

Attracting Foreign Investment and EU Membership

OLEXANDR SHAROV¹

ANNOTATION. The article examines the urgent problem of attracting foreign investment, which is an important factor of economic growth and development for countries seeking to integrate into the European Union (EU). The author examines the impact of the recipient country's accession prospects on the dynamics of foreign investment, paying special attention to the experience of Eastern and Central European countries that joined the EU within the framework of the Fifth and Sixth Enlargement. The conclusions are based on the analysis of economic, political and institutional changes that accompanied the integration process of these countries. The article highlights the relationship between integration processes, investment activity and long-term prospects for economic development. It is proved that the prospect of joining the EU can be an important stimulus for the growth of foreign investors' confidence. However, it is noted that such a positive effect is not an automatic consequence of the mere announcement of accession plans. A prerequisite is the implementation of a significant amount of preparatory work: implementation of European standards, economic reforms and creation of a favourable investment climate, and the rapid completion of the accession process. Particular attention is paid to the need for a strategic approach to attracting foreign investment. The author emphasises that investments should be directed to priority sectors of the economy that can provide the greatest return for the recipient country and strengthen its competitiveness. It is also noted that participation in group enlargements of the EU requires the country to make efforts to ensure a leading position among other candidates, as leadership in the integration process has a positive impact on investment attractiveness. In addition, the importance of ensuring the economic capacity to absorb foreign capital is emphasised. This requires macroeconomic reforms, strengthening of institutions, development of scientific and technical potential, etc.

KEYWORDS: foreign investment, European Union, economic policy, investment policy, investment screening, EU accession.

Introduction

The positive impact of investment on the development of economic processes is a widely recognised phenomenon. That is why attracting foreign di-

¹ **Oleksandr Sharov** — Doctor of Economics, Professor, Chief Researcher at the Institute for Economics and Forecasting of the National Academy of Sciences of Ukraine. Sphere of scientific interests: world economy, international monetary and financial relations, globalisation, European integration, economic diplomacy. E-mail: alex-sharov7@gmail.com ORCID: <https://orcid.org/0000-0001-8460-9996>

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rect investment (FDI), especially to countries with a shortage of equity capital, is one of the priority tasks of governments in the field of economic policy. Especially if such investments are related to high technology. In turn, integration into the global economy, in particular through trade and capital flows, is a key and interrelated element of the investment process. Foreign direct investment (FDI) is a particularly important element of economic integration, as it opens up opportunities for accelerated growth ("catch-up economy"), technical innovation and enterprise restructuring, and capital account relief. EU membership can be seen as a determinant of the development of the business environment, and it can directly affect the volume and pace of FDI flows.

In the process of a country's economic development, FDI increases opportunities for economic growth, improves the balance of payments, increases exports by improving the trade process and expanding the "knowledge space", creates a more skilled workforce and increases employment. However, there is a natural limit to the effectiveness of FDI, as there is an equilibrium level of foreign participation in the economy given the state of institutional and economic development.

To analyse this process, the approach known as the Investment Development Path (IDP), which was laid down by John Dunning and Rajneesh Narula in their work², has been mostly used. The IDP provides a framework for understanding the dynamic interaction between foreign direct investment and economic development and has been the basis for a wide range of theoretical and empirical studies covering many countries. The IDP considers economic development as a sequence of structural changes and argues that such economic and social transformations have a systematic relationship with the behaviour of inward and outward FDI flows (Table 1).

The IDP is an attempt to provide a framework for a series of interrelated dynamic processes related to development and multinational companies (MNCs). However, the stages of the IDP should be seen as indicative rather than categorical. The concept of SDI should be used and interpreted in a broad sense, as it is primarily a tool for analysing the interaction between FDI and development. The broad version of the IDP pays more attention to the heterogeneity of both FDI and territories; to interactions and turning points; and to the role of political orientations.

² Dunning, J.H. (1981), Explaining the international direct investment position of countries: towards a dynamic or developmental approach, *Weltwirtschaftliches Archiv*, No. 119, pp. 30-64; Narula, R., Dunning, J.H. (2010), Multinational enterprises, development and globalisation: Some clarifications and a research agenda, *Oxford Development Studies*, Vol. 38, No. 3, pp. 263-287.

Table 1

**EVOLUTION OF MOTIVATION OF INCOMING
AND OUTGOING PI WITHIN THE SHIRES³**

Stages of the IDP	Inward FDI	Outward FDI
I	Initially, little FDI flows in. As geographical location advantages improve, resource-based motives and the search for new markets come into play	Very small FDI flows abroad. Mostly minor strategic investments and capital flight
II	The growing presence of foreign direct investment seeking a market that can attract some labour-intensive manufacturing.	Little outward FDI abroad. Some inward investment to find resources and markets in other developing countries; some outward investment to developed countries; mostly investment in natural resources or light manufacturing using established technologies.
III	Increased FDI inflows, as a result of market exploration and increased efficiency-oriented FDI in manufacturing, even in activities that supply more complex products to domestic markets or require more skilled labour.	Growth of FDI abroad. All types of investments, including investments to improve efficiency and some investments to increase assets; differentiated consumer goods of mass production, e.g. electrical goods, clothing; more investments in services, e.g. construction, banking.
IV and V	Investments aimed at market growth, efficiency and asset growth	Investments aimed at improving efficiency and increasing assets; regional and global; more mergers and acquisitions (M&A) and alliances; investments in knowledge-intensive sectors, e.g. IT, biotechnology and high value-added services, e.g. consultancy.

It is important to use the concept of IDP in the context of the institutions and policies of an emerging region. It is also important to emphasise that over-reliance on FDI to drive industrial modernisation has its risks. In recent years, the global economic crisis has had a very negative impact on MNCs in the region, casting doubt on the previously optimistic view of FDI-led development success. Foreign direct investment alone does not guarantee productivity gains and industrial modernisation in the long run; the critical issue is the ability of recipient countries to facilitate the entry of multinationals and to upgrade their technological capabilities as wages rise and skills require-

³ Compiled on the basis of: Guimon J., Narula R.. The Investment Development Path in a Globalised World: Implications for Eastern Europe, p.9. *Eastern Journal of European Studies*, Volume 1, Issue 2, December 2010, pp. 5-19

ments change. Changes in available policy options and the ongoing restructuring of multinationals mean that the development of sustainable competitive advantages of geographic location is increasingly important.

There are a number of special studies on the impact of the accession process and accession itself on the stimulation of foreign investment, in particular, in Bevan and Estrin (2000)⁴, Damian and Roetz (2004)⁵, Clausing and Dorobantou (2005)⁶, Grabbe (2014)⁷, Kaya (2020)⁸, Campos et al. (2021)⁹, Dworak (2023)¹⁰, Mrak (2023)¹¹, etc. Some researchers emphasise that in the case of countries with low innovation potential, a prerequisite for successful accession negotiations and economic development is modernisation based on innovation, which increases the profitability of industrial enterprises, real wages and welfare (Zhylynska et al., 2020)¹². Obviously, in the case of Ukraine, there are significant difficulties in fulfilling such requirements in the context of the ongoing war.¹³

Investment processes and regional economic integration

In any case, countries (especially emerging economies) need foreign direct investment. Foreign investors, in turn, have certain preferences, among which profitability is not always the determining factor. They often prefer

⁴ Bevan A.A., Estrin S. (2000) The Determinants of Foreign Direct Investment in Transition Economies // Centre for Economic Policy Research, Discussion Paper Series, December, No.2638, iv+24 pp.+ 9

⁵ Damijan J., Rojec M. (2004) Foreign Direct Investment and the Catching-up Process in the New EU Member States: Is There a Flying Geese Pattern? // Vienna Institute for International Economic Studies, Research Report No. 310, 47 p.

⁶ Clausing K.A., Dorobantu C.L. Re-entering Europe: Does European Union candidacy boost foreign direct investment? *Economics of Transition*, 2005, No.13. Issue 1, pp.77-103.

⁷ Grabbe H. (2014) Six Lessons of Enlargement Ten Years On: The EU's Transformative Power in Retrospect and Prospect. *Journal of Common Market Studies*, Volume 52 Annual Review pp. 40-56.

⁸ Kaya A.I. (2020) Capital Flows to Central and Eastern Europe: The Impact of the EU Accession Process // MSc Economic Development and Globalisation, July, 52 p.

⁹ Campos N., Estrin S., Bruno R. (2021) Foreign investment, European integration, and the Single Market // Vox-EU, CERP, July 17 — URL: <https://cepr.org/voxeu/columns/foreign-investment-european-integration-and-single-market>.

¹⁰ Dworak E. Assessment of Innovativeness of the EU Candidate Countries Based on the European Innovation Scoreboard. *Ekonomia Miedzynarodowa* 41 (2023) — pp.22-37- URL: <https://czasopisma.uni.lodz.pl/em/article/view/18958/23180>

¹¹ Mrak M., Zuber P. (2023) Absorption capacity for the EU cohesion funds: concept, experiences, and lessons learnt // *Analytics Economics*, July 26 — URL: <https://voxukraine.org/en/absorption-capacity-for-the-eu-cohesion-funds-concept-experiences-and-lessons-learnt>.

¹² Zhylynska O., Bazhenova O., Zatonatska T., Dluhopolskyi O. (2020), Innovation Process and Economic Growth in the Context of European Integration. *Scientific Papers of the University of Pardubice*, No. 28(3), 12 p. — URL: https://www.researchgate.net/publication/348431423_Innovation_Processes_and_Economic_Growth_in_the_Context_of_European_Integration/link/5ffe0ea6fdccdb84dd854/download?_tp=eyJjb250ZXh0Ijp7ImZpcnN0UGFnZSI6InB1YmtpY2F0aW9uIiwic29udGVudCI6ImVudG81IiwiaWF0Ijoi

¹³ Honcharov Y., Dykha M.V., Voronina V., Milka A., Klymenchukova N. (2023) Forecasting the innovation of Ukraine's economic development in a global dimension, *Scientific Bulletin of National Mining University*, No.1, pp.174-181-URL: https://nvngu.in.ua/jdownloads/pdf/2023/1/01_2023_Honcharov.pdf.

low risk, a developed institutional infrastructure, market size, a fair judicial system, etc. That is why EU countries attract foreign investors.

Integration arrangements, even those limited to trade, increase the credibility of the government in a transition economy in terms of its commitment to reforms aimed at opening up the economy. Agreements do not necessarily need to have special provisions on foreign investment treatment to serve as a confidence-building mechanism: a domestic liberal regime gains additional credibility when a country becomes a party to an agreement with a highly developed partner. The impact of the policy-driven integration process on foreign capital inflows is twofold. First, by reducing the risks faced by foreign investors and improving the country's business climate, they increase the flow of direct and portfolio investment, often diverting it from other regions. Combined with the additional incentives associated with improved access to developed country markets, the increase in inflows can be quite significant. This may be driven by firms' desire to overcome trade barriers and take advantage of developing economies of scale. Second, increased foreign participation in investment expenditures contributes to faster industrial restructuring based on better technology and know-how, as well as to improved corporate governance. An important aspect of foreign investment that is often neglected in dominant economic commentaries is the fact that FDI allows easier access to international markets through the parent company's sales channels.

For example, Spain and Portugal experienced a significant inflow of foreign direct investment after the start of the EU accession process. The share of FDI in GNP in these countries increased from 1.1 and 0.8 per cent in 1981-85, respectively, to 2.1 and 2.9 per cent in 1988-92.¹⁴

Research confirms that the impact of EU membership on FDI in the host economy is always positive, significant and quite large — around 60% for inward investment from outside the EU and around 50% for inward FDI (Figures 1 and 2). Indeed, these estimates show that the EU is the only bloc for which there is a significant increase in FDI both from outside and inside the bloc.

The impact of EU membership on FDI is found to be significantly larger than that of NAFTA, EFTA and Mercosur, supporting the view that deep economic integration has greater benefits than shallow integration in both capital inflows and trade.

¹⁴ World Bank (2001). How accession to the European Union has affected external trade and foreign direct investment in Central European economies, p. 29. World Bank, The World Bank Group, Trade Development Research Group, April 2001, Policy Research Working Paper No.2578, p.29 — 44 p. — URL:<https://documents.worldbank.org/en/publication/documents-reports/documentdetail/925331468749094416/how-accession-to-the-european-union-has-affected-external-trade-and-foreign-direct-investment-in-central-european-economies>

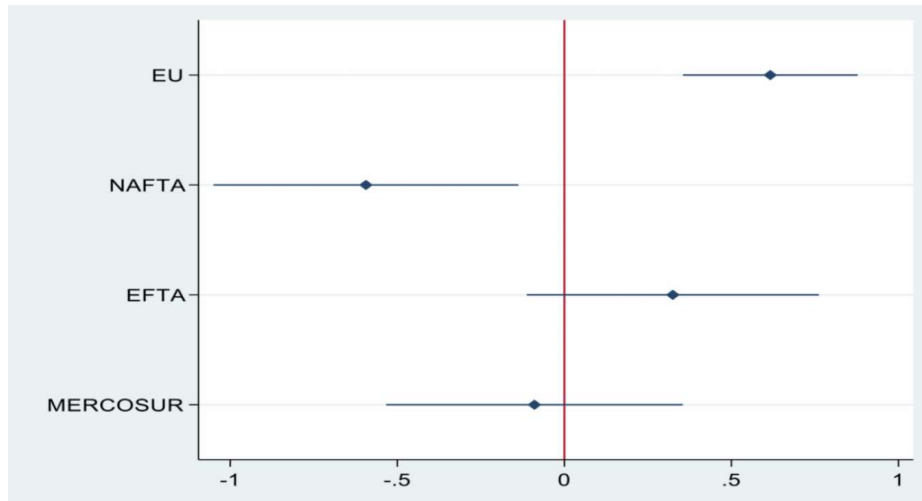


Figure 1. Effect of membership in different integration groups on FDI inflows from outside the bloc¹⁵

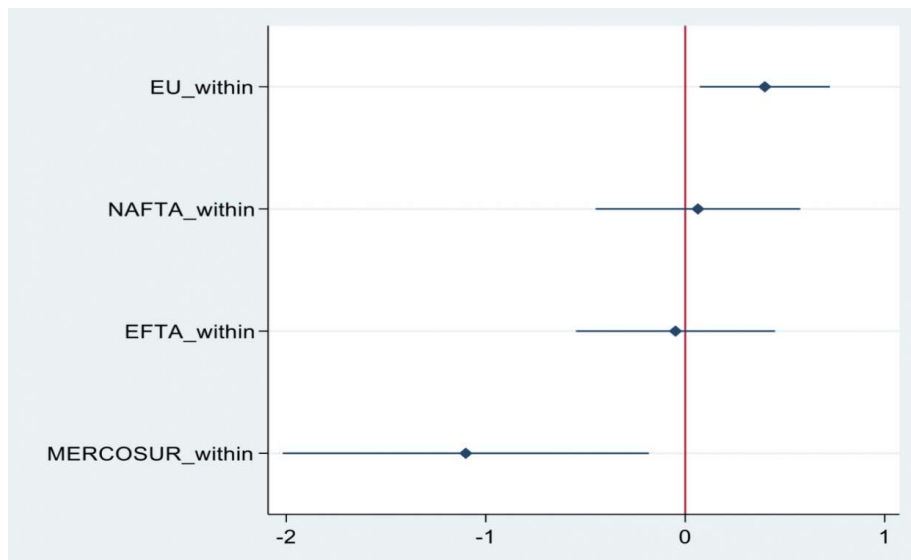


Figure 2. The effect of membership in different integration groups on FDI inflows from other bloc countries¹⁶

¹⁵ Source: Campos N., Estrin S., Bruno R. (2021) Foreign investment, European integration, and the Single Market // Vox-EU, CERP, July 17 — URL: <https://cepr.org/voxeu/columns/foreign-investment-european-integration-and-single-market>

¹⁶ Ibid.

In general, countries classified as "free" according to the Freedom Index demonstrate the strongest FDI per capita, with an average of USD 2,200 FDI investment per person in 2022.

High FDI per capita also demonstrates the strong correlation between economic freedom, political stability and foreign investment, which contributes to the development of the economy and prosperity of host countries. In this context, Europe, especially Western Europe, emerges as a prominent region characterised by the highest degree of freedom.¹⁷

Some researchers¹⁸ have expressed the belief that most of the benefits of EU membership for transition economies will come from increased investment, which will come from both reduced domestic risk and increased FDI flows. This literature suggests that prospective EU membership may be an important independent determinant of FDI in transition economies.

It is only natural that FDI in the new EU member states has grown significantly. At the same time, two powerful factors have influenced their volumes. First, there is the '*positive feedback*' effect, which brings the volumes of domestic and foreign investment to an equilibrium level (the existence of which we have already mentioned above), even without changes in other determinants. Second, during the market transition, the determinants of the equilibrium level of FDI changed, causing changes in the equilibrium level itself. An analysis by Merlevede B. and Schoors K.¹⁹, researchers at Ghent University, using a dataset of bilateral FDI volumes of twelve old EU member states in ten CEE countries, proved that FDI volumes quickly returned to equilibrium. In the case of transition economies, risk perceptions largely reflected progress in institutional development.

The EU's eastward enlargement has played a central role in the post-Cold War architecture of Europe. To a large extent, this was due to the fact that the exclusion of Eastern European (post-socialist) countries would have seriously jeopardised their economic transition, and economic failure in the East could have threatened peace and prosperity in Western Europe. Thus, the balance between the anticipated economic costs and benefits determined the pace and direction of EU enlargement. Such calculations consist of four parts: costs and benefits, respectively, for the candidate countries (CEE) and for the "old Europe". The expert analysis, which included a scenario in which EU accession significantly reduced the

¹⁷ Bertrand J., Lemoine J., Negrea D., Perrin C. Attracting foreign direct investment // Atlantic Council, March 15, 2024 — URL: <https://www.atlanticcouncil.org/in-depth-research-reports/report/attracting-foreign-direct-investments/>.

¹⁸ Baldwin R.E., Francois J.F., Portes R. (1997) The Costs and Benefits of Eastern Enlargement: The Impact on the EU and Central Europe. *Economic Policy*, 1997, vol.24, April, pp.125-176

¹⁹ Merlevede B., Schoors K. (2005) How to Catch Foreign Fish? FDI and Privatisation in EU Accession Countries. William Davidson Institute Working Paper No. 785, August, 24p.-URL: <https://ssrn.com/abstract=903799> or <http://dx.doi.org/10.2139/ssrn.903799>

risk premium for investment in the East, showed huge benefits for the new entrants. The expert opinion at the time showed a surprisingly clear "consensus" assessment that enlargement was a very favourable deal for both current EU members and new members.²⁰

Evidence from the ECB's special report²¹ shows that since the second half of the 1990s, two processes — EU accession and marketisation — have led to a significant increase in net capital flows to CEE countries. FDI accounted for the bulk of these flows. In particular, while manufacturing was the main sector of activity that attracted foreign investors, the share of financial FDI increased sharply in the second half of the 1990s. As a by-product of the privatisation of the banking sector, the presence of foreign bank branches became widespread in all CEE countries, with the partial exception of Slovenia, leading to foreign ownership of more than two-thirds of the banking system in these countries as a whole. A major component of financial sector flows has been foreign-led mergers and acquisitions (M&A), especially in the banking sector. As a result, foreign banks are mostly represented by subsidiaries rather than branches.

According to IMF experts, foreign direct investment has played a significant role in the export growth of Eastern European countries that are now part of the European Union. These eleven countries, Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia, which joined the EU in 2004 and 2007, have attracted a cumulative gross FDI volume of almost \$700 billion as of 2016. FDI inflows took a particular boost after EU membership. Compared to other upper-middle-income countries, the volume of FDI, both as a percentage of GDP and per capita, was significantly higher. Foreign investment has also made a significant contribution to exports, employment, and productivity growth, albeit with differences across countries. IMF experts noted that the main factors considered when deciding whether to make FDI are: access/supply to the local market; growth potential of the local market; corporate labour costs; increased profits; and first-mover advantage. Some other factors are taken into account, for example, the tax system, political stability, efficiency of public administration, public infrastructure, labour market flexibility, and the quality of the local supplier. And the availability of research and development facilities.²²

²⁰ Merlevede B., Schoors K. (2005) How to Catch Foreign Fish? FDI and Privatisation in EU Accession Countries. William Davidson Institute Working Paper No. 785, August, 24p.-URL: <https://ssrn.com/abstract=903799> or <http://dx.doi.org/10.2139/ssrn.903799>

²¹ ECB (2004) Financial FDI to the EU Accession Countries. European Central Bank, March 19, — 60 p. — URL: <https://www.bis.org/publ/cgfs22ecb.pdf>.

²² Jirasvetakul L-B.F., Rahman J. (2018) Foreign Direct Investment in New Member States of the EU and Western Balkans: Taking Stock and Assessing Prospects, pp.3-6. MF Working Paper, WP/18/187, August, 37 p.

Investment and preparation for admission

The issue of pre-accession FDI is relatively less well researched. For example, there are still very few answers to the question of how much additional FDI a country that chooses to participate in deeper forms of economic integration receives. This question, however, is quite important in European political debates. EU membership increases FDI inflows by 60-85 per cent (inward FDI from outside) and by about 50 per cent for EU countries. Furthermore, the single market plays a key role in this increase in FDI. When a country becomes an official candidate, investors may have already formulated their expectations of official membership, which may influence their investment decisions.²³

This topic received more attention when Central and Eastern Europe was a region in transition from a centrally planned economy to an open market economy, and it quickly became an integrated member of the EU. At that time, CEE countries applied for accession one by one: Hungary (31 March 1994), Poland (5 April 1994), Romania (22 June 1995), Slovakia (27 June 1995), Latvia (13 October 1995), Estonia (24 November 1995), Lithuania (8 December 1995), Bulgaria (14 December 1995), the Czech Republic (17 January 1996) and Slovenia (10 June 1996). The European Council at its meeting in Madrid (15-16 December 1995) established the relevant schedule. Accession negotiations began six months after the Intergovernmental Conference that led to the signing of the Amsterdam Treaty. The list also included Cyprus, which had an Association Agreement with the European Economic Community (EEC) since 19 December 1972 and applied for accession on 3 July 1990, and Malta, which had been associated with the EEC since 5 December 1970 and became a candidate country on 16 July 1990, as well as 10 associated candidate countries of Central and Eastern Europe (CEE). As a result, it is not surprising that developments in the region have attracted considerable interest from foreign investors, who are identifying viable and lucrative opportunities in the region.

Immediately after the European Council meeting in Amsterdam (16-17 June 1997) and without waiting for the signing of the Amsterdam Treaty on 2 October 1997, the Commission, headed by former Luxembourg Prime Minister Jacques Santer, submitted its report on 16 July 1997 with "Agenda 2000: For a Stronger and Wider Union"²⁴, which contained ten conclusions on the accession applications of the EEC countries. After analysing the ability of each state to meet the Copenhagen economic and political criteria, the Commission concluded that only the first group of six countries could be eligible to join around 2002-2003 and proposed to start negotiations with them only (Cyprus,

²³ Bevan A.A., Estrin S. (2000) The Determinants of Foreign Direct Investment in Transition Economies, pp.818-819. Centre for Economic Policy Research, Discussion Paper Series, December, No.2638, iv+24 pp.+ 9

²⁴ Agenda 2000: for a stronger and wider Union. Bulletin of the European Union Supplement 5/97,139 p/- URL: <https://aei.pitt.edu/3137/1/3137.pdf>

Czech Republic, Estonia, Hungary, Poland and Slovenia). However, not wanting to discriminate against any of the poorer candidate countries, the European Council at its meeting in Luxembourg (12-13 December 1997) decided to include all ten candidate countries from Central and Eastern Europe, together with Cyprus, in the enlargement process. In practice, however, they were divided into the Fifth and Sixth Enlargement countries, taking into account the state of fulfilment of the requirements.

Statistics show that there is no clear trend of increasing FDI in the EU candidate countries.* As can be seen from Table 2, neither the submission of EU membership applications nor the decision to start negotiations led to an increase in FDI (with the exception of Poland, but Hungary even experienced a decline in FDI).

Table 2

FDI IN EU FIFTH ENLARGEMENT COUNTRIES, BILLION USD USA

Country/Years	1995	1997	1998	2000	2002	2003	2004	2005
Cyprus	0.4	0.4	0.4	0.8	1.0	0.9	8.6	11.1
Malta	0.1	0.3	0.3	0.6	-0.4	1.0	12.6	25.1
Poland	3.7	6.4	6.4	9.5	4.0	4.0	12.1	8.2
Slovakia	2.6	1.0	0.9	2.7	5.7	3.0	4.0	3.1
Slovenia	0.2	0.2	0.2	0.1	1.6	0.3	0.7	0.6
Hungary	5.1	3.3	3.4	2.8	3.0	2.1	4.3	7.7
Czech Republic	2.6	1.3	3.7	5.0	8.5	2.1	5.0	11.7

Source: compiled by the author based on UNCTAD data

However, until 2002, investment volumes gradually increased. But in 2003 (the last year before EU accession), there was another downturn and growth resumed only after the new countries joined the EU. (Sometimes it was rapid growth, as in Malta, where FDI jumped from \$1 billion to \$12 billion, and to \$25 billion in 2005.)

Table 3

FDI IN THE EU'S SIXTH ENLARGEMENT COUNTRIES, BILLION USD USA

Country/Years	1995	1997	1998	2004	2006	2007	2008	2009
Bulgaria	0.1	0.7	0.7	3.4	7.8	12.4	9.9	3.4
Romania	0.4	1.2	2.0	6.4	10.9	9.7	13.5	4.5

Source: compiled by the author based on UNCTAD data

* There are different statistics on FDI in these countries, for example: Hunya G. FDI in the CEECs Hit Hard by the Global Crisis, p.22 // wiiw Database on Foreign Direct Investment in Central, East and Southeast Europe, 2010, 106 p.), but the general situation is virtually the same.

In the Sixth Enlargement countries, FDI picked up somewhat after the adoption of the negotiating schedule and the accession to the union, and it increased significantly after the first group of new member states joined in 2004.

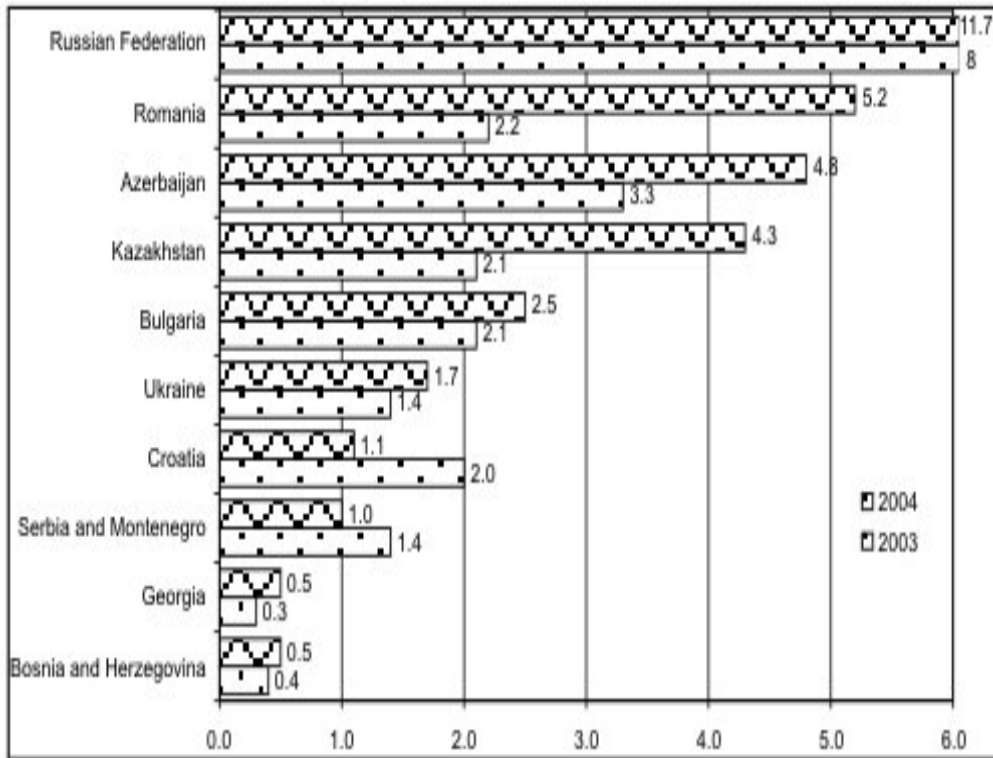


Figure 3. FDI inflows to South-Eastern Europe and the CIS, top 10 recipients, 2003-2004 (USD bn)²⁵

However, after the accession of the Sixth Enlargement countries themselves, foreign direct investment fell. In Romania, the negative trend continued until 2011. Only in 2022 did FDI return to the level of 2007-2008.

In South-Eastern Europe, the main recipients of FDI in 2004 were two EU candidate countries: Bulgaria and Romania. The record level of FDI in the latter was partly due to the privatisation of the oil company Petrom, which was sold to the Austrian OMV. In Bulgaria, the national telephone operator MobilTel was taken over by Telekom Austria, and the American

²⁵ UN (2005). Foreign Direct Investment in South-Eastern Europe and the Commonwealth of Independent States Increased for the Fourth Year in a Row. United Nations Information Centre, Sept. 29 — URL: https://www.un.org.pl/wir/wir2005_3.php.

company Viva Ventures acquired a controlling stake in the state-owned telecommunications company BTC.²⁶

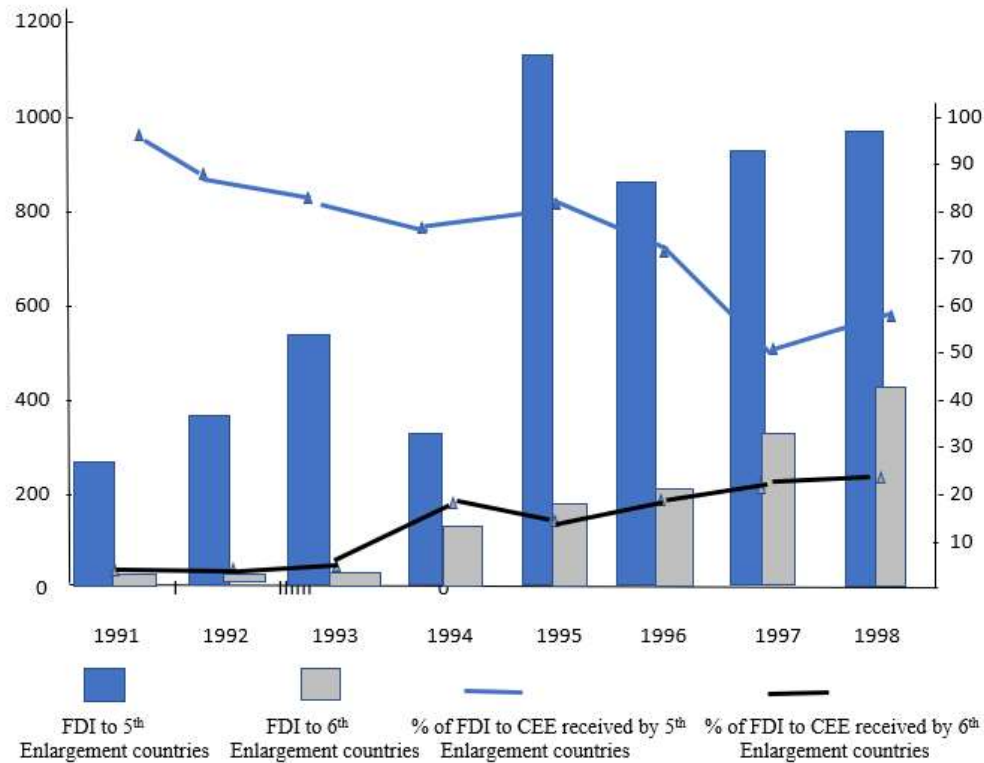


Figure 4: FDI volumes and concentration in CEE candidate countries (USD million and %)²⁷

Nevertheless, long-term statistics indicate that the leaders in the race to attract FDI in the CEE region are Poland, Hungary and the Czech Republic (with accumulated FDI for Poland amounting to USD 109 million in 1990, USD 34,227 million in 2000 and USD 182,799 million in 2009; for Hungary – USD 570 million, USD 2,2870 million and USD 248,681 million in 1990, 2000 and 2009, respectively, and for the Czech Republic: USD 1,363 million, USD 21,644 million and USD 115,899 million in 1990, 2000 and 2009).

²⁶ UN (2005). Foreign Direct Investment in South-Eastern Europe and the Commonwealth of Independent States Increased for the Fourth Year in a Row // United Nations Information Centre, Sept. 29 — URL: https://www.un.org.pl/wir/wir2005_3.php.

²⁷ Bevan A.A., Estrin S. (2000) The Determinants of Foreign Direct Investment in Transition Economies, p.25 // Centre for Economic Policy Research, Discussion Paper Series, December, No.2638, iv+24 pp. 9

These countries are far ahead in the liberalisation process and are also the largest economies in the region. Poland continues to be the main recipient of investment, being in the same group of recipients as Germany, the UK, Japan, Belgium, Canada and other industrialised countries. These three countries together account for more than three quarters of the total FDI inflows to the new EU member states. Indeed, when analysing cumulative FDI inflows for the period 1992-2009, we can see that Poland accounted for \$147.2 billion, the Czech Republic for \$80.8 billion and Hungary for \$69.3 billion.²⁸ Thus, it can be concluded that large-scale structural reforms in line with the EU accession process led to significant capital inflows to CEE countries during the 2000s.

An important aspect of international trade relations is the involvement or potential involvement of individual countries in free trade agreements, customs unions and supranational economic structures such as the European Union. Third countries can invest in such regions to avoid export duties, while enhanced growth and trade due to economies of scale of integration stimulate the demand for FDI. In the context of the EU, accession for transition economies included membership in the Single European Market, and thus provided EU companies with the opportunity to relocate production to areas with lower labour costs. In addition, the prospect of EU membership was seen by potential investors as reducing *country risk*; both because fulfilling the requirements for EU accession is an external confirmation of progress in the transition period and because eventual EU membership provides guarantees of macroeconomic stability, institutional and legal environment, and political stability.

It should be noted that the European Council Conference in Essen (Germany) in December 1994 launched a pre-accession strategy for the candidate countries; a year later, at the Madrid Council, the European Commission reaffirmed its commitment to enlargement and Agenda 2000 was announced.

Some experts believe that the Visegrad countries experienced a significant increase in FDI inflows immediately after the Essen announcement, from 1995 to 1998. To test this, they created an appropriate econometric model, which found a positive and significant coefficient for the interactive variable that took into account the country's membership in the Visegrad Group. Thus, in their opinion, it was indeed true that the Essen Statement had a positive impact on the level of FDI inflows received by the Visegrad countries. This means that the Essen statement caused a significant increase in FDI inflows, but investors directed this only to the countries that were

²⁸ Kottaridi C., Filippaios F. (2015) The FDI and trade relationship revisited under structural change: Evidence from a sector based analysis in Central and Eastern European countries, p.12. *East-West Journal of Economics and Business*, Vol. XVIII, No. 2, pp.11-40.

mentally close to them and were leading the accession process at the time.²⁹ Unfortunately, it also turned out that the Essen Statement, which was not country-specific, led to an increase in FDI received by Visegrad countries alone. Experts have suggested that this result suggests that investors realised that accession was an opportunity and therefore decided to invest in countries that were physically and mentally close, that were leading the transition process. However, if this interpretation is correct, it means that even general announcements from the EU can cause divergences in FDI inflows. Finally, it should be noted that it would be clearly unwise for the EU to react by trying to bridge the gap by exaggerating the prospects of lagging countries, as this would call into question its credibility with consequences that would likely extend beyond FDI attraction.³⁰

Furthermore, it was found that while the Essen Statement led to a once and for all increase in FDI inflows to the Visegrad countries, the adoption of Agenda 2000 only affected the pace of change in FDI. Thus, in the first case, the Essen Statement seems to have led to an increase in FDI flows to mentally close countries that were relatively more in transition at the time. In contrast, the countries selected for the first wave of accession under Agenda 2000 seem to have received a significant boost in their FDI growth rates, while there was no impact on those countries that were excluded from the first wave. Thus, while the excluded countries do not seem to have suffered in absolute terms from the announcements – as there is no significant negative impact – they are likely to have suffered relative to the first wave of enlargement.

It appears that although accession announcements did not directly affect the credit ratings of candidate countries, there was a dynamic transmission mechanism whereby the announcements directly affect FDI, which in turn improves the credit ratings of the country with a lag in one period, and hence improves FDI in the next period. Thus, this feedback loop suggests that countries on the accession path can benefit from a positive cycle, thus widening the gap between them and those lagging behind. In fact, the announcement of Agenda 2000 resulted in a bifurcation of FDI growth to transition countries, with the second wave group relatively suffering. Thus, the available analytical results suggest that the position of delayed countries may well be worse than that of early accession candidates, and that the long-term dynamic implications for delayed accession could be severe.

For this reason, the EU should pay more attention to the political implications of this practice. In view of the above, it can be suggested that the European Commission should commit to setting accession dates for candidate countries as early as possible, as such an announcement seems

²⁹ Bevan A.A., Estrin S. (2000) The Determinants of Foreign Direct Investment in Transition Economies, p. 19. Centre for Economic Policy Research, Discussion Paper Series, December, No.2638, iv+24 pp.+ 9

³⁰ Ibid.

likely to increase the rate of growth of FDI inflows. If such FDI fosters faster reforms, it is possible that this could trigger positive cycles, facilitating the accession process by stimulating development. EU announcements affect the level and growth rate of FDI, which in turn will improve the country's future credit ratings, increase FDI, etc.

Investment vector of development: the experience of Eastern Europe

The transition from planned to market economies opened up previously closed markets to foreign investors. The former socialist countries had a large supply of cheap labour, both skilled and unskilled, some of them had significant deposits of non-renewable natural resources, and others were conveniently located near the EU. Countries that were included in the EU integration project were also offered preferential access to EU markets. In addition, according to World Bank experts, the integration process created a number of potential advantages for attracting foreign investors.

First, EU accession shortened the transition period by eliminating tariffs and quotas on industrial imports from CEE countries: until 1997, CEE industrial exporters enjoyed duty-free access to the market. Thus, investors seeking unimpeded access to EU markets also considered locating production facilities in CEE countries.

Secondly, the Association Agreements with the EU provided for the right of EU firms to establish branches and subsidiaries, as well as commitments to liberalise access to services, along with other provisions that provide for an orderly process of interaction between the EU and its associated members, and served as a mechanism to increase trust.

Third, the provisions that aligned economic regimes with those in the EU were particularly important, as their implementation meant the promise of an orderly transition to an economy based on competitive markets.

In addition, the Association Agreements contained a special provision that allowed CEE countries to use duty refunds, i.e. to reimburse exporters to the EU for customs duties paid on imported inputs. This was a rather unusual arrangement, as FTAs generally prohibit their signatories from using refunds in mutual exports.³¹

The calculated IDP coefficient, which follows the eclectic Dunning paradigm, indicates that CEE economies remained in the second stage of IDP

³¹ World Bank (2001). How accession to the European Union has affected foreign trade and foreign direct investment in Central European economies, pp.29-30. World Bank, The World Bank Group, Trade Development Research Group, April 2001, Policy Research Working Paper No.2578, p.29 — 44 p. — URL:<https://documents.worldbank.org/en/publication/documents-reports/documentdetail/925331468749094416/how-accession-to-the-european-union-has-affected-external-trade-and-foreign-direct-investment-in-central-european-economies>

during the nineties and moved to the third stage in the last years of the sample period. The second stage of development is associated with the production/export of mature products in these economies. Given that FDI in these economies has almost tripled since the announcement of EU enlargement, we can conclude that there has been a significant positive effect of EU enlargement. Especially in the context of the current agenda of further eastward enlargement of the EU with the accession of Turkey and some post-Soviet states, this topic becomes extremely important. In particular, the IDP model assumes, first, that development causes significant structural change in the economy and, second, that such change has a systematic relationship with the structure of FDI. At the same time, for countries in the first and second stages, FDI and trade are likely to be in different sectors. These relationships appear to be complementary for manufacturing and services, but substitutable for agriculture. Furthermore, these results highlight the dynamic structural change in CEE economies, which is clearly evident in the changing factors that attract investors over time.³²

These development path dependencies have created an unusual FDI profile (in the narrow sense) for most of these countries, which does not resemble the FDI profile of economies that have been operating on market principles for a long time. Before 1990, inward FDI in these post-socialist economies was virtually non-existent. Thus, despite relatively high GDP per capita levels, which were similar to those of the second and third stage countries, *net outward investment (NOI)*, *inward FDI* inflows and *outward FDI* were similar to those of the first stage countries (see Table 1). During the 1990s, the transition from a socialist to a market system and the prospects of EU accession brought about radical changes in the socio-economic structure of Eastern Europe. In just a few years, many state-controlled industries were transferred to foreign ownership through privatisation. This happened largely as a result of national budget deficits, pressure from supranational institutions (including the EU, IMF, and WTO), and, in some cases, the inability of domestic investors to compete effectively with foreign corporations.

FDI inflows have played a very important role in the transition process and are often seen as one of the main benefits of EU integration. Foreign investors initially come to the new regions because of economic advantages (low labour costs and low taxes), but over time MNEs modernise their operations, as evidenced by the growth of high-tech industries and high-tech exports. Throughout the 1990s, real wages in CEE countries grew steadily, especially in foreign companies. Foreign-led modernisation is further supported by the fact that MNC subsidiaries have performed significantly better than local firms. It is widely recognised that liberalisation, privatisation

³² Kottaridi C., Filippaios F. (2015) The FDI and trade relationship revisited under structural change: Evidence from a sector based analysis in Central and Eastern European countries, p.34 // East-West Journal of Economics and Business, Vol. XVIII, No. 2, pp.11-40

and inward FDI have contributed to institutional change and economic acceleration. When analysing the FDI performance of CEE countries, it is important to note that a significant portion of FDI during the 1990s was through privatisation-induced acquisitions.

But there are also striking differences between the ten CEE countries that joined the EU in 2004 and 2007. Chobanova³³ explains these differences by their uneven stages of economic development, investment absorption capacity, legal frameworks and industrial policies. Merlevede B. and Schoors K.³⁴, who have studied the relationship between FDI and privatisation in detail, argue that ongoing direct privatisation has an immediate simultaneous positive effect on the equilibrium level of FDI, while indirect privatisation schemes slow down the adjustment to equilibrium.

Also significant is the fact that some countries showed greater transparency in privatisation schemes in the early 1990s, while others postponed market reforms due to political differences and numerous changes in legislation. Other structural factors, such as the size and factor endowments of the various CEE countries, should also be taken into account.³⁵

Investment screening: the need for and principles of implementation

Despite all these advantages, it is very important not only to attract foreign investment, but also to attract it effectively and safely. FDI should be attracted to those sectors that are a priority for the development of both the individual country and the Community as a whole. In his 2017 State of the Union address, EU President Jean-Claude Juncker said: "Let me say once and for all: we are not naive supporters of free trade. Europe must always protect its strategic interests. That is why today we are proposing a new EU framework for investment screening. If a foreign, state-owned company wants to acquire a European harbour, part of our energy infrastructure or a defence technology company, it should only happen in a transparent, thoroughly scrutinised and debated manner. It is our political responsibility to know what is happening in our own backyard so that we can protect our collective security if necessary." Vice President Jyrki Katainen added: "The EU is and will remain one of the most open investment regimes in the world. Foreign direct investment is an important source of growth, jobs and innovation. However, we

³³ Chobanova, Y. (2009), *Strategies of Multinationals in Central and Eastern Europe: Innovation systems and embeddedness* — Basingstoke: Palgrave Macmillan, 2009. xvi+269 p.

³⁴ Merlevede B., Schoors K. (2005) *How to Catch Foreign Fish? FDI and Privatisation in EU Accession Countries*, pp.16-19. William Davidson Institute Working Paper No. 785, August, 24p.-URL: <https://ssrn.com/abstract=903799> or <http://dx.doi.org/10.2139/ssrn.903799>

³⁵ Guimon J., Narula R. (2010) *The Investment Development Path in a Globalised World: Implications For Eastern Europe*, pp.13-16. *Eastern Journal of European Studies*, Volume 1, Issue 2, December, pp.5-19

cannot turn a blind eye to the fact that in some cases foreign takeovers can be detrimental to our interests."³⁶ Although the proposal was limited to the review of foreign investments in the EU, it was adopted by the European Parliament and Council in March 2019 and has now entered into force. Given further developments, the new system is a step in the right direction, but it does not seem to be enough. In principle, FDI can play a key role in accelerating and deepening the recovery through the sustainability of long-term productivity effects, which, if properly facilitated, can be further supported by EU integration, and vice versa, in our view, a selective FDI policy should also apply to candidate countries.

At the application stage, it is quite logical to raise the question of possible contradictions between the economic policy priorities of the European Community and the economic priorities of the new member states. According to many estimates, the consolidation of public finances in most candidate countries is inevitable and independent of the ongoing integration process (which can only accelerate this consolidation to the benefit of the economy). In most CEE countries, the structure of public expenditure at the time of accession was extremely unsatisfactory, and the public sector was "sucking money out of the market" at the expense of the private sector, resulting in a lack of domestic savings to finance high and sustainable economic growth. Of course, due to the ongoing processes of economic transformation and European integration, foreign investors are ready to finance the country's economic development through investments, both in the form of direct investments and portfolio capital. However, it should be remembered that after a while they need income in the form of dividends or interest, and if they notice that the return on investment is falling, they may transfer their capital to other countries (even neighbouring ones). In turn, the consumption of borrowed savings from abroad (instead of pro-investment use) means that the country still lacks domestic savings (private and public) to finance sustainable economic development. In this situation, for example, the following measures have become a priority of Polish economic policy:

—Comprehensive improvement of the structure of public expenditures (including by strengthening and, in some cases, reducing social expenditures, limiting subsidies, as well as guarantees and credit guarantees to loss-making state-owned enterprises)

—at the same time increasing government subsidies for infrastructure investments, including co-financing of projects in the EU structural funds, which will help to increase the growth rate of potential GDP);

—Improving the management of public funds (including ensuring transparency of public finances).

³⁶ State of the Union 2017 — Trade Package: European Commission proposes framework for screening of foreign direct investment. European Commission, September 14 — URL: https://ec.europa.eu/commission/presscorner/detail/en/IP_17_3183.

The Flying Geese Model (FGM)** argues that as a leading country (in our case, the "old" EU member states) moves up the technology ladder, it moves low-tech industries through FDI to less developed countries (in our case, the new EU member states). The analysis shows that, according to this model, FDI is an important, if not the main means of restructuring the manufacturing sector and increasing productivity. In other words, for the new EU member states, FDI is an important element of the process of economic acceleration and convergence with the EU average.

In this respect, the new EU member states are a good example. The positive technological change in Hungary is largely attributable to foreign direct investment, as foreign investor enterprises increased their share in medium-high and high-tech industries by 28 percentage points after Hungary's accession. In the other CECs, technological restructuring was also significantly influenced by foreign investor enterprises, which gradually increased the technological intensity of their activities. However, in this context, the differences between the countries are indeed significant. In the Czech Republic, the structural decline in low-tech industries was largely accompanied by structural growth in medium- and high-tech and high-tech industries. In Estonia, the huge growth of high-tech industries was accompanied by an even larger decline in medium-high-tech industries. In Poland and Slovakia, most of the decline in low-tech industries was far outweighed by the growth of medium-low-tech industries. Slovenia is perhaps the only example where the weighted structural change of foreign investors' enterprises in manufacturing was negative: a significant structural decline in medium-high technology industries was not compensated by structural growth in medium-low and low technology industries. Thus, FDI in Slovenia has shifted from medium-high to medium-low and low-tech industries. Thus, the overall positive technological restructuring of Slovenian manufacturing seems to have come from restructuring among domestic firms.³⁷

At the same time, the new EU member states cannot rely heavily on FDI when trying to catch up with technologically advanced industries at more advanced stages of development. In this context, endogenous efforts are indispensable.

The countries that implemented economic reforms and received FDI consequently maintained the positive trend when their efforts were rewarded with EU approval, which encouraged even more foreign investors and enabled them to embark on the next phase of reforms. But the Balkans were not so lucky, with wars delaying their economic transitions until the sup-

** The Flying Geese model is widely known as a way to explain the rapid economic growth in East Asia. The concept was developed by Japanese economist Kaname Akamatsu in the 1930s and became particularly popular in the 1960s.

³⁷ Damijan J., Rojec M. (2004) Foreign Direct Investment and the Catching-up Process in the New EU Member States: Is There a Flying Geese Pattern?, p.14. Vienna Institute for International Economic Studies, Research Report No. 310, 47 p.

ply of global capital dried up in the early 2000s. As a result, the problems of deindustrialisation were exacerbated, and access to EU markets did not bring profits, jobs and growth as it did in Central Europe.³⁸

Last, but not least, attention should be paid to the capacity of recipient countries to absorb funds (including investments) coming to them from outside. There are basically three main modalities of absorptive capacity for EU funds:

1. *Macroeconomic absorptive capacity* is related to the overall ability of an economy to generate viable investment opportunities that can be financed by external investment support.

2. *Financial absorptive capacity* can be defined as the ability to co-finance EU-supported programmes and projects, to meet additional requirements, to plan and guarantee any national contributions to multi-annual budgets, and to collect these contributions from multiple partners interested in a programme or project.

3. *Administrative or institutional absorptive capacity*. *On the demand side*, administrative capacity is determined by the ability of project applicants to generate projects that meet the tender requirements of the public procurement process. *On the supply side*, administrative capacity is determined by the ability of the authorities to effectively manage the funds entrusted to them at all stages of the investment programme process — from initial planning to project implementation and evaluation.³⁹

This approach to the degree of absorption often dominates both academic research and reports prepared by Member States and EU institutions such as the European Commission or the European Court of Auditors. This is because it is relatively easy to measure and provides a synthetic view of the capacity of the entire institutional system (broadly defined as institutions, procedures and stakeholder engagement) and the ability to mobilise political will to spend available EU funds effectively.

In many Central and Southern European countries, this understanding of absorptive capacity has been the subject of public and media interest, as well as lively political discourse. The main focus of such debates is always to avoid "losing" a single cent of the allocated funds. Thus, the percentage of expenditure achieved in relation to the allocation has become a very important indicator of absorptive capacity and, by extension, a reflection of the quality of the cohesion policy management system in individual countries.

Government quality is a broader concept than administrative capacity to implement structural funds. The most important quality of governmental

³⁸ Grabbe H. (2014) Six Lessons of Enlargement Ten Years On: The EU's Transformative Power in Retrospect and Prospect, p.48. *Journal of Common Market Studies*, Volume 52 Annual Review pp. 40-56

³⁹ Mrak M., Zuber P. (2023) Absorption capacity for the EU cohesion funds: concept, experiences, and lessons learnt // *Analytics Economics*, July 26 — URL: <https://voxukraine.org/en/absorption-capacity-for-the-eu-cohesion-funds-concept-experiences-and-lessons-learnt>.

components includes: (i) an effective regulatory framework for the implementation of public policies; (ii) human and social capital; (iii) effective administration in the delivery of public goods and services; (iv) an effective system of multi-level governance and partnerships; and (v) the political context, including the level of commitment to the Europeanisation process.

Conclusions

Thus, the results of our analysis of investment processes in the EU candidate countries and previous studies by other experts lead to the following conclusions. Foreign direct investment plays an important role not only in the economic development of countries, but also in achieving macroeconomic indicators that meet EU standards and the goals of the Common Economic Policy. In order to facilitate the attraction of investments to achieve these goals, the EU creates appropriate institutional structures to help candidate countries ensure the right conditions for private FDI. Official announcements on the date and procedure of accession of new member states, made clearly and in advance, are themselves conducive to attracting private FDI to these countries.

The EU has an understanding of the relative value of FDI, which is why FDI is subject to analysis (screening) and those that are questionable from the point of view of common security interests and compliance with EU economic priorities are screened out in advance. Such a selective approach to FDI should be introduced at the stage of Ukraine's preparation for EU accession.

An excessive supply of FDI can lead to negative consequences, and therefore the recipient country should first of all take measures aimed at increasing its capacity to absorb investments to ensure their effective use. Taking advantage of the technological benefits of FDI requires a preliminary preparation of the relevant scientific base, and therefore candidate countries should ensure a high level of their own R&D investments.

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