The effects of Foreign Direct Investments on structuring the Varieties of Capitalism in the post-communist states

Abstract: *I investigate some of the most important theoretical approaches to some of the most important economic factor that shaped the economic transformation in the post-communist states, namely the Foreign Direct Investments (FDI). I investigate how, depending on the theoretical framework we employ, the multiple structural effects FDI had on the economies of the transition economies, as well as other parts of the social and political life can be causally interpreted.*

Keywords: *Foreign Direct Investments, post-communism, economic development*

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1. Introduction

In this article I investigate several theoretical questions regarding the causal relation between the Foreign Direct Investment flowing in specific countries and on the types of Varieties of Capitalism developing the post-communist countries. I review the literature that approaches directly or indirectly these issues in order to set out an research design aimed to investigate one of the least understood aspects of globalization, namely the interaction between the FDI and existing institutional framework, interaction that lead economic actors to employ different types of coordination, coordination that influences the economic benefits that can be obtained in specific countries. Also, my inquiry is also driven by the following normative question: under what conditions does globalization brings the presumed universal benefices in terms of economic growth? And from a policy point of view, this approach is concerned with the limits of the ability of politicians to design policies that can both attract FDI and maximize the benefit from its presence.

The fall of communism pushed most of the post-communist countries into a period "great transformations" (Polanyi 1957) that represented instantaneous reforms in the areas of politics, economics, and society, and in some case a national state formation too. In the first part of the transition process the main international institutions, as the IMF and WB, prescribed a universal solution that would solve most problems of transition from a authoritarian, centralized, and state owned economy to a democratic and market-based privatized one. These policy instruments, synthesized in the form of the "Washington consensus"[2] (Wiliamson 2002), met strong political and social resistance in many cases (Nelson 1997), which delayed their implementation or caused an inconsequence between reforms. The success of this approach was much more limited than expected (Kolodko 1998), with the closest to the neoliberal type being least successful in offering both social protection and economic development (Greskovits & Bohle 2007). Overall, these policies have neglected the construction of country-specific institutional frameworks (Shalfiqul 1993, Balcerowicz 1995, Stiglitz 1999, Roland 2002) that would coordinate the state, market and other stakeholders in a deliberative structure (Stark & Bruszt 1998). The academic debate focused on the big bang vs. gradualist approach to reforms, and the degree of insulation of governments during this period, neoliberalism and neoetatism (Stark & Bruszt 1998). While most of the "Washington Consensus" policies concerned macroeconomic stability, the most significant in terms of institutional restructuring concerned the privatization of the state-owned economy. Privatization was pushed at any cost, based on the Coasian argument[3] and the undisputed assumption that policies based on the experience of Western countries would direct countries to an almost unique type of capitalism. However, in recent years a mounting body literature has shown that although globalization pushes some homogenization processes, the advanced capitalist countries are far from converging in terms of both economic organization (Kenworthy 2006, Sullivan 2003, Siaroff 1999, Steinmo 2014) and welfare systems (Pontusson 2005, Iversen 2005).

The present inquiry stands at the intersection of two different theoretical strands of political economy, the VoC literature (Hall and Soskice 2001) and the Global Production Network (GPN) literature (Gerrefi 2005). In the same time, since both literatures represent to a central extent a response to the standard orthodoxy of neoliberal approaches to contemporary problems of economic development, this literature will be analyzed too. First, I survey of the literature on post-communist economic evolutions, and subsequently I analyze the significance of FDI as a factor of globalization will be analyzed. Third, I will present of the VoC and GPN literatures. The fourth section will present a literature review on the effects of FDI, while the last section will develop some theoretical questions concerning FDI and institutional change

2. FDI as an aspect of globalization

The history of post-communist privatization is full with examples of states assets sold to foreign investors for low prices but with the promise (formalized through privatization contracts) of large investments that would bring a flourishing economic revival that was never to come. It might be the case that this is not the predominant story, but nevertheless there are plenty examples of industries in various post-communist countries that virtually disappeared following a 'successfully' privatization. While the literature of the first decade of transition focused on the process of privatization and its effects (Stark and Bruszt 1998; Eyal et al 1998), as the East-European Countries started the process of EU accession negotiation, the effects of globalization and transnational integration become more and more important.

Discussing the distinctive Features of the Contemporary Global Economy, 1960s to the Present, Gerrefi asses that while in terms of trade volume, the actual level was close in the pre First World War period, the actual period is unique through its volume of FDI and de-nationalization of production through the emergence of International Trade and Production Networks. For example between 1983 and 1990 flows of FDI have grown three times faster than trade flows and almost four times faster than output between 1983 and 1990 (Wade 1996, 63), leading to the situation where, Trans National Corporations (TNCs) control one-third of the world's private sector productive assets (UNCTAD 1993, 1). According to Dicken (2003, 198) this totally new phenomena is determined by the fact that TNCs are the only type of institutions that have the ability to coordinate and control supply chain operations in more than one country, even in absence of direct ownership.

One of the first theoretical developments that appeared as a reaction to these evolutions is the Marxist inspired dependency theory. According to Gerrefi the 1970s dependency theory literature have focused on the shifting balance of power from national states to TNCs. Since these the TNCs had the 'power, the resources, and the global reach to thwart the territorially based objectives of national governments in both developed and developing countries' (2001, 165) (see Bergsten, Horst, and Moran 1978; Barnet and Müller 1974; Evans 1979; Gereffi 1983). Nevertheless, due to the reorganization of global production networks toward an intensive outsourcing and the rise of tertial sector, the power of vertically integrated, industrial TNCs has been reduced. Thus, the economic vs. political power relationship has become of secondary interest after 1980s, rebirthing only with the fall of the communism. Nevertheless, most importantly, the deregulation of financial markets and the decreased economic barriers lead to the situation that caital in general and especially FDI an 'systemic power' embedded in the institutional substructure of the economy, especially related to business' liberty in terms of 'exit options'" (Pontusson 1992, 233). On the one hand, FDI flow is far from being enhanced by authoritarian regimes. Busse (2003) analyzes the relationship between FDI and political rights and civil liberties in different countries. According to him, the presumed alliance among TNC and repressive regimes is rather spurious since *ceteris paribus* Except for the 1970s when a significant amount of FDI went to non-democratic countries, FDI is significantly higher in democratic countries, thereby refuting the hypothesis that political repression fosters FDI.

On the other hand, it is rather difficult to separate those reforms made under the pressure of FDI from those purely endogenous, since as Hanke (2001) argues, many times the management of domestic firms may use the rhetoric of external finance to proceed with reforms that they would like to do anyway. According to Hanke the institutional adjustments that happened in France since the 80s can be best explained if we approach the process through the point of view of evolving interest of firm management. While in the beginning of 80s the French economy was state-directed autarchic investment regime with one third of manufacturing GDP under direct state's control (308), in 1998 FDI attracted by France is highest in Continental Europe, a low unionization and low frequency of strikes and an increase sub-contracting structure of production. Under the pressure of economic recession the French large firms have been forced to reorganize their internal structure process that needed and increase managerial autonomy (both from the state, other stakeholders and the market).

3. VoC and Global Network of Production literatures

The neo-institutionalist paradigm focuses on governance system of modern capitalist economies and has as their main unit the national state. According to Gerrefi (2001, 169) the following approaches could be grouped within this paradigm: 'regulation theory (Aglietta 1980; Boyer 1989), national systems of innovation (Lundvall 1992; Nelson 1993), social systems of production (Campbell, Hollingsworth, and Lindberg 1991; Hollingsworth, Schmitter, and Streeck 1994; Hollingsworth and Boyer 1997), and varieties of capitalism (Berger and Dore 1996; Kitschelt et al. 1999; Hall and Soskice 2001).

Built on the literatures of neo-corporatism (Schmitter 1974) and aimed at offering an alternative explanation to the neoliberal framework, the literature on varieties of capitalism (VoC) provides an original explanation of the variations within the OECD countries (Hall & Soskice, 2001). VoC theory defines two system equilibria – LMEs (liberal market economies) and CMEs (coordinated market economies – overlapping to the corporatist type of economy) – each of them based on a distinctive logic of coordination, market-based vs. institutionalized coordination (both on horizontal and with the political and social environment). Market economies differ depending economic policy making, social policy and the mechanism employed by firms to fulfill their core competencies of coordination in five areas: structuring industrial relations, education and vocational training, inter-firm relations, corporate governance (regulates access to financial capital) and employee relations (employment practices). As these relations are interconnected and generate institutional complementarities5 that generate a comparative advantage in the globalize economy, the differences between these two types of economies are reinforced. On the continuum created by positioning on these areas, Germany stands as a paradigmatic CME (closely followed by Austria and Scandinavian countries) while US as a paradigmatic LME (with most English speaking countries).

Nevertheless, although the approach is an actor centered the authors admit that these relationships depend on the institutional support provided for them in the political economy as a whole and need active support for coordination that must be mobilized relatively continuous basis. (Hall & Thelen 2005, 2). Although the VoC approach is well fitted to explain the logic of the functioning of advanced capitalist countries, it is less appropriate for explaining institutional change and the emergence of a new capitalist economy. Nevertheless, the logic of this approach can be adapted for use in studying the emergence of capitalism systems in developing countries. Using a mechanic application of the VoC approach, Feldman (2006) finds that Estonia and Slovenia are very good examples of liberal and coordinated market economies.

According to Gerrefi (2001), the VoC literature and Global Production Networks approach although focus on the same kind of issues, they are totally separate literature. GPN literature focuses on the economic connections between countries at different state of development created by TNCs and interfirm networks from different sectors. Thus governance is not understood as a national system of coordination but as a function exercised by lead firms in global industries. One theoretical development located within the institutionalist approach but that takes into consideration the sectoral differences is the sectoral approach. According to Hollingsworth, Schmitter and Streeck (1994, 11) the increasing globalization of economy increases the importance of sectoral institutional regimes of governance compared with the national institutional order. Thus, analyzing how different modes of governance are embedded in the social environment needs to take into account both the local conditions and the localization of a sector in the global chain of production. As the transactions in specific sectors are more and more insulated from the direct intervention of the national institutions, the evolution of governance should follow the logic of the 'specific productive structures and of the constrains imposed by their particular technologies' (1994, 11). Accordingly, instead of observing a convergence among national governance systems as a whole, we should observe a sectoral-based differentiation. One corollary of this argument is that, FDI should embed in the specific locations, not only according to the institutional environment, but according to its integration in the global production system. Nevertheless, while Hollingsworth, Schmitter and Streeck focused on 'the comparison of sectoral regimes from the viewpoint of their economic performance' (1994, 12), the present approach focus on comparing the influence of FDI in different sectoral regimes from the point of view of its influence on the local economies.

Another approach within the neo-institutionalist framework that aims to offer an alternative interpretation of institutional change is proposed by Crouch (2005). In an attempt to develop an framework for understanding the sources of change within the governance system of the capitalism economies, the author focuses on the recombination of governance mechanism by 'institutional entrepreneurs' that try to resolve different coordination problems. In contrast with the VoC framework that stresses the institutional coherence as a platform for obtaining efficient coordination and thus economic growth, Crouch assesses that the presence of a variety of alternative governance mechanism that can be recombined in different ways is more conducive to efficient coordination. Given the changing conditions, accelerated in the last decades by globalization, flexibility obtained through hybrid governance is an asset more and more important for economic actors. Crouch takes his empirical challenge on VoC approach by using the core example of LME ideal, the Californian biotechnology and ICT sectors. The author asses that at a closer analysis, the Californian high-tech clusters exhibit some of the features of LME while others are closer to a CME. From the point of view of embeddedness two features are of particular relevance.

The financial governance of the biotechnology sector is far from resembling the pure model of financial market spot and impersonal transactions with an easy exit capacity. In fact, given that the time horizon from developing a product and marketing it can be from 6 to 10 years and may come under high uncertainty, this sector needs capital that is both high-risk and patient (Crouch 2005, 130). Thus, in order to manage the specific needs of both the industry and the capital, a dense network of information exchange have arise, where often venture capitalist take seats in the board of companies. The knowledge base of these industries, base that constitutes an important part of the added value of the products developed is far from being a pure market-driven one. Not only that the initial stages of these industries were driven by the military-led research, but also at this stage an important part of the research cost is not internalized by the firms, but supported by public funds through university research programs.

3.1. Industrial upgrading literature

According to Gerrefi (2001) industrial upgrading is 'the process by which economic actors—nations, firms, and workers—move from low-value to relatively high value activities in global production networks.' (2004, 171). The industrial-upgrading approach focuses on the feasible upgrading pathways of developing countries. The evolution of this process depends on a complex mix of government policies, institutions, corporate strategies, technologies, and worker skills are associated with upgrading success. The GPN literature is linked with the industrial-upgrading literature due to the fact that the reorganization of international trade and production networks became one of the most relevant alternatives for developing countries to ameliorate their positions in the value chains of diverse industries. When focusing on state policies the key theoretical focus is on the success of developing countries' attempts to improve their position in the global economy, global economy characterized 'both by power asymmetries and by opportunities for learning through networks.' (2001, 169)

Nevertheless, there should be taken into consideration that there is no recipe for success even in the case of advanced industrial countries, not to talk of emerging economies. For example, Hanke shows how governance reform in France undertook in the 1980s inspired from other countries (especially Germany) have produced different results, as different actors had different ability to take advantage of them. While the financial deregulation resulted in a elite-controlled cross-shareholding system instead of a public capitalism, the Aroux workplace reforms that intended to decentralize employees – employers have wakened even more the unions capacity (2001, 333).

3.2. Neoclassical approach to FDI effects

Economists writing within the neoclassical framework tend to ignore institutional aspects and focus on productivity and technology transfer effects. For example, Goldberg (2007), in an attempt to bridge research on real-side FDI and financial sector FDI, argues that both real-side and financial sector FDI can induce limited technology transfers and productivity gains. Beside increasing one country's integration into world business cycles, financial sector FDI may foster institutional development through improvements to regulation and supervision (2007, 12). The most documented effects of FDI entrance in new countries range from technology transfers, productivity spillovers, wage effects, macroeconomic growth, institutional development, and fiscal and tax concerns. (Goldberg 2007, 4). Goldberg synthesis the main effects of FDI as being: allocative efficiency, technology transfer and diffusion, wage spillovers, institution building, altered macroeconomic cycles, and overall economic stability. Allocative efficiency is generated by reducing local monopolistic distortions and heightening competitive pressure or some demonstration effect that lead local firms to use employ more efficient methods of using and generating resources. FDI increases the rates of transfer and diffusion of technology that subsequently stimulate economic growth. In the same time FDI into host countries also induces higher wages, increase that may be limited to the foreign-owned production facilities and do not spill over more broadly. In the same time, the institutional change generated by FDI can improve regulation and supervision.

Nevertheless, in the last years a series of research using advanced econometric methods show that the effect of FDI is far from being the same independently on the local economic and institutional conditions. For example, Hale and Cheryl (2007) discussing the presumed FDI spillover of productivity and innovation in China, found evidence that there is no unidirectional link. Instead the authors argue that many positive results appear due to aggregation bias or failure to control for endogenity of FDI. Instead, private firms tend to invest less in innovation in the presence of FDI phenomena determined by the fact that domestic private firms tend to be more involved in providing inputs and intermediary goods for foreign firms. In their discussion on the influence of FDI on domestic entrepreneurship Ayyagari and Kosova (2007) Czech Republic discovered that FDI presence stimulates the entry of domestic firms at the industry level (both horizontal and vertical) aspect that indicates a positive horizontal spillovers from FDI effect. Nevertheless, this effect is not general but industry specific. While in service industries spillovers are strong in all directions, manufacturing industries do not experience entry spillovers of any kind. Even more, Mayer-Foulkes and Nunnenkamp (2005) analyzing the effect of US FDI and FDI related economic activities find that this factor is not correlated with income growth. Nevertheless, even these authors agree that 'the central challenge facing policymakers is not to attract FDI, but to improve the local conditions required to benefit from the widely perceived unique advantages of FDI.' (2005, 1)

3.3. Economic effects of FDI in emerging economies

While the neoclassical approach aims to explain why the economic variables lead to a failure of FDI to produce positive effect, Gallagher and Zarsky (2007), analyzing the evolution of IT industry in Mexico showed that under certain conditions (especially a poor regulative capacity of the State) FDI inflow not only that can drive to bankruptcy the existent industry, but also can have no positive effects in term of 'technological' spillovers – but can even hamper the development of state's regulative capacity. Discussing the Italian textile and clothing industries realocation of production in Eastern Europe, Graziani (1998) argues that the main factors that emerged in the beginning of 1990s and created incentives for realocation were: stagnation of consumption growth, increasing of price elasticity, increasing of concentration rate at the industry level and appreciation of the Italian lira.

Focusing on the type of institutional changes that help countries to restrict their economies as to obtain economic growth and promote democracy, McDermott (2002) argues that these institutions can not be simply created by state through legislative change but they are the product of 'specific conflicts that emerge from the interaction between the micro-attempts to reproduce past *sociopolitical networks* and the macro-level attempts to impose state policy designs' (2002, 2). Thus, the various patterns of intranetwork conflicts influences the way different institutional rules are rewritten, resources are redistributed and different actors are redefined. Thus, neither market (through defining the property-rights) nor hierarchies (especially through developmental states) are theoretical lenses that can explain what happened during the transition of postcommunist economies.

In a similar line of argumentation, Snyder (2001) asses that the neoliberal policies of deregulation in Mexico were followed by a response in terms of re-regulation at a more local level. While McDermott focuses on the intranetwork conflicts, Snyder focuses on the conflicts between coffee producers, distributors and local politicians in four regions of Mexico. According to Snyder, the different recomposition of governance mechanism in the four regions was determined by the different interest, organization powers and strategy conflict of these actors.

According to Campino (2007) the main approaches on the FDI decisions to enter new markets are the managerial and the trade literatures, both of them focusing on production side considerations. The managerial perspective (Stephen Hymer 1960) TNC aims at transfering intermediate products across borders, while retaining operational control. The most important factor that help firms increase their market-power is the structural market imperfections that allow firms to overcome some of the disadvantages in competing with domestic firms in foreign markets. The trade literature approach focus on the emergence of monopolistic competition models and incorporate concepts as of increased returns to scale, imperfect competition, and product differentiation to explain the inter-industry and intraindustry trade in the global economy. For example Horstmann and Markusen (1992) analyze the relationship between the firm size and plant specific costs as a method to endogenously determine the presence of FDI. According to Campino (2007) in studying the attractiveness FDI seeking to enter new markets is determined not by the average income level but by its distribution in income decile level. Using this approach he manages to obtain a better prediction of FDI presence in different markets.

4. Implications: FDI, institutional change, VoC

One of the most important research puzzle that stems at the intersection of these literatures is: why did a set of countries with relatively similar economic and political features, that entered simultaneously in the transition process from communism to a democratic and capitalist system under relatively similar homogenizing factors (WB, IMF, EU) developed different types of capitalist systems? (Bohle and Greskovits 2007) Further, another puzzle that has to be investigated refers to the reasons why did this happen before a developed market and a state with strong policy capacity implementation, driven mediating institutions in advanced capitalist countries, were established during the transition process? By analyzing FDI, on of the strongest homogenizing factor, in relation with policy process and other correlative processes (macro-economic policies, welfare system reform, institutional developments) the present investigation attempts to build a framework for understanding the outcomes of the post-communist transition process in terms interaction between path-dependency and freedom in policy-making during transition. Given the significant impact FDI had during these transformative years, its is fundamental to investigate how FDI and associated policies as a source of variety (Hall & Soskice 2001) within the political economy of countries in transition to a capitalist system. A comparative approach to the post-communist transition will be used to generate a most similar system design research on the extent to which the path dependency, given both by the communist legacy and the decisions taken in the period of 'extraordinary politics (Balcerowicz 1995) and policies undertaken further during the transition, and the characteristics of FDI created the base for divergent outcomes (Greskovits and Bohle 2007, Feldman 2006, Buchen 2005).

First, the investigation focuses on the institutional environment that would lead economic actors to employ a specific type of coordination. Dynamic interaction among FDI and the existing environment, or in other words how FDI does becomes embedded in the existing economy, and what makes the difference between a success and a bad story concerning FDI. A second issue that is usually ignored in the FDI literature is the country-of origin source of FDI as a factor that affects the way different investments accommodate in new environments. The represent approach employs VoC thesis that capital is not footless, and the source of FDI can influence the type of coordination system at the sector level. In can be presumed that the higher the presence of FDI from a LME or CME and concentration in specific sectors, the higher the chances that the investors to search to use the same type of coordination as in the home country, thus the higher the chance to develop a specific type of variety of capitalism. Given the time inconsistencies, and initial success, presence of FDI and country origin of FDI, difference of privatization, in the initial stages of transition, different sectors could have developed different types of coordination. Nevertheless, as time passes, especially in more coherent systems of coordination, most of the areas should converge toward a common system. All in all, testing this hypothesis would require a significant methodological effort to avoid the "noise" caused by short term evolutions. Second, concerning the policies concerning privatization (on the four main dimensions) undertaken during the transition (as an outcome of political debates, external influences like the IMF and WB in the initial period and the EU accession negotiations), their more or less successfully implemented, and coherence with previous policies (path dependency[4]), context (interest constellation and strength of stakeholders, economic developments) and state institutional capacity (Evans 1992, Schmitter 1995) will be analyzed as one of the factors that created the base for the initial FDI market entrance. Szanyi (2013, 14) voices that FDI was crucial in the process of technology upgrading and funding investments within these countries. Thus:

> " …CEE became integrated part of global world economy with strong ties to international production networks. High level of openness, important role of foreign companies, dependence from foreign markets on the side of exports and from energy imports coming from CIS (mainly Russia) create the external environment of these economies. The relatively larger domestic market of Poland gives this country a little bit more maneuvering room, but the Polish economy is also strongly linked with the global economy. This economic structure gave rise to impressive increase of productivity, which was in many years faster than increases in wage. Unit labor costs remained rather low compared to developed market economies (Szanyi, 2003). This helped boosting international competitiveness. In case of Hungary and the Czech Republic trade surplus was achieved during the past 5 years (Túry – Vida, 2012)." (Szanyi 2013, 20)

Nevertheless, after 25 years of continuous integration within the world economy, the 10-NMS are among the most globalized countries in the world. Is there another developmental path that could ensure an relatively fast process of convergence with their EU counterparts? Or they are doomed to remain within the same area of semi-specialization. The issue of path dependency and endogenous institutional change: question should use institutional settings as exogenous or try to take into account the endogenity in problem of change? To put it in other words I would try to see how institutions are selected. Thus, institutions should be understood not only as the rules of the game or sanctions and incentives to which actors respond in relatively passive fashion, but as resources that actors use to attain their ends, in some cases switching from one institution to another when it seems more likely to serve their purposes Hall and Thelen (2005, 7)**.** In this sense I would use Stark &Bruszt definition of path dependency and as that initial architecture of transition was created by the complex heritage in terms of networks, political order, and economy that shape actors expectations and reactions (individuals and institutions) toward the reforms in this period.

One of the most challenging aspect of this research is related to choosing the an appropriate level for analyzing the interaction between FDI and the institutional infrastructure. Besides the effect at the firm and sectoral level on FDI should I try to understand how FDI creates a pressure for a specific institutional (regulative) change? In order to test whether employs VoC hypothesis that capital is not footless, I should try to understand how different sources of FDI can influence the type of coordination system at the sector level including the regulative framework that supports it. If I should look at all aspects of FDI governance or I should approach it simply in terms source of money that translates some Standard Operating Procedure – and to compare its effect with other sources of money (banking sectors, capital market, state subsidies). The type of methodological approach regarding the effects among FDI presence and the regulatory framework – and especially the aspects related to the importance of Private governance organism.

Notes

[1] Bursier în cadrul proiectului „Burse doctorale şi postdoctorale pentru tinerii cercetători în domeniile Ştiinţe Politice, Ştiinţe Administrative, Ştiinţele Comunicării şi Sociologie" POSDRU/159/1.5/S/134650, finanţat prin Programul Operaţional Sectorial Dezvoltarea Resurselor Umane 2007-2013, cofinanţat prin Fondul Social European.

[2] Limited fiscal deficits, Public expenditure priorities, Tax reform, Market-determined interest rates, Competitive exchange rate, Import liberalization, similar conditions for FDI, Privatization, Deregulation, Property rights.

[3] The initial private owners do not matter too much since 'the market' soon reallocates the assets to the efficient owners.

[4] The concept will be used in the sense proposed by Stark & Bruszt (1998) and not the one used by historical institutionalism. Path dependency is created by the complex heritage in terms of networks, political order, and economy that shape actors expectations and reactions (individuals and institutions) toward the reforms in this period. This actor centered approach is coherent with varieties of capitalism approach (Hall & Soskice 2001) that explain institutional complementarities in term of actor's expectation toward markets and politics.

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