INSTITUTIONAL ENVIRONMENT AND FOREIGN DIRECT INVESTEMENT IN THE WESTERN BALKANS

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INTRODUCTION

Foreign direct investment is an important source of additional savings for developing countries and countries in transition. It is also a channel through which the recipient country, beside fresh capital, provides the basis for further employment, growth and development, transfer of knowledge and technology and the foundation for future export, which has multiplicative effects on growth.

Private capital flows, particularly foreign direct investment, fell on a global basis in the crisis that affected almost every country in the world. FDI flows also decreased significantly in all countries of the Western Balkans compared to the pre-crisis period. As we can observe, in the time of financial and economic crisis our region followed the trend of decline in FDI flows at the global level, thus registering the reduction of FDI inflow as a result of the global crisis. This means that our region cannot be protected from decline of foreign investment flows in times of deep economic crises such as the present one.

However, since the countries of the developed world and the countries of our region slowly emerge from the crisis, recovery of the FDI flows on the global and regional level can be predicted for the near future. Therefore, bearing in mind the importance of FDI for transition economies, we need to consider the prospective for the renewal of FDI flows in the region, as the world and our region recover from the crisis. The underpinning idea of this paper is that Western Balkan countries have to work harder and faster to develop their institutional environment as an essential location factor that will ensure long-term stable FDI inflows and attractiveness of the region for more FDI in times after this crisis.

THE WESTERN BALKANS: CONCEPT AND PROGRESS

The concept of the Western Balkans is a term which was used for the first time in the early 1990s after the break-up of the former Yugoslavia. It refers to the following countries: Albania, Bosnia and Herzegovina, Croatia, Macedonia, Serbia and Montenegro. In the twentieth century the synonyms for the Western Balkans were "ethnic conflicts, problems of minorities and dislodged persons, secessionist aspirations and violation of territorial integrity" (Bozic-Miljkovic, 2007: 80). Today the general determination of all Western Balkan countries is their common goal towards the EU, i.e. to attain full membership in the European Union. However, the concept of the Western Balkans has been often marked as a "black hole" of Europe mainly because of the region's slow progress towards the EU. Croatia and Macedonia have the status of candidate countries, while Bosnia and Herzegovina, Serbia, Montenegro and Albania still have the status of potential candidates.

Since the fall of communism, the Western Balkan countries have not progressed in the process of transition as was the case with the Central European countries which are now members of the EU. In that light, EU position in the international arena could be considerably harmed by a negative trend of political and socio-economic development in the Western Balkans. This is one of the reasons (Bozic-Miljkovic, 2007) why the EU shows an interest in the development of this part of Europe and why it takes a leading part in solving the dubious political issues of the region.

When the 12 countries of the largest enlargement and Bulgaria and Romania entered the EU, the closest European neighbors became Western Balkan countries. The experience of the newest members showed that the best period for foreign investors to exploit benefits and advantages of new markets are the years just before and after accession (Redzepagic, Richet, 2007). In that sense it could be expected that the speed at which Western Balkan countries advance towards the EU will dictate the pace of entry for foreign investors in the future.

In the next part, the concept of foreign direct investment will be briefly explained as well as its significance, particularly for transition countries.

IMPORTANCE OF FDI

The widespread, theoretically and practically accepted opinion is that the inflow of foreign capital is an important channel for the diffusion of technology, business skills and new ideas across the national borders. This leads to the conclusion that the shooting down of barriers for the movement of foreign capital can create a basis for faster growth in productivity as well as the necessary market reforms in transition countries. However, "despite the strong theoretical case for advantages of free capital flows, many private capital flows pose countervailing risks" (Redžepagić and Richet, 2007: 57). On the contrary, FDI is the least volatile form of capital movement. Moreover, it has a range of further benefits. FDI inflows are more likely to be turned into real domestic investments than other forms of capital.

Foreign direct investment has proved to be particularly significant factor in the process of transformation of former centrally-planned economies, both for Central European countries and South East European countries. In this sense "FDI inflows are viewed as a measure of the extent to which a country or a region is integrated into the world economy" (Pournarakis and Varsakelis, 2004: 78). FDI could be a key factor for improving physical and human capital, increasing export capacity, downgrading external weaknesses and boosting the necessary structural reforms (Redžepagić and Richet, 2007).

According to Bevan and Estrin, "FDI can accelerate the transition process by forming a basis for more effective corporate governance and by promoting enterprise restructuring, which is a crucial to the transition process" (Bevan and Estrin, 2004: 776). The positive effects of FDI are not only limited to the firms that invest (investors). There are also positive spillovers for domestic companies and branches (Zacharov and Kusic, 2003). They are most obvious in the marketing and management areas, but also in the area of new technologies which lead to increases in productivity and overall company performance.

In addition, many analyses have confirmed that there is a direct and significant interaction between foreign direct investment and economic growth (Daude and Stein, 2007). But the structure of investment is much more important than the total amount of received funds. We can distinguish green-fields from the mergers and acquisition (M&A). A greater share of green-field investments means a qualitatively better situation for one country. Green-fields create a production and export oriented base and, which is more important, they employ a new working force, thus decreasing the level of unemployment. As for the Western Balkans, a very small share of investments comprises export-oriented green-fields (Božić-Miljković, 2007).

One example from the new EU member states showed that so-called eastern expansion contributed to an increase of foreign investment during preparation for

EU membership and after accession. The political and economic integration of CEE into the EU released a signal to foreign investors that these countries are better regulated and politically more stable. This factor, along with much lower operating costs than in developed countries, contributed to a higher foreign investment into CEE while at the stage of joining EU. We can expect that in Western Balkan countries similar effects could be achieved as the European Union continues to enlarge in our direction. But creating a good investment environment which could attract fresh new investments requires a much deeper and more decisive reforms in the fields of public administration, public finances, the rule of law and, perhaps most important of all, a strong and determined fight against crime and corruption. Joint actions among all Western Balkan countries in this regard are the only way to reach the desired economic and social results as well as stronger regional integration. An integrated and politically stable region means advantages for each country individually. The process of joining the EU can be used as a good approximation for the general institutional progress in Western Balkan countries. Development of institutional environment, i.e. faster progress of the Western Balkans toward the EU, could mean grater inflows of FDI, which in turn has a range of positive effects.

STEADY GROWTH AND STEEP DECLINE DURING THE CRISIS

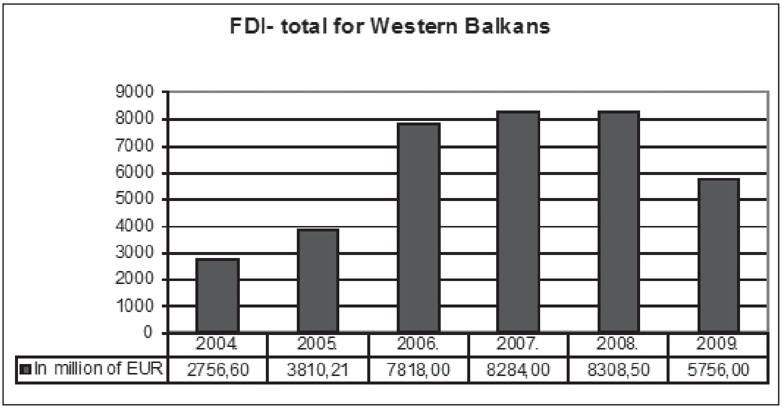
Before we analyze the decline that occurred in 2009 as a result of the world economic crisis, it is important to note that all countries of the region recorded a stable growth in FDI in years prior to the crisis. Mainly due to the global crisis, this growth in the last period was not only slow but it was also negative, as can be seen in the following table and figure.

Table 1: FDI inflows by countries and total amount for the region (in millions of euro)

Country/Year	2001	2002	2003	2004	2005	2006	2007	2008	2009
Bosnia Herzegovina	-	-	-	565	492	610	1517	726	**452**
Serbia	41,6	343	948	652	1180	3375	1431	1687	**1377**
Croatia	1467	1137	1762	949	1467	2764	3678	4195	**2096**
Monte Negro	-0,5	76,3	39	50,5	381	466	672	625,5	**944**
Macedonia	-	-	-	260	77,21	344	505	400	**181**
Albania	-	-	-	278	213	259	481	675	**706**
Total	-	-	104,4	2756	3810	7818	8284	8308	**5756**

Source: countries' national (central) banks

Figure 1: Decline of FDI in 2009



Source: based on previous table

The above table and figure deserve following comments:

- In all years before the crisis FDI inflows recorded constant growth in all of the countries
- FDI inflows for the region fell rapidly in all countries as a consequence of the global economic crisis, except for Montenegro and Albania in 2009
- At the regional level, FDI fell by 30% in 2009, compared to 2008
- Macedonia recorded the largest decrease of 55%, Croatia 50%, Bosnia and Herzegovina 36% and Serbia 19%
- The only two countries that record higher FDI in 2009 compared to 2008 were Albania and Montenegro; in Albania this growth was only 3%, which was much lower than the growth in 2008 when, compared to 2007, investment increased by 40%; for Montenegro, due to its specific economic structure and the current economic and political situation, stable inflows do not cause any surprise since a great deal of investment was directed toward real estates.

One of the main reasons for such a drastic decline of FDI inflows in the region is the decline of FDI that occurred on the global level. According to the last issue of the World Investment Report 2009, released by the United Nations Conference on Trade and Development, in 2009 the inflow of FDI around the world was 39% lower as compared to the previous year due to the global economic crisis. According to this report inflows are expected to have fallen from $1.7 trillion in 2008 to below $1.2

trillion in 2009, with a slow recovery in 2010 (to a level up to $1.4 trillion) and gaining momentum in 2011 (approaching $1.8 trillion)[1].

PROSPECTIVE FOR RENEWAL – DEVELOPMENT OF INSTITUTIONAL ENVIRONMENT

As we can observe, in times of financial and economic crisis our region followed the downward trend in FDI at the global level, thus registering the reduction of FDI inflow as a result of the global crisis. However, since the countries of the developed world and countries of our region are slowly emerging from the crisis, recovery of the FDI flows on the global and regional level can be expected in the near to immediate future. Therefore, bearing in mind the importance of FDI for transition economies, we need to consider prospective for FDI renewal in the region, as the world and our region recover from the crisis.

The main idea of this paper is that Western Balkan countries have to work harder and faster to develop their *institutional environment* as the essential location factor that will ensure the attractiveness of the region for more FDI inflows. The development of institutions and the institutional environment gain increasing importance in the relevant literature but also in the practice of multinational companies compared to traditional location advantages such as the labor law costs or lack of environmental standards.

If one follows Dunning's theory in a general way, institutions are but one among other location factors that affect FDI attraction (Dunning, 1988). John Dunning's OLI paradigm integrates all main determinants of international production. This theory explains activities of multinationals in terms of Ownership (O), Localization (L) and Internalization (I) advantages for going abroad. Ownership advantage means that a firm has its own advantage that could be exploited in the foreign market. Internalization shows that the company must have ownership advantages which are better exploited internally instead of licensing some other foreign firm. *Localization* advantages refer to a host country which is evaluated by a foreign investor as a better location than its home or some other country. Initially, scholars considered factor endowments, especially labor costs and productivity, to be the main location advantages. Now multinational firms consider "created" assets to be more important

[1] World Investment Report 2009, United Nations Conference on Trade and Development (UNCTAD) http://www.unctad.org/en/docs/wir2009_en.pdf (15. 7. 2010.)

than traditional location advantages. These created assets include knowledge-based assets, the infrastructure and the *institutions* of the host country. Hence, investigation of the institutional environment has become a crucial location advantage for attracting FDI, i.e. multinationals. According to Dunning himself, the role of institutions and institutional reform in transition economies has become an essential factor affecting the determination of FDI flows (Dunning, 2004).

The word institution has a diversity of meanings. Douglass North's concept of institutions, frequently used by many authors, defines institutions as the formal and informal "rules of the game" in society. According to North's definition, "institutions are the rules, regulations (humanly devised constraints) that structure political economic and social interaction; they consist of both: formal rules (constitutions, laws, property rights) and informal constraints (sanctions, taboos, customs, tradition and codes of conducts)" (North, 1990: 3). As North states, "the purpose of the rules and conventions is to define the rules by which the game (in this case upgrading competitiveness and attracting FDI) is played, monitored and enforced" (Dunning, 2004: 2). Organization or individuals are entities which devise and implement these institutions. Institutional environment in that sense comprises institutions (formal and informal ones) and an enforcement mechanism[2].

"Institutions reduce uncertainty involved in human interaction by giving us pattern for our behavior" (Dumludag and Sukruogly, 2007: 142). In the context of firm operating costs, the development of a better institutional environment implies lower transaction cost, lower risk and lower uncertainty for foreign companies that are entering new markets. There is a wide literature which confirms that institutions and transaction costs play important roles in the economic performances of a country[3]. Numerous empirical studies have confirmed that lack of political and economic stability, uncertain regulatory frameworks, inexperienced and slow bureaucracies, under-developed legal systems and widespread corruption discourage FDI inflows into the host economies. A transparent and more business-friendly environment is a condition for attracting more investors (Grosse and Trevino, 2005).

Before we present some data regarding institutional environments in Western Balkan countries, let us briefly address the most studied institutions in the literature,

2 If they are not enforced, institutions are ineffective. A state can have intellectual property law, but if it iks not enforced by governments, organizations and individuals can act as if there is no law.

3 The transaction cost theorem was established by Ronald Coase and the theorem is also called the Coase Theorem.

both formal and informal one, which affect location of FDI between countries. According to Bevan and Estrin, these institutions include the following: private property rights (the quality of the process of privatization in transition economies), financial market infrastructure (bank reform and capital market reform), price liberalization, liberalization of foreign exchange market, liberalization of foreign trade, competition policy, the development of a legal system, and corruption as the most important informal institution (Bevan and Estrin, 2004). In providing examples of institutions some other authors consider security of property rights, the ease with which one may create a company, the tax system, contract law and efficiency of justice, prudential standards, competition policy and lack of corruption (Query, Coupet and Mayer, 2005). The main question when assessing the quality of institutions is how to measure such qualities. Different authors use various methodologies to measure the value of institutions[4].

A SHORT ASSESMENT OF THE INSTITUTIONAL ENVIRONMENT IN WESTERN BALKAN COUNTRIES

A widely accepted hypothesis in the specialist literature is that a stage of development of institutions is crucial in order to attract FDI, by reducing the transaction costs of setting up a local operation. If one examines Bevan et al (2003), in transition countries this proposition takes a specific form, "because institutions in question are those underpinning the market economy itself, and they have undergone fundamental transformation in the 1990s" (Bevan, Estrin and Mayer 2003: 47). Hence, the proposition for transition countries particularly states that countries with better developed institutions *for a market economy* receive more FDI inflows. The following table represents widely used proxies for institutional progress which are based on EBRD transition progress indices in various fields[5]. Indices are given on a five-point scale from 1 to 4+, where 1 corresponds to almost complete absence of any departure from a rigid centrally planned economy and 4+ means the achievement of the market economy standards typical for industrialized nations.

[4] The most used proxies as a measurement for quality of institutions are: Freedom House indices, EBRD indices on transition progress, International Country Risk Guide indices, World Wide Governance Indicators (Kaufmann et al), World Bank's World Business Environment Studies, Political Risk Service indices, Index of Economic Freedom

[5] EBRD: European Bank for Reconstruction and Development

Table 2: Measurement of institutional quality based on EBRD transition indicators

Index/ Country	Share of private sector in GDP	Privatization of large enterprises	Privatization of small enterprises	Overall management and structural reorganization of companies	Foreign trade and currency mode	Competition policy	Bank reform and liberalization of interest rates	Stock markets and non bank financial organizations	Overall reforms in infrastructure
Albania	75	4-	4	2+	4+	2	3	2-	2
B&H	60	3	3	2	4	2	3	2-	2+
Croatia	70	3+	4+	3	4+	3	4	3	3
Macedonia	70	3+	4	3-	4+	2+	3	3-	3-
Montenegro	65	3	4-	2	4	2	3	2-	2+
Serbia	60	3-	4-	2+	4	2	3	2	2+
Average	66,2	3,2	3,8	2,3	4	2,3	3,2	2,3	2,3

Source: EBRD Transition Report 2009, in Russian,

http://www.ebrd.com/downloads/research/transition/tr09r.pdf (21. 7. 2010.)

Good progress is made in the field of foreign trade liberalization, not surprisingly, since all Western Balkan countries have liberalized their foreign trade and foreign exchange markets. This was a precondition for any contractual relation with the EU. The worst scenario according to other measures is for overall management and structural reorganization of companies, competition policy, stock market reforms and reforms in infrastructure where the average score is around 2.3.

Frequently used indicators for assessing the overall institutional progress are those given in the report *The Worldwide Governance Indicators* which comprises six dimensions of governance: Voice and Accountability, Political Stability and Absence of Violence, Government Effectiveness, Regulatory Quality, Rule of Law and Control of Corruption. Governance in this sense consists of the *traditions and institutions* by which authority in a country is exercised[6]. This report is made annually for 213 economies. These six governance indicators are measured in units ranging from about -2.5 to 2.5, with higher values corresponding to better governance outcomes[7].

[6] This definition of governance is given by the authors themselves.

[7] The authors of this report are Daniel Kaufmann, Brookings Institution, Aart Kraay, World Bank Development Economics Research Group, Massimo Mastruzzi, World Bank Institute. http://info.worldbank.org/governance/wgi/index.asp (20. 7. 2010.)

Table 3: Kaufman et al Governance Indicators in 2008

Indicators/ Country	Voice and Accountability	Political Stability	Government Effectiveness	Regulatory Quality	Rule of Law	Control of Corruption
Albania	0,13	0,01	-0,34	0,16	-0,6	-0,45
Bosnia and Herzegovina	0	-0,57	-0,55	-0,19	-0,35	-0,32
Croatia	0,48	0,57	0,52	0,5	0,08	0,12
Macedonia	0,16	-0,31	-0,14	0,21	-0,32	-0,11
Montenegro	0,25	0,59	0,01	-0,05	-0,09	-0,28
Serbia	0,19	-0,5	-0,28	-0,21	-0,46	-0,16
Average	0,2	-0,035	-0,13	0,07	-0,29	-0,2
Slovenia	1,02	1,07	1,09	0,81	0,91	0,95

Source: Aggregate Governance Indicators 1996-2008,

http://info.worldbank.org/governance/wgi/index.asp (20. 7. 2010.)

Comparison with Slovenia illuminates the conditions regarding the quality of institutional environment in countries of the Western Balkans according to these indicators.

Table 4 briefly shows barriers of business activities and transaction costs in the Western Balkans measured by some of "Doing Business" indicators for 2009. For comparison, in the last row of the table there are figures for the average among OECD countries.

Table 4: Comparison of "Doing Business" Indicators for Western Balkans and OECD countries

Indicators/ Country/	Starting business Procedures (number)	Starting business Time (days)	Registering Property Procedures (number)	Registering Property Time (days)	Documents to export (number)	Time to export (days)
B&H	12	60	7	84	6	16
Croatia	7	22	5	104	7	20
Serbia	7	13	6	111	6	12
Montenegro	12	13	8	86	7	14
Albania	5	5	6	42	7	19
Macedonia	21	146	5	58	6	12
WB Average	10,7	43,2	6,2	80,8	6,5	15,5
OECD Average	5,7	13	4,7	25	4,3	10,5

Source: World Bank, http://www.doingbusiness.org/ExploreEconomies/ (16. 7. 2010.)

According to the above indicators, it is evident that the attractiveness of the region is not satisfactory. We can legitimately assume that listed indicators represent a huge barrier for potential investors.

It is also interesting to rank countries of the region according to the spread of corruption. Justification for the analysis of corruption as the most important informal institution and the factor that negatively affects FDI has been confirmed in abundant literature which is based on data from the field (Wei, 1997). According to Transparency International's Corruption Perceptions Index (CPI) among 180 countries Albania is ranked at 95th place, Bosnia and Herzegovina at 99th, Croatia at 66th, Macedonia at 71st, Montenegro at 69th and Serbia at 83rd place[8]. It's worth mentioning that our closest neighbor, Slovenia, is placed 27th.

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For the countries of our region we could say that they are far from having secure, regulated and efficient institutional environments. But, in the context of EU enlargement in the Western Balkans, we should expect a better prospective in terms of economic development. Accession and membership in the EU means membership in a single European market, which provides firms located in current EU countries with the opportunity to reallocate their production in new countries with lower costs. Moreover, membership in the EU is viewed by potential investors in the light of lower country risk. Also, EU membership implicitly guarantees future macroeconomic stability and efficient legal framework as well as the necessary political stability. The experience of new member states confirms the previous statement to a large extent. Preparation for proposed accession to the EU force countries to upgrade their institutional infrastructure and "by doing so, reduce both domestic and intra-European transaction and coordinating costs" (Dunning, 2004: 17). By adopting the EU institutional framework and thus establishing a transparent business environment it is to be expected that Western Balkan countries will be able to attract more FDI in the future.

8 Transparency International's Corruption Perceptions Index, http://www.transparency.org/policy_research/surveys_indices/cpi/2009/cpi_2009_table (13. 7. 2010.)

CONCLUSION

Bearing in mind the benefits of FDI inflows and the importance of qualitatively good institutions, it is crucial for Western Balkan countries to create an institutional environment that will ensure long-term stable flows of FDI. This is especially important due to the fact that our region is in a far inferior position compared to some more attractive regions and countries of the world, such as countries in South and South-East Asia. The development of the institutional environment implies lower transaction costs, lower risk and lower uncertainty for foreign companies that are entering new markets. Policy makers in Western Balkan countries will have to give a signal to foreign investors that doing business in their country is not risky and that the rules of the game are known and regulated. Since the countries of the Western Balkans have to make more efforts in the process of EU accession, it is expected that their institutional environment becomes "more business friendly". For each country in the Western Balkans, and also for the region as a whole, it is of crucial importance *to speed up* the process of institutional development. In addition to the fact that a healthy institutional environment is essential *per se*, it represents a necessary and long-term critical factor which could provide greater inflows of foreign capital in the future, i.e. in times after this crisis.

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