THE IMPACT OF INSTITUTIONAL QUALITY ON ATTRACTING FOREIGN DIRECT INVESTMENT IN CENTRAL AND EASTERN EUROPE

A case study of the automotive industry in Slovakia

Master Thesis
Supervisor: prof. dr. H.W. Hoen

Lisan Assen
S2029774
Table of Contents

List of Acronyms ................................................................. 3
List of Figures ........................................................................ 3
List of Tables ......................................................................... 3

Introduction ............................................................................. 4

Methodology ........................................................................... 10
Chapter Outline ................................................................. 10

Chapter 1 Theoretical framework ........................................... 12
Theories on FDI ......................................................................... 12
1.1. Classical theories on FDI .................................................. 12
  1.1.1. Diamond and GEMS Model ...................................... 12
  1.1.2. Dunning’s OLI Framework ....................................... 14
1.2. Extending the Classical FDI theories .................................. 16
1.3. The Role of the EU Accession Process for FDI in the CEE Countries ......................................................... 19
1.4. The FDI Variables considered in this Research .................. 19

Chapter 2: Classical FDI Determinants for Central & Eastern Europe .................. 21
FDI into CEE .............................................................................. 21
Classical Location Determinants .......................................... 23
  2.1. Labor Costs .................................................................. 23
  2.2. Human Capital ................................................................ 25
  2.3. Market Size and the Quality of Infrastructure .................. 26
  2.4. Agglomeration Effects and Connections with Local Suppliers ................................................................. 27
Conclusion ............................................................................... 29

Chapter 3 The importance of Institutional Determinants for FDI in Central and Eastern Europe .... 31
The relationship between Institutions and FDI ................................................. 31
Institutional Determinants .................................................................. 35
  3.1. Political stability ................................................................ 35
  3.2. Legal and Judicial System .................................................. 36
  3.3. Bureaucracy and the Level of Corruption ......................... 39
  3.4 Structural Reforms ................................................................ 41
    3.4.1 Market Facilitating Institutions ................................... 41
    3.4.2 Privatization, and Economic & Financial Liberalization ................................................................. 42
    3.4.3 Investment Incentives Policies ..................................... 44
  3.5. Tax system .......................................................................... 45
Conclusion ............................................................................... 45

Chapter 4 The Role of the EU for Attracting FDI in Central and Eastern Europe ....................... 47
  4.1. The Role of the EU on institution building in CEE ................................................................. 48
  4.2. Rules of Origin and EU limitations on state aid and the effects on FDI inflow ....................... 51
Conclusion ............................................................................... 52
Chapter 5: The Automotive Industry in Slovakia ................................................................. 54

An illustration of the importance of classical determinants, institutions and the EU for FDI inflow .......... 54

5.1. The Size and Composition of the Automotive Industry in Slovakia .................................. 57

5.2. FDI determinants for Automotive Investments in Slovakia ................................................. 59

   5.2.1. Proximity and Free Access to the EU market and Infrastructure quality ......................... 59

   5.2.2. Agglomeration effects ........................................................................................................... 60

   5.2.3. Labor Costs and Human Capital ......................................................................................... 61

   5.2.4. FDI State Promotion .......................................................................................................... 63

   5.2.5. Institutional Determinants and EU Pressure to Reform .................................................... 63

5.3. Inclusive or Exclusive Economic Growth in Slovakia? ...................................................... 67

   Conclusion ...................................................................................................................................... 68

Chapter 6: Conclusion ................................................................................................................ 70

Bibliography ............................................................................................................................. 73

Appendices ...................................................................................................................................... 80

Appendix 1: Case Studies Automotive Investments in Slovakia .................................................. 80
List of Acronyms

CE Central Europe
CEE Central and Eastern Europe
CEEC Central and Eastern European Countries
EBRD European Bank for Reconstruction and Development
EU European Union
FDI Foreign Direct Investment
GEMS model General Economic Management System
GDP Gross Domestic Product
IMF International Monetary Fund
MNC Multinational Companies
OECD Organization for Economic Co-operation and Development
R&D Research and Development
VW Volkswagen
WE Western Europe

List of Figures

Figure 1: Simple wage-adjusted labor productivity in European automotive industry in 2004

Figure 2: Volume of Foreign Direct Investment in Slovakia in US dollars 1993-2013

Figure 3: Passenger car production in Slovakia, 1990-2013.

Figure 4: Structure of Central European exports of automotive components in 1996 and 2006

Figure 5: Hourly compensation costs in manufacturing in Slovakia and Germany, 1996-2012

List of Tables

Table 1: Foreign direct Investment in CEE.
Table 2: CEE Tax Rates after 2004
Introduction
Economic development is a goal all countries strive for, being it for the good of the entire population or for the ruling elite. However, how to reach this goal is subject to fierce debates. Various schools of thought on the underlying drivers of economic development can be identified, all providing different explanations. Some of these schools will be briefly dealt with, to provide the context of the debate in which this research fits.

Scholars that belong to classical schools of thought focus on natural factors, that countries enjoy, to explain differences among countries in terms of economic development. These scholars argue that geographical factors, such as the resources, climate and diseases present determine most of the economic growth of a country. Classical schools of thought also emphasize a number of additional factors, such as human capital, economic policy, and historical events that work in tandem with geographical factors in shaping economic development. However, classical scholars stress that natural factors are most important for explaining a country’s economic development.

Non-classical theories on economic development emphasize the importance of human-made factors for explaining differences in economic development among countries. One popular group of scholars argue that certain cultural traits explain most of the world’s inequality. For instance, Weber, one of the leading academics of this school, argued that countries with a protestant heritage experience higher economic development, due to their protestant work ethic. Another example of a popular school of thought for explaining economic development is the ignorance hypothesis. These scholars argue that world inequality exists because rulers lack the proper knowledge of how to create economic growth. According to this school of thought some countries are poor because of market failures and because policymakers do not know how to get rid of them.

Although the non-classical theories already look at human-made factors for explaining differences in economic development, they still lack one decisive variable. The abovementioned theories fail to understand the importance of institutional variables for explaining economic development. The institutional school attempts to fill this void by pointing out that an effective institutional framework is a precondition for the development of

---

a sustainable economy. The concept institutions refers to the enduring practices that constrains political, economic and social interaction. Institutions describe the rules of the game, they include both formal and informal norms. The institutional school believes that natural factors work through the channel of institutions. This research follows the reasoning of the institutional school in that institutions are a necessary precondition for economic development, and that differences in institutions explain a large part of the differences in economic development among countries.

Despite numerous differences between the different schools of thought on economic development, they agree that foreign direct investment (FDI) can have a profound and positive impact on economic development in transition and developing countries. FDI became an increasingly important element in global economic development during the 90s and is now part of the strategy for economic development of most transition countries. Foreign investments have become the most important form of private capital flows into emerging markets. FDI can have profound positive effects. It is an engine of employment, it leads to innovation, enterprise and industrial restructuring, and the transfer of managerial know-how. All of this can improve a host country’s economic performance. Because FDI is so indispensable for the economic development of the developing and transition countries a deep analysis of the factors that determine FDI inflow is essential.

FDI is defined by the Organization for Economic Co-operation and Development (OECD) “as a category of investment that reflects the objective of establishing a lasting interest by a resident enterprise in one economy (direct investor) in an enterprise (direct investment enterprise) that is resident in an economy other than that of the direct investor. The lasting interest implies the existence of a long-term relationship between the direct investor and the direct investment enterprise and a significant degree of influence on the management

---

4 Acemoglu and Robinson. Why Nations Fail.
8 While being well aware of the fact that there is still an ongoing debate as to whether FDI has positive or negative effects for the economic development of a country. This research moves beyond this debate and assumes that FDI has positive effects on the economic development of developing countries.
Ibid., 7.
of the enterprise. The direct or indirect ownership of 10 percent or more of the voting power of an enterprise resident in one economy by an investor resident in another economy is evidence of such a relationship.” This research follows the OECD definition when talking about FDI.

Countries attract FDI based on multiple location advantages. An evolution of what determines location decisions by foreign investors has emerged in FDI literature since the 90s. Where classical FDI theories focus on traditional variables, such as market size and labor costs. Newer theories have progressively shifted towards focusing more on human-made assets that help countries improve their attractiveness to foreign investors. The institutional quality of a country is now, by many FDI theorists, regarded as an important precondition for FDI inflows. Institutions form the basis of the attractiveness of a country, because other FDI determinants only become important for explaining FDI inflow when institutions are firmly in place. Though, when one assesses the literature on FDI it becomes evident that the relationship between FDI and institutions is an understudied field of research. Classical FDI theories remain dominant. The aim of this research is to make FDI literature more comprehensive by testing the importance of institutional factors for attracting FDI.

The findings of earlier research suggest that the quality of the institutional framework does not only determine economic development and industrialization, but that the relationship also runs the other way around. Meaning that a situation of reversed causality exists. As said by Douglas North “sound institutions may emerge only when their benefits outweigh their costs.” Due to the existence of reversed causality it will be challenging to establish causation between institutional variables and FDI inflows. Nevertheless, by combining a multitude of studies that tested the importance of institutional variables for attracting FDI it will be possible to establish correlation between institutional variables and FDI inflows.

Before investing, firms perform costs-benefit analyses for different locations, in order to optimize their profits. The institutional quality of a country can have considerable effects on the costs for foreign investors and thus on location decisions. Institutions affect foreign

---

investors through two types of costs. First, transaction costs, which represent the costs for negotiating and enforcing an economic exchange in order to do business in the host country. Institutions affect these type of costs because inefficient institutions increase the risks that coincide with economic exchange and thereby also the costs of the exchange. Second, production costs, which are the costs incurred during the production process. Institutions have an effect on production costs because inefficient institutions may cause production delays or delays in issuing licenses or permits. Especially important for both types of costs are the quality of contract law and property rights protection, this will be discussed in further detail in chapter three.11

This research specifically focuses on the role of institutional variables for attracting FDI into the European transition countries. Albeit recognizing that classical FDI determinants also play a crucial role in location decisions by foreign investors in Central and Eastern Europe (CEE)12, therefore the classical determinants will also be dealt with. The choice to focus on CEE is a deliberate one, based on three arguments. First, once a country is industrialized, institutions replace the geographical factors as the most important driving force for economic development, as shown by Luo and Wen in their article “Institutions do not Rule: reassessing the driving forces of economic development”. Institutional differences thus determine much of the per capita income differences among the industrialized countries. Since the European transition countries already went through the process of industrialization, it increases the importance of institutional variables for explaining their economic development and attractiveness to foreign investors.13

The second argument to focus on CEE is because when testing the importance of institutions for attracting FDI, many scholars consider it best to compare countries at similar stages of development, that enjoy similar geographical, cultural, economic, and historical conditions.14 Because the Central European Countries (CEECs) roughly share the same cultural, historical, and to a great extent economic, and geographical variables it cannot be either one of these four variables that can explain their widely diverging paths in terms of FDI inflows. Differences in the institutional quality must therefore explain much of the diverging

12 CEE will be used to discuss the entire Central and Eastern European region. CEEC will be used when talking about the countries that comprise the Central and Eastern European region. CE will be mentioned if the specific part of the research only discusses Central Europe.
paths between the CEECs.

The last argument to focus on the European transition countries is that the process of institution building in these countries offers a unique historical experiment. The CEECs simultaneously embarked on an ambitious path from a centrally planned economy to a market economy. This transition required drastic, comprehensive, and fast reforms in their institutional structure. The CEECs inherited largely similar institutions, similar initial conditions and income levels, but, nevertheless, choose very different strategies and institutional structures. Consequently ending up experiencing very different economic outcomes and FDI inflows. Some experienced rapid economic growth, whereas others lagged behind. The drastic changes in the institutional structure of the CEECs within less than three decades make them an interesting case to see what role institutional changes have played in making them more attractive to foreign investors.

For the purpose of this research it is important to distinguish between the different types of FDI, as both emphasize different location advantages. Two types of FDI can be identified. The first type is classified as horizontal FDI and is a market-seeking investment. The second type is vertical FDI and is cost-minimizing in nature. Differences between these types of FDI motivates firms to make different location decisions. For horizontal FDI market size, usually measured by gross domestic product (GDP), is the most important locational determinant. Whereas for vertical FDI, the minimization of costs is the most important location determinant. This research primarily focuses on location determinants for vertical FDI, because in this era of globalization, horizontal FDI has become less important in CEE, as their market size is no longer sufficiently large. Foreign enterprises nowadays mostly engage in vertical FDI in CEE, because they want to enjoy global economies of scale and scope and other types of cost reductions.

To assess the driving forces behind FDI into the European transition countries, the focus of this research is on the Slovakian automotive industry. A detailed case-study provides the opportunity to evaluate the importance of institutions for attracting FDI. The Slovakian automotive industry is used as an illustration, because it has been able to attract vast amounts of FDI in the past decades. However, this rapid increase in FDI only happened after drastic reforms in the institutional structure of Slovakia since the mid-90s. The choice to focus on the

---

The automotive industry has to do with the fact that it is now one of the leading sectors in CE, especially in Slovakia, and contributes significantly to the GDP of the Visegrád countries.\(^{17}\)

The main question this research attempts to answer is “to what extent have the improvements in the institutional quality of Slovakia, after the fall of communism, contributed to inclusive growth, as defined by Acemoglu and Robinson, and helped Slovakia to attract FDI in the automotive industry?” The answer to the research question is also relevant for the wider industry in Slovakia, and for transition and developing countries in general. This research aims to establish whether, and more specifically, which institutional variables are important location decisions. How Slovakia has been able to improve its attractiveness to foreign investors can serve as a guideline for other eastern European countries who are still more in the transition process, such as Serbia and Ukraine. However, it is important to note that it is extremely hard to generalize on the factors which make a country prosperous. The economies that have flourished in the post-war period have all succeeded via their own particular set of policies. Evidence suggests that no homogenous set of institutional reform exist that produce the same effects in different countries with different legacies.\(^{18}\)

In order to fully understand the determinants of FDI in CEE it is crucial to develop an empirical model that controls for traditional (e.g. market size and labor costs), newer (e.g. institutional variables) as well as transition specific FDI determinants.\(^{19}\) The theory set forward by Acemoglu and Robinson in their book “Why Nations Fail: The Origins of Power, Prosperity and Poverty” is used as the overarching theoretical framework throughout the research. Their theory will be used to evaluate to what extent there has been a transformation from extractive institutions to inclusive institutions in CEE and the subsequent effects on FDI inflows. There are two types of institutions, economic and political institutions, which both have to be inclusive in order to generate sustainable economic growth. Inclusive political institutions ensure a democratic and pluralistic government that ensures that the rule of law applies. Inclusive economic institutions mean that the economy is open to everyone and that the institutions stimulate people to educate, innovate, and invest themselves.

The EU accession process has also played a crucial role in improving the institutional quality of CEE and is therefore also an important variable that needs to be taken into consideration. The accession process has been very important in aligning the CEECs with European standards. The changes in the CEECs economic and political institutions led to the

\(^{17}\) Radosevic and Rozeik, “Foreign Direct Investment,” 4.  
\(^{19}\) Brada, Kutan and Yigit “The Effects of Transition,” 650.
situation where foreign investors felt more secure to invest in CEE.\textsuperscript{20} By incorporating the effects of the EU accession process on FDI inflows, the picture of what determines FDI inflows into CEE is completed. Combining the role of institutional determinants and EU membership on attracting FDI has not been carried out much in the existing literature, adding additional relevance to this research. This research contributes to the debate on the factors which determine FDI inflows into CEE.

\textbf{Methodology}

The aim of this research is to test the causal mechanism between location variables and FDI inflows in CEE, the method of process-tracing is most valuable for this purpose. As it allows us to follow the whole process step-by-step and in that way find causation. The expectation is that process-tracing will provide more insights and understanding into what determines FDI inflows than do other methods, such as quantitative research. Process-tracing can be defined as “the systematic examination of diagnostic evidence selected and analyzed in light of research questions and hypotheses posed by the investigator. Process-tracing can contribute decisively both to describing political and social phenomena and to evaluating causal claims.”\textsuperscript{21}

The primary aim of this research is to test the relevance of inclusive institutions for FDI inflows into CEE. The process from a centrally planned economy to a market economy and the accompanying institutional improvements and the subsequent influence on FDI inflow can best be understood by using process-tracing, as it allows one to understand the relationship between the institutional quality of a country and FDI inflows. The Slovakian automotive industry will be used as an illustration of the importance of institutional variables for FDI inflow. As a case study is most useful to gain insight into the process of institutional change and its effect on FDI inflows.

This thesis makes use of several classical FDI theories and adds the inclusive growth theory by Acemoglu and Robinson to complete the theoretical framework. By combining classical FDI theories with newer theories on FDI the analysis of what determines location decisions by foreign investors in CEE is made more comprehensive.

\textbf{Chapter Outline}

To be able to answer the main question the research is organized as follows, Chapter one introduces the theoretical framework. The chapter starts with the classical FDI theories, after

\footnotesize{\textsuperscript{20} Asenova, “Institutional Determinants,” 15, 18.  
\textsuperscript{21} David Collier, “Understanding Process Tracing,” \textit{Political Science and Politics} 44, No. 4 (2011).}
which the theory by Acemoglu and Robinson will be introduced. Chapter two highlights the most important non-institutional determinants, such as for FDI inflow in CEE. The second chapter deals with factors such as labor costs, market size, and infrastructure. Chapter three goes into more detail about the importance of specific institutional determinants for attracting FDI. Factors such as the level of corruption, the legal system, and the quality of the bureaucracy will be elaborated upon. Chapter four evaluates to what extent the EU accession process improved the institutional quality of the CEECs, making them more attractive to foreign investors. Chapter five evaluates to what extent the improved institutional quality of Slovakia increased FDI into their automotive industry. This chapter is used as an illustration of the importance of institutions for attracting FDI. Chapter seven provides some concluding remarks on the role of institutions on FDI into CEE. This research has chosen to focus on the automotive industry in Slovakia because an in depth study will provide us with more understanding and insights into the importance of *inclusive* institutions for attracting FDI in all developing countries.
Chapter 1 Theoretical framework

Theories on FDI

Most FDI literature stays within the margins of well-established theories on FDI determinants. The focus tends to lie on classical location determinants. This chapter highlights some of these classical FDI theories and points to their merits as well as to their deficiencies. Recent FDI theories have already reduced some of the deficiencies of classical theories, but focus on the importance of institutions for FDI inflows remains insufficient. The institutional framework is important as investors consider the total business environment before deciding to invest in a country. The state plays an important facilitating role in creating a favorable business environment. Institutions are a precondition for the classical determinants to be effective in attracting FDI. The end of this chapter will therefore add institutional determinants to the overall theoretical framework for analyzing location decisions.

Both classical and new FDI theories provide valuable insights in what determines location decisions by foreign investors. For this reason, a hybrid mix of classical and new theories is used throughout this research. Classical FDI theories are combined to evaluate which classical location determinants are important to foreign investors. To complete the analysis of what determines location decisions, theories on the importance of institutions for FDI inflows are incorporated. The theory of inclusive institutions by Acemoglu and Robinson is used as the overarching theoretical framework to evaluate the importance of institutions for FDI. The authors argue that for a country to experience sustainable economic growth, both political and economic institutions have to be inclusive. The last section of this chapter discusses how the FDI variables as set out in the remaining of this chapter are operationalized for the purpose of this research.

1.1. Classical theories on FDI

1.1.1. Diamond and GEMS Model

The first classical FDI theories used for this research are Porter’s Diamond Model and the General Economic Management System (GEMS) Model. Porter’s Diamond model and the GEMS model are economic models that provide an explanation as to why particular industries are competitive in particular locations. According to Porter’s Diamond Model firms, rather than countries, are the principal actors. Firms decide, based on various location determinants,
where to invest their capital. However, Porter does argue that the state, through its regulatory capacities, has the power to influence the environment in which firms operate and can thus shape firms competitive success over time. The GEMS Model is a further extension of Porter’s Diamond Model by Shyam Kamath et al. Their theory offers new insights in understanding economic development. The main focus of both models is on economic clusters. Both attempt to provide a better understanding of why regional clusters develop. A cluster can be defined as a localized concentration of industrial specializations.

The success of clusters is dependent on factors such as the availability of a skilled labor force, good infrastructure, effective property rights protection, and a friendly taxation policy. The GEMS Model expands further upon the variables that contribute to local competitive advantages, than the Diamond Model. The next part of this section combines components of both the Diamond and the GEMS Model into one framework which will be used throughout the remaining of the research.

According to the authors the various components of their models are interdependent. This interconnected relationship between the components is one of the main strengths of both models, as it helps explain how one variable influences another. Which is very helpful for the purpose of this research as it helps explain how the influence of the government goes beyond their direct measures and policies.

The first component, that both models stress, are factor conditions. These are the classical factors that create the foundation for goods and services production in a country. These factors include the amount of skilled labor, the local level of technological development, natural resources, infrastructure, and capital assets. The second component are demand conditions. Meaning the demand for a product or service in the local and the international market. Porter’s Diamond Model attributes much weight to the local market size for location decisions by foreign investors. When the market pressures firms to innovate faster and to create products of higher quality, it helps create a competitive advantage for the companies present. This helps to improve the total quality of the cluster in comparison to other clusters. The third component, is the related and supporting industry. This component includes the quality of local suppliers and supporting companies, the presence of good logistic services, and legal firms who can provide foreign companies with the necessary services. The fourth component, consists of strategy and rivalry. This entails the amount of local competition, and the rules and norms of the local context. The fourth component is divided in

two sub-dimensions by Porter. The first sub-dimension consists of the presence and proximity of competitors and industry leaders. Firms want to be in the same location as their important rivals, to be able to follow and imitate competitor strategies. This phenomenon leads to agglomeration effects. The second sub-dimension is the regional climate for investment, this is determined by macroeconomic policies, political stability and a business-friendly climate. Factors such as the openness to trade and FDI, low levels of corruption, property rights, anti-trust regulations, and the amount of government business ownership play a role in the regional climate.

The GEMS Model further developed Porter’s Diamond Model by adding eight additional variables to enhance the four components mentioned above. In an attempt to provide a deeper understanding to the question why regional clusters emerge. The most important additional variables of the GEMS Model, for the purposes of this research are: first, the public policy variable. This variable refers to those policies and factors that create a favorable context for economic activities, investments and political stability in a country. Second, the GEMS Model adds a favorable business climate as an important variable for location decisions. This variable looks at elements such as having favorable business law, relative low marginal tax rates, and a favorable investment climate.

Both the second sub-dimension of the fourth component of the Diamond Model and some of the additional variables added by the GEMS Model take the role of the state and institutions into consideration. Nevertheless, both models do not stress the importance of these institutional variables enough. They both put more emphasis on demand conditions and factor conditions. Porter thinks that the role of the government in attracting FDI is not large. According to Porter the government plays more of a facilitating role. The GEMS Model does attribute more influence to the role of the government in attracting FDI. Although the GEMS model also has limited expectations about the effects of direct government policies for attracting FDI. This research hypothesizes that the government plays a much larger role in improving the attractiveness of a country, as a conducive institutional structure is a precondition for attracting FDI.²⁴

1.1.2. Dunning’s OLI Framework
According to Dunning, Porter’s Diamond Model and the GEMS Model are not comprehensive enough. Dunning argues that there are additional sources of competitive

advantages, not captured by these models. The three theories all agree on the importance of classical location determinants for attracting FDI. However, Dunning argues that the state, and thus institutions, plays a larger role in making a country attractive to foreign investors than attributed to it in previous FDI models. The state, according to Dunning, has the power to set the ‘rules of the game’ and as such can exert a great amount of influence on the competitiveness of states.\(^\text{25}\) Dunning’s paradigm is different from its predecessors because it attributes a larger role to institutional variables.

Dunning’s eclectic theory attempts to merge different theories on international economics. His paradigm looks both at the competitive advantages of particular firms as well as to those of host countries. According to the OLI Paradigm there are three sets of advantages. First, the Ownership advantages, which are firm specific assets that provide firms with costs advantages and market power to overcome the costs of producing in a foreign location. Second, the Location advantages, this depends on the host country’s specific characteristics that are available to all firms within that country and is an important factor that determines a location attractiveness to foreign investors. Dunning points to classical location advantages such as production costs, but also adds the state as an additional variable. Third, the Internalization advantages are the advantages for a firm to produce the products themselves, rather than through a partnership or licensing agreement.

The location advantages component is most important for the purpose of this research. Due to the focus on the role of a host country’s location advantages for attracting FDI. This variable is therefore dealt with more extensively. Location advantages describe the motives for firms to locate abroad. The key issue for location advantages is the distinction between horizontal and vertical FDI, which determines the relative importance of particular location variables. Horizontal FDI means the moving of the whole production process, with the aim of selling the product in the host market. Whereas the reason behind vertical FDI is to lower production costs or to leverage other location specific advantages by moving parts of the production process to foreign countries.\(^\text{26}\) Dunning’s model focuses more on vertical FDI than earlier FDI theories.

Although Dunning’s paradigm attributes a larger role to institutional variables than previous theories, his theory fails to put enough emphasis on the importance of institutional variables. Dunning’s paradigm should better integrate insights from institutional theory into the analysis. Institutions are vital for explaining a country’s attractiveness, as they are a


\(^{26}\) Ibid.
necessary precondition.  

This research attempts to solve the deficiencies of the classical theories by adding additional weight to institutional variables, as well as to include the theory by Acemoglu and Robinson on inclusive institutions. The reason for including institutional variables into the analysis is because the institutional quality is an important location asset. The OLI Paradigm and the other classical theories will be primarily used to analyze which classical location advantages are important for firms while selecting a location for their investments.

1.2. Extending the Classical FDI theories

The importance of Inclusive Institutions

Although classical FDI theories have taken institutions into consideration more over the past decades. These theories still fail to put enough emphasis on the role of institutional variables and the importance of the inclusiveness of institutions for attracting FDI. Thereby failing to provide a comprehensive analysis of what determines location decisions. For this reason, the theoretical framework is broadened by incorporating a theory on the importance of inclusive political and economic institutions for economic development and FDI. By incorporating this theory the gap that exists in the current literature is reduced and the analysis of what determines FDI inflows becomes more comprehensive.

The theory of inclusive institutions as developed by Acemoglu and Robinson, will be used as the overarching theoretical framework throughout this research. According to the authors countries do not fail because of cultural or geographical differences, but because of differences in their political and economic institutions. The authors argue that it are inclusive economic and political institutions that generate economic growth, and that extractive economic and political institutions impede economic growth.

The economic institutions shape the economic incentives, such as the incentive to become educated, to save and invest, and to innovate. The political institutions determine the power and the capacity of the state to govern society. The political institutions and process determines how the economic institutions are shaped. If there are inclusive political institutions, inclusive economic institutions will also be created. Inclusive economic institutions allow and encourage participation by all people in the economy, where they can make best use of their talents and skills. These institutions foster economic activity,

---

productivity growth, and prosperity. Inclusive economic institutions feature secure property rights, the rule of law, and a provision of public services that provide a level playing field for participants. Economic institutions must also permit the entry of new businesses.

Property rights are absolutely crucial for economic development. Only when property rights are effective are people willing to invest and increase productivity. If a businessman expects its output to be stolen or expropriated, he has little incentive to invest and innovate. Therefore, property rights are among the first variables of the institutional structure that need to be implemented, only then can inclusive and sustainable economic growth be achieved.

A well-functioning and inclusive economy relies on the state to be effective. The state must have the coercive capacity to impose order, and prevent theft and fraud. The law, the protection of property rights, and public services all rely on the state to be effective. Even when markets exist, they can be dominated by a few large firms. This shows that the presence of markets does not necessarily guarantee inclusive economic growth. Inclusive economic growth requires both inclusive economic and political institutions that create a countervailing force against movements away from inclusive markets. The effectiveness of the functioning of the state appears to be decisive for economic success. The willingness of the ruling elite to permit creative destruction, which leads to innovation, is furthermore crucial for economic development. Only in that situation can there be a change from extractive to inclusive economic growth. There is a close connection between the working of the economy and the inclusiveness of the institutions.

Acemoglu and Robinson argue in their book that it is possible to experience economic growth under extractive economic and political institutions, but that it is unsustainable. First, because sustainable growth requires innovation, which leads to creative destruction. When there are extractive political institutions this creative destruction will not be permitted as it destabilizes established power relations in politics. Second, political instability will emerge, due to infighting, because many groups will fight to become the new elite. As the elite is able to benefit greatly from the extractive economic and political institutions.

The authors lend support to their argument by using the city Nogales as an illustration of the importance of inclusive institutions for economic development. Nogales, is a city that situates partly on Mexican soil and partly on American soil. The people of Nogales on the American side of the city are used to secure property rights that protect their investments, to the government being their agent, and to democratic elections. On the other side of town the situation is rather different. There a situation of exclusive economic and political institutions exists. How can it be that the two halves of what is essentially the same city be so different?
These differences cannot be explained by geography, climate nor the types of diseases present. According to the authors there is only one obvious explanation for the observed differences between the two halves of the city; the economic and political institutions to which the inhabitants have access to. On the US side of the town the inhabitants have access to inclusive economic and political institutions. Inclusive institutions enable inhabitants to freely choose their occupations, to acquire schooling, and encourage employers to innovate, leading to more economic growth on that side of the city. Furthermore, US citizens feel safe to invest because they can trust their institutions and the rule of law, they do not worry about the security of their property rights. Additionally, the inclusive political institutions ensure stability and continuity. On the Mexican side of the city the people are less fortunate, they live in a world with different institutions. Their extractive institutional structure creates much less incentives for inhabitants and entrepreneurs to invest. The abovementioned example gives weight to the hypothesis that it is neither culture, geography nor ignorance that can explain the diverging economic paths of countries. We have to look at the differences between institutions for the answer.

The authors furthermore argue that the different set-ups of institutions today are deeply rooted in the past and tend to persist. This explains why it has been an incredibly hard process to change the institutional structure of the CEECs after the fall of communism. The theory of Acemoglu and Robinson is important for this research due to the fact that inclusive institutions, in particular inclusive economic institutions, have important implications for FDI inflows. Property rights, for instance, are crucial for attracting FDI, investors must feel secure that there is no risk of expropriation. One of the other cornerstones of inclusive economic institutions is that no parties, including foreigners, are excluded from participating in economic life. Institutions are part of the eclectic whole and are an important precondition for attracting FDI.

The importance of inclusive economic and political institutions for FDI inflow is considered only from the viewpoint of the CEECs, for reasons mentioned in the introduction. The theory by Acemoglu and Robinson highlights more generally the relationship between institutions and economic growth, whereas this research specifically uses their theory to analyze the role of institutions for attracting FDI in CEE.

---


1.3. The Role of the EU Accession Process for FDI in the CEE Countries

The last variable incorporated into the analysis is the role the EU accession process has played in improving CEE’s attractiveness to foreign investors. The EU accession process has been important for shaping the institutions of the CEECs. The move from a centrally planned economy with extractive political and economic institutions towards a market economy, that combined inclusive economic and political institutions, was greatly enhanced by the demands for institutional change by the EU through the Copenhagen Criteria and the adoption of the acquis. The role the EU accession process has played for attracting FDI is evaluated in chapter four and five.

The role accession to the large internal market has played in making CEE more attractive to foreign investors is also evaluated in chapter two and five. Since being part of one single market, the CEECs are now forced to compete on different factors than demand conditions, as they effectively operate as one large market in terms of demand conditions. For this reason, the CEECs compete vigorously by offering foreign investors favorable investment packages. However, The EU has strict rules when it concerns state aid, as it stresses the importance of fair competition.\(^{30}\) Since investment incentives contribute to the overall attractiveness of a country, it is interesting to analyze the role EU limitations have played on FDI inflows into CEE. Chapter four and five will therefore also evaluate the effects of EU state aid limitations on FDI inflow.

1.4. The FDI Variables considered in this Research

The abovementioned classical FDI theories stress the importance of classical factor conditions for explaining location decisions by foreign investors. Hence the null hypothesis to be tested in this research is:

**Null Hypothesis:** Factor conditions matter for attracting FDI.

This hypothesis will be tested in the second chapter of this research. Where the following factor conditions will be discussed; labor costs and educational attainment, the quality of infrastructure, the role of agglomeration effects, and the importance of demand conditions for location decisions. For the CEE markets, however, it is not only domestic demand that is important, but also the demand from the European internal market at large. To conclude the second chapter an assessment of the importance of these factors for FDI location decisions will be made.

\(^{30}\) Vollers, “The Attraction of,” 70.
The second causal factor to be evaluated in this research is the relationship between institutions and FDI inflows. Newer FDI theories stress the importance of the quality of institutions for location decisions by foreign investors. Therefore, the second hypothesis to be tested is the following:

**Hypothesis 1:** The influence of (inclusive) institutions on FDI is more substantial than currently described in FDI literature.

The third chapter goes into depth about the role the government and institutions play in making a country attractive to foreign investors. The research hypothesizes that an effective institutional framework is a precondition for attracting FDI. The existing FDI theories are extended by adding specific institutional factors, such as the bureaucracy and the quality of the legal and judicial system to the analysis of FDI determinants. The role of public policy will also be added, with a focus on policies that create a favorable climate for economic activities. This chapter also investigates the importance of investment policies for location decisions by foreign investors.

To complete the analytical framework on what determines FDI inflows into CEE the EU accession process will be included. Hence the last hypothesis to be tested is the following:

**Hypothesis 2:** The membership of the EU and the adoption of the acquis had a large and positive influence on FDI inflows in the CEECs.

In chapter four the role of the EU accession process on location decisions by foreign investors will be discussed. The accession process has dramatically improved the institutional quality of the CEECs. This research hypothesizes that these improvements have made them more attractive to foreign investors. Furthermore, the entry into the large internal market have also made the CEECs more attractive to foreign investors.

This chapter has highlighted that a hybrid mix of theories has to be used in order to provide a comprehensive analysis of what determines FDI location decisions in CEE. The remaining chapters of this research will provide the necessary evidence to test the validity of the above mentioned hypotheses.
Chapter 2: Classical FDI Determinants for Central & Eastern Europe

FDI into CEE

This chapter goes into depth about the importance of classical FDI factors for determining location decisions by foreign investors. The null hypothesis which stated that factor conditions matter for location decisions by foreign investors will be tested in this chapter. The hypothesis will be tested by evaluating the importance of several classical FDI determinants.

The collapse of the communist system in 1989 created a myriad of investment opportunities in CEE. These countries were already industrialized and had a relatively cheap, yet skilled, labor force.\(^{31}\) FDI started to increase into CEE after the changes of 1989, however, despite early optimism, regional levels of FDI remained quite minimal in the first years after the transition. In 1992 the FDI stock of the CEECs averaged at just 2 percent of GDP. FDI inflows started to increase rapidly by the end of the 90s in most CEECs. In 2001 the FDI stock had risen to an average of around 40 percent of GDP. By 2006 the average FDI stock as a share of GDP for CEE reached a striking 50 percent of GDP, twice that of the world average and significantly higher than the EU average.\(^{32}\) The CEE region is now regarded as the third most attractive location for FDI, after Western Europe and China and it is the second most favored place for investments within the manufacturing industry.\(^{33}\) FDI has played an important role in the CEECs’ transition from socialist to capitalist economies.\(^{34}\)

However, FDI is not distributed equally among the region, the CEECs have all chosen alternative methods for the transition process, resulting in very different levels of FDI. For instance, Hungary and the Czech Republic recorded comparatively high FDI inflows already a few years into the transition period. Whereas others, such as Slovakia, experienced above average FDI inflows, when compared to their GDP level, only later on. A group of CEECs still lack behind in FDI inflows.\(^{35}\) For this reason, it is important to answer the question why some CEECs have been more attractive to foreign investors than others.

Export-oriented FDI has become the most important type of foreign investment in CEE. Consequently, cost factors, such as economies of scale and scope, are important.

---

34 Clausing and Dorobantu, “Re-entering Europe,” 78.
considerations. The list of determinants for FDI varies widely depending on the type of the project, different investors no doubt stress the importance of different factors. Nevertheless, some important overall determinants for FDI inflows can be identified. Locations are more attractive to foreign investors to the extent that they generate higher after-tax profits than other locations.

As shown by chapter one, location determinants are the only factor that host governments can influence directly. There are a large number of different location determinants that affect the business potential of a country, they can be grouped into three broad categories. (1) economic considerations, (2) the national policy framework for FDI, and (3) business facilitation. Economic considerations, also known as the classical FDI determinants, are important location determinants for FDI and will be discussed in this chapter. Whereas, the effects of the national policy framework and business facilitating activities by the state will be evaluated in chapter three and four.

The economic determinants can be grouped into three broad clusters: (1) resource-seeking, (2) market-seeking, and (3) efficiency-seeking activities. According to classical FDI literature the economic localization advantages are; market size, macroeconomic stability, the cost of labor, the educational level of the labor force, the openness of the economy, the amount of natural resources, and the quality of the infrastructure. Natural resources are discarded in this analysis, because these prove not to be significant for explaining differences in FDI inflows among the CEECs, due to the rather homogeneous distribution of resources within the region. Price liberalization is also an important feature of the transition process, because MNCs do not want to be constrained by governmental price regulations. MNCs want prices to be determined by markets. By 2004, almost all CEECs have achieved price liberalization. Consequently, the observed differences between FDI levels in the region cannot be explained by the extent of price liberalization. This variable is therefore also discarded in the analysis. The importance of macroeconomic stability for FDI inflow is also not investigated in this research as it proves to not play a role in CEE.

38 Clausing and Dorobantu, “Re-entering Europe,” 86.
40 Brada, Kutan and Yigit, "The Effects of," 665.
41 Johnson, “FDI Inflows to the Transition,” 23.
Until 2008 FDI inflows increased rapidly into CEE. However, statistics show a sudden drop in FDI inflow after 2008, which can be largely attributed to the financial crisis of 2008. FDI inflows in 2009 were on average around 50 percent lower when compared to 2008. Since 2009 many foreign investors are more nervous about the stability of CEE and the consequences of their rapid economic growth before 2008. Nevertheless, the region remains an attractive site for many investors, due to the fact that the region offers emerging market growth combined with easy access to the wealthy European market and relatively low production costs.

The four Visegrád countries have emerged as the leading economies of CEE, as can be seen, among other things, by the large amounts of FDI that went into these countries. The question why the Visegrád countries have been more attractive to foreign investors is interesting, as the CEECs roughly share the same factor endowments. The evidence suggests that differences in the quality of institutions between CE and the rest of CEE is important for explaining the observed differences, this will be further analyzed in chapter three.

<table>
<thead>
<tr>
<th>Country</th>
<th>FDI as a cumulative % of GDP 1995</th>
<th>FDI as a cumulative % of GDP 2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Czech Republic</td>
<td>14.1</td>
<td>48.0</td>
</tr>
<tr>
<td>Estonia</td>
<td>19.3</td>
<td>77.6</td>
</tr>
<tr>
<td>Latvia</td>
<td>13.9</td>
<td>35.1</td>
</tr>
<tr>
<td>Lithuania</td>
<td>5.7</td>
<td>27.2</td>
</tr>
<tr>
<td>Hungary</td>
<td>25.3</td>
<td>51.8</td>
</tr>
<tr>
<td>Poland</td>
<td>5.8</td>
<td>24.9</td>
</tr>
<tr>
<td>Slovakia</td>
<td>4.2</td>
<td>31.5</td>
</tr>
<tr>
<td>Slovenia</td>
<td>9.5</td>
<td>20.7</td>
</tr>
</tbody>
</table>

**Table 1: Foreign Direct Investment in CEE.**


The remaining part of this chapter evaluates the importance of the classical FDI determinants for FDI inflows in CEE.

**Classical Location Determinants**

**2.1. Labor Costs**

The classical FDI theories, such as the GEMS Model, the Diamond Model, and Dunning’s OLI framework, argue that relative labor costs are an important location asset. These theories argue that one of the reasons why CEE has been so attractive to foreign investors, is because

---

43 Allen and Overy, “CEE you there!”. 2.

of their low relative labor costs.

Labor-seeking type of investments are mostly undertaken by multinationals (MNC) from countries with high real labor costs. What is relevant is not the absolute level of wages, but the average labor costs per unit produced.\textsuperscript{45} Figure 1 shows clear cost advantages for producing in CEE due to the fact that their average labor costs are significantly lower than in western Europe.\textsuperscript{46}

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{figure1.png}
\caption{Simple wage-adjusted labor productivity in the European automotive industry in 2004 (gross value added per unit personnel cost).\textsuperscript{47}}
\end{figure}

The empirical evidence in general supports classical theories in their argument that labor costs matter for foreign investments. The studies conducted by Bevan and Estrin, Holland and Pain, and Billington all show that labor costs are important for location decisions by foreign investors into CEE.\textsuperscript{48} FDI as a share of GDP was higher in those CEECs with relative low labor costs in the manufacturing industry.\textsuperscript{49} Although most studies confirm the importance of labor costs for FDI, some studies find that labor costs are not an important location determinant. For instance, the study by Devereux and Swain finds that labor costs do not play a significant role for location decisions in CEE.\textsuperscript{50}

\begin{itemize}
\item \textsuperscript{45} Baniak, Cukrowski and Herczynski, “On the Determinants of,” 11.
\item Pavlínek and Guzik, “Industrial Upgrading,” 58.
\item Asenova, “Institutional Determinants,” 17,18.
\item Clausing and Dorobantu, “Re-entering Europe,” 79,80.
\item Clausing and Dorobantu, “Re-entering Europe,” 79,80.
\end{itemize}
Classical FDI theories argue that the CEECs will concentrate on the cost-sensitive and labor-intensive parts of the production chain, as they enjoy relatively low production factors. Evidence shows that these types of investments still make up the bulk of the FDI into CEE. However, investments in the technologically advanced and capital-intensive part of the production chain have also been documented in CEE. This evidence leads some academics to suggest that the East-West division of labor is slowly fading away.\(^{51}\)

Furthermore, the advantage of cheap labor in CEE is not a permanent phenomenon, as can be seen by the slow convergence between the wages in CEE and western Europe. Therefore, it is important for the CEECs to strengthen their other comparative advantages, such as the skillfulness of the workforce. Although there is a slow convergence between CEE and WE wages, statistical analyses show that CEE will not reach EU norms anytime soon. The advantage of low labor costs is thus likely to continue into the near future. The evidence shows that for most foreign investors the relative low labor costs in CEE have been one of the key variables for their decision to invest in CEE.\(^{52}\)

### 2.2. Human Capital

When the government invests in education, foreign companies will take advantage of the well-educated workforce, which leads to investments and innovation. Enabling these countries to grow much faster than countries that do not stimulate their population to educate themselves.

*Inclusive* institutions pave the way for a highly educated population, because of equality of opportunity. An educated population is an important engine of prosperity. The low education level of poor countries is caused by economic institutions who fail to create the incentives for their population to educate their children and by political institutions that do not induce the government to support education. The price for this lack of *inclusive* growth is high, countries which lack *inclusive* institutions fail to mobilize their nascent talent, which hampers their economic growth potential.\(^{53}\)

The level of education is crucial for supporting a country’s reform process. The equality or inequality of opportunity in society is relevant for the successful delivery of the reform agenda. Therefore the authors Acemoglu and Robinson argue that development is generally correlated with *inclusive* economic growth.\(^{54}\) The government can play a large role

---

\(^{51}\) Pavlínek and Guzik, “Industrial Upgrading,” 44.

\(^{52}\) Hošková, “Impact of Foreign Direct,” 45.

\(^{53}\) Acemoglu and Robinson, Why Nations, 113-121.

in facilitating inclusive growth, by stimulating access to education. The role of education has been crucial for the reform process in CEE, because it led to the attraction of additional FDI and a faster transition process.

A skilled labor force is attractive to foreign investors, as can be shown by the large foreign investments conducted in the automotive industry in CE. The educational skills of the labor force have played a major role in attracting these investments, since the automotive industry heavily depends on a well-educated workforce. The CEECs inherited a relative skilled-labor force, making them attractive for investments in certain industries, especially the manufacturing industry. The combination of the well-educated workforce and relatively low wages is one of the major comparative advantages of the CEECs.55

2.3. Market Size and the Quality of Infrastructure
According to classical FDI theories demand conditions are crucial for FDI inflows. Demand conditions can be captured by market factors, which include market size and market growth.56 Countries that have sufficient domestic demand attract larger amounts of FDI. Market-capture motivations played an important role for FDI inflows in CEE, especially in the beginning of the transition period. The importance of market size is one of the reasons why becoming part of the large European internal market has been so important for the CEECs.57 In particular the Visegrád four have become a popular destination for MNCs which are seeking to expand their market base.58 Many study’s point out that market size is one of the primary determinants for FDI inflows into CEE (Bevan and Estrin, Busse and Hefeker, Disdier and Mayer, Lankes, and Venables and Dunning).59 Potential demand does prove to be most important if the firm intends to sell its product in the host country. However, market size can also have an effect on export-oriented FDI, because demand conditions can pressure firms to innovate faster than their competitors.60 Some studies fail to find a significant relationship between market size

55 Hošková, "Impact of Foreign Direct," 36
57 Pavlínek and Guzik, “Industrial Upgrading,” 43
58 Pawel Capik and Jan Drahokoupil, “Foreign Direct Investments in Business Services: Transforming the Visegrád Four Region into a Knowledge-based Economy?” European Planning Studies 19, no. 9 (2011): 1611.
59 Clasing and Dorobantu, “Re-entering Europe,” 79,80.
60 Disdier and Mayer, “How different is,” 286.
Porter, "The Competitive Advantage".
and FDI inflows into CEE. The study conducted by Campos is one example of such a study.\textsuperscript{61}

Since accession into the EU it is no longer only the domestic market that determines the attractiveness of the CEECs. The free access and close proximity to the European market has played an important role in further increasing the attractiveness of the new member states. Accession has effectively enlarged their market size. The proximity and preferential access to EU markets lessened the importance of their domestic market size.\textsuperscript{62}

Per capita GDP also has an impact on FDI inflows, studies indicate that higher consumer incomes have a positive and significant effect on inward FDI.\textsuperscript{63} The study by Price Waterhouse’s points out that FDI as a share of GDP is higher in those CEECs that have higher relative per capita incomes.\textsuperscript{64}

Due to the close proximity of CEE to the WE core market transportation costs are relatively low. Improvements in the infrastructure can further reduce transportation and communication costs. Thereby improving a country’s attractiveness to foreign investors. The infrastructure in CEE has improved drastically in recent years. However, some important improvements in the infrastructure to meet the current and future demands of foreign investors are needed.\textsuperscript{65} By improving the infrastructure the CEE governments can play an active role in making their countries more attractive to foreign investors.

2.4. Agglomeration Effects and Connections with Local Suppliers
The GEMS model adds the agglomeration effect of firms as an important variable for location decisions by foreign investors. Agglomeration can be described as a high concentration of companies within a certain geographical area.\textsuperscript{66} The argument for agglomeration is that externalities such as technological or informational spillovers, a greater specialization of skills, and a larger amount suppliers in the region are sufficiently important to offset the adverse competitive effect of the clustering of firms on their profits.\textsuperscript{67}

In CEE several agglomerations have emerged. The follow-the-leader strategy has been important for the development of these agglomerations. Foreign investors, especially in the

\textsuperscript{61} Campos and Kinoshita, “Foreign Direct Investment,” 21, 22.
\textsuperscript{63} Brada, Kutan and Yigit, “The Effects of,” 665.
\textsuperscript{64} “Foreign Direct Investment,” Price Waterhouse Coopers, 1.
\textsuperscript{65} Radosevic and Rozeik, “Foreign Direct Investment,” 7.
\textsuperscript{66} "Foreign Direct Investment," Price Waterhouse Coopers, 1.
\textsuperscript{67} Vollers, “The Attraction of FDI,” 29, 31.
first years after the end of communism, considered the location decisions by others as a good signal of favorable conditions and imitated the decisions of others to reduce uncertainty.\textsuperscript{68}

Other reasons behind the development of agglomerations in CEE, according to the New Economic Geography framework, is that investors avoid areas where the costs of production are high. Investors locate in central places that guarantee good access to the targeted markets. The grouping together in one area can be observed in particular in the Visegrád countries.\textsuperscript{69} The geographic proximity to the WE market has been one of the underlying reasons for this concentration. A great example of a CEE agglomeration is the automotive industry, it is estimated that approximately 75 percent of all automotive producers and suppliers are located within a 200km radius.\textsuperscript{70} This distinctive automotive agglomeration in CE will be dealt with in more detail in chapter five.

As the Porter’s Diamond Model pointed out, the quality of local suppliers is also important for industries that are grouped together in one region, because they can supply the much needed inputs for the production process. The major obstacles to linkages with local suppliers in CE is the low quality of locally produced inputs, lower flexibility, and insufficient technological sophistication. Due to the lack of good quality of local suppliers, MNCs are often forced to bring their own supply companies. Foreign affiliates do tend to appreciate the good skills of the CEE labor force.\textsuperscript{71} The potential for local linkages between producers and foreign investors can be increased if the CEE governments play a larger role in improving local research and development (R&D).

Agglomeration leads to several advantages for firms. New trade theory suggests that economies of scale and scope emerge due to agglomeration and that they are a driving force of FDI.\textsuperscript{72} Economies of scale emerge when more units of a good or service can be produced on a larger scale with less input costs, leading to efficiency gains for firms. A distinction between internal and external economies of scale can be made. For the purpose of this research external economies of scale are most interesting. External economies of scale emerge within a particular industry, rather than within a firm. When an industry’s scope of operation expands due to, for instance, the creation of better infrastructure, which consequently results in a decrease in the costs for every company within that industry, external economies of scale

\textsuperscript{68} Campos and Kinoshita, “Why Does FDI Go,” 11.
\textsuperscript{69} Disdier and Mayer, “How different is,” 282
\textsuperscript{70} Radosevic and Rozeik, “Foreign Direct Investment,” 35.
\textsuperscript{71} Javorcik and Kaminski, “The EU Factor” 468.
\textsuperscript{72} Campos and Kinoshita, “Why Does FDI Go,” 1.
have been achieved. All firms within the particular industry benefit from those external economies of scale. External economies of scale have also emerged in several industries in CEE, in particular in the automotive industry. Because of external economies of scale large investors are more inclined to invest in those areas in CEE where there are already large producers, because this can lower their costs of production. Economies of scale are part of the reason why the Visegrád countries receive larger inflows of FDI than the rest of CEE.²³

Another advantage that emerges out of agglomeration effects are economies of scope. These are factors that make the production process cheaper for all the producers within the region. Economies of scope can arise when enterprises share centralized functions, such as finance and marketing, or by cross-selling, meaning that firms share certain intermediaries rather than to produce everything themselves. The costs of production go down because only one production facility is used to produce components for multiple enterprises. The desire to develop economies of scope can be a driving force behind the development of large international conglomerates which can rely on cross-selling. The automotive industry in CE is a perfect example of the benefits of economies of scope. Automotive producers reduce the costs of production by cross-selling parts and components.²⁴

The CEECs have greatly facilitated the development of agglomerates by building large supplier parks. The development of these agglomerates and the following cost reductions, due to economies of scale and scope, have improved the region’s attractiveness to foreign investors. Agglomerations effects have thus played an important role in increasing FDI inflows into CEE.

**Conclusion**

The null hypothesis as formulated in chapter one was tested in this chapter. The hypothesis formulated that the classical location advantages remain important for explaining a country’s attractiveness to foreign investors. The empirical evidence in this chapter on general supports the claims made by classical theorists about the importance of classical location advantages. The studies evaluated in this chapter conclude that the following variables are the most important classical determinants for location decisions in CEE: the need to secure market access including access to the EU market, the quality of the infrastructure, agglomeration effects, and the skilled but relatively cheap labor force.

²⁴ “Economies of Scale and Scope,” The Economist.
Differences in the classical FDI determinants can in part explain the diverging levels of FDI inflow into the CEECs. The CEE states can play an active role in increasing their country’s attractiveness to investors, for instance by ensuring an inclusive educational system and by improving the infrastructure. However, despite the importance of classical FDI determinants, non-classical variables also play an important role in attracting FDI. Therefore, the next two chapters will discuss two important additional sets of variables. The next chapter will evaluate the importance of institutional variables for location decisions by foreign investors. Whereas chapter four will discuss the role EU accession has played in making CEE more attractive to foreign investors.
Chapter 3 The importance of Institutional Determinants for FDI in Central and Eastern Europe

The relationship between Institutions and FDI

This chapter attempts to broaden our understanding of what determines FDI inflows into CEE beyond the classical FDI determinants as discussed in the previous chapter. In order to do so we need to understand the relationship between transition, institutions and inward FDI. The concept transition and how this process has changed the business environment in CEE is introduced first, after which the importance of institutional variables will be tested and explained. The reason that CEE is so interesting for the analysis of what determines FDI inflows into a country, is the fact that these countries simultaneously embarked on an ambitious plan to move from a centrally planned economy to a market economy. The CEECs managed to move to a market economy within 10 years after the transition. Making that they can serve as a sort of laboratorial experiment for analyzing the importance of a multitude of location determinants for FDI inflows. During the transition the old system of a centrally planned economy, had to be replaced by a new system of legal, administrative, commercial, and fiscal and monetary institutions capable of supporting a market economy. This chapter will provide the necessary empirical evidence to test the hypothesis that (inclusive) institutions matter for attracting FDI.

Due to failing transition strategies, immediately after the fall of communism, the economic output in CEE declined much more than expected. Economic output declined on average by 41 percent when compared to its 1989 level across all transition countries. After 1993 the CEE economies began growing again, but it took them some time to regain their previous GDP levels. Because of the rapid economic decline, the CEE governments and international organizations began to realize that for the market economy to become a success, the transition process had to be more comprehensive and that painful reforms needed to be implemented.

Some necessary conditions were required to ensure a stable and successful transition to a market economy. For the transition to be successful it had to be comprehensive, by containing elements of; 1) *Liberalization*, meaning the process of allowing most prices to be

---

determined by free markets and the lowering of trade barriers. Liberalization frees the power of the market to allocate resources more efficiently. 2) *Macroeconomic stabilization*, which means bringing inflation under control and lowering it over time. This process requires discipline in both fiscal and monetary policy. Stabilization is crucial for price liberalization to work. 3) *Restructuring and privatization*, this entails the creation of a viable financial sector and reforming the enterprises in the transition economies to render them capable of producing goods that can be sold in free markets and transferring the enterprises ownership into private hands. What is needed for an effective transfer of ownership is a transparent mass privatization program and an effective system of property rights. 4) *Legal and institutional reforms*, coming down to redefining the role of the state in their economies, from being a provider of growth to an enabler, by establishing the rule of law and introducing a favorable business environment. Stabilization, liberalization, privatization and institutional reforms are mutually reinforcing and for this reason it is crucial to implement all four components of the transition process. 78

The establishment of property rights is a necessary precondition for the development of a functioning market economy, therefore this concept deserves some extra attention. Property rights have to be created and credibly enforced before liberalization of the market can take place. Effective property rights are of critical importance for economic development, as they create the incentives to utilize property efficiently and to innovate. Property rights make investors feel secure enough to invest their money, rather than to hold on to it. The efficiency of exchange of property rights is also crucial for an effective market economy. This efficiency is greatly enhanced when exchange is conducted in a stable macroeconomic environment, stabilization is therefore also crucial and should typically precede liberalization reforms.

Advisers and scholars believed that liberalization and macroeconomic stabilization could be undertaken rather quickly in the transition period, as could the privatization of small enterprises. However, the privatization of large enterprises and institutional reforms would take a longer time and could only be intensified at a later stage of the transition process. In the second half of the 90s the realization emerged that transplanting market mechanisms into formerly planned economies was going to fail, unless the right institutional framework for a

---

market economy was securely in place. Political and economic advisers realized that an effective institutional structure is a necessary precondition for a well-functioning economy and for attracting FDI. Therefore the EU, and other international organizations, started to put more emphasis on the importance of institutional reform in CEE. The EU attempted to help the CEECs with institutional reforms and legislative alignment through programs such as Phare and TACIS. The prospects of EU membership and the adoption of the acquis further helped to improve the institutional quality of the CEECs and to secure trust in their institutional quality.

By 2000 the European Bank for Reconstruction and Development (EBRD) reported that although the foundations for a functioning market economy were laid, through liberalization, comprehensive privatization, and the creation of an open economy, multiple institutional challenges remained. The liberalized markets were and still are not always sufficiently competitive, leading to the danger of developing *exclusive* rather than *inclusive* economic growth, which is unsustainable in the long-run. By 2010 the Transition Report of the EBRD concluded that the quality of the market-enabling institutions continued to fall short of what was necessary for a well-functioning market economy. The EBRD urges that the CEE governments should improve their business environment. The EBRD 2013 Report concludes that the CEECs with a strong institutional environment, meaning – countries that enjoy secure property rights, have effective rule of law, good corporate governance, and an uncorrupted public administration – were better placed to attract investments. Those CEECs that were further along the way of institutional reforms, such as the Visegrád countries, also welcomed much higher numbers of FDI.

After this brief explanation of the concept transition, we can now return back to the main question of this chapter; which is the importance of institutional variables for attracting FDI in CEE. By Douglas North’s view the purpose of institutions is to define the rules by which the game is played, monitored and enforced. He furthermore argues that “institutions and the way they evolve shape economic performance.” The economic development of the

84 "Transition Report 2013* *European Bank for Reconstruction and Development.*
European transition countries, although roughly enjoying the same factor endowments, differs so much with regard to economic growth and inward FDI, that the quality of their institutional framework appears to matter decisively. There is the need to understand the role of institutions in making a location attractive to foreign investors.\textsuperscript{85} As Acemoglu and Robinson already argued, institutions are a precondition for economic development.

Due to globalization, localization advantages have gained in importance. The localization advantages are first, as shown by chapter two, based on natural assets, such as the costs and quality of production factors. However, the localization advantages have progressively shifted from natural assets towards created assets. Recent FDI literature has focused on institutions as a major component of localization advantages.\textsuperscript{86} Institutions underpin local business operating conditions, they form the foundation for a well-functioning market economy.

The institutional infrastructure of a country embraces both political and economic institutions, they regulate certain parts of public life. Economic institutions are very important for regulating the business climate, economic institutions include tax law, business law, and contract law. Political institutions regulate political power, they determine the type of political regime, the national structure of decision-making and the judicial system. The key feature of institutions is that they are location bound extra market instruments designed to facilitate economic activity. The political and economic institutions are complementary and mutually reinforcing. The ease of doing business depends on both forms of institutions. Created assets determine more of the investment climate in a country than natural assets.\textsuperscript{87}

The institutional legacies of the past both limit and enable the options of institutional innovation in CEE. Furthermore, the amount of FDI state promotion is likely to depend on certain country-specific legacies, such as the extent of reforms during socialism and the initial choice of privatization policy. Evidence shows that this has on general been the case. Market based economic transactions, such as FDI, are more likely to be legitimized earlier in those economies that experienced some reforms during their socialist system. The privatization process is also an important determinant of FDI inflow, because the privatization method in some countries was more welcoming to foreign capital than others. Economic and political

\textsuperscript{85} Fabry and Zeghni, "Inward FDI in," 77, 78.
\textsuperscript{87} Violeta Asenova, "Institutional Determinants," 14.
Fabry and Zeghni, "Inward FDI in," 80, 82.
Campos and Kinoshita, "Foreign Direct Investment," 7,8.
Institutions have to be *inclusive* in order to develop sustainable economic growth. Those CEECs that have been more welcoming to foreign investors, thus being more *inclusive*, have all experienced higher economic growth and FDI inflow.\(^8^8\)

The CEE governments actively tried to improve their country’s attractiveness to foreign investors through three ways. First, the political commitment to liberalization. Second, professionalization of the state by the establishment of a state FDI agency, showing the commitment of the government to FDI and facilitating these type of transactions. Third, the form of the privatization process, if a CEE country decided to start selling strategic national assets to foreigners the amount of FDI rapidly increased, it served as an important signal for the shift in a state’s practical stance toward foreign investors.\(^8^9\)

To be able to answer the question whether the FDI inflow into CEE is linked to institutional variables, we need to understand the role of institutional variables in making a location attractive to foreign investors.\(^9^0\) The role of the following institutional localization advantages: the quality of the legal and judicial system, the bureaucracy and the level of corruption, political stability, investment incentives policies, market facilitating institutions, structural reforms, and the tax system, on FDI inflows will be evaluated in the remaining of this chapter.

**Institutional Determinants**

### 3.1. Political stability

Political stability can be measured by the ability of the government to carry out policies, to stay in office, and to be authorized by lawful parliamentary elections.\(^9^1\) There is no consensus in the literature about the importance of political stability for FDI inflows. Some authors consider political stability to be an important variable for attracting FDI, whereas others do not find a statistically significant relationship between the two.\(^9^2\) The studies by Busse and Hefeker, and Bevan and Estrin found a positive and significant relationship between government stability and inward FDI.\(^9^3\) The study by Brada specifically examined the effects of transition and political instability on FDI inflows in CEE and also found a positive relationship between political stability and FDI inflows. Brada argues that FDI is a forward-looking activity, based on investor’s expectations about future returns, FDI location decisions,

\(^8^8\) Nina Bandelj, “How EU Integration,” 487-489.
\(^9^0\) Fabry and Zeghni, “Inward FDI in,” 77.
\(^9^1\) Hošková, “Impact of Foreign Direct,” 17.
\(^9^2\) Asenova, “Institutional Determinants,” 17,18.
\(^9^3\) Busse and Hefeker, “Political Risk, Institutions and Foreign Direct,” 2-20.

Busse and Hefeker, “Political Risk, Institutions and Foreign Direct,” 2-20.
by its very nature, require some assessment of the political future of the host country. Perceived political stability is thus important to make investors feel secure about investing in a country.  

However, other studies such as the one conducted by Daude and Stein do not find a statistically significant relationship between political stability and FDI inflows. Despite the fact that the CE countries experienced more political stability and higher levels of FDI gives weight to the hypothesis that political stability is attractive to foreign investors. It is possible that these higher levels of FDI can be entirely attributed to other factors. Due to the lack of consensus in the literature it is hard to draw conclusions on the importance of political stability for FDI inflows into CEE.

3.2. Legal and Judicial System
FDI is the most stable capital flow to transition countries and accelerates innovation and economic growth. Yet, specialized and long-term investments will only be made if the right economic institutions are in place, as shown in chapter one. The legal and judicial is of particular importance to foreign investors, because it works as a safeguard for investors. The regulatory capacity is the ability of the government to formulate and implement sound policies and regulations that promote private sector development.

Defining a well-functioning legal and judicial system that fosters inward FDI is challenging. However, there are some clear strands of law, when implemented effectively, that can have a profound direct effect on inward FDI. Examples are property- contract- and business law. Although economic determinants are crucial for FDI, they only come into play if the regulatory framework is sufficiently enabling. The vigor of markets depends, to a large extent, on the enforcement of property, contract and business law. A combination of a proper legal institutional framework and economic liberalization fosters economic development.

The legal system in a rule-of-law state establishes the rules of the game, people use the system to structure their economic activities and to resolve disputes. Acemoglu and Robinson argue that if countries want to thrive, they have to develop inclusive political and economic institutions. The institutions should encourage citizens to innovate, invest and develop. The

The institutional framework has to effectively enforce property rights, enforce private contracts, create a level playing field, and encourage investments in new technologies and skills. A country should furthermore have an unbiased system of law.\(^\text{97}\)

Economic law has multiple functions. First, it defines and protects property rights. Second, it promotes competition and defines the rules for entering and exiting the market. Third, it settles disputes between parties, through the judiciary and lastly it describes the rules for businesses, through business law.\(^\text{98}\) Property protection, non-discrimination, contract enforcement and business law are important principles that establish a sound investment climate. If these laws do not work effectively economic growth will be suboptimal, due to a lack of investments. The level of protection should encourage both innovation and investment.\(^\text{99}\) An effective legal and judicial system is a necessary precondition for attracting foreign investors.

Studies show that the quality of the regulatory framework, in particular the enforcement of property rights and contract law, plays a large role in determining a country’s FDI inflow. The judicial system is also important for a country’s attractiveness to foreign investors, as it ensures that the rule of law in fact applies (Knack and Keefer, Daude and Stein, Javorcik, and Cooter).\(^\text{100}\) An efficient legal system makes investors more confident to invest their capital.\(^\text{101}\)

As mentioned in the introduction effective property rights are of critical importance for economic development, as they create the incentives to utilize property efficiently and to innovate. There will be a lack of investments if there is no reasonable level of security for investing in private business.\(^\text{102}\) The creation and enforcement of an effective system of property rights, which governs ownership, the use and exchange of real and financial assets over time, and the distribution of state property to the public is thus crucial. Efficiency also demands that exchange of property can be conducted with relatively low transaction costs. The existence of credible monetary institutions that are capable of establishing a monetary

\(^{97}\) Acemoglu and Acemoglu, *Why Nations Fail,* 115.


\(^{100}\) Pinheiro, *Judicial,* 29.


\(^{102}\) Cooter and Schäfer, *Solomon’s Knot.*

\(^{102}\) Javorcik and Kaminski, ”The EU Factor,” 459.


\(^{102}\) Johnson, Mcmillan and Woodruff, “Entrepreneurs and the Ordering,” 1,4.
medium of exchange with a stable value is a necessary condition for low transaction costs.\textsuperscript{103}

Due to the perceived positive effects of a proper legal and judicial system for economic growth, developing the legal base of a market economy became a priority task for all the transition countries, after the fall of communism. However, in the second half of the 90s the old communist legislation still prevailed in some important sectors, such as banking and finance, intellectual property rights, and international trade.\textsuperscript{104} Many CEECs only initiated necessary but difficult legal reforms after EU accession drew closer.

There is thus ample evidence in the literature that a well-functioning legal- and judicial system fosters economic development and inward FDI. Slovakia’s experience with FDI gives further weight to the claim that legal reforms are crucial for attracting FDI.\textsuperscript{105} Slovakia only experienced a surge in FDI after some important legal reforms were initiated. One should, however, not confuse reform efforts with reform outcomes, reforms are only effective if properly enforced.\textsuperscript{106}

The legal texts of a country must furthermore be well-defined, otherwise the country risks the problem of enforcement of legislation. The problem of enforcement occurs when there is ambiguity of the legal texts. Imprecise definition of terms creates uncertainty with regard to the legal system, which acts as a hindrance to business activity. Improvements in the legal framework, such as improvements in transparency, reduce the costs of investment, thereby creating incentives for investors.\textsuperscript{107}

The formal legal institutions rely on an efficient and fair judicial system, which greatly reduces transaction costs for businesses.\textsuperscript{108} Laws mean nothing if they are not properly implemented.\textsuperscript{109} Although most disputes are solved without going to court, commercial dealings always take place in the shadow of the law.\textsuperscript{110} Courts play a central role in making sure that the rule-of-law in fact applies, rather than just on paper. A well-functioning judicial system has to ensure that people are punished for violating the country's law, thereby increasing the trust of foreign investors. The judicial system should have low cost, assured access, fairness, and predictable and timely outcomes. Another crucial element of a well-functioning legal system is the ability to enforce court decisions. Enforcement depends on

\begin{flushleft}
\textsuperscript{103} Edgar L Feige, “The Transition to a Market Economy,” 3-7.
\textsuperscript{105} Javorcik and Kaminski, “The EU Factor,” 459.
\textsuperscript{106} Campos and Kinoshita, “Foreign Direct Investment, Structural,” 17.
\textsuperscript{108} Fabry and Zeghni, “Inward FDI in,” 81.
\textsuperscript{109} Armando Castelar Pinheiro, Judicial, 3.
\textsuperscript{110} Kenneth W dam, The Law, 123.
\end{flushleft}
both the power of the state as well as on the quality of the law.\textsuperscript{111}

Effective property-, contract- and business law, and effective enforcement can thus minimize the costs of conducting business, minimizing risk and optimizing profits. The quality and efficiency of the legal institutions of a country, along with other factors, determines a country’s attractiveness to foreign investors.\textsuperscript{112} Foreign investors feel more secure in a country where they feel confident that their investments will not be expropriated, either by a third party or by the government.\textsuperscript{113}

It is important to highlight some of the limitations of the studies above. Although there has been progress in recent years in finding better proxies, there is still no perfect method for measuring a country’s legal and judicial quality. Besides that, the quality of the legal and judicial system of a country is only one of the reasons for observed differences in countries’ economic development.\textsuperscript{114} Making it hard to establish the causal link between the legal and judicial system and inward FDI. However, the studies above all show a clear correlation. For this reason, one can conclude that an efficient and predictable legal and judicial system is an important factor, that most foreign investors take into consideration, when making decisions on where to invest their capital.

According to the survey by Johnson the legal system in the CEECs currently in general works. The majority of firms interviewed in Johnson’s study confirmed that they can make use of courts to enforce agreements.\textsuperscript{115} Which, according to the analysis above, is beneficial for the level of FDI into CEE, because investors feel more secure about their investments if the rule-of-law in fact applies.

3.3. Bureaucracy and the Level of Corruption
Investment costs consist not only of economic costs, they also include non-economic costs, such as time lost in dealing with the bureaucracy. The bureaucracy entails the quality and capacity of the state administration. Improvements in the efficiency of the bureaucracy reduces both the time and complexity of doing business, thereby improving a country’s attractiveness to foreign investors.\textsuperscript{116} The relationship between FDI inflow and the quality of the bureaucracy has been examined in several studies. Some studies find that the quality of

\begin{thebibliography}{99}
\bibitem{111} Armando Castelar Pinheiro, \textit{Judicial}, 6, 13.
\bibitem{112} Violeta Asenova, “Institutional Determinants,” 8.
\bibitem{113} Armando Castelar Pinheiro, \textit{Judicial}, 6, 13.
\bibitem{114} Armando Castelar Pinheiro, \textit{Judicial}, 31.
\bibitem{115} Johnson, Mcmillan and Woodruff, “Entrepreneurs and the Ordering,” 7.
\bibitem{116} Matthias Busse, “Political Risk, Institutions and Foreign Direct,” 2-20.
\end{thebibliography}
the bureaucracy is more important than others, but all agree that there is a positive and significant relationship between the two (Busse and Hefeker, Baniak, and Campos and Kinoshita). In the study by Campos and Kinoshita the quality of the bureaucracy even turns out to be the most important institutional factor for attracting FDI into the transition countries.117

The importance of corruption for location decisions by foreign investors is also a variable that needs to be taken into consideration. Corruption can be defined as the extent to which public power is exercised for private gain.118 Civil servants, at each level of the bureaucracy, are able to ask bribes in order to leave private agents operating in the country. Bribes increase the marginal cost of operation for MNCs.119 A country with a low level of corruption is more conducive to foreign investors, due to the fact that corruption increases the costs of doing business. Corruption affects FDI inflows, by affecting the perception of stability and investment potential of a country.120 A low level of corruption is associated with more sustainable economic growth.121

Multiple studies find a negative and significant relationship between the level of corruption and FDI inflow. The study by Johnson indicates that control of corruption is essential if entrepreneurship is to develop.122 The study by Campos and Kinoshita states that the quality of the bureaucracy reflects two things: first, the level of corruption and second, the ease of regulations. Their study shows that both the quality of the bureaucracy and the level of corruption are significant for FDI inflows. Poor quality of the bureaucracy or a high level of corruption is detrimental to economic growth, as it leads to lower levels of FDI.123

However, not all studies find a significant relationship between corruption and FDI inflow. According to the study’s by Tøndel, and Mateeva and Tsekovb a high level of transparency of the bureaucracy and a low level of corruption does not have a major direct impact on FDI. However, according to Mateeva and Tsekovb, less corruption could have a positive indirect effect on FDI inflows through its positive effects on the overall economy. The predictability of corruption also matters for determining how harmful corruption is for FDI. When the bribe payer receives what he pays for, corruption will be less damaging to FDI.

as when the outcome of paying a bribe is uncertain.\textsuperscript{124}

In conclusion, all studies find a significant and positive relationship between the quality of the bureaucracy and the level of inward FDI. The literature is more ambiguous on the relationship between the level of corruption and FDI, making it hard to draw any conclusions as to whether corruption perceptions matter for location decisions by foreign investors into CEE.

3.4 Structural Reforms
3.4.1 Market Facilitating Institutions
Structural reforms refer to the extent of privatization, the openness of markets, progress in financial sector reform and the creation of a legal and institutional framework that supports private sector activity.\textsuperscript{125} The first structural reforms to be discussed are the market-related institutions, because they have a significant effect on FDI inflows. The authors Fabry and Zeghni identified four types of market facilitating institutions: market creating, market regulating, market stabilizing, and market legitimizing. The market creating institutions uphold the rule of law, they define property rights and contract law. These formal institutions rely on an efficient and fair judicial system. Market creating institutions greatly reduce the transaction costs for businesses. Thereby creating incentives for investment and private sector development.\textsuperscript{126} Market regulating institutions help to regulate market externalities. The regulations ensure fair competition, minimization of distortions, the enhancement of privatization, and deregulation. Market stabilizing institutions improve the level of institutional stabilization and reduce the level corruption. The expenditure on health and education as a percentage of GDP is used to measure market legitimizing institutions.

The study by Fabry and Zeghni investigated the relationship between the market institutions and FDI levels by using a time series cross-sections analysis of 11 CEECs. Their analysis shows that countries with stable and reliable market creating and market regulating institutions attract more FDI. These two types of market institutions improve inclusive growth through inclusive legislation and the opening up of the market. Countries that effectively protect property rights and create incentives for investment and private sector development, through inclusive institutions, thus attract more FDI. Market stabilizing and market


\textsuperscript{125} Miroslav Mateeva and Iliya Tsekov, "Do Central and Eastern European Countries Posses FDI Advantages to More Developed Western Countries?" (Paper presented at the Annual Meeting of the Midwest Finance Association), (2013): 20.

legitimizing institutions do not appear to be significant for attracting FDI.\footnote{Asenova, “Institutional Determinants,” Fabry and Zeghni, “Inward FDI in,” 81.}

The purpose of an effective and market facilitating institutional structure is to reduce transaction costs. Transaction costs represent the hassle costs of doing business and the uncertainties arising from possible opportunism, moral hazards, and incompleteness of commercial dealings. Transaction costs can be reduced by well-defined property rights, an effectively regulated banking system, less corruption, well-developed financial markets and a good incentive structures.\footnote{Dunning, “Institutional Reform,” 3.}

Observes, such as the EU, overestimated the ability of the transition countries to build effective market institutions. Institutions lack flexibility and institutional reforms may encounter local resistance. According to the analysis of Fabry and Zeghni, the CE countries received higher levels of FDI than the other CEECs, because they are historically and culturally closer to the EU and because their local institutional arrangement seems more suitable to foreign investors.\footnote{Fabry and Zeghni, “How Former Communist Countries,” 205.}

### 3.4.2 Privatization, and Economic & Financial Liberalization

One of the most important sort of structural reforms is the method of privatization. Privatization can be defined as “all monetary receipts to the government resulting from partial and full divestitures, concessions, leases and other arrangements.”\footnote{Campos and Kinoshita, “Foreign Direct Investment,” 16.} Privatization is an important signal for the commitment to private property. Studies conducted by Holland and Pain, Campos and Woodward et al., and Carstensen and Toubal all confirm the positive and significant relationship between the privatization of formerly state-owned enterprises and FDI inflow.\footnote{Asenova, “Institutional Determinants,” 17.}

Private ownership is one of the cornerstones of a market economy. Privatization constitutes a fundamental part of the transition-process to a market economy. Privatization by itself is not the only important variable, the choice of the privatization method also has an impact on FDI inflow. As highlighted in the study by Holland and Pain, the ability to attract FDI also depends on the privatization method used by the host country. According to the World Bank there are three major methods of privatization; 1) direct sales to outsiders, 2)
voucher-based mass privatization, and 3) so called management and employee buyouts. Holland and Pain found that the direct sales method to outside owners had the largest effect on FDI inflows, because it enables foreign investors to buy formerly state-owned enterprises. All CEECs have used more than one method, making it problematic to divide the economies according to the chosen method of privatization and the subsequent effect on FDI inflows.

Although it is difficult to divide the CEECs according to their privatization methods, it is evident that the privatization policies of some the CEEC’s were much more open to foreign investors than others, which led to major differences in terms of FDI inflow. The countries whom initiated fast privatization methods, such as Hungary, already experienced high inflows of FDI early on. Whereas other countries, who started large-scale privatization only later on, experienced much lower levels of FDI in the initial years of transition. The sort of privatization strategy is not the only important aspect, governments also have to ensure transparency throughout the whole process in order to attract foreign investors.

The process of privatization is still not fully completed in CEE. The problem according to the EBRD is that some of the transition economies have become “stuck in transition”. Small-scale privatization was mostly completed by the end of the 1990s. However, large-scale privatization and some other institutional reforms are still not comprehensive enough, impeding the economic convergence of the CEECs with WE.

Other important structural reforms for transition are related to the liberalization of the economy. Trade liberalization ahead of EU accession worked in favor for CEE as a low-cost production location, because of the easier and cheaper access to the European market. Foreign investors want to be able to export the produced goods and to import intermediate goods without restrictions. The study by Busse and Hefeker investigated the importance of the openness to trade, measured by the ratio between exports and imports to GDP, to foreign investors. Their study finds that the influence of this variable depends on the type of FDI. Vertical FDI is attracted to open economies with little barriers to trade, as that would increase transaction costs. Whereas in the case of horizontal FDI, a more restrictive trade regime may induce more FDI, as that protects their output in the local market.

---

133 Johnson, "FDI Inflows to the Transition," 29.
135 Radosevic and Rozeik, "Foreign Direct Investment," 7.
trade liberalization and FDI is thus not straightforward, the effect depends on the type of FDI. For CEE trade liberalization has on general been positive for FDI inflows, because most of the FDI in CEE is export-oriented.

Financial liberalization and reforms can also be attractive to foreign investors. Campos’ study shows that financial reform and liberalization, in particular bank efficiency, are both positive and statistically significant for FDI inflows. Foreign investors are attracted to countries when there are less restrictions on the expansion of bank credits, greater supervision over the banking sector, and more liberalized securities markets.\(^{138}\) Much of the banking sector in the CEECs has been privatized and liberalized.\(^{139}\) The study by Campos suggests that the banking reforms in CEE have led to additional FDI inflows in the region.

From the above analysis it can be concluded that the amount and vigor of structural reforms can partially explain a country’s attractiveness to foreign investors, as it improves the overall business environment.

### 3.4.3 Investment Incentives Policies

The CEECs actively seek to attract foreign investors by offering them investment incentives in the form of subsidies, tax breaks, development of infrastructure, preferentially priced land, and other types of financial and non-financial advantages. Incentive based competition among the CEECs has increased rapidly. These incentives can play an important role in location choices by foreign investors. As Dunning already suggested, new variables such as differences in government policies towards FDI may need to be incorporated into the analysis of location decisions by foreign investors.\(^{140}\) For some foreign investment projects government incentives may not be considered crucial, whereas for other projects it may directly tip the balance in one country’s favor.\(^{141}\)

The CEE member states, after EU accession, have to ensure that any incentives offered comply with EU law. States are only allowed to grant aid to facilitate the development of certain economic activities and regions. The CEECs are often allowed to provide investment incentives due to the fact that they stay behind economically. The investment incentives offered by the CEECs have, in some cases, been crucial in tipping the balance in a country’s favor. The KIA investment in Slovakia, which will be dealt with in more detail in the Appendix, is a clear example of the important role that investment incentives can play in

---


\(^{140}\) Dunning, “Toward an Eclectic,” 7.

\(^{141}\) Allen and Overy, “CEE you there!” 6.
attracting FDI. The conclusion that can be drawn from the above analysis is that the investment incentives offered by the CEECs have made them capable of attracting additional FDI, as it lowers the costs for producers.142

3.5. Tax system
Corporate taxes reduce profits and hence the tax rate affects location decisions. The analysis by Kimberly et al., and Overesch and Wamser shows that countries with relative high corporate tax rates receive less FDI. The CEECs acknowledge the importance of low tax rates for attracting FDI and are therefore actively attempting to attract MNCs by establishing favorable taxing conditions. The average corporate tax rate of the CEECs declined from 32.2% in 1996 to 19.2% in 2005. The analysis by Overesch and Wamser supports the hypothesis that the new tax policies of the CEECs contributed to the rise of FDI in the region.143 The Visegrád countries, for instance, all introduced flat tax rates, which increased the transparency and simplicity of their tax system. These new tax rates have made doing business in CE both less complicated and more profitable.144

<table>
<thead>
<tr>
<th>Taxation</th>
<th>Czech Republic</th>
<th>Hungary</th>
<th>Poland</th>
<th>Slovak Republic</th>
</tr>
</thead>
<tbody>
<tr>
<td>Statutory corporate income tax</td>
<td>24</td>
<td>16</td>
<td>19</td>
<td>19</td>
</tr>
<tr>
<td>Effective corporate income tax rate</td>
<td>17.1</td>
<td>14.0</td>
<td>17.5</td>
<td>16.8</td>
</tr>
<tr>
<td>VAT (general rate)</td>
<td>19</td>
<td>20</td>
<td>22</td>
<td>19</td>
</tr>
<tr>
<td>Personal income tax rate</td>
<td>15–32</td>
<td>18–38</td>
<td>19–40</td>
<td>19</td>
</tr>
</tbody>
</table>

**Table 2: CEE: Tax Rates (percent) after 2004**
(Source: Allen & Overy 2006)145

**Conclusion**
The literature review has shown the positive and significant relationship between institutions and FDI inflows in CEE. The analysis above shows that an effective bureaucracy, comprehensive structural reforms, in particular the opportunities presented by large-scale privatization, low relative tax rates, market-facilitating institutions, an effective legal and judicial system, and effective property rights play a crucial role in determining the amount of

---

142 Allen and Overy, “Foreign Direct,” 10, 12.
145 Clausing and Dorobantu, “Re-entering Europe,” 78, 87-98.
148 Allen and Overy, “Foreign Direct,”
FDI inflow into CEE. The effects of political stability and low levels of corruption on FDI inflows is more ambiguous, although there is some indication that these two variables also played a role in attracting FDI.

A slow process of industrial upgrading is noticeable in CEE, expertise is emerging in several industries, this expertise must be facilitated by a conducive institutional structure. The state must provide the investors with the rules by which the game is played. Especially property rights are crucial for the development of a competitive inclusive economy. An inclusive institutional structure stimulates economic growth and FDI inflows. The analysis in this chapter has shown the importance of institutional variables for attracting FDI. Because the CE countries have been more successful at developing an effective, business friendly, institutional framework, they have also been more successful in attracting FDI. The hypothesis that (inclusive) institutions matter for FDI inflows has thus been proven plausible by the analysis in this chapter.

By combining chapter two and three it is possible to make a more comprehensive analysis of the variables that determine FDI inflows into CEE. The previous chapter found that the classical factor endowments remain important for location decisions by foreign investors. This chapter has shown that a new source of competitiveness of countries is a good business environment through an effective institutional structure.\textsuperscript{146} So, the classical factors remain key for explaining FDI inflows, but a specific institutional framework is a precondition for foreign investors to consider investing in a country. The institutional quality has to be sufficiently conducive and inclusive to foreign investors. A poor institutional quality can lead to unnecessarily high costs for doing business.\textsuperscript{147} The next chapter will complete the analysis by adding the last important variable for location decisions in CEE, namely the role the EU accession process has played in improving CEE’s attractiveness.

\textsuperscript{146} Fabry and Zeghni, “Inward FDI in,” 81.
\textsuperscript{147} Bissoon, “Can Better Institutions,” 59.
Chapter 4 The Role of the EU for Attracting FDI in Central and Eastern Europe

As shown by the last two chapters traditional FDI determinants as well as the institutional determinants of a country are key factors for attracting FDI. The first two hypotheses have thus been confirmed by the above analysis. It is now time to test the third hypothesis, which states that the EU accession process had a large and positive influence on FDI inflows in CEE.

For many post-socialist states integration into the EU provided the impetus to break away from the old political and economic structures. EU membership helped as a seal of approval for the transition process. In political terms, EU membership meant the symbolic acceptance into the Western world. In economic terms the new member states gained access to the large European market, as well as to financial assistance. The integration into the EU has changed the comparative advantages of the CEECs. The EU accession process is likely to have influenced the level of FDI in the region, due to a reduced perceived level of risk. Additionally EU membership offered some important benefits, such as the guarantee of free trade with the EU member states and the CEECs adoption of a business and legal environment similar to that of the old member states.

The EU transfer of rules, through conditionality, has been “the most massive international rule transfer in recent history.” The Europeanization strategy covers economic, political and legal institutions. Rules were transferred by using conditionality in the form of the Copenhagen Criteria which cover; 1) The economic criteria, this required the CEECs to have a functioning market economy and be able to face the competitive pressures from within the EU. 2) The political criteria, which required the countries to be stable democracies, governed by the rule of law. 3) The administrative criteria, this required that the acceding countries have the proper institutions in place to be able to adopt the legislative framework of the EU. The alignment with EU legislation covers a wide domain of legislative activities such as competition law, banking law, and environment and consumer protection. Through the Copenhagen Criteria the EU has been capable of exerting a substantial influence on institutional reform in CEE. The next section will investigate the relationship between the EU

Bandelj, “How EU Integration,” 481, 482.
149 Disdier and Mayer, “How different is,” 281.
150 Clausing and Dorobantu, “Re-entering Europe,” 81-85.
Schweickert et al., “Prospective NATO or EU, Membership,” 667-673.
accession process, institutional change, economic considerations, and the level of FDI into the new member states.

4.1. The Role of the EU on institution building in CEE
Several studies have investigated the relationship between the EU accession process, institutional reforms, and FDI inflows into CEE. Some of these studies will be highlighted in this section. The studies by Bevan and Estrin, Clausing and Dorobantu, and Bandelj all used the 1993 announcement for the prospect of admission and the Agenda 2000 enlargement announcement to evaluate the role of the EU accession process on FDI inflows, but the conclusions of their studies differ in some important aspects.

In the Agenda 2000 the Commission evaluated, for the first time, the progress made by the CEECs in meeting the accession criteria. The CEECs were divided into three groups during that meeting. The first wave countries, that were told that they satisfy the Copenhagen Criteria enough for EU admission and could begin negotiations (the Czech Republic, Hungary, Poland, Slovenia, and Estonia). The second-wave countries, which were evaluated by the EU as exhibiting good progress and were likely to be invited to begin negotiations (Slovakia, Latvia, and Lithuania) and countries that were not deemed to have made sufficient progress (Bulgaria and Romania).

The study by Bevan and Estrin examined which factors determined FDI inflows into the CEE accession countries over the period 1994 to 1998. The analysis by Bevan and Estrin concludes that the 1993 announcement had a statistically insignificant effect on FDI inflows into CEE. Their analysis furthermore finds that the Agenda 2000 announcement only had a significant effect on the second-wave countries and not on the first-wave countries. In sum, the study by Bevan and Estrin provides some indication of the direct effects of EU enlargement on FDI. Because the CEECs had to meet the requirements for admission which involved an external validation of the quality of their institutional development. However, Bevan and Estrin found that the effect of the EU enlargement variable on FDI inflows is very small and not as robust as one might expect.\textsuperscript{151}

The studies by Clausing and Dorobantu and the one conducted by Bandelj reach a different conclusion, although using the same set of variables. Their studies show that the EU enlargement effect on FDI inflows is much larger. According to them, the study by Bevan and Estrin exhibits some serious flaws. The study by Clausing and Dorobantu argues that the fact that Bevan and Estrin found hardly any notable impact from the prospect of EU membership

\textsuperscript{151} Bevan and Estrin, "The Determinants of Foreign Direct Investment."
on FDI inflows is due to the limitations of their study. The largest limitation being the time dimension of their work. Bevan and Estrin’s study only covers the period 1994-1998. They thereby fail to see the long-term effects of EU accession on FDI inflows.\textsuperscript{152} The study by Clausing and Dorobantu finds that the EU accession process had a more significant effect on FDI inflows than Bevan and Estrin. Their analysis shows that the FDI stock of the majority of the candidate countries experienced a significant increase in time periods that coincided with key EU announcements regarding accession. Their study finds that the Copenhagen announcement of 1993 did have a positive effect on FDI inflows. The commitment to enlargement probably lowered the perceived risk associated with investing in CEE. The study by Clausing and Dorobantu agrees with Bevan and Estin’s study in that the Agenda 2000 announcement proves to have been significant for FDI inflows only for the second wave countries, likely due to the fact that the transition process in the second wave countries has been much slower. Consequently, there was considerable doubt prior to the release of the Agenda 2000 as to whether these countries would be offered EU membership at all. The Agenda 2000 reduced this doubt and therefore had a positive effect on FDI inflows into the second wave countries.\textsuperscript{153}

The study conducted by Bandelj, suggests that the lack of strong effects found in Bevan and Estrin’s study is largely due to a lack of attention to the indirect effects of the EU accession process. The majority of the existing literature focuses on how EU membership influences the behavior of potential investors, but largely ignores the impact of the EU on state action. Many studies on FDI location decisions rely on the assumption that location decisions are driven solely by investor considerations of risk and return, including how EU memberships affects this perceived level of risk. The role of the host country is by large neglected. The idea that hosts can have an independent effect, because they engage in state-sponsored efforts to attract FDI, is not part of this economic explanation. However, since FDI is a relational process by definition, both sides have to play an active role for the transaction to be realized. It is therefore crucial to not only consider the supply-side determinants, but also the active role played by host states. These indirect effects on FDI occur due to interaction with liberal market-minded EU elites, who compel post-communist decision-makers to promote FDI as a desirable economic development strategy. “The EU’s expectations of liberalization and marketization generated discursive resources that shaped the

\textsuperscript{152} Clausing and Dorobantu, “Re-entering Europe,” 85, 86.
\textsuperscript{153} Bandelj, “How EU Integration,” 482-487, 494.
Clausing and Dorobantu, “Re-entering Europe,” 78, 85-98.
alternatives that decision-makers saw as more or less plausible.” The FDI promotion policies of the CEECs were also directly influenced by conditionality, leading to the pressure to liberalize, that comes from the EU’s insistence that a liberal market economy is a precondition for membership. In several of the candidate countries the privatization of strategic sectors, such as banking, telecommunications, or utilities happened only after the EU exerted great pressure on the national governments to initiate these reforms. Privatization led to a sharp increase in the level of FDI into CEE as shown in chapter three.

According to Bandelj, the EU integration effect on FDI inflows worked in conjunction with specific country legacies. Those CEECs that chose privatization strategies that were open to outsiders, that experienced some economic reforms already during socialism, and those with a history of state-sovereignty were all more likely to engage in FDI state promotion. Most scholars that study post-communist transformation recognize some form of path-dependency, meaning that pre-existing institutional arrangements, and cultural and structural legacies play a role in determining the reform process of a country. EU conditionality and domestic conditions both influence state-decision making on FDI strategies.

The last study considered is the one conducted by Schweickert et al., this study measured the institutional quality of 25 transition economies in the period from 1996 to 2008. They grouped their variables into external and internal determinants for institutional development. Their analysis shows that international organizations, in particular the EU, exerted a large and positive influence on institutional development in CEE. Both internal and external factors can influence the institutional development of transition countries, subsequently making a country more attractive to foreign investors. Schweickert et al. show that the pre-accession incentives provided by the EU clearly mattered for institutional development in CEE. The economic benefits resulting out of membership increased the payoff of institutional reforms. The reunification of Europe has provided a strong pull effect in favor of a good institutional framework in CEE. Schweickert et al. show that post-communist democratization and institutional consolidation has been much faster in those countries that were more likely to become EU members. The faster institutional reforms improved the attractiveness of these countries to foreign investors in comparison to the other CEECs.

The EU has been capable of exerting an unprecedented influence on the restructuring

---

156 Schweickert et al., “Prospective NATO or EU, Membership,” 667-687.
of domestic institutions in CEE, due to their desire to become EU member states. According to Schimmelfennig, EU rule transfer can best be explained by the external incentives model of governance, of which its effectiveness varies with the credibility of EU conditionality and the domestic costs of rule adoption. The external incentives model of governance argues that a state will only adopt EU rules if the benefits of EU rewards exceed the domestic adoption costs.

EU rule transfer can predominantly be described as a policy of conditionality. EU conditionality is a strategy that relies on reinforcement by reward. Conditionality started with the first programs for regulatory alignment with the internal market and became more encompassing with the beginning of the accession negotiations in 1998 and 2000. Once an issue area became the subject of EU conditionality, rule adoption increased drastically. Due to conditionality being most effective in creating institutional reform, the external governance stands out as the main mechanism for EU rule transfer. With the benefits of EU membership in mind the fulfilment of the EU acquis became one of the highest priorities in the candidate countries.  

EU membership offered great opportunities for those CEECs that became member states. For instance, a larger market due to free access to the large European market, it also provided the legal guarantee of the right of establishment in CEE for EU firms, and reduced the perceived level of risk of CEE. Through the need to adopt the acquis and the Copenhagen criteria, the EU accession process furthermore greatly improved the institutional quality of the CEECs. All of these factors made the CEECs more attractive to foreign investors.

4.2. Rules of Origin and EU limitations on state aid and the effects on FDI inflow

EU local content regulations have increased the value-added from production sites in CEE and led to higher levels of FDI into the region. The EU rules of origin have forced firms to develop supplier networks in CEE, because the products exported from CEE to the EU market are obliged to contain a certain percentage of local value-added. These supplier networks generated significant economic benefits, by increasing the value of production in host economies and by spillovers, which increased the competitiveness of domestic firms.

One important additional influence of the EU membership on FDI levels in CEE is the general prohibition EU law has put on providing any form of state aid to investors. A

---


The fundamental principle of EU law is the promotion of competition. The giving of incentives by states to particular enterprises is regarded as anti-competitive by the Commission and thus prohibited. The general prohibition of state aid can have a potential negative effect on attracting FDI.

However, there are some important exemptions to this general prohibition. State aid can be allowed when offered to improve the standard of living in the poorer regions of the member states. Due to the frequently lower standards of living in the CEECs, their governments are often allowed to provide a certain amount of investment incentives. This can be very important for attracting FDI. The CEECs have competed vigorously for major FDI investments, by offering generous investment packages.

Governments offer foreign investors subsidies, tax breaks, preferentially priced land, and other types of financial and non-financial advantages. As shown in chapter three these incentives can play an important role for location decisions by foreign investors. The structure or shape of the investment incentives are not defined nor restricted by the Commission, giving member states some flexibility and ample opportunities for competition. The reality shows that the investment incentives offered by the different CEECs differ significantly. Some countries offer less than the maximum allows for, whereas others are tempted to offer more than they are legally entitled to. Investment incentives have sometimes tipped the balance in favor of a country that probably otherwise would have lost the foreign investment. An example of this can be found in the appendix.

**Conclusion**
The institutions of the CEECs are progressing towards the old EU member states standards. This is partly due to the enlargement process, which involved the need to adopt the acquis. The literature on Europeanization concludes, with some exceptions, that EU pressures led to more convergence among CEECs towards a common set of EU laws, norms and institutions.

On the one hand, the improvements in the institutional structure of the CEECs reduced the perceived level of risk of these countries, thereby greatly facilitating FDI inflow. On the other hand, accession to the EU also meant that the CEECs became restricted by European law and therefore could no longer offer the very generous investment packages. However, due to the on average lower standard of living in CEE, they can still offer, albeit smaller, investment packages. On general it can be concluded that the EU accession process had a significant and positive effect on FDI inflows into CEE. The evidence shown in this chapter

---

160 Allen and Overy, “CEE you there!” 14-23.
confirms the hypothesis as formulated in chapter one about the positive influence the EU accession process has had on FDI inflows into CEE.
Chapter 5: The Automotive Industry in Slovakia

An illustration of the importance of classical determinants, institutions and the EU for FDI inflow

The previous chapters have provided the necessary empirical evidence to confirm the importance of classical, institutional and EU variables for FDI inflows into CEE. This chapter will serve as an illustrative case to provide additional evidence to the hypotheses as formulated in chapter one. The theoretical concepts as formulated and analyzed in this research will be applied to the Slovakian automotive industry. The aim of this chapter is to see whether the theoretical concepts can explain some of the success of the automotive industry in Slovakia. The choice to focus on the Slovakian automotive industry is because Slovakia evolved in ten years from being a marginal automotive producer to being the largest automotive producer per capita in the world. In 1993 Slovakia only exported 43 million dollars’ worth of automobiles, this number increased to an impressive 1.37 billion dollars by 2000.\textsuperscript{161} The rapid evolution of the automotive industry coincided with drastic reforms in the institutional quality of Slovakia, suggesting a strong correlation between institutional variables and FDI inflows.

Slovakia was regarded as a regional laggard in the implementation of reforms and economic performance until 1998.\textsuperscript{162} Throughout the early and mid-90s Slovakia was not seen as an attractive destination for foreign investments, due to perceived uncertainty related to the establishment of the newly independent country, lacking institutional reforms, and a high level of corruption of the privatization process.\textsuperscript{163} In between 1993 and 1998 Slovakia experienced a vicious circle, while those CEECs that opted in favour of radical reforms experienced a virtuous cycle of economic development. Hence, although Slovakia enjoyed roughly the same classical FDI factors as the other CEECs, their institutional structure was not sufficiently conducive to foreign investors. This is the reason why their FDI levels lacked behind in comparison to other CEECs.\textsuperscript{164} Slovakia’s institutional structure improved after the government changes in 1998, the path towards a return to Europe was initiated and the business climate greatly facilitated through the introduction of economic and political reforms.

The lack of institutional reforms and openness to foreign investors resulted in initial

\textsuperscript{161} Javorcik and Kaminski, "The “EU Factor,” 464.
\textsuperscript{164} Javorcik and Kaminski, "The “EU Factor.”}
disappointing FDI inflows. In 1998 Slovakia only received 2.9 percent of all the FDI that entered CEE, whereas Poland received 33 percent, Hungary 26.8 percent and the Czech Republic 18.5 percent. The government change of 1998 and the subsequent economic and political reforms led to a striking increase in FDI inflow. The new government was successful at implementing several key reforms, such as banking sector restructuring, improvements in the general business environment, better state regulation of the financial sector, restructuring of the privatization process, and reforms in tax and labor law. The governments reforms paid off, Slovakia’s transition to a market economy accelerated, underpinned by stable macroeconomic policies and an improved business environment.165

By 2003 Slovakia’s share of FDI that entered the CEECs had risen to 7 percent. The institutional reforms played a large role in the improved attractiveness of Slovakia, it has made the classical FDI determinants able to flourish. The institutional framework provided the proper foundation. Today foreign investors have become an inseparable part of the national economic policy of Slovakia. Slovakia has emerged as one of the leading reformers and fastest growing countries of CEE.166

Figure 2: Volume of Foreign Direct Investment in Slovakia in billion U.S. dollars167
(source: The World Bank)

In 2006 a new populist government came to power, which led to fears of setbacks for the FDI promotion strategies and the reform agenda. Despite the initial promises to roll back some of the reforms, that were having a negative social impact according to public perception, most of the reforms were kept in place. The line of promoting FDI was also continued. The

166 Allen and Overy, “Foreign Direct,” 3.
political developments and reforms, initiated by the different governments in power after 1998, had a profound impact on FDI. FDI increased at steady rates after 2000, with a short downturn of inflows after 2009, due to the worldwide economic crisis. Although FDI inflows have picked up again after the 2008 crisis, total investments remained around 13 percent lower in real terms in 2013, when compared to its pre-crisis level. The world-wide economic crisis also had a profound impact on the Slovakian automotive industry, through reductions in demand for cars, which led to reductions in production and FDI inflow.

By 2014 economic growth picked up again in Slovakia by 2,4 percent, driven by a recovery in domestic demand. Export growth, in contrast, weakened, because foreign demand declined. The domestic demand is expected to remain the main driver of economic growth in the upcoming years, even though it is expected that export demand will also increase again by 2016. Slovakia’s economy, including the automotive industry, remains to a large extent dependent on external trade. For instance, 90 percent of the produced cars are being exported. Therefore, it is of vital importance for the Slovakian economy that the export demand will increase again.

Most of the automotive industry in Slovakia is now controlled by foreign capital. In 2004, 97,3 percent of the automotive industry was controlled by foreign capital and 93,5 percent of the technologies were imported. This pattern shows that there is a small amount of local R&D, which can become a major challenge in the future.

The FDI-driven transformation of the automotive industry has been geographically very uneven, the major difference has emerged between CE and the rest of CEE. Foreign automotive MNCs have so far on general preferred to invest in CE. The most important reasons for the observed differences, that are mentioned in the literature, include: CE’s geographic proximity to WE, the better institutional framework, the highly skilled yet cheap labor force, its faster pace of economic transformation combined with relative political stability, its car-making and manufacturing traditions, and its better infrastructure. A distinctive automotive agglomeration has emerged in CE, covering most of the Czech Republic, western Slovakia, north-western Hungary, and south-western Poland.
The remaining part of this chapter analyzes the classical FDI factors and institutional variables that contributed to Slovakia’s increased attractiveness to foreign investors in the automotive industry. At the end of the chapter it will be discussed whether Slovakia has been able to create inclusive and sustainable economic growth.

5.1. The Size and Composition of the Automotive Industry in Slovakia

This paragraph evaluates the development and composition of the automotive industry in Slovakia, and the impact of the automotive industry on the Slovak economy. After the end of communism there has been a rapid increase in automotive investments in CE. The trade in motor vehicles and parts is now an important share of the overall trade between the Visegrád countries and the WE market.\(^{175}\) No other CE country is so dependent on automotive exports for its economic welfare as Slovakia.\(^{176}\) The automotive industry in Slovakia has developed rapidly since the beginning of the 90s, driven by FDI inflows of 2.4 billion euros. The Slovakian automotive production increased from 3000 units in 1993 to a staggering 980,000 units in 2013.\(^{177}\)

\[\text{Figure 3. Passenger car production in Slovakia, 1990-2013.}^{178}\]

(Source: Based on data from OICA, 2014 and ZAP, 2000)

The local content of the automobiles is highly dependent on the nature and complexity of the assembly operations.\(^{179}\) Four types of passengers car production in CE can be identified;

\(^{175}\) Radosevic and Rozeik, “Foreign Direct Investment,” 23.
\(^{176}\) Pavlinek and Guzik, “Industrial Upgrading,” 44, 45, 55.
\(^{179}\) Radosevic and Rozeik, “Foreign Direct Investment,” 19, 31.
1. Medium to high local content with well-developed links to the domestic economy and an important role for local R&D. Škoda is the only producer in CE that fits within this category.

2. Medium to high local content with well-developed links to the domestic economy, but with an insignificant role for local R&D. Large-volume car produces with a longer history in CE typically fall within this second category.

3. Medium to high local content with weak links to the domestic economy and insignificant local R&D. The third category is represented by recently established greenfield assembly plants, such as Kia Slovakia.

4. Low local content with weak links to domestic economy and insignificant local R&D.

Figure 4: Structure of Central European exports of automotive components in 1996 and 2006 (Source: Based on OECD (1996) and Eurostat (2006) data)\(^{180}\)

There has been a significant change in the structure of CE automotive exports between 1996 and 2006. Whereas in 1996 only 14.1 percent of exports were classified as high-value added, by 2006 their share increased to 32.3 percent. Nevertheless, the importance of relatively labor-intensive low-value-added products remains high, especially in Slovakia. In Slovakia the overall share of low value-added automotive components in fact increased, which is less beneficial to the host country’s economy. The higher a country’s value-added to products they produce, the more economic welfare they gain.\(^{181}\)

\(^{180}\) Pavlínek and Guzik, “Industrial Upgrading,” 49.

\(^{181}\) Pavlínek and Guzik, “Industrial Upgrading,” 49, 54, 55.
The presence of foreign-owned suppliers is having spill-over effects on the economy, it helps spur domestic competition. Employment and spill-over effects from foreign automotive investors may even be larger than shown by many data, due to the fact that the automobiles produced in CE have become more complex over the past years. Resulting in a greater share of supplies that are coming from other sectors such as the rubber, plastic, and electrical sectors. However, some problems between MNCs and local suppliers can be identified, which can have a detrimental effect on developing better linkages between them. Evidence suggests that there are some problems in terms of the quality and the ability to develop more complex assemblies. Therefore most high-tech and high-value-added components still originate from western firms. This problem can eventually have a negative effect on economic growth in CE, because of missing linkages with domestic producers and less value-added.

5.2. FDI determinants for Automotive Investments in Slovakia
This section investigates the variables that have played a role in attracting automotive foreign investments into Slovakia. The current comparative advantages of Slovakia can be divided into three sets of factors; 1) cost-efficiency of production, 2) the increasing embeddedness of the automotive industry, and 3) the business environment, which was greatly facilitated through institutional reforms. The Slovak Investment and Trade Development Agency gives the following reasons for investing in Slovakia:

- The excellent geographical location in the middle of Europe and free access to the European market, as well as the improved infrastructure;
- Agglomeration effects;
- Low real labor costs combined with a skilled labor force;
- Investment incentives;
- A conducive, business friendly, institutional structure;
- EU membership.

5.2.1. Proximity and Free Access to the EU market and Infrastructure quality
The proximity to the WE core market is an enormous comparative advantage for Slovakia, especially for the supply of low-value added products. Additionally, because of the existence of the common market, Slovakia’s trade with WE has been free of trade barriers for both

---

183 Pavlinek and Guzik, “Industrial Upgrading,” 58.
automobiles and components since 1997.\textsuperscript{185} The automotive industry in Slovakia is predominantly export-oriented, primarily to the WE market (71.9\% in 2006). The geographic proximity and free access to the European market greatly enhanced the country’s attractiveness to foreign investors.\textsuperscript{186}

The quality of the infrastructure is also of major importance to foreign investors, as better infrastructure reduces transportation and communication costs. The infrastructure in Slovakia has improved in recent years.\textsuperscript{187} However, at the moment, the infrastructure in Slovakia is still not sufficiently developed, negatively affecting Slovakia’s competitiveness. The export-oriented specialization of Slovakia is placing increasing demands on its transport infrastructure.\textsuperscript{188} The digital infrastructure is also important to MNCs. Slovakia scores poorly in several areas of the digital infrastructure. Slovakia, for instance, has the lowest fixed broadband coverage of the whole EU, but the coverage is expected to improve in the upcoming years.\textsuperscript{189} Even though the infrastructure has improved in recent years. In order to be able to meet the current and future needs of MNCs. Improvements in the infrastructure are vital for the competitive position of Slovakia.

5.2.2. Agglomeration effects

A distinctive automotive agglomeration has emerged in the Visegrád countries. The majority of the automotive producers are located within a radius of 200 kilometers. This concentration of automotive FDI is driven by the better infrastructure in these regions, better access to skilled labor, and the close proximity to the WE market.\textsuperscript{190} The quality of local suppliers is also important, because they can supply the much needed inputs for the production process. The major obstacles to linkages with local suppliers in CE is the often low quality of the locally produced inputs, the lower flexibility, and insufficient technological sophistication. Due to this MNCs keep on bringing their own supply companies to the region.\textsuperscript{191}

Chapter two and the evidence from the development of the automotive industry in CE shows that agglomeration effects are an important comparative advantage for host countries.

\textsuperscript{185} Pavlínek and Guzik, “Industrial Upgrading,” 60.
Javorcik and Kaminski, ”The "EU Factor."
\textsuperscript{186} Hošková, "Impact of Foreign Direct," 42.
\textsuperscript{187} Radošević and Rozeik, "Foreign Direct Investment,” 7.
\textsuperscript{189} Jakubiak et al., "The Automotive Industry," 31, 36, 37.
Disdier and Mayer, “How different is,” 282.
Radošević and Rozeik, "Foreign Direct Investment,” 35.
\textsuperscript{190} Javorcik and Kaminski, "The "EU Factor,” 468.
Foreign investors often decide to locate in central areas that already have experience in certain industrial sectors. Therefore, the history of automotive production and previous investments by other MNCs in CE contributed strongly to the surge of large automotive foreign investments into CE since the early 90s. The geographical proximity to other large automotive manufactures makes it easier to share suppliers and parts. Economies of scale and scope have emerged in the automotive industry in CE making production more cost-efficient. The Visegrád countries possess an attractive structure to foreign automotive investors as the agglomeration effects lead to cost-efficient production and thus to higher profits.\(^{192}\)

### 5.2.3. Labor Costs and Human Capital

Skilled, abundant, and cheap labor is an important comparative advantage for Slovakia for attracting automotive FDI. The legacy of communist industrialization and the relatively well-educated workforce have been important factors in the success of the automotive industry in Slovakia. In addition, unit labor costs in Slovakia have been rising at the slowest rate in the region. Even though the wages in CE have increased in recent years. The wage disparities between CE and WE remain substantial.\(^{193}\) Due to the still relatively low wages, Slovakia continues to produce low-value-added labor-intensive automobiles and parts. Nevertheless, Slovakia has increasingly been able to attract more capital-intensive and skill-intensive manufacturing of high-value-added components and automobiles. This suggests a gradual process of industrial upgrading.\(^{194}\)

---


\(^{194}\) Pavlinek and Guzik, "Industrial Upgrading," 49.
Figure 5: Hourly compensation costs in manufacturing in Slovakia and Germany, 1996-2012.\(^{195}\)

However, a problem for the further development of the automotive industry are the recently reported shortages of sufficiently skilled labor. Despite the remaining relatively high unemployment rate in Slovakia, there is a current skill mismatch. If the educational system is not reformed, to better meet the needs of foreign investors, these skilled labor shortages could potentially lead to less FDI in the future.\(^{196}\) The Slovakian government has to ensure that the educational system is kept *inclusive*. The government has to ensure equal access for everyone to the educational system, including marginalised communities. Current inequalities in education are holding back *inclusive* economic growth. The government furthermore has to improve the quality and relevance of the science base, and implement plans to foster knowledge transfer between research and business.\(^{197}\)

It can be concluded that the abundance of skilled and cheap labor has been a crucial factor for the attraction of automotive FDI in Slovakia. However, if Slovakia wants to keep this competitive edge it must reform its educational system. Only when the government ensures that the institutional quality encourages participation by everyone in the educational system can Slovakia keep its competitive edge.


5.2.4. FDI State Promotion

This section considers the role FDI state promotion has played in the rapid development of the automotive industry in Slovakia. By accommodating the strategic needs of foreign capital the state played an important role in attracting automotive FDI. The goal of investment policies has been to improve the country’s competitive position in the transnational flows of FDI. After EU accession, the EU rules concerning investment incentives also apply to Slovakia, limiting their ability to offer investment incentives. There is now an upper ceiling to the total amount of investments incentives that can be offered legally.

Despite the upper ceiling to the amount of investments that can be offered, the Slovakian government played an important role in attracting FDI. By creating highly favorable conditions for foreign capital and by offering generous investment incentives. Although Slovakia has a Slovak Act on Investment Incentives since 2005. It still allows for special treatment of investors that are considered to be of strategic importance. Several industrial parks have also been set up in Slovakia. The state furthermore subsidizes up to 85% of the costs for improving the infrastructure.

The bargaining power of Slovakia vis-à-vis MNCs is undermined due to their small domestic market and the fierce competition from neighboring countries that share similar factor endowments. This weakness has been exploited by automotive MNCs. They played countries off against one another to secure the best deal for them. The generous investment incentives offered by the Slovakian government sometimes directly tipped the balance in favor of their country, because these incentives lower the MNCs costs of production. An example of this can be found in the appendix.

5.2.5. Institutional Determinants and EU Pressure to Reform

Evidence from the Slovakian automotive industry gives further weight to the hypotheses that both institutional determinants and the EU accession process had a significant impact on FDI inflows into CEE. The reform process in Slovakia stalled after the break-up of Czechoslovakia in 1993. This lack of reforms resulted in disappointing levels of FDI inflow in the first years after the fall of communism. The lack of reforms also had important implications for the return to Europe. The white paper on enlargement that was approved at the Cannes summit in 1995 identified certain key legislative, regulatory, and institutional aspects of the acquis that countries were required to meet for accession. A strong punishment

Allen and Overy, “CEE you there!” 47–49.
mechanism for exit was also put in place, of which Slovakia was the first victim. Slovakia was accused by the Commission that it was not fulfilling “in a satisfactory manner the political conditions set out by the European Council in Copenhagen, because of the instability of Slovakia’s institutions, their lack of rootedness in political life and the shortcomings in the functioning of its democracy.”

Concerns over the democratic consolidation in Slovakia swayed the decision of the EU, at the 1997 Luxembourg Summit, not to include Slovakia in the first accession wave. Sending a strong message that better compliance with political and economic reforms was necessary, if Slovakia wanted to join the EU. The public fear that the government policies jeopardized prospects for EU accession probably tipped the political balance in favor of the pro-reform candidate Mikulas Dzurinda in the 1998 elections. Dzurinda had liberalization to FDI as one of his reform goals. After 1998 Slovakia became one of the regional leaders in FDI inflows, due to the implementation of drastic reforms.

Foreign investors started to perceive Slovakia as an attractive and secure location for their investments. The change of government in 1998 also led to a new positive relationship between Slovakia and the EU. The EU accession process led to accelerated convergence of Slovakia’s institutions and policies with the acquis. Thereby further improving the country’s attractiveness to foreign investors.

The reforms in the political and economic institutions were frequently politically painful, as the reforms often infringed upon entrenched vested interests. Slovakia went through significant changes in economic policies, embarking on ambitious fiscal and structural reforms aimed at creating a favorable business environment. Slovakia made a remarkable turnaround, drastically improving its institutional quality and political stability. This made Slovakia an acceptable candidate for the first wave of accession in 2004. The reforms in Slovakia have positively changed the perception of investors and boosted FDI inflows. However, some important business facilitating reforms still have to be initiated.

The public administration, for instance, continues to be rather sluggish, despite major improvements in the past decades. Slovakia remains among the EU member states in which exports take the longest (16 days), mainly due to administrative hurdles and poor infrastructure. Slovakia did make major improvements in reducing the time it takes to start a business, thereby improving the business environment. However, it continues to rank

200 Bandelj, “How EU Integration,” 469
relatively low on several indicators of the business environment, such as the ease of starting a business. As shown in chapter three the quality of the bureaucracy is important for location decisions. Investment costs also include non-economic costs, such as time lost in dealing with the bureaucracy. Improvements in the efficiency of the bureaucracy reduces the time and complexity of doing business, thereby making a country more attractive. Slovakia has a relatively low efficiency of public administration, this leads to less efficient allocation of resources in the economy. Corruption can also have considerable economic costs in terms of a misallocation of resources. The tackling of corruption is largely inefficient in Slovakia. There is no independent body charged with fighting corruption. This lack of effectively combating corruption can potentially have negative effects on FDI. Although, as shown in chapter three, the literature does not uniformly agree on whether or not corruption has a detrimental effect on FDI inflow.

The effectiveness of the legal and judicial system proves to be crucial for FDI inflow as shown by chapter three. Especially property rights are vital for attracting FDI, as it protects the investments of foreign investors. Slovakia has implemented effective property rights after the fall of communism. However, other important legal and judicial reforms still have to be implemented. Especially major improvements in the judiciary are necessary. The judicial proceedings in Slovakia continue to take a long time (on average 70 days), which can have a detrimental effect on FDI as it increases the time and costs of doing business.

Despite the lack of reforms in certain areas some important institutional reforms have been initiated in recent years. The reforms have greatly facilitated doing business in Slovakia and has made them able to attract large amounts of FDI. For instance, in 2003 Slovakia initiated drastic reforms in tax law, introducing a flat personal and corporate income tax of 19 percent. The new tax regime has greatly improved the transparency and simplicity of the system, thereby facilitating doing business in Slovakia.

Privatization is also crucial for FDI inflows, Hungary in 1995 alone, as a result of privatization of strategic sectors, received twice as much FDI as Slovakia during the whole 1993-1999 period. In addition, privatization related FDI inflows induce other forms of FDI,

Campos and Kinoshita, "Foreign Direct Investment," 17, 18.
including green- and brownfield investments. Under Meciar’s rule (1994-1998) Slovakia did little to promote FDI and even adopted a law that excluded certain strategic monopolies from foreign privatization. Slovakia not only failed to promote FDI, but even implemented laws that were actively preventing FDI, thereby inhibiting inclusive economic growth.206 The Slovakian government began to realize that in order to generate sustainable economic growth it was necessary to open up to foreign investors, by creating a more conducive and open business environment. The government adapted its approach to privatization in the following years. First by discarding voucher privatization. Voucher privatization excludes foreign investors by definition. However, in order to attract foreign firms the state has to ensure transparency throughout the whole process. Unfortunately Slovakia’s privatization process remained far from transparent, as a result FDI inflows continued to be limited until 2000. After 2000 Slovakia experienced a notable increase in FDI. The increase in FDI inflows after 2000 can to some extent be attributed to further changes in the government’s approach to privatization. However, most of the increase in FDI can be attributed to improvements in the overall institution, business and legal climate and the ensuing change in Slovakia’s international perception.207

The Slovakian government also implemented some important legislative acts specifically targeted at facilitating the automotive industry. In June 1997, the government established a government position for the development of the Slovakian automotive industry. Its task is to coordinate the activities of various state institutions. A year later, the government adopted a “Program for the Development of the Automotive Industry in Slovakia”, which stipulated the precise goals and measures to be implemented.208 The program listed some basic goals. First, to increase automotive output and the restructuring of related industries. Second, to increase Slovakian integration in the global economy through the automotive industry. The Slovakian government relied, to a great extent, on foreign capital for financing the automotive industry. Third, the program stressed the importance of investment incentives, it also declared support for labor force training and improvements in the infrastructure and automotive R&D in Slovakia.209 The above mentioned general government policies, as well as the specific government policies directed at the automotive industry has made doing business in Slovakia easier and thereby more attractive to foreign automotive companies.

The rapid catch-up of Slovakia can furthermore be explained by solid macro-economic

206 Bandelj, "How EU Integration," 469.
policies, which enabled them to become part of the Eurozone in 2009, and by the liberal investment climate. The euro can be of great benefit to Slovakia because it eliminates much of the exchange rate risk.\textsuperscript{210} The euro adoption was, for instance, one of the main reasons for Volkswagen to choose Slovakia as the production site for its new “Up!” model. The debt ratio of Slovakia is also below the EU average, making its financial system quite robust when compared to other CEE member states.\textsuperscript{211} The liberal investment climate enables foreign investors to easily and safely invest in Slovakia.

The drastic reforms that have been implemented since the government changes of 1998 thus greatly improved Slovakia’s attractiveness to foreign investors. However, some important political and economic reforms still have to be implemented. The bureaucracy continues to be rather sluggish and the legal and judicial system must also be partially reformed. However, the Slovakian institutional structure has proven to be conducive enough to foreign investors, as shown by the great amounts of FDI inflow.

5.3. Inclusive or Exclusive Economic Growth in Slovakia?
According to Acemoglu and Robinson for a country to be able to experience sustainable growth there has to be a turn from exclusive to inclusive growth. Slovakia, and the other Visegrád countries, have, to a large extent, been able to move from exclusive to inclusive economic growth. During the first years of (automotive) FDI into CE the investors ‘exploited’ the cheap labor force, a sign of exclusive economic growth. However, at present the skills of the labor force in CE are becoming increasingly more important. Contributing to the inclusiveness of the economy and the development and industrial upgrading of the automotive industry.

The government must play a facilitating role for inclusive growth to be able to take hold. The government has to ensure that the right legislative framework is in place. The institutional quality has to be sufficiently conducive to foreign investors. An inclusive institutional framework fosters participation by foreign investors. The government can decisively contribute to the development of inclusive growth. What you see happening in CE is a slow process of industrial upgrading. Expertise is emerging in the automotive industry in CE, this expertise must be facilitated by a conducive institutional structure. The state must provide the investors with the rules by which the game is played, especially property rights are crucial for the development of a competitive inclusive industry. Furthermore, the state

\textsuperscript{210} Hoen, “De Slovaakse.”


must make sure that the economy is open to everyone, that there is equal access to education, and that foreign investors can bring profits back to their home countries.

The automotive industry in Slovakia has been able to slowly move to an *inclusive* industry. The Slovakian economy is open to everyone, including foreign investors, and is making great use of the educational skills of the Slovaks. The amount of skilled workers shows that the Slovakian educational system is open to many, which is crucial for the development of *inclusive* economic growth. The prove that *inclusive* economic growth has been reached in the Slovakian automotive industry is delivered by the effects of the worldwide economic crisis of 2008. The automotive industry, despite the economic downturn and drop in production, has been able to survive. The automotive industry has thus been able to stabilize its growth pattern and to produce *inclusive* economic growth. The move from *extractive* political and economic institutions towards *inclusive* institutions was greatly facilitated by the demands for institutional change by the EU, as shown by chapter four. The fact that Slovakia has been capable of developing inclusive institutions enabled its economy to flourish.²¹²

**Conclusion**

Foreign investors choose a location for their investments based on the expected profitability of that location, which is closely related to the country’s comparative advantages.²¹³ The Classical Factor endowments played a large role for FDI attracting FDI, MNCs can achieve significant efficiency and cost reduction gains in Slovakia. Furthermore, most investors prefer to invest in those places that already attracted other investments, which led to a major automotive agglomeration in CE.

The institutional quality is also crucial for a country’s attractiveness to foreign investors. Slovakia was a relative laggard in reform implementation and FDI inflows in the early- and mid-90s, but right now it is one of the region’s top performers, especially in the automotive industry. The drastic reforms, together with continued and credible commitment to these reforms, and subsequent improvements in the institutional quality were preconditions for attracting the automotive investors in the first place and the key factors that have enabled these investments to flourish. Especially certain legal reforms were crucial for improving Slovakia’s attractiveness to foreign investors. It is vital that investors feel secure about their investments, the calculated risk premium is decisive for location decisions. However, some

---

²¹² Acemoglu, and Robinson, *Why Nations Fail*.
important institutional reforms still need to be implemented, in order to ensure Slovakia’s continued attractiveness to foreign investors. The EU accession process greatly facilitated the improved institutional quality of Slovakia, thereby also increasing its attractiveness to foreign investors. Slovakia’s inclusion into the large regional economic bloc, the EU internal market, has too enabled them to attract more FDI.\textsuperscript{214}

From the case study it can be concluded that it are both classical FDI factors and a sufficiently enabling institutional framework that determines the amount of FDI flowing into a country. The illustrative chapter provides further evidence to the validity of the three hypotheses as formulated in chapter one.

Chapter 6: Conclusion

Most FDI literature remains focused on classical FDI variables for explaining location decisions by foreign investors and lack to put enough emphasis on institutional variables in the analysis. They thereby fail to see the importance of an enabling institutional framework as a precondition for attracting FDI. This research tried to fill this gap by analysing the importance of (inclusive) institutions for explaining FDI inflow into CEE. Foreign investors choose a location based on the expected profitability of that location. This is closely related to the country’s comparative advantages, which are based on both natural and created assets.\(^{215}\). An empirical model that combined traditional, institutional as well as transition specific variables was developed to fully understand FDI determinants in CEE.

Three hypotheses on the importance of natural and created assets for location decisions by foreign investors were formulated, which were tested for their validity throughout the research. The null hypothesis stated that classical determinants matter for location decisions by foreign investors. The research found that the attractiveness of the CEE region remains to a large extent based on the potential of major cost reductions, as shown by chapter two. However, this research has shown that classical factors conditions only work through the channel of institutions.

The second hypothesis stated that the influence of (inclusive) institutions on FDI is more substantial than currently described in FDI literature. The research proves that an effective institutional framework is a precondition for attracting FDI. Institutions have to provide a facilitating business environment so that business can flourish. Differences in the quality of institutions among countries can explain a large part of the observed differences in FDI inflow. The evidence from CEE gives further weight to the claim that institutions are crucial for explaining a country’s attractiveness to foreign investors. The EBRD Reports conclude that those CEECs with a strong institutional environment are better placed to attract investments.\(^{216}\) The economic development among the CEECs, although roughly enjoying the same factor endowments, differs so much with regard to economic growth and inward FDI, that the quality of their institutional framework appears to matter decisively.\(^ {217}\)

The literature review also showed that economic and political institutions have to be inclusive in order to attract great amounts of FDI. For this reason it was important to evaluate whether the CEECs have been able to develop inclusive economic growth. For an inclusive

---


\(^{217}\) Fabry and Zeghni, “Inward FDI in,” 77, 78.
economy the state must provide the investors with an effective legislative framework, has to ensure that the economy is open to everyone, that there is equal access to education, and that foreign investors can bring their profits back home. The CEECs have been able to slowly move from exclusive to inclusive economic growth. During the first years of FDI inflow into CEE foreign investors mostly exploited the cheap labor force, a sign of exclusive economic growth. However, at present the skills of the labor force are becoming increasingly more important, contributing to the inclusiveness of the economy. Those CEECs that have been more welcoming to foreign investors, thus being more inclusive, have all experienced higher economic growth and FDI inflows.218

The third hypothesis formulated that EU membership and the adoption of the acquis had a large and positive influence on FDI inflows. Chapter four investigated the role of the EU accession process on FDI inflows in CEE, and thereby completed the analysis of what determines FDI inflows into CEE. The EU accession process has played a role in different aspects. The most important being that it helped the consolidation of institutional change in CEE. The CEECs adopted a business and legal environment similar to that of the old member states, thereby reducing the perceived level of risk of these countries and making them more attractive to foreign investors.219 In economic terms the new member states gained free access to the large European market, which has also proven to be an important comparative advantage for the CEECs.

The Slovakian automotive industry served as an illustrative case to assess the driving forces behind FDI into CEE. The last chapter provided additional data for the validation of the three hypotheses as formulated in chapter one. The institutional reforms in Slovakia have made the classical FDI determinants able to flourish. The improved institutional framework laid the proper foundation for foreign investors to be attracted to the country. Today, due to drastic reforms and continued and credible commitment to these reforms, Slovakia has emerged as one of the leading economies of CEE.220 The case study is a prime example of a situation where an effective institutional framework enabled the country to make proper use of its classical FDI factors to attract a substantial amount of FDI.

FDI is crucial for the economic development of the developing countries, therefore the attraction of FDI is now part of the strategy of most transition countries. The importance of institutions for attracting FDI counts for all developing countries, not only for the CEE

219 Disdier and Mayer, “How different is,” 281.
transition countries. An effective institutional framework, especially property rights, are a precondition for all the transition countries for attracting FDI. If the institutional quality of a country is sufficiently enabling, classical FDI factors take over as the main determinant of FDI inflows. This research has furthermore pointed out that it is not only the quality of institutions that is vital for attracting FDI but also the inclusiveness of these institutions. The institutions of a country have to be sufficiently open and welcoming to foreign investors. This research has provided evidence that it is crucial for FDI theorists to incorporate institutional variables when explaining a country’s attractiveness to foreign investors, as it is a necessary precondition. Nevertheless, the bulk of FDI literature continues to only attribute a small role to institutional variables when explaining location decisions. This research has shown that institutional variables are fundamental for explaining differences in FDI inflows among countries and should thus be incorporated to the analysis.
Bibliography


Appendices

Appendix 1: Case Studies Automotive Investments in Slovakia
This section will highlight the three major automotive investments in Slovakia. These case studies can help to understand the importance of specific factor endowments and policies for attracting foreign investors.221

Volkswagen (VW) Slovakia
Automotive FDI in Slovakia in the 90s was closely linked to VW investments at the BAZ factory. In 1991 VW proposed to assemble 30,000 cars annually at the BAZ factory, to produce gearboxes, and to reorganize the automotive supplier network in Slovakia. By 1994 VW became the sole owner of VW Bratislava, renamed as VW Slovakia in 1991. One of the main reasons for VW to buy the BAZ plant was to increase its cost competitiveness, due to the relatively low labor costs in Slovakia.

However, despite the low production costs, output of VW Slovakia increased only slowly to 41,000 cars in 1997. VW demanded lower taxes before they would increase production. After the taxes were lowered by the Slovakian government production was increased. By 2003 VW Slovakia was assembling 281,000 cars a year. This explosive growth was strongly supported by the state, by providing investment incentives to VW, by means of tax cuts, and through the construction of supplier parks. Since 2004, most of VW’s principal suppliers are located in two newly build supplier parks. In 2009 the state offered even more support, which led to the expansion of production to 400,000 cars per year.

The state (investment) policies towards VW contributed significantly to the development of the competition state. Since the early 2000s, Slovakia is capable of competing with other CEECs in attracting large FDI flows. The rapid expansion of the VW factories attracted a number of large foreign suppliers. The positive experience of VW in Slovakia also had a demonstration effect on other car producers and made Slovakia a more attractive location for their investments.222

PSA Peugeot-Citroën
In 2002 PSA Peugeot-Citroën announced to invest 700 million euros in an assembly plant in one of the CE countries, effectively starting a bidding war among the Visegrád countries. PSA eventually accepted the Slovakian offer to locate at the proposed Trnava site on January the

---

15th of 2003. The total investment incentives were limited by EU regulations. Slovakia offered 152 million euros of investment incentives in the form of land for the factory site, infrastructure building, tax holidays, a 1.640 euro subsidy for every additional job, and 11.3 million euro for worker training.

The combination of the low labor costs (75 percent lower compared to France), skilled labor, the high unemployment rate, proximity to large markets, railway and highway accessibility of the site, the country’s tradition in car manufacturing, and the investment incentives were the most important factors that made PSA decide to locate in Slovakia. The Peugeot-Citroën investment was termed the investment of the decade. It enabled the government to present Slovakia as a reforming and rapidly developing nation, becoming an increasingly attractive for foreign investors. This media effect was significant for FDI inflows into Slovakia.223

Kia Motors

Kia announced that it was going to make an investment of 1.5 billion US dollars in one of the Visegrád countries, the competition for the KIA investment was very aggressive. In August 2003 Kia announced that the choice was either Hungary or the Czech Republic. After this announcement, the Slovak minister of Economy traveled to South Korea to present a new package of investment incentives to KIA. An offer impossible to refuse according to the Slovak government. Kia eventually decided to select Slovakia for its investment on the second of March 2004. Slovakia simply offered what Kia was asking for, including that the state would not change laws that would endanger Kia’s economic benefits.

The contract was very one sided, because Kia did not had to make any guarantees about the investments it said it would make, suggesting a very asymmetrical power relationship between Kia and the Slovak government. The KIA investment suggests two conclusions. First, that investment incentives do matter for MNCs in their decision where to invest. Second, after the controversy that emerged after the investment incentives for KIA the government recognized that attracting FDI at any price could in fact be counterproductive for economic development.

The additional factors that attracted KIA beside the generous investment incentives included cheap and skilled labor, lack the tax system, and the commitment to develop infrastructure in the region. The government further stressed that the improved economic

policies, successful reforms, and favorable business environment further contributed to the decision by KIA to invest in Slovakia.\textsuperscript{224}