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"The monograph is a commendable contribution to the understanding of FDI, institutional quality, and economic growth in European transition countries. The clarity in presentation, rigorous methodology, and insightful findings make it a valuable resource for academics, policymakers, and researchers in the field of international economics and development studies".

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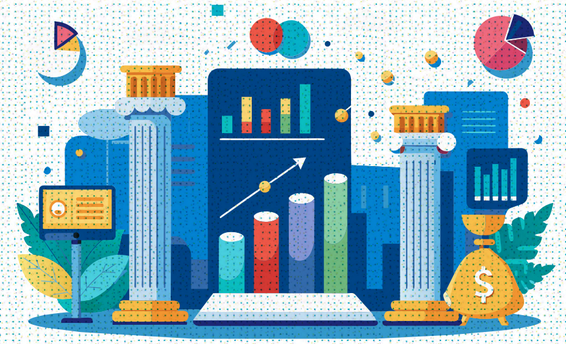

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Jelena Zvezdanović Lobanova

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He who learns but does not think, is lost!
He who thinks but does not learn is in great danger.
Confucius

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INTRODUCTION

Foreign direct investment (FDI) is a key feature of globalization, whose notable rise is paralleled by advancements of technological innovations and the liberalization of global capital flows. FDI is commonly viewed as a prevalent mode of international capital movement that contributes to higher levels of economic growth and enables access to local and regional markets, while also enhancing competitive advantages of the recipient country. Considering the plentiful possible economic and social advantages of FDI inflows (job creation, increase in productivity, growth of export potential, rise in economic competitiveness, technology transfer, diversification of economy structure, infrastructure development, etc.), countries are engaged in intense competition on the global capital market to attract foreign investors, with the aim of promoting their economic and social welfare.

FDI and institutional quality have been and inexhaustible source of research since the 1990s. Transition countries are highly interesting for such research due to the complexity of their institutional environment and numerous difficulties during post-socialist transformations. The transition process began after the collapse of the socialist socio-economic systems in Eastern European countries and the Soviet Union, whose institutions were at a less favourable stage of development. The lack of institutional quality and/or insufficiently developed existing institutional capacities to facilitate the transition to open market economy comprised key obstacles to development. The goal was specifically to create a more favourable investment environment for attracting a larger volume of foreign capital. The introduction of a market-based economic systems and the development of new institutional structures took place in very complex conditions, particularly in the SEE and CIS countries.

Taking into consideration their insufficient domestic savings and limited possibilities for foreign borrowing, most of the transition countries welcomed this type of international movement of capital with great expectations related to the spillover of technological innovations and know-know. The FDI inflows grew in accordance with the effectiveness of policy reforms towards a liberalized market-driven economy and economic stabilization. Their economic effects largely depended on the stability and predictability of the political, institutional and legal environment, as well as of the absorptive capacity. In the majority of transition countries (with the exception of some post-Soviet republics), the improvement of institutional setting was conditioned by the efforts to satisfy the requirements known as the Copenhagen criteria.

With the aim of understanding the association between FDI and quality of institutional arrangements on the one hand, and their impact on the real gross domestic product (GDP) per capita on the other, we applied panel quantile regression technique within the sample set of 22 European transition countries from 2002 to 2020. This approach enabled us to address heterogeneity in our variables of interest, as well as economic growth (GDP per capita) as dependent variable across the given group of countries. Our hypothesis is that FDI stock and overall institutional quality, as well as various governance dimensions, are positively associated with economic growth, which means that they encourage real GDP per capita growth in transition countries.

A couple of questions arose from the basic hypothesis, which needed to be addressed. Is the inward FDI stock more important for the countries characterized by reduced economic expansion compared to those with higher economic growth? Which aspects of institutional quality have decisive importance for the economic growth in the European transition countries? Does the impact of governance indicators differ significantly across given countries depending on the level of their economic performance? Which aspect of governance should be given special attention in order to achieve highest economic growth?

The aim of our study was to determine whether a higher quality of institutions and FDI stock could boost the economic

growth in European transition countries. We investigated how the impact of these variables differed with the conditional growth distribution. Therefore, we identified the set of growth determinants, which had the sign and magnitude in line with theoretical predictions. We offered an empirical explanation for the variations observed in the economic outlook (in terms of GDP per capita) between given countries depending on the governance and FDI stock. Considering the six aspects of governance, we underscored the dimensions most vulnerable to the quality of institutional settings and captured the heterogeneous impact of our variables in the conditional distribution of economic growth. According to our findings, there is a heterogeneous FDI-growth and institutions-growth nexus: their impact on economic growth is positive and stronger in the countries characterized by lower growth rates. The contribution of our empirical analysis is that we provide evidence whether the inward FDI stock and governance affect economic growth depending on the conditional growth distribution, i.e. on a transition country's economic performance.

The structure of the monograph is outlined below. After the introduction, in Chapter One, we provide various definitions of institutions and highlight their crucial role in shaping social, economic and political landscapes. We also present institutional economic theories that has influenced our understanding of economic institutions. Chapter Two deals with the concept and types of international capital flows, the driving factors behind the multinational companies' (MNCs) investment location decisions and the main economic implications of FDI inflows, as well as cross-border mergers and acquisition (C-B M&As) and greenfield investment. Moreover, we present the determinants of FDI inflows in transition countries, the linkages between the privatization and FDI inflows, as well as the evolution of FDI trends in given countries from the year 2000 onwards.

The goal of Chapter Three is to present major economic challenges and risks in transition countries during their post-socialist system transformation. We provide an overview of institutional settings in different group of countries by emphasizing the key economic, political and social struggles in reform

implementation. In Chapter Four, we highlight the significance and different types of FDI incentives as crucial measures in capital attraction. In addition, we show how the majority of transition countries tried to increase the attractiveness of their business environment by adopting FDI incentive policies as key instruments, in the increasingly fierce competition on the global capital market, while also addressing the challenges and risks associated with these efforts. Finally, in Chapter Five, we specify the research methodology which was used to analyse the determinants of the economic growth in 22 European transition countries from 2002 to 2020. We present the outcomes of our empirical research, acquired through a panel quantile regression approach, and provide interpretations.

The first chapter of the monograph, as well as certain sections in the subchapters 2.2, 2.8.1, 2.8.2, and 2.8.3, include the results of the work performed in the development of the doctoral dissertation entitled "Institutional Setting as a Determinant of Economic Effects of Cross-border Mergers and Acquisitions in European Transition Countries," defended in 2017, at the Faculty of Economics and Business in Maribor.

1 THE DEVELOPMENT OF INSTITUTIONAL THEORY

Chapter One presents a brief overview of the various definitions of institutions and institutional economic theories like Old Institutional Economics (OIE), New Institutional Economics (NIE), and neoclassical theory. We point out the significance of the theory of institutional change and path dependence in explaining the variations observed in the economic development levels among countries. These theories enable the understanding of the importance of institutions in economic performance and the relationship between past, present and future historical events, as well as the evolution and role of political, social and economic institutions in shaping the future spectrum of opportunities available to society. These theoretical perspectives underscore the necessity of robust institution building and enhancement efforts in fostering enduring economic growth and societal prosperity. Therefore, we underscore the importance of institutions in shaping economic performances and behaviours.

1.1 THE CONCEPT OF INSTITUTIONS

Many economists and political thinkers, like Adam Smith, Thomas Hobbes, John Locke, Friedrich Hayek, and Joseph Schumpeter, have expressed their interest in the study of the impact and functioning of institutions. They have recognized the role and importance of institutions in shaping economic, political and social behaviour, as well as their influence on the direction of strategic policy for the future. North defined institutions as 'the rules of the game in a society or, more formally, as the humanly-devised constraints that shape human interaction and shape structure incentives in human exchange' (North, 1990: 3).

According to North, institutions include formal rules (such as property rights and an official ethical code of conduct), in-

formal constraints (norms of behaviour, conventions, and self-imposed codes of conduct), and the enforcement characteristics of both, which human beings devise to shape their interaction (North, 1993: 2). Informal institutions have been formed over a long period and remain resistant to rapid and sudden changes. This social capital represents a by-product of religion, tradition, shared historical experience and other types of cultural norms (Fukuyama, 2000: 15). As the unwritten rules of behaviour, it encourages cooperation and the settlement of disputes between actors with low transaction costs.

Acemoglu argues that geography and institutions are of central importance when explaining the fundamental causes of differences in prosperity between countries (Acemoglu, 2003: 27). He points out that institutions play an important role in stimulating investment in human and physical capital, and in technology, and therefore, provide a powerful incentive for overall development. As Matthews put it, institutions are the sets of rights and obligations, which have an influence on people's economic lives (Matthews, 1986: 905). Based on an analysis of definitions by other authors, he differentiates between approaches that identify institutions in terms of property rights, conventions, types of contract, and authority.

Pejovich defines institutions as 'the legal, administrative and customary arrangements for repeated human interactions' (Pejovich, 1998: 23). He develops the interaction thesis, which suggests that harmonious interaction between formal and informal rules leads to a reduction in transaction costs and provides resources for the production of wealth. Therefore, it is not surprising that countries have achieved different levels of economic development and stability due to the effect of this interaction on incentives and transaction costs.

The state is expected to create an efficient and transparent legal and institutional framework and market institutions, which will provide protection for property rights and equal conditions for all actors in the society. Institutions, as the backbone of society and the economy, direct and coordinate the community and organizations' involvement in the most important development activities. According to Tang, they are the products

of politics, and, therefore, made and backed by power (Tang, 2011: 4). He points out that they become a kind of power source and the instruments and facilitators for the exercising of power.

Rodrik and Subramanian distinguish four types of institutions which should be built in order to achieve long-term economic development:

- market regulating – which deal with externalities, economies of scale, and imperfect information;
- market stabilizing – which maintain low level of inflation, reduce macroeconomic volatility, and prevent financial crises;
- market legitimizing – which ensure social protection and insurance, involve redistribution, and manage conflict;
- market creating – referring to markets that do not exist or perform very poorly (Rodrik & Subramanian, 2003: 32).

Brennan and Buchanan argue that the behaviour of individuals and the institutional framework in which they interact have a greater relevance than the physical constraints of nature (Brennan & Buchanan, 1985). They explain that the interdependence process results in the existence of rules through which it is possible to direct the actions of individuals. Each individual has different potential and the ability to achieve different gains by taking into account the influence of varying sets of rules. In this sense, Buchanan and Tullock conclud that institutions and legal constraints should be organized to ensure the realization of private gains which will be consistent with the achievement of group goals as a whole (Buchanan & Tullock, 1962). They assert that voluntary arrangements might emerge to provide cooperation in the organization of a private police force in conditions where state institutions cannot provide protection for collective goods.

Hamilton believed that the nature and extent of order among economic phenomena could not be assessed on the basis of the price movement on the market (Hamilton, 1919: 311). According to him, the right approach is to observe them by taking into account the institutions that represent the organization of

modern industrial society. If the legal system is set up rationally, the appropriate legal rules allow for the effective resolution of conflicts that arise due to unforeseen circumstances by establishing mutual obligations. When effective mechanisms for resolving such problems are built, business entities can overcome them relatively easily and without excessive costs. Efficient markets are structured by institutions that are supposed to have low transaction costs and incentivize participants to compete through price and quality competition (Maksimović, 2021: 19). Therefore, it is necessary to focus on the quality of institutional solutions that allow unhindered economic activities in the long run.

1.2 THE BASICS OF INSTITUTIONAL ECONOMICS

This part analyses the perspectives of OIE and NIE representatives, unravelling their distinct interpretations of institutions. Subsequently, our focus is on identification of the inconsistencies and contradictions that emerge when comparing neoclassical economic theory with the tenets of NIE.

1.2.1 *Old Institutional Economics*

The institutional tradition dates back to the end of the 19th and the beginning of the 20th centuries and was important until the spread of Keynesianism. The most important contributions to this paradigm were made by Thorstein Veblen, Wesley Mitchell, John R. Commons, and Clarence Ayres (Rutherford, 1994: 1). Studies of its modern contributors (Marc Tool, David Hamilton, Anne Mayhew, etc.) aimed to provide a comprehensive, contemporary formulation of institutional economy. According to Hamilton, institutionalism fulfils the criteria necessary to be classified as an economic theory, since it represents a unified economic science and is relevant to the modern problem of control (Hamilton, 1919: 311). Based upon an acceptable theory of human behaviour, institutions and matters of process are central to institutional economics (ibid.: 314).

At the turn of the 20th Century, the social and economic effects of industrialization on the U.S. economy deeply influenced Veblen's and Commons' way of thinking. They neglected the earlier traditions of economic thought and developed an institutional theory whose main ideas were evolution, culture, cultural relativity, and instrumental valuing (Mayhew, 1987: 973). When institutionalism attracted attention as an important alternative to neoclassical orthodoxy, especially among American academic economists, there was a widespread belief that this theoretical approach had emerged from behaviourism (Ayres, 1944). The invocation of natural sciences within institutionalism has been a subject of great debate amongst academic researchers and the theoretical or methodological use of the analogy to natural sciences is a matter, which has divided opinions within the scientific community.

Veblen asserts that the evolution of social structure is the process of the natural selection of institutions (Veblen, 1899: 125). From his point of view, institutions do not only represent a 'selective and adaptive process', but they are also 'special methods of life and of human relations' which influence individuals' attitude and capacities. Veblen rejects classical and marginalist standpoints whereby he strongly attacks the so-called Leisure Class living at the expense of American society. His criticism successfully highlighted the core economic issues of contemporary society, showing the shortcomings of liberal capitalism.

Commons defined institutions as definite and accepted modes of mutual dealing, handed down from generation to generation, which shape an individual's behaviour and actions (Commons, 1899: 3). He also showed that every institution had a body of accepted beliefs, a group of material products and organizations which determined an individual's place in society. Social beliefs are the psychic foundation of each institution (ibid.: 6). The smallest unit for institutional economists is a transaction which includes the three constituents of dependence, conflict, and order established by social control (Commons, 1931). According to him, an institution can be defined as a collective action in the control, liberation, and expansion of an individual action. Since the emphasis is on the behaviour of individuals and

their participation in transactions, he concludes that people's economic behaviour is an issue of key importance to institutional economics.

Ayres indicats that institutionalism does not reduce the significance of the institutional patterns of society in recognition of the dynamic character of technology (Ayres, 1951: 51). According to him, institutions, which determine wants and scarcities in any community, are derived from the pre-existing institutions and the immemorial past. He concludes that the shape, modification and attenuation of institutional heritage depend on the influence of technology. The institutionalists suggest finding the meaning of 'economy' in the interplay of institutions and technology, which in turn represents its basic analytical principles.

Institutionalism received new impetus for change during the late 1960s, with elaborations on the concept of transaction costs, property rights, and their influence on economic performance. According to Demsetz, property rights can be treated as an important instrument of society: they enable an individual to create expectations expressed in the laws, customs and mores necessary for his dealings with others (Demsetz, 1967: 347). He believed that their emergence was due to the efforts of interacting individuals to adjust to new benefit-cost possibilities, i.e. in conditions where those affected by externalities decided to internalize benefits and costs.

1.2.2 *New Institutional Economics*

New Institutional Economics (NIE) was developed in an effort to overcome some obvious weaknesses of neoclassical economics and to test the acceptability of its rigid assumptions (Furubotn & Richter, 2005). Its proponents criticized the mechanisms that were prevalent in neoclassical economics and its inability to provide an answer to the question of spending significant efforts on contracting and transactions. The term NIE was introduced by Oliver Williamson in 1985 in order to distinguish it from the OIE. The revival of interest in institutions

during the 1980s can be attributed to political scientists James March and Johan Olsen. The reaffirmation of their economic importance was a logical consequence of the growing influence of the rational choice theory and behaviourism. Namely, in the paper titled 'The New Institutionalism: Organizational Factors in Political Life', these first researchers and advocates of the NIE criticized the given approaches based on contextualism, reductionism, utilitarianism, functionalism and instrumentalism (Peters, 1999: 15).

New institutional economists argued that it was necessary to acknowledge the role of institutions, taking into account the time and ability of people to learn and understand fundamental changes over time (North, 2016). Institutions can reduce transaction costs, which occur due to the transfer of property rights from one economic agent to another, facilitate information, and reduce uncertainty (Tang, 2011: 58). Their role is especially prominent in conditions where imperfect markets prevent the achievement of optimal economic results. The intention of most scholars from this field was to retain the rationality assumption and mathematically-based optimization procedures and to introduce other modifications to the neoclassical model (Furubotn & Richter, 2005: 505).

The widespread belief is that the NIE was significantly developed by the article 'The Nature of the Firm', in which Ronald Coase introduced the term transaction cost into economic analysis (Coase, 1998: 72). The introduction of this term represented a change in the previous understanding of decision-making in the economic system. The economics of transaction costs, as part of the NIE, aims to facilitate comprehension of management processes and internal rules. Coase showed that traditional basic microeconomic theory was incomplete because it only included production and transport costs, whereas it neglected the costs of entering into and executing contracts, and managing organizations (Coase, 1937: 391).

From Williamson's point of view, the main preoccupations of the NIE are the origins, incidence and ramifications of transaction costs (Williamson, 1979: 233). According to him, transaction cost economics represents the modern counterpart of

institutional economics, which relies heavily on comparative analysis. He demonstrated that the three crucial elements of every transaction were uncertainty, frequency, and the degree to which durable transaction-specific investments were incurred (ibid.: 239). In his book titled 'The economic institutions of capitalism', Williamson explains that the institutions of capitalism (especially firms, markets, and relational contracts) exert the main impact on reduction of transaction costs (Williamson, 1985: 1).

Under the new institutionalism, it is possible to distinguish rational choice, historical, and sociological institutionalism as the three approaches, which derive from the old version of institutional analysis (Hall & Taylor, 1996; Campbell, 2004). All three versions are characterized by a static approach and the same way of conceptualizing institutional change as an exogenous shock. According to historical institutionalists, human beings behave as self-interested actors whose actions are constrained by formal and informal rules and procedures (Steinmo, 2008: 162). Historical institutionalism explores political evolution and institutional development for a better understanding of the formation and adjustment of institutions to specific time processes. Its representatives address the historical context of the operation of different institutions that shape policies over time. Special attention is given to issues of broad significance, like formal and informal aspects of government, determinants of policy and its outcome, theories of political institutional development, and policy performance (Campbell, 2004).

One of the basic premises of rational choice institutionalism is that institutions are seen as self-enforcing equilibria in which behaviour is generated endogenously (Hall & Taylor, 1996). The crucial function of institutions is to reduce the uncertainties that may occur as a consequence of the variety of preferences and to facilitate coordination for and among individuals in order to achieve joint gains. The object of explanation in the rational choice version of institutionalism is the behaviour of rational actors who employ logic of calculation to maximize their preferences (Schmidt, 2009: 126). In order to understand the forms of collective action, it is necessary to take into consideration

the analogy of human behaviour, because individuals act in line with their expectations and preferences. Shepsle showed that there were two ways of defining institutions within this tradition (Shepsle, 2005: 1). According to the first, institutions are seen as exogenously imposed constraints or are 'given game form' that shape human actions. In the second interpretation, the actors in the game define the rules of their future actions, which means that institutions are not interpreted as exogenous.

The norms and culture of social agents who follow the logic of appropriateness (Steinmo, 2008: 163) represent the core interest of sociological institutionalists. They study the complex network of social and economic relations for a better understanding of preference formation within institutions. Individuals are seen as social beings whose actions are guided by rules of appropriate behaviour, organized into institutions (March & Olsen, 2004: 2). According to Mahoney and Thelen, the representatives of this paradigm place special emphasis on non-codified, informal conventions and collective scripts that have an influence on human behaviour and actions (Mahoney & Thelen, 2010: 5). They also stress that individuals have the same institutional logic regardless of the domain, and they carry their existing scripts forward even in cases where institution building is unlikely.

In spite of the fact that these institutionalist paradigms rely on different assumptions, areas of common interest undoubtedly exist. For example, rational choice and historical institutionalists are interested in investigating the role and the influence of institutions on political strategies and outcomes (Thelen & Steinmo, 1992: 7). Representatives of both paradigms point out that institutions are important for political actors because they enable them to determine their strategy and pursue their interests with the imposed constraints in mind. The main area of disagreement between the representatives of these paradigms lies in their understanding of preference formation, since historical institutionalists consider it as endogenous, while rational choice scholars view it as exogenous (ibid.: 8). In addition, unlike rational choice scholars, historical institutionalists highlight that institutions have a much greater influence on politics and political history in general.

Comparing the NIE and the OIE, Hodgson concluded that these two economic perspectives have something to offer since the NIE contains many elements of the old version through which to understand politics (Hodgson, 1989: 266). The attitude of the representatives of the OIE is that the NIE has a limited scope of application because it considers individuals as agents who should be rational. While old institutionalism observes humanity as a product of culture, new institutionalism accepts a view of the 'rational chooser' (Mayhew, 1989: 319). On the other hand, the failure of old institutionalists to have a greater impact on economic theory and practice stems from inadequately defined doctrines (Matthews, 1986: 903). Their only clear message was related to criticism of neoclassical economics. The biggest criticism of the OIE is related to the lack of a theoretical basis and few interesting insights (Coase, 1998, Ayres, 1951). Institutionalism, regardless of its version, stems from static and linear premises and is characterized by inertia and persistence.

1.2.3 *Inconsistencies in Perspectives: A Comparative Analysis of New Institutional Economics and Neoclassical Theory*

During the 1960s and 1970s, the majority of scholars believed that neoclassical approaches could be used with some modifications for resolving new problems and addressing challenges in economy and society (Furubotn & Richter, 2005: 505). The NIE accepts scarcity and competition assumption as key foundations of the neoclassical theory, while rejecting instrumental rationality. New institutionalists call into question the use of 'frictionless' models of competition and imperfect competition based on assumptions of costless transactions, perfect individual rationality, and exogenously given institutional structure (Furubotn & Richter, 2005).

The attitude of neoclassical economists which indicates that gains from trade are realized with zero transaction costs in conditions of perfect information is unsustainable (North, 1994: 1). This simplification leads to wrong or unrealistic conclusions and is highly questionable in the conditions of market

imperfections. Institutionalists argue that the reality is quite different from these idealized views of the neoclassical economists. In fact, North maintains that individuals are faced with incomplete information and insufficient information feedback, which should serve as a corrective mechanism for subjectively derived models (North, 1990: 17).

Within the framework of neoclassical economics, institutions are treated as 'allocationally neutral' and exogenous, established to support the functioning of the market economy. Therefore, their existence is neglected, because economic agents possess all the information necessary to make the right decision. Each individual is 'homo economicus' since decision-making is based on the principle of maximizing utility functions. On the other hand, new institutionalists insist that institutions ought to be the basic unit of analysis and the central concern of research. They are built and maintained by individuals in order to serve the interests of those with the bargaining power to devise new rules (North, 1990: 16).

Another deficiency of the neoclassical theory could also be its inability to adequately consider the diverse performance of societies and economies, both at one moment in time and over time (North, 1993: 1). While neoclassical economists tend to explain collective outcomes on the basis of the choices made by rational individuals (Bates, 1997: 28), new institutionalists argue that it is necessary to take into account a number of constraints that affect their decisions. In neoclassical models, households and enterprises are considered as individuals, and therefore, their decision-making process is based on individual decisions and neglects the impact of complex phenomena. Furthermore, neoclassical economists explain that business investment can be denoted as a rational and maximizing decision (Pressman, 2003). This means that potential investors tend to compare the cost and benefits of investing before decision-making. When the benefits are greater than the costs, the investor will invest in the project. According to neoclassical scholars, the economy can reach a first-best solution – an optimal Pareto allocation of resources in the conditions of perfect competition, well-established free markets, and an adequate pattern of factor ownership.

Neoclassical economists support 'laissez faire' policy prescriptions and, therefore, argue in favour of a minimal role of the state in economic activity (Pressman, 2001). They seek to explain economic patterns with the help of the individual actions of human beings, who are what they are 'by nature'. Hence, they have overlooked the fact that human beings are social phenomena whose actions are the results of social patterns. On the other hand, Jensen argues that institutionalists have adopted the concept of a person whose nature evolves as the result of interaction with culture (Jensen, 1987). He points out that Veblen considered human nature in the same way as evolutionary biology. Individuals can be denoted as social-cultural persons characterized by multiple and complex motivations and behaviour. They are not just utility maximizers whose natures are fixed and final. That is why it is impossible to interpret economic developments only on the basis of price trends.

The neoclassical theory has been criticized for its description of economic agents and the mechanism by which their behaviour determines prices (Schotter, 1983). Its underlying assumption is that all agents behave as price takers and maximize the value of their objective function, taking these prices as given. Neoclassical theory mostly focuses on competitive markets as one limited type of social institution. Since an efficient market already exists, economic agents are capable of correctly assessing all the available alternatives and making decisions aimed at welfare maximization. This approach simplifies the analysis because it ignores the psychology of individuals unjustifiably. Human behaviour is so complex and confusing and cannot be presented through such a simple behavioural assumption. It is well known that people have the tendency to act in one way even when they feel something completely different. Moreover, their actions are shaped by the belief system, which affects the incentive structure. In short, neoclassical economists failed to understand the nature of human coordination and cooperation (North, 1990: 11).

Moreover, the neoclassical theory was unable to give a satisfactory explanation for the long-term differences in economic development between countries. Neoclassical represen-

tatives ignored the importance and influence of institutional structures and arrangements on economic behaviour and performance. They did not realize that the same economic policy could have different effects in different countries due to the existence of institutions as North asserted (North, 1990). For instance, the shock therapy approach was implemented in the majority of transition countries, which were characterized by different social, political and economic conditions at the beginning of their transition. Economic reforms in line with the 'shock therapy' scenario were not appropriate for the countries in the early stages of transition, since they did not have stable and well-developed legal frameworks and market-supporting institutions. This is the reason why the use of a neoliberal concept of economic reforms in terms of under-developed or unstructured institutions resulted in devastating consequences for those economies in transition.

1.3 THE THEORY OF INSTITUTIONAL CHANGE

Institutional changes encourage market transformation of the economy and contribute to the creation of a sustainable economic system. They represent the main driver of social changes and can be viewed as the process of selecting ideas, which are then turned into institutions, hence meaning that the competition of ideas and a power struggle lie at their core (Tang, 2011: 2). Schultz defines institutions as behavioural rules pertaining to social, political and economic behaviour which are subject to change (Schultz, 1968: 1114). The majority of institutions undergo change as a consequence of the requirements of economic growth. This is why Schultz suggested bringing institutions into the theoretical core of economics. He believed that the approaches of modern economics cannot provide an adequate analysis of the relationship between institutional change and growth dynamics, because institutions are treated as a part of the 'state of nature'.

Lin shared the same view of institutions as Schultz (Lin, 1989; Schultz, 1968). He added that these are human devices

created in order to overcome uncertainty and the possibility of disaster, and to increase individual utility. Since institutions provide these services, which necessarily come at a cost, the optimal choice of an institutional arrangement would be the one with the lowest costs when providing a given amount of services. Actually, the decision about a competitive institutional arrangement will depend on a comparison of its cost and benefits. Lin distinguished between induced and imposed institutional change (Lin, 1989: 4). Induced institutional change can be initiated, organized and executed by an individual or a group of individuals who tend to take advantage of profitable chances related to institutional disequilibria. Such disequilibria may occur because of changes in the institutional choice set, technology, relative factor and product prices, as well as in other institutional arrangements. In contrast to this, an imposed institutional change is introduced and executed by the government.

Mahoney and Thelen demonstrate that institutions have a tendency to change slowly and piecemeal across time, by shaping human behaviour and substantive political outcomes in a society (Mahoney & Thelen, 2010: 15). The authors drew attention to the following four modal types of institutional change:

- Displacement occurs with the induction of new and the removal of old rules. This change may involve a rapid and sudden breakdown of institutions, followed by revolutions or slow-moving processes.
- Layering refers to attaching new rules to the existing ones and implies amendments, revisions, or additions in order to shape the behaviour of the individuals.
- Drift is associated with environmental changes which influence the existing rules. For example, this modal type happens when the inactivity of individuals to react to such changes leads to changes in the impact of institutions.
- Conversion is present in the conditions where the existing rules are interpreted and enacted in a new way as a consequence of their strategic redeployment.

Considering the role of institutions in society, North asserts that changes in informal norms occur gradually and sometimes entirely subconsciously due to the development of alternative patterns of behaviour initiated by individuals in contrast to formal rules (North, 1993). According to him, the agent of change is the entrepreneur whose subjective perceptions influence the organization's decisions and choices (ibid.: 4). In his book 'Institutions, Institutional Change and Economic Performance', the author emphasizes that the key determinants of change are changing relative prices or preferences, which influence the individual's incentives in human interaction. Describing the process of change as incremental and revolutionary, he shows that institutional change can be observed as typically incremental, rather than discontinuous. The institutional framework is usually stable, but sometimes changes are inevitable due to unexpected events such as revolution and conquest. In addition, the complexity of the institutional change process can be explained by the fact that the majority of changes typically happen at the margin.

Roland outlines that the interaction between fast-moving (political) and slow-moving (culture, values, beliefs and social norms) institutions can be used to explain the pattern of institutional change (Roland, 2004: 109). The pace of their change (slow and continuous vs. rapid and irregular) is the criteria for the division of institutions into these two groups. While political institutions can be changed literally overnight because of revolutionary developments, social norms and values are characterized by a slow but continuous tempo of change. Legal systems change faster than social norms but more slowly than political institutions (ibid.). Therefore, institutional change is considered an essential factor for the creation of a social environment that accelerates and facilitates economic, social and political processes. A new institutional order cannot be created only on the basis of rapid and radical changes in formal institutions, but should also respect the impact of informal institutions. It should also be noted that formal and informal rules inherited from the past prevent the establishment of new institutions (North, 1990). These old institutions provide resistance to changes in

the existing structures, and this consequently threatens the free market economy and slows down economic growth.

1.4 THE PATH DEPENDENCE PHENOMENON

The concept of path dependence is important for understanding the evolution of political, social and economic institutions. It provides the basis upon which it is possible to explain the relationship between previous, current and future actions or decisions. It influences the choice of technologies, networks, standards, and industrial location, as well as a wide range of arrangements, which are characterized by increasing returns to scale (Liebowitz & Margolis, 1995: 34). Scholars usually use this term to denote the conditions where the economic outcome exhibits inertia. Representatives of the path dependency approach argue that history matters (David, 1985; Arthur 1989; Margolis, 2009), i.e. small earlier events or decisions can have profound consequences. Decisions and actions taken in the past affect not only the opportunity set, which is currently available, but also the choices that can be made from the universe of possibilities (Margolis, 2009).

According to this concept, previously established institutions have an impact on the actions of individuals, even in those cases where it is possible to form new and more efficient institutions. The old institutions continue to exist since the cost for their abolition may be very high. David showed the influence of path dependence in the case of the QWERTY keyboard layout, named after the initial letters of the standard typewriter keyboard (David, 1985). He explained that the organization of the letters on this keyboard was the result of small chance events. It clearly represents an example of how path dependence can cause market failures. As was shown by Liebowitz and Margolis, the QWERTY layout became dominant and was adopted as the standard, so alternative typewriter keyboards have been unable to dislodge this entrenched incumbent (Liebowitz & Margolis, 1990: 19). Despite the fact that the Dvorak Simplified Keyboard has proved vastly superior in comparison to QWERTY, it has never been widely accepted.

The path dependence of technology can also be seen in the example of competition between BetaMax and VHS recorders (Arthur, 1990: 92). When considering the market of videotaping formats, it is obvious that choices for video recorders were made under the influence of the path dependence effect. Regardless of the Beta format being technically superior to its rival, the VHS experienced increasing returns on early gains, which enabled it to gain gradual control of the entire market of video recorders.

Arthur claimed that the economy can become progressively more locked-in by historical events due to technology choices made in the past (Arthur, 1989: 117). He highlights competition between agents when it comes to the choices regarding the adoption of the technologies which exhibit increasing returns as a clear example of the path dependence concept. In his opinion, one of the agents in this process can gain an initial advantage by adopting such technology in conditions which are outside his ex-ante knowledge. The choices between alternative technologies depend on the number of them on the number of each adopted at the time of making a choice. With advanced technology, other potential adopters may apply measures for its further adoption and progress. As such, the technology that was first adopted could become widely accepted in the market by other adopters, while other (perhaps superior) alternatives might not achieve significant results. Arthur believed that positive feedback could lead to the economy gradually locking itself into an outcome that was not necessarily superior to alternatives, not easily altered, and not entirely predictable in advance (Arthur, 1989: 128). This 'lock-in' effect could be explained by the entry of a dynamic economic system into a trapping region; the system cannot escape from it until the occurrence of an external force or shock (David, 2007).

Liebowitz and Margolis pointed out that path dependence, as a significant reformulation of the neoclassical theory, represented an alternative perspective of economics (Liebowitz & Margolis, 1995). Taking into account durability, limitations on knowledge and remediable inefficiencies, they proposed the following taxonomy of path dependence (ibid.: 210):

- the first degree of path dependence implies the existence of durability without error of prediction. In such conditions, the individual simply feels the consequences of the decisions made in the past;
- the second degree of path dependence occurs when the individual makes a decision and later recognizes that there were alternative solutions which could have yielded greater wealth;
- the third degree of path dependence refers to the existence of remediable inefficiencies and includes errors. It implies that decision error could have been avoided since there were superior alternatives.

Page singled out increasing returns, positive feedback, self-reinforcement, and lock-in as the main causes attributable to path dependence (Page, 2006: 88). He contributed to the theory by distinguishing path dependence, state dependence, and 'phat dependence' processes. State dependence is described as a form of dependence whose outcome in any period depends only on the state of the process at that time. His perception of 'phat dependence' was similar to path dependence, i.e. events in the path are important, but not their sequence. Comparing the level of history dependence, he demonstrated that state dependent processes could be seen as the least history-dependent, while path dependent processes were strongly affected by previous events.

Ebbinghaus outlined two interpretations of path dependence which explain historical sequencing (Ebbinghaus, 2005: 4). The first path dependence theorem, named 'trodden path', refers to the subsequent repeated use of a spontaneously chosen path by another individual. According to the second theorem, 'branching pathways', decision-making is based on the available alternative pathways which serve as a precondition for the continuation of the journey. The first type of pathway leads to the spontaneous evolution of institutions, while the second involves a branching out of an interdependent sequence of events that represent available alternatives.

Taking into account the importance of path dependence for political, social and economic development, it is necessary to discover and carefully analyse the connection between past and future decisions, or the actions of individuals, for better understanding of institutional evolution and change. Changes occur in society and their possible outcomes are not only determined by the current situation, but also by past events. As institutions are characterized by long-term persistence, special attention should be paid to investigating the influence of the path dependence processes on the macroeconomic performance of transition countries.

2 FOREIGN DIRECT INVESTMENT: THE CASE OF TRANSITION COUNTRIES

In Chapter Two, the spotlight is on international capital flows and their different types, definition of FDI and its main classifications. We consider investor's motives of international expansion, FDI effects on host countries' competitiveness, main determinants of FDI inflows, as well as their economic impact in the host country. Besides, we highlight the potential of FDI in transition countries and the main catalysts of their inflows. We point out the linkages between FDI and privatization process, the strengths and weakness of the applied privatization methods and the specificity of economies in transition. Moreover, we analyse the fluctuations in the FDI inflows trends across European transition countries considering their geographical dimensions during the period 2000 to 2021.

2.1 THE CONCEPT OF CROSS-BORDER CAPITAL MOVEMENT

International capital flows are essential for the functioning of the global economy, providing significant benefits for economic development, on the 6one hand, and various challenges related to possible financial shocks, on the other. From the viewpoint of the host country, international capital movement have influence on income redistribution, resource allocation, employment upsurge, short-term balance of payments improvement, tax system adjustments and overall welfare enhancements (Salvatore, 2016). FDI inflows represent the main form of international capital movement, offering numerous benefits for the recipient country (Zvezdanović, 2013). It is the most desirable external channel for funding economic expansion in emerging markets. Most countries are actively engaged

in this kind of global capital mobility, because of inadequate accumulation of domestic capital required to boost the economic growth and development. Their rationale for attracting FDI could be explained makes reference to its contributions, such as complementary assets provision, access to foreign markets, employment growth, stimulation of local entrepreneurship and domestic rivalry (Dunning, 1994).

According to the UNCTAD, the main channels for FDI spillover effects in the host country are: 1. technology transfer and know-how, 2. enterprise development and restructuring, 3. international trade integration, 4. human capital formation, and 5. fostering competition among business sector (UNCTAD, 2003a). The positive influence on human capital (knowledge and expertise) and financial system development may stem from its impact on economic performance (Cakerri et al., 2021). The UNCTAD defines FDI as 'an investment involving a long term relationship and reflecting a lasting interest and control by a resident entity in one economy (foreign direct investor or parent enterprise) in an enterprise resident in an economy other than that of the foreign direct investor' (UNCTAD, 2022: 3). According to the Organization for Economic Co-operation and Development (OECD, 2008: 50), FDI entity can be defined as 'an enterprise resident in one economy and in which an investor resident in another economy owns, either directly or indirectly, 10% or more of its voting power if it is incorporated or the equivalent for an unincorporated enterprise'.

Besides FDI, we distinguish two more types of global capital mobility: lending or loan capital and portfolio investments. Portfolio investments include purchasing abroad various types of securities, such as shares and bonds, whereby the foreign investor is guided by the principle of diversification with the goal to achieve the optimal ratio between the expected return in the form of dividends, interest or capital gains and risks. Through the purchase of financial assets, the investor lends capital in exchange for a fixed pay-out at the end of the period, or for returns at regular intervals, with the repayment of the nominal value of a specified bond on a predetermined data. The main motivation of investors for undertaking

international portfolio investment is the possibility of achieving higher returns abroad compared to the home country, by controlling for risk thoughtful asset allocation.

FDI inflows consist of equity capital (purchase of company shares abroad), reinvested earnings (the part of the branch's profit that was not paid out in the form of dividends and not repatriated to the foreign investors, but rather reinvested), and the provision of short and long-term intra-company loans (between parent and affiliate enterprises). Besides transnational companies that appear as the main driver of FDI, the providers of FDI can also be persons who are residents of one country and acquire control over a company in another country. In terms of destination, FDI can be categorized as either inward or outward. In addition, we can distinguish the following forms of FDI:

- Cross-border mergers involve the joining of two or more equal entities in order to create an entirely new business entity. The mergers can be horizontal (joining of the companies from the same sector or industry) and vertical (mergers of companies characterized by different phases of the production process). In contrast, cross-border acquisitions imply purchases of existing business entities abroad. We distinguish between the majority acquisitions (ownership stake of 90% or more) and minority acquisitions (involve less than 50% of the target company). The patterns of C-B M&A activity are very sensitive to macroeconomic developments and largely depend on geographic and cultural barriers, as well as destination factors (like the level of financial development and quality of institutional arrangements) (Davies et al., 2018).
- Greenfield investments are undertaken in order to create completely new companies abroad. MNCs, as a crucial channel through which international flows of capital, labour and technology take place, develop the new facilities, which can have an immediate impact on increasing employment and productivity growth in the host country. According to the United Nations

Trade and Development (UNCTAD, 2000b), developing and transition countries can derive more benefits from greenfield investments than from C-B M&As. Unlike C-B M&A deals, the inflows of greenfield investments are relatively more determined by the origin comparative advantage and destination taxes (Davies et al., 2018).

- Brownfield investments imply the purchase of largely abandoned or underused industrial facilities in order to take control of them. Through their modernization, it is possible to achieve numerous economic, environmental and social benefits. Although formally representing acquisitions, this type of FDI resembles greenfield investments more, since it involves the complete replacement of the production facilities and lines, as well as equipment, by foreign investors.
- Joint ventures imply the existence of a long-term partnership between companies, in order to create a separate business entity, whereby each of them contributes in terms of capital, technology, and human resources. Investment can be arranged in an existing domestic enterprise for the creation and utilization of the benefits that arise from joint economic cooperation. This type of investment is characterized by the existence of a jointly controlled entity, where two or more venturers are bound by a contractual arrangement.

According to the forms of the production process organization, one can distinguish between:

1. Horizontal FDI, implying that multinational companies (MNCs) engage in the identical manufacturing abroad (the production of the same product, or a group of related products) i.e. investing company extends the same operational activity in different countries in order to serve local markets. Regardless of its geographical location, each entity of MNCs produces the same product, so the production remains consistent. The main motivation behind this foreign activity is the intention to win and maintain a position in the host country's market. Horizontal

integration can result from the establishment of a new company, merging with a foreign firm, and through an acquisition, i.e. by purchasing a controlling stake in a company producing the same products.

2. Vertical FDI means relocation of different phases of the vertical production chains to a different country. Foreign investors tend to exploit the comparative advantage benefits of the host countries for each phase of the production (for example, the availability of quality and cheap resources). Unlike horizontal FDI, the focus lies on the export of products to the home country, or to the global market.

3. Conglomerate FDI implies that MNCs allocate resources in businesses or industries which do not involve their primary business activities, i.e. a foreign company ventures markets unrelated to its current business operations. The aim is to reduce business risks through business activities' diversification, which can be achieved, for instance, by purchasing the majority of shares in a foreign company, or by merging with a foreign company of a different production type.

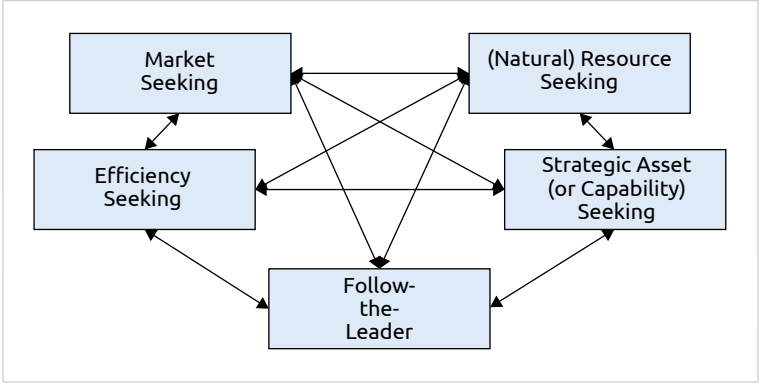
A key feature of FDI is the existence of spillover effects, which can be divided into the horizontal and vertical ones. Horizontal or intra-industry spillover effects take place when the benefits of the functioning of MNCs are limited to only those companies within the same industry (branch). For instance, local companies operating in the same industry could experience positive outcome from innovations that have arisen because of the introduction of a new technology or advanced production techniques by MNCs. Vertical or inter-industry spillovers represent spillovers to local or domestic companies in all other industries or branches, as well as for the consumers of their products. We distinguish between backward spillovers (upstream suppliers) and forward spillovers (customers down the stream) (Laenarts & Merlevede, 2011). For instance, the business operations of MNCs can have beneficial impact on local suppliers and downstream industries. In order to fulfil the requirements and standards demanded by the business practices of foreign companies, local suppliers will be forced to improve their efficiency and productivity, or upgrade their technology.

2.2 THE FACTORS INFLUENCING FOREIGN INVESTMENT CHOICES

The strong growth of FDI in the second half of the 20th century has led to an increase in research activities in order to explain FDI decisions for different locations. Unfortunately, the vast number of theoretical and empirical studies on FDI have not yielded a consensus. The OLI paradigm developed by Dunning (the acronym for Ownership, Location, and Internalization – whose advantages we consider below) is one of the most important theoretical approaches for singling out factors involved in cross-border capital investment. Dunning argues that, from the perspective of the investing firm, the motives behind FDI inflow can be put into the following categories: a) the search for natural resources, b) the search for new markets, c) improving efficiency, and d) the search for strategic assets (see Figure 1) (Dunning, 2000).

Resource-seeking FDIs (also called vertical or export-oriented) occur when foreign investors want to obtain resources that are not available or are more expensive in the country of origin, such as natural resources, raw materials, or low-cost labour (Bruno & Campos, 2010: 35). Dunning and Lundan point out that the main determinants of FDI inflows are physical resources and infrastructure (such as ports, railways, roads etc.), along with

Figure 1. Motives of MNCs for Internationalisation



Source: Morschett et al., 2015: 80

the cheap, unskilled or semi-skilled labour force (Dunning & Lundan, 2008). Furthermore, technological capacity and organizational, management or marketing skills from the host country are denoted as the crucial factors influencing this form of capital investment. Through this type of investment, foreign investors relocate parts of their production process to the host country.

The main aim of market-seeking FDIs is to serve local markets through local production. According to Dunning and Lundan, investors' motives for entering a foreign market may vary, but the most commonly mentioned ones are the market size and opportunities for market growth, the need to be close to their key suppliers or customers, access to regional and global markets, adapting products and services to local needs, and to avoiding costs associated with supplying the market from a distance (Dunning & Lundan, 2008). Tariffs and transportation expenses are commonly employed to impede and deter the inflow of this form of FDI.

Efficiency-seeking FDIs takes place when a firm can gain from the common governance of geographically dispersed activities in the presence of economies of scale and scope (Demirhan & Masca, 2008: 358). Taking into account differences in consumer preferences or the capacities of a supplier, the company achieves economies of scale and scope and diversification with the help of the differences in the availability and cost of traditional factors in different countries (Dunning & Lundan, 2008: 72). A foreign investor aims to minimize overall costs (including labour and transportation expenses) by expanding its operations to countries strategically positioned in close proximity, thereby capitalizing on advantageous geographic locations.

It is important to recognize that distinguishing between situations where the primary motives of FDIs are resource acquisition and those where investments are directed towards enhancing efficiency, can be exceedingly challenging. Investing overseas to secure resources encompasses scenarios where the necessary resources are inaccessible domestically, or are considerably more affordable in the host country. Conversely, efficiency gains may result from leveraging economies of scale, diversification, or accessing input factors at discounted prices.

Foreign investors may be incentivized to allocate their capital towards the sectors in which the host country possesses technological expertise. Such an advantage is typically acquired through strategic partnerships, or acquisitions of local enterprises. Foreign companies strive to improve their competitive position and achieve their long-term strategic objectives by acquiring technological know-how from overseas (Dunning & Lundan, 2008: 72). Besides the presence of the firm-specific assets, the determinants of strategic asset-seeking FDIs also include

Table 1. Benefits of FDI Inflows in Recipient Country

FDI effects on host countries' competitiveness	Types of FDI
Complementary assets provision	Natural resource-seeking Market-seeking
Access to foreign markets	Natural resource-seeking Efficiency-seeking Strategic asset-seeking
Possible impact on local spin-off effects on industrial customers, e.g. secondary processing activities	Natural resource-seeking
Raising product quality standards	Natural resource-seeking Market-seeking Efficiency-seeking
Potential implications on promotion of clusters of resource based related activities	Natural resource-seeking
Promotes the building of reverse supply chain and clusters of skill labor markets and agglomerative economies	Market-seeking Efficiency-seeking
Increasing consumer standards for domestic rivals	Market-seeking
Small scale business development and fostering of competition on the local market	Market-seeking Strategic asset-seeking
Enhance global labor allocation and cross-border networking	Efficiency-seeking Strategic asset-seeking
Access to source of supply	Efficiency-seeking
Aids structural adjustment	Efficiency-seeking
New finance capital and complementary assets	Strategic asset-seeking

Source: Dunning, 1994: 31

simplifying C-B M&A deals, as well as efficiency and transparency of financial markets.

Each type of the previously mentioned FDIs brings numerous benefits for the host country, as indicated in Table 1. An FDI recipient country can expect a greater inflow of FDI in case it provides a consistent and inclusive regulatory setup, reliable macroeconomic conditions and availability of human capital, physical infrastructure and other crucial resources. A MNC will engage in a FDI if it possesses certain advantages that influence the company's global production strategy[1]:

- The company achieves ownership advantages through exclusive possession of particular intangible assets that can easily be transferred within MNCs at low costs (Dunning, 1988: 15). Bearing in mind the fact that performing operations in different countries leads to additional costs for MNCs, a company should possess some advantages that will lead to higher marginal profitability or lower marginal costs when compared to other competitors on a foreign market (Dunning 1980, 1988). A foreign investor should have advantages over local companies in order to avoid risks, manage challenges, and compensate for the costs which usually occur in a host country's business environment. The company's ownership advantage may be reflected in the possession of legally protected rights, a commercial monopoly, exclusive control over particular market outlets, etc. (Dunning, 1980: 10).
- Locational advantages arise from the prices and availability of required resources, the proximity to the market, superiority of the production method in the host country, supportive and stable legal, social and political frameworks, bypassing customs, etc. A foreign company will undertake cross-border investment

[1] These three main elements in the decision-making process constitute the OLI paradigm (Ownership, Location, and Internalization), which represents an important tool for understanding the determinants of successful international expansion by MNCs.

only if it is possible to successfully combine its spatially transferable intermediate products with at least some immobile factor endowments, or other intermediate products in the host country (Dunning, 2000: 4).

- Internalization advantages occur primarily due to improvements in the efficiency of business activities, which are realised between the subsidiary and the parent company, rather than through the market. If production proves to be desirable in terms of ownership and location advantages, a firm should possess internalization advantages which influence the choice between direct investment and arms-length arrangements (for instance, production licensing or franchising) (Bende-Nabende, 2002: 37).

2.3 THE FDI EFFECT ON HOST COUNTRY

The findings of empirical studies regarding the interplay between FDI and economic growth are inconsistent. The predominant group of authors argue that FDIs generate beneficial or neutral effects on host country (Raza et al., 2021; Liang et al., 2021; Mohamed et al., 2021; Claudhury et al., 2020), while other authors point out that FDI adversely affects economic performance (Mencinger, 2003; Curwin & Mahutga, 2014). According to Baiashvili and Gattini, FDI enhances economic growth, whereas it contributes more to economic performance in developing countries characterized by higher demand for investment and larger needs for advanced technologies in comparison to developed countries (Baiashvili & Gattini, 2020). Moreover, it has been determined that the quality of institutional framework exerts a moderating positive impact on FDI across various country income groups.

Gezdim and Zortuk examined the FDI growth effects in 19 transition countries in the 2000–2014 period (Gezdim & Zortuk, 2018). The authors point out that FDI inflow effectively stimulate economic growth in transition countries characterized by middle to high economic growth rate. The similar findings are

revealed in the empirical study by Dinh et al. who investigated the FDI-growth relationship, both in the short- and long-run in the developing countries defined as lower middle-income economies in 2000–2014 (Dinh et al., 2019). The policy for FDI attraction should be defined with a view to long-term outcomes, in order to achieve positive FDI effects in the host country. The results of the these studies are in line with conclusions made by Zvezdanović Lobanova et al. who demonstrate that C-B M&As adversely impact GDP per capita during the year of C-B M&A deals' realisation, while their lagged level's impact exerts a robust positive influence one year afterward (Zvezdanović Lobanova et al., 2016). The authors highlight that the growth in C-B M&A activity counteracts the positive influence of fight against corruption on the current period's economic growth.

Emako et al. investigate the channels through which FDIs influenced structural transformation in 44 developing countries and four newly industrialized countries in the period 1990–2018 (Emako et al., 2022). They discover that FDI has a crucially beneficial role in facilitating structural transformation. According to their findings, the manufacturing and service-sector output, as well as employment growth and urbanization, as the four major structural change indicators, are crucial pathways via which FDIs stimulate structural transformation in this group of countries. These results diverge from the recently published empirical study by Tsaurai which implies that FDIs have had harmful effects on economic growth in the group of BRICS countries in the period from 1991 to 2019 (Tsaurai, 2023a). However, the author asserts that the quality of financial development could enhance the positive impact of this type of capital investment on economic performance.

Regarding its effect on domestic investment, Miao et al. finds that the impact of Chinese FDI on African countries' domestic investment has been positive and largely depends on the improvements in the governance environment (fight against corruption, government effectiveness, and voice and accountability) (Miao et al., 2021). Sucubasi et al. also find that inward FDIs and real economic growth in the Western Balkan countries have had positive and significant effect on domestic investments

(Sucubasi et al., 2021). The authors point out that such positive influence can be explained by the fact that FDI inflow leads to increasing production capacity, employment growth, introduction of new technology and knowledge and import dependency reduction.

On the other hand, the recent empirical study by Gokceli et al. shows that FDI has neutral effect on domestic investment in the receiving country (Gokceli et al., 2022). However, they point out that this impact differs across countries: the FDI from developed countries has crowding-in effect on domestic investment while the FDI from less developed countries do not show significant correlation. In turn, Bucevska and Merdzan demonstrated that FDI had short-term crowding out effect on domestic investment in the economies of Central, Eastern and South-Eastern Europe from 1995–2021 (Bucevska & Merdzan, 2022). The authors stressed that the crowding-in effects were visible only in the long term. They also found that the significance of institutional arrangements was particularly pronounced in shaping the association between domestic investment and FDI. The similar findings were revealed by Zvezdanović Lobanova et al. who prove that C-B M&As have influence on the displacement of domestic companies during the year of the transaction's realization, while their lagged level shows a pronounced crowding-in effect afterwards (Zvezdanović Lobanova et al., 2018b). The authors also highlighted that the quality of institutions and the rule of law adversely influence the interaction between C-B M&As and domestic investment, in both short and long term.

2.4 ECONOMIC IMPLICATIONS OF DIFFERENT TYPES OF FDI

The two most common forms of foreign market entry of MNCs are M&As and greenfield investments. From the perspective of country of receipt, the primary economic impacts of these investments are capital accumulation, job creation, technology transfer and dissemination, change of competition and efficiency enhancement (Kang & Johansson, 2000).

The C-B M&A activity have potential to improve the host country's competitiveness, as these are linked with the innovation growth, the level of financial market development and share in market size. The benefits of greenfield FDIs on host countries are related to building of new facilities, employment growth and the augmentation of productive capacity (Ai-jun et al., 2023). Authorities from transition countries have been especially interested in this type of FDI, since they expected that these deals would increase privatization incomes, lead to fostering of managerial capabilities, technology improvements, know-how transfer, gaining of competitive edge in the global market, access to new markets, etc. (Maček, 2014).

M&A as a powerful strategy for business expansion can lead to an improvement of company's performance through synergies acquired, market power, firm profitability, risk diversification, and integrated management strategy (Hossain, 2021). A merger is more likely to occur between firms which are culturally very similar, and the announcement of C-B M&As deals is followed by positive market reactions. Moreover, there is an increase in the competitiveness of C-B targets after the realisation of the M&A deal (Otchere & Oldford, 2018). However, strong resistance usually accompanies the realization of this type of foreign capital expansion (Hawn, 2021). Namely, the fears of employees, domestic investors, customers, local authorities, community activist groups and others involved in this process, represent a crucial barrier to completing these deals. As noted by Ovin and Maček, the crowding-out of domestic industry, reduction of employment, low prices of sold assets, decrease of competition in the home country and undermining of the domestic economic development strategy represent the main possible threats of C-B M&As (Ovin & Maček, 2021). Taking into account all these possible negative implications in transition countries, the authors showed that the majority of professionals included in their empirical study assessed media attitude towards inward C-B M&A as neutral or not to friendly. Taking into account their numerous negative effects (technology transfers concerns, national security issues, market dominance, cultural clashes etc.), Heinemann demonstrates that the

majority of countries have adopted control mechanism in order to screen C-B M&A deals for their compatibility with national interests (Heinemann, 2012).

In the economic literature, the authors usually compare the effects of C-B M&As and those of greenfield investments, on the economic performance of the host country. In contrast to greenfield investments whose effects are expected shortly, the impact of M&As on employment growth and capital accumulation is visible only in the long run. At the time of M&A entry, unemployment growth is usually recorded, as well as replacement of domestic firms that could not endure the intense competition within the local market, by foreign companies (Zvezdanović Lobanova et al., 2016). However, in the long run, C-B M&As foster growth in GDP per capita, which can be attributed to the synergetic advantages derived from the strategic alliances between local and international companies, employees' effective skills enhancement and technology spillovers.

Luu concludes that these two main modes of entry have positive impact on the growth acceleration in emerging countries (Luu, 2016). The author highlights that, in case of human capital enhancement, more FDI benefits could be obtained. By comparing the impact of C-B M&As and greenfield investments on economic growth, Eren and Zhuang show that availability of absorptive capacity stimulates their growth effects (Eren & Zhuang, 2015). The impact of C-B M&As on economic growth depends on the degree of financial market development, while the positive effects of greenfield investment are expected where a minimum level of human capital has been achieved. A recent research conducted by Nguyen et al. shows that greenfield investments crowd in domestic investment, which positively reflects on the long-term economic growth (Nguyen et al., 2021). According to their findings, C-B M&As have strong and significant crowding-out effects and hamper economic performance in both the short and the long run.

2.5 THE STRATEGIC POSITIONING OF FDI IN TRANSITION COUNTRIES

During the process of structural and institutional transformation, transition countries sought to attract FDI, since these investments were considered as the main driver of economic growth and employment. As Central and Eastern European (CEE) countries were insulated from international capital flows, the FDI inflows were used to support the initial implementation of reforms amidst insufficient capital accumulation and domestic savings. These countries have endeavoured to take advantage of the FDI (strength and opportunities in Table 2) in such way that would contribute to the production restructuring and increasing competitiveness on the international market.

FDI inflows provided support in setting the transition countries onto the path of convergence with their more affluent neighbours (Sohinger, 2005). Due to their growth-enhancing capacity, these countries managed to overcome the transitional recession and increase their presence on international markets. The foreign firms affected domestic firms' performance in transition countries through the FDI spillover effects that have been recorded within (in labour-intensive sectors) and across sectors (high-tech sectors) in which foreign firms operate (Nicolini & Resmini, 2010). Moreover, there is an undeniable effect on the labour market, due to the spillover of organizational and management skills to the local workforce. The positive dynamics of labour productivity is associated with attracting FDI and increasing the share of foreign companies in the total output structure (degree of foreign capital penetration) in case of 12 CEE and SEE countries (Lobanov et al., 2022).

In the initial phase of the transition, FDI inflows were mostly used for the purchase of state-owned companies through C-B M&As, which had a positive effect on the use of available resources and productivity growth. In order to make their countries more attractive to foreign investors, governments offered various privileges and allowed unhindered entry for MNCs as some kind of compensation for the high costs of doing business in uncertain conditions. The volume of FDI inflows in the

Table 2. SWOT Analysis of FDI for Transition Countries

STRENGTHS	WEAKNESS
• company performance improvements • increase in labour mobility and productivity in the target company • reduce the disparity between revenues and costs • access to global market and value chains • generate tax revenues for the host country • the expansion of production sites and infrastructure in the target country • notable shifts in the production and export patterns • knowledge and technology spillovers • job creation • creation of a more competitive business environment • improve the physical and institutional infrastructure development (investment in and maintenance of local facilities) • covers trade deficit and stabilizes the balance of payment	• possible crowding out of domestic companies • leading to the rise in unemployment in the short run (FDI in form of C-B M&As) • withdrawing all profits gained from their investment from the target country • high dependency on foreign entities • loss of government's control over crucial sectors • environmental degradation and pollution (transfer of "dirty" to the domestic economy) and resource depletion • non-competitive conduct of foreign branches • negative balance of payments effects for the host country, reducing its fiscal revenues • the export of technology and know-how weakening the competitiveness of the recipient country
OPPORTUNITIES	**THREATS**
• external financial support for economic expansion (especially if the country has a lack of domestic savings) • diversification of industry • enhancing entrepreneurship cultureenhancing innovation capacity skill development • creating positive spillovers and linkages for the host country's domestic firms • putting unused resources to work • assisting human capital formation • crucial mechanism for catching up • contributing to global trade integration • fostering trade interaction on a global scale	• FDI tends to concentrate in the regions with better infrastructure and institutions which can create regional disparities in the host country • income inequality within the host country • growing market consolidation and reduction of the market share and profitability of domestic firms • risk of resource exploitation, including labour exploitation or adverse social impacts on local communities • increasing the political and economic dependence of the host country on foreign interests, compromising its sovereignty, autonomy, and policy space (especially in the field of agriculture) • impact of cultural homogenization • skill mismatch between those required by foreign investors, and those possessed by the local workforce

Source: Compiled by the author

transition economies of Central Europe, the Baltics and the Balkans was directly affected by the success with stabilization and reform implementation (Brada et al., 2006). On the other hand, the outcome of transition process relied on the inherited conditions from the previous system, as well as policies and strategies for the implementation of certain measures during the transformation.

2.6 FDI CATALYSTS IN TRANSITION COUNTRIES

In the economic literature, there are plenty of studies addressing FDI determinants, but there is no clear agreement about the factors affecting the international movement of capital. The majority of authors usually stress that the key drivers of FDI are the market size, trade openness, better infrastructure, depreciation in the exchange rate, human capital and interest rates (Jaiblai & Shenai, 2019; Saini & Singhania, 2018; Kumari & Sharma, 2017). Since FDI is one of the main determinants of economic development in transition countries, the growing interest in studying this topic is not surprising. The most recent empirical study by Tsaurai showed that infrastructure development, economic growth, domestic investment, complementarity between infrastructural and financial development, trade openness and savings were among the factors that positively and significantly influence the FDI inflows across CEE countries in the period 1994–2020 (Tsaurai, 2023b).

Dauti analysed the drivers of FDI stock to 5 SEE countries and the 10 New Member States (NMS) of the European Union (EU) in the period 1994–2010 by using an augmented Gravity Model (Dauti, 2015). The author identified that factors such as gravity (including distance and GDP) and indicators of institutional quality (such as corruption control, progress in transition, political stability, WTO membership, and regulatory standards) significantly influenced the decisions by foreign investors from the core EU countries to invest in the economies of the SEE region and new EU member states. Institutional quality improvement strongly influences the readiness of foreign investors to

undertake investment projects. Foreign investors tend to invest in those countries that provide legal certainty and secure the protection of intellectual property rights. It should be highlighted that FDI inflows and their potential gains, as well as the stability of the business environment, were greatly influenced by the EU integration process. For instance, Benfratello et al. point out that European investors are encouraged to invest in the countries that strive to join the EU (Benfratello et al., 2023). When country becomes an official candidate for EU membership, this means that state authorities are still working hard to create an adequate legal and institutional environment that guarantees the protection of the foreign investors' rights.

The positive gains in FDI have been associated with the EU accession. Bandelj showed that FDI in CEE were indirectly affected by the EU integration (Bandelj, 2010). She highlighted that these countries implemented FDI promotion policies and strategies that were not only in line with the EU membership criteria, but also depended on factors such as reform progress, initial choice of privatization method and the history of state sovereignty. Zvezdanović Lobanova et al. find that unstable political environment and violence of human rights have a detrimental impact on foreign investors' confidence in transition countries (Zvezdanović Lobanova et al., 2021). The authors point out that enhancing institutional quality in terms of comprehensive combat against corruption and promoting transparency and accountability, yielded positive effects on FDI inflows. The intricate correlation between GDP per capita on the one hand, and overachieving institutional environment, voice and accountability, regulatory quality and governance effectiveness on the other, is positive and significant, suggesting that the institutional setting quality's marginal effect is markedly influenced by the dynamics of macroeconomic development. Therefore, authors conclude that the impact of governance on FDI inflows depends on the countries' macroeconomic outlook. Pečarić et al. examined the system determinants and transmission mechanisms of the sectoral structure of FDI inflows in 10 Central and East European EU countries in the period 1995–2019 (Pečarić et al., 2021). They found that greater FDI inflows into the services sectors were

due to a developed credit market and the purchasing power of residents. On the other hand, the main capital inflows drivers in manufacturing sector were higher GDP growth rate and a devalued real exchange rate.

2.7 PRIVATIZATION AND FDI SYNERGY

Privatization[2], as one of the key element of transition, implies a change in the ownership of the socially-owned and state-owned companies, since it was impractical to build a market economy on their foundations. The aim of this process was to enhance their economic efficiency (reduction of operation costs, financial recapitalization, better work organization and discipline), improve the state's financial position (through privatization income, increase in tax revenues from economic activity and cutting or phasing out of the government's financial support for the state-owned and social-owned companies) and remove the preferential treatment of the state and social sectors, shifting the balance in favour of private businesses (Begović et al., 2000).

The comprehensive reform programs related to state-owned companies were expected to contribute to the creation of fiscal savings and increase the efficiency and competitiveness of the domestic economy. Hagemejer and Tyrowicz point out that there is a strong effect of privatization via FDI on the improvement of the company's performance (Hagemejer & Tyrowicz, 2011). Compared with the economic performances of state-owned firms, they show that the privatized foreign companies operate significantly better, which is manifested in higher profits, increased investment opportunities, greater efficiency and stronger export orientation. The privatization boosts the encouragement for FDI, while its optimal degree is determined by the cost difference of the firms, foreign firm's entry mode, the fixed cost of undertaking FDI and the demand parameter (Mukherjee & Suetrong, 2009).

[2] The crucial pillars of reform during transition were macroeconomic stabilization, liberalization, and privatization.

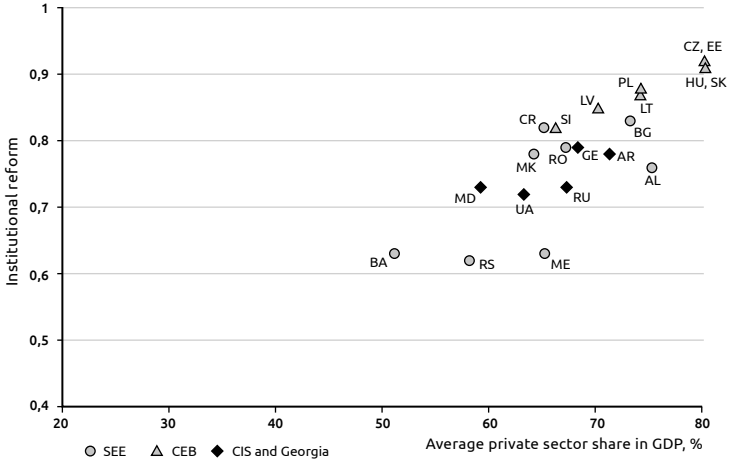
During the first years of the transition, the privatization and restructuring were of crucial importance for new firm creation (Tubke, 2003). Transition countries initiated the process of mass privatization completely unprepared, lacking adequate knowledge and expertise of policymakers in the context characterized by the absence of a foundation in the rule of law and effective supervision. On the other hand, the privatization of the state-owned enterprises required a high degree of institutional capacity since this process was accompanies by numerous informational asymmetries.

From the very beginning of transition process, the strong association was developed between FDI inflows and privatization in the majority of CEE countries (Kalotay & Hunya, 2000). However, while privatization has clearly prevailed in FDI attraction, FDI has not been a leading form of privatization, aside from Hungary who encouraged the entry of foreign capital since the beginning of the transition (UNCTAD, 2003b: 2). Figure 2 illustrates how the advancement of institutional reform coincided with the establishment of a conducive environment for private sector growth. The Czech Republic, Estonia, Hungary, and Slovakia emerged as frontrunners in terms of state contribution to fostering private sector expansion. On the other hand, private sector growth in SEE and CIS nations fell behind the more developed CEE countries. Their advancement was notably sluggish due to prolonged delays in extensive privatization, posing a significant obstacle to economic transformation. Belarus stands out as an exception, with the state maintaining dominance in economic affairs despite persistently low institutional quality.

The privatization of the state-owned enterprises included some of the following three basic methods, or a combination thereof: insider privatization (Albania, Croatia, Romania, Poland, Slovenia, Slovakia, and Ukraine), the voucher privatization (Bosnia and Herzegovina (BiH), Czech Republic, Latvia, Lithuania, Moldova, Montenegro and Russia), and direct sales to external investors (Bulgaria, Estonia, Serbia and Hungary)[3].

[3] The countries that used the given privatization method as their main method are shown in brackets.

Figure 2. Institutional Reforms and the Private Sector Contribution to GDP



Note: AL – Albania; AR – Armenia; BY – Belarus; BA – Bosnia and Herzegovina; BG – Bulgaria; CR – Croatia; CZ – The Czech Republic; EE – Estonia; GE – Georgia; HU – Hungary; LV – Latvia; LT – Lithuania; MK – Macedonia; MD – Moldova; ME – Montenegro; PL – Poland; RO – Romania; RU – Russia; RS – Serbia; SK – Slovakia; SI – Slovenia; UA – Ukraine.

Institutional reform is presented by the average European Bank for Reconstruction and Development (EBRD) index, which is normalized to a range from 0 to 1 in order to improve the visual presentation of the indicators. We calculated average levels for the period 2000–2010.

Source: Author's display based on the data from EBRD, 2023

Mass or voucher privatization implies the distribution of vouchers to citizens based on the previously assessed capital values of the state-owned enterprises. These vouchers were used for the purchase of shares corresponding to the value achieved on the stock market. In the economic literature, this method of privatization is defined as fast, fair and especially suitable for implementation in the transition countries lacking a well-established capital market. It is characterized by the establishment of investment privatization funds, which issue their shares to citizens in return for vouchers (diversification of risk for citizens) (Babička, 2022). These funds are overseen by managers, whose compensation is not tied to their performance, leading to a lack of interest in

corporate restructuring. The main disadvantages of this privatization method are minimal privatization revenues, the lack of capital for enterprise investment, possible depressing share prices, liquidity risk in the countries without well-established stock exchange, the absence of control (Jeffries, 2002). Using the Czech Republic as an example, Nellis explains that the problems arose due to the under-regulated privatization investment funds, which held considerable controlling stakes in the majority of companies privatized by vouchers (Nellis, 2001). It is interesting that the owners of the majority of these large funds were leading domestic banks, in which Czech state maintained control and even a large ownership share.

The management employee buyouts, or insider privatization, implies the sale or donation of the company's shares to the employees and managers, according to the duration of employment in that organization, at a lower price and with favourable repayment conditions. It is marked by undervalued share prices, as the employees do not have sufficient money and/or interest to participate in the privatization. In order to address this issue, trust funds are created, to which commercial banks grant loans that the workers gradually repay from their salaries. The method is quite simple for realization and it offers job-loss compensation through the provision of social security benefits. However, it is characterized by the lack of diversification and expertise, risk of management inefficiencies, opposition to restructuring, as well as divergent interests among managerial team and other stakeholders about earnings distribution (Merlevede, 2000).

Direct sale of the state assets and share issues involves the sale of the company to outside investors under commercial conditions, through a competitive bidding process, or negotiations. It contributes to the growth in the government's revenues and involves sale of the state assets to the private sector at realistic market prices. However, in the conditions of underdeveloped capital markets, this model of privatization could be very slow, costly due to a potential negotiation complexity, implying limited competition, and possible underestimation of the state asset's value (Havrylyshyn & McGettigan, 1999).

Estrin et al. demonstrated that transition countries recorded a notable economic downturn during the initial three to

eight years of the transformation process, which was aligned with the launch of privatization (Estrin et al., 2009). The authors identified a generally positive impact of privatization on the economic performance at the micro level, which depended on the institutional and legal setting, type of private ownership, access to markets and know-how and corporate governance. Privatization does not guarantee that the company's performance will be strengthened, while its positive effects on the domestic owners could be expected only in the long run. Based on the experiences of the countries that have excelled in their ownership transformation (Poland – direct sale and insider privatization, Hungary – direct sale and Slovenia – insider privatization), it is evident that the method of privatization does not play key role in achieving optimal market positioning and company's performances. This is supported by the fact that the identical models of privatization applied in different countries, did not bring the same effects. For instance, in Slovenia, the management employee buyouts were applied, which, together with the gradual introduction and maintenance of the state's role as the dominant owner in certain companies, yield extraordinary results. The transition model mix, which included crucial aspects of Keynesian and Post-Keynesian approach, had conducive impact on the economic activity and social integrity in Slovenia, as the transitional recession was brief, giving way to a sustained phase of a steady economic growth (Kračun, 2013). On the other hand, this model was implemented in Russia, together with voucher privatization, and the results were devastating, including: an output decline, unemployment growth, rise in speculative activity during the ownership restructuring, as well as growth in the corruption, organized crime, unfriendly bureaucracy, inequality and poverty (Black et al., 2000).

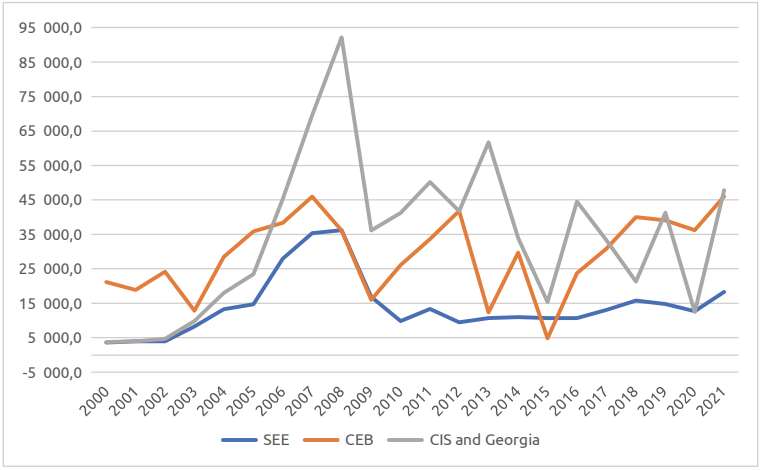
As shown by Havrylyshyn and McGettigan, the approach to privatization influenced the efficiency improvements in the cases where insiders dominated privatization, caused the oligopolistic rent-seeking behaviour, prevented the establishment of dynamic and competitive marketplace and normal conditions for new entrepreneurial ventures (Havrylyshyn & McGettigan, 1999). The policymakers misunderstood the importance and role of privatization, since they believed that the change

of the ownership structure would immediately help in solving the long-term accumulated problems. Contrary to expectations, extensive social wealth came into the hand of the people close the government, but also those possessing dubious capital and known criminals, which further led to the growth of poverty, social stratification and unemployment.

2.8 THE CHANGES IN FDI PATTERNS WITHIN THE EUROPEAN TRANSITION COUNTRIES

The FDI inflows in the European transition countries had maintained their upward trend until 2008 (with the exception of the CEB region in 2003) when they reached a peak (see Figure 3). SEE countries recorded less FDI inflows than other transition countries due to the factors such as market size, quality of institutional setting, distance from the source economies and prospects of the EU membership that influenced MNEs' decision to invest (Estrin & Uvalić, 2014). In 2009, FDI inflows fell significantly due to the global economic and financial crisis, which spread via

Figure 3. FDI Inflows in European Transition Countries between 2000 and 2021 (in millions of dollars)



Source: Author's display based on UNCTAD, 2023

several transmission channels such as limited access to finance, gloomy market prospects, and risk aversion (UNCTAD, 2009: 5).

After a couple of years of moderate growth, FDI inflows recorded decline in 2013 and 2015, which mostly struck the CEB region. In 2014, the level of FDI inflows in the CIS region, Ukraine and Georgia was halved due to the regional conflict and emerging political risks. During the same year, FDI inflows in the CEB region increased, while SEE countries faced stagnation. In the period 2015–2021, the FDI inflows in the CIS region, Ukraine and Georgia were very volatile due to economic sanctions against Russian Federation imposed by the EU and the United States and high political risks. After 2015, the CEB region have experienced a growing level of FDI activity, while SEE also recorded higher FDI inflows, but at a much lower growth rate.

The upward trend of FDI inflows declined in 2020 due to the break out of the coronavirus disease (COVID-19) that led to the collapse of economic and investment activity, the reduction of international trade, disruptions in productions and decline of the performance of small and medium-sized enterprises (SMEs) (decrease in production volume, demand fall, liquidity crisis, delayed transportation, raw material shortage etc.) The comprehensive emergency response to the incidence of the COVID-19 among the population drastically affected the performance of business sector, especially the enterprises in the tertiary sector (Nikolić & Zvezdanović Lobanova, 2022). The decrease in foreign investment activity in 2020 was more profound in the countries of the CIS and SEE region than in CEB, which leads to the conclusion that major transition countries like Russia and Ukraine were most direly affected by the pandemic.

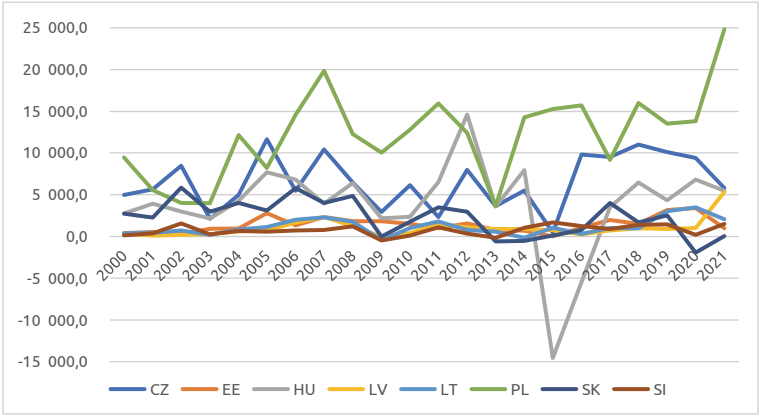
From the 2000s onwards, the growing trend of FDI inflows has been evident, as well as their unequal distribution. These variations in FDI inflows can be justified by the quality of the institutional settings, prevalent model of transition and privatization, as well as the negative impacts of unforeseen global shocks and conflicts and their spillover effect on transition countries.

2.8.1 *Central and Eastern Europe and the Baltic States*

Within the Central-Eastern Europe and the Baltic states (CEB) region, the most advanced transition countries, like Hungary, the Czech Republic and Poland, have had the highest annual FDI inflows over the past two decades (they also stood out in 2009 in terms of FDI stocks). As far as Poland is concerned, it became a major FDI recipient mostly due to its large domestic market (second only to Russia in terms of GDP volume and third after Russia and Ukraine in terms of population) (UNCTAD, 2000b). The share of CEB in the total FDI stock of all 27 transition countries accounted for 71% in 1995, but later it started to decrease. As a result of the prospect of the EU membership, improved economic performance and strong reform efforts, FDIs in the EU accession countries (excluding the Baltics) have seen an increase from the mid-1990s onwards.

In the early 2000s, the significant drop in FDI, in particular C-B M&As, was a consequence of the slow economic growth in the majority of the countries, the volatility of stock markets, and the completion of the privatization process in several countries

Figure 4. FDI Inflows in the CEB Countries between 2000 and 2021 (in millions of dollars)



Note: CZ – The Czech Republic; EE – Estonia; HU – Hungary; LV – Latvia; LT – Lithuania; PL – Poland; SK – Slovakia; SI – Slovenia.

Source: Author's display based on UNCTAD, 2023

(see Figure 4). For instance, C-B M&As in 2003 fell back to the 1992 level due to the negative spillover effects of the dotcom crisis. The decrease in FDI inflows in 2003 within the CEB region was caused by the slowdown of the privatization process in the Czech Republic and Slovakia (these two countries were among the most active in privatization at the time). The higher FDI stock in the EU accession countries was caused by positive achievements in different areas of reform, as measured by the EBRD liberalization indicators. From the second half of the 2000s onwards, Estonia and Hungary have recorded the highest ratio of the inward FDI stock to GDP within the region.

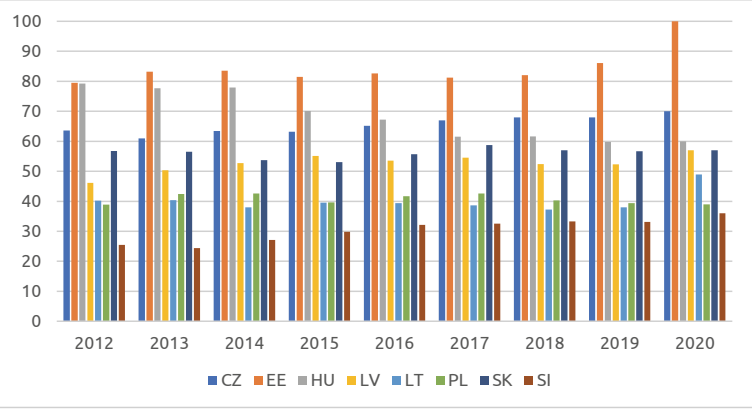
Due to the economic recession caused by the global financial crisis, international capital flows were significantly reduced in this region. The global economic crisis had an adverse effect on FDI and caused disinvestments, i.e. FDI outflows. The decline in FDI inflows influenced the readiness to establish new production capacities. It was followed by an economic growth slowdown, a reduction in the number of jobs, and an export and demand decrease. While all FDI components were influenced by the crisis, the most significant decline was recorded in the sphere of equity capital flows, which had strong links to the investment strategies of MNCs (UNCTAD, 2010: 56). The global financial crisis caused a further slowdown in C-B M&A activity. As a result, there was a sharp decline in C-B M&As, which took the form of a rising wave of disinvestments and restructurings (UNCTAD, 2009).

Slow economic growth rates placed additional pressure on the inward FDI in terms of restrictive monetary policy, lower domestic demand, and recession in the countries which were the largest foreign investors (UNCTAD, 2009: 72). The total FDI inflows in 2009 (US$18 billion) reached only about a half of the volume of the previous year and fell to the levels of 2001. A decline in FDI inflows by more than 60% was registered in Hungary and Latvia in 2009. It is worth noting that Lithuania, Slovenia and Slovakia experienced negative FDI inflows, i.e. disinvestment. However, in the same year, the level of FDI inflows in Estonia actually increased. Unlike other countries in the region, the FDI inflows to Poland were barely affected (a decrease of only 14%). FDI inflows began to show signs of recovery only in 2010 when

they reached the same level as 2004. The significant decrease in FDI inflows in 2013 was the result of the European debt crisis and lowered investment attractiveness of the CEB region. We can illustrate this trend by the fact that the value of C-B M&A deals in 2012 within the CEB region declined by 88%.

In 2014, FDI inflows increased by more than two-fold compared to 2013. Unfortunately, another decline in investment activity was recorded in 2015 when FDI inflows dropped by 83.8%, which was mainly associated with the disinvestment in Hungary. Such net FDI flows in this country could be explained by the negative debt instruments and equity investment (Hunya & Schwarzhappel, 2016). The decline in foreign investment activity was so profound that Hungary did not managed to reach the 2014 post-crisis peak. Its FDI inflows were negative both in 2015 and 2016, at minus $14 billion and $5 billion, respectively. In 2016, FDI inflows in Latvia and Lithuania were down due to capital withdrawal, mainly because of the risks associated with political and economic situation in Russia and Ukraine. Large disinvestment in the Poland's banking sector in 2017 had strong impact on FDI inflows decrease in this country. The inflows amounted to US$ 9.1 billion and were 40% lower than in 2016.

Figure 5. FDI Stock as Percentage of GDP in CEB Countries in the 2012–2020 period



Note: CZ – The Czech Republic; EE – Estonia; HU – Hungary; LV – Latvia; LT – Lithuania; PL – Poland; SK – Slovakia; SI – Slovenia.

Source: Author's display based on UNCTAD, 2023

By observing the level of FDI stock in the period from 2012 onwards (see Figure 5), the CEB countries that have recorded the highest amount of FDI relative to their size are Estonia, Czech Republic, Hungary and Slovakia, whose share has been above 60% of GDP. On the other hand, this indicator has had a less significant role in the countries like Slovenia, Poland and Lithuania (with FDI of 25–45%). Such level of investment activity could be partly explained by the fact that these countries tried to protect their economies by discouraging FDI investment activity.

According to the UNCTAD data, the outbreak of the COVID-19 pandemic had little impact on the dynamics of the FDI movement in this region. Namely, the FDI inflows' decline in the CEB region has amounted to 7.2%, while five of the eight countries even recorded increase in 2020. The difference between the inward and outward FDI inflows was negative only in Slovakia. The FDI inflows in 2021 increased by 30% due to the high investment activity in Poland and Latvia, while other countries from the region recorded decline of FDI inflows.

2.8.2 *South-Eastern Europe*

Since the beginning of the transition process, the South-Eastern Europe (SEE) countries have been characterized by the high divergence in the level of the attracted FDI inflows, while their share in the total FDI stock in all 27 transition countries has been changing moderately. For instance, the inward FDI stock in SEE countries in 1997 was US$6.9 billion, or 8.5% of the total inward FDI stock in all 27 transition countries[4] and by 2014 it rose to 14%. In this group of countries, Romania, Croatia and Bulgaria were the main recipients of FDI inflows. There were also large differences in M&A activity. Namely, those countries which became EU members were involved in the majority of M&A deals.

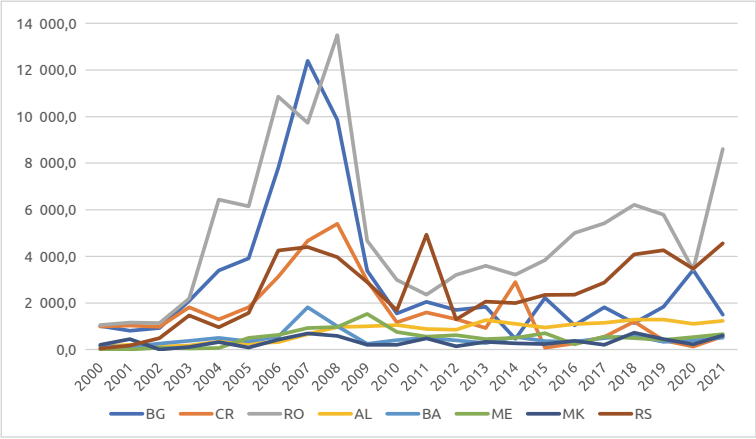
FDI in SEE countries generally started to rapidly increase only during the first decade of the 21st century. According to the UNCTAD data, the SEE region experienced a ten-fold increase

[4] Data for Serbia and Montenegro is available from 2006 and onwards.

in FDI inflows between 2000 and 2008 (from US$3.41 billion to US$36.67 billion) (see Figure 6). In the mentioned period, SEE countries attracted US$147.4 billion, while the largest FDI inflows were achieved in Romania (US$52.2 billion, or 35%), Bulgaria (US$42.2 billion, or 28.6%) and Croatia (US$21.1 billion, or 14.3%). Among the Western Balkan countries, Serbia has had the greatest success in FDI attraction, since it achieved US$17.3 billion, which represents about 11.7% of the total FDI inflows in the SEE region.

The robust growth of the FDI inflows in SEE countries after 2002 was caused by the privatization of public enterprises and the realization of large-scale projects (thanks to low production costs), as well as the EU pre-accession process. Economic reforms and the implementation of the Central European Free Trade Agreement (CEFTA) signed by the SEE countries were among the most important stimuli for FDI inflows. According to the data on the inward FDI stock/GDP ratio, it is obvious that SEE countries got accustomed to this type of foreign capital inflow. For instance, Bulgaria (90%) and Croatia (76%) had the highest

Figure 6. FDI Inflows in SEE Countries between 2000 and 2021 (in millions of dollars)



Note: AL – Albania; BA – Bosnia and Herzegovina; BG – Bulgaria; CR – Croatia; MK – Macedonia; ME – Montenegro; RO – Romania; RS – Serbia.

Source: Author's display based on UNCTAD, 2023

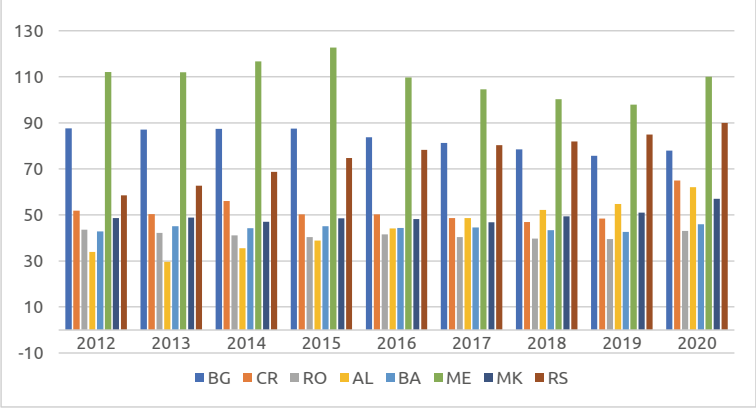
FDI stock/GDP ratios in 2007. Bulgaria has recorded the highest value of this ratio within the given region since 2004 (accounting for 98% in 2009). However, the global economic crisis of 2008 led to a large decline in the FDI inflow in this region. In 2009, Romania, Macedonia, Bulgaria, and BiH faced a decline in FDI of more than 60%. It is surprising that in such conditions, the level of FDI inflows actually increased in Albania and Montenegro.

Serbia, Romania and Bulgaria emerged among the top FDI destinations: they attracted 72% of the total inflows in this region. In 2012, FDI inflows were still below the peak reached in 2008 (Zvezdanović Lobanova et al., 2014). The most of the FDIs in this region were vertical FDI type, implying that foreign investors were attracted by cheap labour force, as well as the progress made on the path towards EU membership (Mamučevska & Nikolovska, 2018). The European debt crisis put additional pressure on the aggregate demand and FDI. However, SEE countries recorded a higher level of FDI inflow in 2013 than in the previous year, due to the privatization of the remaining state-owned enterprises in the services sector (UNCTAD, 2014).

The FDI inflows in 2013–2016 remained at a constant level, while Romania and Serbia were the largest FDI recipient in the region. For instance, the average level of FDI inflows in Romania and Serbia were at US$ 3.9 billion and US$ 2.3 billion, respectively. According to UNCTAD, foreign investors mostly targeted manufacturing in this region (UNCTAD, 2015). In 2015, Croatia recorded the lowest level (the lowest in the entire period of observation) of FDI inflow due to negative inflows to manufacturing (coke and petroleum industry), and lower greenfield investment (Hunya & Schwarzhappel, 2016). For two consecutive years (in 2017 and 2018), the FDI inflows were growing in all countries with the exception of Bulgaria and Montenegro. In 2018, FDI inflows to Serbia increased by 44%, making the country the second largest FDI recipient among the transition countries (UNCTAD, 2019). It is noteworthy that North Macedonia reached an increase of FDI inflows by more than 250%, directed to the automotive industry in the Technological Industrial Development Zones. During the same year, Croatia recorded a drop of 43% to US$1.2 billion, while the Bulgarian decline amounted to 21%, i.e. to US$2 billion.

The large differences in the success of attracting FDI can be also identified by observing inward FDI stock (see Figure 7). For instance, in 2011 only three SEE countries were responsible for the largest part (overall 76.1% – Romania 36.7%, Bulgaria 24.1% and Croatia 15.3%) of the total inward FDI stock. In comparison to 2021, the share of these countries changed insignificantly (70%), while the share of Serbia's FDI stock increased (from 13% to 18%). SEE countries based their development strategy on attracting foreign investors and were largely dependent on the inflow of foreign capital. In 2019, FDI stock represented more than 50% of GDP in this group of countries (in Montenegro 104,1%, Serbia 82%, Bulgaria 77%, Albania 57,4%, North Macedonia 51%).

Figure 7. FDI Stock as Percentage of GDP in SEE Countries in the 2012–2020 period



Note: AL – Albania; BA – Bosnia and Herzegovina; BG – Bulgaria; CR – Croatia; MK – Macedonia; ME – Montenegro; RO – Romania; RS – Serbia.

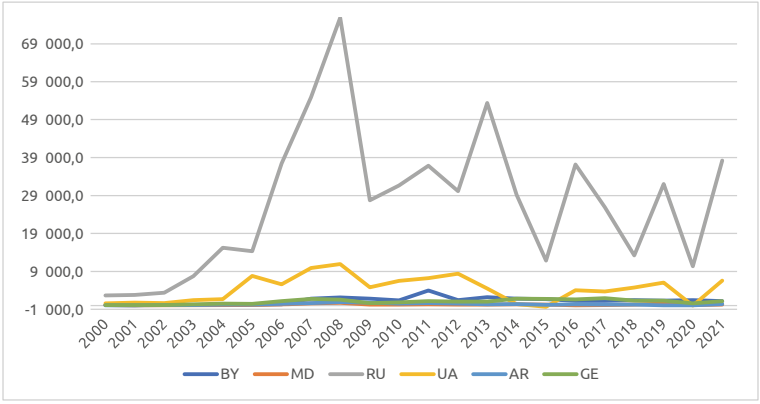
Source: Author's display based on UNCTAD, 2023

The total FDI inflows in 2020 amounted to US$12.7 billion and was reduced by 14% due to the spread of the negative effects of the COVID-19 pandemic. All SEE countries experienced a decline in FDI inflows which amounted to 65.5% in Croatia, 48.4% in North Macedonia, 40.7% in Romania, 18.7% in Serbia and 13.9% in Albania. In comparison to 2019, the FDI inflows in 2020 increased substantially in Bulgaria – 86.5%, BiH 26.9% and Montenegro 15.6%.

2.8.3 *Commonwealth of Independent States, Ukraine and Georgia*

From the early 2000s to 2008, the Commonwealth of independent states (CEB) and Georgia saw a continuous growth in FDI inflows, which increased twenty-four-fold, as can be seen from Figure 8. These inflows were mainly concentrated in Russia and Ukraine (94% of the total FDI to the CIS region). In terms of their share in the total FDI stock in all 27 transition countries, CIS countries and Georgia experienced an increase from 15% in 1995 to as high as 43% in 2007. As expected, Russia experienced the highest level of FDI inflows within the CIS region in the period covered. The FDI inflows in CIS countries, Ukraine and Georgia reached their peak in 2008. According to UNCTAD, Russia was the target of four mega M&A deals during that year (UNCTAD, 2009). However, in 2009, after a nine-year upward trend, the FDI inflows to CIS countries, Ukraine and Georgia declined by 51%. All the economies experienced a large reduction in FDI inflow (Russia by 70%, Ukraine by 56%, and Georgia by 58%). However, in the early 2010s, FDI inflows started to

Figure 8. FDI Inflows in CIS Countries, Ukraine and Georgia between 2000 and 2021 (in millions of dollars)



Note: Note: AR – Armenia; BY – Belarus; GE – Georgia; MD – Moldova; RU – Russia, UA – Ukraine.

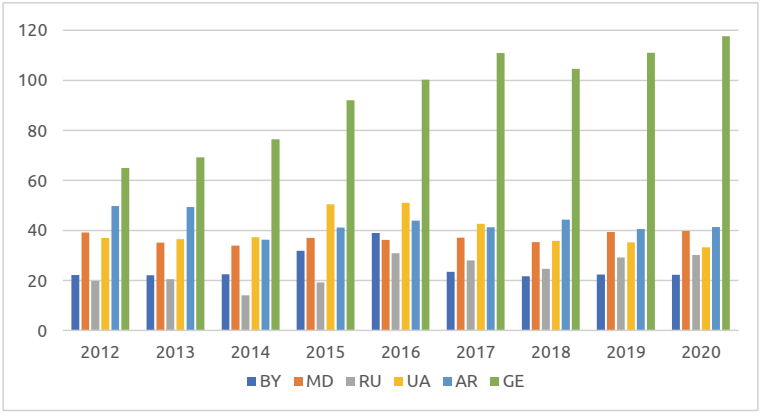
Source: Author's display based on UNCTAD, 2023

recover and reached record levels again in 2013. In 2011, C-B M&As peaked for this region (US$31 billion). Russia emerged as the main C-B M&A destination with an average share in the total volume of M&A deals of around 85%. Russia was the world's third largest recipient of FDI and the fourth largest investor in 2013, mostly due to a single large deal (UNCTAD, 2014). Its FDI inflows grew eight-fold, from US$7.9 billion in 2003 to US$69 billion in 2013.

In the last 10 years, the annual FDI inflows to the Russian Federation had grown by almost five times, from $15 billion in 2004 to $69 billion in 2013, before they fell dramatically in 2014. In 2014, the FDI inflows in the CIS region, Ukraine and Georgia fell by 67% to US$25 billion due to the consequences of regional conflict and sanctions against Russia. Because of the imposed restrictions, the sharp depreciation of its national currency, and other macroeconomic influences, Russia attracted just US$21 billion of FDI – 70% less than in 2013. Ukraine also experienced a drastic decline in FDI inflows (of 90%) because of the military conflict in the Donbass region and associated geopolitical risks, which reduced the confidence of foreign investors. The extremely low inflow of FDI was a consequence of the withdrawal of capital by investors from Russia and Cyprus (UNCTAD, 2015).

In 2015, the sharp drop in FDI inflows in Russia was associated to various factors such as economic downturn, the Western embargo on Russian entities, banks limiting international transactions, new Russian anti-Offshore policy and tightening of the EU regulations on capital transitions. FDI solely consisted of reinvestment of earnings by foreign investors, while the inflow of equity and loan instruments recorded a negative trend (Hunya & Schwarzhappel, 2016). In comparison to the previous year, the FDI inflows in 2016 almost tripled from US$ 15 billion to US$ 44.5 billion. Russia, Ukraine and Armenia were the main FDI host countries that recorded remarkably high inflows in 2016, following unusually low inflows of the previous year. However, in 2018, the FDI inflows to Russia halved to US$13 billion, as foreign investors' decision were affected by geopolitical developments.

Figure 9. FDI Stock as Percentage of GDP in CIS Countries, Ukraine and Georgia in the 2012–2020 period



Note: Note: AR – Armenia; BY – Belarus; GE – Georgia; MD – Moldova; RU – Russia, UA – Ukraine.

Source: Author's display based on UNCTAD, 2023

In the period from 2012 to 2020, the stock of FDI as a percentage of GDP was noticeably higher in Georgia (more than 100 % since 2016), while in Armenia and Moldova amounted to about 40% (see Figure 9). CIS region, Ukraine and Georgia registered several drops in foreign investment activity (in 2008 – 36%; in 2015 – 54.8%; in 2017 – 25%; and in 2020 – 69.6%). Such patterns of FDI were associated with Russian Federation as the largest FDI recipient in the region (accounting for 80% of the FDI inflows in region in 2021) – economic sanctions against Russian Federation and the presence of political risks (Knobel & Zaitsev, 2019). Unfortunately, the pre-crisis level of Russian FDI inflow (global financial crisis of 2008–2009) which amounted US$ 75 billion, has never been reached again.

The CIS, Ukraine and Georgia countries have been severely affected by the COVID-19 pandemic: the FDI inflows were down by 70.6% in Moldova, 67.5% in Russian Federation, 57% in Georgia, 52.3% in Armenia, while the only Belarus recorded a higher FDI inflows in 2020. The strongest decline was experienced by Ukraine, where the FDI inflows decreased by almost $6 billion, turning into net disinvestment ($36 million). It is noteworthy

that the FDI inflows in this region declined more than threefold, to US$ 12 billion, to their lowest level since 2003. According to Adarov and Hunya, international capital investments, both in terms of FDI flows and greenfield investments in manufacturing sector, were the most vulnerable, because of the COVID-19 pandemic (Adarov & Hunya, 2020). A further decrease in FDI inflows is expected due to the Ukraine military crisis, political instability, deteriorating conditions of financial markets, as well as macroeconomic problems, such as rising interest rates and higher energy prices on domestic demand. The conflict in Ukraine has prevented not only the recovery of the investment activity, but has also caused significant changes to the FDI structure.

3 THE SOUNDNESS OF INSTITUTIONS IN TRANSITION

In Chapter Three, we analyse major economic challenges and risks in transition countries during their post-socialist system transformation. The importance of institutions as drivers of FDI inflow is explored based on the review of the most recent empirical studies which deal with this topic. In this part, special attention is dedicated to an overview of the institutional arrangements in different groups of countries, by outlining the crucial economic, political and social struggles in reform implementation. We also highlight the role of well-crafted institutional setting in providing the necessary structure for economic activities and creating a conducive environment for market-oriented reforms.

3.1 NAVIGATING ECONOMIC TRANSITION: CHALLENGES AND RISKS

The major constrains for the former centrally planned economies were the lack of market-oriented infrastructure and limited integration in the world economy. The countries encountered an institutional vacuum and the growth of transaction costs for adaptation to the market business conditions and formation of new institutional framework during the first years of their transformation. The post-socialist system transformation has undergone two separate phases (Exeter & Fries, 1998). During the first phase, transition countries implemented market and trade deregulation, privatization of the state-owned enterprises, while the government involvement in various spheres was diminished. The second phase was more demanding and challenging, since it implied building and enhancing public and private institutions, the drivers of effective market economy, raising national

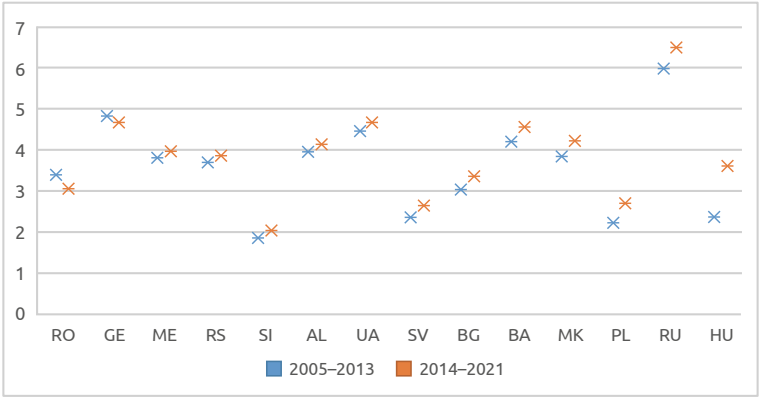
capacity for revenue generation and public service provision, as well as secure implementation of sound business strategies.

Transition countries were advised to limit the scope of the state influence as quickly as possible, which created a huge dilemma for them – whether to reduce the power of the state, or to create a need for those state capabilities that were either weak, or non-existent (Fukuyama, 2000). Unfortunately, over time, it became evident that these countries had merely decided to reduce the scope and strength of state institutions. Although there were significant differences in their initial conditions, De Melo et al. point out that all transition countries were marked by a strong common legacy (De Melo et al., 1996). According to their opinion, the four crucial features of this common legacy were the achievement and maintenance of macroeconomic balance through direct control, economic activity coordination via planned efforts, distorted prices, and practical absence of the private ownership. Moreover, the communist legacy implied the existence of companies whose efficiency was questionable, while their managers were not chosen based on the expertise and abilities, but rather for political loyalty (Jeffries, 2002).

During the 1990s, the construction of democratic societies in the CEE frontrunners, in which political rights and civil liberties had taken precedence over the dominance of single political ideology and untouchable political group, began (Demeš, 2011). The first decade of the 21st century was characterized by various unexpected political, economic and security challenges not only in CEE, but also in the other transition countries, which largely contributed to setbacks in democracy and human rights. In Figure 10, we show the transition countries which achieved the most significant progress/deterioration during the periods 2005–2013 and 2014–2021, using the data from Freedom House (Fredom House, 2023). The selection of the post-2004 period was deliberate, since in that year, as many as eight transition countries from our sample received the status of EU member states. This suggest that these countries, among other achievements, established stable institutions as the guarantors of democracy, the rule of law, protection of human rights and minority legal protection. As it can be seen from figure 10, the NMS

countries from the fifth wave of expansion that have recorded the largest deterioration in their democracy score are Hungary, Poland and Slovakia. The state of democratic institutions has improved significantly in countries such as Romania and Georgia, while Belarus and Russia are considered by Freedom House as non-democratic countries.

Figure 10. Democracy Scores in 2005–2013 and 2014–2021: the Transition Countries with the Most Significant Changes



Note: We have assessed the rankings based on the average Democracy Score for 2005–2013 and 2014–2021 periods. Democracy Score ranges between 1 and 7, where 1 indicates the highest and 7 represents the lowest degree of democracy within the selected countries.

AL – Albania; BA – Bosnia and Herzegovina; BG – Bulgaria; GE – Georgia; HU – Hungary; MK – Macedonia; ME Montenegro; PL – Poland; RO – Romania; RU – Russia; RS – Serbia; SK – Slovakia; SI – Slovenia; UA – Ukraine.

Source: Author's research based on the data from Freedom House, 2023

The burning issue for policymakers was how to provide the guarantee of private property rights that was closely associated with the establishment of a democratic society. These vulnerabilities in the property rights' protection, as well as growing state power, has reflected on the readiness of the local and foreign investors to invest in post-communist countries (Aslund, 2018). The most concerning challenge was the large-scale privatization of politicizing state-owned enterprises characterized by political interference and persistent excess in workforce.

King asserts that the rapid and mass privatization of large enterprises implemented in line with the neoliberal principles caused multiple supply and demand shocks, which represented significant barrier for the firms striving to navigate successful restructuring, creating a fiscal crisis for most enterprises and the state (King, 2003). The state-owned enterprises (in particular the Soviet ones) received more freedom in decision-making and a possibility to preserve a large proportion of their profits. In addition, the financial oversight of enterprises have been eased, while the short-term credits were granted to enterprises practically on their demand (Montias, 1990).

Organized crime flourished during the initial phase of transformation and its entities successfully managed to infiltrate and become integral parts of state institutions. It originated from the informal networks of the communist era, macroeconomic volatility, the diminished state marked by the shortcomings in regulatory and law enforcement capacities, criminal privatization and inadequate institutional setting (Ivanova, 2012). The empowerment of both the state and self-interests of organized crime entities caused the broadening of their involvement with political structures. In such conditions, a complex nexus of interdependency was created, in which political representatives and individuals from criminal networks collaborated by sharing their own resources and provided mutual support (Stephenson, 2017). The escalation of criminal behaviour was stimulated by disorganized macroeconomic systems marked by frequent change of regulations on economic activity (Lotspeich, 1995). Given the situation, individuals were encouraged to engage in illegal activities since the possibility of detection and punishment was very low.

The three main strategies at the very beginning of the transition process were shock therapy, neoclassical gradualism and post-Keynesian model. Poland, Latvia, Lithuania, Czech Republic, Slovakia, Estonia, Russia and Bulgaria belonged to the group of transition countries which opted for the 'big-bang' or neoclassical shock therapy approach (rapid liberalization, privatization and implementation of macroeconomic stabilization measures), while Slovenia, Romania, Georgia and Croatia progressively phased out their planned economy systems. Berg et

al. argue that BRO countries' (Baltics, Russia and other countries of the former Soviet Union) comparative performance with CEE countries could be attributed to the successful structural reform implementation, rather than being solely influenced by the differences in their initial conditions (Berg et al., 1999). Based on their evidence, unfavourable initial conditions (such as trade dependency and over-industrialization) had a profound influence on the initial output decline, while decisive structural reform packages were seen as the primary impetus for recovery.

As highlighted by Falcetti et al., the initial conditions dominated the effects of reform on economic growth during the first decade of the transition (Falcetti et al., 2002). The authors demonstrate that the influence of initial conditions on reform levels wanes over time, as those that initially lag behind in reform tend to narrow the gap in subsequent years. These findings imply a trend toward convergence in both economic growth and reform among countries, regardless of their starting conditions, wherein progress can be hastened through steadfast dedication to reform efforts. While the starting conditions did not influence the trajectory of the Type I reforms (price liberalization, small-scale privatization, cutting-down of subsidies, macroeconomic stabilization etc.), they had profound effects on the Type II reforms which included large-scale privatization, building of market-oriented legal system, labour market policies and rules (Svejnar, 2002).

3.2 THE INFLUENCE OF INSTITUTIONAL SETTING ON FDI INFLOWS

The quality of institutions as FDI driver in transition countries, as well as their economic implications, became research topics of great interest in the first decade of the 21st century. The relevance of institutional drivers in shaping FDI inflows has been identified across a range of empirical studies. For instance, Minović et al. stress out that governance indicators such as political stability, rule of law and control of corruption boost FDI inflows in the Western Balkan region (Minović et al., 2021).

The authors assert that a reciprocal relationship exists between FDI inflows and anti-corruption measures, between the rule of law and corruption control, and between political stability and adherence to legal principles.

Gorbunova et al. argue that market stabilizing institutions had more pronounced significance for the attraction of foreign investors than the institutions advancing market formation during the peak of transition and in the post-transition period (Gorbunova et al., 2012). In addition, the possibility of obtaining the EU membership represents an additional confirmation to foreign investors that a transition country is on the right track i.e. that solid market institutions have been established and transformation successfully finalised. The similar findings have also been made by Tintin who argues that EU membership was of crucial importance in encouraging a higher level of FDI inflow in the CEE countries (Tintin, 2013). Moreover, the strength and competence in facing challenges and vulnerability, available political rights and civil liberties, as well as economic freedom were also beneficial for these countries in acquiring capital.

By investigating some crucial aspects of both institutional and cultural behaviour of transition countries, Silajdzić and Mehić find that specific cultural features hold greater significance than formal institutions for MNCs' strategic decisions concerning geographic positioning (Silajdzić & Mehić, 2020). According to their findings, cultural values and informal economic structures have potential to bridge the gaps of underdeveloped institutions in transition countries. Ovin and Maček point out that the common denominator for disinvestment sentiments was mixed success in transition countries, while the gap in institutional transition prevented connection with interests of foreign investors and host country (Ovin & Maček, 2021) point out that the common denominator for disinvestment sentiments was mixed success in transition countries, while the gap in institutional transition that prevented connection with interests of foreign investors and host country. On the other hand, the factors that promote and stimulate institutional development in some of the transition countries include the initial conditions that reflect historical, cultural and socio-economic context, abundance of natural resources, as well

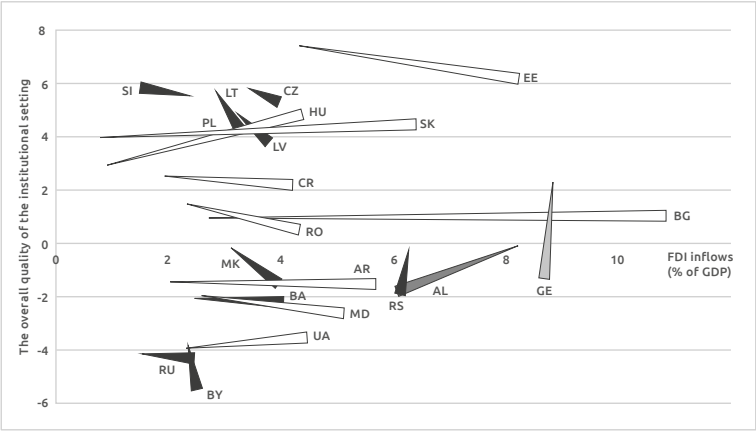
as the aspiration of accession to the international organization such as the North Atlantic Treaty Organization (NATO), the EU and the WTO (Piątek et al., 2019). These determinants have been shown to have a long-term impact on the quality of the institutional setting (development of economic and political institutions), showing the presence of institutional path dependence.

In Figure 11, we demonstrate the interlinked relationship between the FDI inflow and quality of institutions. We computed the global governance indicator as the sum of the averages scores across all governance dimensions for the countries included in our sample for 2002–2013 and 2014–2021, and the average FDI inflow as a percentage of GDP across the same time span. The arrows depicted on the graph indicate the change in the status of the specified country since the early 2000s, with the colours reflecting the interdependence between institutional structures and the significance of FDI in the economy.

Countries featured in black in the graph (Czech Republic, Poland, Slovenia, Latvia, Lithuania, Serbia, BiH, North Macedonia, Russia, Belarus) constitute the group characterized with no significant dynamics of FDI inflow as a percentage of GDP, whose institutional environment remained largely unchanged. Georgia's example confirms the hypothesis regarding the non-interdependence of the considered indicators (light-grey arrow). One can explain that experts might overestimate the success of institutional reforms when there is no noticeable increase in FDI attraction to the local market, especially amid investment deficits and a shortage of internal capital sources.

It is noteworthy, that our estimates for 2000–2004 and 2010–2014 periods show that alterations in the quality of the institutional framework did not significantly impact the country's performance as a recipient of foreign investment. However, such changes could prove consequential when combined with other factors. Our analysis revealed that North Macedonia, Serbia, Albania, and Belarus consistently exhibited persistently negative values across governance indicators. However, simultaneously, they experienced notable growth in relative indicators of FDI inflow, suggesting that the experts assessing their institutional development success potentially undervalued them. But for the

Figure 11. Mapping Linkages: Institutional Performance and FDI Inflow



Note: The comprehensive evaluation of the institutional environment is determined by computing the average global governance indicator spanning from 2002 to 2013 and from 2014 to 2021. Global governance is derived from the mean value of the six indicators for each country in our sample.

The arrow illustrates the shift in the country's position from the period 2002–2013 to that of 2014–2021. Its colour reflects the nature of the correlation between the institutional framework and the significance of FDI inflows in the national economy. For instance, dark grey: governance indicators showing negative values, yet witnessing notable growth in relative FDI performance (suggesting underestimated governance improvements); light grey: absence of correlation between institutional framework and FDI inflows (in certain cases, potentially overestimating success of governance reforms); black: minimal changes observed in the institutional framework and FDI attractiveness; white: substantial decrease in FDI attractiveness alongside sustained governance levels.

AL – Albania; AR – Armenia; BY – Belarus; BA – Bosnia and Herzegovina; BG – Bulgaria; CR – Croatia; CZ – The Czech Republic; EE – Estonia; GE – Georgia; HU – Hungary; LV – Latvia; LT – Lithuania; MK – North Macedonia; MD – Moldova; PL – Poland; RO – Romania; RU – Russia; RS – Serbia; SI – Slovenia; SK – Slovakia; UA – Ukraine.

Source: Author's research based on World Bank, 2023 and UNCTAD, 2023

periods 2002–2013 and 2014–2021 this conclusion can only be drawn in relation to Albania (see Figure 11, dark grey arrow).

Finally, the countries depicted in white (Hungary, Slovakia, Estonia, Croatia, Bulgaria, Romania, Armenia, Moldova, Ukraine) exhibit a common trend: a significant decrease in relevant figures of FDI attraction in 2014–2021 compared to 2002–2013, which had no correlation with institutional development – the

quality of institutional setting remained practically the same. The reason behind this can be attributed to the decline in the pace of privatization across most of these countries. Additionally, in certain instances, this phenomenon could be clarified by a reduced level of competitiveness in the global capital market, or a shift towards a model centred on exploiting the advantages of a sizable domestic market.

3.3 OVERVIEW OF INSTITUTIONAL ARRANGEMENTS: PROGRESS OR BACKSLIDE

In the parts that follow, we highlight the institutional achievements in transition countries. Their progress in the field of building and strengthening of institutions has been determined based on the comparative analysis and the indicator derived from the WGIs data.

3.3.1 *Institutional Transformation: Central-Eastern European and Baltic Member States*

During the 1990s, the CEB region was characterized by considerable heterogeneity among the countries, while the EU integration was seen as the only resilient strategy to overcome these gaps (Langewiesche, 2016). Being strongly oriented towards the EU integration, CEB countries were motivated to satisfy the Copenhagen criteria, as the foundations of the enlargement policy. The Copenhagen criteria imply (1) successful establishment of institutional equilibrium that guarantees democracy, the rule of law, respect for human rights and the protection of minorities, (2) a functional market economy, as well as ability to cope with the pressure of competition in the single market of the EU, and (3) the rights and obligations deriving from EU membership and Community law (commitment to the goals of political, economic and monetary union) (European Commission, 2022). EU accession process implied the implementation of legal and technical requirements aimed at a thorough

transformation of the administrative and judicial structures in potential member countries.

The eight CEE countries signed Association Agreements (AA) with the EU during the 1991–1996 period (Demeš, 2011). The accession negotiations started in 1998 for Hungary, Poland, Estonia, the Czech Republic and Slovenia, while for the Slovakia, Lithuania and Latvia, this process was initiated in 1999. Since the negotiations were successfully finished in 2002, the most comprehensive enlargement in EU's history occurred in 2004. It is denoted as the fifth wave of enlargement when ten countries join the EU, the majority of them being members of the former Eastern Bloc. The NMS[5] successfully complied with the EU law since they managed to establish administrative expertise (with the aim of overcoming deficiency in public management) for aligning with the EU legislation as a prerequisite for EU membership (Sedelmeier, 2016).

The prospect of EU membership had crucial influence on filling in the institutional vacuum that arose due to the collapse of socialism (Campos, 2021). Successful removal of this vacuum had significant political, as well as economic implications. The impacts of conditionality related to the accession to the EU and NATO on the institutional development in transition countries, proved to be positive and significant (Schweickert et al., 2011). The EU influenced candidate countries through its motivational power (by offering the prospect of membership and emphasizing the fulfilment of the accession criteria), economic power (encouraging trade integration and FDI attraction, ensuring financial resources through various funds) and institutional power (the establishment of numerous institutional arrangements) (Stoian, 2007). EU membership represented some kind of 'soft security' for this group of countries, in tandem with the 'hard security' assurance associated with NATO membership. The EU integration processes can be observed as an anchor that has supported the governments of transition countries in introducing the institutions of the market economy (Ovin, 2001).

[5] The eight CEE countries are Estonia, Latvia and Lithuania, Slovakia, Slovenia, Poland, Czech Republic and Hungary.

In the wake of the EU integration, both old and new members experienced robust advancements, while their integration into the EU structures turned out to be a win-win situation (Palánkai, 2010). EU enlargement proved to be a driver for further comprehensive reforms, providing the NMS necessary assistance to align with European values, standards and practices. For instance, Hagemeyer et al. investigated the NMS' performance in the period 6 to 12 years after their joining (Hagemeyer et al., 2021). Their findings suggest that the positive outcomes of memberships are long-lasting and grow gradually, and are large on average, but not universal. The authors stress out that the economically advanced NMS such as Czech Republic and Slovenia recorded modest benefits from the EU membership unlike others.

On the other hand, Jovanović and Damjanović explain the economic aspect of eastern enlargement as a 'hybrid bag of effects for the EU's eastern countries because membership in the EU is not a tide that lifts all boats' (Jovanović & Damjanović, 2014). Their empirical study shows that the main economic benefits for the NMS have been better economic outlook, trade expansion and higher FDI inflow, while, on the flip side of the coin, there has been an increase in their domestic and foreign debts, because of the need to back up their achievements. Immediately after joining the EU, this group of countries faced post–accession crisis whose socio-economic impacts have overwhelmed their governments. The NMS were quite exposed to the EU pressure regarding the requirements for membership (institutional changes, euro-zone and Schengen acquis) and social consolidation (reaching the 'normal' level of standard of living and public services) (Agh, 2010).

During the second half of the 1990s, nearly all CEB countries attained notable scores in terms of price liberalization, signifying their successful alignment with the standards and performance expected of a market economy. The economic performance of CEB countries which carried out the major institutional reforms during the initial ten years of their transition, outperformed others in terms of economic results. Nevertheless, after becoming the EU member states, the speed of reform progress, as well as the enthusiasm for implementing change,

has significantly dropped. Contrasting the World Bank data from 2013 and 2021 (see Table 3), we conclude that Poland recorded a decline in the quality of institutional setting in all areas of governance. Hungary achieved improvements only in the realm of political stability and the prevention of violence, while Slovakia has only made strides in enhancement of legal framework.

Table 3. Comparative Governance Assessment for CEB Countries (2021 vs. 2013)

Country	Voice and accountability		Political stability		Government effectiveness		Regulatory quality		Rule of Law		Control of Corruption	
	2013	2021	2013	2021	2013	2021	2013	2021	2013	2021	2013	2021
CZ	0,98	1,02	1,08	0,96	0,92	1,11	1,07	1,34	1,02	1,12	0,29	0,64
EE	1,12	1,19	0,74	0,75	0,97	1,38	1,44	1,56	1,19	1,42	1,18	1,54
HU	0,73	0,40	0,79	0,86	0,68	0,63	0,89	0,49	0,58	0,53	0,29	0,03
LV	0,77	0,91	0,59	0,68	0,88	0,87	1,03	1,22	0,76	0,98	0,32	0,74
LT	0,94	1,04	0,96	0,81	0,82	1,05	1,15	1,27	0,83	1,11	0,41	0,85
PL	0,99	0,58	0,97	0,51	0,66	0,29	1,05	0,84	0,84	0,44	0,64	0,57
SK	0,96	0,91	1,12	0,56	0,72	0,53	0,93	0,87	0,46	0,71	0,04	0,23
SI	1,00	0,91	0,88	0,76	1,01	1,17	0,62	0,83	0,99	1,03	0,72	0,71
CEE	**0,94**	**0,87**	**0,89**	**0,74**	**0,83**	**0,88**	**1,02**	**1,05**	**0,83**	**0,92**	**0,48**	**0,66**

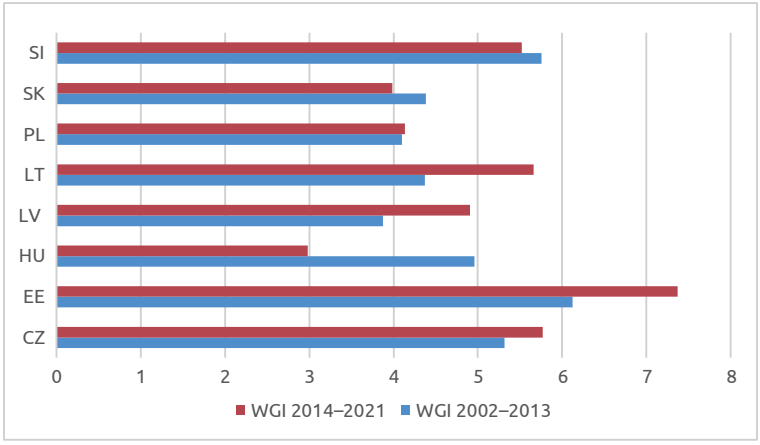
Note: CZ – The Czech Republic; EE – Estonia; HU – Hungary; LV – Latvia; LT – Lithuania; PL – Poland; SK – Slovakia; SI – Slovenia.

Grey colour represents the positive development of governance indicator.

Source: World Bank, 2023

In Figure 12, we show the ranking of the CEB countries based on the global governance indicator, as the total of the average scores across all governance dimensions (Fabry & Zeghni, 2010) for each CEB country across two periods: 2002–2013 and 2014–2020. The value of the governance dimensions may fall within the range of -2.5 to 2.5, meaning that lower values signify lower quality of institutional settings, and vice versa. The value of the calculated global governance indicator has a potential variation between -15 and +15. According to our calculation for the CEB countries, it ranges from 2.98 to 7.37.

Figure 12. Global Governance Performance of CEB Countries



Note: CZ – The Czech Republic; EE – Estonia; HU – Hungary; LV – Latvia; LT – Lithuania; PL – Poland; SK – Slovakia; SI – Slovenia.

Source: Author's own calculation using the data from the World Bank, 2023

Estonia, Czech Republic, Lithuania, and Slovenia have demonstrated the highest level of governance in the CEB region over a long term, earning recognition as frontrunners in institutional quality. Estonia demonstrates exceptional performance across a wide range of governance areas and its governance performance is noticeably better than that of its neighbours. This country is also best positioned according to the EBRD's transition scores regarding the six dimensions of sustainable market economy. In comparison to the period 2002–2013, Slovenia, Slovakia and Hungary recorded deterioration in their overall score of institutional setting. The institutional development achievements in Hungary have been deteriorating since the 2008, due to the factors such as a high level of corruption and informal power networks as the key pillars of party-state capture (BTI, 2023). As for 2014–2021, the country lags significantly behind the regional average. Until 2015, Poland was achieving improvements in all aspect of state governance, but subsequently the performance deteriorated. The level of democracy has continuously declined with the introduction of media and civil society restrictions. Backsliding has been noted in all aspects of governance

and the most problematic areas include voice and accountability, political stability and government effectiveness.

Slovakia has obtained the notably lowest WGI score among the CEB countries concerning fight against corruption and maintenance of the established rule of law. According to the estimates, the burning issue for the Slovak government is the pervasive corruption, which has undermined the macroeconomic stability. The least effective country in terms of political stability and the prevention of violence is Latvia whose value of the indicator has highly oscillated during the observed period. The lagging behind the other CEB countries could be explained by the fact that the Latvian political system is under undue influence of the powerful Latvian 'oligarchs' (BTI, 2023).

3.3.2 *Institutional Developments in the South-Eastern European Member States and Candidate Countries*

After the collapse of communism during the 1990s, the SEE countries have been experiencing fundamental transformative processes. The foundation of the decentralised system required comprehensive changes (legislative, economic and political). The first elections were organized in 1989–1992. The 1990s were marked by disorder for the entire region, dissolution of Yugoslavia and dramatic collapses of output, which can be attributed to the old-type of state-citizens relations (Jano, 2008). Several processes, such as deterioration of economic situation, ethnic conflicts and wars in the former Yugoslavia, restructuring of ownership rights, raising poverty and inequality, etc. occurred simultaneously.

Unlike other communist countries, the Socialist Federal Republic of Yugoslavia (SFRY) already had some experience with market-oriented economic reforms (for instance, the proclamation of worker's self-management in the early 1950s) (Uvalić, 2010). Unfortunately, the majority of the SEE countries were marked by governance incapacity, which hindered the formation of a democratic society and the shift towards a market economy. The implementation of comprehensive institutional

and structural reforms in order to promote private sector and foreign activity were called into question due to deep-rooted social, economic and political challenges. The SEE countries achieved different results on their path to market economy, since some of them (like Bulgaria and Romania) were more successful and faster in the transformation process (despite the economic instabilities which they expirienced in the second half of the 1990s). The EU integration process in Romania and Bulgaria started in the early 1990s, after the fall of communism. In 1993, these countries signed the AA (came into force in 1995), which enabled the gradual establishment of a free-trade area, cooperation in economic, financial and cultural matters, conduction of regular political dialogue and approximation of legislation (CVCE, 2023). The macroeconomic stabilization programmes were introduced in 1991 in Bulgaria, 1992 in Albania and 1993 in Romania, but did not succeed in solving the majority of the problems.

In order to support Bulgaria's and Romania's preparations for joining, the EU defined a pre-accession strategy in 1994 which was based on substantial financial assistance. Namely, the financial assistance was transmitted via three pre-accession instruments: Phare programme (Poland and Hungary: Assistance for Restructuring their Economies)[6], SAPARD (Special Pre-Accession Programme for Agriculture and Rural Development) and ISPA (Pre-accession Instrument for Structural Policies) (Hubbard & Hubbard, 2008). The main advantage of the EU enlargement process was reflected in the fact that it remarkably reinforced economic, political and institutional reform efforts in the candidate countries. The accession negotiations for Romania and Bulgaria started in 1999, but they failed to join the EU in May 2004 because of the lack of integration process results. Since the economies of Romania and Bulgaria recovered faster than those of their neighbours and met the Copenhagen accession criteria, they became a part of the EU in 2007 in the fifth wave of the EU enlargement. Their joining the EU meant that they

[6] This programme was originally formulated for Poland and Hungary but it was later expanded on other countries.

managed to establish functional market economy (economic conditionalities), effectively implement the EU acquis (political/administrative conditionalities) and provide stable political institutions, protection of minorities, democracy and rule of law (political conditionalities).

Unfortunately, others countries from SEE region were faced with serious difficulties, such as armed conflicts, authoritarian regimes, UN sanctions against the Federal Republic of Yugoslavia (FRY), NATO bombing of FRY, Greek trade embargo on the former Yugoslav Republic of Macedonia (FYROM), etc. Unlike the other post-socialist countries of Central and South-Eastern Europe, the former Yugoslavia started an effective transition with a delay of ten years because of the political events of the 1990s. Serbia, Montenegro, and BiH were the last countries in the SEE region that have begun a comprehensive transition toward market-based systems (for instance, BiH in the second half of the 1990s, Serbia and Montenegro in early 2000s). That is the reason why they tried to implement rapid and notable transformation of institutional setting and significant structural and economic reforms in order to catch up with other SEE countries, and mitigate economic volatility. These countries were stimulated to carry out comprehensive changes of their political systems and institutional environment with the aim to eliminate the 'governance gap' between them and the EU. Bearing in mind that sudden socioeconomic changes were implemented in these countries, it is not surprising that the institutional framework and necessary control mechanisms were not quickly and normally established.

In 1999, the EU Council launched the Stabilisation and Association Process (SAP) in order to established legal framework for cooperation among Western Balkan countries and gradual approximation to European standards. In order to promote good neighbourly relations and peace in the region, the EU ensured political and financial support for these countries. The SAP aimed to stabilize the Western Balkan countries, support their transition to market economy and strength the regional cooperation with the prospect of accession to the EU. The SAP is based on the idea that EU accession of Western Balkan countries is not

possible without stability in the region, while the stabilization is achieved much more effectively when the goal – integration – is correctly defined (Ćeranić, 2012). At approximately the same time, another initiative was launched, namely the Stability Pact for Southeastern Europe (established in 1999), which was supposed to serve as an important form of building new relations in the region (mitigation and elimination of instability and hostility, termination of war tensions). The initiative to create a free trade zone in the SEE region originated from the Stability Pact for Southeastern Europe with the intention to support these countries in the EU accession process. The signatory countries were obliged to demonstrate their ability to adopt and pursue a common economic policy and take responsibility for the future of the entire region.

In the first half of the 2000s, the prospect of EU accession had a very strong impact on the pace of institutional and economic reforms (especially in the area of strengthening the rule of law, protection of civil rights, democracy consolidation, improvement of economic governance) (Dabrowski & Myachenkova, 2018). Unfortunately, the legacy of violent conflicts and of the communist past strongly limited the progress towards EU accession. That is why it was of crucial importance to overcome the political challenges of EU accession, improve and maintain good neighbourly relation and step up the pace of reform implementation. A more significant step forward in the field of institutional and economic reforms was made after the signature of the SAA with the EU and again after the start of the membership negotiations (Zvezdanović Lobanova et al., 2023). North Macedonia (2005), Montenegro (2010), Serbia (2012), Albania (2014), and BiH (2022) have received candidate status. The EU has launched the accession negotiations with Montenegro in 2012, Serbia in 2014, North Macedonia and Albania in 2020.

In 2018, the European Commission announced the Strategy for the Western Balkans ('A credible enlargement perspective for and enhanced EU enlargement with the Western Balkans') that comprises six crucial initiatives: the rule of law; socio-economic development; digital strategy; transport and energy connectivity; security and migration control and reconciliation and

good neighbourly relations (European Commission, 2018). The implementation of these initiatives will provide support to the Western Balkan countries in meeting the Copenhagen criteria for accession to the EU.

Since the beginning of the 1990s, due to the war conflicts, the SEE region was considered problematic and still insufficiently stable. Despite the fact that all SEE-non-EU countries have been fully committed to the European integration, a deterioration of the quality of institutional setting has become evident in the last couple of years. Namely, an erosion of fundamental freedoms, disrespect for social justice and degradation of established democratic institutions and procedures have occurred. Since 2002, all the SEE countries have made progress in the field of the rule of law, denoted as the basic precondition for the EU membership. The rule of law is one of the main parts of the 'Fundamental First' approach and the EU-Western Balkans strategy which outlines six pivotal initiatives. The accession process is directly related to the progress achieved in this field by the candidate countries. Based on the WGIs data from 2002 onwards, the weakest progress in strengthening the rule of law was reported for Albania and BiH, which can be denoted as outliers in this governance category.

The control of corruption indicator had a negative score for 2013 and 2021 for all the countries, except Croatia (see Table 4). Since the mid-2010s, Albania, BiH and Serbia have shown deterioration of the value of this indicator due to the challenges of widespread corruption. Unfortunately, pervasive corruption remains serious concern for the governments of all SEE countries in spite of strong EU supports (technical expertise and financial aid through the Instrument for Pre-accession Assistance (IPA). Romania and Croatia are top ranked countries in this category, as they were achieving systematic improvements during the entire observation period. The high values of regulatory quality indices can be explained by the fact that the countries managed to build their capacity to adopt and implement EU law. Due to extensive regulatory barriers and burdens, BiH and Serbia are at the very bottom of the ranking in this analysis. They are denoted as countries with the regulatory frameworks most restrictive to

competition. For instance, according to the World Bank, barriers to competition and gaps in the regulatory process and administrative burdens on start-ups in Serbia are more distortive than in the EU member states (World Bank, 2019).

According to the governance indicators that measure the strength of political institutions (PSAV and VA), BiH and North Macedonia are the worst performers in the SEE region in the field of political stability. Since 2014, BiH's score in the category of voice and accountability has continuously deteriorated, because of the dysfunctional state and political institutions. The performance of North Macedonia in this governance aspect deteriorated in the period 2007–2016 due to very low levels of fundamental freedom of association and civil liberties and participation. In the category 'Political stability and absence of violence', the value of indicator for these two countries is below zero. The two countries also failed to raise public trust and confidence in the courts and judiciary to a greater extent and

Table 4. Comparative Governance Assessment for SEE Countries (2021 vs. 2013)

Country	Voice and accountability		Political stability		Government effectiveness		Regulatory quality		Rule of Law		Control of Corruption	
	2013	**2021**	**2013**	**2021**	**2013**	**2021**	**2013**	**2021**	**2013**	**2021**	**2013**	**2021**
AL	0,05	0,09	0,09	0,11	-0,32	-0,01	0,25	0,19	-0,52	-0,25	-0,75	-0,55
BA	-0,12	-0,31	-0,41	-0,38	-0,43	-1,04	-0,07	-0,17	-0,14	-0,28	-0,24	-0,64
BG	0,34	0,29	0,17	0,46	-0,02	-0,14	0,54	0,45	-0,15	-0,04	-0,32	-0,24
CR	0,51	0,61	0,64	0,71	0,68	0,59	0,37	0,50	0,18	0,30	0,11	0,06
MK	-0,06	0,14	-0,42	0,12	-0,17	-0,08	0,25	0,42	-0,23	-0,07	-0,05	-0,35
ME	0,18	0,17	0,50	-0,15	0,15	0,01	0,09	0,43	-0,03	-0,06	-0,29	-0,02
RO	0,31	0,60	0,18	0,53	0,13	-0,13	0,63	0,31	0,19	0,41	-0,30	-0,04
SR	0,28	-0,12	-0,07	-0,13	-0,18	0,05	-0,06	0,05	-0,30	-0,09	-0,32	-0,43
SEE	**0,19**	**0,18**	**0,08**	**0,16**	**-0,02**	**-0,09**	**0,25**	**0,27**	**-0,12**	**-0,01**	**-0,27**	**-0,27**

Note: AL – Albania; BA – Bosnia and Herzegovina; BG – Bulgaria; CR – Croatia; MK – Macedonia; ME – Montenegro; RO – Romania; RS – Serbia.

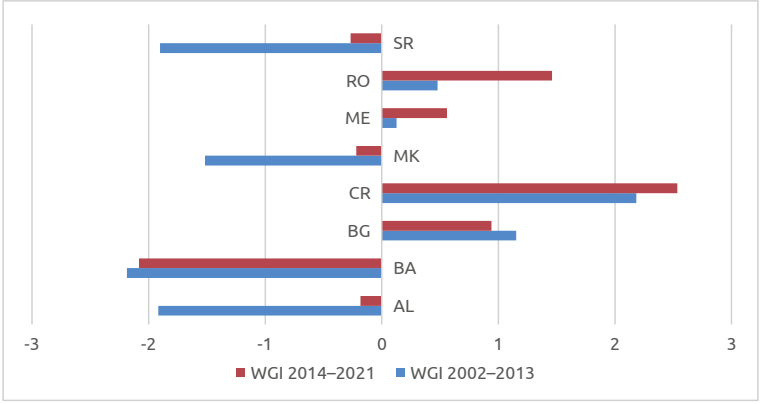
Grey colour represents the positive development of the governance indicator.

Source: World Bank, 2023

build a law-abiding society. Additionally, the government of BiH is denoted as highly inefficient due to the costly multiple levels of government, while the stormy past from the 1990s has deeply influenced the process of election and organization of its parliament and government.

According to the overall governance indicator in Figure 13, the institutional landscape underwent additional advancement across most countries. However, the results of BiH for almost all aspects of institutional arrangement (with the exception of political stability) deteriorated. The process of institutional change in BiH occurs within a complex legal framework characterized by multiple levels of governance. Although negligible improvements can be observed, BiH still lags far behind the neighbouring countries. Bulgaria also recorded a deterioration in its overall score, as well in particular governance indicators, which can be attributed to declining of trust in the institutions, widespread corruption, undermined rule of law and low judicial independence.

Figure 13. Global Governance Performance of SEE Countries



Source: Author's own calculation using the data from the World Bank, 2023

According to the EBRD's evaluations of six key dimensions essential for a sustainable market economy, SEE countries have failed to establish well-functioning and sustainable market economy, denoted as 'competitive, well-governed, green, inclusive,

resilient and integrated' (EBRD, 2023). In comparison to 2017[7], modest improvements were made in almost all areas, while decline tends to be concentrated in the integration scores (foreign trade openness, investment and finance, as well as internal and international infrastructure networks).

The EU member states from the SEE region could be marked as leaders in relation to institutional setting performance, while candidate countries are followers, since they continue to encounter difficulties associated with preserving stable macroeconomic conditions and strengthening of institutional frameworks. Due to the failure to achieve the economic and political convergence, as well as 'enlargement fatigue', the prospect of European integration has been called into a question. There is a justified fear that the willingness for further institutional reforms' implementation in the SEE non-EU countries will decrease due to the reluctance among EU members to admit new countries, as well as inability of these countries to fulfil the accession criteria. The slow process of reforms also causes the growing dissatisfaction of the people with the lack of economic conditions.

3.3.3 *Institutional Dynamics in the Post-Soviet Space*

The CIS countries, Ukraine and Georgia, as successor states of the former Soviet Union (FSU), initiated their transition to a market economy from a common starting point in the final stages of the Perestroika (synonym for restructuring in Russian language) which was adopted due to a deepening of economic crisis in 1986 (Dabrowski & Antczak, 1995). A couple of years before the collapse, some radical market-oriented reforms were implemented in the decades-old, rigid central market practice, as well as variety of changes in the political (Glasnost – openness) and economic systems (Uskorenie – acceleration of economic growth), the results of which were unsatisfactory and chaotic,

[7] Since 2017 EBRD started to track countries' progress against six key qualities of a sustainable market economy. The indicators range from 1 to 10, where 10 stands for the standards of a sustainable market economy.

causing sustained macroeconomic imbalances, challenging and hostile business environment and unstable institutional settings.

The transition to a market economy began in extremely difficult conditions, where the economic and political transitions in the post-communist countries were correlated, with the political one affecting the pace of economic reforms (Dabrowski, 2023). The year 1992 is taken as the beginning of the systematic transition in these countries, while stabilization programs were introduced mainly in 1994. The variations in the institutional development achievements among these countries can be explained by the diverse approaches taken in adopting transition strategies, particularly in terms of timing and sequencing of the reforms. For instance, Russia opted for the shock therapy approach, which was latter aborted, Armenia, Georgia and Ukraine implemented gradual reforms, while the policymakers from Belarus conducted only limited economic and political reforms.

As opposed to Poland, in Russia the privatization strategy envisioned by the Big Bang approach had disastrous and long-lasting effects. It included what seemed to be an egalitarian voucher privatization, as well as a 'top-down' privatization that was legalized in 1996 under the slogan 'loans for shares', although these were actually the loans through which the private sector corrupted the impoverished state (Milanović, 2022). According to the EBRD's transition indicators, the majority of given countries undertook crucial reforms, such as price liberalization and small-scale privatization, aside from Ukraine. Unfortunately, Moldova, Russia and Ukraine had become caught in political and an economic underreform trap of rent-seeking and oligarchy, but they managed to escape from it at the beginning of 2000s and recorded growth, with the exception of Ukraine (Aslund, 2015).

The second wave of reforms began after the Russian 1998 monetary and financial crisis, the impact of which was very strong throughout the post-Soviet region due to the intertwined economic relationships. In the early 2000s, political stability in Russia improved owing to the consolidation of power, while experts from international non-governmental organizations recorded a serious degradation in the institutional areas, such as voice and accountability (Szarzec et al., 2014). On the contrary,

other FSU countries were shaken by political 'earthquakes' during the first decade of the 21st century. For instance, in Ukraine the so-called Orange Revolution in 2004 sparked by the large social protests after the presidential elections; in Belarus the social protests of 2006 (the so-called Jeans revolution) were held due to the similar reasons, as well as due to the restriction imposed on the opposition; in Georgia the so-called Rose Revolution in 2003. The common denominator of the problems of all these countries was widespread institutionalized corruption, which permeated all other spheres of social action. Therefore, Black and Tarassova point out that to control the corruption was a core element of successful transition, since the privatization in the CIS countries marked by weak institutional setting did not yield notable improvements in efficiency through substantial restructuring (Black & Tarassova, 2003). This process was plagued by pervasive corruption and created new class of oligarchs who have been standing against continuation of the reform initiatives. The trajectory and speed of institutional reform was deeply influenced by the socialist legacy.

The perspective of becoming EU members has been a crucial driver in initiating and implementing reform in Ukraine, Moldova and Georgia. In 2022, the European Council granted Ukraine and Moldova candidate status, while Georgia received the perspective of becoming an EU member state. This was explained by their capacity to fulfil the Copenhagen criteria established in 1993, as well as 1995 Madrid criteria related to the functionality of the public administration and judicial systems. The AA and Deep and Comprehensive Free Trade Area (DCFTA) entered into force in 2016 in Georgia and Moldova, and in 2017 in Ukraine. 'The AA/DCFTA is the key bilateral legal instrument serving as the basis for deepening political ties, stronger economic linkages, the promotion of common values and enhanced cooperation in areas of mutual interest' (European Commission, 2022). Taking into account the condition set by the AA/DCFTA, these countries have implemented crucial comprehensive reforms in the area of democracy, the rule of law, functioning of the market economy, etc., which has enabled them to further align to EU standards and norms.

Table 5. Comparative Governance Assessment for the CIS Countries, Ukraine and Georgia (2021 vs. 2013)

Country	Voice and accountability		Political stability		Government effectiveness		Regulatory quality		Rule of Law		Control of Corruption	
	2013	2021	2013	2021	2013	2021	2013	2021	2013	2021	2013	2021
AR	-0,58	0,06	0,11	-0,83	0,08	-0,25	0,23	0,14	-0,34	-0,09	-0,53	0,07
BY	-1,54	-1,58	0,01	-0,74	-0,95	-0,77	-1,16	-0,92	-0,88	-1,10	-0,40	-0,23
GE	0,13	0,01	-0,44	-0,42	0,62	0,65	0,72	1,06	0,01	0,17	0,46	0,68
MD	-0,07	0,05	0,001	-0,21	-0,40	-0,40	-0,08	0,01	-0,37	-0,33	-0,75	-0,45
RU	-1,02	-1,10	-0,74	-0,64	-0,45	-0,17	-0,36	-0,53	-0,82	-0,87	-1,02	-0,90
UK	-0,31	0,07	-0,77	-1,10	-0,66	-0,41	-0,58	0,27	-0,84	-0,66	-1,17	-0,76
CUG	-0,56	-0,41	-0,30	-0,65	-0,29	-0,23	-0,21	0,01	-0,54	-0,48	-0,57	-0,26

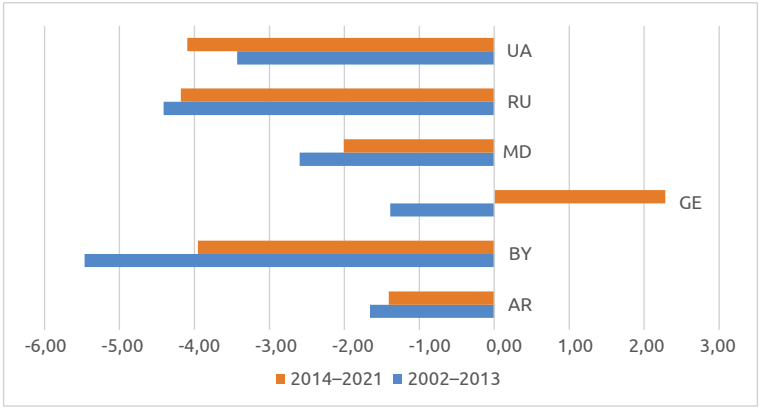
Note: Note: AR – Armenia; BY – Belarus; GE – Georgia; MD – Moldova; RU – Russia; UA – Ukraine; CUG – CIS, Ukraine and Georgia.

Grey colour represents the positive development of governance indicator.

Source: World Bank, 2023

Among the post-Soviet republics, Georgia achieved the best results in all the aspects of institutional capacity development, with the exception of political stability and absence of violence (due to politic polarization that has endangered the country's democratic processes). It is evident that notable institutional improvements have been reported by the World Bank experts after the 2003 Rose Revolution. Georgia is claimed to be the best in terms of fighting against corruption, with a positive score indicator since 2010 (see Table 5). When it comes to the 2002–2020 period, corruption is perceived by the World Bank as a wide-ranging phenomenon in Russia and Ukraine. In order to fight against the corruption, the governments of these countries adopted various laws and actions plans, but the results were unsatisfactory due to the lack of political will among the elites for their implementation. The concentration of political and economic powers jeopardized the fight against corruption. According to the World Bank estimates, the legacy of corruption and high government ineffectiveness have adversely reflected on the rule of law. The scores for the rule of law in Russia, Belarus and Ukraine have all been well below zero.

Figure 14. Global Governance Performance of the CIS Countries, Ukraine and Georgia



Source: Own calculation using data from World Bank, 2023

Since 2014, Ukraine (sharp decline started in 2012) has had the lowest political stability and absence of violence levels in this group. The so-called Maidan Revolution and military conflict in the Donbass region are the main reasons for such a decline in the value of the indicator. The scores in the category 'Voice and accountability' for Ukraine, Georgia and Moldova show fluctuations around 0, while Belarus is denoted as outlier. The World Bank experts also argue that the level of freedom of expression and association, free media and ability of the population to engage in the election of their government in Russia has declined remarkably since the beginning of the 2000s. The ability of government to develop and implement effective internal policies is also called into question in Russia, Ukraine and Belarus. Compared to the period 2002–2013, the given group of countries have made few improvements in the areas such as political stability, government effectiveness and the rule of law. These countries are marked by a low level of governance strength, while particular weaknesses are recorded in the areas such as the rule of law and control of corruption. Hence, efforts aimed at improving the predictability and consistency of the rule of law are indispensable for achieving and maintaining the stability and legitimacy of the political systems.

4 FDI INCENTIVE POLICY IN TRANSITION COUNTRIES

In this section, we highlight the importance of FDI incentive policy and its economic implications for host countries. We describe the three types of incentives, as well as risks and challenges that arise from balancing the need for foreign capital with the intention to protect host countries' goals and interest. We stress out how the majority of transition countries tried to increase the attractiveness of their business environment by liberalizing their investment regulations and adopting FDI incentive policies, whose effectiveness largely depended on their macroeconomic conditions and global market dynamics.

4.1 CONCEPT AND IMPORTANCE OF FDI INCENTIVE POLICIES

FDI incentive policies represent some kind of compensation for inheriting persistent shortcomings within the host country's market, or a type of additional assistance to improve the attractiveness for foreign capital. Its aim is to encourage FDI inflow by reducing transaction costs and related business risks, as well as correcting market irregularities in the host country. According to the OECD, FDI incentives can be defined as 'measures designed to influence the size, location or industry of a FDI investment project by affecting its relative cost or by altering the risks attached to it through inducements that are not available to comparable domestic investors' (OECD, 2003: 12). UNCTAD define FDI incentive as 'any measurable advantages accorded to specific enterprises or categories of enterprises by a government, in order to encourage them to behave in a certain manner' (UNCTAD, 2000a: 11).

Granting incentives for FDI is considered desirable and justified if it leads to spillover effects (transfer of foreign technological advancements and expertise) in the host country. Due to the established connections between local enterprises and foreign investors, and their inclusion in the FDI value chains, there might be an increase in productivity and quality of products, strengthening of foreign trade ties and expansion of export. Positive effects can also arise if the host country authorities stimulate projects that include the technology transfer along the supply chain, or when domestic companies are able to exploit the diffusion of the latest knowledge about products, processes, as well as market insights provided by MNC affiliates.

When it comes to the usage of incentives, it is advisable that their benefits be greater than the budget expenditures. If the incentives potentially exceed the level of the spillover advantages, it can contribute to a loss of social welfare (Blomstrom et al., 2003). The decision about their allocation and usage should be based on a cost-benefit analysis, which should compare the possible tax revenues of the host country based on the growth of investment and spillover effects, with the costs related to the introduction of these incentives, whereby ensuring that they yield a significant positive impact relative to the state expenditures. The amount of incentives that should be allocated for an investment realization is inversely proportional to the quality of the business environment. In fact, the goal of any FDI inflow encouraging and attracting policy is to optimize the sustained positive impact of foreign corporative entities.

From a foreign investor's view, decision regarding the allocation of financial resources is based on the expected returns and costs (risks) associated with the investment project. For example, foreign investors consider tax incentives as a factor influencing asset allocation only when the analyses have indicated that it is possible to achieve the desired rate of return, adjusted for country risk before taxation (Kovač, 2003). If the FDI incentives are high enough, it signals that the business risks in the potential FDI host country are elevated. In such circumstances, the government, through incentives, endeavours to establish conditions that favour investors, where the potential returns on

investment are greater than the associated risks. The positive side of the incentive-based competition between potential FDI recipient countries is reflected in the fact that they provide strategic investment deployment, optimize tax effectiveness, secure optimal capital dispersion across region and cut down wasteful government expenditures (Christiansen et al., 2003).

It is worth emphasizing that perceived benefits are readily noticeable, while certain costs are very hard to quantify because they are spread out over long periods of time (Blomstrom et al., 2003). The FDI attraction strategy should not be based on the presence of an overly generous system of financial and non-financial incentives for foreign investors. The infusion of foreign capital should not be used to address fiscal requirements with the aim of boosting employment. By striving to maximize the FDI inflows and surpass intense competition on the global capital market, governments reduce tax rates and relax their labour and environmental standards (Olney, 2013). In economic literature, this phenomenon is denoted as the 'race to the bottom', which is not sustainable in the long run due to the absence of technological benefits for the local producers, inadequate infrastructure development, insufficient investment in human capital and shortcomings in institutional settings. As shown by Davies and Vadlamannati, there is an interdependence of labour standards between countries, i.e. the relaxing of labour standards to encourage the foreign firms in one country is positively associated with the same standards elsewhere (Davies & Vadlamannati, 2013). Tax incentives also lead to a destructive competition in the taxation of corporate profits, whilst also adversely affecting democratic governance frameworks and governance capacity in delivering public services due to the tax revenues reduction (Gurtner & Christensen, 2009).

On the other hand, in terms of their influences on employment dynamics, FDI incentives could cause not only direct (employment opportunities supported by subsidized funding) and indirect growth of employment (jobs generated due to the crowding-in and spillover effects), but also job reduction stemming from the adverse effects of crowding-out small firms on labor market (Delević, 2020). Although being aware of their

negative effects, governments continue to participate in competitive incentive battles, to their own disadvantages. In economic literature, this phenomenon is termed as prisoners' dilemma, implying a conflict between the individual incentives of local governments and what is collectively best for the government as a whole (Cedidlová, 2013). The prisoners' dilemma, as the well-known example of the Game Theory, implies that state will not be interested in approving the incentives for upgrading the overall attractiveness of investing if the others do not approve them. However, if potential competitors actively implement incentive policies, the state will adopt and grant incentives due to the concerns about being outpaced by others in the competition for investment (despite their negative effects), as well as wishing to secure economic and political standing in comparison to neighbouring countries (Petrov, 2001).

4.2 TYPES OF FDI INCENTIVES

The FDI attraction represent fundamental strategic consideration for many countries, as heightened investment activity have potential to enhance industrial growth, reduce unemployment, raise productivity, facilitate the transfer of new technology and innovations and integrate countries into the global economic flows. The policymakers strive to improve the appeal of the business climate and join global competition by offering FDI incentives that can be categorized into fiscal, financial and regulatory incentives (OECD, 2003).

Fiscal incentives can be identified as the most important, as well as the most frequently used measure in promoting investments from both domestic and international sources, aiming to enhance competitiveness in the international capital market. The adopted measures in the field of tax policy contribute not only to an increase in FDI inflow but also to the competitiveness of the host country's FDI tax system. This type of FDI incentives usually attracts efficiency-seeking foreign investors driven by the goal of lowering production costs, as well as the overall cost of investment (Andresen et al., 2018). Host country authorities

most often opt to lower corporate income tax rates, provide full or partial tax holidays for 'newly-established firms' and special economic zones (SEZs), as these measures facilitate a boost in the production capacity and encourage higher levels of investment (Burns, 2023). In the last two and a half decades, the number of SEZs have increased significantly, in particular in developing and transition countries. Poland was the first transition country to establish SEZs, using them as the main instrument to attract FDI. Their specificity is reflected in the fact that they represent a separate, usually uninhabited area were business can be started and conducted under preferential conditions, such as preferential tax regime (for example, foreign and domestic investors are exempt from paying value-added tax and custom duties on the import of raw material and materials intended for the production of export goods) and reduced regulatory requirements, with the aim of encouraging development, managing industrial capacities and infrastructure, increasing employment and attracting foreign investors (CEVES, 2019).

Foreign investors also have at their disposal incentives for capital formation, including allowances on reinvested profits, special investment allowances (accelerated depreciation) and investment tax credits (tax deductions for investments in fixed assets, for the profits earned in a newly established unit in underdeveloped areas, as well as tax credit for newly employed workers). Moreover, removing barriers to cross-border activity is realized through withholding tax (an advance payment of income tax that can be applied to offset or diminish tax obligations), taxation of foreign trade (lowered import and export duties and tariffs), and taxation of employees (reduced personal income tax and decreased social security contributions).

Financial incentives include direct financial transfers and subsidies from the government budget in situations where host country authorities seek to promote regions that are economically underdeveloped and unattractive for investment. This type of incentive is usually negotiated between the host country authorities and large foreign entities, including the provision of physical infrastructure or communication networks according to the preferences and demands of the investors, government-backed

educational training initiatives, low-interest loans or interest subsidies to MNCs, selling real estates and properties to MNCs at discounted prices far below the prevailing market rates, provision of administrative assistance through the investment promotion agencies (IPAs), cost participation, incentives for investments in the research and development sector, etc.

As an integral part of FDI strategies, countries establish IPAs with the aim to actively promote investment opportunities and assist potential investors. Their relevance is particular evident in the countries characterized by greater physical and cultural distance from the home countries of the investors (Andersen et al., 2018). The role of these agencies includes the preparation and presentation of information on various business opportunities and investment program in certain areas, highlighting the advantages of their investment locations, providing expert assistance to foreign investors during the decision-making process regarding the choice of a region and site for investment, as well as offering support after the initial investment. In certain countries, these agencies assist foreign investors in obtaining licenses and permits for the performance of particular activities or investments from the competent authorities. They also facilitate direct contacts direct contracts between local legal and natural entities and interested foreign investors, collaborating with pertinent institutions and organizations.

Regulatory incentives imply granting exceptions from national or sub-national regulation. The host country authorities' mitigate certain rules and regulations in the areas such as environmental, health, labour and social policies, and adopt stabilization clauses ensuring that current regulations remain unchanged to the disadvantage of investors (Edwards & Newton, 2016).

4.3 THE IMPACT OF INCENTIVE POLICY ON FDI INFLOWS IN TRANSITION COUNTRIES

The intense growth of the capital markets and financial systems led to a drastic reduction of barriers and the creation of incentives for international capital flows. FDI incentive policies

as instruments for stimulating international capital movements have been the subject of many a discussion and research. It is noteworthy that in the economic literature, the emphasis has mainly been on investigating the impact of tax incentives on FDI inflows, as their influence can be more easily quantified. The empirical studies demonstrate that investment incentives can encourage FDI inflow in transition countries (Ślusarczyk, 2018), but this is effective solely in the countries characterized by stable macroeconomic conditions and well-established institutional settings. Namely, despite numerous financial and fiscal incentives, the FDI inflow can be influenced by the constraints such as regulatory and administrative barriers, high level of political risk and instability, widespread corruption, etc.

The research conducted by Miskinis and Mikneviciute demonstrates that there has been no association between FDI and the scope of FDI incentives provided by the host countries' authorities in NMS (Miskinis & Mikneviciute, 2010). They also revealed that financial incentives exerted a more significant influence, than tax incentives, or SEZ in shaping foreign investors' choices. Employment subsidies and financial grants stand out as widely embraced financial measures, while administrative subsidies and real estate available at discounted rates are seldom used and receive little recognition from foreign investors. The similar findings are also observed by Bobenič Hintošová et al. who argue that financial incentives (in the form of grants for tangible fixed assets and intangible fixed assets and/or contribution for newly created jobs) positively and significantly influence FDI inflows, while the impact of fiscal incentives is the opposite (Bobenič Hintošová et al., 2021). The authors discovered only one indirect outcome of investment invectives, which is associated with the decreasing unemployment via FDI inflows.

Kersan-Škabić demonstrate that corporate tax is not a significant determinant of FDI inflows in SEE countries in comparison to other market-driven factors (market size, GDP per capita, wages, growth rates) that affect the FDI attractiveness (Kersan-Škabić, 2014). Therefore, this type of FDI incentives can be used only as a half-hearted try of the host country authorities to provide infusion of foreign capital by offsetting the

shortcomings of the macroeconomic and institutional environment. The empirical study by Bitzenis also provides evidence that the significance of tax incentives for foreign investors in Bulgaria has not been as pronounced, as that of the non-fiscal incentives such as stable political and economic climate, functioning market economy, fight against corruption, administrative red tape, the prospects of EU membership and potential for market expansion (Bitzenis, 2003).

On the other hand, the importance of tax incentives on the pattern of regional FDI has been confirmed in the study by Blažić and Vlahinić-Dizdarević who argue that their effect is especially strong in the SEE countries' competition for attracting FDI, in the cases when initial investment decision has been made and the investor is deliberating among various locations within a specific region (Blažić & Vlahinić-Dizdarević, 2006). Ginevičius and Šimelytė found that fiscal incentives, primarily tax deduction, are more important as determinants of FDI inflow in CEE countries than financial incentives (Ginevičius & Šimelytė, 2011). Silajdzic and Mehić assessed the effects of corporative tax rate as the crucial policy tool in the FDI policy framework, on the volume of the FDI inflow in SEE countries in the 2000–2018 period (Silajdzic & Mehić, 2022). Their findings suggest that this instrument of FDI policy mix has more profound effect in the transition countries characterized by a lower level of economic and technological development. Such conditionality implies that significant differences in economic structure and technological infrastructure between home and host countries clarify the growing marginal impact of the corporate income tax on FDI inflows.

Transition countries mainly opted for fiscal and financial incentives and Investment Promotion Agency (IPA) as the instruments of FDI encouragement. Cass highlights that these incentives were not used for addressing shortcomings in the business climate in the initial phases of the transition process (Cass, 2007). He points out that there has been strong association between the integration of the IPAs and the progress achieved during the market transformation, as transition countries become more economically developed.

4.4 THE CHALLENGES FOR FDI INCENTIVE POLICY IN TRANSITION COUNTRIES

The FDI incentive policy, as well as its scope and structure, varied significantly among transition countries. Given measures represented the crucial instrument of economic policy aimed at encouraging the mass employment of medium and low-skilled unemployed workers (i.e. incentives were primarily directed on the projects that provided employment that entails manual labour with reduced salaries, yielding comparatively modest added value). Host transition countries' authorities adopted systems of investment incentives such as tax holidays, investment grants, subsidies salaries and custom tax reliefs, and established specially designed agencies of SEZs for removing constraints to business friendly environment (Garvanlieva Andonova, 2020). Even after a span of twenty-year from the transition, the usage of FDI incentive strategies remained crucial for the macroeconomic development and industrial expansion of these countries. Unfortunately, the regulatory frameworks governing the operation of promotion policies and IPAs are largely outdated and rooted in the policies of the 1990s (Szent-Ivanyi, 2017).

The majority of these countries exhibited insufficiently developed institutional and physical infrastructure. This, coupled with an elevated political risk, represented an obstacle to the further development of economic and investment activity. Consequently, countries sought to compensate for their institutional deficiencies through investment policies whose economic efficiency was questionable (Tmušić & Rapaić, 2022). They primarily relied on fiscal policy instruments, which entailed allocating non-reimbursable budget funds to foreigners for the initial investments in the construction of new or the expansion and modernization of the existing production capacities.

Through the implementation of such policy, the state typically establishes two parallel systems – one for domestic companies and another for privileged foreign investors that operate under special business conditions, resulting in so-called dualism of economy. This can have profound and lasting consequences, reflected in the further growth of corruption, public debt,

violations of workers' rights, and the crowding-out of domestic investors. If subsidies are granted based on the number of employed workers, then it is quite logical that this kind of incentivising policy will affect the structure of FDI. Namely, foreign investors will be interested in the manufacturing sectors where it is possible to employ a large number of workers (mostly cheap labour). Since the transition process was accompanied by deindustrialization, leading to a significant increase in unemployment and a reduction in labour costs, the incentive policy additionally encourage investments in labour-intensive industries.

The empirical study by Cedidlová shows that the effectiveness of investment incentives approved in the Czech Republic was generally high, as well as the performance of the foreign companies benefiting from incentives (Cedidlová, 2013). MNCs characterized by the highest effectiveness influenced the local and regional environment through workforce migration and substantial contributions in social and health insurance and taxes. The empirical study by Dinga which deals with the impact of investment incentives on the regional distribution of FDI also in the Czech Republic, revealed beneficial impact of the investment scheme the influence which was focused at the lowest available unemployment threshold (Dinga, 2011). Incentives gain particular significance in the regions facing significantly higher than average unemployment rates, as their approval stimulates the revitalization of industrial centres and distressed areas, reducing large regional disparities in development levels and inequality. On the other hand, as proven by Delević, the financial subsidies for FDI attraction in transition countries cannot be denoted as effective when it comes to employment growth, as it the crowding-in effect has not been recorded, apart from the job opportunities generated by the subsidized MNEs (Delević, 2020). The authors point out that the absorptive capacity, and consequently the spillover effect, are greater in the areas where the labour force is more educated and local infrastructure more developed. For instance, the impact of subsidies on employment in Serbia is significantly higher in better developed municipalities.

However, in the conditions of legal instability, high corruption and the shortage of qualified labour force (all of which

has been recorded in some transition countries), narrow incentives in the form of grants, tax allowances, etc. cannot endlessly compensate for the worsening business climate (Elteto & Antaloczy, 2017). In many cases such a stimulus-driven policy was counterproductive, as countries tried to compensate for the perceived shortcomings with generous subsidies, without considering the elimination of key risks to their operations. The procedure of allocating subsidies and other state aid is accompanied by a lack of transparency in the functioning of government authorities, creating incentives for corruption, rent-seeking and capturing of the state. Moreover, there is no information about their efficiency and economic implications on the host country. FDI incentives are discriminatory, as they prioritize the needs of foreign investors, by providing them an unfair, discriminatory advantage compared to domestic investors, potentially leading to the creation of a crowding-out effect.

The need for establishing better control over the capital movement has gained particular importance in recent years due to the withdrawal of foreign investors from the markets undergoing transition (i.e. in the frames of backshoring or nearshoring). Namely, foreign investors could unexpectedly flee out of markets, after the contract expiration date (i.e. exhaustion of state subsidies, leaving huge debts to the employees and the state). In such circumstances, foreign investors have maximized their utilization of the available opportunities and benefits, domestic investors were discriminated against and crowded-out from market, while host country has been left without long-lasting revenues.

The incentive programmes mainly involved subsidies per job, which motivated some foreign investors guided by rent-seeking interests to employ a higher number of people with lower salaries, without considering the rights of employees and fair and dignified working conditions. Furthermore, the local governments provided land for the construction of the factories, as well other necessary infrastructure, free of charge, or at a very low negotiated price. What is particularly worrying is the fact that some foreign investors are driven by aspiration to take advantage of cheap and qualified labour, while there is a handful

of them who bring new technological achievements to the recipient countries. For instance, in many Balkan countries such behaviour of certain foreign investor has been frequently observed. These are foreign companies that have been reliant on continual subsidies, or other forms of privileged positions, such as tax incentives, to function within the host country's borders.

The Turkish company JEANCI Istanbul (its subsidiary company founded in the town of Leskovac) represents an example of a market withdrawal from transition countries, having fully exploited all the available advantages and preferences. In 2011, this company invested 2.75 million euros upon its establishment in the town of Leskovac, concurrently securing a subsidy of 1.75 million euros form the Republic of Serbia. For each newly hired employee, this company received 4000 euros in subsidies from the host country. Unfortunately, despite the favourable loan of 1 million euros in 2020 provided by the Development Fund of the Republic of Serbia, the company was unable to overcome the business difficulties caused by the spread of COVID-19 and the consequences of the energy crisis. The main challenges arose in supplying material and adapting to the EU market conditions. Consequently, the company was forced into liquidation and literally closed its facilities overnight (Euronews, 2023). In addition to untimely settlement of the debs related to investment credits and loans to maintain liquidity, the company remained indebted not only to its employees (in terms of wages and social and health insurance contributions), but also to the state and local self-governance (unpaid taxes and local duties – rent for premises, electricity and water supply) (RTS, 2023). Except of the aforementioned difficulties, the reduction in the number of employees also happened due to violations of workers' rights, and non-compliance with the contracts and labour laws.

Bearing in mind all the aforementioned challenges and problems, policymakers should give priority to the needs of the investors who are already operating in the market of the host country, ensuring a variety of follow-up services aiming to boost reinvestment, upgrading and productivity spillovers (Szent-Iványi, 2017). Moreover, it is crucial to create conditions not only for foreign investors' attraction, but also for their regular

operation within the countries undergoing transition, in order to achieve long-term benefits of FDI inflows. In order to overcome possible negative effects of the existing policy of subsidizing foreign investors and encourage technology spillover effects, it is desirable to adopt tax incentives in the area of corporate income tax that would stimulate research, development and innovation. Furthermore, it is essential to clearly define the requirements that a foreign investor should fulfil to be granted any incentive package. Long gone is the perspective that attracting and retaining both foreign and domestic investors is possible exclusively through fiscal incentives and financial privileges. Additionally, more and more attention is being devoted to the quality of communication that investors establish with the local and state authorities, as well as the impressions and expectations regarding possible partnerships in the future.

5 ECONOMIC IMPLICATIONS OF FDI AND INSTITUTIONS ON ECONOMIC GROWTH

In this chapter, we explore the factors influencing the economic outlook in 22 European transition countries from 2002 to 2020. In our empirical analysis, we applied the panel quantile regression (PQR) technique in order to gain a detailed outlook and determine the growth determinants of differently conditioned economic growth distribution. We tried to capture the heterogeneous patterns of inward FDI stock and quality of institutional arrangements effects across growth distribution. We first introduce the data and research methodology and conduct preliminary tests with the aim to provide a comprehensive picture concerning the characteristics of variables. Then, we present the findings from our empirical research, provide analysis and offer recommendations for policymakers.

5.1 SAMPLE AND DATA SOURCES

In our empirical study, we employed the data of 22 European transition countries[8] for the period 2002–2020. A PQR analysis was conducted to evaluate the impact of institutional improvements and FDI on the economic performance in the given countries. In table 6, we display a comprehensive compilation of all variables used in our analysis, along with their definitions and data sources. The main variable under consideration was real GDP per capita as a proxy for economic growth, while our crucial independent variables were inward FDI stock and indicators of institutional settings. Instead of FDI inflows, the FDI stock as a percentage of GDP variable, was used to assess the

[8] The countries comprising our sample are Albania, Armenia, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Georgia, Estonia, Hungary, Latvia, Lithuania, Montenegro, Moldova, North Macedonia, Poland, Romania, Russia, Serbia, Slovakia, Slovenia and Ukraine.

impact of the level of foreign investment relative to the overall size of the economy. We controlled for the variables such as trade openness, gross fixed capital formation, inflation and government expenditure. As for the expected sign of the regression coefficients, we hypothesized that FDI stock and overall institutional quality, as well various governance dimensions, are positively associated with economic growth, which means that they encourage the growth of real GDP per capita in the chosen group of countries. Taking into account the findings of the previous empirical studies and the economic theories, both inflation and government expenditures (in particular non-productive government spending) can have ambiguous effect on economic outlook. On the other hand, we assume that greater trade liberalization and gross fixed capital formation are key factors to boost economic growth.

Table 6. Data Definition, Measurement and Source

Variables	Definition and measurement	Source
GDPpc	GDP per capita PPP, Constant USD 2017	WDI database, World Bank
FDIs	Inward FDI stock as percentage of GDP	UNCTAD
INF	Inflation, GDP deflator (annual %)	WDI database, World Bank
OPEN	Trade openness (the sum of exports and imports of goods and services measured as a share of GDP)	WDI database, World Bank
GFCF	Gross fixed capital formation as percentage of GDP	WDI database, World Bank
EXP	General government final consumption expenditure as percentage of GDP	WDI database, World Bank
WGI	The comprehensive index of institutional quality derived via PCA	Author's calculation
VA	Voice and accountability shows the perceived assessment of the degree to which citizens are able to engage in the democratic process related to the selecting their government authorities, freedom of expression, freedom of association, and a free media. This indicator may vary between -2.5 to 2.5, with a higher value indicating a better quality of institutions.	Worldwide Governance Indicators database

Variables	Definition and measurement	Source
PSAV	Political stability and absence of violence shows the perceived assessment of the probability of the government's destabilization and/or overthrow by unconstitutional or violent means, including politically-motivated violence and terrorism. This indicator may vary between -2.5 to 2.5, with a higher value indicating a better quality of institutions.	Worldwide Governance Indicators database
CC	Control of corruption shows the perceived assessment of the degree to which public power is exploited for personal benefits, encompassing both petty and grand corruption, and the state capture by the elites and private interests. This indicator may vary between -2.5 to 2.5, with a higher value indicating a better quality of institutions.	Worldwide Governance Indicators database
RL	The rule of law shows the perceived assessment of the degree to which agents have trust in and adhere to the rules of the society, and particularly the efficiency of enforcing contract mechanism, property rights, law enforcement, judicial system and the prevalence of crime and violence. This indicator may vary between -2.5 to 2.5, with a higher value indicating a better quality of institutions.	Worldwide Governance Indicators database
RQ	Regulatory quality shows the perceived assessment of the government's capability to design and enforce reliable policies and regulations conducive for boosting private sector expansion. This indicator may vary between -2.5 to 2.5, with a higher value indicating a better quality of institutions.	Worldwide Governance Indicators database
GE	Government effectiveness shows the perceived assessment of the quality of public and civil service and the extent of the government's autonomy from the political influence, the quality of policy design and enforcement, and its dedication to such policies. This indicator may vary between -2.5 to 2.5, with a higher value indicating a better quality of institutions.	Worldwide Governance Indicators database

With the help of the Principal Component Analysis (PCA), we calculated the composite governance indicator, which denotes the overall quality of institutional arrangement. As a tech-

nique for data dimensionality reduction and feature extraction, the PCA summarizes the six dimension of governance into a single factor which explains the variance. It transforms these original variables into a new set of uncorrelated variables that represent their linear combinations. Each of the individual indicators can record a value from -2.5 to 2.5, where higher values imply better quality of institutional arrangements.

Table 7. Principal Components/Correlation for WGIs

Rotation: (unrotated = principal) **Number of comp. = 1** **Trace = 6** **Rho = 0.8438**				**Number of obs = 414**
Component	**Eigenvalue**	**Difference**	**Proportion**	**Cumulative**
Comp1	5.0625	4.6393	0.8438	0.8438
Comp2	0.4232	0.1773	0.0705	0.9143
Comp3	0.2458	0.1046	0.0410	0.9553
Comp4	0.1412	0.0613	0.0235	0.9788
Comp5	0.0799	0.0328	0.0133	0.9921
Comp6	0.0471		0.0079	1.0000

Source: Author's research

Based on our findings in table 7, the first principal component explains about 84% of the total variance. Regarding the appropriateness of factor analysis, the Kaiser-Meyer-Olkin (KMO) measure of sampling adequacy amounts to 0.90, indicating the data's appropriateness for PCA (see Appendix 1). We employed the first PCA component as measure of the overall effectiveness of the institutional framework, with the aim to address concerns arising from omitted-variable bias (Zvezdanović Lobanova et al., 2018a). On the other hand, each governance indicator is individually analysed in quantile regression, with the aim to avoid the multicollinearity caused by the high correlation coefficients among indicators of institutional quality. The estimations were conducted in the STATA 14 software (with the exception of the unit root tests, which were conducted in EVIEWS 13).

5.2 RESEARCH METHODOLOGY

We estimated the effect of inward FDI stock and institutional quality indicators on economic growth with this PQR model:

$$QGDPpc_{i,t}(\tau|\cdot) = a_{1,\tau}FDIs_{i,t} + a_{2,\tau}INF_{i,t} + a_{3,\tau}OPEN_{i,t} + a_{4,\tau}GFCF_{i,t} + a_{5,\tau}EXP_{i,t} + a_{6,\tau}INS_{i,t} + \beta i + \mu t \; i = 1,\ldots, N, \; t = 1,\ldots, T$$

with βi and μt as the country and time fixed effects, respectively, while $a_{1,\tau}$ to $a_{6,\tau}$ being coefficients. $GDPpc_{it}$ represents real GDP per capita (as a measure for economic performance or development); $FDIs_{it}$ denotes inward FDI stock as a share of GDP; INF_{it} is inflation (GDP deflator) as a measure of macroeconomic stability; $OPEN_{it}$ denotes trade openness as a measure of trade liberalization, or degree of openness of economy; $GFCF_{it}$ is gross fixed capital formation as percentage of GDP, as a measure of physical stock of capital or domestic investment (plant, machinery and equipment purchases, land improvements, the construction of roads and railways etc.)[9]; EXP_{it} refers to general government final consumption expenditure as percentage of GDP, being a proxy for government spending ; INS_{it} symbolizes comprehensive index of institutional quality derived via PCA (WGI) and the governance indicators that we incorporated independently with the intention of preventing multicollinearity. With the exception of WGIs, all other variables are expressed in natural logarithms. By their converting into natural logarithms, we are able to show the elasticity of GDP per capita with respect to the explanatory variables.

The formula of the PQR can be expressed as follows:

$$y_i = x_i'\beta_\theta + u_{\theta i}, \; 0 < \theta < 1 \qquad (1)$$

$$\text{Quant}_\theta(y_i|x_i) = x_i\beta_\theta \qquad (2)$$

[9] As the main component of domestic investment, the GFCF comprises gross private domestic investment (new construction and spending by businesses) and gross public domestic investment (investment made by government and/or public enterprises).

where y determines the dependent variable; x is considered a vector of the explanatory variables; u denotes a random error term whose conditional quantile distribution is equal to zero; $\text{Quant}_{\theta}(y_i|x_i)$ refers to the θth quantile of the explained variable, while β_{θ} stands for the estimated parameter of the θth quantile (Eq. (3)) (Xu and Lin, 2020).

$$\min\sum_{y_i \geq x_i'\beta} \theta|y_i - x_i'\beta| + \sum_{y_i \geq x_i'\beta}(1-0)|y_i - x_i'\beta \tag{3}$$

We opted for the PQR approach, since it enables us to explore whether the effect of our variables of interest varies across the full distribution, in particular at the extreme quantiles of dependent variable. Its specificity is reflected in the fact that it is useful for gaining a better insight into the association between dependent and explanatory variables by assessing the impact at each quantile of the distribution (Cade & Noon, 2003). This approach is especially useful in empirical analysis, because it provides robust results in condition of outliers and skewed, or heavy-tailored distributions. The requirement related to the normal distribution of the variables does not have to be satisfied (Xu & Lin, 2020). By analysing the relationship between variables, this powerful statistical technique takes into account the different parts of distribution of the dependent variable, rather than just its mean, which is the case with the traditional linear regression. It is especially valuable for investigating heterogeneous effects and addressing issues related to non-normally distributed data.

With the help of the quantile regression technique, we were able to discover the sign and/or magnitude of our variable of interest, taking into account transition countries' growth performance. The PQR estimation was performed using 50 bootstrap replications. This technique implies the creation of multiple bootstrap samples by randomly drawing observations from the original dataset with replacement from the observed data. In such way, it is possible to enhance the reliability of estimates and achieve more robust standard errors and confidence intervals. In our estimations, we chose nine quantiles (0.10, 0.20, 0.30, 0.40, 0.50, 0.60, 0.70, 0.80, and 0.90) in order to gain a

whole picture concerning the changes in coefficients across the conditional distribution of growth. Countries that are located from 10th to 30th quantiles could be denoted as those with low growth rates, while the quantiles from 70th to 90th refer to the countries with high growth rates.

We also calculated the test of coefficient homogeneity for every explanatory variable across the conditional distribution of the output growth rate. The null hypothesis refers to the default prediction of slope equality existing across quantiles. The rejection of the null hypothesis implies that there are statistically significant differences in slope coefficients for the explanatory variables. In addition, we conducted three panel unit root tests – the Levin-Lin-Chu, Fisher-type ADF and Im, Pesaran, Shin test to investigate the stationarity characteristics of the variables incorporated in our study. The null hypothesis is standardized across all unit root tests, implying the presence of a unit root test in each panel.

5.3 EMPIRICAL RESULTS AND DISCUSSIONS

In table 8, we provided a brief descriptive analysis, which shows the distribution properties of the variables used in the study. With the exception of the WGIs, all other variables were transformed in natural logarithms. We assessed the skewness, which is a measure for the asymmetry of a probability distribution and has zero value in case of normal distribution. In addition, we showed the values for kurtosis, which is a measure for the tailedness of distribution. The kurtosis of normally distributed data is 3. As for the degree of asymmetry, our findings suggest that GFCF, CC, RL and GE are positive, meaning that their tail is on the right side of the distribution. All other variables are negative (tail is on the left side of the distribution). Based on the value of kurtosis, the majority of variables have values lower than 3, which indicates platykurtic kurtosis. Other variables, whose values are greater than three, have leptokurtic distribution. We applied the Jargue-Bera test with the null hypothesis assuming that the data was normally distributed. If the

p-value is below a chosen significance level, we reject the null hypothesis, implying that the data follow normal distribution. According to the values of Jarque-Bera statistics, all variables are not normally distributed.

Table 8. Descriptive Statistics

Variable	Mean	Median	Std. dev.	Min	Max	Skewness	Kurtosis	J-B test	Pr. (J-B test)	N
GDPpc	9.798	9.8406	0.462	8.510	10.621	-0.370	2.277	18.64	0.00	418
FDIs	3.722	3.730	0.514	1.967	4.80	-0.549	3.603	26.43	0.00	404
INF	1.270	1.358	1.118	-2.778	4.321	-0.686	4.524	70.01	0.00	399
OPEN	4.613	4.607	0.312	3.827	5.245	-0.0257	2.543	8.25	0.01	418
GFCF	3.145	3.125	0.208	2.587	3.846	0.456	3.450	18.06	0.00	418
EXP	2.863	2.911	0.201	2.094	3.399	-1.187	4.535	139.4	0.00	418
WGI	7.06e	-0.162	2.250	-4.599	4.382	-0.044	1.795	25.18	0.00	414
VA	0.269	0.302	0.684	-1.766	1.214	-0.857	3.331	53.17	0.00	418
PSAV	0.182	0.275	0.653	-2.020	1.303	-0.647	2.995	28.94	0.00	414
CC	-0.067	-0.136	0.588	-1.264	1.610	0.290	2.404	12.07	0.00	418
RL	0.061	-0.072	0.657	-1.303	1.372	0.098	1.889	22.14	0.00	418
RQ	0.372	0.442	0.657	-1.596	1.695	-0.458	2.683	16.28	0.00	415
GE	0.155	0.107	0.623	-1.209	1.334	0.114	1.924	20.09	0.00	415

The correlation coefficients for GDP per capita regression variables are reported in table 9. These results show us the strength of the association between our variable, as well as possible presence of the multicollinearity between explanatory variables. The highest correlation coefficients linked to GDP per capita, aside from governance indices, were detected in relation to government expenditure, trade openness, and the inward FDI stock (shown in diminishing pattern). GDP per capita is positively correlated with the overall institutional quality index, RL and GE and correlation coefficients had a value higher than 0.7, suggesting possible presence of multicollinearity.

Table 9. Correlation Matrix

	GDP-pc	FDIs	GDPD	TRA-DE	GFCF	EXP	WGI	VA	PSAV	CC	RL	RQ	GE
GDP-pc	1.00												
FDIs	0.28	1.00											
INF	-0.24	-0.32	1.00										
OPEN	0.40	0.36	-0.11	1.00									
GFCF	-0.12	-0.19	0.23	-0.01	1.00								
EXP	0.43	0.15	-0.10	0.30	-0.32	1.00							
WGI	0.71	0.46	-0.40	0.53	-0.01	0.30	1.00						
VA	0.56	0.45	-0.38	0.40	-0.11	0.32	0.90	1.00					
PSAV	0.63	0.20	-0.30	0.53	0.16	0.27	0.80	0.64	1.00				
CC	0.67	0.39	-0.32	0.56	0.03	0.32	0.91	0.76	0.70	1.00			
RL	0.72	0.45	-0.39	0.54	-0.03	0.33	0.97	0.88	0.75	0.90	1.00		
RQ	0.61	0.56	-0.40	0.40	-0.02	0.18	0.93	0.88	0.64	0.80	0.91	1.00	
GE	0.78	0.47	-0.40	0.47	-0.08	0.25	0.94	0.81	0.70	0.87	0.92	0.89	1.00

In order to determine the degree of multicollinearity in our PQR analysis, we applied additional tests to confirm that variables are not highly correlated. This statistically measure is used to provide the reliability of regression results since multicollinearity leads to inflated standard errors and less precise parameter estimates. Problematic level of multicollinearity occurs if a variance inflation factor (VIF) value surpasses a critical value – over 10 or the tolerance is 0.05 or less. Given our findings, we proceed with our further analysis and interpretation of regression results (see Appendix).

The results of the panel unit root tests are presented in Table 10. As our findings indicate, there is a mixture of integration of orders 0 and 1, so we conclude that variables are integrated of order one. Hence, the first difference sequences are used in our empirical analysis since the unit root null hypothesis for all of the variables at the first difference is rejected at the 1% level. Thus, we excluded the possibility of acquiring the spurious relationships.

Table 10. Panel Data Unit Root Test Results

Variables	Levin-Lin-Chu test		Fisher-ADF test		Im, Pesaran, Shin test	
	Level	1st difference	Level	1st difference	Level	1st difference
GDP-pc	-3.170***	-3.089***	55.414	61.230**	-1.359*	-2.271***
FDIs	-4.660***	-15.267***	70.093***	214.491***	-2.381***	-11.630***
INF	-3.321***	-10.180***	56.266	131.625***	-0.703	-5.825***
OPEN	-1.768**	-4.776***	61.803**	98.306***	-1.768**	-4.776***
GFCF	-3.057***	-8.704***	56.037*	101.949***	-1.588**	-5.089***
EXP	0.075	-3.874***	60.711**	103.354***	-0.882	-5.058***
VA	-1.699**	-4.523***	55.556	103.656***	-1.368*	-5.334***
PSAV	-6.238***	-9.226***	89.724***	158.498***	-3.886***	-8.994***
CC	1.769	-3.505***	45.023	87.030***	0.392	-4.026***
RL	-0.626	-5.848***	49.484	129.876***	-0.544	-7.185***
RQ	-2.715***	-2.689***	49.479	111.389***	-0.624	-5.948***
GE	0.446	-4.238***	45.022	108.170***	-0.104	-5.583***

Note: ***, **, and * indicate that the estimated coefficient is significant at the 1%, 5%, and 10% levels, respectively. Both a constant and a trend were included in the panel unit root tests.

Our findings, which entail estimation from PQR approach, are provided in table 11. The PQR estimates for quantiles 10 through 90 provided varied results. FDI stock has a positive impact on economic growth, but the effect is stronger in lower quantile of the growth distribution. FDI stock maintains significant relationship at 10th quantile and from the 30th to the 60th quantile. The negative influence coefficient of FDI stock on economic performance did not passed significance test at 90th quantile level. The results for inflation show a positive insignificant sign for all quantiles, meaning that it does not represent a relevant growth determinant.

Table 11. Panel Quantile Regression Results (with WGI)

Variable	10th	20th	30th	40th	50th	60th	70th	80th	90th
FDIs	0.287***	0.103	0.079**	0.049*	0.035*	0.034*	0.028	0.015	-0.049
	(2.69)	(1.42)	(2.06)	(1.70)	(1.66)	(1.71)	(1.38)	(0.62)	(-0.90)
INF	0.001	0.001	0.00003	0.0008	0.001	0.001	0.001	0.001	0.002
	(0.10)	(0.20)	(0.01)	(0.26)	(0.51)	(0.70)	(0.60)	(0.59)	(0.51)
OPEN	0.396*	0.350**	0.297***	0.244***	0.210***	0.192***	0.191***	0.162***	0.113
	(1.65)	(2.17)	(2.85)	(2.58)	(2.99)	(3.43)	(3.47)	(2.45)	(1.17)
GFCF	0.119	0.175**	0.145***	0.143***	0.130***	0.134***	0.139***	0.165***	0.207***
	(1.22)	(2.28)	(2.90)	(3.36)	(3.80)	(4.11)	(5.14)	(4.89)	(3.84)
EXP	-0.181	-0.077	-0.077	-0.117	-0.087	-0.071*	-0.064*	-0.050	-0.018
	(0.85)	(-0.52)	(-0.72)	(-1.59)	(-1.49)	(-1.67)	(-1.71)	(-1.30)	(-0.31)
WGI	0.135**	0.119**	0.088	0.064	0.048	0.037	0.030	0.036*	0.038
	(2.40)	(2.01)	(1.49)	(1.16)	(1.09)	(1.15)	(1.14)	(1.68)	(1.42)
Intercept	-0.084***	-0.016	0.004	0.018***	0.027***	0.037***	0.043***	0.053***	0.077***
	(-3.02)	(-1.00)	(0.50)	(2.55)	(11.41)	(13.92)	(23.33)	(15.08)	(12.13)

Note: The quantiles are classified in three areas: low (L) or lower tail of distribution, which includes the 10^{th}–30^{th} quantile; middle (M), which includes the 40^{th}–60^{th} quantile; and high (H) or higher tail of the distribution, which includes the 70^{th}–90^{th} quantile.

***, ** and * indicate statistical significance at the 1%, 5% & 10% levels, respectively. The standard errors are presented in the parentheses, which are obtained with a bootstrap of 50.

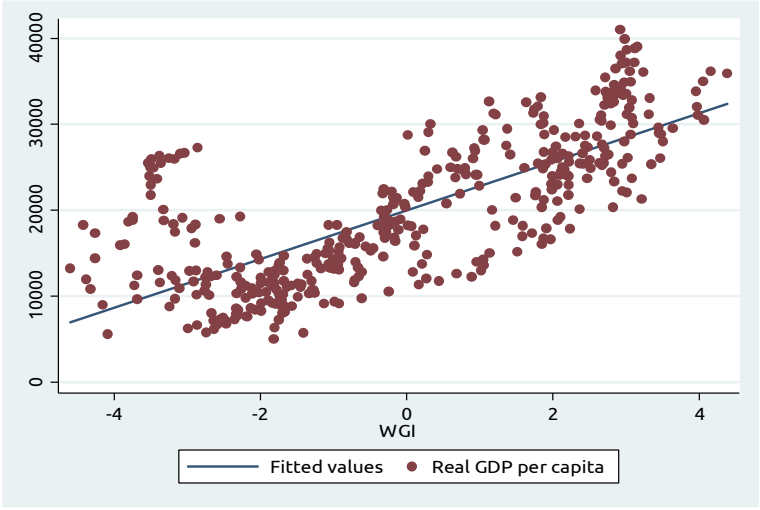
The coefficient of trade openness is positive and significant and it is characterized by a decreasing tendency in line with the increase in quantiles. A 1% increase in trade openness leads to an increase in GDP per capita by 0.113–0.396 %. Therefore, trade openness has been clearly characterized by a large impact in the countries with the lower and middle level of economic growth (see Table 12). The declining trend in magnitude indicates that the positive effect of trade openness on economic growth is stronger in the countries characterized with initially low and middle growth levels. However, it is visible that this impact dissipates in the high-growing countries (90^{th} quantile). Our finding are opposite to the results of Silva et al. who found that trade openness had positive relationship with economic growth, but this association is higher in higher growth countries (Silva et al., 2018).

Table 12. Classification of Countries by Real GDP Per Capita

Real GDP per capita	Quantiles		
	10-30th	40-60th	70-80th
Countries	Albania Armenia BiH Georgia Moldova Ukraine	Belarus Bulgaria Latvia Montenegro North Macedonia Poland Romania Russia Serbia	Croatia Czech Republic Estonia Hungary Lithuania Slovakia Slovenia

The positive significant impact of GFCF's coefficient on economic growth decreased from 0.175 at 20th to 0.130 at 50th quantile, and then recorded an increase and reached its peak at 90th quantile. Such outcome indicates that physical capital accumulation is a crucial growth determinant, which has a stronger impact in countries with lower and higher levels of economic growth. The negative sign of the coefficient government expenditure is consistent with the expectations of economic theory, but it is only apparent in top quantiles (60th and 70th).

Figure 15. Real GDP Per Capita and Overall Quality of Institutional Setting



The quality of institutions exerts a statistically significant positive influence on economic growth at the top end of growth distribution (10th, 20th and 80th quantile). The coefficient of WGI is highly significant at the low end of the economic growth distribution, which means that the improvement of the institutional setting in the countries characterized by lower levels of economic growth had strong impact on the their economic performance. Namely, this implies that the low-growth transition countries reacted better to the enhancement of the institutional framework than the high-growth ones. In figure 15, we showed the relationship between real GDP per capita and the overall quality of the institutional setting. It can be concluded that there is a positive relationship between these two variables, but the degree of this association varies across countries. It is interesting that in the case of the 90th quantile (the highest income group countries), only gross fixed capital formation of the explanatory variables proved to be highly statistically significant and affecting the economic growth.

Taking into account that WGIs cover three crucial areas of institutions, we analysed separate impacts of each of them on economic growth in the following sections. Kaufmann et al. distinguish the following groups of governance:

- voice and accountability (VA) and political stability and absence of violence (PSAV) indicators assess 'the process by which governments are selected, monitored and replaced';
- government effectiveness (GE) and the rule of law (RL) indicators captures 'the capacity of the government to effectively formulate and implement sound policies';
- control of corruption (CC) and regulatory quality (RQ) indicators refers to 'the respect of citizens and the state for the institutions that govern economic and social interactions among them' (Kaufmann et al., 2011).

5.3.1 *Economic Effects of Public Governance on GDP per Capita*

The functioning of the public governance is analysed relying on the indicators such as RL and GE – institutional aspects that reinforce and support each other in the pursuit of a well-functioning institutions. The findings of the PQR in the case of considering the rule of law's influence on economic growth (see Table 13) show significant positive impact of inward FDI stock on economic growth from the low (10^{th}) to higher (70^{th}) quantiles. This significant impact is fading away at the 80^{th} quantile, but then turning to a negative non-significant effect in the upper quantile (90^{th} quantile). For instance, while a 1% increase in FDI stock increases GDP per capita by 0.247% in the under-performing transition countries (the lowest quantile), a 1% increase in FDI stock increase the GDP per capita by 0.028 in high-middle income countries (70^{th} quantile). Our findings are in contrast with the conclusions of Gezdim and Zortuk who found that FDI was more beneficial to transition countries, which recorded a period of middle to high economic growth (Gezdim & Zortuk, 2018). On the other hand, Raifu and Aminu demonstrate that FDI has negative and significant effect on economic growth, the detrimental impact of which is stronger in the countries with higher economic performance (Raifu & Aminu, 2023). Our results are not in line with the conclusion made by Ansari and Sensarma who found that FDI adversely affected economic growth, with lower growth economies being more vulnerable to its negative impact (Ansari & Sensarma, 2019).

The coefficients of inflation and government expenditures have signs in accordance with theoretical prediction, but the effect is non-significant in any of the quantiles. Trade openness significantly increase GDP per capita from the lower (10^{th}) to higher (80^{th}) quantiles. The magnitude of coefficient's significance is higher in lower quantiles of the growth distribution. We demonstrate that trade openness has potential to augment economic growth, as is also shown by Tsaurai (Tsaurai, 2023b) and Liang et al. (Liang et al., 2021) who argue that greater trade liberalization lead to upsurge in economic growth. Our findings show

a positive and significant impact of GFCF on economic growth in almost all quantiles with the exception of the 10th quantile level (as in previous tables). We argue that physical capital is more beneficial to the countries that experience middle and higher levels of economic growth rates. It is a vital component for the promotion and facilitation of sustained economic growth and development, as is shown in the study by Fetahi-Vehapi et al. (Fetahi-Vehapi et al., 2015) where they also reveal evidence for the growth enhancing effect of physical capital accumulation.

Table 13. Panel Quantile Regression Results (with RL)

Variable	10th	20th	30th	40th	50th	60th	70th	80th	90th
FDIs	0.247***	0.116**	0.066*	0.050*	0.037**	0.040***	0.028*	0.022	-0.027
	(3.22)	(2.10)	(1.83)	(1.91)	(2.28)	(2.64)	(1.72)	(0.93)	(-0.65)
INF	0.003	-0.004	-0.0006	0.001	-0.0009	0.0008	0.002	0.002	0.001
	(0.33)	(-1.14)	(-0.27)	(0.50)	(-0.49)	(0.54)	(1.24)	(0.88)	(0.32)
OPEN	0.387**	0.335**	0.280***	0.265***	0.204***	0.194***	0.190***	0.198***	0.125
	(1.93)	(2.25)	(2.73)	(3.46)	(3.51)	(4.86)	(4.48)	(4.01)	(1.47)
GFCF	0.224	0.161**	0.147***	0.151***	0.130***	0.148***	0.136***	0.152***	0.204***
	(1.53)	(2.42)	(2.57)	(3.62)	(3.66)	(5.66)	(4.93)	(4.99)	(3.59)
EXP	-0.203	-0.107	-0.124	-0.092	-0.097	-0.062	-0.055	-0.047	-0.036
	(-0.89)	(-0.62)	(-1.03)	(-1.03)	(-1.44)	(-1.03)	(-1.03)	(-0.75)	(-0.41)
RL	0.516***	0.464***	0.334**	0.256**	0.182**	0.156**	0.145***	0.120**	0.132*
	(3.47)	(2.61)	(2.30)	(2.20)	(2.09)	(2.40)	(2.53)	(1.98)	(1.64)
Intercept	-0.078***	-0.026*	0.002	0.016***	0.028***	0.036***	0.044***	0.051***	0.076***
	(-3.95)	(-1.91)	(0.32)	(3.02)	(8.17)	(15.64)	(20.78)	(13.05)	(11.17)

Note: The quantiles are classified in three areas: low (L) or lower tail of distribution, which includes the 10th–30th quantile; middle (M), which includes the 40th–60th quantile; and high (H) or higher tail of the distribution, which includes the 70th–90th quantile.

***, ** and * indicate statistical significance at the 1%, 5% & 10% levels, respectively. The standard errors are presented in the parentheses, which are obtained with a bootstrap of 50.

There is a strong and significant relationship between the rule of law and economic growth, implying that RL represents an important determinant of economic growth in transition countries. The positive effect of RL reaches the maximum point at the 10th quantile, and afterwards this positive and significant

effect declines. As we move from low to high quantile levels, the impact of RL on economic growth tends to decrease gradually (from 0.516 at the lower tail to 0.132 at the higher tail of the growth distribution). Moreover, in lower-growth countries, the promotion and strengthening of the rule of law contributes to economic growth more than in the countries with high rates of economic growth. The rule of law is considered the main prerequisite and essential element of any democratic system that represents the basis for achieving the sustainable development goals. By protecting the economic sphere from political influence, the rule of law aims to establish and maintain the predictability of the institutional environment and political, economic and legal stability. That is why the strengthening of the rule of law, as a multidimensional concept, is seen as a key reform step in the direction of the overall development of countries. The outcomes of our study correspond to the findings of Zarić and Bacić (Zarić & Bacić, 2021), Bayar (Bayar, 2016) and Nedanovski and Shapkova Kocevska (Nedanovski & Shapkova Kocevska, 2023). For instance, Zvezdanović Lobanova et al. find that strengthening the rule of law produces positive economic effect on output growth (Zvezdanović Lobanova et al., 2016). Legal certainty and a functional judiciary stimulate the growth of domestic and foreign investment activity and economic growth. A stable and credible legal framework creates a favourable environment for the emergence and further development of entrepreneurial ideas, which is of key importance for economic efficiency.

In Figure 16, we portray the variations in the explanatory variables' coefficient over the conditional quantiles. The effect of inward FDI stock has a decreasing trend in all the selected quantiles. According to the sign and the magnitude of the coefficient for this variable, we conclude that FDI decreases monotonically with the level of economic development. All of our key independent variables have heterogeneous impact on economic growth in its conditional distribution. It is noteworthy that RL, OPEN and GDFC show decreasing trend from the lower to higher quantiles, suggesting that their effects on economic performance are influential at the bottom quantile levels (less developed transition countries).

Figure 16. Change in the Panel Quantile Regression Coefficients

Note: Y-axes stands for the coefficient of independent variables (FDI, INF, OPEN, GFCF, EXP and RL) and x-axes shows the quantiles of the dependent variable (economic growth). The blue shaded area represents the 95% confidence intervals of quantile regression estimates in both directions while the blue line in the middle refers to PQR estimates.

In table 14, we included the GE as the second governance dimension that evaluates the state's capacity to proficiently execute and enforce sound policies. The inward FDI stock has a positive influence on economic growth. However, it should be mentioned that as the FDI stock increase, we recorded positive effect on economic growth, which has the tendency to decrease from the lower to higher quantile levels. Namely, every 1% increase in the inward FDI stock increases the 10th quantile of economic growth by 0.370%, the 40th quantile by 0.056% and the 60th quantile by 0.038%. As in the previous quantile regressions, the positive impact of this variable diminishes in higher quantiles, where the transition countries denoted as the best performers in terms of economic performance are located. The coefficients of trade openness are positive and statistically significant in all quantiles (with exception of the 90th quantile),

which indicates that the conditionally low-growth countries react more than the conditionally high-growth countries to an increase in trade openness.

A positive and significant relationship between economic growth and GFCF is apparent in all the quantiles. It is noteworthy that the magnitude of the coefficients decreases from the 10th to the 50th, records stagnation and a small decline from the 60th to the 80th quantile levels, and then increases again. The coefficient of government expenditure is negative and statistically significant from the 40th to the 70th quantiles. At lower percentiles, an increase in government spending share have an insignificant negative impact on economic growth, but as we move across the quantiles the significance of this regressor increase. The negative impact of this variable means that government

Table 14. Panel Quantile Regression Results (with GE)

Variable	10th	20th	30th	40th	50th	60th	70th	80th	90th
FDIs	0.370***	0.130	0.061	0.056*	0.046*	0.038**	0.030	0.024	-0.033
	(4.51)	(1.12)	(0.92)	(1.64)	(1.75)	(2.00)	(1.48)	(0.92)	(-0.80)
INF	-0.016	-0.003	0.001	0.0002	-0.0003	-0.0003	0.0005	0.002	0.005
	(-1.30)	(-0.45)	(0.24)	(0.09)	(-0.14)	(-0.23)	(0.30)	(1.30)	(1.24)
OPEN	0.404**	0.350**	0.235***	0.222***	0.195***	0.186***	0.186***	0.169***	0.124
	(1.99)	(2.14)	(2.70)	(3.94)	(4.49)	(4.07)	(3.93)	(2.63)	(1.26)
GFCF	0.289*	0.211**	0.174***	0.151***	0.148***	0.150***	0.150***	0.136***	0.194***
	(1.71)	(2.13)	(3.48)	(5.07)	(6.16)	(7.50)	(5.91)	(4.05)	(4.03)
EXP	-0.335	-0.166	-0.129	-0.139*	-0.110*	-0.093**	-0.086*	-0.077	-0.042
	(-1.26)	(-0.86)	(-1.08)	(-1.76)	(-1.89)	(-2.10)	(-1.74)	(-1.36)	(-0.59)
GE	0.418***	0.178	0.089	0.055	0.041	0.034	0.033	0.046*	0.047
	(2.96)	(1.39)	(1.22)	(1.36)	(1.38)	(1.44)	(1.52)	(1.82)	(1.40)
Intercept	-0.119***	-0.016	0.012	0.024***	0.031***	0.038***	0.043***	0.053***	0.078***
	(-5.17)	(-0.65)	(1.16)	(6.32)	(10.73)	(19.14)	(23.75)	(19.13)	(15.35)

Note: The quantiles are classified in three areas: low (L) or lower tail of distribution, which includes the 10th–30th quantile; middle (M), which includes the 40th–60th quantile; and high (H) or higher tail of the distribution, which includes the 70th–90th quantile.

***, ** and * indicate statistical significance at the 1%, 5% & 10% levels, respectively. The standard errors are presented in the parentheses, which are obtained with a bootstrap of 50.

expenditures are not properly and effectively invested in areas that raise productivity, innovation and social well-being. Their effectiveness largely depends on the specific economic and institutional context. Unproductive government spending can have direct and/or indirect negative impact on economic growth, by crowding out private sector investment (domestic or foreign) in case when the expenditures are allocated inefficiently or misallocated.

We found that GE have significant encouraging effect on economic growth only at the 10^{th} and 80^{th} quantile levels (at lower and upper tail of growth distribution). It is worth mentioning that the effect of government effectiveness on economic growth is strong at extreme quantile levels, suggesting that the impact of this governance dimension is profound in the countries with either lower or higher levels of economic performance. Improving the quality of public and civil service and increasing the degree of its independence from political pressure has impact on raising trust in government institutions. A cumbersome and unreformed public sector reduces the quality of education, healthcare and public infrastructure, which inevitably affects competitiveness and economic performance with growing social dissatisfaction. Therefore, the enhanced effectiveness of government (strengthening the state administration capacity through increasing responsibility, transparency, work efficiency and improving the coordination) is found to be a positive driver of economic growth. Public sector performance is directly related to efficient and transparent government which is able to provide public services and implement sound policies to foster private sector development. Such an environment is conducive for domestic entrepreneurships and foreign investors, since investment activity can be carried out unhindered, with confidence that the rules and property rights will be respected consistently and fairly.

5.3.2 *Economic Effects of Confidence in Institutions on GDP per Capita*

The RQ and CC are pivotal aspects of governance, whose intersection establishes a robust governance framework. In our empirical analysis, we used these two institutional aspects as essential benchmarks for investigating the confidence in institutional setting. The PQR estimates in table 15 (incorporating the RQ into this model) clearly demonstrate that inward FDI stock positively determines the economic growth, and this effect is clearly heterogeneous. At initial (10^{th}) and middle (50^{th}) quantiles, FDI stock has significant coefficient at 5% and 10% level of significance, respectively. It is noteworthy that the estimated 10^{th} quantile coefficient of the inward FDI stock is at least eight times larger than that of the 50^{th} quantile. A positive and significant association between trade openness and economic growth is evident in all quantiles, with the exception of the 90^{th} quantile (in the highest growing countries). The magnitude of these coefficients are greater in the countries characterized with lower growth rates, which implies that they have made greater efforts to remove the trade barriers and create market-friendly regulatory policies. Such findings are in line with the outcome of Gezdim and Zortuk who argue that trade openness is a crucial growth determinant in the countries with lower economic performance (Gezdim & Zortuk, 2018).

From the 20^{th} quantile onwards, physical capital has a significant and positive effect on economic growth. GFCF is found to be an important accelerator of economic growth in the European transition countries. We demonstrate that an increased economic growth is triggered by higher investment in the fixed capital formation. As in the previous tables, government expenditure figures with an insignificant negative effect on economic growth at the 10^{th} to 40^{th} quantiles. Then, it begins to have a significant effect from the 50^{th} to 70^{th} quantiles. Our conclusion that government expenditure is harmful for GDP per capita is in line with the findings of Andrade et al. who argue that government spending is growth detrimental for the countries denoted as over achieving (Andrade et al., 2014).

Table 15. Panel Quantile Regression Results (with RQ)

Variable	10th	20th	30th	40th	50th	60th	70th	80th	90th
FDIs	0.272**	0.085	0.044	0.039	0.035*	0.022	0.019	0.014	-0.024
	(2.48)	(0.96)	(0.85)	(1.54)	(1.76)	(1.22)	(0.99)	(0.60)	(-0.63)
INF	-0.013	-0.005	0.0009	-0.00003	0.001	0.0001	0.001	0.002	0.004
	(-0.83)	(-0.73)	(0.25)	(-0.01)	(0.75)	(0.06)	(0.75)	(1.02)	(0.76)
OPEN	0.600**	0.341*	0.238**	0.202***	0.188***	0.188***	0.178***	0.169***	0.123
	(2.18)	(1.67)	(1.99)	(2.92)	(3.63)	(3.97)	(3.64)	(2.64)	(1.19)
GFCF	0.026	0.198***	0.140***	0.139***	0.146***	0.134***	0.142***	0.164***	0.182***
	(0.17)	(2.64)	(3.48)	(4.69)	(7.12)	(7.02)	(5.88)	(5.92)	(4.21)
EXP	-0.196	-0.105	-0.138	-0.125	-0.099*	-0.088**	-0.091**	-0.057	-0.040
	(-0.56)	(-0.54)	(-1.20)	(-1.50)	(-1.66)	(-2.11)	(-2.31)	(-1.52)	(-0.74)
RQ	0.202	0.242*	0.129	0.093*	0.094**	0.084**	0.071	0.074*	0.057
	(1.28)	(1.89)	(1.37)	(1.61)	(2.11)	(2.03)	(1.58)	(1.69)	(1.41)
Intercept	-0.083**	-0.015	0.011	0.022***	0.028***	0.037***	0.044***	0.052***	0.076***
	(-2.42)	(-0.94)	(1.23)	(5.55)	(10.81)	(17.55)	(23.44)	(17.47)	(16.11)

Note: The quantiles are classified in three areas: low (L) or lower tail of distribution, which includes the 10^{th}–30^{th} quantile; middle (M), which includes the 40^{th}–60^{th} quantile; and high (H) or higher tail of the distribution, which includes the 70^{th}–90^{th} quantile.

***, ** and * indicate statistical significance at the 1%, 5% & 10% levels, respectively. The standard errors are presented in the parentheses, which are obtained with a bootstrap of 50.

The relationship between regulatory quality and economic growth is positive and significant at the 20^{th}, in range between the 40^{th} and 60^{th} (middle group), as well as at the 80^{th} quantile levels. The promotion of structural reforms on country's regulatory framework has a positive and significant contribution to economic growth. An effective regulatory system stimulates competition, enhances the ease of doing business and provides numerous economic and social benefits, which directly and indirectly reflect on the economic prosperity. Well-designed, robust and transparent regulatory framework aligned with international standards ensures stability and certainty, raises domestic and foreign investors' confidence and protects property rights. Such business-friendly environment encourages more FDI inflows and contributes to the overall economic growth. Our findings are also confirmed by Petreski (Petreski, 2014), Mokhtarifar et al.

(Mokhtarifar et al., 2023) and Abd Rahman et al. (Abd Rahman et al., 2021).

In table 16, all the estimated coefficients have signs which are consistent with the theoretical assumptions. The FDI stock has a heterogeneous effect on economic growth, which is evident from the first row of the table. From the lower tail of the growth distribution, this coefficient is positive and significant at the 10th and 20th quantiles, with 1% and 5% levels of significance, respectively. Then, it remains positive, yet becomes insignificant from the 30th to the 50th quantile levels. However, our findings show positive and significant effect of FDI stock on economic growth at the 60th and the 70th quantile levels. Interestingly, at the 90th quantile level, we found a negative and non-significant relationship between these variables. Such results can be explained by the fact that FDI could be detrimental to economic growth in the following cases: a) if this type of investment is concentrated in a few industries or sectors upon which the overall performance of the economy heavily depends; b) when they provoke a rapid appreciation of the local currency, or cause financial market distortions; c) repatriation of profits; d) increase income inequality among different regions within the country, etc.

The impact of trade openness on economic growth shows a decreasing trend in all the selected quantiles. The coefficient is positive and highly statistically significant in almost all our regressions. Once again, we concluded that greater openness to trade encourages economic growth in the countries characterized with lower economic performance. Trade openness's coefficient decreases from 0.418 at the 10th quantile to 0.172 at the 60th quantile level, suggesting that greater trade liberalization had a large impact in the under-performing countries. The coefficient of influence of GFCF on economic growth has just passed the significance test from the 30th to 90th quantile levels. Its coefficient decreases from the lower tail of the growth distribution, at about 0.200 at the 10th to 0.128 at the 50th quantile level, and then records an increase. The relationship between government spending and economic growth is negative and significant only at the 40th and the 50th quantiles, so we conclude that government spending is especially growth detrimental for middle-growth countries.

Table 16. Panel Quantile Regression Results (with CC)

Variable	10th	20th	30th	40th	50th	60th	70th	80th	90th
FDIs	0.320***	0.158**	0.075	0.062	0.044	0.039**	0.028*	0.015	-0.016
	(3.93)	(1.95)	(1.18)	(1.32)	(1.54)	(2.16)	(1.71)	(0.71)	(-0.45)
INF	-0.014	-0.001	-0.001	-0.0008	0.0007	0.001	0.002	0.002	0.005
	(-0.98)	(-0.12)	(-0.24)	(-0.33)	(0.36)	(0.84)	(0.91)	(0.84)	(1.17)
OPEN	0.418***	0.378**	0.247**	0.217***	0.174***	0.172***	0.175***	0.186***	0.143
	(2.49)	(2.48)	(2.12)	(2.97)	(3.66)	(3.83)	(3.51)	(2.62)	(1.49)
GFCF	0.200	0.156	0.155**	0.133***	0.128***	0.137***	0.137***	0.151***	0.189***
	(1.39)	(1.58)	(2.43)	(3.59)	(4.02)	(5.19)	(5.06)	(4.31)	(3.63)
EXP	-0.172	-0.157	-0.197	-0.189**	-0.137*	-0.080	-0.070	-0.055	-0.052
	(-0.72)	(-0.91)	(-1.44)	(-2.10)	(-1.82)	(-1.31)	(-1.45)	(-1.06)	(-1.39)
CC	0.446***	0.330**	0.153	0.104	0.070	0.052	0.061**	0.070**	0.016
	(4.19)	(2.41)	(1.08)	(0.97)	(1.08)	(1.30)	(2.07)	(2.27)	(0.42)
Intercept	-0.098***	-0.027	0.007	0.020**	0.030***	.038***	0.044	0.052***	0.074***
	(-4.25)	(-1.25)	(0.50)	(2.40)	(6.59)	(13.88)	(18.80)	(17.07)	(11.06)

Note: The quantiles are classified in three areas: low (L) or lower tail of distribution, which includes the 10^{th}–30^{th} quantile; middle (M), which includes the 40^{th}–60^{th} quantile; and high (H) or higher tail of the distribution, which includes the 70^{th}–90^{th} quantile.

***, ** and * indicate statistical significance at the 1%, 5% & 10% levels, respectively. The standard errors are presented in the parentheses, which are obtained with a bootstrap of 50.

The impact of CC on economic growth is varied. We found positive impact of CC on economic growth across all quantiles. The highest significant value of the coefficient is recorded at the 10^{th} quantile, and afterward it decreases. Besides, the coefficient is significant at the 20^{th} and the 70–80^{th} quantile levels, suggesting that the fight against corruption produces effective results in the countries located in the bottom and top quantiles of the growth distribution. High dependence on the public sector has likely caused the rise in corruption level in transition countries. The expansion of private business has depended on political support, which has had a limiting effect on their economic development. Corruption, as an essential component of governance, has led to further deepening of socio-economic inequalities and injustice, which has had a profound impact on economic efficiency. In the economy and society, the respect for the rules and procedures and trust in government institutions have been lost

in many countries. State capture, as a type of systemic political corruption that is present in certain transition countries, could lead to adverse consequences in all the aspects of governance. Since it prioritizes the private interest over public interest, government is not focused on creating economically sound policy in accordance with public well-being. Therefore, the introduction and effective implementation of a regulatory mechanism that ensures effective control of corruption was intended to increase the economic growth in these countries. For that purpose, raising awareness about the fight against corruption, with the respect for democratic values, the rule of law and the protection of basic human rights and freedoms, were of key importance.

5.3.3 *Economic Effects of Political Institution's Strength on GDP per Capita*

We evaluated the impact of institution's strength on economic growth based on the indicators such as PSAV and VA. Resilience of institutions is greater in the countries characterized by long-term peaceful conditions and mechanisms that provide citizens to express their opinion and hold state authorities accountable. The findings in Table 17, where we included PSAV into our model, show that the impact of inward FDI stock on economic growth is stronger for countries located in the 10^{th} quantile, as well as for those from the 40^{th} -70^{th} quantiles. The coefficient of inflation is negative and highly significant only at the 10^{th} quantile. Therefore, we conclude that inflation is especially adverse for economic growth in under-performing countries. Unlike previous tables, the coefficient of trade openness has an insignificant positive effect at the 20^{th} and 90^{th} quantiles. The positive impacts of trade openness of the low quantile countries are greater than those of the middle and high quantile countries. In addition, our findings yield positive effect of GFCF on economic output. Therefore, we conclude that the effects of trade openness and physical capital are stronger for the low-growth countries. The EXP is a statistically significant negative coefficient at lower quantiles (20^{th} and 30^{th} quantiles). For the

lower quantiles, our findings suggest that government spending represent a less important growth determinant.

PSAV figures as an insignificant negative effect on economic growth in the 10th quantile, while its positive but also non-significant impact continues throughout the rest of the quantile regressions. Although insignificant, the negative sign could be justified by the following mechanism: political stability can hamper economic growth in condition when it is achieved and maintained with the help of repression or prolonged dominance of a single political party. If one party or a coalition of parties in government maintains political stability, it could potentially hinder economic development in the long run. In such circumstances, the thus established long-standing political stability characterized by the lack of political pluralism and concentration of power in the hands of wealthy elites, could lead to raising inequality, causing social division and social unrest. Growing

Table 17. Panel Quantile Regression Results (with PSAV)

Variable	10th	20th	30th	40th	50th	60th	70th	80th	90th
FDIs	0.303**	0.088	0.065	0.043**	0.036**	0.044***	0.033**	0.019	-0.023
	(2.18)	(1.05)	(1.58)	(1.91)	(2.46)	(3.26)	(2.23)	(1.09)	(-0.64)
INF	-0.034***	-0.004	-0.001	-0.0006	-0.001	0.0001	0.0001	0.002	0.003
	(-2.76)	(-1.00)	(-0.46)	(-0.24)	(-0.87)	(0.11)	(0.07)	(0.96)	(0.67)
OPEN	0.545**	0.294	0.211**	0.201***	0.166***	0.177***	0.183***	0.156**	0.144
	(2.15)	(1.45)	(2.18)	(3.31)	(3.48)	(3.73)	(3.49)	(2.25)	(1.56)
GFCF	0.362**	0.144*	0.163***	0.137***	0.144***	0.140***	0.138***	0.165***	0.177***
	(2.25)	(1.87)	(4.35)	(4.48)	(6.14)	(6.65)	(6.66)	(5.37)	(4.09)
EXP	-0.245	-0.264*	-0.217**	-0.136	-0.103	-0.087	-0.072	-0.050	-0.056
	(-0.80)	(-1.68)	(-2.13)	(-1.49)	(-1.36)	(-1.30)	(-1.17)	(-0.78)	(-0.71)
PSAV	-0.030	0.012	0.015	0.003	0.009	0.012	0.015	0.026	0.017
	(-0.31)	(0.31)	(0.66)	(0.21)	(0.79)	(1.03)	(0.92)	(1.23)	(0.62)
Intercept	-0.097***	-0.003	0.012**	0.025***	0.033***	0.039***	0.043***	0.055***	0.076***
	(-2.72)	(-0.26)	(2.50)	(8.24)	(15.37)	(23.99)	(18.79)	(21.08)	(14.11)

Note: The quantiles are classified in three areas: low (L) or lower tail of distribution, which includes the 10th–30th quantile; middle (M), which includes the 40th–60th quantile; and high (H) or higher tail of the distribution, which includes the 70th–90th quantile.

***, ** and * indicate statistical significance at the 1%, 5% & 10% levels, respectively. The standard errors are presented in the parentheses, which are obtained with a bootstrap of 50.

political polarization in transition countries could downgrade economic growth outlook, as political instability opens up space for corrupt activities, erodes investor confidence and hampers unhindered economic activity. Our findings are aligned with those obtained by Piatek et al. who argue that political freedom seems to have neutral effects on economic growth in transition countries, while the expansion of economy could potentially affect the degree of political freedom (Piatek et al., 2013).

In table 18, the estimated magnitudes varied considerably from lower to higher quantiles. The countries having lower economic growth (at 10th quantile) record positive and strong impact of FDI stock on economic growth. Our regression quantile analysis also shows the positive effect of FDI stock on economic performance within the 40th–60th quantile range (in the middle tail of the conditional distribution), which implies that FDI represents a crucial determinant of economic growth in this group of transition countries (with low and middle economic growth).

The trade openness has positive and significant association with economic performance: the magnitude of coefficients decrease as the quantiles increase. Trade openness has positive effect on economic performance in transition countries at all quantile levels, and for every 1% increase in trade openness, economic growth increases in the range of 0.175–0.710. The estimated GFCF's coefficients for the lowest (10th) and highest (90th) quantiles are not statistically significant. The influence coefficient of government spending on economic growth was significant at quantile the 60th and 70th levels and the coefficient sign was negative.

Voice and accountability is found to have an insignificant positive effect on economic growth in all the quantiles. We argue that the majority of transition countries have low voice and accountability mechanisms i.e. citizens have limited opportunities to engage in decision-making processes and express their concerns about political situation in the country. It is worth mentioning the VA's impact and interplay with other facets of institutional environment (in particular political stability, fight against corruption and the rule of law), which hold important significance for foreign investors' decision-making. Our findings

indicate that all transition countries have made progress in the field of strengthening of political institutions, yet insufficiently for achieving positive impact on the economic outlook.

Table 18. Panel Quantile Regression Results (with VA)

Variable	10th	20th	30th	40th	50th	60th	70th	80th	90th
FDIs	0.289***	0.095	0.056	0.052**	0.032**	0.027*	0.028	0.018	-0.021
	(2.65)	(1.07)	(1.19)	(2.19)	(1.93)	(1.75)	(1.60)	(1.05)	(-0.48)
INF	-0.022	-0.006	-0.0003	-0.0008	-0.0008	-0.001	0.0003	0.001	0.005
	(-1.49)	(-1.10)	(-0.14)	(-0.42)	(-0.44)	(-0.69)	(0.16)	(0.61)	(1.35)
OPEN	0.710***	0.356*	0.234*	0.227***	0.199***	0.185***	0.189***	0.195***	0.175*
	(2.93)	(1.62)	(1.86)	(3.17)	(3.97)	(4.37)	(4.51)	(3.22)	(1.80)
GFCF	0.149	0.156*	0.134***	0.116***	0.135***	0.149***	0.142***	0.148***	0.185
	(0.92)	(1.87)	(3.07)	(3.43)	(5.07)	(7.77)	(7.60)	(4.55)	(3.58)
EXP	-0.224	-0.138	-0.126	-0.108	-0.097	-0.088**	-0.086***	-0.067	-0.033
	(-0.91)	(-0.80)	(-1.18)	(-1.36)	(-1.60)	(-2.18)	(-2.90)	(-1.59)	(-0.93)
VA	0.190	0.140	0.100	0.095	0.078	0.056	0.051	0.068	0.053
	(1.01)	(0.86)	(0.79)	(1.01)	(1.07)	(0.99)	(1.03)	(1.22)	(0.58)
Intercept	-0.093***	-0.009	0.014*	0.023***	0.032***	0.039***	0.044***	0.054***	0.077
	(-3.04)	(-0.53)	(1.71)	(6.43)	(13.06)	(20.73)	(26.43)	(19.66)	(15.93)

Note: The quantiles are classified in three areas: low (L) or lower tail of distribution, which includes the 10^{th}–30^{th} quantile; middle (M), which includes the 40^{th}–60^{th} quantile; and high (H) or higher tail of the distribution, which includes the 70^{th}–90^{th} quantile.

***, ** and * indicate statistical significance at the 1%, 5% & 10% levels, respectively. The standard errors are presented in the parentheses, which are obtained with a bootstrap of 50.

Based on empirical findings in Tables 11–18, we provide support for the validity of our research results. In order to test the robustness, we conducted the quantile regression analysis by replacing the core variable (inclusion of governance indicators in regressions one at a time). The coefficients of FDI stock, inflation, trade openness, physical capital accumulation and governance expenditures do not change significantly. Therefore, we conclude that our panel quantile model of the impact of FDI and quality of institutional setting on economic growth is indeed robust.

Table 19. Equality Test

Variable	WGI 1	RL 2	RQ 3	CC 4	GE 5	PSAV 6	VA 7
FDIs	1.46	2.44***	1.60	2.70***	3.26***	1.33	1.63
INF	0.04	0.85	0.74	0.41	0.90	2.31**	1.05
OPEN	0.57	0.84	0.59	1.01	0.46	0.65	0.87
GFCF	0.59	0.66	1.00	0.41	0.49	0.92	0.48
EXP	0.50	0.26	0.52	0.60	0.75	0.98	0.52
INS	0.73	1.76*	0.66	3.30***	1.55	0.51	0.34

Note: ***, ** and * indicate statistical significance at the 1%, 5% & 10% levels, respectively.

Finally, we calculated the slope equality test to assess potential crucial differences in the effects of explanatory variables on the economic growth, or to evaluate whether certain coefficients remain consistent across different quantiles. According to our findings (see Table 20), the effects of FDI vary significantly across different quantiles in columns 2, 4 and 5 (in case of inclusion of governance indicators such as RL, CC and GE). Furthermore, the null hypothesis of slope equality across quintiles is also rejected for the explanatory variables RL and CC, suggesting a higher impact for the lowest quantile levels. The test of the equality of slopes also indicates the presence of parameter heterogeneity for inflation (see column 6).

5.4 CONCLUDING REMARKS

We applied PQR technique to detect the heterogeneous effects of institutional quality and inward FDI stock on economic growth in 22 European transition countries in the period 2002–2020. Our empirical study is characterized by the following limitations. We used open data sources on inward FDI stock and the quality of governance. As concerning the quality of institutional development data, we believe that the WGI data are based on expert opinions about the level of development and quality of institutions. This means that the data may lack objectivity and may not reflect the true state of governance in specific countries.

We found that the FDI stock is one of the growth determinants which has positive impact on economic performance in the low and middle income growth countries. Its positive impact is higher for the countries denoted as underperformers in terms of their economic outlook (slow growing transition countries). Trade openness has also positive effect on economic upswing whose growth impact is quantitatively higher for the slow growing or under-performing countries. Domestic investment has a quantitatively higher growth effect in under- and over-performing countries (lower and upper tail of the growth distribution). On the other hand, we found that in the majority of regressions, the growth performance of the middle-growing transition countries has been jeopardized by an increase in government spending.

Table 20. The Statistical Significance of Governance Indicators

Economic growth	Low			Middle			High		
Quantiles	10	20	30	40	50	60	70	80	90
WGI									
RL									
RQ									
CC									
GE									

Note: Black, deep grey and light grey colours denotes statistical significance at the 1%, 5% & 10% levels, respectively.

We confirmed our hypothesis about the heterogeneous impact of the overall institutional quality, as well various governance dimensions (with the exception of PSAV and VA) on the economic growth across quantiles. The positive and significant association between economic performance and indicators of institutional setting is also in line with the findings of Raza et al. (Raza et al., 2021). The effect of the overall quality of the institutional setting on economic growth is positive and significant for the lower and higher quantile levels. However, the positive impact of the overall institutional quality is larger in the countries

experiencing lower economic growth performance than in the countries where the economic growth performance has been fast. We found that governance indicators are positively associated with economic growth, which means that they encourage real GDP per capita in the given group of countries. Moreover, two aspects of institutional quality – public governance (GE and RL) and confidence in institutions (CC and RQ) proved to be relevant for the economic performance in transition countries. Namely, our estimates indicate that GE (at the low and high quantile levels) and RL (at all levels) have positive and significant influence on economic growth.

Regulatory quality drives economic growth in middle and high-income countries, as well as improvement of the legal and institutional anti-corruption framework. We demonstrate that the governance dimensions, which assess the strength of political institutions – PSAV and VA – prove to be insignificant for the economic growth in European transition countries. Although the PSAV coefficient at the 10^{th} quantile level is not statistically significant, it is necessary to investigate in detail what causes an adverse effect on economic growth in the underperforming transition countries, and implement measures and activities to create and maintain stable political environment as a prerequisite for continuous sustainable growth in transition countries. The majority of transition countries was faced with the lack of institutional mechanisms to ensure the protection of property rights, while the implementation of law was associated with inconsistency and political subjectivism. Unfortunately, the undertaken reforms in the areas of raising judicial efficiency and adoption of an adequate legislative framework have had a limited impact.

The rule of law is the foundation of constitutional democracy and is one of the key conditions for EU membership. The rule of law, as a guarantor of order, security and stability, and the fight against corruption are two sides of the same coin, since these two governance dimensions are very closely related. Corruption has a detrimental impact on the principles of legality and legal certainty, which undermines citizens' trust in institutions. It also calls into question two essential values on which the rule of

law is based – justice and freedom of citizens. At the same time, corruption could lead to the collapse of institutions in charge of rule of law implementation – ruining the basis on which all other dimensions of the quality of democracy and political institutions rest. In some transition countries, pervasive corruption and the abuse of the entrusted power for private gain are deeply ingrained in social and economic interaction. However, such environments are extremely unfavourable for attracting economy-driven capital, as they undermine the stability and functioning of democratic institutions and the rule of law.

Several important implications for policymakers may be drawn based on our findings. First, it is necessary to create the conditions not only conducive for the foreign investors (which contribute to an increase in employment, rise in productivity, infrastructure development, diversification of industrial structure), but also facilitating their regular economic functioning, in order to achieve long-term benefits of the capital inflow. In case of some transition countries, when the process of approximation to the core EU values and principles is concerned, further reforms are needed in areas such as the rule of law, control of corruption and government effectiveness. The process of European integration provides a pathway for the development of democratic norms and effective market economy.

The legal framework is largely harmonized with the EU legislation, although there remains significant challenges related with the problem of incomplete, inconsistent and/or selective implementation of the regulation. Despite the formal prerequisites, the lack of full institutional support has jeopardized the rule of law and governance, which drags down potential foreign investments. The state administration in many transition countries is still inefficient, ineffective and cumbersome, while the overlap of institutional responsibilities causes redundant, complicated and expensive procedures. There is still a deep gap between strong policy management system that includes a legal framework and necessary bodies, on the one hand, and limited implementation of laws and policies and ineffective collaboration among various state bodies, on the other.

Besides further improvements in regulatory quality, transition countries should focus on creating an environment for the application of regulations, in terms of protecting the independence and autonomy of competent institutions from political and other influences in the process of decision-making, as well as increased responsibility for the quality of the entrusted tasks' performance. In order to make the fight against corruption more effective, it is necessary to strengthen the cooperation between the public and private sectors, in order to increase the transparency of public administration work. The involvement of business representatives in the process of creating laws and by-laws, as well as other strategic documents, is of key importance. Poor implantation of anti-corruption policies is not only the result of the absence of will of the state authorities, but also a reflection of the lack of capacity for its implementation. Bearing in mind its negative consequences, the fight against corruption should begin with the strengthening of institutions that are directly involved in that process, as well as the adoption of a regulatory framework that will prevent and punish those involved in corrupt activities. The interplay between control of corruption, foreign investment activity and economic growth, underlines the role of anti-corruption attempts in building and maintaining vital environment for the domestic and foreign investment activity. We believe that governments should make additional efforts to establish and maintain political stability and voice and accountability mechanisms in order to foster sustainable economic growth. In case when citizens can express their concerns and participate in the decision-making process, governments are encouraged to formulate and implement consistent and sound policies that promote long-term economic performance rather than short-term political gains.

Our research has potential to be extended by investigating the influence of the interdependence between FDI stock and the quality of the institutional setting at the macroeconomic level. We can also include other indicators, which measure the quality of institutional arrangements, or add other countries undergoing transition.

APPENDIX

Appendix 1. *The Principal Component Analysis for the Overall Institutional Quality Index*

Table 1.1 Principal Components (Eigenvectors)

Variable	Comp1	Unexplained
VA	0.4041	0.1734
CC	0.4084	0.1554
GE	0.4225	0.0926
RL	0.4353	0.0405
RQ	0.4170	0.1199
PSAV	0.3578	0.352

Source: Author's research

Table 1.2 Kaiser-Meyer-Olkin Measure of Sampling Adequacy for WGI

Variable	kmo
VA	0.9310
CC	0.9083
GE	0.9221
RL	0.8503
RQ	0.8811
PSAV	0.9314
Overall	0.9002

Source: Author's research

Appendix 2. *The Assessment of Collinearity for Regression Variables*

Table 2.1 The Assessment of Collinearity for Regression

Variables	VIF	1/VIF
FDI	1.21	0.824
INF	1.19	0.838
OPEN	1.16	0.860
WGI	1.14	0.877
GFCF	1.07	0.933
EXP	1.03	0.966
Mean VIF	1.14	

Variables used in PQR Model from Table 12

Table 2.2 The Assessment of Collinearity for Regression

Variables	VIF	1/VIF
FDI	1.29	0.776
RL	1.24	0.808
INF	1.19	0.840
OPEN	1.17	0.857
GFCF	1.07	0.932
EXP	1.04	0.962
Mean VIF	1.17	

Variables used in PQR Model from Table 14

Table 2.3 The Assessment of Collinearity for Regression

Variables	VIF	1/VIF
INF	1.18	0.844
FDI	1.18	0.846
OPEN	1.17	0.853
GE	1.10	0.911
GFCF	1.07	0.932
EXP	1.03	0.966
Mean VIF	1.12	

Variables used in PQR Model from Table 15

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