PANEL DATA ANALYSIS OF THE IMPACT OF ECONOMIC AND INSTITUTIONAL FACTORS UPON THE FDI INFLOW IN SEE COUNTRIES

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Abstract

The panel data analysis presented in this paper focuses on the impact of economic and institutional factors upon the attractiveness of the economies of South- East Europe (SEE): Albania, Bosnia and Herzegovina, Bulgaria, Macedonia, Montenegro, Romania, Serbia, Kosovo and Croatia for foreign direct investment (FDI). The analysis was done for a period of twenty years (1995-2015) in order to examine which determinants are significant for increased FDI inflow in the SEE countries on a basis of a holistic approach using multiple regressions. Taking into account both economic and institutional variables, the results of the analysis indicate both of them to be significant for attracting FDI.

1. Introduction

The level of FDI inflow into an economy is strongly linked to the level of development, economic and political stability, trade openness and other macroeconomic factors. The goal of this paper is to measure the influence of certain economic and institutional variables upon the attractiveness of FDI in the region of South-East Europe. The countries that are included in the analysis are the countries that are members of CEFTA-2006 (Albania, Bosnia and Herzegovina, Kosovo, Macedonia, Montenegro, and Serbia), and the three countries that became EU members: Bulgaria, Romania, and Croatia.
Improved economic conditions have positive impact upon the FDI inflow, while FDI itself may stimulate economic growth. Economic growth induces growing markets for investors' output, and regional integration increases the scope of easily accessible markets. Macroeconomic stability allows better access to external finances and provides greater stability of currencies, which altogether leads to lower vulnerability to external shocks. The main advantage for investors is predictability of returns on investments.

The conditions for investors improved considerably in the economies of South- East Europe over the past 20 years. Most of the economies have faced a difficult transition period, but in recent years they have embarked on a sustainable growth path. The 2008 global financial crisis had it's own effect over the external vulnerability of these countries with prolonged and slow economic recovery. As a result, GDP per capita in the region lags substantially behind most EU-CEE members (CEFTA-2006 Investment Report, 2017). The region has on average growth of the annual gross domestic product (GDP) of 2.3 % in the period from 2010-2015; which is better than the annual average growth for the European Union by 1.2 %, but less than that of other European and Central Asian economies which is 2.9 % (UNCTAD, 2017).

Political instability in the region has its own effect on significantly setting back the economic development, and the process was compounded by some South-East European economies (Bulgaria, Romania and Croatia) missing out the early waves of EU accession.

Although many challenges remain, the region has made considerable advances to improve the investment climate and offers potentially attractive opportunities for foreign direct investors. One of the objectives of the SEE 2020 Strategy is to increase the annual FDI inflow to the region by at least 103 % (160 % including Croatia).

For the purposes of our analysis we have run multiple regressions using panel data for the period of twenty years, 1995-2015. The paper is structured as follows: in the first section we provide some theoretical background on FDI, as well as literature review on FDI in the region of SEE; in the second section we make a brief overview of the FDI inflows in the countries of South-East Europe; in the third section we explain the model and the results from the regressions; and in the last section we give the conclusion from the analysis.

2. Theoretical background on FDI and literature review

The abundant economic literature on FDI comprises a vast number of different theories created in the period from the appearance of the classical economic school until the development of the latest new trade theories. During the 1970's the economic thought focused on explaining FDI motivation from the position of the model of imperfect competition on the world market. Following the flows of capital on the relation among developed economies, the creators of this concept claimed that FDI had exceptional positive influence upon the economic growth of both the home and the host economy and especially stressed advantages realized by spill-overs of knowledge and managerial skills (Kindelberger & Andretsch, 1983, and Vernon, 1979). Later on, this concept was extended and developing countries were involved in further research and theoreticians claimed that this would lead to the same positive effects upon the economic growth for their economies as well.

The contemporary concepts on FDI were mostly influenced by Dunning's OLI Paradigm (Dunning, 1988) and Porter's Diamond of Competitive Advantages (Porter, 2000). While within the OLI Paradigm the outflow of capital is still an alternative to export of goods, in Porter's theory both of the flows have to continue simultaneously, as they are not substitutes or alternatives to each other in the contemporary global environment. In 1993, Dunnig and Rojec accepted Porter's theory and upgraded it pointing out that FDI support not only the economic growth and development of the home country, but also could support the wellbeing and growth of the host country. They were among the first who applied this model upon the transition economies and related the inflow of FDI with the opportunity of increasing productivity in manufacturing industries that already existed in those countries; the opportunity of bringing innovations and improvements of the existing productions, processes and organizational structures; the promotion of new allocation of recourses among different sectors; the opportunity to get access to new markets; and the acceleration of structural changes within the economy and decrement of costs needed for technological changes (Dunning & Rojec, 1993). In 2001, Kalotay has found that the systemic impact of FDI through privatization has been positive in Central and Eastern Europe and more substantial than was expected at the beginning of the transition process.

Lately there are a considerable number of theories that refer to the influence of economic factors (such as market growth and trade openness of the economy) upon the inflow of FDI (Deichman et al, 2003; Asiedu, 2006; Mohamed & Sidiropulus, 2010). Yet, these theories did not provide any reliable proof that the mentioned determinants are significantly important for attracting FDI.

From the stand point of transition economies, Jadhav (2012) has found that economic factors in BRICS economies are more important than institutional and political determinants for attracting FDI. Market size measured as real GDP, trade openness, natural resources availability, rule of law and voice and accountability have positive effect on total inward FDI in BRICS economies. The research of Gharaibeh (2015) has analyzed that for Bahrain general government consumption expenditure; inflation rate;

economic stability; labor force; trade openness: public education; and population have statistically significant and positive influence on FDI inflows.

However, institutional framework and its influence upon the attractiveness for FDI is also important. The institutional approach refers to the level of institutional reforms that influence the quality of institutions. Institutional reforms should provide tools for fighting corruption and political instability, as they both degrade quality of institutions and prevent their development (Cleeve, 2008). Bevan and Estrin (2004) have studied the FDI determinants in Western European countries, as well as in Central and Eastern European on bilateral level. They applied the gravity model and found out that announcements on EU accession proposals had an impact on FDI for future member countries. The EU enlargement in 2004 included eight Central and Eastern European economies, followed by Bulgaria and Romania in 2007. This encouraged investment by non-European firms as well as by EU-based multinationals in both manufacturing and services sectors in the new member-states. Jovanovic B. and Jovanovic B. (2017) found out by analyzing 27 ex-socialist countries that investors were discouraged by bureaucracy and bureaucratic impediments rather than financial costs. In 2017, Kikerkova I. et al., applied VECM on FDI and their impact in the Republic of Macedonia and found out economic factors, such as: the rate of GDP growth, trade openness and labor productivity were the leading factors for increasing FDI inflow in Macedonia.
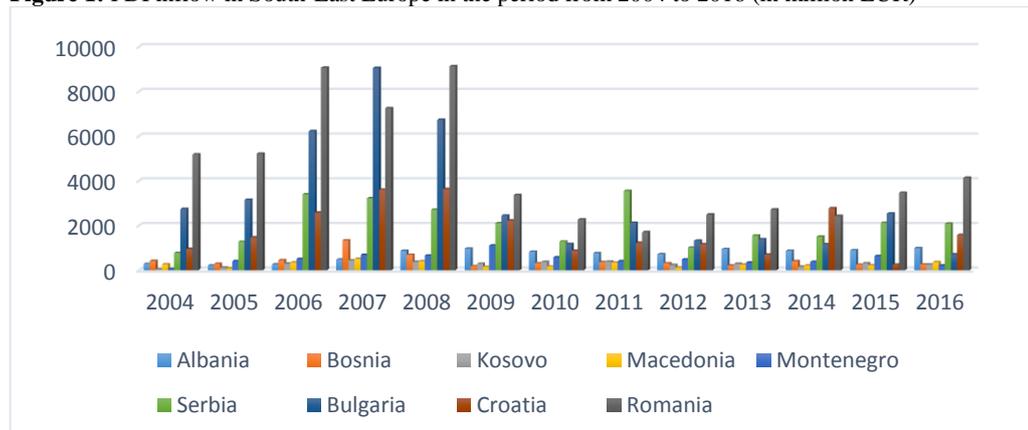
The role of incentives for attracting FDI is analyzed in the academic literature, as well. Cass F.,(2007) investigated the role of fiscal and financial incentives, on one hand, and the policy applied by Investment Promotion Agencies (IPAs) in attracting FDI into European transition economies. Results of different researches led in this field were basically conflicting or with predominantly negative connotation. Most of the authors came to conclusion that the active approach in granting incentives to foreign investors might have strong negative impact upon the corruptive practices within the institutions of the system and might lead to withdrawal of the decision of a foreign investor to effectuate the investment. (Zemplinarova, 1996; Osman, 2000; Cleeve, 2008). Abundant tax relieves usually have a negative impact on the total effect from the attracted FDI, as they increase the costs for the host country to an extent that might overcome the total positive effect of the effectuated foreign investment. It is even more important to point out that the up-to-date research in the area did not provide a proof on the statistically significant relation in attracting FDI neither with regard of institutional determinants nor in regard of financial and fiscal incentives (Assunchao et.al., 2011).
Kalotay (2008) analyzed the FDI inflows in Bulgaria and Romania at the beginning of their EU accession process and found that despite the major labor cost and corporate tax advantages these countries attracted relatively few efficiency seeking projects, mostly in garments and footwear. He further explains that in order to increase and materialize the FDI potential of these countries they need to improve the business environment by strengthening the judiciary system, fighting against corruption and organize crime in Bulgaria.

3. Characteristics of FDI inflow in the countries of South-East Europe

Due to political instability and the many war conflicts, the countries of South-East Europe lost a whole decade of the 90's on macroeconomic stabilization, privatization and transformation of their systems towards a market economy. Since the beginning of the 21st century the political and economic situation within these countries started to change gradually. In the period from 2001-2008 economic reforms and privatization process in the region started to accelerate and the region gradually liberalized trade, especially with the EU. All this led to substantial changes and improvement of the business climate in all of the countries throughout the region. Most of the economic reforms that were implemented in different countries relied on legal reforms in favor of FDI regime liberalization and pursued active policies on attracting foreign investors' attention. These efforts led to an increment of the total FDI inflow, which reached its peak in the period before the world financial crises in 2007-2009. Data in Figure 1, confirm that the crisis in 2008 had a strong negative impact upon FDI inflow in the countries of South-East Europe and cut more than a half of the total inflows of FDI at regional level. The recovery period lasted until 2014, when FDI inflow started to increase again, but it was far from catching up the 2008 levels.

Figure 1: FDI inflow in South-East Europe in the period from 2004 to 2016 (in million EUR)

Source: CEFTA-2006 Investment Report 2017, CEFTA Secretariat, Brussels, 2017, p.77

If we analyze the FDI inflow by country, we can resume the following: in Albania the FDI inflow has increased 3 times (278 mill. Euros in 2004 - 983 mill. Euros in 2016); in Bosnia & Herzegovina the level of FDI inflow has diminished after the crises and could not reach the pre-crisis level; in Kosovo the level of FDI inflow has been low, but higher in comparison to the pre-crisis level; in Macedonia the level of FDI inflow has been volatile throughout the past 12 years, but expresses a slow upward trend though (261 mill. Euros in 2004 - 359 mill. Euros in 2016); Montenegro in the analyzed period has experienced considerable growth of FDI inflow, however after the crisis amounts significantly decreased and were far below the pre-crisis level; in Serbia the situation is slightly better since FDI inflow started to increase in the last two years and nearly reached the level before the crisis; Bulgaria had an upward trend of FDI inflow in the

period before the crisis, however in the period after the crisis the inflow was volatile and decreasing; in Croatia the situation is similar to Bulgaria as after the crisis the country faces volatile FDI inflow; and in Romania the FDI inflow records an upward trend which is significantly lower than the level it had before the crisis (*CEFTA-2006 Investment Report,* 2017, p.7).

Barlett and Prica (2012) suggested that the extent of openness to FDI flows was a major cause of the transmission of the crisis to the region. The 2008 global economic crisis exposed two weaknesses in the South-East Europe investment profile in terms of concentration of foreign direct investment in the financial sector and limited private sector development.

The slow-down of FDI inflow in the region was not caused only by the crisis, but generally it was a result of the completion of the privatization process and the lack of interest of foreign investors to invest in already existing enterprises. FDI inflow within the region created about 8% of the total GDP on average. Although this indicator differs throughout the countries in the region, its average for the region as a whole is significantly above the figures of the same indicator calculated for the countries from Central and Eastern Europe, where it reached 3% of GDP. Foreign investors consider Serbia to be the country with the biggest capacity for attracting FDI within the region. However, Montenegro with 6,290 EUR per capita was the country with highest FDI stocks per capita in 2013, while Macedonia happens to be the least attractive country in the region (Pinto et al., 2016).

Another aspect visible from data in Figure 1 points out that FDI inflow was considerably higher in the countries that became EU member - states than in CEFTA-2006 members. This is completely in line with the finding of Bevan and Estrin (2004) that the announcements on EU accession have a positive impact on FDI for the future member-states.

4. Specification of the model and the results

4.1. Explanation of the model

In order to examine the relationship between foreign direct investments and different economic and institutional variables, a panel regression OLS model is used. The model is described in the following equation:

$$y_{it} = \alpha + \beta_{x_{it}} + u_{it}$$

where y_{it} is the dependent variable, α is the intercept term, β is a $kx1$ vector of parameters to be estimated on the explanatory variables, and x_{it} is a $1xk$ vector of observations on the explanatory variables, $i = 1, ..., N$ and it stands for cross-sectional unit (number of countries), while $t = 1, ..., T$ and it stands for time period (Brooks, 2014).

The analysis includes nine South-East European countries (Albania, Bosnia and Herzegovina, Bulgaria, Macedonia, Montenegro, Romania, Serbia, Kosovo and Croatia) for the period from 1995-2015. Two separate panel regressions were run in order to

compare relationship between FDI and two groups of factors: economic factors and institutional factors. The first regression evaluates the relationship between FDI and economic factors and the second one the relationship between FDI and both economic and institutional factors. The authors deliberately did not take into account the expectations of becoming full members of the EU (for those which still are not EU members), as they wanted to measure only the impact of endogenous factors of the attractiveness for FDI of the SEE - countries.

The dependent variable is **_foreign direct investment net inflows_** as % of GDP (fdi_{it}), while the independent variables are divided into two groups: economic and institutional factors.

Economic factors include: GDP annual percentage growth (gdp_{it}); trade as percentage of GDP ($trade_{it}$); GDP per employee measured in PPP in constant terms for 2011 as an indicator of labor productivity ($productivity_{it}$); unemployment as a percentage of total labor force ($unemployment_{it}$), general government final consumption expenditure as percentage of GDP ($government_{it}$); and population growth as annual percentage growth ($population_{it}$).

Data observed in terms of economic variables are in annual frequency for the period from 1995-2015, and are retrieved from World Development Indicators data base that includes World Bank National Accounts Database and OECD National Accounts Database.

In this group of variables the variable *population growth* is included which stands for annual population growth rate. It is the exponential rate of growth of midyear population from two subsequent years in percentages. Population is based on the *de facto* definition of population, which counts all residents regardless of their legal citizenship status. Data are derived from the World Population Prospects of the United Nations Population Division and United Nations Statistical Division. The values are based on the *de facto* definition of population, presented as midyear estimates.

The second equation, besides economic variables, includes **institutional variables** as well. The first variable is: *Political Stability and Absence of Violence Index* ($political_{it}$). This index is published in the Worldwide Governance Indicators, a colossal research project by the World Bank. It measures perceptions of the likelihood of political instability and/or politically motivated violence, including terrorism (Kaufmann, Kraay & Mastruzzi, 2010). This aggregate indicator originally is published on a -2.5 - 2.5 scale. For the purposes of our research, we have rescaled the Index on a 0 - 100 scale, where 0 (zero) stands for worst, while 100 (hundred) for the best performance.

Additional four indicators are taken from the 2017 Index of Economic Freedom (Miller & Kim, 2017). The Index of Economic Freedom calculates four separate groups of indicators: Rule of Law, Government Size, Regulatory Efficiency and Open Markets. Since we already took in consideration the government debt as an economic indicator, we chose indexes from the rest of the three groups. As a part of the Rule of Law, we

included Property Right($right_{it}$). It measures the degree to which country's laws protect private property rights and the degree to which the government enforces those laws. It also assesses the likelihood that private property will be expropriated and analyzes the independence of the judiciary, the existence of corruption within the judiciary, and the ability of individuals and businesses to enforce contracts. The property right score for each country is a number between 0 and 100, with 100 equaling the private property guarantees by the government.

In the area of Regulatory Efficiency we used two indicators: Business Freedom and Monetary Freedom.

Business freedom ($business_{it}$) is an overall indicator of the efficiency of government regulation of business. The business freedom score for each country is a number between 0 and 100, with 100 equaling the freest business environment. The score is based on 10 factors, all weighted equally, using data from the World Bank's Doing Business Study. *Monetary freedom* ($monetary_{it}$) combines a measurement of price stability with an assessment of price controls. Here again the number varies between 0 and 100.

In the area of Open Markets we used the variable: *Financial Freedom* ($financial_{it}$), as a measure of banking efficiency as well as a measure of independence from government control and interference in the financial sector. An overall score on a scale of 0 to 100 is given to an economy's financial freedom through deductions from the ideal score of 100. Before choosing the panel regression model, pre-tests for panel unit roots were made. The panel unit root tests indicate that most of the variables are stationary (the results somewhat change depending on what type of a test is performed and the deterministic term involved). The first equation has the following form:

$$fdi_{it} = \alpha + \beta_1 gdp_{it} + \beta_2 trade_{it} + \beta_3 productivity_{it} + \beta_4 unemployment_{it} + \beta_5 government \lambda_t + v_{it}$$

where λ_t is a time-varying intercept that captures all of the variables that affect the dependent variable and that vary over time but are constant in cross-section terms (Brooks, 2014). The total number of observations in the first model equals 108.
In order to prove the robustness of the model, we present the construction of the model, by adding variables one by one. The sign and the significance of the variables is not changed which confirms the robustness of the model.

3.2 Presentation of results

In Table 1 are presented the results from six consecutive regressions. It is visible that the sign and the significance of the variables remain the same in all regressions. When we run the regressions we added additional variables one by one. However, for the purposes of our analysis only the third and the last (sixth) column are of importance as the first indicates the importance of all economic variables in attracting FDI in South-Eastern European countries, and the last column takes into consideration both economic and institutional variables that we analyze.

Table 1. Presentation of the results

	(1)	(2)	**(3)**	(4)	(5)	**(6)**
Log (GDP)	0.161**	0.177**	**0.211*****	0.215***	0.238***	**0.251*****
Log (Trade)	0.155***	1.870***	**1.740*****	1.720***	0.314***	**0.850*****
log (Productivity)	-0.554***	-0.652***	**-0.665*****	-0.655***	-0.626***	**-1.428*****
Unemployment		-0.017***	**-0.020*****	-0.022***	-0.027***	**-0.018*****
Government			**0.044*****	0.045***	0.057***	**0.107*****
Population				0.032	0.006	**0.118**
log(Rights)					0.05	**0.125**
Monetary					0.017***	**0.012*****
log(Political)						**1.239*****
log(Business)						**1.325*****
log(Financial)						**1.250*****
R-square	0.252	0.269	**0.323**	0.323	0.420	**0.614**
Adjusted R-square	0.240	0.248	**0.296**	0.298	0.373	**0.563**
Observations	133	108	**108**	108	96	**87**

Note: $p < 0.10$, * if $p < 0.05$; ** if $p < 0.01$; *** if $p < 0.001$.

From the results presented in the regression taking into account selected economic factors important for attracting FDI we can see that trade as a percentage of GDP and GDP annual growth are most significant factors. This means that an increment of trade of 1% may lead to increment of FDI of 1.74% in South-Eastern European countries. The influence of general government final consumption expenditure is also positive, but little less significant (at level of 95%) for attracting future FDI inflow in the region. 1% Increase of the general government final consumption may lead to 4.4% increase of FDI. The influence of the other two economic variables: productivity measured as GDP per employee and unemployment as a percentage of the total labor force, appear to be statistically significant but with a negative sign. This indicates that increasing productivity in this group of countries leads to less FDI inflows. In the other way, decreasing productivity in these countries may lead to more FDI. This opposite interaction between FDI inflows and level of productivity measured as GDP per person in these countries may be explained by the low level of industrialization as manufacturing is the major source of innovation and productivity growth. FDI in this region took advantage of previous existing manufacturing base, went to some smaller sectors or shaped new specialization patterns; and the countries from this region are weak and moderately integrated into international trade and production networks (CEFTA Investment report, 2017). As for the unemployment, it may be explained with

the fact that most of these countries face high unemployment but they are still cost competitive in terms of lower wages and unit labor costs.

The results presented in the last column take into consideration the influence of all nine independent economic and institutional variables on attracting FDI inflows in the region. The results in the last phase confirm the positive and statistically significant influence of the same economic variables: GDP annual growth, trade as a percentage of GDP and general government final consumption expenditure as a percentage of GDP. We should underline that the importance of the variable measuring government final consumption expenditure has the greatest impact in attracting FDI inflows in these countries. An increment of 1% of the general government final consumption expenditure may lead to 10.7% growth of FDI inflows in the countries of South-East Europe.

From all institutional factors taken into account it might be confirmed that the influence of the following four factors: political stability and absence of violence index, monetary freedom as a measure of price stability, business freedom as an indicator of the efficiency of government regulation of business, and financial freedom as a measure of efficiency of the banking and the whole financial sector, are statistically significant and have positive influence in attracting FDI in the region of South-East Europe. The values of the coefficients of all four variables are around 1.2 (1.3 for political stability) meaning that a change of 1% in one of the four variables may lead to 1.2% (1.3% for political stability) growth of FDI inflows.

The variable population growth rate and the variable property rights measuring the degree to which national laws in the region protect private property appear to be not significant in attracting future FDI inflows in the region.

5. Conclusion

South-East European countries experienced prolonged recovery from the last global financial crisis, and their economies still have a weak performance. FDI inflow is also lagging behind and in general is not back to the pre-crisis levels measured as a share of GDP. Manufacturing is a major source of innovation and productivity growth in the countries of South-East Europe. Foreign investors took advantage of previous existing manufacturing base through privatization of steel companies, food industry, textiles; or went to some smaller sectors; or have shaped new specialization patterns in slowly emerging medium-high-tech industries. The region's competitiveness is severely hampered by poor infrastructure development in all areas, which limit trade and investment opportunities within the region. All of the Southeastern European countries and especially CEFTA member-states are weakly or moderately integrated into international trade and production value chains.

The purpose of this paper was to analyze and measure the importance of certain economic and institutional variables and their influence in attracting FDI in these countries. The results pointed out that both the economic and institutional variables are important for the increment of FDI inflows in the region. Among the economic variables the General Government Final Consumption Expenditure as a percentage of GDP

appears to be with the greatest influence in attracting FDI inflows. GDP annual growth and trade as a percentage of GDP are also significant and with positive influence but with a lower value of the coefficient.

From institutional variables taken into account we can confirm that the influence of four factors: Political Stability and Absence of Violence Index, Monetary Freedom as a measure of price stability, Business Freedom as an indicator of the efficiency of government regulation of business, and Financial Freedom as a measure of efficiency of the banking and the whole financial sector, are statistically significant and have positive influence upon attracting FDI in the region of South-East Europe.

The results should be taken into consideration on creating better policies in future. Combined with the goals defined in the Berlin Process the regional dimension should be strengthened. The final goal is to enable positive influence upon future FDI inflow in the region and thus support and enhance its economic growth.

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