

FDI and State in Transformation. The role of foreign direct investment in the economic development of post-socialist Eastern Europe

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The question I intend to research is whether foreign direct investment (FDI) promotes or restrains the course of social, political and economic development in Eastern Europe's post-socialist transformation. What makes this question relevant is the fact that the structural necessity of capital import¹ resulted in a dominance of foreign investors in a number of key economic sectors across Eastern Europe, especially in most of the advanced transformational countries.² Thus, it might seem that a successful post-socialist transformation leads directly to foreign control over the economy. Is this the fate of Eastern Europe?

The course of post-socialist transformation can be understood as a catch-up attempt of a semi-periphery of the global economy. At least two other such attempts have occurred throughout the twentieth century: attempts of the Latin American and the East Asian countries. The role of FDI has been assessed in both of them by various authors. Broadly one can claim that FDI has been playing a more important economic role in Latin America than in East Asia, although foreign capital in general, and American bilateral aid in particular, played a vital role in the post-WWII era in East Asia too.

However, one of the most important determinants behind the East Asian success stories was a strong and capable state that could effectively “internalize” foreign economic resources.³ Moreover, East Asian states could become “developmental states” that exercised effective control over the course of economic development by carrying out sectoral policies and allocating a sufficient amount of economic resources accordingly.⁴

The Latin American states, by contrast, proved to be far less efficient in promoting economic development. Instead of controlling politically the major economic actors, the governments in Latin America rather established exclusive relations to groups of private asset-holders, be they foreign or domestic.⁵ The difference between the Latin American and East Asian development paths, therefore, not only lies in the role of FDI in the economy but also includes the different level of state capacity in controlling it.

The role of FDI could also be assessed in light of FDI-state relations in the course of East European

¹ The structural necessity of capital import derives from the circumstances of external indebtedness (in the Hungarian case particularly) and/or the necessity of achieving and maintaining competitiveness on the global markets.

² As the group of advanced transformational countries I consider the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia.

³ By “internalization” of foreign resources I mean that the East Asian states were able to retain (or achieve) domestic control over most of the strategically important industries, including those that were established by foreigners initially, such as, for example, the Korean electrical engineering industry.

⁴ Peter B. Evans, „The State as Problem and Solution: Predation, Embedded Autonomy, and Structural Change” in S. Haggard and R. R. Kaufman eds., *The Politics of Economic Adjustment. International Constraints, Distributive Conflicts, and the State*. Princeton, NJ: Princeton University Press, 1992.

⁵ Peter B. Evans, *Dependent Development. The Alliance of Multinational, State, and Local Capital in Brazil*. Princeton, NJ: Princeton University Press, 1979.

post-socialist transformation. Not so much, however, has been written on this so far. The dominant theory for assessing FDI-state relations in the past decades has been Raymond Vernon's and Theodore Moran's bargaining model. The notion of "obsolescing bargain," developed by Vernon, supposes a shifting balance of power between the foreign investors and the host country over the course of investment. Hence, the initial balance of power, deriving from mutual monopolies over capital and know-how on the one side and political power on the other, shifts towards the benefit of the host country. This is because the investors face an increasing amount of sunk costs, while the host authorities might go through a learning process over the time.

However, the theory of obsolescing bargain has been concentrating traditionally on raw material extraction and applied less on manufacturing industries, while the latter have been playing a much more important role in the advanced East European transformational countries. Nevertheless, some analyses have been written on FDI-state relations in respect of Eastern Europe's car manufacturing industries by Moran as well as Bartlett and Seleny.⁶ They have described particularly the situation of the Polish and Hungarian states vis-à-vis those car-maker multinational companies which have established their East European manufacturing plants in order to service the local and the EU markets. Although the capacity of East European states in influencing car manufacturer giants' development policies has been limited, according to Bartlett and Seleny the growing presence of multinationals as well as some EU restrictions on subsidizing companies have strengthened the position of the Hungarian state.

What should be emphasized, though, – and what is missing from the analysis of Bartlett and Seleny – is that relying on the competition of multinationals and referring, at the same time, to restrictive EU policies is not enough for enhancing state capacities effectively. Further, growing state capacities are not only vital to achieve conditions of investments that are favorable for East European countries, but also to formulate and implement effective developmental policies as well as to maintain law and order and improve social circumstances.

My assumption, based on the previous catch-up attempts of semi-peripheries, is that the growing stock of FDI promotes development if the state can fulfill its role in exerting social and economic coordination effectively. Therefore, the theoretical model I propose is as simple as this: Growing FDI leads to economic improvement in Eastern Europe whenever sufficient capacities are obtained by the state for controlling the course of development. This assumption is in line with experiences of the advanced post-socialist transformational countries, which have managed to establish relatively mature, western-type state institutions, while transformed their economies quite successfully, utilizing on FDI significantly. For, on the other hand, foreign investors' resources seem to be critical to make East European economies competitive globally.⁷

The major policy implication that derives from this is that strategies of post-socialist transformation

⁶ Theodore H. Moran, *Foreign Direct Investment and Development: The New Policy Agenda for Developing Countries and Economies in Transition*. Washington DC: Institute for International Economics, 1998; and David Bartlett and Anna Seleny, „The Political Enforcement of Liberalism: Bargaining, Institutions, and Auto Multinationals in Hungary”, *International Studies Quarterly* Vol. 42 (1998), pp. 319-338.

⁷ Péter Mihályi, *FDI in Hungary: The Post-Communist Privatization Story Reconsidered*. Working Paper Series 2/2000. Central European University, Department of Economics, Budapest.

should combine a major role of FDI with the enhancement of state capacities. Thus, it is not enough to sell most economic assets to foreigners – or, for that matter, to extremely skillful, experienced, and globally well-connected domestic investors – and to circumscribe the economic role of the state radically. For the simple reason that a skillful – and globally well-connected – state is inevitable to keep economic development under political control and coordination.

In order to be able to incorporate both advanced and laggard transformational countries into my analysis, first I sought to choose a comparative method that allows for multi-case analyses. That is why I developed a 3x3 matrix, in which I placed all the 19 East European post-socialist countries according to the level of state capacity and the amount of FDI they have obtained by the end of the first decade in the transformation. Assessment of the level of state capacity is based on the literature of comparative politics, including the surveys of the World Bank and the EBRD, regarding the achievements of transformational countries in improving state institutions, avoiding state capture, enforcing law and order, collecting taxes, and implementing developmental policies. The amount of FDI can be traced from statistics compiled by the EBRD, UNCTAD, World Bank, OECD and national statistical agencies. Having placed particular countries into a context of synchronic, cross-regional analyses, I would turn to analyze the Hungarian post-socialist development particularly. In my model Hungary is considered as a country of middle-level state capacity and high-amount of FDI, with a major task of improving state capacities while maintaining attractiveness towards FDI.

A matter of comparison in this respect would be Ireland. For it has had a similar development story with an easily accessible and quite an extensive literature on the role of foreign investments during effective economic improvement and European integration. Moreover, the Irish State seems to have improved the quality of economic coordination substantially while having witnessed an enormous flow of FDI into the country. Thus, the most important questions are what kind of policies had been carried out during the courses of economic upgrading and the European integration in Ireland? And, correspondingly, how could the Hungarian State retain more capacity while employing a large amount of foreign investment in developing the economy?

Level of state capacity and amount of FDI in European post-socialist countries and in Ireland.		Amount of FDI		
		HIGH	MIDDLE	LOW
Level of State Capacity	HIGH	<i>Ireland</i>	Slovenia	
	MIDDLE	Czech Republic, Estonia, Hungary , Poland	Croatia, Latvia, Lithuania, Slovakia	Belorussia
	LOW		Bulgaria, Macedonia, Romania	Albania, Bosnia-Herzegovina, Moldova, Russia, Ukraine, Yugoslavia