INSTITUTIONAL DETERMINANTS OF INVESTMENT INFLOWS INTO TRANSITION ECONOMIES[1]

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Abstract

This article investigates the relationship between institutional quality and the level of investment inflows into post-communist countries. We attempt to empirically verify the argument that institutional determinants are essential in explaining the variation in investment inflows into transition economies after the demise of socialism in the early 1990s. The role of institutions is assessed using Economic Freedom indices provided by the Heritage Foundation. Consequently, to investigate the progress of institutional quality in transition economies, we further employ indicators developed by the European Bank for Reconstruction and Development. Using a panel data set for 11 transition countries from 1993 to 2013, we conclude that the impact of institutional quality on investment inflows is not negligible, yet much weaker than suggested by the existing theoretical literature. Using a fixed-effects model framework in both regression benchmarks with metrics from the Heritage Foundation and the European Bank for Reconstruction and Development, respectively, we observe that the impact of institutional variables on the level of investment was less significant than expected. Moreover, macroeconomic fundamentals appear to always play a more substantial role than institutional factors.

Introduction

With the rise of globalisation, foreign direct investment (FDI) has become an important stimulus for productivity and economic growth for both developed and developing countries. Foreign capital can substitute a lack of domestic one, and thus countries tend

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to develop sustainable conditions for attracting investment inflows into their economies. Yet, although the level of FDI increases continuously, its spread among countries is very uneven. The available literature tries to explain the uneven allocation by providing empirical analyses of the main determinants specific to transition economies. Most of these investigations stress the role of market size, economic reforms and labour costs as the main factors attracting investment inflows without substantial focus on the potential role of institutions. Daude & Stein [2007] emphasise the significance of institutional factors for the FDI levels, a fact also supported by Pournarakis & Varsakelis [2002] and Fabry et al. [2006]. By contrast, authors such as Akçay [2001] did not observe any clear relationship between institutions and the level of investment inflows.

The aim of this paper is to fill the gap in the current debate on the main determinants of FDI inflows specifically in the post-communist countries by providing a quantitative analysis of the potential institutional factors affecting investment inflows into eleven post--communist transition countries, with a time span from 1993 to 2013. We develop a model that combines traditional FDI determinants and specific institutional indicators, all of which are expected to play a significant role in explaining the cross-country variation in FDI inflows. The proposed econometric model relies on a panel data set which is developed in order to capture the dynamic behaviour of the parameters in the regression and to provide a more efficient estimation of the parameters employed in the model. Institutional quality is being assessed using two sets of indicators. The first group relates to the Economic Freedom Indices provided by the Heritage Foundation, while the second one monitors issues of transition economies and is provided by the European Bank for Reconstruction and Development (EBRD).

The rest of the article is structured as follows: Sections 2 and 3 summarise recent literature available on FDI, institutions and previous empirical research on the topic. Section 4 provides detailed information on the empirics employed, including a description of variables, hypotheses and model specifications. Section 5 concludes the article.

Literature review

Foreign direct investment is conventionally considered a type of investment that includes insertion of foreign funds into an entity that operates outside the investor's country of origin. We differentiate among several investment strategies; one of them is known as "brownfield investment". This is based on a company acquiring existing facilities to initiate a business activity in a certain country. The opposite strategy is "greenfield investment" and it consists of developing new equipment and starting an activity from ground zero. It is usually accompanied by providing long-term job opportunities for local people. Grčić & Babić [2003] stated that FDI has specific features in comparison with other forms of capital and financial transactions and unlike conventional loan it is more based on investors' long-term interest in the area in which they invest. Generally, firms invest in countries with favourable economic and political environments in order to minimise transaction costs and maximise profits.

We can distinguish among horizontal, platform, and vertical FDI; however, the differences between these types are often unclear in practice. Demekas et al. [2005] stated that the horizontal FDI is targeted towards the local markets of the host country when the production is considered more profitable, thus source countries, instead of considering exports, expand their activity on the host country market. Accordingly, market size would

represent one of the main determinants for horizontal FDI and costs of labour for vertical FDI. Although Demekas et al. [2005] suggest that horizontal FDI are observed on a large scale in comparison with vertical FDI, both types can be encountered simultaneously. Finally, platform investment serves purely for re-exports to third countries.

Since the 1970s, a significant increase in FDI inflows has been observed in the world economy. Moreover, the growth of FDI inflows has exceeded the growth of world trade and world output [Bissoon, 2011]. Meanwhile, for transition economies, increase in FDI inflows is associated with improvement in the country's economic growth strategy. Bevan & Estrin [2000] stated that the main problem of these economies is the lack of capital and technology necessary to spur growth while there are sufficient stocks of human capital. Considering this aspect, the region became more eager and open to foreign investors after the political changes in the early 1990s. Their deteriorated economic conditions led them to begin massive restructuring in order to attract FDI. Therefore, foreign companies were expected to provide assistance through various channels. One of them would be competitiveness improvement via innovation in products, production processes and organisational issues. Secondly, it would provide financial support in order to reduce the existing debt burden and, finally, it would improve the social imbalances concerning poverty, job losses, and incomes [Pournarakis & Varsakelis, 2002]. In the last years, massive FDI inflows were observed in exactly those regions, stressing the fact that these economies have made significant progress. The uneven distribution can be determined by localisation advantages, political, social and economic progress, which might have influenced the decision making process in a positive manner. Economies in transition start to earn credibility, which consequently gives an impulse to these countries to continue their socio-economic and infrastructural development. It is a win-win situation when host countries benefit from financial assistance and source countries are provided with advantageous incentives.

Besides the recorded progress, there are certain characteristics that investors take into account when deciding to invest in a specific region. According to Dunning [1988], there are several factors that attract or restrain the level of FDI inflows. He provides a theoretical framework where it is argued that FDI are determined by three sets of advantages: ownership, localisation and internationalisation, while it is also referred to as Dunning's OLI paradigm. Ownership advantages refer to the ability of a company to hold products and services that cannot be easily duplicated by competitors or possession of sufficient financial resources required to enter specific closed markets. Localisation advantages refer more to the issues regarding the market under consideration, market risk, market potential, market expansion available to all firms, etc. Finally, internalisation advantages arise with the costs associated with choosing a hierarchical mode of operation over an external mode [Dunning, 1988]. These are the transaction costs and due to the fact that they cannot be calculated accurately before the international operation has been established, many studies exclude this factor [Dunning, 1993]. Consequently, Dunning developed a framework concerning multinational enterprises (MNEs) and their strategies and motivations when investing abroad. According to Dunning [1993], MNEs can be classified in three categories: market seekers, natural resource seekers, and efficiency seekers. Market seekers take into consideration market size and market growth of the host country. Resource seekers, on the other hand, are more interested in the resources available in the host country that are not significant in the home country. These can include natural resources, quality raw materials or cheap labour force. Last but not least, efficiency seekers rely

more on the quality of institutional arrangements, economic policies, demand patters, market structures that they consider when concentrating production in specific locations that would be able to supply multiple markets.

However, even if at a first glance it may seem that transition economies mainly attract market-seekers, Pournarakis et al. [2002] argued that the presence of natural resources and cheap labour force do not seem to be the main drivers of FDI nowadays. They stated that MNEs are slowly shifting to efficiency-seeking FDI, therefore the emphasis is now more on quality and stability. Even though inexpensive labour might not always be the main driver for investors, Botrić & Škuflić [2006] state that FDI into developing countries consist more in knowledge transfer using the production already present in the host country. Nevertheless, the authors mention that labour market conditions of a country are of significant importance. Besides inexpensive labour, one should also take into consideration productivity and quality of the labour force.

Still, the literature has established market size as the most significant factor upon which investors base their investment decisions, a fact confirmed by many [Carstensen & Toubal, 2004; Janicki & Wunnava, 2004]. Meanwhile, authors such as Garibaldi & Mauro [2002] and Bevan & Estrin [2000] have found out that determinants such as labour costs, trade openness and macroeconomic stability explain the level of FDI inflows into these countries the best.

Institutions and FDI

Until quite recently, a country's institutional framework was not much taken into consideration when analysing the level of FDI inflows. In institutional economics, the term "institutions" has a variety of meanings. As North [1990, pp. 27] puts it, *"They provide rules, constraints and incentives that are instrumental for the governance of exchanges"*. The institutional framework consists of three components: formal rules, informal rules and enforcement mechanisms. Formal rules are considered to be the written rules of a society. Examples of formal institutions could be regulation of banks, imposition of tariffs and quotas, or laws governing contracts [North, 1990]. Ali; Fiess & MacDonald [2008] found that good institutions with efficient rules of enforcement tend to substantially decrease the costs of doing business. Among other things, institutional determinants depend on the efficiency of government policy implementation and also on features of political and social entities. These characteristics include the level of political and social risks, transparency of regulatory frameworks, political stability and effective property rights protection, rule of law, lack of corruption and efficient banking environments. These are considered significant factors since lack of protection of property rights may lead to expropriation, which may decrease the chances of companies investing in a certain area. Corruption creates conditions for unfair competition, which creates barriers for investors. The taxation system is also taken into consideration since high taxes may hamper growth and productivity, and discourage investment.

The empirical investigation on institutional quality is rather limited despite the vast research performed on determinants of FDI. The available literature mentions that factors such as effectiveness of property rights, sound and stable regulatory frameworks, economic freedom and lack of corruption are of significant importance for investor decision making processes. It is deemed that localisation advantages make some countries more

attractive than others. Those can be market size, macroeconomic stability, labour costs, economic growth, trade openness, political stability, transparent regulatory frameworks, corruption, and privatisation processes [Dumludag, 2009].

An early attempt to study the impact of institutions on FDI levels was made by Wheeler & Moody [1992]. Taking the first principal component of 13 risk factors (including legal system quality, corruption, bureaucracy and political instability), they did not find that "good" institutions have a considerable impact on the location of US foreign affiliates. However, the index also included factors, such as inequality level and environment of expatriates, that are not directly related to the quality of institutions. Moreover, Rodrik [1999] added to his estimations the "social conflict" indicator as one of the explanatory variables. His empirical results have shown that what really matters are the rules and games in a society. Daniele & Marani [2006] discuss potential channels through which institutions may affect the level of investment. First, the presence of good institutions tends to improve productivity, and subsequently stimulates investment, regardless whether domestic or external. Also, good institutions are associated with lower investment transaction costs. Finally, FDI engage high sunk costs. Thus, good institutions will add more credibility and security for MNEs.

Still, empirical evidence is quite inconclusive. For instance, Jensen [2003] focusing on 114 developing countries worldwide using a panel regression for the years 1970–1997, found that expropriation, corruption levels, bureaucratic frameworks and rule of law are insignificant determinants, while trade openness and economic growth appear to be important factors influencing FDI inflows. By contrast, Busse & Hefeker [2005], when analysing a data sample consisting of 83 developing countries between 1984 and 2003, identified that indicators that matter the most to investors are government stability, law and order and the level of democracy. The level of macroeconomic stability represented by inflation and corruption turned out to be significant to a lesser degree.

Analysis of institutional quality in transition countries is of major interest since these economies, in general, represent a suitable natural environment model for studying institutional improvements of economic development [North, 2005]. The change of the economic system in former socialist countries included a significant institutional change, allowing researchers to econometrically test the importance of institutions for several areas of economic life. One of the earliest attempts to investigate institutional frameworks in transition economies was made by Holland & Pain [1998]. They examined a time series of 11 transition countries from 1992–1996 using the specific transition indicators from the EBRD database. The analysis showed that besides macroeconomic indicators such as trade openness and labour costs, the method of privatisation appeared to be an important determinant influencing FDI inflows.

Likewise, Pournarakis & Varsakelis [2002] analysed institutional environment impacts on investment inflows into 10 transition countries in the CEE region for the period 1997–2000. They found that weak civil and political rights prevent the country from being attractive to foreign investors. Moreover, a transparent business environment is a significant advantage regarding the attraction of FDI from EU member states. Sušjan et al. [2007] confirm the assumption that FDI can spur economic growth in transition economies and that institutions play an important role for the level of FDI. Employing Economic Freedom Indices from the Heritage Foundation database, they emphasised that property rights protection and regulation are major institutional determinants for FDI inflows.

The EBRD transition indicators have been used in various empirical studies due to the fact that they are more closely related to issues of transition economies in the CEE region. Fabry & Zeghni [2006] employed these indicators in their studies focusing on the type of ownership, banking sector reform, trade liberalisation and legal development. On a sample of 11 countries, along with property rights, private sector development and overall regulatory frameworks were observed to significantly influence investors' decision making processes. Among the recent empirical studies, Kersan-Škabić [2013] analysed the institutional environment in the Balkans and the impact on the level of FDI inflows. The author states that besides main macroeconomic drivers, the level of corruption, large scale privatisation and overall infrastructure reform play an important role in assessing institutional factors which determine the level of investment inflows into the region.

Fabry & Zeghni [2006] also analysed the importance of the EU membership variable in explaining the level of FDI in transition economies. It was stated that FDI are more sensitive to institutions in non-candidate countries than those in future or existing EU members. This can be explained by the fact that before joining the EU, candidate countries make substantial efforts to improve their legal, political and economic institutions shifting towards more stable and transparent rules. The EU integration process positively affected FDI inflows in the CEE in the recent years. To prove this assumption, Bevan & Estrin [2000] constructed variables which represented significant political announcements for admission of the CEE countries into the EU as a result of the progress made by candidate countries in fulfilling membership criteria of the Essen European Council Meeting in 1994–1995 and the Agenda 2000 document which announced the "first" and the "second" wave countries. The results show that the countries announced with the future perspective of EU enlargement significantly improved their image as investment destinations. Consequently, the same authors mention that countries such as the Czech Republic, Hungary, Slovakia and Poland observed an increase in the FDI levels after the official announcement. They conclude that positive feedback related to the progress of these countries might improve their institutional quality because they comply more with the EU requirements.

Empirical assessment

The study aims to fill the gap in the current debate on the determinants in the post-communist countries by providing an econometric analysis of the institutional factors affecting investment inflows into 11 transition economies, namely, the Czech Republic, Poland, Hungary, Slovakia, Lithuania, Latvia, Estonia, Bulgaria, Bosnia and Herzegovina, Albania, and Croatia covering a time span of 21 years from 1993–2013. For a better assessment of the specific institutional environment, we grouped the countries according to their geographical position and provided a comparative analysis of the results obtained in each group of countries. We developed a model that combines traditional FDI determinants and the specific transition factors (such as privatisation level, government effectiveness, and the like), expected to play a certain role in the decision making processes of multinational companies that have invested in these countries. The proposed econometric model relies on a panel data set which aims to capture the dynamic behaviour of the parameters and provide a somewhat more efficient estimation of the parameters employed in the model.

Along the lines of previous research, the endogenous variable in this study was chosen to be foreign direct investment net inflow per capita. This allows us to take the relative

country size into account. The values for FDI per capita for each country were obtained by calculating the ratio of FDI (balance of payments in current US$) for the country i at the time t divided by the total population for each country separately. Values for both the indicators were collected from the World Bank Indicator Database. Thus, the dependent variable is the log of FDI per capita and the independent variables were chosen based on previous literature and availability of the dataset for the selected period.

Market size is represented by GDP per capita in purchasing power parity values.[2] It is considered one of the most important factors in explaining foreign investment in both levels and inflows [Chakrabarti, 2001; Carstensen & Toubal, 2004; Janicki & Wunnava, 2004]. It also captures potential economies of scale in production. The data for this variable are derived from the World Bank Economic Indicators. It is expected to be a positive and significant determinant of FDI inflows, as suggested by numerous empirical studies [Bevan & Estrin, 2000; Asiedu, 2002; Garibaldi & Mauro, 2002].

A faster *GDP growth rate* typically attracts more FDI. That implies that investors are attracted to countries with faster growing markets, a fact confirmed empirically by a number of studies [Barrel & Pain, 1996].[3] The data for the metrics are retrieved from the World Bank Economic Indicators and it is expected to be a positive and significant determinant of FDI inflows.

Trade openness shows the extent of international openness to flows of goods and services, increasing the country's potential market size. In the standard literature, if the ratio of trade to GDP is lower, the country may either have formal and/or informal restrictions to trade or its external competitiveness may be hampered. The metrics is proxied as the ratio of exports and imports combined divided by GDP, and the data are available from the World Bank Economic Indicators. The empirical evidence suggests a positive relationship in the case of the post-communist economies; therefore, we expect this factor to be a significant determinant of FDI in this region [Chakrabarti, 2001].

Labour costs are a major component of total production costs of businesses in most countries and industries. It is particularly true for labour-intensive production activities that higher wages may discourage a portion of FDI [Ranjan & Agrawal, 2011]. As a measure of labour costs, we employ the logarithm of gross average monthly wages for the country i at the time t. The data are collected from the UNECE Statistical Division Database, and compiled from national and international (OECD, EUROSTAT, CIS) official sources. The wages are computed using the respective nominal exchange rates to the US$ in the year of observation. They should therefore satisfactorily capture the accounting

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2 Although we realise that GDP per capita is perhaps not the best proxy for the market size, lack of micro data does not permit us to better determine the market size according to the sector of production which would be a better indicator. Likewise, we realise that for the members of the EU or even the Euro Zone, market size might in reality be more substantial in case GDP per capita in those countries is lower than that of the supranational entity they are members of. Still, together with Kersan-Škabić [2013], we expect the immediate market size to be an important driving factor on average, as investors tend to be interested in locating some of their production in the market they are present in.

3 In our research, only one-way relationship is considered and GDP growth is taken as an exogenous variable. We realise that faster GDP growth can also be, and frequently is, a result of stronger FDI inflows, but a closer look on this would require that a VAR model be used. Still, to circumvent and/or soften this issue, instead of current we are using a one-period lagged value of GDP growth.

wage costs for an investor. The analysis would have perhaps been made more robust if a currency fluctuation dummy variable was taken into account. Yet, such a step would diminish the degrees of freedom of the model, while literature still does not give a persuasive answer about the real importance of currency stability for investors in case the potential geographies are not extremely divergent.

Corporate tax rates can be a decisive factor for companies when considering to extend their investment activities abroad. The data are retrieved from the Trading Economics website.

Education. Investors conventionally stress the importance of employing skilled versus less skilled labour. Therefore, in our study, we employ a tertiary education variable, which is the proportion of labour force with tertiary education[4] as a percentage of the total labour force. However, in some cases, and for that matter, countries, the low-skilled labour force can be more attractive to investors as it is associated with lower unit labour costs. In general, whether high-skilled or low-skilled labour force is being sought by the investors depends largely on their production pattern. The data are retrieved from the World Bank Economic Indicators, the original source being International Labour Organization.

The index of economic freedom compiled by the Heritage Foundation is assessed as an indicator of a country's economic and social progress. Features characterising a solid economic freedom index are healthy societies, higher per capita wealth, democracy, and also poverty reduction. The index is measured based on ten factors grouped into four categories which define economic freedom. For convenience, we have chosen four factors from each dimension for inclusion in our model. The overall score is calculated by averaging all indicators and assigning equal weights to them afterwards [Heritage Foundation, 2015].

In order to analyse the institutional environment specific for transition economies, we employ the European Bank of Reconstruction and Development (EBRD) indicators used to track reform developments in all transition economies since their proclamation of independence. The main goal of the EBRD is to assist and provide financial support to countries during the process of becoming market economies. The set of indicators is measured on a scale from 1 to 4+, where higher value signifies a full transition to market economy while the lowest value stands for a centrally planned economy. Our hypotheses are stated as follows:

H1: *Higher FDI inflows are associated with a more stable, developed and dynamic macroeconomic environment with both/either reasonable production costs and/or skilled labour force.*

H2: *The safer and more reliable the political, economic, and social institutions in a country, the higher the FDI inflows.*

Based on the hypotheses stated above, we estimate the following model:

$$LFDI_{it} = \alpha + \beta 1 INST_{it} + \beta 2 LGDP_{it} + \beta 3 GDPGR_{it} + \beta 4 dOPENNESS_{it} +$$
$$+ \beta 5 LWAGEN_{it} + \beta 6\, dTAXES_{it} + \beta 6\, EDUC_{it} + \varepsilon,$$

(1)

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4 The World Bank defines tertiary education as including universities as well as institutions that teach specific higher learning such as colleges, technical training institutes, nursing schools, etc.

where

$LFDI_{it}$ is the log of net inflows of foreign direct investment per capita into the country
    i in the year t,
$INST_{it}$ stands for the indicators that measure institutional factor for the country i in the
    year t,
$LGDP_{it}$ is the log of GDP per capita for the country i at the time t,
$GDPGR_{it}$ is the GDP growth rate in percent for the country i at the time t,
$OPEN_{it}$ stands for the difference in trade openness for the country i at the time t,
$LWAGEN_{it}$ is the log of gross average monthly wages for the country i at the time t,
TAX_{it} stands for the official corporate tax rate for the country i at the time t and it repre-
    sents a part of costs of doing business. It is taken as a metric showing the potential
    for future profitability of companies,
$EDUC_{it}$ is the tertiary education level as a percentage of total population to control for
    quality of labour force.

Our empirical investigation is based on a methodology using panel data specificati-
ons. This technique presents a set of advantages in comparison with pure time series and
cross-sections since it incorporates all the available information that might provide useful
insights when analysing the dataset [Baltagi & Kao, 2000]. Ranjan & Agrawal [2011] con-
firm that the panel data method has advantages by hinting to an individual heterogeneity,
which reduces the chances of obtaining biased and/or inconsistent results and generally
provides a large framework of data points.

For this model, we assume time invariant effect for each entity that might be correla-
ted with the regressors. Lower differences in coefficients indicate the use of fixed effects
as well. Moreover, the fixed effects method is appropriate to employ when we focus on
a specific set of countries. An econometric problem which may arise is that panel regre-
ssion analysis may entail autocorrelation of disturbances. This specific issue was solved
by taking the first difference of institutional variables. The test using Durbin-Watson stati-
stics demonstrated that autocorrelation was substantively reduced in the model. Moreover,
lagged values of institutions are incorporated to assess whether new FDI inflows have
a tendency to follow previous investment trends. For this matter, we incorporate lagged
values of macroeconomic variables in the model (i.e., GDP per capita, GDP growth, and
education) in order to assess the level of profits reinvested from previous FDI based on
specific country indicators. Finally, appropriate transformation of the data significantly
reduces multicollinearity in the model, evidenced by mostly low correlation coefficients
between explanatory variables in the correlation matrix.

The ordinary least squares (OLS) or even pooled OLS method is highly sensitive to
outliers, so in order to deal with this issue and to reduce the data variation, improving
the stability of the model and its significance, we transform some eligible data by taking
their natural logarithms. Therefore, the variables that are skewed and are not ratios or
net amounts leading to possible negative values (i.e., GDP per capita or wages) are log-
-linearised. Finally, all models are adjusted for heteroscedasticity using cluster robust
standard errors.

Results and interpretation

The panel OLS estimation results for 11 transition countries are presented in the tables below.[5] The countries were grouped according to their geographical location in order to provide a comparative assessment of the institutional framework specific for each of them.[6] The first group consists of the Visegrad countries, i.e., the Czech Republic, Poland, Hungary, and Slovakia. The second group is represented by the Baltic countries, i.e., Lithuania, Latvia, and Estonia, and the third group consists of selected Balkan countries,[7] mainly based on data availability: Bosnia and Herzegovina, Bulgaria, Albania and Croatia. Institutional variables have been added into the model as an aggregate and subsequently singly added to the benchmark model. Both the Heritage Foundation and EBRD indicators are employed in the model for each highlighted group of countries.[8]

In following Tables 1–3, the institutional variables that have not yet been explained in equation (1) refer to the following:

CORR is the Freedom from Corruption indicator. It is based on Transparency International's Corruption Perceptions Index (CPI). The higher the index, the less corruption is present in the country. An intuitive expectation goes that investors mostly seek a low-corruption environment.

FISC denotes the Fiscal Freedom indicator, or a measure of the total tax burden imposed in the country. Higher values of the indicator are associated with lower total tax burden in the economy. Lower tax burden is typically preferred by investors; therefore, we expect a positive sign in the regression.

BUSINESS refers to the Business Freedom indicator, or a quantitative measure of how costly it is to start, operate, and shut down business in the particular country. The higher the indicator, the less red tape and administrative burden there is in the country. A positive sign is expected in the model as more red tape is associated with additional costs for investors.

INVEST refers to Investment Freedom, or the ability to move capital freely across industries and countries. Countries with no restrictions on capital movement would score the highest in the indicator. We expect a positive sign in the regression as investors typically seek free movement of capital on the back of efficient allocation of resources.

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5   In the paper, Gretl 1.9 and Stata 11 software has been used for all econometric modelling and some calculations.

6   Apart from certain exceptions, such as Poland in the group of Visegrad countries, geographical location also in this case offers a satisfactory economic similarity of the chosen countries in terms of GDP per capita, tax system, GDP growth, trade openness, etc. This has also been one of the motivations to cluster countries into different groups to obtain more generalisable results.

7   Sometimes also referred to as the *Southeast European region* or *Southeast Europe* (SEE).

8   EU membership dummy variable was initially used as a control in the model, however results showed little significance for investors.

Table 1 | Determinants of FDI inflows into Visegrad countries using Heritage Foundation indices

	Model 1-FE	Model 2-FE	Model 3-FE	Model 4-FE	Model 5-FE
D_CORR_1	-0.0124*** (1.11e-07)	-0.0119*** (4.85e-05)			
D_FISC_1	0.0067*** (4.99e-017)		0.0094*** (0.0007)		
D_BUSINESS_1	0.0020 (0.4091)			0.0002 (0.8069)	
D_INVEST_1	0.0179*** (8.49e-018)				0.0178*** (1.03e-012)
LGDP_1	-0.2189 (0.8318)	-0.2215 (0.8330)	-0.2292 (0.8254)	-0.2500 (0.8067)	-0.2539 (0.7993)
GROWTH_1	0.0126 (0.7106)	0.0122 (0.7291)	0.0091 (0.7553)	0.0101 (0.7585)	0.0111 (0.7402)
D_OPENNESS	0.0055 (0.5327)	0.0048 (0.5678)	0.0046 (0.5785)	0.0046 (0.5731)	0.0054 (0.5305)
LWAGE	1.1762*** (0.0034)	1.1994*** (0.0026)	1.1938*** (0.0034)	1.1982*** (0.0023)	1.1786*** (0.0022)
D_TAX	-0.0281 (0.5715)	-0.0209 (0.6721)	-0.0224 (0.6550)	-0.0204 (0.6733)	-0.0262 (0.5811)
EDUC_1	-0.0148** (0.0337)	-0.0204*** (0.0038)	-0.0214*** (0.0058)	-0.0214*** (0.0056)	-0.0162** (0.0441)
Adj. R-sq. F-test (model) S.D. (dep.var.) Obs.	0.3651 0.0001 0.9586 63	0.3918 0.0011 0.9586 63	0.3900 0.0012 0.9586 63	0.3884 0.0013 0.9586 63	0.3956 0.0008 0.9586 63

Note: The asterisks "***", "**" and "*" indicate significance at 1%, 5% and 10% level, respectively. Individual p-values are in parentheses. Meanwhile, "D" refers to a fi rst diff erence of the variable and "_1" is a one-year lag of the particular variable.

Source: Authors' own calculation

The findings suggest that most institutional variables except business freedom, along with the macroeconomic variables such as wages and education, determine FDI inflow into the Visegrad countries. It is worth mentioning that GDP per capita does not have the expected sign although it is statistically significant. This may be due to the fact that the sample consists of only four countries, so the scope for variation is limited. Moreover, the sign for corruption did not meet our expectations either, which may imply that investors think that institutions in this specific set of countries have a settled regulatory framework, not requiring further intervention. The outcome is, however, in line with Egger & Winner [2005], who found a positive relationship between corruption and FDI on a sample of 73 countries. Analysing the model by singly adding the institutional variables, we obtain similar results and significance of variables as stated previously. The adjusted R-squared suggests that the model explains only close to 40% of variability of the dependent variable and is similar across specifications, with no specification standing out. The explicative

value of the model is therefore rather low, meaning that other factors, not included in the model, such as FDI inertia may also play a role for this group of countries.

Table 2 | Determinants of FDI inflows into Baltic countries using Heritage Foundation indices

	Model 1-FE	Model 2-FE	Model 3-FE	Model 4-FE	Model 5-FE
D_CORR_1	-0.0055 (0.7390)	0.0012 (0.9592)			
D_FISC_1	0.0644** (0.0200)		0.0662** (0.0474)		
D_ BUSINESS_1	0.0895* (0.0954)			0.0888* (0.0876)	
D_INVEST_1	0.0332* (0.0903)				0.0303* (0.0888)
LGDP_1	-2.0287** (0.0431)	-1.5268 (0.4376)	-2.4816 (0.1133)	-1.3788 (0.3109)	-1.2427 (0.5030)
GROWTH_1	0.0392 (0.1899)	0.0573 (0.1349)	0.0544 (0.1541)	0.0426 (0.1868)	0.0569 (0.1244)
D_ OPENNESS	0.0273 (0.2362)	0.0267 (0.3384)	0.0284 (0.2565)	0.0254 (0.2818)	0.0273 (0.2959)
LWAGE	2.5896*** (0.0003)	2.4142* (0.0505)	3.0008*** (0.0053)	2.1954** (0.0140)	2.2331* (0.0675)
D_TAX	-0.1599 (0.1380)	-0.1641 (0.2089)	0.0053 (0.1076)	-0.1596 (0.1954)	-0.1634 (0.1652)
EDUC_1	0.0452* (0.0638)	0.0455 (0.1147)	0.0560* (0.0501)	0.0440*** (0.0078)	0.0379 (0.1655)
Adj. R-sq. F-test (model) S.D. (dep.var.) Obs.	0.4986 0.1167 1.3678 46	0.4429 0.2585 1.3678 46	0.4583 0.2133 1.3678 46	0.5189 0.1098 1.3678 46	0.4483 0.2135 1.3678 46

Note: The asterisks "***", "**" and "*" indicate significance at 1%, 5% and 10% level, respectively. Individual p-values are in parentheses. Meanwhile, "D" refers to a first difference of the variable and "_1" is a one-year lag of the particular variable.

Source: Authors' own calculation

The regressions performed for the Baltics and the Balkans separately suggest a more important significance of the institutional framework than in the previous case of the Visegrad countries. For the Baltics, fiscal freedom is significant and for the Balkans business and investment freedom play a role in investors' decision making processes. An interesting finding is that for the Baltic countries, the wage level is significant for investors, confirming our previous hypothesis that higher salaries might be induced by a more solid employee skills development. Other macroeconomic variables seem not to play an important role except education, which matters especially under the setup including business freedom. It seems that investors put an emphasis on more educated workforce when deciding to expand and operate their business activities in the Baltics. Also, judging purely from the fitted values, the model seems in general to better suit this set of countries than

the Visegrad group. Yet again, with the R-squared close to 50 %, the explicative value of the model is not very high, though somewhat better than previously.

Table 3 | Determinants of FDI inflows into the Balkans using Heritage Foundation indices

	Model 1-FE	Model 2-FE	Model 3-FE	Model 4-FE	Model 5-FE
D_CORR_1	-0.01238*** (8.70e-09)	-0.0051 (0.1132)			
D_FISC_1	0.0130 (0.4260)		0.0216 (0.3724)		
D_BUSINESS_1	0.0413** (0.0157)			0.0487* (0.0766)	
D_INVEST_1	0.0092*** (3.37e-09)				0.0211*** (0.0057)
LGDP_1	0.5704*** (0.0002)	0.4588*** (0.0005)	0.4724 (0.1544)	0.5016*** (0.0028)	0.3652*** (4.09e-015)
GROWTH_1	0.1278*** (2.02e-024)	0.1260*** (3.57e-017)	0.1303*** (8.45e-040)	0.1239*** (2.29e-016	0.1324*** (2.18e-020)
D_OPENNESS	0.0135*** (2.60e-017)	0.0165*** (9.67e-011)	0.0172*** (1.04e-05)	0.0119*** (9.84e-022)	0.0168*** (1.45e-07)
LWAGE	0.2079 (0.1171)	0.3815*** (0.0018)	0.3881** (0.0239)	0.2227 (0.2258)	0.3759*** (1.46e-06)
D_TAX	-0.0152 (0.4113)	0.0432*** (0.0012)	-0.0500*** (1.25e-016)	0.0057 (0.8713)	-0.0451*** (4.31e-05
EDUC_1	0.0835*** (1.24e-021)	0.0847*** (1.21e-014)	0.0824*** (5.76e-05)	0.0850*** (8.07e-027)	0.0971*** (8.19e-018)
Adj. R-sq. F-test (model) S.D. (dep.var.) Obs.	0.5980 0.3730 0.9705 40	0.5699 0.7214 09705 40	0.5849 0.6146 0.9705 40	0.6145 0.3915 0.9705 40	0.6080 0.5371 0.9705 40

Note: The asterisks "***", "**" and "*" indicate significance at 1%, 5% and 10% level, respectively. Individual p-values are in parentheses. Meanwhile, "D" refers to a first difference of the variable and "_1" is a one-year lag of the particular variable.

Source: Authors' own calculation

The results for the Balkans show a major significance of the macroeconomic variables along with the institutional indicators. The lagged values of GDP per capita, GDP growth level, and education level seem to be the main drivers for investors. Since the countries in the sample are developing economies, investors put an emphasis on these aspects more before deciding on further investment plans. In comparison with the countries in the first two groups, where a strong macroeconomic development is assumed, the Balkans are subject to a more complex review from the economic, social and institutional

perspective. Taking all the sets of countries into consideration, it appears that macroeconomic development plays a more important role for investors in the Balkans along with the institutional indicators, while for the Visegrad and Baltic states, institutional development has a higher importance under the circumstances that they have achieved a certain economic stability.

In Tables 4–6 below, the institutional variables that have not yet been explained in equation (1) refer to the following:

PRIVAT refers to a large-scale privatisation indicator, where a higher value refers to more private ownership in the country. We expect a positive sign in the regression since investors conventionally, albeit not always, prefer to invest in an environment with a predominance of the private sector.

GRES denotes governance and enterprise restructuring, where lower values signify soft budget constraints and poor corporate governance, while higher values stand for rigorous capital control typical in advanced economies. We expect a positive sign for the reasons discussed above.

PRICE stands for price liberalisation, whereby low values present a situation in which most prices are controlled by the government, while high values denote a situation with nearly zero price control outside housing, transport and natural monopolies. A positive sign is expected as investors essentially prefer price-adjustable environments.

TFOR refers to the trade and foreign exchange system indicator. Higher values capture WTO-like standards of trade exchange. Again, we conventionally expect a positive sign in the regression since most investors seek a free trade economic environment.

COMP denotes a competition policy indicator. Higher values signify rigorous competition policy rules, including unrestricted market entry in most industries (at least from the institutional perspective). The sign of this indicator can perhaps vary according to the country concerned as some investors, particularly in low-skilled industries, may find loose competition policy advantageous.

The second set of regressions includes the specifications with the EBRD indicators to assess the institutional framework specific of transition economies. In the first set of countries, institutions seem to play an insignificant role for the investors in the setup with the complete set of institutional indicators. Performing separate regressions, we observe a 1 % significance for price liberalisation, foreign exchange system and competition policies. It is safe to assume that investors do not neglect completely the institutional framework but rather assess it under specific conditions and criteria depending on their investment purposes and previous investment trends. We observe the same pattern as with the Heritage Foundation indices for the macroeconomic variables, where wages and education were important determinants of FDI inflows. GDP per capita, growth level and trade openness are significant only in the aggregate model specification assuming that generally investors tend to assess country using all the aspects. Judging solely from the adjusted R-squared values, the EBRD indicators may be somewhat more suitable metrics for the Visegrad countries than the set offered by the Heritage Foundation, as the models can essentially explain more than half of the variability in the dependent variable. However, the model does not capture the variability of the dependent variable in a very satisfactory manner, and it is therefore questionable to what extent it bears informative or predicative value.

Table 4 | Determinants of FDI inflows into Visegrad countries using EBRD indicators

	Model 1-FE	Model 2-FE	Model 3-FE	Model 4-FE	Model 5-FE	Model 6-FE
PRIVAT_1	-0.1052*** (0.0012)	0.1201 (0.1885)				
GRES_1	-0.3283 (0.1790)		0.1437 (0.6917)			
PRICE_1	0.5415 (0.4872)			0.4391*** (0.0078)		
TFOR_1	0.0915 (0.9118)				0.4157*** (2.19e-05)	
COMP_1	-0.1790 (0.3158)					-0.1987*** (0.0021)
LGDP_1	1.0151*** (2.83e-017)	0.2361 (0.6796)	0.1392 (0.7676)	0.5929 (0.2034)	0.5710 (0.2064)	0.3536 (0.5143)
GROWTH_1	0.0342** (0.0327)	0.0200 (0.2136)	0.0190 (0.2870)	0.0298 (0.1467)	0.0274 (0.1506)	0.0208 (0.1777)
D_OPEN-NESS	0.0097*** (0.0091)	0.0089* (0.0710)	0.0089 (0.1776)	0.0103*** (0.0080)	0.0102*** (0.0091)	0.0084 (0.1515)
LWAGE	0.7587*** (2.47e-06)	1.0136*** (1.03e-06)	1.0462*** (0.0095)	0.7114*** (0.0024)	0.7450*** (0.0001)	1.1261*** (0.0001)
D_TAX	-0.0560* (0.0676)	-0.0421 (0.2317)	-0.0397 (0.3749)	-0.0576 (0.1038)	-0.0546 (0.1028)	-0.0361 (0.3492)
EDUC_1	-0.0198*** (5.45e-014)	-0.0175*** (0.0001)	-0.0189*** (0.0041)	-0.0202*** (3.37e-010)	-0.0208*** (1.60e-012)	-0.01793*** (0.0008)
Adj. R-sq.	0.5141	0.5151	0.5134	0.5355	0.5326	0.5149
F-test (model)	0.0007	0.0012	0.0009	0.0002	0.0002	0.0007
S.D. (dep. var.)	1.028	1.0287	1.028	1.0287	1.0287	1.0287
Obs.	75	75	75	75	75	75

Note: The asterisks "***", "**" and "*" indicate significance at 1%, 5% and 10% level, respectively. Individual p-values are in parentheses. Meanwhile, "D" refers to a first difference of the variable and "_1" is a one-year lag of the particular variable.

Source: Authors' own calculation

Table 5 | Determinants of FDI inflows into Baltic countries using EBRD indicators

	Model 1-FE	Model 2-FE	Model 3-FE	Model 4-FE	Model 5-FE	Model 6-FE
PRIVAT_1	1.4720*** (0.0085)	0.8216 (0.2312)				
GRES_1	0.3074 (0.8123)		1.1430** (0.0150)			
PRICE_1	-10.5927** (0.0149)			-7.81819** (0.0492)		
TFOR_1	-1.3772* (0.0740)					
COMP_1	-0.8616 (0.3062)				0.0936 (0.7662)	-0.6587 (0.6859)
LGDP_1	4.8145 (0.1719)	3.1133 (0.2009)	3.4562 (0.1506)	4.4120* (0.0880)	3.7178 (0.1794)	4.5708 (0.3387)
GROWTH_1	0.0529** (0.0295)	0.0439* (0.0999)	0.0469*** (0.0011)	0.0582*** (4.30e-09)	0.0545** (0.0167)	0.0533** (0.0376)
D_OPEN-NESS	0.0324** (0.0162)	0.0231*** (0.0001)	0.0216*** (0.0018)	0.0268*** (4.07e-06)	0.0238*** (0.0043)	0.0244*** (0.0006)
LWAGE	-0.5621 (0.6708)	-1.0627 (0.4446)	-1.3277 (0.1800)	-0.7446 (0.5626)	-1.0577 (0.4478)	-1.0492 (0.4382)
D_TAX	-0.2179** (0.0321)	-0.2023* (0.0762)	-0.1962 (0.1104)	-0.1962 (0.1265)	-0.1977 (0.1272)	-0.1981 (0.1497)
EDUC_1	-0.0709* (0.0927)	0.0433 (0.3655)	0.0479 (0.1965)	-0.0360 (0.1149)	0.0435 (0.2884)	0.0389 (0.3768)
Adj. R-sq.	0.6956	0.6145	0.6068	0.6577	0.5950	0.5983
F-test (model)	0.0249	0.0721	0.2958	0.0005	0.0205	0.0176
S.D. (dep. var.)	2.0131	2.0131	2.0131	2.0131	2.0131	2.0131
Obs.	57	57	57	57	57	57

Note: The asterisks "***", "**" and "*" indicate significance at 1%, 5% and 10% level, respectively. Individual p-values are in parentheses. Meanwhile, "D" refers to a first difference of the variable and "_1" is a one-year lag of the particular variable.

Source: Authors' own calculation

For the Baltic countries, we observe that the level of private ownership and the progress with corporate governance of the enterprises is one of the most important factors for investors in their decision-making processes. It may be the case since the privatisation process is widely utilised in the former socialist countries. Moreover, the level of GDP growth, trade openness and level of taxation are essential to assess a country's potential

to become an investment partner. In this case, relatively high values of adjusted R-squared indicate a relatively good fit of the model.

Table 6 | Determinants of FDI inflows into the Balkans using EBRD indicators

	Model 1-FE	Model 2-FE	Model 3-FE	Model 4-FE	Model 5-FE	Model 6-FE
PRIVAT_1	1.4431*** (0.0006)	0.8923*** (4.89e-05)				
GRES_1	1.4746* (0.0501)		1.1131*** (1.16e-05)			
PRICE_1	-0.2081*** (0.0059)			0.4929*** (2.54e-022)		
TFOR_1	-1.2946* (0.0993)				0.7897*** (2.02e-019)	
COMP_1	-1.4072*** (2.79e-041)					-0.1355 (0.7395)
LGDP_1	-1.3399 (0.2188)	-2.3591 (0.1175)	-1.3733 (0.1952)	-1.7466 (0.3058)	-1.6366 (0.2049)	-1.1390 (0.5665)
GROWTH_1	0.0657*** (0.0012)	0.1102*** (3.66e-012)	0.1299*** (1.05e-012)	0.1349*** (5.08e-039)	0.1291*** (1.47e-032)	0.1345*** (7.35e-023)
D_OPEN-NESS	0.0058*** (2.17e-05)	0.0095*** (4.95e-011)	0.0105*** (2.47e-023)	0.0095*** (2.46e-019)	0.0120*** (1.18e-017)	0.0109*** (2.54e-027)
LWAGE	0.8711*** (1.26e-07)	1.3976*** (0.0018)	1.0855** (0.0117)	1.3855** (0.0356)	1.3862*** (0.0085)	1.2482* (0.0916)
D_TAX	0.0681 (0.3224)	-0.0050 (0.9181)	-0.0501** (0.0460)	-0.0691** (0.0316)	-0.0857*** (0.0014)	-0.1108*** (0.0012)
EDUC_1	0.1304*** (7.26e-010)	0.1750** (0.0110)	0.1171* (0.0684)	0.1986* (0.0638)	0.1736** (0.0397)	0.1800* (0.0785)
Adj. R-sq.	0.7117	0.6995	0.6562	0.6463	0.6460	0.6271
F-test (model)	0.5927	0.0549	0.8911	0.1677	0.4327	0.2952
S.D. (dep. var.)	1.2211	1.2211	1.2211	1.2211	1.2211	1.2211
Obs.	43	43	43	43	43	43

Note: The asterisks "***", "**" and "*" indicate significance at 1%, 5% and 10% level, respectively. Individual p-values are in parentheses. Meanwhile, "D" refers to a first difference of the variable and "_1" is a one-year lag of the particular variable.

Source: Authors' own calculation

Finally, for the Balkans, we see a decisive impact of institutional along with macro-economic variables. In comparison with the Baltics, the whole institutional environment is weighted accordingly. Among the main drivers, private enterprise ownership, efficient

corporate governance, price liberalisation and removal of tariff barriers seem to be the main institutional determinants of FDI inflows. Moreover, the macroeconomic basis and potential are intensely considered for further investment plans. Also, the fit of the model is very satisfactory, pointing to the fact that the specification suits the Balkans the most and/or the four selected countries qualify more fully as emerging markets than in the case of the previous groups.

Yet, in more general terms, the adjusted R-squared for specifications incorporating EBRD indicators seems to have a more robust explanatory power, assuming that this specific set of indicators fits the model better. We observe a similar pattern when comparing with the results for the Heritage Foundation indices, which emphasise that the Balkans undergo a complex review due to their current economic and social framework.

Conclusion

We have demonstrated that institutional development plays a non-negligible role in determining the level of investment inflows into transition economies. When comparing the results among the groups of selected countries using the Heritage Foundation indices, the Balkans are subject to a more complex screening of both macroeconomic fundamentals and institutional indicators. Assuming that the first two sets of countries have a settled and well-functioning regulatory framework similar to most developed Western economies, the dual emphasis is more vivid in the developing countries such as those in the SEE region. The main institutional determinants significant for investors are business and investment freedom and denote the importance of a good regulatory framework and absence of tariffs and non-tariff barriers affecting trade levels. Even so, overall results for the benchmark performed with the Heritage Foundation indicators suggest a modest impact of institutions on investment inflows.

To extend the previous empirical research and provide a comparative assessment, EBRD indicators are incorporated into our model specification along with the macroeconomic fundamentals. The results stress the importance of economic variables (growth level, trade openness, and corporate taxation level) along with the institutional factors (i.e., private enterprise ownership, efficient corporate governance, and price liberalisation), yet to a lesser extent. The importance of the enumerated variables varies across the country sample, while for the Balkans a similar pattern as in the case of the Heritage Foundation indices is observed. Still, the impact of institutional variables seems to be on a lower scale than the results presented in the existing literature, both theoretical and empirical. Macroeconomic variables seem to play a more significant role in aggregate than the institutional ones. Also, we can observe that different groups of countries behave differently, an observation not explicitly made in the previous research.

Still, limitations of the model include the impossibility to incorporate all post-communist countries due to lack of data. Moreover, the investment incentives indicator was not incorporated due to missing granularity of the already large-scale data and the general setup of the model. Incorporating more countries and, most importantly, grouping them according to their common features, allowed us to emphasise that institutional frameworks vary across geographical regions and investors assess their quality considering more complex factors. Moreover, an interesting finding suggests that macroeconomic

fundamentals behave differently across datasets, stressing the uneven economic and social development.

Although the most important theoretical and empirical questions were addressed, room remains for further research. For example, the analysis with micro and/or sectoral data would allow for a more detailed overview of the institutional framework, more granular results, and a more thorough assessment of institutional determinants across geographical regions. At the same time, controlling attentively for investment incentives, still so much present in some industries, would render the results even more accurate.

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