MEASURING THE FDI ATTRACTIVENESS IN THE EAP COUNTRIES FROM AN INSTITUTIONAL PERSPECTIVE

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Abstract. Countries in the European Union's neighborhood, such as those in the Eastern Partnership (EaP), have a particular interest in attracting foreign direct investment (FDI) because investment inflows can guarantee them a number of advantages needed for accession. This paper proposes a comparative analysis of the investment attractiveness of the EaP countries in the period 2005–2019 considering the institutional theory of FDI inflows. The research methodology considers a quantitative approach that uses the composite index as a tool. The results show that half of the EaP countries have a high level of investment attractiveness, while the institutional quality has an important influence on attracting FDI.

Keywords: investment attractiveness, doing business, Eastern Partnership, country risk, institutional quality, democracy, economic freedom.

JEL Classification: F21, B52, C38, P33.

Introduction

Many countries believe that the implementation of favorable policies for foreign investors and the adoption of fiscal and financial incentives are enough to attract foreign direct investment (FDI). Even if these aspects have an important role for stimulate FDI inflows, most of countries must pay attention to improve the quality of governance (Mengistu & Adhikary, 2011; Saha et al., 2022). Institutional quality has an important role in stimulating FDI inflows, especially for developing and transitional countries. In the case of former communist countries

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from Eastern Europe, the investors' perception of the unstable economic and political region negatively influences FDI, despite the efforts of these countries to attract foreign investors using fiscal and financial incentives. Government policies adopted in order to offering an attractive macroeconomic environment for foreign investors are ineffective without institutional reforms (Buchanan et al., 2012).

Countries with strong democratic structures are more attractive for foreign investors than the autocratic economies. Economic integration and both political and civil freedoms make democratic states more capable to attract foreign investors, while political instability inhibits FDI inflows (Harms & Ursprung, 2002; Quazi, 2007). In addition, FDI inflows tend to increase in countries that have a higher quality of governance, even if countries have some deficiencies in terms of regulatory quality or voice and accountability (Mengistu & Adhikary, 2011). Especially in the case of emerging and developing countries, the fact of having free and open markets with less regulatory burden and a low level of corruption attracts FDI (Lucke & Eichler, 2016).

On the other hand, foreign investors are interested by countries with high political liberties, even if the level of corruption is higher compared to their home country or the level of democracy and of civil liberties is low (Adam & Filippaios, 2007; Lucke & Eichler, 2016). Transition economies with high levels of corruption are more capable to attract FDI inflows because foreign investors prefer an arbitrary corruption or an uncertain corruption rather than a widely present one (Cuervo-Cazurra, 2008). In some cases, poorly quality of formal institutions is associated with high market potential. Foreign investors may consider that countries with a low level of institutional development are less risky compared to their home country institutions (Duanmu, 2012).

Considering the multitude of opinions regarding the impact of institutional quality on FDI inflows, it is interesting and important to see which of the two opposing views is valid in the case of the Eastern Partnership countries (Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine). For the EaP countries, the importance of FDI derives from multiple benefits. Despite the economic gains, through FDI, these countries are capable to modernize their economies and align them with technical and technological standards similar to those in the European Union and in the world. At the same time, the political environment and the institutional aspects are improving through the transfer of democratic values and governmental knowledge, especially since these countries have suffered many deficiencies in this regard due to their communist past.

Considering these aspects, the main goal of this study is to provide a comparative analysis of the FDI attractiveness in Eastern Partnership countries (EaP) in the period 2005–2019 and to observe if the institutional quality of these countries has an influence on FDI attractiveness. The need of this study derives by the fact that these countries have experienced an institutional transition from central planning to market competition in an incremental way or with disruptions. In the case of the former Soviet Union countries, such those from Central and Eastern Europe (including the EaP countries), some institutional changes have occurred suddenly and rapidly in the early 1990s. Most of these countries have managed to complete their transition process, culminating in accession to European structures or in signing association agreements. The creation of new markets in case of

transition economies have stimulated FDI inflows because transition reduced the transaction costs associated with bureaucracy and uncertainty (Bevan et al., 2004). Nevertheless, the EaP countries are still politically and socially instable, having an opportunistic and corrupt behavior, but also macroeconomic imbalances and inefficient governments. In this regard, the EU support through the Eastern Partnership is a solution for such institutional problems (Socoliuc & Maha, 2019).

In accordance with previous studies, which measure the investment attractiveness using various variables, one of the main contributions of this study is to highlight the role of business environment, institutional quality, and economic, fiscal, financial and democratic factors in determining the level of investment attractiveness for the EaP countries. Moreover, this paper presents a comparative analysis of the investment attractiveness through a composite index, applied to all the EaP countries, for not only one or part of these countries. Therefore, the research hypotheses are the following:

– H1: The investment attractiveness of the EaP countries is influenced by a combination of institutional, fiscal, financial, political, and business environment related factors;
– H2: Institutional quality exerts an influence on the investment attractiveness in the case of the EaP countries;
– H3: There are significant differences between the EaP countries in terms of investment attractiveness.

This article considers the investment attractiveness of the EaP countries in relation to all countries, as these countries are located in important geostrategic areas for the European Union and the United States, as well as for Russia and China. In this way, the analysis considers the investment attractiveness for the EaP countries disregarding the special relations developed with the EU and their institutional progress for joining the European structures, which can be subjects of future research.

This paper aims to develop the existing body of theory related to FDI location choice by focusing on reasons for which foreign companies place their investments in specific geographic areas. This paper explores this line of research by bringing as main originality and theoretical contribution the sample of the EaP countries in order to answer why foreign companies place their specific activities in these transitional economies and to explain why the FDI attractiveness of the EaP countries depends on institutional quality.

This paper has the following structure. The next section examines the main theoretical and empirical approaches related to the FDI, investment attractiveness, and institutional quality. The second section presents the methodology used for this empirical study. The third section analyses the results and the ending section presents the conclusions of the empirical study.

1. Literature review

1.1. Theoretical framework

A large number of studies have examined the motivations behind the investment process, dividing the International Business literature on foreign location between the economics tradition and the behavioral theory (Kim & Aquilera, 2016). The economics tradition investigates the investment process through market imperfections' theories and hypothesis

(see Dunning, 1993; Moosa, 2002). On the other hand, the behavioral theory explains how foreign companies start their expansion in geographically, culturally and institutionally close countries, considering that distance plays a high role in bilateral trade and investment flows (Blanc-Brude et al., 2014). The main motivations for foreign company to invest result from the need to protect their market share, the superiority of knowledge, the transfer of advantages to subsidiaries and the innovation progress.

The synthesis of the multiple theories regarding the investment flows was produced by Dunning (1993) through the *eclectic theory* (OLI model), which shows that investment flows are influenced by the combination given by three types of advantages. First are the investing company or property advantages (Ownership) in terms of technology, access to raw materials, capital, skilled labor, and sources of financing. Second type are those offered by the beneficiary state or local advantages (Location) in terms of taxation, favorable conditions, institutional quality, political environment, and access to raw materials and cheap labor. Thirdly, it interferes the company's ability to internalize these benefits (Internalization). In the absence of internalization benefits, the company opts to expand production through licensing. If they exist, but local advantages allow expansion only in the country of origin, then the company chooses to export to foreign markets. The happiest case is when the company has all kinds of advantages and can make FDI (Nielsen et al., 2017).

Many researchers have tried to explain the location choice of FDI and to identify the main drivers of investment attractiveness in terms of market size, trade costs, wage levels, human capital, infrastructure, and well-developed financial system (Carstensen & Toubal, 2004; Blanc-Brude et al., 2014; Nielsen et al., 2017; Pirju et al., 2023). Differences in terms of the degree of endowment with natural resources, geographical location, common borders, and cultural distance are also important (Pain & Holland, 1998; Bevan et al., 2004; Lucke & Eichler, 2016). In addition, the foreign investors are interested in the existence of a cheap and numerous labor force. In this way, countries such as India, Mexico or those for Eastern Europe (also valid for the EaP countries) are more attractive for FDI than developed economies due to the low level of wages (Moosa, 2002; Bellak et al., 2008). However, beyond the wage levels, the quality of the labor force is important for investing companies. The high level of qualification and specialization of personnel in Central and Eastern Europe has led to the signing of numerous research and development partnerships between the United States and countries such as Lithuania, Ukraine, and Hungary (Michalet, 1997). This can be also valid for the EaP countries with advanced human capital in the attempt to attract FDI (Deichmann et al., 2003).

Beyond these social and cultural factors, the host countries need some political prerequisites in terms of economic and political stability, liberalized markets (Dunning, 2005; Marselina & Prasetyo, 2023), high-quality business environment (Vuckovic et al., 2020), and low level of country risk (Carstensen & Toubal, 2004; Hassan, 2022). Gilmore et al. (2003) have developed a list about the determinants of the location choice of FDI, in which they mentioned both economic and political aspects. This list includes: (i) the size and growth of the foreign market; (ii) economic policy; (iii) political stability; (iv) government attitude regarding FDI and financial incentives; (v) technology; (vi) resources' availability; (vii) characteristics of foreign market regarding knowledge and experience; and (viii) transportation

material and labor cost. In the case of Eastern European and Balkan economies (even the EaP countries), FDI depends on the size of the market, the methods of privatization, trade openness and economic modernization. There are significant differences in terms of investment flows attracted by these states (Pain & Holland, 1998; Hassan, 2022).

Nevertheless, one of the most important political factor remains the institutional quality (Nielsen et al., 2017; Tag & Degirmen, 2022). Both domestic and foreign investments are affected by the host country's governance environment and institutional quality. Good institutions have a positive influence on economic activities, but also on investment attractiveness, because they can reduce costs related to doing business, investment, production, and transaction. On the other hand, countries with weak institutional quality are seen as time and resource consuming, while foreign investors cannot afford to risk their capitals (North, 1990).

Most of scholars agree that a high level of institutions quality stimulates FDI inflows (Campos & Kinoshita, 2003; Bevan et al., 2004; Nielsen et al., 2017). In this regard, Dunning (1998) combines the economic factors with the institutional ones, in order to explain that countries, which offer great institutional and economic facilities, are more willing to attract FDI. On the other hand, weak institutional quality acts as a barrier to FDI inflows, especially for countries characterised by political instability, corruption, excessive bureaucracy or administrative problems (Saha et al., 2022). Moreover, inadequate protection of property rights makes foreign investors subject of two types of risks. A direct risk occurs when the host country's government starts to have an opportunistic behaviour and is looking to claim or to nationalize the returns. On the other hand, an indirect risk involves the influence of local competitors to government to favour them against the foreign investors (Henisz, 2000).

The influence of the institutional quality on FDI is more visible for transition economies, such as the EaP countries, that encouraged large-scale institutional transformations while moving from central planning to open market. The institutional transition can occur with disruptions that often appeared when new institutions have not efficiently changed the old institutions. There were still institutional patterns from the previous system, suggesting an institutional upheaval. In some cases, the new institutions have developed slowly, even 10 years after the political changes (Newman, 2000). Because of their communist past, the former Soviet Union countries are perceived as having poor institutional basis with extractive institutions that make them more vulnerable to corrupt behaviors and with a higher tendency of using political power for personal needs (Socoliuc et al., 2022).

1.2. Empirical findings

Various studies underline the impact of various economic, political, financial, fiscal, and institutional factors on FDI attractiveness (Dunning, 1993; Hines, 1996; Kersan-Skabic; 2015). Bailey (2018) suggested that countries with good institutional quality in terms of rule of law, political stability and democracy are more willing to attract FDI, while tax rates, corruption and cultural distance have a negative influence on FDI inflows. At the same time, Yerrabati and Hawkes (2016) discovered that countries are able to attract more FDI inflows if they have strong legal system, a good quality regulation and low levels of corruption. Keeping the same path, Mengistu and Adhikary (2011) identified that only four from six indicators of

good governance have a positive impact in attracting FDI, namely political stability, control of corruption, rule of law, and government effectiveness. On the other hand, Kim (2010) suggested that countries with low political rights and high level of corruption have recorded a high FDI inward performance. Lucke and Eichler (2016) found that foreign investors are interested by countries with a higher level of corruption compared to their home country. At the same time, foreign investors seem to be attracted by countries with high political, but low civil liberties, according to Adam and Filippaios (2007).

Beyond these contradictory views, it is clear that the quality of institutions influences FDI inflows. Previous studies prove the connection between institutional quality and FDI, either positive or negative. Only a few studies disprove this link. Jayasuriya (2011) discovered that an improvement of institutional quality, reflected by Ease of Doing Business Rankings, determines an increase of FDI inflows, but this relationship is insignificant for developing countries. Harms and Ursprung (2002) suggested that institutions have no robust impact on FDI, whereas foreign investors are interested in countries with political freedoms and civil liberties. Jensen (2003) had the same opinion, stating that institutional aspects do not influence FDI and that only democracy has a positive and significant impact.

The influence on investment attractiveness, manifested by this large number of economic, political, financial, fiscal, and institutional factors, is also valid in the case of transition economies. In order to measure the investment attractiveness (Table 1), the empirical approaches consider different techniques and variables for the European countries, the Central and Eastern Europe or at the EU regional level (samples that also include transitional economies).

Table 1. Empirical studies to measure the investment attractiveness (source: own processing)

Authors and year	Method used	The sample used	Period examined	Variables used
Deichmann et al. (2003)	Composite index and multiple regression	Former Soviet Union economies, including the EaP countries	1993–1998	GDP growth and per capita, inflation, trade, urban population, infrastructure, rule of law, coastal access, share of private sector, reforms, natural resources, and credit to private sector.
Carstensen and Toubal (2004)	Dynamic panel date	Transition economies from Central and Eastern Europe	1993–1999	FDI, GDP, trade costs, labor costs, gross fixed capital formation, corporate tax rate, country risk, privatization, and private market share.
Bevan et al. (2004)	Composite index and multiple regression	East European transition economies, including Ukraine	1994–2000	GDP, labor costs, common border, cultural and linguistic distance, and institutional development.
Groh and Wich (2009)	Composite index	127 countries; only five of the EaP countries are included; except Belarus	2000–2008	GDP, population, economic activity, legal and political systems, business environment, and infrastructure.

Authors and year	Method used	The sample used	Period examined	Variables used
Buchanan et al. (2012)	Multiple regression	164 countries, including the EaP ones	1996–2006	FDI inflows, volatility of FDI, trade, governance, domestic investment, GDP per capita growth, and money growth.
Sabir et al. (2019)	Composite index and GMM system	89 developed countries and 59 developing countries, including the EaP ones	1996–2016	Institutional quality, trade openness, GDP per capita, inflation, agriculture, and mobile phone subscriptions.
Shenai et al. (2020)	ARDL model	Armenia, Belarus, Kazakhstan, Moldova, Russia and Ukraine	1995–2017	FDI inflows, real GDP, GNI per capita, fixed and mobile subscriptions, official exchange rate, inflation, trade openness, and infrastructure.
Cieslik and Gurshev (2020)	Estimation model	Ukraine	2013–2017	GDP size, human capital, geographical distance, trade freedom index, investment freedom index, political stability, democracy, and autocracy and polity indexes.
Saha et al. (2022)	Dynamic panel estimation	28 lower-middle income countries, including Ukraine	2002–2018	Institutional quality, GDP per capita, trade openness, total population, and inflation.

Some scholars found that for transitional countries, the FDI inflows are stimulated by factors such as economic reforms, good infrastructure, abundant natural resources, level of privatization, methods used for privatization, human and social capital, financial markets, and country risk (Campos & Kinoshita, 2003; Deichmann et al., 2003; Carstensen & Toubal, 2004; Cieslik & Gurshev, 2020). The political factors and institutional quality are also among the elements that the authors have taken into consideration in measuring investment attractiveness. Most studies confirm the link between institutional quality and FDI inflows, proving a positively and significant influence (Campos & Kinoshita, 2003; Bevan et al., 2004; Buchanan et al., 2012; Saha et al., 2022). On the other hand, Subasat and Bellos (2013) suggested that poor governance in case of transition countries better attracts FDI inflows and that the low level of governance is seen as a source of attraction for multinational companies rather than an impediment. Shenai et al. (2020) studied four of the EaP countries, while Georgia and Azerbaijan are missing from sample. They found that FDI inflows are attracted by countries with good infrastructure, high-income levels, but with high inflation, currency depreciation, and small markets with low openness.

Some studies disapprove the link between institutional quality and investment attractiveness. For example, Kersan-Skabic (2015) found that corporate tax rates and institutional aspects are insignificant to influence the FDI inflows for countries from Southern and Eastern Europe. Cieslik and Gurshev (2020) suggested that political stability and factors related to democracy, polity and autocracy have no statistically influence on FDI for Ukraine.

In all these studies regarding the main factors of the investment attractiveness for the transitional economies, the EaP economies have been studied either separated as one or part of the group, either in wider samples (such as Central and Eastern countries or the former Soviet Union countries). Starting from these aspects and previous studies, this article brings as novelty the analysis of the links between FDI inflows and institutional quality for all the EaP countries, considered as an exclusive sample.

This study takes into consideration the institutional theory of North (1990) and other empirical studies mentioned above that confirm the existence of a link between FDI and institutional quality. Moreover, for this analysis, the first two groups of determinants specified by Dunning (1993) in terms of marketing factors and investment climate, but also those specified by Gilmore et al. (2003) regarding the economic policy, political stability, government attitude regarding FDI, and financial incentives were taking into consideration.

2. Data and methodology

The methodology purposes a composite instrument called Investment Attractiveness Index (IAI), which reveals the level of investment attractiveness of the EaP countries and a hierarchy of these countries. The sample of countries considered in the empirical study includes Armenia, Azerbaijan, Belarus, Georgia, Moldova, and Ukraine in the period 2005–2019. The period of 15 years captures both the investment attractiveness before the signing of the Eastern Partnership (2009) and the one after. The year 2005 is a reference moment because this year the European Neighborhood Policy (ENP) was implemented in all six countries analyzed (Perchoc, 2016). In addition, the five-year period (2005–2009) is wide enough to capture the investment attractiveness of the EaP countries between the implementation of the ENP and the launch of the EaP. On the other hand, 2019 is a reference moment so that the effects caused by the Covid-19 pandemic do not influence the results.

The analysis basis for the IAI includes indicators from several statistical sources. First, aspects related to economic, fiscal and financial performance for the EaP countries are extracted from The World Bank's statistical base (The World Bank, 2020c). For elements related to the business environment and regulation, Doing Business indicators were taken into consideration, also from the World Bank's statistical database (The World Bank, 2020b), covering 10 areas of business regulation. Second, in terms of governance and institutional performance, the Governance Indicators developed by the World Bank (2020a) were used, to which were added the perceptions of country risk offered by the OECD (2020). Thirdly, the aspects of freedom and democracy were taken into account, using the Index of Economic Freedom, developed by the Heritage Foundation (2020), to which are added the Freedom Index and Democracy Index, composite instruments offered by Freedom House (2020). Appendix Table A2 presents the statistical data used, reflecting the average values of the 2005–2019 period for each EaP country.

After collecting the statistical data, the first stages of the analysis are to calculate the average values for each EaP country for the period 2005–2019 and then to eliminate the outliers and the insignificant data. Thus, from the multitude of indicators extracted from international databases, only 40 have been statistically eligible and, therefore, selected for the IAI.

The list of eligible indicators is presented in Appendix Table A1, some of them being marked with a "negative" sign (–), others with "positive" sign (+) and a few of them with "L". These signs show the relation between indicators and FDI for the EaP countries, while indicators with "L" have a lesser influence and are insignificant for IAI.

The methodology required for IAI development takes into consideration the steps for designing a composite indicator offered by the OECD (Organization for Economic Cooperation and Development) in Nardo et al. (2008) such as:

– The Principal Component Analysis (PCA), which explains the variation of variables from a wide database and helps to extract the main components;
– The selection of significant factorial axes, classified in descending order of variation.

At this stage, the PCA results reveal the most significant indicators for the investment attractiveness of the EaP countries, grouped on the main components (factorial axes). A factorial axis is eligible if it simultaneously fulfils three conditions: (i) Kaiser's criterion (eigenvalues greater than 1); (ii) its individual contribution explains more than 10% of the total variation; (iii) all the factorial axes have a cumulative contribution more than 60% of the total variation.

– The selection of significant indicators, stage in which, for each factorial axis, the indicators with factor loadings higher than 0.7 were selected, regardless of the negative or positive sign;
– Final calculation of IAI using mathematical formulas applied to the values resulting from the PCA.

First mathematical formula is required for determining the weight (P_i) of each factor loading (FL_i) in the composition of the factorial axis (Fa_i), while FL_i^2 represents the square value of the factor loading:

$$P_{iFLj} = \frac{FL_i^2}{\sum FL_i}. \tag{1}$$

The second formula determines how much is the weight (P_i) of each factorial axis (Fa_i) in the cumulative influence of the eligible factorial axes.

$$P_{iFaj} = \frac{Fa_i}{\sum Fa_i}. \tag{2}$$

The third formula calculates the value of each factorial axis (Fa_i) by the sum of the products between the standardized value for each indicator (S_i) and its weight (P_i).

$$Fa_i = \sum Pi_{Sj} \times S_i. \tag{3}$$

The last formula calculates the final score of *IAI* for each EaP country by the sum of the products between the factorial axes (Fa_i) and its weight (Pi_{Faj}).

$$IAI = \sum Pi_{Faj} \times Fa_i. \tag{4}$$

The final *IAI* scores will help to rank the EaP countries from the perspective of investment attractiveness. The *IAI* is determined in units of a standard normal distribution

[0 to 1]. Therefore, the high positive values reveal a high level of investment attractiveness and high negative values suggest a low level of investment attractiveness.

3. Empirical results and findings

3.1. Selecting the variables and calculating factorial axes

Applying the OECD methodology (Nardo et al., 2008), only the first three factorial axes have been considered eligible, having simultaneously achieved the conditions, as it can be seen in Table 2. Each of these factorial axes reveals a dimension that influences the FDI for the EaP countries.

Table 2. The characteristics of the factorial axes (source: own processing)

Component	Initial eigenvalues	Individual variance	Cumulative variance
1	19.710	44.805	44.805
2	9.430	26.293	71.098
3	5.071	10.247	81.345

The eigenvalues are greater than 5 for each axis so the Kaiser's criterion is accomplished. In addition, the factorial axis individual variance is higher than 10% for each factorial axis, so the second condition is satisfied. The cumulative contribution of these three factorial axes is more than 81%, fulfilling the third eligibility condition.

For each factorial axis, the most relevant and important indicators were selected and being normalized, whose factor loadings are higher than 0.7, regardless their negative or positive sign. From 40 variables used in Principal Component Analysis, only 29 have a higher influence. Appendix Table A3 presents the variables and their influence on FDI attractiveness. The selected variables, which have factor loadings higher than 0.7, are grouped on the factorial axes.

Considering the nature of eligible variables and the number of factorial axes, three dimensions have been established which reflect the most important aspects that influence FDI attractiveness for the EaP countries in the period 2005–2019. *The results confirm the first hypothesis* according to which a combination of institutional, fiscal, financial, political, and business environment related factors exerts an influence on the investment attractiveness of the EaP countries. There are three pillars (Appendix, Table A3), starting with *regulatory quality and economic freedom*, which includes 20 indicators regarding institutional quality, fiscal aspects, business environment, and economic freedom. The second dimension includes seven variables related to *rights and democracy*, suggesting that factors related to democracy and political freedom play an important role for investment attractiveness. Finally, the third pillar has two variables regarding the *political stability*.

The following step includes the application of mathematical formulas to determine the weight of each factorial axis, then the value of each factorial axis and, finally, the IAI scores needed to compare the investment attractiveness of the EaP countries in the period 2005–2019 and to observe the key elements that stimulate FDI into these economies.

3.2. Results and discussions

Table 3 presents the IAI scores in order to compare the EaP countries on each dimension of investment attractiveness, but also covering all three dimensions in the period 2005–2019.

Table 3. The hierarchy of the EaP countries according to IAI Index (source: own calculations)

No	Country	First pillar	Second pillar	Third pillar	IAI final score
1	Georgia	0.888	0.502	–0.089	0.640
2	Armenia	0.458	0.087	0.144	0.298
3	Moldova	–0.063	0.304	–0.146	0.045
4	Azerbaijan	0.096	–0.594	0.153	–0.120
5	Ukraine	–0.786	0.545	–0.197	–0.281
6	Belarus	–0.593	–0.844	0.135	–0.582

Georgia and Armenia have a high level of investment attractiveness, while Moldova has a medium level. On the other hand, for Belarus, Azerbaijan and Ukraine the level is extremely low. *The results confirm the third hypothesis* according to which there are different levels of investment attractiveness in the case of the EaP countries. At the same time, results are to some extent in line with Groh and Wich (2009). While this study reveals that Georgia, Armenia and Moldova have a high-medium level of investment attractiveness for 2005–2019, Groh and Wich (2009) suggested that Georgia has the most attractive for foreign investors between 2000 and 2008, but the second and the third place are taken by Ukraine and Armenia.

As regarding the influence that institutional quality may exerted to the investment attractiveness, *the results partially confirm the second hypothesis*. The existence of a link between institutional quality and investment attractiveness in the case of the EaP countries is valid for Georgia, Armenia and Ukraine. Indeed, for Georgia and Armenia, the first pillar namely regulatory quality and economic freedom is the one with a greater influence in determining the IAI scores. This suggests that institutional quality exerted the highest impact on the investment attractiveness. According to Table 3, Georgia has the highest score regarding the first dimension of IAI, namely regulatory quality and economic freedom, and the second highest score in terms of rights and democracy (after Ukraine). Between 2005 and 2019, Georgia`s investment attractiveness was almost twice higher than Armenia, which had the second level of investment attractiveness among the EaP countries, with almost 0.3 points. On the other hand, Armenia ranks behind Georgia in terms of regulatory quality and economic freedom and behind Azerbaijan regarding the political stability.

Despite the case of Georgia and Armenia, the institutional quality plays an important role for Ukraine, but from a different perspective. If for Georgia and Armenia, a better institutional quality suggests a higher level of investment attractiveness, for Ukraine the situation is reversed. Having positive scores on rights and democracy, the IAI score of Ukraine is affected mainly by regulatory quality and economic freedom. This suggest that a poor institutional quality determines the low level of investment attractiveness. However, in this process political instability also plays an important role.

For the other three EaP countries, institutional quality has a lesser or no influence on investment attractiveness. Being the third according to IAI scores, Moldova has positive values only in terms of rights and democracy, suggesting that this pillar is more important for its investment attractiveness than institutional quality or political stability. In a similar situation is Azerbaijan. Even if the regulatory quality and economic freedom (first pillar) and political stability (third pillar) have positive values, the score of investment attractiveness according to IAI is negative. In this situation, rights and democracy have a higher influence on investment attractiveness than institutional quality or political stability. In case of Belarus, the negative scores on the first two pillars affect the level of investment attractiveness. In this process, rights and democracy pillar plays a higher role than the regulatory quality and economic freedom.

Taking particular cases, for *Georgia*, the investment attractiveness is, mainly, driven by institutional aspects, confirming the institutional theory of North (1990) and the existing empirical studies in the literature (Campos & Kinoshita, 2003; Yerrabati & Hawkes, 2016; Tag & Degirmen, 2022). In other words, Georgia is attractive for foreign investors due to good regulatory quality, economic freedom, ease of doing business, rights, democracy, and low taxation, being in line with some scholars (Harms & Ursprung, 2002; Addison & Heshmati, 2003; Saha et al., 2022). According to Appendix Table A2, Georgia has good performances in terms of government effectiveness, regulatory quality, and starting a business. During the 2005–2019 period, the index of economic freedom for Georgia has improved, having over 70 points since 2010, while the average for business freedom exceeded 80 points, both being the highest among the EaP countries. The time required to start a business and to register property is the shortest among the EaP countries, less than 5 days, while for these operations no more than three procedures are necessary. In terms of taxation, Georgia has the lowest total tax rate, averaging 22.55% for the period 2005–2019 and does not apply labor tax and contributions since 2009. In addition, since 2011, companies in Georgia pay only five taxes, while Georgia has the second shortest time for paying taxes (on average 335 hours per year), after Moldova (The World Bank, 2020c). Moreover, Georgia has the second highest score at second pillar, namely rights and democracy, after Ukraine. According to Appendix Table A2, Georgia has good performances in terms of trade freedom, democracy index, civil liberties (being the second at all three), and of political rights and freedom index (the third place among the EaP countries). Nevertheless, Georgia has some deficiencies at third pillar, having a negative score. This means a political instability that may affect the FDI inflows, being in line with Quazi (2007), Carstensen and Toubal (2004) and Hassan (2022). Indeed, according to Appendix Table A2, Georgia has, on average, only 27 points at political stability and absence of violence between 2005 and 2019, while country risk has a high value (6.13 points from maximum of 7).

Armenia is unique among EaP countries, being the only one with positive scores at all three pillars. However, the regulatory quality and economic freedom (first pillar) plays the major role for Armenia's investment attractiveness. This means that institutional quality stimulates investment attractiveness for Armenia as like Georgia, confirming the institutional theory of North (1990) and the studies of Campos and Kinoshita (2003), and Tag and Degirmen (2022). At first pillar, Armenia ranks behind Georgia in terms of institutional

quality. More precisely, according to Appendix Table A2, Armenia ranks second in terms of scores obtained on starting a business, government effectiveness, regulatory quality, and economic and business freedoms. At the same time, Armenia has the highest level of investment freedom, the second lowest tax rate (averaging 30.6% of profit) and the second lowest labor tax and contributions, both after Georgia. Moreover, Armenia does not apply labor tax and contributions since 2014, has the second lowest time required to start a business and to register property (after Georgia), while for some operations no more than six procedures are necessary (Appendix, Table A2). At second pillar, Armenia has a poor score regarding rights and democracy. Even if the trade freedom was the highest between 2005 and 2019 among the EaP countries, the voice and accountability indicator, democracy index, civil liberties, political rights, and freedom index were very poor for Armenia. At third pillar, Armenia was the second, after Azerbaijan, but the political stability is very low (almost 40 points on average), while country risk has a high value (6.07 points from maximum of 7).

Along with Georgia and Armenia, *Moldova* also has positive IAI score (0.045 points), being ranked third among the EaP countries, according to Table 3. The positive score of the investment attractiveness is largely due to rights and democracy, suggesting that civil and political rights rather than institutional quality or political stability drive the investment attractiveness. This result is being in line with Harms and Ursprung (2002), and Addison and Heshmati (2003), whereas regulatory quality, economic freedom and political instability may impede the FDI inflows (Carstensen & Toubal, 2004). Moldova has negative scores regarding the first and the third pillar. However, its investment attractiveness is given by political rights (the highest level among the EaP countries, between 2005 and 2019), freedom index (the second highest level after Ukraine), civil liberties, democracy index, and voice and accountability, being the third after Georgia and Ukraine (Appendix, Table A2).

On the other hand, Azerbaijan, Ukraine and Belarus have negative IAI scores, showing a low level of investment attractiveness in the period 2005–2019, according to Table 3. This situation has several causes.

In case of *Azerbaijan*, the shortcomings occurred in terms of rights and democracy were so evident that they have cancelled the positive influences of institutional quality and political stability on investment attractiveness. The FDI inflows are impede by the fact that Azerbaijan has not improved its business environment, institutional quality, and political and civil liberties. Azerbaijan has the lowest political stability and the second lowest scores among the EaP countries on trade freedom, democracy index, civil liberties, political rights, freedom index, and voice and accountability for the entire period 2005–2019 (Appendix, Table A2). On the other hand, Azerbaijan has positive scores at first and third pillar, suggesting a medium level of institutional quality. At the third pillar, Azerbaijan has the highest score, thanks to its better rank according to country risk among the EaP countries. Being the third at first pillar, Azerbaijan ranks behind Georgia and Armenia in terms of government effectiveness, easiness of starting a business, index of economic freedom, level of labor tax, and business and investment freedoms.

As regarding *Ukraine*, most of the FDI inflows were concentrated before the Crimean crisis of 2014. Political and civil rights are more important than institutional quality in attracting foreign investors, the case of Ukraine being in line with results finding by Harms and

Ursprung (2002), and Addison and Heshmati (2003). For the period 2005–2019, the results reveal that Ukraine has good values at the second pillar in terms of rights and democracy. Indeed, according to Appendix Table A2, Ukraine has the highest level of democracy and civil liberties, and the biggest freedom index among the EaP countries. Moreover, Ukraine is the second EaP country regarding the political rights, getting credit, and voice and accountability. However, poor institutional quality and political instability affect the Ukraine's investment attractiveness, especially following the Crimean crisis. For the period 2005–2019, the results reveal that Ukraine has one of the lowest levels of institutional quality, poor governance and business environment, being one of the countries with the highest taxes, along with Belarus. The results show a combination of institutional, political and legislative barriers that impedes Ukraine from increasing its investment attractiveness as Ishaq (1997) also found.

In case of *Belarus*, the main positive fact is its political stability reflected by the positive scores of the third pillar. It seems that Belarus is the most political stable country among the EaP ones, having, on average, almost 52 points on political stability and absence of violence between 2005 and 2019 (Appendix, Table A2). However, this advantage does not determine a positive score of IAI. Poor institutional quality and low level of rights and democracy negatively influence the investment attractiveness. This result is in line with Mengistu and Adhikary (2011) and Bailey (2018), who have suggested that political stability has a positive influence on FDI inflows. In addition, Belarus is in the case described by several authors (Campos & Kinoshita, 2003; Buchanan et al., 2012; Yerrabati & Hawkes, 2016) when low institutional quality negatively influence the investment attractiveness.

Having an increasing interest for the EU accession, the EaP countries should work more for attract FDI from different sources, especially from developed countries. For this purpose, the EaP countries can observe other economies that have succeeded in attracting FDI by improving institutional quality, democracy, rights and political stability. Hungary, Israel, Kuwait, Nicaragua, Jamaica, Peru, Uganda and El Salvador are some examples of good practices in institutional improvements (Boudreaux & Holcombe, 2018). At the same time, Ireland managed to attract FDI by improving the institutional quality through measures that involved tax reductions, the increasing emphasis on competition and deregulation, improving infrastructure and education, partnership between labor market, government and industry, as well as promotion of FDI in IT industry, financial services, pharmaceutical industry and international services. In addition, having a socialist past, the Baltic States managed to attract FDI due to low corporate taxes, focus on competition, promotion of free zones, stimulating the IT industry, and prudent fiscal policies (Organization for Security and Cooperation in Europe [OSCE], 2006). At the same time, Croatia and Mozambique are examples of countries that attracted FDI in post-conflict conditions in order to promote economic development and political stability (UNCTAD, 2009). Therefore, the Baltic States, Croatia, Ireland, and Hungary are best examples of good practices all the more so as they have managed to join the EU.

Conclusions

The results allow concluding that there are three dimensions of investment attractiveness for these countries, such as regulatory quality and economic freedom, rights and democracy, and

political stability. The results confirm the first hypothesis according to which a combination of institutional, fiscal, financial, political, and business environment related factors influences the investment attractiveness of the EaP countries. These results are to some extent in line with institutional theory and other empirical studies, which found that institutional quality and specific variables influence FDI.

Another conclusion is that Georgia and Armenia have a high level of investment attractiveness, while Moldova has a medium level, mainly due to significant governance performance, institutional and democratic progress, but also due to improvement of business environment and investment climate. Even if Belarus, Azerbaijan and Ukraine made some progress and improvements, their level of investment attractiveness is extremely low. Therefore, there are differences between the EaP countries in terms of investment attractiveness.

Another conclusion is that institutional quality has an important influence for investment attractiveness of the EaP countries, especially in the case of Georgia, Armenia and Ukraine. This result partially confirms the second hypothesis regarding the influence that institutional quality may exerted to the investment attractiveness. However, every country has its own path. For Georgia, institutional quality stimulates the investment attractiveness, but political instability has a negative impact. If foreign investors can overlook these small shortcomings and see the positive side, in the sense of a high level of institutional quality, then FDI inflows have a chance to grow for Georgia in the future. At the same time, institutional quality has an important influence on Armenia's investment attractiveness. Even if high institutional quality is attractive for foreign investors, the precarious situation in terms of civil and political rights, lack of democracy, high country risk and political instability can stop investors from really entering the Armenian market. On the other hand, for Moldova, performances regarding rights and democracy rather than by institutional quality or political stability stimulate the investment attractiveness.

For Azerbaijan, Ukraine and Belarus, the investment attractiveness is low, while IAI scores are negative. In case of Azerbaijan, this situation occurs because of the lack of reforms after the 2016 and poor level of rights, democracy and political stability that have determined a reduction of investment attractiveness. In case of Ukraine, the geopolitical events regarding the Crimean crisis affect the investment attractiveness. The lowest level of investment attractiveness has recorded by Belarus, even if Belarus has the highest level of political stability among the EaP countries. These results confirm the third hypothesis according to which there are significant difference between the EaP countries in terms of investment attractiveness.

These findings have multiple implications. Faced with increasing interest for the EU accession, the EaP countries should work in attracting FDI from developed countries, since through the FDI inflows they have the opportunity to bridge their economic, institutional, social and political gaps and to prepare for possible accession to the EU. Despite the political and economic difficulties suffered, especially due their communist past and by Russian influence, it would be great for the future of the EaP countries to work more for creating a favorable environment for foreign investors, but also for their own independent development. As this study has proved each EaP country has its own advantages in attracting FDI and put notable efforts in improving its own attractiveness investment. Nevertheless, each country must pay attention to a mix of elements consisting good institutional quality, inves-

tor-friendly business environment, better political stability, and a more active democracy for guaranteeing civil and political rights. These countries can observe the examples of good practices like the Baltic States, Croatia, Hungary and Ireland, which improved their institutional quality, stimulated FDI and succeeded to join the European Union. Priorities could be the endorsement of some national programs for a more efficient and transparent business environment combined with an adequate regulatory framework, a lowering of the political environment influence on economy and a reduction of state-owned companies. Alternatively, the EaP countries can follow the measures that the Baltic countries or Ireland have done for improving their institutional quality.

Although this study provides a comparative analysis of investment attractiveness for the EaP countries, there are some limitations, such as those related to the sample of selected indicators and the time span. At the same time, this analysis may have some limitations due to the small number of studies related to investment attractiveness for the EaP countries.

Future research may explore the possibility to extend the Investment Attractiveness Index in order to include more variables and representative elements of each field. This will give more relevance to the analysis. At the same time, it may be interesting to study the investment attractiveness of the EaP countries in relation with the EU or Russia. Further analysis from this point of view will provide a better understanding of the institutional quality influence on investment attractiveness.

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APPENDIX

Table A1. Variables used in the study

No	Variable used	Unit	Short name	Sign[1]	Source
1	FDI, net inflows	trillion USD	A	–	The World Bank (2020c)
2	Profit tax	% of profits	B	L	The World Bank (2020c)
3	Labor tax and contributions	% of profits	C	–	The World Bank (2020c)
4	Tax payments	number	D	–	The World Bank (2020c)
5	Total tax and contribution rate	% of profits	E	–	The World Bank (2020c)
6	Dealing with construction permits	0–100	F	+	The World Bank (2020b)
7	Time required to enforce a contract	weeks	G	L	The World Bank (2020b)
8	Enforcing contracts	0–100	H	L	The World Bank (2020b)
9	Getting credit	0–100	I	–	The World Bank (2020b)
10	Paying taxes	0–100	J	+	The World Bank (2020b)
11	Time for paying taxes	Hours/year	K	–	The World Bank (2020b)
12	Protecting minority investors	0–100	L	L	The World Bank (2020b)
13	Registering property	0–100	M	+	The World Bank (2020b)
14	Time required to resolve insolvency	years	N	L	The World Bank (2020b)
15	Starting a business	0–100	O	+	The World Bank (2020b)
16	Trading across borders	0–100	P	L	The World Bank (2020b)
17	Deposit interest rate	Annual %	Q	L	The World Bank (2020c)
18	Real interest rate	Annual %	R	L	The World Bank (2020c)
19	GDP growth	Annual %	S	L	The World Bank (2020c)
20	GDP, PPP	billion USD	T	–	The World Bank (2020c)
21	Government Effectiveness	0–100	U	+	The World Bank (2020a)
22	Control of Corruption	0–100	V	L	The World Bank (2020a)
23	Political Stability and Absence of Violence	0–100	W	+	The World Bank (2020a)
24	Regulatory Quality	0–100	X	+	The World Bank (2020a)
25	Rule of Law	0–100	Y	+	The World Bank (2020a)
26	Voice and Accountability	0–100	Z	–	The World Bank (2020a)
27	Country Risk	7–0	AA	+	OECD (2020)
28	Index of Economic Freedom	0–100	AB	+	The Heritage Foundation (2020)
29	Business Freedom	0–100	AC	+	The Heritage Foundation (2020)
30	Investment Freedom	0–100	AD	+	The Heritage Foundation (2020)
31	Trade Freedom	0–100	AE	–	The Heritage Foundation (2020)
32	Democracy Index	7–1	AF	+	Freedom House (2020)
33	Civil Liberties	7–1	AG	+	Freedom House (2020)
34	Political Rights	7–1	AH	+	Freedom House (2020)
35	Freedom Index	7–1	AI	+	Freedom House (2020)

End of Table A1

No	Variable used	Unit	Short name	Sign[1]	Source
36	Human Development Index	0–1	AJ	L	United Nations Development Programme [UNDP] (2020)
37	Time required to start a business	days	AK	–	The World Bank (2020c)
38	Start-up procedures to register a business	number	AL	–	
39	Time required to register property	days	AM	–	
40	Procedures to register a property	number	AN	–	

[1]*Note:* The sign of the relationship with the factor to which it contributes. L means that the contribution of that factor is very low and insignificant for study.

Table A2. Statistical data used (the average values of the period 2005–2019)

Variables	Armenia	Azerbaijan	Belarus	Georgia	Moldova	Ukraine
A	0.46	3.66	1.63	1.28	0.32	5.59
B	16.62	13.40	15.88	12.96	7.23	11.17
C	13.15	25.22	40.12	6.85	31.15	40.57
D	31.93	17.93	50.33	16.27	34.80	72.73
E	30.62	40.75	78.37	22.55	38.61	52.64
F	59.81	49.52	62.33	77.17	38.29	34.71
G	65.14	37.38	36.43	41.57	65.98	54.03
H	59.33	68.38	75.95	71.47	69.98	64.87
I	63.58	50.33	32.58	70.92	57.33	70.00
J	58.71	70.91	41.18	75.54	69.01	46.20
K	431.87	358.40	535.20	335.27	207.73	804.60
L	45.69	51.82	50.22	68.49	60.62	47.42
M	91.12	82.42	79.06	94.13	81.73	59.37
N	1.90	1.50	3.53	2.43	2.80	2.90
O	90.65	87.94	82.98	95.10	86.53	79.11
P	71.52	49.12	60.63	78.48	66.09	56.72
Q	8.90	10.13	12.13	9.76	9.76	10.70
R	12.73	10.33	-5.41	8.24	5.33	0.65
S	5.22	8.25	3.77	5.27	4.01	0.67
T	27.25	129.96	153.39	37.25	23.16	436.36
U	49.85	34.77	23.90	65.48	31.50	31.75
V	33.11	14.23	38.01	65.63	26.33	18.77
W	39.93	25.27	51.91	26.49	36.55	26.71

End of Table A2

Variables	Armenia	Azerbaijan	Belarus	Georgia	Moldova	Ukraine
X	60.62	39.10	14.56	70.18	49.44	34.12
Y	42.98	25.85	17.19	53.56	40.82	25.16
Z	30.28	10.15	7.82	48.91	42.95	45.31
AA	6.07	5.10	6.87	6.13	7.00	6.58
AB	69.04	59.23	49.89	70.57	56.93	49.43
AC	79.89	68.25	66.44	83.79	67.31	51.53
AD	73.00	47.67	24.00	69.67	40.33	25.33
AE	83.46	75.83	74.96	83.02	79.05	82.21
AF	5.31	6.47	6.64	4.77	4.95	4.57
AG	4.00	5.40	6.00	3.20	3.47	2.73
AH	5.13	6.33	6.93	3.33	3.07	3.20
AI	4.57	5.90	6.47	3.27	3.27	2.97
AJ	0.75	0.73	0.79	0.77	0.72	0.76
AK	9.73	18.27	23.43	4.93	11.80	20.47
AL	5.53	6.00	7.80	3.00	7.27	8.80
AM	6.47	18.07	54.60	2.53	17.20	67.87
AN	3.07	3.87	5.27	2.07	5.27	8.67

Note: Authors calculation based on sources presented in Table A1.

Table A3. Factor loadings (FL) (source: authors' calculation)

Variables	FL for first factorial axis	FL for second factorial axis	FL for third factorial axis
A	−0.738a	−0.078	−0.656
B	0.234	0.526	−0.059
C	−0.919a	0.247	0.227
D	−0.903a	−0.192	0.273
E	−0.702a	0.550	0.337
F	0.727a	0.158	0.022
G	0.025	−0.534	0.443
H	−0.054	0.344	0.200
I	0.177	−0.898a	−0.326
J	0.736a	−0.238	−0.382
K	−0.772a	−0.124	−0.150
L	0.540	−0.385	−0.007
M	0.983a	0.147	0.103
N	−0.503	−0.072	0.666
O	0.982a	−0.112	−0.137
P	0.670	−0.520	0.422
Q	−0.620	0.461	0.176

End of Table A3

Variables	FL for first factorial axis	FL for second factorial axis	FL for third factorial axis
R	0.688	−0.186	−0.421
S	0.687	0.538	−0.410
T	−0.897a	−0.184	−0.308
U	0.773a	−0.481	−0.250
V	0.624	−0.279	0.222
W	−0.053	0.506	0.831a
X	0.762a	−0.601	−0.157
Y	0.777a	−0.625	0.036
Z	0.089	−0.991a	0.061
AA	−0.354	−0.310	0.848a
AB	0.925a	−0.245	−0.161
AC	0.980a	0.022	0.072
AD	0.896a	−0.227	−0.173
AE	0.261	−0.840a	−0.028
AF	−0.006	0.995a	−0.045
AG	0.028	0.992a	0.048
AH	0.008	0.968a	−0.044
AI	0.017	0.988a	−0.011
AJ	−0.158	0.163	0.292
AK	−0.829a	0.554	−0.014
AL	−0.919a	0.151	0.270
AM	−0.951a	0.083	0.093
AN	−0.975a	−0.186	0.072

Note: Values marked with *a* reveal the factors with an important contribution for study and their weights. For each of these, the factor loading values must be greater than 0.7, regardless the sign.

The IAI dimensions and components:
  – **First pillar**: **Regulatory Quality and Economic Freedom:** (A) FDI, net inflows; (C) Labor tax and contributions; (D) Tax payments; (E) Total tax and contributions; (F) Dealing with construction permits; (J) Paying taxes; (K) Time for paying taxes; (M) Registering property; (O) Starting a business; (T) GDP; (U) Government effectiveness; (X) Regulatory quality; (Y) Rule of law; (AB) Index of Economic Freedom; (AC) Business freedom; (AD) Investment freedom(AK) Time required to start a business; (AL) Procedures to register a business; (AM) Time required to register property; (AN) Procedures to register a property.
  – **Second pillar: Rights and Democracy:** (I) Getting credit; (Z) Voice and accountability; (AE) Trade freedom; (AF) Democracy index; (AG) Civil liberties; (AH) Political rights; (AI) Freedom index.
  – **Third pillar: Political Stability:** (AA) Country risk and (W) Political stability.