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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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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.

The analysis is based on data of bilateral FDI flows between 1994 and 1998 from the major source countries to the 10 EU accession candidates from Central Europe plus Russia and the Ukraine, thus covering the bulk of FDI to the region over this period (see [Bevan & Estrin, 2000](#)). We find that institutional development in general enhances FDI receipts, and further identify specific institutions with positive influence: private sector growth; development of the banking sector; foreign exchange and trade liberalization; and legal development. In contrast, the development of the financial sector outside banking, domestic price liberalization and competition policy does not appear to enhance FDI. These results point to complementarities as well as potential conflicts between policy reform and the attraction of FDI.

This paper is structured as follows: in Section 2, we consider, at a theoretical level, the interaction of FDI with institutions and locational advantages and develop hypotheses. Our methodology and data are considered in Section 3, the empirical analysis is contained in Section 4 and Section 5 concludes.

2. Theory and hypotheses

The concept of locational advantages captures properties of host locations that make them attractive to potential foreign direct investors ([Dunning, 1958, 1998](#)). Initially, scholars concentrated on factor endowments, especially labor costs and productivity, as locational advantages. In recent years, multinational enterprises increasingly focus on “created assets” ([Narula & Dunning, 2000](#)) including knowledge-based assets, infrastructure and institutions of the host economy.

In consequence, the institutional environment has become a crucial locational advantage. Efficient markets depend on supporting institutions that can provide the formal and informal rules of the game of a market economy, allowing a lower transaction and information costs and reducing uncertainty ([North, 1990](#)). The legal and governmental arrangements as well as informal institutions underpinning an economy influence corporate strategies ([Oliver, 1997; Peng, 2000](#)) and thus profoundly influence the operation and performance of businesses ([Dacin, Goldstein, & Scott, 2002; North, 1990; Scott, 2001](#)).

Institutions are important as locational advantages in international business because they “represent the major immobile factors in a globalized market... Legal, political and administrative systems tend to be the internationally immobile framework whose costs determine in international attractiveness of a location. Institutions affect the capacity of firms to interact and therefore affect the relative transaction and coordination costs of production and innovation” ([Mudambi & Navarra, 2002: p. 636](#)).

Thus, FDI is increasingly undertaken not only to exploit existing resources, e.g. by selling produce in the local market, but by augmenting resources and capabilities through the interaction with diverse locations. Hence, investors seek locations where the institutional environment facilitates the development of their global

firm-specific advantages, and this creates new challenges both for MNE and public policy (Rugman & Verbecke, 2002).

For firms contemplating FDI, the restrictions and incentives created by institutions “shift the playing field favoring some deals and opportunities while disadvantaging others. They force the investing firms to think strategically about how to avoid the limits imposed by domestic laws as well as how to reap the benefits that the law and particular circumstances are capable of providing” (Spar, 2001). The range of policies of concern to foreign investors is wide, as illustrated by the long list of policies aimed at selectively attracting or moderating inflows in developing countries identified by Guisinger (1985).¹ Empirical research points to crucial institutional influences in home and host countries on international business strategies, notably the choice of entry mode, the magnitude of investment, the probability of survival and the variety of international expansion strategies (Delios & Henisz, 2001; Henisz, 2000; Meyer, 2001a,b; Yiu & Makino, 2002).

2.1. Business strategies and institutions in transition

The transition economies are moving from socialist to private ownership, and usually from central planning to market systems of resource allocation (see World Bank, 1996). Hence, the legal framework has been changed radically to create a new set of formal institutions during the 1990s. Yet, this process varied considerably across countries, and often the transformation of informal institutions lagged changes in the law (e.g. Peng, 2000). There are many reasons to believe that the emergence of smoothly operating markets has been sporadic, slow and uneven across the transition economies. One can cite the widespread emergence of barter throughout the former Soviet Union, the disintegration of business to business relationships between buyers and sellers, the opaque legal and regulatory frameworks, and the underdeveloped political, constitutional court systems in many countries, as well as the emergence of significant corruption and bureaucratic inefficiency (see EBRD, 2001). The weak institutional framework increases search, negotiation and enforcement costs (see Antal-Mokos, 1998). This implies high transaction costs of establishing new business relationships and inhibits potential transactions (Meyer, 2001b).

Direct investors have had to adapt their strategies to these local institutions (Oxley, 1999; Peng, 2000). Western businesses entering the transition economies probably face higher transaction costs than in mature market economies because the transition temporarily creates an incomplete institutional framework. Moreover, these costs are variable across transition economies because the speed of adjustment to the market economy differs enormously (see EBRD, 2001). It can also impact differentially on firms from alternative countries of origin because the experience of operating in such environments varies (see Estrin, Hughes, & Todd,

¹ Of course institutions are also the outcome of social and political processes, in which international businesses play a part (Spar, 2001).

1997). Hence, one can hypothesize a positive cross-sectional relationship between institutional development and FDI receipts.

Empirical research about the impact of host country institutions on FDI has indicated the general impact of the institutional, social and legal framework. [Brenton, Di Mauro and Lücke \(1999\)](#) show an economic freedom index to be positively related to FDI flows. A different line of research has focused on the impact of institutional variables on specific strategic decisions such as the control over foreign operations. In the transition economy context, such research has shown that institutional development as measured by an aggregate index ([Meyer, 2001b](#)) or intellectual property rights protection ([Oxley, 1999](#); [Smarzynska, 2002](#)) facilitates foreign investment in the form of wholly owned rather than jointly owned ventures.

Our central hypothesis is that, at an aggregate level, the stage of development of institutions is crucial to attract FDI, by reducing the transactions costs of setting up a local operation. In transition economies, this proposition takes a particular form, because the institutions in question are those underpinning the market economy itself, and they have undergone fundamental transformation in the 1990s. We can first posit the overall process of institutional building, incorporating both formal and informal institutions in North's definition, facilitates FDI.

Hypothesis 1. *Countries with better developed institutions for a market economy receive more FDI inflows.*

2.2. *Focus on institutions: which ones matter?*

While there is strong support for the proposition that institutions matter, there is little agreement on their relative importance when it comes to attracting inward investors. We thus extend the previous literature by looking at the constituent elements of the institutional framework to discover which institutions are crucial to FDI in the transition context. While we would like to test for formal and informal institutions, data limitations allow a separation of formal and informal aspects only for the last of our propositions.²

Possibly, the most important formal institutional change in transition economies is the change of ownership (e.g. [World Bank, 1996](#)). Most firms were state owned in the communist era, so many companies needed to be privatized while the small-scale entrepreneurial sector gradually gained market share (see [Bonnell & Gold, 2002](#)). The extent of private sector development will influence FDI since investors find it more attractive to do business with privately owned firms:

² An important aspect of informal institutions affecting foreign investors is the extent to which corruption is used in the business–government relations and between businesses ([Wei, 2000](#)). In further analysis not detailed here, we also tested for corruption using, among other measures, the Transparency International Index, both as level and as home–host country difference. Unfortunately, we did not obtain statistically significant results, perhaps because the intercountry variation for our sample is relatively modest. Hence, the regressions are not reported in the paper.

- Private firms have stronger incentives to increase productivity and profitability; hence their objectives are more compatible with those of foreign partners.
- Private ownership encourages entrepreneurs to seek new business opportunities (see Peng, 2001), some of which may be found in collaboration with foreign investors.
- Partly as a consequence of the above, private firms develop corporate cultures that are more market friendly (Meyer, 2001a), which reduces cultural distance and thus for example negotiation costs for foreign partners.

Finally, privatization creates opportunities for acquisitions, which can be an important avenue for entry (e.g. Uhlenbruck & De Castro, 2000). In prior research, Lansbury, Pain and Smidkova (1996) find that the private sector share has a positive effect on inward FDI in Central Europe, though this result is not confirmed by Holland and Pain (1998) using a larger set of host countries. Private sector development has numerous dimensions in transition economies, which we expect to have a positive impact on FDI:³

Hypothesis 2a. *Countries with greater privatization and more advanced private sector development receive more FDI inflows.*

Progress in establishing financial infrastructure and capital markets reduces transaction costs for local financial services, such as the payment system. Moreover, it facilitates access to complementary local finance, which can reduce foreign investor's exposure to exchange rate risk. Local customers are also more likely to gain access to bank credit, which can accelerate the demand for, e.g. industrial machinery and up-market consumer goods that often are bought on credit. Thus financial sector reform increases business opportunities for foreign investors.⁴ We therefore propose:

Hypothesis 2b. *Countries with more developed financial market infrastructure receive more FDI inflows.*

International businesses have to adapt to a variety of regulatory regimes that, even if pursuing similar objectives, may apply radically different rules. This requires adaptation to different formalities when interacting with authorities, and, what are

³ In practice, FDI represented only a very small proportion of privatization activity in almost every transition economy except Latvia and Hungary in this period (see EBRD, 1999). Indeed, in many countries, early privatization policies e.g. mass privatization, discriminated against potential foreign buyers. Moreover, though there might be some simultaneous determination of privatization activity and FDI, the sequencing of the policies, with privatization usually occurring before significant FDI flows indicates the causality must run from the former to the latter (see Stiglitz, 1999). A similar logic applies with respect to other institutional changes.

⁴ The effect of capital market development on FDI is not necessarily unidirectional. Foreign investors may substitute locally raised capital for capital raised on international capital markets, but we expect this to be outweighed by the business opportunity effect.

often more challenging, different patterns of competition as a consequence of regulation.

The creation of markets has been the prime objective of transforming centrally planned economies. The most crucial step has been the liberalization of prices in both domestic and international markets for goods and services. Foreign investors usually prefer to operate on competitive domestic markets, although there are exceptions such as established foreign-owned firms benefiting from administrative barriers to entry. Price liberalization thus creates new business opportunities for foreign investors, while the abolition of exchange restrictions and multiple exchange rates allows repatriation of profits and reduces transaction costs.

Progress in establishing market institutions moreover reduces institutional uncertainty if bureaucratic interference in business transactions is subject to clear rules and regulation. This applies notably to competition policy, which is important to protect consumers but can also be (ab-)used to inhibit foreign entry. Regulatory policy is of particular concern for investors in industries with incumbent national monopolists, such as telecommunications (Ramamurti, 2000). In Eastern Europe, the process of designing and implementing competition policy has been far more complex, and in consequence slower, than the liberalization of markets for most goods and services (e.g. Stiglitz, 1999).

Governments in the less reformed countries continue to protect markets of their local firms, even at subnational level. This protection of incumbents against entrants can take different forms. Dutz and Vagliasindi (2000) find sharp differences in both rules and implementation across the region's countries and time, though, in their work, only successful implementation has a strong positive relationship with economy-wide intensity of competition, whereas the mere existence of rules do not. This is an important distinction which we are not easily able to develop in our work, though see below.

Weak enforcement of regulatory policies tends to favor incumbent firms with large market shares, or firms with access to political and bureaucratic decision makers. This can create a bias against foreign investors. On the other hand, changes in competition policy may change the relative competitiveness of firms operating within a given market, and in consequence provide major opportunities for competitive advantage for foreign investors (Spar, 2001).

We thus suggest two hypotheses on the establishment of markets:

Hypothesis 2c. *Countries with more extensive liberalization of domestic and international markets receive more FDI inflows.*

Hypothesis 2d. *Countries with more developed regulation and competition policy receive more FDI inflows.*

An efficient legal infrastructure reduces institutional uncertainties for foreign investors, facilitates establishment and enforcement of contracts and reduces the transaction costs of doing business. Prior research has focused in particular on the impact of intellectual property rights protection on FDI; Oxley (1999) and Smarzynska (2002) found that weak property rights inhibit FDI inflows. However, in

the transition economies, not only *intellectual* property rights are of concern, and we require a broader index of the legal framework.

Though, by the late 1990s, many elements of a market-based legal framework had been established, the implementation of laws was often weak (EBRD, 1999; Murrell, 2001). This is attributed, among other reasons, to the fact that it takes time to establish the informal institutions that need to underpin the law: trained lawyers, independent judges, and general knowledge about laws and legal proceedings. Therefore, we need to distinguish the extensiveness and effectiveness of legal reform. As North (1990) argued, informal institutions need to complement formal institutions. When a formal legal framework is in place, but the enforcement is only sporadic, or legal costs are high, transaction costs are hardly lowered, and informal institutions such as relationship-based business prevail (Peng, 2000; Murrell, 2001). Hence, we expect legal effectiveness to have a more powerful effect than legal extensiveness.

Hypothesis 2e. *Countries with more extensive and more effective legal systems receive more FDI, with the impact of legal effectiveness being stronger.*

3. Methods and data

3.1. *Methods of empirical analysis*

Cross-sectional analysis has frequently been employed to analyze aggregate FDI flows; for transition economies by Lansbury et al. (1996) and Holland and Pain (1998). Martin and Velazquez (1997) and Resmini (2000), among others, use country level data but do not consider the bilateral relationship between host and home countries; the few studies which do (e.g. Brainard, 1997) have concentrated on gravity equations.

Our analysis is based upon a dataset on FDI flows between source and host country between 1994 and 1998. Each observation constitutes a bilateral relation between a source country i (EU-14, as Belgium and Luxembourg are merged, Korea, Japan, Switzerland and the USA) and a host country j (Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Russia, Slovak Republic, Slovenia and Ukraine).⁵ As illustrated in Table 1, we measure FDI and our other continuous variables in DM. This enables us to minimize the influence of exchange rate distortions in our dataset given that the data period of this study extends before the introduction of the euro, when many European currencies were effectively in a fixed exchange rate regime led by the DM.

In order to assess the implications of general transition performance for FDI inflows, we firstly estimate a base model comprising the aggregate institutional index and control variables, which are explained below. We first estimate as model

⁵ The FDI data are derived from various issues of the *International Direct Investment Statistics Yearbook* published by the OECD.

Table 1
Hypotheses, constructs, and their measurement

Hypothesis	Construct	Predicted effect	Variable definition	Data source
1	Institutional Development Privatization	+	(Aggregate) transition index (discrete 1–4+ variable)	EBRD (1999)
2a	Privatization	+	Small-scale privatization index (discrete 1–4+ variable)	EBRD (1999)
		+	Large-scale privatization index (discrete 1–4+ variable)	EBRD (1999)
2b	Financial infrastructure	+	Host privatization method (discrete 1–4 dummy)	Holland and Pain (1998), EBRD (1999)
		+	Host private sector share of GDP (percentage)	EBRD (1999)
		+	Index of banking sector reform (discrete 1–4+ variable)	EBRD (1999)
		+	Index of non-banking financial institutions reform (discrete 1–4+ variable)	EBRD (1999)
2c	Liberalization	+	Index of price liberalization (discrete 1–4+ variable)	EBRD (1999)
		+	Index of forex and trade liberalization (discrete 1–4+ variable)	EBRD (1999)
2d	Regulation and competition policy	+	Index of competition policy (discrete 1–4+ variable)	EBRD (1999)
2e	Legal extensiveness	+	Index of legal extensiveness (discrete 1–4+ variable)	EBRD (1999)
		+	Index of legal effectiveness (discrete 1–4+ variable)	EBRD (1999)
Control variables (i or j variables)	Source country GDP	+	Source country GDP in current prices (DM mn)	IMF International Financial Statistics Yearbook (1999)
	Host country GDP	+	Host GDP in current prices (DM mn)	IMF International Financial Statistics Yearbook (1999)
Control variables (j variables)	Russia	?	Russia dummy	–
	Relative unit labor cost	+	See text	See text
	Common border	+	Common borders dummy	–
	Geographic distance	–	Geographic distance between capital cities of host and donor (km)	How far is it? Website

1, an equation of the following form:

$$FDI_{ij} = F(\text{GDP}_i, \text{GDP}_j, \text{Distance}_{ij}, \text{RULC}_{ij}, \text{Common Border}_{ij}, \text{Aggregate Institutional Index}_j, \text{Russia}) \quad (1)$$

The precise definition, form and source of these and all other variables used in our analysis are presented in [Table 1](#), which also summarizes the predicted effects of each independent variable on country to country FDI flows. Descriptive statistics and correlations for each variable are presented in [Table 2](#). The transition index averages around 3 on a 1–5 scale, with considerable variation in average level across the disaggregated categories of institutional reform. Reforms are most advanced in small privatizations and forex liberalization, least in non-bank reform and competition policy. Since reforms tend to go together, there is collinearity between the overall index and several of the individual items e.g. large privatization, bank reform and price liberalization, which leads us to a particular estimation process discussed below. However, the individual reform items are not always closely correlated.

Estimating an equation of this form enables us to determine the general influence of the development of formal institutions on FDI inflows to the transition economies, while controlling for the influence of economic, logistical and cultural influences. We then investigate which particular institutions influence FDI flows by using 11 individual indicators of institutional development singly or jointly in equations of the form:

$$FDI_{ij} = F(\text{GDP}_i, \text{GDP}_j, \text{Distance}_{ij}, \text{RULC}_{ij}, \text{Common Border}_{ij}, \text{Individual Institutional Indices}_j, \text{Russia}) \quad (2)$$

Note that the institutional indices are host country level variables, while the dependent variable and some control variables are on the level of the bilateral relationship between countries ij . Each variable is constructed as the arithmetic average over the 5-year period of our sample. This allows us to address a number of issues. First, the “lumpy” nature of FDI flows makes it hard to identify a robust model of FDI as a function of what are relatively stable independent variables. Averaging enables us to overcome these problems. Moreover investment projects typically have a life-span of more than one period, and hence the initial inflow that occurs when a project is undertaken is effectively a stock rather than flow variable. Models that use country characteristics to explain FDI inflow on the basis of one data period may be biased by including the initial large set-up flow, while failing to control for the longer-term implications of the investment.⁶

⁶ This is particularly problematic in small countries (e.g. the Baltic States) and/or countries that do not receive a great deal of FDI, as one large project may account for a large proportion of total FDI receipts in any one period.

Table 2
Descriptive statistics and pairwise correlations

Variable	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15		
1 FDI	94.41389	21.65963	1.00														
2 Transition index	3.075755	3.182857	0.24	1.00													
3 Host GDP	86.54545	46.37326	0.28	-0.06	1.00												
4 Source GDP	1734.016	599.0143	0.19	-0.03	-0.01	1.00											
5 Small privatization	3.804304	4.18	0.21	0.92	0.08	-0.03	1.00										
6 Large privatization	3.094937	3.12	0.21	0.90	0.06	-0.03	0.83	1.00									
7 Privatization method	2.126582	2	-0.03	0.30	-0.18	-0.01	0.12	0.44	1.00								
8 Private sector share	59.88165	61	0.23	0.71	0.06	-0.03	0.66	0.83	0.17	1.00							
9 Bank reform	2.76962	2.94	0.13	0.90	-0.36	-0.03	0.79	0.72	0.38	0.53	1.00						
10 Non-bank reform	2.540665	2.5	0.31	0.85	0.18	-0.02	0.77	0.71	0.14	0.44	0.68	1.00					
11 Price liberalization	2.981013	3	0.24	0.83	0.02	-0.02	0.81	0.67	0.19	0.56	0.87	0.69	1.00				
12 Forex liberalization	3.885949	4	0.10	0.78	-0.33	-0.02	0.65	0.59	0.27	0.38	0.86	0.54	0.67	1.00			
13 Competition policy	2.453797	2.35	0.25	0.84	0.01	-0.03	0.73	0.80	0.20	0.78	0.65	0.73	0.55	0.47	1.00		
14 Legal extensiveness	3.475316	3.5	0.30	0.64	0.14	-0.03	0.53	0.62	0.26	0.61	0.60	0.44	0.64	0.70	0.40	1.00	
15 Legal effectiveness	3.314873	3.5	0.21	0.66	-0.14	-0.03	0.43	0.61	0.50	0.33	0.69	0.61	0.54	0.69	0.45	0.71	1.00
16 Relative unit labor costs	0.3611489	0.3217434	0.03	0.07	0.17	-0.30	0.12	0.16	0.04	0.18	-0.01	0.04	0.07	-0.03	0.05	0.09	-0.05

N = 158.

3.2. Construct measurements of the independent variables

Our measure of overall institutional development (the aggregate institutional index) that it used to test proposition 1 is based on a series of indicators of progress in transition constructed by the EBRD. The EBRD has recorded and classified the pace of development of institutions for a market economy and reports it in form of “transition indicators”, as institution building is considered to be at the core of the move from plan to market. Each of these individual indices are reported on a 1–4+ scale with higher numbers indicating that institutions are closer to free market model of mature market economies.⁷ We firstly construct an annual aggregate institutional index as the unweighted average of seven EBRD measures of the development of formal institutions, namely progress in: small-scale privatization; large-scale privatization; banking sector reform; non-bank financial sector reform; price liberalization; foreign exchange and trade liberalization, and competition policy. As with all other variables in our analysis, we estimate Eq. (1) using a simple numerical average of the annual aggregate institutional index over 5 years.

For the next propositions, we employ the indices separately, supported by other indicators of institutional development. As Table 2 illustrates, in some cases, there is some collinearity between the indicators of institutional development, largely because progress in various elements of the transition process often occur simultaneously, if unevenly, in particular countries. For this reason, we test Hypotheses 2a–e by estimating a series of equations, one for each institutional development index. The regressions illustrate that, although simple pairwise correlations indicate some collinearity between the institutional indices, there is considerable variation in the impact of specific institutional developments on FDI inflows to the transition economies.

Hypothesis 2a is tested with four separate measures of privatization and private sector share (models 2–5): the EBRD, indices on progress in small- and large-scale privatizations, the private sector share in GDP and an index indicating privatization method derived from Holland and Pain (1998). Transition countries have chosen different methods to privatize their state-owned firms, which in turn affects the way private business develops and the opportunities for foreign investors. Countries that chose to sell more enterprises to foreign investors, such as Hungary and Estonia, might receive more FDI. Holland and Pain (1998) find that the method of privatization, measured on a 4-point scale from 1 (vouchers) to 4 (sale to outsiders), was positively associated with greater FDI inflows.

Financial market development has particularly focused on banks and securities markets (see World Bank, 1996) and in models 6 and 7, we use distinct indicators for the two institutions to test Hypothesis 2b. For Hypothesis 2c, we use the EBRD indices to distinguish between liberalization of domestic and international markets in models 8 and 9, while the impact of competition policy (Hypothesis 2d) is tested in model 10. Finally, we address legal extensiveness and effectiveness to

⁷ Since the scale includes + and –, it effectively has 11 points.

test Hypothesis 2e in model 11 (extensiveness), model 12 (effectiveness), and models 13 and 14 (extensiveness and effectiveness jointly).

3.3. Control variables

In order to ensure that we are able to obtain unbiased econometric estimates of the influence of institutional development on FDI inflows, our analysis controls for a number of factors that the existing literature has identified as important determinants of FDI.

A major part of FDI has been motivated by the opportunities to lower production cost by relocating production to CEE. This type of FDI may not account for a large number of projects, but is an important factor in many larger investments, which dominate FDI capital flows (Meyer, 2001a,b; Lankes & Venables, 1996). The cost of labor is an important locational advantage of any potential host economy, particularly for firms seeking to locate manufacturing operations in a global supply chain for a worldwide market. FDI was expected to utilize labor cost differences and to build export oriented production in Central and Eastern Europe and the region still has low labor costs compared with Western Europe, although higher than some locations in Southeast Asia. Manufacturing businesses has thus experienced simultaneously a cost-push in Western Europe, with rising wages, and a cost pull to Eastern Europe (Meyer, 1998; Ozawa, 1992). The link between wage costs and FDI has been shown in prior research in transition economies. Lansbury et al. (1996) isolate a negative effect of unit labor costs on FDI in Visegrad countries (Czech Republic, Hungary, Poland and Slovakia) which however is insignificant in all but one of the equations, Holland and Pain (1998) indicate a significant negative impact of wage levels in the host countries, whether or not controlling for productivity, while Bevan and Estrin (2000) found a significant negative relationship between unit labor costs and FDI.

The attraction of the relocation opportunity depends not only on the level of wages and productivity in the host economy, but—due to the sunk costs of relocation—on the cost advantage *relative* to production costs at the firm's existing production sites. FDI between nations should therefore be specified as a function of locational advantages in the host country, relative to the advantages of the home country. Thus, this control variable needs to be specified carefully, because multinational firms would not wish to invest abroad, even if wage costs are modest, if the productivity levels attained in their foreign plants are low. For each of our source and host countries, we calculate unit labor costs as the ratio of the annual average wage in each economy (measured in DM) to GDP per capita in each economy (also in DM). In this way, our measure of unit labor cost is effectively a unitless ratio. Data on average monthly earnings and productivity in manufacturing are as reported by the *International Labour Organisation Yearbook of Labour Statistics* (ILO, 1999) and for host countries as from EBRD. The relative unit labor cost (RULC) between each source and host country pair is then defined as the arithmetic difference between the unit labor cost of each source and host economy pair.

Moreover, we need to control for the cultural and linguistic distance between source and host country as it affects the costs of internal organization and economic risk. This is because it affects the availability of information about the local environment and the personal interaction between local and foreign individuals. The international business literature has used the concept of “distance”, sometimes going beyond geography to include cultural factors. Prior research has generally found that distance—geographical and psychic—reduces FDI. For instance, [Martin and Velazquez \(1997\)](#) find a significantly negative effect of distance on FDI in the OECD countries and a positive significant effect if the host and source countries share a common border. “Distance” is an especially important variable in Central and Eastern Europe, a region where borders have also changed enormously over the past century reflecting the closely intertwined history and culture of the region. For this reason, we include two measures in our regressions: geographical distance between source and host country and a dummy variable taking the value unity if a pair of countries share a common border.

Further variables control for the size of the respective home and host economies. The former reflects the economic power of the source country to generate multinational firms and outward FDI, the latter the attraction of the host country as a market and as a location for complementary resources. Surveys (e.g. [Meyer, 1998](#)) indicate that the search for new markets has been a major motive for FDI into transition economies. We include in our regressions gross domestic product (GDP) in current prices for source and host countries, as reported in IMF International Financial Statistics. Moreover, Russia is a special case among transition economies, having lost a considerable proportion of its former territories in 1992, with a volatile political system during the period under study and having a high proportion of its GDP and trade deriving from the energy sector. We therefore felt it was desirable to control for this using a dummy variable. This view is confirmed by [United Nations \(2002\)](#), which notes that Russia receives significantly less FDI than any other transition economy, especially when its size and resource base are taken into account.

4. Results of the empirical analysis

4.1. FDI flows and progress in transition

In model 1, we report estimates of Eq. (1), regressing the level of FDI flow from each source country i.e. to each recipient country j against our various source and recipient country characteristic variables and the aggregate index ([Table 3](#)). Overall, the regression is highly significant; we reject the null hypothesis of joint insignificance of the coefficients at the 1% level. Moreover, all the independent variables are statistically significant with the predicted sign. Commencing with the control variables, our model confirms that FDI is lower between more distantly located countries and higher in ones that share a common border. We find that firms from large economies invest abroad significantly more than those from smaller ones. We

Table 3
Base model, and FDI and privatization

	Model 1	Model 2	Model 3	Model 4	Model 5
FDI					
Source GDP	0.02449*** (0.00597)	0.02466*** (0.00608)	0.0245*** (0.00599)	0.02414*** (0.00594)	0.02554*** (0.00617)
Host GDP	1.20838*** (0.33123)	1.26422*** (0.32416)	1.26733*** (0.32703)	1.24623*** (0.32670)	1.45333*** (0.34367)
Distance	-0.03643*** (0.01155)	-0.03685*** (0.01187)	-0.03664*** (0.01167)	-0.03565*** (0.01174)	-0.03936*** (0.01241)
Relative unit labor cost	68.76288*** (26.5921)	71.83382** (28.06061)	66.58475*** (25.65273)	62.87117** (25.69717)	76.38704*** (28.32616)
Common border	307.7798** (155.0867)	311.9852** (154.2312)	305.9291** (154.7899)	310.3921** (152.8225)	314.7506** (152.3826)
Russia	-401.5899** (156.6886)	-438.5573*** (153.4398)	-439.0038*** (154.6528)	-429.5544*** (154.6716)	-512.6157*** (161.2696)
Constant	-156.1672** (69.70573)	-91.13421** (43.7643)	-108.9364** (45.66824)	-165.1715*** (59.8886)	-65.45919* (34.59712)
Transition index (aggregate)	48.97338** (26.09451)				
Small-scale privatization		21.77027* (13.10366)			
Large-scale privatization			33.12967* (17.61119)		
Private sector share in GDP				2.67448** (1.13561)	
Privatization method					22.19657 (14.55581)
Number of observations	158	158	158	158	158
F-value	5.15	5.13	5.33	5.34	4.84
R ²	0.3937	0.3894	0.3960	0.3931	0.3991

Note: Robust standard errors in parentheses.

* Significant at the 10% level.

** Significant at the 5% level.

*** Significant at the 1% level.

also confirm that FDI is attracted to bigger markets, with the coefficient on the host GDP being large and positive, and that FDI is significantly higher between countries where the relative unit labor cost advantages of relocation are greater. We included the Russia dummy because of the suspicion that the factors driving FDI to that country during the estimation period might differ from these in Central and Eastern Europe. Model 1 confirms this to be the case if the coefficient is highly significant and negative. This confirms the assertion in the UNCTAD (2002) report that Russia underperformed relative to other transition countries in terms of FDI. We return to this issue below.

4.2. FDI flows and institutional progress

The most important result in model 1 concerns the general impact of institutions on business strategies. Our regression indicates that the establishment of institutions for a market economy increases FDI flows significantly. However, the result is not very strong: the level of significance is around 6%. This is perhaps because we are still relatively early in the transition process, and the time period under consideration is quite short. Nonetheless, model 1 does provide evidence in support of Hypothesis 1.

We next explore the empirical impact of the separate institutional developments: privatization; financial sector reform; liberalization; and legal developments. The resulting estimations are presented in Tables 3–5, which reveal the coefficients of

Table 4
FDI and reform of financial sector and market institutions

	Model 6	Model 7	Model 8	Model 9	Model 10
FDI					
Source GDP	0.02446*** (0.00592)	0.02488*** (0.00601)	0.02446*** (0.00589)	0.02472*** (0.00608)	0.02473*** (0.00604)
Host GDP	1.24358*** (0.32176)	1.18145*** (0.39292)	1.19443*** (0.32789)	1.27922*** (0.32061)	1.19281*** (0.33742)
Distance	-0.03620*** (0.01142)	-0.03773*** (0.01168)	-0.03638*** (0.01142)	-0.03698*** (0.01188)	-0.03714*** (0.01177)
Relative unit labor cost	69.12496** (27.05236)	73.34912*** (26.7246)	69.31162** (27.07391)	73.01143*** (27.96252)	71.03865*** (26.85747)
Common border	310.2681** (154.472)	309.9339* (157.2098)	312.6831** (154.7203)	310.8525** (153.322)	311.0257** (154.0134)
Russia	-390.3199** (153.1932)	-401.955** (178.7779)	-400.205** (155.2054)	-418.352*** (150.7623)	-399.2605** (159.0928)
Constant	-150.8465** (63.80066)	-70.97872 (70.00579)	-648.4195* (386.791)	-163.4198** (51.28257)	-79.9206* (42.24412)
Bank reform	50.8449** (25.34613)				
Non-bank reform		26.45974 (35.06161)			
Price liberalization			215.8771 (133.6432)		
Forex and trade liberalization				39.07755*** (13.51787)	
Competition policy					30.63767 (20.89418)
Number of observations	158	158	158	158	158
F-value	4.89	4.83	4.81	5.30	4.86
R ²	0.3959	0.3884	0.3939	0.3928	0.3910

Note: Robust standard errors in parentheses.

* Significant at the 10% level.

** Significant at the 5% level.

*** Significant at the 1% level.

Table 5
FDI and legal reform

	Model 11	Model 12	Model 13	Model 14
FDI				
Source GDP	0.02419*** (0.00588)	0.02519*** (0.00611)	0.02420*** (0.00598)	0.02384*** (0.00615)
Host GDP	1.12676*** (0.31632)	1.12242*** (0.32226)	1.12441*** (0.32388)	0.41718*** (0.12836)
Distance	-0.03537*** (0.01165)	-0.03836*** (0.01203)	-0.03541*** (0.01196)	-0.03634*** (0.01239)
Relative unit labor cost	65.20709** (26.67228)	73.46961*** (27.54375)	65.28735** (27.13819)	49.20247* (26.55095)
Common border	313.9118** (150.4116)	310.9904** (151.644)	313.7977** (151.1236)	317.642* (163.1926)
Russia	-383.2193** (150.1858)	-348.0326** (152.5397)	-381.3394** (155.429)	
Constant	-205.1469*** (48.20546)	-126.9089*** (41.60562)	-205.4065*** (49.71605)	-244.9286*** (62.16172)
Legal extensiveness	59.03379*** (14.67597)		58.14673*** (15.66924)	39.85106** (18.30668)
Legal effectiveness		37.44549*** (13.80597)	1.02691 (16.13716)	43.42452** (21.43143)
Number of observations	158	158	158	158
F-value	5.77	5.01	5.18	4.97
R ²	0.4102	0.3995	0.4102	0.3717

Note: Robust standard errors in parentheses.

* Significant at the 10% level.

** Significant at the 5% level.

*** Significant at the 1% level.

the basic model to be robust to specification changes. Models 2–5 present the results on the impact of privatization and enterprise reform, and these support Hypothesis 2a. Both small- and large-scale privatizations have a positive and weakly significant impact upon FDI receipts (models 2 and 3), while model 4 indicates that FDI receipts are positively associated with the share of GDP produced by the private sector, with significance at the 5% level. Thus, both privatization and private sector development serve to encourage FDI, though the result is stronger when the private sector share is used. The method of privatization, however, does not have significant implications for FDI (model 5). This implies that countries that do not sell enterprises directly to foreign investors receive an equal amount of FDI in other forms, i.e. via greenfield investment or via acquisition of already private firms. This confirms case study findings about investors' intentions and motives (see Estrin et al., 1997). It also suggests that causality runs from institutions to FDI, rather than the converse because when privatization occurs by sale

to foreigners, rather than for example by a voucher privatization, this does not lead to more FDI.

We find evidence in [Table 4](#), model 6, that banking sector reform has been significantly associated with greater FDI inflows (Hypothesis 2b). We interpret this as suggesting that foreign investors are concerned with the effectiveness of the banking sector to serve as a robust payment system and source of non-equity finance, and are worried about the possibility of banking crises. But model 7 shows that non-bank reform is of little importance for foreign investors into transition economies, suggesting that multinational firms operating in transition countries made little use of local capital market institutions e.g. security markets, perhaps relying on their own resources or those available in their domestic economies as the source economies resources.

Turning to Hypothesis 2c, we find partial evidence in [Table 4](#) that the liberalization of domestic and international markets has a positive and significant effect on FDI inflow in models 8 and 9. Progress in domestic price liberalization does not have a significant effect on FDI inflows, but foreign exchange and trade liberalization do; indeed, the coefficient is significant at the 99% level. We also cannot accept Hypothesis 2d since model 10 shows that the development of competition policy does not have a significant impact on FDI receipts. Taken together with the results of model 8, this suggests that the building of institutions to develop flexibility and competition in domestic markets is not a significant factor in influencing foreign investment decisions, though a liberal foreign exchange regime is important. The insignificance of domestic price factors on FDI may be because the attraction of investing in economies with developed domestic market institutions is offset by the desire to invest in highly protected or regulated markets to gain market power and to monopoly rents. However, this may lead to lower allocative efficiency (whoever appropriates the rents: multinational firms, their local partners, or the regulators). Competition policy may thus be primarily an instrument to manage the spillovers from FDI to the host economy, rather than to encourage FDI per se.

We present our findings on Hypothesis 2e in [Table 5](#). Models 11 and 12 shows that the development of the legal system has a strong effect on FDI inflow, both if measured in terms of the extensiveness of the legal framework (model 11) and its implementation (model 12). But contrary to our expectations, when both variables are included simultaneously in model 13, we find that legal extensiveness dominates effectiveness. This appears to suggest that the formal aspects of institutions dominate over informal ones in investors' assessments.

However, the Russia dummy variable, while negative and significant under model 11, loses value when combined with legal effectiveness in model 12. Low legal effectiveness may therefore help to explain the poor FDI performance of Russia, a suggestion we test by excluding the Russian dummy in model 14. Legal extensiveness appears to dominate effectiveness when Russia is controlled for, but both variables become positive and significant once the dummy variable is removed. This suggests that investors are more concerned about formal institutions than about informal ones, unless informal institutions show highly unusual fea-

tures. More specifically, the gap between legal extensiveness and effectiveness was probably the prime obstacle to FDI in Russia in the sample period.⁸

5. Conclusions and policy implications

Our analysis of the impact of institutional development on FDI in transition economies indicates that the hypothesized relationship does hold at an aggregate level. We also identify individual key factors by disaggregating to subsets of institutional development. The results suggest that several institutional changes have particularly enhanced FDI receipts to transition economies:

- Development of private-owned businesses in place of state-owned firms;
- Development of the banking sector, but not necessarily the non-banking financial sector;
- Liberalization of foreign exchange and trade, but not necessarily of domestic markets and prices;
- Development of legal institutions, but not necessarily competition policy.

However, domestic price liberalization and the development of competition policy do not appear, in our equations, to be significant in motivating FDI, perhaps because some foreign investors have been attracted by the possibility of earning monopoly rents. Insofar as we could address the question, we also did not find strong evidence for the importance of informal institutions, once formal institutions have been controlled for. This could imply that development of formal institutions in transition economies has been associated with the emergence of informal ones, with the one important exception of Russia.

These results are highly suggestive of the influence of institutional development on inward foreign investment. Foreign investors appear to react positively to government policy that facilitates both exploitation and augmentation of their own resources and capabilities. Hence, foreign investors and host governments have complementary interests with respect to some policy measures and institutional development, yet conflicting interests on other items (Rugman & Verbeke, 2001). Our study points out where collaboration between foreign investors and local policy makers may foster institutional development, namely in private sector development, banking sector reform, liberalization of foreign trade and investment, and strengthening of the legal framework.

However, policy makers also have to be aware that what is good for domestic economic development does *not* necessarily attract more foreign investors. For example, competition policy eases entry, but it makes it less attractive for a foreign firm to acquire an incumbent monopolist. Governments privatizing tele-

⁸ The values for Russia are legal extensiveness 4, legal effectiveness 2+. No other country has a similarly large gap. Indeed, excluding Russia from our sample, we find legal effectiveness to dominate extensiveness.

communications face the trade-off, as liberalization would reduce prices for consumers, but it might also deter potential foreign investors or reduce the receipts from selling as an entity the incumbent state-owned monopoly provider. Future theoretical research may thus focus on the potentially conflicting interests of foreign and domestic businesses with respect to institutional development.

A limitation of this study, as with other studies incorporating institutional variables in an empirical model, is the interdependence, and thus correlation, between different aspects of the institutional framework. We offer a methodology to make progress toward disentangling the effects of different institutions. However, future empirical research might usefully try to analyze a larger and possibly a more diverse set than our 26 countries.

Future research may also address related conceptual issues. Firstly, theoretical research has pointed to the importance of informal institutions (Mudambi & Navarra, 2002; North, 1990; Peng, 2000), while empirical research faced considerable obstacles in developing suitable proxies for these concepts. New, creative proxies such as the legal effectiveness measure, and corruption indices may advance this line of inquiry. Moreover, the concept of legal effectiveness as informal institution merits further investigation, building for instance on recent work by Murrell (2001) who presents a favorable image of law in Russia, yet with some flaws that may be crucial for business. Secondly, one might argue that FDI positively influences institutional development, and private sector development in particular. Such possible reverse causality would be clarified by using longer time periods and panel estimation, a luxury not yet available for the transition economies where reform only commenced during the 1990s.

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