

Capitalism on the Rise:

Effects of Politics and Policy on U.S. Foreign Direct Investment in Central and Eastern Europe

Abstract: What are the reasons why some countries succeed in attracting foreign direct investment while others fall short? What role could the politics and policy choices in the host country play in this equation? This paper seeks to find answers to these questions by examining data concerning the political and policy aspects of governments from sixteen Central and Eastern European countries. This project looks at the impact of the political environment and the policy choices of these countries since the fall of the Iron Curtain in 1990 and how these factors affected the flows of U.S foreign investments. The findings of this study reveal a significant impact of the political environment on FDI levels. More specifically, the findings point to rule of law and political stability as the main political determinants of foreign direct investment.

I. Introduction

In this paper, I seek to examine the relationship between, on the one hand, government policies and political and institutional factors, and on the other, American foreign direct investment. I am particularly interested in how U.S.-based multinational corporations alter their location decisions in response to the political climate and policy environment of the potential host countries. In 2010, U.S. foreign direct investment outflows amounted to 325.5 billion dollars (UNCTAD 2011). This figure represents 2.2% of the U.S. GDP in 2010 and 28.9% of the global FDI flows in the same year (UNCTAD 2011). Clearly, the capital invested abroad by U.S. economic agents is far from negligible. In this context, it is fascinating to uncover some of the factors that determine these flows.

I will focus my analysis on a set of Central and Eastern European countries that have transitioned from communist regimes to democracies in the last two decades, since the fall of the Iron Curtain in 1990. I have chosen this region of the world for several reasons. First, despite U.S. government rhetoric throughout the early part of the 1990s encouraging capital to move into new markets opened by the 1989 overthrow of communism in Central and Eastern Europe (U.S. Congress 2000), systematic research regarding the activities of U.S.-based companies in that region is practically nonexistent. Second, this group of countries represents an invaluable laboratory for understanding the relationship between nascent democratic regimes and FDI. Finally, due to a combination of shared recent histories, especially their experience with communist regimes, similar political and economic structures, and comparable workforces, the countries in this study are highly valued by political scientists eager to examine the connection between governmental and political factors and foreign direct investment. Thus, my main purpose in this study is to find answers to the question of why some countries in Central and Eastern Europe were able to significantly outpace the others in their ability to attract American investments, even though they enjoyed similar starting points. I will first identify the main characteristics of the host countries to which American

entrepreneurs respond positively, negatively, or remain indifferent. I will also compare the decision-making process of U.S. corporations to the decisions of investors from other parts of the world.

As the transition to democracy was unfolding during the early 1990s, the countries of Eastern and Central Europe were confronted with similar opportunities and challenges.¹ Their economies were heavily dependent on state-owned enterprises, and the quality of their workforces resembled closely (Hamilton 1992). Generally speaking, the previous communist governments made significant investments in the areas of education and infrastructure, albeit in a rather inconsistent manner. Thus, the countries examined in this study enjoyed somewhat peculiar circumstances as they began to welcome foreign investors when compared with other developing countries in places like South America or Asia. The Central and Eastern European countries entered the competition for FDI on equal footing. However, as time passed, some governments proved less corrupt and more competent at creating conditions for economic growth, while others fell behind. For example, Poland witnessed an increase in its democratic indices from a low score of 5 in 1990 to a maximum score of 10 in 2011 (Marshall 2010). On the other hand, Ukraine remained stagnant over the twenty years period with a score of 6, albeit witnessing minor fluctuations over the years. These differences were evident not only in the news media or in the official government statistics, but also in the appearance of the physical and technological infrastructure of the countries in the region. As further evidence of this discrepancy between the countries in Central and Eastern Europe, a quick comparison of two capitals in the region proves the point. While Prague is regarded as an important tourist destination for Americans and other foreigners visiting Europe, Bucharest, the capital of Romania, is largely overlooked as a worthwhile tourist attraction. Furthermore, the city is often confused with the Hungarian capital of Budapest.

Soon after the collapse of the communist dictatorships in Central and Eastern Europe, investors were eager to explore the region and bring their capital to take advantage of the cheap and

¹ The countries included in this study are presented in Table 3 in the Appendix.

skilled labor force present in these countries. Among the myriad foreign investors in this region were American companies that sought to expand their markets and acquire access to a highly qualified labor force which could manufacture products and demand lower wages than the American workers. Many of the first and most ambitious American corporate explorers in Central and Eastern Europe chose to establish regional branches in Austria due to the country's affinity with the region and the stability of its political and legal institutions ("Trading with Austria" 1990). One organization created to respond to the newfound demands from American entrepreneurs was the Vienna-based Management Consulting Institute. The purpose of the institute was to "help American companies navigate the political and economic shoals of Eastern Europe" (Auerbach 1990). According to Joseph R.G. Mack, the founder of the institute, the mission of the Management Consulting Institute was to provide resources for "any Western company or agency that wants to participate in the modernize [sic] of the East" (Auerbach 1990).

However, as the economies of Central and Eastern Europe stabilized after the transition to democracy in 1990, American investors began to open regional branches and move some of the production facilities to the region. These efforts were actively supported by the U.S. government, and more specifically by the Department of Commerce. U.S. administration officials believed that American private investment and managerial experience would help the countries in Central and Eastern Europe transition to full-fledged democracies and evolve into genuine market economies. The Deputy Secretary of State Lawrence S. Eagleburger echoed the views of other officials in the U.S administration in 1990 when he asserted that "the U.S private sector will be the principal vehicle of the American presence and American influence in Europe, East and West" (Auerbach 1990). Furthermore, many of the top-level government officials believed that the best policy the U.S. government could pursue was that of foreign direct investment. They favored private American investment into the region over any type of government-supported development aid. Many argued that the countries in Central and Eastern Europe did not require a modernized version of the Marshall

Plan that had helped Western Europe get back on a strong economic footing after the devastation of the Second World War, but rather “an infusion of capitalist know-how that can come only with private sector investments” (Auerbach 1990).

A critical initiative of the U.S. government to aid American investors in their attempt to explore the yet unknown economic opportunities in Central and Eastern Europe was the American Business and Private Sector Development Initiative (ABI). The \$45 million, two year project debuted during the first few months of 1991 and its main goal was to transfer “U.S. commercial expertise and capital to Central and Eastern Europe” (“U.S Business Initiative Targets Eastern Europe” 1991). The newly created government program helped streamline some of the efforts of organizations such as USAID, the Overseas Private Investment Corp., and the U.S. Trade and Development Program in order to provide American companies with adequate knowledge and expertise as they ventured into Central and Eastern Europe. ABI sought to expand the existing U.S. government programs for investors and developed six new initiatives in the following strategic sectors: agriculture, energy, environment, telecommunications, and housing. The government initiative proved extremely successful in facilitating the expansion of U.S. companies in Central and Eastern Europe. By 1993, two years after the program was created, American companies were already outpacing their rivals from Western Europe in the number and quantity of investments in the region. Based on a survey conducted by the *East European Investment Magazine*, U.S.-based companies were winning the race for investments in Eastern Europe, ahead of companies from the Italy, the UK, and Germany. According to the report, the countries with the greatest number of U.S. investment projects in the region were Poland, Czechoslovakia and Hungary (Marray 1993).

In light of these findings that showcase the U.S. government’s willingness to facilitate investments in the newly opened markets in Central and Eastern Europe, one arrives at the obvious question, namely, what caused American companies to invest in some countries and yet avoid others? It is true that the size of the market must have played a role, albeit a diminished one, due to

the fact that many of the factories opened by U.S. investors in Eastern and Central Europe produced goods intended for exports. Otherwise, how could one explain the fact that Slovakia, a landlocked country with a little more than five million people witnessed U.S. FDI levels of 7.1% of its GDP in 1999, while Ukraine with over forty-five million inhabitants recorded a significantly lower level of U.S FDI flows in the same year, at only 1.9% of its GDP? Therefore, it becomes imperative to examine the impact of politics and policy on U.S. FDI inflows.

Hence, in this paper I ask: How have the political environment and government policies affected American foreign direct investment inflows in Central and Eastern Europe since the fall of communism in 1990? I will examine a sample of sixteen countries from 1990 to 2010 and I will attempt to find a correlation between, on the one hand, government spending on education and infrastructure coupled with three political risk factors, and on the other, foreign direct investment. The three political risk factors which I have found to be most important in determining incoming FDI levels are corruption, government stability, and law and order. While the effect of political factors on FDI has been studied extensively (e.g., Wei 2000; Jensen 2008; Pajunen 2008; Busse and Hefeker 2005), the relationship between politics and foreign capital in Central and Eastern Europe has received little attention (Holland and Pain 1998).

Furthermore, the relationship between American FDI and political factors in the Eastern European region has not been studied systematically. I believe that exploring the effects of both politics and policy on the decisions of U.S. investors in the context of post-communist Central and Eastern Europe is particularly appealing. My project adds to the existing knowledge on the topic because it offers insights into the political-economic dynamics in a relatively understudied region and, because Central and Eastern Europe, due to the structural similarities among their countries, provide the proper context for untangling the role that government policy and political risk factors play in attracting FDI.

The paper is organized as follows. Section II provides an overview of the existing literature on the topic and the most important findings of researchers who have examined the relationship between politics and FDI. Section III presents the argument and hypotheses. Section IV contains the research design and the statistical techniques employed in order to analyze the data. The findings and their interpretation are presented in Section V. The final section concludes with the outcomes of the research and suggests some ways in which the current research could be extended.

II. Existing knowledge and beyond: Expanding the definition of location

Location, location, location! This well-known phrase seems to matter in every circumstance, and particularly when foreign corporations decide to invest (Dunning 1998). In this paper, I expand the definition of location to include not just the geographic context but also the policy and political aspects that define a country or a region. Therefore, location is defined not only by physical resources (minerals, land, human capital, climate, etc), but also by the policy choices that a particular government makes (in this case, policies on education and infrastructure), and the political environment, which in this paper is defined by three political risk factors, namely corruption, rule of law, and political stability.

The importance of location to foreign investors has been thoroughly documented in the past few decades, and one of the first to establish and better assess this relationship was John Dunning (1981). He introduced the “OLI framework,” which is based on the three pillars of ownership, location and internalization, and is considered the quintessential model for firms investing abroad. In regards to the second pillar of location, Dunning (1981) argues that firms are motivated to invest abroad based on the locational advantages that the host countries provide. Transportation costs are taken into account when firms decide on a particular investment location, and these are directly related to the availability and the quality of the host country’s physical infrastructure. Furthermore, foreign corporations are keenly interested in the quality of the country’s workforce which is

intricately related to the quality of the educational system of the host country. In essence, firms look for locations that allow them to produce the same good or service at lower costs than they would in their home countries or other nations.

II.1. The role of policy in defining location

According to Dunning (1998), foreign investors have become increasingly interested in locations which offer “the best economic and institutional facilities for their core competencies to be efficiently utilized” (51). In his paper, Dunning (1998) mentions a study conducted on U.S. multinational enterprises from 1982 to 1988, showcasing the most important locational factors for investors. Two of the three principal factors were quality of infrastructure and degree of industrialization, with the latter including aspects related to education and workforce quality. Dunning (1998) found that beginning in the 1980s multinational firms have switched from prioritizing resource-rich countries or those with access to important markets to focusing on countries with “knowledge-intensive assets and learning experiences” (54). In other words, companies became more interested in securing investment locations with highly skilled labor forces and where the degree of industrialization was conducive to the most efficient production. Furthermore, the author states that the physical and human infrastructure of host countries together with their institutional framework “tend to play a more decisive role than they once did” (54). Thus, as the collapse of communism in 1990 opened up new markets in Central and Eastern Europe to foreign investors, the trends among MNCs that Dunning mentioned in his study became a staple among investors looking for potential locations in the region.

In view of this finding, I expand the definition of location to explicitly include infrastructure and education policy. Furthermore, I argue that it is not only the realized level of infrastructural development and industrialization that enter the decision of U.S. entrepreneurs, but also a country’s potential for development. Since foreign direct investments have medium to long time horizons, it is

reasonable to assume that investors' decision models include expectations about the medium and long term location advantages of potential hosts. Current government decisions regarding infrastructure and education are good indicators of future infrastructural development and industrialization.

II.2. The role of politics in defining location

The political determinants of foreign direct investment have been well documented by researchers across the political science and international business fields (e.g. Wei 2000; Jensen 2008; Pajunen 2008; Busse and Hefeker 2005). Among the many dimensions that define a country's political environment, three stand out in the literature as particularly relevant to foreign investors: corruption, political stability, and rule of law. I discuss each of them below.

The impact of a host country's corruption on its levels of foreign direct investment has been thoroughly examined, and researchers have arrived at similar conclusions. They claim that corruption negatively impacts FDI inflows because foreign companies are unlikely to enter markets where they will face legal and economic obstacles. Furthermore, some researchers have found that multinational corporations based in countries that have stringent laws in regards to bribery of foreign governments are less likely to engage in such practices when investing abroad (Cuervo-Cazurra 2006; Wei and Shleifer 2000).

Wei (2000) defines corruption as "the extent to which firms and individuals need to pay bribes to government officials to obtain permits, licenses, loans, or other government services needed to conduct business in another country" (304). He examined the impact of host country corruption on the quantity and type of incoming FDI and concluded that corruption significantly reduces the levels of foreign direct investment. In his analysis, Wei (2000) controlled for government policies for FDI, such as incentives or barriers to investment. Furthermore, Pajunen (2008) mentions corruption as one of the seven critical factors related to FDI inflows and reinforces Wei's findings regarding the negative relationship between corruption and FDI.

Pajunen (2008) adds political stability as another critical institutional component that conditions FDI inflows, which is a subcomponent of political risk. The concept of political stability coupled with the absence of violence has been well documented in the literature concerning the topic of foreign direct investment. Pajunen (2008) defines political stability as the “likelihood of violent threats to, or changes in, government” (654). Globerman and Shapiro (2003) found that political stability is conducive to FDI. Li and Resnick (2003) concluded that the political instability of a country may inhibit FDI inflows, despite the lack of a strong relationship between the two variables.

In addition to corruption and government stability, previous research has identified ‘law and order’ as another critical component of political risk (Busse and Hefeker 2005). Busse and Hefeker define ‘law and order’ as “the strength and impartiality of the legal system” (6). Their analysis shows that of all the factors examined, government stability and law and order are the two most closely associated with FDI and have the greatest impact on foreign investment. According to the authors, the changes in these two components of political risk “are highly relevant for investment decisions of multinationals” (Busse and Hefeker 2005, 21). Moreover, the Worldwide Governance Indicators project, which measures the quality of the rule of law in each country on a scale from -2.5 to 2.5, states that the rule of law reflects the popular perceptions of the extent to which the people have confidence in the legal system and abide by its rules. Furthermore, the index denotes the “quality of contract enforcement, property rights, the police and the courts, as well as the likelihood of crime and violence” (The World Bank Group 2010).

The aforementioned political factors have been proven to affect the decision-making process of investors. Public perception of corruption and its subcomponents such as bribery of public officials and red tape, among others, have a direct impact on multinational companies deciding on future investment locations. Foreign corporations are particularly sensitive to such issues because they represent the outsiders in this scheme. Oftentimes, they lack the knowledge of the local customs and do not have the political connections that the domestic firms have. Thus, many multinational

corporations are wary of dealing with corrupt foreign governments because of the unknown risks. Furthermore, based on the literature, political stability and rule of law seem to have a direct effect on FDI inflows in the host country. Corporations are reluctant to make medium and long-term investments in places where their operations are at risk of being expropriated or where the court systems are unfair and corrupt. In order to invest capital and resources in a foreign location, MNCs must ensure that their endeavors do not become subject to the whims of the local politicians. Corporations investing abroad require a stable and secure physical and political environment.

III. Argument and Hypothesis

This paper seeks to determine the effect of policy choices and political factors on American companies seeking to invest in Central and Eastern Europe. Based on previous findings, it is expected that the choices that governments make in relation to their countries' infrastructure and educational systems have an effect on foreign investors' decisions. Furthermore, it has been widely documented that investors are quick to react to the political risk environment in a country and base their investment strategies largely on factors such as political stability levels, corruption levels, and the rule of law. In the previous section, I introduced a revised definition of location and explained why the policy and political factors were added. In this section of the paper, I discuss my expectations regarding the effect of these new dimensions of location on foreign investor decisions.

In order to integrate my current research into the larger picture of political and policy determinants of FDI, I decided to analyze the impact that the aforementioned factors (corruption, political stability, rule of law, government spending on education, and infrastructure quality) have on attracting global investments to the Central and Eastern European region. Thus, I seek to compare and contrast the response of both American and global investors to policy choices and political risk factors in order to shed light on the potential similarities and differences. My hypothesis is that higher levels of spending on infrastructure and education combined with lower levels of political risk

lead to greater levels of net FDI inflows. I expect to observe this relationship in cases concerning both U.S. and global foreign investors.

More specifically, in terms of education and infrastructure spending, I expect both global investors and their American counterparts to respond positively to such policy initiatives on behalf of the Central and Eastern European governments. Thus, my expectation is that countries with higher and increasing levels of spending on both public infrastructure and education will showcase higher levels of FDI as percentage of their GDP. Corporations seek countries with quality infrastructure and a skilled labor force. At the same time, given the longer time horizons of foreign direct investment projects, corporations will likely take into account a country's potential for infrastructural and human capital development. Investors will then respond to both the state of development at the time of the investment and indicators of future developments. Therefore, countries that make a deliberate effort of investing in education and infrastructure are most likely to reap the benefits of higher foreign investment levels.

Moreover, I expect that countries with lower levels of corruption will display higher degrees of foreign investment as percentage of their GDP. I also expect that higher levels of political stability and rule of law will result in higher degrees of U.S. and global FDI. As previously explained, corruption along with political stability and law and order have been identified as key factors that investors take into account when choosing a location. Corruption has been shown to have a negative effect on foreign investment because it deters investors from committing capital and human resources long-term to a specific location. Corporations are wary of potential dangers and unexpected circumstances that may rise in a corrupt environment. Coupled with corruption, political instability and the absence of the rule of law further dissuades investors from starting a business in a host country where violence is rampant, the political situation is frail, and the courts are partial and corrupt.

Regarding differences between US investors and investors from the rest of the world, based on previous literature, I anticipate no difference in responses to either politics or policy. Both U.S. and global investors should respond positively to government initiatives for infrastructure and education improvement. Similarly, both U.S. and global investors should respond negatively to elevated levels of corruption, political instability, and the absence of the rule of law.

IV. Research Design

IV.1. Sample

For the present analysis, I collected a panel data set with information from sixteen countries in Central and Eastern Europe that experienced communist regimes for most of the latter part of the 20th century. In my sample, I included former Soviet Union Republics such as Ukraine, Moldova and Belarus as well as the Baltic states of Lithuania, Latvia and Estonia. However, I excluded East Germany due to its reunification with West Germany soon after the fall of the Berlin Wall and its peculiar political and economic conditions that did not resemble the experiences of the countries in Central and Eastern Europe. Although the countries in my study differ demographically and culturally, they share similar experiences with communist and Soviet governance, similar development levels, and rather parallel transitions to democracy soon after the end of the Cold War in 1990. The countries selected for this study are included in Table 3 in the Appendix.

My initial goal was to analyze data concerning these countries from 1990 to 2010. However, it must be mentioned that while some country-specific data was available for every year, most of the variables I analyzed were available only for certain years, mainly after 1995. For instance, Bosnia and Herzegovina and Serbia had higher degrees of missing data due to the Yugoslav Wars of 1990-1991 and later independence dates. While it would have been highly desirable to have data for the entire period following the regime change, my estimation sample only covers the years between 1995

and 2010. Still, the data I was able to collect and analyze provides a relatively accurate image of the relationship between policy, politics, and FDI in the post-communist countries of Europe.

IV.2. Measurement

Dependent variables

The dependent variables in my study are U.S. FDI levels and global FDI levels as percentage of a country's GDP. The data concerning U.S. foreign direct investment was taken from the U.S. Department of Commerce's Bureau of Economic Analysis. Each country's gross domestic product (GDP) over a twenty years period was available in the World Bank's World Development Indicators database. In order to determine each country's net global FDI inflows, I also used the World Development Indicators database. This variable is calculated by subtracting total FDI outflows of domestic capital from the total inflows of foreign capital (Jensen 2003, 597). A country with positive net FDI inflows is attracting new FDI investment, while a country with negative FDI inflows is experiencing an outflow of foreign capital.

Main explanatory variables

Policy

I measure the quality of education policy as education spending as percentage of GDP. For the countries in my data that are members of the European Union, I employed data collected by the European Commission and readily available on the Commission's website (ec.europa.eu). For the remaining countries in my study, I utilized the data available from the World Development Indicators database. This variable ranges from a minimum value of 2.6% (Bulgaria in 1996) to a maximum value of 9.5% (Moldova in 2009) with a sample average of 4.99% (Latvia in 2007).

Furthermore, because there were no readily available statistics on infrastructure spending by governments, I collected data for the following variables: telephone lines and internet users per a

hundred people, road density measured as kilometers of road per 100 square kilometers of land area, and agricultural irrigated land as percentage of total agricultural land. However, due to the lack of sufficient data for the latter two variables, the resulting estimation sample would have been too small to draw any statistically significant conclusions. Thus, I was forced to employ only the first two variables pertaining to infrastructure, namely the number of telephone lines and internet users per a hundred people. The data regarding the infrastructure variable were taken from the World Development Indicators databank. The first variable, telephone lines, ranges from a minimum value of 7.1 telephone lines per 100 people (Bosnia and Herzegovina in 1995) to a maximum value of 48.5 telephone lines per 100 people (Slovenia in 2008), with a sample average of 26.5 (Ukraine in 2006). The second variable, internet users, ranges from 0.0005 internet users per 100 people (Belarus in 1994) to 79.8 internet users per 100 people (Slovakia in 2010), with a sample average of 21.1 (Poland in 2002).

Politics

In regards to the political aspect of the study, I focused on the following three variables: political stability, rule of law, and perception of corruption. In regards to the first two variables, I found data available only from 1996 to 2010, with data for the years 1997, 1999 and 2001 missing. These indicators are taken from the 2010 Worldwide Governance Indicators website and are based on thirty underlying data sources. The project reports the perceptions of governance based on a large number of survey respondents and assessments. The political stability indicator reflects “perceptions of the likelihood that the government will be destabilized or overthrown by unconstitutional or violent means, including politically-motivated violence and terrorism” (The World Bank Group 2010). Furthermore, rule of law refers to the “quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence” (The World Bank Group 2010). Each country will display values ranging from -2.5 (weak governance) to 2.5 (strong

governance). Thus, the higher the values, the greater are the levels of political stability and rule of law in a particular country. In regards to the political stability variable, the values recorded in my study range from a minimum of -2.1 (Serbia in 1998) to a maximum of 1.2 (Slovenia in 2002), with a sample average of 0.33 (Bulgaria in 2000). In respect to rule of law, the variable ranges from -1.3 (Serbia in 1998) to 1.2 (Slovenia in 1998), with a sample average of 0.09 (Croatia in 2004).

For the third political risk variable, I used the Corruption Perception Index which is published by Transparency International each year. The index reflects the level of corruption in the public sector and takes into account various forms of corruption, from bribery of public officials to embezzlement of public funds. The index is an aggregate indicator of corruption because it incorporates different sources on corruption such as the public's perception of corruption as well as opinions from foreign investors operating in host countries. This non-profit organization analyzes the results from more than a dozen surveys and assessments. Furthermore, the index assigns values ranging from 0 to 10, with 0 representing the most corrupt countries while 10 representing the least corrupt. In my study, this variable ranges from a minimum value of 1.5 (Ukraine in 2000) to a maximum value of 6.7 (Slovenia in 2008), with a sample average of 4 (Bulgaria between 2002 and 2006).

Control variables

In order to improve the accuracy of my results, I employed a number of control variables in my analysis. These variables are based on the standard in the literature and include population wealth, market growth, and openness to trade. Population wealth is measured by the gross domestic product (GDP) per capita which is calculated by dividing the GDP of a country in a particular year by its population in the same year. Market growth refers to the real growth of the GDP each year. To eliminate any discrepancies due to inflation, the values reflecting population wealth and market growth were measured in constant 2000 U.S. dollars. Furthermore, openness to trade reflects a

country's propensity to engage in trade and is represented by the value of trade as percentage of GDP. The aforementioned control variables were available through the World Development Indicators database from the World Bank website.

In respect to the first variable, population wealth, measured as GDP per capita, the values in my study range from a minimum of 346 constant 2000 US dollars (Moldova in 1999) to a maximum of 13,836 constant 2000 US dollars (Slovenia in 2008), with a sample average of 3,644 constant 2000 US dollars (Croatia in 1994). Furthermore, in regards to the second control variable, namely market growth, measured as percentage growth of GDP per year, the values range from -32% (Latvia in 1992) to 88% (Bosnia and Herzegovina in 1996), with a sample average of 1.6% (Poland in 2009). Finally, the third control variable, openness to trade, measured as value of trade as percentage of GDP, has values ranging from 39% (Romania in 1991) to 174% (Slovakia in 2007), with a sample average of 105% (Lithuania in 2001).

IV.3. Method

In addition to bivariate correlations (e.g. graphs), I use linear regression because my dependent variables are continuous. This method estimates the average effect of each explanatory variable on the dependent variables. To control for time lags in the effects of the explanatory variables on the dependent variables, I lagged the explanatory variables by one year. Thus, the new dependent variables will be called "FDI-forward" and "USFDI-forward" referring to the global FDI as percentage of a country's GDP for the following year and American FDI as percentage of GDP for the following year, respectively. To control for trending in the FDI and the other economic data I also included the variable "year" in the models. Furthermore, in order to account for influences not captured by the explanatory variables I estimated two models that included a lagged dependent variable.

V. Findings

Table 1 in the Appendix presents the results from four models. The first two models estimate the relationship between the political variables and U.S. and global FDI flows. Included in the models are also the control variables. I expected countries with lower levels of corruption and higher levels of political stability and rule of law to display higher degrees of U.S. and global FDI flows. Model 1.1 partly supports this hypothesis in regards to U.S. FDI. Both political stability and rule of law have a positive and statistically significant effect on U.S. foreign investment. On the other hand, the relationship shown in Model 1.1 between transparency, or lack of corruption, and U.S. FDI contradicts the hypothesis. There seems to be a negative correlation between the two variables, pointing to the fact that transparency may have a negative effect on FDI flows from U.S.-based companies. Model 1.2 presents the relationships between the political factors and global FDI levels. Similar to the effect observed in Model 1.1, rule of law has a positive and highly significant impact on global FDI flows. Contrary to the relationships observed in the previous model, political stability does not have a statistically significant effect on global FDI, while transparency seems to affect FDI flows positively, thereby proving my hypothesis.

The latter two models in Table 1 of the Appendix include the effects of policy choices on U.S. and global FDI, in addition to the control variables. My expectation was that countries with higher levels of spending on both public infrastructure and education would showcase higher levels of FDI flows as percentage of their GDP. Contrary to my hypothesis, education spending seems to have no statistically significant effect on either American or global FDI. Such results come as a surprise because foreign investors are known to value a highly skilled labor force in the host countries. What could better indicate the likelihood of such outcomes to potential investors than a quality education system supported by high levels of government spending? Furthermore, there is no clear relationship between the number of internet users per 100 people and FDI flows. In both cases (Model 2.1 and Model 2.2), the relationships are not statistically significant. The only variable that

seems to affect the levels of FDI in the host countries is ‘telephone lines.’ Model 2.2 shows a positive and statistically significant relationship between telephone lines per 100 people and global FDI levels, thus supporting my hypothesis. On the other hand, the variable has a significant and negative effect on U.S. FDI flows, as can be seen in Model 2.1.

Substantively speaking, how large are the effects of the political and policy variables on U.S. and global FDI levels? According to the estimates in the full models, one point increase in rule of law leads to 1.99% increase in U.S. FDI flows as a share of GDP. Furthermore, the same increase in rule of law seems to have a greater effect on global FDI levels, causing a 3.5% increase in FDI flows. One point increase in political stability causes a 1.7% rise in the share of U.S. FDI as percentage of GDP. Finally, Model 1.1 shows that one point increase in the level of transparency leads to a 0.55% decrease in U.S. FDI. On the flipside, one point increase in the transparency index causes a 1.05% increase in global FDI levels. In regards to the impact of the policy variables on foreign investment, there are only two statistically significant relationships shown in Table 1. Model 2.1 points to the fact that an increase of one point in the number of telephone lines leads to a slight decrease of 0.05% in the levels of American investment. On the other hand, a one point increase in the number of telephone lines per 100 people causes an increase of 0.11% in global FDI flows.

In respect to the control variables included in Table 1, there seems to be a small negative and statistically significant relationship between GDP per capita and global FDI. In both Model 1.2 and Model 2.1, a one point increase in the value of GDP per capita leads to a 0.001% decrease in global FDI flows. On the other hand, GDP per capita has a very small but statistically significant positive effect on U.S. FDI. Models 1.1 and 2.1 demonstrate this effect. In terms of the relationship between GDP growth and FDI flows, Table 1 shows significant effects in some models, but the effects are not robust across model specifications. Among the control variables, the one relationship that is positive and statistically significant in all four models is between trade as percentage of GDP and U.S. and

global FDI. In other words, countries whose economies are more dependent on trade tend to attract higher levels of foreign direct investment from both American and global multinational corporations.

Table 2 in the Appendix includes some robustness tests and shows a rather complicated picture. Among the relationships identified in the two models included in Table 2, only rule of law remains statistically significant across the board, in both cases of U.S.-based FDI and global FDI. One point increase in the index leads to a 0.85% increase in U.S. foreign direct investments and a 2.88% increase in global FDI flows. Furthermore, transparency has a positive and significant effect on global FDI, causing a 1.35% rise in share of global FDI as percentage of GDP as a result of a one point increase in the level of transparency. The relationship between telephone lines and total FDI levels remained positive and statistically significant, as can be observed in Model 3.2. A one point increase in the number of telephone lines per 100 people leads to a 0.16% increase in global FDI. Finally, the number of internet users per 100 people seems to negatively impact U.S. foreign investment flows. An increase of one point in the number of internet users in the host country causes a slight decrease of 0.03% in the level of American FDI.

VI. Conclusion

The goal of this project was to understand why some countries in Central and Eastern Europe were successful in attracting American investments while others lagged behind. More specifically, I wanted to determine the impact that the political environment and policy choices of these countries have had on U.S. FDI levels since their transition to democracy. Furthermore, I included global FDI flows to the region over the same period of time in my analysis in order to examine the larger context and be able to draw better informed conclusions. I collected data from sixteen countries between 1995 and 2010 and performed basic statistical analysis using the SPSS software. The findings are presented in Tables 1 and 2 in the Appendix. This project represents the first systematic study of U.S. investments in Central and Eastern Europe since the demise of the communist regimes. Furthermore,

this study brings to the existing literature an expanded definition of location which includes not only the geographic and physical components, but also the policy and political aspects. Finally, the current research project required me to collect data from a variety of sources and compile an entirely new data set that included the political, policy and economic variables from the countries included in my study.

The research into the topic of policy and political determinants of foreign direct investment brings to light some important observations. First, there seems to be minor differences in the effects of government policies and political risk factors on U.S. and global FDI levels, but these differences are rather small and mainly the result of data inconsistencies and insufficiencies. However, it is clearly evident that both U.S. and global investors respond positively to higher levels of rule of law. In addition, American companies seem to regard political stability of the host country as an important factor when deciding on the location of their investment. In regards to policy choices that governments in Central and Eastern Europe have made since their transition to democracy, there seems to be no clear relationship between education and infrastructure spending and FDI flows. What is particularly surprising and unexpected is the lack of a statistically significant relationship between education spending as percentage of GDP and foreign investment. Based on these findings, one arrives at the conclusion that policy decisions seem to matter less to foreign investors than the political environment of the host countries. In other words, both U.S. and global investors weigh the political situation of the potential host country more than the policy choices of its government in regards to infrastructure and education.

While the U.S. government encouraged American companies to invest in Central and Eastern Europe soon after the collapse of the communist regimes in 1990, and while all of the countries in my study experienced similar starting points, the political environment that these countries nurtured made the difference. For instance, Hungary had a political stability score of 0.95 and a rule of law score of 0.89 in 2006 (out of a maximum of 2.5), and was able to attract very high levels of U.S. FDI

in the following year, at 10.9% of its GDP. On the other hand, Bulgaria recorded significantly lower scores in the political stability and rule of law categories in 2006, 0.39 and -0.17 respectively, and witnessed relatively low levels of American investment the following year, at only 3.4% of its GDP.

In light of these findings, there are several policy recommendations for the leaders of host countries interested in attracting higher FDI inflows. First, policy makers need to pay close attention to the levels of law and order present in their countries. More specifically, government leaders must ensure that they respect contracts with foreign companies, safeguard property rights, and guarantee the transparency and impartiality of the courts and the police system. Furthermore, if countries want to attract higher levels of American investments, their governments must create and maintain a politically stable environment. Basically, American investors are likely to pay close attention to the likelihood that governments will be “destabilized or overthrown by unconstitutional or violent means, including politically-motivated violence and terrorism” (The World Bank Group 2010). Therefore, countries with higher scores in the ‘rule of law’ and ‘political stability’ categories will most likely reap economic benefits as a result.

This study is a first attempt at determining the relationship between the political environment and the policy choices of post-communist countries in Central and Eastern Europe and American foreign direct investment. While it presents several interesting findings regarding the impact of the political environment on U.S. FDI, it opens the door for future research. Social scientists eager to explore this area further are advised to collect better and more complex data on policy choices, and more specifically on infrastructure, in order to account for both present quality of roads, ports, electricity grids, etc., and expected future spending. The measures employed in this study in regards to infrastructure are not able to paint the whole picture to potential investors. These shortcomings in the present research are mostly due to the lack of sufficient and readily available data.

Future research on this topic could also incorporate information regarding the political and diplomatic relationships between the home and host countries. My study showed that there are

differences in American and global MNC's reactions to the same set of conditions in their potential host countries. Some of these differences likely result from home government policies and bilateral politics between a corporation's home country and its potential host. In fact, in the beginning of this paper, I discussed how the home government of US-based corporations was purposeful in directing US FDI to a specific region of the world. Further attention to home-country politics is certainly warranted.

Another exciting component of future projects could be an examination of the impact that various ethnic groups represented in the United States might have on the FDI levels in countries of the same ethnic composition. In other words, what role could the presence of a large Polish community in the U.S. have played in convincing U.S. investors to move their capital to Poland after 1990? Finally, a thorough investigation into the different effects of the host country investment policy on U.S. and other global investors represents an interesting future endeavor. Nevertheless, despite the data-related challenges encountered during this study and despite the multiple avenues for future research enumerated above, the current project exposes several interesting aspects of the decision-making process of U.S investors and how they compare to global investors.

Appendix

Table 1

Explanatory Variable	Model 1.1 (US FDI) Political variables +controls	Model 1.2 (Total FDI) Political variables + controls	Model 2.1 (US FDI) Policy variables + controls	Model 2.2 (Total FDI) Policy variables + controls
Transparency (lack of corruption)	-.553** (.016)	1.05† (.15)		
Political Stability	1.712*** (.0015)	-1.88 (.2)		
Rule of law	1.996*** (.000)	3.51** (0.03)		
Education spending			-.098 (.2545)	-.469 (.168)
Telephone lines			-.045** (.03)	.111* (.084)
Internet users			-.017 (.175)	.039 (.259)
GDP per capita	.000*** (.001)	-.001*** (.0055)	.000*** (.01)	-.001** (.028)
GDP growth	-.023 (.239)	.240** (.0335)	-.081** (.032)	-.146† (.1475)
Trade (%GDP)	.006† (.1485)	.034* (.085)	.007† (.112)	.054*** (.0025)
Year	.151*** (.0015)	.202 (.1615)	.125** (.0425)	.120 (.306)
Lagged dep. var.				
N	146	151	160	170
R-square	0.291	0.1	0.1	0.12

Note:

- 1-tailed p-values shown in parentheses
- † p≤0.15; * p≤0.1; **p≤0.05; ***p≤0.01

Effect of Rule of Law: Based on this sample, holding everything constant, rule of law has a positive and statistically significant (97%) effect on Total FDI flows. One point increase in rule of law leads to a 3.51 percent increase in FDI flows as a share of GDP. Furthermore, rule of law has a positive and statistically significant (100%) effect on U.S. FDI flows. In other words, one point increase in rule of law leads to a 1.996 percentage increase in U.S. FDI inflows as a share of GDP.

Effect of Political Stability: Based on this sample, holding everything constant, political stability has a positive and statistically significant (99.85%) effect on U.S. FDI flows. One point increase in political stability leads to a 1.721percent increase in U.S. FDI flows as a share of GDP. Furthermore,

political stability has no statistically significant effect on Total FDI flows to Central and Eastern European countries.

Effect of Corruption: Based on this sample, holding everything constant, corruption has a negative and statistically significant (98.4%) effect on U.S. FDI flows. One point decrease in corruption leads to a 0.533 percent decrease in U.S. FDI flows as a share of GDP. Furthermore, corruption has no statistically significant effect on Total FDI flows to the region analyzed.

Effect of Telephone Lines: Based on this sample, holding everything constant, the number of telephone lines per 100 people has a negative and statistically significant (97%) effect on U.S. FDI flows. One point decrease in the number of telephone lines leads to a 0.045 percent decrease in U.S. FDI flows as a share of GDP. On the other hand, the number of telephone lines has a positive and statistically significant (91.6%) effect on global FDI. In other words, one point increase in the number of telephone lines leads to a 0.111 percent increase in total FDI flows as a share of GDP.

Effects of Education Spending and Internet Users: Based on this sample, holding everything constant, the level of education spending and the number of internet users per 100 people in each country examined have no statistically significant effect on either global or American FDI flows.

Among the control variables, GDP per capita has a negative effect on total FDI and no effect on U.S.-based FDI. Trade has no significant effect on U.S. FDI inflows, but a slightly positive effect on global FDI. Finally, GDP growth has a positive effect on total FDI (see Model 1.2), but a negative effect on U.S. FDI (see Model 2.1).

Table 2 (Robustness tests)

Explanatory Variable	Model 3.1 (US FDI) All variables (including LDV)	Model 3.2 (Total FDI) All variables (including LDV)
Transparency (lack of corruption)	-.146 (.223)	1.346† (.108)
Political Stability	.271 (.265)	-.799 (.365)
Rule of law	.845** (.028)	2.875† (.11)
Education spending	-.101 (.19)	-.944* (.077)
Telephone lines	-.001 (.4725)	.159** (.05)
Internet users	-.026** (.0465)	-.071 (.197)
GDP per capita	-3.159 (.348)	-.001*** (.0095)
GDP growth	-.008 (.399)	.049 (.395)
Trade (%GDP)	.004 (.1685)	.025 (.1565)
Year	.136** (.0395)	.490† (.12)
Lagged dependent variable	.845*** (.000)	.494*** (.000)
N	110	117
R-square	0.777	.439

Note:

- 1-tailed p-values shown in parentheses
- ‘†’ p≤0.15; * p≤0.1; **p≤0.05; ***p≤0.01

Effect of Rule of Law: Based on this sample, holding everything constant, rule of law has a positive and statistically significant (97.2%) effect on U.S. FDI flows. One point increase in rule of law leads to a 0.845 percent increase in U.S. FDI flows as a share of GDP. Furthermore, rule of law has a positive effect on total FDI flows and is borderline statistically significant (89%, as denoted by the symbol ‘†’). In the case of total FDI, one point increase in rule of law leads to a 2.875 percentage increase in FDI inflows as a share of GDP.

Effect of Corruption: Based on this sample, holding everything constant, corruption has a positive and borderline statistically significant (89%) effect on total FDI flows. One point decrease in

corruption leads to a 1.346 percent increase in U.S. FDI flows as a share of GDP. On the other hand, corruption has no statistically significant effect on U.S. FDI flows to the region.

Effect of Education Spending: Based on this sample, holding everything constant, education spending has a negative and statistically significant (92.3%) effect on total FDI flows. One point increase in education spending as percentage of GDP leads to a 0.944 percent decrease in total FDI flows as a share of GDP. Education spending has no statistically significant effect on U.S. FDI flows.

Effect of Telephone Lines: Based on this sample, holding everything constant, the number of telephone lines has a positive and statistically significant (95%) effect on total FDI flows. One point increase in the number of telephone lines per 100 people leads to a 0.159 percent increase in total FDI flows as a share of GDP. The number of telephone lines has no statistically significant effect on U.S. FDI flows.

Effect of Internet Users: Based on this sample, holding everything constant, the number of internet users per 100 people has a slightly negative and statistically significant (95%) effect on U.S. FDI flows. One point increase in the number of internet users per 100 people leads to a 0.026 percent decrease in U.S. FDI flows as a share of GDP. On the other hand, the number of internet users has no statistically significant effect on total FDI flows.

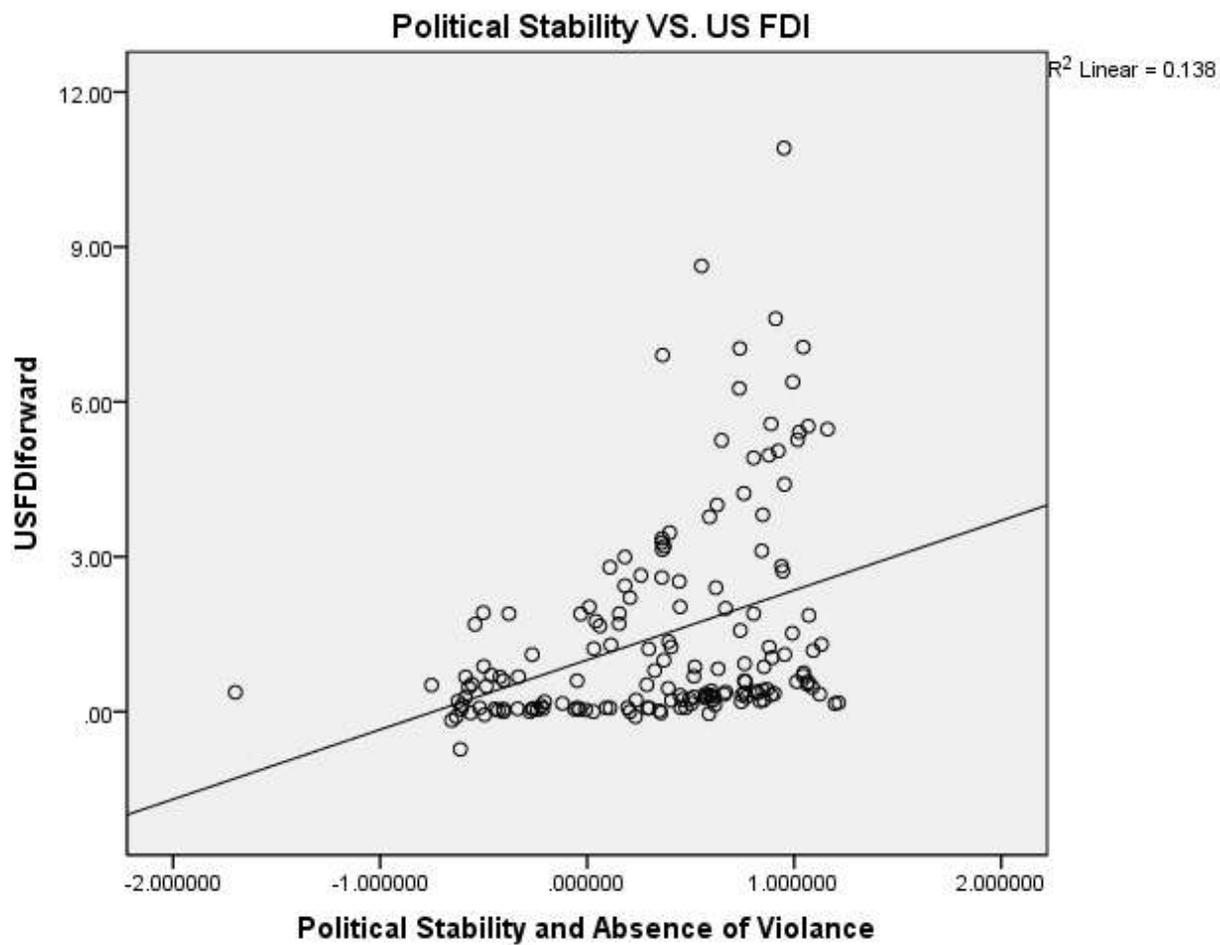
Effect of Lagged Dependent Variable: Based on this sample, holding everything constant, the lagged dependent variable has a positive and statistically significant effect (100%) on both U.S. and total FDI inflows. This means that the amount of FDI received by the host country the previous year coupled with a host of other variables that are not taken into account in this study account for the increase in U.S. and global FDI in the following year.

Among the control variables, GDP per capita has a negative effect on total FDI and no statistically significant effect on U.S.-based FDI. Trade and GDP growth have no significant effects on either U.S. or global FDI inflows.

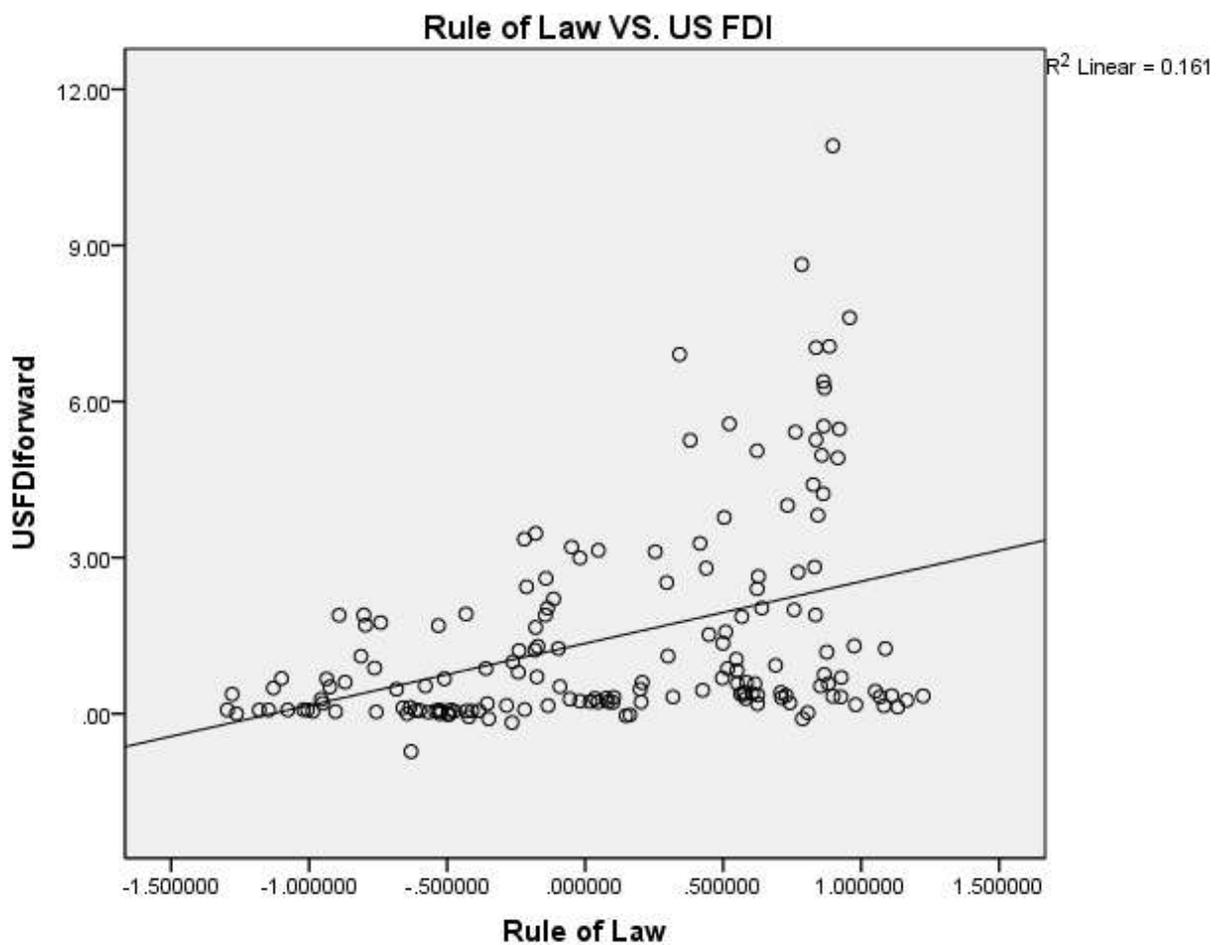
Table 3

Country
Belarus
Bosnia and Herzegovina
Bulgaria
Croatia
Czech Republic
Estonia
Hungary
Latvia
Lithuania
Moldova
Poland
Romania
Serbia
Slovakia
Slovenia
Ukraine

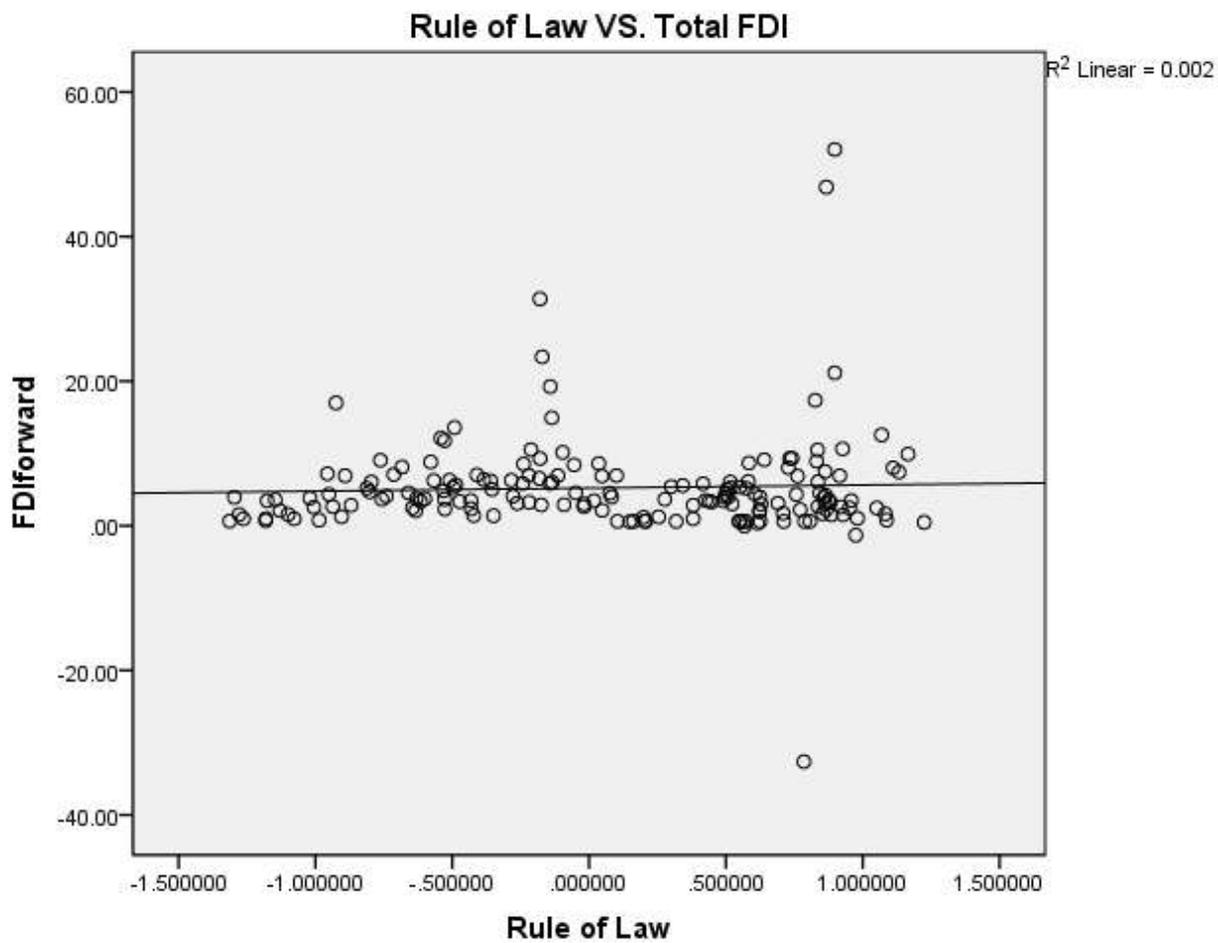
Graph 1



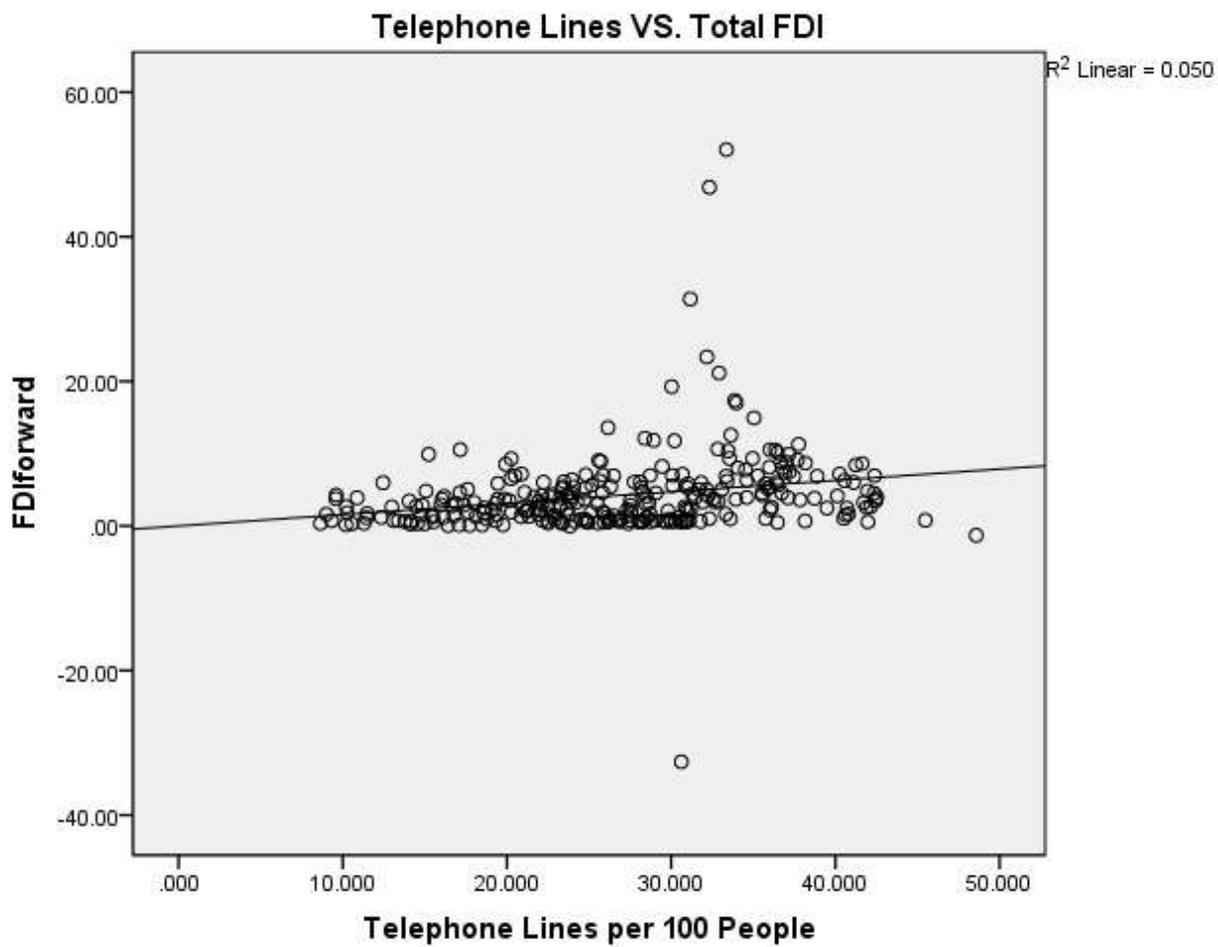
Graph 2



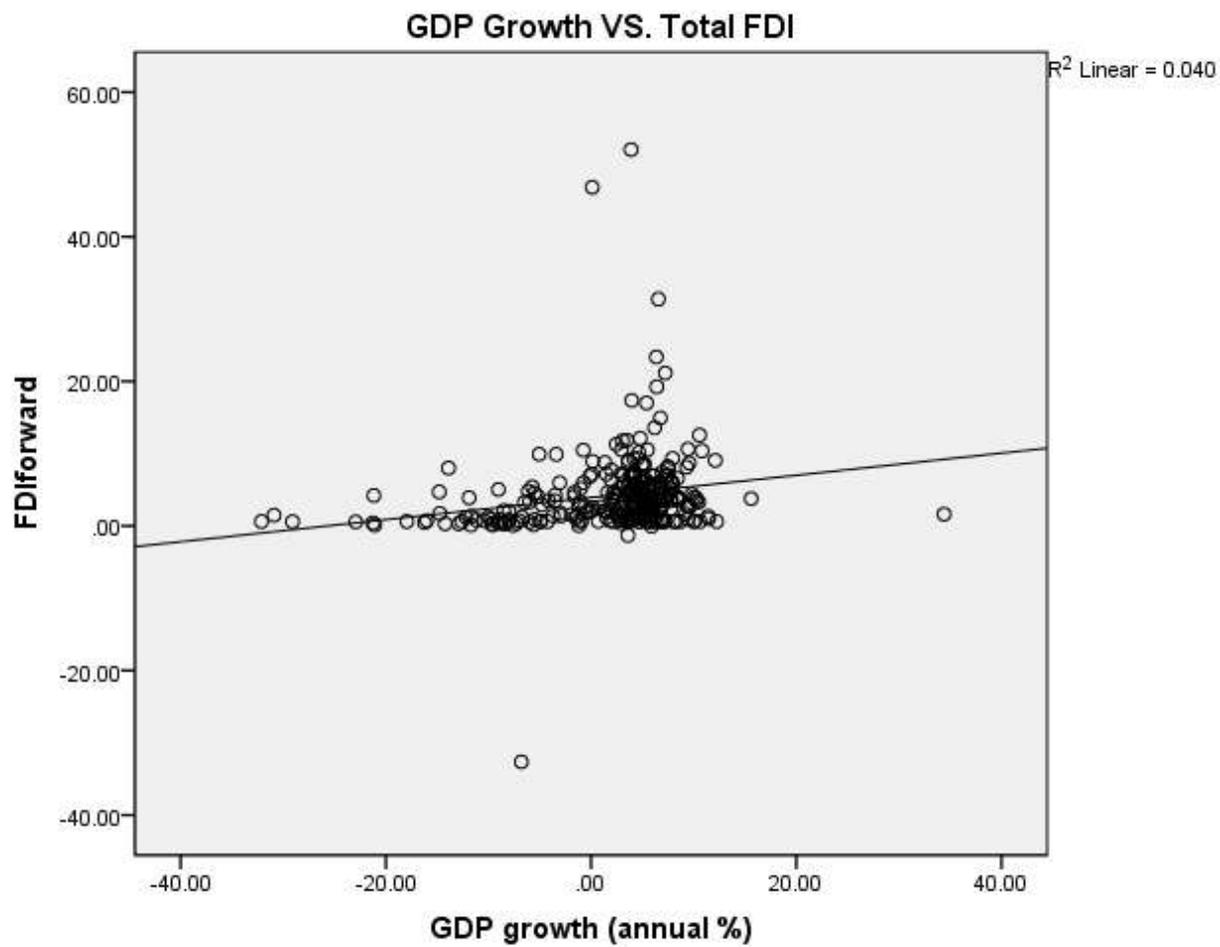
Graph 3



Graph 4



Graph 5



Bibliography

- Auerbach, Stuart. 1990. "Helping Ease the Rush Into Eastern Europe; High-Level Officials Mingle at Symposium." *The Washington Post*. LexisNexis Academic (April 12, 1990).
- Busse, Matthias, and Carsten Hefeker. 2005. "Political Risk, Institutions and Foreign Direct Investment." *Hamburg Institute for International Economics* (July).
<http://www.etsg.org/ETSG2005/papers/busse.pdf> (February 3, 2012).
- Cuervo-Cazurra, Alvaro. 2006. "Who Cares about Corruption?" *Journal of International Business Studies*, Vol. 37, No. 6 (November): 807-822. <http://www.jstor.org/stable/4540385> (February 12, 2012).
- Dunning, John H. 1981. "Explaining the International Direct Investment Position of Counties: Towards a Dynamic or Developmental Approach." *Weltwirtschaftliches Archiv*, Bd. 117, H. 1: 30-64. <http://www.jstor.org/stable/40438551> (March 12, 2012).
- Dunning, John H. 1998. "Location and the Multinational Enterprise: A Neglected Factor?" *Journal of International Business Studies*, Vol. 29, No. 1 (First Quarter): 45-66.
<http://www.jstor.org/stable/155587> (February 16, 2012).
- European Commission. 2012. "EU Policy Indicators." <http://www.ec.europa.eu> (February 2, 2012).
- Globerman, Steven, and Daniel Shapiro. 2002. "Governance Infrastructure and US Foreign Direct Investment." *Journal of International Business Studies*, Vol. 34, No. 1 (January): 19-39.
<http://www.jstor.org/stable/3557137> (March 10, 2012).
- Hamilton, Carl B., L. Alan Winters, Gordon Hughes, and Alasdair Smith. 1992. "Opening up International Trade with Eastern Europe." *Economic Policy*, Vol. 7, No. 14 (April): 77-116.
<http://www.jstor.org/stable/1344513> (March 15, 2012).
- Holland, Dawn and Nigel Pain. 1998. "The Diffusion of Innovations in Central and Eastern Europe: A Study of the Determinants and Impact of Foreign Direct Investment." *National Institute of*

- Economic and Social Research* (June). <http://zunia.org/uploads/media/knowledge/dp137.pdf> (April 10, 2012).
- Jensen, Nathan. 2003. "Democratic Governance and Multinational Corporations: Political Regimes and Inflows of Foreign Direct Investment." *International Organization*, Vol. 57, No. 3 (Summer): 587-616. <http://www.jstor.org/stable/4594838> (January 30, 2012).
- Jensen, Nathan. 2008. "Political Risk, Democratic Institutions, and Foreign Direct Investment." *The Journal of Politics*, Vol. 70, No. 4 (October): 1040-1052. <http://www.jstor.org/stable/30219483> (January 30, 2012).
- Li, Quan and Adam Resnick. 2003. "Reversal of Fortunes: Democratic Institutions and Foreign Direct Investment Inflows to Developing Countries." *International Organization*, Vol. 57, No. 1 (Winter): 175-211. <http://www.jstor.org/stable/3594829> (February 18, 2012).
- Murray, Michael. 1993. "US leads ventures in Eastern Europe." *The Independent (London)*. Section: Business and City Page. LexisNexis Academic (January 4, 1993).
- Marshall, Monty G. 2010. "Polity IV Project: Political regime Characteristics and Transitions, 1800-2010." <http://www.systemicpeace.org/polity/polity4.htm> (March 15, 2012).
- Pajunen, Kalle. 2008. "Institutions and Inflows of Foreign Direct Investment: A Fuzzy-Set Analysis." *Journal of International Business Studies*, Vol. 39, No.4 (June): 652-669. <http://www.jstor.org/stable/25483292> (February 2, 2012).
- The World Bank Group. 2010 "Worldwide Governance Indicators. <http://www.govindicators.org> (February 2, 2012).
- "Trading with Austria: Eastern European Countries Attract U.S. Companies." 1990. *Journal of Commerce*. LexisNexis Academic (April 10, 2012)
- UNCTAD. 2011. "Global and Regional FDI Trends in 2010." *Global Investment Trends Monitor*, Vol. 5 (January). http://unctad.org/en/docs/webdiaeia20111_en.pdf (March 15, 2012).

- UNCTAD. 2011. "Global and Regional Trends of FDI Outflows in 2010." *Global Investment Trends Monitor*, No. 6 (April). http://unctad.org/en/docs/webdiaeia20114_en.pdf (March 15, 2012).
- "U.S Business Initiative Targets Eastern Europe." 1991. *Eastern Europe Report*, Vol. 1, No. 13, Pg. 4. American Banker-Bond Buyer Publication. LexisNexis Academic (April 8 1991).
- U.S. Congress. Senate. Committee on Foreign Relations. 2000. Prepared Statement of Charles M. Ludolph. <http://www.ogc.doc.gov/ogc/legreg/testimon/106s/ludolph0628.htm> (April 4, 2012)
- Wei, Shang-Jin, and Andrei Shleifer. 2000. "Local Corruption and Global Capital Flows." *Brookings Papers on Economic Activity*, No. 2: 303-354. <http://www.jstor.org/stable/2667361> (March 26, 2012).