Institutions in transition: is the EU integration process relevant for inward FDI in transition European economies?

Article

Published Version

It is advisable to refer to the publisher's version if you intend to cite from the work. See Guidance on citing.

www.reading.ac.uk/centaur

CentAUR

Central Archive at the University of Reading

Reading's research outputs online

EURASIAN JOURNAL OF ECONOMICS AND FINANCE

www.eurasianpublications.com

INSTITUTIONS IN TRANSITION: IS THE EU INTEGRATION PROCESS RELEVANT FOR INWARD FDI IN TRANSITION EUROPEAN ECONOMIES?

Uros Delevic
Corresponding Author: University of Reading, UK. Email: u.delevic@pgr.reading.ac.uk

Irina Heim
University of Reading, UK. Email: i.heim@pgr.reading.ac.uk

Abstract

This research challenges the contemporary view of economic policy makers in transition European economies that the EU integration process will lead to a greater inflow of Foreign Direct Investments (FDI), thereby increasing living standards. With the Brexit referendum, the integration of the EU has been threatened by a distressing existential question: is EU membership valuable for transition countries if even developed countries (like the UK) vote to leave or decided not to align like Switzerland and Norway in the past? Our analysis considers the success of several countries in Eastern Europe in attracting and benefiting from FDI on their way to EU membership. Analyzing a 13-year panel data of 16 transition countries, we found no statistically significant positive association between FDI inflow and EU accession. We argue, that it is also important to consider the welfare for domestic economies that can emerge from those investments. We illustrate this through the case study of a successful combination of institutional development and local content policies implementation accompanied by sufficient FDI inflows in a non-EU country - Kazakhstan.

Keywords: Transition Economies, Institutional Change, Economic Development, EU Integration, Foreign Direct Investments, Theory of MNEs

JEL Classification: P33, F23, F02, L52, B52

---

1. Introduction

It has been more than two decades since former command economies started their transition to market economies, believing that replicating certain policies of developed countries would make them developed too. Unfortunately, this idea was too simplified, and impossible in reality. As economic reforms continued, it was more and more obvious that application did not fit the socio-economic system of transition countries. The judiciary system was strongly influenced by ruling political parties that tailored privatization of state-owned enterprises according to their personal needs, so national resources often become privately owned overnight (Berend, 2009). All of this make transition economies specific in terms of potential benefits that they could exploit from FDI.

The basic premise in the new neoliberal concept of economic reforms was the necessity to radically abolish trade barriers and liberalize FDI policies, as well as deregulate capital

markets. There was no promise that this would bring economic growth or social welfare. As a matter of fact, scholars like Stiglitz (2000) warned that countries with weak legal framework and decades of command economy would suffer disastrous effects of such radical implementation of neoliberal policies. Former socialist economies understood transition as a deregulation but that does not mean no rules at all. The process of market formation required a whole set of new institutions that did not exist before. These include laws that regulate bankruptcy, protect competition, rules for banking, mortgage, privatization, intellectual property rights etc. Stiglitz (2000). All of these regulations in transition countries came into implementation too late. Because of differences in the stage of economic and institutional development between developed and developing countries, FDI also affects them differently.

As Berend (2009) noted, the attitude of transition countries towards FDI had been hostile for a long time. Under the socialist economic order, foreign investments and foreign capital considered as a threat to national security and social order, which was quite an extreme view. Since the market reforms started, the view about FDI changed completely and went to another extreme. Economic policy viewed FDI as a source of, inevitably, positive influence on the economy.

Moreover, the prevailing dogma, in the transition region, suggested that integration into the EU would lead to the greater inflow of FDI (Stosic *et al.* 2011; Bitzenis, 2013). The main logic behind this assumption is that countries which are on the way to the EU membership have to adopt EU legislation that otherwise would not have been adopted. This, as shown below, is quite a simplified view as some countries in Central Asia adopt EU legislation even though they are far from the EU.

We have chosen the case of Kazakhstan to illustrate our arguments for a number of reasons:

- The wealth of nations today has to do with a path which a society has chosen in the past. We would like to consider a country with a similar path, i.e. a transition country which is changing from a centrally planned to a market economy.

- Kazakhstan's population is similar to the combined population of South-Eastern European (SEE) countries (Bosnia and Herzegovina, Croatia, FYR Macedonia, Montenegro, Serbia, and Slovenia), which were part of ex-Yugoslavia.

- Kazakhstan has a strategic position between the EU and China, yet it is not about to become the EU member.

- Finally, we have chosen a non-European country, which has demonstrated strong economic growth and institutional development in the recent years, in order to dissect EU effects.

It is also believed that institutional stabilization (economic and political) is driven by the necessity to fulfill EU requirements. Strong institutions (which mean low corruption and high transparency) are assumed to be the result of EU integration Tintin (2011), and also to lead to the inflow of FDI which inevitably has positive developmental effects. Therefore, there is a legitimate need to raise the question (1) of correlation between institutional development (that is considered to positively influence FDI inflows) and the EU integration process, and question (2) about the assumed positive developmental effects of FDI in a transition region.

We argue that positive developmental effects of FDI are far from appearing automatically and that the ability of transition countries to facilitate FDI with high spillover potential is the focal point in the process the attraction of FDI. Moreover, we argue that economic policies concerning FDI should follow *the rule of three*: (1) attraction, (2) embodiment and (3) aftercare. As further research will show, transition countries mainly focus on the first step-attraction of FDI, believing that once MNEs set up their operation and employ labor, governments should not engage anymore.

It is difficult to assume that transition countries can attract FDI with high spillover potential without developing local capabilities and therefore using strategies involving the implementation of industrial policies such as local content development policies or performance requirements. Although there are some arguments that performance requirements have deployed inefficiently in many countries (Hufbauer and Schott, 2015), there are also examples of infant industry protection where performance requirements have been used effectively

(Chang, 2003). In order to illustrate successful local content development policy implementation accompanied by sufficient FDI inflow, we consider the case of Kazakhstan.

2. Literature Review and Theoretical Framework
2.1. Location Determinants of FDI

There is a growing interest in the literature about the role of FDI in economic development, developing countries. In order to consider the relevance of the EU integration process for institutional development and FDI, we need to understand how and why companies internationalize. In addition, it is necessary to analyze the process of institutional development in transition countries from a theoretical point of view, in order to understand external factors that might influence this process.

The literature on FDI is supportive of this type of investment mainly because of positive expectations, which are related not only to the inflow of capital itself but more importantly to the inflow of new technologies, managerial knowledge and presumably investments in human capital. It is suggested that FDI can contribute to the host country economy in the long run.

I order to explain why companies would make foreign investments and not in any other form of internationalization, Buckley and Casson (1976) introduced an internalization theory and Dunning (1980) built upon this concept and developed the eclectic framework. Those two concepts become the foundation of the theory of MNEs. Dunning's (1980) eclectic framework provides a means of analyzing FDI more comprehensively. This framework is based on the idea of three principal advantages of MNEs - Ownership, Location, and Internalization, also called the OLI framework- drive internationalization of production. It analyses correlation of the three advantages at the industry level: successful internationalization is dependent on a core competitive advantage, host country location endowments, and the ability to internalize sources of competitive advantage. The explanation provided by the eclectic framework allows for a better understanding of the MNEs' motives, and abilities to engage in production in foreign countries.

According to the eclectic framework, whichever is the motive for the internationalization of production (efficiency, market, resource or asset seeking) companies must develop core competencies (ownership advantages), in the home market. These are portrayed in specific tangible assets like specific technology, managerial practices, and sources of finance, as well as intangible assets like reputation, organization and employee skills. However, whether ownership advantages are efficiently exploited which is very much dependent on the location characteristics of the host country. In other words, the location advantages of the host country compensate for the home market deficiency. These can be larger market size, availability of skilled human capital, and natural resources or institutional stability.

Some researchers, like Baldwin (1969) or Damijan *et al.* (2013), add EU membership as an important determinant for FDI. On the other hand, Cristina and Cantemir (2012) have examined attractiveness indexes of public policies for FDI in CEE countries, and found that the increase of the FDI per capita since the EU accession years is, at least partially, due to the increasing attractiveness of the public policies, like state subsidies (Bellak and Leibrecht, 2005). The beneficiary are those countries that improve the infrastructure, the institutions' quality and labour market conditions (Demekas *et al.* 2007). However, the question whether this improvement is the result of EU accession, or just the result of efforts of the governments to attract FDI with subsidies, or the result of privatization, remains unanswered in this paper.

Radulescu and Jianu (2011) analyzed Romania and Spain's entry into the EU and did not find any positive relationship between EU accession and inward FDI. A number of studies like Narula and Bellak (2008) have illustrated that relying only on market size and low wages is no longer a factor that determines the attraction of FDI. It is rather a strong institutional framework, which is the key factor of success.

However, as we can see, theoretical grounding does not recognize this type of location advantage. Membership in the EU per se will not make a country's labor cheaper, its natural resources richer or technologies more advanced. What it might be related to the market size, as member states are also part of the European Economic Area, which enlarges their market

(Brenton *et al.* 1999). At the same time, this is also the case with other non-EU countries in Europe and around the world, which has free trade agreements with the EU, for example, South Korea, Norway or Israel.

2.2. The Relevance of Institutional Efficiency for the Attraction of FDI

The institutional theory explains that firm behavior is determined by the external institutional environment which includes formal institutions such as law, regulations and rules, and informal institutions such as norms, cultures, and ethics. North (1990) defined institutions as the rules of the game in a society or, more formally, are the humanly devised constraints that shape economic interaction. Thus, institutions create an environment within which economic transactions are undertaken.

The institutional theory emerged from two streams of economic thoughts: first, the idea that the state defines a legal framework, which ensures that market economy functions, and second, that transactions cost theory explaining that economic organizations manage themselves in order to reduce costs associated with economic transactions, which are influenced by the institutions governing the market. Without a stable institutional framework, transaction costs may become so high, that certain transactions are not undertaken at all (Peng and Meyer, 2011). Institutions develop over time and the institutional transition is "fundamental and comprehensive change introduced to the formal and informal rules of the game that affect organizations as players" (Peng, 2003, p. 275).

Institutions continue to remain regulated at the national level, so the changes are multidirectional and very slow. It takes decades to create and sustain a certain type of institutional system. On the other hand, most countries are now trying to promote economic growth through FDI and international trade. However, in a completely liberalized environment FDI does not necessarily lead to growth if there is no growth of domestic investment, therefore, FDI lead to growth only where the "domestic investment has the ability to internalize the externalities from FDI" (Narula, 2015, p.17).

3. FDI and the EU Integrations

Statements about the EU integration process leading to higher living standards, repeated innumerable times, are in high discordance with economic evidence[1] and have only political connotations. The period of EU integrations in transition countries in South-East and Eastern Europe was characterized by a severe decline in population and a radical increase in unemployment and poverty. The analysis below will also show that membership in the EU per se, cannot be considered as a location advantage and that institutional convergence that creates grounds for approximation of income per capita to the levels of developed European economies may be correlated, to some extent, with the free trade area, i.e. the European Economic Area (EEA).

Research about FDI in transition regions has considered its volume, origins, and destination according to economic activity. Damijan *et al.* (2013) suggest that FDI in developing European countries have traditionally been accessed as a source of productivity growth and export restructuring. Rojec and Penev (2004) see the key positive location advantage in transition countries to be high-quality cheap labor. This is very problematic, as high-quality labor is by definition not cheap. Moreover, with regional economic integration, particularly in the EU that allows free movement of people, cheap labor loses its location-specific characteristic.

Another argument in favor of EU integrations, in relation to FDI inflows, relies on the fact that countries enlarge their market by joining the European Free Trade Area. This is considered an important location advantage in Dunning's (1993) OLI framework, but nowadays, the EU is 28 country club that follows the global tendency of trade liberalization in line with WTO rules. Moreover, companies in transition countries have built their competencies in the period of

---

[1] For more information see Institute of Economic Science of Serbia (2012) and World Bank (2015).

socialism and can hardly win an open market battle with experienced companies of a developed Europe in a single market (Radosevic, 2004).

The key advantage of cheap labor in transitions countries, which have been identified by Rojec and Penev (2004), seems to be outdated nowadays. Local and regional labor markets allow employees to look for jobs in countries other than their own. Authors like Narula (2009) and Blomstrom and Kokko (2013), clearly argue that developing European countries should overcome the low labor cost trap as this kind of location advantage is generic, there is an increasing number of countries that can offer exactly the same. Radulescu and Jianu (2011) also argue that relying on labor costs and EU integrations for FDI attraction is unsustainable, and irrelevant for high-quality investments. Moreover, labor cost is not what makes FDI *sticky*, it is rather labor quality, i.e. its ability to achieve process/product innovations (Narula, 2009).

At the same time, economic development in transition European economies is, being linked not only by government officials but also by some members of the academic community, with a country's progress in the EU integration process Champion and von Reppert-Bismarck (2005). For example, Stosic *et al.* (2011) suggests that in the last few years, countries like Bulgaria and Romania were able to attract more FDI than Serbia, because they were going through the EU integration process faster than Serbia. That is why they concluded that Serbia needs to be "brought closer to the European Union" in order to improve a business environment that will attract foreign investors.

The data provided in Table 1 below shows that on the World Bank report "Doing Business 2010" Serbia rank quite low in the 88th position, whereas Bulgaria and Romania are ranked at the 44th and 55th position, respectively. The study indicates how easy it is to start a business, get construction permits, employ workers, trade across borders, enforce contracts, etc. It is not debatable that Bulgaria and Romania have received a significantly greater amount of inward FDI than Serbia, but Serbia has received almost as much inward FDI as Greece (from 2000 to 2012). Figure 1 below summarizes the average annual FDI inflows for the period 2000-2014. The figure also shows that Serbia was a more attractive location for FDI than, for example, Slovenia or Estonia, which are ranked higher in the "Doing Business 2010" report.
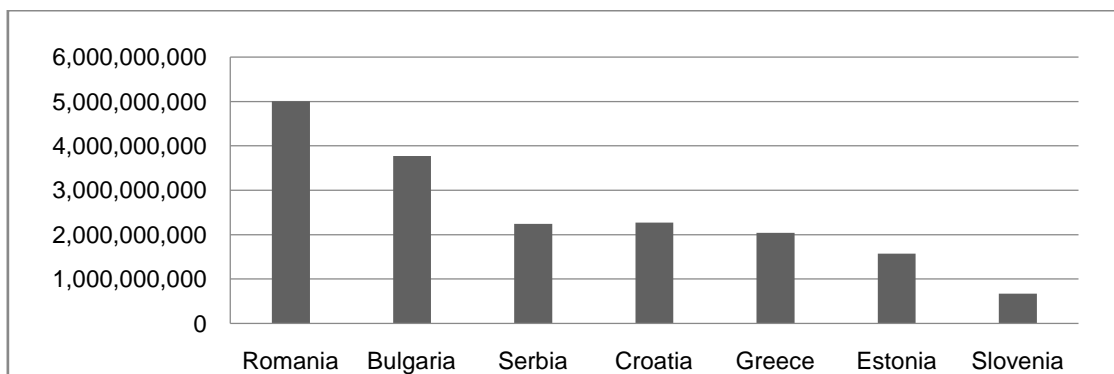

Figure 1. Average Annual Net FDI Inflows, 2000-2014 (current US$)
Source: UNCTAD (2014)

The improvement of the "ease of doing business indicators" is, undoubtedly, important for the improvement of the business environment and establishment of efficient institutions. However, a broader image unambiguously shows no reason to link improvement of the business environment with EU integration. There are at least for two reasons: (1) nation-states are sovereign territorial units and implement policies independently of anybody's requirement, (2) there are cases of the EU members which have considerably lower Doing Business indicators than other European countries which are not the EU members (for example, Italy 56th, Greece 61st versus Norway 6th, Switzerland 20th).

If we apply the logic of EU integration being responsible for the improvement of the business environment that led to greater FDI inflows in Bulgaria and Romania, then it is reasonable to question why this has not been the case in Greece or Italy. As a matter of fact,

Italy is ranked at the 56th position in the World Bank's "Doing Business 2015" report which is behind Bulgaria and Romania. At the same time, inward FDI flows are significantly greater in Italy than in Bulgaria and Romania. Table 1 below illustrates country's position at the World Bank's Doing Business ranking and inward/outward FDI flows in 2015.

Table 1. Measuring competitiveness: Italy, Bulgaria, Romania

Country	Ease of doing business rank	Inward FDI flows (in million US$)	Outward FDI flows (in million US$)	Net Outward Investment (NOI) position
Italy	56	11,451	23,451	Positive
Bulgaria	38	1,733	506	Negative
Romania	48	3,234	-77	Negative

Source: World Bank (2014), UNCTAD (2014)

As we can see, among the three EU members, Italy has the lowest rank in easy of doing business ranking report, which means that bureaucratic procedures for starting, running and closing the business are considerably greater in Italy than in Bulgaria or Romania. However, investors have preferred Italy over Bulgaria and Romania for their operations. Therefore, we cannot judge on a country's ability to attract FDI by looking only at indicators of "ease of doing business", as this indicator do not represent the quality of institutions. More importantly, we can see that the EU membership cannot be linked to a country's ability to improve its business environment. The country's business environment is shaped by overall institutional quality, which includes corruption perception and other measures of effective governance. It is important that overall institutional environment increases predictability and trust, and limits opportunistic behavior (North, 1990).

The importance of institutional quality for international business is recognized in the IB literature, as an important driver of FDI Alfaro *et al.* (2008). The supporting formal institutions, which include laws and regulations, private property, protection and equality of parties in the judiciary system, allow businesses to operate at a lower transaction cost, and to invest more securely (Van Hoorn and Maseland, 2016). Yet, there is no evidence to consider this type of institution-building to be the result of the EU integration process.

As Radulescu and Jianu (2011) noted, EU countries like Greece, Italy or Spain are perfect examples of old EU members which show the complete irrelevance of the EU integration process for FDI inflows. Although a steady increase of foreign investments happened in Greece, the growth was 10 times slower than in other Mediterranean economies. The reason is that institutional development occurred at a different rate in different countries, regardless of the EU integrations. Moreover, global trade liberalization and market deregulation allow countries to participate in free trade without being members of the EU single market. Therefore, the research question in this paper will be: Does amount of inbound FDI in transition countries depend on the EU accession?

3.1. Methodology

Building on previous literature that has considered the role of the EU integration process in institutional development and thereby FDI attraction, (Oxelheim and Ghauri, 2004; Nakamura *et al.* 2012), we consider data in the World Governance Index (WGI) in 16 Eastern European countries[2]. These include countries that are on their way to EU membership, current members and non-members. The institutional development in these countries is observed over the period from 2002 to 2014, as many countries have become EU members during this period, and some countries are still integrating.

---

[2] The list of countries: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Serbia, FYR Macedonia, Montenegro, Slovenia, Czech Republic, Estonia, Latvia, Lithuania, Greece, Romania, Hungary, Kazakhstan

However, as the theory of multinational enterprise implies, there are many different factors which drive FDI, apart from the institutional development of host countries. According to Dunning (1993), location advantages of host countries also include market size, labour wage, and openness for trade. Therefore, we include various instrumental variables. The choice of the countries is motivated by many commonalities between countries. First of all, there is the heritage of a socialist past and institutional similarities. Secondly, there is a policy debate in transition regions about the role of EU integrations for FDI. Therefore, the hypothesis is that EU accession is not correlated with the amount of inbound FDI.

A correlation-regression equation (1 and 2) describing the relationship between FDI inflows and its determinants (Simelyte, 2013), where t stands for the year, and i – a host country:

$$y \text{ (FDI)} = f \text{ (GDP;LFS,C;ID;IN;LCP)} \tag{1}$$

$$y \text{ (FDI)} = \alpha + \beta_1 GDP_{it} + \beta_2 LFS_{it} + \beta_3 C_{it} + \beta_4 ID_{it} + \beta_5 IN_{it} + \beta_6 LCP_{it} \tag{2}$$

where:

GDP - Gross Domestic Product; LFS - Labor Force Size; C - Corruption Perception Index; ID – Institutional Development.

3.2. Data and Variables

The empirical analysis in this study is based on panel data of 16 countries over the 13-year period 2002–2014 (inclusive) supplied by UNCTAD, World Bank and Transparency International (Table 2).

The dependent variable, collected from the UNCTAD's (2014) World Investment Report, is an inflow of FDI (millions of US dollars). As control variables, we introduce several measures of institutional development, following Van Hoorn and Maseland (2016). Those include: Voice and Accountability; Political Stability and Absence of Violence; Government Effectiveness; Regulatory Quality; Rule of Law; Control of Corruption, all summed up under the World Governance Indicator (WGI), where an estimate of governance ranges from approximately -2.5 (weak) to 2.5 (strong) governance performance. We take averages of countries' scores on these indicators for the period 2002-2014. There is a theoretical grounding, according to Dunning (1993), to account for those factors as determinants of FDI. There is also a notion that the EU integrations process influences the improvement of those factors (Baldwin *et al.* 1997). We also introduce several control variables to ensure that relevant factors that can influence FDI inflows are accounted for. These include the size of a country's labor force, GDP per capita and corruption perception index. Concerning the EU accession, we have divided countries into three groups and created 3 dummy variables (in STATA): for the EU membership variable would take "1" (EU-member), all observations before EU accession year are denoted as zero (non-member) – "2" and Kazakhstan – "3" as it has no intention to join the EU (Table 3).

Table 2. Variables, definitions and data sources.

Variable	Definition	Source[3]
Dependent variable		
Inbound FDI	Natural log of total inbound FDI received by a country	UNCTAD (2014) www.unctad.org
Independent variables		
The Worldwide Governance Indicators 2016: Voice and Accountability, Political stability, Government effectiveness, Regulatory quality, Rule of law, Control of corruption	Averages of countries' scores	World Bank (2016) The Worldwide Governance Indicators www.govindicators.org
Control variables		
GDP per capita	Market opportunity, natural log of gross domestic product in current international dollars, purchasing power parity PPP adjusted)	World Bank (2015) www.worldbank.org
Labour force size	Natural log of millions people in labour	World Bank (2015) www.worldbank.org
Corruption perception index	Averages of countries' scores	Transparency International (2015) www.transparency.org
Year dummies	Dummy variable used for years 2002-2014	-
EU accession dummies	0 – non-member 1 – member 2 - KZ	-

Table 3. CEE, Baltic and SEE countries and their year of EU accession

Country	Year of EU accession
Albania	recognized candidate
Bosnia and Herzegovina	potential candidate
Bulgaria	2007
Croatia	2013
Czech Republic	2004
Estonia	2004
Greece	1981
Hungary	2004
Kazakhstan	not applicable
Latvia	2004
Lithuania	2004
Montenegro	recognized candidate
Romania	2007
Serbia	recognized candidate
Slovak Republic	2004
Slovenia	2004

---

[3] All electronic sources accessed on April 20, 2016.

3.3. Analytical methods
3.3.1. Correlations and multicollinearity

In performing tests to account for the most appropriate econometric model, we consider the possibility of multicollinearity. Imperfect multicollinearity occurs when two or more regressors are highly correlated (a cut-off point for the correlation coefficient > 0.7). There are particularly large, positive and significant correlations between all Worldwide Governance Indicators 2015 (Table 4): Voice and Accountability, Political stability, Government effectiveness, Regulatory quality, Rule of law, Control of corruption, except between Political stability and Voice of accountability (0.6156) and Political stability and Corruption perception (0.6773),where the correlation is strong but VIF values are less than the 0.7 cut-off point. Based on our calculations we excluded all WGI indicators from our model apart from Control of Corruption, and opt to keep the Corruption perception index. There is no correlation of Worldwide Governance Indicators 2015 with the other variables in our model such as EU accession, GDP, labor force size and therefore we have concluded that multicollinearity has no effect on the coefficient between iFDI and the fact of EU accession. The characteristics of key variables are presented in descriptive statistics (Table 5).

Table 4. Correlation coefficients

	C	Y	RL	CC	RQ	PS	GE	VA	LFS	CP	EUa	GDP	iFDI
C	1.000												
Y	0.000	1.000											
RL	0.198	0.148	1.000										
CC	0.213	0.006	0.912	1.000									
RQ	0.071	0.082	0.915	0.831	1.000								
PS	0.262	0.004	0.754	0.689	0.758	1.000							
GE	0.237	0.237	0.933	0.876	0.890	0.806	1.000						
VA	0.162	0.034	0.873	0.868	0.856	0.620	0.840	1.000					
LFS	0.108	0.007	0.214	0.347	0.144	0.067	0.276	0.349	1.000				
CP	0.143	0.289	0.826	0.848	0.793	0.681	0.787	0.699	0.239	1.000			
EUa	0.180	0.276	0.275	0.103	0.269	0.336	0.247	0.077	0.436	0.272	1.000		
GDP	0.242	0.476	0.730	0.561	0.605	0.614	0.714	0.465	0.129	0.637	0.626	1.000	
iFDI	0.009	0.046	0.108	0.198	0.030	0.071	0.102	0.262	0.645	0.094	0.410	0.178	1.000

Note: C- Country, Y – Year, RL – Rule of law, CC – Control of corruption, RQ – Regulatory quality, PS – Political stability, GE – Government effectiveness, VA- Voice and accountability, LFS – Labour force size, CP – corruption perception, EUa – EU accession, GDP – GDP per capita, iFDI – inflow Foreign Direct investments

Table 5. Descriptive statistics

Variable	Observations	Mean	Std. Dev.	Min	Max
FDI	208	2832.433	3237.822	-476	14375
Nonmember	208	0.4182	0.4944	0	1
KZ	208	0.0625	0.2426	0	1
GDP per capita	208	17457.56	6975.707	4785.9	31185.9
ln LFS	208	14.6035	0.9385	12.40395	16.1529
GE	208	0.3267	0.5837	-0.97	1.19
CC	208	0.0228	0.5100	-1.1	1.27

3.3.2. Analytical models and robustness tests

First, we defined panel data by using command "xtreg" with the option "fe" to perform fixed effect regression in STATA (Table 6).

Table 6. Panel data definition and coefficients for the within-subjects (fixed-effects) variables

FDI	Coef.	Std. Err.	t	P>ItI	95% Conf. Interval	
Nonmember	517.9137	677.8615	0.76	0.446	-819.9223	1855.75
KZ	Omitted because of collinearity					
GDP per capita	-0.10284	0.1094	-0.94	0.349	-0.3188	0.1131
lnLFS	21174.67	5287.914	4.00	0.000	10738.38	31610.97
GE	-1068.917	1427.26	-0.75	0.455	-3885.775	1747.942
CC	2356.889	1340.93	1.76	0.081	-289.5877	5003.365
_cons	-306175.9	76784.8	-3.99	0.000	-457719.3	-154632.5

Notes: sigma_u: 18134.691; sigma_e: 1973.2339, rho: 0.98829894 (fraction of variance due to u_i); Fixed-effects (within regression), Number of observations – 208, Group variable – country, Number of groups – 16, R-sq: within = 0.3207, between = 0.6466, overall = 0.3759, Number of groups – 16, Obs per group:min = 13, avg = 13.0, max = 13, $F_{(17,175)}$ = 4.86, Prob > F = 0.0000.

Second, we get both the within and between effects with a **xtreg-re** command (Table 7):

Table 7. Panel data definition and coefficients for the within-subjects (fixed-effects) and between-subjects effect variables.

FDI	Coef.	Std. Err.	z	P>IzI	95% Conf. Interval	
Nonmember	973.475	598.4392	1.63	0.104	-199.4443	2146.394
KZ	5351.083	1652.113	3.24	0.001	2113.001	8589.165
GDP per capita	-0.0289	0.0806133	-0.36	0.719	-0.1869	0.129
lnLFS	1997.312	396.914	5.03	0.000	1219.38	2775.148
GE	143.7223	1004.031	0.14	0.886	-1824.143	2111.687
CC	1227.017	1073.196	1.15	0.252	-874.4093	3332.443
_cons	-28209.88	5713.714	-4.94	0.000	-39408.55	-17011.21

Notes: sigma_u: 1139.5346; sigma_e : 1973.2339 ; rho: 0.25009462 (fraction of variance due to u_i). Random-effects GLS regression; Number of observations – 208; Group variable – country Number of groups – 16; R-sq: within = 0.2651Obs per group:min = 13; between = 0.8119, avg = 13.0, overall = 0.5589, max = 13, Wald chi2 (18) = 107.60, Corr (u_i, X) = 0 (assumed), Prob > chi2 = 0.0000.

To decide between fixed or random effects we have run a Hausman test where the null hypothesis is that the preferred model is random effects vs. the alternative the fixed effects (Table 8).

Table 8. Hausman test.

	Coefficients			
	(b) fe	(B) re	(b-B) Difference	Sqrt (diag (V_b-V_B) S.E.
Nonmember	517.9137	973.375	-455.5614	318.3815
GDP per capita	-0.1028	-0.0289	-0.0738	0.074
lnLFS	21174.67	1997.312	19177.36	5273.001
GE	-1068.917	143.7223	-1212.639	-1014.393
CC	2356.889	1229.017	1127.872	803.9548

Notes: Test: H0: difference in coefficients not systematic; Prob>chi2 = 0.4051 > 0.05 (i.e. not significant), therefore we use random effects model.

3.4. Results

The findings of this research make two important contributions. First of all, we reaffirm the relevance of institutions for FDI. Secondly, from an empirical perspective, the period of the EU integration process was not characterized by substantial improvement of governance indicators

in the transition region. Moreover, we can see that institutional improvements and increased FDI inflows happened in countries which are not intending to join the EU. This is a clear suggestion that internal economic and political reforms in sovereign states are the only ones that matter for institutional development, thus attracting more FDI. Similarly to Radulescu and Jianu (2011), who excluded the role of the EU in the attraction of FDI for Romania, results of this research suggest that transition European economies are capable of improving institutional efficiency, and attract more FDI regardless of their EU aspirations.

The case of Kazakhstan is an example of a country which is not an EU-member and is not going to access the EU in the future. However, it adopted a variety of new legislative norms, and in comparison with new EU members, nevertheless substantially increased the amount of inward FDI in the last 15 years, as illustrated by our data and results.

3.5. Limitations

Our data did not include measures of discrimination or incentives for FDI. Those factors, combined with other relevant determinants of FDI, may have important implications for location choices of MNEs. Furthermore, research can be further extended by an observation of FDI performance in other European countries which are not in the EU integration process.

4. The Role of FDI in Transition Economies

Although we considered the amount of FDI inflows in relation to the improvement of certain institutional factors, we did not consider the quality of investments. The transition economies experienced FDI inflows and certain institutional reform during their EU integrations, but this has been the scenario in the non-EU countries as well. The question of the influence of the FDI on economic growth and development is a separate one and should be considered in the context of the participation of the local business in the MNE production network.

As shown by Narula and Guimon (2010) the role of the state is to create a network of supporting business environment, that include the availability of research institutes and competitive suppliers which can create linkages with MNEs. This is how domestic firms can benefit from the spillover effect and MNE positive externalities,[4] direct and indirect. This is what we consider to be the role of government in the embodiment step.

However, MNEs are not ready to expose their ownership advantages to local competitors as this is fundamental for their competitiveness. MNEs are ready to outsource only what they can afford to lose. Therefore, the role of policy makers is essential in supporting the greater availability of innovative organization and production processes. Transition countries have shown very low adaptability to the needs of technologically advanced MNEs, and are stuck in low value adding production.

Finally, the main point of the attraction of FDI is to make foreign companies stick to the local environment. Therefore, in the aftercare process, governments have to ensure sustainability of foreign investment process and benefits for the host country. As much as globalization has made internationalization of production easy it is also easy to leave countries and move production to new places.

5. Sourcing benefits from FDI in Kazakhstan

Kazakhstan is an export-oriented country with oil and gas industry increasingly dominating its economy. Therefore, a major part of inward FDI investments is concentrated in this sector of the economy. As the oil and gas projects can be very investments intensive, since obtaining independence, the government of Kazakhstan has adopted a series of reforms to liberalize its economy and facilitate foreign investment, first of all in the oil and gas sector. Figure 2 shows a steady increase in inward FDI measures year by year in the period between 2002 and 2014. In

---

[4] Note: Externalities influence every economic unit, but spillover effects pertain only companies that have direct links with MNEs (suppliers, distributors, and etc.)

order to diversify its economic structure, Kazakhstan has embarked on an ambitious program of diversification, innovation, investment in human capital, international trade and FDI attraction for job creation (UNCTAD, 2013).
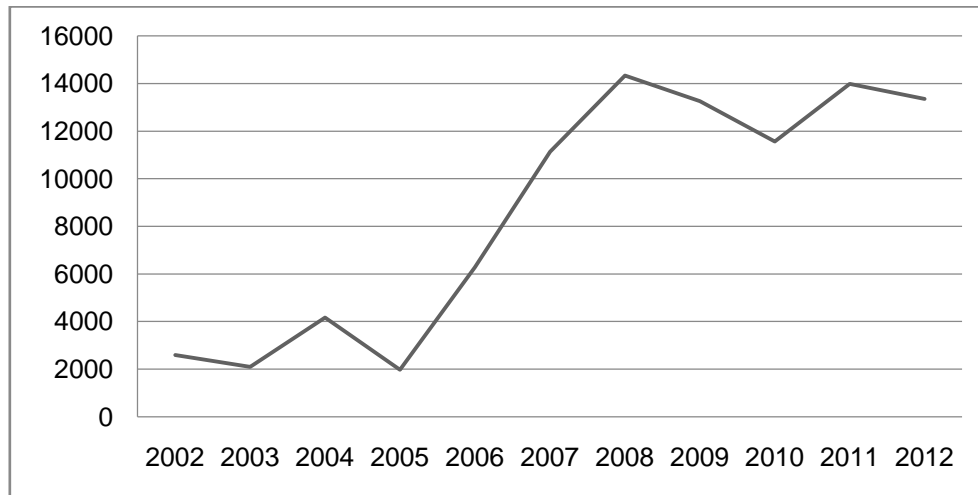

Figure 2. FDI in Kazakhstan in 2002 – 2014
Source: UNCTAD (2014)

However, Kazakhstan shows awareness of the potential negative effects of FDI, especially as motives for FDI in Kazakhstan are resource-seeking (Tordo *et al.* 2013). The FDI in the host country may crowd out the domestic firms, and thus have destructive effects on the level of employment and profits in that country (Greenwald and Stiglitz, 2006). For example, Aitken and Harrison (1999) found that increases in resource-seeking FDI negatively affected the productivity of domestically owned firms in the same industry. This result may explain in part why governments in host countries are so interested in policies that could protect domestic industries. On the other hand, any restriction on the use of inputs is clearly detrimental to efficiency. Therefore, the level of local content restrictions should be negotiated with all stakeholders (Ado, 2013).

The motive of the recent rise in protectionism – what has been termed "global protectionism" in the name of nations - and even nationalization of resource-based industries ("resource nationalism") such as oil in countries like Kazakhstan or Russia (restrictions on foreign investment in the energy sector) appears to be an intention to capture a greater share of value, or to use energy revenues to rebuild the broader economy (Enderwick, 2011 and Mares, 2010).

There is no one generally accepted definition of local content policy (LCP) and often different companies and countries employ different measurements for it. Richardson (1993, p.12) defined LC plans as a requirement "that a firm must use a certain 'amount' of domestically produced inputs in producing its final output". We broadly understand under the term "local content", the wealth shared with the national economy from the purchase of goods and services, including wages and benefits, materials, equipment and plant, subcontracts and taxes (Warner, 2011). Through LC in the oil and gas industries, policy-makers particularly understand value-added activities in which local business competes for subcontracts or service contracts, as well as broader "social" participation by the foreign investors" (Kalyuzhnova, 2008). The modern definition of LC assumes that it is "an industrial tool that can enable domestic producers to expand their activities, at least partially with domestic inputs, and gain access to international technological and managerial expertise… [in order to] enhance their competitiveness" (Kalyuzhnova *et al.* 2016, p3).

There are different development objectives and reasons why countries implement performance requirements, and therefore arguments for protection. For example, Reinert (2007)

has shown how rich countries have developed through a combination of government intervention, protectionism, and strategic investment - rather than through free trade.

The main argument in favor of protection is support of infant industries – domestic competitive industry experiencing dynamic learning effects external to firms, and competing with mature foreign industry producing an imperfect substitute for the domestic goods. Imposed protection must be temporary and the emerging industry must then mature and become viable to survive on its own (Melitz, 2005 and Enderwick, 2011). Historically, this argument was used by the United States as it sought to industrialize in the face of British dominance of world trade and, more recently, by both Japan and South Korea as they sought to become global competitors.

The LC schemes refer to those of the areas of the theory of protection (Vousden, 1987), based on the early theoretical analyses of content protection made by Wonnacott and Wonnacott (1967) and Munk (1969). Grossman (1981) proposed a content protection scheme which requires that a given percentage of domestic value added or domestic components should be embodied in a specified final product. This model considers a domestic goods sector purchasing from an intermediate sector, either nationally or importing from abroad. Grossman (1981) found, that the degree of protection is variable and difficult to predict and because of this, content protection "may fail to attain the noneconomic objectives of the policy maker".

According to Johnson (1960), non-economic objectives are "objectives of various kinds, identified in one way or another with the effects of the tariff on domestic production and consumption of certain products". He identified five non-economic objectives: national self-sufficiency and independence achieved through an increase in the proportion of consumption supplied from domestic production. The diversification, industrialization, or agriculturalization leading to an increase in production in the supporting industries. The promotion of farming as "a desirable way of life" implying subsidizing employment in this sector. The military preparedness expressed in maintaining a higher level of domestic production of certain strategic commodities. The bargaining, i.e. inflicting economic damage upon another country or countries in order to obtain advantageous tariff concessions. Since these researchers, the limited theoretical literature on content protection has been developed: for example, Davidson *et al.* (1985) investigated the interrelation between the impact of foreign investments on welfare, output and employment in the host country and the level of LC requirements. He has argued that local requirements to some point are the source of host country's welfare, output and employment.

Kazakhstan started to support and develop local content in the oil and gas industry since the declaration of its independence in 1990th years. The first version of the Subsoil Use Law which required applicants in tender proposals to set out their proposed obligations to engage a certain percentage of goods, works and services of Kazakhstan-origin and Kazakhstani personnel was introduced in 1996.

With the introduction of the Law of the Republic of Kazakhstan "On subsoil and subsoil use" (Kazakhstan Republican Center of Legal Information, 2016) in 2010, LCPs in Kazakhstan include procurement, labor and technology transfer policies and social projects. Although there are some challenges associated with the implementation of the local policies in Kazakhstan, and local capacity still remains low (Kalyuzhnova *et al.* 2016), recent researches (Azhgaliyeva *et al.* 2016) demonstrate, that LCP has a positive effect on local economy. For instance, it is strongly associated with firm competitiveness and the decisions to export and LCP may also foster firm competitiveness under a set of conditions (Veloso, 2008).

6. Conclusion

The aim of this paper was to challenge the contemporary view of policy makers in transition countries, which try to justify their EU integrations with the expectation of greater FDI inflows, which are expected to have positive developmental effects. As theoretical arguments and empirical data have shown, investment decisions of MNEs are driven by factors which are divorced from integrations in any political unions.

Overall, the theoretical arguments suggest that there are certain location-specific advantages of host countries which drive FDI movements. However, these can hardly be

associated with the EU integration process and many transition economies were unsuccessful in FDI coordination despite EU integrations. On the other hand, the attracted FDI have had limited developmental effects due to, *inter alia*, inadequate linkages between domestic and foreign enterprises i.e. due to lack of local content policies.

There is no reason to believe that foreign investors would not to invest in transition countries if they were not on the EU path, as long as they are dedicated to the implementation of internal institutional reforms.

References

Ado, R., 2013. Local content policy and the WTO rules of trade-related investment measures (TRIMS): the pros and cons. *International Journal of Business and Management Studies*, 2(1), pp.137-146.

Aitken, B.J. and Harrison, A.E., 1999. Do domestic firms benefit from direct foreign investment? Evidence from Venezuela. *American Economic Review*, 89(3), pp.605-618. https://doi.org/10.1257/aer.89.3.605

Alfaro, L., Kalemli-Ozcan, S., and Volosovych, V., 2008. Why doesn't capital flow from rich to poor countries? An empirical investigation. *The Review of Economics and Statistics*, 90(2), pp.347-368. https://doi.org/10.1162/rest.90.2.347

Azhgaliyeva, D., Belitski, M., and Kalyuzhnova, E., 2016. *Local content policy and sustainable firm performance: case study Kazakhstan. Long Range Planning.* (In Press).

Baldwin, R.E., 1969. The case against infant-industry tariff protection. *The Journal of Political Economy*, 77(3), pp.295-305. https://doi.org/10.1086/259517

Baldwin, R.E., Francois, J.F., and Portes, R., 1997. The costs and benefits of eastern enlargement: the impact on the EU and central Europe. *Economic Policy*, 12(24), pp.125-176. https://doi.org/10.1111/1468-0327.00018

Bellak, C. and Leibrecht, M., 2005. *Effective tax rates as a determinant of Foreign Direct Investment in Central-and East European Countries.* SFB International Tax Coordination Discussion Paper, (7).

Berend, T.I., 2009. *From the Soviet bloc to the European Union: the economic and social transformation of Central and Eastern Europe since 1973*. Cambridge: Cambridge University Press. https://doi.org/10.1017/CBO9780511806995

Bitzenis, A., 2013. *The Balkans: foreign direct investment and EU accession.* Surrey: Ashgate Publishing Ltd.

Blomstrom, M. and Kokko, A., 2003. Human capital and inward FDI. *EIJS Working Paper Series,* No. 167.

Brenton, P., Di Mauro, F., and Lücke, M., 1999. Economic integration and FDI: An empirical analysis of foreign investment in the EU and in Central and Eastern Europe. *Empirica*, 26(2), pp.95-121. https://doi.org/10.1023/A:1007006429600

Buckley, P.J. and Casson, M., 1976. *Future of the multinational enterprise.* London: Palgrave Macmillan UK. https://doi.org/10.1007/978-1-349-02899-3

Champion, M. and von Reppert-Bismarck, J., 2005. Talking Turkey pays dividends: Mere start of EU negotiations is enough to encourage investors. *Wall Street Journal,* Issue 18.

Chang, H.J., 2003. Kicking away the ladder: Infant industry promotion in historical perspective. *Oxford Development Studies*, 31(1), pp.21-32. https://doi.org/10.1080/1360081032000047168

Cristina, P.O. and Cantemir, C.A., 2012. Attractiveness of public policies for FDI in Central and Eastern European countries. *The Annals of the University of Oradea*, 1(1), p.61-67.

Damijan, J.P., Kostevc, C., and Rojec, M., 2013. Global Supply Chains at Work in Central and Eastern European Countries: Impact of FDI on export restructuring and productivity growth. *LICOS Discussion Paper Series, No. 332/2013, pp.1-35.*

Davidson, C., Matusz, S.J., and Kreinin, M.E., 1985. Analysis of performance standards for direct foreign investments. *Canadian Journal of Economics*, 18(4), pp.876-890. https://doi.org/10.2307/135097

Demekas, D.G., Horváth, B., Ribakova, E. and Wu, Y., 2007. Foreign direct investment in European transition economies— The role of policies. *Journal of Comparative Economics*, 35(2), pp.369-386. https://doi.org/10.1016/j.jce.2007.03.005

Dunning, J.H., 1980. Toward an eclectic theory of international production: Some empirical tests. *Journal of International Business Studies*, 11(1), pp.9-31. https://doi.org/10.1057/palgrave.jibs.8490593

Dunning, J.H., 1993. *Multinational enterprises and the global economy.* Reading, MA: Addison-Wesley Publishing Company.

Enderwick, P., 2011. Understanding the rise of global protectionism. *Thunderbird International Business Review*, 53(3), pp.325-336. https://doi.org/10.1002/tie.20410

Greenwald, B. and Stiglitz, J.E., 2006. Helping infant economies grow: Foundations of trade policies for developing countries. *The American Economic Review*, 96(2), pp.141-146. https://doi.org/10.1257/000282806777212206

Grossman, G.M., 1981. The theory of domestic content protection and content preference. *The Quarterly Journal of Economics*, 96(4), pp.583-603. https://doi.org/10.2307/1880742

Hufbauer, G.C. and Schott, J.J., 2013. *Local content requirements: A global problem.* Washington, DC: Peterson Institute for International Economics.

Institute of Economic Science of Serbia, 2012. *Macroeconomic analysis and forecasts.* [online] Available at: <http://www.ien.bg.ac.rs/images/stories/Izdavastvo/map/12/map12_1-2.pdf> [Accessed on 1 June 2016].

Johnson, H.G., 1960. The cost of protection and the scientific tariff. *The Journal of Political Economy*, 68(4), pp.327-345. https://doi.org/10.1086/258340

Kalyuzhnova, Y., 2008. *Economics of the Caspian oil and gas wealth: Companies, governments, policies.* New York, NY: Palgrave Macmillan. https://doi.org/10.1057/9780230227552

Kalyuzhnova, Y., Nygaard, C., Omarov, Y., and Saparbayev, A., 2016. *Local content policies in resource-rich countries.* New York, NY: Palgrave Macmillan. https://doi.org/10.1057/978-1-137-44786-9

Kazakhstan Republican Center of Legal Information, 2016. On subsoil and subsoil use, legal information system of regulatory legal acts of the Republic of Kazakhstan. [online] Available at: <http://adilet.zan.kz/rus>[Accessed on 14 January 2016].

Mares, D.R., 2010. Resource nationalism and energy security in Latin America: Implication for global oil supplies. [online] Available at: <http://www.bakerinstitute.org/media/files/Research/edacf0ea/EF-pubMaresResourceNationalismWorkPaper-012010.pdf> [Accessed on 1 June 2016].

Melitz, M.J., 2005. When and how should infant industries be protected? *Journal of International Economics,* 66(1), pp.177-196. https://doi.org/10.1016/j.jinteco.2004.07.001

Munk, B., 1969. The welfare costs of content protection: the automotive industry in Latin America. *The Journal of Political Economy*, 77(1), pp.85-98. https://doi.org/10.1086/259496

Nakamura, H.R., Olsson, M. and Lonnborg, M., 2012. FDI in the post-EU accession Baltic Sea Region: A global or a regional concern*? Baltic Journal of Economics*, 12(2), pp.89-108. https://doi.org/10.1080/1406099X.2012.10840519

Narula, R. and Bellak, C., 2008. EU enlargement and consequences for FDI assisted industrial development. *MERIT Working Papers*, No. 067, pp.1-34.

Narula, R. and Guimon, J., 2010. The investment development path in a globalised world: implications for Eastern Europe. *Eastern Journal of Europeans Studies*, 1(2), pp.5-19.

Narula, R., 2009. Attracting and embedding R&D by multinational firms: policy recommendations for EU new member states. *UNU-MERIT Working Papers*, No. 033, pp.1-38.

Narula, R., 2015. The Importance of Domestic Capabilities for FDI-assisted Development: Lessons from Asia and Latin America. *Henley Business School Discussion Papers*, No. 05, pp.1-24.

North, D.C., 1990. *Institutions, institutional change and economic performance*. Cambridge: Cambridge University Press. https://doi.org/10.1017/CBO9780511808678

Oxelheim, L. and Ghauri, P.N., 2004. The *European Union and the race for foreign direct investment in Europe*. Oxford: Emerald Group Publishing.

Peng, M.M. and Meyer, K.E., 2011. *International business*. London: Cengage Learning.

Peng, M.W., 2003. Institutional transitions and strategic choices. *Academy of Management Review*, 28(2), pp.275-296.

Radosevic, S., 2004. A two-tier or multi-tier Europe? Assessing the innovation capacities of Central and East European countries in the enlarged EU. *JCMS: Journal of Common Market Studies*, 42(3), pp.641-666. https://doi.org/10.1111/j.0021-9886.2004.00522.x

Radulescu, M. and Jianu, E., 2011. FDIs in Spain after its EU Accession. Spanish investments in Romania and how can be used Spanish Experience for Romania's Development. *Annals of the University of Petrosani, Economics*, 11(2), pp. 233-256

Reinert, E.S., 2007. *How rich countries got rich... and why poor countries stay poor*. London: Constable.

Richardson, M., 1993. Content protection with foreign capital. *Oxford Economic Papers*, 45(1), pp.103-117.

Rojec, M. and Penev, S., 2011. The attractiveness of Western Balkan countries for FDI. In: M. R. Markovic, S. Redzepagic, J. S. Andrade and P. Teixeira, eds. 2011. *Serbia and the European Union: economic lessons from the new member states*. Coimbra: Faculty of Economics, University of Coimbra. pp. 27-43.

Simelyte, A. and Antanaviciene, J.G., 2013. Foreign direct investment policy as an instrument for sustainable economic growth: a case of Ireland. *Journal of Security and Sustainability Issues*, *2*(4), pp.25-34. https://doi.org/10.9770/jssi.2013.2.4(3)

Stiglitz, J., 2002. *Globalization and its discontents*. London: The Penguin Press.

Stosic, I., Nikolic, D., and Djukic, M. 2011. The attractiveness of Serbia for FDI: Tendencies, obstacles and perspectives. In: M. R. Markovic, S. Redzepagic, J. S. Andrade and P. Teixeira, eds. 2011. *Serbia and the European Union: Economic lessons from the new member states*. Coimbra: Faculty of Economics, University of Coimbra, pp. 47-60.

Tintin, C., 2011. *Do institutions matter for FDI? Evidence from Central and Eastern European countries.* In Proceedings of ETSG 2011. Copenhagen: ETSG.

Tordo, S., Warner, M., Manzano, O. and Anouti, Y., 2013. *Local content policies in the oil and gas sector.* Washington DC: World Bank Publications. https://doi.org/10.1596/978-0-8213-9931-6

Transparency International, 2015. *Corruption perception index report*. [online] Available at: <http://www.transparency.org/cpi2015> [Accessed on 1 June 2016].

UNCTAD, 2013, *World investment report*. [online] Available at: <http://unctad.org/en/PublicationsLibrary/wir2013_en.pdf> [Accessed on 14 January 2016].

UNCTAD, 2014, *Foreign direct investments inflows table.* [online] Available at: <http://unctadstat.unctad.org/wds/TableViewer/tableView.aspx?ReportId=96740> [Accessed on 1 June 2014].

Van Hoorn, A. and Maseland, R., 2016. How institutions matter for international business: Institutional distance effects vs institutional profile effects. *Journal of International Business Studies,* 47(3), pp.374-381. https://doi.org/10.1057/jibs.2016.2

Veloso, F.M., 2006. Understanding local content decisions: Economic analysis and an application to the automotive industry. *Journal of Regional Science*, 46(4), pp.747-772. https://doi.org/10.1111/j.1467-9787.2006.00476.x

Vousden, N., 1987. Content protection and tariffs under monopoly and competition. *Journal of International Economics*, 23(3), pp.263-282. https://doi.org/10.1016/0022-1996(87)90055-9

Warner, M., 2011. *Local content in procurement: Creating local jobs and competitive domestic industries in supply chains*. UK: Greenleaf Publishing.

Wonnacott, R.J. and Wonnacott, P., 1967. *Free trade between the United States and Canada: The potential economic effects.* Cambridge, MA: Harvard University Press.

World Bank, 2014. *Doing business report 2014.* [online] Available at: <http://www.doingbusiness.org/rankings> [Accessed on 11 August 2015].

World Bank, 2015. *Economic indicators.* [online] Available at: <http://databank.worldbank.org/data/reports.aspx?source=world-development-indicators> [Accessed on 1 June 2016].

World Bank, 2016. *The worldwide governance indicators.* [online] Available at: <http://info.worldbank.org/governance/wgi/index.aspx#home> [Accessed on 1 June 2016].