The Effects of Enhancing Competitiveness on FDI Inflows in CEE Countries

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Abstract

The objective of this paper is to identify how an increase in competitiveness could improve FDI in ten Central and Eastern European (CEE) countries. For assessing competitiveness, we employ the variables used by World Economic Forum in designing the Global Competitiveness Index and find that half of the analyzed countries could see the most important increases in FDI/capita if making institutions more competitive, four other countries should accelerate on improving innovation and infrastructure while another country should work on labour market efficiency. We also calculate the potential increase in FDI/capita due to similar changes in different competitiveness variables.

Keywords: foreign direct investment; competitiveness; Central and Eastern Europe;

JEL Classification: F23; H11; O52;

1. Introduction

FDI are seen as of source of competitiveness through their characteristic of being a capital flow that also provides technology and knowledge transfer from the home to the host country. Through the same channels, foreign investments have a positive impact on economic growth. For these reasons, the efforts for attracting FDI should be considerable. But the literature also indicates that competitiveness is a determinant factor for foreign investors. This is not surprising, as competitiveness is associated with high standards of living, added value, costs reduction, quality standards, improvements, efficiency and so on. Competitiveness is seen as a location advantage of a country, as described by the OLI paradigm. The studies regarding the relationship between competitiveness and FDI inflows are scarce in the literature, mostly because there is a lack of consent regarding a universally accepted definition of economic competitiveness, as Criste et al. (2008) observed. Still, the variables defining competitiveness are found to be important determinants for attracting foreign investors, as presented in the literature described below.

Under these circumstances, we are interested how an increase in competitiveness could improve FDI. In establishing the potential FDI increase, we will refer to the pillars taken into account for computing the Global Competitiveness Index, as provided by the World Economic Forum. We consider that this index offers a wide coverage of competitiveness and has a good visibility among foreign investors. Moreover, in making efforts for increasing the attractiveness of the economic environment for investors, public decision

makers can relate to this index and have the possibility to establish measurable objectives in terms of improving competitiveness. In this way, they will also be able to quantify the expected FDI inflows. The rest of the paper is organized as follows: in the first part, we review some significant studies in the literature regarding the variables describing competitiveness and their impact on FDI. In the second part, we describe the methodology used for assessing to what extent an increase in competitiveness leads to an improvement of FDI and we provide and discuss the results. In the last part, we provide some concluding remarks.

2. Literature Review

The importance of location factors for attracting FDI in the host country is strongly emphasized along with the Dunning's eclectic paradigm, or OLI paradigm. The internationalization of the production is depending on three types of advantages: O – ownership advantages, L – location advantages and I – internalization advantages. If the ownership and internalization advantages depend on the multinational company, the location advantages depend on the host country endowments and can also by shaped by the country's public policies.

Starting with the '90s, the studies in the literature started to be more focused on the location determinants for increasing FDI inflows (Dunning, 2000), mainly due to expanding globalization and the transition process in Central and Eastern Europe. Researchers emphasized that the location determinants are submitted to continuous changes (for more details, see Popovici and Călin, 2014a). The literature points to a transition in FDI determinants, from natural endowments to created resources. Today, a country capacity to attract investors lies in its ability to provide a set of distinctive, hard to imitate, created assets (Dunning, 2000). This is why Saskia Wilhelms, in the theory of institutional fitness, considered that all countries have the possibility to expand their comparative advantages for attracting FDI. The countries' capacity of attracting FDI is depending on their capacity to adapt to FDI as regards their governments, markets, educational system and social and cultural context (Wilhelms, 1998). Moreover, Dunning (2003) notes the increased attention on the "soft" variables of location, related to the quality of life, such as minimizing pollution, violence, corruption and other unacceptable social behaviours. FDI determinants could also take into account the economic morality.

The economic competitiveness of a country is also included in the location determinants of FDI. Dunning and Zhang (2008) consider that the resources, capabilities and markets, composing the physical environment of a country, and then the institutions – that describe the human environment – are the main components of competitiveness. In the category of resources, capabilities and markets, Dunning and Zhang (2008) include natural resources, created assets (such as technological capacity and buildings), educated labour, organizational capacity, knowledge about domestic and foreign markets etc. In the institutions category are included law and regulations but also traditions, culture and enforcement mechanisms.

UNCTAD (1998) provides an early classification of location factors attracting FDI. The policy framework for FDI comprises the institutional settings (regulations for entry and operations, for example). The economic determinants are represented by the market dimension, availability of natural resources and of infrastructure, the skilled labour force,

the quality of technological endowment and so on. Finally, business facilitation regards the means for promoting investment, the investment incentives, low corruption and bureaucracy.

Anastassopoulos (2007) examine the relationship between international competitiveness of EU-15 countries during 2003-2006 and FDI inflows. The author refers to the competitiveness as presented in the IMD World Competitiveness Yearbook. Thus, he takes into account the four pillars on which competitiveness is defined: economic performance, governmental efficiency, business efficiency and infrastructure, along with their related indicators. The main result is that FDI determinants are different between northern and southern EU member states. While in the northern economies, investors are interested in the dimension of the market, a low degree of bureaucracy, openness and efficiency of the business sector, in the south are more important the efficiency of the government and the reduction of the investment risk.

Taken into account the lack of a definition to consider for competitiveness, we will present some of the studies including components of competitiveness that establish a significant relationship with FDI inflows. Castro and Buckley (2001) provide an analysis of Portugal's competitiveness in relation to its inward FDI. The authors find that the competitiveness of Portugal for FDI is eroding. One of the reasons is the failure of the country to compensate the higher production costs with created assets. Narula and Wakelin (1998) put technology at the core of competitiveness. Their empirical results show that inward FDI is influenced by technological capability and human capital availability, pointing that more innovative countries are attractive for foreign investors. In addition, natural resources and the openness to trade are also important for investors. For the developing countries, investors are more interested in exploiting their natural resources or in their large markets. Sass (2003) points that improving the investment environment through developing infrastructure, education and training and assuring a healthy macro-economic environment are tools for increasing a country capacity for attracting foreign capital.

Competitiveness is proven to be a determinant for FDI in seven Central and Eastern European (CEE) countries in Popovici and Călin (2012b). Based on four variables making up the competitiveness index (the real effective exchange rate, the export market shares, the nominal unit labour costs and GDP per capita), the authors also establish that foreign investors are searching for the most competitive CEE countries after the economic and financial crisis. Two other studies taking into account the attractiveness of public policies in Central and Eastern European countries found a positive impact between the improvements in infrastructure, institutions' quality, labour market conditions and companies' taxation and the level of inward FDI (Popovici and Călin, 2012a; Paul *et al.*, 2014).

3. Research Methodology, Results and Discussions

Our analysis is focused on the ten EU member states in Central and Eastern Europe (Bulgaria, the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania, Slovenia and Slovakia). We are interested in answering two research questions:

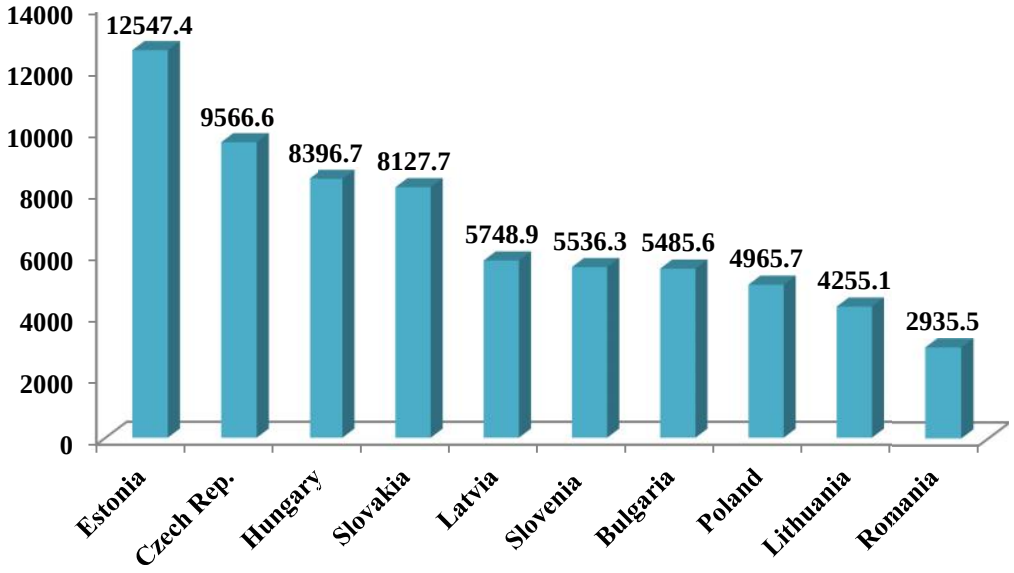
- Firstly, if the pillars taken into account for computing the Global Competitiveness Index are also correlated to the FDI/capita volume in these countries.

- Secondly, to what extent an increase in competitiveness causes an improvement of FDI inflows.

More accurate, we start with the hypothesis that there is a positive relationship between FDI and competitiveness and we search for the correlation between FDI and the competitiveness pillars, as described in the Global Competitiveness Index. We are interested how an increase in these pillars could contribute in further attracting FDI. We have already identified in the literature several studies concluding that there is a positive relationship between FDI and competitiveness pillars, as mentioned earlier. Yet we intend to deepen the studies in the literature by focusing on several countries in the EU.

Our analysis takes into account 10 countries, among the newest EU member states. Their main characteristic is that they share a common history of communism and transition. In this context, one should expect to find more similarities in the level of attracted FDI or in their degree of competitiveness.

Figure 1. Volume of FDI/capita stocks in 2013, euro

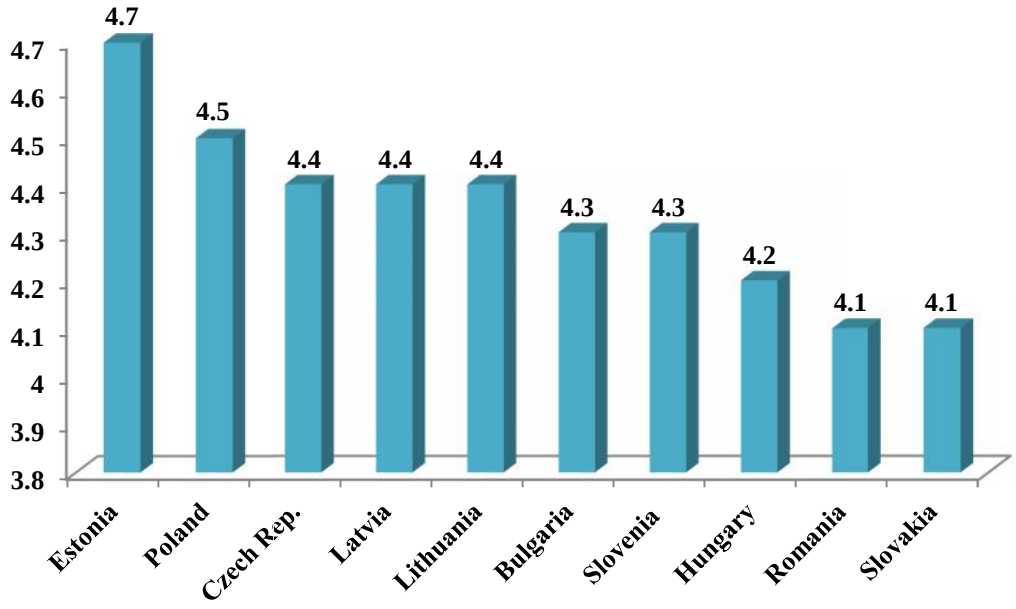


Source: UNCTAD database, Eurostat

However, we notice an important difference in the FDI/capita stocks in these countries. Although a small country, Estonia receives the largest amount of FDI/capita, 4.3 times more than the last ranked, Romania. This means that Estonia managed to accumulate faster foreign investments, therefore providing more public policies or incentives and having more positive evolutions for increasing its attractiveness for foreign investors, such as a better business environment.

The Global Competitiveness Index ranking also offers a heterogeneous picture of competitiveness in Central and Eastern Europe. There are countries that managed to increase their competitiveness more quickly than their neighbours. Estonia is far from other countries in terms of competitiveness, while Romania and Slovakia are on the last place, with a similar index. This example could be a reason for the different levels of FDI/capita, as we shall see further.

Figure 2. Global Competitiveness Index in analyzed countries, 2013



Source: World Economic Forum, Global Competitiveness Report, 2013-2014

In order to have a clear picture of competitiveness distribution in these countries, we will use the competitiveness description provided by World Economic Forum in their Global competitiveness reports. Here, competitiveness is described based on twelve pillars, grouped in three domains, as expressed in Table 1.

Table 1. Indicators describing competitiveness in Global Competitiveness Report

Domain	Indicators
Basic requirements	Institutions
	Infrastructure
	Macroeconomic environment
	Health and primary education
Efficiency enhancers	Higher education and training
	Goods market efficiency
	Labour market efficiency
	Financial market development
	Technological readiness
	Market size
Innovation and sophistication factors	Business sophistication
	Innovation

Source: World Economic Forum, Global Competitiveness Report, 2013-2014

We will use part of these indicators for assessing the impact of competitiveness on FDI in our group of countries, namely: institutions, infrastructure, macroeconomic environment, higher education and training, goods market efficiency, labour market efficiency, financial market development, technological readiness, business sophistication, innovation, because these are the variables we identified in literature as being FDI determinants. We choose these indicators based on similarity with other variables used in the literature as determinants for FDI, as we already mentioned. We do not take into account the pillar regarding the market size as it comprises variables that are difficult to influence on the short and medium term. For the analyzed group of countries, the values extracted for each indicator are presented in Table 2.

Table 2. The values of the 10 competitiveness pillars in the CEE countries

	BG	CZ	EE	HU	LV	LT	PL	RO	SI	SK
Institutions	3.4	3.6	4.9	3.7	4.1	4	4	3.3	3.9	3.3
Infrastructure	3.9	4.7	4.7	4.4	4.2	4.7	4	3.3	4.9	4.1
Macroeconomic environment	5.6	5	5.9	4.5	5.6	4.9	4.9	5.1	5	4.9
Higher education and training	4.3	4.9	5.2	4.7	4.8	5.2	4.9	5.5	5.2	4.4
Goods market efficiency	4.2	4.4	4.7	4.2	4.5	4.4	4.3	3.9	4.3	4.2
Labour market efficiency	4.4	4.2	5	4.2	4.8	4.3	4.2	4	4	4.2
Financial market development	3.9	4.2	4.6	3.9	4.5	3.8	4.5	4	3	4.5
Technological readiness	4.4	4.9	5.2	4.4	4.7	4.8	4.5	4.1	4.9	4.2
Business sophistication	3.6	4.4	4.3	3.7	4	4.3	4.1	3.6	4.1	4
Innovation	3	3.7	3.9	3.5	3.2	3.6	3.2	3	3.6	3

Source: World Economic Forum, Global Competitiveness Report, 2013-2014

Although we use variables that are mentioned as being FDI determinants, we will check if, for our group of countries, these indicators are correlated with the stocks of FDI/capita. For assessing the correlation between FDI and competitiveness in the analyzed countries, we use the Pearson coefficient. The results are presented in Table 3.

Table 3. Pearson correlation coefficients

Pillar	Pearson correlation coefficients
Institutions	0.48874
Infrastructure	0.519932
Macroeconomic environment	0.267353
Higher education and training	-0.18634
Goods market efficiency	0.635407
Labour market efficiency	0.536746
Technological readiness	0.536
Business sophistication	0.444118
Innovation	0.610271
Financial market development	0.398368

Source: authors' own calculations

The values of the Pearson correlation coefficient between 0.4 and 0.59 indicate a positive moderate correlation, while the ones between 0.6 and 0.79 prove a positive strong correlation between the variables. Based on this interpretation for the Pearson coefficient, we choose to take in the forward analysis only the first six indicators for which we find the strongest correlations. We obtained similar results as those identified in the literature: we find positive relationship between FDI and institutions, as well as Wilhelms (1998), Anastassopoulos (2007), Dunning and Zhang (2008), with infrastructure, as in UNCTAD (1998), Sass (2003), Anastassopoulos (2007), with goods market efficiency, as in Dunning (2000) who emphasize the role of created assets for attracting FDI, with labour market efficiency, as in UNCTAD (1998), Sass (2003), Popovici and Calin (2012b) and with technological readiness and innovation, also identified in the studies of Narula and Wakelin (1998) or UNCTAD (1998). We do not find important correlations with the macroeconomic environment; a possible explanation is given by the way the index is built. An interesting result is obtained as regards the correlation with higher education and

training: we find low, but negative correlation, pointing that foreign investors in these countries are not necessarily interested in qualified labour force. Our result is consistent with the one obtained by Strat (2014) for Romania: the author finds that FDI is influencing the number of students on the short term, but the reverse is not true. Finally, a medium correlation is found for financial market development. The investors are not interested in listing their companies on the local financial markets, especially as these countries do not have developed financial markets. Therefore, for the rest of the analysis we will only use the six correlated coefficients.

Given that variables expressing competitiveness and FDI/capita are correlated, we can assume that an increase in competitiveness will improve the FDI/capita in a country. We are interested in finding what volume of FDI can be supplementary attracted if one country improves its competitiveness in all or just one of the pillars expressing competitiveness.

In this respect, we adapt for our analysis the methodology applied in Demekas *et al.* (2007) and Bellak *et al.* (2008), tested in Popovici and Călin (2014a) in relation to public policies impact on FDI and further used in Popovici and Călin (2014b) for assessing the impact of competitiveness on increasing the living standards of a country.

In this respect, in the first step we establish the benchmark level of competitiveness that should be aimed by a country. For each indicator and each analyzed country, we take into account the best value of the indicator. We see that Estonia is the most competitive country in the group of the ten newest EU member states for all the indicators, except for the one regarding infrastructure (Table 4).

Table 4. The benchmark level of variables

	The benchmark level	Country
Institutions	4.9	Estonia
Infrastructure	4.9	Slovenia
Goods market efficiency	4.7	Estonia
Labour market efficiency	5	Estonia
Technological readiness	5.2	Estonia
Innovation	3.9	Estonia

Source: World Economic Forum, Global Competitiveness Report, 2013-2014

The second step is to calculate for each country and indicator the percentage difference from the benchmark level. The results are presented in Table 5.

Table 5. The percentage difference from the benchmark level, %

	BG	**CZ**	**EE**	**HU**	**LV**	**LT**	**PL**	**RO**	**SI**	**SK**
Institutions	44.1	36.1	-	32.4	19.5	22.5	22.5	48.5	25.6	48.5
Infrastructure	25.6	4.3	4.3	11.4	16.7	4.3	22.5	48.5	-	19.5
Goods market efficiency	11.9	6.8	-	11.9	4.4	6.8	9.3	20.5	9.3	11.9
Labour market efficiency	13.6	19.0	-	19.0	4.2	16.3	19.0	25.0	25.0	19.0
Technological readiness	18.2	6.1	-	18.2	10.6	8.3	15.6	26.8	6.1	23.8
Innovation	30.0	5.4	-	11.4	21.9	8.3	21.9	30.0	8.3	30.0

Source: authors' calculations

Note: the missing values are related to the countries which records the benchmark levels.

The third step is to calculate the potential percentage change of FDI due to a change in competitiveness level, ceteris paribus. Therefore, each of the result obtained in step two will be multiplied by the Pearson coefficient previously obtained. Table 6 presents the percentage change in FDI/capita if each of the analyzed countries improves its competitiveness to the benchmark level, i.e. to reach at least the competitiveness of Estonia.

Table 6. The potential percentage change of FDI/capita, %

	BG	CZ	EE	HU	LV	LT	PL	RO	SI	SK
Institutions	**21.6**	**17.6**	-	**15.9**	9.5	**11**	11	23.7	12.5	**23.7**
Infrastructure	13.3	2.2	**2.2**	5.9	8.7	2.2	11.7	**25.2**	-	10.2
Goods market efficiency	7.6	4.3	-	7.6	2.8	4.3	5.9	13	5.9	7.6
Labour market efficiency	7.3	10.2	-	10.2	2.2	8.7	10.2	13.4	**13.4**	10.2
Technological readiness	9.8	3.3	-	9.8	5.7	4.5	8.3	14.4	3.3	12.8
Innovation	18.3	3.3	-	6.9	**13.4**	5.1	**13.4**	18.3	5.1	18.3

Source: authors' calculations
Note: the missing values are related to the countries which records the benchmark levels.

Half of the analyzed country would have the highest increases in FDI/capita if improving the quality of the institutions. It is the case for Bulgaria, the Czech Republic, Hungary, Lithuania and Slovakia. Latvia and Poland should accelerate on improving innovation for having important increases in FDI/capita. Slovenia should work on labour market efficiency, while Estonia on infrastructure. Romania also should improve the infrastructure quality to the level reached by Slovenia in 2013 in order to the have its FDI/capita increased by 25.2%. Moreover, the FDI/capita would increase by 23.7% and by 18.3% if Romania would make efforts to improve the quality of institution and the innovation level to the performance that Estonia established in 2013. Similar increases in FDI/capita are possible for the rest of the countries due to improvements for each competitiveness indicator.

In the fourth step, we can also provide the nominal volume of potential FDI inflows, by multiplying the FDI/capita in 2013 with the percentage change obtained in the third step. The results are provided in Table 7.

Table 7. Potential increase in FDI/capita, euro

	BG	CZ	EE	HU	LV	LT	PL	RO	SI	SK
Institutions	1183	1688	-	1331	548	468	546	696	694	1926
Infrastructure	731	212	278	496	498	94	581	740	-	825
Goods market efficiency	415	414	-	635	162	184	294	383	327	615
Labour market efficiency	402	978	-	858	129	372	508	394	743	831
Technological readiness	535	314	-	818	328	190	414	422	182	1037
Innovation	1004	316	-	586	767	216	663	537	282	1488

Source: authors' calculations
Note: the missing values are related to the countries which records the benchmark levels.

Improvements in the quality of institutions could bring 1183 euro in FDI/capita for Bulgaria, 1688 euro for the Czech Republic and 1926 euro for Slovakia. Romania could see a total increase of 3172 euro in FDI/capita if improving each of the competitiveness indicators to the benchmark level established by Estonia and Slovenia. Urgent

improvements are needed in infrastructure and institutions' quality. We can calculate the same improvements for all the countries. For example, Hungary would have an increase of 4724 euro in FDI/capita if would tackle all of the six pillars to improve competitiveness at the benchmark established in 2013 by Estonia and Slovenia, followed by Bulgaria with 4270 euro. Certainly, there is enough space for Estonia and Slovenia to improve their competitiveness at the level of Germany or United Kingdom, or to reach the score of 7 for each pillar, use by the World Economic Forum for signalling the most important performances in terms of competitiveness. In this way, they also have the possibility to increase their FDI/capita.

4. Conclusions

The economic competitiveness of a country is included in the location determinants of FDI. Although there is not a general consensus in the literature regarding the definition of competitiveness, we find that some of the variables describing the Global Competitiveness Index establish a significant relationship with FDI. Therefore, in the first stage, we are testing if ten of the variables describing competitiveness, as defined by World Economic Forum in designing the Global Competitiveness Index, are correlated with FDI stocks per capita. For the sample of the ten CEE countries analyzed in this paper, we find that FDI stocks per capita are high correlated with institutions, infrastructure, goods market efficiency, labour market efficiency, technological readiness, business sophistication and innovation. Our results are in accordance with those identified in the literature, as we already mention in the Results section. We do not find important correlations between the macroeconomic environment, higher education and training and financial market development, due to several reasons we exposed earlier in the paper.

Our results are also in accordance with the economic theory which suggests that competitiveness, measured for example as total factor productivity or, in other words, an improvement in the labour force efficiency or at the production level, is able to enhance economic growth. Also, such types of improvements are often found in the FDI theory literature as being attractive for foreign investors.

Based on these argumentations, in the second stage, we calculated the potential percentage change of FDI due to a change in competitiveness level. We find that half of the ten analyzed countries could see the most important increases in FDI/capita if only making institutions more competitive (Bulgaria, the Czech Republic, Hungary, Lithuania and Slovakia). Two other countries (Latvia and Poland) should accelerate on improving innovation for having important increases in FDI/capita, while Slovenia should work on labour market efficiency. For Romania, major and urgent efforts are needed in terms of infrastructure, institutions' quality and innovation for improving competitiveness and increasing its FDI/capita. The direct consequence of applying such types of policies – only on improving the quality of institutions – would mean 1183 increase in FDI/capita for Bulgaria, 1688 euro for the Czech Republic and 1926 euro for Slovakia. Romania could see a total increase of 3172 euro in FDI/capita if improving each of the competitiveness indicators to the benchmark level established by Estonia and Slovenia.

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