

Impact of Investment Environment on Foreign Direct Investment (FDI): Case of the Republic of Kosovo

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Abstract

The main objective of this paper is to investigate the impact of the investment environment on Foreign Direct Investment (FDI) in the Republic of Kosovo, by employing IV-GMM times series estimator, where Control of Corruption and Political Stability, Absence of Violence/Terrorism and Distance to frontier score (Doing Business) are used as main variables, while as pull factors are used GDP per capita, unemployment rate and profit tax rate. Further, The empirical findings reveal that Control of Corruption and Political Stability and Absence of Violence/Terrorism have positive and significant effect on attracting FDI flows, while Distance to frontier score (Doing Business) has shown negative effect on FDI flows in the case of Republic of Kosovo for the time period 2009q1 -2016q4. Furthermore, This paper for the first time tries to address the Kosovo case, using the IV-GMM estimator method and handling the above mentioned variables over this time period, presenting a unique case with regard to the Republic of Kosovo because, from our best knowledge, has not been addressed before such nexus for the case of Kosovo. In addition, This paper will also contribute to the existing literature rather than solving the existing debate among scholars, by using these measures to investigate their impact on attracting FDI in a transition country such as the Republic of Kosovo.

Keywords: FDI, investment environment, IV-GMM, time series, transition.

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1. Introduction

A country's investment environment is a wide area including many different aspects and determinants that may affect one or other form in attracting FDI. Creating an attractive environment for potential investors, and in particular foreign investors, represents an ever-increasing challenge for different states, especially for developing countries, where Kosovo is a part of, looking at increasing competition in the future and taking measures from different countries to improve the investment environment and attracting FDI.

Some transition countries, with particular emphasis on Balkan countries, including Kosovo, have failed to reach a high level of FDI in their own countries. Estrin & Uvalic (2013), emphasizes that Balkan countries have failed to improve their institutions, for example, regarding the protection of property rights or the investment climate and levels achieved by more advanced economies. They suggest that this has inevitably cost these countries in terms of FDI. Foreign Direct Investment (FDI) in the Balkan countries could be further enhanced through governmental policies, but this would mean deep institutional reforms in capturing deeply rooted nettles (negative phenomena), it is also highlighted by the aforementioned authors. Also, Ganic (2013) points out that, in contrast to Central and Eastern European countries, Western Balkan countries are the least targeted regions, which means they have attracted less FDI. FDI inflows into the Western Balkans region were not sufficient either in scope or structure, to restructure economic activity, or to boost export competition. FDI inflow into transition economies was mainly caused by the privatization process that had taken place during this phase.

However, these states are undertaking continuous steps towards improving the investment environment and attracting Foreign Direct Investment (FDI) in their countries.

Also, the Government of the Republic of Kosovo has taken some measures to improve the investment environment, one of which is the Law on Foreign Investments, adopted in December 2013 with the purpose of regulating the protection, promotion and stimulation of foreigners investments in the Republic of Kosovo, as well as the provision of basic rights and guarantees to provide security to foreign investors for their investments.

The Law on Strategic Investments, adopted in December 2015, intended the same goal of improving the investment environment, creating facilities and stimulating investors to invest, including foreign investors. The law has been implemented by the country's institutions.

Moreover, regarding the case of Kosovo, Control of Corruption and Political Stability and Absence of

Violence/Terrorism have positive and significant effect on attracting FDI flows, while Distance to Frontier score (Doing Business) has shown negative effect on FDI flows.

The structure of the paper is organized as following: in the section 2, it is presented a brief overview regarding the relevant literature of the nexus between investment environment and FDI flows. Further, section 3 is dedicated to the research methodology and data, while the empirical findings are presented in the section 4. Last section deals with the conclusions and recommendations implied from the empirical findings.

2. Literature Review

text text text text Many scholars have tried to treat investment environment and Foreign Direct Investment (FDI) from different aspects and countries, which are presented below:

Haile & Assefa (2006) tried to investigate determinants of foreign direct investment in Ethiopia over the period 1974-2001, using time-series analysis and they pointed out that stable macroeconomic and political environment are essential to attract FDI to Ethiopia. Furthermore Lim (2001) emphasizes an unstable political situation, or economic instability would make the host country less attractive for FDI. In addition, in the decision of foreign investors to invest, the political risk plays a major role, Moosa (2002).

Another study conducted by Barlow & Wender (1955), in interviewing 247 US companies on their strategies to invest abroad, shows that the host country's political stability is among the main factors in attracting FDIs. In addition this finding was confirmed by a survey of 205 companies carried out by Robinson (1961) and also Aharon (1966). Further, many scholars from different countries point out the importance of political stability in attracting FDI flows such as Loree & Guisinger (1995); Woodward & Rolfe (1993); Campos & Nugent (2003); Sethi et al., (2003); who emphasize that political stability has a significant positive relationship with FDI flows. Also Mengistu & Adhikary (2011), in their study; analyze the impact of political stability on FDI inflows and they found out that political stability is among main factors on FDI location. In this line is also Samimi & Ariani (2010) who studied the impact of a political stability on Foreign Direct Investment and they have noticed that political stability has a positive impact on FDI inflows.

Nazeer & Masih (2017) using time series data over the period of 30 years ranging from 1984 to 2013, attempting to estimate the effect of political instability which is an index made of: Government Stability, Corruption, Law and Order, Democratic Accountability, Bureaucracy Quality on FDI and economic growth, hence, from their empirical results reveal that there are both long and short run relationship between political instability, FDI and economic growth in Malaysia.

Control of corruption has been identified as one of the main factors of FDI location, this finding was highlighted by the authors, Mengistu & Adhikary (2011). Also Samimi & Ariani (2010) have pointed out that control of corruption has positive impact on FDI inflows. Teksoz (2006), corruption has a negative and significant impact on the foreign direct investment inflows. Hellman, et al., (2002), corruption not only reduces FDI inflows, but attracts lower quality investments in terms of governance standards. On the other hand Gutierrez (2015) notes that the high level of corruption in Argentina does not adversely affect its FDI within the country, because FDI mainly focuses on exploiting the country's natural resources.

Mahuni & Bonga, (2017) analyzed the impact of various Ease of Doing Business Indicators on FDI inflows in Zimbabwe. The study employed a Time Series Analyses using data from 2009-2016. They pointed out that, Paying Taxes (PT), Enforcing Contracts (EC), and Getting Electricity (GE) had negative significant impact on FDI inflows.

Kasongo (2013) in his study noticed that some indicators from Doing Business results suggest an insignificant (albeit negative) association between the cost to start a business, time to register property, time to import, time to export and FDI. Also he points out that starting a business, cost of registering a property were found to be significant in determining FDI inflows. Also Shahadan et al (2014) studied how FDI is influenced by Doing Business Indexes (DBI) for six Asian countries namely; Afghanistan, Bangladesh, India, Iran, Pakistan and Sri Lanka. Panel data was employed for the period 2004-2013. The major justification of the selected sample by the researchers was that the countries are closer to each other and hence the indicators are likely to have a strong influence on FDI inflows for the countries under study. Researcher pointed out that there is a strong negative correlation between starting a business, dealing with construction permits indexes and quite small and negative correlation with closing business or resolving insolvency index, but surprisingly FDI inflows is highly negatively correlated with paying taxes index. Also they found out that factors such as registering property, getting credit and trading across borders were all significant and positively related to explaining FDI inflows for the countries.

There are various studies that have tried to address the tax aspect in attracting Foreign Direct Investment, but not specifically and separately profit tax. Bailey (2018), pointed out that tax rates had negative relationship with FDI flows. Also from their point of view Barlow & Wender (1955) noticed that favorable taxes were 10% as a condition for FDI. In this line is also Robinson (1961) who points out that when other factors such as political and economic stability, infrastructure and transport costs are almost equal among potential countries, taxes may have a significant impact on FDI, otherwise taxes do not have any impact on FDI, where one of the respondents during

his research stated that "tax exemption is like a dessert, it is good to have it, but it does not help much if food is not there". Therefore the power of taxation should not be overestimated Tanzi & Zee (2000) indicate, much more important are other factors such as availability of natural resources, economic and political stability and other factors than the tax. Nevertheless they admit that if two countries do not differ too much in other factors, unilateral tax measures can be effective.

Aktar & Öztürk (2009), from their analysis of the Turkish state pointed out, there is no causal relationship between the unemployment and the inflow of foreign direct investment in this country. Also Saray (2011) had found similar results when analyzed data stretching from 1970-2009, for Turkish economy.

Bekhet & Othman (2011) using time series data for the time period 1971-2009, reveal that GDP growth was found to be significant on FDI. Also results from Haile & Assefa (2006) employing time series analysis emphasized that growth rate of real GDP has positive impact on FDI. In the same line is also Shahzad et al. (2013) who conducted their research for the time period 1991-2011 highlights that the growth of the GDP ratio has a positive impact on the inflow of Foreign Direct Investment in Pakistan.

3. Research Methodology and Data

In order to analyze the relationship between investment environment and Foreign Direct Investment in the Republic of Kosovo, IV-GMM time series estimator was used for the time period 2009q1-2016q4. The limitation of the time series was mainly because of some restrictions, since Kosovo has declared its independence in 2008 and since 2009, starting to record the data in international financial institutions.

In addition, the following variables included in the model are presented in table 1.

Table 1. Descriptions of dependent and independent variables.

Variable	Definition	Source
FDIOFGDP	FDI net inflows as percentage of GDP are the net inflows of investment to acquire a lasting management interest (10 percent or more of voting stock) in an enterprise operating in an economy other than that of the investor. It is the sum of equity capital, reinvestment of earnings, other long-term capital, and short-term capital as shown in the balance of payments. This series shows net inflows (new investment inflows less disinvestment) in the reporting economy from foreign investors, and is divided by GDP.	World Bank
FDIOFGDP (-1)	First lag of FDI as percentage of GDP	World Bank
CC	Control of Corruption captures perceptions of the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as "capture" of the state by elites and private interests. Percentile rank indicates the country's rank among all countries covered by the aggregate indicator, with 0 corresponding to lowest rank, and 100 to highest rank.	World Bank
SPOL	Political Stability and Absence of Violence/Terrorism measures perceptions of the likelihood of political instability and/or politically-motivated violence, including terrorism. Percentile rank indicates the country's rank among all countries covered by the aggregate indicator, with 0 corresponding to lowest rank, and 100 to highest rank.	World Bank
EDB	Distance to frontier score (Doing Business) illustrates the distance of an economy to the "frontier," which represents the best performance observed on each Doing Business topic across all economies and years included since 2005. An economy's distance to frontier is indicated on a scale from 0 to 100, where 0 represents the lowest performance and 100 the frontier.	World Bank
GDPcap	GDP per capita is gross domestic product divided by midyear population. GDP is the sum of gross value added by all resident producers in the economy plus any product taxes and minus any subsidies not included in the value of the products. It is calculated without making deductions for depreciation of fabricated assets or for depletion and degradation of natural resources. Data are in current U.S. dollars.	International Monetary Fund (IMF)
UNEMP	Unemployment Rate (Annual) (Percent)	World Bank
PT	Profit tax rate is the amount of taxes on profits paid by the business.	World Bank

Source: Authors' compilation

In addition, as a dependent variable is set the FDI net inflows as percentage of GDP, while in the framework of the investment environment used as endogenous variables are taken variables as: Control of Corruption, Political Stability and Absence of Violence/Terrorism and Distance to frontier score (Doing Business). In addition, in the

GMM – IV, the rank condition, requires at least as many exogenous variable (instruments) as the endogenous variables, thus the following variables used as exogenous are GDP per capita, Unemployment rate and Profit tax rate. Data related to this paper have been collected by the World Bank for the period 2009-2016, but in order having higher number of observations it is done converting annual data into quarterly data for this time of period.

Further, the basic model of this paper is shown below:

$$FDI_{it} = \beta_1 FDI_{i,t-1} + \beta_2 CC_{it} + \beta_3 PS_{it} + \beta_4 DB_{it} + \beta_5 GDP_{capit} + \beta_6 UNEMP_{it} + \beta_7 PT_{it} + u_{it} \quad (1)$$

where:

FDI_{it} represents the Foreign Direct Investments as percentage of GDP,

$FDI_{i,t-1}$ represents the first lag of Foreign Direct Investments, thus the main dependent variables,

$\beta_2 CC_{it}$, represents Control of Corruption;

$\beta_3 PS_{it}$, represents Political Stability and Absence of Violence/Terrorism;

$\beta_4 DB_{it}$, represents Doing Business, respectively Distance to Frontier score;

$\beta_5 GDP_{capit}$, represents GDP per capita,

$\beta_6 UNEMP_{it}$, represents Unemployment Rate

$\beta_7 PT_{it}$, represents Profit Tax rate. These three recent variables may affect the dependent variable;

u_{it} , represents the error term over years.

4. Empirical findings

Below you can see Table 2, which shows the descriptive statistics of the dataset used in the analyses, respectively, there are presented: the number of Observations (OBS), Average (MEAN), Standard Deviation (STD.DEV), Minimum (MIN) and Maximum (MAX). From the results it can be seen the average of dependent variable is 5.52, minimum it is 2.70, while maximum value is 8.40.

Table 2. Descriptive statistics

Variable	Obs	Mean	Std.Dev	Min	Max
FDIOFGDP	32	5.529406	1.860917	2.704707	8.407612
LAG1	32	5.529406	1.860917	2.704707	8.407612
CC	32	33.64816	3.574678	29.85782	43.50962
SPOL	32	29.57379	14.36382	14.69194	72.74881
EDB	32	62.42211	4.850992	56.36	69.42
GDPcap	32	3616.562	228.0476	3232.026	4016.459
UNEMP	32	35.50563	6.368627	24.8	45.7
PT	32	10.8	3.697237	9.3	23.95

Source: Authors' compilation

In addition, the following table represents the effects of investment environment on FDI inflows of Republic of Kosovo, for the time period 2009 q1 – 2016 q4. In addition, IV - GMM technique has been used to determine the relationship among these variables and the results are represented in the following table 3:

Table 3. IV - GMM results

VARIABLE	COEFFICIENT	STD. ERROR	T – STATISTICS	PROB
FDI % GDP (- 1)	.3235	.2224501	1.45	0.146
Control of Corruption	.0612456 ***	.0212352	2.88	0.004
Political stability	.1124723 ***	.0405449	2.77	0.006
Distance to frontier score	-.4490549 ***	.1718784	-2.61	0.009
Profit tax	-.4741986 **	-.2008723	2.36	0.018
R – square	0.9557			
J test			2.81826	0.1932
*statistically significant at 90% level of significance. **statistically significant at 95% level of significance. ***statistically significant at 99% level of significance. Instrumented: Profit tax; Instruments: Control of Corruption, Political stability, Distance to frontier score, lag1 GDPcap, Unemp				

Source: Authors' compilations.

As it can be noticed from the Table 1, Control of Corruption and Political Stability and Absence of Violence/Terrorism have positive and significant effect on FDI flows in Republic of Kosovo, for the time period 2009q1 – 2016q4. In addition, Distance to Frontier score (Doing Business) has negative and significant effect on FDI flows in this country. Moreover, profit tax has negative and significant effect on FDI flows in Republic of Kosovo. In addition, Hansen J test results fail to reject the null hypothesis, thus the over identification restrictions

are valid.

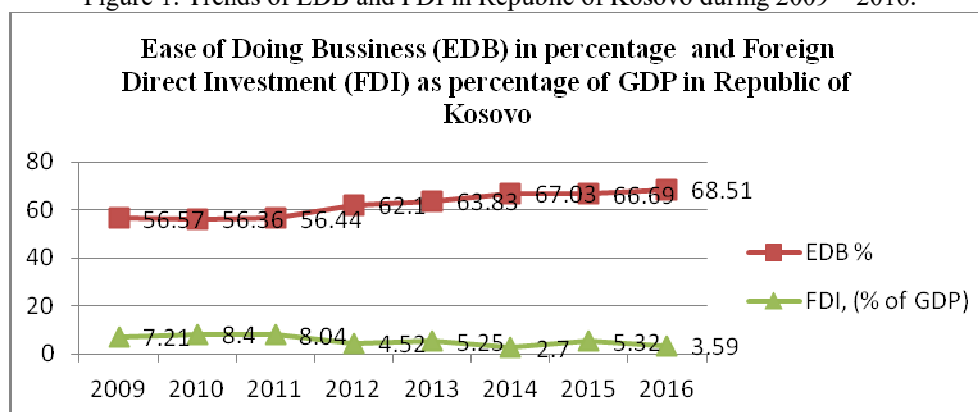
Further, Political Stability and Absence of Violence/Terrorism has shown a positive result on FDI, which is in line with existing literature, Haile & Assefa (2006), Lim (2001), Nazeer & Masih (2017), Moosa (2002), Barlow & Wender (1955), Robinson (1961), Aharon (1966), Lore & Guisinger (1995), Woodwarf & Rolfe (1993), Campos & Nugent (2003), Sethi et al (2003), Mengistu & Adhikary (2011), Samimi & Ariani (2010). Also Control of Corruption has positive and significant effect on FDI flows, similar to the authors before, Mengistu & Adhikary (2014), Samimi & Ariani (2010).

Unemployment rate has not shown any impact on FDI, similar to the results of Saray (2011), Aktar and Öztürk (2009). Also GDP per capita has shown no impact on FDI in the state of the Republic of Kosovo.

While on the other hand, Distance to Frontier score variable, from Doing Business, has negative impact in FDI in Republic of Kosovo, where some scholars have researched some of the indicators from doing business for different countries and they have founded some indicators with negative impact in FDI as Mahuni & Bonga (2017), Shahadan et al (2014). Regarding this indicator, it should be noted, based on World Bank's Doing Business reports, the Republic of Kosovo has made significant progress in recent years in improving the business environment in the country, as evidenced by statistics of the overall indicator from "Doing Business", which is Distance to Frontier (DTF) score, where during the years 2009-2016 there has been a positive trend, from 56.57% in 2009 to 68.51% in 2016, ie an increase of 11.94 percentage points over this time period. Despite this increase and improvement of this indicator, Foreign Direct Investment (FDI) has declined, mainly due to: high level of corruption and political instability in the country. So these factors have contributed to the fact that, despite the improvement of Ease of Doing Business (EDB) factor, there is a decline in FDI over these years, which at first glance may seem as a negative impact of this factor on FDI, but the impact of other factors mentioned above has actually caused this decline in FDI.

This ratio between Ease of Doing Business (EDB), expressed in percentage and Foreign Direct Investment (FDI) as a percentage of Gross Domestic Product (GDP) in the Republic of Kosovo can be seen in the figure below.

Figure 1. Trends of EDB and FDI in Republic of Kosovo during 2009 – 2016.



5. Conclusion

Main aim of this paper was to empirically investigate the impact of the investment environment on Foreign Direct Investment (FDI) in the Republic of Kosovo, by employing IV-GMM times series estimator, where Control of Corruption and Political Stability, Absence of Violence/Terrorism and Distance to frontier score (Doing Business) are used as main endogenous variables, while as exogenous variables are used GDP per capita, unemployment rate and profit tax rate.

Further the empirical findings revealed that Control of Corruption and Political Stability and Absence of Violence/Terrorism have positive and significant effect on attracting FDI flows, while Distance to frontier score (Doing Business) has shown negative effect on FDI flows in the case of the Republic of Kosovo, for the time period 2009q1 -2016q4.

Furthermore, This paper for the first time tries to address the Kosovo case, using the IV-GMM estimator method and handling the above mentioned variables over this time period, presenting a unique case with regard to the Republic of Kosovo because, from our best knowledge, has not been addressed before such nexus for the case of Kosovo.

Also profit tax has shown negative impact in FDI. Many authors have tried to address the tax aspect in attracting Foreign Direct Investment, but not specifically and separately profit tax as we have taken.

On the other hand, two variables Unemployment rate and GDP per capita have not shown any impact on FDI in the state of the Republic of Kosovo.

From this research and analysis of data on the investment environment in Kosovo and FDI, some recommendations can be made, as follows:

- for the government it should be priority combating corruption, where, the new Criminal Code of Kosovo has entered into force since 14 April 2019 and provides harsh measures for all who misuse the country's taxpayers' money. Through this Penal Code it is expected an uncompromising fight against corruption which could affect the growth of Foreign Direct Investment in the Republic of Kosovo. This importance of combating corruption is also presented by these results, considering this as one of the main factors that impact in attracting Foreign Direct Investment (FDI) in Republic of Kosovo.

- also the creation of political stability in the country should be among the first priorities of the government of the Republic of Kosovo, because investors prefer their investment to become a politically stable country as also this research poses a very important factor in attracting FDI.

- it is also very important for the government creating a more favorable environment in terms of providing tax incentives for investors, since, based on these results this could increase FDI inflows into the Republic of Kosovo. In addition, it is important to mention that this paper contributes to the existing literature, rather than solving the existing long debate among scholars, by using these measures to investigate their impact on attracting FDI in a transition country such as Republic of Kosovo.

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