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INSTITUTIONS AND FOREIGN DIRECT INVESTMENT: WHAT ROLE FOR INVESTMENT POLICY IN SOUTHEAST EUROPE?

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Abstract

Institutions are generally perceived as an important determinant of Foreign Direct Investment (FDI). Which institutions matter and why for FDI, remains however one of prominent questions in public policy debate amid complexities related to different institutional dimensions, and incomplete or even vague understanding of underlying mechanism(s) at work. In this paper we account for these ambiguities, and focus on institutions that reveal government efforts to design proper institutional and policy framework to attract FDI, as opposed to considering institutions in broader sense. Specifically, we contribute to FDI policy debate by analysing the impact of institutions measuring Investment policy and promotion on inward FDI flows in South East Europe (SEE). To this end we use a unique dataset that is comprised of specific, FDI related institutional indicators developed and published by the OECD. The results of this empirical investigation deeper our understanding on whether differences in FDI policies and institutional set-up across South East European (SEE) countries explain variations in inward FDI flows relaying on bilateral FDI flows and the gravity modelling technique. We bring novel evidence that investment policy efforts seemingly do pay off, highlighting the importance of progress and reforms embodied not only in FDI regulation, but also in FDI policy variables including FDI Promotion and Facilitation, Transparency, Privatisation policy and Public Private Partnership in attracting FDI in SEE. The analysed institutional effect properly accounts for the possible time-variant and context-dependant effect of institutions. The suggested importance of FDI policy variables seem valuable in terms of general FDI policy issues and trade-offs.

Keywords: *Foreign direct investment, transition economies, institutions*

JEL classification: *F13, F21, F23*

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1. Introduction

The financial and economic recovery in South East European (SEE) countries remains fragile, threatened by the emerging risks associated with recent austerity policies such as cuts in public investment and increases in taxes, as well as vague EU integration prospects for the Western Balkan countries. These countries were

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hard hit by the outbreak of global financial crisis back in 2008 with slow pace character of economic growth recovery persistent for over a decade. The recent crisis caused by COVID-19 global pandemic further contributed to bleak economic prospects and projected real growth rates below 2% in 2022. Continued external demand contraction seriously undermine much needed growth of the real sector, especially in the context of small-open economies and high dependence on external demand and foreign investments as is the case of SEE countries. In regard to foreign investments, recent shifts in modes of vertical integration depicted in strategies of 'near-sourcing' rather than simply 'outsourcing' point to the increased relevance of geographic distance in formal partnerships and locational investment decisions by multinational corporations. These changes caused by global pandemic pose a new opportunity for SEE to attract foreign direct investments (FDI) e.g. those aiming at 'closer' locational sites via vertical integration. In view of this, it is worth noticing that traditional, resource base and low cost determinants of FDI seem important but not sufficient to foster dynamic restructuring via FDI among SEE countries. As indicated by previous research, including more recent empirical evidence (Hossain et al. 2018; Jovanović and Jovanović 2017), institutional development remains crucial for stimulating private sector growth and employment in SEE, principally through dynamic and growing FDI inflows. However, which institutions, and what policies matter for FDI becomes a very important question. Past reviews of institutional reforms across SEE countries largely account for the progress made within the FDI related institutional framework (OECD 2010:2016). The reviewed FDI policy reforms encompass institutional set-up and policy measures specifically designed to target and accommodate the interests of foreign investors (OECD 2010). Relaying on these institutional indices, in this paper we analyse the role of FDI policy in attracting FDI, while examining the effectiveness of specific FDI policy initiatives and measures.

The acknowledged importance of institutions rests on the premise that institutions affect economic agents', including multinational cooperation (hereinafter: MNCs'), transaction and production cost (North 1990). They constitute a country specific locational advantage as they evolve in accordance with the intrinsic and indigenous historical, political and cultural setting of individual societies. As such, institutions are considered to represent an important 'immobile structure in a globalised market' (Mudambi and Navarra 2002), features of which underpin social and economic performance of individual countries. Moreover, in a world characterised by increasing number of countries competing for higher share of world's FDI, institutions are expected to play more important role and increasingly influence MNCs locational pattern (Dunning 1998).

Nevertheless the empirical evidence on the matter is mixed and conclusions on the role of institutions in attracting FDI are far from uniform (Bailey 2018; Kapas 2020; Ali et al. 2010). Most of the studies examining the impact of institutions on MNCs location decision focused on institutional dimension related to political crisis/stability as well as corruption, rule of low and efficiency considered crucial for contract enforcement, property rights protection, risk of expropriation and nationalisation. Although it seems reasonable to expect that these institutional features not only indirectly but also directly affect the costs and operations of MNCs in host countries as they affect MNCs' capacity to effectively utilise their knowledge and competencies, the literature reveals inconclusive evidence (see for instance Ali et al. 2010). Whereas cross-country analysis by for instance Addison and Heshmati (2003), Asiedu (2005), Campos and Kinoshita (2003) provide evidence in favour of these institutional dimensions and FDI, studies by Bevan et al. (2004), Busse (2004), Harms and Ursprung (2002), Globerman and Shapiro (2002) reveal mixed and inconclusive evidence on the importance of institutions in attracting FDI.

There are number of deficiencies associated with the empirical literature ranging from conceptual and measurement issues to methodological and data issues that have attributed to the inconsistency and lack of conclusive evidence favouring institutions. The conceptual and measurement issues are mostly attributed to the lack of clear and mutual understanding on which institutions matter and why (Bevan et al. 2004), as well as the failure to comprehend the importance of context of investigation including similarities and/or differences between countries included in sample. The results on the impact of institutions on FDI seem to vary substantially depending on a sample of countries included in the analysis. We treat these issues with caution and forethought. Precisely, in this paper an attempt is made to develop a clear conceptual framework encompassing specific institutional and policy reforms related to investment policy and promotion. Considering rather vague and unclear theoretical links and causal relationships between broad-ranging market based institutions and FDI, we emphasise the importance of, and discuss the mechanism(s) underpinning the analysed institutional and policy effects on MNCs, including explanation of direct links as well as positive externalities assumed to impact/minimise transition, coordination and operating costs of the multinationals.

First, following Havrylyshyn and Van Rooden (2003) reasoning, we argue of the importance of distinguishing between general purpose market-based institutions, from institutional reforms depicting government policy efforts. By the latter we mean deliberately designed policy measures and incentives that serve exact purpose, that is, reforms formulated and implemented as means to desired societal and economic ends, and managed by specific policy objective(s). No doubt, FDI policy and promotion indicators should be acknowledged as policy as opposed to general-purpose institutional measure per se, amid the very nature of FDI policy. The policy focus is on adopting regulation favouring foreign investors and on provision of incentive structures enabling special treatment of multinationals. This is to say that FDI policy is designed to impact MNCs locational decisions directly, penetrating investment and operating costs associated with both transiting to, and conducting business in host economy, as opposed to general-purpose institutional indicators that reflect on market structures and incentives on the whole. FDI policy measures often target provision of benefits associated with specificities of investment sites including infrastructure, availability of resources and factor inputs, linkages with local companies, as well as fiscal privileges of various sorts. While legal and regulatory institutional indicators reflect risks mostly associated with 'transaction costs' phenomena, the institutional reform indicators depicting FDI policy incentives are assumed to reflect on locational advantages of a host economy in a more direct manner. In light of this discussion, although investment climate and promotion related policy reforms fall under the umbrella of general institutional reforms and institutional progress in transition, in this analysis we use narrow interpretation of institutional development in that we separate the effects of institutions from policy effects.

Second, we account for the importance of specificities related to the sample of countries included in the analysis. Here, we argue that transition economies (hereinafter: TE) pose a right context to study the relationship between institutions or essentially institutional development and FDI. There are principally two reasons to expect that institutions are important determinant of FDI and positively affect MNC locational decisions in transition economies. The first is that transition economies are characterised by underdeveloped institutional setting including underdeveloped or non existent institutions essential in governing transitions associated with free market economy. The second reason is that TE often lack other important created assets especially those associated with knowledge and innovation. Therefore it seems reasonable to expect that TE compete aggressively in creating an institutional environment conducive to foreign investors.

The aim of this paper is to investigate the aspects of institutional development that seem important determinant of FDI receipts in transition economies. Unlike previous literature we rely on indicators of institutional development directly related to FDI that have not been used in past empirical research and examine the role of institutions in enhancing FDI flows. We contribute to the recent literature by distinguishing institutions and policy incentives in host transition economies that are assumed to be of precedent importance to foreign investors in that the quality of these institutions is expected to impact strategic locational decisions of foreign investors.

Relaying on extensive institutional data set covering Investment Reforms in South East Europe (SEE), provided by OECD for 8 SEECs, we analyse the importance of range of institutional and policy variables on FDI. The institutional indices in essence depict policy incentives specifically designed to attract and promote foreign investment inflows in the selected group of countries. Past research has principally highlighted the importance of general-purpose, market-enhancing institutions including rule of law, protection of intellectual property rights, transparency and government efficiency in promoting FDI inflows in transition economies. We go beyond the existing literature in that we analyse the relevance of specific institutions and policies designed to address foreign investor's interests and strategies. Specifically, we analyse the effects of FDI Facilitation and promotion, FDI policy, Privatisation and Private-Public Partnership policy in host economies on FDI. The principal question investigated is whether or not these policies are effective in promoting FDI in South East European Countries. To the best of our knowledge, the impact of these policy factors has not been previously investigated.

It is worth noticing that although we make use of unique dataset on FDI policy incidence, the nature of the data does not allow as to investigate the impact of these policy factors in a dynamic econometric framework, or to account for the impact of recent FDI institutional development. Instead, we rely on FDI policy data published in the 2010 OECD report, and account for their impact in a cross-sectional setting within the gravity econometric framework. Yet the empirical setting, the OLS method of investigation and the estimated models, account for the time-variant effects of institutions, as we regress FDI policy variables on FDI data averaged over 2007-2010 period, and on FDI data averaged over 2011-2014 period. The latter analysis accounts for the effect of institutions with a

time lag as suggested by previous research (Efendić and Pugh 2015). Taken as a whole, in this analysis we carefully consider and address the issue of data limitation, method of investigation and discuss the relevance of this empirical analysis integrating FDI policy indicators for the year 2010. In particular, in view of the specific context of the SEE countries, the obtained results i.e. coefficient estimates of institutions and policy variables are robust and as such seem of crucial importance since they render support to the FDI policy effectiveness. The findings feed in today's lively discussion on FDI policy perspectives.

This paper is structured as follows: in what follows we first consider theoretical aspects of the importance of institutional development and critically assess the basic premises related to the importance of institutions in enhancing foreign investments. We then briefly review past empirical research on the role of institutions in attracting FDI. Since it is beyond the scope of this analysis to provide a detailed assessment of recent studies, an attempt is made to review evidence in relation to purpose and motive of the study, scope of the study, method of investigation, institutional dimension and control variables. Section 3 elaborates the model and the methodology to be used in the analysis, while section 4 discusses the results of the empirical analysis. Conclusion follows.

2. Institutions and FDI: Theoretical conceptions and literature review

2.1. Institutions as locational advantage: theoretical premises

Institutional environment commonly encompasses political systems, policy making and policy enforcing institutional structures which determine economic structures at the national and sub-national levels. It includes institutional setting that provides formal rules of the game and sets forth the incentives to economic/societal agents as well as informal norms, set of beliefs, systems of values, customs considered also an important feature of the institutional environment of a given country. Different scholars perceive differently the relative importance of these various components, including the role played by formal and informal rules and conventions as well as the importance of and role played by organisations, encompassing both economic and social agents of various sorts. The FDI literature mostly emphasise the relevance of formal institutions as locational advantage as reliance on informal institutions tend to increase transaction costs of foreign investors relative to domestic agents. Studies by Meyer (2001) and Henisz (2000) have shown that institutional development in transition economies has had an impact on foreign investors' strategic decisions, arguably their entry modes, whereby quality of formal institutions seems of greater importance for establishing wholly owned ventures. In what follows we discuss in greater detail the relevance of institutions in international business and briefly review past empirical research on the role of institutions in attracting FDI.

The traditional locational advantages have been usually attributed to the overall macroeconomic conditions such as market size and growth, macroeconomic stability factors including inflation rate, sustainability of the balance of payments and external debt, as well as country/sector level features including factor endowments/resources, availability of (skilled) labour and its costs. Until relatively recently and along the lines of neoclassical theory more weight in terms of locational advantages has been given to factor resources and factor prices and other forms of more 'created assets' (Dunning 1998) including knowledge-based assets, infrastructure and institutional environment of a host country were not considered crucial (Bevan et al. 2004). The 1990s have witnessed the increasing internationalisation of production and operating activities by MNCs, not so much to low cost area but predominantly and increasingly to areas characterised by knowledge, innovation and the related pecuniary externalities (Lall 2003; Dunning 1998). The rapidly changing location pattern of MNEs is attributed to changing MNEs strategies which seem increasingly of the knowledge-facilitating kind (Dunning 1998) with the exception of some low-value added activities in developing countries. MNCs increasingly opt for internalisation in an attempt to seek efficiency and knowledge-related strategic assets (Narula and Dunning 2000). There are several and increasing number of studies pointing to the importance of wide range of knowledge and innovation-related factors found to be significant determinant of FDI including pecuniary externalities associated with supply chains and linkages (Grabher 1993), spillover effects associated with agglomeration and clustering of firms (Lall 2003; Damijan et al. 2008; Smarziynska 2002), externalities associated with agglomeration economies including degree of industrialisation and the existing level of FDI (Wheeler and Mody 1992), availability of skilled labour and R&D-related premises (Lall 2004; OECD 2010; UNCTAD 2006). In the similar vein Dunning (1998) points that institutional framework tends to play more decisive role than it once did, hence where firms have a choice.

The institutional factor has largely been neglected in empirical analysis of FDI determinants until relatively recently. The notable exception are early studies by Taylor (1993), UNCTAD (1996), Hatem (1997) which point to the importance of not only economic but also institutional facilities including FDI incentives in attracting FDI. The main premise put to the fore in these studies is that institutional environment tends to play more important role in attracting FDI even in case of FDI prompted by more traditional cost and market driven investments such as is often the case of FDI to less developed countries.

The rationale behind the importance of institutions and yet institutional development as important locational advantage of host country rests primarily on the concept of transaction costs. Institutions encompass both formal rules in the form of laws and regulations and informal aspects related to human interactions such as customs or conventions (North 1990). Institutions reduce uncertainty and offset for the indivisibilities associated with investments in new business environments through establishing predictable framework for economic interaction. Quality institutions affect economic transactions in that they: (1) minimise the costs associated with economic exchange; and (2) protect and enforce the legitimate rights of parties involved in economic transactions. North (1990) asserts that economic exchange often involves complex transaction and impersonal exchange and necessitates institutions which minimise uncertainty related to the third party behaviour. In addition, contract enforcement and property rights protection tend to assure efficient economic exchange. Further, North (1990) argues that institutions establish rules and incentives for economic agents that affect not only transaction but also production costs. Inefficient bureaucracy can directly increase the costs of production by disrupting the supply/value creation activities through uncertainty, delays and lengthy time needed to obtain licences and permits. Inefficient and extensive regulatory burden increases the risk premium of economic agents. Further, Mudambi and Navarra (2002) emphasise that institutions affect the relative transaction and coordination costs of both production and innovation. Institutions set the incentives embodied in business environment which may be conducive to innovation by promoting competitions and openness, may favourably affect a capacity of firms to interact and exchange information, and/or reveal policy incentives which may directly affect firms' prospects for innovation.

The increasingly acknowledged importance of institutions in international business has certainly had an impact on the MNCs perception of internationally competitive environment. The importance of institutions in international business is supported by perception that institutions present 'the major immobile factors in a globalised market" features of which determine the international attractiveness of a location (Mudambi and Navarra 2002). MNCs are expected to be less reluctant to invest in familiar business environments or generally in countries governed by clear rules, efficient judiciary and governance systems, as well as regulatory framework which substantially reduce uncertainty involved in economics exchanges. Foreign firms have to adjust to local conditions such that underdeveloped or volatile institutional framework affect not only transaction cost of the firm but influence MNC strategic decision on entry mode choice. To accommodate for high transaction costs associated with ineffective or poor quality institutions MNC are expected to reluctantly opt for green field investments, and rely more on networking-strategies with local firms. Meyer (2001) shows that underdeveloped institutions drive up the costs of establishing wholly-owned ventures in transition economies. In light of this discussion, the world is increasingly being characterised by competing institutional systems where institutional dimension is considered crucial locational advantage of a given country.

Notwithstanding this, as pointed by Bevan et al. (2004) there is little agreement on which institutions are important and why. Although, the role of institutions in international business is becoming prominent in academic and policy discussion, the empirical evidence on the matter remain unclear.

2.2. Review of past empirical research

Previous literature examined FDI inflows largely through considering institutional framework or its specific dimension(s) at the country level. The examined importance of institutions mostly relates to the rule of law and protection of intellectual property rights in particular, political stability and corruption, quality of bureaucracy and government effectiveness. Although it is reasonable to assume that these institutional features influence MNC location decisions, the conclusions resulting from empirical literature are, however, far from uniform (see for instance Ali et al. 2010; Sethi et al. 2009). Studies investigating the impact of political stability and democracy reveal mixed and even opposing evidence on the matter. The results seem to very depending on the sample of countries used and the period under observation. A study by Addison and Heshmati (2003), using a sample of 110 developed and developing countries, show that democracy,

generally linked to political stability and the rule of law, has a positive impact on FDI. Conversely, a study by Noorbakhsh et al. (2001) suggests that democracy and political risk have no influence on FDI relying on a sample of 36 developing countries. Further, Asiedu (2002) suggests that political and expropriation risk have no significant impact on FDI using a sample of 71 developing countries, whereas his later study, Asiedu (2005), indicate positive and significant impact of various institutional dimensions including less corruption, greater political stability, and reliable legal system on FDI using a sample of 22 African countries in the period 1984-2003. Furthermore, Harms and Ursprung (2002) provide inconclusive evidence whereby political and civil freedoms exhibit positive impact on FDI and other important institutional dimensions, including those closely related to intellectual property rights such as expropriation, bureaucratic quality, low and order, contract repudiation have no robust impact on FDI. Interestingly, Busse (2004) reveals empirical evidence which strongly suggest that the relationship between democracy and FDI is positive from 1990 onwards, but finds no evidence during 1970s and 1980s relaying a sample of developing and emerging market economies. Busse (2004) concludes that the inconclusive evidence may have to do with the sectoral composition of FDI to developing countries i.e. switch from primary to manufacturing sector in the 1990s.

Apparently according to recent empirical evidence corruption, efficient administration and bureaucracy, sound regulatory framework, extensive and efficient legal framework seem important locational attributes that are or should be taken into consideration by MNCs when entering new environment. In addition, recent studies covering SEECs indicate the importance of business environment depicted in World Banks Doing Business indicators in attracting FDI (Hossain et al. 2018; Jovanović and Jovanović 2017). However, most studies lack a comprehensive conceptual framework on the matter. The issue here is not so much about whether or not these institutional dimensions are important, but which institutional dimensions are decisive drivers of MNCs location decision? Precisely, most empirical analyses fail to provide clear link with respect to how the aforementioned institutional features enter MNCs strategic decisions and does it reflect actual MNC practice. Understanding the mechanism through which positive externalities are transmitted and/or elements of which are assumed to favourably affect FDI is considered of outmost importance (Sethi et al. 2009). In view of this, it is not surprising than that the literature on the role of institutions reveals ambiguous results.

In addition, we lack empirical evidence on the potentially weighted or unequal importance of diverse institutional dimensions in determining inter-, and intra-country FDI locational pattern. To large extent, limitations of the available and disaggregated data on institutions have hampered the research in this area (UNCTAD 2006). Which specific institutional dimensions are important for attracting FDI relative to other more traditional location-specific advantages, and how these are related to sectoral FDI (e.g. resource and cost-efficiency based FDI vs. innovation and knowledge based FDI) and mode of entry, although important from both theoretical and policy-oriented point of view, remain seriously underresearched.

Notable exceptions are studies by Sethi et al. (2009) and Mayer (2001). Whereas a study by Mayer (2001) provide evidence that host country institutional development has an impact on the choice of entry modes in transition economies, a study by Sethi et al. (2009) reveals evidence in favour of varying degree of importance of FDI policy and incentives across industries (i.e. extractive, manufacturing, high-tech). The conceptual framework developed in these studies enables more precise understanding of differences in FDI inflows across and within countries. An important implication of the empirical evidence reviewed here reveals that the importance of institutions should not been applied uniformly to all types of FDI, and to all industries without properly taking into account other vital industry-related locational advantages e.g. resource and cost attractiveness, infrastructure, education and skills. In the light of this reasoning, in this study we investigate the impact of FDI related institutional dimension on attractiveness of a location while controlling for important traditional locational advantages along the lines of a gravity model.

The empirical analyses on the role of institutions in transition economies have studied the importance of institutional development generally at an aggregate level (Heinsz 2000; Mayer 2001). A study by Campos and Kinoshita (2003) examine the importance of various institutional aspects mostly linked to property rights such as rule of law, political stability measured by International Country Risk Guide (ICRG) and quality of bureaucracy in 25 transition countries over the early and mid-transition period i.e. 1990-1998. The results of their empirical analysis show that all institutional variables are positive and significant determinant of FDI. Bevan et al. (2004) extend the pervious work by using more disaggregated institutional proxies reflecting transition reform progress in 25 transition countries measured by EBRD. The study uses gravity equation to investigate the impact of disaggregated

institutional proxies on bilateral FDI flows with variables averaged over the 5 year period i.e. 1994-1998. Main conclusion stemming from this empirical analysis suggest that while private ownership of business, banking sector reform, foreign exchange and liberalisation and legal development positively influence FDI flows, domestic price liberalisation, non-bank financial sector development and competition policy do not exhibit significant impact on FDI. The results of their study point to the potential conflict between policy reform and strategic interest of multinational firms, as noted by the authors. We further point that the results of this study, amid mixed results obtained, raises further question on the relevance of specific institutional dimensions for FDI. In what follows, we synthesise the results of the previous work in the context of transition economies, and develop a conceptual framework of this study.

Overall, the quality of market-based institutions relating to political and legal aspects of institutional reforms in transition, seem crucial determinant of FDI (Kampos and Kinoshita 2003; Hossain et al. 2018). These aggregate institutional indices reflect on fundamental aspects of a functioning market system, indicating political and investment risks principally associated with a (im)proper legal framework e.g. rule of law and efficiency, intellectual property rights protection and enforcement. The results are consistent when it comes to the importance of basic legal rights relating to commercial issues, its efficiency and enforcement, and indivisibilities stemming from (in)proper functioning of legal environment.

Notwithstanding these, the importance of institutional reforms specific to transition economies, and measured by EBRD transition indicators seem unclear (Bevan et al. 2004). According to the literature relaying on EBRD transition reform indicators, some institutional dimension(s) may be of lesser importance to foreign investors. It seems plausible to argue that some transition policy reforms are not directly related to strategies by foreign investors, as well as that the impact of these institutional reforms may vary by the receiving sectors as discussed earlier in this paper. Institutional dimension may well be neglected in the case of cost-efficiency seeking FDI (Spar 1999) and limited choices, such as is the case of transition economies. The relevance of these institutional reforms, then, should be studied at a more disaggregated data, as pointed by (Heinsz 2000; and Mayer 2001). Hence the relevance of institutional reforms in transition may vary depending on the characteristics of a receiving industry, and on motive of investment. Some aspect of institutional development may be neglected by foreign investors as often is the of case of low-cost and/or resource based FDI, or some aspects of institutional underdevelopment of a host economy may in fact coincide with foreign investors interests, amid well-known imperfect competition argument anticipated in theories of international production. Having said this, it's worth mentioning that competition and price liberalisation policy did not seem to affect FDI in transition according to the work of Bevean et. al. (2004). These institutional factors clearly reveal market imperfections stemming from inadequate regulation of competition, and improper price incentive structure in place, a factors which may give rise to (dis)advantages of various sorts to multinationals transiting to a host economy. It is worthy noticing, that theoretically these market imperfections may not always be at odds with MNCs interest, on the contrary.

All things considered, in this paper, we argue that some aspects of institutional underdevelopment, affecting costs and market structure(s) may even pose a favourable institutional environment depending on the strategic interest of foreign investors, and specific industry characteristic. The imperfect competition argument is well substantiated in the literature on FDI and cannot be neglected. This has important implications for empirical work addressing institutional reform in transition economies. Apparently a thoughtful approach to theoretical underpinnings and the underlying mechanisms at work is required when determining the causal link between institutions and FDI.

In light of the foregoing discussion, we develop a concept useful to the analysis of institutions and FDI in transition or emerging market economies. We argue that first, it seems reasonable to distinguish between general purpose market-enhancing institutions vs. institutions and policies designed to serve specific interest or policy objective, or are sector specific. Second, the importance of the dynamics of institutional reform in transition cannot be mistreated. This is to say that while establishment of core and functional market-based institutions was of precedent importance in the early phases of transition. In recent times a limited variation of these institutions across countries may prevail, while it is also possible that some of transition policy reforms are not directly related to strategies by foreign investors, as well as that the impact of institutions may vary by the receiving sectors. The specific context underpinning institutional reforms and their links to foreign investors' interest need be properly accounted for. In this paper, we develop an argument that, nowadays, institutional and policy reform relating to investment climate and policy incentives may seem more important. From MNC perspective, 'special

treatment' and privileges awarded to foreign investors through various policy initiatives envisaged and enforced from 2000 onwards in most transition economies, are more closely related to strategic interest of multinational. SEE countries concentrated considerable efforts on designing and establishing favourable investment climate, perceived of crucial importance for restoring economic growth in transition economies (OECD 2010:2016:2018) How effective have been these policy efforts in attracting FDI seem important question to be investigated.

While we do have some empirical evidence highlighting the importance of general-purpose, market-enhancing institutions in attracting FDI in transition economies, and consistent results highlighting the relevance of industry characteristics in examining the impact of institutions on FDI (Heinsz 2000; Mayer 2001), we do lack empirical evidence relating to the importance of specific FDI institutional setting and policy. This analysis attempts to remedy for this shortcoming in the literature. Empirical analyses on the matter have been principally constrained by lack of data, that is, institutional indicators covering FDI policy aspects.

2.3. What role for FDI policy and institutions in transition economies: conceptual approach and empirical strategy

2.3.1. Conceptual framework

Notably, institutions constitute important locational advantage complementary to traditional FDI determinants including market size, labour costs, infrastructure, human capital, and natural resources. Which institutions matter and why for FDI, remains, however, one of prominently debated questions among scholars and policy makers. In view of the inconsistent empirical evidence on the matter, discussed earlier, and in view of suggestions for further research stemming from recent meta-analysis on institutions and FDI (Bailey, 2018), we contextualise the relationship between institutions and FDI. In this analysis we focus on institutions that reveal government efforts to design proper institutional and policy framework to attract FDI. Further, in line with suggestions from Kapas (2020) review of institutional determinants of FDI we rely on institutional economics theoretical framework and assume the relevance of hierarchy of institutions suggested by Williamson (2000). In what follows we discuss the relevance of FDI policy and its institutional setting in attracting FDI.

General purpose institutions vs. FDI policy framework

The conceptual and empirical framework developed in this study allows for a more plausible comprehending of what role for FDI policy in specific transition economy context. How institutions affect FDI is important issue addressed in this paper. We argue at length that while general purpose institutions such as rule of law and efficiency, legal indicators, governance and bureaucracy systems are core to well functioning market economies, they, however, reflect on basic regulation governing economic transaction. In view of this, it seems reasonable to postulate that they are important to the extent we observe significant variations in functioning of these institutions across countries. A useful analogy is here worth mentioning. Among industrialised countries, for instance, the significant impact of these institutional dimensions on FDI is difficult to hypothesise given limited variation across institutional settings and the *a priori* assumption of well functioning market-enhancing institutions in these countries, at least at an aggregate level. In the similar view, it seems reasonable to expect that, over time, the relevance of these general purpose institutions may diminish amid and along the path of economic progress and institutional transformation of emerging market and transition economies.

In view of this, the proper question seems not the one of their importance, but the one of factors explaining profound differences in establishing core institutions among transition countries over time. These are possibly related to socio-political and cultural aspects of individual countries, difficult to be accounted for and measured in the context of informal institutions and their relevance (Kapas and Czegledi 2020; Kuncic and Jaklic 2014). For instance, the relevance of informal institutions and structures including political ties on firm productivity and innovation has recently been investigated by Can Li (2020). This aside, the interest of policy makers has increasingly been focusing on explicit institutions and policies underpinning FDI. Recent studies covering business environment indicators and examining their impact on FDI present an important step forward (Hossain et al. 2018; Jovanović and Jovanović 2018). Moreover, in a similar vein, a recent study by Farok et al. (2021) finds that entry and exit regulation and contract enforcement are important FDI determinant that thus complement institutional deficiencies. Seemingly, whether specific policy efforts and institutional aspects can be considered important complementary factors influencing locational decisions of foreign investors seem to be important, new insight for researchers (see for instance Sen and Sinha (2017)).

What role for FDI policy and regulation

Following these arguments, the conceptual approach in this analysis takes into account institutional dimensions strictly related to FDI including a foreign investment regulatory framework and specific policy incentives aimed at attracting FDI i.e. FDI regulation and policy incentives. We extend the previous work on transition economies by examining institutional development revealing institutional environment directly linked to the interests and strategies of foreign investors. We attempt to go beyond recent literature by accounting for very specific FDI-related institutional developments measured by OECD Investment index reform for SEE countries. Specifically, we analyse whether differences in FDI policies and institutional set-up across SEE countries explain variations in inward FDI flows relaying on bilateral FDI flows and the gravity modelling technique. To this end we use a unique dataset that is comprised of specific, FDI related institutional indicators developed by the OECD. To the best of our knowledge these data are only available for the group of South East European Countries, and similar institutional indicators that reflect on the quality of FDI policy incentives, measures and institutions is not available for any other country or group of countries. Having said this, this paper shed some light on the importance of institutions and policies designed to promote and facilitate foreign direct investments.

The OECD FDI policy institutional indicators encompass four distinct institutional indicators, namely i) *FDI policy* assessing legal and administrative systems associated with FDI (i.e. intellectual property rights & protection, expropriation, property-related bureaucracy and administration, international agreement and regulation, FDI incentives); ii) *FDI promotion and facilitation* assessing specific policy initiatives, government actions and services designed to attract and retain FDI inflows (i.e. FDI Strategy, FDI institutional set-up, promotion services, on-stop shop assistance, client-relationship management); iii) *Transparency* assessing the extent to which government give prior notification to interested parties regarding new or revision of the existing investment laws and regulations (e.g. regular consultation processes, summaries and feedback); *Privatisation policy and PPP* assessing policy initiatives and government activities aimed at facilitating privatisation and PPP to attract foreign investors (Privatisation policy and consultation targeting potential foreign investors, PPP policy and government unit, legislative framework covering PPP). A detailed description of institutional variables is given in Table 1.

The importance of FDI institutional set-up and FDI policy, as such, in attracting FDI has not been previously investigated in transition economies. We contribute to recent literature in two respects. First, we measure the effects of Investment policy and promotion on FDI relaying on this novel methodology and unique institutional data. We bring new empirical evidence shedding some light on the effectiveness of FDI policy efforts. From the public policy perspective this is an important question amid concentration of resources and efforts that are costly and time-consuming, as well as in view of policy-trade offs and tight budget constraints in the context of less advanced transition economies of the South-East Europe. The empirical results obtained contribute to policy debate, and recent discussion on transition policy issues and dilemmas, highlighting the importance of FDI policy perspectives and policy choices. Specifically we help identify *'the kinds of institutional upgrading'* (Dunning 2004) that helps exert greater FDI inflows in transition economy context.

Second, we contribute to theoretical debate on institutions and institutional reform in transition by employing the dichotomy between general, market-enhancing institutions, depicted in diverse institutional indicators ranging from legal, political and governance indicators, to the very specific policy-oriented indicators used in this analysis. We argue at length that reasons behind unclear impact of institutions on FDI embodied in previous literature principally have to do with ambiguous and unclear mechanisms underpinning the influence of various institutional indicators. The notion of institution(s) need be made clear before institutions can be integrated into a sound and consistent theory of the determinants of economic activity (Nelson 2001:2008; Scott 1991) including FDI. We believe this paper helps to surge interest of scholars to move into this direction and pave the way towards coherent theory of institutions and FDI.

2.3.2. Empirical strategy and research design

The empirical strategy employed in this analysis makes use of the OECD methodology employed in developing FDI policy and promotion institutional indicators for SEE. It is worthwhile mentioning that the way the aforementioned variables are measured, enables us to (clearly) distinguish between institutional and policy framework(s) and investigate their individual impact on FDI. We start by explaining and defining the institutional indicators used. The four OECD institutional indicators are split into two narrowly defined categories,

namely institutional variables and policy variables. We build on previous work by Dunning (2004) and Sethi et. al. (2002) who proposed a conceptual framework on determinants of FDI, incorporating institutions as important determinants of FDI. These authors identify those institutions that have become more important in the last decades. Following these studies, and previous research, in this paper we distinguish between general-purpose business facilitating institutional framework, notably adequate bureaucracy, good infrastructure, rule of law, property rights, support to competition, control of corruption, good governance, from policy framework. The distinction between institutional and policy variables is not an easy task since institutions and policies are interdependent, and policies are embodied in institutions and organisations. This is to say that policy effectiveness is conditional on quality of those institutions by which these policies are implemented. Inadequate institutions my inhibit government actions. Having said this, the kind of measurement of the identified OECD institutional indicators, allows us to draw somewhat clear boundaries between policy incentives and institutional factors depicted in investment regulation.

First, we mark that institutional indicators are often perceived as regulatory dimension that are not in direct government control, including rules that regulate business and investment climate in general, and institutions that affect the implementation and the efficiency of those rules. These are considered extra market instruments devised to serve general-purpose functioning of the markets. In view of this, Institutional variables in this analysis assess regulation, extensiveness and efficiency of laws and legal provisions related to investment climate and foreign investors. These variables present formal institutional framework for FDI. Following Dunning, (2004) we postulate that these institutions underpin investment risks associated with regulation, institutional quality and effectiveness. Never the less, these institutional indicators depict on general business environment and/or investment climate conditions that constitute somewhat static institutional framework. To this end, in this analysis we include *FDI regulation variable*. This variable, assess diverse components of legal provisions relating to foreign investors interest including: restrictions to national treatment; FDI incentives; transfers; titling, cadastre and restitution; intellectual property rights; int'l arbitration and agreements; land ownership; and expropriation. These aspects of FDI regulation underpins risks and indivisibilities associated with costs of transiting to, and operating in a new business environment.

Second, we make use of FDI policy variables. Policies generally reveal government incentives purposefully designed to affect market structures, operational costs and dynamic economies associated with cooperation, interaction, collaboration among firms and institutions. This is why, in this study an attempt is made to include FDI policy variables. Policy indicators used in this analysis capture policy initiatives, measures and instruments specifically designed to facilitate foreign investment activity including activities and tasks assigned to, and performed by various government and FDI related agencies and organisations. To this end, we include three distinct FDI policy variables; namely i) *FDI Promotion and Facilitation* depicting policy measures and institutional arrangements that pertain to investment and follow-up activities; ii) *Transparency policy variable* that depict on formalised and systematic government consultation activities and collaboration efforts with foreign investors; iii) *Privatisation and Public Private Partnership (PPP) policy variable* that depict on policy measures to boost acquisitions of SOE and foster foreign investments via PPP projects. The importance of these specific FDI policy incentives has not been previously investigated. We postulate that policies matter and affect multinational decisions on not only where to invest, but they also may affect long-term investment and productivity patterns of foreign enterprises in the chosen location site, thus depicting on some aspects of dynamic investment framework.

3. Empirical analysis

3.1. Sample and data

The empirical analysis covers eight South East European countries containing information on FDI and host country characteristics in the period 2007 - 2014. Precisely, the analysis is based upon a dataset on FDI flows between source and host country over the years 2007-2014. Each observation constitutes a bilateral relation between a source (home) country *i* (EU-27 member states) and a host country *j* (Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Macedonia, Montenegro, Romania and Serbia). We use this limited time frame for our analysis given the data constraints on FDI institutional variables, which are of interest in this empirical investigation. Specifically, the discussed FDI institutional and policy variables are only available for the year 2010 (OECD, 2010) and reflect on the institutional reforms in the period 2007-2009. Other OECD investment reforms and investment climate

publications (i.e. OECD 2016:2018:2020) present institutional indicators that rest on different methodology, definitions, classification and measurement of institutional indicators that are seemingly inconsistent with the purpose of this analysis. Thus, given the progress of FDI –related institutional reforms, we could not regress institutional indicators on FDI inflows beyond 2014. We strongly believe that the impact of FDI policy variables measured in OECD, 2010 report is of outmost importance to policy makers. This is why we rely on this data, and design empirical strategy to bring novel evidence on the relevance of FDI policy in the specific context of South East Europe. Importantly, in sections to follow we discuss the data limitation issue and elaborate in detail the relevance of this empirical analysis based upon data on FDI flows from 2007 to 2014.

The nature of our data set allows us to make use of cross-section analysis within the gravitiy empirical framework. Precisely, although each observation point in our dataset reveals FDI flows between home country i (EU-27 member states) and host country j (Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Macedonia, Montenegro, Romania and Serbia) in the period under observation, the data included in final samples used for econometric analysis have been modified and constructed to fit the cross-sectional nature of the FDI policy variables. Considering that FDI policy data are obtained only for the year 2010, the final sample integrates cross-sectional data for all variables. Specifically, we constructed two separate cross-sectional data-sets. The first data-set covers the period 2007-2010, and the second data-set covers the period 2011-2014. Note that each variable is constructed as the arithmetic average over the 4-year period of each sample. For instance, as per FDI variable, each observation in these data-sets reveals bilateral data on FDI flows averaged over a four year period for the two samples i.e. first sample integrates FDI data averaged over 2007-2010, and the second sample integrates data averaged over 2011-2014 period. Similarly, data on host country characteristics have been included in the samples as arithmetic averages of the two respective time periods. Averaging enables us to control for the 'lumpy' nature of FDI flows, by minimising possible biases arising from the initial large set-up inflow (Bevan et al. 2004), as well as to control for the time dependant nature of institutional effects as discussed below. Noteworthy is that the institutional and policy indices, as well host country characteristics are host country level variables, while the dependent variable and some control variables are on the level of the bilateral relationship between countries ij (*i.e. Distance and Common Border variables*).

Note that we have included all data on bilateral FDI flows between home (EU-27) countries and host (8 SEECs) recorded for the period under observation. However, the final samples consist of about 120 observations each; since the data on FDI inflows from EU-27 countries are inconsistent i.e. the data on FDI inflows to individual SEEC-8 are not recorded for some years. Amid absent flows from all EU-27 home countries to individual SEE host country in the period, we constructed sample data using information on FDI inflows that are consistent in terms of source (i.e. country of FDI origin) and time (i.e. recorded for the periods under observation 2007-2010 and 2011-2014, respectively).

Empirical analysis that use institutional variables in a cross-sectional setting often fail to control for the time-variant effect of institutions, and long term implications of the institutional reform and development. We lessen this problem in our analysis by constructing all variables as arithmetic averages, and running separate regressions of the same models independently for the two data samples. The reason we constructed two samples is to expand the data set and minimise possible biases arising from time-dependent nature of institutions. More precisely, we attempt to control for possible lagged effect of institutions (see for instance Efendić and Pugh, 2015).

In the first sample, we control for time-dependant nature of institutional effect by averaging FDI data over the four year period 2007-2010. That is, in the first sample we average FDI data for the period in which the actual reforms were undertaken allowing for possible short-run effect of institutions. Although we account for the time-dependant and non-instantaneous nature of institutional effect, by the way we construct our data in the first sample, we still possibly fail to control for the longer-term implications of the forgone institutional changes considering the short time span covered.

This is why we constructed a second sample that includes data averaged over the period 2011-2014. Following earlier empirical studies examining the effect of institutions on economic performance (Efendić and Pugh, 2015) and the effect of institutions on FDI (Kapas, 2020) we postulate that FDI institutional and policy reforms assessed and measured in the year 2010 may take longer time to influence FDI flows. For instance, a four year lag of institutional effect is for instance suggested by Efendić and Pugh (2015) who conducted a meta-regression analysis on the matter. Last but not least, the results obtained from the two samples enable us to conduct not only deeper analysis of time-variant influences of institutions, but also comparative analysis of independent influences of

FDI policy variables in two independent empirical settings. In other words, the empirical strategy employed allows us to contrast the obtained results amid the same models and methods of investigation deployed over the two time periods.

3.2. Model and methodology

In this analysis a gravity model is developed to estimate the determinants of FDI in transition countries using the Ordinary Least Squares (OLS) method of estimation. The cross-sectional nature of our samples dictated by the 'one point in time' FDI policy data, as explained earlier, implies the use of the OLS. In regard to this, first it seems important to emphasise that the nature of our samples' integrates information with respect to a 8 year period and lessens the biases of one data period often assumed in aggregate (cross-sectional analysis) FDI analysis. Second, the samples' account for the bilateral relationship between host and home countries and enables us to make use of gravity equations. The gravity empirical setting allows for more precise and accountable measurement of FDI flows and their determinants. Only few studies have concentrated on gravity equations while estimating the effect of institutions on FDI in transition economies (Bevan et al. 2004; Brainard, 1997). In view of this, we assume the estimated effects and the obtained coefficients of the FDI institutional and policy variables are robust to violations of assumptions of time-sensitive nature of FDI data (i.e. the 'lumpy' nature of FDI flows) and thus time-dependant nature of institutional effects (i.e. lagged effect of institutions) by the underlying data-generating process. In addition, we emphasise favourable properties of OLS method conditional on compliance with its underlying assumptions (i.e. BLUE), which we carefully consider in this analysis.

It is worth noticing, however, that although we make use of unique dataset on FDI policy incidence, the nature of the data does not allow as to investigate the impact of these policy factors in a dynamic econometric framework, or to account for the impact of recent FDI institutional development. Instead, we rely on FDI policy data published in the 2010 OECD report, and account for their impact in a cross-sectional setting within the gravity econometric framework. Yet the empirical setting, the OLS method of investigation and the estimated models, account for the time-variant effects of institutions, as we regress FDI policy variables on FDI data averaged over 2007-2010 period, and on FDI data averaged over 2011-2014 period. In light of this discussion we argue that despite the obvious limitations associated with the FDI policy data, the estimated coefficients are reliable and as such have important policy implications that are relevant for today's FDI policy discourse. This is to say that limited time span covered in our analysis i.e. 2007-2014 period, does not render support to the assumption that the estimated coefficients using OLS gravity framework are 'out dated'. The econometric framework used enables us to analyse the relationship between FDI policy variables and FDI, which has not been previously investigated, and examine the nature of this relationship in the manner that allows us to generalise about the obtained results in the specific context of SEE. This is to say that the obtained coefficients and causal-inferences are not to be interpreted in the context of 'time period covered by the analyses'. Instead they examine the causal-effect between institutions and FDI, and bear important lessons on FDI policy effectiveness in SEE countries.

Following the earlier analysis we employ gravity framework to analyse FDI determinants. Accordingly we assume that FDI flows are positively related to the levels of development of host and home countries and negatively related to the distance between them. We start with parsimonious model specification that includes traditional determinants of FDI within the gravity empirical setting. According to FDI literature, and the results of past research we control for economies of scale, labour costs, macroeconomic stability and institutional development. Namely we include market size for home and host countries (*lnGDPi and lnGDPj respectively*), distance (*lnDISij*), wage (*LCj*), inflation (*INFj*) and aggregate institutional development index (*AGG_INSTj*). Accordingly, we develop a baseline specification of the following form:

$$\ln FDI_{ij} = \beta_0 + \beta_1 \ln GDP_i + \beta_2 \ln GDP_j + \beta_3 \ln DIS_{ij} + \beta_4 LC_j + \beta_5 INF_j + \beta_6 AGG\_INST_j + \varepsilon_i \quad (1)$$

Where the dependent variable, FDIij denotes log FDI stock between home and host countries; GDPi denotes log of gross domestic product of home country i; GDPj denotes log of gross domestic product of host country j; DISij denotes log distance between capital cities of host and home countries; LCj denotes relative unit labour cost of the host country; INFj denotes the inflation rate of the host country j; AGG_INSTj denotes aggregate institutional index of host country j; ε_i denotes error term.[i]

We then investigate which particular features of institutional development are important determinant of FDI flows in transition economy context while incorporating 4 individual institutional indicators in equations of the form:

$$\ln FDI_{ij} = \beta_0 + \beta_1 \ln GDP_i + \beta_2 \ln GDP_j + \beta_3 \ln DIS_{ij} + \beta_4 LC_j + \beta_5 INF_j + \beta_6 IND\_INST_j + \varepsilon_i \quad (2)$$

It should be noted that we distinguish between variables which relate only to either home or host country (denoted i and j variables respectively), and those which concern the level of the bilateral relationship between countries (i.e. variables denoted *ij*). Each variable is constructed as the arithmetic average value over the three year period of our sample except for the distance and institutional related variables.[ii] According to Bevan (2004) averaging in this way enables us to overcome the problems of estimating annual cross-sectional regressions on FDI data that tends to be 'lumpy' in nature. As pointed by Bevan (2004, p.52) "investment projects typically have a life-span of more than one period, and hence the initial inflow that occurs when a project is undertaken is effectively a stock rather than flow variable."

3.3. Variables

The dependant variable

In this research, we use FDI, as our dependent variable, which is the log of stock FDI between home and host countries in USD, measured as average FDI stock in the period 2007-2010. There are advantages to the use of FDI stock instead of FDI flows. Except for very 'stable' investor countries, yearly country-to-country FDI flows vary considerably through time, especially in transition economies given the pace and character of the privatisation process, and may result in a failure to capture the effects of individual explanatory variables. According to Christie (2003) looking at the stock level has the advantage of stripping out the business cycle and any other 'time anomalies'. Another justification for this choice is linked to the functional form of the gravity equation. FDI inflows can be nil or even negative, which is something that the gravity equation cannot account for. Stocks at least can never be negative. The source of data for this variable is Database on FDI published by The Vienna Institute for International Economic Studies (WIIW).

Institutional variables

The principal variable of interest in this analysis is formal institutional development. Our measure of institutional development is based on a series of IRI (Investment Reform Index) indicators of progress in policy reforms to improve the investment climate in South East Europe published by OECD. The IRI index has several advantages over other measures of institutional quality. First, it provides a detailed assessment framework that focuses explicitly on policies and institutional setting related to private investment. Second, the assessment process is based on international best practices as well as regional 'good practices taken from CEE countries, it is highly participatory and inclusive, involving policy makers, independent experts and the private sector in each SEE country. Third, from a strictly methodological point of view, the IRI combines original data collected by the OECD Investment Compact with existing data from sources such as the European Commission, the World Bank and EBRD to provide governments with a broad overview of strengths and policy priorities, offering countries a unique and common reference point for institutional assessment and policy priorities. Finally, indicators have been structured to be fully compatible with the European Union (EU) accession process in SEE, and to cover other dimensions important for the investment climate which are not included in the acquis communautaire (OECD 2006).

The IRI (2010) provides information on eight dimensions[iii] of institutional quality: investment policy and promotion, human capital development, trade policy and facilitation, access to finance, regulatory reform and parliamentary processes, tax policy analysis, infrastructure for investment and SME policy. In our analysis focus is on investment policy and promotion dimension. It is enables us to identify institutional aspects most closely related to FDI. Although important, the former institutional dimensions are not directly related to the interests of foreign investors or strategies for FDI promotion per se. They rather reflect on wide range of socio-economic institutional reforms. Instead, the investment policy and promotion dimension and the institutional indicators developed assesses the policy frameworks governing FDI. Specifically, the investment policy and promotion dimension examines the types of services and activities used to facilitate the entry and expansion of foreign investment and the transparency of investment-related laws, regulations and procedures. The framework used comprises four subdimensions: (i) foreign direct

investment (FDI) policy (*FDI regulation in Table 1*), with a focus on the legal and regulatory framework for foreign investment based on the principles of stability and predictability; (ii) promotion and facilitation with the investment promotion services and activities to promote and facilitate inward investors; (iii) transparency with the focus on transparency of laws, regulations and procedures, including access to senior policy makers through consultations; and (iv) privatisation and public-private partnerships (PPPs) frameworks supporting privatisation and public-private partnerships (PPPs). A detailed description of each institutional variable used in this analysis is given in Table 1.

Control variables

Further, we incorporate a set of control variables. In our model we include information on gross domestic product of home and host country (GDPi and GDPj), distance (DIS), labour cost (LC), openness (OP) and inflation rate (INF), which proved to be significant in a number of previous empirical studies on economic growth (Grossman and Helpman 1991; Lankes and Venables 1996; Bevan and Estrin 2000; Kinoshita and Campos 2004). The home country market size is approximated by the home country GDP and reflects the economic power of the source country. With respect to home country market size one can expect an ambiguous impact. Large domestic markets can encourage companies to utilize economies of scale and concentrate production in a single plant and export. However, economies of scale and scope of logistics can also allow the placing the production capacities closer to the markets, thus making it more profitable to invest aboard and establish multinationals (Bevan and Estrin, 2000). Notwithstanding this, most empirical studies on FDI in transition countries suggest positive relationship between home country GDP and FDI (Resmini 2000).

In addition, our model includes host country GDP which serves as a proxy for the host country market size and thus the potential market for the investor's products. A larger market allows more ways of new

Table 1. Description of institutional variables

Variable	Abbreviation	Description
FDI regulation	FDIREG	The assessment of foreign direct investment (FDI) regulation covers three broadly defined policy (regulation) areas critical to attracting foreign enterprises: non-discrimination, property rights and investor protection. Non-discrimination concerns the treatment accorded to foreign investors relative to domestic investors. The assessment of property rights examines the extent to which ownership of property is legally recognised and protected. This includes both tangible property (i.e. real estate) and intangible property (i.e. intellectual property rights). (p. 38)
Promotion and facilitation	PF	Investment promotion and facilitation (IPF) covers issues bearing on the IPF strategy, the institution implementing the strategy (such as the Investment Promotion Agency), and the monitoring and evaluation mechanisms in place to gauge progress. The IPF subdimension also assesses specific investment promotion services and activities to attract and retain foreign investment. These activities include, among others, the development of linkages between foreign investors and local enterprises, implementing client relationship management processes and one-stop shop assistance for foreign investors in their pre-establishment phases. (p. 51)
Transparency	TRANS	Transparency assesses the extent to which governments give prior notification to interested parties regarding new (or revisions to existing) investment laws and regulations. In addition, the indicator considers if the government holds face-to-face consultations with a broad range of interested parties on a periodic basis and releases summaries or transcripts of those consultations. (p. 58)
Privatisation and PPP policy	PPPPPOL	Privatisation and public-private partnerships (PPPs) are intended to evaluate the presence of: a specific unit within government to co-ordinate and develop privatisation and PPP policy; a legislative framework covering PPP projects; a consultation process; a method for conducting cost-benefit analysis; and monitoring mechanisms. (p. 61)

Source: OECD (2010)

product placement, although it depends both on the overall market size and on the dynamics of the market (Resmini 2000). Generally, the market size is assumed to represent the location specific advantage of the host country and the positive relationship is anticipated.

Distance in this paper pertains to geographic distance serves as a proxy for all possible transportation, public infrastructure, and operating costs such as placing personnel abroad, language and cultural differences, communication costs, and costs of being outside domestic networks (see Brenton et al. 1999; Limao and Venable 2001). The rationale behind including geographic distance to explain FDI is the greater cost of obtaining relevant information as well as the difficulties in managing affiliates in distant regions. The distance in this paper represents the geographical distance between the capital cities of home and host country in km. The source for this data is CEPII database.

Further, the prevailing factors for attracting FDI, besides market size and dynamics and access to host market, certainly include the costs and quality of the input factor (Neuhaus, 2005). A company can undertake a foreign investment because of the advantages, i.e. lower production costs in host economy including costs of labour, energy and raw materials. In this respect, labour cost has a particular significance for enterprises in labour-intensive industries. Results of research into the relationship between labour cost and FDI suggest that labour cost frequently does not have a particular significance for FDI location decision and the results from empirical analysis are far from uniform i.e. proxy variables for labour cost are neither consistently statistically significant in FDI models nor consistently negatively related to FDI. Econometric results in the study by Lansbury et al. (1996) indicate that relative labour cost in Visegrad economies have a negative and significant effect on FDI inflow. Carstensen and Toubal (2004) also found that labour cost have a negative and statistically significant effect on FDI. Similar research results can be found in studies by Bevan and Estrin (2004), Galego et al. (2004), Bekes (2005), Resmini (2000), Altomonte (1998) etc. On the other hand, some authors obtained results where variables for labour cost show a negative and statistically non-significant effect (Johnson 2006; Clausing and Dorobantu 2005; Murgasova 2005), or a positive and (non)significant effect on FDI trends (Benassy-Quere and Lahreche-Revil 2005; Wang and Swain 1995; Boudier-Bensebaa 2005; Walkenhorst 2004). Thus, results of individual studies lead to the conclusion that with respect to the effect of labour cost on FDI there is no prevailing view for transition countries.

In view of this ambiguity, it should be noted that it is not only the wage level that matters but also the productivity of the labour force (Bevan et al. 2004, Neuhaus 2006). Moreover, higher labour costs (i.e. nominal wages) are found to be closely related to higher productivity levels and are often associated with higher investments in more technology intensive industries (Resmini 2000). Accordingly, it has been argued that potential foreign investor is not only concerned with labour costs per se (i.e. wage levels) but likewise with the productivity levels of labour force (i.e. unit labour costs) when considering where to invest (Neuhaus 2006). In view of this, it is not surprising then that the conclusions arising from empirical analysis on the matter are inconclusive. In our analysis unit labour cost is measured as a share of average gross monthly wages in GDP per capita for each host country, thus taking into account the productivity achieved in individual countries as well. By the way we measure labour costs in this analysis, the problem of ambiguous relationship between labour costs and FDI is lessened in our analysis, and thus negative relationship is anticipated. Source for these variables are data published by UNECE.

Finally, we incorporate inflation rate as a control variable in our model. Inflation rate is often used as a proxy for prudent fiscal policy and macroeconomic stability in general. It is assumed that successful implementation of economic reforms in transition countries is a good sign to potential investors, since stable macroeconomic performance implies a lower risk for investment. In this context, low inflation signal to investors the extent of government commitment and credibility. Thus, the lower the average inflation rate is in the host country, the more foreign investment will be attracted to the country (Kinoshita and Campos 2002). We expect that foreign investment, ceteris paribus, will be attracted to countries with lower inflation rates. Source for this variable is Transition report (2010). Descriptive statistics for each variable is presented in Table 2.

Importantly, as per both samples data, we observe that with respect to all variables there are no large variations around the mean and that there is sufficient variability among variables across countries. Descriptive statistics with respect to FDI stock suggests relatively low levels of average FDI inflows (i.e. average FDI level per capita) in the region, thus huge discrepancies in FDI inflows among SEE countries are observed. Turning to institutional variables, descriptive statistics suggests that there are no large discrepancies in institutional reforms measured by aggregate

Table 2. Descriptive statistics

Sample data covering 2007-2010 period

Variable	Obs	Mean	Std. dev.	Min	Max
FDI	126	5.95	1.63	0.71	9.46
GDPj	126	10.75	1.11	8.75	12.38
GDPi	126	12.64	1.49	9.13	14.81
DIS	126	6.86	0.64	4.76	7.84
LC	126	0.06	0.02	0.03	0.11
INF	126	5.57	2.27	2.30	9.00
IPP	126	3.73	0.15	3.29	3.86
FDIREG	126	4.07	0.19	3.72	4.36
TRANS	126	3.84	0.15	3.66	4.00
PF	126	3.21	0.37	2.50	3.75
PPPPPOL	126	3.63	0.35	2.87	4.06

Sample data covering 2011-2014 period

Variable	Obs	Mean	Std. dev.	Min	Max
FDI	119	5.66	1.90	0.50	9.51
GDPj	120	11.07	1.12	9.11	12.86
GDPi	120	12.80	1.52	9.11	15.09
DIS	120	6.81	0.67	4.76	7.84
LC	120	6.59	0.36	5.86	7.24
INF	120	2.95	1.83	1.18	7.05
IPP	120	3.72	0.16	3.29	3.86
FDIREG	120	4.05	0.20	3.72	4.36
TRANS	120	3.85	0.15	3.66	4.00
PF	120	3.18	0.39	2.50	3.75
PPPPPOL	120	3.63	0.34	2.87	4.06

investment policy and promotion index (IPP) and SEE seem to have embarked on the course of valuable institutional development. The SEE average is 3.7 on a scale from 1 to 5 with relatively low S.D. (i.e. 0.16) suggesting somewhat similar progress in institutional reforms related to investment policy and promotion dimension. However, we observe considerable variation among disaggregated institutional indices, with notable exception of *Transparency* variable. In particular, greatest progress has been achieved in the FDI policy sub-dimension, whereas reforms are least advanced in promotion and facilitation. Although there are variations across disaggregated institutional categories there is collinearity between individual institutional indices (see Table 3). This is somewhat expected since institutional reforms tend to go together (Bevan et al. 2004), and individual indices are closely correlated (see Table 3 below). This is why we incorporate institutional variables singly in equations (1). The results of regression analyses are discussed in section that follows.

Table 3. Correlation matrix

Sample data covering 2007-2010 period

	FDI	GDPj	GDPi	DIS	LC	INF	IPP	FDIREG	TRANS	PF	PPPPPOL
FDI	1.0										
GDPj	0.5	1.0									
GDPi	0.1	0.1									
DIS	-0.1	0.1	0.2	1.0							
LC	-0.2	-0.4	-0.0	-0.2	1.0						
INF	0.1	0.4	0.0	0.1	-0.5	1.0					
IPP	0.2	0.3	-0.0	0.2	-0.6	0.5	1.0				
FDIREG	0.4	0.6	0.0	0.2	-0.5	0.4	0.8	1.0			
TRANS	0.1	-0.1	-0.0	0.3	-0.6	0.1	0.4	0.2	1.0		
PF	-0.1	0.1	-0.0	-0.1	-0.2	0.5	0.5	0.1	0.4	1.0	
PPPPPOL	0.1	0.0	-0.0	0.3	-0.3	0.1	0.7	0.6	0.6	-0.0	1.0

Sample data covering 2011-2014 period

	FDI	GDPj	GDPi	DIS	LC	INF	IPP	FDIREG	TRANS	PF	PPPPPOL
FDI	1.0										
GDPj	0.5	1.0									
GDPi	0.2	0.1									
DIS	0.0	0.1	0.2	1.0							
LC	0.0	-0.1	-0.0	-0.2	1.0						
INF	0.1	0.2	0.0	-0.0	-0.1	1.0					
IPP	0.3	0.4	0.0	0.3	0.1	0.5	1.0				
FDIREG	0.4	0.6	0.0	0.2	-0.5	0.4	0.8	1.0			
TRANS	-0.0	-0.0	-0.0	0.3	-0.5	0.1	0.1	0.2	1.0		
PF	0.1	0.1	-0.0	-0.0	-0.2	0.5	0.5	0.1	0.4	1.0	
PPPPPOL	0.1	0.1	-0.0	0.3	0.2	0.1	0.6	0.6	0.6	0.6	1.0

4. Results

Table 4 and 5 report the results of the econometric analysis of the model specifications presented above for the two samples. Precisely, Table 4 reports the results obtained from the sample covering 2007-2010 period, while Table 5 reports the results covering the period 2011-2014 and includes models with institutional variables. We first estimate equations (1) using the investment policy and promotion dimension (i.e. aggregate index) as proxy variable for institutional quality at an aggregate level.[iv] We then investigate which particular institutional progress influence FDI by using four individual subdimensions of institutional development singly in equations (1) due to the problem of multicollinearity between the individual institutional variables. The diagnostic tests suggest that we can proceed with the interpretation of our results; the assumptions of normality, homoscedasticity and correct functional form cannot be rejected at conventional levels of significance (i.e. models 1,3,4,5,6 and 7). Given the relatively small number of degrees of freedom we consider significance at the 5% and 1% levels, although we indicate the 10% level of significance as well. Interpretation of variables' coefficients refers to on average, ceteris *paribus conclusions*.

Considering the baseline specification (models 1 and 2 in Table 4) of the first sample we find that both home and host country market size proxied by GDP

levels significantly increase FDI flows across SEE countries. The inflation rate is not suggested to influence FDI flows. This is perhaps because we are no longer in the early years of the transition process and all SEE countries are characterised with relatively stable macroeconomic environment. The distance variable is also found to have significant implications for FDI flows which is in line with the gravity model hypothesis and previous findings. We also find that unit labour costs adversely affect FDI flows pointing to the importance of differences in labour costs. The coefficient on labour cost is negative and significant at 5 % level. However, the labour cost variable seem to no longer significantly influence FDI flows among SEE countries once institutional variables are added to the model (see models 3, 4, 6 and 7 Tables 4 and 5).[v] Overall, the results obtained for both samples may indicate that strategic decisions of multinationals investing in the region are predominantly driven by quality of FDI-related institutions and policies, hence pointing to the relatively similar economic and industrial structures among SEE countries, and small variations in labour costs. In view of this, we assume that quality of institutions matter, and could potentially off set for the similar economic

Table 4. Regression results: FDI and institutions (2007-2010)

	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6	Model 7
Host GDP	0.699*** (5.64)	0.729*** (4.30)	0.686*** (5.54)	0.419*** (2.87)	0.684*** (5.56)	0.867*** (6.45)	0.726*** (5.91)
Home GDP	0.179** (2.12)	0.181** (2.12)	0.194** (2.30)	0.214** (2.62)	0.176** (2.11)	0.195** (2.37)	0.198** (2.37)
Distance	-0.652*** (-3.24)	-0.632*** (-2.90)	-0.714*** (-3.49)	-0.826*** (-4.12)	-0.694*** (-3.46)	-0.796*** (-3.93)	-0.768*** (-3.74)
Common border		0.041 (0.21)					
Openness		0.002 (0.27)					
Unit labor cost	-15.571** (-2.25)	-14.558* (-1.80)	-11.284 (-1.51)	-11.007 (-1.62)	-14.250** (-2.07)	4.978 (0.50)	-10.001 (-1.37)
Inflation	-0.072 (-1.08)	-0.071 (-1.05)	-0.103 (-1.47)	-0.101 (-1.56)	0.001 (0.02)	-0.018 (-0.27)	-0.054 (-0.82)
Investment policy and promotion			1.555 (1.49)				
FDI Regulation				2.961*** (3.33)			
Promotion and facilitation					-0.731* (-1.94)		
Transparency						3.405*** (2.82)	
Privatisation and PPP policy							0.828** (2.16)
Number of observations	126	126	126	126	126	126	126
R^2	0.33	0.34	0.40	0.35	0.35	0.38	0.36
F test stat. (6.119) Prob > F	12.34 0.000	8.69 0.000	11.30 0.000	10.76 0.000	11.15 0.000	12.20 0.000	11.37 0.000

Notes: Dependent variable: bilateral FDI stock between home and host country

*Significance level=0.10; **Significance level=0.05; *Significance level=0.01

and costs structures among SEE, and relatively low levels of productivity in SEE transition economies.

Turning to the institutional variables, the most important conclusion resulting from our analysis suggests that the effect of institutional and policy reforms is time-dependant as discussed earlier. In particular, the effect of certain policy reforms may take longer time. In the context of our analysis and the institutional indices accounted for, we find that aggregate policy efforts relating to *Investment policy and promotion* (*IPP*) and those related to FDI *Promotion and Facilitation* (*PF*) effect FDI inflows with considerable time lag. Specifically, while aggregate institutional index does not exhibit significant influence on FDI flows in SEE (IPP) in the initial years of institutional reform (i.e. Sample data covering period 2007-2010), the effect of this aggregate institutional variable is suggested to be significant and positive for the second sample (results reported in Table 5). Overall, FDI policy reforms are suggested to positively impact FDI flows but it certainly may take years before these policy efforts pay off. Similarly, long term rather than short term effect of FDI policy reforms captured by the *Promotion and Facilitation* (*PF*) variable is suggested by the analysis. The results reported in Table 5, suggest positive and significant impact of aggregate institutional reforms (*IPP variable*) on FDI inflows in SEE countries, while the estimated coefficient of this variable for the 2007-2010 period is suggested to be negative, though significant only at 10% (Model 5, Tables 4 and 5). This is quite important result given that this indicator covers main aspects of FDI policy assumed to directly affect strategic locational decisions of FDI such as the development of linkages with local enterprises/suppliers/investors, as well as the presence and the quality of pre-investment and post investment support services.

A possible explanation for the obtained contrasting results with respect to the two periods under observation, may lay in the fact that SEE countries have been too early in the process of PF kind of institutional development (OECD 2010). More precisely, given the nature of sample data in the first analysis covering

Table 5. Regression results: FDI and institutions (2011-2014)

	Model 3	Model 4	Model 5	Model 6	Model 7
Host GDP	0.894*** (6.22)	0.654*** (3.24)	0.997*** (7.42)	1.018*** (7.53)	0.995*** (7.29)
Home GDP	0.325*** (3.40)	0.328*** (3.24)	0.307** (3.21)	0.315** (3.27)	0.307** (3.17)
Distance	-0.470** (-2.04	-0.494** (-2.14)	-0.323 (-1.48)	-0.424* (-1.80)	-0.358 (-1.52)
Unit labor cost	0.284 (0.71)	0.112 (0.27)	0.230 (0.53)	0.982* (1.95)	0.492 (1.24)
Inflation	-0.131 (-1.63)	-0.064 (-0.80)	0.202** (-2.03)	-0.049 (-0.54)	-0.099 (-1.22)
Investment policy and promotion	2.151** (2.07)				
FDI Regulation		2.567** (2.30)			
Promotion and facilitation			0.761* (1.95)		
Transparency				1.808 (1.35)	
Privatisation and PPP policy					0.285 (0.62)
Number of observations	119	119	119	119	119
R^2	0.40	0.40	0.39	0.39	0.38
F test stat. (6.112) Prob > F	12.62 0.000	12.90 0.000	12.16 0.000	11.96 0.000	11.57 0.000

Notes: Dependent variable: bilateral FDI stock between home and host country

*Significance level=0.10; **Significance level=0.05; *Significance level=0.01

2007-2010 period it may have been too early to capture the effects of both aggregate FDI policy reforms (IPP) as well as investment promotion and facilitation activities (PF) on FDI flows. The latter analysis, the results of which are presented in Table 5, suggest strong and positive impact of these variables, pointing to the relevance of considerable time lag when examining the effect public policy changes.

Similarly the estimated effects of privatisation and public and private partnership (PPP) is suggested to be time and context dependant. Privatisation policy has had significant implications for FDI flows in SEE countries in the initial period under observation i.e. 2007-2010, while the effect of this policy variable is suggested to be insignificant for years to come i.e. 2011-2014 period. A plausible explanation could be that privatisation policy including the creation of the specific unit within the government assigned with the privatisation program task loosens its importance with time, amid reduced scale of privatisation programmes. Similarly, the time and context dependent influence of Transparency variable on FDI flows is also indicated (model 6). However, given the limited variation in the Transparency variable data, the obtained results need be interpreted with caution.[vi] Overall the results seem to render support to the hypothesis that institutions matter, but so do policies. The relatively low R2 values are also found in other similar bilateral FDI flow analysis (Bevan and Estrin 2004; Bailey 2018).

Moreover, the empirical evidence on the effect of institutions on FDI unambiguously suggests time and context dependant nature of institutional influences, which seem to be in line with more recent empirical evidence. In particular, the findings are in line with the suggested non-linear and time-variant relationship between institutions and FDI (Kurul 2017) and context-dependant nature of institutions suggested by Bailey (2018).

Essentially, the effect of FDI regulation variable is found to be consistent across time i.e. both samples. With respect to model 4 the results suggest highly significant impact of *FDI regulation* (FR) on FDI flows across both periods under investigation. It should be noted that given that this FDI institutional index assesses the reforms and progress with respect to legal environment, specifically institutional features related to non-discrimination, property rights and protection, the obtained result highlight the importance of proper legal environment which serves to encourage FDI flows as anticipated.

The results obtained in this analysis i) deepen our understanding on the FDI policy relevance in the specific transition economy context, ii) highlight the importance of distinguishing between policy and institutional factors, iv) time-variant, direct and indirect effects of institutions on FDI; iii) and suggest a context dependant effect of FDI policy variables. The findings seem insightful for further research in terms of carefully considering which institutions matter for FDI and why.

5. Conclusion

The empirical analysis in this paper attempted to investigate the impact of specific FDI related institutional dimensions in attracting FDI flows to SEE region. The paper uses private investment institutional data that have not been used in pervious analysis on the determinants of FDI. The importance of institutional dimensions associated with the FDI policy and incentives remain seriously under-researched. In this paper we attempt to fill in this gap in the literature and go beyond recent literature by accounting for very specific FDI-related institutional developments measured by the OECD Investment index reform for SEE TEs. We rely on FDI policy data published in the 2010 OECD report, and account for their impact in a cross-sectional setting. Despite the one point in time nature of the FDI institutional and policy data, we analysed the time-variant effects of institutions, as we regress FDI policy variables on FDI data averaged over 2007-2010 period, and FDI data averaged over 2011-2014 period. By the latter analysis we account for the effect of institutions with a time lag, and contrast the findings with respect to two distinct data samples. This empirical strategy allowed us to address possible time dynamics involved in FDI policy effects, and account for the context dependant nature of FDI policy variables.

Overall, the results of the empirical analysis suggests that institutional reforms and progress significantly increases FDI flows in transition economies with significant coefficients obtained for individual institutional proxies including FDI regulation, FDI policy, Transparency and Privatisation policy. The results, however, do not reveal consistent positive and significant influence of policy variables across two time periods, with the notable exception of FDI regulation variable. Instead, the results point to the time-dependant and thus context-dependant nature of policy effects. Basically, institutional features related to FDI promotion and facilitation are not found to be positively related to FDI in the 2007-2010 period, perhaps because it may have been too early to assess the impact of this particular policy reform. However, the analysis carried out for the 2011-2014 period supports the proposition that quality of institutions associated with policy measures aimed at serving (strategic) interests of

multinationals do pay off. Finally, the important policy implications stemming from this research include:

The persistent, positive effect of general-purpose institutions on FDI underlining the importance of investment climate institutional framework. The obtained consistent, positive effect of FDI regulation (i.e. legal provisions governing FDI) on FDI flows reflects on the importance of more static but long-lasting significance of investment climate encompassing restrictions on national treatment, FDI incentives, intellectual property rights, cadastre and restitution, land ownership and expropriation, int'l arbitration and agreements, transfers and titling.

The time-dependant effect of FDI policy factors. The importance of FDI promotion and facilitation that is suggested to impact FDI with significant time lag, points to the relevance of time dynamics when examining the impact of policy factors. FDI policy measures that target direct and specific interests of individual investors including project based approach and follow-up activities are expected to take significant time to exert an influence in a systemic manner and at an aggregate level. These policy factors are assumed to constitute a more dynamic institutional setting which is in direct government control, and as such, bear significance in terms of careful consideration of FDI policy design, evaluation and monitoring.

The context dependant effect of policy initiatives as indicated by the short-term positive effect of privatisation policy on FDI. While privatisation policy measures may have been important in the initial period covering 2007-2010 period, the scaling down of privatisation programs has lessened the relevance of these policy measures for attracting FDI in more recent period.

These policy implications seem pertinent to ongoing discussion on SEE policy perspectives and institutional reforms (OECD 2020).

Endnotes

i Initially we deeloped a base model incorporating also trade oppeness and common border as control variables. However, these variables were left out upon considering the model statistics (see section 4, Footnote 5). The results of this extended model and are presented in Table 4.

ii In this analysis, we use data on institutional indicators from IRI (Investment Reform Index) published in 2010 because the data on institutional development cover the period of observation in our analysis, namely from 2007 to 2009 (for methodology of data collection see OECD (2010)).

iii Each policy dimension is further divided into sub-dimensions. Sub-dimensions are divided into indicators structured around five levels of policy reform with 1 the weakest and 5 the strongest. Each sub-dimension and indicator are assigned a weight in order to calculate the total score for each policy dimension.

iv We also present the extended model (i.e. model 2), the one that includes trade openness and common border as control variables. However, given that the model diagnostic suggests that we can reject the hypothesis of correct functional form at the 5% level of significance and that the variable deletion test indicates that the model is better specified upon exclusion of these variables (F statistics: $F(2, 118) = 0.06$; $Prob > F = 0.9393$), we proceed with model 1 as baseline model and we do not interpret the results with respect to model 2. However, it should be noted that the baseline model is robust to the inclusion of these variables as control variables, indicating stability of baseline specification.

v A possible explanation could be the relatively high correlation between labour costs and individual institutional variables (i.e. see correlation matrix Table 3), hence LC variable does not loose significance in model 4 where the colinearity between PF institutional variable and labour costs is low (i.e. –0.19). Given this, it seems that the individual effect of labour cost variable is lessened once institutional variables are included in the models due to possible multicolinearity.

vi The importance of Transparency reflecting on government transparency, participatory and inclusive process of developing regulatory procedures, formulations of investment laws and its revisions, would requires additional data.

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