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

Revised Proposal for the EPIC Second Cohort Advance Research Workshop

June 2001

Nina Bandelj
Department of Sociology
Princeton University
nbandelj@princeton.edu

Research Question and Its Significance

Prominent international organizations have advocated 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 suggest that, "without massive inflows of foreign capital, successful transition [from planned to market economies] in Central and Eastern Europe is unlikely" (Schmidt 1995: 268). As a catalyst in the transition from state socialism, FDI is reported to affect key macroeconomic indicators, such as the balance of payments and employment. Moreover, foreign investors bring financial, managerial, and technological resources that induce corporate restructuring in formerly state-owned enterprises (Meyer 1998).

Despite the acknowledged key role of FDI in the transition process, flows of foreign direct investment into individual countries of Central and Eastern Europe show a great variation. Moreover, FDI flows within a particular Central and East European country with an assessed overall level of risk vary substantially by the investor's country of origin. 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 utilitarian assumption that investors select investment sites which maximize their profitability. In order to account for the patterns of macroeconomic exchange, this approach suggests that host country characteristics provide information about potential returns on investment. Profit-maximizing investors then choose those countries whose characteristics promise the highest returns. While adopting this broad assumption, particular empirical studies have

operationally distinguished between economic and political country characteristics as determinants of investment profitability and FDI flows.

Most research on FDI determinants examines the effects of economic opportunities generated by the demand and costs associated with the supply at the investment site. Market potential is commonly measured by the size and growth of GDP and sometimes by size and growth of population, overurbanization or government consumption (Dunning 1994 and Crenshaw 1991, respectively). Key cost factors include the availability or labor, as reflected in the unemployment rate, labor costs and inflation, development of infrastructure of the host country as well as the skill and education levels of the work force (Agarwal 1980, Schneider and Frey 1985, Dunning 1994). Overall, this research suggests that FDI will flow to countries with economic indicators that increase revenues and human and physical capital indicators that decrease costs.

The political stability of host countries also influences FDI. Political instability provides a hostile environment for foreign corporations, discouraging their investment (Bennett and Green 1972). Thus, executives report that political instability is the most important variable influencing their foreign investment decisions, aside from market potential (Basi 1963, Ahargoni 1966). While early research focused on developing 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. Consequently, frequency of changes in a country's legal policies and bureaucratic/administrative barriers decisively shape investment choices (OECD 1994). Overall, political uncertainty in Central and East European region suggests that political instability in a host country reduces FDI.

Foreign investment policies may also facilitate or deter investment inflows (Stoever 1986, Hein 1992, Wint 1992). Those Central and East European transition countries with active national policies on FDI provide incentives to foreign investment through tax breaks, exemptions from certain import duties, establishment of free economic zones, and prevention of double taxation. In countries with passive policies, FDI is discouraged through the requirement of investment permits or registration, screening or sectoral restrictions and barriers (Alter and Wehrle 1993). Overall, we would expect that the FDI policy, which provides high investment incentives and eliminates administrative barriers for investors, would increase profitability for investors and thus have a positive effect on FDI flows.

In contrast to the assumptions of profit maximization guiding most research on FDI, London and Ross (1995) adopt a 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

The governments of Central and East European countries 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 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 of investment efforts 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 detailed case reports and qualitative comparative analysis (Ragin 1994).

Select References

Agarwal, Jamuna P. 1980. "Determinants of Foreign Direct Investment: A Survey." *Welwirtschaftliches Archiv* 116: 739-773.

Aharoni, Yair. 1966. *The Foreign Investment Decision Process*. Cambridge, Mass.: Harvard Graduate School of Business.

Alter, Rolf and Frederic Wehrle. 1993. "Foreign Direct Investment in Central and Eastern Europe: An Assessment of the Current Situation." *Intereconomics* May/June.

Basi, R. S. 1963. *Determinants of United States Private Direct Investment in Foreign Countries*. Kent State University Press.

Bennett, Peter D. and Robert T. Green. 1972. "Political Instability as a Determinant of Direct Foreign Investment." *Journal of Marketing Research* 9: 182-186.

Bollen, Kenneth A. and Scott T. Jones. 1982. "Political Instability and Foreign Direct Investment: The Motor Vehicle Industry, 1948-65." *Social Forces* 60(4): 1070-1088.

Crenshaw, Edward. 1991. "Foreign Investment as a Dependant Variable: Determinants of Foreign Investment and Capital Penetration in Developing Nations, 1967-1978." *Social Forces* 69(4): 1169-1182.

Dunning, John H. 1994. "The Prospects for Foreign Direct Investment in Central and Eastern Europe." In *The Economics of Change in East and Central Europe*, edited by Peter J. Buckley and Pervez N. Ghauri. London: Academic Press Limited.

EBRD. 1997. *Transition Report 1997: Enterprise Performance and Growth*. United Kingdom: EBRD Publication Desk.

Granovetter, Mark. 1985. "Economic Action and Social Structure: The Problem of Embeddedness." *American Journal of Sociology* 91: 481-510.

Guillen, Mauro. 1994. Models of Management: Work, Authority, and Organization in a Comparative Perspective. Chicago: University of Chicago Press.

Hein, Simeon. 1992. "Trade Strategy and the Dependency Hypothesis: A Comparison of Policy, Foreign Investment, and Economic Growth in Latin America and East Asia." *Economic Development and Cultural Change* 40(3): 495-521.

IMF. 1997. *World Economic Outlook*. Washington, D.C.: International Monetary Fund.

London, Bruce and Robert J.S. Ross. 1995. "The Political Sociology of Foreign Direct Investment." *International Journal of Comparative Sociology* 36(3-4): 198- 218.

Meyer, Klaus. 1998. *Direct Investment in Economies in Transition*. Massachusetts: Edward Elgar Publishing.

OECD. 1994. *Assessing Investment Opportunities in Economies in Transition*. Paris, France: OECD.

Ragin, Charles C. 1994. "Introduction to Qualitative Comparative Analysis." Pp. 299-319 in *The Comparative Political Economy of the Welfare State*, edited by Janoski, Thomas/ Hicks, and Alexander. Cambridge: Cambridge University Press.

Schmidt, Klaus-Dieter. 1995. "Foreign Direct Investment in Eastern Europe: State-of-the-art and Prospects." In *Transforming Economies and European Integration*, edited by Rumen Dobrinsky and Michael Landesmann. Aldershot, UK:Edward Elgar.

Schneider, Friedrich and Bruno S. Frey. 1985. "Economic and Political Determinants of Foreign Direct Investment." *World Development* 13(2): 161-175.

Stoever, William A. 1986. "Foreign Investment as an Aid in Moving from Least Developed to Newly Industrializing: A Study in Korea." *The Journal of Developing Areas* 20: 223-248.

UNCTAD. 1998. *World Investment Report*.

Weber, Max. 1968. *Economy and Society*. New York: Bedminster Press.

Welfens, Paul J. J. 1993. "The Growth of the Private Sector: Privatization and Foreign Direct Investment in Eastern Europe." Pp. 119-166 in *Overcoming the Transformation Crisis*, edited by Horst Siebert. Tuebingen, Germany: J. C. B. Mohr.

Wint, Alvin G. 1992. "Liberalizing Foreign Direct Investment Regimes: The Vestigial Screen." *World Development* 20(10): 1515-1529.

Zukin, Sharon and Paul DiMaggio (eds.). 1990. *Structures of Capital: The Social Organization of the Economy*. Cambridge, Mass.: Cambridge University Press.