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Nina Bandelj: From Communists to Foreign Capitalists

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Chapter 1

SOCIAL FOUNDATIONS OF THE ECONOMY

IN 1985, THE ECONOMIC order of the day in socialist Central and Eastern Europe¹ was full employment and absence of private property, domestic or foreign. Only fifteen years later, in 2000, the economic systems were based on private ownership and market competitiveness. Numerous postsocialist firms were in the hands of foreign investors, absorbing some of the \$1.4 trillion of that year's world foreign direct investment, which itself has increased more than twentyfold since 1985. In only fifteen years, how did we get from there to here?

This book is about the confluence of two grand processes of economic transformation that define our times: the transformation from command economies of state socialism to liberal market capitalism, and the intensification of transnational flows of capital as the defining characteristic of contemporary economic globalization. The book addresses two broad concerns. On the one hand, how have the economies in Central and Eastern Europe changed over the first decade after the fall of the Berlin Wall? How has market-based activity proliferated, and how do these newly established markets operate? On the other hand, what patterns global economic exchange? What influences whether a nation is more or less integrated into global capital flows, or whether a firm is controlled by foreign or domestic owners? Examining the determinants of foreign direct investment in Central and Eastern Europe is a strategic research site that allows me to simultaneously engage both sets of issues.

Foreign direct investment (FDI) is investment made by a company in the investor country in a foreign, host country. FDI refers to business transactions and does not include contributions from foreign governments, such as foreign aid. The objective of FDI is to obtain a lasting interest and an active role in a host company. The lasting interest implies the existence of a long-term relationship between the investor and the host and a significant degree of influence by an investor on the management of a company in a host country. Hence, FDI is usually classified as investment leading to ownership of 10 percent or more of the host firm, as opposed to portfolio investment, which refers to purchase of smaller equity shares.² FDI can take the form of foreign acquisition, in which the investor obtains partial or full ownership in an existing company. On the other hand, foreign investors can establish new companies in the host country, referred

to as *greenfield* investment, wholly foreign-owned or in partnership with domestic investors (Dunning and Rojec 1993).

From a macroeconomic perspective, FDI is a crucial medium through which national economies become interconnected on a global basis. In fact, world FDI flows in the past three decades show exponential growth in the intensity of global exchanges, and an ever more pronounced role of multinational corporations (MNCs) in creating a global economy. While in 1970, annual world FDI flows were a mere \$12 billion, in 1990 this figure was up to \$200 billion, and by 2000 FDI had increased dramatically to \$1.4 trillion (UNCTAD 2002).

FDI in postsocialist countries provides an ideal research opportunity because it allows us to examine how certain economic activity comes into existence *de novo*. These formerly socialist countries received virtually no foreign investment before 1989 because regimes were closed and private firms did not exist. Just fifteen years later, however, Central and Eastern Europe was very substantially penetrated by foreign capital. In 2004, average FDI stock as a share in gross domestic product (GDP) for these countries reached 39 percent, which is almost twice the average for the developed economies and significantly higher than the share in developing countries. To compare, FDI stock as share in GDP of China, one of today's premier investment locations, was (only) 16 percent in 2004 (UNCTAD 2006).

The goal of this book is to exploit the advantages of this unique research setting in three ways: first, to trace the origins of FDI flows to postsocialist Europe and empirically examine the determinants of cross-border investment exchanges; second, to use this empirical case to learn more about the actual process of economic transformations in postsocialism; and third, to theoretically build on the empirical findings and advance our understanding of the creation and operation of markets in conditions of uncertainty.

THE ARGUMENT

On November 9, 1989, the Berlin Wall, which separated the socialist East from the capitalist West, fell. The fall symbolized what may be the most dramatic and revolutionary transformation of political and economic institutions in the twentieth century—the collapse of Communist regimes and socialist command economies. Vindicated by the eventual dismantling of the Iron Curtain, neoliberals³ saw the collapse of Communism as an impetus to unleash the “natural” form of economic organization: free-market capitalism. After all, in the eyes of these observers, planned socialist economies were artificially manufactured systems that created inefficiencies, which would be corrected once the intervention of the Party state

in the economy was eliminated and free markets were allowed to emerge. This view reflected the notion that in a socialist system, economic organization is closely intertwined with politics and ideology. In fact, the close coupling of economic and noneconomic institutions, or *economic embeddedness* as defined by Karl Polanyi (1944, 1957), may have been the key distinguishing feature of the socialist system. At the same time, according to the neoliberal view, self-regulating markets are by nature free of political and social constraints on efficiency-seeking economic agents. From this perspective, to “transition” to market means to “disembed” the socialist economy, that is, to remove the political, social, and ideological influences that are assumed to impede the emergence of markets and constrain the natural propensity of economic agents to maximize efficiency. But does the “disembeddedness” perspective capture the character of *actual* economic changes in Central and Eastern Europe after 1989?

In this book, I use a case study of foreign direct investment in eleven postsocialist European countries, Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia, to empirically examine claims about spontaneous market emergence and the asocial nature of market exchanges. (See the map of the region in figure 1.1.) In fact, I am skeptical about both of these assumptions. First, as research in economic sociology contends, markets are institutions that do not emerge naturally or spontaneously but are socially created (Polanyi 1944; Swedberg and Granovetter 1992; Swedberg 1994, 2005; Lie 1997; Fligstein 2002). The socialist command economies were created by the Communist rulers. In a similar vein, markets in Central and Eastern Europe have been created by postsocialist states, international organizations, foreign investors, and domestic economic actors who had to learn new rules of economic behavior. Market “transition” has involved a transformation of one type of institutional order, socialism, into another, capitalism.⁴ Importantly, this transformation is not about eradicating social influences from the economic sphere. It is not about eliminating the role of the state in economic activity, and erasing the influence of ideational structures and political arrangements on economic transactions. Rather, it is about changing *how* these social forces structure the new market-based system of economic organization. From this perspective, socialist command economies and free-market systems are *formally very similar*, in the sense that both are socially constructed instituted systems, and in both, economic exchanges are embedded in social forces. However, these two economic systems are *substantively very different*. They exhibit different varieties of economic embeddedness. That is, each system is a configuration of different kinds of social-structural, political, and cultural influences on economic life.⁵

Second, I follow a sociological perspective on economic behavior, which understands *economic* transactions as *social* relations, enabled and



Figure 1.1. Map of Central and Eastern Europe

constrained by three key social forces: social structures, power, and culture (Zukin and DiMaggio 1990).⁶ Structural conditions encompass the influence of repeated patterns of social interaction, which can take the form of social networks or social institutions, both consequential for economic processes. The role of power is visible because of the uneven distribution of resources, which gives rise to issues of control and disposal, and stimulates the pursuit of political interests and power struggles in the economic sphere. Culture is consequential because shared collective understandings and meanings shape economic strategies and goals, and affect the interpretations of economic situations. In this view, social influences of different kinds course through *any* economic transaction, whether it occurs in a competitive market or in a redistributive system of a command economy. Importantly, social forces not only *constrain*

efficiency-seeking economic agents, as most analysts emphasize, but they *enable and empower* social actors to construct and then execute economic strategies of action in conditions of uncertainty.

This perspective, that social forces not merely constrain but constitute economic behavior, rests on the distinction between two different analytic understandings of the nature of economic worlds and economic action, which I call the *instrumentalist* and the *constructivist* perspectives (table 1.1). On the one hand, from the instrumentalist standpoint, economic action is perfectly possible without the interference of social structures, politics, or culture. Such may very well be the ideal conditions for economic exchange. This is because social forces are conceived as something separate from and outside of the economic sphere. Should they transgress into the economic domain, they can be accounted for as constraints that shape the structure of incentives for rational actors. They either impede economic efficiency because they raise transaction costs, or they can be strategically employed as an efficiency-enhancing mechanism. The rational actor model aligns well with the instrumentalist perspective: economic agents are independent in their decision-making, with known, stable, and transitive preferences, and guided by inherent self-interest to maximize economic utility. When they make decisions, they follow a means-ends logic: they have *a priori* determined goals (ends), usually profit maximization, and compare and evaluate possible strategies of action (means) to select the one that is estimated to yield the greatest profits. Worlds in which these economic agents conduct exchanges are conceived as inherently knowable so that any uncertainty is treated as ignorance of objectively available information. But economic agents are seen as capable of dealing with such uncertainties by reducing them into risk probabilities, which can then be integrated into utility maximization calculations.

On the other hand, the social-constructivist model sees economic actors as always interdependent (embedded in social networks), influenced by interests and politics (politically embedded), and guided by culturally specific preferences and goals (culturally embedded). The socially constructed nature of social worlds implies that economic processes are inherently uncertain and not objectively knowable. Actors can deal with uncertainty only if they rely on social forces, which make their decision-making possible by helping them to construct strategies of economic action and providing them with a framework to evaluate them. Within stable worlds, where social forces congeal into institutions, taken-for-granted rules of interaction allow actors to reach a common basis of understanding—a common evaluation metric—and treat uncertainty as risk. However, in changing environments during unsettled times,⁷ economic actors may not have clear and consistent preferences, may be unable to reliably evaluate alternatives, and may have difficulty judging probabilities of future (truly uncertain) outcomes. Hence, they are incapable of

TABLE 1.1
Instrumentalist and Constructivist Perspectives on Economic Issues

<i>Economic Issue</i>	<i>Instrumentalist Perspective</i>	<i>Constructivist Perspective</i>
Relationship between the social and economic spheres	Separated; if acknowledged, social forces considered as context for economic action	Permeated and embedded; economic action is social action; social forces constitute economic action
Nature of economic worlds	Objectively knowable	Inherently uncertain
Treatment of uncertainty	Uncertainty can be turned into calculable risk	Uncertainty necessitates reliance on social forces
Model of economic actor	Rational	Practical
Goals of economic action	Efficiency maximization	Multiple goals, economic and noneconomic
Strategy of economic action	Means-ends instrumental rationality	Substantive and procedural varieties of action
View of economic change	Natural evolution to one best way of free-market organization	Institutional transformation from one kind of embedded, socially constituted economy to another

turning uncertainties into risk probabilities, and will at best satisfy (Simon 1957) rather than maximize. Moreover, in conditions of radical uncertainty, economic actors may be ambiguous even about their goals of action; they may be attached to certain strategies rather than set on goals, or forced by contingencies to adjust both ends and means during the action process itself. To accommodate these circumstances, actors adopt economic strategies outside of the clear means-ends framework of instrumental rationality, such as following commitments, muddling through situational contingency, or improvisation. This means that economic action has multiple substantive and procedural varieties. To account for this diversity and flexibility of strategies, the social-constructivist model aligns best with the conception of actors as *practical* (Bourdieu 1980) rather than rational. Depending on context, economic-social actors will hold both economic and noneconomic motives for action, and their attempts at instrumental calculations will be mixed with, or even replaced by, affect, value judgments, and routine, which *may or may not* lead to efficiency maximization.

Needless to say, the social-constructivist model treats economic behavior as fundamentally social. Social forces are not imagined as something separate from the economic sphere. Instead, the social and the economic

worlds interpenetrate so much that economic action is impossible without social structures, politics, or culture, which come to constitute economic behavior.⁸ While often these social forces support bounded rationality of actors, and help them enhance their material positions, social forces sometimes limit efficiency, as economic actors follow value commitments, get caught up in political games, or are hindered by social networks in which they are embedded. Hence, while the instrumentalist view on economic life sees economic action as a rational search for material efficiency, the social-constructivist perspective focuses on actors' practical engagement in the processes of production, consumption, distribution, and exchange, and is agnostic about the resultant efficiency. That is, the constructivist approach does not assume maximization *a priori* but relies on concrete empirical investigation to specify the conditions in which economic behavior is or is not efficiency enhancing.

The instrumentalist and constructivist perspectives have different implications for the study of foreign direct investment in postsocialist Europe. From the instrumentalist perspective, which has dominated existing research, FDI is *a product of an investor's calculation of risk and return* to determine the investment that yields the highest profit. In this view, the collapse of Communist regimes and withdrawal of the Party states from the economy liberates Western corporations to pursue investment opportunities in Central and Eastern Europe. The investors compare likely investment profit across different alternatives, calculate expected returns and costs, and then invest in those places that promise the highest returns for the lowest costs.

In contrast, this book applies the constructivist perspective to FDI. The tenets regarding the socially constructed character of economic systems and social nature of economic transactions lead me to theorize and empirically analyze FDI as a *socially constituted relational process, negotiated by practical economic actors*. Fundamentally, FDI is a relational process—an exchange between two sides to the transaction, investor and host. Not only investors' but also hosts' actions play an important role in shaping FDI. Specifically, it is not the state's withdrawal from the socialist economy upon the collapse of Communist regimes that induces FDI inflows. On the contrary, postsocialist states need to be significantly involved in constructing FDI markets by institutionalizing and legitimizing exchanges with foreigners as appropriate and desirable economic behavior. In particular, because of the increased international integration of economies induced by globalization, postsocialist states shape FDI flows by negotiating liberalization pressures from the international environment with often protectionist domestic interests grounded in nationalist discourse. Because of the relational nature of FDI, the investment flows are not shaped only by the host country's economic and political characteristics (as cues for

investors' calculations of risk and return) but are channeled through the existing network of social relations between countries.

Moreover, if FDI is a *socially constituted* process, transactions at the level of firms will be heavily influenced by (a) business and personal networks in which investors and hosts are embedded, (b) political interests and vying for power between and within firms engaged in FDI transactions, and (c) culturally embedded understandings that investors and hosts have about appropriate economic partners, desirable economic goals, and plausible strategies to reach them. These social forces will not simply impose constraints on otherwise universally rational investors and hosts by increasing transaction costs. Rather, facing radical uncertainty that characterizes fundamental transformations in postsocialist Europe, investors and hosts will be able to accomplish FDI transactions *only if* they rely on social forces and act practically. Embeddedness in networks, institutional arrangements, power distributions, and cultural understandings will enable and empower both hosts and investors to partake in FDI transactions because it will help them manage the unpredictability of doing business in a turbulent environment. Paradoxically, being rational in conditions of unmeasurable uncertainty is an impediment. In such conditions, investors and hosts would likely be incapacitated because they could not precisely calculate the risk and returns of all possible investment alternatives. Or, should they nevertheless follow an *a priori* determined satisficing strategy, they would sacrifice precious flexibility to adjust when unexpected events came their way. Therefore, investors and hosts *act practically*. They use their social ties, draw on extant cultural conceptions, and sway with political currents. The social embeddedness of their actions gives rise to practical economic strategies, such as following commitments, muddling through situational contingency, or improvising. Some of these strategies may turn out to be suboptimal with respect to material efficiency. FDI business in unsettled times may or may not result in profit maximization. Uncertainty may help open up new strategic opportunities for entrepreneurial profits (Knight 2002) but it may also limit efficiency.

In the next section I detail the social-constructivist perspective on economic organization and action that provides the basis of the arguments advanced in this book and informs the empirical analyses of FDI flows to postsocialist Europe, which follow in subsequent chapters.

A SOCIAL-CONSTRUCTIVIST PERSPECTIVE ON ECONOMIC ORGANIZATION AND ACTION

Departing from the neoclassical conception of a market as an abstraction equilibrating supply and demand via a price-setting mechanism, sociolo-

gists have pointed to the social-network, cultural, political, and state-institutional dimensions of markets (for a recent review see Smelser and Swedberg 2005). One of the most prominent strands in this research takes off from the famous statement by Mark Granovetter that economic behavior is “constrained by ongoing social relations” (1985, 481) and examines the role of networks in economic activity.⁹ The network approach has provided a powerful antidote to atomistic conceptions of economic actors prevalent in economics. Nevertheless, this research has been critiqued for its lack of attention to cultural, political, and institutional forces (Zelizer 1988, 2001, 2002a; Fligstein and Mara-Drita 1996; Emirbayer and Goodwin 1994; Barber 1995; Nee and Ingram 1998; Spillman 1999; Krippner 2001; Bandelj 2002; Fligstein 2002), which have been shown to importantly structure economic life. Hence, we now have a smaller but growing body of work in economic sociology, which has responded to Viviana Zelizer’s (1988, 618) call to avoid “social structural reductionism” and pay attention also to cultural dimensions of economy (e.g., Zelizer 1979, 1987, 1994, 2005; Biggart 1989; Smith 1990; DiMaggio 1994; Dobbin 1994a; Abolafia 1996, 1998; Beckert 2004; Velthuis 2005). A third prominent line of work in economic sociology, closely aligned with political economy research, took seriously Max Weber’s (1978, 67) suggestion that “it is essential to include the criterion of power of control and disposal . . . in the sociological concept of economic action” (e.g., Mills 1956; Zeitlin 1974; Mintz and Schwartz 1985; Fligstein 1990, 1996; Carruthers 1996; Roy 1997; Bourdieu 2005). A variety of this research investigates the role of states in economic development (e.g., Evans 1979, 1995; Block 1994; Ó Riain 2000; Fligstein 2001a; Block and Evans 2005) or broadly accounts for the political-legal and institutional bases of markets (e.g., Hamilton and Biggart 1988; Campbell and Lindberg 1990; Gao 1997, 2001; Biggart and Guillén 1999; Campbell and Pedersen 2001; Fligstein and Stone Sweet 2002; Guillén 2001b; Nee 2005).

As this short, in no way exhaustive, literature review shows, economic sociology is a very vital and diverse field of inquiry.¹⁰ It harbors multiple approaches, often distinguished by the one social force that researchers privilege in their analyses.¹¹ For instance, research in the network tradition almost exclusively focuses on the role of social structures. Political economists stress state institutions as paramount. Cultural analyses underscore the importance of symbolic meanings. Often, then, vying for theoretical territory and armed with their one favored explanatory factor, scholars engage in debates over “structure versus culture” or “power versus institutions.” Not only are such theoretical debates largely counterproductive, but various research in economic sociology shows that social structures (networks, institutions, and states), power, and culture *all* matter for economic activity. The social constructivist perspective, which I

advance in this book, takes this as a basic premise. Indeed, if the economy is an integral part of society, and if economic action is socially constituted, then social structural, political, and cultural forces all course through any economic transaction, at the micro level, and their configurations constitute every economic system, at the macro level of analysis. The constructivist perspective encourages the analytical integration of these three key social mechanisms, and the empirical examination of their *concurrent* influences on economic organization and economic action. Such analyses avoid one-sided explanations, which are likely skewed because they leave important causal factors unconsidered.

At the macro level of economic systems, examining all three key social forces allows us to identify the social organization of economies. Analysis of merely the structural, political, or cultural dimensions of economy will not be sufficient for this task since it is precisely the configurations of, and interrelations between, different social forces that characterize unique varieties of economic organization. For instance, state socialism, as an ideal type, is characterized by structures of redistribution, central planning, an absence of private enterprise, autocratic power of the Communist Party, and a prevalent ideology of Marxism-Leninism, which privileges collective interest. The structures-power-culture configuration of Western capitalism is marked by private property rights and competitive market structures, a multiparty polity, and an ideology of individualization that privileges self-interest. As I will try to show, tracing the *reconfiguration* of the structures-power-culture nexus helps us explain the paths to economic transformation.

At the micro level of economic action, exchanges are social relations that have structural properties, but they also require attendant frameworks of understanding that enable actors to make sense of their role position. At the same time, any single position in the structure of social relations comes with different resources/power vis-à-vis actors in other positions. In addition, cultural understandings shape the articulation of interests (desired goals, preferred means) that actors pursue in exchanges. Thus, every economic exchange will be simultaneously influenced by social structures, cultural understandings, and distributions of power. While some of these forces may be causally more important than others for any specific economic transaction, we need to disentangle these relationships in rigorous empirical research that concurrently considers all three aspects.

Furthermore, the social-constructivist focus (on how economic outcomes result from mutual shaping of structures, power, and culture) underscores that social forces do not only comprise a “context” for what is otherwise an inherently asocial autonomous economic transaction (cf. Zelizer 2001, 2002a). Rather, social factors generate and constitute economic activity—by providing cultural and material resources, which help actors to make sense of economic situations, enable them to construct economic

strategies of action, and empower them to engage in economic interactions. The emphasis on the constitutive rather than merely contextual properties of social forces underscores that economic exchanges are social relations, navigated by practical actors. It is also on this count that the social-constructivist view on economic life sharply departs not only from neoclassical economic tradition but also from transaction cost institutional economics and rational-choice economic sociology. While these latter two perspectives acknowledge the role of social forces, they treat them as part of the context that shapes incentives for rational actors: either as transaction costs that impede the pursuit of inherent self-interest, or as efficiency-enhancing mechanisms that rational agents strategically employ.

Substantive Varieties of Embedded Economies

A basic assumption is that not structures (states, institutions, networks) alone, not culture alone, and not power alone, but all of these social forces together, matter in constituting economic activities. However, the real and challenging task for analysts of economic processes is to articulate the different *substantive varieties*¹²—different types and kinds—of political factors, cultural understandings, institutional arrangements, and social ties that shape different systems of economic organization at the macro level, or different economic outcomes at the micro level.¹³ Moreover, if any economic system is a configuration of different kinds of social structures, power distributions, and cultural understandings, then economic change needs to be conceptualized as a *re-configuration*, a movement from one kind of embedding to another, that is, a change in the substantive variety of economic embeddedness.

The fundamental transformation from command economies to market economies—which is “nothing short of revolution” (Szelényi, Beckett, and King 1994, 242)—provides a particularly fruitful area in which to examine the reconfiguration process. So far scholars have largely disagreed on how market transition is (best) accomplished because they operate with different assumptions about institutional change. On one hand, many prominent economists propose what may be called blueprint capitalism (Sachs 1989; Lipton and Sachs 1990; Sachs and Lipton 1990; Blanchard et al. 1991; Fischer and Gelb 1991; Aslund 1992, 1994, 1995; but see Murrell 1992; North 1990, 2005). This perspective is grounded in neoclassical economics and the assumption that the Western economic model of a market and the profit maximization principle is universally applicable. Thus Eastern European countries are advised (often quite literally by international financial organizations and Western experts) to quickly—as in shock therapy—implement tight monetary policy, restricted fiscal policy, and export-led growth, which will yield markets. Advocating that capitalist institutions should be replicated according to

Western experts' blueprints, this perspective assumes a clean slate, *tabula rasa*, after the fall of socialism, which allows for a rapid emergence of a new system. Underlying this blueprint capitalism (or shock therapy) perspective is the assumption that laissez-faire is the one best and most efficient way to organize contemporary capitalism. Once inefficient state intervention is eliminated, the invisible hand of the market will demonstrate its powers.

On the other hand, scholars working in the tradition of historical institutionalism emphasize that change is "path dependent" because structures inherited from before and during the state-socialist period influence the postsocialist transformation (Comisso 1991, 1995; Bruszt 1992; Stark 1992, 1996; Campbell and Pedersen 1996; Széleányi and Kostello 1996; Verdery 1996b, 2003; Róna-Tas 1997; Stark and Bruszt 1998; McDermott 2002; Ekiert and Hanson 2003). Policymakers who align with this perspective advocate a gradual transformation, not shock therapy. This historically grounded perspective privileges continuity between socialist and postsocialist periods. It suggests that multiple transformations—not a transition with a single known destination—occur *with* (not merely *on*) the ruins of the former regime in path-dependent ways (Stark 1996).¹⁴ Since the ruins of Communism vary, as do the paths of extrication, postsocialist transformations can hardly be expected to evolve toward a singular and uniform end point. Rather, a variety of capitalist arrangements is expected to emerge in postsocialist Europe, all as viable forms of capitalist organization, since there is no evidence that one single and uniform set of economic institutions is superior in its efficiency.

From a social-constructivist viewpoint, either explanation seems incomplete. While Communist institutions cannot vanish over night so they can be replaced with a neoliberal blueprint, it is also difficult to imagine how significant economic change is possible if the past commands the future. Likely, it is both new and old institutions that shape economic transformations. Indeed, if we analyze the changes after socialism as an instance of reconfiguration of one substantive variety of economic embeddedness (socialist redistribution) to another (capitalist markets), we become interested in *how and why* new and old institutions matter for postsocialist transformations. We study, on the one hand, the more or less rapid dismantling of centralized command over production and redistribution and, on the other hand, the establishment of new economic institutions of private property and market exchange. We see a more or less radical shift in the distribution of power among economic actors, with the Communist Party losing its despotic throne and supranational bodies, such as the European Union and international financial organizations, assuming substantial control over national economic matters. These changes are accompanied by a more or less extensive legitimization of new economic priorities of profit maximization and self-interest over socialist concerns

with job security and other social protections. The process of change is characterized by fundamental uncertainty, and actors, maneuvering the shifting economic space, need to be practical rather than rational. They may learn to adapt to new formal market institutions, but their learning will be shaped by the informal taken-for-granted rules and practices that accompanied socialism, which are most resistant to change (North 1990, 1993). Vestiges of socialism not only hamper learning the new rules of the game, and therefore limit efficiency, they also enable actors, as they face novel challenges, to create solutions that lead to innovative change. Hence, institutions of postsocialism, old and new, do not merely constrain self-interested behavior, as proposed by an instrumentalist perspective, but also enable practical economic actors to manage uncertainty and articulate their interests.

Finally, what are the implications of the constructivist approach for economic development? When we describe the substantive varieties of embeddedness, we identify specific configurations of social structures, power distributions, and cultural understandings that congeal into distinct forms of economic organization (cf. Whitley 1992a, 1992b; Dobbin 1994a; Guillén 2001b). Such investigation into the social organization of the economy elucidates a variety of potentially viable paths of economic performance because “effectiveness” and “rationality” have multiple instantiations. Concretely, this implies that free-market economies are not naturally superior to state-socialist systems. Both are socially, culturally and politically defined. Both reside on some notion of organizational effectiveness, such as insuring full employment in the socialist system, or pursuing profitability in capitalism. Both systems are governed by a particular power structure, either the Communist Party or neoliberal elites and international organizations. And both systems have established institutions that hold their cultural and political structures in place.

Embeddedness of Economic Action

The notion of substantive varieties of embeddedness elucidates the broad macro patterns of economic organization and transformation, but the social-constructivist perspective also has implication for our understanding of economic action.¹⁵ On the one hand, the instrumentalist view is clear on the theory of action: economic actors are rational utility-maximizers. This means that they know what they want and they decide how to get it in a way that is most efficient, that is, incurs lowest costs for maximum benefits. All this implies known and stable goals, and exogenously given, stable, and transitive preferences. On the other hand, from the constructivist viewpoint, uncovering social foundations of economic action exposes the limits to the rational actor model because it highlights *substantive varieties of rationality* and *procedural variation in the logic of economic*

action, going beyond profit maximization and beyond rational means-ends calculations, respectively.

As regards buying, selling, producing, and exchanging in markets, the traditional economic account privileges the understanding that firms strive to maximize profits. This is primarily because most of such work assumes behavior in contemporary competitive Western-style markets. However, if social forces constitute economic preferences, then there may be other likely and legitimate goals of economic action, resulting in different substantive varieties of rationality. To isolate one such goal, Neil Fligstein proposes that we “replace profit-maximizing actors with people who are trying to promote the survival of their firm” (2001a, 17). Firms may also explicitly target shareholder value, or market share, and not simply the highest profits. Moreover, when states act as economic actors, they may aim at political power or job protection. In the case of FDI in Central and Eastern Europe, decisions could also be informed by value rationality, whereby certain investment locations, such as a country to which one maintains affiliate ties, will be preferred on normative grounds and the conviction that one should do good for that country. In the case of East European émigrés or their children investing in their home countries, economic action may have an ideological basis, such as building capitalism after the fall of Communism. Consequently, not all market activity should be seen as profit-maximizing. Likely, the conception of economic action that encompasses substantive varieties of goals and preferences has more empirical utility. Moreover, while the instrumentalist perspective treats economic motives as exogenous, the social-constructivist focus can contribute significantly to the understanding of goals and preference formation, by tracing their social construction.

Still, strictly speaking, any substantive variety of rationality can be subsumed under the rational-action perspective. As a matter of fact, in the formulations of rational action that go beyond allocative efficiency within a market setting, a claim that an act is rational refers less to its substance than to its procedural means-ends logic. The means-ends schema implies internal coherence of decision-making whereby actors have clear fixed goals and stable preferences, and they decide upon the means to reach goals in a way that maximizes their utility, whatever the components of their utility function may be.

However, if economic processes have social foundations, the influence of social networks, cultural understandings, and politics on economic activity will also shape the procedural logics of action, resulting in behavior that is quite different from rational means-ends calculations. Distributions of power and political interests may lead people to strongly identify with certain strategies of action or solutions to problems, so that they may be unable or unwilling to switch to alternatives, even when they are recog-

nized as more cost efficient. In these cases, means-to-act are independent of goals, and goals are often identified only as a consequence of committing to certain means.¹⁶ Moreover, shared understandings (or lack thereof), which develop during the course of action between transaction partners, create emotionally charged circumstances that can compel actors to change their initial goals or modify their preferences. Likewise, new information that comes to actors via their social networks may induce them to change their preferences as transactions unfold. All this suggests that social forces not only constitute actors' preferences and goals but also affect their stability, and hence the procedural logic of decision-making.

In addition, different types of economic arrangements or processes in different temporal and spatial contexts encounter more or less environmental uncertainty, such as changes in the legal and political environment or economic crises that commonly occur during postsocialist transformations. Under conditions of uncertainty, rational means-ends schemas can be difficult to identify, much less implement, as actors will shift their goals or strategies to reach them. Indeed, their final goals will likely be articulated on-the-fly during the process of action itself. Therefore, the goal they reach at the end of the transaction may be quite different from that which they wanted in the beginning. If means and ends of economic action are not fixed at the beginning of transactions, but emerge out of situations themselves, actions are better conceived as creative rather than rational (Joas 1996).

The traditional economic account of clear fixed goals, stable preferences and cost minimization strategies is monolithic. Uncertainty, and the resultant embeddedness, can render situations in which economic action does *not* follow from straightforward, means-ends calculation. Rather, economic action can be based on commitment (where goals are articulated as a consequence of the choice of means); it may reflect muddling through¹⁷ due to situational contingencies (where ends and means articulated at the beginning differ from those achieved in the end because preferences change during the process); or it may resemble improvisation (where both ends and means evolve during the process of action itself). Paying attention to different kinds of social forces and degrees of uncertainty, we can identify conditions when means-ends schema can be usefully retained, but also those where practical actors employ alternative economic action strategies.

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Rather than rational asocial systems in which agents pursue their universal self-interest, I suggest that economies are socially constructed institutional arrangements where practical economic action is constituted by social structures, power relations, and cultural understandings. But it is

an empirical question whether uncovering the social foundations of economic organization and action really helps us better understand economic processes in times of change. Hence, in the second part of this introduction, I explicate the details of the empirical case that will be used to examine the explanatory power of the social-constructivist perspective—the case of foreign direct investment in postsocialist Europe.

THE EMPIRICAL CASE: FOREIGN DIRECT INVESTMENT IN POSTSOCIALIST EUROPE

Globalization, the intensification of cross-national flows of goods, services, people, technology, and capital that create the compression of time and space, is distinctly marked by the recent unprecedented rise in FDI. World FDI flows, which increased more than twenty-fold over the past twenty years, were valued at \$1.4 trillion in 2000 (UNCTAD 2002). In fact, the activities of multinational corporations (MNCs), mostly U.S.-based firms investing in other developed countries, started to make a significant impact on the international economy as early as the 1950s (Gereffi 2005, 164). A couple of initial MNC studies examined these trends, highlighting the benefits of U.S. FDI for host economies (Dunning 1958; Safarian 1966). Among the earliest attempts to extensively study MNCs was the Multinational Enterprise Project, started in 1965 by Raymond Vernon, an economist at the Harvard Graduate School of Public Administration who focused on the strategies of MNCs, highlighting the role of the product cycle in determining foreign investment decisions (Vernon 1971, 1999). Whether interested in macro international capital flows or micro firm-level behavior, these first studies of MNCs were all grounded in neoclassical economic theory, analyzing corporate strategies as examples of rational profit-maximization and transnational investment as beneficial to global welfare (Kindleberger 1970; Stopford and Wells 1972; Knickerbocker 1973; Hymer 1976).

New research approaches emerged in the 1970s, primarily among sociologists, who questioned the proclaimed positive spillovers of MNC activities and emphasized the uneven power relations between Western core nations that provided the source of FDI and underdeveloped peripheral countries that were the destinations. Concerned with how worldwide expansion of capitalism leads to dependency in Third World countries, the dependency school argued that MNCs, as instantiations of the uneven link between developed and underdeveloped countries, create dependencies because they hurt the ability of the Third World countries to build domestic industries controlled by locally owned firms (Cardoso and Falletto 1979; Gereffi 1978, 1983; Evans 1979).¹⁸ With a similar focus on

the political economy of FDI, world systems theorists have argued that foreign investment serves primarily the investors from developed core states and thus retards the development of poor countries on the periphery (Wallerstein 1974; Chase-Dunn 1975; Bornschieer and Chase-Dunn 1985). The deleterious effects of foreign investment, these researchers posit, result because the entry of MNCs distorts a nation's forces of production such that it relies on low-wage and unskilled labor to produce goods at low levels of technological sophistication. This creates few opportunities for beneficial "spillover" effects such as research and development, industrial services, or differentiation and constrains economic growth (Galtung 1971; Bornschieer and Ballmer-Cao 1979; Bornschieer and Chase-Dunn 1985). Furthermore, heavy dependence on foreign capital promotes an uneven distribution of capital intensity across sectors and geographical regions in the receiver economy. This concentrates income in (typically more productive) outward-oriented sectors, increasing overall income inequality (Frank 1967; Stack 1980). In addition, foreign capital penetration limits the production of human capital within the receiver economy and constrains the development of bureaucratic skills necessary for a highly functioning business sector (Bornschieer and Ballmer-Cao 1979; Evans and Timberlake 1980; Bornschieer and Chase-Dunn 1985). Scholars also argue that foreign capital penetration encourages inequality by influencing the distributive capacity of nation-states. Increases in global capital flows tend to produce a "race to the bottom" in which governments in developing nations seek to attract foreign investment by implementing policies that lower the bargaining power of labor, eliminate provisions that encourage full employment and wage enhancement, such as job training and local purchasing requirements, and thus remove institutional constraints on rising income inequality (McMichael 1996; DeMartino 1998; Ranney 1998; Beer and Boswell 2002).¹⁹

Nonetheless, arguments about the positive effects of liberalization and foreign investment reemerged in the 1980s as part of the "Washington consensus," advocated by international development agencies like the IMF and the World Bank (Gore 2000). John Williamson, who coined the name *Washington consensus*, argued that its principles of stabilization, liberalization, privatization, and deregulation constitute "the common core of wisdom embraced by all serious economists" (1993, 1334). Indeed, the Washington consensus—also referred to as neoliberalism—is closely related to neoclassical development economics, and a basic tenet is that growth in the stock of capital is the primary driver of economic expansion (Solow 1956; Swan 1956; Barro and Sala-i-Martin 1995). According to this view, for underdeveloped countries with dearth of domestic capital, the inflow of foreign investment increases the stock of capital and stimulates domestic economic growth (Balasubramanyam, Salisu,

and Sapsford 1999). In addition to propelling capital accumulation, investment by MNCs also has positive spillover effects, including job creation, skill upgrading, and the transfer of technological and managerial know-how to domestic firms (Markusen 1995; Blomstrom and Kokko 1997; Markusen and Venables 1999; Javorcik 2004). But how do these expectations square with empirical research that finds negative impacts of FDI for economic growth and equality? They don't.

There is very little consensus in the literature on the role of FDI in development. In fact, scholars working in different theoretical or disciplinary traditions propose contradictory effects. How to adjudicate between these diverse findings? In my view, the only way to better comprehend the *consequences* of economic globalization is to first understand the *causes and processes* of actual foreign direct investment activities. We need to know what structures FDI flows and what shapes firms' decisions on foreign investment. Contributing to this effort, my study of FDI in Central and Eastern Europe is particularly valuable because it provides a natural experiment setting. As table 1.2 shows, FDI was restricted before 1989 and diffused into the region in subsequent years. Hence, tracing the trajectories of FDI flows in postsocialist Europe offers an excellent opportunity to examine the evolution of FDI markets. While initial flows into the region were minimal in absolute numbers, FDI has grown significantly over the past fifteen years, leading to substantial FDI stock when considered relative to the size of these transition economies. As shown in table 1.2, since 1995 average FDI stock as a percentage of GDP for Central and Eastern Europe has been higher than the world average; by 2004, it was almost twice as high.

Explicating the determinants of FDI is also significant for understanding postsocialist economic transformation. It is precisely FDI that has been advocated by prominent international organizations as an engine in the transition to market and a powerful force for integration of this region into the global economy (IMF 1997; UNCTAD 1998). Many experts have suggested that "without massive inflows of foreign capital, successful transition [from planned to market economies] in Central and Eastern Europe is unlikely" (Schmidt 1995, 268). As a catalyst in the transition from state socialism, FDI would affect key macroeconomic indicators, such as the balance of payments and employment. Moreover, foreign investors would bring financial, managerial, and technological resources to induce corporate restructuring in formerly state-owned enterprises (Meyer 1995, 1998; Lankes and Venables 1996; OECD 1998c; Bevan and Estrin 2004).

Sociological research on postsocialist transformations has only begun to recognize the crucial role of foreign investment. In a recent review of

TABLE 1.2
Foreign Direct Investment Trends

	<i>FDI Inflows (\$ billions)^a</i>		<i>Average FDI Stock as % of GDP^b</i>	
	<i>CEE^c</i>	<i>World</i>	<i>CEE</i>	<i>World</i>
1970	0	13	0	
1980	0	55	0	5
1981	0	69	0	5
1982	0	59	0	6
1983	0	57	0	6
1984	0	59	0	6
1985	0	58	0	7
1986	0	87	0	7
1987	0	140	0	7
1988	0	165	0	7
1989	<1	193	<1	8
1990	<1	208	2	8
1991	2	161	2	8
1992	3	169	5	8
1993	4	228	7	9
1994	4	259	9	9
1995	10	341	10	9
1996	9	393	12	10
1997	10	488	16	12
1998	18	701	19	14
1999	19	1,092	23	16
2000	21	1,397	27	18
2001	22	826	31	20
2002	25	716	35	21
2003	17	633	37	22
2004	28	648	39	22

Source: UNCTAD 2006.

^a Cumulative FDI inflows in a particular year.

^b Average for the region/world.

^c CEE includes Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia.

the post-communist economies, King and Szelényi (2005) write that the most advanced among them have been successful because they have built capitalism from “outside,” with foreign capital, and that foreign investors constitute the new ruling elite in Central and Eastern Europe (cf. Eyal, Szelényi, and Townsley 1998). If foreign investors participate in the transformation of property rights *as well as* formation of new class structures, then their relevance for the creation of capitalism in postsocialist Europe could not be greater. Still, scant attention is paid to how foreign investors

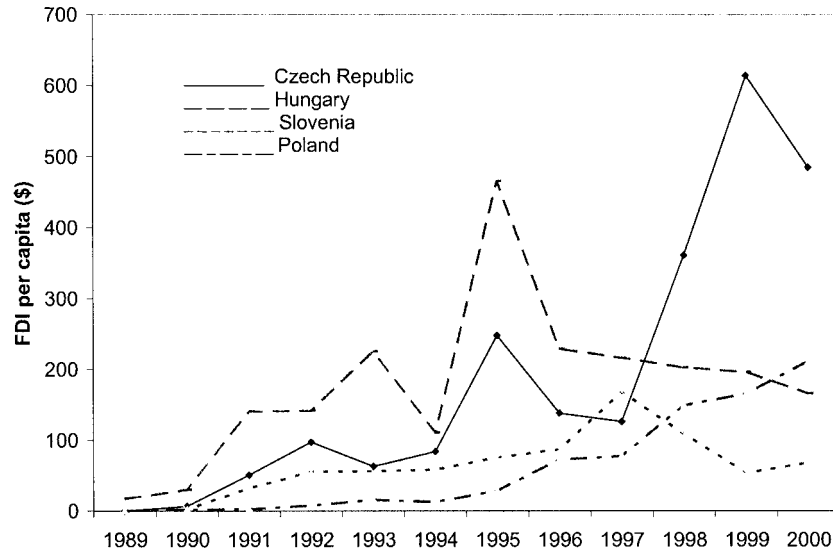


Figure 1.2. FDI Inflows in Select Central and East European Countries, 1990–2000

come to be involved in the creation of market processes in postsocialist Europe, and why the extent of their presence differs in individual countries.

Indeed, despite its alleged key role in postsocialist economic transformations, empirical data show substantial cross-national variation in FDI flows (figure 1.2). For instance, in the period from 1995 to 1997, foreign investment levels in Hungary and Latvia reached over 6 percent of GDP in comparison to 2 percent for Slovenia and Lithuania. Foreign direct investments in Poland and Slovakia were less than the 1997 regional average of 3.3 percent, while the Czech Republic and Estonia attracted above-average FDI levels (UNCTAD 1998). By 2000, FDI stock in Latvia amounted to only about \$2 billion, while in Poland it was almost fifteen times higher. But it is not only the size of the economy that matters: Estonia, with a population of 1.5 million, attracted about \$2,500 per capita in FDI stock by 2000, while for Romania, fourteen times larger, this figure was \$300.

FDI is not only highly variable across individual Central and East European countries and over time, but *within* countries. There are differences in who invests where. By 2000, Germany and the Netherlands were the biggest investors in the region. Both countries invested substantially in Hungary and Slovakia, but while Dutch investment was significant in the Czech Republic and Poland, Germany invested more in Bulgaria and

Latvia. U.S. investment featured prominently in Croatia and Lithuania. Among smaller investors, Estonia received more than three-quarters of Finland's investment in the region and almost 50 percent of FDI in Slovenia came from Austria. Australia invested some in Poland, Croatia, and the Czech Republic, but Asian and Latin American investments in the region were negligible.

Variation in FDI also exists at the level of firms. Some attempts at FDI are successfully realized to the mutual satisfaction of all parties involved. Many FDI attempts are modified in scope or in mode of entry during the process of negotiation with host governments or targeted firms. An investor company might attempt to acquire a 100 percent ownership of an existing company, but then forms a joint venture with the host firm, or perhaps ends up establishing a completely new entity in that country (so-called greenfield investment). Furthermore, some attempted FDI transactions (albeit very difficult to track down) fail to materialize. Investor firms may encounter resistance, if not outright rejection, at local sites and decide to withdraw their investment offers. Host firms actively looking for a foreign partner may also be unsuccessful in their search. Moreover, many opportunities for FDI are never even considered.

In short, FDI in Central and Eastern Europe varies across countries over time, within countries by the investor's country of origin, and across organizational cases. What explains this variation? What determines FDI flows and transactions in postsocialist Europe?

Economics and Political Economy of Foreign Direct Investment

Economists have studied FDI extensively and built their explanations around a central thesis: FDI, like other economic behavior, reflects independent economic agents responding to freely determined prices in pursuit of utility maximization. In particular, MNCs consider the profitability of alternative investment strategies and decide to engage in foreign direct investments because this minimizes their transaction costs and promises high returns. Most analyses of FDI flows at the country level examine the effects of economic opportunities generated by the demand and costs associated with the supply at the investment site (Basi 1963; Aharoni 1966; Agarwal 1980; Dunning 1980; Grubaugh 1987; Alter and Wehrle 1993; Welfens 1993; Schmidt 1995; Jun and Singh 1996; Markusen 1995; Meyer 1995, 1998; Billington 1999). Demand is estimated by market potential in terms of size and growth. Key cost factors include the availability, skill, and cost of labor; macroeconomic stability; and development of infrastructure.

Several studies by political economists add political risks, government policy, and the level of democratic development of host countries to this

list of cost factors that investors should consider in their calculations of risk and return. This research hypothesizes that political hazards add to investment risks and therefore discourage FDI (Kobrin 1982, 1984; Gastanga, Nugent, and Pashamova 1998; Delios and Henisz 2000; Henisz 2000, 2002; Wei 2000; Henisz and Delios 2001). In addition, researchers argue that foreign investment policies of host countries, which provide incentives to investors in the form of tax holidays or exemptions from import duties, have an impact because they deflect costs at investment sites, while protectionist policies increase them (Bhagwati, Dinopoulos, and Wong 1992; Brewer 1993; Blonigen and Feenstra 1996; Ellingsen and Wärneryd 1999; UNCTAD 2002). Investigating a relationship between democracy and FDI, in a recent comprehensive study Nathan Jensen (2006) finds that democracies attract more FDI, arguing that this is because democratic governments can more credibly commit to market-friendly policies than can authoritarian regimes. Earlier studies, however, found no effect of the political regime (Oneal 1994; Alesina and Dollar 1998) or found evidence of a negative relationship between democracy and FDI (Li and Resnick 2003).

Whether it is because of promising economic conditions or political stability or tax incentives for investors, this research uniformly concludes that those countries which promise highest returns and minimum costs will attract the most FDI. The prosperity and the stability of the economy will have a positive effect on FDI, while political risks and high tax costs will reduce it. But do these trends hold for the uncertain and transforming postsocialist Europe? For instance, Slovenia, a country considered as the most advanced in the transition process, with little investment risk, has seen comparatively small FDI flows. Latvia and Lithuania, two Baltic states quite similar in their economic and political development, have attracted significantly different FDI amounts. For Poland, the country with the largest domestic market in the region, FDI stock has represented a much smaller share than for Estonia, which has the smallest domestic market in the region. Moreover, if uniform country characteristics are key determinants of FDI flows, how can we explain variations in the investor country of origin?

Existing studies of FDI transactions at the firm level focus on why and how firms decide to undertake direct investments abroad. Research suggests that firms, as profit-maximizing agents, are motivated to exploit their own advantages, such as access to patented technology, specific management or marketing skills, or ownership of brand names, and to exploit institutional and productive factors of the target setting (Hymer 1976; Vernon 1971; Stopford and Wells 1972; Dunning 1981, 1995; Wheeler and Moody 1992). Minimization of transaction costs, or strategic behavior aimed at maximization of profits, guides firms' choices about the form

of internationalization (direct investment abroad, trade, or licensing) and the form of FDI entry, such as greenfield investment, joint ventures, or mergers and acquisitions (Williamson 1975, 1985; Buckley and Casson 1976; Hennart 1982; Vernon 1983; Vickers 1985; Anderson and Gatignon 1986; Hill, Hwang, and Kim 1990; Oxley 1997; Sun 1999). Enhancement of learning and technological capabilities may also be important goals (Kogut 1988; Kogut and Chang 1991; Kogut and Zander 1993).

Focusing on the motives of foreign investors, this research is strangely silent about the host side of FDI transactions. What happens when foreign direct investment efforts, identified as cost-efficient and profitable by investors who attempt them, are resisted by host firms or the host country's government?

Sociology of Foreign Direct Investment

Research that emphasizes the potential profitability of investment locations and minimization of transaction costs as key determinants of FDI rests on two assumptions. First, such analyses are investor-centered and either ignore the role of the hosts or treat them as passive receivers of investment. Second, this research adopts the instrumentalist view of economic life, assuming that economic processes are largely asocial and that economic outcomes are a straightforward result of instrumentally rational calculation of risk and return, and efficiency.

Instead of treating hosts as passive recipients of foreign investment and investors as efficiency maximizers, I adopt a social-constructivist perspective and conceptualize and empirically analyze FDI as a relational, socially constituted process. Why relational? By definition, investment flows from an origin (investor) to a destination (host). Thus, FDI results from a relation between two parties to an economic exchange. Consequently, the causes of FDI must likewise be traced to the actions of both investors and hosts and the relations between them. In doing so, we can examine how not only Western foreign investors but also hosts on the periphery importantly influence the FDI process by making it a site for the assertion of local interests and possible resistance to globalization (cf. Guillén 2001a, 2001b, 2002a).

Why social? Because FDI involves actors who are oriented to each other in their behavior, attribute meaning to economic exchanges, are influenced by power dynamics, and rely on networks and institutions to practically navigate economic interactions. Social structures, distributions of power, and cultural understandings constitute any economic action, and FDI is no exception. In fact, some exemplary studies that pay attention to the role of social forces have found that national culture influences the mode of foreign entry (Kogut and Singh 1988), that investors embedded

in interorganizational networks imitate behavior of their peers (Delios and Henisz 2000; Henisz and Delios 2001; Guillén 2002a, 2002b), and that institutional distributions of power structure the frequency of hostile takeovers as an FDI strategy (Schneper and Guillén 2004). I build on these studies to bring to the fore the social foundations of cross-border investments. I expect that the variability in FDI across countries and across organizational cases in transforming Central and Eastern Europe will have more to do with institutions, social networks, politics, and culture than objective risk-and-return indicators.

To test the explanatory power of this argument, I empirically examine in this book the following questions about the determinants of FDI at three different levels of analysis:

1. What accounts for the differences in country-level FDI trajectories since 1989? In particular, how do postsocialist states, international and regional organizations, such as the IMF and the EU, and domestic nationalist discourse influence the creation of FDI markets?
2. What explains the cross-sectional variation in national FDI flows? In particular, what is the significance of political, economic, and cultural relations between investor and host countries for determining which countries are more or less integrated into transnational capital flows?
3. What determines the realization of foreign investment attempts at the firm level? In particular, what is the role of institutions, social networks, power struggles within firms, and cultural understandings of economic partners, strategies and goals, in shaping the practice of FDI transactions in conditions of high uncertainty?

After setting the stage with chapter 2, which provides a general overview of the socialist system and the larger context in which postsocialist economic changes occur, I take up the first empirical question outlined above in chapter 3, which examines the proliferation of FDI exchanges in eleven postsocialist countries from 1989 to 2000. Theorizing market transition, the orthodox economic perspective stipulates that markets will emerge spontaneously once the control of the Party state is abolished and an incentive structure is put in place for self-interested actors to exchange and maximize utility. But what my analyses show is that economic incentives and stabilization in host countries explain little about FDI flows to eleven Central and East European countries in the first ten years after the fall of the Berlin Wall. Rather, the findings show that the efforts of postsocialist states to institutionalize and legitimize FDI make the crucial difference. It is in those countries where FDI is encouraged by privatization policies, by a political commitment of postsocialist government to

liberalization, and by concrete state actions to increase the legitimacy of FDI practice that we see the highest foreign investment inflows. These results suggest that it is the involvement of the postsocialist states rather than their withdrawal from the economy that facilitated the marketization of Central and Eastern Europe in the first decade after 1989. Moreover, contrary to the instrumentalist view suggesting that economic efficiency is the key reason for states to encourage FDI, I find that host states' decisions to legitimize FDI depend most upon the legacy of previous policies, mimetic and coercive pressures from the international environment, and efforts to protect domestic ownership in the newly established states. This means that postsocialist states construct markets in ways that reflect institutionalized alternatives for action available to political actors, which are themselves shaped by existing cultural repertoires and international power relations.

But how do FDI markets operate? The second set of questions outlined above focuses on what structures cross-national capital flows across countries and provides the basis for chapter 4. FDI flows to postsocialist Europe reveal substantial within-country variation by investor country of origin. Basically, there seems to be a pattern in who invests where, suggesting that a set of relations between individual postsocialist countries and world investor countries can be more important than a postsocialist country's economic prosperity or political turbulence. The empirical analyses of FDI between investor-host country pairs substantiate that FDI flows between countries that have established political, migration, trade, and cultural relations, underscoring the fundamentally relational aspect of cross-border transactions.

The weakness of standard risk-and-return indicators to explain macro-level FDI flows implies that, at the micro level, economic actors involved in FDI transactions may not maximize profits. While preexistent business and personal ties forged through trade and migration flows between nations likely decrease transaction costs, established connections, personal affiliations, and cultural conceptions may also lock actors into a limited number of alternatives. Moreover, these macro-level analyses point to a possibility that local actors at investment sites interfere with investors' efforts to maximize profits by modifying investors' original intentions, and sometimes by rejecting them altogether. However, what happens at the level of firms can only be inferred from macro-level analyses, and it is more effective to directly examine organizational decision-making. I do that in chapter 5. The empirical question here is this: What determines the realization of FDI transactions? Instrumentalist explanations of FDI make these exchanges seem very straightforward and unilateral. The investor weighs costs and benefits and decides to invest abroad because FDI is less costly than other forms of internationalization, such as trade or

licensing. Calculating transaction costs, firms first decide on the mode of foreign entry (e.g., joint venture, greenfield investment, or acquisition), and on the investment location. And then they realize their investment. Investigating a number of concrete FDI attempts in transforming Central and Eastern Europe shows that the practice of FDI is not as straightforward as the economic model portrays it. To understand why certain FDI efforts pan out while others don't, we need to go beyond efficiency calculations of investors, and examine how the organizational behavior of both investor *and* host firms is shaped by the social structures, cultural understandings, and power relations in which they are embedded.

In keeping with the neoinstitutionalist perspective in organizational analysis (Powell and DiMaggio 1991), case analysis of organizational behavior in FDI transactions demonstrates that FDI decisions by Western firms can be often characterized as jumping on the East European bandwagon, since the behavior of peer firms is followed more frequently than objective evaluations of alternative strategies. In addition, social networks matter because investors use the information they get from their business partners or colleagues to make decisions about investment targets, and they are often swayed by personal ties to a particular country or company. For both investors and hosts, conceptions of different nations and cultures influence the evaluation of potential partners. The ability to build shared understandings during the negotiation process often seals or breaks the deal. Furthermore, economic exchanges are in no way isolated from issues of power and control between stakeholders, nor from the interventions of political elites. In firms, political coalitions often form to resist or champion particular FDI attempts. Finally, transactions are structured by state policies and institutional arrangements of the host country. These policies do not just regulate investment and impose constraints on investors. The institutional makeup of postsocialism, especially nontransparency and ambiguity, frequently also represents a resource by means of which economic actors on both sides of the transaction pursue their preferred strategies of action.

“Foreign investment in Central and East European countries is based too much on emotional prejudices and daily political needs and is far from rational economic considerations,” lamented John Dunning (Dunning and Rojec 1993, 12), one of the most prominent economists of FDI. Chapter 6 is motivated by my observation that his words capture well the empirical reality of FDI in postsocialist Europe, though I do not share his sense of discouragement. I argue that to understand socially embedded economic action in situations of high uncertainty, we need to step outside of the confines of the rational action model. In conditions of high uncertainty—in times when cultural ideas of valued economic goals are changing, when new economic and non-economic institutions are being built

hastily, and when sudden changes among ruling political elites are commonplace—FDI transactions are not a matter of rational profit maximization of economic agents because not all uncertainty can be turned into risk (Knight 2002). Rather, the uncertainty and resultant social embeddedness of economic processes contribute to substantive and procedural variability in economic action. Substantively, there are many competing ideas as to what valuable economic goals should be. In particular there are great differences between goals emphasized during socialism, such as full employment, and those promoted in the postsocialist period, such as shareholder value. Procedurally, because of cognitive and situational uncertainty, and resultant structural, political, and cultural embeddedness, economic actions based on commitment, muddling through situational contingency, and improvisation are more common than rational means-ends calculations.

In the concluding chapter, I make the case that understanding economic processes is greatly enhanced by a constructivist sociological perspective. Social forces are not mere constraints on profit maximization, because somehow the “true nature” of markets is to be void of social influences. Rather, social structures, distributions of power, and cultural understandings are integral components of market organization, as they constitute every economic transaction. Discussing the implications of this study for theory building in economic sociology, I underscore the social-constructivist view, which pays attention simultaneously to the three key mechanisms that structure economic organization and action—repeated patterns of social interactions that manifest themselves in institutions and social networks, allocations of power, and cultural understandings.

Finally, I consider how this research contributes to the empirical study of market transition and what its implications are for the varieties of postsocialist capitalism. Transformation from redistributive socialism to market capitalism implies that redistributive arrangements are replaced with self-regulated market exchange. With the fall of Communist regimes, many analysts expect the social, political, and cultural forces in the economy to easily give way to the profit-maximization market imperative and considerations of efficiency. Instead, a comparative sociological approach—one that draws on a variety of data sources and methods of analysis—substantiates the embedded, socially constructed character of postsocialist economies, shaping the multiple paths to economic development in Central and Eastern Europe.

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How are markets created and how do they operate? A fundamental transformation of economic systems in Central and Eastern Europe offers ideal opportunities to reconsider the assumption that markets are asocial and

that actors are always profit-maximizers. Using empirical analyses of foreign direct investment in postsocialist Europe, I argue that our understanding of economic organization and action will be greatly limited if it ignores the interrelationships between social structures, power distributions, and cultural understandings, which do not merely constrain economic life but make it possible.