

# Exploring Institutional Determinants of Private Equity and Venture Capital Activity in Europe

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## Abstract

*This paper examines the determinants of private equity activity across Europe. We analyze a total of 43 explanatory variables, categorized into six groups: Economy, Finance and capital markets, Quality of institutions, Life quality, Economic freedom and Globalization. We assess their impact on three target variables representing overall private equity activity: Investments, Divestments and Fundraising. The study covers 26 European countries over the period from 2007 to 2022. Using Bayesian Model Averaging and panel data analysis, we identified the key variables that countries should prioritize to stimulate private equity activity and enhance sector attractiveness through strategic policy adjustments. Our findings, robust across multiple specifications and priors, underscore the importance of treating private equity as a stage-specific process, in which investments, divestments and fundraising are shaped by distinct economic, financial and institutional factors.*

## 1. Introduction

Private equity (PE) is a form of investment that involves investing in companies that are not listed on a public exchange (Cendrowski et al. 2012; Lerner, Hardymon and Leamon, 2012). The primary goal of private equity investing is to acquire significant equity ownership, implementing strategies to enhance value before exiting through sale or public offering. One of the most important subsets of private equity is venture capital (VC), which focuses on investing in risky, early-stage, high-potential growth companies (Cendrowski et al. 2012). In addition to venture capital, private equity also includes the following investment stages: growth capital, replacement capital, rescue/turnaround and buyouts (Invest Europe, 2018).

Over the past decade, there has been a positive trend in private equity investments as a percentage of European GDP, increasing from 0.29% in 2012 to 0.82% in 2021 (Invest Europe, 2024). The expansion of PE and VC activity in Europe has led to increased research interest in this field, marking a notable departure from the traditionally US-centric focus. However, significant open issues and controversies

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persist. Many studies examining the determinants of PE and VC activity begin with the premise that there are vast differences between individual countries and regions across Europe. Groh, Liechtenstein and Lieser (2010) describe these differences as a "built-in bias", suggesting that the entire investment chain - from institutional investors to the ultimate funded companies - is influenced by geographic factors. They argue that there must be additional factors that drive institutional investors' decisions regarding capital allocation. Alongside Groh, Liechtenstein and Lieser (2010), several other authors have attempted to explain the variations in PE activity, with a primary focus on macroeconomic variables (Jeng and Wells, 2000; Bernoth and Colavecchio, 2014). More recently, attention has shifted towards cultural and socio-entrepreneurial variables (Espahbodi and Dahlman, 2023; Cumming et al., 2016).

This paper examines the significance of certain established variables while also introducing new variables that have not been previously studied. We observe a total of 46 variables: three dependent (Investments, Fundraising and Divestments) and 43 independent variables categorized into six groups: Economy, Finance and Capital Markets, Quality of institutions, Life quality, Economic freedom and Globalization. The analysis covers 26 European countries (for Investments and Divestments), and 23 European countries (for Fundraising) over a 16-year period from 2007 to 2022.

First step in our quantitative analysis was to narrow the variable base and choose only those that are relevant for further research. We did so by assessing multicollinearity among the variables and making informed decisions about which ones to retain. The refined set of variables was then used in the Bayesian Model Averaging (BMA) estimation with several types of priors. The analysis was conducted separately for each dependent variable under both lagged and non-lagged specifications. The obtained results and their implications for potential policy actions are discussed in the final section.

This study contributes to the literature in several ways. First, it provides a comprehensive analysis of PE/VC activity across European countries by examining all three core components: investments, fundraising and divestments - an approach that has rarely been taken in prior research. Second, we introduce a broader set of macroeconomic, institutional and structural variables, some of which have not been previously explored. Third, we apply rigorous and objective methods for identifying the most robust determinants of PE activity, strengthening the empirical reliability of our results. Finally, although the analysis is empirical in nature, the paper contributes to public policy discourse by highlighting policy changes that could be implemented in order to increase PE activity in observed European countries. These recommendations serve as a broad preliminary framework, providing a basis for future research on targeted, country-specific policy interventions.

The paper is structured as follows: In Section 2, we provide literature review discussing historical development of the topic and main findings. In Section 3, we present observed variables and sources of data for our research. Section 4 explains methodology, Section 5 presents results and Section 6 discussion. Section 7 summarizes our work with concluding remarks.

## 2. Literature Review

Extensive research has investigated factors impacting private equity and venture capital activity across various countries and regions. However, there is no consensus on the key determinants. Gompers and Lerner (1998) were among pioneers in the examination of venture capital determinants, analyzing data on the US venture capital industry over the period 1972-1994. They found that GDP growth, increased R&D spending, and low capital gains tax positively influence levels of venture capital investment.

Jeng and Wells (2000) analyzed data from 21 developed countries, covering the period from 1986 to 1995. They found that initial public offerings (IPOs) were the strongest determinant of VC investing, while GDP and market capitalization growth were surprisingly insignificant. Notably, Jeng and Wells's work builds on Black and Gilson's (1998), who confirmed the significance of well-developed stock markets and IPOs.

Balboa and Marti (2004) introduced new explanatory variables in their analysis of 17 European countries from 1987 to 2000. They found that previous investment activity, market liquidity, GDP growth, and the evolution of gross domestic savings significantly affected total funds raised.

Romain and van Pottelsberghe (2004) observed 16 major OECD countries over the period 1990-1998 and found that GDP growth, short-term interest rate, level of entrepreneurship as well as technological opportunity (number of triadic patents, business R&D growth and stock of knowledge) have a positive impact on VC activity in observed countries.

Groh, Liechtenstein, and Lieser (2010) investigated the factors that make a country attractive for PE/VC investments. They developed a composite index that measures a country's overall attractiveness for these investments based on six key determinants: (1) economic activity, (2) depth of the capital market, (3) taxation, (4) investor protection and corporate governance, (5) human and social environment, and (6) entrepreneurial culture. This index was later expanded to include 125 countries and is published annually by the IESE Business School as The Venture Capital and Private Equity Country Attractiveness Index (Groh et al., 2023).

The overall research base on drivers of PE/VC activity can be divided into two categories based on their main focus: 1) market development/geographical criterion and 2) types of variables.

### 2.1 Market Development/Geographical Criterion

Majority of research is focused on developed countries, particularly the USA, which has created a significant gap in the literature regarding other countries and regions. Cumming et al. (2023) found that between 2001 and 2021, 51.58% of studies focused on the USA, 10.05% on the UK, and 8.47% on China. Interestingly, during the most recent period observed (2017-2021), there was a notable rise in studies focusing on China, at the expense of research previously centered on the USA and the UK. A majority of these studies concentrate on individual countries (40.17%), with a significant portion also analyzing multiple countries simultaneously (32.73%).

When it comes to emerging markets, Lerner et al. (2016) argue that while these markets exhibit high growth potential, they also pose significant risks. One significant

risk is the uncertainty faced by PE investors regarding their ability to exit investments and achieve returns in these underdeveloped capital markets. It is clear that a strong capital market is a prerequisite for PE activity in any country, as investors require liquidity for their holdings. However, Štofa and Šoltés (2020) found that stock market development does not significantly affect PE investment activity in European countries, since divestments in Europe are not primarily executed via capital markets.

The literature on European countries commonly divides them into two categories: Central and Eastern European (CEE) countries and Western European (WE) countries. Several studies compare VC/PE determinants between CEE and WE countries (Bernoth, Colavecchio, and Sass, 2010; Bernoth and Colavecchio, 2014; Kočenda and Rai, 2023). Bernoth, Colavecchio, and Sass (2010) find that commercial bank lending, equity market capitalization, unit labor costs, and corporate tax rates significantly affect PE activity. Bernoth and Colavecchio (2014) identify additional factors such as economic activity, the inflation rate, equity market capitalization, unit labor costs, the unemployment rate, and the institutional and legal environment. However, Kočenda and Rai (2023) find that most of the analyzed macroeconomic determinants do not significantly influence fundraising and investing activities in CEE and WE countries, noting a strong impact of factors directly related to the PE process.

Karsai (2023) finds that differences between European countries increased sharply during the period 2016-2020: the Baltic countries of Estonia and Lithuania have a very strong VC industry given their liberal market regulation and high digitalization level; countries that operate under illiberal conditions, Hungary and Poland, rely heavily on EU funds and consequently have a number of artificially inflated startups; other EU countries are in the process of market liberalization and institutional transformation which is expected to boost VC activity in the future; non-EU countries don't have developed VC market and its activity could be considered sporadic.

## 2.2 Types of Variables

In addition to the geographical concentration of research, a major problem with previous studies is that the observed variables, i.e. potential drivers of PE/VC activity, are remarkably similar across the research base. Most studies focus on classic economic and regulatory factors such as GDP growth and taxes, along with cultural variables that have gained interest in recent years. Oberli (2014) categorizes the determinants studied in economic literature into five groups: capital market-related, macroeconomic, fiscal/legal environment, government intervention-related, and process and culture-related factors. These variables include past investor returns, IPOs, recent investment activity, GDP growth, interest rates, gross domestic savings, capital gains taxation, legal systems, fairness, property rights protection, liberal bankruptcy laws, investment regulations, labor market policies, the maturity and size of the private equity market, technological opportunities, risk capital culture, and managerial talent. This classification aligns partially with the framework proposed by Groh, Liechtenstein, and Lieser (2010).

Several studies examine how formal and informal institutions influence private equity and venture capital activity. North (1990) was the first to introduce the classification of institutions into formal and informal categories. According to North,

institutions are humanly devised constraints that shape human interaction. Formal institutions encompass economic, political and contractual rules, whereas informal institutions consist of social norms, codes of behavior, and conventions rooted in the cultural heritage of specific geographic contexts (North, 1990, 1994). Jeng and Wells (2000) define formal institutions as legally binding rules and regulations, contrasting them with informal institutions which encompass social norms, networks and trust.

Grilli et al. (2019) underscore the importance of both formal and informal institutions in assessing their influence on the evolution of the VC industry. Their analysis of 35 empirical studies identified key themes within formal institutions (regulatory institutions, government quality and financial market conditions) and informal institutions (entrepreneurialism, cultural dimensions and social capital). The results they presented are consistent with the main conclusion regarding the whole topic: there is no consensus on what variables are most important drivers of PE/VC activity. For instance, Aggarwal and Goodell (2014) and Groh and Wallmeroth (2016) suggest that investor protection positively influences VC activity, whereas Jeng and Wells (2000) and Cumming et al. (2016) found no significant impact from this factor. High capital gains taxes are believed to negatively affect VC activity by Gompers and Lerner (1998) and Bedu and Montalban (2014), yet Jeng and Wells (2000) found no significant impact. Rigid labor market regulations are reported to have a negative impact by Bonini and Alkan (2012), Cumming and Li (2013), and Groh and Wallmeroth (2016), while Bedu and Montalban (2014) found no significant impact, and Schertler (2003) suggests a positive impact.

Felix et al. (2013) found that stock market development negatively impacts VC activity, contrasting with Jeng and Wells (2000), Bonini and Alkan (2012), and Cumming and Li (2013) who found no significant impact. Conversely, numerous authors including Black and Gilson (1998), Gompers and Lerner (1998), Schertler (2003), Cumming et al. (2016), and Groh and Wallmeroth (2016) argue for a positive impact of stock market development. Regarding macroeconomic factors, Jeng and Wells (2000) and Cumming and MacIntosh (2006) found no significant impact of GDP growth rate on VC activity, while Gompers and Lerner (1998), Romain and van Pottelsberghe (2004), Li and Zahra (2012), and Hain et al. (2016) argue for a positive impact.

Cherif and Gazdar (2009) analyzed public institutions and venture capital in Europe, concluding that governmental effectiveness, regulatory quality, political stability, voice and accountability, as well as corruption control, positively impact total VC activity.

In the realm of informal institutions, several authors examined culture through the well-established Hofstede dimensions (Li and Zahra, 2012; Aggarwal and Goodell, 2014; Gimenez-Jimenez et al., 2020; Espahbodi and Dahlman, 2023). The original Hofstede dimensions comprised power distance, individualism, masculinity and uncertainty avoidance (Hofstede, Hofstede, and Minkov, 2010). Subsequently, these dimensions were expanded to include two additional factors: long-term orientation and indulgence. Uncertainty avoidance is one of the most frequently analyzed indicators of VC activity and it is thought to have a negative impact (Li and Zahra, 2012; Aggarwal and Goodell, 2014; Cumming et al., 2016).

In addition to the mentioned cultural dimensions, some authors consider entrepreneurialism as part of informal institutions. Felix et al. (2013) argue that

entrepreneurialism negatively affects VC activity. Conversely, Armour and Cumming (2006) and Li and Zahra (2012) find no significant impact, while Romain and van Pottelsberghe (2004) and Bonini and Alkan (2012) suggest a positive impact.<sup>2</sup>

### 3. Research Design

#### 3.1 Variables

The aim of this paper is to examine variables acknowledged in the literature as drivers of PE/VC activity, along with new variables that have not been previously tested. The study focuses on three dependent variables: Investments, Fundraising and Divestments and 43 independent variables categorized into six groups: Economy, Finance and Capital Markets, Quality of Institutions, Life quality, Economic freedom and Globalization.

Investments refer to the capital deployed by PE funds into portfolio companies. Fundraising denotes the total amount of capital raised by PE funds within the observed period, destined for future investments. Divestments represent exit activity – disposal of PE stakes through sale, IPO or write-off of portfolio holdings.

Below is the list of all independent variables, organized by thematic categories<sup>3</sup>:

#### Economy

First group of independent variables consists of:

- Classic economic variables:
  - GDP growth rate [GDP\_G],
  - Inflation rate [INF\_R],
  - Labor force, million people [LAB\_F],
  - Unemployment rate [UNE\_R];
- Variables related to innovations:
  - Research and development expenditure, percent of GDP [RDE],
  - Patent applications by residents [PAT].

Many of these variables have been analyzed in previous studies, as documented in the Literature review. However, unresolved questions persist regarding their role as significant drivers of PE/VC activity. This uncertainty motivated us to reassess their importance.

#### Finance and Capital Markets

In the second group there are variables related to the financial sector:

- Interest rate [IR],
- Bank credit to the private sector, percent of GDP [BANK\_C],
- Bank assets, percent of GDP [BANK\_A],

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<sup>2</sup> Table A1 in the Appendix offers a structured summary of all referenced studies and their key findings.

<sup>3</sup> Table A2 in the Appendix provides a detailed overview of all independent variables.

- Stock market capitalization, percent of GDP [SM\_CAP],
- Stock market return, percent [SM\_RET],
- Stock price volatility, percent [SP\_VOL].

Previous research has predominantly focused on the capital markets for two main reasons. Firstly, this sector is highly developed in the USA, a country which is a primary focus of PE research. Secondly, Initial Public Offerings (IPOs) represent one of the most prevalent methods for exiting PE investments. However, in Europe banks dominate the capital market - a fact that has not received full recognition in studies examining the drivers of PE/VC activity. We aim to address this literature gap by highlighting the significance of the banking sector for the development of PE/VC industry across European countries. To our best knowledge, there has been no prior examination of Bank credit to the private sector (percent of GDP) and Bank assets (percent of GDP) as determinants of PE fundraising, investments, and divestments.

### **Quality of institutions**

The group "Quality of Institutions" includes governance indicators that reflect the political and legal environment of each respective country:

- Rule of law index [RL\_I],
- Government effectiveness index [GE\_I],
- Control of corruption [CCOR\_I],
- Regulatory quality index [RQ\_I],
- Voice and accountability index [VA\_I],
- Political stability index [PS\_I],
- Corruption perceptions index [CORP\_I].

There is limited research that has considered these variables, with some notable exceptions such as Cherif and Gazdar (2009) and Kočenda and Rai (2023). We chose to examine these variables because they provide a robust means to quantify the quality of governance, institutions, and regulations - crucial but often difficult-to-measure social aspects that significantly impact the economy and investments within it.

### **Life quality**

This group of variables indicates standard of living in a country:

- Human development index [HD\_I],
- Uneven economic development index [UNED\_I],
- Human rights and rule of law index [HRRL\_I],
- Human flight and brain drain index [HFBD\_I],
- Percent urban population [URB\_POP],
- Internet users, percent of population [INT\_US],
- Mobile phone subscribers, per 100 people [MOB\_PH],
- Public spending on education, percent of GDP [PS\_ED1],
- Public spending on education, percent of public spending [PS\_ED2].

To our best knowledge there is no research that examined the influence of above mentioned variables on overall PE/VC activity in Europe. Our primary rationale for selecting these variables was based on the assumption that societies with higher standards of living, increased investment in education, and greater adoption of technology are more likely to foster innovation and attract private equity funds and investments.

### **Economic freedom**

Variables in this group indicate the levels of freedom in different segments of the economic and social activity:

- Economic freedom, overall index [ECF\_OI],
- Fiscal freedom index [FF\_I],
- Business freedom index [BF\_I],
- Labor freedom index [LF\_I],
- Monetary freedom index [MF\_I],
- Trade freedom index [TF\_I],
- Investment freedom index [IF\_I],
- Financial freedom index [FINF\_I],
- Freedom from corruption index [FCOR\_I],
- Property rights index [PR\_I].

These variables could be important because they indicate the investment climate, regulatory environment, and ease of doing business in a particular country. Previous research in this area has yielded varied conclusions without reaching a uniform consensus.

### **Globalization**

These variables indicate level of country openness and its inclusion in the overall globalization process:

- Globalization index [GLOB\_I],
- Economic globalization index [EG\_I],
- Political globalization index [PG\_I],
- Social globalization index [SG\_I],
- Trade openness - exports plus imports as percent of GDP [T\_OP].

Globalization permeates nearly every aspect of life, including the economy, politics and society. Countries that embrace globalization benefit from increased market opportunities and access to a broader pool of potential investments for both startups and private equity firms (i.e. investments and fundraising). To our best knowledge, there has been no research examining globalization indices obtained from The Swiss Institute of Technology in Zurich and trade openness in relation to our specific focus.

### 3.2 Data Sources

The primary data source for dependent variables was The European Data Cooperative (EDC) managed by Invest Europe.<sup>4</sup> While the EDC offers extensive datasets on indicators across individual countries, some countries were categorized into groups: the Baltic countries (Estonia, Latvia, Lithuania) and Other CEE countries (Bosnia and Herzegovina, Croatia, Macedonia, Moldova, Montenegro, Serbia, Slovakia, Slovenia). This posed challenges for analysis as independent variables were country-specific. Due to the limited significance of the Other CEE group, these countries were excluded from the analysis. Data on individual Baltic countries was subsequently obtained, but only for two out of three dependent variables (Investments and Divestments), since Invest Europe's reporting policy necessitates a minimum of five funds per year for data presentation and this condition was not fulfilled for Fundraising. In addition to Estonia, Latvia and Lithuania, our analysis encompassed the following countries: Austria, Belgium, Bulgaria, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Luxembourg, Netherlands, Poland, Portugal, Romania, Spain, Sweden, United Kingdom, Norway, Switzerland, and Ukraine. All dependent variables were standardized by GDP to ensure comparability across countries.

The main source for independent variables was The Global Economy, a comprehensive data provider aggregating indicators from authoritative institutions like the World Bank, International Monetary Fund, United Nations, World Economic Forum, Heritage Foundation, Fund for Peace, national agencies and statistical offices etc. Table A2 in the Appendix gives a comprehensive overview of sources.

### 3.3. Evolution of Dependent and Independent Variables

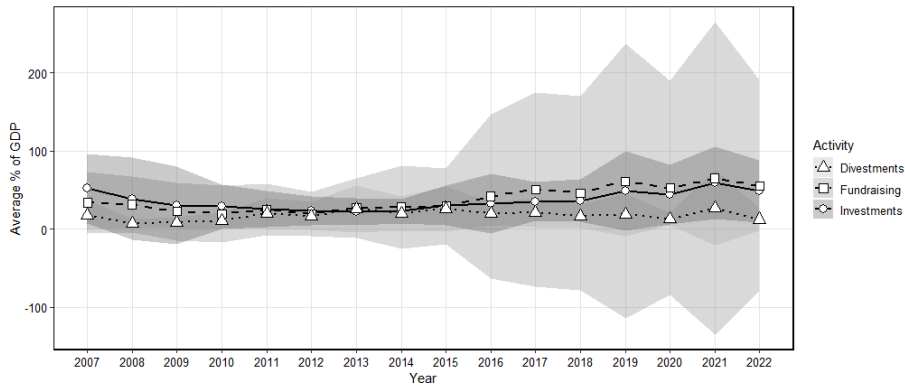
Levels of PE/VC activity<sup>5</sup> vary significantly among European countries. During the observed period, the highest levels of activity were recorded in the United Kingdom, France and Germany. Figure 1 presents the average annual levels of investments, fundraising, and divestments, each expressed as a percentage of national GDP and averaged across 26 European countries for the period 2007–2022. Data on PE/VC activity were obtained from Invest Europe – Private Equity Activity Database, while GDP data were drawn from the Global Economy database.

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<sup>4</sup> Invest Europe represents Europe's private equity, venture capital and infrastructure investment firms, along with their investors. In collaboration with national association partners, Invest Europe established the EDC as a joint initiative to gather comprehensive industry data on PE and VC activity across Europe, including its social impact.

<sup>5</sup> Measured by average values of investments, fundraising and divestments standardized by GDP in the period 2007-2022.

**Figure 1 Average Values of Investments, Fundraising and Divestments Standardized by GDP Over the Period 2007 - 2022**



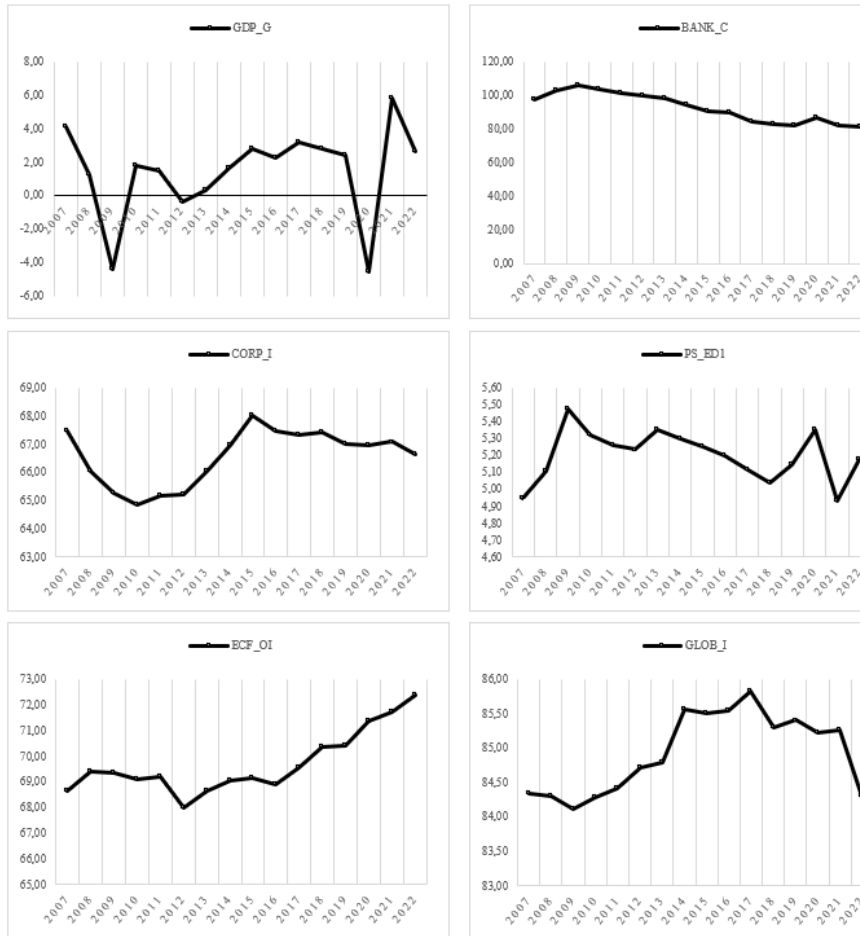
The chart shows that the three components of PE activity follow notably different trajectories. Investments were the most stable over time, maintaining a relatively consistent share of GDP. In contrast, Fundraising was the most volatile, particularly after 2015, likely due to changing investor sentiment and macroeconomic uncertainty. Divestments remained the lowest in magnitude with least variation, reflecting the slower and more cautious nature of exit activity in Europe. The presented patterns indicate that the dynamics of PE activity are highly stage-specific.

In order to gain perspective on the possible relationship between dependent and independent variables, we observe the movement of selected independent variables - one from each group as presented in Section 3.1. Variables. These include: GDP growth rate [GDP\_G], Bank credit to the private sector, % GDP [BANK\_C], Corruption perceptions index [CORP\_I], Public spending on education, percent of GDP [PS\_ED1], Economic freedom, overall index [ECF\_OI] and Globalization index [GLOB\_I].

There appears to be no evident correlation among the selected variables; each exhibits its own distinct movement pattern. The GDP growth rate is notably volatile, reflecting the numerous disruptions Europe has experienced during the last 20 years: the global financial crisis, the migrant crisis, Brexit, the COVID-19 pandemic, the war in Ukraine etc. In contrast, bank credit to the private sector is the least volatile of the variables, demonstrating a consistent negative trend. People's perception of corruption improved following the global financial crisis, as evidenced by a sharp increase in the Corruption Perceptions Index between 2010 and 2015. This improvement is likely attributable to the implementation of tighter regulations and enhanced supervision as part of the response to the crisis. Economic freedom, overall index and globalization index could be considered somewhat similar, but their movements in the observed period were not harmonized. Generally, higher economic freedom tends to foster greater globalization by improving market conditions and openness. However, the immediate impact of external shocks such as COVID-19 pandemic on globalization shows that global integration can be significantly disrupted even when economic freedom is on the rise. Variable whose trend is most dependent on country-specific decisions is public spending on education as a percentage of GDP. The high volatility

observed in this variable suggests significant inconsistencies and varying degrees of autonomy in decision-making regarding education funding.

**Figure 2 Average Values of Selected Six Independent Variables Over the Period 2007 - 2022**



When interpreting these trends, it is important to note that several macroeconomic indicators display well-documented statistical outliers (such as Ireland’s 24.37% GDP growth in 2015, driven by multinational reclassifications rather than genuine domestic expansion), which can not be fully absorbed by fixed-effects estimation.

#### 4. Methodology

This study employs a three-stage empirical strategy to identify robust institutional and macroeconomic determinants of PE activity. The first stage conducts a preliminary multicollinearity assessment to refine the initial set of 43 explanatory

variables. The second stage applies BMA to this refined variable set, testing multiple specifications to identify a consistent group of robust determinants. The third and final stage performs panel analysis to quantify impacts of significant variables on PE activity.

#### 4.1 Descriptive Statistics

We obtained 416 observations for each dependent variable, except for Fundraising, where we had 368 observations due to unavailability of data from the Baltic countries. Complete descriptive statistics is presented in the Appendix - Table A3.

#### 4.2 Multicollinearity assessment

We constructed four separate correlation matrices: two for Investments and Divestments (lagged and non-lagged) and two for Fundraising (lagged and non-lagged)<sup>6</sup>. Variables exhibiting a pairwise correlation greater than 0.8 were considered highly collinear. When deciding which variables to keep, we considered their practical implications for the models' overall quality and interpretability, as well as their theoretical significance. The following variables were excluded from further analysis: Rule of law index, Government effectiveness index, Control of corruption, Regulatory quality index, Voice and accountability index, Freedom from corruption index, Economic freedom overall index, Human rights & rule of law index, Internet users, Corruption perceptions index, Globalization index, Social globalization index, Human development index, Bank assets, Patent applications by residents.

#### 4.3 Bayesian Model Averaging (BMA)

The refined set of variables was then advanced to the BMA analysis. BMA provides a coherent and systematic mechanism for accounting for model uncertainty by assessing the relevance of different variables in selected models. The methodology was originally developed by Madigan and Raftery (1994) and Raftery, Madigan, and Hoeting (1997), and further discussed by Fragoso and Louzada-Neto (2015). Rather than selecting a single best model, BMA considers a range of plausible models and evaluates the importance of each variable based on how frequently it appears in those models.

The interpretation of BMA results is based on three standard indicators:

- Posterior Inclusion Probability (PIP): the probability that a variable is included in the best-performing models. Higher values (closer to 100) indicate higher relevance of variable.
- Expected Value (EV): the average effect of independent variable on dependent variable across all models. A positive EV suggests a positive average effect, and vice versa.
- Standard Deviation (SD): the variability of the variable's effect. Lower values suggest a more consistent effect across models.

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<sup>6</sup> The correlation matrices can be found in the Appendix (Tables A4 – A7).

Variables are identified as robust determinants if they consistently demonstrate a  $PIP > 80$  across different priors and specifications.

We conducted BMA analysis separately for each dependent variable. Each model was estimated under two specifications: contemporaneous (NoLag), relating PE activity to explanatory variables within the same year, and the lagged specification (Lag), linking PE activity to variables from the preceding year. In addition to this, we employed three priors: the Unit Information Prior (UIP), which is conservative and favors parsimonious models; the Risk Inflation Criterion (RIC), which is less restrictive and allows for larger model spaces; and the Hyper-g Prior, an adaptive prior commonly applied in sensitivity analyses.

The results we obtained are presented in the Appendix (Table A8).

#### **4.3.1 Investments**

Three variables emerge as consistently dominant across all six specifications (NoLag/Lag; UIP, RIC, hyper-g): Trade openness (PIPs = 100), Economic globalization index (PIPs 100), and Trade freedom index (PIPs > 92). This means that these variables are highly likely to be included in the underlying models explaining PE investments. Stability of their PIPs across all prior structures and temporal specifications confirms that the results are robust and not driven by prior selection or model uncertainty. Overall, these findings underscore the central role of international economic integration in shaping cross-border PE capital flows in Europe.

#### **4.3.2 Divestments**

The results point to two dominant factors across all six specifications: Percent urban population (PIPs = 100) and Stock price volatility (PIPs > 84). Percent urban population captures market size and depth relevant for exits, meaning that divestments occur in larger urban areas with solid financial and technological infrastructure. Stock price volatility exhibits high inclusion in all models (PIPs > 84%), reflecting the importance of market stability for valuation and deal execution. Among other determinants, Fiscal freedom is highly robust (PIPs > 94% in all contemporaneous specifications and in the lagged RIC and hyper-g cases), indicating that predictable and flexible tax conditions facilitate exit execution.

#### **4.3.3 Fundraising**

Three variables are consistently dominant across all six specifications: Economic globalization (PIPs > 98), Bank credit to the private sector (PIPs = 100), and Trade openness (PIPs = 100). Economic globalization reflects sustained integration with international markets, which supports long-term capital commitments. Bank credit depth indicates a stable and accessible financing system, while Trade openness captures the degree of market integration and signals broader growth opportunities, as firms operating in more open economies can expand more easily and access larger markets. Two further variables are highly robust: Divestments (PIPs > 97% in five of six models; 69.2% in NoLag–UIP), pointing to a direct link between successful exits and subsequent fundraising capacity, and Political globalization (PIPs above 94% in all but the NoLag–RIC specification), indicating the importance of broader international ties and policy integration.

#### 4.4 Panel Data Analysis

We now turn to panel data analysis, a critical step in our analytical framework. This approach enables us to use both the cross-country and time dimension of the dataset and to control for unobserved, time-invariant country characteristics that could otherwise bias the results. We estimate fixed-effects (FE) and random-effects (RE) models. FE is suitable when country-specific factors are likely to be correlated with the explanatory variables, whereas RE assumes no such correlation. To decide between them, we apply the Hausman test, which examines whether individual effects are correlated with the regressors. The null hypothesis states that the RE model is appropriate (no correlation), while the alternative hypothesis favors the FE specification.

The results of the Hausman test are presented in the table below:

**Table 1 Hausman Test**

	<i>Variable</i>	<i>Chi-square</i>	<i>p-value</i>	<i>Result</i>	<i>Estimation</i>
<b>noLag</b>	Investments	129,34	0,0000	Rejected Ho	Fixed effects
	Divestments	65,86	0,0000	Rejected Ho	Fixed effects
	Fundraising	138,05	0,0000	Rejected Ho	Fixed effects
<b>Lag</b>	Investments	101,63	0,0000	Rejected Ho	Fixed effects
	Divestments	52,52	0,0010	Rejected Ho	Fixed effects
	Fundraising	170,02	0,0000	Rejected Ho	Fixed effects

The results point that the FE model is appropriate for all three variables.

### 5. Results

#### 5.1 Investments

The FE model with non-lagged specification (Model 1) shows significant relationships between Investments and variables:

- GDP rate, Trade openness, Trade freedom index, Financial freedom index, Labor force, Market capitalization/GDP, Economic globalization index, Public spending on education (total) ( $p < 0.01$ );
- Property rights index, Mobile phone subscribers ( $p < 0.05$ );
- Inflation ( $p < 0.1$ ).

The FE model with lagged specification (Model 2) indicates importance of the following variables:

- Trade openness, Business freedom index, Mobile phone subscribers, Economic globalization index ( $p < 0.01$ );
- Property rights index, Market capitalization/GDP, Political globalization index ( $p < 0.05$ );

- Financial freedom index, Labor force ( $p < 0.1$ ).

Out of all variables, the largest positive effect on Investments is present with Labor force. Its impact is substantial in both the contemporaneous model (coef. 0.0582) and the lagged model (coef. 0.0783). Other significant variables are Economic globalization index (coef. 0.0200 in the non-lagged model and 0.0353 in the lagged model), as well as Market capitalization/GDP and Mobile phone subscribers, which are consistently positive and significant, but with coefficient of less magnitudes (0.001 to 0.005). GDP is significant in contemporaneous model (coef. 0,0125), but not in the lagged model.

Variable with strongest negative impact on PE investments is Public spending on education (coef. -0.0513), followed by Trade freedom index (coef. -0.0298). Additional variables that show consistent negative effect on Investments are Trade openness and Financial freedom index.

## 5.2 Divestments

The FE regression model with non-lagged specification (Model 3) shows significant relationships between Divestments and variables:

- Trade openness, Stock price volatility ( $p < 0.01$ );
- Inflation ( $p < 0.1$ ).

The FE model with lagged specification (Model 4) indicates importance of the following variables:

- Trade openness, Stock price volatility ( $p < 0.01$ ).

The only significant positive driver of Divestments is Trade openness (coef. 0.0025 in the non-lagged model and 0.0039 in the lagged model), while negative impact is present with Stock price volatility and Inflation.

## 5.3 Fundraising

This FE regression model with non-lagged specification (Model 5) indicates that the following variables influence Fundraising:

- Divestments, Inflation, Trade openness, Business freedom index, Bank credit to the private sector, Political globalization index ( $p < 0.01$ );
- Investments, Interest rates, Mobile phone subscribers, Economic globalization index ( $p < 0.05$ );
- Political stability index, Property rights index, Percent urban population ( $p < 0.1$ ).

The FE model with lagged specification (Model 6) indicates importance of the following variables:

- Divestments, Trade openness, Political stability index, Percent urban population, Bank credit to the private sector, Economic globalization index, Political globalization index ( $p < 0.01$ );
- Investments, Interest rates, Business freedom index, Trade freedom index ( $p < 0.05$ );
- Inflation, Research and development ( $p < 0.1$ ).

The most significant positive effect on Fundraising comes from Percent urban population, (coef. 0.0563 for non-lagged and 0.0828 for lagged model) and Interest rates (coefficients of 0.0490 and 0.0557). The two most robust positive determinants, Trade openness and Bank credit, have smaller but exceptionally significant coefficients.

Variables with the strongest negative impact are Political stability index (coef. -0.2304 non-lagged and -0.3468 lagged) and Political globalization (coef. -0,0397 non-lagged and -0.1420 lagged).

## 6. Discussion

### 6.1 Key findings

While the results are statistically robust, certain outcomes may appear counterintuitive and therefore require further elaboration.

Our findings indicate that PE activity is not uniform but a multi-stage process in which the same variables exert different effects across investment, divestment and fundraising stages. Cases where variables have opposite impact on investments and fundraising (e.g. Economic globalization index and Inflation) can be attributed to critical difference between capital deployment and capital sourcing. Namely, investment decisions reflect an active search for opportunities: capital is deployed where economies exhibit growth potential and offer credible exit options (+GDP growth rate, +Market capitalization/GDP), supported by quality labor force (+Labor force, +Mobile phone subscribers). At the same time, investors tend to avoid environments that are fully liberalized (-Trade freedom index, -Financial freedom index), as excessive trade and financial freedom may intensify competitive pressures and reduce the availability of undervalued or improvable investment targets.

Fundraising, by contrast, reflects a long-term, risk-sensitive assessment of the overall financial and macroeconomic environment. Capital is committed where there is a stable financial infrastructure (+Bank credit, +Interest rates, +Percent urban population). Findings on the negative influence of Political stability and Political globalization do not imply that instability is desirable; they rather suggest that excessive regulatory uniformity, administrative complexity or rigid political frameworks may reduce the flexibility and dynamism that PE requires.

Divestments have only three significant drivers. Exit activity is higher in open economies, where cross-border integration increases the number of potential buyers (+Trade openness). Conversely, unstable markets with price volatility and uncertainty suppress exit activity, because of difficulties in determining fair value of assets (-Stock price volatility, -Inflation).

The only variable that is significant across all six models is Trade openness. Obtained results indicate that Trade openness supports fundraising and divestments,

but is associated with lower investments. One possible explanation for this is that openness may facilitate capital outflows, directing funds toward more favorable opportunities abroad - especially within the integrated European market. In addition, in more open economies, foreign direct investment (FDI) and joint ventures may be preferred vehicles for capital inflows over private equity. As a result, PE activity may be displaced by other, often less risky, forms of international investment. Furthermore, openness can lead to greater market saturation in some industries, intensifying competition and lowering profit margins, thereby reducing the attractiveness of local firms as PE targets.

Other broadly consistent variables, included in four out of six models, are Economic globalization index and Inflation. Economic globalization exerts a positive influence on investments, as greater international integration broadens the range of potential target companies and facilitates exits through international transactions. However, it shows a negative association with fundraising, reflecting the intensified global competition for capital. Similarly, inflation has a positive effect on investments, as fund managers accelerate capital deployment to decrease the risk of the real value erosion, yet a negative impact on fundraising and divestments, since macroeconomic uncertainty and valuation volatility discourage long-term commitments and delay exits.

Significant contribution of this study is the identification of Bank credit to the private sector as one of the most robust determinants of fundraising - a factor largely overlooked in prior PE research despite the bank-dominated nature of European markets. This proves that a well-capitalized and stable banking sector can be seen as a key enabling condition for funding activity.

The consistent negative association between public spending on education and PE activity may point to inefficiencies in how education budgets are allocated: there could be a mismatch between educational outputs and the skill sets required by start-ups and innovative firms. To contextualize this result, we reference the OECD's Education at a Glance (2022), which reveal wide disparities in educational effectiveness and outcomes across Europe. These findings suggest that it is not the volume but the quality and alignment of education spending that may influence investment attractiveness.

## 6.2 Our Findings vs Previous Research

In confronting our results with the existing literature, we emphasize a stage-specific perspective, showing that certain previously inconclusive findings can be better understood once investments, divestments and fundraising are analysed separately.

Regarding macroeconomic and financial variables, the literature provides no consensus on the role of core macroeconomic indicators. Our results indicate that the GDP growth rate exerts a positive influence on investments, consistent with Gompers and Lerner (1998), but no significance for fundraising, consistent with Jeng and Wells (2000). Market capitalization, long debated in PE studies, also reveals a clear split. While Štofa and Šoltés (2020) report insignificance, our findings show that market depth supports investments, in line with the exit-related arguments of Black and Gilson

(1998), whereas it remains irrelevant for fundraising, supporting Jeng and Wells (2000).

Regarding institutional quality, the literature generally assumes that stronger institutions attract investment (e.g., Cherif and Gazdar 2009; Aggarwal and Goodell 2014). Our analysis gave the opposite, surprising results: property rights, business freedom, financial freedom, and related institutional indicators consistently show negative associations with both investments and fundraising. One of the possible explanations could be that highly efficient and liberalized markets tend to lack the inefficiencies, valuation gaps, or operational shortcomings that PE typically leverages to create value. In such environments, the opportunity to generate above-market returns is reduced, making PE investment activity less attractive.

A positive association between the labor force and investment activity aligns with the broader literature that emphasizes the importance of a deep and adaptable workforce (Bonini and Alkan 2012; Schertler 2003).

Our findings on importance of bank credit activity are consistent with Bernoth, Colavecchio and Sass (2010), who also highlight the importance of bank lending. It underscores that in Europe, a deep and stable banking sector is a fundamental precondition for successful PE fundraising.

### **6.3 Possible Policy Actions**

Building on the empirical results presented above, this section sets out targeted policy actions that countries could implement to strengthen PE activity. Noteworthy, policy measures should be stage-specific, given that most determinants affect different stages of PE activity in distinct ways.

#### **6.3.1 Investments**

Policies aimed at enhancing PE investment should focus on strengthening domestic investment capacity rather than relying solely on liberalization. Our results point to a clear pattern: while GDP growth, labor force, and technological readiness support investment activity, variables associated with extensive liberalization - most notably Trade openness, Trade freedom and Financial freedom - exhibit negative and significant effects. This suggests that environments characterized by very high openness may expose domestic firms to competitive pressures too early, reducing their capacity to attract PE investment. Policies should therefore balance openness with measures that enhance firm competitiveness, such as targeted tax incentives, support for productivity improvements, and programs that facilitate scaling and technological advancement.

The strong positive effects of variables such as Labor force and Mobile phone subscribers highlight the importance of investing in human capital in order to gain skilled workforce. These findings also provide context for the negative association between Public spending on education and PE investment: current expenditure policies are not sufficiently aligned with market needs. Both sets of findings point toward the same policy direction -improving the efficiency, relevance, and labor-market orientation of education and training systems, rather than focusing on higher spending levels alone.

### 6.3.2 Divestments

Policies targeting PE divestment dynamics should aim to maintain liquidity for exits while reducing the risk of premature capital outflows. The strong positive impact of Trade openness on divestments highlights the role of economic integration in facilitating cross-border exits. However, this may also encourage premature capital outflows. Policymakers should therefore implement reinvestment incentives, such as favorable tax treatment for reinvested proceeds and mechanisms that facilitate secondary buyouts and domestic reallocation of capital.

The negative influence of stock price volatility reinforces the need for stable and transparent capital markets. Regulatory authorities should strengthen disclosure standards, enhance market supervision, and limit speculative trading practices to create predictable exit conditions. Maintaining inflation stability is equally important, as valuation uncertainty and real-return erosion hinder both exit and fundraising decisions.

### 6.3.3 Fundraising

Fundraising dynamics require a distinct policy approach aligned with the structural characteristics of the European financial system. Bank credit to the private sector consistently emerges as a highly robust determinant of fundraising, confirming that a strong banking sector is complementary to, rather than competitive with, private equity. Policies should therefore encourage joint financing mechanisms and credit facilities that support leveraged transactions.

Banking activity, together with significance of Urban population implies that fundraising is more likely to occur in environments with concentrated financial expertise. Strengthening urban financial centers and improving local financial infrastructure can therefore contribute to more effective capital sourcing. Findings on the negative impact of Political stability and Political globalization could be translated into measures that simplify regulatory procedures, reduce administrative burdens and ensure that capital-market rules remain efficient, predictable, and adaptable.

## 7. Conclusions

This paper provides a comprehensive assessment of the determinants of PE activity across Europe by analysing 43 independent variables and three core components of the PE activity: investments, divestments and fundraising. Using a structured empirical approach that combines multicollinearity analysis, BMA under several priors, and fixed-effects panel estimation, the study offers new evidence on how macroeconomic conditions, institutional frameworks, financial depth and structural factors shape the functioning of European PE markets.

The panel results reveal several consistent patterns. Trade openness emerges as the only determinant significant across all specifications, despite the fact that its effects differ systematically across stages: it is negatively associated with investment activity, yet positively related to both divestments and fundraising. This stage-dependent behaviour is further reflected in the roles of economic globalization and inflation, which also appear as significant determinants in multiple models but with contrasting signs. These findings underscore the importance of treating PE as a multi-stage process

rather than an aggregate one. The results also highlight the relevance of financial depth and structural conditions. Bank credit availability and market capitalization support the overall capacity of the PE sector, while urbanization, digital infrastructure and economic growth contribute to a more favourable environment for both investment and exit activity. At the same time, several institutional variables traditionally associated with liberalization - such as trade freedom and financial freedom - exhibit predominantly negative effects, suggesting that overly efficient or competitive environments may reduce the availability of viable targets and limit the scope for value creation.

These findings have direct implications for economic policy. They indicate that broad, uniform reforms are unlikely to be effective, as the drivers of investment, divestment and fundraising operate through different channels. Enhancing investment requires strengthening domestic firm capacity. Supporting divestments calls for stable, transparent capital markets and sustained integration with international markets. Attracting fundraising depends on financial depth, macroeconomic predictability and regulatory frameworks that enables flexibility and growth opportunities.

By linking empirical evidence with actionable policy guidance, this study contributes to a more integrated understanding of private equity. Rather than treating PE activity in isolation, the analysis highlights its embeddedness within broader institutional, macroeconomic and structural frameworks. In doing so, we provide a solid foundation for both scholarly inquiry and evidence-based policy aimed at fostering a more dynamic and resilient private equity landscape across Europe.

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