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Institutional Foundations of Economic Transformations in Central and Eastern Europe (1990-2000)

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The changes in Central and Eastern Europe after the fall of the Berlin Wall in 1989 have provided social scientists with an unprecedented social laboratory. \* Analysts of economic changes in post-socialism have plunged into theorizing and examining the East European “emerging markets,” not only to produce voluminous scholarship but also to shape economic policy. The label “emerging markets,” coined by the International Finance Corporation in 1981, was to generally denote that after the fall of state-socialism these “developing” or “transitional” countries started to open their previously closed economies to free market exchange (Emerging Market Directory 2004).

But there is more to the “emerging market” label than a mere denotation. Webster Dictionary defines “emerging,” as “becoming manifest,” “becoming apparent”, or “evolving,” implying spontaneity, naturalness, or inevitability. In this sense, do markets “emerge”? The question is not only rhetorical. The idea of markets as something natural and inevitable seem to be well in line with a belief in “a certain propensity in human nature... to truck, barter, and exchange one thing for another,” stipulated by Adam Smith. At the macro level, the label “emerging markets” as applied to the post-socialist context epitomizes an understanding of market-exchange as a natural way of economic organization, which will emerge as soon as the (un-natural) control of the party-state is abolished. In the absence of intervention self-interested market actors will be free to exchange and maximize utility. As one observer stipulated, “if given the presence of rational, self-interested actors and the absence of government interference, market exchange takes place of its own accord, market economies should emerge automatically” (Koslowski 1992: 674). Stimulating the emergence of market economies as quickly as possible through neo-liberal “shock therapy” was seen as the way to create efficiency and generate economic growth in post-socialism (Sachs 1994).

Using Polanyi’s (1951) distinctions, “the emergence” of markets in post-socialism is about the transformation from economic organization on the basis of redistributive arrangements to a system dominated by self-regulating market-exchange. The socialist command economy in Central and Eastern Europe can be characterized by redistributive arrangements, where central authority allocates the surplus (Szelenyi et al. 1994: 239). Such economic organization is marked by a strong role of the party-state and the influence of political alliances in the redistribution. On the other hand, the essence of capitalism is that goods are allocated on competitive markets where market players pursue profit maximization. Transition to capitalism, then, is a replacement of

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redistributive arrangements with self-regulating market-exchange. How does such a transformation occur? How does market exchange come to proliferate after the party-state relinquishes its redistributive authority?

Most analysts of economic transformation in Central and Eastern Europe agree that basic institutional foundations for markets need to be put in place for market-exchange to proliferate. Privatization, stabilization and liberalization are key to market transition (Sachs and Lipton 1990). However, analysts disagree on the role of state institutions in economic transformation once the incentive structure for free exchange is put in place. The neo-liberal view, advocated by neo-classical economists and international institutions such as the World Bank and International Monetary Fund, suggests that once the incentive structure is established by allocating property rights and liberalizing prices, market-exchange will emerge. States should not play a part in the economy, but rather allow the “invisible hand” of the market to do its job and assure efficient allocation of resources. Indeed, should the states get involved they would intervene and constrain free market activity.

On the other hand, economic sociology and political economy scholarship highlight markets as continuously shaped and structured by the state and political institutions, whereby the “state action *always* plays a major role in constituting economies... [so] it is not useful to posit states as lying outside of economic activity” (Block 1994: 696). Hence, the central proposition of this literature is that states’ involvement in the economy should not be understood as a mere constraint through intervention but, moreover, facilitation of economic processes and creation of markets.

The present study aligns with the perspective that states, politics and institutions are always implicated in market activity, suggesting that state actions and institutional foundations will influence the proliferation of market transactions in post-socialist Central and Eastern Europe. Going beyond this basic assumption of state-market embeddedness, however, the present analysis seeks to better understand the nature of the role of states and institutions in how they pattern economic processes. The task is certainly not to adjudicate whether states should or should not structure markets. Rather, my attempt is to empirically investigate what kind of state institutions matter (or not) for proliferation of market-exchanges in post socialist Europe. With this, the theoretical objective of the analysis is to go beyond stating that markets are embedded in state institutions and to explicate the substantive type of this embeddedness for different socio-historical contexts.

Furthermore, in contrast to most of the studies in the literature on East European post-socialist transformations which offer detailed, generally qualitative, analysis of one or a few country cases (Offe 1991; Stark 1992; Bartlett 1997; Rona-Tas 1997; Stark and Bruszt 1998; Eyal, Szelenyi and Townsley 1998; Buroway and Verdery 1999; Borocz 2001; King 2001; Orenstein 2001), I attempt to examine and quantify patterns across eleven countries in the region for the first decade after 1989, in order to begin to identify possible trends in economic transformations after state-socialism.

Exploiting the natural experiment conditions, I study proliferation of one type of market exchange that was absent before the fall of the Berlin Wall in 1989, that is, foreign direct investment transactions. I use originally collected cross-national longitudinal data on foreign direct investment (FDI) to trace the proliferation of foreign direct investment transactions in eleven Central and East European countries. Covering a span of only one decade (1990-2000), this is necessarily a limited analysis.

However, considering the fast speed of post-socialist transformations, this analysis nevertheless captures the forces that significantly influence the initial creation of FDI markets in post-socialist Europe.

Findings of pooled cross-sectional time series analysis show that economic incentives and stabilization in host countries contribute little to explaining the inflow of FDI into Central and Eastern Europe. Similarly, instituting democratic order in post-socialism is not significantly related to the speed of marketization. However, the direct involvement of post-socialist states in the economic transformation is crucial. The extent of privatization, a pro-market reform government in place, and host states acting as market players by selling large state monopolies to foreigners all significantly induce FDI. Overall, the results show that, at least in the first decade of post-socialism, it is the involvement of the state rather than its withdrawal from the economy that facilitates marketization.

### The Case of Foreign Direct Investment in Post-Socialist Europe

Social scientists rarely come across a natural experiment setting that allows them to examine the conditions under which a market comes into existence *de novo*. Even in the case of Central and Eastern Europe, trade exchanges, labor markets and black market commodity exchanges were present. However, one particular case of market behavior, which was for all practical purposes non-existent before 1989, was foreign direct investment.<sup>1</sup>

Foreign direct investment (FDI) is investment made by a company in the investor country into a foreign, host country. It can take a form of an acquisition of already existing host firms or establishment of new companies in the host country, referred to as greenfield investment. In either case, foreign direct investment transactions involve investors (buyers) and hosts (sellers) to come together and exchange ownership stakes in either existing firms or in assets that will be used in establishing new private enterprises. Prices of these transactions are negotiated between buyers and sellers. All in all, the resource allocation is determined by a price-setting mechanism (market exchange) and not via a central authority (redistribution) or voluntary bestowal on one another (reciprocity). Thus, following Polanyi's (1992) typology foreign direct investment transactions are market-exchanges.

**Table 1. FDI Inflows (\$ billion)**

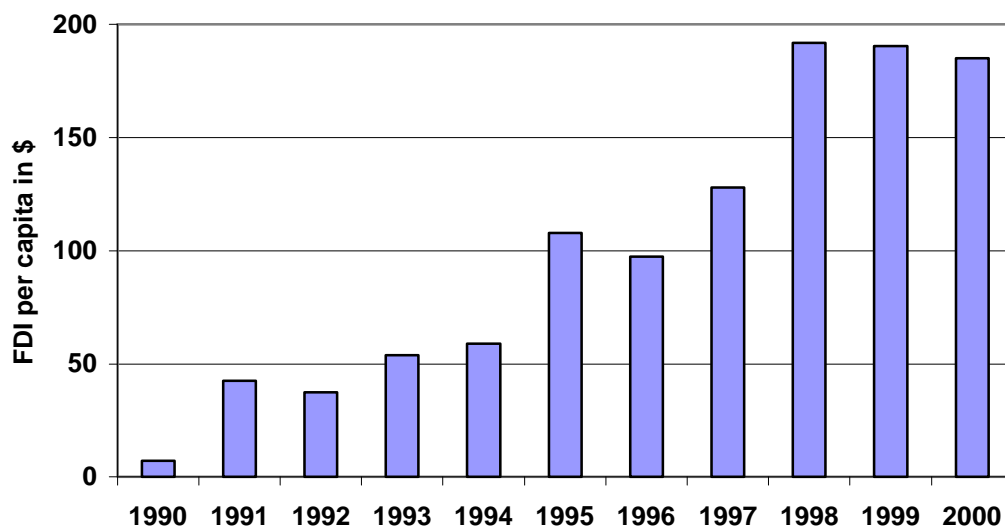
	<b>1970</b>	<b>1980</b>	<b>1990</b>	<b>2000</b>
<b>World</b>	13	55	203	1492
<b>Central and Eastern Europe</b>	--	0	1	27

Source: UNCTAD 2002

<sup>1</sup> Country case studies show that Hungary, Poland and Slovenia may have established exemplary joint-ventures with foreign owners during state-socialism. However, these are certainly exceptions rather than the rule.

Analysis of FDI in Central and Eastern Europe provides an excellent opportunity to trace the emergence of this type of market exchange. As Table 1 shows, the region attracted virtually no foreign investment before the fall of the Berlin wall in 1989 due to the closed economic and political regimes in these former state-socialist countries. The stock of investment in the Central and East European region represented 0.1% of the total world's investment stock. After 1989, foreign capital began to flow into the region, but the initial regional inflows were minimal compared to the global FDI. The median per capita inflow for the sample of eleven countries studied here was only \$2 per capita in 1990. With FDI expanding globally, 1995 marked the year of the first substantial surge of foreign investment into the Central and East European region; flows grew by 80 percent over the prior year, amounting to 4.3% of total world FDI. In 1995, the average inflow into the eleven countries studied here was \$108 per capita. After 1989, FDI flows into individual Central and East European countries show a general growth trend with a leveling off by 2000 (see Figure 1). While the average FDI inflow per capita is \$8 in 1990, flows increase to \$191 in 1998 (the year of the highest inflows) and then subside slightly to \$185 in 2000.

**Figure 1. Average FDI Inflows into Eleven Central and East European Countries**

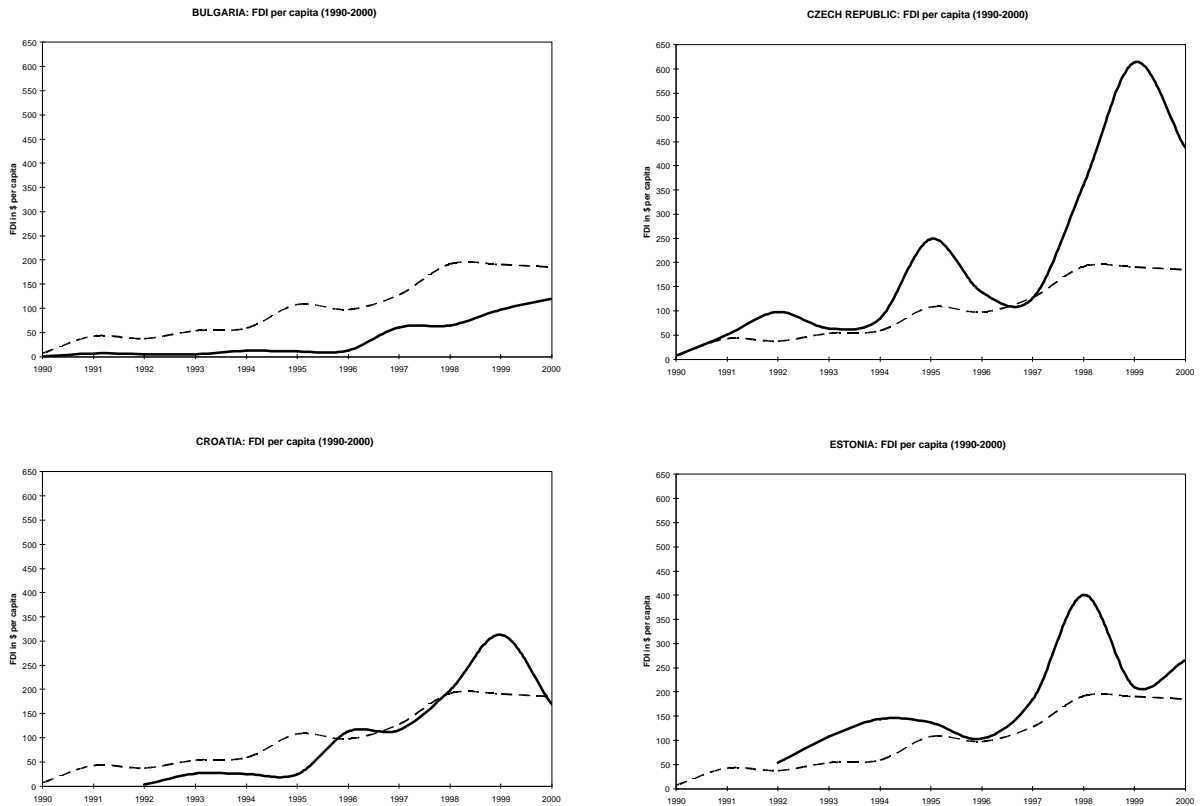


As Figure 2 shows, despite a general growth trend, individual country trajectories exemplify a variety of paths, differing in the timing of the initial increase in FDI inflows (from early to late adopters), and in the size and frequency of the peaks in the series (from more to less steady series). Hungary, for example, has a most noticeable increase in FDI inflows right after 1989. With a median inflow at \$2 per capita across the eleven countries in 1990, Hungary attracted \$30. Analysts suggest that the main reason for this increase is that Hungary opened itself to FDI through their privatization policy. The Hungarian political elite decided to sell their state-owned enterprises to whomever paid most for them, domestic or foreign, in order to service their high foreign debt (Stark and Bruszt 1998; King 2001; Hanley et al. 2002). However, after a sharp initial increase and a substantial surge in FDI in 1995, inflows into Hungary have stagnated at the regional average level. Like Hungary, Czech Republic and Estonia recorded relatively high numbers already a few years into the transition period, but unlike for Hungary FDI inflows

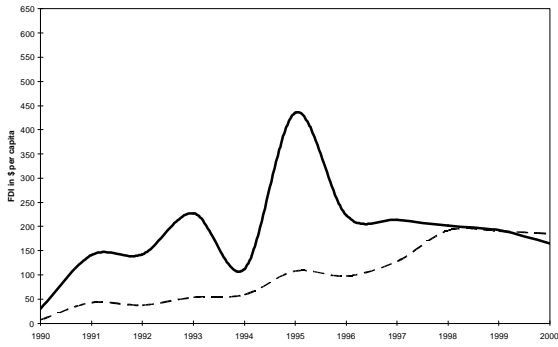
into these two countries have not leveled off but continued to fluctuate.

In Poland, on the other hand, we see a relatively linear FDI trajectory with inflows increasing slowly but consistently, hence no fluctuations characteristic of most other countries. The shape of the Bulgarian FDI trajectory is similar to the Polish trend, although it takes several more years for the FDI inflow to start growing in Bulgaria, and the absolute levels remain under the regional average. A few other countries, like Romania and Lithuania, also stagnate at the bottom for several years before they show any growth in FDI, albeit non-steady. Lithuania, Croatia and Slovakia are among the countries whose FDI inflow is low until the late 1990s, but then it increases significantly. In contrast, Slovenia is right at the average levels up until 1997, but after that its inflows remain substantially under the regional average. How can we explain these varied levels of foreign direct investment in the Central and East European countries over time? Can we identify some trends across countries which would allow us to stipulate what influences proliferation of FDI exchanges in post-socialist Europe? Reviewing theoretical considerations from the existing literature helps generate a set of explanatory factors.

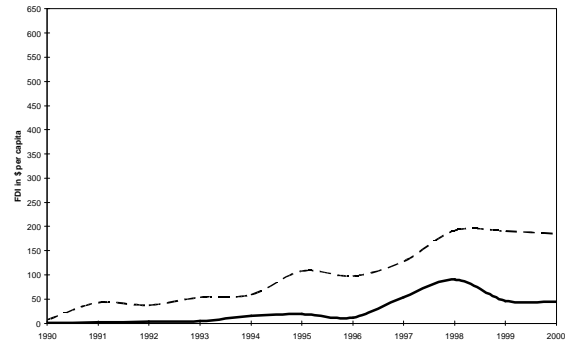
**Figure 2. FDI in Central and Eastern Europe**



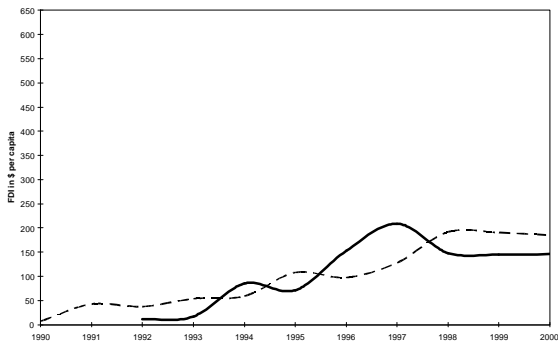
HUNGARY: FDI per capita (1990-2000)



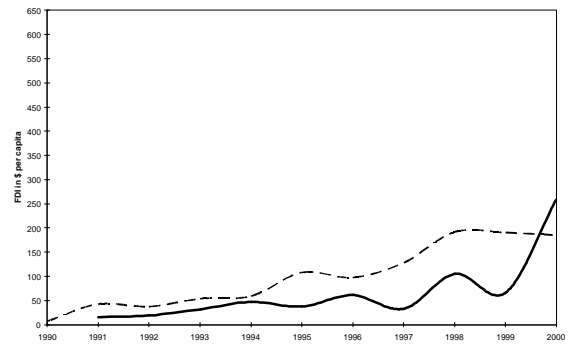
ROMANIA: FDI per capita (1990-2000)



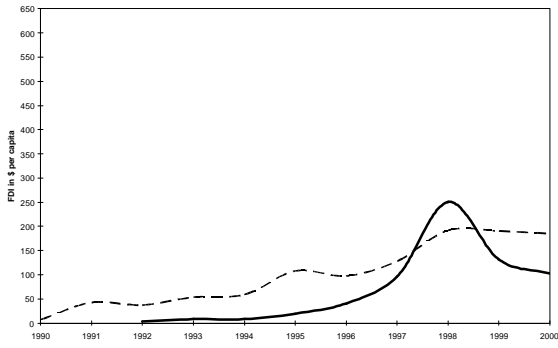
LATVIA: FDI per capita (1990-2000)



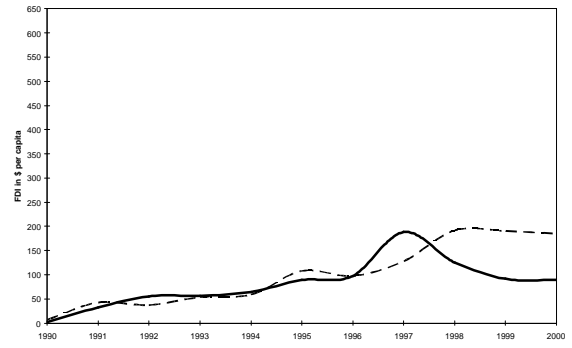
SLOVAKIA: FDI per capita (1990-2000)



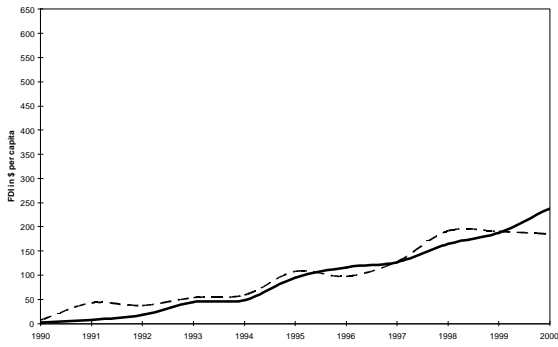
LITHUANIA: FDI per capita (1990-2000)



SLOVENIA: FDI per capita (1990-2000)



POLAND: FDI per capita (1990-2000)



Note: Solid lines represent country trends, dotted lines represent region average

## **Theoretical Considerations**

### **Orthodox Economic View of Markets and FDI Determinants**

In an economic view, the market is an abstraction. Economists commonly imply rather than investigate where markets come from (Barber 1977). According to a microeconomics textbook, “by definition, a market is simply a mechanism or arrangement which brings buyers or “demanders” and sellers or “suppliers” of a good or service in contact with one another” (McConnell and Brue 1993: 37). How do these buyers and sellers come together? How do they begin to exchange with one another? As Marx noted, “it is plain that commodities cannot go to the market and make exchanges on their own account” (Marx [1867] 1906: 96). The understanding of market as a price-setting and resource allocating mechanism regulating exchange of commodities implies that prices are somehow inherent properties of objects themselves and that the exchange is guided by an invisible force.

In case of the post-socialist economy, the orthodox economic perspective stipulates that markets will emerge spontaneously once the control of the party-state is abolished as the absence of intervention will free self-interested economic actors to exchange and maximize utility. In this view, the incentive structure for rational exchange is the key. Because economic actors are self-interested, they will spontaneously begin to engage in transactions which will be guided by their efforts to maximize utility.

In terms of FDI transactions, investors will look for investment sites that promise highest returns for minimum costs (Basi 1963; Ahargoni 1966; Hymer 1976; Agarwal 1980). In the context of post-socialist Europe, one would expect proliferation of FDI transactions to depend primarily on economic prosperity and stabilization of a post-socialist country (Alter and Wehrle 1993; Welfens 1993; Dunning 1994; Schmidt 1995; Meyer 1998). Based on this perspective, we would expect FDI to increase with higher economic potential and greater economic stabilization, which promise high returns and low risk, respectively.

### **Institutional Embeddedness of Markets**

While the traditional economic approach isolates markets from the intervention of states, economic sociology and political economy views markets and states as strongly related, emphasizing the role of states in structuring markets and creating capitalism (Evans, Rueschemeyer, and Skocpol 1985; Campbell, Hollingsworth, and Lindberg 1991; Block 1994; Hollingsworth, Schmitter, and Streeck 1994; Evans 1995; Fligstein 1996, 2001; Hollingsworth and Boyer 1997; Fligstein and Stone Sweet 2002). Largely, these studies are inspired by Karl Polanyi’s analysis of the social construction of a market society in the 19<sup>th</sup> century. As Polanyi (1944: 139) writes, “there was nothing natural about laissez-faire; free markets could never have come into being merely by allowing things to take their course... laissez faire itself was enforced by the state.” Pointing to state-led social-construction of markets, Polanyi here makes a point that self-regulating markets do not emerge ex nihilo and highlights the crucial role of the state in their creation.

Simply claiming that states matter in shaping market processes does not specify what precisely the state’s role is. The old paradigm on the state’s role in the economy



focused on state intervention, but the new paradigm holds that state actions are always implicated in constituting, not only constraining, economies (Block 1994). Campbell and Lindberg (1990) argue that, in the advanced capitalist societies, the role of the state in the economy is through the manipulation of property rights. Fligstein (1996, 2001) proposes that in addition to *property rights*—social relations which define who has claims on the profits, states also provide *governance structures*—laws and informal institutional practices that define relations of competition, cooperation and organization, and *rules of exchange*—rules about who can transact with whom and under what conditions. This line of research suggests that the role of post-socialist states will be crucial in explaining the creation of FDI markets in Central and Eastern Europe.

Advancing the literature on state-economy relations, Peter Evans (1995) began to emphasize the variation in the way the states are organized and tied to society, advancing our understanding about differences in state-market relations across different contexts. Evans outlined different roles that the state can play in their countries' industrial transformation (i.e., custodial, demiurge, midwifery, husbandry), distinguishing between two main types of states in relation to national development: predatory states that are ruthlessly extracting and providing nothing of value in return, and developmental states which promote industrial transformation.

To advance the theoretical proposition that state-market relations will be qualitatively different across different socio-political contexts, I stipulate that transformations in Central and Eastern Europe will necessitate that states negotiate between the simultaneous processes of privatization, democratization, and globalization. The simultaneity of these reforms presents post-socialist Europe with challenges unlike those accompanying economic and political transformation in East Asia, Latin America or China. Unlike the East Asian societies, which started with democratization only after they already established links to the global economy (Evans 1995), East European political transformations are congruent with liberalization of their economies. And while economic and political transitions in Latin America were undertaken at the same time, these reforms did not involve a fundamental transformation of property regimes, as is the case in Eastern Europe. Central and Eastern Europe could also not be easily compared to China. While the state-socialist past creates commonalities, the fact that China has not democratized nor substantially privatized, is a major difference (Walder 1995).

What types of involvement, then, can we expect of post-socialist states in Central and Eastern Europe to facilitate the economic transformation? If we focus on stimulating the proliferation of market-exchange, I propose that states can be involved in the following four ways: a) establishing property rights through privatization, b) fostering democratization, c) showing political commitment to market reforms, and d) setting an example as a market leader.

Most obviously, as institutionalists and political economists propose, states shape the institutional organization and governance of the economy by providing property rights. Since property rights are rules that define ownership and control of assets, and consequently specify what people can withhold from or grant to another person, they are indeed a necessary condition for market exchange (Lindblom 1980). In the transformation of property rights, post-socialist states institutionalize conditions

for market exchange by developing privatization schemes and deciding when and how to transfer the ownership rights of state assets (Dallago et al. 1992; Earle et al. 1993; Stark 1992).

Indeed scholars of transition find that the capacity of the state to allocate ownership rights can crucially influence economic development in post-socialism (Hanley et al. 2002).<sup>2</sup> Through the privatization process, economic actors (individuals or firms) are either automatically granted or they acquire the rights to engage in market-exchange. In the Czech Republic, for example, the privatization process meant getting ownership of assets by exchanging vouchers for which one paid a nominal fee. In contrast, in Slovenia, privatization involved distribution of certificates of ownership in form of grants to citizens who would subsequently invest these certificates into corporations of their choice. Overall, for proliferation of FDI the allocation of property rights is a necessary condition if actors are to engage in market exchange by selling their newly acquired ownership rights to foreign investors and participating in FDI transactions.

Second, in an indirect way states can establish those non-economic institutions that will facilitate economic transformation. Since, as many scholars suggest, the “political and economic reforms in post-communism are intimately connected,” (Campbell 1996: 75) then we can expect an association between recent institutional changes, such as democratization, and the current economic activity. While most scholarship considers how economic transformations affect the nature of democratic consolidation (e.g., Haggard and Kaufman 1995), some analysts of post-socialist transition also argue for the reverse effect - that the establishment of democratic institutions in post-socialism assists marketization. Bartlett (1997) shows how the emerging democratic institutions in Hungary facilitated pro-market economic reform because they insulated state agencies from the opponents of economic reforms. In his view,

“The opponents of Hungary’s economic reforms enjoyed greater influence under the communist regime, whose institutional structure afforded local agents multiple access points to negotiate individual exceptions to market rules. The demise of communism disrupted the political channels through which vulnerable actors secured compensation for the socioeconomic fallout of adjustment. Democratization facilitated marketization by insulating state agencies from particularistic claims and channeling distributional politics into the electoral arena, where the ‘losers’ of reform operated at a disadvantage in the early postcommunist period. Hungary’s experience thus demonstrates not only that political liberalization and economic transformation are compatible but that the former promotes the latter.” (Bartlett 1997: 2-3)

Based on the reasoning provided by Bartlett, however, it is not simply the greater extent of democratization that directly induces more marketization. The democratic institutions of electoral politics may provide the context, but the actual market reforms (or lack thereof) depend on the orientation and commitment of political parties in power.

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<sup>2</sup> It is important to note that neo-classical economists wouldn’t disagree with the role of the state in creating property rights as they claim that privatization is the key for successful transition. However, this neo-liberal perspective would insist that states do not intervene into the economy beyond establishing these basic institutions.

Hence, one could imagine that democratic order may also halt the extent of marketization if, reversing Bartlett's phrase, the proponents of reform "operate at a disadvantage" in the electoral arena. This leads me to suggest that the crucial factor influencing the liberalization of post-socialist economies in terms of FDI is not the extent of democratization but the political persuasion of the government in power with regard to economic reform. Thus, political commitment of the ruling elite to market reform should also have an influence on actual marketization of their economy.

Last, I propose that post-socialist states can get involved in the transformation of their economies as economic actors in their own right. Such involvement is likely specific to the post-socialist context where large scale privatization and liberalization occur simultaneously. While, as stated above, post-socialist states grant ownership rights to its citizens and firms by instituting property rights, it is also often the case that states themselves, as economic actors, can negotiate the sale of property with foreign buyers directly. This might happen most frequently in the instance of large state monopolies which are usually not privatized via regular privatization methods (such as vouchers, direct sales, or management and employee buyouts), precisely because they involve issues of national sovereignty, strategic control and large sums of money.

Having a legitimate actor, such as the state, act as a market player may also prove crucial for the structuring of markets. According to White (1981a, 1981b), markets are "self-reproducing role structures among specific cliques of firms and other actors who evolve roles from observations of each other's behavior" (1981b: 518). This conception of markets as cliques of mutually aware actors observing each other highlights that market activity is structured by the connections between participants and the processes of signaling and communication. However, if observation of each other's behavior is to happen, it is likely that having a role-model to observe would induce other actors to participate. This role may be akin to that of an institutional entrepreneur needed for advocating new institutions and helping structure the organizational field (DiMaggio 1988; Fligstein and Mara-Drita 1996). In case of post-socialist Europe, where private organizational actors are only beginning to affirm themselves, the state is likely to assume the role of market leader.

### **Institutional Path-Dependence and Post-Socialist Transformations**

Next to scrutinizing the role of post-socialist states, the institutional perspective also highlights how pre-existing institutional arrangements create path-dependent contexts for future economic action (Steinmo et al. 1992; Thelen 1999). In fact, almost all research on post-socialist transformation recognizes some form of path-dependency (Eyal et al. 1998). This literature focuses on the ways in which structures inherited from before and during the state-socialist period influence the transformation processes, so that transformations occur out of the ruins of the former regime and often result in reproduction of existing institutions rather than social change (Seleny 1991; Stark 1992; Hausner, Jessop and Nielsen 1995; Campbell and Pedersen 1996; Szelenyi and Kostello 1996; Rona-Tas 1998; Smith and Pickles 1998; Stark and Bruszt 1998). According to Stark and Bruszt (1998: 7), we should "see social change not as transition from one order to another but as transformation – rearrangements, reconfigurations, and recombinations that yield new interweavings of the multiple social logics that are a modern society."

It is important to note, however, that the conception of path dependency advocated here does not condemn actors to simple repetition or retrogression. It is unrealistic to expect that actors are rigorously locked into certain paths. Nevertheless, the established shared understandings of how the world works and established institutions that cement these understandings, may leave a mark on the creation of historically subsequent institutional forms. Economic institutionalists argue that previously existing institutions, formal and informal, constrain the range of institutional alternatives from which actors choose, locking actors into certain courses of action which may be difficult to reverse (North 1990). However, existing institutions do not only create constraints on subsequent courses of action, but also present resources for actors by constituting the strategies of action that actors envision as more plausible and more likely than others (Dobbin 1994a, 1994b). Existing institutions set a range of acceptable options that are available and considered appropriate. In this vein, future economic processes will be predicated upon the previously institutionalized structures and institutions. This also implies that current institutional arrangements are not directly linked to the conditions that created the past institutions from which they evolved. Thus, institutions can persist even when the initial conditions that created them change substantially, that is, even after the break-up of the socialist system.

In terms of foreign investment, institutional path-dependence would suggest that the decisions to involve foreign investment in national economies after state-socialism might be dependent on the overall social organization of the socialist economies, including their concrete structures as well as their informal institutional arrangements. In terms of FDI, the sectoral structure of the economy developed during the socialist period may play an important role for two reasons. First of all, the sectoral composition may make certain host economies more or less attractive to foreign investors. In addition, large agriculture or manufacturing sectors may facilitate consolidation of organized political constituencies, such as farmers or industrial workers, who would be encouraged to voice their interests with the emergent democratic order. Because of that, sectoral composition would exert an indirect influence on FDI since different political constituents may resist to foreign investment on the basis of ideological reasons and fears for their material well-being (Bandelj 2003).

Social organization of the economy may also have path dependent influence on particular economic processes because certain structural features cement shared cultural understandings of how economic activity should be conducted and what kind of economic processes are considered legitimate (Biggart and Guillen 1999). In terms of foreign investment, the decisions to engage in foreign investment transactions after the fall of state-socialism might be dependent on the place of market-based activity in socialist economies. In closed political regimes in pre-1989 Central and Eastern Europe, there was formally no private ownership, but in practice some private sector activity was present. If pre-existing institutional arrangements influence the economic activity in the future, then we would observe that the greater the openness to market-based activity during the socialist times, the greater the liberalization of the economy in subsequent years.

## **Data and Analysis of Cross-national FDI Flows (1990-2000)**

An institutional analysis of FDI flows would argue for the importance of macro conditions that enable and constrain individual economic actors, which cannot be reduced to a simple aggregation of these actors' attributes and motives, and can thus be only revealed at a supra-individual level of analysis. Moreover, economic indicators proposed as FDI determinants by traditional economic research are attributes of countries. For these reasons, the units of analysis in this study are nation-states.

### **Longitudinal FDI inflows to Central and Eastern Europe**

Specifically, the dependent variable in this analysis is the per capita foreign direct investment flow into a particular country in a given year. The dataset includes annual observations of the following countries: Bulgaria, Czech Republic, Hungary, Poland, Slovenia (1990-2000), Romania, Slovakia (1991-2000), Croatia, Estonia, Latvia, and Lithuania (1992-2000).

A note about sample selection is warranted. The geo-political notion of Central and Eastern Europe would also include Albania, FR of Macedonia, Bosnia and Herzegovina and Serbia and Montenegro. However, longitudinal data for these countries is not available. At the same time, the eleven countries included in the analysis are all Central and East European states which have begun with the European Union membership negotiations by 2002, a factor which specifies a common set of external environment influences and binds these countries into a comparable set. Keeping in mind these scope conditions of the analysis, findings should not be generalized beyond the advanced post-socialist countries without caution.

As a measure of yearly FDI flows into a host country, the outcome can have positive or negative values (signaling dis-investment) but there are no negative values in my sample. Since the dependent variable is clustered at zero, it is logged to reduce skewness and heterogeneity of error variance. The variables used in the analysis are listed in Table 2. To help establish causal priority, the predictors are measured prior to the outcome, at time  $t-1$ , which limits the sample to 101 observations.

### **Economic Incentives**

The economic perspective on markets emphasizes the role of incentives for rational exchanges between self-interested actors aiming to maximize their utility. Both economic growth and economic stabilization send signals about potential revenues and risks and should significantly impact the proliferation of FDI exchanges.

*GDP per capita:* Most commonly used as a general indicator of economic performance of a country, GDP per capita also captures the size of the potential market for a foreign investor. The economic argument stresses the importance of incentives for market exchange. *Ceteris paribus*, if it is the conditions that promise high returns that will attract investors, then *higher GDP levels should encourage more FDI*.

**Table 2. List of Variables Used in the Pooled Cross National Time Series Analysis of Foreign Direct Investment Flows into Central and Eastern Europe**

Variable	Description	Mean (S.D.)	Effect
<b>DEPENDENT VARIABLE</b>			
Foreign Direct Investment	Inflows of FDI (US\$ per capita)	116.08 (107.77)	
<b>ECONOMIC INCENTIVES</b>			
Economic Potential	Gross Domestic Product (US\$ per capita, '000)	3.30 (2.15)	+
	Gross Domestic Product growth (percent)	-.364 (7.37)	+
Investment Risk	Institutional Investor Country Credit Rating, 100-point scale indicating the expert assessed risk of default on investment for a particular country (0=highest risk, 100=lowest risk)	37.11 (13.57)	+
Economic Stabilization	Rate of inflation (percent)	98.94 (240.01)	-
<b>ROLE OF STATES</b>			
Extent of Privatization	Percent of private sector contribution to GDP	52.97 (18.25)	+
Extent of Democratization	7-point scale indicating freedom and fairness of elections and popular participation in the political process (7=highest, 1=lowest)	6.09 (.96)	+/?
Pro-reform Government	Dummy variable indicating whether the government in power is in favor of democratic and liberalization reforms	.65 (.48)	+
Direct Sale to Foreigners	Dummy variable indicating a period before and after the first host state sale of banks, telecommunications, or utilities to foreigners (before=0, after=1)	.43 (.50)	+
<b>INITIAL CONDITIONS</b>			
Share Employed in Agriculture in 1989	Percent Employed in Agricultural Sector in 1989	16.45 (7.77)	-
Size of Private Sector in 1990	Percent of private sector contribution to GDP (1990)	14.82 (6.72)	+
<b>INVESTOR INTEREST</b>			
Inflow of FDI into CEE	Net total FDI into Central and Eastern Europe (in \$ billion) - total less inflow into country i at year j	12.91 (7.57)	+

Note: See Appendix A for data structure and sources.

*Inflation:* A stable economic environment signals economic potential and future revenues for potential foreign investors. If prices significantly increase from year to year, this is a sign of instability and risk; in contrast, low inflation is viewed as a sign of economic stability. Thus, if economic destabilization signals higher risks to potential investors, *then higher inflation rate should be negatively associated with FDI inflows.*

## **Role of States**

According to the institutional perspective, states are always implicated in economic processes in more or less direct ways. The theoretical overview suggested the importance of privatization, democratization, politics and direct state action as influences on the proliferation of FDI exchanges in post-socialist Europe.

*Private Sector Share in GDP*<sup>3</sup>: Scholars of transition agree that establishing property rights is a precondition of market exchange. In the post-socialist transformation in Central and Eastern Europe, property rights have been established through different privatization policies. Clearly, without property rights domestic economic actors could not begin exchanging with foreign investors. Thus, we expect that the level of FDI into a country at a particular year will depend on the size of the private sector. Hence, *the greater the private sector contribution to GDP, the higher the FDI inflows.*

*Democratization:* Measuring democratization in Central and Eastern Europe overtime is constrained by the data availability. In this study I use one democratization indicator, i.e. a measure of political processes derived by Freedom House. High scores on the *Freedom House index* indicate low levels of fairness and freedom at national executive and legislative elections, a weak development of multiparty systems, and low participation in the political process. For simplicity, I reverse this index, so that low values indicate less democratization. If democratization directly facilitates marketization we should see *higher democratization scores associated with higher FDI levels.*

*Pro-reform Government:* Political commitment of the state toward market reform may be a necessary condition for changes in the actual levels of marketization. Pro-reform governments may not only show political commitment to marketization but may be accountable to voters to speed up the transformation process by instituting rules and laws governing private sector activity and overseeing their implementation. Political commitment as well as actual legal and policy changes brought about by pro-reform governments should have a positive effect on proliferation of FDI market-exchanges because they will facilitate both domestic as well as foreign actors' involvement in FDI transactions. Thus, *having a pro-reform government in place should have a positive effect on the proliferation of FDI transactions.*

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<sup>3</sup> I should note that this indicator for privatization does not distinguish between the formation of new private firms through domestic or foreign investment and conversion of existing collective assets to new non-collective forms of ownership. While in the initial period after 1989, when citizens of Eastern Europe in general did not possess sufficient private resources (Borocz 1993), the increases in this measure are likely primarily related to ownership conversion of existing assets, we should be aware of this limitation in interpreting the results.

*Direct Sale to Foreigners:* If post-socialist states directly engage in the economic process of FDI, they negotiate sales of strategic national assets to foreigners directly. These strategic assets most often include state monopolies in the banking, telecommunications and utilities sectors. A state's action to start selling these sectors signals an important shift in the state's official attitudes toward economic liberalization and foreign investment. I hypothesize that these actions would mark a significant turning point in the longitudinal FDI inflow into a country, rendering the average levels of FDI significantly higher in the years after these events compared to the period before. This effect would result because the acting of post-socialist states as market players has consequences for other business actors in the domestic economy as well as other potential foreign investors. Once a precedent is set and selling to foreigners is legitimized by a powerful actor such as the state, other domestic business actors in that country would be more willing to engage in market-transactions with foreign investors as well. In addition, a large inflow of foreign capital resulting from the sale of a strategic monopoly, often widely publicized as a mark of a country's progress in transition, would also encourage foreign investors to pursue opportunities in that country. Based on both of these consequences, it follows that *the years of and after the first sale of large state monopolies by post-socialist states to foreign owners should show an overall increase in FDI levels.*

### **Initial Conditions**

Path-dependence perspective suggested that not only newly adopted institutions but also historically institutionalized organization of the economy will influence future economic outcomes. Different structural features of socialist economies are proposed to matter because they a) create material conditions for investment, b) give rise to concomitant political groups whose interests may be related to the economic processes, and c) consolidate sets of cultural understandings that shape future outcomes.

*Share Employed in Agriculture in 1989:* The sectoral organization of socialist economies is likely to influence the prospects for proliferation of FDI. In her research, Katherine Verdery (1998) highlights the significance of national ownership of land in post-socialism. She states, "land has a special place in post-1989 Eastern European economies" (Verdery 1998: 298), proposing that people in Eastern Europe are very wary of selling their land to foreigners. In fact, by 2000 almost all Eastern European countries had some restrictions on foreign ownership of land (EBRD 2001b). All this suggests that foreign investment might be generally lower in countries with larger employment in agriculture. This may reflect the general levels of public resistance in a country to offering national assets to foreign ownership. In addition, as Bartlett and Hunter (1997: 98) point out, agrarian parties in transition countries tend to have anti-market orientation and "populist appeals to national, cultural and religious sentiments." It is likely that with larger agrarian sectors, the political organization of this fraction will be stronger and receive more support for their arguments about national assets protection. If so, this would have a general negative impact on foreign investment into that country. It is also likely that countries with larger agricultural sectors may be less attractive for FDI, but this would hold only for investments based on acquisition of already existing firms and not necessarily halt newly established ventures, so called, greenfield investment. Overall, we expect that *the higher the share of those*



*employed in agriculture in 1989, the lower the overall FDI inflows into that particular country.*

*Initial Private Sector Size:* Path-dependence arguments would suggest that the arrangements instituted during the state socialism will have an effect on the future institutions. We can expect that the presence of private sector activity during the socialist period should have a positive effect on the liberalization of the economy after 1989 because domestic actors exposed to private sector activity during the socialist regime may be more ready and willing to engage in private sector exchanges and even actively search for foreign investment opportunities into their country (Estrin et al. 1997). Thus, *the higher the private sector share in GDP in 1990, the greater the future FDI inflow into the economy.*

### **Random Effects Regressions**

To investigate the determinants of FDI across countries and overtime, we need to pool the individual countries' time series cross-sectionally. Pooling creates correlations in the data due to country- and time-specific effects. Such clustering would yield coefficient standard errors smaller than those obtained for independent data. One standard econometric approach for dealing with this problem is to estimate a random effects error components regression model (Amemiya 1985).

Results of random effects regression analyses are reported in Table 3. The main goal of these analyses is to test which factors significantly influence the inflows of foreign direct investment into Central and Eastern Europe after the fall of state-socialism. While the economic perspective highlights the importance of economic stability, growth and privatization, I also want to examine how proliferation of market-exchange is embedded in the political environment, influenced by direct state action and the social organization of the economy instituted during the socialist past.

The results reported in the first column of Table 3 point to weak effects of economic potential and stabilization indicators. While both GDP per capita and inflation effects are in the hypothesized direction, most of the variance in this first model is actually explained by the variable which controls for the overall inflow of FDI into the region, taking into account investor interest for investment opportunities in Central and Eastern Europe.<sup>4</sup> The effect of economic stabilization measured by the level of inflation seems to be somewhat more influential than the economic potential indicator, suggesting that foreign investors coming to Central and Eastern Europe may be influenced more by

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<sup>4</sup> To make sure that the weak effects of the economic conditions were not an artifact of the choice of the measures, I tested models with different specifications of economic factors (such as GDP growth, country credit rating, unemployment, account balance and government balance). All of these could not be included in the analysis simultaneously because of multi-collinearity and degrees of freedom problem. These tests showed that the results are not dependent on the choice of the measure. Since GDP and inflation are most common economic indicators of prosperity and stability, the decision was made to present models with these two variables. In addition, it is not likely that the weak effects are due to little variability in economic conditions across countries included in the analysis (since the sample includes those countries that advanced enough in the transition to be able to apply for European Union membership). As standard deviations reported in Table 2 show, variability is substantial.

transaction costs associate with higher instability than the promise of high revenues. On the host side, it seems that economic growth in the first ten years of transition does not generate a substantial amount of new economic assets to further empower domestic actors to engage in market-exchanges with foreign investors.

**Table 3. Random Effects Regression on Logged FDI Inflow per capita**

	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6	Model 7	Model 8
<b>ECONOMIC INCENTIVES</b>								
GDP per capita	.017 (.084)							-.061 (.064)
Inflation	-.001+ (.000)							-.0004+ (.0002)
<b>ROLE OF STATES</b>								
Privatization		.019** (.007)				.019** (.006)	.031*** (.005)	.027*** (.005)
Democratization			.055 (.113)			-.038 (.093)	-.108 (.074)	-.061 (.083)
Pro-reform government				.908*** (.185)		.749*** (.176)	.852*** (.154)	.875*** (.161)
State sale to foreigners					.753*** (.175)	.578*** (.164)	.775*** (.141)	.709*** (.149)
<b>INITIAL CONDITIONS</b>								
Share employed in agriculture in 1989							-.067*** (.009)	-.078*** (.017)
Size of private sector in 1990							.023* (.011)	.030* (.014)
<b>INVESTOR INTEREST</b>								
Total FDI into region	.082*** (.011)	.054** (.016)	.087*** (.009)	.071*** (.008)	.063*** (.009)	.019 (.015)	-.007 (.012)	-.010 (.012)
Constant	3.200*** (.331)	2.558*** (.331)	2.808*** (.672)	2.791*** (.232)	3.137*** (.255)	2.513*** (.587)	3.256*** (.432)	3.427*** (.464)
Chi-Square	125.50***	133.34***	119.64***	168.57***	161.08***	227.32***	326.84***	310.17***
R-square	<b>.327</b>	<b>.388</b>	<b>.303</b>	<b>.521</b>	<b>.424</b>	<b>.633</b>	<b>.795</b>	<b>.801</b>
BIC <sup>a</sup>	-11.35	-17.52	-11.82	-28.27	-20.19	-33.95	-55.48	-52.78

Note: N=101, standard errors in parentheses

<sup>a</sup>Bayesian Information Criterion assesses the goodness of model fit [BIC=  $n \log(1-R^2) + k \log n$ ;  $n$  is sample size,  $k$  is number of parameters,  $R^2$  is model fit]. The lower the BIC statistic, the better the model.

+  $p < .10$  \* $p < .05$ , \*\*  $p < .01$ , \*\*\*  $p < .001$  (two-tailed tests)

Models 2 through 5 measure the influence of different institutional factors on proliferation of market exchanges. As expected, privatization is positively related to proliferation of FDI reaffirming that allocating property rights is a necessary condition for economic liberalization. The extent of democratization, however, is not significantly related to marketization (as measured by FDI), but the type of government does make an

important difference. The years when the host government in power favors market transition reform show substantially higher FDI inflows into that country. This puts in perspective Bartlett's (1997) argument that democratization facilitated marketization in Hungary. When Hungary's experience is compared to its peers in the region, I find that consolidating democratic rule in post-socialist countries is not necessarily related to greater liberalization of these economies in terms of FDI. This is because democratic principles encourage political pluralism but are not necessarily synonymous with economic liberalization. It is possible that political constituencies that gain most popular support in elections voice opposition to foreign investment. Thus, it is the persuasion of the government in power, rather than a general level of democratization, that influences actual market activity. What also matters significantly for proliferation of FDI exchanges is direct state action in establishing markets, which, as Model 5 shows, is also strongly associated with increased FDI inflows. As the results show, overall levels of FDI into a particular country substantially increase after the state engages in the sale of its large state monopolies to foreigners.

Scholars in favor of path-dependent transformation arguments would predict that the social organization of the economy institutionalized during the state-socialist period will have a lasting effect on future attempts of marketization. As results reported in Model 7 show, having a large agricultural sector will dampen the level of foreign direct investment into a country. This indicates that having sizeable employment in agriculture increases the likelihood of consolidation of farmers into a political constituency which expresses nationalist concerns and resists selling national assets, in particular land, to foreign investors (Bartlett and Hunter 1997). In addition, structural economic features established during the socialist times influence the attractiveness of the economy for future foreign investment. Likewise, the size of private sector in 1990 variable, serving as a proxy of exposure to market economic organization during socialism, significantly encourages future types of market exchange, at least in case of FDI.

Model 8 checks the influence of state and institutional factors controlling for the effects of economic incentives due to economic potential and stability. The indicators of institutional foundations of market transformation remain significant predictors of FDI in Central and Eastern Europe during the first decade after 1989. This further highlights the explanatory power of an institutional explanation for understanding the creation of foreign direct investment markets in post-socialist Europe in contrast to a perspective which emphasizes the significance of macro-economic conditions in a host country.

### **Diagnostics and Sensitivity Analysis**

Using time series data, one always needs to be cautious about the problem of nonstationarity of the data. Since many time series have trends, it is important to remove trends from both dependent and independent variables. Because we are dealing with a data frame with neither time nor panel dominance, and because of the small sample size, there may not be one best way of addressing potential error dependency and nonstationarity problems. Table 4 reports results from models that employ different diagnostics, by including a time trend (Model 9) or lagged dependent variable (Model 10).

**Table 4. Robustness of Institutional Effects on Logged FDI Inflow per capita**

	<b>Model 9</b>	<b>Model 10</b>	<b>Model 11</b>
<b>ECONOMIC INCENTIVES</b>			
GDP per capita	-.059 (.066)	-.055 (.054)	.039 (.091)
Inflation	-.0004+ (.0002)	-.0002 (.0002)	-.0003 (.000)
<b>ROLE OF STATES</b>			
Privatization	.030*** (.005)	.015** (.005)	.017** (.007)
Democratization	-.085 (.079)	-.053 (.070)	-.019 (.124)
Pro-reform government	.935*** (.160)	.616*** (.157)	.777** (.219)
State sale to foreigners	.783*** (.148)	.449*** (.140)	.571** (.187)
<b>INITIAL CONDITIONS</b>			
Share employed in agriculture in 1989	-.079*** (.016)	-.051*** (.015)	NA
Size of private sector in 1990	.032** (.012)	.018+ (.010)	NA
<b>INVESTOR INTEREST</b>			
Total FDI into region	.007 (.021)	-.008 (.011)	.013 (.021)
<b>TIME TREND</b>			
	-.045 (.061)		
<b>LAGGED DEPENDENT VARIABLE</b>			
		.381*** (.078)	
<b>COUNTRY FIXED EFFECTS</b>			
			Included
Constant	3.442*** (.460)	2.584*** (.434)	2.652* (1.226)
Chi-Square	368.55***	485.88***	NA
R-square	<b>.801</b>	<b>.844</b>	<b>.850</b>
BIC <sup>a</sup>	-50.77	-61.45	-49.14

Note: N=101, standard errors in parentheses. Model 11 is a fixed effects model, with HC3 standard errors correction for heteroscedasticity (Long and Ervin 2000).

<sup>a</sup>Bayesian Information Criterion

+ p < .10 \*p < .05, \*\* p<.01, \*\*\* p<.001 (two-tailed tests)

Results from these robustness checks show that the effects of privatization, pro-reform government in place and states beginning to sell large monopolies to foreigners remain robust predictors of the proliferation of FDI exchanges in Central and Eastern Europe after 1989. The inclusion of the lagged dependent variable adds considerably to the explained variance in FDI inflows, but the magnitude of this coefficient is not overpowering the model. Besides serving to capture possible serial auto-correlation, it is not difficult to provide a substantive interpretation for why FDI inflows in year t would be positively associated with FDI inflows in year t+1. Based on the case study information of FDI transactions in Central and Eastern Europe collected by Estrin et al. (1997), there are

two mechanisms that explain the association between current and future FDI into the same country. To get information about potential investment opportunities investors rely on their business contacts and networks, and thus likely consider going to those locations that are also chosen by their peers, also known as the herding effect. In addition, it is often that upon establishment of a foreign subsidiary, suppliers of multinationals follow their contractors to these same locations, which would also add to future FDI inflows into that country.

The inclusion of the lagged dependent variable does render the indicator of the exposure to market economic organization during socialism somewhat weaker. This may be because the presence of private-sector activity during socialism was not strongly institutionalized. After all, the key characteristic of state-socialist economies was collective as opposed to private ownership. As one might expect, weaker initial institutional arrangements will have a weaker effect on future institutions. It can also be that the new policies and institutions adopted after 1989 to encourage fast privatization may adjust one country's trajectory in development and rectify its limited exposure to market-exchange during state-socialism. All in all, these findings suggest that not all initial conditions will have persistent effects on future outcomes. More theorizing is needed to understand the variability in path-dependent effects that various institutions have on subsequent processes.

Random effects approach allows us to control for dependency among covariates across years, but it does not adjust standard errors for unobserved heterogeneity among a country's multiple observations. Under this condition, fixed-effects estimation constitutes a superior technique in that it only uses within-subject variation to compute coefficients and standard errors (Allison 1999). While this leads to standard errors that are typically larger than those obtained from random effects estimation, the model takes care of potential spuriousness problems. That is, putative correlations between a dependent and the independent variable could be caused by an unobserved characteristic that systematically varies across clusters of countries (such as any other fairly stable country specific characteristic).

Model 11 includes country fixed effects and is a very stringent test for the robustness of the institutional and political effects, since it controls for all idiosyncratic characteristics associated with particular countries. When we include fixed effects, we cannot simultaneously include time invariant conditions, so those needed to be left out of the analysis. The results showed that even in the fixed effects specification the institutional effects remain significant predictors of FDI inflow. The magnitude of coefficients is somewhat smaller, which should be expected with the increased number of predictors included in the model. However, fixed effects does not provide a very parsimonious explanation, resulting in a higher BIC (Bayesian Information Criterion) statistic, indicating that in terms of fit, this model is inferior to the random effect specification that includes the lagged dependent variable (Model 10), which based on this goodness of fit measure emerges as the best specification.

Finally, an approach to use change variables instead of absolute levels was also considered to address possible concerns with nonstationarity of time series data. For all time variant independent variables, change scores were computed so that values for individual years were  $X_t - X_{t-1}$ . This should take the trends from the independent variables and correct any nonstationarity. Using the change variables did not substantially alter the results.

## Discussion

The basic feature of a state-socialist system was the control of the party-state in the economy, leading to the characterization of these societies as “command economies.” Thus, for many analysts, the key to economic transformation and thus development and prosperity in Central and Eastern Europe meant disbanding the control of the party-state and its inefficient redistributive arrangements. For some, free market exchange is only possible with the state’s complete withdrawal from the economic sphere. A prominent economist Lawrence Summers, presented this perspective by stating, “the invisible hand is more powerful than the [hand of the government]. Things will happen in well organized efforts without direction, controls, plans. That’s the consensus among economists” (quoted in Yergin and Stanislaw 1998: 150-51).

Literatures in the political economy and economic sociology denounce the separation of state and market into two separate spheres, arguing that markets are embedded in institutions. The implication of the “separate spheres” argument is that any state involvement into the economy is considered an intervention or interference, in a sense contaminating pure economic exchange and rendering it inefficient. On the other hand, the view of market embeddedness emphasizes not only the constraining force of a state, but moreover, its constitutive influence on the economy. The present analysis tried to empirically examine how state actions facilitate foreign direct investment transactions in Central and Eastern Europe and thus creation of FDI markets. Theorizing that the substantive variety of state-market embeddedness in post-socialist Central and Eastern Europe will be crucially determined by the simultaneity of the processes of privatization, democratization and globalization ensuing in this region, I proposed several ways in which post-socialist states can facilitate economic transformation.

A concern with the role of post-socialist states in societal transformations in Eastern Europe has received varied attention in the scholarship on transition. For instance, tracing the pathways of transformation in East Central Europe David Stark and Laszlo Bruszt highlighted the role of inter-enterprise networks in the transformation processes and saw the following role for the post-socialist states:

“[W]ithout directly intruding on enterprise affairs, the [post-socialist] state can facilitate decentralized institutions that constrain the networks to take into account long-term dependencies. It should not regulate *content*, but it can regulate the *context* of enterprise governance through legislation that weakens or strengthens the ability of social actors to negotiate about these interdependencies. Not by issuing directives or by setting substantive targets but by shaping the environment of procedural rights, the state can facilitate the deliberations that lengthen time horizons” (1998: 200, emphasis in original).

The analyses presented in this paper show that the role of post-socialist states after the fall of the regime goes beyond the vision that Stark and Bruszt (1998) anticipated. Instituting democratic order and issuing legislation that creates a formal legal framework for market exchange do not adequately encompass the state’s role in marketization. Fundamentally, the unprecedented challenge for states in post-socialism on their way to create markets is to negotiate the simultaneous processes of privatization and economic liberalization. To do

so, states act as economic agents in their own right. In case of FDI markets examined here, they engage in market exchanges by selling large state monopolies to foreign buyers.

All this suggests that markets in Central and Eastern Europe after 1989 will not simply *emerge* in the presence of rational profit-maximizing actors and the absence of central control. In fact, the notion of *emerging* markets is misleading. There is little that is spontaneous or natural in the transformation to a system predominated with market-exchange. Thus, I argue that it is more appropriate to think about proliferation of market exchanges in Central and Eastern Europe as a process created by post-socialist states. Still, the analysis does not only reiterate a well known point made by Karl Polanyi (1944) about another great transformation at another time and place. The state in the context of post-socialist transformations is not only responsible for creating the institutions of market society, but it also exerts its influence by acting as an economic agent in its own right, establishing itself as a market leader and role-model for newly established private economic actors.

The expectations based on the economic theory of market exchange imply that economic incentives are the most important determinants of exchanges between buyers and sellers since they create conditions for self-interested actors to maximize profits. While this study leaves the motivations for market action unexamined, it does find, however, that, at the macro economic level, economic prosperity and stabilization of a country do not exert a significant influence on the initial phases of foreign direct investment market creation. Rather, it is the actions of host country states, political choices and structures inherited from the socialist times that shape these markets most significantly. This finding also sheds light on the current research on foreign direct investment which has been dominated by the perspective of rational investors, without paying much attention to the active role of the hosts in the investment process.

Some may argue that the span of 10 years is too short to be able to put the economic explanations to a robust test, because in the long run the economic incentives will become more important. That may be, although it is unclear what the precise time span then represents an adequate test. While the analyses presented here show that in the first decade after 1989 the state and path-dependent institutional factors are crucial, it remains an empirical question whether the state's role will persist over time and for how long will post-socialist economies feel the effects of the socialist legacy.

In fact, this analysis is among the first to empirically test the path dependency argument and to provide quantitative evidence for the influence of institutions and practices established before and during state-socialism on the post state-socialist period. While paying attention to path dependency of institutions is emphasized by most scholars of the transition, studies usually do not ask which types of institutions matter and which institutions will have more or less path-dependent effect for future outcomes. I argue that it is an empirical question, which institutions have long term effects and what these effects are. To simply state that societal transformations are path-dependent does not provide much analytical leverage.

This analysis shows that various structures established during the socialist times will have differential effects on future attempts of marketization. These results align best with the so-called trajectory adjustment understanding of transition presented by Eyal, Szelenyi and Townsley (1998). These authors proposed a transition theory which argues that "evolutionary adjustment to new challenges and the path-dependent transformation of

previous institutions/behaviors occur simultaneously” (Eyal et al. 1998: 8). Applying their theory to the role of various elites in building capitalisms in Hungary, Czech Republic and Poland, the authors suggested that new institutions shape the dispositions of individuals who in turn contest and transform those institutions, which leads to individual trajectory adjustment. Applying this perspective at the country level, we might expect that historically shaped country trajectories would adjust in response to the implementation of new institutions. As the analysis presented in this paper shows, the effects of institutional persistence will depend on the strength of formal and informal institutionalization during the socialist regime. In our case, we saw that the extent of private sector activity during socialism had a somewhat weaker effect than the sectoral composition of the socialist economy.

The effect of past institutions is elusive also because if institutions enable actors and serve as resources, actors can use the available institutional material to innovate in the future. Stark and Bruszt (1998: 7) emphasize that “it is precisely in reworking the institutional materials at hand that actors innovate... It is through a political and an economic bricolage that new institutions and new practices emerge.” While this approach emphasizes the agency and creativity of actors, in an almost “everything is possible” manner, it does not explain well why certain courses of action are chosen over others. More work is needed in specifying the conditions in which different kinds of new institutions emerge.

In addition, the process under investigation, in our case FDI, will influence the type of the institutions and structural features that will show persistent effects overtime. This also highlights a source of specificity in this study that can limit generalizability of the findings. Foreign direct investment markets are likely structured differently than other types of markets. For example, the importance of the size of the employment in agriculture as an initial condition that has a persistent influence on market exchanges is rather particular to FDI, both because it may render a specific country less attractive to foreign investors and because it allows for the opportunities of political mobilization against foreign investment. In addition, the fact that negotiating the terms of exchange usually takes a long time, involves many actors and that property rights cannot be quickly sold once they are acquired (such as in the case of financial markets, for example) may all matter in how these exchanges are structured. Overall, this suggests that thinking about the substantive variety of markets under investigation (financial, labor, FDI, etc.) should lead an investigator to generate a set of theoretically relevant influences on structuring of these market exchanges.

## **Conclusion**

This paper examined sources of foreign direct investment in Central and Eastern Europe, using longitudinal data for eleven Central and East European countries from 1990-2000. The empirical findings provide support for the institutional underpinnings of economic processes and for examining the actions of host states in addition to the profit-making interests of investors privileged in previous studies. Strong effects of the direct state’s involvement in the economy, shaped by the path-dependent patterns of economic organization, point to limitations of the scholarship that emphasizes the necessity of a state’s withdrawal for market transition. In fact, findings of this study suggest that it is



better to conceive of markets in post-socialist Europe as begin created and constructed rather than emerging.

Advancing the perspective of markets as embedded in states and institutions, I set out to uncover the substantive variety of this embeddedness in the case of Central and Eastern Europe, which is distinct from economic and political reforms in countries of East Asia, Latin America or China. Because of the simultaneous processes of privatization, democratization and globalization, post-socialist states in Central and Eastern Europe facilitate marketization by not only establishing the legal framework for property rights, and showing political commitment to market reforms but also acting as economic agents in their own right, engaging in market transactions with foreign investors. While the character of state involvement in the economy, that is, the substantive variety of market-state relations examined in this study, may be specific to places characterized by simultaneous processes of privatization, democratization and integration into a global economy, what is likely widely applicable is the theoretical argument advanced in this research—the claim about institutional foundations of economic processes and markets as social constructions. Ultimately, this study suggests that our understanding of economic transformation will be seriously impaired if it does not pay attention to the specific configurations of institutions, politics and state action that not merely impinge on it, but make it possible.

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## Appendix A – Data Structure and Sources

### **SAMPLE: POOLED CROSS-NATIONAL TIME SERIES**

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

Time Period: 1990-2000 (for Bulgaria, Czech Republic, Hungary, Poland, Slovenia), 1991-2000 (for Romania, Slovakia), 1992-2000 (for Croatia, Estonia, Latvia, and Lithuania)

*Note:* Time series start at different years because several of these countries did not exist as national units before 1992 and thus data are not available. Moreover, none of these countries (or then territories) kept a record of FDI before the fall of socialism because FDI was officially prohibited during state-socialism.

### **DEPENDENT VARIABLE**

Foreign Direct Investment Flows

Sources: WIIW- The Vienna Institute for International Economic Studies, International Investment Statistics Yearbook 2000, EBRD (European Bank for Restructuring and Development) Transition Report 2000

### **ECONOMIC INDICATORS**

GPD per capita

Sources: International Financial Statistics Yearbook 1999, EBRD Transition Report 2000, Business Central Europe Statistics

GDP growth

Sources: International Financial Statistics Yearbook 1999, EBRD Transition Report 2001

Country Credit Rating

Source: Institutional Investor, <http://institutionalinvestor.com>

Inflation rate

Sources: International Financial Statistics Yearbook 1999, EBRD Transition Report 2001

### **ROLE OF POST-SOCIALIST STATES**

Private Sector Share in GDP

Source: EBRD Transition Report 2001

Democratization index

Source: Freedomhouse Nations in Transit <http://www.freedomhouse.org/research/nattransit.htm>

Pro-reform Government in Power

Source: Freedom House Nations in Transit 1998, Freedom House Nations in Transit 2002  
<http://www.parties-and-elections.de/europe.html>

Direct Sale to Foreigners

Source: EBRD Transition Report 2001, National Accounts

### **INITIAL CONDITIONS**

Share Employed in Agriculture (1989)

Source: EBRD Transition Report 2000

Private Sector Share in GDP (1990)

Source: EBRD Transition Report 1999

### **INVESTOR INTEREST**

Inflow of FDI into Central and Eastern Europe

Source: UNCTAD World Investment Report (2002)