

Inward FDI in seven transitional countries of South-Eastern Europe: a quest of institution-based attractiveness

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Abstract

The main question we address is whether the weak FDI level in the SEE-7 is linked to ill-adapted institutions or not. In order to answer it, we need to understand the role of institutions in shaping a strong localization advantage for FDI. We develop a theoretical framework to understand the relationship between Transition, Institutions and inward FDI. We assume that the ability to attract FDI depends on the local institutional arrangement. We present our pattern of institutional arrangement that may help us understand why, in spite of identical institutions, countries attract a different level of FDI. We split the SEE into two categories of host countries, each category being characterized by a specific institutional arrangement and level of FDI. We conclude with the relevance of our proposition to develop an analytical framework where FDI is the outcome of a new and well-adapted institutional arrangement.

Key words: FDI, transition, institutions, attractiveness, South-Eastern Europe, institutional arrangement

JEL classification: D73, F21, O43, P37

1. Introduction

After fifteen years of transition, institutions, mainly market and political ones, appear to be a strong foundation for a rapid but irreversible shift from socialism to market-oriented economy (Johnson, Kaufmann, Shleifer, 1997; Nagy, 2002). However, the economic performances of transitional countries, with regard to growth and inward FDI, are unequal so that the quality of domestic institutions, and more and more their flexibility and credibility, have

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emerged as a relevant subject of interest (Daude, Stein, 2007; Fabry, Zeghni, 2009; Rodrik, Subramanian, 2003).

Institutions¹ are a local arrangement of conventions and rules embedded in a historical, cultural and geographical context. They are an endogenous element of a country's economic growth and attractiveness of FDI. The aim of this paper is to analyse the link between inward FDI and the institutional arrangement set up in seven countries (Albania, Bosnia-Herzegovina, Bulgaria, Croatia, Macedonia, Romania, and Serbia) in the South East of Europe² (SEE-7). FDI in SEE-7 is concentrated at 81,3% in three countries (Bulgaria, Croatia, and Romania) and the SEE-7 receives 30,2% of the total inward-FDI in the transition countries (EBRD, 2009).

Ethnic origins, religion and culture, combined with the communist legacy, make these countries singular. First, they are *latecomers* in term of FDI hosting because the collapse of communism created windows of opportunities for ethnic and religious communities but not for FDI. The splitting of the Yugoslav Republic into Bosnia & Herzegovina, Croatia, Slovenia, FYR of Macedonia, Serbia, and Montenegro was a consequence of internal conflicts and civil wars (Broadman et al., 2004). These 'new' but heterogeneous micro- countries are not naturally attractive for FDI because they have small market size and they lack intra-regional integration and intangible resources. Second, except Bulgaria, Romania, Croatia and the FYR of Macedonia who were guided by the *Copenhagen criteria*³, the SEE have to *set up major reforms*. New institutions need to be introduced and former institutions to be reshaped to support a market-oriented economy and also democracy. The task is difficult in comparison with

¹ For North (1990, p.3), institutions are "*the humanly devised constraints that structure human interaction*" including formal institutions (law and regulation) and informal ones (convention). Similarly Scott (1995, p.33) defines institutions as "*cognitive, normative and regulative structures and activities that provide stability and meaning to social behaviours*".

² FIAS (2007) consider as SEE the seven countries we selected and the Republic of Moldova. We excluded the Republic of Moldova because it did not receive a consistent amount of inward-FDI during the period 1996-2009.

³ Before accession, Bulgaria and Romania had to fulfil the three main Copenhagen criteria: the *political criterion* (stability of institutions, the level of democracy, the rule of law, human rights and the respect for and protection of minorities), the *economic criterion* (efficient market economy, capacity to cope with competitive pressure and market forces within the European Union), the *Acquis Communautaire criterion* (the ability to take on the obligations of membership including adherence to the aims of the Political, Economic and Monetary Union). Croatia and the FYR of Macedonia have been candidate countries since 2005. On the 25th of October 2010 the European Commission President made it clear that Croatia's accession talks to join the EU may be completed by the end of 2011 rather than in the spring, as initially targeted by the Croatian Government. The European Commission President referred to chapter 23 of Croatia's accession negotiations on fighting corruption as a key test for the country's accession. He said that whilst important progress had been made, more concrete reforms were needed. The negotiation process of Croatia was interrupted in 2008 over a border dispute with Slovenia, which was resolved by arbitration and supported by a referendum in Slovenia.

the high rate of poverty and the war disasters that damaged political stability, the infrastructure reliabilities, the industrial structures, and affects the foreign investors' perception of risks. Among countries not devastated by ethnic conflicts, the level of corruption, the lack of entrepreneurship mood and capabilities, the weaknesses of the industrial structures also deter inward-FDI (Gray, Hellman, Ryterman, 2004) so that most of the SEE-7 is at the periphery of the EU from a geographical point of view but also from an economic and social one⁴. Finally, the SEE-7 has to deal with *the challenge of globalization*. All countries, whatever their development level and historical background, have to host inward-FDI to stay competitive. In the specific case of transitional countries, FDI may help to upgrade the industry, enhance foreign technologies absorptive capacities and promote international trade (Gosh, Wang, 2009; Fabry, Zeghni 2003).

As shortly described, the actual institutional context is a barrier to attractiveness and development. The main question we address in this paper is whether the weak inward-FDI level is linked to ill-adapted institutions or not. In order to answer it, we need to understand the role of institutions in shaping a strong localization advantage for FDI. The quest of reliable and safe institutions has emerged in the economic literature as a catalyst for growth⁵ and as an inward-FDI attractor (Pournarakis, Varsakelis, 2004; Bevan, Estrin, Meyer, 2004; Bevan, Estrin, 2004). But questions are still arising about institutional arrangement as FDI attractor in transition. According to Rodrik (2004), each development level generates a specific institutional arrangement. A logical prolongation consists in establishing institutional pattern in order to understand the trajectories of these countries as well as their attractiveness (Bertheliet et al., 2003). We assume that the ability to attract inward FDI depends on the local institutional arrangement.

This paper aims to understand the relationship between Transition, Institutions and inward FDI. It is structured as follows: first of all we discuss the link "Institutions and FDI" and consider Institutions as FDI attractors particularly in a transitional context. Secondly we will focus on the measurement of institutions and explain why the quality of institutions is a derivate from the quality of governance. Then we propose a pattern of *institutional arrangement* that may help us understand why, in spite of identical institutions, countries attract a different level of FDI. Finally, we conclude with the relevance of our proposition to develop an analytical framework where inward FDI is the final outcome of a new and well-adapted institutional arrangement.

⁴ According to the World Investment Report (2008), Bulgaria, Romania and Croatia are *front runners*, Albania and Macedonia *above potential* and the others countries are not mentioned.

⁵ See Fabry, Zeghni (2009), Kukeli (2007); Rodrik, Subramanian (2003), Edison (2003), Tidrico (2007), Wernick et al. (2009).

2. Institutions as FDI attractor

The relationship between institutions and FDI may have to gain from the literature devoted to the link “institutions and growth”. Authors that have studied the relationship between institutions and growth stressed that good institutions stimulate growth and development rather than the contrary⁶. Kaufmann and Kraay (2003) noticed that the quality of institutions has an impact on growth but the reverse influence depends on the democratisation process and on the public governance. Acemoglu et al. (2001, 2002, 2005) show that the quality of institutions has a more important effect on the long-term growth than on the short term one. Authors like Edison (2003) or Rodrik and Subramanian (2003) pointed out that a successful transfer of market institutions depends on path dependence and local abilities to make them effective within a local institutional arrangement.

As we mentioned elsewhere (Fabry, Zeghni, 2009), institutions are considered globally. They need to be split in different categories in order to take into account the *communist past dependency* (Fabry, Zeghni, 2006; Zweynert, Goldschmidt, 2005) that makes some institutions sticky and ill adapted.

2.1. Institutions, FDI and the localization advantage

As first developed by Dunning (1993), to invest abroad, a firm needs to gather simultaneously *an ownership advantage*, a *localization advantage* and an *internalisation advantage (OLI framework)*. Since the global era, the localization advantage gains increasingly in importance.

This localization advantage is first based on *natural assets* offered by a country to foreign investors (see table 1). These assets may be declined in various FDI determinants that influence the firm’s decision to enter in vertical and/or horizontal FDI (Demekas et al, 2007). The ease of doing business in a host country depends less on natural assets than on created assets. Such assets, considered a *localization advantage*, have been first developed by authors focusing on *spillovers*, *clusters* and *networks* (Barell, Pain, 1999; Campos, Kinoshita 2003).

In transitional countries, FDI agglomeration may be explained more by the lack of local infrastructure, by the weakness of the local sub-contractors network and even by the unfavourable business environment than by positive externalities. This points out, that institutions are a strong part of the *localization advantage*.

⁶ See Acemoglu et al. (2004), Kaufmann, Kraay (2003).

Table 1. The localization advantage as FDI determinant

Asset	FDI determinants		MNE strategy
	Aims	Explanatory variables	
Natural	Costs optimization	Productivity and quality of factors mainly labour (cost of unskilled labour, pool of skilled labour), quality and reliability of infrastructures, raw material endowments, quality of social and political environment, level of technology.	Supply oriented (vertical FDI)
	Market shares Domestic market entry	Growth of demand, market size, consumer preferences, per capita income, and access to regional markets	Demand oriented (horizontal FDI)
	New sources of competitiveness	Combination of market access, production costs optimization and business environment (law and regulation, macroeconomic stability, taxes, presence of local or foreign competitors, distances)	Global strategy (Efficiency-seeking FDI)
Created	Linkages effects	Spillovers, clusters, networks	Positive externalities (horizontal FDI)
	Institutions	Market supporting institutions, political institutions	

Source: authors

The idea that institutions are not only FDI determinants but also created assets has been developed in the empirical literature (Narula, Dunning, 2000; Pournarakis, Varsakelis, 2004; Sehti et al. 2002) but we need to know more formally which institutions are relevant to attract FDI. This raises the question of the institutional pattern and governance.

2.2. Institutions and governance

Two kinds of institutions should be distinguished: first, the *formal institutions* at the legal, economic and political level, and second, the *informal institutions* more complex to capture because rooted in the social area.

Rodrik and Subramanian (2003) offer a functional typology of four *formal institutions* that helps us specify what a good market oriented institutional pattern could be. *The Market creating institutions* represent the *rules of law* that define and protect property rights and make contracts fair and reliable for all. Such formal institutions based on clear legislation and on an efficient and fair judicial system reduce transaction costs and create incentives for investment and

private sector development (Blonigen, 2005). Given that context of transparency, the degree of corruption should be low. The next three institutions support the emergence of a social consensus about risks, burden and prosperity sharing. *The Market regulating institutions* help to *regulate market externalities*, imperfect and asymmetric information or scale economies in sectors like transportation, telecommunication or environment. Regulation stresses on fair competition, distortions minimization, and enhance privatisation and deregulation. *The Market stabilizing institutions* reduce *macroeconomic instabilities* (inflation, currency rate, balanced budget, tax burden, trade policy, fiscal rules, banking system), prevent major political crises and contribute to the insertion of the countries in international trade. As Dhakal et al. (2007) noticed foreign investors are seeking openness and deregulation particularly if their affiliates are cost minimization-oriented.

Finally, the *market legitimizing* institutions support social protection and manage social conflicts. It can be an insurance system or a welfare system that protects *a minima* people from social dropping out. These institutions create favourable socio-economic conditions (Insurance system, welfare system, education, infrastructure, and business development). Political institutions are not only complementary to the economic ones but they are also mutually reinforcing. For example, the transparency of the government actions contributes to the shaping of a stable environment for actors. Busse (2004) demonstrates that FDI is more sensitive to democracy when foreign firms are seeking new market shares development. Reversely, FDI is not democracy sensitive in the case of raw materials and energy exploitation.

Informal institutions rely on culture, mentalities, habits, trust, norms, conventions, codes, networks, and even on nationalism (acceptance to sell national assets to foreigners, Ethnic tensions) or religion. Knowles and Weatherston (2006) noticed that informal institutions, assimilated to *culture* (Tabellini, 2010) or *social capital* (Putnam et al., 1993), are fundamental in explaining development and income differences. In some transitional countries, informal institutions play a major role (Jütting, 2003) in deterring the adoption of best practices and the change of habits.

Formal institutions are introduced (imposed?) by the State in a top down logic while informal institutions are developed by the community, in a bottom up logic. Transition makes the former institutional pattern ill fitted so that a new institutional pattern needs to be set up rapidly. Therefore, the quality of the institutions becomes a key factor particularly in attracting FDI (Benassy-Quéré et al. 2007).

Recent empirical analyses generally retain three definitions of the “quality” of the institutions: the quality of public affairs management, the existence of laws protecting the private property and the application of these laws, and the limits imposed on political leaders (Daude, Stein 2007; Kessing et

al., 2009; Wernick et al., 2009). These analyses put forward various measures of the quality of the institutions among which we generally distinguish objective and subjective ones. *Objective indicators* try to measure indirectly the quality of institutions. This raises the problem of the phenomenon which is actually measured. If we take into account the condemnation rate for corruption in a country, does the indicator reflect a high level of corruption or the good performance of justice? Moreover, these indicators exist only on restricted samples and consequently limit the use of international comparisons. *Subjective measurements* are founded on appreciations and evaluations of experts or on evaluations of the population through surveys carried out by international organizations and NGOs⁷. Obviously subjective, these measures of the quality of institutions raise some difficulties. For example, a data survey, to apprehend correctly the situation, needs to rest on a broad sample, which is expensive to carry out. Moreover, it is not excluded that the interpretation of a question varies according to the country where one is located (i.e. the perception of human rights in France compared to China). For their part, the evaluations of experts generally rest on a restricted number of opinions, which poses the problem of the sample size and, as Kaufmann, Kraay and Mastruzzi (2003) stressed, of the possibility of an ideological bias.

In spite of the fact that international organizations (Heritage foundation, Transparency International, World Bank, EBRD) publish data and indicators based on survey and experts' rating, international comparisons are difficult to draw. Consequently, the indicators must be used carefully (Bloningen, 2005). Measuring institutions is complex and does not make it easy to identify with exactitude which institution is responsible for the bad/good economic performances. In that context, how to draw some recommendations of economic policies? Last but not least, models suppose that institutions are endogenous. But if institutions influence the economic results of a country, economic variables may reversely influence institutions. This raises a causality problem able to generate a bias of simultaneity.

As noticed by Busse et al. (2007), institution quality may be approached by governance defined by Kaufmann, Kraay and Mastruzzi (2008, p.7) as "*the traditions and institutions by which authority in a country is exercised. This includes the process by which governments are selected, monitored and replaced; the capacity of the government to effectively formulate and implement sound policies; and the respect of citizens and the state for the institutions that govern economic and social interactions among them*". Dixit (2009) considers that good economic governance contributes to the protection of property rights,

⁷ See <http://einstein.library.emory.edu/govinstlinks.html> for databases on the quality of institutions.

enforces contracts and supports “*collective action to provide appropriate physical and organizational infrastructure*”.

The higher the quality of governance, the better it will influence the decisions of the firms to invest in a specific country. A high quality of governance will, at a firm level, help to reduce transaction costs. At a country level, it announces that the government is committed to provide a stable business environment and to set up market friendly policies. It is a “positive” signal given to foreign firms (Benassy-Quéré et al. 2007).

3. The local institutional arrangement and FDI

Rodrik (2004) argues that each stage of economic development implies different “*institutional arrangements*”. A catching up process may involve some originality in an institutional pattern, depending on each country’s characteristics (Murell, 2008). We consider that a good institutional arrangement is the interplay between a new set of formal economic and political rules (mostly inspired from western practices⁸) and a set of informal institutions. The compatibility (or incompatibility) between these two types of institutions may explain the wide variations in the impact of law and institutional reform across countries and hence on FDI inflows.

3.1. FDI and the institution-based attractiveness

To understand the nature of the local institutional arrangement we need to consider different areas of interaction such as the social structure of the country, the rules of the games, the play of the game, the allocation mechanism (Jütting, 2003). If the rules are efficient, the economic, political, legal and social interactions will create effective conditions for FDI.

The local institutional arrangement is a recombination (Djelic and Quack 2003) that includes a mix of institution creation (greenfield institution) and institution reshaping (brownfield institution)⁹ in order to create a new environment for business and to help the transformation of local organisations and institutions. The speed of institutional recombination depends on the matching of formal institutions with informal ones. It is a protection against stickiness or incompatibility between imported rules and local practices.

⁸ It is the case of candidate countries willing to enter the EU and having to respond to the *Acquis communautaire* requirements.

⁹ Greenfield Institutions did not exist under the communist era and needed to be created and introduced while Brownfield Institutions existed but needed to be adapted and reshaped to fit the market economy. The problem is to identify and fight local reluctance among actors unwilling to get rid of their former but outdated practices and/or unable to adopt new practices.

The local institutional arrangement relies on the articulation between institutions but also on their credibility and flexibility (Zheng, 2006) so that two countries with identical institutions may attract different amounts of FDI.

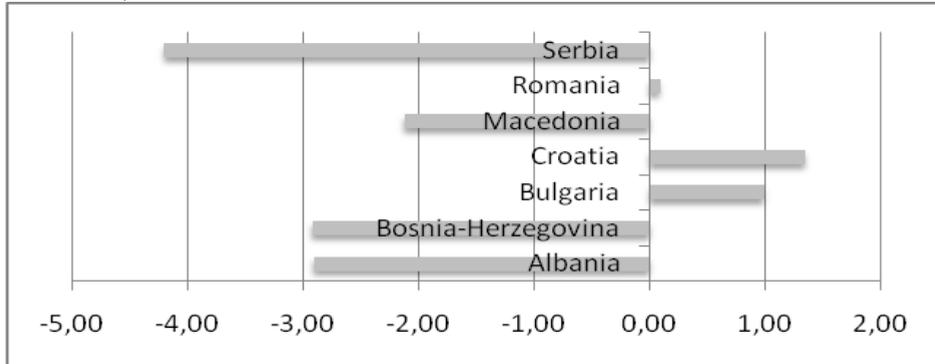
Having presented what we regard as an *institution-based attractiveness for FDI*, our purpose needs now an illustration.

3.2. SEE-7 host countries: the leaders and the followers

Neither institution nor institutional arrangement is optimal. Nevertheless, some institutional environments are more favorable to economic development than others (Berthelier et al., 2003) and the ability of institutions to adapt appears to be an advantage for a country (Brousseau, 2000). The concept of institutional profile reflects the idea that, starting from a panel of available institutions, we can define a set of characteristics that make countries comparable.

To establish this institutional profile we used the *global governance index* (WGI) developed at the World Bank. As Kaufmann, Kraay and Mastruzzi wrote (2008, p. 7) “*we define governance broadly as the traditions and institutions by which authority in a country is exercised*”. Considering that *governance* is an approximation of formal and informal institutions of a country, the authors split the governance into six *dimensions* all measurable by an indicator telling a level of governance perception. These six indicators are: *Voice and accountability*, *Political stability and absence of violence/terrorism*, *Government effectiveness*, *Regulatory quality*, *Rule of Law*, and *Control of corruption*. Finally, they construct an aggregate indicator from these six indicators. Good governance at each level will result in good global governance, which may be considered as a safe fundament for institutions building.

Figure 1 ranks the SEE-7 according to the quality of their global governance. The global governance is the sum of the averages of the six indicators for the period 1996 – 2009 calculated for each country. Each indicator may vary from -2.5 to 2.5 so that their sum may vary, in theory, from -15 to +15. For the SEE-7 the interval is between -4.2 and 1.35. Three countries (Bulgaria, Croatia and Romania) get positive global governance and may be considered as having a relatively good quality of institutions. Without surprise, the other countries have negative global governance, among them Bosnia and Serbia at war for a long time. The former may be considered as leaders, and the latter as followers (FIAS, 2007).

Figure 1. Country ranking according to their global governance (average 1996-2009)

Sources: Calculus from authors according to the WGI database (various issues) Wired at <<http://info.worldbank.org/governance/wgi/resources.htm>>

Table 2 gives more details about the institutional profile of each country and its evolution between 1996 and 2009. One indicator (control of corruption) has a negative score for the whole period and all the countries except Croatia. It is approximately the same for *Government effectiveness* and the *Rule of Law*. Only Croatia and Romania, during the period, have a shift from a negative score to a positive one. This indicates that public governance in SEE-7 is weak including for new EU members. Nevertheless, Bulgaria, Croatia, and Romania have relatively good performances compared to the other SEE selected. Their scores improved during the period for almost all the criteria.

Table 2. The quality of institutions (1996 VS 2009)

	Albania		Bosnia-Herz.		Macedonia		Serbia	
	1996	2009	1996	2009	1996	2009	1996	2009
Voice & Accountability Political, civil and human rights	-0,57	0,16	-0,5	-0,05	-0,04	0,13	-1,38	0,32
Political stability no violence Violence, political stability, absence of terrorism	-0,12	-0,07	-0,50	-0,57	-1,28	-0,65	-1,11	-0,50
Government effectiveness Efficient bureaucracy, quality of public service delivery	-0,54	-0,20	-1,28	-0,65	-0,47	-0,14	-0,45	-0,15
Regulatory Quality Market friendly policies	0,04	0,28	-0,60	-0,06	-0,07	0,32	-1,22	-0,10
Rule of Law Quality of contract, police and justice, crime	-0,01	-0,52	-0,02	-0,39	-0,11	-0,22	-1,00	-0,41
Control of corruption Measures corrupted practices	0,05	-0,40	-0,26	-0,31	-1,07	-0,03	-1,06	-0,19

	Bulgaria		Croatia		Romania	
	1996	2009	1996	2009	1996	2009
Voice & Accountability Political, civil and human rights	0,11	-0,34	0,18	0,56	0,18	0,46
Political stability no violence Violence, political stability, absence of terrorism	-0,22	-0,10	0,39	0,60	0,39	0,40
Government effectiveness Efficient bureaucracy, quality of public service delivery	-0,96	0,01	-0,82	0,64	-0,82	-0,13
Regulatory Quality Market friendly policies	0,19	0,14	-0,23	0,55	-0,23	0,62
Rule of Law Quality of contract, police and justice, crime	-0,04	-0,55	0,01	0,22	0,01	0,10
Control of corruption Measures corrupted practices	-1,02	-1,01	-0,23	0,03	-0,23	-0,13

Sources: WGI database (various issues), Wired at
<<http://info.worldbank.org/governance/wgi/resources.htm>>

The FIAS (2007) survey on foreign investor's expectations about SEE attractiveness confirms that Croatia, Romania and Bulgaria are the leading host countries and that the other countries are lagging behind because of a lack in business environment stability, infrastructure reliability, and a low perspective to enter the EU. The survey points out that demand is also an important determinant of FDI in SEE. 68% of the surveyed investors are attracted by the market size and 61 % by the GDP growth.

4. Concluding remarks

Transition is a two-step process. First, it is a *global shift* towards market economy that may be guided by international institutions and/or the EU. Second, it is a *specific direction* taken by each country in order to articulate a panel of local institutions with the requirements of the market economy. In that sense, institutions and their combination (institutional arrangement) become the corner stone of growth and FDI attraction.

We put forward two institutional profiles in the present paper. The first (EU members and candidate countries) reflects a profile where the institutional arrangement attracts FDI, as well as demand. The second (other SEE countries) presents a profile where institutions are considered weak. The first profile may expect to host FDI in a long-term perspective and gain from the presence of foreign investors through spillovers and knowledge transfers. The second, to avoid hosting nomad FDI, needs to improve the institutional pattern towards more reliable and effective reforms. We can conclude on the fact that reforms

need to be effective and perceived as such by actors. Reform effectiveness reflects the quality of the governance, which reflects the quality of institutions.

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