



## Friend or Foe? On the role of institutional reforms in the investment development path of Central and East European economies



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### ABSTRACT

Many existing studies on emerging markets and firms have concentrated on the separate effects of institutional reforms and quality of the institutional infrastructure for attracting inward foreign direct investment (FDI) and fostering outward FDI. We argue that both these perspectives should be considered in an interplay, as there are links between inward and outward FDI in a country's economic development, which is captured by the investment development path (IDP) concept. Moreover, while predominant attention has been paid to emerging markets, little has so far been done to evaluate the sustainability of the institutional development, including later post-transition stages. We extend the IDP with insights from the institutional theory and conduct a comparative analysis of the effects of institutional reforms on IDP paths of ten Central and Eastern European (CEE) post-communist European Union (EU)-members. We find that while most of the studied post-transition economies follow a quadratic relationship between the net outward investment (NOI) position and each country's economic development, the role of institutional reforms is not in all cases accelerating the movement through the stages of the IDP. We attempt to explain the ambiguous role of institutions in an ensuing detailed discussion of the investigated countries.

### 1. Introduction

The concepts of country and firm competitiveness, and foreign direct investment (FDI) have always stood at the forefront of international business (IB) research (Buckley & Castro, 1998; Stoian, 2013). The interplay between inward and outward FDI, as expressed by the net outward investment (NOI) position, in conjunction with economic development of a given country constitutes the essence of the investment development path (IDP) paradigm (Dunning, 1981, 1996, 1986, Dunning & Narula, 1994). However, while there have been a number of replication studies empirically testing these relationships (Bellak, 2001; Boudier-Bensebaa, 2008; Buckley & Castro, 1998; Narula & Guimón, 2010), it has been so far unresolved how the interplay between outward and inward FDI differs between advanced and emerging markets and how these different development paths can be modelled (Gorynia, Nowak, Trąpczyński, & Wolniak, 2016).

Furthermore, while there has been a plethora of research on FDI from and into emerging markets (Dadzie, Larimo, & Nguyen, 2014; Ramamurti et al., 2010), they have predominantly addressed these two

phenomena and their determinants in isolation. Some of these studies have addressed the role of institutional reforms in attracting foreign investors (Aziz, 2018; Cuervo-Cazurra & Dau, 2009; Cuervo-Cazurra, 2008; Dau, 2012; Godinez & Liu, 2015), while others have concentrated on the positive (Stoian, 2013) or negative (Cuervo-Cazurra, Narula, & Un, 2015) effects of home-country institutions on the international operations of local firms.

However, these studies, while they have advanced our general understanding of the effects of institutions on specific phenomena, including establishment mode choices or ownership mode choices (e.g. Arslan, Tarba, & Larimo, 2015; Brouthers, Brouthers, & Werner, 2008), they have mostly left aside the conceptual and empirical notion that countries, and their firms, follow a certain progression. While it has been acknowledged thus far that this country and firm development has to be analyzed also with regard to the role of institutional frameworks (e.g. Stoian, 2013); institutional analyses have largely referred to aggregated data, therefore neglecting the idiosyncratic paths of countries and hence limiting the implications that these idiosyncrasies can generate for further research and policy measures. Conversely, research

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belonging to the strand of transition economics has clearly indicated that institutional idiosyncrasies affect the economic development paths of countries (Demirbag, McGuinness, Wood, & Bayyurt, 2015; Wood & Demirbag, 2015). While it has been argued that different reform design choices may lead to divergent performance outcomes (Dewatripont & Roland, 1995; Hoff & Stiglitz, 2002), there has been limited reference to institutional reforms in exploring the patterns of FDI in the countries' growth trajectories.

In this context, the first objective of the paper is to explore the relationships between outward and inward investment, economic growth, and institutional reforms in post-communist economies of Europe, using an IDP model enhanced with the institutional approach as a research framework. The second objective, which also attempts to address an existing research gap, is to assess how and why institutional reforms affect these relationships in different economies. These objectives are pursued in the empirical setting of ten economies of Central and Eastern Europe (CEE), now members of the European Union (EU). The post-socialist countries of the region, while having a common political legacy, have demonstrated significant institutional idiosyncrasies and followed different reform paths (Gevorkyan, 2015; Mazhikev, Edwards, & Rizov, 2015). In this context, we extend the IDP with insights from the institutional theory and conduct a comparative analysis of the effects of institutional reforms on IDP paths of ten Central and Eastern European (CEE) post-communist European Union (EU)-members. We find that while most of the studied post-transition economies follow a cubic relationship between the net outward investment (NOI) position and each country's economic development, the role of institutional reforms is not in all cases accelerating the movement through the stages of the IDP. We attempt to explain the ambiguous role of institutions in an ensuing detailed discussion of the investigated countries.

The paper sets out by presenting the IDP model and briefly describing its five stages. The subsequent section discusses the relationships between inward and outward foreign direct investment, and economic growth in (post-)transition economies, which results in the formulation of the first hypothesis. Thereafter, the authors discuss the role of institutional reforms in the aforesaid relationships and formulate the second hypothesis. The following sections present the empirical part with its method design and results. The presentation of results is followed by an in-depth discussion of the institutional idiosyncrasies of the investigated countries. The paper wraps up with detailed implications for theory and policy, as well as a proposed program for further research.

## 2. Conceptual overview

The IDP concept (Dunning, 1981, 2002, 1996, 1986, Dunning & Narula, 1994) provides a basic framework for analyzing the dynamic relationship between FDI and economic development. The two variables used in determining a country's position on the IDP are NOI and GDP/GNP per capita. The NOI is calculated as a difference between outward FDI and inward FDI stock. Thus, the dynamic relationship between outward and inward FDI is at the heart of the IDP model. Changes in GDP are treated as proxy of economic development. As countries develop, they pass through 5 consecutive stages of the IDP (see Fig. 1). Each stage can be succinctly summarized as follows:

- Stage 1 – Countries receive little inward FDI initially and make almost no outward FDI. The NOI is negative and decreasing, first slowly and then more rapidly.
- Stage 2 – Countries receive growing amounts of inward FDI but still invest relatively little abroad, thus becoming a large net FDI importer. At the end of this stage however, outward FDI grows faster than inward FDI and the negative NOI stops increasing.
- Stage 3 – Countries still record more inward than outward FDI stock but the latter is growing faster than the former. As a result, at the

end of this stage, the NOI assumes values close to zero.

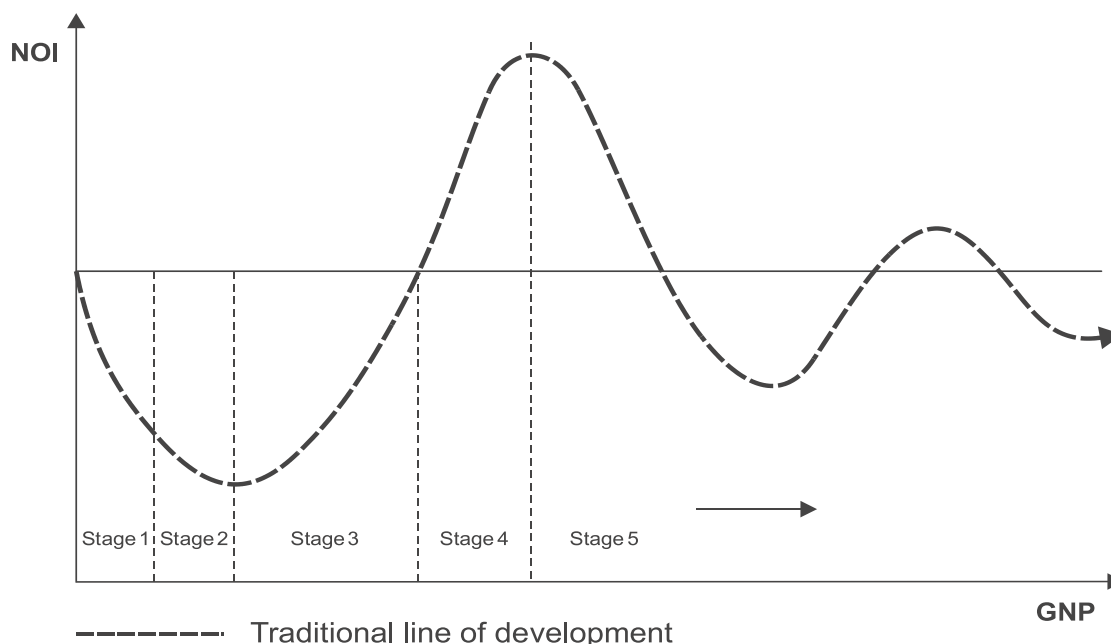
- Stage 4 – Countries record more outward than inward FDI stock, thus being a net FDI exporter. The NOI assumes consistently positive and growing values.
- Stage 5 – After having seen inward FDI growing faster than outward FDI, countries experience balanced, albeit fluctuating from year to year, high levels of inward and outward FDI. The NOI first falls and then fluctuates, assuming temporarily positive and negative values.

The theoretical explanation of the underlying causes of the above-outlined stages is rather complex, but generally one can state that the IDP changes occur in response to the interplay between investment attractiveness of a country (L-advantages) and the international competitiveness of its firms (O-advantages). Moreover, movement along the IDP generally parallels countries' growing wealth, measured by GDP. Accordingly, developed countries are typically in stages 4 and 5, least-developed countries are in stage 1 and developing and transition economies are in stage 2 or 3.

Transition or post-transition economies such as those investigated in this study are generally positioned somewhere between the end of stage 2 and the beginning of stage 3. This can reflect their specific duality. On the one hand, factors such as their growing internal markets and improving institutional environments may lead to a relative deterioration of their NOIs and hold them at the end of stage 2. On the other hand, there are drivers such as these same better institutions and/or improved firm specific competitive advantages of domestic firms which can be responsible for the shift in their positioning into the more advanced IDP stage 3, evidenced by the decrease in the negative values (and thus relative amelioration) of their country NOIs.

We chose the IDP model as a conceptual framework for our study because the model is recognized as the most developed theory attempting to explain the interplay between inward and outward FDI (see e.g. Stoian, 2013) and has been applied in numerous studies of countries net outward FDI position (Barry, Goerg, & McDowell, 2003; Bellak, 2001; Boudier-Bensebaa, 2008; Buckley & Castro, 1998; Gorynia, Nowak, & Wolniak, 2006; Gorynia, Nowak, & Wolniak, 2010a; Gorynia, Nowak, & Wolniak, 2010b; Gorynia, Nowak, Tarka, & Wolniak, 2012) or outward FDI (Andreff, 2003; Ferencikova & Ferencikova, 2012; Kalotay, 2004; Rugraff, 2010; Stoian, 2013; Svetličič & Jaklič, 2003). However, the model is not free from criticism (see e.g. Durán & Úbeda, 2001, 2005), the main criticism being that both GDP and NOI are too coarse variables that conceal important structural and institutional changes occurring alongside the movement of a country on the IDP and may influence that movement. As a result, countries with similar GDP levels and dynamics may experience different NOI positions. Indeed, Narula and Dunning (2010) caution against a simplistic, or narrow, application of these two variables – NOI and GDP – in order to identify and explain countries' IDP. They argue that studies using the IDP framework should adopt a broader perspective on a country FDI changes, taking into account the idiosyncratic economic structure of each country, as well as the complex forces and interactions that determine the turning points of the IDP in each case. This is echoed by Narula and Guimón (2010) who recommend that an empirical analysis of the relationship between a country's NOI position and its GDP per capita “need to be complemented with a deeper qualitative assessment of the interaction between FDI and development” (p. 8). At the same time, Dunning et al.'s (2001) study of Korea and Taiwan, incorporating trade and industrial structure change into the IDP analysis, points to an interface between the investment development path (IDP) and the trade development path (TDP), resulting in the growth of trade and FDI to be positively correlated with GNP and with the created asset intensity of products.

One set of the factors that may have a moderating effect on the IDP trajectory are institutional factors, including institutional reforms and policies. These are particularly relevant in the context of transition economies of Central and Eastern Europe, as the IDPs of these



*Note: Not drawn to scale - for illustrative purposes only*

Source: Dunning and Narula, 2002, p. 139.

Fig. 1. IDP The Pattern of the Investment Development Path.

Note: Not drawn to scale - for illustrative purposes only.

Source: (Dunning & Narula, 2002, p. 139).

economies are expected to be heavily influenced by the transition from socialism to capitalism and the subsequent EU membership (Narula & Guimón, 2010). Yet most empirical studies applying the IDP model test the concept regressing NOI on only GDP/GNP.

Further, the literature review reveals one strand of multi-country studies using cross-sectional analysis, often with pooled data sets (Boudier-Bensebaa, 2008; Dunning, 1996; Durán & Úbeda, 2001, 2005; Narula, 1996;). The other strand of studies focuses on one or two countries' NOI position either vis-à-vis other countries (Ozawa, 1996; Campa & Guillen, 1996; Graham, 1996; Buckley & Castro, 1998; Bellak, 2001; Barry et al., 2003; Dunning, Kim, & Lin, 2001; Dunning & Narula, 1994; Gorynia, Nowak, & Wolniak, 2007). However, multi-country designs do not allow for gleaning the peculiarities of individual country IDPs and conducting a comparative analysis between the countries. Due to the expected idiosyncratic IDP trajectories of individual countries, the results of the studies based on large groups of countries must be interpreted with caution (Narula, 1996, p. 22). An approach that seems to remedy the problem with using pooled datasets is to empirically analyze the individual IDPs of a group of (fairly homogeneous) countries and compare the results across these countries in order to reveal and explain both the similarities and differences. Our literature review shows that such approach is rare (among the few studies of this nature are Gorynia et al., 2012 and, to some degree, Kalotay, 2004; Boudier-Bensebaa, 2008; and Narula & Guimón, 2010).

Empirical studies on the IDP show a considerable variation in the investment development paths across both the developed, transition and developing countries. It is apparent from these studies that a particular IDP trajectory also reflects differences other than those in GDP/GNP per capita. It is recognized that idiosyncrasies are due to number of factors, such as resource endowments, institutions and government policy (Birsan et al., 2011; Dunning & Lundan, 2008a). While the significance of these factors has been widely recognized and argued for, almost no empirical research incorporates institutional factors into

econometric modeling of the IDP (Dunning, 2005a, 2005b; Stoian, 2013).

### 3. Hypotheses development

#### 3.1. The IDP in post-communist economies

The IDP model has been used as a conceptual framework in numerous empirical studies, a number of which directly or indirectly focus on CEE countries. These multi-country, comparative studies have usually positioned the CEE countries in transition from stage 1 to stage 2 of the IDP in the latter part of the nineties and moving along stage 2 in the 2000s, with some of the countries apparently approaching or entering stage 3 in more recent years (Boudier-Bensebaa, 2008; Gorynia et al., 2010a, 2012; Kalotay, 2004; Svetličič & Jaklič, 2003, 2010b; Zdziarski, 2016).

According to Gorynia et al. (2012), 10 CEE EU-countries followed the basic premises and trajectories as set forth in the original IDP model. Yet, the regression analysis indicated that five of the studied countries (Czechia, Estonia, Hungary, Lithuania and Poland) were in stage 3 of their IDPs, whereas the other five (Bulgaria, Latvia, Romania, Slovenia and Slovakia) were still in stage 2, although Slovenia showed a tendency to fluctuate around the border of stage 3 and Romania was about to enter stage 3. Other studies do not corroborate Gorynia et al.'s (2012) findings regarding stage 3. Narula and Guimón (2010) compare NOIs of four CEECs (Bulgaria, Czechia, Hungary and Romania) with those of six "older" members of the EU and conclude that the changes in NOI positions of CEE countries in the first decade of 2000s were characteristic of stage 2 of the IDP. Similarly, Zdziarski (2016) places four Central European countries (of the Visegrad Group) in stage 2. According to the descriptive data analyzed by Gorynia et al. (2016), Bulgaria, Hungary, Slovakia, Lithuania and Estonia were found to be positioned at the very beginning of their IDP stage 3. More advanced on

the IDP curve of stage 3 were Latvia, Croatia, and Slovenia.

The aforesaid studies used the original IDP model with NOI p.c. as the dependent and GDP p.c. as the independent variable. Stoian (2013) took a different approach. While placing her study in the context of the IDP concept, Stoian tested a number of hypotheses derived from an augmented IDP model, but did not treat NOI as a dependent variable. The augmentation of the model consisted of incorporating into it the effects of home country institutional factors on the level of OFDI. The premise of this study was that GDP per capita is too coarse an indicator of economic development and thus supplementary factors should be included in the IDP model (Stoian, 2013). It was found that overall institutional reforms and reforms related to competition policy enhanced OFDI, while large scale privatization, enterprise restructuring or trade liberalization alone did not. Stoian (2013) concluded that all CEE countries were in the second stage of the IDP, consistent with the earlier studies (notably Boudier-Bensebaa, 2008; Kalotay, 2004) but contradicting the findings of a more recent study by Gorynia et al. (2012).

To summarize, research findings are inconsistent regarding the positioning of CEE countries on the IDP. While there is almost a consensus that these countries moved from stage 1 to stage 2 in the 1990s, conclusions differ regarding the possible transition to stage 3 of the IDP in the first decade of the 2000s. There is, therefore, a need to revisit this assessment, using newer data sets (covering years after 2008) and more rigorous quantitative methods of analysis, notably regression analysis, as some of the previous conclusions were based on assessment of FDI descriptive statistics. Although determining those stages may have little practical significance, in reality it does have important policy implications, as different government actions and measures are needed at different stages of the IDP. Thus, it is argued that given the current state of economic development of post-transition economies and their integration into international business (notably FDI), their level of advancement should indicate an increasing role of internationalization by indigenous firms as opposed to inward FDI, thus requiring a quadratic model form to adequately model these factors. Accordingly, we pose the following two hypotheses:

**H1.** CEE EU-member states are currently on the borderline between stages 2 and 3 of their IDP.

### 3.2. The moderating role of institutional reforms

"Institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction" (North, 2011: 3). In other words, institutions pose a structure which reduces uncertainty by limiting the set of choices made by individuals. North, perhaps more than any other scholar, advanced our understanding of institutions at the macro level (Dunning & Lundan, 2008a). IB economists have investigated the impact of country-level institutions on the behavior of domestic and foreign MNEs (Dunning & Lundan, 2008b). Dunning (2005a, 2005b) recognized that the extent and quality of a nation's institutions and its institutional infrastructure are increasingly becoming a critical determinant of the successful deployment of firms' ownership advantages and thus an important consideration in FDI location choice by MNEs.

In fact, IB researchers using institutional theory have analyzed FDI location choices (e.g. Gliberman & Shapiro, 1999, 2008; Habib & Zurawicki, 2002), FDI mode choice decisions (e.g. Estrin, Baghdasaryan, & Meyer, 2009; Rodriguez, Uhlenbruck, & Eden, 2005; Yiu & Makino, 2002), as well as the performance implications of these choices (e.g. Brouthers et al., 2008), generally suggesting that a lower level of host-country institutional hostility, restrictiveness and instability attract more FDI. While the focus on host-country institutions as an FDI determinant is predominant, a part of research efforts aim at exploring how home-country institutions, in particular government policies, can constrain or accelerate firm internationalization (Gorynia, Nowak, Trapczyński, & Wolniak, 2015; Marinova, Child, & Marinov,

2012).

Institutional theorists have debated the relation between institutional change and institutional stability. One stream of institutional scholars (DiMaggio & Powell, 1983; Zucker, 1987) has focused on a more mature and stable environment and the role of institutions in reducing variety, limiting choice, and stabilizing the practices that characterize a particular institutional field. On the other hand, another stream of institutional researchers (Chung & Beamish, 2005; Peng, 2003) has emphasized the context of an emerging and turbulent institutional environment and the role of institutional environments in generating change. The institutional development of an economy focuses on the extent to which a country has developed formal rules, systems, and structures that lower transaction costs and facilitate corporate activity (Brouthers, 2013; Deephouse, Newbury, & Soleimani, 2016). Important institutional dimensions include: distribution systems for moving inputs to producers and final goods to customers; financial systems facilitating capital movements; labor market freedom; educational systems providing training for skilled personnel; and government institutions promoting transparency and reducing corruption (Berry, Guille'n, & Zhou, 2010).

Dunning and Lundan (2008a) argue that institutional reconfiguration and upgrading is a path-dependent process, and there are considerable transaction costs in changing any existing institutional artifacts, as both individuals and organizations tend to embrace such changes with great caution. Dunning (2005a, 2005b) further argues that of the specific variables that account for a country's institutional infrastructure, both change of ownership (in the form of privatization) and private sector development have been found to be positively (though not significantly) related to FDI flows. In particular, the creation of new markets was shown to reduce transaction costs associated with uncertainty and bureaucratic opportunism. More significantly, the quality and transparency of the financial sector and banking reform was seen to be significantly correlated with FDI flows; but non-bank institutional upgrading, e.g. with respect to capital markets, appeared to be less so. However, the liberalization of domestic markets, the strengthening of competition policies and a movement towards a more open trading regime was seen to have had a strong positive effect, as in the case of the upgrading of the legal system.

In a similar vein, Trevino, Thomas, and Cullen (2008) argue for the context of Latin America that privatization emerges as one of the most significant explanatory variables of inward FDI as it sends a strong signal to the investing community that the government is willing to allow the private sector to play an increasingly larger role in the economy (*regulative pillar*). Additionally, however, this process must be initiated by actors who support an institutional shift (*cognitive pillar*) and accepted by society at large as a willingness to open its economy to foreigners (*normative pillar*). These authors also posit that political uncertainty repels inward FDI as it increases costs for foreign investors. Moreover, they find that the degree of tax reform in the host country is positively associated with the level of its inward FDI.

To summarize, previous research has demonstrated that the quality of the institutional environment is crucial to the country's involvement in international business. However, in doing so, most contributions have been related separately either to inward FDI and its institutional determinants (see e.g. Trevino et al., 2008), or the propensity of firms from particular institutional frameworks to engage in outward FDI (Delios & Henisz, 2000). We argue that institutional changes affect both inward and outward FDI and moderate the effects that economic growth has on the interplay of both types of investment.

In fact, the importance of institution building, and related government policies, as a necessary prerequisite for FDI is widely recognized in the IB literature (Cui & Jiang, 2010; Dunning, 2001; Dunning et al., 2001; Dunning & Lundan, 2008c; Holland, Sass, Benacek, & Gronicki, 2000; Meyer, 2001). Moreover, some authors stress the importance of placing the IDP concept within the context of the transition economies' evolving institutions and policies (Bevan, Estrin, & Meyer, 2004;



Dunning, 2005a, 2005b; Narula & Guimón, 2010; Stoian, 2013). Dunning's (2005a, 2005b) assessment of the role of institutional infrastructure (II) in facilitating FDI in European transition economies, based on a review of a number of available empirical studies, points to the significance of II as a determinant of FDI flows into the region under study. At the same time, Dunning argues that by upgrading their institutions and innovatory capacity, European transition economies do not only attract better quality FDI but also help their own indigenous firms to become outward foreign investors. As specific institutional variables, both change of ownership (in the form of privatization) and private sector development are seen to be positively correlated with FDI (Dunning, 2005a, 2005b). Also, the quality and transparency of the financial sector and banking reforms are positively correlated with FDI flows, as is the upgrading of the legal system.

On the other hand, the liberalization of domestic markets, the strengthening of competition policies and a movement towards a more open trading regime can be considered to have a positive effect on outward FDI. We argue that for the same level of economic development of a given country, a higher level of advancement of its institutional reforms will – depending to the IDP stage of the country and the related location and firm-specific advantages – lead to higher levels of inward and outward FDI, hence leading to a faster progression along the predicted IDP path. Thus, we propose:

**H2.** *The level of institutional reforms advancement accelerates the movement along the IDP path in post-transition economies.*

Fig. 2 presents the analytical framework of the study.

## 4. Research methods

### 4.1. Data and operationalization of variables

In order to address the research objectives of the paper and empirically verify the hypotheses formulated above, we recur to multiple regression analysis in order to verify the appropriateness of the IDP approach in CEE countries under study. In line with a number of scholars we have applied a quadratic function to estimate a non-linear IDP relationship (Barry et al., 2003; Boudier-Bensebaa, 2008; Dunning & Narula, 2002). The transitional aspect of these economies makes them an ideal context to test the limits of applicability of extant theories and thereafter to extend them (Meyer & Peng, 2005) by drawing on institutional theory. Furthermore, the variety of institutional contexts across the sample and the remaining on-going reforms allow drawing conclusions with regard to the institutional factors that 'do matter' for FDI, leading also to specific policy implications. This ensures the timeliness of the current investigation and its relevance to both theory and practice. Our focus on a particular region is further justified by the fact that most research is pursued on a region by region basis (Meyer & Peng, 2005) and by the distinctiveness of this group of countries from other emerging or transition economies, especially in terms of their institutional fabric (Demekas, 2007).

With regard to sampling, we focus on a sample of new-EU member states from the CEE region, which are all post-communist countries and share a common institutional heritage, yet on the other hand show significant institutional diversity (Hoskisson, Wright, Filatotchev, & Peng, 2013). In doing so we aim to exploit a fertile ground for observing institutional heterogeneity. On the other hand, analyzing countries at different stages of their institutional transition, including changes resulting from the EU accession, allows to capture the effects of reforms in their continuity and entirety. We thus include in the sample the following countries which are classified as Central and Eastern European economies (EBRD, 2015) and for which the EBRD has calculated its transition indicators<sup>1</sup>: Bulgaria, Croatia, Estonia, Hungary, Latvia,

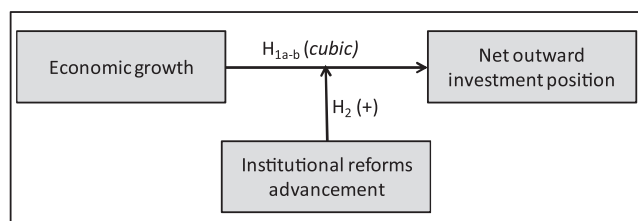


Fig. 2. Analytical framework.

Lithuania, Poland, Romania, the Slovak Republic, and Slovenia. The timeframe for the analysis spans the period 1990–2014, which covers the beginning of the system transformation in the region and all extant accessions of the said transition economies to the European Union, which can be regarded as evidence of advancing institutional alignment with advanced economies. Hence, for the 10 countries in the sample, the country-specific analyses spanned from 22 to 25 years (depending on data availability), while for the panel data analysis to investigate the overall relationships across the sample, the panel spanned 22 years for the 10 countries, leading to a sample of 220 year-observations.

Our dependent variable, in line with the IDP paradigm which is at the core of this study, is the net outward investment per capita (NOI p.c.), computed as the difference between outward FDI and inward FDI stock per capita derived from the UNCTAD database (see Table 1). The independent variable is the level of home country economic development, expressed by the home country's GDP per capita (Narula & Dunning, 2010), also extracted from the UNCTAD database. Furthermore, to capture the advancement of institutional reforms, we used EBRD's (2015) transition indicators as an aggregate index of Large-scale privatization, small-scale privatization, governance and enterprise restructuring, price liberalization, trade and foreign exchange system, and competition policy (see Table 1). For each of these specific dimensions, the EBRD has provided evaluations on a 5-point scale, based on a classification system originally developed in the 1994 Transition Report, but refined and amended in subsequent reports.

### 4.2. Analytical approach

In line with our research objectives, non-linear, quadratic regression analyses using the SPSS 24 software package were applied to the two key variables of the IDP model: NOI per capita, as the dependent variable, and GDP per capita and the advancement of institutional reforms as the independent variables. Non-linear regression proved to be appropriate since the relationship between the dependent and independent variables is not intrinsically linear (Boudier-Bensebaa, 2008; Durán & Úbeda, 2001, 2005; Zhang & Van den Buckle, 1996).

The regression equation for the quadratic specification can be expressed as

$$\text{NOI p.c.} = \alpha + \beta_1 \text{GDPpc} + \beta_2 \text{GDPpc}^2 + \beta_3 \text{Institutional Reforms} + \mu$$

Given the existence of potentially relevant factors affecting the investigated relationships and documented in earlier studies, several control variables were introduced. We added the EU membership of the given country in each investigated year (Stoian, 2013), the size of the economy given by its population, as well as the home country exchange rate against the dollar. We do not report these variables in the final models, nor in the previous section, as (1) they did not turn out to be significant; (2) they do not affect the shape of the studied relationships; and (3) they reduce the statistical power of the models due to small sample size. For the panel data regression, the model also included

(footnote continued)

analyses due to the limited availability of data for all years concerned.

<sup>1</sup> Of these CEE new EU member states, Czechia was left out in the present

**Table 1**  
Operationalization of variables.  
Source: Authors.

Variable	Measurement	Data source
<b>Dependent variable</b>		
Net outward investment per capita (NOI p.c.; 1991–2014)	Difference between outward FDI and inward FDI stock per capita	UNCTAD Stat
<b>Independent variable</b>		
Home country economic development (1991–2014)	Home country GDP per capita	UNCTAD Stat
<b>Moderating variable</b>		
Institutional reforms advancement (1991–2014)	<i>Large scale privatization</i> , expressing the share of large-scale enterprise assets in private hands or in the process of being privatized (with the process having reached a stage at which the state has effectively ceded its ownership rights), but possibly with major unresolved issues regarding corporate governance; <i>Small scale privatization</i> , referring to the progress of privatization of small companies; <i>Governance and enterprise restructuring</i> , expressing budget constraints (e.g. credit and subsidy policies) and other reforms promoting corporate governance; <i>Price liberalization</i> , pertaining to the extent to which the government controls prices for different product categories; <i>Trade &amp; Forex system</i> , related to the level of liberalization of import and/or export controls; the extent of current account convertibility in principle, as well as the transparency of the foreign exchange regime; <i>Competition Policy</i> , expressing the advancement of related legislation and institutions set up, reduction of entry restrictions or enforcement action on dominant firms.	EBRD, 2015 EBRD, 2015 EBRD, 2015 EBRD, 2015 EBRD, 2015 EBRD, 2015

years of observation and population as a control variable.

Two types of econometric modelling have been used in the analyses. In order to explore overall trends across the investigated sample of countries, a panel data non-linear regression has been used on 220 country-year-observations. Secondly, to analyze country-specific paths, cross-sectional regression analyses were conducted for each country for 22–25 years in each case (depending on data availability).

In order to ascertain the appropriateness of all OLS multiple regression models, several assumptions had to be validated. Firstly, before running the regressions, several statistical checks (correlation analysis, independent sample tests) were conducted in order to detect multicollinearity between the explanatory variables, as well as to provide an initial understanding of the relationships between both independent and control variables (see Table 2). In order to alleviate the concern of multicollinearity, which was tangible because of the inclusion of interaction terms with quadratic terms of the same variable, all variables were mean-centered. The analysis of variance inflation factors (VIF) for all regression models revealed no major problems with regard to multicollinearity, as VIF values for all variables in all models were within an acceptable threshold of 10 (Chiao, Yu, Li, & Chen, 2008; Georgopoulos & Preusse, 2009).

As regards the panel data regression specifically, we used a fixed-effect model. From a conceptual point of view, since individual effects are linked to country-specific characteristics, they can be assumed to be deterministic and non-random. From a statistical perspective, a fixed effect model seems more appropriate since NOI is examined for countries which are not randomly drawn from a larger population but belong to a predetermined sample. Additionally, from an econometric perspective, the Hausman specification test led to the rejection of the use of a random effect model in favor of a fixed-effect model.

**Table 2**  
Descriptive statistics and correlation matrix (N = 220).  
Source: Authors' calculations based on SPSS 24 software package.

	Mean	Std. dev.	1.	2.	3.	4.	5.
1. NOIP_pc	-2.89	2.78	1				
2. GDP p.c.	354.50	4916.26	-0.79***	1			
3. Institutional reforms	0.20	0.30	-0.63***	0.67***	1		
4. Year	11.50	6.36	-0.80***	0.91***	0.83***	1	
5. Population	6164.28	5763.81	0.12 <sup>†</sup>	-0.02 <sup>*</sup>	-0.05	-0.04	1

Standard errors in parentheses. \*\*\*p < 0.001; \*\*p < 0.01; \*p < 0.05; <sup>†</sup>p < = 0.10; Panel data for 10 countries and 22 years (N = 220).

## 5. Results

### 5.1. Regression findings

Table 4 reports the results of our econometric modelling. The quadratic models controlling for the advancement of institutional reforms explain to a large extent the relationship between GDP per capita and NOI per capita in the investigated countries. Starting with the panel data regression for all 10 sample economies (220 year-country-observations), the overall shape of the relationship is not clear, with the quadratic term not showing statistical significance, which points to the necessity of country-specific analyses. Turning to country-specific regressions, the U-shaped relationship is significant for Hungary, Poland, Romania, Slovakia, Latvia, Lithuania and Slovenia, as the quadratic term coefficients are positive and significant at least at a level of p < 0.1. However, due to the non-linear nature of the relationship, in order to assess the switch between stages 2 and 3 in line with the criteria specified in Section 2 above, a graphical interpretation of the non-linear relationships is required. Accordingly, the graphic interpretations clearly indicate a U-shaped form, with the right-hand part of the curve clearly emerging, indicating movement through early stage 3 for Hungary, Slovakia, Estonia and Slovenia. For Bulgaria, Romania, Croatia, and – surprisingly – Poland, Latvia and Lithuania, there is support for the notion of still remaining in late stage 2.

Based on the results of the regression analysis as visualised in Fig. 3, a number of extensions can be made as to the descriptive findings reported previously (e.g. Gorynia et al., 2016). The estimation of non-linear curves largely corroborates the previous assertion that countries like Poland, Lithuania, or remarkably Romania, are firmly on the way towards stage 3 of their IDP, given the clear signs of the point of inflection in the estimated curve towards the last available data points.

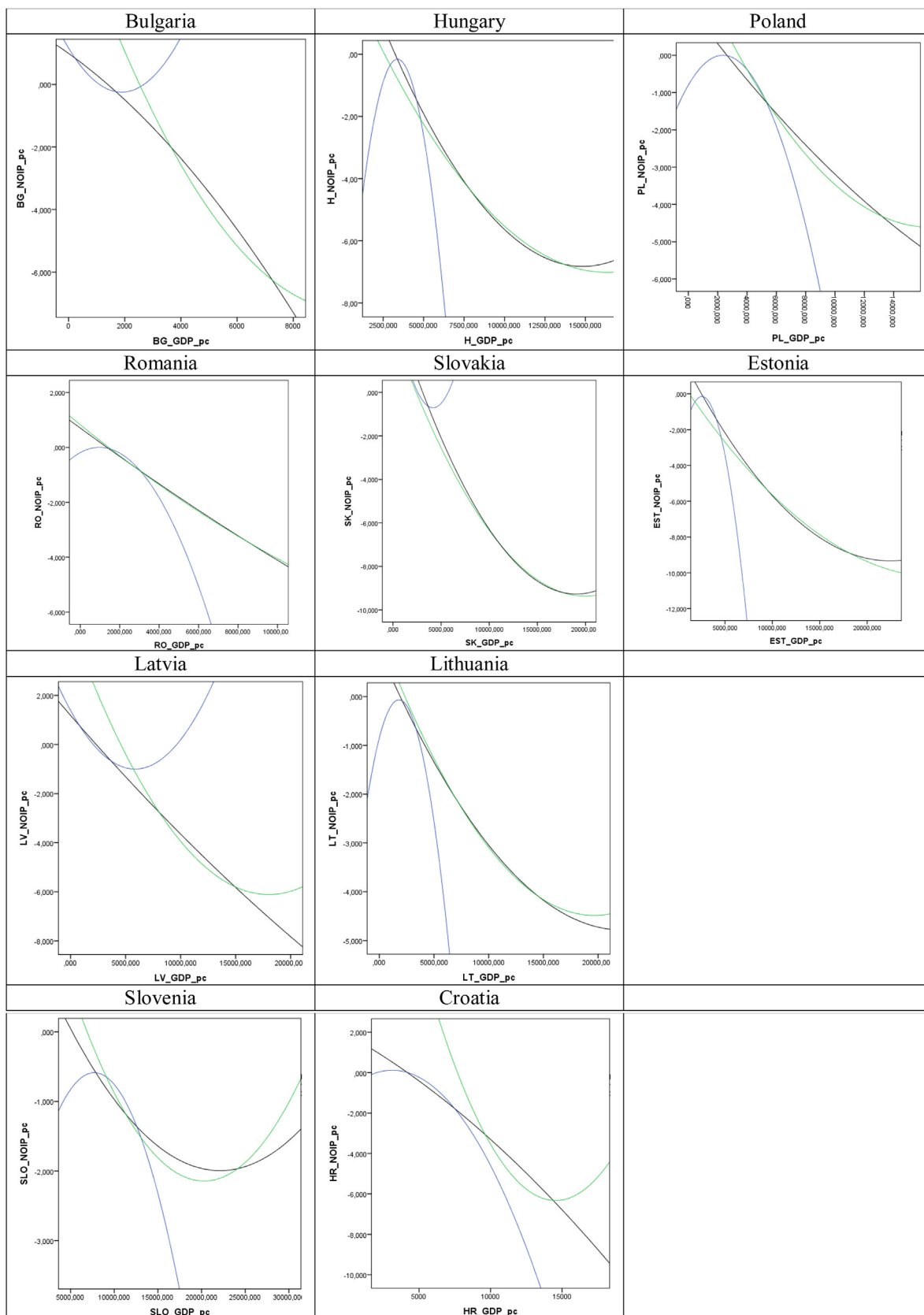


Fig. 3. Moderating effect of institutional reforms on the relationship between NOI p.c. and GDP p.c. blue line - low level of institutional reforms advancement; green line - high level of institutional reforms advancement. Source: Authors' calculations.

However, Latvia and Croatia turn out to have already entered stage 3. Slovenia seems even more advanced in its stage 3, however the dispersion of data points, makes any related generalizations more difficult. Hungary, Bulgaria and Slovakia seem to be still on the verge between stages 2 and 3. Interestingly, Estonia still seems to remain at the end of stage 2. Moreover, the different coefficients of linear and quadratic terms in each country demonstrate that each country's development shows an idiosyncratic path. However, the purpose of this analysis was not to test the direction or significance of particular coefficients, but to model IDP relationships in post-transition economies. Accordingly, on the whole the visual representations shown in Fig. 3 demonstrate that the non-linear curves fit the data using the non-linear algorithm and do indeed mostly follow the patterns posited by the IDP paradigm. Thus, on the whole, Hypothesis 1 receives empirical support.

In the panel regression, the interaction term of institutional reforms with GDP p.c. level is negative and significant ( $p < 0.05$ ), which would suggest that the effect of GDP on NOI p.c. is weakened with the rising advancement of institutional reforms. Interestingly, also the direct effect of the variable of institutional reforms advancement on NOI p.c. is mostly either negative or insignificant, apart from a positive coefficient of its direct effect on NOI p.c. in Estonia. However, as the dependent variable is NOI p.c., its relationship with other variables is not straightforward, thus the interpretation of direct effects is difficult. Moreover, this leads us to subsequent analyses in which the institutional reforms advancement does not play a direct, but a moderating role. The coefficient of the interaction term is significant and negative for Bulgaria, Poland, Romania, Latvia, Lithuania and Slovenia, similar to overall CEE panel data results, which would suggest a negative moderating effect of institutional reforms. Only for Estonia, this interaction has a positive and significant sign. For other countries, the interaction is statistically non-significant. Yet, given the difficulty with interpreting the interaction term for an inherently non-linear relationship, we further estimated and plotted quadratic curves, distinguishing between lower and higher levels of institutional advancement in order to verify the shape of the NOI-GDP relationship in each case (see Fig. 3).

As it can be inferred from the plotted curves, for Hungary, Poland, Estonia, Lithuania, Slovenia and Croatia the effect of institutional reforms appears to be clearly positive, strengthening the NOI p.c.-GDP p.c. relationship. However, for Bulgaria, Slovakia, and Latvia the effect is reverse, i.e. institutional reforms advancement has a negative, i.e. slowing-down effect on the non-linear relationship between NOI p.c. and GDP p.c. Thus, Hypothesis 2 received partial support and requires further analyses (Table 3).

### 5.2. Robustness checks

In order to shed more light on the inconsistencies in the effect of institutional reforms, we have also estimated cubic models with the interaction term (not reported here due to high VIF values), observing fundamentally similar signs as in the reported models in Table 4. An analysis of coefficients of interactions with the squared and cubic term was difficult due to the high VIF values, whereby illusory relationships may have emerged out of collinearity. Thus, we also performed simple slope analysis to determine whether the effect of GDP p.c. on NOI p.c. is weaker or stronger for different levels of institutional reform advancement. This analysis provides support for the positive moderating effect of institutional reforms for Hungary, Lithuania, Estonia and Slovenia. However, its negative effect for Poland, Romania and Croatia adds inconsistency to the findings reported above. For Bulgaria, Slovakia and Latvia, the negative moderating effect is reinforced.

As the nature of non-linear relationships, as well as the limited sample size, call for caution, further in-depth discussion and additional explanations are warranted. Therefore, in the ensuing sections we will elaborate more in depth on the effects of institutional reforms in the post-communist economies under study.

## 6. Discussion and conclusions

### 6.1. Institutional idiosyncrasies and the IDP

In an attempt to explain the heterogeneous effects of institutional reforms, the discussion will be brought to the level of the idiosyncrasies of the analyzed countries and their institutional paths.

#### 6.1.1. Negative moderating effect of institutional reforms

As regards the decelerating effect of institutions, in such a category were Bulgaria, Latvia and, at first glance surprisingly, Slovakia. For the former two countries, the beginning of the transition was slow as opposed to their CEE peers, as they were significantly lagging behind all institutional changes, except trade and foreign exchange reforms (EBRD, 1994). While both countries increased their integration with international associations, such as the EFTA or WTO by 1995, slow large-scale privatization and the severe deficiencies of the largely state-owned bank sector (EBRD, 1998) were among the factors affecting the countries' progression along the IDP path. While both small-scale and large-scale privatization accelerated, the legislative framework for bankruptcy still needed to be strengthened to promote the restructuring of non-viable firms (EBRD, 1999, 2004; EBRD, 1995; EBRD, 1999, 2004). Although barriers to entry in domestic markets have been eased, the

**Table 3**  
Regression models for NOI p.c. (dependent variable) with the moderation of institutional reforms (standardized  $\beta$ ).  
Source: Authors' calculations based on SPSS 24 software package.

	CEE-10 <sup>#</sup>	Bulgaria	Hungary	Poland	Romania	Slovakia	Estonia	Latvia	Lithuania	Slovenia	Croatia
<b>GDP p.c.</b>	-0.24 <sup>‡</sup> (0.00)	-0.73 <sup>***</sup> (0.00)	-0.77 <sup>***</sup> (0.00)	-0.99 <sup>***</sup> (0.00)	-0.41 <sup>*</sup> (0.00)	-1.16 <sup>***</sup> (0.00)	-2.73 <sup>**</sup> (0.00)	-0.07 (0.00)	-0.25 (0.00)	0.36 <sup>***</sup> (0.00)	-0.92 <sup>**</sup> (0.00)
<b>GDP p.c.<sup>2</sup></b>	0.01 (0.00)	-0.00 (0.00)	0.19 <sup>***</sup> (0.00)	0.29 <sup>**</sup> (0.00)	0.12 <sup>†</sup> (0.00)	0.21 <sup>***</sup> (0.00)	0.10 (0.00)	0.07 <sup>‡</sup> (0.00)	0.23 <sup>***</sup> (0.00)	0.43 <sup>†</sup> (0.00)	0.08 (0.00)
<b>Institutional reforms</b>	-0.08 (0.79)	-0.29 <sup>**</sup> (0.37)	-0.53 (1.68)	-0.18 (0.66)	-0.76 <sup>***</sup> (0.39)	0.02 (1.39)	1.69 <sup>‡</sup> (1.69)	-0.77 <sup>***</sup> (0.48)	-0.73 <sup>**</sup> (0.87)	-1.68 (2.22)	-0.03 (2.51)
<b>GDP x Institutional reforms</b>	-0.15 <sup>*</sup> (0.00)	-0.25 <sup>**</sup> (0.00)	-0.39 (0.00)	-0.32 <sup>**</sup> (0.00)	-0.64 <sup>***</sup> (0.38)	0.04 (0.00)	1.53 <sup>‡</sup> (0.00)	-0.66 <sup>***</sup> (0.12)	-0.65 <sup>**</sup> (0.00)	-1.49 <sup>‡</sup> (0.00)	-0.19 (0.00)
<b>Population</b>	-0.25 <sup>‡</sup> (0.00)										
<b>Year</b>	-0.25 <sup>**</sup> (0.00)										
Adj. R <sup>2</sup>	0.665	0.982	0.967	0.969	0.979	0.984	0.948	0.990	0.978	0.645	0.874
Std. error	1.61	0.37	0.50	0.32	0.23	0.49	0.85	0.24	0.25	0.42	1.05
F	73.49 <sup>***</sup>	320.92 <sup>***</sup>	174.23 <sup>***</sup>	188.82 <sup>***</sup>	277.15 <sup>***</sup>	330.74 <sup>***</sup>	101.68 <sup>***</sup>	573.04 <sup>***</sup>	249.89 <sup>***</sup>	11.01 <sup>***</sup>	39.01 <sup>***</sup>
N	220	25	25	25	25	22	23	23	23	23	23

Standard errors in parentheses. \*\*\* $p < 0.001$ ; \*\* $p < 0.01$ ; \* $p < 0.05$ ; <sup>‡</sup> $p < 0.10$ ; <sup>#</sup>Panel data for 10 countries and 22 years (N = 220).



**Table 4**  
Summary of institutional reform profiles of the 10 CEE countries.  
Source: EBRD (1994–2015).

Country	Role of reforms	Large-scale Privatization	Small-scale Privatization	Governance and enterprise restructuring	Price liberalization	Trade & Forex system	Competition Policy
Hungary	<i>Positive moderating effect</i>	gradual but steady, driver of inward FDI particularly in energy and natural resources	by 1990 vast majority transferred to private hands	subsidy reduction and market-orientation of credit policies, tight bankruptcy regime already from 1992	by 1994 90% of prices free of controls	gradual liberalization, by 1989 licensing requirements and quotas removed; early guarantees to foreigners to repatriate profits and capital	law on the prohibition of unfair market practices passed in 1990; major MNEs are beginning to relocate their research activities
Lithuania		Voucher privatisation began as early as 1991; Restitution law adopted	focus of privatisation shifted to infrastructure (minor concerns about the role of the government in the sales process)	By 1998 FDI limited largely to retail trade and light industry	Rapid liberalization of commodity prices by 1992	in 1992 export surrender requirement abolished	by 1994 early dismantling of monopolies; new competition law enacted and national agency established
Slovenia		slow to materialise by 1994, but comprehensive by 1995	1994: all small-scale trade and services in private hands	still by 1998 corporate governance remained poor, dominated by insiders with low levels of FDI restructuring in the hands of investors, with support of international support programmes	Most prices liberalised already in 1994	Foreign trade law adopted by 1993	by 1994 early dismantling of monopolies' competition law enacted by 1993
Estonia		Privatisation Act in 1993	rapid small-scale privatization already by 1994	restructuring in the hands of investors, with support of international support programmes	early removal of price controls in 1989, completed early	almost no trade restrictions, full current account convertibility early on	bankruptcy law passed already in 1992, FDI as driver of enterprise restructuring
Poland	<i>Ambiguous effects</i>	multi-track approach to privatisation, by 1998 a large part of large enterprises still state-owned	most small retail, wholesale and construction enterprises privatized early	by 1998, the progress on corporate governance remained slow	liberalized, yet with important exceptions	By 1994 in particular sectors, (e.g. automotive) important barriers remained; some limits on capital transfer remained	By 1998, despite some progress, competition in the banking sector still limited.
Romania		Still by 1998 privatisation continued	Rapid small-scale privatization	poor governance, gradual and erratic approach to restructuring	only half of the prices freed by 1993	few restrictions due to international integration by 1995 (WTO)	bankruptcy law only in 1995
Croatia		to lag behind schedule the system of former Yugoslavia provided a degree of self-management	extensive privatisation already under the former Yugoslav law	limited success in the transformation of management structures initially	By 1994 direct price controls removed, apart from energy sector	By 1994 liberal trade regime	Still by 1998, enterprise restructuring inhibited by poor corporate governance
Bulgaria	<i>Negative moderating effect</i>	Large-scale privatization slow by 1994	The law regulating small-scale privatization adopted only in 1993	enterprise restructuring hampered by vested interests and inexperience of courts in bankruptcy cases; complex legal rules and space corruption	Despite liberalization by 1994, there was still some backtracking on prices and foreign trade	By 1994 import tariffs tended to increase after earlier cuts; export restrictions on agricultural and other commodities in 1996; foreign exchange crisis in 1996	By 1994 no antitrust policy in important areas (e.g. agro-industrial whole-sale trade), regulatory framework for natural monopolies missing
Slovakia		occurring in waves and lacking transparency, thus deterring FDI	controversial style of privatization still by 1998	Efforts made to attract foreign investors with limited success; absence of effective bankruptcy proceedings	Most prices freed by 1991	by 1991 most controls on export and import removed; full current account convertibility	competition law passed in 1991, but continued existence of unprofitable firms
Latvia		By 1994 still lagging behind other reforms	advanced privatisation by 1994	the bankruptcy law passed in 1991 considered inadequate (no criteria for initiating bankruptcy proceedings)	no formal controls by 1992	after tariff reform of 1994, basic import tariff rate relatively high, export duties on certain raw materials	Organic growth of new enterprises inefficient and sometimes corrupt bureaucracy still by 1998

enforcement of property rights depends on the effective implementation of judicial and administrative reforms. Thus, local firms were struggling to become or remain competitive in international markets with a view to outward FDI (EBRD, 2011). These cases of these two countries demonstrates that the mere opening of the economy towards international business, as well as the absorption of EU structural and cohesion funds, cannot guarantee a faster progression of the countries' along the typical IDP path. In fact, even for high institutional reform scores (as measured in our quantitative analyses), the qualitative structure of institutional change has to be balanced to ensure both a favorable environment for foreign investors and local firms to engage in outward FDI in a competitive manner.

A somewhat different case is provided by Slovakia. The privatization process was criticised for a lack of transparency in the timing of sales, choice of buyers, and special terms and conditions offered to select buyers. While the private sector consistently recorded faster output and employment growth than the public sector, firm profitability remained generally low and deteriorated in many cases (EBRD, 1998). Among medium-sized and large enterprises, there were as many profitable as loss-generating firms. The virtual absence of bankruptcy continued to inhibit the exit of unprofitable firms and to weaken financial discipline. The privatization of large-scale enterprises was reinvigorated only by 2000 (EBRD, 2000). Yet, by 2002, reforms of corporate governance and business standards, improvements in enterprise legislation and anti-corruption measures, which are necessary to support employment creation and growth, were still overdue (EBRD, 2002). Furthermore, the government's decision in 2006 not to pursue further privatizations was deterring foreign investors (EBRD, 2005, 2006). As the focus of institutional reforms shifted more to the higher-order needs related to the long-term competitiveness of local firms, by 2008 the country still had a long way to go with regard to a more flexible labour market (EBRD, 2008).

#### 6.1.2. Positive moderating effect of institutional reforms

For countries, for which the role of institutional reforms was an accelerator of their IDP paths, i.e. Hungary, Estonia, Lithuania and Slovenia, some consistent patterns can be identified, as well. Apart from Slovenia, which proved slow in large-scale privatization, all these countries' demonstrated a radical approach to enterprise restructuring, including the introduction of bankruptcy laws (EBRD, 1994, 1995). In particular, Estonia and Lithuania were the only ones to fully commit themselves to full convertibility of their currencies for both current and capital account purposes. In addition, Hungary and Estonia did what was problematic in Slovakia, i.e. they placed emphasis in their comprehensive privatization programmes on sales of majority stakes to strategic (often foreign) investors, mainly for cash (EBRD, 1995). Estonia in some cases combined the sale of majority stakes to a strategic investor with sale of minority stakes for mass-distributed vouchers, and has thereby extracted some benefits of mass participation while escaping problems associated with diluted ownership. Despite the overall success of privatization tenders in these countries by 1998, the introduction of direct sales had raised concerns about the transparency and consistency of the national governments' roles in the process, as well as drew attention to the ongoing weaknesses of the banking sector and to limited progress in some strategic sectors, which were particularly FDI-intensive, such as energy and telecoms (EBRD, 1998). By 1999 all these countries also faced the challenge of fostering inflows of FDI and eliminating legal and regulatory obstacles to effective corporate governance (EBRD, 1999).

Despite the overall successful reforms on the said four countries' path toward EU accession, by 2002 they still faced some problems limiting inward FDI. In Hungary, for instance, as a result of the global slowdown and the practice of the preceding government of limiting procurement contracts for large infrastructure projects to local enterprises, net FDI inflows fell to about 1 per cent of GDP in 2002 from 4.4 per cent in 2001 (EBRD, 2003). In a countervailing move, the

government set up funds to attract FDI in higher value-added activities, which highlights that institutional factors affect the quality, not only the quantity of FDI, and thus the shape of the inward-outward FDI relationship as expressed in the IDP.

#### 6.1.3. Ambiguous effects of institutional reforms

With regard to Poland, Romania and Croatia, for which our quantitative results were partly positive, yet ambiguous, it can be noted that these countries were quick to launch small-scale privatization, as well as trade and foreign exchange reforms, leading to early on inflows of FDI (EBRD, 1994, 1995). However, in other areas the group faced mixed success, in particular with regard to capital markets which should provide complementary support for larger privatization projects, as well as foster the competitiveness of indigenous firms helping them to internationalise their operations. The gradual completion of bank restructuring and privatization enhanced competition and alleviated some of the remaining inefficiencies in the banking sector (EBRD, 1998). The link between economic reforms and FDI inflows was reflected in the timing of these inflows. In the case of Poland, the effects of liberalization policies on FDI were somewhat delayed until 1992, when the macroeconomic stabilization programme begun to show results. FDI inflows increased immediately after the Privatization Law of 1990. Corporate governance still remained poor as compared to mature economies. Particularly for Croatia, a greater inflow of FDI into already privatised firms was one of important factors which encouraged advancements in corporate governance and restructuring (EBRD, 1999). Inward FDI was not significant and corporate governance remained weak (EBRD, 1999).

As these countries were moving towards integration with the EU, they needed to shift attention from inward-FDI oriented policies to those improvements in the legal framework that were needed to reduce the potential for corruption, to promote investment and to facilitate the creation and development of new companies, in order to boost the competitiveness of their firms in international markets (EBRD, 2001, 2002). In fact, by 2004 these countries still needed to strengthen institutions, such as the judiciary and public administration (EBRD, 2004).

#### 6.2. Research contribution

While there is almost a consensus that European post-communist countries moved from Stage 1 to Stage 2 in the 1990s, conclusions differ regarding the possible transition to Stage 3 of the IDP in the first decade of the 2000s. Therefore, there has long been a need to revisit this assessment, using newer data sets and more rigorous quantitative methods of analysis, as some of the previous conclusions were based on often an intuitive assessment of FDI descriptive statistics. The determination of those stages has important policy implications, as different government actions and measures are needed at different stages of the IDP (see sub-section below).

Our analyses demonstrate how distinct countries, even if sharing a similar institutional heritage, can evolve in different directions with different outcomes. Their common denominator pertains to experiencing institutional upheaval as a result of the shift from a centrally planned to a market-led system. Thereby, not only political systems, laws, regulations, and financial markets, but also the fundamental values guiding business activities are being replaced, with a gradual prevalence of market-based mechanisms over "state-policed firms", limiting opportunistic behavior (Kostova & Roth, 2003). In the case of transition economies, the cost of undertaking FDI is high (Meyer, 2001). In addition to the normal costs associated with conducting business in a foreign country, foreign firms entering transition economies may face increased levels of uncertainty resulting from high inflation, opaque regulatory environments, underdeveloped judicial and financial systems and corruption. Institutional reforms such as large-scale privatization and enterprise restructuring are interdependent processes which

have proved to be necessary to overcome the legacy of communism, change firm ownership, introduce market economy mechanisms, and increase the competitiveness of domestic firms, both locally and internationally (Stoian & Vickerman, 2006).

While the status of the post-communist countries of the CEE region as to the completion of their transition process is unclear (e.g. MSCI, 2015), we do not evaluate whether these (post-)transition economies have fully accomplished their institutional upgrading. It is essential for the present study, in turn, to consider that the IDP paths have played a significant role in the context of their economic transition and an increasing integration of local economies into the global business environment. CEE states show a relative homogeneity in terms of sharing the same communist heritage, common experience in establishing and developing a market economy, and in acceding to the European Union (in the period between 2004 and 2013). Moreover, all of these countries display relative homogeneity in terms of many socio-economic variables (Niroomand & Nissan, 2007) and have exhibited a tendency to economic convergence over the last two decades (Amplatz, 2003; Matkowski & Próchniak, 2007). Simultaneously, however, there are considerable differences between them in their level of development and in completion of the transition process to the market-led system (see e.g. Caporale, Rault, Sova, & Sova, 2009). This divergence in institutional paths and levels of transition completion allows to analyze the diverse effects of institutional variables on the overall transition path, and not merely its narrow fragment, as has been frequently undertaken in earlier research to date.

Accordingly, there has indeed been a need to supplement the two variables embedded in the original IDP model (NOI and GDP per capita) with an analysis of institutional factors pertaining to the reforms undertaken by CEE countries as part of their transition to a market economy and accession to the EU. The latter analysis has a potential to produce unique insights on the applicability of the IDP model to CEE and the idiosyncrasies of IDP patterns in individual countries. Design and application of extended IDP models to CEE can provide a better understanding and explanation of what drives inward and outward FDI in this region and how the interface between the two is shaped. Our present study provides a first effort in this respect. Institutional theory has emerged as an approach to the study of organisation environment relations (Chung & Beamish, 2005; DiMaggio & Powell, 1983). However, early institutional research was focused on the study of more mature and stable environments. The context of a rapidly changing and turbulent institutional environment has remained relatively under-explored (Hoskisson et al., 2013). Although institutional theorists have paid increasing attention to institutional change as the theory was extended, the focus of institutional change has been incremental since it was conceptualised as ‘marginal adjustment’ to the complex mix of rules, enforcement, and norms that constitute the institutional framework (North, 2011). In this context, we follow Dunning and Lundan (2008c) to argue that institutional analysis, both at the micro and macro level, offers great promise for reinvigorating many areas of IB research by providing the intellectual tools that allow scholars to confront the complexities that characterise the contemporary global economy.

Finally, it is important to conclude in this discussion that our study contributes to IB scholarship by bridging international business and transition economics. It does so by explicitly acknowledging the role of institutional reforms in the trajectories of inward and outward FDI, whereby institutional idiosyncrasies exclude any general prescriptions as to an “optimal” package of reforms. While we identified countries in which the institutional advancement appeared to have a positive effect on the IDP trajectories, the intention of the study was to focus on the heterogeneity of reforms. It must be noted, however, that transition economies also displayed a significant “inherited heterogeneity”, which results in both different starting points for the transition process, and indirectly also affected the reform choices due to inherited differences in formal and informal institutional settings (Gevorkyan, 2015; Kedia &

Bilgili, 2015). While we did not explore this path dependency in this study, it can be a worthwhile aspect for future studies.

### 6.3. Policy implications

Recommendations for economic policy based on the IDP analysis conducted in this study focus on the issue of government support for and stimulation of outward FDI of their firms. Moreover, a careful scrutiny of received FDI theory reveals at the microeconomic level, more or less explicitly, that outward FDI does serve as a means of achieving firms’ strategic objectives and enhancing their international competitiveness. At the macroeconomic level there is no sound evidence that outward FDI has a long term detrimental effect on home economies. The consequences of outward FDI for home economies vary in the short-run and in the long-run, as well as between developed, developing and post-transition countries, which does not make formulating clear policy recommendations an easy task (Gorynia et al., 2015).

Sustained investment expansion of home country firms abroad should be considered as a basic on-going government policy approach, such investment program being a driver stimulating economic growth and at the same time being its net result. Optimally, in order to upgrade its overall efficiency and reduce possible overlap of responsibilities, a central authority institutional framework is needed to be set up with a clearly defined scope of responsibility and appropriate competences in terms of fostering outward foreign direct investment. Such centralization would potentially also contribute to an improvement of awareness by the potential recipients of such support measures.

Apart from issues concerning the institutional arrangement, a more nuanced approach seems to be necessary to reflect the potential effects of outward FDI for the home economy. One of the important variables determining the access to and type of support measures should be the origin of capital of outward investors, whereby genuinely domestic firms should be fostered rather than foreign subsidiaries of multinational corporations (MNCs) located in a given host country, whose rationale for investing is often vastly different. More importantly, going beyond mere support for outward FDI by local firms it turns out crucial to foster a favorable institutional environment. Such objective can be fulfilled by a liberal-institutional industrial policy, which promotes entrepreneurship and growth through, inter alia, support for investments, innovations, education and training, as well the creation of appropriate information systems and promotion of information diffusion (Gorynia, 2002).

Moreover, if home countries are to benefit from knowledge and efficiency spillovers from OFDI, domestic firms must develop an appropriate absorptive capacity. Thus, Globerman and Shapiro (2008): 263) suggest that rather than discussing the effectiveness of particular measures, “the ostensibly weaker linkages between OFDI and the benefits of globalization point to the fundamental importance of policies focused on improving the capabilities of emerging economies and local companies”.

To summarize, a general conclusion of this study supports earlier research in that the current findings shed light on the role of reforms in the success of the transition process to a market led system which was initiated almost three decades ago and of the leading role which FDI has played in this process, and on the overall economic development of these economies. However, it is the structure of institutional change, not merely its volume, that matters, as our quantitative findings indicate. We demonstrate that while overall institutional reform scores may increase, this is not a guarantee for a quicker progression along the IDP path. Gorynia (2002) argues that, in the context of a transition economy’s internationalization, the effectiveness of direct support measures for FDI might be questionable if the basic conditions of the home economy’s competitiveness, including the reduction of transaction costs or the creation of a high-quality labor market are not fulfilled in the first place. Economic policy should foster both the competitiveness on the level of domestic firms in foreign markets and the

competitiveness of firms within the open home market, where they also face foreign rivals (Gorynia, 1998).

#### 6.4. Limitations and future research directions

The present paper contributes to the understanding of differentiated effects that institutions have on the progression of countries along paths of inward and outward FDI aligned with economic growth. In order to explore the individual paths of each country, our analysis was purposefully not based on aggregate panel data, which results in lower statistical power and thus lower generalizing potential of all findings. While the use of an averaged institutional reform index was deliberately meant to reflect the overall state of reform progress, in order to demonstrate its overall effect and explore its structure in an ensuing discussion, it also in a way oversimplified of our analysis. As it has been argued earlier (e.g. Gevorkyan, 2015) institutional change is difficult to capture in a set of discrete indicators. Moreover, it may not be appropriate to discuss types of paths of economic development, but context-specific configurations of institutional factors, which requires more in-depth analysis (Jackson & Deeg, 2008).

Despite these limitations, it appears that the IDP evolution of the 10 investigated countries of CEE, members of the EU, was basically driven by the transformation processes to a market-led system initiated at the beginning of the nineties of the last century. Their progress was dependent on two variables: a widely conceived aftermath of the centrally planned economic system and the policy of systemic change. Between the 10 CEE countries there were significant differences regarding each of these two variables, which unquestionably contributed to the creation of differing foreign capital absorption capacities as well as different premises for capital exports. Thus, the comparative analysis of this study could be complemented and enriched by a country case study approach, since even in the situation of congruence of some of the investigated factors it is quite probable that they could conceal dissimilar economic, sociological, political and institutional components, generating considerable IDP country idiosyncrasies.

A second research avenue could focus on international comparisons of groups of countries, determined according to various criteria. The IDP model in such approach could yield much insight if in its framework for example, the evolution of the new EU members from CEE was set against the earlier entrants, such as Spain, Portugal and Greece. Another comparison in the IDP context could embrace the present 10 CEE countries and those post-communist states that did not join the EU. It is evident in this case that the roles of inward as well as outward FDI in both those groups can be significantly different and contribute to a differentiated level of economic development. Thus, the scale and mechanisms generating such differences are worthy of exploration and could form a promising research agenda.

The third potential research issue consists of investigating the present 10 countries from the perspective of geographic and industry structures of their inward and outward FDI. Determining and explaining differences along such dimensions, as well as showing their consequences for each country development, could also develop into an inspiring research project.

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