Culture, Contacts and Capital: Social Relations as Determinants of Foreign Direct Investment in Central and Eastern Europe

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Research Question and Its Significance

Official reports concerning Central and East European transition economies view foreign direct investment (FDI) as an engine in the transition from state socialism and a powerful force for integration of this region into the global economy (IMF 1997, UNCTAD 1998). Many experts agree that, "without massive inflows of foreign capital, successful transition [from planned to market economies] in Central and Eastern Europe is unlikely" (Schmidt 1995, p.268). As a catalyst in the transition from state socialism, FDI is reported to influence a host country's macroeconomic performance, including indicators like the balance of payments and employment. Moreover, foreign investors as the new owners of formerly state-owned enterprises have the skill and ability to induce corporate restructuring because they can provide managerial and financial resources. They can create immediately effective corporate governance and contribute crucially needed managerial as well as technological know-how (Meyer 1998).

Despite the acknowledged key role of FDI in the transition process, flows of foreign direct investment into Central and Eastern Europe have been consistently *smaller* than FDI flows into the developing countries of Asia and Latin America (UNCTAD 1998). It is also surprising that those Central and East European countries, which are evaluated as most developed and least risky for investment, have *not* attracted the most FDI. To address these empirical puzzles, my project studies the determinants of foreign direct investment into Central and Eastern Europe.

Previous Research on FDI

Most prior research on FDI is premised on the rational choice thesis and the assumption that independent and cost efficient investors select those investment sites, which will maximize their profitability. In order to account for the patterns of macroeconomic exchange, this approach suggests that host country characteristics signal information about potential returns on investment. Market oriented investors choose those countries whose characteristics promise maximum profits. While of the same theoretical persuasion, particular empirical studies have operationally distinguished between the influence of economic, political and legal country characteristics in influencing investment profitability.

Most FDI studies investigated how economic and human capital indicators influence foreign investment. For example, Dunning (1994) distinguished among three sets of economic influences on FDI including: (1) market factors, such as the size and growth of the market measured by the GDP of the host country; (2) cost factors, such as the availability of labor, low labor costs and inflation; and (3) the investment climate, as measured by the degree of foreign indebtedness and the state of balance of payments. In addition, Agarwal (1980) focused on the degree of economic development in terms of infrastructure of the host country. Schneider and Frey (1985) focused on the impact of human capital and suggested that skill of the work force matters in attracting FDI. Proposing that, "the structure of foreign capital penetration is an essentially rational outcome of market-oriented behavior," Crenshaw (1991: 1179) found that national development, measured as overurbanization, economic growth, population growth, government consumption and human capital formation, encourages FDI growth.

Research has also focused on how political stability of host countries influences FDI. For example, Bennett and Green (1972) argued that political instability provides a more hostile environment for foreign corporations, thus discouraging their investment. Basi (1963) and Ahargoni (1966) found that executives report political instability as the most important variable influencing their foreign investment decisions, aside from market potential. While these studies have focused on FDI in Third World countries, Welfens (1993) suggests that in transition economies like Central and Eastern Europe, a set of credible political institutions, and stabilizing monetary and fiscal policies are also needed to attract FDI. Therefore, an OECD (1994) study proposed that the frequency of changes in a country's legal policies and bureaucratic/

administrative barriers decisively shape investment choices. However, these studies were primarily speculative and did not quantify the effects of political, fiscal and legal stability on FDI flows in Central and Eastern Europe. More recent evidence also undermined the importance of political stability as a determinant of FDI. For example, studying FDI in the motor vehicle industry from 1948-65, Bollen and Jones (1982) found that the effect of political instability was much weaker than suspected.

Some research on FDI determinants also suggested that legal characteristics of host countries, in form of foreign investment policies, could facilitate or deter investment inflows (Stoever 1986, Hein 1992, Wint 1992). In some Central and East European transition countries national policies on FDI may provide incentives to foreign investment through tax breaks, exemptions from certain import duties, establishment of free economic zones, and prevention of double taxation. In other countries, FDI is discouraged through a requirement of an investment permit or registration, high degree of screening or sectoral restrictions and barriers (Alter and Wehrle 1993).

In contrast to the rational choice research on FDI determinants, a recent study by sociologists London and Ross (1995) premised the inquiry in the theory of global capitalism, which contends that developed countries seek more docile and less costly Third World labor. The authors argue that labor control and labor cost are key determinants of FDI, net of level of development. Although grounded in a conflict rather than rational choice perspective, this research nevertheless similarly predicts that national development and political stability, as attributes of a host country, would encourage FDI.

Proposed Alternative Theoretical Solution

Prior research on the determinants of FDI flows focuses without exception on the effects of country characteristics. The reviewed studies treat foreign investment markets as *atomistic*, assuming that nation-states as economic actors are independent from one another. But "[actors] are so constrained by ongoing social relations, that to construe them as independent is a grievous misunderstanding" (Granovetter 1985: 482). Nation-states are embedded; their connectivity through political relations, migration and trade flows, or associational alliances constrains and enables the choice of FDI locations and the size of investments. Likewise, business organizations are embedded; their connectivity to other organizations in their field, interpersonal networks between organizational actors at home and abroad, power relations between and within firms as well as cultural matching between investors and hosts constrain and enable investment transactions. All this suggests, that it is crucial to treat social relations between investor and host countries and relations between investor and host firms as determinants of FDI. In sum, I will test how social relations between investors and hosts determine FDI, net of investor and host characteristics, which have been the focus of prior research.

This work contributes to the current literature in economic sociology, which challenges a key assumption in neo-classical economics that investment decisions are simply guided by rational expectations about profitability (Schneider and Frey 1985). Economic sociology approach understands economic action as social action (Weber 1964) and investigates how economic behavior and institutions are embedded, i.e. constrained and enabled by three sets of social forces. First, political interventions of state governments, non-market institutions and power elites shape economic activity. Second, structural conditions are influential because economic actors are located in networks of ties. Third, cultural effects are reflected in how shared collective understandings and meanings attached to economic action shape strategies and goals (Zukin and DiMaggio 1990).

Policy Implications

Identifying the determinants of FDI has significant policy implications for the governments of Central and East European countries, which adopt measures to either actively solicit FDI or discourage it. Namely, some offer financial incentives to investors, sign bilateral investment agreements, or incorporate FDI as an integral part of the privatization process. Other countries with passive FDI policies impose sectoral barriers to foreign investors and promote hostile public attitudes toward incoming foreign capital. Understanding what determines investment location choices can help inform the consequences of implementing passive as opposed to active FDI policies by host country governments as well as provide tools for FDI Agencies in these countries to formulate their strategies. Moreover, an in-depth understanding of economic activity in Central and Eastern Europe provides insights into the transition process. If the embeddedness theory proposed in this study is confirmed, the results would qualify the expectations of Central and East European countries to smoothly transition to the western form of capitalism and view economic behavior in these states as path dependent. Moreover, it would revert the focus of attracting FDI from state to organizational level action, paying attention to the organizational mediators and drawing on pre-existent social ties.

Research Design

I intend to conduct my analysis at the nation-state level as well as organizational level. For the analysis of country level FDI determinants, I will use multivariate regression analysis with country-dyads as units of analysis. Independent variables include statistics on investor and host country characteristics (GDP, GDP growth, population, wages, inflation, infrastructure, education levels, unemployment, political stability, FDI policy) as well as statistics on relational variables (foreign aid, migration and trade flows, presence of national-minorities as a measure of historical cultural contact, and institutional arrangements between investors and host, such as EU Agreements and bilateral investment treaties). Because of the data availability and political formation of East European states, I will use my predictor variables from 1992-1994 period and my outcome (FDI flows) from 1995-1997.

For the organizational level analysis, I will collect case studies of foreign investment efforts in Croatia, Czech Republic, Hungary, Poland, Slovakia and Slovenia. I will do so by talking to FDI Agency officials and key experts on FDI in these countries, as well as content analysis of news articles. I selected my sample of countries to have variation between historical (Hungary and Poland) and newly established states, as well as to track divergent development of countries with historically common origin (Croatia and Slovenia, and Czech Republic and Slovakia). In collecting case studies of foreign investment efforts, my primary goal is to secure a sample with cases that were attempted but failed or postponed in order to have variance on my dependent variable. Having a group of cases that are similar on most independent variables but differ on the outcome, I should be able to identify the key independent variables that influence the success versus failure of a foreign investment attempt. Because of the case study approach my sample size will be limited. Thus, the method of analysis will be a combination of illustrative case reports and Boolean analysis of small cases (Guillen 1994).

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