

FDI Determinants, Incentive Policies and FDI Effects in the Western Balkan Countries

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Abstract Foreign direct investment (FDI) is one of the least understood concepts in international economics. Their main proponents argued that FDI is a long-term and stable cross-border flow of capital that enhances productive capacity of domestic economies and helps them to meet their balance-of-payments shortfalls. Moreover, FDI supports transfers technology and management skills and links domestic economies with the wider global markets. But, in reality, the effects from FDI for the host countries are very ambiguous. There are number of debates among scholars and policy makers regarding its nature and impact on capital accumulation, technological progress, industrialization, growth and development in the host countries. However, in the last two decades, FDI has increasingly been viewed by policy makers in the Western Balkan countries (WBCs) as one of the most important external sources to finance development, increase productivity and import new technologies. This has been accompanied by an increase in competition among the WBCs to attract FDI, resulting in higher investment incentives offered by the host governments. So, for policy makers one of the most important issues is being able to determine which factors are crucial in driving FDI inflows and what the real effects of these policies are. Thus, the main focus of this paper is to address these questions.

Keywords FDI inflows • Determinants • Western Balkan countries • Effects • Economic policies

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1 Introduction

UNCTAD (2016) reported a strong recovery of FDI flows in 2015. Global FDI flows increased by 38% and reached to 1.76 trillion US dollars. This is their highest level since the global economic and financial crisis of 2008–2009, but they still remain below the 2007 peak. More than a half of the total inward FDI flows were realized in the developed economies. Strong growth in inflows was recorded in the European countries. In the USA, FDI almost quadrupled. FDI inflows in developing economies reached a new high of 765 billion US dollars and the Asian countries are the biggest recipients.

FDI inflows to transition economies declined further, from 85 billion US dollar in 2013 and 56 billion US dollar in 2014 to 35 billion US dollar in 2015. The low commodity prices, weak domestic markets and the geopolitical tensions were the main driving factors behind the negative trends of FDI. The fragility of the global economy, persistent weakness of aggregate demand, anemic economic growth in some commodity exporting countries, effective policy measures to restrain tax inversion deals and decreasing profits of multinational companies, are expected to result in FDI decline by 10–15% in 2016 (UNCTAD 2016).

However, in the upcoming periods, FDI inflows will be one of the most important external sources to finance development, increase productivity and import new technologies in the Western Balkan countries (WBCs). Scarce potential financial resources, from one side, and the progress of globalization and regionalization, on the other side, will increase a competition among the WBCs to attract FDI, and consequently it will result in higher investment incentives offered by the host governments. The ambiguous effects of FDI and their spillovers in the Western Balkan economies, anemic economic growth and moderate new job creation increasingly provoke debates regarding the concept of FDI incentives policies. So, for policy makers one of the most important issues is being able to determine which factors are crucial in driving FDI inflows and to design adequate investment incentive policies that will generate high net benefits for the domestic economy.

Thus, this paper focuses on the trend and distribution of FDI in the WBCs and makes an attempt to reveal the main determinants that have influenced the FDI inflows to the WBCs. Based on the available data on six WBCs (Albania, Bosnia and Herzegovina, Macedonia, Montenegro, Serbia and Kosovo) over the period 2004–2015 the authors are trying to assess the effects of FDI on economic growth in these countries as well.

The structure of this paper is as follows. The first section deals with the theoretical concepts of FDI and with the determinants which are most commonly recognized as relevant factors for FDI in the existent empirical literature. The second section deals with the trend and distribution of FDI among the WBCs. The third section is dedicated to the econometric analysis of the determinants of FDI in WBCs. The fourth section discusses the effects of FDI in these economies. Finally, the fifth section summarizes the main findings of the research.

2 Theoretical Background

The economic theory remains indecisive regarding whether FDI inflows are beneficial for the host economy. Considering the main properties of the neoclassical growth theory,¹ foreign capital inflows do not affect the long-term growth rate. A high level of FDI only temporarily increases the amount of capital per capita due to the declining returns on the capital. But the positive impact on long-term growth rate is likely to prevail if the FDIs stimulate technological development and increase employment in the host economy. The endogenous growth theory² gives more room for a potentially positive impact of FDI on the growth rate in the host economy. FDI positively affects the growth rate through research and development activities and by increasing the human capital. Also, FDI may influence growth through externalities which may include improvement of human capital, improvement of fixed assets, implementation of better organization forms, cooperation with local companies, better market access, and improved financing conditions (Sass 2003). These factors increase the productivity of the subsidiary of multinational companies and of the related local companies in the host economy.

However, the presence of FDI does not imply a technology transfer with positive impacts on economic growth by default. Perhaps the transferred technology is not appropriate for the level of human capital in the host economy, or there is no significant transfer of technology due to institutional deficiency or lack of receptiveness by local companies. Thus technology and new knowledge do not broadly disseminate in the economy. Sometimes, the isolation of the subsidiaries of multinational companies into special economic (free) zones precludes local companies from the potential positive effects of technology transfer.

The empirical literature finds mixed evidence on the positive impact on growth in the host country generated by FDI inflows. Alfaro et al. (2006) suggest that developed financial markets may create the preconditions for the links between foreign and local firms to turn into FDI spillovers. So, their research indicates that economies with well-developed financial markets experience growth rates that are twice of those of economies with underdeveloped financial markets. Furthermore, higher level of FDI leads to higher additional growth in economies with developed financial markets compared to those observed in the economies with poor financial markets. Alfaro et al. (2006) also points out that local conditions such as market structure and human capital are important for the effect of FDI on economic growth.

¹The model was independently developed by Solow (1956) and Swan (1956). The main properties of the model are: constant economies of scale, decreasing marginal products of inputs, positive substitution elasticity of inputs and existence of perfect competition. The steady-state capital—labor ratio is constant and growth equals the sum of exogenously given population growth and technological progress (Heijdra and Van Der Ploeg 2002).

²The endogenous growth models omit the assumption of perfect competition. The models are ‘endogenous’ because the growth rate is not affected only by exogenous parameters, but also by the savings rate. In the case of labor-substituting endogenous growth, labor becomes less important. For more on the endogenous growth models see Heijdra and Van Der Ploeg (2002).

Lee and Chang (2009) are on the same line. They are very conclusive that a highly developed financial sector can represent a source of numerous comparative advantages for the host country, and that these advantages make it easier for the country to absorb the positive impact of FDI, which in turn will encourage overall economic activity. De Mello (1999) does not find a significant and positive correlation between economic growth and FDI. He estimates the impact of FDI on capital accumulation, output and total factor productivity in the host economies and infers that the extent to which FDI is growth-enhancing depends on the degree of complementarities and substitution between FDI and domestic investment. Lipsey (2002) explains that subsidiaries of multinational companies generally have higher productivity than local companies, but the evidence for spillovers to local companies' productivity is mixed. Also he finds the mixture of impacts of FDI to host-country growth. The expected positive effects to economic growth and spillovers generated by the FDI highly depend on the host country policies and environments from one side and from the technological level of the industries and the companies in the host country on the other side.

Generally, FDI is a form of capital flow resulting from the behavior and international activities of multinational companies. Thus, the factors which affect the behavior of multinational companies strongly determine the scope and direction of FDI. Traditional theories in International Business used the OLI-framework as the explanation for FDI inflows. OLI framework was developed by Dunning (1993) and it is a set of factors consisting of ownership advantages (O), location advantages (L) and internalization advantages (I) that affect investors' decision making process. Ownership advantages refer to those assets of the investing companies that enable them to compete successfully in international markets despite the costs of setting up a subsidiary in the host country. These types of advantages typically encompass superior technology and management knowledge in comparison with local companies. Location advantages refer to those benefits that a host country may offer to an investing company, such as, large markets, low-cost labor force, low production costs and a good infrastructure. Internalization advantages cover advantages in terms of lower transaction costs and arise when it is more beneficial to enter the market of the host country with setting up local production rather than exporting products from the source country. While ownership and internalization advantages are investor's specific determinants, the location advantages are more specific to the host country. In this context, OECD (2001) argues that location advantages have gained importance in the multinational companies' decision making process and consequently this increases competition among host countries for attracting FDI.

For more comprehensive interpretation of the findings in the empirical literature on the determinants of FDI inflow it is helpful to note the distinction between two types of FDI identified in the theory i.e. horizontal FDI (HFDI) and vertical FDI

(VDFI).³ HFDI is more of a market-seeking type of FDI. Tariff-jumping or export-substituting FDI is a variant of the HFDI. Trade restrictions, high tariffs and transport costs, market size and potential growth of the host economy play an important role in the process of encouraging the HFDI. VFDI is a resource-seeking FDI (or cost-minimizing investment), when multinational companies choose the location of each segment of their production chain in order to minimize global costs. Availability of low-cost labor force strongly stimulates VFDI. As a result of these differences in companies' incentives the different characteristics of the host country may provoke different effects on HFDI and VFDI. However, according to Demekas et al. (2007), both types of FDI are subject to 'agglomeration', i.e. clustering in certain locations (where the business infrastructure serves the particular industry or there is presence of positive externalities through network effects) and 'herding' (where investors tend to follow a leader that establishes operations in a particular country). Demekas et al. (2007) emphasize that HFDI is more prevalent type of investment in developed countries, while recent FDI inflows to developing countries were mainly VDFI.

There are many determinants that the empirical studies have used to explain the scope and pattern of the FDI inflows. But, the most frequently used ones are: market size and growth prospects, natural and human resources endowments, physical, financial and technological infrastructure, openness to international trade and access to international markets, regulatory and policy framework and policy coherence, investment promotion and protection policy (OECD 2001).

Market size and growth prospects are important determinants for attracting FDI. Host countries with larger market size and higher degree of economic development provide better opportunities for multinational companies to explore their ownership and internalization advantages. Demirhan and Masca (2008) find out that countries with larger and expanding markets are more attractive for FDI. These markets offer possibility for multinational companies to receive higher return on their capital. On the same line is Charkrabarti (2001) too; he supports the idea that large markets are needed for better exploitation of economies of scale and scope. Furthermore, he argues that fast growing economies provide better opportunities for earning higher returns on investment and consequently making higher profits than ones growing slowly.

³Dunning (1993) distinguishes three types of FDI inflow based on the motives behind the investment decision of the multinational companies. The first type is market-seeking FDI whose aim is to serve domestic and/or regional markets in the host country. In this case, local production is seen as a more efficient than exports from the source country and thus this type of investment involve replication of production facilities in the host country. Second type is called resource-seeking FDI, when the prime motive for investment abroad is to obtain resources which are not available in the home country, such as natural resources, raw materials, or low-cost labor. The third type is called efficiency-seeking FDI and it occurs when multinational company may exploit benefits of economies of scale and scope from the common governance of geographically dispersed activities.

Availability of natural and human endowments is a driving factor for FDI attraction, as well. Export-oriented FDIs, in particular, tend to seek low-cost labor force and abundance of natural resources. Demirhan and Masca (2008) note that low labor costs have positive significant effects for FDI in labor-intensive industries and for export-oriented subsidiaries. Bellak et al. (2008) point out that recently attention has shifted from natural resources and labor endowments to ‘acquired’ endowments of resources, such as availability of intermediate goods, skilled labor, technological and innovative assets. Therefore, when wage rates vary little from country to country, then the skills of the labor force are expected to have an impact on decisions about FDI location.

The term “Infrastructure” covers many aspects—from transportation, telecommunication systems and financial system to institutional development. Differences in infrastructure influence the FDI location decision not only among countries but also among different regions within a country. According to OECD (2001), FDI is more likely to flow to countries or regions with better infrastructure facilities. Good quality and developed infrastructure increases productivity of companies in a country and consequently positively affects FDI inflows toward the country. However, Demirhan and Masca (2008) find out that there is substantial foreign participation in the infrastructure sector in developing countries and argues that from this aspect, poor infrastructure can be seen as an opportunity for foreign investment in these countries.

It is very likely that host country’s openness to international trade and access to international markets may stimulate the inflows of FDI. But, according to Demirhan and Masca (2008), the evidence of the empirical literature is not decisive. For instance, market-seeking FDI are more prone to trade restrictions. The intuitive reasoning behind this is that multinational companies prefer to set up subsidiaries in the host country due to difficulties with import of their products to the country. Additionally, high trade restrictions limit domestic market competition. Contrary to market-seeking FDI, export-oriented FDI are more prone to realize in the more open economies. OECD (2001) suggests that the attractive and strategic geographic position of a country could also be a significant determinant in attracting FDI.

A transparent and well-functioning legal framework, accompanied by a good business environment is of prime importance for attraction of FDI. Regulations regarding the entry and operation of foreign companies and treatment of foreign companies are of particular interest to potential foreign investors. Bureaucratic and restrictive administrative procedures accompanied with rent-seeking activities incur additional costs which adversely affects potential FDI decisions and successive reinvestment of earnings. In this context, political risk is also relevant for attracting FDI. In general, as long as foreign investors are confident in being able to work profitably without excessive risk to their capital, they will continue to invest (Kearney 2016).

Investment promotion activities and incentives packages are becoming increasingly important in the process for attracting FDI. Host countries offer different fiscal, financial and other incentives (most of them are in the domain of the state-aid measures) that affect investors’ future net profit.

In a nutshell, there are many determinants that have been used in empirical studies to explain the scope and pattern of the FDI inflows. The most relevant determinants vary from country to country, from region to region. One set of determinants are relevant for developed economies, where most of the FDI inflows are from HFDI. For these country ‘acquired’ endowments of resources, such as availability of intermediate goods, skilled labor, technological and innovative assets are more important determinants in attraction of FDI. Developing countries are target for VFDI and consequently they attract FDI through low labor and production costs and generous investment policy with high fiscal and financial incentives.

3 Trends and Distribution of FDI in the Western Balkan Countries

Throughout the 1990s most of the WBCs suffered from political and economic instability. Transition reforms and slow economic recovery resulted in lower levels of FDI inflows compared to other transition countries from South and Central Eastern Europe. According UNCTAD statistics (WIR database) over the whole 1990–2000 period, the inward FDI stock in the WBCs amounted US\$ 8.4 billion or 4.5% of total inward FDI stock in all transition countries.

Since 2001, under the Stabilization and Association Process, lunched by the European Union, WBCs implemented trade liberalization with the EU, gradually improved the business environment and privatized a significant number of their state owned companies. Despite these facts, anemic trends in FDI inflows in WBCs are continuing beyond 2001, when the whole region reached a satisfactory level of political and macroeconomic stability (see Fig. 1). The share of the WBCs in the total FDI inflows in transition economies is low during the whole analyzed period.

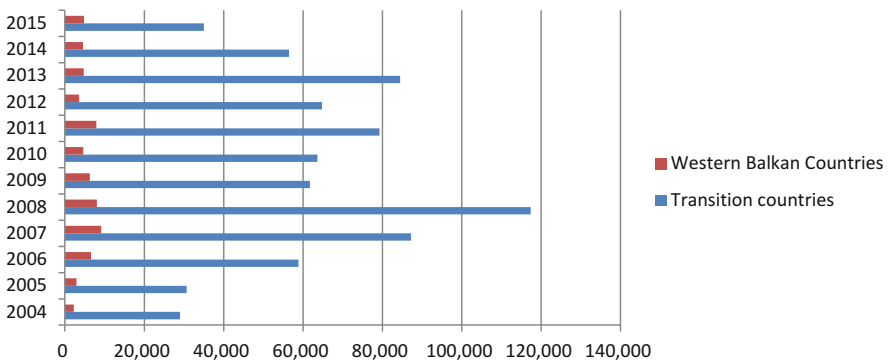


Fig. 1 FDI inflows by region (in 10,000 US dollars) in the period 2004–2015. Source: UNCTAD, WIR database (www.unctad.org). Note: Transition economies: Western Balkan countries and Commonwealth of Independent States (CIS)

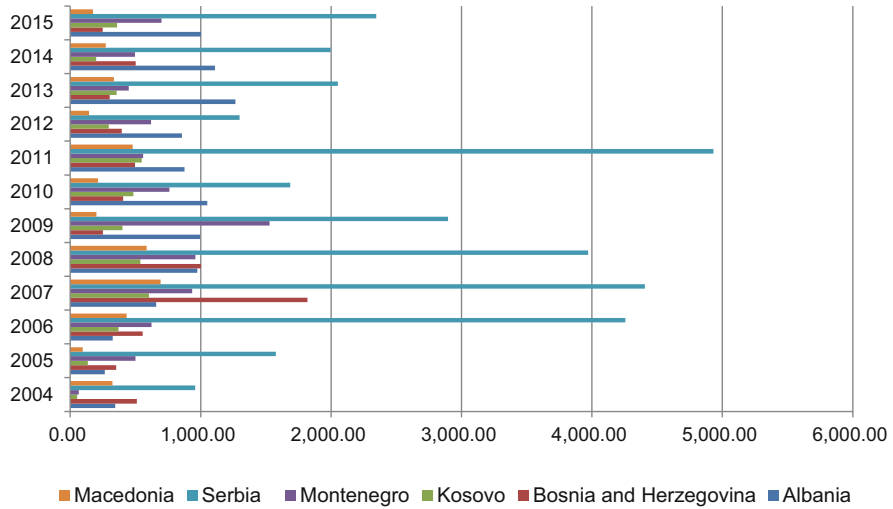


Fig. 2 FDI inflows by country in the period 2004–2015 (in 100,000 US dollars). Source: UNCTAD, WIR database (www.unctad.org)

In 2004 only 9.40% were directed in WBCs, in 2005 it was 9.53%, in 2010 7.23% and in 2015 it was 13.81%. The higher share in 2015 is due to the significant decline in the total FDI inflows in all transition countries.

It is very likely that low FDI inflows are due to the ‘Balkan effect’ and on the competition from more prosperous transition economies. At first glance, an image of wars and conflicts rather than investment opportunities and economic potential, is characteristic for this region. Considering this, Estrin and Uvalic (2013) found out significant negative regional effect on the FDI inflows to WBCs. Furthermore, the FDI inflows by country were very uneven. During the period 2004–2015 the FDI inflows in Serbia and Montenegro were higher than in the rest of the WBCs. This was a result from the advanced privatization processes in these economies where most of the prosperous state-owned companies were sold out to foreign investors. The economic crisis from 2007 had negative impact on FDI inflow in the region. In all countries FDI inflow has not reached its pre-crisis level (Fig. 2).

The values of the annual averages of FDI inward stock by country are uneven as well. During the three comparable periods, Serbia and Bosnia and Herzegovina have the highest value of the annual average of FDI inward stock (see Fig. 3). Variations in the FDI inward stock among countries are due to the different impact of the economic crisis on the individual countries, to country’s privatization process⁴ and in some part to the countries’ investment incentives policies.

The distribution of FDI by sector of economic activity is very important in terms of assessment of long-term effects of FDI inflows on host economies. Based on the

⁴Due to war and political instability Bosnia and Herzegovina has started privatization process very late, after 2003.

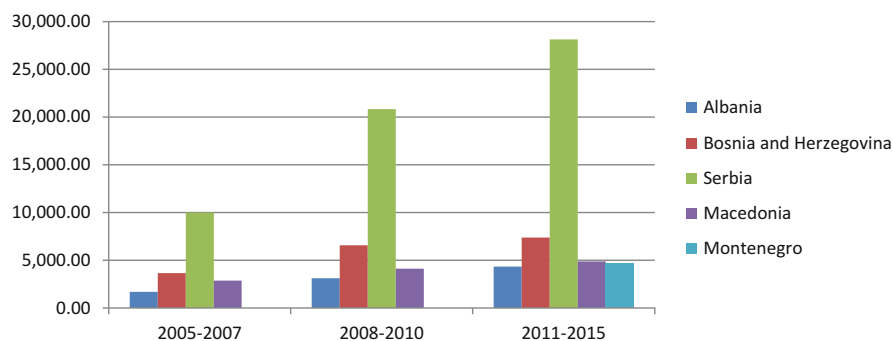


Fig. 3 Annual average FDI inward stock by country for the period 2005–2017, 2008–2010 and 2011–2015, respectively, (in millions US dollars). Source: Authors' calculations based on UNCTAD, WIR database (www.unctad.org). *Note: available data for Montenegro is for the period 2011–2015

Table 1 Inward FDI stock/flow by sector or industry in the WBCs

Country	Latest available year	Inward FDI stock/flow by sector or industry (in percent)				
			Primary	Manufacturing	Services	Unspecified
Albania	2012	Stock	25	12	52	11
BIH	2015	Stock	4	28	63	5
Macedonia	2014	Stock	5	36	59	0
Serbia	Q12016	Flow	9	31	58	2
Kosovo	2015	Flow	1	7	91	1

Source: Authors' calculation based on statistics from the central banks of WBCs

Note: There are no available data for Montenegro

countries' statistical data for their international investment position, the services sector accounted for most inward FDI stock (or flow). For the four WBCs (Albania, Macedonia, BIH and Serbia) FDI in the services sector accounted to 58% of the total, on average. Kosovo is a unique case, where in 2015 91% of the total value of all FDI flows was directed to the services sector (see Table 1). Banking, telecommunications, real estate and retail trade have been among the most preferred sectors of foreign investors in the WBCs. The manufacturing sector has absorbed around 22.8% of total FDI. Serbia (31%) and Macedonia (36%) have attracted a considerable amount of FDI in manufacturing.

According to the UNCTAD (2014) report on FDI distribution by sectors, the situation is similar in developed and other transition countries as well (see Fig. 4). In 2011, 64% of total FDI were directed to the services sector, 25% in manufacturing and 6% in the primary sector. Collapsing commodity prices resulted in a significant decline of FDI flows to the primary sector in developed countries. In the transition countries as a result of structural characteristics of their economies,

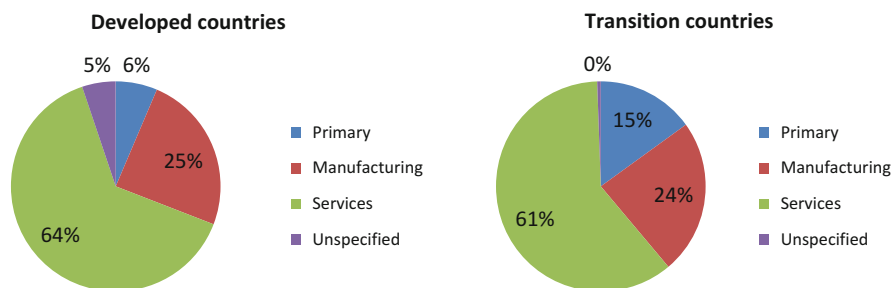


Fig. 4 Estimated Inward FDI stock, by sector or industry, in developed and transition countries for 2011. Source: Authors' calculations based on UNCTAD, WIR database (www.unctad.org)

Table 2 FDI inward stock or flow by source country

Country	Latest available year		Inward FDI stock/flow by source country (top 5 investors -in percent of total)				
Albania	2013	Stock	Greece	Canada	Netherlands	Austria	Turkey
			37.75	27.96	13.65	13.51	10.0
BIH	2005	Stock	Austria	Serbia	Croatia	Russia	Slovenia
			20.39	16.91	16.88	8.05	6.99
Macedonia	2013	Stock	Netherlands	Austria	Greece	Slovenia	Hungary
			20.48	12.17	20.89	9.97	8.15
Montenegro	2011	Stock	Russia	Italy	Switzerland	Hungary	Cyprus
			15.4	11.8	9.0	8.4	8.2
Serbia	2015	Flow	Norway	Italy	Hungary	Russia	South Africa
			35.23	12.02	7.45	5.97	4.44
Kosovo	Q1 2016	Flow	Turkey	Germany	Switzerland	Slovenia	Austria
			11.14	9.3	7.61	6.86	5.59

Source: Authors' calculation based on statistics from the central banks of WBCs

the share of the primary sector in the FDI stock is higher (15%). A share of FDI in services is 61% of total, while in the manufacturing it is 24%.

Additional insight is provided by Table 2, which contains the major source countries of FDI in the WBCs. Almost all FDI source countries are the neighboring countries of the WBCs. Intuitive reasoning suggests that distance between host and source country may have a significant effect on FDI inflows. In regards with this, Demekas et al. (2007) argued that gravity factors explain a large part of FDI inflows in SEE, but also host-country investment policies such as relative unit labor costs, the corporate tax burden, infrastructure and the trade regime are matter.

4 Determinants of FDI in the Western Balkan Countries

In order to study the main determinants of FDI inflows in WBCs, the selection of variables is based on the previous empirical research for the determinants of FDI in Central European and South Eastern European Countries made by Estrin and Uvalic (2013), Brenton et al. (1999), Campos and Kinoshita (2003), Bevan and Estrin (2004), Bucevska (2009) and Trpkova and Tashevskva (2009). The paper analyzes the impact of three groups of variables: (1) standard independent variable (market size, labor costs, quality and skills of labor force, quality of infrastructure facilities and transportation cost), (2) policy variables (macroeconomic stability and openness of the economy) and (3) non-economic factors: governance and the effect of EU accession of the country on the FDI).

This econometric analysis is based on the models used by Bucevska (2009), with some modifications, and they are estimated by using the ordinary least square method (OLS). Based on a sample of 60 observations (12 years and 5 countries),⁵ the following four models were used:

$$\ln FDI_t = \beta_0 + \beta_1 \ln GDP + \beta_2 LCOST + \beta_3 SECONDARY + \beta_4 \ln MOBILE + \beta_5 \ln DIST + u \quad (1)$$

$$\ln FDI_t = \beta_0 + \beta_1 \ln GDP + \beta_2 LCOST + \beta_3 SECONDARY + \beta_4 \ln MOBILE + \beta_5 \ln DIST + \beta_6 CPI + \beta_7 \ln EXIM + u \quad (2)$$

$$\ln FDI_t = \beta_0 + \beta_1 \ln GDP + \beta_2 LCOST + \beta_3 SECONDARY + \beta_4 \ln MOBILE + \beta_5 \ln DIST + \beta_6 CPI + \beta_7 \ln EXIM + \beta_8 CRISK + u \quad (3)$$

$$\ln FDI_t = \beta_0 + \beta_1 \ln GDP + \beta_2 LCOST + \beta_3 SECONDARY + \beta_4 \ln MOBILE + \beta_5 \ln DIST + \beta_6 CPI + \beta_7 \ln EXIM + \beta_8 CRISK + \beta_9 NEG + u \quad (4)$$

where:

t —is a particular year ($t = 1, 2, \dots, 12$) in the period 2004–2015; $\ln FDI$ —is the logarithm value of the 28 EU FDI outward stock to the WBCs; (from Eurostat); $\ln GDP$ —logarithm value of the gross domestic product per capita of the WBCs measured in million Euros (from Eurostat); $LCOST$ —data on average gross monthly wages in US dollars (from UN Economic Commission for Europe); $SECONDARY$ —total gross secondary school enrolment rate (from UNESCO Institute for statistics); $MOBILE$ —number of active mobile cellular subscriptions per 1000 people in the WBCs (from World Bank WDI database); $DIST$ —airline distance in kilometers between capital cities of 28 EU countries and the capital cities of WBCs (from indo.com/distance); CPI —consumer price index where 2010 is the base year (from Eurostat); $\ln EXIM$ —logarithm value of the share of export

⁵ Available data for: Albania, Bosnia and Herzegovina, Macedonia, Montenegro and Serbia.

and import in GDP (from UNCTAD database); CRISK—denotes the rank of the country according to the Euromoney country risk ranking (from www.euromoneycountryrisk.com); NEG—dummy variable for EU formal negotiations. It takes value 1 for the period from formal beginning of the accession negotiations onwards and 0 otherwise. Obtained econometric results are presented in Table 3.

The results suggest that GDP per capita, as a proxy for market size, labor costs, transportation costs and quality of infrastructure have the main roles in attracting FDI from the European Countries. When it comes to the educational level of the labor force, we may conclude that foreign investors are not looking for well-educated and skilled workers, but they prefer a cheap labor force. This confirmed our previous expectations that FDI in the WBCs is an efficiency-seeking type of investment. Distance among source country and host country affects inversely the level of FDI stock in WBCs. Macroeconomic stability (measured by CPI) and the level of openness of the economy (measured by export and import/GDP ratio) do not significantly influence the investors' decisions. Regarding country risk; this variable is statistically significant and shows that a better ranking of a country will stimulate more FDI inflows. The last model (4), shows that the dummy NEG variable is statistically significant, which suggests that EU accession effect has a strong impact on the attracting FDI in the WBCs.

Table 3 Determinants of FDI (Dependent variable is FDI stock in year t)

Variable	M1 (ln FDI)	M2(lnFDI)	M3(lnFDI)	M4(lnFDI)
lnGDP	0.6543 (0.1733)***	0.6448 0.1821***	0.0141 0.3525	0.1729 0.3727
LCOST	0.0009 (0.0002)***	0.0009 (0.0003)***	0.0009 (0.0004)*	0.0004 0.0004
SECONDARY	0.0063 (0.0273)	0.0032 0.0292	0.0214 0.02814	0.0413 0.0281
ln MOBILE	0.5266 (0.0924)***	0.4357 0.1027***	0.5266 0.1132*	0.4058 0.2341
lnDIST	-1.6753 (0.4206)***	-1.2383 0.8415	-0.9921 0.8207	-1.2383 0.9527
CPI		-0.0014 0.0035	0.0025 0.0036	-0.0017 0.0034
lnEXIM		0.7521 0.9072	0.0083 0.0286	1.4897 0.9530
CRISK			0.0522 0.0289*	0.0249 0.0298
NEG				0.4583 0.1898*
Number of Observations	60	60	60	60
Adjusted R ²	0.94	0.94	0.95	0.96

Standard errors are presented in brackets below the coefficients

***, **, *, indicate statistical significance at level of 1%, 5% and 10% respectively

5 FDI Effects and Investment Incentives Policies in the Western Balkan Countries

The main goals of government incentives policies for attraction of FDI is framed in higher rates of economic growth, improvement of export structure and employment generation in the host countries. Thus, using this frame we will analyze the effects of FDI in the WBCs.

FDI has played an important role in the WBCs during their transition period to market economy. As an external capital accumulation, FDI inflows have supplemented the scarce domestic savings and helped to complete privatization processes in these economies. Thus, the ratio of FDI inflows to gross fixed capital formation (GFCF) has higher values than the average of the transition countries during the period 2004–2015. Within the WBCs, the highest values of ratio of FDI to GFCF have Montenegro (76.2%) and Serbia (33.8%) (Table 4).

The inward FDI stock as a percentage of GDP is considered as an indicator of the penetration of foreign capital in an economy. Due to the low level of domestic accumulation, inward FDI stock as a percentage of GDP has higher values in all WBCs (except in Albania), than in the transition countries (see Table 5). The annual

Table 4 FDI inflows as a percentage of GFCF [Annual average for the period 2004–2015 (in percent)]

Transition countries	14.7
WBCs	29.5
Albania	23.3
Bosnia and Herzegovina	17.2
Montenegro	76.2
Serbia	33.8
Macedonia ^a	18.26

Source: Authors' calculations based on UNCTAD, WIR database (www.unctad.org)

^aData for the period 2004–2013

Table 5 FDI inward stock as a percentage of GDP [Annual average for the period 2004–2015 (in percent)]

Transition countries	26.3
WBCs	42.9
Albania	26.2
Bosnia and Herzegovina	35.4
Montenegro ^a	106.7
Serbia	48.6
Macedonia	43.9

Source: Authors' calculations based on UNCTAD, WIR database (www.unctad.org)

^aData for the period 2010–2015; No available data for Kosovo

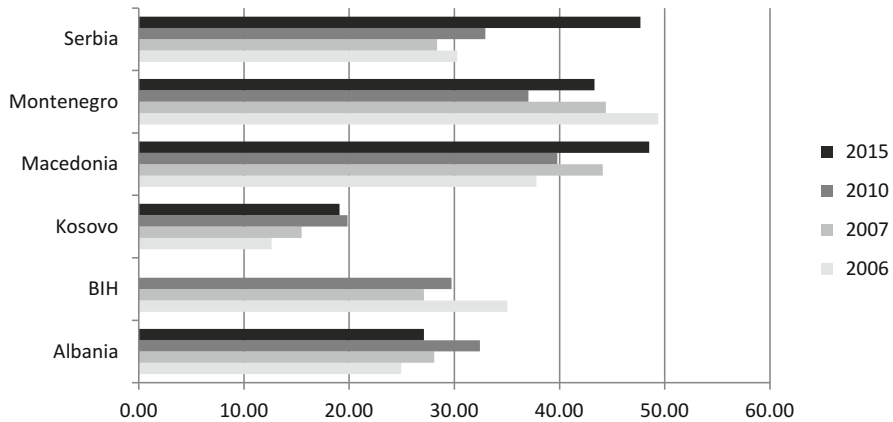


Fig. 5 Exports of goods and services as a percentage of GDP (for selected years) Source: World bank database (world development indicators)

average value of this ratio, for the entire period, for all transition countries was 26.3% and 42.9% for WBCs.

The 'exports of goods and services to GDP' ratio increases during the whole analyzed period, except in 2010, when as consequence of the economic crisis the ratio decreased. But, given that around 60% of all FDI inflows have been attracted in the services sector, FDI inflows have not significantly contributed to improving the export structure in the WBCs. The intermediary goods, food and raw materials still keep their high levels in the structure of exports.⁶ This type of export structure makes the Western Balkan economies more vulnerable to volatility of economic activities in the developed countries, since the markets of the latter are their main export destination (Fig. 5).

For more than 20 years, WBCs have struggled with persistent high unemployment rates. Considering the fact, that almost 60% of all FDI inward stock was directed to the services sector, it is not surprising that an increased level of FDI has not generated significant new job positions in these economies. Moreover, the amount of greenfield FDI in the WBCs is low. In 2015, only 24.04% of the total greenfield FDI in the transition countries was in the WBCs. The distribution of greenfield investments is very uneven among the WBCs (see Table 6). Labor tax incentives have not stimulated the process of new job creation in the affiliations of foreign companies.

In view of the changes in values of the Global Competitiveness overall index (GCI) 2015–2016, the competitiveness of the economies from the Western Balkan region has not improved. Serbia, Montenegro and Bosnia and Herzegovina received

⁶A small change is notice in the structure of Macedonian export in 2015, when goods with higher added value increased their participation. This is due to the exports of the foreign companies which operate in the established free economic zones.

Table 6 Distribution of the total value of announced greenfield FDI projects in WBCs (for selected years, in percent)

	2005	2010	2015
Albania	15.04	1.17	1.53
Bosnia and Herzegovina	52.03	6.26	36.71
Montenegro	2.11 ^a	7.49	0.50
Serbia	26.87	75.95	56.25
Macedonia	6.06	9.14	5.01

Source: Authors' calculations based on UNCTAD, WIR database (www.unctad.org)

^aNote: calculation based on the data for 2006

lower values of the index for the analyzed period (2015–2016) and have lower ranks (94, 70 and 111, respectively (Schwab and Sala-i-Martin 2015) compared with their ranks in 2008–2009 (85, 65 and 107, respectively (Schwab and Porter 2008). The lower ranks in the overall GCI ranking mean that competitiveness of these economies has decreased. Only Albania and Macedonia registered better rank position in terms of GCIs and they have moved from 108 and 89 place in 2008–2009 to the 93 and 60 place in 2015–2016, respectively.

To summarize, throughout the whole analyzed period, the FDI inward stock was not sufficient to provide significant impulse for more dynamic economic development in the WBCs. As Christie (2003) stated, the economic costs of instability in the Balkan region in terms of forgone FDI have been very high. As a result of this, the gap between the estimated potential and the real FDI stock is very large. Demekas et al. (2007) showed that for 2003, the gap between potential and real FDI stock in Albania, Bosnia and Herzegovina and Macedonia was very high. They argued that the situation has moderately improved, but the significant gap still exists. Thus, Demekas et al. (2007) suggested that WBCs may increase FDI inflows by designing FDI-friendly investment policies for promotion and attraction of foreign investors.

However, as a result of the increased levels of international and regional trade liberalization, WBCs have little room to apply the standard instruments for attracting FDI. Therefore, the focus of their policy is given to other promotion activities and measures (i.e. government subsidies per job created by foreign investor, real estate provide below market prices, customs free areas, establishing special economic zones, providing direct financial assistance and reducing the total tax burden on foreign investors). But, on the other side, governments attach various conditions and performance requirements to the incentives measures in order to assure the FDI delivers in terms of employment generations, higher growth rate, restructuring of export structure and increasing export of goods and services. Haaland and Wooton (1999) found out that the level of subsidies may be so high that the foreign investors are the net beneficiaries even if considerable positive effects exist in the host economy. In that context, UNCTAD (2016) reported that in 2015, 85% of measures were favorable to foreign investors.

Due to the lack of reliable data, we are very inconclusive regarding the overall effectiveness of the national policies for promotion and attraction of FDI in the WBCs. There is no strong evidence which may confirm that the quantitative effects of the increased levels of FDI inflows are transformed into better qualitative performances of the Western Balkan economies.

6 Conclusion

The analysis in this paper leads to the following conclusions:

- Due to the high political and economic instability of the Western Balkan region, historically WBCs have not been an attractive destination for the inward FDI flows and stock. Their importance as host countries has increased after 2001, when the level of FDI inward flows increased, although it still remains on a lower level when compared to the more prosperous transition countries of South Eastern Europe. Cviic and Sanfey (2010) stressed that the negative image of the Western Balkan region adversely affects FDI inflows in this group of countries.
- Most of the FDI to the WBCs are VFDI type, which means that foreign investors prefer cheap labor force over well-educated and skilled workers. In addition to low labor costs, market size, transportation costs and quality of infrastructure play vital role in attracting FDI in the host countries. Also, the progress in the EU accession process has significant effect in the attracting FDI in the host countries of the Western Balkan region.
- More than half of the total inward FDI stock has been directed into the services sector of the WBCs and consequently FDI has not had significant effect on the process of job creation and restructuring of the countries' export structures. Furthermore, low commodity prices, weak domestic markets and geopolitical tensions are key factors that keep the greenfield FDI on a very low level in these countries.
- Due to the specific economic characteristics of the WBCs, there are low spillover effects of the FDI over the other sectors in economies. Domestic companies are not able to absorb the positive aspects of technology transfers from the FDI. Thus, during the whole analyzed period, economic growth in the regions was anemic and it did not transform into qualitative economic development.
- The progress of globalization and regionalization has yet another important consequence regarding the investment incentive competition. As the integration of markets further intensifies, the competition is likely to occur between more and more countries. This is because all these countries offer similar conditions, and the incentives have a greater weight in the choice between them. Thus policy makers in the WBCs have little room to apply the standard instruments for attracting FDI and they have put the focus on other promotion activities and

measures. But on the other hand, in order to preserve the domestic economies from potential negative behavior of foreign investors, governments should impose precise performance requirements to foreign investors as a precondition for gaining access to the fiscal and other financial benefits.

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