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What is This?

The Global Economy as Instituted Process: The Case of Central and Eastern Europe

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I argue that economic globalization, indicated by the tremendous rise in world foreign direct investment (FDI) in recent decades, is not driven simply by investor considerations of economic risk and return, but is significantly shaped by the construction of demand for foreign capital by receiving states. States signal this demand through the levels of formal and substantive legitimacy they grant to FDI. They institutionalize globalization in formal rule as a normatively desirable development strategy. States substantiate this commitment by providing domestic and foreign actors with ideational and organizational resources to facilitate FDI. To illustrate this argument, I use the case of Central and Eastern Europe, which was largely closed to global capital before the collapse of Communism. Analyses of quantitative and qualitative data show that substantive legitimacy granted to FDI by host states, more than formal regulations, determined the size of foreign capital flows into postsocialist countries in the first decade of market reform. These findings point to social foundations of macroeconomic trends beyond the instrumental considerations of risk and return privileged in previous research.

Contemporary globalization is distinctly marked by the unprecedented rise in foreign direct investment (FDI). Considered "one of the most stable and economically important of the international capital flows" (Jensen 2006:23), world yearly FDI inflows reached a spectacular $1.4 trillion in 2000. By 2004, countries had accumulated an estimated $9 trillion in FDI stock, or 22 percent of the world gross domestic product (GDP) (UNCTAD 2006). What drives these cross-border economic exchanges?

Most existing studies of determinants of FDI offer *supply-side* explanations, focusing on investors and their instrumental calculations in search of profits across national borders (for recent reviews, see Blonigen 2005; Chakrabarti 2001). By contrast, I emphasize the social foundations and active construction of *demand* for foreign capital by receiving countries that want to integrate into global connections. I argue that states contribute to the institutionalization of the global economy by granting formal and substantive legitimacy to FDI. Formal legitimacy reflects a state's efforts to institutionalize globalization, in formal free market policies, as a normatively desirable development strategy. Substantive legitimacy refers to how a state's commitment to attracting FDI is reflected in informal norms and practical economic interactions. Largely independent of the general set of rules they adopt, states can provide domestic and foreign business actors with more or less ideational and organizational resources to encourage foreign investment. Levels of formal and substantive FDI legitimacy signal the intensity of demand for foreign capital and significantly shape the amount of FDI that countries receive. I test this argument by examining

11 Central and Eastern European (CEE) economies that were closed to FDI flows before the collapse of Communism, but within only a decade after 1989 were deeply integrated into the global economy.

FOREIGN DIRECT INVESTMENT

Foreign direct investment (FDI) is investment made by a company from an investor country in a foreign host country with the goal of creating a long-term relationship with significant management influence. FDI is usually classified as investment leading to ownership of 10 percent or more of the host firm.[1] FDI sometimes takes the form of foreign acquisition, in which an investor obtains partial or full ownership in an existing company. Foreign investors can also engage in *greenfield* investment (i.e., establish new companies in a host country, wholly foreign-owned or in partnership with domestic investors).

Interest in FDI, particularly the focus on the role of multinational corporations (MNCs), dates to the 1950s (Gereffi 2005). Since then, a large literature has treated FDI as an *independent variable* to understand its consequences for economic growth and inequality. Economic studies usually follow the neoclassical tenet that growth in the stock of capital (domestic and foreign) is the primary driver of economic expansion, so transnational investment is beneficial to global welfare (e.g., Dunning 1958; Kindleberger 1970; Safarian 1966). In contrast, world systems theorists argue that foreign investment serves primarily the investors from developed core states and thus retards the development of poor countries on the periphery (Bornschier and Chase-Dunn 1985; Chase-Dunn 1975; Wallerstein 1974). In a similar vein,

the dependency school points to dependencies created by MNCs that hinder the industrial development of locally-owned firms in developing countries (Cardoso and Faletto 1979; Evans 1979; Gereffi 1978, 1983).[2]

The neoliberal era has brought a renewed interest in FDI, as the Washington consensus calls for liberalization of economies to cross-border investments (Gore 2000). Now the key question is: Why do some countries get more and others get less tightly integrated into the global economy? The answer requires an examination of FDI as *a dependent variable.* In fact, much research in economics and political economy has been generated in pursuit of this line of inquiry.

Most economic studies are based on the central thesis that FDI, like other types of economic behavior, reflects how independent economic agents respond to freely determined prices in pursuit of utility maximization. Firms consider the profitability of alternative investment strategies and decide to engage in investments abroad because this minimizes their transaction costs. At the aggregate level, FDI depends on the returns/revenues and risks/costs it generates. Returns are estimated by market potential in terms of size and growth. Key cost factors include macroeconomic stability, infrastructural support, and the availability, skill, and cost of labor (Billington 1999; Dunning 1980; Jun and Singh 1996).

Political economists add political risks to this list of cost factors (Gastanga, Nugent, and Pashamova 1998; Henisz 2000; Kobrin 1982; Wei 2000). In addition, they stipulate that host countries' foreign investment policies, which provide incentives to investors in the form of tax holidays or exemptions from import duties, have an impact because they deflect costs at investment sites, whereas protectionist policies

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[1] The 10 percent cutoff is defined by the international organizations that collect information on FDI, including the International Monetary Fund (IMF), the Organization for Economic Cooperation and Development (OECD), and the United Nations Conference on Trade and Development (UNCTAD). It is accepted by most national accounting systems that abide by these international standards. Purchase of equity stakes smaller than 10 percent is classified as portfolio investment. FDI *inflows* refer to the aggregate of all FDI transactions in a particular year. FDI *stock* refers to the cumulative inflows over years.

[2] Firebaugh (1992) critiques these early world systems and dependency studies for faulty interpretations. Recently, several studies that take into account Firebaugh's critique still find negative effects of long-term FDI on economic growth and income inequality (Alderson and Nielsen 1999; Dixon and Boswell 1996; Kentor 1998), while De Soysa and O'Neal (1999) largely replicate Firebaugh's findings. In addition, some studies conclude that FDI has no effect on economic growth (Dutt 1997; Hein 1992).

increase costs (Bhagwati, Dinopoulos, and Wong 1992; Brewer 1993; Ellingsen and Wärneryd 1999). Moreover, political regime is expected to matter because democratic governments can more credibly commit to market-friendly policies than can authoritarian governments (Jensen 2006; but see Li and Resnick 2003).

Motivating economic and political science studies alike is the assumption of instrumental rationality that guides the risk and return calculations of profit-minded investors. It is expected that the prosperity and stability of an economy will have a positive effect on FDI, while political risks and high tax costs will reduce FDI. But do these trends hold for the transforming CEE? For instance, Slovenia, considered the most advanced country in the transition process, with low investment risk rating, has seen comparatively small FDI inflows. Similarly, for Poland, a country with the largest domestic market in CEE, FDI stock represents a much smaller share of GDP than it does for Estonia, the country with the smallest domestic market in the region. These trends go against the standard instrumental expectations. I propose that they can be better explained by a social-constructivist account of economic action, which emphasizes that institutional, political, and cultural forces guide FDI behavior and, consequently, that aggregate demand for FDI is created and should not be taken as self-evident.

THE CONSTRUCTIVIST RELATIONAL ACCOUNT OF FDI DETERMINANTS

Economic sociologists have long emphasized the relational, embedded nature of economic action, exposing the social bases of economic behavior and market institutions (e.g., Dobbin 1994; Fligstein 1996, 2001; Granovetter 1985; Krippner 2001; Polanyi 1944; Smelser and Swedberg 2005). Following these lines of inquiry, I theorize FDI as a relational, socially-constituted process. First, FDI is a relational process because, by definition, it describes a relationship between investor and host. The causes of FDI should thus be traced to the actions of both investors and hosts.

Second, as previous research shows, FDI is shaped by network structures (Guillen 2002; Henisz and Delios 2001), distributions of power (Schneper and Guillen 2004), and cultural understandings (Kogut and Singh 1988). Although this research recognizes the importance of social factors, it often treats them as part of a context that constrains investors' instrumental pursuits. In contrast, I emphasize the enabling properties of social forces. I treat social forces not as contextual but as *constitutive of economic action* (cf. Zelizer 2005). I consider exchanges with partners across national borders not as spontaneous reactions to incentive structures based on inherent motives to maximize profits, but as practical economic actors' social behavior, which is *institutionalized as legitimate economic action.*

A large body of institutional analysis argues that institutionalization encompasses the establishment of formal rules and informal norms of behavior (see Campbell 2004). These rules and norms are accompanied by cultural accounts of what is "appropriate and inappropriate, 'right' and 'wrong,' 'possible' and 'impossible' . . . thereby organizing behavior into predictable and reliable patterns" (Streeck and Thelen 2005:9). The concept of legitimacy is used to capture these notions of appropriateness (Suchman 1995). To distinguish between the legitimacy of rules written in law and policy and informal norms evidenced in practice, I differentiate between formal and substantive legitimacy.

From an institutional standpoint, I expect that proliferation of FDI into host countries depends on the extent to which countries legitimize FDI in both formal rule and practical behavior. Adopting liberal market rules is consequential because it provides the formal institutional basis for free cross-border economic exchange and aligns a country with neoliberal standards promoted by international financial organizations. Moreover, providing ideational and organizational resources to empower business actors to engage in FDI transactions helps to confer substantive legitimacy to FDI and to institutionalize informal norms related to practical FDI behavior. States are among the key actors that shape macroeconomic trends, influence the levels of formal and substantive legitimacy granted to FDI, and

consequently help construct the aggregate demand for foreign investment.[3]

FORMAL LEGITIMACY OF FDI

To attract FDI flows, states put in place market-based institutions that support liberalization to foreign capital, including private property rights and market governance structures and rules that define relations of competition, cooperation, and organization in a market economy (Campbell and Lindberg 1990; Fligstein 1996, 2001).

In the case of CEE, the fundamental set of rules that the postsocialist states had to institute to facilitate market behavior, and therefore FDI, were the rules that define ownership and control of assets, specifying what people can withhold or grant to another person (i.e., private property rights achieved during the process of privatization) (Boycko, Shleifer, and Vishny 1996; Stark and Bruszt 1998). For foreign investors to participate as market players in a postsocialist economy, they must be allowed to acquire property rights, including the right to dispose of these assets at their will. Moreover, if postsocialist actors are to sell ownership stakes in existing domestic firms to foreign buyers, then these firms' ownership structures need to be clarified.

In addition to private property rights, states also had to put in place governance structures that define relations of competition, cooperation, and organization (Fligstein 1996, 2001). Specific changes in laws and policies regulating economic activity after the fall of Communism have been tremendous. For instance, since 1995, the European Bank for Reconstruction and Development (EBRD) has published yearly *Transition Reports* that include literally hundreds of pages about the institutional changes in areas of liberalization, stabilization, and privatization, as well as enterprise, infrastructure, finance, and social reforms, that

have taken place in postsocialist countries since 1989.

The EBRD reports make apparent not only the vastness of formal institutional changes necessary to implement market-based economic order, but also the role of international organizations in the process of economic liberalization. Immediately after 1989, postsocialist states started to seek membership in the European Union (EU) and needed to align their economic institutions with the EU's liberal market rules. These countries also signed agreements with the International Monetary Fund (IMF), including Article VIII that stipulates that members agree "not to impose restrictions on the making of payments and transfers for current international transactions," thereby facilitating cross-national financial flows (IMF 2005:1). Domestic liberalization efforts in postsocialist Europe thus need to be considered in the context of the rising prevalence of neoliberal policymaking worldwide (Fourcade-Gourinchas and Babb 2002). Precisely because of this external, often coercive, influence on domestic economic policymaking, it is plausible that new rules to support liberal markets were written into law but were not consistently implemented in practice (cf. Bandelj 2004; Schimmelfenning and Sedelmeier 2005). It is important to take into account not only the formal but also the substantive legitimacy of FDI.

SUBSTANTIVE LEGITIMACY OF FDI

How can we capture the extent of substantive legitimacy granted to FDI activities in host countries? To answer this question, I conducted interviews with FDI experts and professionals in six CEE states and examined the public polemics surrounding decisions about FDI liberalization. Based on this qualitative endeavor, three kinds of substantive legitimization efforts, in which states provided ideational and organizational resources to FDI actors, emerged as dominant: (1) commitment of the governing elite to FDI, (2) professionalization of FDI activity, and (3) production of high-profile FDI outcomes.[4]

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[3] States are obviously not the only actors that help construct the demand for FDI, but they are arguably the most relevant for examining construction at the aggregate level. In addition, I recognize that state decision making is influenced by transnational pressures, but I bracket these processes in the present analysis.

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[4] These legitimization strategies also correspond to those summarized by Suchman (1995) in his review on the topic.

POLITICAL COMMITMENT TO FDI LIBERALIZATION. To sell or not to sell "the family's silver" to foreign owners is a highly politicized issue in postsocialist countries (Sinn et al. 1997). Because of pressures from the EU, which made liberalization a condition for accession (Bandelj 2004), as well as support for liberalization from domestic neoliberal economists (Bockman and Eyal 2002), many postcommunist governments showed their commitment to attracting FDI by emphasizing its benefits for economic restructuring and growth in public polemics and parliamentary debates. Postcommunist governments also demonstrated their willingness to offer national assets to foreign buyers by providing special accommodations to lure them. Examples include Estonia's government led by the reform architect Mart Laar (O'Dwyer and Kovalčik 2007), the rule of the Hungarian Democratic Forum (MDF) from 1990 to 1994 (Stark and Bruszt 1998), and Poland's first postcommunist government, with Leszek Balcerowicz as the finance minister (Bockman and Eyal 2002).

Not surprisingly, governments ruled by unreformed successor communist parties, such as those in Bulgaria and Romania during the first years after 1989, did not show commitment to FDI, as they were generally less eager to embrace market reforms. In addition, governments ruled by nationalist parties harbored strong protectionist stances that were not conducive to attracting FDI. For instance, during Mečiar's rule in Slovakia (1994 to 1998), company insiders, and therefore Slovak nationals, were privileged in privatization and a law was enacted that excluded strategic monopolies from foreign privatization altogether. This law was revoked when a new pro-reform Dzurinda government took charge in 1998 and set liberalization to FDI as one of its reform goals (Gajdzica et al. 2003). Despite reasonable improvements in economic stability since 1993, FDI inflows to Slovakia remained below the regional average until 1998, but they have increased significantly since then.

PROFESSIONALIZATION OF FDI. As neoinstitutionalists emphasize, professionalization helps disseminate practices considered "normative" within organizational fields, which influences the adoption of such practices by firms within those fields (DiMaggio and Powell 1983).

In the case of FDI, establishing professional organizations that stimulate foreign investment transactions is an important legitimization effort in influencing firm-level FDI behavior. State FDI agencies play this role because they are charged with promoting their countries as FDI destinations and servicing the needs of foreign investors and domestic actors looking for foreign partners. For instance, the Polish Foreign Investment Agency (PAIZ) "exists to increase the inflow of foreign direct investment (FDI) into Poland, by encouraging foreign corporations to invest [there]. It serves to help them deal with all the administrative and legal procedures encountered during the investment process" (PAIZ 2005). Likewise, "[the] Bulgarian Foreign Investment Agency [is] a one-stop shop institution for foreign investors. . . . It provides to prospective investors up-to-date information on the investment process in the country, legal advice, identification of suitable Bulgarian partners, [and engages in] co-ordination of the investment policy with other institutions" (IBA 2005).

The first two FDI agencies in this region, the Polish and Czech agencies, were established in 1992. Hungary and Latvia followed suit the next year, Estonia in 1994, Bulgaria, Lithuania, and Slovenia in 1995, Croatia in 1996, Romania in 1997, and Slovakia, the last among these states, in 2000. These FDI agencies were all established and financially supported by their respective governments, demonstrating the states' concrete commitments to FDI. Coupled with the effects of FDI professionalization that these agencies stimulate, this substantiates the legitimacy of FDI practice.

PRODUCING HIGH-PROFILE FDI OUTCOMES. Legitimacy is also enhanced by "producing proper outcomes" (Suchman 1995:600). In our case, this means a state's engagement in high-profile FDI transactions. Such involvement is likely specific to the postsocialist context, in which privatization and market liberalization occur simultaneously. One of the most common privatization strategies in postsocialist countries was direct sales, often to foreign investors. Some of the most prominent of these sales involved large state monopolies in public utilities or banking (EBRD 2001). Selling these assets to foreign owners was highly politicized and publicized because it involved

issues of strategic control, national sovereignty, and big money. For instance, the decision to sell one-third of the biggest Slovenian bank to the Belgian KBC bank was preceded by a fervent debate in the press about the Slovenian national interest with regard to FDI. Many argued for "a right dose of healthy nationalism" and "strategic support of domestic capital" (Seljak 2002). In fact, a protectionist discourse was dominant during the first decade of Slovenia's transition (Bandelj 2008) and may have contributed to the country's reluctance to start selling strategic monopolies to foreigners. I argue that this indicates a low level of substantive FDI legitimacy. In comparison, Estonians sold their telecommunications giant to foreigners as early as 1992, and Hungarians sold Matav Telecommunications to foreigners in 1993.

If my argument about the importance of substantive legitimacy for FDI inflows is on target, then public resistance to FDI, which reduced ideational resources needed for business actors to consider FDI a desirable strategy, contributed significantly to the relatively low levels of FDI in Slovenia. In contrast, production of high-profile FDI outcomes early in Estonia's and Hungary's transitions contributed to higher overall levels of substantive legitimacy and led to comparatively greater FDI flows to these host countries.

EXPLAINING FDI TRENDS

Traditional explanations of FDI, what I call the instrumentalist accounts, highlight the importance of economic prosperity and political stability, which create incentives for risk-and-return-calculating investors. In contrast, I argue that FDI is a socially-constituted process that reflects negotiations between investors and hosts, and thus depends heavily on the formal and substantive legitimization efforts of host states. States need to institutionalize FDI as appropriate and desirable economic behavior in formal rules and informal norms. Using multivariate regression analyses, I can test the relative explanatory power of both the instrumentalist and constructivist accounts.

THE EMPIRICAL CASE: FDI IN CENTRAL AND EASTERN EUROPE

In any effort to examine the determinants of economic globalization, a study of FDI in CEE is particularly valuable because CEE provides an almost perfect natural experiment setting. Socialist command economies abolished property rights, so during the Communist period these countries were closed to what we today define as FDI flows. We should note that as part of their socialist reform, some countries, notably Hungary, Poland, and the former Yugoslavia, did allow for foreign firm registrations and joint ventures (Michalak 1993). Nevertheless, in terms of aggregate FDI flows, the presence of transnationals in state socialism was "negligible" (Lane 2004:39). As Figure 1 illustrates, aggregate-level liberalization of CEE is evident only by the late 1980s. While initial flows into the region were minimal in absolute numbers, the influx of yearly FDI into CEE grew significantly over the first decade after 1989, leading to substantial FDI stock relative to the size of the postsocialist economies. In fact, since 1995, the average FDI stock as a percentage of GDP for this region has been significantly higher than the world average, pointing to deep integration of CEE into the global economy.

Indeed, prominent international organizations and many economists put great emphasis on the role of FDI for the market transition and global integration of CEE (Bevan and Estrin 2004; Meyer 1998; Schmidt 1995). Sociologists also argue that the most advanced postcommunist economies have been successful because they built "capitalism from outside" (i.e., with foreign capital) (King and Szelényi 2005) and that foreign investors constitute the new ruling elite in CEE (Eyal, Szelényi, and Townsley 1998). If foreign investors participate in the transformation of property rights as well as the formation of new class structures, then their relevance for the creation of postsocialist transformations is paramount. Still, we know little about why some countries receive significantly more FDI than others, as is indicated in Figure 2. This study fills this gap by examining trends from 1990 to 2000 in 11 countries: Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia. Longitudinal data for postsocialist countries are scarce, and data points are few.
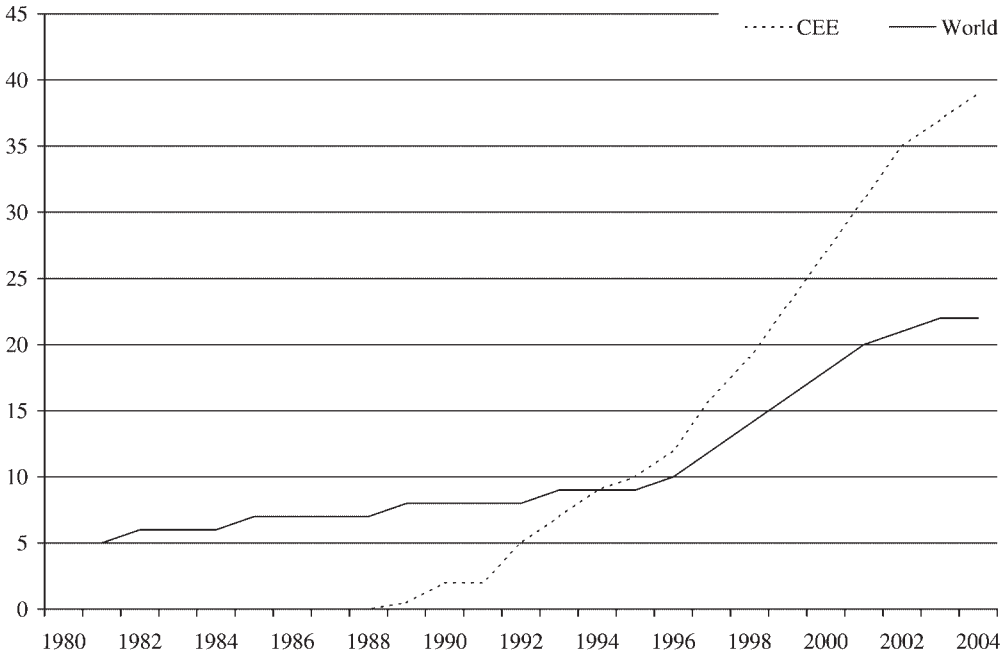
Figure 1.   Foreign Direct Investment (FDI) Trends in Central and Eastern Europe and Worldwide
(average FDI stock as percentage of gross domestic product)

Source: UNCTAD (2006).
Note: Central and Eastern Europe (CEE) includes Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia,
Lithuania, Poland, Romania, Slovakia, and Slovenia.

In light of such data constraints, this sample
selection maximizes the number of comparable
postsocialist countries on many relevant coun-
try characteristics, while still assuring hetero-
geneity in the outcome of interest.

Immediately after 1989, as Figure 2 shows,
Hungary registered the most noticeable increase
in FDI inflows, followed by the Czech Republic,
Estonia, and Latvia. In the Czech Republic and
Estonia, inflows have continued to increase,
putting these countries at the top of CEE FDI
destinations in terms of inflows and stock,
respectively. Poland, because of its sheer size (a
population of almost 40 million), has also
attracted significant FDI in absolute numbers.
When measured as per capita inflow or stock as
share in GDP, however, Polish inward FDI has
stayed below the regional average throughout
this period. Bulgaria, Lithuania, and recently
Slovakia, experienced small FDI inflows in the
early period but attracted above average inflows
later. Croatia and Romania stagnated at the bot-
tom for several years before they showed mod-
est inflows. Slovenia, the wealthiest among

these countries, recorded below average inflows
throughout this period. My empirical analyses
attempt to explain this over-time and cross-
country variation.

CONSTRUCTION OF DEMAND FOR FDI BY HOSTS: MEASURES OF FORMAL AND SUBSTANTIVE LEGITIMACY

FORMAL LEGITIMACY. The extent to which states
institutionalize globalization as a development
strategy is reflected in the adopted formal rules
and regulations that encourage FDI transac-
tions. To capture this, I use the Transition Index
produced by the European Bank for
Reconstruction and Development (EBRD),
which is a composite average of the institu-
tional environment assessed along the follow-
ing eight dimensions: small-scale privatization,
large-scale privatization, price liberalization,
foreign exchange and trade liberalization, enter-
prise reform, competition policy, banking sec-
tor reform, and reform of non-banking financial
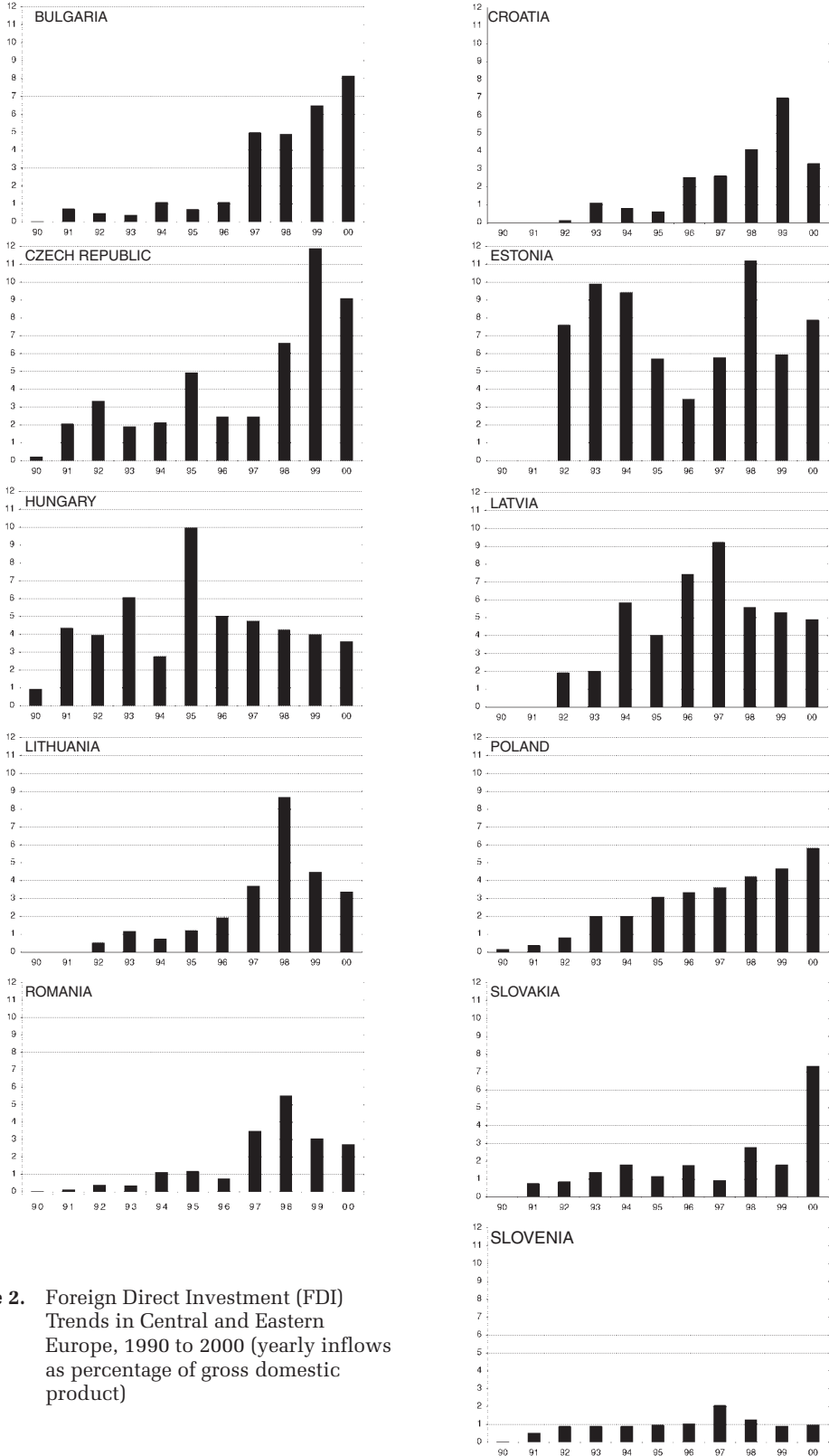institutions. EBRD's measure evaluates all the

Figure 2. Foreign Direct Investment (FDI) Trends in Central and Eastern Europe, 1990 to 2000 (yearly inflows as percentage of gross domestic product)

conceptually relevant formal institutions outlined in the previous section—establishment of private property rights through privatization and governance structures, and rules that define relations of competition, cooperation, and enterprise organization. As defined by the EBRD staff assessors, a higher score reflects a closer approximation to the market standards typical of advanced industrial economies, including liberalization to foreign capital. I expect that *the higher the EBRD index score (i.e., the more conducive the formal regulatory environment), the higher the FDI inflow.*

SUBSTANTIVE LEGITIMACY. Besides instituting formal rules, states also need to shape the informal norms related to FDI. States do this by providing domestic and foreign economic actors with ideational and organizational resources to facilitate and encourage their engagement in FDI interactions. By ideational resources, I mean ideas, notions, and convictions of what counts as appropriate and desirable economic strategies. In the case of FDI, business actors must be convinced that acquiring significant assets in foreign countries (for investors), or being acquired by foreign firms (for hosts), is a desirable business strategy. Organizational resources refers to the administrative, logistical, and sometimes political support of professional agencies. These agencies help foreign and domestic actors find partners abroad and bring FDI attempts to completion.

To capture these efforts, I construct an index of substantive legitimacy that combines three measurable dimensions that tap into the construction of informal norms of FDI behavior.[5] First, the ruling elite's political commitment to FDI contributes ideational resources and enhances the general perception and public discourse in a country of FDI as an appropriate and desirable activity. Due to their protectionist stances and general lack of dedication to market reform, I code governments with nationalist and unreformed communist parties in power as lacking such commitment.

Second, professionalizing FDI helps disseminate practices considered normative. Establishing an FDI agency indicates such pro-

fessionalization efforts. In addition, FDI agencies provide concrete organizational resources and hands-on assistance to help foreign and domestic actors realize their FDI goals.

Third, legitimacy-enhancing production of high-profile FDI outcomes is reflected in states' decisions to sell strategic national assets to foreigners. This is captured by the occurrence of the first foreign privatization of either the banking or telecommunications monopolies. Setting a precedent with such highly publicized transactions enhances ideational resources related to FDI for both domestic and foreign actors. Domestic business actors should more readily understand FDI as an appropriate and desirable economic strategy and be more likely to engage in market transactions with foreign investors. International publicity surrounding big FDI deals highlights a country as an investment destination in the eyes of potential foreign investors and encourages them to look for opportunities in that country.

Based on all these mechanisms behind the influence of informal norms on FDI behavior, I expect that *the higher the substantive legitimacy score (i.e., the more extensive the ideational and organizational resources for FDI practice), the greater the subsequent FDI inflows.*

DRIVERS OF FDI SUPPLY BY INVESTORS: MEASURES OF ECONOMIC RISK AND RETURN [6]

GDP PER CAPITA. GDP per capita is the most commonly used general indicator of a country's economic performance (Chakrabarti 2001). According to the economic argument, which stresses the importance of economic incentives for market exchange, *higher GDP levels should be related to higher FDI.*

INFLATION. Alternatively, a significant increase in prices from year to year is a sign of instability that signals high risks to potential investors and should deter investment efforts. Thus, *a high inflation rate should be negatively associated with FDI inflows.*

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[5] Cronbach's alpha reliability coefficient for the index is .8.

[6] I tested several other economic indicators, as reported in the notes to Table 1.

CONTROL VARIABLES

Following arguments about the importance of political risk for investment, reviewed in the first half of this article, I control for (1) the ideology of the government (left governments are thought to be less friendly to multinational corporations), (2) the extent of democratization (higher levels are expected to lead to higher FDI), and (3) the role of external institutional arrangements, such as those related to IMF conditionality and EU accession (both are expected to increase FDI).

I also control for three structural conditions of FDI demand and supply. First, to account for the size of the host economy, I include population size. Second, to control for the industrial structure of the economy (which has an impact because foreign investors attracted to CEE are interested in the services and manufacturing sectors and not in agriculture), I add a variable that captures the size of the agricultural sector. Third, I include two controls that take into account the general propensity of investors to engage in FDI on a global scale: (1) a variable that captures the amount of FDI flowing into other developing countries and (2) the amount of FDI flowing into developed countries. Because the developed countries include mostly Western European states, the relationship between FDI flowing into developed countries and FDI flowing into CEE may be negative. Investors (who come mostly from developed countries) may decide to explore opportunities in CEE emerging markets instead of pursuing investments in the West.

DEPENDENT VARIABLE

The dependent variable in this analysis is FDI per capita flows in constant $US (logged due to skewness) into host country h (h = 1,..., 11) in year t (t = 1990,..., 2000). The figures refer to net inflows as an aggregate of all FDI transactions in a particular host country for one year, and thus they can have both negative and positive values. Very few disinvestments occurred during this period, yielding overall positive net inflows for all years and countries under consideration. I theorize the predictors as temporally prior to the outcome, so the outcome is measured at time $t + 1$, and all predictors are measured at time t.

METHODS

Pooled cross-sectional time-series analysis allows us to study variation in FDI across countries and over time. The specificities of this analytic technique necessitate adjustments to the violations of ordinary least-squares (OLS) regression assumptions of error independence and constant variance that can lead to biased estimates and misleading significance tests (Frees 2004). To deal with contemporaneous and serial error correlation and heteroskedasticity, I employ the commonly used panel-corrected standard errors specification (PCSE) with autocorrelation (AR1) adjustment (Beck 2001).[7] However, the PCSE regressions are recommended primarily for the temporally dominated rather than the case-dominated design (i.e., for studies with a larger number of years analyzed rather than a larger number of countries included in the sample) (Beck 2001). Because my sample has more country cross-sections than year periods, I check the robustness of results by specifying generalized least-squares random effects and fixed effects models (Halaby 2004; Hsiao 1986). The Hausman test preferred the fixed-effects specification, which also represents a more stringent test of the key independent variables of interest, especially in small sample studies. Because time series of variables included in the analysis appear to be trending upward, it may be appropriate to introduce a time trend in the regressions (Baltagi 2002).[8] The time trend is almost perfectly collinear with the control variable for the amount of FDI flowing into developing countries (r = .96), so this control variable also performs the function of the time trend.[9] Table 1 reports the results of the analysis. Descriptive statistics and the correlation matrix are provided in the Appendix, Tables A1 and A2, respectively.

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[7] Models that include the lagged dependent variable instead of the autocorrelation adjustment produce substantively similar results.

[8] Because of the small N and small T, I cannot statistically test whether non-stationarity is really an issue (Hadri 2000).

[9] The results are substantively similar if either a trend variable or a control for FDI into other developing countries is included in the models.

Table 1.   Predictors of FDI Flows to Central and East European Countries, 1990 to 2000

	Model 1 PCSE[a]	Model 2 PCSE	Model 3 PCSE	Model 4 FE [b]	Model 5 2SLS [c]
Formal Legitimacy					
Formal institutional and regulatory environment for FDI	1.098***	1.155***	.010	−.091	.082
	(.274)	(.294)	(.349)	(.983)	(.614)
Substantive Legitimacy					
Informal ideational and organizational resources for FDI	.316***	.281**	.382***	.460**	.412**
	(.084)	(.105)	(.071)	(.172)	(.081)
Economic Indicators[d]					
GDP/capita		−.030	−.013	−.889	.010
		(.070)	(.076)	(.538)	(.061)
Inflation		−.001	−.001	−.000	−.001**
		(.001)	(.001)	(.001)	(.000)
Controls					
Left government			−.012	.039	−.002
			(.158)	(.205)	(.141)
Democratization			−.049	.126	−.174
			(.068)	(.194)	(.164)
IMF program			.113	.250	.058
			(.189)	(.304)	(.139)
EU agreement			−.438	.007	−.346
			(.210)	(.342)	(.231)
Population size			.019*	4.552*	.019
			(.009)	(1.949)	(.010)
Percent labor in agriculture			−.507***	−.517	−.519*
			(.144)	(.782)	(.190)
FDI to other developing countries			.402**	.521*	.395*
			(.141)	(.264)	(.158)
FDI to developed countries			−.228**	−.161	−.234*
			(.070)	(.107)	(.087)
Country fixed effects			Included		
Constant	.319	.260	3.925***	−4.234	4.296
	(.898)	(.949)	(1.128)	(5.289)	(2.127)
R^2	.436	.562	.727	.828	.735
N	61	61	61	61	61

Note: Dependent variable is FDI per capita host country in constant US$; standard errors in parentheses.
[a] PCSE: ordinary least squares estimation with panel corrected standard errors and autocorrelation (AR1) adjustment.
[b] FE: fixed effects specification equivalent to adding a set of country dummies to the analysis; with HC3 robust standard errors, which provides conservative confidence intervals given the small sample size (Long and Ervin 2000). Hausman test preferred fixed effects over random effects.
[c] 2SLS: two-stage least squares with panel clustered robust standard errors. Instrumented: formal legitimacy, substantive legitimacy, democratization. Instruments: previous FDI inflow and country fixed effects, as well as all other covariates (GDP/cap, inflation, democratization, left government, EU Agreement, IMF program, percent labor in agriculture, population size, FDI to other developing countries, FDI to developed countries).
[d] Other economic indicators tested include institutional credit rating, GDP growth, wages, unemployment, trade, budget deficit, foreign debt, level of education, infrastructure support, and corruption. None of these alternative measures of economic risk and return are statistically significant.
* $p < .05$; ** $p < .01$; *** $p < .001$ (two-tailed tests).

RESULTS

Model 1 in Table 1 examines my thesis that the construction of demand for global capital by host states is highly consequential for FDI flows.

Statistically significant coefficients for formal and substantive legitimacy variables provide support for this argument. With R^2 at .43, these two variables also help explain a sizable amount

of variance in the outcome. It is important, however, to test the power of these legitimacy variables when we control for the factors privileged in previous research. Model 2 adds measures of "objective" economic incentives. In contrast to instrumentalist predictions, the results show that the influence of GDP per capita and inflation is weak and not statistically significant. I conducted additional analyses that checked separately for the importance of institutional credit rating,[10] GDP growth, wages, unemployment, trade, budget deficit, foreign debt, level of education, infrastructure support, and corruption[11] to make sure that the weakness of economic factors was not related to the choice of economic indicators. None of these other alternative measures of economic risk and return show a statistically significant relationship to FDI flows.

Model 3 adds several additional controls proposed as important in previous research. These results show that the formal legitimacy effect is quite sensitive to the inclusion of controls, while the substantive legitimacy coefficient remains strong and robust. In terms of control effects, left persuasion of the government, speed of democratization, and external pressures from participation in an IMF program or EU integration do not have a significant direct influence on FDI inflows, which is likely due to the relatively low heterogeneity of these variables in our small sample. Moreover, the logic underlying the relationship between political risk and FDI is akin to economic instrumentality. These variables are meant to capture the level of political risks that figure into investors' incentive structures.

Hence, the low importance of these indicators is consistent with my core argument, that FDI is determined not simply by risk and return calculations, but by the actions of host states that help construct FDI as a legitimate business strategy.[12]

ROBUSTNESS CHECKS

To advance a convincing explanation of FDI, it is important to check the robustness of results for alternative model specifications appropriate for panel data that researchers have used in previous studies. Model 4 in Table 1 presents a country fixed-effects model to account for possible unmeasured heterogeneity, which is equivalent to adding a series of country dummy variables to the estimation. Fixed effects represents a very stringent test, particularly for our case with its very small N and extremely scarce degrees of freedom, because it takes into account any possible time-invariant country characteristic that may influence FDI. It thus controls for potentially omitted relevant variables related to specific country histories and other characteristics. It yields factors that explain temporal variation within single countries.

The results of the fixed-effects specification provide further support for the substantive legitimacy variable and undermine the significance of the formal legitimacy indicator and the effect of the formal rules and regulations on FDI behavior.[13] This differentiation between the informal and the formal is consistent with some

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[10] For investors' reference, professional agencies, such as Institutional Investor or Euromoney, compile credit ratings for individual countries that indicate the expert-assessed risk of default on investment in a particular country. These credit ratings include not only economic potential for revenues, but also an evaluation of the general investment climate, such as the policy environment, corruption, and other economic factors that affect the general levels of risk and thus provide an overall assessment of country risk.

[11] For the time period included in this analysis (1990 to 2000), very limited data (in total only 27 observations) on corruption for CEE countries are available from Transparency International. Using these data, the regression of corruption score on subsequent FDI inflows, with or without basic controls, shows that there is no statistically significant relationship.

[12] The control variable "percentage share of labor in agriculture" is significant in almost all models. Beside capturing the industrial structure of an economy (countries with larger agriculture sectors should attract less FDI, which flows mainly into manufacturing and services), this variable may also indicate the sheer size of the potential interest group (i.e., farmers) that lobbies against foreign capital (e.g., the case of José Bové against McDonalds in France [Bové and Dufour 2001]). This possibility should be checked in future analyses.

[13] This weakness persists if we measure formal institutions by dropping any individual component of the eight-dimension index from the composite EBRD score. Even the sole inclusion of the foreign exchange and trade liberalization dimension (arguably the one most closely related to FDI) is not consistently significant.

of my interview data. According to a high-ranking official of the Central and East European Privatization Network, when countries want to attract prominent foreign investors, transactions are negotiated on a case-by-case basis and official country regulations are often bypassed.[14] Moreover, the decoupling of the formal and informal spheres has been suggested as a defining feature of the socialist life-world, persisting into the postsocialist period (Böröcz 2000; Stark 1996; Verdery 1996). All this implies that substantive legitimacy (i.e., an assessment of how states shape informal norms related to FDI practice), rather than the extent of formal legitimacy, may be better at tapping the influence of the construction of demand by postsocialist states on actual FDI inflows. Indeed, the substantive legitimacy index is the strongest and most robust predictor of FDI inflows in the analysis.

Finally, it is important to address potential endogeneity issues. Much research on state policymaking shows that institutionalization and legitimization are structurally, politically, and culturally embedded processes (e.g., Dobbin 1994; Fligstein 1996; Mizruchi and Fein 1999; Schneiberg 2005). One could thus argue that the ideological orientation of a government and the IMF's and EU's external pressures work indirectly through their effects on these endogenous institutional foundations of FDI. Furthermore, a concern could be raised that the extent of legitimacy is influenced by levels of FDI into a particular country.

I ran a two-stage least squares (2SLS) analysis to address these concerns (Model 5 in Table 1).[15] In the first stage, the model estimates equations for formal and substantive legitimacy using (1) previous FDI flow to account for potential reverse causality, (2) a set of country dummies to account for any possible country time-invariant characteristic that might impinge on legitimization (e.g., the extent of reform during socialism or choice of privatization strategy), and (3) all other independent variables included in Models 3 and 4 (as the 2SLS specification requires). I then used the resulting fit-

ted values for formal and substantive legitimacy, rather than the raw scores, in the second-stage regression, which estimates the dependent variable, FDI inflows.

Model 5 presents the results of this second-stage regression, which also adjusts for panel-correlated errors due to the country-clustered structure of the data. The results confirm that when reverse causality and plausible indirect influences are accounted for, the level of substantive legitimacy of FDI at a given point in time has a large and significant direct effect on subsequent FDI flows.[16] An increase of one point on the substantive legitimacy scale increases FDI inflows by over 40 percent.

DISCUSSION

This study counters previous empirical findings, as well as common assumptions, about how global markets operate. First, it is important to understand why standard economic indicators that carry the explanatory weight in previous research perform poorly in this analysis. When examining the raw data in detail, it becomes apparent that all countries during the period captured in this analysis experienced severe economic and political volatility after the collapse of communist regimes. Postsocialist Europe experienced unanticipated sudden changes, which can make an investment location look very promising one day and very unattractive the next. This kind of unanticipated "true uncertainty" cannot be measured as a risk probability to be subsumed into rational calculations or risk and return (Knight [1921] 2002).[17] Rather, as my qualitative evidence suggests, in such highly uncertain conditions, for-

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[14] In-person interview, Ljubljana, Slovenia, January 10, 1999.

[15] I used the OLS routine with panel-clustered robust standard errors as performed by ivreg command in the Stata 9.0. statistical package.

[16] The first-stage regressions indicate that substantive legitimacy is significantly correlated with orientation of government and previous FDI. This is consistent with the operationalization of substantive legitimacy, which includes governments' attitudes toward FDI and production of high-profile FDI outcomes as index components.

[17] According to Knight ([1921] 2002:233), "the practical difference between the two categories, risk and [unmeasurable/true] uncertainty, is that in the former the distribution of the outcome in a group of instances is known (either through calculation a priori or from statistics of past experience), while in the case of [unmeasurable/true] uncertainty this is not

eign and domestic business actors seem to act practically and rely on social, political, and cultural clues. This includes following opportunities in countries where they already have contacts, pursuing options they hear about from their networks, and judging prospects based on the professed political commitment of the government in power. Moreover, investors are not proactive only in selecting investment locations, but they sometimes engage in FDI by retroactively responding to offers that come from domestic firms or via FDI agencies. Investors' profit maximization efforts are curtailed because FDI exchanges are always relational, involving two sides to a transaction.[18] While most current research focuses on investor behavior and assumes that investors can easily calculate risk probabilities, my analyses show that disregarding the actions on the host side and sidestepping implications of unmeasurable uncertainty provide a grossly skewed explanation of the FDI process. Both the relational nature of transactions and the unexpectedly changing environments in which they take place impede investors' profit-maximizing efforts and obscure the relationship between standard economic indicators and FDI at the aggregate level.

Second, in contrast to assumptions that host countries play a passive role in accepting investors' global pressures, this study points to their important role in creating and sustaining the institutional conditions for cross-border exchanges. These findings are in line with the perspective in political economy and economic sociology that sees states not as an unnecessary intervention *constraining* self-regulating markets, but as an enabling force that facilitates the functioning of markets (Block 1994; Block and Evans 2005; Campbell and Lindberg 1990; Chibber 2002; Evans 1995; Evans and Rauch 1999; Fligstein 2001). My study advances this line of inquiry by showing that states not only secure the formal institutional bases of markets but also help constitute actors' interests and practices. States provide the ideational and organizational resources needed to empower economic actors to get involved in practical

FDI interactions. By promoting FDI as an appropriate and desirable economic strategy in ideas and practice, states help to institute the global economy.

Certainly, state actions are path dependent and embedded in the larger international environment, points that I cannot examine in detail in this study. It may be useful, however, to touch on these issues and provide a brief qualitative illustration of the construction of demand for FDI in two comparable postsocialist countries, Estonia and Slovenia. These two countries stand at opposite ends of the FDI continuum, with relatively very high and very low levels of FDI stock, respectively. By 2003, Slovenia had accumulated a meager 16 percent of FDI stock as a share in its GDP, whereas in Estonia this proportion stood at a striking 79 percent (the average for the EU was 33 percent) (UNCTAD 2006). An analyst following a standard economic account on FDI determinants would be quick to examine the economic conditions that shaped the investors' risk-return calculations in these countries. Both countries, however, performed rather well after 1989. If anything, Slovenia has consistently outperformed Estonia in terms of GDP and investor risk ratings. Moreover, both countries are very small (1.4 million Estonians and 1.9 million Slovenians) and thus do not offer investors huge market potential. In terms of political risks, Slovenia has recorded fewer shifts in its political environment, while several of Estonia's governments have been dissolved before the end of the election term. Still, considering that these countries were among the first to complete the EU negotiations, investors could have been confident in both countries' stability and progress. So what is different? And how does this difference explain the starkly different FDI penetration into these two countries?

According to the argument advanced in this article, Estonia's construction of demand for FDI should have been the opposite of Slovenia's. Indeed, Estonia was eager to liberalize its Soviet-style economy and open itself freely to foreign investment. Mart Laar's 1992 to 1994 government was strongly neoliberal, with a "Just do it!" motto (Smith 2001:83). To privatize, the Estonian state relied on direct sales through auctions to outside bidders, which attracted many foreigners. The Estonian telecommunications monopoly was privatized in 1992, and

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true, the reason being in general that it is impossible to form a group of instances, because the situation dealt with is in a high degree unique."

[18] Elsewhere, I directly test the effects of investor–host country relations (Bandelj 2002).

the country established an FDI agency to actively promote and attract FDI in 1994. These efforts helped institutionalize and legitimize FDI as a desirable and appropriate development strategy, providing organizational and ideational resources for business actors, both foreign and domestic, to engage in FDI transactions in Estonia.

Conversely, Slovenia's workers' self-management socialism left a mark on the preferred method of privatization—management and employee buyouts, not direct sales—which limited the involvement of foreign investors. Moreover, the whole process of privatization and restructuring was much more gradual than in Estonia. Privatization was accompanied by a protectionist public discourse that largely framed FDI as a threat to national interests. The Slovenian FDI agency was established in 1995, later than in many peer countries. The first sale of a strategic monopoly to foreign investors did not happen until 2001, making Slovenia the very last among its peers. In large part influenced by the impending EU accession, in which full liberalization to foreign capital was part of the conditions, the state finally agreed to sell a minority share in one of the largest Slovenian banks to a Belgian investor.

Overall, the comparison of Estonia and Slovenia is consistent with my story about the importance of postsocialist states' efforts to construct the demand for FDI through implementation of formal liberal market institutions and legitimization of FDI practice. It also indicates, however, that the state actions in these two countries were influenced by international pressures and domestic politics. While I cannot pay sufficient attention in this analysis to the political struggles surrounding state decision making about FDI, my qualitative findings show that these struggles were consequential primarily because they translated into the different types and amounts of ideational and organizational resources that states provided business actors to encourage FDI, to a lesser or greater extent.

Finally, a cautionary note is in order to qualify the generalizability of the key finding. Although the effect of substantive legitimacy for economic globalization is strong and robust to different model specifications and testing for selection effects, it is important to keep in mind that the analyses in this article reflect the processes related to the initial phases of FDI penetration into a highly uncertain environment, as they capture only the first 10 years after the fall of communist regimes. It is quite likely that institutionalization and legitimization are particularly crucial in this initial stage of globalization. Once open market exchange becomes the "normal" mode of economic behavior (i.e., becomes fully institutionalized so as to be taken for granted) and uncertainty is reduced, the processes of institutionalization and legitimization may not show such an obvious and direct quantitative effect. This suggests that different stages of market development may require different explanatory frameworks because they involve different social processes (cf. Fligstein 2001). Further empirical research is needed to show precisely how distinct or similar these processes are.

CONCLUSIONS

This article argues that the global economy can be conceptualized and empirically analyzed as an instituted process.[19] Using the initial penetration of foreign direct investment (FDI) into Central and Eastern Europe (CEE) after the fall of Communism, I focus on postsocialist states' actions to construct demand for FDI as a key explanatory factor driving the integration of this region into the global economy. Pooled cross-sectional time-series analyses of the consequences of these efforts for actual inflow of FDI in the first decade after 1989, coupled with qualitative data from interviews and public documents for select country cases, provide strong support for the institutional underpinnings of FDI and the importance of analyzing not only supply-driven but also demand-generative factors of global capital flows.

Economic theory posits that economic incentives are the most important determinants of FDI because they create conditions for instrumental actors to maximize profits. In contrast, my analysis shows that neither a country's economic prosperity and stability nor political risks

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[19] This phrase takes after Polanyi's (1957) statement about "economy as instituted process," in which he argues that economic behavior is embedded and enmeshed in both economic and noneconomic institutions.

exert a crucial influence during the initial phases of FDI proliferation into a country. Rather, the actions of host countries in constructing the demand for FDI matter most significantly. To encourage FDI inflow, states must institutionalize FDI as a legitimate market behavior. An integral part of this institutionalization is not only the setting up of *formal* rules for the global market game, but also the socialization of actors into a legitimated set of norms, standards, and practices, that is, setting up *informal* institutions that sustain FDI interactions. I thus distinguish between the role of formal rules and regulations (i.e., formal legitimacy) and the institutionalization of informal understandings and practices related to FDI behavior (i.e., substantive legitimacy). This distinction proves to be crucial. The findings show that in conditions of high uncertainty—characteristic of the fundamental social transformations in transition countries, as well as unstable environments in developing countries—economic actors rely more on social, political, and cultural cues that often help them identify what their business interests should be, rather than on formal indicators of economic efficiency.[20]

These points also speak to the study's policy implications. International financial institutions and institutional economists emphasize the importance of institutional reforms for attracting foreign capital, which is expected to facilitate the growth of developing and transitional countries (see Bénassy-Quéré, Coupet, and Mayer 2007). In scholarly circles, these ideas are often framed as the "race to the bottom" to describe how countries compete for FDI by lowering their labor and environment standards and providing tax incentives to multinational corporations (Bhagwati 2003; London and Ross 1995; Monks and Minow 2004; Mosley 2003; Robinson 1995; Rodrik 1997). Whether or not states engage in a race to the bottom by manipulating their rules and regulations, my findings suggest that, first, formal institutional provisions can be easily decoupled from informal norms, and second, norms are more consequential for FDI inflows. Attracting FDI rests more on the extent to which states commit

ideational and organizational resources to legitimize the practice of FDI than on what they write in formal policy. All this points to the fact that economic globalization has not only structural but also cultural manifestations. Increases in cross-border exchanges of financial capital, goods, and people are accompanied by a diffusion of ideas about appropriate economic strategies, which, as this study shows, are crucial for sustaining the global economy.

Overall, this investigation demonstrates the utility of a social-constructivist relational view of FDI that moves beyond a focus on instrumental investors privileged in previous research. I show that an investor-centered, *supply*-driven perspective provides a highly skewed portrayal because it ignores the *demand*-side politico-cultural economy of FDI. States may structure the incentives for investors, but they also, crucially, construct the demand for FDI in their countries. They provide ideas concerning plausible strategies of action to help constitute the interests of investors *and* hosts, as well as providing administrative and logistical resources that facilitate cross-border exchange. Ultimately, FDI is a product of negotiation between investors and hosts. A theory of FDI must account for active influences from both the supply (investor) and demand (host) sides of this relational process, as well as the possibility that economic action is not simply instrumental but is politically and culturally constructed. Future research should specify the scope conditions of this theory and examine how the institutionalization of the global economy happens for different regions, times, and kinds of economic transactions.

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[20] This finding is in line with other economic sociology research on decision making under conditions of uncertainty (e.g., Guseva and Róna-Tas 2001).

APPENDIX: DATA STRUCTURE AND SOURCES

SAMPLE

Countries: Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia.

Time Period: 1990 to 2000 for Bulgaria, Czech Republic, Hungary, Poland, and Slovenia; 1991 to 2000 for Romania and Slovakia; 1992 to 2000 for Croatia, Estonia, Latvia, and Lithuania. Time series start at different years because of data unavailability for the countries that used to be part of federations (i.e., Czech Republic, Croatia, Estonia, Latvia, Lithuania, Slovakia, and Slovenia). The EBRD index is not available for the years before 1994.

DEPENDENT VARIABLE

Foreign Direct Investment Flows in constant US$ (computed by the author from EBRD 2001 and IMF 2001).

FORMAL LEGITIMACY

EBRD Index (source: EBRD Transition Report 2001).

SUBSTANTIVE LEGITIMACY

Legitimization of the FDI Practice Index

- Political commitment to foreign liberalization (sources: Freedom House Nations in Transit 1998, 2002 [http://www.freedomhouse.org/research/nattransit.htm]; Political Parties in Europe Database [http://www.parties-and-elections.de]). *Note:* The time the nationalist party or unreformed postcommunist party ruled the government is coded as 0 for Bulgaria (1990 to 1996), Croatia (1992 to 1999), Latvia (1992 to 1994), Lithuania (1992 to 1995), Romania (1990 to 1995), and Slovakia (1993 to 1998); otherwise 1.
- Establishment of FDI agencies (sources: agency Web sites, interviews with agency officials). *Note:* Coded as 1 beginning the year the agency is established and all subsequent years (establishment information written in text).
- Sale of strategic monopolies to foreigners (source: EBRD 2001, National Accounts). *Note:* Coded as 1 from the year the first sale in the telecommunications or banking sector to foreign investors happened and in all subsequent years. First sales occurred as follows (year and host company): Bulgaria (1997, United Bulgarian Bank), Croatia (1999, Hrvatski Telekom), Czech Republic (1999, CSOB Bank), Estonia (1992, Eesti Telefon), Hungary (1993, Matav Telecommunications), Latvia (1994, Lattelecom), Lithuania (1998, Lietuvas Telekomas), Poland (1993, Wielkopolski Bank Kredytowy), Romania (1998, RomTelecom and Romanian Development Bank), Slovakia (2000, Slovak Telekom), Slovenia (no sale before 2001).

ECONOMIC INDICATORS

GPD per capita, in current US$, PPP (sources: EBRD 2001; IMF 2001).

Inflation rate (sources: EBRD 2001; IMF 2001).

CONTROL VARIABLES

Left government (sources: Freedom House Nations in Transit [http://www.freedomhouse.org/research/nattransit.htm]; Political Parties in Europe Database [http://www.parties-and-elections.de]).

Democratization (source: Freedomhouse Nations in Transit [http://www.freedomhouse.org/research/nattransit.htm]).

IMF program (source: Vreeland 2002 [http://pantheon.yale.edu/~jrv9/DATA_PAGE.html]).

EU agreement (source: European Union 2005 [http://europa.eu.int/comm/enlargement/pas/europe_agr.htm]).

Share of Labor in Agriculture (source: World Development Indicators online database [http://devdata.worldbank.org/dataonline]).

Population size (source: EBRD 2001).

FDI to other developing countries (source: UNCTAD online database [http://stats.unctad.org/fdi/ReportFolders/ReportFolders.aspx]).

FDI to developed countries (source: UNCTAD online database [http://stats.unctad.org/fdi/ReportFolders/ReportFolders.aspx]).

Table A1.   Variables Used in the Analysis of FDI Flows into Central and Eastern Europe (1990 to 2000)

Variable	Description	Mean (SD)
Dependent Variable		
Foreign direct investment	Inflows of FDI per country/year (constant US$ per capita).	97.49 (87.72)
Formal Legitimacy		
Formal institutional and regulatory environment for FDI	EBRD Transition Index: composite average of the following eight indicators: price liberalization, foreign exchange and trade liberalization, small-scale privatization, large-scale privatization, enterprise reform, competition policy, banking sector reform, reform of non-banking financial institutions (0 = no progress since the fall of Communism; 4.3 = standards typical of advanced industrial economies).	3.26 (.33)
Substantive Legitimacy		
Informal ideational and organizational resources for FDI	Index of the extent of ideational and organizational resources provided for FDI practice: composite of three legitimizing strategies: (1) *political commitment to FDI* (0 = nationalist party or unreformed postcommunist party rules the government; 1 = otherwise); (2) *professionalization of FDI* (1 = establishment of FDI state agency; 0 = otherwise); (3) *producing high-profile FDI outcomes* (1 = first state sale of assets from the banking or telecommunications sectors to foreigners has occurred; 0 = otherwise) (composite of scores for 1, 2, and 3 for country/year, with 0 = low legitimacy of FDI practice, 3 = high legitimacy). See Data Structure and Sources in the Appendix for coding details.	1.79 (1.20)
Economic Indicators		
Economic prosperity	Gross Domestic Product (US$ per capita, in thousands).	3.30 (2.15)
Economic stability	Rate of inflation (percent).	98.94 (240.01)
Controls		
Left government	Dummy variable indicating whether political party in power is of left orientation (1 = communist, post-communist, socialist; 0 = otherwise).	.44 (.50)
Democratization	7-point scale indicating freedom and fairness of elections and popular participation in the political process (7 = highest, 1 = lowest).	6.09 (.96)
IMF program	Dummy variable indicating whether a country is under IMF loan program in a particular year (1 = yes, 0 = no).	.69 (.46)
EU agreement	Dummy variable indicating whether a country is bound by the "Europe Agreement" in a particular year (1 = yes, 0 = no).	.64 (.48)
Share of labor in agriculture	Share of labor employed in agriculture on a scale from 0 to 1; due to collinearity, orthogonalized with GDP/capita (Draper and Smith 1981).	.18 (.10)
Population size	Size of the country population (millions).	10.51 (10.99)
FDI to other developing countries	Total yearly FDI inflow to developing countries of Africa, Asia, America and Oceania, as classified by UNCTAD (2006) (millions).	137.90 (71.41)
FDI to developed countries	Total yearly FDI inflow to developed countries of America, Asia, Europe, and Oceania, as classified by UNCTAD (2006) (millions).	376.76 (336.06)

Table A2.   Correlation Matrix

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
(1) FDI/cap												
(2) Formal Legitimacy Index	.517											
(3) Substantive Legitimacy Index	.570	.439										
(4) GDP/cap	.337	.446	.215									
(5) Inflation	–.278	–.253	–.288	–.255								
(6) Left Government	.071	–.033	–.014	.111	–.084							
(7) Democratization	.347	.476	.506	.369	–.200	.147						
(8) IMF Program	–.138	–.468	–.060	–.606	.043	.004	–.335					
(9) EU Agreement	.324	.123	.508	.081	–.344	.136	.481	–.036				
(10) Labor in Agriculture	–.491	–.655	.178	–.542	.177	.004	–.402	.358	.007			
(11) Population	–.113	.051	.107	–.216	–.056	.042	.030	.042	.221	.587		
(12) FDI to Other Developing Countries	.470	.347	.523	.226	–.250	–.067	.296	–.175	.551	–.082	.072	
(13) FDI to Developed Countries	.350	.315	.623	.277	–.326	–.170	.249	–.215	.363	–.068	–.037	.867

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