraine is of very poor quality due to its pseudo nature. Moreover, they emphasize that the major foreign investors in the above mentioned food industry who managed to establish successful businesses are predominantly large elite MNEs that entered Ukraine in the beginning of the 1990s. Latecomers and smaller foreign investors were not as fortunate or successful.

In general, lately the number of real foreign investors in Ukraine drastically decreased. Moreover, a lot of real better quality investors are leaving the country due to the growing power of informal institutional influence, contributing to even further deterioration of the already extremely unattractive institutional environment in the country (Research Interviews, 2012; Pryadko, 2013; LB.ua, 2013). An ideal illustration in support of this statement is situation in banking industry.

Online newspaper Focus.ua (2011; 2012) reported that independent experts explained the escape of Banks from Ukraine not only by a slowdown of the economic growth in the country and the world crisis but also by the negative impact of shadow economy and political risks, in general, and corruption, in particular. Only during 2011 - 2012 more than ten foreign banks closed down or sold their subsidiaries in Ukraine. Among these banks were Swedish Group Skandinaviska Enskilda Banken or SEB bank, Swedbank and “East” Platinum Bank; Netherlands-Israeli TBIF Financial Services; German Dresdner Bank, Bayerisch Landesbank, Societe Generale Group and Commerzbank; British HSBS; Polish Bank Pekao; Check Home Credit bank; South Korean Kookmin Bank; Bank of Georgia and Russian Radabank and “Renaissance Capital” banks (Focus.ua, 2011; 2012).

It is noteworthy that, for example, the British company HSBS unsuccessfully disputed over obtaining permits for work in Ukraine with various state authorities for 11 months and eventually withdrew from the market (Korrespondent, 2013). The

Swedish giant IKEA had a similar experience. The company had been trying to obtain land in Kiev and Odessa for opening a hypermarket since the mid-2000s. After the years of efforts to acquire a permit without resorting to corruption this MNE decided to sell its furniture and woodworking factories in Western Ukraine and left the country in 2010-2011 (Korrespondent, 2013). The list of other large foreign investors which also could not survive in the country includes, for example, insurance companies Belgian Dutch Ageas and Italian Assicurazioni Generali, Polish distributor of consumer electronics Action S.A., British Peacocks, American Steve Madden, clothing brand Seppold, Finish company Stockman and even Russian industrial giant Mechel (Korrepondent, 2013; LB.ua, 2013).

Overall, since the beginning of the Viktor Yanukovich's presidency in 2010, more than thirty large investors left the Ukrainian market. Moreover, during the same period no single large foreign investor entered the country (Korrespondent, 2013). The FDI inflow into Ukraine fell from \$142 to \$132 per person between 2010 and 2012 (State Statistics Committee of Ukraine, 2013). Besides, experts insist that this investment can hardly qualify as real FDI since two thirds of them originated from Cyprus (Korrespondent, 2013; State Statistics Committee of Ukraine, 2013). Thus, the sum of real iFDI in Ukraine after the deduction of round tripping or pseudo-FDI equals no more than \$40 per person, which is 14 times lower than the average of \$550 in Organization of Economic Cooperation and Development (OECD) countries.

Experts claim that the absence of guaranties for business protection, raider attacks, bureaucratic pressure and omnipresent corruption are the main concerns for existing and potential foreign investors in Ukraine (Research Interviews, 2012; Korrespondent, 2013; LB.ua, 2013). Pryadko (2013), in line with these research findings, stated that foreign investors are leaving Ukraine under the pressure of their fears of local courts, corruption and strengthening of the pro-government business clans and poverty of the population.

#### **7.4.6 Changing political system in Ukraine**

Thus, as a primary condition for improving political system in Ukraine respondents point to the need in a systemic change. Deregulation must be a priority

for reformists. Then secure the functional legal and regulatory environments. Decrease of bureaucracy and westernization of all procedures in terms of open constructive compliance thinking are the next steps on the way of improving the functionality of political system in Ukraine.

Realization of all of the above requires a team of strong dedicated uncorrupted political leaders capable to develop a strategy.

Interviewed legal advisors insist that MNE politically cannot influence any changes in our political system.

#### **7.4.7 Attempts to change political, economic and business culture in Ukraine**

Both experts and foreign investors attested that no attempts are being undertaken to change political, economic and business culture in Ukraine. According to them, it is obvious that the ruling elites and incumbents at all levels are not interested in any revolutionary developments of this kind, because this would most probably result in their loss of office and power. Moreover, inaction of the prevalent share of both foreign and domestic business elites and their compliance with the unfair and, in most cases, unlawful treatment of their companies reinforces and contributes to the further worsening of the existing problems in Ukraine.

ELA1 provides the following example to support the above statement. His company, being a very active member of a society and trying to contribute to understanding and initiate actions necessary to commence systemic changes in the country, often organizes country-wide round tables to discuss sensitive issues and existing problems interfering with and impeding the work of most businesses in Ukraine. Each such event focuses on a certain clear-cut issue. Based on a discussion and analysis of the issue under consideration, participants produce recommendations for action which are submitted to the relevant authority.

However, there is only a very small group of genuine activists who participate in each of such events eagerly trying to improve the operational environment in Ukraine. Most business executives, in spite of their constant complaints about the multiple obstacles, deficiencies and general problems for their business operations in

Ukraine, refrain from participation. Such inaction definitely contributes to further rooting of inadequate principles continuing to destroy the remnants of the business environment in Ukraine.

#### **7.4.8 Potential solutions for the problem of merging political, economic and criminal powers**

For the solution of the problem of merging political and economic powers in Ukraine experts suggest two possible scenarios. Firstly, it could be a result of a natural development of events. EA1 proposes a practically unrealistic scenario according to which:

At certain point the Ukrainian population can undergo the change of mentality, finally, overcome its passivity, take up an active position and decide not to vote for the rich businessmen-politicians and prevent them from forming their 'pocket' government.

Second scenario, however, implies that the existing set up could be changed much faster under external influence. Experts insist that in this case the feasibility of transition from absolutely corrupted to civilized state is completely dependent on the pro-activeness and rigidity of USA and EU countries. The latter should commit to legal pursuit and prosecution of all representatives of Ukrainian political elites without any exceptions. Experts claim that if all Ukrainian high-rank businessmen-politicians, such as above mentioned Lazarenko, will see the real threat of being imprisoned for their economic crimes in these developed countries and of their property being arrested, then to preserve their freedom and assets these business political elites will be left with no choice but immediately react by changing their attitude to the Ukrainian state and to the compliance with its laws. Otherwise, they will not be able to retain all those resources which they have been acquiring and transferring to developed countries starting from the day of declaration of Ukrainian independence.

Unfortunately, developed countries do not seem to be willing to engage in and initiate any such activities to change the existing corrupted order and system in Ukraine. Experts assume that the main reason of their inaction is their fears that

under their strong pressure Ukrainian elites might choose to seek protection in Russia as it happened with Belarus before.

#### **7.4.9 Summary**

This section of the thesis addresses the last research questions on self-assessment of different groups of FIs' success and efficiency in prompting institutional changes in Ukraine and overall iFDI and institutional environment quality in Ukraine. FIs evaluation of institutional environment provides more evidence for supporting a 'blind bargaining' model. All investors admit their highly limited and significantly decreased within the last 20 years bargaining power due to institutional voids backed and nurtured by co-existent dominating informal institutional mechanisms and arrangements.

The awareness on the selective application and enforcement of regulations in line with the personal interests of government actors representing ruling elite clans leads to various behavioral patterns and level of confidence of elite, low-, and mid-profile FIs. The largest share of the interviewees representing the latter two groups admits they are very passive, particularly in terms of their operational conduct, due to their fear of retaliation for their actions and to their lack of resources and faith in their ability to cause any positive changes in the existing institutional order in Ukraine.

Moreover, low- and mid-profile FIs reveal two new types of their buffering strategies for protecting their interests and assets in Ukraine, namely increasing physical protection of their assets and masking their investments as domestic ones to avoid undesirable attention of powerful Ukrainian business elites and raiders .

Overall, both FIs and experts identify a quality of iFDI in Ukraine as very low. They acknowledge that merging of political, economic, and criminal powers and inaction of the prevalent share of both foreign and domestic business elites and their compliance with the unfair and, in most cases, unlawful treatment of their companies reinforces and contributes to the further worsening of the existing problems in Ukraine. At this point they can only see two potential unrealistic ways to change the situation: voting for the rich businessmen-politicians who will prevent them from forming their 'pocket' government and legal pursuit and prosecution of all

representatives of Ukrainian political elites without any exceptions by international community.

Overall, the findings of the qualitative part of this thesis reveal and provide detailed evidence for multiple elements of a newly-developed ‘blind bargaining’ model. The next chapter will combine the findings of all three studies to answer the research questions and finalize a ‘blind’barganing’ model.

## **CHAPTER EIGHT: DISCUSSION OF FINDINGS**

### **8.1 Introduction**

This chapter focuses on answering the research questions on the quality of iFDI and FIs' relations with host state institutions to develop a new model of bargaining in neo-patrimonial transition states proposed in this study. Combining the results of the two macro-level quantitative and one micro-level qualitative parts of this research project we review all the elements relevant to the quality of iFDI and their impact on changes in institutional environment in transition economies, in general, and in Ukraine, in particular. Initially, the first part of this chapter based on the findings of the two quantitative studies reviews the relationships between the presence of 'blind bargaining' and the quality of iFDI in the sample group of post-Soviet countries. The analysis in the rest of this chapter is based on the results of the micro-level qualitative research of foreign investors' political behavior in Ukraine. It examines how the relationships between the levels of political activity and pro-activeness, choices of political strategies, and success and efficiency in efforts to influence institutional changes in Ukraine vary between different groups of companies with iFDI to determine and refine all elements of a newly-proposed 'blind bargaining' model.

Such combination of both method and data triangulation serves the main goal of this project to identify which of the existing or proposed by this research bargaining models is the most appropriate for transition economies. Based on the evidence obtained in the course of both qualitative and quantitative analyses, this study argues that the newly developed 'blind bargaining' model provides the best framework for explaining the patterns of foreign investors – host states' government relationships in case of post-Soviet neo-patrimonial transition economies.

### **8.2 The quality of foreign direct investment**

#### **8.2.1 Definition**

The study of various aspects of iFDI in transition economies has been a very popular topic since the dissolution of the Soviet Union (Akinlo, 2004; Alfaro &



Charlton, 2007; Basu & Guariglia, 2007; Bengoa & Sanches-Robles, 2003; Bevan, Estrin & Meyer, 2004; Borensztein, De Gregorio & Lee, 1998; Chowdury & Mavrotas, 2006; Durham, 2004; Hansen & Rand, 2006; Lee, Baimukhamedova, Akhmetova, 2010; Li & Liu, 2005; Vu & Noy, 2008; etc.). However, fairly small amount of attention has so far been devoted to the analysis of the quality of iFDI in terms of its impact on institutional environment, especially in transition countries (Cole, Elliot & Fredriksson, 2006; Kwok & Tadesse, 2006; Malesky, 2005; Malesky, 2009; Robertson & Watson, 2004). Moreover, all of the existing studies employed quantitative techniques to analyze this relationship.

This study presents a very comprehensive mixed-method approach attempt to review various aspects of the problem of quality of iFDI with the focus on FIs' political behavior and develop a new 'blind bargaining' model of relationships between FIs and institutions in neopatrimonial transition states. First of all, it includes two quantitative inquiries into the bilateral and interdependent nature of the relationships between the quality of iFDI and the quality of institutional environment in post-Socialist transition economies. Second of all, to our knowledge it is the first study that is seeking to look for further interpretations, clarifications and explanations of identified relationships within the context of one country applying qualitative research methods.

The operationalization of such complex phenomenon as the quality of FDI is a very challenging task. For the purpose of this analysis, following the trend observed in previous research on this subject (See Chapter 1, Section 1.2), this study suggests to determine the quality of iFDI in terms of an impact of a unit of iFDI on institutional environment measured by country risk indicators. Further, following Moran (1998) it is suggested to label iFDI as 'malign' or 'benign' depending on the direction of their impact on the host country's institutional environment. As a result, if iFDI has a destabilizing impact on institutional competencies of a host country, we refer to it as 'malign' iFDI.

## 8.2.2 Quantitative analyses of iFDI quality

The results of both quantitative studies on the iFDI quality partially support 'malign' iFDI hypothesis. Initially, the first quantitative analysis supports the hypothesis that presence of 'blind bargaining' in neo-patrimonial states results in attracting riskier lower quality iFDI. Further, the second quantitative study provides evidence of a risk increasing role of such lower quality iFDI in twelve post-Soviet transition countries, including the Central and Eastern European States of Belarus, Moldova, Russia, and Ukraine, and the Central Asian Republics of Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan.

Test of the impact of iFDI on the changes in host country risks in the sample countries proves that iFDI has a marginally risk increasing effect on overall country risks and a strong effect on economic and legal risks. In the case of the latter the observed relationships are the most significant. Contrary to the Malesky's (2006) findings that FDI has a significant positive effect on economic reforms in the region supporting the traditional view of iFDI, the results of this research provide evidence for an alternative iFDI hypothesis (Hausmann & Fernandez-Arias, 2000; Moran, 1998). It shows that the growth of iFDI is related to the deterioration of an economic and, to a greater extent, legal component of institutional environment in sample countries, in terms of a degree of market orientation, policy consistency and forward planning, diversity and resilience of the economy in the former case and quality of legislation, its transparency, independence and experience in the latter case.

However, it is necessary to emphasize here that the results of this quantitative analysis should be interpreted with caution. Potential problems with the quality of dataset, including limited time frame (Greene, 2008), measurement problems (Beugelsdijk *et al.*, 2010; UNCTAD, 2002), ignoring the presence and impact of pseudo-FDI, and not accounting for iFDI endogeneity (Li & Liu, 2004; ) as well as for the industry- and country-concentration effects (Hunya, 2006), limit the generalizability of these findings.

As a result, even though this analysis partially undermines the prevailing in the international business literature positive orthodoxy view of iFDI impact on recipient economies (Balasubramanyam, Salisu, and Sapsford, 1996; Borensztein, De Gregorio and Lee, 1998; De Melo, 1999; Dyker, 1999), further more focused micro-level country- and industry-specific analysis is required to identify and support the hypothesis on the quality of iFDI in transition economies.

The qualitative part of this research is making an attempt to fill this gap by examining multiple aspects of iFDI quality in post-Soviet transition states. Adopting a primary step in achieving more objectivity in this analysis is to distinguish between the genuine and pseudo-FDI and separately account for their effect on institutional changes and quality of iFDI in Ukraine.

### **8.2.3 Pseudo-FDI**

In contrast to the previous research on transition economies with only several exceptions such as in cases of China (Boisot & Meyer, 2008; Fung, Yau & Zhang, 2011; Morck, Yeung & Zhao, 2008; Sutherland *et al.*, 2010; Xiao, 2004) and Russia (Abalkin & Whalley, 1999; Buitier & Szegvari, 2002; Ledyeva, Karhunen & Whalley, 2013; Loungani & Mauro, 2001; Mulino, 2002), this study emphasizes the need to distinguish between genuine and pseudo-FDI.

Unfortunately, the quantitative analysis does not allow singling out the effect of pseudo-FDI on institutional environment in transition economies due to the data availability and measurement problems (Beugelsdijk *et al.*, 2010; UNCTAD, 2002). However, the results of the qualitative analysis of foreign investors' political behavior in Ukraine provide initial evidence supporting our suggestion that accounting for the role of pseudo-FDI and/or even the study of the relationship between pseudo-FDI and the quality of host countries' formal and informal institutional environment is crucial for the advancement of our knowledge on both extent and directions of real and pseudo-iFDI impact on all aspects of development, particularly institutional changes, in transition countries, and, as a result for the development of a 'blind bargaining' model.

Our findings demonstrate that the domineering presence of pseudo foreign investors representing the interests of powerful domestic political-economic elites in the Ukrainian market discourages ‘benign’ investors from entering the country and causes deterioration of its institutional environment. The most recent scandalous exposure of information on active Ukrainian President’s, Petro Poroshenko, ownership of offshore businesses and assets serves as the best evidence for the domineering of powerful pseudo FIs in Ukraine (OCCRP, 2016; TSN, 2016).

All experts, low- and mid-profile investors and a half of the elite MNEs’ representatives suggest that, in addition to several common advantages inherent to the status of ordinary pseudo foreign investors such as access to additional resources (Ledyeva, Karhunen & Whalley, 2013; Sutherland *et al.*, 2012), increase in bargaining power (Boisot & Meyer, 2008), superior organization capabilities and higher security of their assets (Ledyeva, Karhunen & Whalley, 2013), avoidance of liability of foreignness (Ledyeva, Karhunen & Whalley, 2013; Zaheer, 1995), monopolistic behavior of pseudo-FDI representing the interests of merging political, economic and criminal elites nourishes a sustainment of a specific system of power in Ukraine characterized by the lack of centralization of government and the lack of control over regions, resulting in a highly diversified and archaic rent-seeking governance (Ignatov, 2002; Lyubavskiy, 2000; Lyubavskiy, 2012; Granovskiy, 1868). Moreover, as a result, such pseudo investors also play a crucial role in sustaining the highly corrupt institutional order and environment in Ukraine.

Thus, these findings not only to a great extent explain the Ukrainian failure to create an attractive investment climate in the country and the reluctance of real good quality ‘benign’ foreign investors to enter, work and stay in this market but also substantiate our proposition that negative impact of iFDI on the quality of institutional environment in post-Soviet transition states can be, at least partially, explained by the predominance of pseudo-FDI. The latter becomes an important element of a ‘blind bargaining’ model as personal interests of ruling elite in such neo-patrimonial states as Ukraine significantly undermine real FIs’ bargaining capacities by creating multiple constraints for their operations in such host markets.

In this light, further both qualitative and quantitative research effort focusing on the study of various aspects of pseudo-foreign investors' behavior in transition countries is required to find evidence and support for existing theoretical assumptions and identify new important elements of this phenomenon in different contexts.

#### **8.2.4 Raiding**

Very important contribution of this research to international business, in general, and FDI literature, in particular, is an introduction of a raiding problem as an important element affecting and determining the quality of iFDI in transition countries, with the focus on Ukraine. Overall under researched and poorly understood (Osipyan, 2010; Pojansky, 2013; Pojansky, 2014; Zimmerer & Khmara, 2012) the raiding problem has never been examined in terms of its relationships and impact on the quality of iFDI in transition countries.

The results of the qualitative part of this research provide evidence that even high profile elite MNEs characterized by a strong support of their developed home countries and, as a result, possessing significant bargaining power, refuse to renew their partnerships or enter the Ukrainian market due to the persistent growth in deterioration of institutional environment in the country. These investors testify that they prefer to invest less attractive, in terms of the quality of its location specific advantages, countries with lower risk than in transition countries like Ukraine where raiders, representing the interests of economic, political and criminal power elites, exploiting the existing institutional voids, use various criminal, legal, administrative and regulatory tools to achieve their treacherous goals.

The PCP1 director reveals that:

As a result of a failed raiding attack on our company, our high profile foreign partners from a developed country decided to move to other developing countries, such as India, characterized by lower levels of political, operational and legislative risks. The FI's management specifically emphasized that unreliability, inconsistency, and volatility of local

authorities' decisions outweighs even much lower levels of skill and expertise in a new host markets.

The choice of the tools is, at least partially, determined by the evolutionary phases of raiding (Gabor & Khmara, 2012; Osipyan, 2010; Pojansky, 2013; Pojansky, 2014) which can be identified with the evolutionary phases in the emergence and consolidation of the economic and, consequently, political elites in transition countries.

As a result, this research shows that interviewed foreign investors operating in the Ukrainian market reject legal advisors' suggestions that a sophisticated enterprise security scheme can ensure the successful protection of foreign businesses in Ukraine. These investors insist that only the possession of such critical intangible assets as close relationships with power elites can safeguard businesses operating in Ukraine from raiding attacks. Moreover, in line with existing research on raiding (Pojansky, 2013; Pojansky, 2014), all but one FIs also are very skeptical with regard to a proposition that an immunity of businesses to raiding attacks can be secured by their impeccable operational conduct and flawless reputations due to its practical unattainability in realities of post-Soviet transition.

Similarly to the case of pseudo-FDI, such allegations provide additional evidence for the hypothesis on the quality of institutional environment in Ukraine and lay a foundation for several other very important building blocks of a 'blind bargaining' model, namely tacit relational resources and informal element of a bargaining process in such neo-patrimonial states as Ukraine.

### **8.3 'Blind bargaining' model**

The most important finding and contribution of this research to international business literature is the development and test of a new model of bargaining relationships between foreign investors in neo-patrimonial transition host countries. The 'blind bargaining' is built upon the elements of the obsolescing bargain model originally determined and utilized by Vernon (1971) in his analysis of the stability of MNE – host state government relationships and Eden, Lenway & Schuler's (2004;

2005) political bargaining model. Similarly to the obsolescing bargain model, ‘blind bargaining’ model is proposed as a special case of the political bargaining model.

‘Blind bargaining’ model is build upon the obsolescing bargain (Brewer, 1992; Fagre & Wells, 1982; Grosse, 1996; Grosse & Behrman, 1992; Kobrin, 1987; Moran, 1974; Moran, 1985; Stopford & Strange, 1991; Vachani, 1995; Vernon, 1971; Vernon, 1977) and political bargaining models (Eden, Lenway & Schuler’s, 2004; 2005) by incorporating and combining insights from neopatrimonialism (Eisenstadt, 1973; Zon, 2001); neo institutionalism (Hall & Soskice, 2001; Henisz, 2000; Henisz & Zelner, 2005; Mantzavinos, North & Sahriq, 2003; North, 1981; North, 1990; North, 1995; North, 2003; Persson, & Sjostedt, 2009; Rodrik, 2002; Rodrik, Subramanian, & Trebbi, 2002), particularly social conflict view (Acemoglu, Johnson & Robinson, 2004), institutional voids (Doh *et al.*, 2014; Khanna & Palepu, 1997; Khanna & Palepu, 2013; Palepu & Khanna, 1998; Prokopovych, 2011; Puffer, McCarthy & Boisot, 2010) and institutional change (Kingston & Caballero, 2009; Libecap, 1989; North, 1981; North, 1990; Ostrom, 2005); bargaining power theories (Bacharach & Lawler, 1981; Bachrach & Baratz, 1970; Hay, 1997; Lukes, 1980; Oppenheim, 1972); political strategies (Baron, 1993; Baron, 2006; Getz, 1993; Hillmann & Hitt, 1999; Hillmann & Hitt, 2004; Keim & Zeitaml, 1986; Lawton, McGuire, Rajwani, 2012); and the existing research on iFDI quality (Cole, Elliot & Fredriksson, 2006; Kwok & Tadesse, 2006; Malesky, 2005; Malesky, 2009; Robertson & Watson, 2004; etc.) amended by accounting for the impact of pseudo-FDI (Boisot & Meyer, 2008; Fung, Yau & Zhang, 2011; Morck, Yeung & Zhao, 2008; Sutherland *et al.*, 2010; Xiao, 2004; Abalkin & Whalley, 1999; Buiter & Szegvari, 2002; Ledyeva, Karhunen & Whalley, 2013; Loungani & Mauro, 2001; Mulino, 2002) and raiding (Gabor & Khmara, 2012; Osipyan, 2010; Pojansky, 2013; Pojansky, 2014; Zimmerer & Khmara, 2012).

Apart from and in addition to the theoretical core the elements of this model are developed, refined and backed by the results of qualitative analysis of foreign investors’ political behavior in Ukraine and quantitative tests of iFDI quality and its relationships with institutional environment in post-Socialist transition countries.

‘Blind bargaining’ is a model depicting the cognitive situation of a foreign investor who is lacking the clarity on the situation he is in and, as a result, bound to act in conditions of extreme uncertainty due to the high degree of intransparency and instability of the "rules of the game" at any given moment and of their propensity for unpredictable change at any time in the future. It is argued that ‘blind bargaining’ originates from the specific state and society relationship which can be formed in neo-patrimonial host states where economic decisions are often not directed towards serving national interests, but towards supporting personal aims of the officials in power. ‘Blind bargaining’, which ultimately undermines the relationships between foreign investors and such neo-patrimonial host states, reflects both the presence of the latent conflict between national and personal interests of the state representatives and the inability of the existing political system to sanction individual self-enrichment.

Following the approach adopted by Eden, Lenway & Schuler (2004; 2005), we compare the three models along six different dimensions characterizing foreign investors – host state bargaining relationships. These elements constituting the base for comparison are both parties’ goals, resources, constraints, bargaining issues, outcomes and foreign investors’ strategies.

First of all, in the light of the changes introduced by the political bargaining model and goals pursued by the ‘blind bargaining’ model, we point out that restricting the business participants’ category of the bargaining process just to the MMEs’ population, as in obsolescing bargain (Vernon, 1971) and political bargaining models (Eden, Lenway & Schuler 2004; 2005), will eventually impose empirical and theoretical limitations on the existing bargaining models. Thus, our ‘blind bargaining’ model attempts to provide a framework which includes and allows accounting for the interests of the whole class of foreign investors (FIs), including MNEs, in their bargaining relationships with host states.

Further, we identify and provide a detailed account of differences between ‘blind bargaining’ and the other two models (see Table 8.1). Our model is in partial agreement with the political bargaining model in terms of the character of FI-host states bargaining relationships. Moving away from conflictual nature of such



relationships suggested by Vernon (1971), Eden, Lenway & Schuler (2004; 2005) argue that even though MNE - host country goals are different they are typically becoming more cooperative nowadays. 'Blind bargaining' model, however, indicates that in case of neopatrimonial states FIs can expect to build cooperative relationships with host countries only in those cases when their interests coincide or do not interfere with personal economic and political interests of ruling elite.

Specific host countries' and FIs' goals vary significantly between all three models. Obsolescing bargain model focuses on the analysis of market and resources seeking MNEs entering the countries pursuing to improve their national welfare by adjusting their economic, social and political goals. Political bargaining model, pointing to the value of access to host countries' location specific advantages and building upon the liability of foreignness, transaction cost economics and the resource based view, particularly emphasizes the growing importance of obtaining organizational legitimacy relative to efficiency and market power goals.

'Blind bargaining' model establishes the necessity to distinguish between different types of investors. It argues that goals of different types of FIs vary significantly depending on their nature. Thus, in case of neopatrimonial transition states it is suggested to separately consider the motives of two types of FI, namely real or genuine iFDI and pseudo-FDI. The first group consists of market- and resource-seeking FIs. The second group includes domestic businessmen who returns as foreign investors to their home countries from offshore zones searching for efficient forms of investment protection (increased security of assets, equal access to justice, secrecy of investors' identity), increase of bargaining power and/or competitiveness due to the combination of exploitation of their privileges of foreign investors' status (access to value added services, lower taxes, government incentives for FDI) and of local experience and knowledge (avoiding a liability of foreignness), money laundering and others.

It is obvious that the goals of such polar groups of FI will vary significantly and, as a result, require exceptional individual examination. The latter statement gains even more value in the light of the analysis of host countries' goals. In neopatrimonial transition states the latter goals reflect the interests of ruling political-

economic clans which want access to FIs' non-location bound FSAs. Moreover, the largest share of pseudo-FDI belongs to the representatives of these ruling political-economic clans. Thus, all decisions are guided by the pursuit for the increase of personal ruling elite businesses' competitiveness.

All three models acknowledge the importance of location-specific and ownership-specific resources for foreign investors and host countries, respectively. However, political and blind bargaining model also point to the growing role of tacit relational-based resources. Moreover, blind bargaining model additionally points out to the fact that pseudo foreign investors do not possess any managerial, technological or any other of this sort ownership-specific resources comparable to the ones transferred with real iFDI. However, they are still able significantly increase their competitive advantage due to higher tacit relation-based resources which allow them to capitalize on local experience and knowledge.

All three models admit the importance of both domestic and international economic and political constraints effecting the changes in potential bargaining power of both parties. Political bargaining model expands this variable by adding up the institutional element and pointing to the role of international institutions and home country governments in determining the course of bargaining process and its results. Eden, Lenway & Schuler (2004; 2005) also emphasize the governance inseparability can also restrict foreign investors in their negotiations due to their inability to change or differentiate governance modes.

'Blind bargaining' model spotlights several more factors creating additional constraints for the negotiating parties in the bargaining process. Firstly, it is unreliability and volatility of any host country decisions due to heterogeneity of bargaining interests of government actors and incentive incompatibilities faced by them. Secondly, based on the findings of the qualitative part of this research project this model identifies pseudo investors and state officials' fear for personal assets' safety abroad as important factors affecting bargaining outcomes.

In obsolescing bargain model bargaining is restricted to the agreements on MNE entry conditions and subsequent negotiations regarding the access to host country

resources and the ability to repatriate profits. Political bargaining model argues that MNEs and governments engage in repetitive bargaining over various public policies concerning their industrial interests. Blind bargaining model advances the ideas proposed in its predecessors by pointing to the need to distinguish between formal and informal elements of the bargaining process. Within its framework it is specifically indicates that bargaining of companies with FDI in neopatrimonial transition countries is not restricted to only formal negotiations over public policies in industry-specific issues. Informal bargaining over the safety of their assets and fair law enforcement is a crucial element for foreign investors' operational sustenance in this group of countries.

The range of FIs' strategies is, first of all, determined by their goals. In case of obsolescing bargain MNEs are seeking for strategies effective in preventing host governments' opportunistic behavior. Political bargaining model moves ahead and distinguishes between economic and political strategies employed by MNEs to overcome their liability of foreignness and to strengthen their relationships with host countries by increasing organizational legitimacy, political accommodation and resource complementarity between them, and building personal relations with state officials.

'Blind bargaining' model extends the range of applicable strategies by insisting on applicability of all market and nonmarket strategies. Moreover, based on combination of the theoretical insights (Collins, Ulluenbruck & Rodriguez, 2009; Lawton, McGuire, Rajwani, 2012; Venard, 2009) and results of the qualitative analysis of FIs' political behavior in Ukraine corruption, rejected as one of political strategy in developed countries, is added as one of the most important political strategies for low- and mid-profile foreign investors in neo-patrimonial transition states. Also, in neopatrimonial transition states the efficiency of FIs' relational resources is not simply determined by their relationships with any state officials but depends upon their ability to access and built personal relations with representatives of ruling elite clans.

Finally, all three models present different approaches to measuring and evaluating bargaining outcomes. Obsolescing bargain model suggest that bargaining

outcomes are not stable and obsolesce over time. They depend on the relative goals, resources and constraints possessed by both parties and are measured in terms of the percentage of ownership retained by the MNE as a result of the bargaining. According to political bargaining model the winner is the party which managed to attain its goals to a greater extent. Within this framework additional important moderating variables include governance inseparability, firm rivalry, liability of foreignness, other governments and international institutions.

‘Blind bargaining’ model insists that in neopatrimonial transition states outcome evaluation requires distinguishing between its two components including official approval of negotiated government policies and actual enforcement of approved government policies. Due to the specific nature of the state and society relationships key variable affecting bargaining outcomes in such countries is personal interests of government actors representing ruling elite clans. Moreover, the selective application and enforcement of laws does not guarantee realization of FIs’ expectations and in many cases even prevent them from getting a legitimate pay off on their effort. The results of the qualitative analysis show that FIs’ ability to achieve a fair enforcement of laws is determined by their status in the world economy.

Overall it can be concluded that ‘blind bargaining’ model, developed as a special case of political bargaining model, provides a comprehensive framework for explaining FI – host state bargaining relationships in neopatrimonial transition economies. This model was tested both quantitatively for the sample of 27 post-Socialist countries, including its various sub-groups, and qualitatively for the case of Ukraine within this research project. The results of both analyses provide evidence in support of this model. Further country-specific tests are necessary to test its applicability beyond the transition countries, particularly emerging and developing countries.

**Table 8.1. Obsolescing bargain, political bargaining and ‘blind bargaining’ models: comparative analysis**

	Obsolescing bargain model		Political bargaining model		Blind bargaining model	
	MNE	HC	MNE	HC	FI	HC
	MNE-HC goals are conflictual but the bargain is potentially positive sum (both parties can gain).		MNE-HC goals are different and typically cooperative, there is positive sum bargaining.		Foreign investors (FI) -HC goals are different and cooperative only in those cases when their interests coincide or do not interfere with personal economic and political interests of ruling elite.	
Goals	Market or resource seeking goals.	Economic, social and political goals, focusing on national welfare.	MNE wants access to HC’s location-bound CSAs. Importance of organizational legitimacy, relative to efficiency and market power goals.	Host country wants access to MNE’s non-location-bound FSAs. Goals vary by type of host country. Importance of national competitiveness.	Two types of FDI: 1. Real FDI Predominantly market and/or resource seeking goals. 2. Pseudo-FDI Search for efficient forms of investment protection (increased security of assets, equal access to justice, secrecy of investors’ identity), increase of bargaining power and/or competitiveness due to the combination of exploitation of their privileges of foreign investors’ status (access to value added services, lower taxes, government incentives for FDI) and of local experience and knowledge (avoiding a liability of foreignness).	Host country represents personal interests of ruling political-economic clans which want access to FIs’ non-location bound FSAs. Importance of personal ruling elite businesses’ competitiveness.

	Obsolescing bargain model		Political bargaining model		Blind bargaining model	
	MNE	HC	MNE	HC	FI	HC
Resources	FSAs of the MNE. FDI is a bundle of capital, technology and managerial skills.	CSAs of the host country (economic, social and political) that attract FDI.	MNE transfers non-location-bound resources that are property-based and tacit/relational based.	HC offers location-bound resources (property-based and relational-based).	1. Real FDI Transferring non-location-bound resources that are property-based and tacit/relational based. 2. Pseudo-FDI Tacit/ relational based: capitalizing on local experience and knowledge	HC offers location-bound resources (property-based and relational-based).
Constraints	Economic and political constraints, both domestic and international.		Economic, political and institutional constraints. Governance inseparability constraints outcomes. International institutions and home country governments can affect outcomes.		Economic, political and institutional constraints. Unreliability and volatility of any host country decisions due to heterogeneity of bargaining interests of government actors and incentive incompatibilities faced by them. Governance inseparability constraints outcomes. International institutions, home country governments, pseudo-investors, state officials' fear for personal assets' safety abroad can affect outcomes.	
Bargaining	Bargain over MNE entry. Subsequent bargains with same firm(s) over access to HC and ability to repatriate profits.		MNEs and governments bargain over public policies in industry-specific issue areas.		Need to distinguish between formal and informal bargaining. Bargaining of companies with FDI not restricted to formal negotiation only over public policies in industry-specific issues. Informal bargaining over the safety of their assets and fair law enforcement is a crucial element.	

	Obsolescing bargain model		Political bargaining model		Blind bargaining model	
	MNE	HC	MNE	HC	FI	HC
FI/ MNE strategies	MNEs focus on preventing opportunistic behavior by the host government.		MNEs use economic and political strategies, lobbying for legitimacy in order to overcome liability of foreignness. MNE-HC relations can be strengthened through organizational legitimacy, political accommodation, resource complementarity and personal relations.		Companies with FDI use various market and nonmarket strategies. Corruption is added as one of the most important political strategies for low- and mid-profile foreign investors in neo-patrimonial transition states. FIs' resources-HC relations depend on political accommodation, resource complementarity and personal relations with representatives of ruling elite clans.	
Outcomes	Outcomes measured by percentage of ownership retained by the MNE. Outcome depends on relative goals, resources and constraints. Initial bargains favor MNE and then obsolesce over time.		Outcomes measured by which party most closely achieves its goals. Outcome depends on the parties' relative goals, resources and constraints. Governance inseparability, firm rivalry and liability of foreignness are key variables affecting bargaining outcomes. Other governments and international institutions are important moderating variables.		Outcome evaluation requires distinguishing between its two components or stages: <ol style="list-style-type: none"> <li>1. Official approval of negotiated government policies.</li> </ol> Outcome depends on the parties' relative goals, resources and constraints. Here, key variable is personal interests of government actors representing ruling elite clans. Other (especially developed home states) governments and international institutions are important intervening variables. <ol style="list-style-type: none"> <li>2. Actual enforcement of approved government policies.</li> </ol> Selective application and enforcement of laws: depends on the status of foreign investor in the world economy.	

Table, including the parts on obsolescing bargain and political bargaining models, adapted from Eden, Lenway & Schuler (2004; 2005). The part on 'blind bargaining' model is developed in the course of this research.

### 8.3.1 Quantitative test of the ‘blind bargaining’ hypothesis

Our comparative analysis of the impact of country risks and economic indicators on the quality of interactions between FDI and host states, conducted for 27 post-Soviet and CEE countries, supports the ‘blind bargaining’ hypothesis and the main argument of this paper in that it documents differential relationships between FDI inflows and other variables for different groups of countries. The latter include all post-soviet states except Baltic states, Central European accession and non-accession countries and Baltic states, Central European post-soviet states (Belarus, Moldova, Russia and Ukraine), and Central Asian States. To preserve the homogeneity of the sample, this analysis deliberately excludes the three Baltic states, whose economic development was affected relatively early on by their eventual succession to the European Union (Hunya, 2004).

Questioning the dominant orthodoxy of iFDI that increased foreign investment will, in virtually all instances, benefit the recipient nation (Aitkin, Harrison and Lipsey, 1996; Balasubramanyam, Salisu, & Sapsford, 1996; Borensztein, De Gregorio & Lee, 1998; De Melo, 1999; Dyker, 1999; Rodrik, 2003; Sachs & Warners, 1995), this analysis argues that iFDI differs by its quality and, following Moran (1998), and suggests distinguishing between ‘malign’ and ‘benign’ iFDI. Combining this classification with neo-patrimonial (Zon, 2001), neo-institutional (North, 1990; Rodrick, 2003; Rodrik, Subramian and Trebbi, 2001; Williamson, 1975; 1985), and alternative theories of FDI, trade, and development (Hausmann & Fernandez-Arias, 2000; Moran, 1998), it further proposes that the failure of post-Soviet states to attract the required amounts of quality FDI can be, first of all, explained by the presence of ‘blind bargaining’.

The most stable relationship that can be observed for all groupings is the strong correlation between FDI levels of economic risks. The significance and strength of this attests to the significance of ‘blind bargaining’ context since one of the main criteria upon which Global Insight bases its rating of this type of risk is policy consistency and forward planning of the economy. The latter is, first of all, dependent on the quality and independence of a state’s economic and political system, the lack of which reflects latent conflict between genuine economic goals



and the private interests of these states' ruling elite; which, in turn, creates high levels of uncertainty and instability with regard to policies.

This analysis provides support for an alternative hypothesis of iFDI quality (Hausmann & Fernandez-Arias, 2000; Moran, 1998). Based on its results it can be concluded that there is quantitative evidence for lower quality iFDI in neo-patrimonial post-Soviet states. Moreover, it can be further argued that the subordination of state politics to personal economic interests of ruling elite, as a main characteristic underpinning the existence of 'blind bargaining', explains the inability of many such states to attract the required amounts of quality iFDI. It also explains attractiveness of these states to riskier investors and consequently the inflows of mostly 'malign FDI' into these countries.

However, similarly to the previous quantitative inquiry undertaken in this study, it is emphasized that the result of this analysis should be also interpreted with caution due to the same data quality reasons (see section 8.2.2).

### **8.3.2 Qualitative test of the 'blind bargaining' model**

Qualitative analysis of foreign investors' political behavior in Ukraine provides evidence and support for each element of a 'blind bargaining' model. The results of this inquiry show that host goals of Ukraine as a host country in any negotiations are determined by the interests or ruling political-economic clans. Overall, all respondents agree that politics is a business project in Ukraine. For example, representatives of elite MNEs report that:

Even at the Presidential Administration level the outcome of any legislative negotiations depends on the presence and bargaining power of powerful and influential vested interests such as political elites representing their business, including various large domestic FIGs and multiple pseudo-FDI holdings.

Combined with a unanimous agreement about the crucial role of pseudo foreign investors in inducing adverse institutional changes and in undermining real foreign investors' competitiveness, this testimony and evidence prove and substantiate the need for the distinction between real and pseudo-FDI.

The interviewees also explain that at present in Ukraine such tacit relational based resources as personal relations and friendship with state officials, members of the ruling elite and representatives of the parallel criminal hierarchy are the most efficient channels for companies to exercise influence on the institutional environment. Moreover, at the same time these resources turn into constraints for foreign investors due to all businesses', including foreign investors', high degree of dependence on the diverging demands of the state officials representing bargaining political and economic interests of these ruling elites.

The results of this study, in line with social conflict view (Acemoglu, 2006; Acemoglu & Robinson, 2006; Persson, & Sjöstedt, 2009), also confirm that the high degree of power personalization and the inability of the existing political system to sanction individual self-enrichment lead to the latent conflict between national and personal interests of the state representatives and encourage treacherous and even criminal behavior of state officials threatening foreign investors' security in the country. As a result, companies with iFDI are forced to engage in two different types of bargaining: formal over various public policies and informal over the safety of their assets and fair law enforcement.

Such pressing need for businesses' participation in informal bargaining practically leads to legalization of corruption. As a result, following Lawton, McGuire & Rajwani (2012) the latter is added to the list and acknowledged as one of the most important political strategies for low- and mid-profile foreign investors in neo-patrimonial transition states, particularly Ukraine.

The interviewed representatives of companies with iFDI and experts provide evidence for the 'blind bargaining' model's assumptions on the need to account for the duality of bargaining outcomes. They report about double standards and double-cross approach of Ukrainian authorities to the fulfillment of their responsibilities. For, example, on one hand, Ukraine plays by the rules of the developed world and satisfies the requirements with regard to the norms of civilized lobbying through allowing participation in and certain degree of influence by international professional and business associations on the law-making process and meeting their demands. On the other hand, when it comes to the final law-enforcement phase of this cycle

respective authorities just cross out all the rules formalized at the previous stages and continue to play by their own informal illegal rules, for example, through discretionary law enforcement.

It is also acknowledged in the ‘blind bargaining’ model that the applicability of some of its components differs depending on certain foreign investors’ characteristics determining their affiliation with a particular group. Even though the qualitative study successfully tests the ‘blind bargaining’ model and provides evidence and support for its each element for low- and mid-profile foreign investors, it can be argued that some foreign investors claim that they do not engage in any informal activities and use the same operational mode in Ukraine as in any developed country. Thus, it is noteworthy, that elite MNEs with a high profile status in the world economy, claim their capacity to protect themselves from institutional deficiencies of Ukrainian market. Further analysis of findings from the qualitative study on foreign investors’ political behavior in Ukraine will focus on providing evidence of variations in political bargaining behavioral patterns of different groups of companies with iFDI.

#### **8.4 Political strategies of foreign investors in Ukraine**

The analysis of empirical findings obtained in the course of this qualitative inquiry provides evidence of different patterns of political behavior and use of different political strategies by various groups of companies following the classification suggested for the purpose of this study (see Chapter 2, Section 2.6). Clearly, elite MNEs, on one hand, and low- and mid-profile foreign investors, on the other hand, choose distinct models of their relationships with a host state’s institutional environment both in terms of applied political strategies, persistence in time and participation model. The only exception is rare occasional deviations from the group’s options of upper rank mid-profile foreign investors.

The review of foreign investors’ political behavior supports Hillmann & Hitt’s (1999) proposition that the respective companies’ with FDI choices are determined by combinations of company ownership-specific and host country location-specific characteristics and the nature of the disputed or proposed issues. The status of a

company with iFDI in a world economy determined by the prominence of its international profile based on such characteristics as visibility, reputation, level of home country's development, relational resources in terms of strong connections with and support of a home state and various supranational institutions is identified as the most important ownership specific characteristic.

Thus, elite MNEs operating in Ukraine follow the relational approach. They prefer to rely on long-term relationships and strategies (Hillmann & Hitt, 1999). In contrast, low- and mid-profile foreign investors resort to transactional approach. Their use of political strategies is short-term and issue-based (Hillmann & Hitt, 1999), first of all due to their lack of both financial and, as a result, relational resources.

Moreover, this research identifies another very important reason for the lack of low- and mid-profile foreign investors' enthusiasm for engaging in political activities. Both interviewed experts and company representatives claim that these companies prefer staying out of spotlight of corrupt state officials to avoid attention and excessive pressure on their side.

Form of foreign investors' participation in political activities is determined by the same factors. Very often the choice of political strategies depends on the form of investors' participation. All low- and lower rank mid-profile foreign investors undertake individual attempts to protect their interests by the means of corruption. Due to the discussed above lack of resources combined with the characteristics of Ukrainian institutional environment, in most cases corruption becomes the only and the most efficient instrument for protecting companies' interests.

Scholars focusing on the study of political activities of businesses in emerging, developing and transition economies (Collins, Ulluenbruck & Rodriguez, 2009; Khatri, Tsang & Begley's, 2006; Venard, 2009) argue that corruption, cronyism and extensive use of connections should be also classified as political strategies (Lawton, McGuire, Rajwani, 2012). The findings of this research provide empirical evidence for supporting the proposition. In countries like Ukraine low- and lower rank mid-profile foreign investors rarely employ any other bargaining instruments but corruption. As a result, the list of political strategies is expanded by introducing

corruption as one of the most popular and efficient instruments for resolving institutional problems in transition countries. This finding is applied within the ‘blind bargaining’ model framework.

Moreover, the results of this research also show that the combination of omnipresent corruption and selective or discriminative enforcement of laws partially resolves the free-riding problem (Olson, 1965) in Ukraine and other countries with the same institutional environment. According to Olson (2002: 15) “the very fact that a goal or purpose is common to a group means that no one in the group is excluded from the benefit or satisfaction brought about by its achievement”. However, in neopatrimonial states, in contrast to developed less corrupt societies, low- and mid-profile companies with FDI not participating in collective bargaining over relevant to their businesses policy issues cannot benefit from value-creating outcomes of such policies free of charge. Since most of high rank mid-profile foreign investors and all of the elite MNEs pay for the beneficial outcomes through active participation in collective bargaining process and underdeveloped law enforcement mechanism ensures that every non-participating company, except for the companies possessing tacit relational resources such as pseudo-FDI belonging to ruling political-economic clans, will have to pay a bribe to persuade corrupt state officials for applying the desired law in their case, it resolves the free-riding problem.

Thus, the analysis of a ‘blind bargaining’ model sets a framework for new research on the free riding problem in neopatrimonial states. Several important elements, including tacit relational resources, such as close ties with or belonging to ruling political-economic elite clans, informal bargaining process, and actual selective application and enforcement of laws, determine the potential for resolving the free-riding problem for different groups and types of FIs, were identified in the course of testing and refining a ‘blind bargaining’ model.

This research also provides evidence that the elite MNEs’ choice of political strategies depends on the form of their participation in the bargaining process (Hillman, Keim & Schuler, 2004). Both individual and collective participation usually involves information strategies, including direct lobbying (Hillman, Keim & Schuler, 2004; Johnson, 1992; Katzenstein, 1985; Murtha & Lenway, 1994a),

company led research projects and reporting research results, testifying as expert witnesses in hearings and/ before other government bodies, and providing decision makers with position papers and/or technical reports (Buchanan & Tullock, 1962; Hillman & Hitt, 1999; Lord, 2000a; Schuler, 1996; Rehbein & Schuler, 1999) and most of the constituency building strategies namely coalition building (Getz, 1997; Hillman & Hitt, 1999; Keim & Zeithaml, 1986). and advocacy advertizing (Hillman & Hitt, 1999; Keim & Zeithaml, 1986; Keim, Zeitmal & Baysinger, 1984; Sethi, 1979; Sethi, 1987) and denying application of grassroot mobilization techniques (Hillman & Hitt, 1999; Sholzman & Tierney, 1886; Wilcox *et al.*, 2003). It is noteworthy that all elite MNEs in Ukraine reject employing any financial incentive strategies (Hillman & Hitt, 1999) explaining this by their disengagement from politics in Ukraine.

### **8.5 Political activity and pro-activeness of foreign investors in Ukraine**

A clear distinction in the patterns of low- and mid-profile investors' and elite MNEs' involvement in relationships with various branches of power at different levels also can be observed in terms of their pro-activeness. The results of this study, in line with the existing literature, show that elite MNEs very actively employ a wide range of buffering strategies to protect their interests in the Ukrainian market (Hillman, Keim & Schuler, 2004; Meznar & Nigh, 1995).

All elite MNEs representatives declared that they are highly involved in and constantly seeking dialog with both the Ukrainian population and the authorities. Naturally, elite MNEs are very actively building their relationships with local authorities and communities in regions where their production facilities or offices are located. These foreign investors said that they also work a lot with local communities by investing significant resources into various projects based on the principles of corporate social responsibility.

At the national level, elite MNEs have access to, and actively cooperate directly with, cabinet of ministers, the Presidential Administration, and the parliament (Ukrainian: *Verkhovna Rada*). Interviewees emphasized that direct access to these

critical decision-making centers provides them with a certain bargaining leverage and advantage over their competitors.

In contrast, both low- and mid-range profile investors prefer avoiding any unnecessary contacts with any authorities at all levels due to a lack of resources and a fear of being noticed and, as a result, becoming victims of extortion by corrupt authorities.

The interviewees explain that at present in Ukraine personal relations and friendship with members of the ruling elite and representatives of the parallel criminal hierarchy are the most efficient channels for companies to exercise influence on the institutional environment. Respectively, this dependence on incumbents' perception and almost absolute absence of fair mechanisms controlling the changes in institutional environment greatly decreases the confidence of all businesses, including foreign investors', in the security of their future operations and even continued existence in the country. This, in turn, partially explains the reluctance of new foreign investors to enter, and the growing tendency of existing foreign investors to exit, the Ukrainian market.

Under such circumstances it is also not surprising that the fear to become public and to reveal any information about them grow into the most important problem for low- and mid-range profile foreign investors. Three quarters of these companies explained that very often they just literally hide from any public involvement, assuming a very passive position and, as a result, avoiding any attention. Therefore they usually do not participate in any forums, round tables and any other activities through which they could contribute to filling the existing institutional voids and to initiating changes in the institutional environment.

Overall, low-and mid-profile foreign investors admit that they just learn to adapt to all formal and informal requirements of Ukrainian institutional environment. Thus, it can be concluded that these two groups of foreign investors primarily rely on bridging strategies to ensure the persistence of their operations in the country (Hillman, Keim & Schuler, 2004; Meznar & Nigh, 1995).

However, it is also noteworthy that all low- and mid-profile foreign investors when asked about buffering mechanisms (Hillman, Keim & Schuler, 2004; Meznar & Nigh, 1995) first of all named physical protection of their assets. It is clear that a real threat of raiding attacks forces the representatives of these two groups of foreign investors to literally fortify their business by improving their security systems and increasing the number of their security personnel. Moreover, these investors also admit that some of them to avoid both physical threats and excessive regulatory and administrative pressure on their businesses also choose to conceal their FDI by registering their businesses as domestic; thus representing an opposite of pseudo-FDI that could be referred to as pseudo-domestic companies.

As a result, the findings of this qualitative inquiry allow suggesting the extension of an existing classification of buffering strategies (Hillman, Keim & Schuler, 2004; Meznar & Nigh, 1995). Thus, in the context of transition countries we propose adding two evolving buffering techniques namely improvement of physical security and pseudo-domestic business operation mode.

#### **8.6 Foreign investors' success and efficiency in securing positive institutional change in Ukraine**

The results of this qualitative analysis both confirm and question the existing theoretical insights on the effectiveness of corporate political activity. On one hand, in compliance with Oliver & Holzinger's (2008) view interviewed representatives of companies with FDI, primarily elite MNEs, testified that their success and efficiency in achieving desirable policy outcomes is determined by their firms' exogenous and endogenous dynamic capabilities, specifically emphasizing the value of their status in the world economy and relational resources. They also emphasized the advantages of diversification and dynamic adjustments of their political strategies in promoting their position on specific policy issues (Oliver & Holzinger's, 2008). Low-and mid-profile foreign investors admitted to the crucial nature of the same instruments by acknowledging their lack of capacity of influencing any desirable institutional changes due to their lack of these required resources.



On the other hand, in contrast to Kudina & Collinson (2009) assumption it is argued that in the context of neopatrimonial transition states like Ukraine the pursuit and consecutive approval of a certain desirable policy does not guarantee its positive effect on the corporate performance of the entire population of foreign investors.

We argue that the assessment of the effectiveness of corporate political activity and bargaining should include two components of a 'blind bargaining' model. Firstly, the evaluation of the officially approved policies is required to assess the effectiveness of the overall foreign investors' effort in terms of achieving their desirable objectives. However, their success in supporting the approval of any legislative act does not pass automatically to the success of its enforcement. Unfortunately, in case of neopatrimonial transition countries, particularly Ukraine, selective application and enforcement of laws determines the need for the efficiency evaluation of the second component such as actual enforcement of approved government policies. This study confirms that the degree of success in both components varies significantly for different types of companies: being higher for elite MNEs and lower for low- and mid-profile foreign investors.

## **8.7 Summary**

This research has developed and tested a new 'blind bargaining' model of relationships between FIs and institutions in neo-patrimonial states. The model was build based on the analysis of several very important elements relevant to the quality of iFDI and their impact on institutional changes in transition neo-patrimonial states. Two research hypothesis and four research questions were suggested and addressed to identify all components which combined determine 'blind bargaining' model.

First of all, even though quantitative analysis produced strong significant evidence of iFDI risk-increasing effect, the results of the qualitative analysis point to the need of differentiating between real and pseudo-FDI. Raiding problem, corruption, personal interests of government actors representing ruling elite clans, including pseudo foreign investors, merging economic, political and criminal powers, selective application and enforcement of laws are among other very

important factors that drive quality iFDI out of transition countries and cause further deterioration of institutional environment.

This study also reveals that various aspects of foreign investors' political behavior are determined by ownership-specific advantages. Thus, evidence is provided that choices of political strategies, level of pro-activeness and efficiency of different groups of investors varies significantly with the foreign investors' status in the world economy. Elite MNEs claim their bargaining positioning to be relatively strong and low- and mid-profile foreign investors admitting the vulnerability and insecurity of their businesses in Ukraine.

Finally, based on the combination of empirical and theoretical insights discussed above, a 'blind bargaining' model was developed as a special case of political bargaining model. It provides a comprehensive framework for explaining foreign investor – host state bargaining relationships in neopatrimonial transition economies and reveals several distinctive characteristics of both parties' behavior in terms of their goals, resources, constraints, nature of bargaining process, strategies and outcomes. This model was tested both quantitatively for the sample of 27 and 12 post-Socialist countries and qualitatively for the case of Ukraine within this research project. The results of both types of analyses provide evidence in support of this model. However, it is suggested that further country-specific tests are necessary to examine its applicability beyond the transition countries, particularly emerging and developing countries.



## **CHAPTER NINE: CONCLUSION**

### **9.1 Introduction**

The overall goal of this thesis was to develop a new ‘blind bargaining’ model of relationships between FIs and neo-patrimonial receipt states. This objective was pursued by analyzing the quality of iFDI in transition economies with special focus on post-Soviet countries and by examining the relationships between iFDI and institutional environment in host countries at both macro- and micro-levels. It is argued that certain combinations of patterns of quality of iFDI and host-country institutional variables determine foreign investors’ political influence and political behavior and further allow them to pursue their economic goals through manipulation of political regimes and consequently reshaping the host country’s institutions in accordance with their strategic goals.

The combination of findings from both qualitative and quantitative analyses allows identifying, first of all, important characteristics determining the iFDI quality and causing deterioration of institutional environment in transition countries and, second of all, patterns of political behavior performed by different groups of foreign investors. Moreover, combined with theoretical insights these empirical findings contribute to the development of a ‘blind bargaining’ model as a special case of political bargaining model for transition economies.

This chapter has the following structure. Firstly, the review of contributions and implications of the results of this study for the literature is provided. Secondly, we discuss the applicability of both theoretical and empirical findings of this research for businesses and education. Thirdly, the discussion of implications and recommendations for public sector is suggested. And finally, the review of limitations and future research directions complete this study.

### **9.2 Implications for the literature**

The two most important contributions of this study to the international business literature, particularly in the field of bargaining power, FDI theories and nonmarket, specifically political, strategies and behavior research, are the development of a

‘blind bargaining’ model and the first qualitative analysis of foreign investors’ political behavior in transition post-Soviet country, Ukraine. Moreover, other important elements specific to foreign investors’ relationships with host states and their political activities in transition post-Socialist countries were revealed and, as a result, allowed adjusting the existing theoretical and empirical studies, pointing to the research gaps and suggesting new research directions.

‘Blind bargaining’ model provides a framework for analyzing foreign investors – host states relationships in the context of transition economies. It is a result of multidisciplinary approach. Combining insights from international business, political science, sociology, economics and transition economics literature eventually led to filling the gap in international business literature on bargaining, FDI, foreign investors political behavior, MNEs – state relationships, institutional quality and institutional change, to mention just a few. Moreover, several very important elements introduced within this model also represent contributions to the existing literature independently by itself.

‘Blind bargaining’ is defined as a model depicting the cognitive situation of a foreign investor who is lacking the clarity on the situation he is in and, as a result, bound to act in conditions of extreme uncertainty due to the high degree of intransparency and instability of the "rules of the game" at any given moment and of their propensity for unpredictable change at any time in the future. It is argued that ‘blind bargaining’ originates from the specific state and society relationship which can be formed in neo-patrimonial host states where economic decisions are often not directed towards serving national interests, but towards supporting personal aims of the officials in power. ‘Blind bargaining’, which ultimately undermines the relationships between foreign investors and such neo-patrimonial host states, reflects both the presence of the latent conflict between national and personal interests of the state representatives and the inability of the existing political system to sanction individual self-enrichment.

Following the approach adopted by Eden, Lenway & Schuler (2004; 2005), the ‘blind bargaining’ model is characterizing six different dimensions of foreign investors – host state bargaining relationships. These elements include both parties’

goals, resources, constraints, bargaining issues, outcomes and foreign investors' strategies.

The first contribution to the bargaining literature and difference between blind bargaining and obsolescing bargain (Brewer, 1992; Fagre & Wells, 1982; Grosse, 1996; Grosse & Behrman, 1992; Kobrin, 1987; Moran, 1974; Moran, 1985; Stopford & Strange, 1991; Vachani, 1995; Vernon, 1971; Vernon, 1977) and political bargaining (Eden, Lenway & Schuler 2004; 2005) models is the extension of the analysis to the entire populations of foreign investors as opposed to restricting it to MNEs only.

'Blind bargaining' model is a result of a multidisciplinary effort building on a combinations of various international business, political science, sociology, and economics theories, including theory of neopatrimonialism (Eisenstadt, 1973; Zon, 2001) and social conflict view (Acemoglu, Johnson & Robinson, 2004). It argues that in case of neopatrimonial states FI can expect to built cooperative relationships with host countries only in those cases when their interests coincide or do not interfere with personal economic and political interests of ruling elite.

Further, 'blind bargaining' model establishes the necessity to distinguish between different types of investors. It argues that goals of different types of FIs vary significantly depending on their nature. Thus, it suggests considering separately the motives of two types of FI, namely real or genuine iFDI and pseudo-FDI.

Combining the multiple bodies of literature and indicating the need to differentiate between real and pseudo-FDI in studies on FDI relationships with and their impact on various host state characteristics is an important contribution to the literature on FDI. Pointing to the role and focusing on segregating the impact of pseudo-FDI in any previously examined FDI relationships creates a strong case for questioning the results and reviewing the existing scholarly work in this field. It is obvious that the goals of such polar groups of FI will vary significantly and, as a result, require exceptional individual examination.

The latter statement gains even more value in the light of the analysis of host countries' goals. In neopatrimonial transition states the latter goals reflect the

interests of ruling political-economic clans which want access to FIs' non-location bound FSAs. Moreover, the largest share of pseudo-FDI belongs to the representatives of these ruling political-economic clans. Thus, all decisions are guided by the pursuit for the increase of personal ruling elite businesses' competitiveness.

'Blind bargaining' model spotlights several more factors creating additional constraints for the negotiating parties in the bargaining process. Firstly, it is unreliability and volatility of any host country decisions due to heterogeneity of bargaining interests of government actors and incentive incompatibilities faced by them. Secondly, based on the findings of the qualitative part of this research project this model identifies pseudo investors and state officials' fear for personal assets' safety abroad as important factors affecting bargaining outcomes.

Another very important element of the 'blind bargaining' model, which constitutes an independent contribution to the bargaining and institutional literature is the proposition to distinguish between formal and informal elements of the bargaining process. Within its framework it is specifically indicates that bargaining of companies with FDI in neopatrimonial transition countries is not restricted to only formal negotiations over public policies in industry-specific issues. Informal bargaining over the safety of their assets and fair law enforcement is a crucial element for foreign investors' operational sustenance in this group of countries.

The next findings within this research project constituting an independent contribution to the literature on foreign investors' political strategies and applied within the 'blind bargaining' model is an addition of corruption as one of the most important political strategies for low- and mid-profile foreign investors in neopatrimonial transition states. This suggestion is based on combination of the theoretical insights (Collins, Ulluenbruck & Rodriguez, 2009; Lawton, McGuire, Rajwani, 2012; Venard, 2009) and results of the qualitative analysis of FIs' political behavior.

Also, the results of the qualitative analysis provide evidence that in neopatrimonial transition states the efficiency of FIs' relational resources is not

simply determined by their relationships with any state officials but depends upon their ability to access and built personal relations with representatives of ruling elite clans.

The proposition regarding the last element of the ‘blind bargaining’ model, assessment of outcomes evaluation and their efficiency constitutes a very important contribution to the literature on the effectiveness of corporate political strategies (Baysinger, 1984; Keim & Baysinger, 1988; Kudina & Collinson, 2009; Oliver & Holzinger, 2008). It is argued that in neopatrimonial transition states outcome evaluation requires distinguishing between and separate evaluation of its two components including official approval of negotiated government policies and actual enforcement of approved government policies. The discriminative application and enforcement of laws does not guarantee realization of FIs’ expectations and in many cases even prevent them from getting a legitimate pay off on their effort.

Overall it can be concluded that ‘blind bargaining’ model, developed as a special case of political bargaining model, provides a comprehensive framework for explaining FIs – host state bargaining relationships in neopatrimonial transition economies. This model was tested both quantitatively for the sample of 27 post-Socialist countries and qualitatively for the case of Ukraine within this research project. The results of both analyses provide evidence in support of this model. Further country-specific tests are necessary to test its applicability beyond the transition countries, particularly emerging and developing countries.

There are also several more findings which were not directly discussed within the framework of the ‘blind bargaining’ model but which constitute important contributions to the literature. First of all, the qualitative analysis of foreign investors’ political behavior in Ukraine identifies a gap in international business literature on FDI. Recognizing raiding problem as an important element affecting and determining the quality of iFDI in transition economies, based on the results of this analysis, it establishes the need for combining FDI and raiding literature (Osipyan, 2010; Pojansky, 2013; Pojansky, 2014; Zimmerer & Khmara, 2012) and for reconsidering previously produced results.



The qualitative analysis shows that the degree of a company's involvement in a public decision-making and its political pro-activeness as well as the choice of particular political strategies and tactics is determined by numerous combinations of various company and host-country specific characteristics. It is established that a company's elite status in the world economy to a great extent determines its bargaining power and security of its assets in Ukraine.

Thus, a clear distinction in the behavioral patterns of low- and mid-profile investors, on one hand, and elite MNEs, on the other hand, can be observed in terms of their choice of political strategies, levels of political activity and pro-activeness, and degrees of success and efficiency in their efforts to influence institutional changes. For example, it is established that elite MNEs choose relational approach to their political strategies and pursue long-term relationship and apply predominantly buffering strategies. In contrast, the first two groups of foreign investors stick to transactional approach and adapt to the realities of Ukrainian business environment, including both its formal and informal components.

It is noteworthy that the findings of this qualitative inquiry also allow suggesting the extension of an existing classification of buffering strategies (Hillman, Keim & Schuler, 2004; Meznar & Nigh, 1995). All low- and mid-profile foreign investors identify as their buffering strategies physical protection of their assets and concealment of their FDI by registering their businesses as domestic, thus representing an opposite of pseudo-FDI that could be referred to as pseudo-domestic companies. As a result, in the context of transition countries we propose adding two evolving buffering techniques namely improvement of physical security and pseudo-domestic business operation mode.

The last but not the least important contribution of this research pertains to the collective action literature (Olson, 1965). This analysis establishes and explains the reasons for irrelevance of free-riding problem for almost all business actors in Ukraine, except for those possessing significant tacit relational resources and/ or representing personal interests of ruling political-economic clans. The results of this research show that it is the combination of omnipresent corruption and discriminative enforcement of laws resolve the free-riding problem (Olson, 1965) in Ukraine and

other countries with the same institutional environment. Here, in contrast to developed less corrupt societies, low- and mid-profile companies not participating in collective bargaining over relevant to their businesses policy issues cannot benefit from value-creating outcomes ensured by the approval of such policies free of charge. It is explained by the fact that literally under no circumstances corrupt state officials in Ukraine will apply the desired law in any case without receiving a bribe, which resolves the free-riding problem.

Overall, this discussion reveals several very important contributions on the quality of iFDI, foreign investors' impact on institutional change, political behavior and relationships with host states in transition economies. Some of the findings were tested only in the context of one country, Ukraine. Thus, in order to take the literature forward, the test of the 'blind bargaining' model and other findings is required in the context of other transition countries. Moreover, it is also advised to examine their applicability for other emerging and developing countries.

### **9.3 Implications for business practice and education**

The value and relevance of providing a better contextual insight into the dynamics of the relationships between institutional environment and foreign investors' non-market strategies, particularly their political behavior and activities, cannot be overemphasized. In spite of the recent upsurge of research efforts in this area, more context-specific studies are encouraged under the conditions of perpetually changing global and country-specific characteristics of business environments and their relationships. Under such circumstances, the findings of such inquiries would have important implications and reveal information and evidence invaluable for keeping abreast education, business practice and management (Nartey, 2013). The use of multidisciplinary approach, upgrading of existing theories and inclusion of new theoretical and practical materials and courses at all levels of both academic and executive education will equip practitioners with the knowledge and tools necessary for improving their operational performance in various institutional environments (Nartey, 2013).

Thus, the potential advancement in the quality of relationships between companies with FDI and institutions and of institutional environment in Ukraine, in particular, and in transition countries, in general, is dependent on several factors. First of all, in accordance with the findings of this research it is suggested that companies entering or working in the markets characterized by extremely complex and imperfect nature of institutional environment should seek external advice and consult experts in different operational spheres, including legal, tax, government relations and other specialists. This requirement is specifically applicable for smaller foreign investors which do not possess adequate internal resources for undertaking independent expert assessment of irregularities and deviations in business conduct and environment in the countries of their existing or prospective investments.

Secondly, it is crucial for the companies, particularly smaller investors and joint ventures, to overcome their inertia and take a more proactive and, what is more important, less self-interests centered and more holistic, contributing to the aggregate development of institutions and improvement of institutional environment, position with regard to their participation in all stages of policy cycle. The latter include issue identification, policy analysis, policy instrument development, consultations, coordination, decision-making, implementation and evaluation activities.

Finally, the principal and imperative conditions for the successful reform of institutional environment in Ukraine and other transition and developing countries are companies' adherence to active citizenship position and, as a result, to corporate socially responsible practices without any exclusions. Particular emphasis is placed here on corporate behavior concerning corruption. This research provides proof that in surviving transition countries' style raiding attacks only those companies succeeded that sustained a completely legal and transparent pattern of conducting business in Ukraine. On the other side, there is also evidence that many of the companies impaired their status and bargaining position by embarking into path of corruptive practices. Representatives of many such companies admitted that this decision led to their eventual withdrawal from the market.

#### **9.4 Implications for public policy**

Reform of institutional environment in Ukraine requires commitment and cooperation of both business and public sectors. Representatives of both sectors must realize that building and maintaining strong, productive, and efficient cooperative relationship is a principal condition for the development and improvement of institutions in transition and developing countries. By its nature public sector should take a leading part in establishing, reinforcing and promoting of such joint effort. Public sector should be actively seeking to set up and maintain various communication channels with members of business community. The most important requirement here is that these activities were not treated just like a simple formality.

This research demonstrated that relatively numerous currently existing channels of cooperation such as various agencies, round tables, etc. do not really fulfill their mission. For example, respondents pointed to the lack of publicity with regard to information about events putting on a stage for a dialogue and debate on abolition, modification or introduction of new policies, legislation and regulatory procedures. Moreover, the respondents indicated that in most of the cases their recommendations were ignored and, as a result, their participation in such events did not generate an adequate reaction from public authorities.

Thus, public sector, in general, and policy makers, in particular, are called for changing their demeanor on the subject of its communication and cooperation with business sector. It is possible to accomplish by ensuring the availability of efficient system which would ensure availability of timely information and of uncorrupted insightful, responsive to the external critique and recommendations, specialists with appropriate skills, experience and knowledge to originate and enact necessary changes in the area of their expertise.

#### **9.5 Limitations of the study**

Sample and nature of the researched phenomenon are the main sources of this project's limitations. One of the major obstructions for this study is the inequality and, in some cases, lack of representation of companies within different groups distinguished in accordance to a number of important characteristics identified as

determinants of companies with FDI status and behavioral patterns in their relationships with host countries' institutions. Moreover, self-selection of participating companies, some companies' rejection to participate in this research after their better acquaintance with the topic, as well as some of the participating companies' conditioning their participation in this research through securing their right to discretely answer the questions of their choice, all signify that this analysis could be a subject to several types of bias.

Firstly, it is likely that self-selection of companies within the originally constructed sample and optional disclosure of facts by some of the participating companies could generate a bias resulting from omission of data that could be otherwise obtained from informants representing the companies which rejected their participation and in a case of absolute transparency in revealing details of their political behavior by some of the participating companies. Secondly, the reliance on informal content analysis and the self-reported data obtained in the process of interviewing of a small sample of top-ranking companies' representatives on such sensitive issues as their companies' political behavior is a limitation in itself.

Another very important limitation is a failure to gain access to representatives of legislative and policy-making branch of power in host country to unfold their perspectives on the issue under consideration and assessment of the companies' with FDI impact on their activity and its outcomes. The cross-examinations and cross-test of the both sides' perceptions and positions on the subject matter would produce a more accurate picture and contribute to better understanding and to possibility of reaching more objective answers to the research questions.

## **7.6 Future research directions**

On the basis of our analysis we can conclude that empirical evidence obtained has provided inconsistent and often conflicting results. This lack of strong evidence can be first of all explained by the complexity and sensitivity of the examined phenomenon, by the dynamically changing nature of both global and local business environment, including its both market and non-market components, by the imperfection of research methods, and also data availability, reliability and

measurement problems. Moreover, our qualitative analysis shows that the relationships between companies with FDI and institutional environment of host countries are extremely context specific. They depend on the variety of numerous combinations of company-, industry-, and country-specific characteristics, particularly the degree of uncertainty and lack of stability in the host country's political, social and economic domains.

For obtaining stronger and more consistent evidence future research effort should be focused on qualitative country- and industry-specific comparative studies examining the relationships between companies with FDI and host countries' institutions, particularly in terms of different types of both individual MNEs/companies with FDI and their groups' political behavior and their impact on various host-country policies, as well as on other non-market environment targets, such as public opinion, media, industry associations and NGOs, etc.

Thus, further research should involve more projects looking into the findings pointing out to the differences in behavioral and impact patterns between and matching patterns across various groups of companies with FDI. Besides, particularly interesting and contributory for gaining a better insight into the relationships between MNEs and host countries' institutions would be to fill out the gap in literature and counteract the findings of existing qualitative and quantitative research on MNEs behavior with qualitative studies focusing on the analysis of activity and opinions of representatives of various branches of power, specifically executive branch in case of transition countries.

Moreover, 'blind bargaining' model, developed as a special case of political bargaining model, provides a comprehensive framework for explaining FI – host state bargaining relationships in neopatrimonial transition economies. This model was tested both quantitatively for the sample of 27 post-Socialist countries and qualitatively for the case of Ukraine within this research project. The results of both analyses provide evidence in support of this model. Further country-specific tests are necessary to test its applicability beyond the transition countries, particularly emerging and developing countries.

In addition, several supplementary contributions to the existing international business and political science literature identified as a result of developing a ‘blind bargaining’ model, including findings on corruption as a one of the most important political strategies and a solution of a free riding problem for almost all business actors in neo-patrimonial states, open absolutely new and very challenging prospects for future research effort in this field.

Finally, all the suggestions on the directions for future research assume that prospective studies must follow a more multidisciplinary approach.

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## APPENDIX A

### A1. SOLICITATION LETTER: ENGLISH LANGUAGE



Dear Sir/ Madam

As a PhD student in Strategy & International Business, the University of Edinburgh I am undertaking a survey looking into the relationship between companies with foreign direct investment (FDI) activity and quality of institutional environment in host countries. As a result, I would greatly appreciate it if you or your colleague with an interest in or responsible for your enterprises' government relations, public relations, and other activities related to the relationships with community, mass media, other enterprises and various state institutions could spare a few minutes for a research interview with me (face-to-face, phone or Skype).

I am aware that your time is precious but by participating in this research you will be helping us to draw up a comprehensive picture of companies' interactions with various market and non-market actors with the purpose of changing institutional environment in a host country and foreign investors' role in this process.

The information is being sought purely for educational and academic purposes. I hope that you will be interested in issues raised by the questionnaire, and I would be more than willing to send you an executive summary of my findings at your request.

All responses to this research project will be handled in the strictest confidence and in compliance with Data Protection Act 1998. All companies and individuals contributing to the survey will do so anonymously.

Many thanks for considering this request.

Look forward to hearing from you.

Yours sincerely,

Nataliya Acc-Nikmehr  
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Business School, The University of Edinburgh  
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## A2. SOLICITATION LETTER: RUSSIAN LANGUAGE



Уважаемый Коллега,

Будучи аспирантом Университета Эдинбурга по специальности Стратегия и Международный Бизнес, я изучаю проблему взаимодействия и взаимоотношений международных компаний (МНК) с иностранными инвестициями (связи с общественностью, государственными структурами, лоббизм и т. д.) и изменениями институциональной среды в Украине. Я была бы весьма признательна, если бы Вы согласились на интервью со мной (лично, по телефону или в Skype).

Ваше согласие дать интервью поможет мне составить полную картину влияния МНК, отечественных предприятий, компаний специализирующихся на лоббировании и других бизнес групп на различные рыночные и вне рыночные субъекты с целью улучшения институциональной среды в Украине.

Вся информация будет использована исключительно в научных целях. Я надеюсь, что Вас заинтересуют вопросы затронутые в интервью, и я с готовностью предоставлю Вам результаты моих исследований по Вашему желанию.

Всем компаниям и частным лицам принимающим участие в моём исследовании гарантируется анонимность и строгая конфиденциальность.

Большое спасибо за ваше внимание к моей просьбе.

С нетерпением жду вашего ответа.

С уважением

Наталия Асс-Никмер  
Управление Бизнесом  
Стратегия и Международный Бизнес  
Бизнес-школа  
Эдинбургский Университет  
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### A3. SOLICITATION LETTER: UKRAINIAN LANGUAGE



Шановний Колего!

З'являючись аспірантом Університету Едінбурга за фахом Стратегія та Міжнародний Бізнес, я вивчаю проблему взаємодії та взаємовідносин міжнародних компаній з іноземними інвестиціями (зв'язки з суспільством, державними структурами, лобізм і т. п.) та зі змінами інституціонального середовища в Україні. Була б Вам дуже вдячна, якщо б Ви згодні були дати мені інтерв'ю (особисто, у телефонній розмові, або у Skype (моє Skype ім'я: Nataliya Ass-Nikmehr).

Інтерв'ю з Вами допоможе мені скласти повну картину впливу компаній з іноземними інвестиціями, вітчизняних підприємств, компаній, які спеціалізуються на лобіюванні, та інших бізнес угруповань на різні ринкові та позаринкові суб'єкти з метою покращання інституціонального середовища в Україні.

Уся інформація буде використованна виключно у наукових цілях. Сподіваюсь що Вас зацікавлять запитання затронуті у інтерв'ю і з радістю додам Вам результати моїх досліджень за Вашим бажанням.

Усім компаніям та приватним особам приймаючим участь у моєму дослідженні, гарантується анонімність та сувора конфіденційність.

Дякую Вам за увагу до мого прохання.

З нетерпінням чекаю Вашої відповіді.

З повагою

Наталія Асс-Нікмер  
Управління Бізнесом  
Стратегія та Міжнародний Бізнес  
Бізнес школа  
Едінбургський Університет

## APPENDIX B

### B1. SEMI-STRUCTURED INTERVIEW PROTOCOL: ENGLISH LANGUAGE

#### COMPANIES WITH FDI CHANGE IN BARGAINING POWER, NONMARKET STRATEGIES, POLITICAL BEHAVIOUR AND IMPACT ON INSTITUTIONAL ENVIRONMENT

##### SECTION 1: COMPANY PROFILE

1. How long have your company been working in Ukraine?
2. What are the company's/subsidiary's main activities and what are the sectors/ industries of your company's/subsidiary's operation in Ukraine?
3. What form of ownership does your company/subsidiary have in Ukraine?
4. How was this company/subsidiary established?
5. What is the main reason for your investment in Ukraine?
6. How many full-time employees has your company/subsidiary been employing in Ukraine?

	Starting year of company's work	Present time
Number of employees		

##### SECTION 2: BARGAINING POWER

7. What are Ukraine's main bargaining strengths and weaknesses as a host country for your company/ subsidiary?
8. How important are the fluctuations in host country risks for your company? Why? Examples.
9. Does your company try to cause the changes, particularly decrease, of country risks in Ukraine? By what means? How successful are these attempts? Examples.
10. What are the main bargaining strengths and how important are these characteristics of your company/ subsidiary for its work in Ukraine?
11. What are the main sources of pressure/ influence on your company in Ukraine?
12. Respond to the pressures of which of the above mentioned groups is the primary task for your company/ subsidiary? Why?
13. How conflictive are the above mentioned pressures? Why? Examples.

14. How substantive is the problem of presence and influence of pseudo-FDI (also referred to as round tripping FDI: Ukrainian domestic companies' FDI from offshore zones) for your company as well as for realizing full working potential of real investors in general and for attracting new FDI?
15. What are the directions and essence of pseudo-FDI influence on FDI in Ukraine?
16. What is the impact of pseudo-FDI on the changes in real foreign investors' bargaining power?
17. How substantive is the 'raiding' problem for companies with FDI in Ukraine? Why? Examples.
18. Does the presence of 'raiding' problem influences foreign investor's bargaining power? How?
19. How substantive is the problem of merging political, economic and criminal powers for businesses, in general, and for foreign investors, in particular, in Ukraine in your opinion?
20. Do you think that personal relationships with representatives of various state offices increase the bargaining power of your company in Ukraine? If YES, to what extent it does so?
21. How do you consider your company's relative bargaining power have changed at present as compared to the time of entering the Ukrainian market & to what degree? Why? Examples.

**SECTION 3: POLITICAL BEHAVIOUR/ NONMARKET STRATEGIES/ INTERACTIONS WITH INSTITUTIONAL ENVIRONMENT**

22. How is functional field of interactions with nonmarket environment, including political activity, organized in your company?
23. Part of what departments (if any) is nonmarket, in general, and political activity, in particular, in your company?
24. What are the participants of the bargaining process with Ukraine on the part of your company/subsidiary?
25. How dependent is your subsidiary on the head office directives in terms of choice, formulation and implementation of political strategies and political activities?
26. What channels does your company/subsidiary use to cause the changes in the host country's institutional environment & to what degree? Why? Examples.

27. What are the means used by your company for the interaction with non-market environment actors & to what degree? Why? Examples.
28. How does your company/subsidiary assess the effectiveness of undertaking its political activities through various means?
29. What do the choices of cooperation modes of your company's/subsidiary's political activity depend on? Why? Examples.
30. What professional and business associations your company/subsidiary is a member of?
31. How do you assess the efficiency and degree of success of companies and professional and business associations in Ukraine in terms of their input and influence on the changes in/ improvement of institutional environment in the country? Why? Examples.
32. At what levels and with what branches of government does your company/subsidiary interact in the process of its work and to what degree?
33. Is there an open dialog and programs for active attraction of companies with FDI and various professional and business associations into a discussion of problems on improvement of existing & development of new laws, policies and regulatory mechanism which would contribute to the improvement of institutional environment in Ukraine? Examples.
34. How actively do state authorities attract experts (including companies with FDI, MNEs, other professional and business association) for the participation in such programs? Why? Examples.
35. How actively do these experts, particularly your company/subsidiary, seek for such participation? Why? Explain activeness or passiveness.
36. What spheres and types of policies are the focus of your company's/subsidiary's interest & influence and to what degree? Why? Examples.
37. At what stages of policy cycle and how actively is your company/ subsidiary involved in host countries, particularly Ukraine? Examples.
38. How responsive are government authorities to experts' (particularly your company's/ subsidiary's) opinions and recommendations? Why? Examples.



39. What particular laws, policies, decrees, permits and other kinds of institutional changes have your company/subsidiary been pursuing and lobbying for in Ukraine and its degree of success?

Successfully implemented

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Failed to implement (Why?)

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In process of negotiation

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40. Will introduction of a new Law on Lobbying in Ukraine facilitate the process of political bargaining for your company/subsidiary in Ukraine and to what degree?

**SECTION 4: SELF-ASSESSMENT OF THE FOREIGN INVESTORS' DEGREE OF PRO-ACTIVITY AND EFFICIENCY IN TERMS OF THEIR INTERACTIONS WITH INSTITUTIONAL ENVIRONMENT IN UKRAINE**

41. How would you assess the input of your company in terms of its contribution to the changes, in particular improvement, of an institutional environment in Ukraine?

42. How would you assess you company's/ subsidiary's Corporate Social Responsibility practices?

43. How effectively does your company/ subsidiary manage its relationship with various government authorities with the purpose of improving institutional environment in Ukraine? Why? Examples.

44. How pro-active and successful is your company in envisioning and preventing forthcoming legal, regulatory and other institutional changes which could have negative impact on the work of company/ subsidiary with FDI in Ukraine? Why? Examples.

45. What kind of buffering mechanisms does your company/subsidiary use to protect itself from the deficiencies of institutional environment in Ukraine and excessive government interference?

46. How do you assess the effectiveness of your company's selected nonmarket strategies, in general, and political strategies, in particular?

47. How is your company/subsidiary planning to change the intensity of its political involvement in Ukraine? Why?

48. Do you think that personal relationships with representatives of various state offices facilitate the functioning of businesses in Ukraine? If YES, to what extent it does so?

49. How substantive is the problem of potential liabilities for political ties for businesses in Ukraine in your opinion? Why?
50. How would you assess the quality of existing FDI in Ukraine? Why?
51. What is the role of your company, other companies with FDI and various professional and business associations in fighting corruption in Ukraine?
52. How do you assess the quality and efficiency of work of legislative, executive and judicial branches of power in Ukraine? Why? Examples.
53. How would you assess the quality of business environment and efficiency of your subsidiary's work in Ukraine as compared to your company's other Central and Eastern European subsidiaries? Why? Examples.
54. What would you like to change in Ukraine's political system if you could?

Any other comments and recommendations

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**THANK YOU VERY MUCH FOR YOUR PARTICIPATION**

## B2. SEMI-STRUCTURED INTERVIEW PROTOCOL: RUSSIAN LANGUAGE

### РАЗДЕЛ 1: О КОМПАНИИ

1. Как давно Ваша компания/ дочернее предприятие работает в Украине?
2. Каковы основные направления деятельности и в какой отрасли промышленности работает Ваша компания/дочернее предприятие в Украине?
3. Какова форма собственности у Вашей компании/ дочернего предприятия в Украине?
4. Как Ваша компания / дочернее предприятие было создано?
5. Что является основной причиной Ваших инвестиций в Украину?
6. Сколько штатных сотрудников в Вашей компании/ дочернем предприятии в Украине?

	Год начала работы компании	Настоящее время
Количество сотрудников		

### РАЗДЕЛ 2: РЫНОЧНАЯ ВЛАСТЬ

7. Каковы наиболее популярные и наиболее перспективные с точки зрения развития экономики отрасли промышленности для привлечения иностранных инвестиций в Украине?
8. Какие из характеристик Украины на сегодняшний день являются наиболее благоприятными факторами для привлечения инвестиций и развития бизнеса в стране, а какие наоборот способствуют отчуждению инвестиций?
9. Насколько важны колебания рисков в стране для Вашей компании? Почему? Примеры.
10. Предпринимает ли Ваша компания попытки повлиять на изменения, в частности в направлении сокращения рисков в Украине? Какими средствами? Насколько успешны эти попытки? Примеры.
11. Каковы основные преимущественные характеристики Вашей компании, способствующие укреплению её рыночных позиций в Украине?
12. Каковы основные источники давления на Вашу компанию в Украине?
13. Удовлетворение требований каких из вышеуказанных Вами источников давления является первостепенной задачей для Вашей компании / дочернего предприятия?
14. Насколько конфликтны направления давления вышеуказанных Вами источников влияния? Почему? Примеры.

15. Насколько существенна проблема присутствия и влияния псевдо-ПИИ (прямых иностранных инвестиций украинскими отечественными компаниями из оффшорных зон) для Вашей компании, а также для реализации полного рабочего потенциала реальных инвесторов и для привлечения новых ПИИ?

16. Каковы направления и сущность влияния псевдо-ПИИ на качество и количество реальных ПИИ в Украине?

17. Как псевдо-ПИИ влияют на изменение рыночной власти настоящих иностранных инвесторов в Украине?

18. Насколько существенна проблема рейдерства для компаний с иностранными инвестициями в Украине?

19. Влияет ли присутствие проблемы рейдерства на изменения рыночной власти иностранных инвесторов в Украине? Если ДА, то какова сила и направление этого влияния?

20. Насколько актуальна и существенна проблема слияния политических, экономических и криминальных сил для бизнеса в целом и иностранных инвесторов в частности в Украине по Вашему мнению?

21. Думаете ли Вы, что личные отношения с представителями власти и различных государственных структур и организаций способствует росту рыночной власти Вашей компании в Украине? Если да, то в какой степени?

22. Кто является участниками переговорного процесса с Украиной со стороны Вашей компании / дочернего предприятия?

23. Как и в какой степени по Вашему мнению изменилась относительная рыночная власть/ переговорная сила Вашей компании в настоящее время по сравнению со временем начала её работы в Украине? Почему? Примеры.

**РАЗДЕЛ 3: ВЗАИМОДЕЙСТВИЕ С ИНСТИТУЦИОНАЛЬНОЙ СРЕДОЙ: ВНЕРЫНОЧНЫЕ И ПОЛИТИЧЕСКИЕ СТРАТЕГИИ (связи с общественностью, государственными структурами, средствами массовой информации, лоббизм и т. д.).**

24. Каким образом организована функциональная область взаимодействия с внерыночной средой, в целом, и с институциональной средой, в частности, в Вашей компании?

25. Частью какого отдела (если таковой имеется) является деятельность по данному направлению в Вашей компании?

26. Насколько зависим Ваш филиал/ дочернее предприятие от директив головного

офиса в вопросах выбора, разработки и реализации инициатив по изменению институциональной среды в Украине?

27. Какие каналы и в какой степени Ваша компания наиболее эффективно использует с целью влияния на изменения в институциональной среде Украины? Почему? Примеры.

28. Какие инструменты и в какой степени Ваша компания использует при взаимодействии с различными внерыночными структурами и организациями? Почему? Примеры.

29. Насколько эффективна деятельность Вашей компании по изменению институциональной среды в Украине при её проведении следующими способами?

30. От чего и насколько зависит выбор Вашей компанией вышеперечисленных режимов сотрудничества по вопросам влияния на изменения в институциональной среде Украины? Почему? Примеры.

31. Членом каких профессиональных и бизнес ассоциаций является Ваша компания/ дочернее предприятие? Перечислите их.

32. Как Вы оцениваете эффективность и успешность компаний с иностранными инвестициями и профессиональных и бизнес ассоциаций в плане их вклада и влияния на изменения институциональной среды в в Украине?

33. На каких уровнях, с какими ветвями власти и в какой степени Ваша компания/ сотрудничает по вопросам улучшения институциональной среды в Украине?

34. Существует ли открытый диалог и программы по привлечение иностранных инвесторов и различных профессиональных и бизнес организаций к обсуждению проблем по улучшению функционирующих и созданию новых законов, политик и регулятивных механизмов, которые способствовали бы улучшению институциональной среды в Украине? Примеры.

35. Насколько активно государственные организации различного уровня пытаются привлечь экспертов (включая представителей компаний с иностранными инвестициями, транснациональных корпораций, профессиональных и бизнес ассоциаций и др.) к участию в таких программах? Примеры.

36. Насколько активно сами эксперты, в частности Ваша компания, стремятся к такому участию?

37. Какие сферы экономики и политики, на каких стадиях и в какой степени находятся в центре внимания и влияния Вашей компании?

38. В каких стадиях цикла по разработке политики и насколько активно принимает участие Ваша компания/ дочерняя компания?

39. Насколько серьёзно представители государственных структур относятся к мнению, советам и рекомендациям экспертов, в особенности представителей Вашей компании?

40. Какие конкретные законы, политики, постановления, разрешения и другие виды институциональных изменений Ваша компания лоббирует в Украине и степень ее успеха?

Успешно реализованные

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Не удалось реализовать

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В процессе переговоров

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41. Упростятся ли и в какой степени процессы и процедуры переговоров Вашей компании с государственными структурами в результате введения нового Закона о Лоббировании в Украине ?

#### **РАЗДЕЛ 4: ОЦЕНКА АКТИВНОСТИ И ЭФФЕКТИВНОСТИ ДЕЙСТВИЙ КОМПАНИИ ПО ВОПРОСАМ ВЗАИМОДЕЙСТВИЯ С ИНСТИТУЦИОНАЛЬНОЙ СРЕДОЙ В УКРАИНЕ.**

42. Каков, по Вашему мнению, вклад Вашей компании с точки зрения её влияния на изменения институциональной среды в Украине?

43. Насколько эффективны взаимоотношения Вашей компании с различными государственными структурами по вопросам влияния на изменения институциональной среды в Украине? Почему? Примеры.

44. Насколько про-активна и успешна Ваша компания в вопросах предвидения и предотвращения возможных предстоящих правовых, нормативных и других институциональных перемен, введение которых оказало отрицательное влияние на работу Вашей компании в Украине? Почему? Примеры.

45. Какие механизмы защиты Ваша компания использует для того, чтобы оградить себя от неполноценности институциональной среды и чрезмерного государственного вмешательства в её работу в Украине?

46. Как Вы оцениваете эффективность вне рыночных стратегий Вашей компании в целом и политических стратегий в частности?

47. Как Ваша компания планирует изменять интенсивность своей вовлечённости по вопросам улучшения институциональной среды в Украине?

48. Являются ли личные связи с сотрудниками государственных структур, народными депутатами и т. п. важным фактором для функционирования различных компаний в Украине?

Если ДА, то в какой степени это упрощает процессы и процедуры переговоров компаний в Украине с различными государственными структурами?

50. По Вашему мнению насколько существенна для бизнеса в Украине, особенно для компаний с иностранными инвестициями, проблема потенциальной ответственности за политические связи? Почему?

51. Как Вы оцениваете качество целевых иностранных инвестиций в Украине? Почему?

52. Какова роль непосредственно Вашей компании, других компаний с иностранными инвестициями и различных профессиональных и бизнес ассоциаций в борьбе с коррупцией на Украине?

53. Как Вы оцениваете качество и эффективность работы правовых, исполнительных и судебных ветвей власти в Украине? Почему? Примеры.

54. Как Вы оцениваете качество бизнес среды и эффективность работы Вашей компании в Украине по сравнению работой дочерних предприятий в странах Центральной и Восточной Европы? Почему? Примеры.

55. Что бы вы хотели изменить в политической системе Украины, если бы могли?

56. Предпринимали ли Вы какие либо попытки по осуществлению перемен предложенных Вами в предыдущем вопросе? Какие?

**ОГРОМНОЕ СПАСИБО ЗА ВАШЕ УЧАСТИЕ В ПРОЕКТЕ**

### B3. SEMI-STRUCTURED INTERVIEW PROTOCOL: UKRAINIAN LANGUAGE

#### РОЗДІЛ 1: ПРО КОМПАНІЮ.

1. Як довго Ваша компанія/дочірнє підприємство працює в Україні?
2. Які основні напрямки діяльності та у якій галузі промисловості працює Ваша компанія/дочірнє підприємство в Україні?
3. Яка форма власності Вашої компанії/дочірнього підприємства в Україні?
4. Як Ваша компанія/дочірнє підприємство було створено?
5. Яка головна причина Ваших інвестицій в Україну?
6. Кількість штатних співробітників у Вашій компанії в Україні

	Рік початку роботи компанії	Нинішній час
Кількість співробітників		

#### РОЗДІЛ 2: РИНКОВА ВЛАДА

7. Які найбільш популярні та найбільш перспективні, з точки зору розвитку економіки, галузі промисловості для прилучення іноземних інвестицій в Україні?
8. Які з характеристик України, на нинішній час, з'являються найбільш сприятливими факторами для прилучення інвестицій та розвитку бізнесу у країні, а які навпаки сприяють відчуженню інвестицій?
9. Наскільки важливі коливання ризиків у країні для Вашої компанії? Чому? Приклади.
10. Чи застосовує Ваша компанія спроби впливу на зміни зокрема у напрямку скорочення ризиків в Україні? Якими засобами? Наскільки успішні ці спроби? Приклади.
11. Які основні переважливі характеристики Вашої компанії сприяють укріпленню її ринкових позицій в Україні?
12. Які головні джерела тиску на Вашу компанію в Україні?
13. Задоволення яких вимог, з вищевказаних Вами джерел тиску, з'являється першорядним завданням для Вашої компанії/дочірнього підприємства?
14. Наскільки конфліктні напрямки тиску вищевказаних Вами джерел впливу? Чому? Приклади.



15. Наскільки суттєва проблема присутності та впливу псевдо-ППІ (прямих іноземних інвестицій українськими вітчизняними компаніями з офшорних зон) для Вашої компанії, а також для реалізації повного робочого потенціалу реальних інвесторів та для приваблення нових ППІ?
16. Які напрямки та сутність впливу псевдо-ППІ на якість та кількість реальних ППІ в Україні?
17. Як псевдо ППІ впливають на зміни ринкової влади справжніх інвесторів в Україні?
18. Наскільки суттєва проблема рейдерства для компаній з іноземними інвестиціями в Україні?
19. Чи впливає присутність проблеми рейдерства на зміни ринкової влади іноземних інвесторів в Україні? Якщо так, то яка сила та напрямок цього впливу?
20. Наскільки актуальна та суттєва проблема злиття політичних, економічних та кримінальних сил для бізнесу у цілому та частково для іноземних інвесторів в Україні, на Ваш погляд?
21. Чи гадаєте Ви що приватні відношення з представниками влади та різних державних структур та організацій сприяють зросту ринкової влади Вашої компанії в Україні? Якщо так, то у якій мірі?
22. Хто з"являється учасниками перемовного процесу з Україною з боку Вашої компанії/дочірнього підприємства?
23. Як та у якій мірі, на ваш погляд, змінилась відносна ринкова влада/перемовна міцність Вашої компанії у нинішньому часі в порівнянні з часом початку її роботи в Україні? Чому? Приклади.

**РОЗДІЛ 3: ВЗАЄМОДІЯ З ІНСТИТУЦІОНАЛЬНИМ СЕРЕДОВИЩЕМ: ПОЗАРИНКОВІ ТА ПОЛІТИЧНІ СТРАТЕГІЇ . (зв"зки з суспільством, державними структурами, засобами масової інформації, лобізм та т. д.)**

24. Яким чином організована функціональна область взаємодії з позаринковим середовищем у цілому, та з інституціональним середовищем, частково, у Вашій компанії?
25. Частиною якого відділу (якщо такий є) з"являється діяльність у даному напрямку у Вашій компанії?
26. Наскільки залежить Ваш філіал/дочірнє підприємство від директив головного офісу у питаннях вибору, розробки та реалізації ініціатив з погляду інституціонального середовища в Україні?

27. Які канали та у якій мірі Ваша компанія найбільш ефективно використовує з метою впливу на зміни у інституціональному середовищі в Україні? Чому? Приклади.
28. Які інструменти та у якій мірі Ваша компанія використовує у взаємодії з відмінними позаринковими структурами та організаціями? Чому? Приклади.
29. Наскільки ефективна діяльність Вашої компанії зі змінювання інституціонального середовища в Україні при її проведенні слідуючими засобами?
30. Від чого та наскільки залежить вибір Вашої компанії вищеперелічених режимів співробітництва у питаннях впливу на зміни у інституціональному середовищі України? Чому? Приклади.
31. Членом яких професійних та бізнес асоціацій з"являється Ваша компанія/ дочірнє підприємство? Перелікуйте їх.
32. Як Ви оцінюєте ефективність та успішність компаній з іноземними інвестиціями та професійних та бізнес асоціацій у плані їх вкладу та впливу на зміни інституціонального середовища в Україні?
33. На яких рівнях, та з якими гілками влади та у якій мірі Ваша компанія співробітничает у питаннях покращання інституціонального середовища в Україні? Приклади.
34. Чи існує відкритий діалог та програми по залученню іноземних інвесторів та відмінних професійних та бізнес організацій до обговорювання проблем покращання функціонуючих та створенню нових законів, політик та регулятивних механізмів, котрі сприяли б покращанню інституціонального середовища в Україні? Приклади.
35. Наскільки активно державні організації відмінного рівня намагаються залучити експертів (включаючи представників компаній з іноземними інвестиціями, транснаціональних корпорацій, професійних та бізнес асоціацій та ін.) до участі у таких програмах? Приклади.
36. Наскільки активно самі експерти, частково Ваша компанія, прагнуть до такої участі?
37. Які сфери економіки та політики, на яких стадіях та у якій мірі знаходяться у центрі уваги та впливу Вашої компанії?
38. У яких стадіях циклу з розробки політики та наскільки активно приймає участь Ваша компанія/дочірня компанія?

39. Наскільки серйозно представники державних структур відносяться до думок, порад та рекомендацій експертів, особливо представників Вашої компанії?
40. Які конкретні закони політики, постанови, дозволи та інші види інституціональних змін Ваша компанія лобіює в Україні та ступінь її успіху? (Перелікуйте все, будь ласка.)

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Не вдалось реалізувати

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У процесі перемовин

41. Чи спростяться та у якій мірі процеси та процедури перемовин Вашої компанії з державними структурами, у результаті введення нового Закону про Лобіювання в Україні?

#### **РОЗДІЛ 4: ОЦІНКА АКТИВНОСТІ ТА ЕФЕКТИВНОСТІ ДІЙ КОМПАНІЇ З ПИТАНЬ ВЗАЄМОДІЇ З ІНСТИТУЦІОНАЛЬНИМ СЕРЕДОВИЩЕМ В УКРАЇНІ.**

42. Який, на Вашу думку, вклад Вашої компанії з точки зору її впливу на зміни інституціонального середовища в Україні?
43. Наскільки ефективні взаємини Вашої компанії з відмінними державними структурами з питань впливу на зміни інституціонального середовища в Україні? Чому? Приклад.
44. Наскільки про-активна та успішна Ваша компанія з питань передбачення та запобігання можливих наступних правових, нормативних та інших інституціональних змін, введення яких виявило б негативний вплив на роботу Вашої компанії в Україні? Чому? Приклади.
45. Які механізми захисту Ваша компанія використовує для того, щоб обгородити себе від неповноцінності інституціонального середовища та надмірного державного умішування в її роботу в Україні?
46. Як Ви оцінюєте ефективність позаринкових стратегій Вашої компанії у цілому та політичних стратегій частково?
47. Як Ваша компанія планує змінювати інтенсивність своєї участі з питань покращання інституціонального середовища в Україні?
48. Чи з'являються приватні зв'язки з співробітниками державних структур, народними депутатами та т. п. важливим фактором для функціонування відмінних компаній в Україні? Якщо ТАК, то у якій мірі це спрощує процеси та процедури перемовин компаній в Україні?

49. Наскільки, на Ваш погляд, суттєва для бізнесу в Україні, особливо для компаній з іноземними інвестиціями, проблема потенційної відповідальності за політичні зв'язки? Чому?
50. Як Ви оцінюєте якість цільових іноземних інвестицій в Україні? Чому?
51. Яка роль безпосередньо Вашої компанії, інших компаній з іноземними інвестиціями та відмінних професійних та бізнес асоціацій у боротьбі з корупцією в Україні?
52. Як Ви оцінюєте якість та ефективність роботи правових, виконавчих та судових гілок влади в Україні? Чому? Приклади.
54. Як Ви оцінюєте якість бізнес середовища та ефективність роботи Вашої компанії в Україні в порівнянні з роботою дочірніх підприємств у країнах Центральної та Східної Європи? Чому? Приклади.
55. Щоб Ви бажали змінити у політичній системі України, якщо б були спроможні?
56. Чи здійснювали Ви якісь спроби з виконання змін, пропонованих Вами у попередньому питанні? Які?

**ЩИРО ДЯКУЮ ВАМ ЗА УЧАСТЬ У ПРОЕКТІ.**