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# Foreign investment location and institutional development in transition economies

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## Abstract

Institutions are widely regarded as a crucial locational advantage of host countries aiming to attract foreign investors. However, there is little agreement on which institutions matter, and why. This study contributes to filling this gap by analyzing the impact of different dimensions of the newly created institutional framework in East European transition economies on foreign direct investment (FDI).

Using a dataset detailing FDI flows from individual market economies to transition ones, we examine the relationship between institutional development and FDI inflow. We find that FDI is positively related to the quality of formal institutions, though an impact from informal institutions can only be shown for the special case of Russia, which has suffered from a gap between the extensiveness and effectiveness of legal reform. Several specific formal institutions are found to influence FDI: private ownership of business, banking sector reform, foreign exchange and trade liberalization, and legal development. Conversely, domestic price liberalization, non-bank financial sector development and competition policy do not enhance FDI. These results point to important complementarities, but also potential conflicts, between policy reform and the interest of multinational firms.

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*Keywords:* Foreign Direct Investment; Transition economies; Institutions

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## 1. Introduction

Foreign direct investors view institutions as an important aspect of the locational advantages of a potential host country. They form part of the “created assets” of countries, and have arguably become increasingly significant relative to more conventional “natural assets”, like raw materials or cheap labor (Narula & Dunning, 2000; United Nations, 2002). The specific features of formal institutions shape the incentives faced by private businesses, and in consequence have been found to influence the extent of foreign direct investment (FDI) (Henisz, 2000; Mudambi & Navarra, 2002; Ramamurti, 2001).

Hoskisson, Eden, Lau and Wright (2000: p. 252) argue that institutional theory should be “preeminent in helping explain impacts on enterprise strategies” in emerging markets. Economic institutions establish the incentives faced by domestic economic actors as well as foreign investors (North, 1990). In this spirit, institutional variables such as government policy (Gomes-Casseres, 1991), intellectual property rights protection (e.g. Oxley, 1999) or political risk (e.g. Henisz, 2000) have been incorporated in the study of foreign investment strategies, notably entry mode choice. However, prior to deciding how to enter, investors have to decide where to invest; the institutional framework has an equally if not more important influence on locational choice. Since Guisinger (1985), the impact of different aspects of the institutional framework on inward FDI has rarely been addressed.

Transition economies are an interesting context to explore the impact of institution building because the entire set of formal institutions has been remodeled in the 1990s. A distinct yet diverse business environment has evolved in the process of transition from socialist planning to the market economy (Meyer, 2001a). The institutions reflect both the heritage of communist ownership and the need to build market interactions from scratch, including private ownership, a system of private property, capital markets and an appropriate legal and institutional infrastructure. Critical scholars like Kogut and Spicer (2002), and Stiglitz (1999) have argued that the establishment of new institutions is at least as important as more conventional macroeconomic policy objectives. The consistency and completeness of institutions influence the strategies of previously state-owned firms before and after privatization (e.g. Peng, 2000; White & Linden, 2002), the creation of new firms (McDermott, 2002) and the strategies of foreign investors (Henisz, 2000).

However, the interactions between national economic institutions and enterprise level organizational strategies are still under-researched (Mudambi & Navarra, 2002). This is particularly relevant for emerging markets because the underlying economic mechanisms are typically underdeveloped (see e.g. Clague, 1997; Harriss, Hunter, & Lewis, 1995). Research in transition economies has started to analyze how institutions influence strategies by foreign investors, notably their entry modes (Henisz, 2000; Meyer, 2001b). This research shows the importance of institutional development, yet only at an aggregate level. We extend this work by differentiating institutions in host transition economies that may impact on inward FDI. We seek to explain, in a comparative perspective, the aspects of institutional development that provide a significant determinant of FDI receipts.

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