THE IMPORTANCE OF FDI AND INSTITUTIONS IN THE DEVELOPMENT OF THE WESTERN BALKANS

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Foreign direct investment and efficient institutions are essential for the economic growth of every country. The same is true for the Western Balkans economies – Albania, Bosnia and Herzegovina, Montenegro, North Macedonia, and Serbia. Using a panel data analysis for the 2000-2019 period, the study shows that both FDI and institutional development significantly negatively affect economic growth. When interacted, the results reveal no impact of FDI, institutional development, or their interaction term on economic growth. A lack of FDI inflows in recent years and low levels of institutional development could be attributed to such results. This calls for urgent actions on the part of policymakers if they want to turn this situation in their favor.

Introduction

Throughout history, the Western Balkans region – Albania, Bosnia and Herzegovina, Montenegro, North Macedonia, and Serbia – played a central role in world affairs due to its strategic position within geopolitical and geoeconomics relations. At the end of the twentieth century, the region was exposed to several military conflicts – in Bosnia and Herzegovina (1992–1995), Kosovo (1998–1999), and Macedonia (2001) – and various sanctions[1] that affected its overall development. Since the 1990s, the region was also subject to significant structural changes as it moved from a socialist or

[1] In addition to wars, several countries were under embargos: For instance, during 1992–1996 and 1998–1999 periods, the Federal Republic of Yugoslavia (later known as Serbia and Montenegro) was under severe UN and EU sanctions. Similarly, North Macedonia was under economic sanctions imposed by Greece (Estrin & Uvalić, 2016).

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planned economy to a market economy. This process is still ongoing as these countries are considered transition economies.

Due to their transitional nature, these countries are undergoing significant institutional reforms. However, their institutional development is not meeting the European Union (EU) standards. A high level of corruption, lack of rule of low, and a large but inefficient local, regional, and state administration are but few persisting problems faced by the Western Balkans countries (Popovic et al., 2020). These factors affect the foreign direct investment (FDI) inflows and economic growth of these countries.

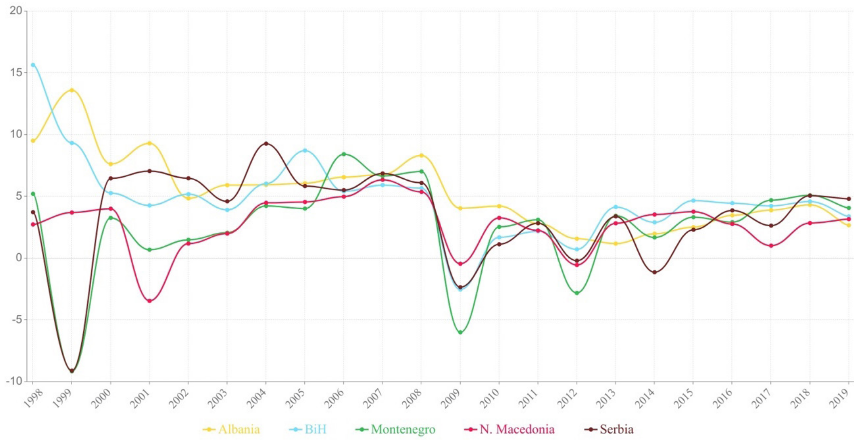
The Western Balkans countries in particular and transition economies, in general, are in dire need of FDI inflows that would support infrastructural and other developmental projects that could boost economic growth. The main objective of this study is to look at the effect of FDI and institutional development on economic growth, focusing on the Western Balkans countries.

The rest of the chapter is structured as follows. *Section 2* provides an overview of the Western Balkans regions. *Section 3* briefly discusses the existing body of literature on the topic. *Section 4* describes the data, methodology, and a brief discussion of empirical results. Finally, *Section 5* provides concluding remarks.

The Western Balkans in Numbers: An Overview

As pointed earlier, the Western Balkans countries faced several impediments during the 1990s due to military conflicts that led to political and economic sanctions. The prevalence of nationalist ideologies contributed to inefficient development and policy implementations. Positive trends in the form of macroeconomic improvements, economic reforms, and rapid growth started with the new millennium (see Figure 1). Furthermore, the region witnessed significant improvements in international trade within the region and with the EU following trade liberalization and privatization. This also led to a rise in the region's FDI inflows, which was not the case before 2000. Besides the FDI inflows from the EU countries, the region attracted significant investments from Russia, Turkey, Norway, and Canada. Unfortunately, instead of these funds being directed into manufacturing sectors, the majority went into non-tradable services such as banking, telecommunications, retail trade, and real estate. As a result, FDI inflows contributed to economic growth only slightly (Uvalić, 2010, 2013).

Table 1: GDP per capita growth (annual %)

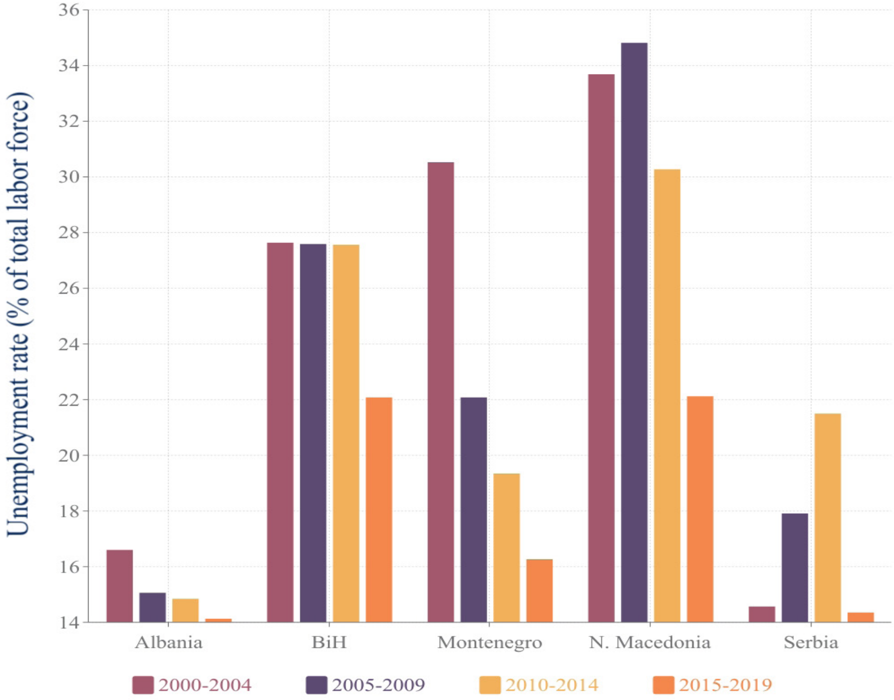


Source: World Development Indicators

These positive trends came to a halt in 2008 with the emergence of the global financial crisis that exposed all weaknesses and structural issues of the countries. Consequently, the region experienced an economic slowdown and started its recovery only in 2010-11. However, prior privatization led to the integration of the Western Balkans region with the EU. This, in turn, led to another round of recession caused by the eurozone's sovereign debt crisis (Uvalić, 2013).

All of this contributed to the already difficult situation in the region. Several structural problems dominate, such as increasing current account and trade deficits due to inefficient policies, infrastructure, and non-competitive enterprises on global markets (Estrin & Uvalić, 2016). Furthermore, throughout the study period, the region faces low employment rates far higher than in EU member states. For instance, the highest unemployment rate was in North Macedonia, where it was 33.70% for the 2000-2004 period and going down to 22.13% for the 2015-2019 period. During the same period, the unemployment rate went down from 16.62% to 14.14% in Albania, from 27.65% to 22.09% in Bosnia and Herzegovina, and 30.54% to 16.28% in Montenegro. The unemployment rate of Serbia was on the rise since the 2000-2004 period when it was 14.58% but started decreasing after 2013 and was 14.36% for the 2015-2019 period (see Figure 2 for details).

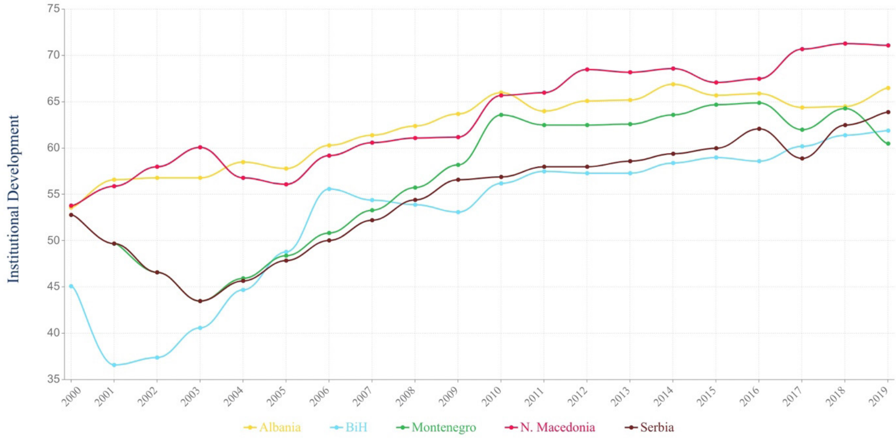
Table 2: Unemployment rates of the Western Balkans countries (% of the total labor force)



Source: International Labour Organization, ILOSTAT database.

While the Western Balkans countries have been undergoing significant institutional changes over the years, these processes and conditions of these countries differ significantly. Even though many changes and reforms have been done (some of which have been sponsored and supervised, to some extent, by EU representatives and institutions), there are still numerous institutional issues that are detrimental to FDI inflows and economic growth (Popovic et al., 2020). Figure 3 shows a steady improvement in the institutional development of the Western Balkans countries, with North Macedonia being the leader. According to the Heritage Foundation's overall score for institutional development, the lowest point (36.60) was recorded in BiH in 2001 and the highest in North Macedonia (71.30) in 2018, with the region's average score being 58.07. During the same period, the lowest point (47.30) among the EU member states was recorded in Bulgaria in 2000 and the highest (82.60) in Ireland in 2007 with 67.86. However, it is worth noting that the gap between the EU and the Western Balkans states is narrowing down if we focus on the last ten years alone, indicating significant convergence of institutional development between the two regions.

Table 3: Institutional development of the Western Balkans(the overall score)

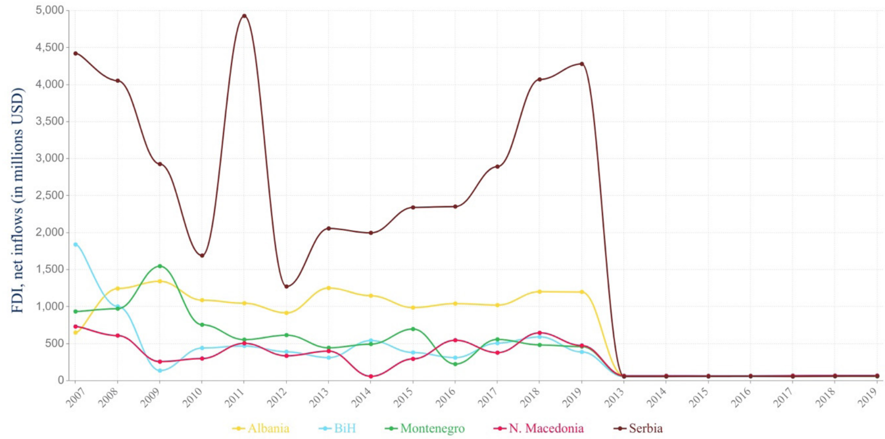


Source: The Heritage Foundation.

Although the region witnessed a relative improvement in the overall institutional development, as pointed briefly above, this did not help the region attract FDI for its further development. Low growth rates and competitiveness of the region, combined with high unemployment (Popovic et al., 2020) and lack of efficient institutions and the overall infrastructure, are some of the main reasons for the lack of investments inflows in the region. Foreign investors are also reluctant to invest in the region as the business environment is not investment-friendly. According to the latest Doing Business Index published by the World Bank, North Macedonia (17) is ranked the best, followed by Serbia (44), Montenegro (50), Albania (81), and Bosnia and Herzegovina (90).[2] Figure 4 shows the trend of foreign investments in the region. Since 2007, Serbia has attracted more FDI than the other countries together. However, there has been a sharp decline in the FDI inflows in the region from 2013. Since then, FDI inflows in the Western Balkans have been very low (below 9% of GDP).

[2] For details see: https://www.doingbusiness.org/en/rankings?region=europe-and-central-asia.

Table 4: Net inflows of FDI (in millions of USD)



Source: International Monetary Fund, Balance of Payments database.

Literature Review

There is a significant amount of research on the growth-FDI and growth-institutions relationships. In recent studies, researchers are investigating the combined effect of the FDI and institutions on economic growth. In the following paragraphs, the study will discuss the main findings of these studies. In short, the results offered by these studies are inconclusive.

FDI–economic Growth

Given its advanced economies and institutions, the developed world attracted most international FDI inflows in the past. In recent years, however, the World Investment Report points to a changing trend. According to the Report, the global FDI flows decreased by 13% to $1.3 trillion in 2018 (from $1.5 trillion in 2017). This marked the lowest FDI flows since the 2008 global financial crisis. At the same time, developing countries recorded the highest share (54%) of the global FDI with an annual 2% steady increase (UNCTAD, 2019).

The existing empirical studies offer no clear conclusions when it comes to the topic of this study. For instance, (1992) FDI inflows (measured as a percentage of GDP) positively correlate with GDP per capita across developed countries. They find that FDI inflows are more beneficial for countries with higher per-capita income levels than those with lower per capita income levels. This is due to insufficient technological and human capital levels in emerging countries, making them less competitive and less attractive to large corporations (Blomstrom et al., 1992). Similarly, Bengoa & Sanchez-Robles (2003), Zhang (2001), Elboiashi (2015), and Borenstein (1998) find that FDI inflows are highly significant only in economies that meet minimum requirements of human capital needed, i.e., that the economy is absorbent enough to use and efficiently utilize FDI.

A long-term relationship between FDI and the real GDP is found in Estonia, transforming itself from a planned- to the market-based economy within a short period (Kisswani et al., 2015). Focusing on ten European transition economies, Asteriou et al. (2005) find that a ratio of FDI net inflows to GDP has a positive and significant impact while the ratio of the net portfolio investments to GDP has a negative but insignificant effect on economic growth.

However, the impact of FDI on economic growth can also be damaging. While FDI contributes to the technology, know-how, skills transfer, and efficient resource allocation, it reduces local firms' comparative advantage and labor productivity (Lutz & Talavera, 2004; Minović et al., 2021). Further, Anetor (2020) finds that FDI is significantly negative while portfolio investment has a positive but insignificant impact on sub–Saharan African countries' economic growth–contrary to Asteriou et al. (2005) mentioned above.

In addition, the studies by Carkovic and Levine (2002) and Lyroudi et al. (2004) find no significant relationship between FDI and economic growth. The former focused on 72 developed and developing economies, while the latter focused on 17 transition economies (Central and Eastern Europe).

Several studies are investigating this relationship in the case of the EU and the Western Balkan countries. For instance, Angelopoulou and Liargovas (2014) examine the FDI-growth relationship using several sample groups. In particular, focusing on 27 EU, 16 EMU member states, and 18 transition economies, they found no evidence for causality between the two. Lyroudi et al. (2004) report similar results. Similarly, Estrin & Uvalic (2016) report the insignificant impact of FDI on value-added, employment, and exports of manufacturing sectors of the Western Balkan countries

Institutional Quality and Economic Growth

The relationship between institutional development and economic growth is subject to significant scientific scrutiny as well. Different authors used different proxies such as property rights, freedom of the press, bureaucratic procedures, democracy levels, political stability, business environment indices, and others for institutional development measures. Conventional wisdom says that well-functioning institutions have a positive impact on economic growth. However, institutional development itself depends on several factors. For instance, institutional efficiency that leads to the economic growth of Pakistan depends on efficient government and functional democracy (Murtaza & Faridi, 2016). Similarly, an institution's impact on economic growth depends on the public debt level (Sani et al., 2019) and entrepreneurship (Urbano et al., 2019).

At the same time, bureaucratic quality, property rights, and political stability of nations contribute to economic growth and investment (Knack & Keefer, 1995), while corruption decreases economic growth (Easterly, 1999; Minović et al., 2021). Economies with higher political, civil, and economic freedom are almost twice as efficient and productive as societies with lower degrees of freedom (Scully, 1988). Furthermore, economies with selected few or 'elite' that holds political authority and controls institutions and regulations will use those for their benefits (Nigar, 2015). Such an environment results in inefficient resource allocation (concentration of wealth among the rich people), undermining economic growth (Sonin, 2003). This ability of the politically powerful individuals to take advantage of weak institutions and utilize resources for their benefit is explained through a lack of democracy reflected in political and wealth inequality (Sonin, 2003; Nigar, 2015).

FDI, Institutional Quality and Economic Growth

Recent studies support the theory that both FDI and institutional quality individually and jointly contribute to the overall economic development. By improving the overall institutional quality, a country would be able to improve its economic growth. This would further attract FDI inflows that would also contribute to additional economic growth (Van Bon, 2019; Hayat, 2019; Raza et al., 2019). This, however, does not apply to all countries. Hayat (2019) reports that this is true for the low and middle-income countries, but not for the high-income countries where it is found that FDI inflows decrease economic growth.

Furthermore, the complementary role of institutional quality on economic growth through financial development (Haini, 2020) and FDI inflows (Kutan et al., 2017) is also evident. Nevertheless, this complementary role of institutions has its limitations. Jude and Levieuge (2015) show that institutional development needs to reach a certain threshold for FDI to impact economic growth. This is also confirmed in the case of the sub-Saharan African (SSA) countries, MENA, Europe, Asia, and America regions (Trojette, 2016).

Contrary to the theory and the above studies, no impact of either FDI or institutions on growth is found in SSA countries (Agbloyor et al., 2016). Not only that, the complementary role of institutions on FDI is not confirmed either. Focusing on the same countries, Asamoah et al. (2019) found a positive effect of institutional quality and a negative impact of FDI on economic growth. Furthermore, although institutional development contributes to growth, Nguyen et al. (2018) found that it hinders the positive effects of FDI and trade openness on growth.

Data, Methodology, and Analysis

Data and Methodology

To investigate the impact of FDI and institutional development, individually and jointly, on the economic growth of the Western Balkans countries, we use the following two models, in line with Azam and Ahmed (2015):

$$Y_{it} = \alpha + \beta FDI_{it} + \delta ID_{it} + \theta X_{it} + \varepsilon_{it}$$

$$Y_{it} = \alpha + \beta FDI_{it} + \delta ID_{it} + \theta X_{it} + \varepsilon_{it}$$

(1)

Furthermore, to see whether the FDI-growth relationship depends on institutional development, we introduce an interaction term to equation ***(1)*** as presented in equation ***(2)*** below:

$$Y_{it} = \alpha + \beta FDI_{it} + \delta ID_{it} + \vartheta(FDI_{it} \times ID_{it}) + \theta X_{it} + \varepsilon_{it}$$

$$Y_{it} = \alpha + \beta FDI_{it} + \delta ID_{it} + \vartheta(FDI_{it} \times ID_{it}) + \theta X_{it} + \varepsilon_{it}$$

(2)

where for country *i* (the cross-sectional dimension) at time *t* (the time dimension), Y_{it} is the annual real per capita GDP growth rate, FDI_{it} represents FDI inflows, ID_{it} is a measure of institutional development, $FDI_{it} \times ID_{it}$ represents the interaction variable, X_{it} is a vector of all control variables, and ε_{it} is a random error term that captures all other variables.

For this purpose, we use annual time series data of the selected macroeconomic indicators, namely: the real per capita GDP growth (GDP) as a measure for economic growth; net FDI inflows as a percentage of GDP as the foreign investment indicator; and institutional development is measured by overall institutional quality (control of corruption, political stability, and the rule of law) from the Heritage Foundation. As for control variables, we use gross capital formation, trade openness, labor force, and inflation. All data are sourced from the World Bank's database and cover the

2000-2019 period. Furthermore, two panel techniques are used to estimate the results: pooled ordinary least squares (POLS) and fixed effect (FE) estimates with Driscoll and Kraay's (1998) standard errors. The Hausman test (Hausman, 1978) is used to choose between POLS and FE models.

Analysis of Results

Models (1) and (2) of Table 1 provide the estimated results based on *Eq (1)*, while models (3) and (4) provide results based on *Eq (1)* using the POLS and the FE estimators with Driscoll-Kraay standard. The R-square results reveal that our models explain from 77.1 to 77.8 percent of variations in economic growth.

Based on the Hausman test, we should rely on the results provided by the POLS estimator when looking at the results from *Eq (1)*. In general, our results indicate that both FDI and institutional development have a significantly negative impact on economic growth in the Western Balkans countries. In other words, foreign investment and institutions are impediments to the economic growth of these countries.

As for interaction models (3) and (4) based on *Eq (2)*, we rely on FE estimation results based on the Hausman test. In short, introducing interaction terms in our models makes the majority of our main variables insignificant. It seems that neither FDI nor institutional development affects the economic growth of these countries. Furthermore, the results indicate the FDI-growth relationship does not depend on institutions, and the institutions-growth relationship does not depend on FDI either. This is no surprise as we know from earlier analysis that foreign investment has been insignificant since 2013 and that institutions are still undergoing significant structural changes. Furthermore, earlier studies indicate a threshold for institutional development to affect either growth or FDI-growth relationship (Trojette, 2016).

Table 5: FDI-Institutions-Growth nexus

VARIABLES	(1)	(2)	(3)	(4)
	POLS	FE	POLS	FE
Foreign direct investment inflow (FDI)	-0.085**	-0.138**	-0.650	-0.126
	(0.030)	(0.048)	(0.408)	(0.309)
Institutional development (ID)	-0.177**	-0.039	-0.225***	-0.038
	(0.045)	(0.049)	(0.043)	(0.055)
Interaction term (FDIxID)			0.010	-0.000
			(0.007)	(0.005)
Gross capital formation	5.475**	3.719**	5.648**	3.699**
	(1.558)	(0.823)	(1.481)	(1.033)
Trade openness	-1.436	1.769	-1.062	1.786
	(0.692)	(1.440)	(0.763)	(1.398)
Labor force	-0.016	2.587	0.105	2.597
	(0.282)	(5.252)	(0.300)	(5.425)
Inflation	-0.428*	-0.394*	-0.274	-0.396*
	(0.169)	(0.174)	(0.215)	(0.184)
Constant	4.744	-48.978	-	-48.209
	(8.077)	(70.975)	-	(74.839)
Year Dummy	YES	YES	YES	YES
Obs.	88	88	88	88
No. of groups	5	5	5	5
R^2	0.771	0.778	0.777	0.778
F-stat.	138.350	3930.461	61.283	5399.392
F-stat. p-value	(0.000)	(0.000)	0.001	0.000
Hausman	-	1.872	-	1.762
Hausman p-val.	-	(0.282)	-	(0.302)

Note: Regression with Driscoll-Kraay standard errors. Standard errors in parentheses. Significance level *** p<0.01, ** p<0.05, * p<0.10.

Conclusion

Foreign investments and efficient institutions are essential ingredients for the economic growth of every country. While foreign investments are needed for infrastructural and institutional improvements and developments, institutional development is necessary to attract foreign investments. This study investigates the importance of foreign investment and institutional development for the economic growth of five Western Balkans economies – Albania, Bosnia and Herzegovina, Montenegro, North Macedonia, and Serbia. Over the years, these countries experienced structural and institutional changes that altered their socio-political environment. The region is still facing significant structural issues that impede its economic development.

Given the existing challenges, it is no surprise that our investigation reveals that foreign investment and institutions deteriorate the region's economic growth. Once the foreign investment interacts with institutional development proxy, the results indicate that both, including the interaction term, are negative but insignificant for economic growth. Keeping in mind that the foreign investment inflows in the region are minimal lately and that institutions are below the EU standards, these results are expected. As a result, policymakers need to improve the overall infrastructure and make necessary improvements within their economies to attract more foreign investments in the region that would help further institutional and infrastructural development.

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