

Macroeconomic Impacts of FDI in Transition Economies: A Meta-Analysis

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Summary. — In this paper, we conduct a meta-analysis of the literature that empirically examines the impact of foreign direct investment (FDI) on economic growth in Central and Eastern Europe and the former Soviet Union. We found that existing studies indicate a growth-enhancing effect of FDI in the region as a whole. The results of our meta-regression analysis suggest that the effect size and statistical significance of the reported estimates strongly depend on study conditions. We also found that the relevant studies fail to present genuine evidence of a non-zero FDI effect. More research is necessary to identify the true effect.

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1. INTRODUCTION

When the transition toward a market economy began in Central and Eastern Europe (CEE) and the former Soviet Union (FSU), policy makers and academic researchers widely expected that foreign direct investment (FDI) could play a significant role in the economic recovery in this region (Bangert & Poór, 1993; Carlin & Landesmann, 1997; Jensen, 2006). Nevertheless, as Sinn and Weichenrieder (1997) pointed out, “the low level of FDI has been a big disappointment” (p. 180) except for in a few reforming countries.¹ In fact, according to Figure 1, the cumulative value of FDI in the region during the 1990s reached only 141 billion USD, and just three countries, the Czech Republic, Hungary, and Poland, represented 54%, or 76 billion USD, of the total investment. Due to unsatisfactory trends in foreign capital inflow in the 1990s combined with various technical constraints, including limited data availability and accessibility, empirical studies of FDI were far from adequate in terms of both quality and quantity throughout the first decade of transition. However, this shortage of studies was greatly ameliorated thanks to active research conducted in the 2000s with a remarkable increase of FDI during the same period. Now the number of studies on this topic has reached a certain level, and thus we may be able to draw a general picture regarding the role of FDI in transition economies.

One of the issues of great interest is whether FDI produced a sufficient effect to encourage economic growth in the post-communist states. However, the economic theory does not support the positive effect of FDI in this respect. In fact, according to the neoclassical growth theory, where FDI is deemed to be a pure factor input, FDI’s effect on economic growth in the long term is neutral, although it does affect the national income level. This is because the growth rate will converge in the long run as the marginal product of capital diminishes its returns over time, even if the exogenous increase

in capital realized in the form of capital inflow from foreign countries may temporarily expand production (Solow, 1956).²

In contrast, according to the endogenous growth theory, where attention with regard to FDI is focused on its function as a delivery vehicle for transferring excellent technology, knowledge, and know-how accumulated in developed economies, FDI has a positive effect on long-term economic growth as long as it brings improvements in technology systems and/or human capital to the recipient countries through the contributions of foreign participation in management, the establishment of local subsidiaries by multinational enterprises, the outsourcing of contracts between local and foreign firms, etc. (Aghion & Howitt, 1997; Grossman & Helpman, 1991). As Borensztein, De Gregorio, and Lee (1998) and Durham (2004) argue, the growth-enhancing effect of FDI largely depends on the absorption capacity of local entities (i.e., domestic firms and workers). Nevertheless, based on the assumption of high levels of education and sufficient penetration of modern rationalism in the former socialist bloc, many

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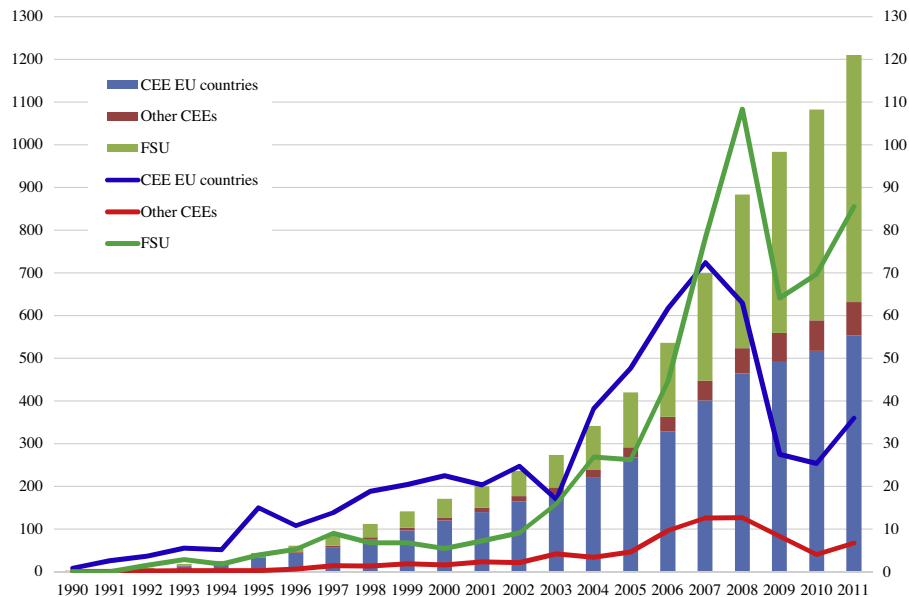


Figure 1. *The dynamics of foreign direct investment into CEE and FSU countries in 1990–2011 (Billion USD). Note: The line graph (right axis) and the bar graph (left axis) illustrate the annual inflow and cumulative value of foreign direct investment, respectively. CEE EU countries denote the 10 Central and Eastern European countries that joined the European Union either in 2004 or 2007. FSU excludes the Baltic countries. The data is derived from the UNCTAD website (<http://unctadstat.unctad.org/>).*

researchers anticipated that the possibility of such an effect would never be low in transition economies (UNECE, 2001).

However, FDI could rather negatively affect economic growth in the recipient countries if it hampers domestic investment. In fact, Mišun and Tomšík (2002) report that FDI crowded out domestic investment in Poland during the period 1990–2000.³ Moreover, Kosová (2010) also found that, in the Czech Republic, the new entry of foreign-affiliated firms significantly pushed up the ex post exit rate of domestic firms during the period 1994–2001. Taking into account the weak management base and backward production technology of former socialist enterprises in comparison with multinational corporations based in developed economies, it is highly likely that such negative external effects took place in many transition economies.

Moreover, as pointed out by Easterly (1993), the exemptions from corporate income tax and other FDI-friendly policies to attract foreign firms might negatively affect economic growth if these measures heavily distort incentives for domestic entities. It is a well-known fact that CEE countries launched extremely preferential policies to induce FDI in a competitive manner (Cass, 2007; Ikemoto, Iwasaki, & Sugiura, 2008). Hence, we cannot rule out the possibility that what Easterly (1993) has called the “adverse incentive effect” might actually have had a negative impact on domestic firms in these states.

As mentioned above, FDI has the potential to bring about both positive and negative macroeconomic effects for the recipient countries, but it is extremely difficult to theoretically predict the respective degree of these countervailing effects, and thus economists should leave this issue to empirical research. As we report later, however, the empirical results reported in previous studies regarding the causality between FDI and macroeconomic growth in CEE and the FSU are too mixed to draw a conclusion simply by looking at them. To overcome this problem, in this paper, we conduct a meta-analysis of the literature that empirically examines the impact of FDI on economic growth in the CEE and FSU countries.⁴ More

specifically, we ask the following questions: What do existing studies tell us about the macroeconomic impact of FDI as a whole? What determines the differences in the empirical evidence reported in these studies? Is there any artificial bias in their publication, and, if there is, are the relevant studies sufficient for identifying the true effect of FDI on economic growth beyond such a bias?

We found that existing studies indicate a growth-enhancing effect of FDI in the region as a whole. The results of our meta-regression analysis (MRA) suggest that the effect size and statistical significance of the reported estimates strongly depend on study conditions. In particular, the estimation period, data type, estimator, and type of FDI variable are important factors that explain the heterogeneity in the empirical results. The degree of freedom greatly affects the magnitude of the FDI variable as well. We also found that the relevant studies fail to present genuine evidence of a non-zero FDI effect due to the presence of publication selection bias and insufficient empirical evidence.

The remainder of this paper is organized as follows: The next section describes our methodology for literature selection and meta-analysis. Section 3 gives an overview of selected studies for meta-analysis. Section 4 demonstrates our synthesis of collected estimates. Section 5 performs meta-regression analysis to explore the observed heterogeneity between studies. Section 6 assesses the publication selection bias. Section 7 summarizes the major findings and concludes the paper.

2. METHODOLOGY OF LITERATURE SELECTION AND META-ANALYSIS

In this section, we describe our methods of selecting and coding relevant studies and for meta-analysis based on the empirical evidence collected.⁵

In order to identify studies related to FDI in the CEE and FSU countries as a base collection, we first searched the

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