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## What drives foreign direct investment into post-communist economies?

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### **Abstract**

This study explores the factors that attract foreign direct investment (FDI) in Post-Communist countries. To do so, for the first time in the extant literature on ex-communist countries, we use panel data over the period 1990-2015. The key findings are as follows: (a) the rate of return and enrollment in education and cost of fuel are negatively associated with FDI inflows to Post-Communist countries; and (b) there is a positive link between FDI inflows to the region and stability of political regime and rule of law; (c) our estimates further confirm the market seeking hypothesis for the nature of FDI to the Post-Communist countries.

**Keywords: FDI; determinants; Post-Communist; rule of law; democracy; market seeking.**

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## 1. INTRODUCTION

Nearly 25 years have passed since the collapse of the Soviet Union and the emergence of new states that began their transition from planned to market economy. The first decade of the transition period was characterized by large and persistent drops in economic output, increases in economic inactivity, drastic disruption of trade links and total restructuring of the economic systems (World Bank, 2001). To overcome the emerging challenges and to sustain and extend the existing infrastructure and economic activity many governments of post-Soviet economies sought foreign direct investment as an essential source for economic modernization (Holland & Pain, 1998; Globerman et al., 2004).

Indeed, foreign direct investment has been found to facilitate cross-border integration via the transfer of production facilities, technology and knowledge across the globe (Baldwin & Martin, 1999; OECD, 2007). Moreover, through its spill-over effects FDI enhanced not only the existing capital stock but also employment and production capabilities of the countries (Ho and Rashid, 2011). Therefore, for many post-Soviet economies continuous inflow of FDI has been a key prerequisite for economic development.

Still, despite common acceptance of the importance of FDI by the governments in post-Soviet economies, certain countries were less successful in attracting inward FDI throughout their transition history. Moreover, if certain countries were successful in attracting foreign investment to nearly every key sector of the economy, the rest enticed foreign capital inflow into only one or two sectors.

The theory and empirical literature provide a number of explanations for such heterogeneous distribution of inward FDI across transition economies. Specifically, the motives for foreign companies to invest into transition economies are well captured by fundamental Dunning's (1981, 1993, 1998) OLI (ownership, location and internalization) paradigm which basically shows that foreign companies may pursue capturing natural resources, market shares, efficiency, and strategic assets.

Since ownership and internalization are features that depend on firms' capacity the location is something that is inherent to a host nation. Thence, location being the product of economic (gross domestic product, labor resources, public debt, market scope, inflation, etc.), socio-political and institutional factors (public governance, trade barriers, taxation, intellectual property rights, political stability, etc.) along with geography (distance between investing and host country, access to sea, transport infrastructure, etc.) provides the environment decisive for the level and direction of inward FDI.

Considering that the ability of a transition economy to attract and sustain inward FDI depends to a large extent on a set of economic, socio-political and institutional factors, in this paper we carefully examine why certain transition economies have been more successful than the others in attracting inward FDI throughout the transition phase.

Specifically, by applying GMM model to a sample of standard FDI determinants taken from World Development Indicators and UNCTAD database, and common in empirical literature across developed and developing economies, we study the key determinants of inward FDI to transition economies for the period of 1990-2015.

Our findings show that such factors as market size, type of political regime, ICT infrastructure and trade openness are important determinants of capital inflows for all

transition countries. We also find that integration of Post-Communist economies had a positive effect of FDI inflow to the region.

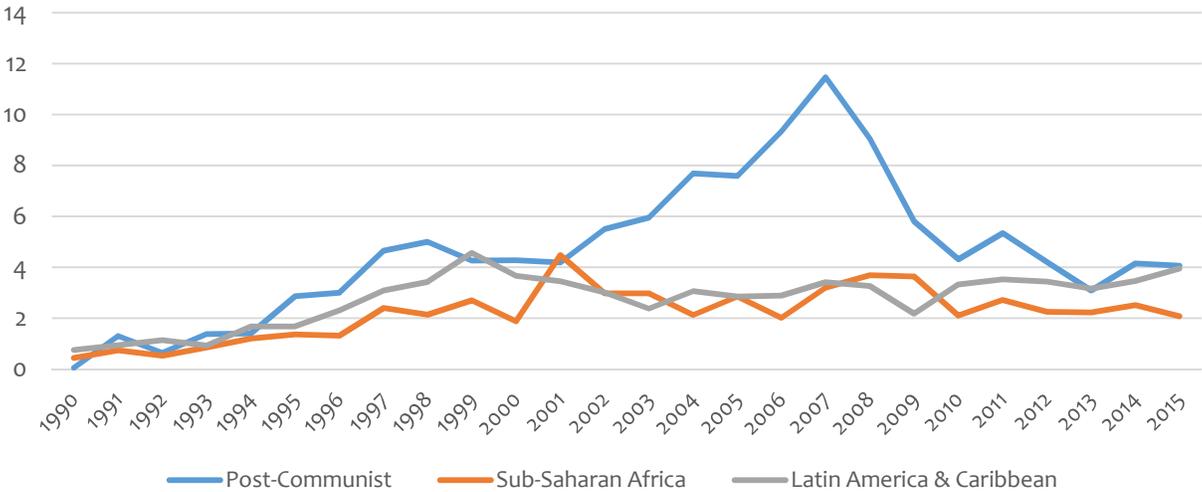
The paper is structured as follows. Section 2 presents a snapshot of FDI in post-Communist countries throughout the period of 1990-2015. Section 3 briefly reviews the impact of various economic, socio-politic and institutional factors of FDI inflows common across empirical literature, discusses data, variables and empirical approach adopted to access the determinants of inward FDI in transition economies. Section 4 presents and discusses estimation results. Finally, a summary and conclusions derived from the study are provided in the final section with particular reference to policy implications for countries under the analysis.

**2. STYLIZED FACTS ON FDI INFLOWS TO POST-COMMUNIST COUNTRIES**

As of 2015, FDI accounted for 3.95 percent of transition economies’ gross domestic product. The bulk of FDI attracted to ex-communist countries was largely concentrated in Poland (13.4%), Russia (10.3%) and Turkmenistan (9.1%).

On a global scale, a preliminary trend analysis of FDI inflows reveals that inward FDI as percent of GDP to post-Communist countries exceeded the investments to Sub-Saharan and Latin American countries (see figure 1). Moreover, within 2001-2009 the gap in FDI inflows between these regions has significantly widened, with the inward FDI to post-Communist countries peaking at 11.5 of GDP in 2007.

During 1994-1999 the total inflow of FDI to Post-Communist countries increased by 404% to 28 billion USD. In it necessary to highlight that, although this region has performed well in attracting FDI, some nations were especially lucrative. For instance, over 1994 to 1999 the net FDI to Armenia, Belarus and Lithuania increased by 1500% and 1580% respectively. In recent years, from 2010 to 2015, the most significant increase in FDI was observed in Slovenia (320%), Kyrgyzstan (181%) and Latvia (163%).



**Figure 1**  
FDI trends in selected regions, 1990 – 2015

### 3. DESCRIPTION OF THE DATA AND VARIABLES

#### 3.1 Determinants of inward FDI common in empirical literature

Factors influencing inward FDI common in econometric models range from a set of economic, socio-politic, institutional and geographical characteristics of a host country. In accordance with OLI paradigm (Dunning, 1993) foreign investors are motivated by three cornerstone investment decisions - resource-seeking, market seeking, and efficiency-seeking. Within the above framework the availability and abundance of natural and labor resources that drive down the production costs are among the key drivers behind host country's attractiveness for inward FDI. Foreign investors that seek larger market shares and new markets are attracted by such factors as income per capita, economic growth, economies of scale, population size and the level of competition in the host countries.

Finally, the efficiency-seeking motive is influenced by such factors as political regimes and stability, state of infrastructure, government policy favoring inward FDI, government transparency, the level of governance, trade openness and membership in trade agreements, and cultural aspects to name a few.

Recent empirical studies<sup>2</sup> use a number of determinants to explain the trends in inward FDI in EU, Asia, Latin America and transition economies. These factors usually include such determinants of inward FDI as market size, labor costs and skills, openness risk, macroeconomic and political stability, governance, rule of law, knowledge and human capital among the others.

In our study the econometric framework follows the insights provided by empirical studies in developed and developing economies.

#### 3.2 Econometric specification and data

##### 3.2.1 Dependent variable

The dependent variable in our study is FDI normalized by GDP. Foreign direct investment are inflows of investment to acquire a lasting management interest (10 percent or more of voting stock) in an enterprise operating in an economy other than that of the investor. It is the sum of equity capital, reinvestment of earnings, other long-term capital, and short-term capital as shown in the balance of payments. The data are from World Bank.

##### 3.2.2 Discussion of independent variables and descriptive statistics

**Rate of return.** As apparent from theory FDI goes to countries characterized by higher return on capital. Considering that developing countries inherently possess lower capital stock, the theory suggests that marginal product from additional unit of capital is higher, thus, allowing FDI to generate a higher rate of return.

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<sup>2</sup> See Anil et al. (2011), Leitao (2010), Casi & Resmini (2010), Anyanwu (2011), Globerman et al. (2004), Jadhav (2012), Yin et al. (2014), Pantelidis and Nikolopoulos (2008), Jeon and Rhee (2008), Maniam (2007), Skabic and Orlic (2007), Rodriguez and Pallas (2008), Sun et al. (2002) Moosa, Markusen(12001)

Despite theoretical predictions, the empirical estimations in developing and transition economies with inefficient capital markets and underdeveloped financial institutions, seem to be complicated by identifying a relevant measurement for the rate of return (ROR).

Therefore, in line with related empirical literature we use logged inverse real per person GDP as a proxy for return on capital in post-Communist countries. Indeed, if marginal product of capital is equal to the return on capital than capital scarce countries that are associated with lower per capita will produce a higher ROR.

On the other hand, the empirical evidence on the link between GDP per capita and FDI in developing countries is mixed. For example, Jaspersen et al. (2000), finds that ROR, measured by inverse GDP per capita, is positively related with FDI inflows. When foreign investors seek markets rather than efficiency, there is negative relationship between inverse GDP per capita and FDI (Tsai, 1994). If we obtain a negative estimate for the ROR in our regressions this indicates that there are better prospects for foreign investors in host country.

**Market size.** We follow empirical literature and adopt per capita gross domestic product growth rates as a measure of the market size. In line with the literature we expect that inward FDI is positively related to economic growth in our sample of post-Communist countries. In our sample, the average GDP per capita growth rates were 2.75 and it ranged from -44.9% in Georgia for the year 1992 to 88.96% in Bosnia and Herzegovina for the year 1995. Over the past two decades the growth rates of GDP per capita in our sample were very with volatile with the standard deviation equaling to 8.9%. In addition, we control for the level of inflation, as a proxy for macroeconomic market stability.

**Enrollment rates.** Certain studies use educational levels as an indicator of labor force quality and consequently its costs (Globerman et al. 2004). Considering that it requires the time-series data on various tiers of educational level of population, such information is absent in the dataset for all post-Communist countries. Therefore, as a proxy for educational attainment we use the enrollment rates to secondary education. Following the literature, we expect that lower relative labor costs and a higher enrollment rates encourage inward FDI. The average enrolment rate in post-Communist countries is 93.17%, indicating that more than 90% of labor force has attained secondary education.

**Infrastructure.** Apart from return on capital, countries with well-developed infrastructure may attract more FDI through the positive link between quality of infrastructure and the productivity of investments. Plethora studies shows that infrastructure development is positively linked with inflow of FDI in Africa (Musila and Sigue, 2006), emerging economies (Zhang, 2001) and developing countries (Mengistu and Adams, 2007). For example, Loree and Guisinger (1995), using data for flows of U.S. foreign direct investment, find that host countries with better transport and telecommunications infrastructure attracts more FDI from the U.S. More recently, Kaur et al. (2016), using data for FDI inflow to India between 1991 and 2010, show that railway density is a significant predictor of FDI, while ICT or air transportation are insignificantly related with foreign investment. In this study, we use two proxies for infrastructure development, namely, fixed phone

subscriptions per 100 inhabitants (ICT infrastructure) and rail lines per 1000 square kilometers (transport infrastructure).

**Trade policies.** In addition, existing trade policies may also be related to FDI. In empirical studies, trade openness of a country is measured by the sum of imports and exports expressed as % of GDP. Moreover, this variable successfully captures the degree of trade restrictions. In countries with higher levels of trade restrictions FDI tend to be market seeking, thus trade openness is inversely related to FDI/GDP.

In contrast, if foreign investors are involved in geographical specialization of production, then we may expect that host countries that are more trade integrated are likely to attract more inward FDI (Carstensen & Toubal, 2004; and, Globerman et al. 2004).

**Resources.** It is also important to test the importance of availability of resources for the inflow of FDI to post-Communist countries. In our study we control for the cost of fuel and total natural resources rents as a share of GDP. We conjecture that abundant natural resources should be positively linked with inward FDI, while estimate for the cost of fuel should be negative in our estimations. Indeed, post-Communist nations are some of the world's largest holders of oil, gas and other natural resources. For example, Central Asia countries only possess more than 24% of world's discovered gas resources. Similarly, natural resource rents accounted more than 16% of GDP of the Russian Federation in 2015.

**Political regime.** Types of political regimes and their stability are factors that have been shown to predict FDI to developing regions. Moreover, the relationship between political regimes type and FDI is very complex for countries with different level of endowments with natural resources. For example, Asiedu & Lien (2011), using data for more than 100 countries for the period 1982–2007, show that the impact of democracy on FDI depends on the share of primary goods in the host country's exports. Jensen (2008) finds that frequent leadership turnover and lack of political constraint is associated with frequency of FDI expropriation. Thus, we may predict that in more stable political regimes there should be higher share of FDI relative to the GDP. In our study, as a proxy for types of political regime we use democracy index measures as simple average of civil liberties and political rights indices from Freedom House.

**Governance.** Considering that the transition from planned to market economy requires not only economic reforms but also restructuring and revising institutional framework and policy reforms, we include governance indicator into our econometric model. We follow empirical literature in transition and developing economies and define governance as consisting from “laws, regulations and public institutions that determine the extent of economic freedom in a country, the security of private property rights, the costs to the private sector of complying with government regulations and legislation, the competence and efficiency of the civil service in carrying out state activities that, in turn, affect the efficiency of private sector enterprises, the transparency of the legal system and the honesty of government officials” (Slangen et al., 2003; Globerman and Shapiro, 2002; Globerman et al. 2004, p-9). We assume that inward FDI is positively related to good governance, which

encompasses sufficient economic freedom, rule of law, government transparency and efficient public sector, low levels of government regulations and restrictions in economy.

Taking into account cross-section and time series nature of the data, this study adopts panel data techniques such as pooled OLS, fixed effects and GMM on a sample of 24 countries for the period 1990-2015. The 1990 is selected as the starting points as this period marks the collapse of the Soviet Union and the onset of democratization processes in post-Communist countries. The descriptive statistics are presented in Table 1.

To model the motives for FDI to post-Communist countries the estimated econometric model can be expressed as follows:

$$y_{i,t} = \alpha_i + b_1X_{1it} + b_2X_{2it} + \dots + m_i + v_{it} \quad (1)$$

where  $y$  is the share of FDI in the GDP in country  $i$  at year  $t$ ;  $X_{it}$  is a set of control variables, potential drivers of FDI,  $b$  is vector of regression parameters and  $v_{it}$  is the error term satisfying normality assumptions.

The regression is primarily estimated using Pooled OLS estimator and then subsequently adopting fixed effects (FE) and GMM. The choice of the fixed effects model over the random effects estimator is dictated by resulting Hausman test for the model specification.

Considering that conventional mean regression does not take into account unobserved effects, possible endogeneity, unobserved heterogeneity and inertia in investment processes, we resort to FE and GMM regression techniques.

**Table 1**  
Descriptive statistics

Variable	Mean	Std. Dev.	Min	Max
FDI as % of GDP	5.13	6.12	-16.09	50.78
GDP per capita	11650.11	7560.16	1040.26	30823.00
GDP per capita growth	2.76	8.91	-44.90	88.96
Trade as % of GDP	83.28	31.06	19.69	170.84
Deflator	138.15	782.41	-20.93	15444.40
Democracy index	3.51	1.97	1	7
Natural resource rents as % of GDP	8.56	15.58	0.06	92.02
Rail roads per 1000 square km.	39.93	29.11	2.17	123.89
Phone users per 100 population	21.93	10.94	3.49	51.22
Secondary enrolment rates	93.17	7.42	72.37	110.95
Cost of fuel	0.84	0.47	0.50	1.98
Rule of Law	0.09	0.99	-2.22	1.75
KOF index	55.62	17.83	17.26	89.67

#### 4. MAIN FINDINGS

The main results are reported in Table 2. The pooled OLS regression in column 1 is our least preferred estimator as it ignores the panel structure of the data. Indeed, in pooled OLS estimator coefficients are correlated with the residual term and, thus, produce biased estimates. On the other hand, pooled OLS estimates provide preliminary correlations between our dependent variable and independent controls.

Fixed effects estimator takes into account unobserved characteristics of each country in our sample. However, empirical literature suggests the presence of FDI inertia in nearly all developing countries. Therefore, the inclusion of lagged dependent variable correlated with the error term may further yield biased estimates. Thus, we apply Fixed effects and GMM estimator that has numerous advantages over pooled regressions and mainly discuss results reported in columns 2 – 5.

First, we find empirical evidence for the FDI inertia in ex-Communist countries. Our test of efficiency seeking motives hypothesis produced mixed results. Specifically, we find that the ROR is negative and statistically significant at the 1% level only in GMM estimator. This implies that larger volume of FDI to post-Soviet countries relative to the size of market was attracted to countries with higher level of GDP. Furthermore, the coefficient of economic growth being positive and statistically significant at 1% level in all specifications further suggests that FDI to post-Communist countries was mainly driven by market seeking motives. For example, the results in column 5 indicate that a 1% increase in economic growth was associated with 0.17 percentage points increase in the share of FDI in GDP.

The inverse relationship between enrolment rates and inward FDI in FE and GMM estimators also supports the idea that inward FDI to post-Communist countries were attracted by economic growth and cheap labor resources.

Democracy is positively and only marginally significant in columns 1 to 4. We find that a one standard deviation increases in the democracy index results in between 0.88 and 1.14 percentage points increase in inward FDI. These results are in line with previous empirical studies suggesting that inward FDI are attracted to nations with higher political stability (Li, 2006) and lower risks (Li, 2008).

Of our two proxies for infrastructure we find that only ICT development mattered for FDI inflows to post-Communist countries. Specifically, we find that when fixed phone subscriptions increased by 10%, inward FDI increased by nearly 0.18 percentage points.

As expected, we find that the cost of fuel and inward FDI to post-Communist countries are inversely related. That is, higher cost of energy resources (fuel), *ceteris paribus*, reduce the inflow of FDI to a post-Communist country.

Turning to the role of trade policies, we find that trade openness is insignificant in FE regression, but marginally significant in GMM estimator. This implies that post-Communist countries with higher degree of trade openness were more successful in absorbing inward FDI.

Finally, we fail to find statically significant associations between inward FDI, inflation rates and natural resource exploitation. Such surprising finding is associated with the observations that the majority of inward FDI over the past decades has been absorbed by Baltic and Eastern European countries.

**Table 2**  
Main results

	(1)	(2)	(3)	(4)	(5)
	Pooled OLS	Fixed effects	Fixed effects	Fixed effects	GMM
FDI/GDP, lagged one year					0.454*** (0.056)
FDI/GDP, lagged two years					-0.240*** (0.051)
Return on capital (log)	1.012** (0.481)	-9.044* (4.512)			-11.822*** (2.874)
Economic growth	0.261*** (0.063)	0.220** (0.085)	0.195** (0.076)	0.257*** (0.070)	0.128** (0.057)
Trade openness (log)	2.494** (1.170)	3.404 (3.013)	2.588 (1.687)	3.831 (2.773)	4.097** (1.957)
Inflation	0.000 (0.001)	0.000 (0.001)	0.000 (0.001)	-0.001 (0.001)	0.001 (0.002)
Democracy	0.428** (0.178)	1.468** (0.602)	1.463** (0.601)	1.380** (0.648)	1.090 (0.796)
Resource rents (log)	0.781*** (0.242)	-0.457 (0.815)	0.104 (0.718)	-0.523 (0.792)	-0.323 (0.763)
Transportation (log)	0.126 (0.421)	8.367 (5.414)		6.069 (3.882)	
ICT (log)	2.074*** (0.583)	-0.150 (1.653)	2.708*** (0.884)		-1.357 (1.906)
Enrollment rates	-0.143*** (0.038)	-0.190* (0.092)	-0.084 (0.070)	-0.130* (0.072)	-0.269*** (0.077)
Cost of fuel	0.909 (0.617)	-4.291 (2.937)	-0.196 (1.199)	0.045 (1.569)	-6.343*** (1.761)
N	315	315	359	316	304
adj. R <sup>2</sup>	0.100	0.138	0.077	0.097	
Sargan test, p-value					0.287

Standard errors in parentheses; \* p<0.1, \*\* p<0.05, \*\*\* p<0.01

Table 3 presents extensions to our main results by investigating the effects of quality of institutions. In line with extant studies, we proxy quality of institutions and legal enforcement with rule of law index from World Bank Governance Indicators (WDI). We estimate the effect of rule of law in a separate table, as the data for this index is available mostly from the year 2000. The related extant evidence on the role of the rule of law in attracting FDI to developing countries is mixed (Wang et al., 2012; Pierre, 2015).

First, our results indicate that the baseline coefficients remained overall unchanged both in terms of direction and significance of the coefficients. Moreover, we find that rule of

law had positive and statistically significant effect (at the 10% level) on inward FDI in post-Communist countries. Our findings are in line with empirical literature (see Hewko, 2002) and suggest that consistent and effective legal system is an important determinant of inward FDI in transition economies.

Table 3  
Main results: the effect of rule of law

	(1) Fixed effects	(2) GMM
FDI/GDP, lagged one year	0.586*** (0.088)	0.573*** (0.057)
FDI/GDP, lagged two years	-0.329* (0.163)	-0.360*** (0.055)
Return on capital (log)	-4.752* (2.543)	-6.212* (3.448)
Economic growth	0.175*** (0.039)	0.140* (0.071)
Trade openness (log)	2.700 (2.120)	4.022 (2.514)
Inflation	-0.000 (0.001)	-0.001 (0.004)
Democracy	-1.469** (0.641)	-1.446* (0.841)
Resource rents (log)	-0.140 (0.625)	-0.209 (0.943)
Transportation (log)	7.138 (5.701)	6.734 (5.788)
ICT (log)	0.161 (1.903)	1.345 (2.345)
Enrollment rates	-0.145* (0.080)	-0.204** (0.084)
Cost of fuel	-2.985* (1.631)	-4.332** (1.738)
Rule of Law	2.434* (1.315)	4.416* (2.272)
N	279	237
adj. R <sup>2</sup>	0.382	
Sargan test, p-value		0.131

Standard errors in parentheses

\* p<0.1, \*\* p<0.05, \*\*\* p<0.01

To ensure completeness of our estimations of inward FDI determinants we consider the role of integration in attracting FDI to the region. To capture this effect we separately

included KOF index of globalization to our econometric model. KOF index of globalization measures the three main facets of integration, namely, economic, social and political. The data is an updated dataset from Dreher (2006). The results reported in Table 4 suggest that regional cooperation and integration had positive effect on inward FDI to post-Communist countries. Specifically, our GMM estimations presented in column 2 show that inward FDI increased by 3.8 percentage points when KOF index increased by one standard deviation.

Table 4  
Main results: the role of globalization

	(1) Fixed effects	(2) GMM
FDI/GDP, lagged one year	0.605*** (0.077)	0.596*** (0.057)
FDI/GDP, lagged two years	-0.344** (0.157)	-0.390*** (0.055)
KOF	0.150** (0.065)	0.214** (0.109)
N	283	242
adj. R <sup>2</sup>	0.403	
Sargan test, p value		0.034

Standard errors in parentheses; control variables are included but not reported here

\* p<0.1, \*\* p<0.05, \*\*\* p<0.01

## 5. CONCLUSION

What are the motives for FDI to Post-Communist nations? To answer this question and to shed light on the antecedents of inward FDI to this region, we rely on Fixed Effects estimator and GMM using a panel of 24 countries for the period 1990 – 2015.

The key empirical findings of this research are summarized as follows: (i) the rate of return and enrollment in education and cost of fuel are negatively associated with FDI inflows to Post-Communist countries; and (ii) there is a positive link between FDI inflows to the region and stability of political regime and rule of law. On the other hand, we fail to find evidence that natural resource seem to be an important predictor of FDI.

These results offer a set of key policy suggestions. First, our estimates further confirm the market seeking hypothesis for the nature of FDI to the Post-Communist countries that foreign investor tap on the markets with higher size, robust economic growth and abundant cheap labor.

Second, another important finding is that FDI is positively correlated with KOF index of globalization indicating that promoting cooperation and global integration of Post-Communist countries will attract more FDI restricted to a certain degree by the small size of some countries in the region. This is crucially important taking into account the FDI to Post-Communist countries is driven by market seeking motives.

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