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# The Impact of Institutional Quality on Foreign Direct Investments: Insight from Western Balkan Region

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# The Impact of Institutional Quality on Foreign Direct Investments: Insight from Western Balkan Region

**Abstract**

The aim of this research is to provide empirical evidence and to investigate the impact of institutional quality on foreign direct investment in Western Balkan countries over the period 2000-2019 using the panel data analysis. We used the technique of pooled OLS, fixed effects, random effects and Hausman-Taylor model with Instrumental Variables (IV). The results show that only two components of institutional quality have significant correlation with FDI. Rule of Law (RL) has a negative effect on FDI while Political Stability (PS) has shown a positive effect on FDI. Also, the determinant of FDI, such as inflation has shown significant positive correlations with FDI. The policies that should be taken by central and local government to overcome these barriers and identifying motivating strategies for existing investors for the purpose of maintaining and expanding their investment (re-investments) would be a guide for reforms to be made in the development of overall economic and FDI.

**Keywords**: Foreign direct investment, Institutional quality, Western Balkan, panel data analysis.

## Introduction

The degree to which institutional quality affects the promotion of foreign direct investment (FDI) in countries along the belt and road remains unclear. A key factor in establishing an open economy is the presence of strong institutions, a point emphasized in past research (Wang et al., 2019). To delve deeper into how institutional quality impacts FDI promotion, scholars have turned to national panel data (Wang et al., 2019), conducting empirical analyses to explore this connection. Ultimately, their aim has been to discern the role institutional quality plays in facilitating FDI (Wang et al., 2019). The flow of FDI is enhanced by the relationship between institutional quality and macroeconomic uncertainty, which mitigates the negative impact of economic uncertainty (Echeverri et al., 2013). Consequently, the presence of effective regulations is crucial in promoting the growth effect of FDI (Buchanan et al., 2011). This reinforces the notion that institutional quality is a critical factor in bolstering FDI (Echeverri et al., 2013). According to research (Echeverri et al., 2013), an increase in institutional quality can boost the flow of foreign direct investment (FDI). For FDI to have a growth effect, it is also crucial to have effective and top-notch

regulations in place (Buchanan et al., 2011). Interestingly, total, credit market, business, and labor market regulations have all been found to have a significant positive impact on economic growth when combined with FDI (Buchanan et al., 2011). Furthermore, institutional characteristics, especially regulations, seem to play a crucial role in determining the FDI-growth nexus (Buchanan et al., 2011).

Moreover, the quality of institutions is one of the factors that can affect the impact of FDI on business formation (Echeverri et al., 2013). The relationship between institutional characteristics and FDI is complex and may require model development to fully understand (Echeverri et al., 2013). In this regard, it has been found that institutional characteristics can impact the effects of FDI on business formation (Echeverri et al., 2013). The effect of institutional quality on FDI facilitation is influenced by factors such as laws and regulations (Wang et al., 2019). The implementation of the Belt and Road Initiative has significantly enhanced the promotional effect of institutional quality on FDI facilitation (Wang et al., 2019). This impact mechanism involves mediating factors such as laws and regulations (Wang et al., 2019). It has also been found that good institutional quality positively and significantly affects FDI (Buchanan et al., 2011). It is important to note, however, that FDI volatility may have an adverse effect on economic growth (Buchanan et al., 2011).

This necessitates the importance of institutional reform, which is equally important as offering the correct macroeconomic environment in attracting FDI into countries (Buchanan et al., 2011). The study also considers how institutional characteristics contribute to the groundwork for business development in emerging countries, examines the interplay between FDI, institutional quality, and the free market, and assesses the contingency impact between the two channels of home country institutions (Echeverri et al., 2013). Numerous economic and political institutions have an influence on the level of FDI in a country (Sabir et al., 2019). The type of institution, and its strength, can greatly affect inward FDI (Sabir et al., 2019). Studies have sought to measure the impact of institutional quality on FDI (Sabir et al., 2019), such as the degree of political risk, cultural approach, market scale, and geographic distance of the host country (Chen & Jiang, 2021). Other factors taken into consideration are the degree of corruption, GDP and fiscal deficit, exchange rate, return rate of FDI, situation of infrastructure, degree of openness, and intellectual property protection (Chen & Jiang, 2021). In addition, the text states that weak institutions are associated with less FDI (Sabir et al., 2019). In contrast, developed countries generally have stronger institutions, which positively impact FDI (Sabir et al., 2019). On the other hand, developing countries with weaker institutions may experience negative impacts on FDI (Sabir et al., 2019). Moreover, political stability, even in the face of policy uncertainty, encourages investors to invest more capital in countries (Sabir et al., 2019). Government effectiveness and regulatory quality also have a positive impact on FDI in low and lower-middle-income countries, as does political stability in these countries (Sabir et al., 2019). Furthermore, public and civil services, independent of political pressure, are important for encouraging investment by entrepreneurs and investors (Sabir et al., 2019). Lastly, institutional reform is deemed an essential determinant for

attracting FDI in all countries, and efficient markets in terms of institutions, trade openness, GDP per capita, and better infrastructure are all important determinants of FDI (Sabir et al., 2019).

Numerous theories have been proposed to explain the institutional quality of a country and its impact on inward FDI. Dunning's eclectic paradigm theory and North's institutional theory posit that institutional quality is a factor in determining inward FDI (Sabir et al., 2019). Further, the four institutional-quality factors, namely government intervention, access to sound money, legal structure and security of property rights, and regulation of credit, labor and business, critically influence the technological assets-related overseas investment of the firm (Kim & Choi, 2020). These institutional quality measures moderate the diverse contingencies in a firm's investment decision (Kim & Choi, 2020). These measures include the size of government, legal structure and security of property rights, access to sound money and regulation of credit, labor and business (Kim & Choi, 2020). Additionally, the nature of an institution can be either supportive or oppressive for a firm's strategic decision, such as investments (Kim & Choi, 2020), and institutional quality matters for FDI in manufacturing, particularly in services (Ali et al., 2010). Research has concluded that institutions are a robust predictor of FDI, however, they do not have a significant impact on FDI in the primary sector (Ali et al., 2010). Moreover, the most significant institutional aspects linked to propriety rights influence the decision to invest in a country (Ali et al., 2010).

Additionally, GDP per capita, agriculture value-added as a percentage of GDP and inflation influence FDI inflows negatively in developed countries, and institutional quality has a positive impact on FDI in all groups of countries (Sabir et al., 2019). Institutional quality is a more important determinant of FDI in developed countries than in developing countries, and trade openness as a percentage of GDP and infrastructure positively affect FDI in developed countries, while GDP per capita, trade openness, agriculture value-added as a percentage of GDP and infrastructure have positive and statistically significant impacts on FDI inflows in developing countries (Sabir et al., 2019). Additionally, control of corruption, government effectiveness, political stability, regulatory quality, rule of law and voice and accountability have a greater impact on FDI inflows in developed countries than in developing countries (Sabir et al., 2019). Furthermore, institutional reforms are crucial for countries with limited fiscal space and a reliance on foreign investment to enhance their prospective growth, but the uneven implementation of institutional reforms can lead to an ineffective institutional environment which weakens fair competition and the enforcement of contracts (Aziz, 2017). Ultimately, better institutional environment is characterized by high private investment and FDI inflows, however, the Arab region has poor business quality due to its failure to adopt adequate institutional reforms and reduce political instability (Aziz, 2017). Moreover, control of corruption and regulatory quality enhance FDI inflow in lower-middle income countries, with regulatory quality having the greatest impact on foreign investment inflows among all the institutional metrics (Aziz, 2017). Additionally, institutional factors have a different impact on attracting FDI in lower-middle income countries compared to high and low-income countries, but the outcome is largely similar

in the three subgroups (Aziz, 2017), however, high rule of law and voice and accountability mitigate FDI inflow in lower-middle income countries.

**$H_1$:** The institutional quality indicators have a significant effect on FDI inflows in the Western Balkans.

## 2. Literature Review

### 2.1 Corruption and FDI

Corruption is a phenomenon that involves the misuse of public power for private gain, often through bribery or the misuse of public funds (Korkmaz & Çelik, 2021) (Epaphra & Massawe, 2017). It has a negative impact on foreign direct investment (FDI) by increasing uncertainty and risk, reducing investor returns, and increasing transaction costs (Korkmaz & Çelik, 2021) (Habib & Zurawicki, 2002) (Epaphra & Massawe, 2017) (Canare, 2017). Countries with high levels of corruption are less attractive to foreign investors because corruption can reduce returns on investment and increase the uncertainty of business operations, leading to reduced FDI inflows (Korkmaz & Çelik, 2021) (Habib & Zurawicki, 2002). The Corruption Perceptions Index (CPI), developed by Transparency International, is used to measure corruption in countries. There is a statistically significant link between CPI and FDI flows to 54 developing and developed countries, and an improvement in the CPI score can lead to an increase in FDI (Zhao, Kim & Du, 2003). A one-point improvement in CPI can generate an additional FDI of 0.5% of GDP on average, while a three-point improvement can more than double the corporate tax take on average (Zhao, Kim & Du, 2003). Corruption also affects the generation of taxable income and tax revenues in each country, which can further discourage foreign investors (Zhao, Kim & Du, 2003). A high level of corruption significantly hinders the inflow of FDI to host countries, creating significant uncertainty and increased transaction costs for foreign investors. Countries with lower levels of corruption tend to attract more FDI, and corruption can lead to a misallocation of resources, reducing productivity and competitiveness (EPAPHRA & MASSAWE, 2017) (Zhao, Kim & Du, 2003) (Canare, 2017). Overall, corruption remains one of the greatest obstacles to economic and social development in low-income countries, and its effects on FDI inflows are significant and negative (Ketkar, Murtuza & Ketkar, 2005).

Corruption can be detrimental to the economic growth of a country in several ways. One such way is its impact on foreign direct investment (FDI) and financial markets. Research shows that higher levels of corruption can discourage investors and reduce FDI, hindering financial development in developing countries (Freckleton et al., 2012) (Voyer & Beamish, 2004). Additionally, corruption can hinder financial development in these countries, which can then impede overall economic growth (Kholdy & Sohrabian, 2008). The lack of legal and regulatory frameworks in emerging nations can make corruption have an even more negative impact on FDI (Voyer & Beamish, 2004). Managers may also consider corruption as a factor when assessing potential investments in a

market (Voyer & Beamish, 2004). Suspiciously close ties between politics and business can contribute to corruption in developing countries, which can further hinder financial development and ultimately lead to a lack of economic growth (Kholdy & Sohrabian, 2008). While research has not examined the combined effect of corruption and foreign investment on financial development,it is clear that corruption has a significant impact on the link between FDI and financial markets (Kholdy & Sohrabian, 2008). Therefore, reducing corruption should be a priority for policymakers to promote economic growth and attract more foreign investment to their country.

Corruption can take on many different forms and categories, and the impact it has on foreign direct investment (FDI) can vary depending on the particular form of corruption involved. Overall, corruption tends to have a negative effect on FDI, as investors are often wary of entering markets where corruption is rampant (Habib & Zurawicki, 2002) (Zurawicki & Habib, 2010). However, the relationship between corruption and FDI is not always straightforward, as some studies have found that certain forms of corruption may actually attract more FDI in transition economies, while structural reforms have a stronger impact on FDI in countries with lower levels of corruption (KORKMAZ & ÇELİK, 2021). For future research, it is important to examine the differential impacts of various forms of corruption and transparency on FDI in order to obtain a more nuanced understanding of the relationship between the two (Zhao, Kim & Du, 2003). Despite some nuanced findings, the majority of studies confirm that corruption has a negative impact on FDI, and that reducing corruption can make countries more attractive to investors (Mathur & Singh, 2013) (Castro & Nunes, 2013). Some of the most common forms of corruption include fraud and embezzlement by public officials, and these types of corruption have been found to negatively impact inward foreign direct investment (Ketkar, Murtuza & Ketkar, 2005). In fact, research has shown that corruption has a significant negative impact on the FDI performance index for countries worldwide, with higher levels of corruption leading to lower FDI performance. Overall, it is clear that reducing corruption is an important step for promoting foreign direct investment and economic development.

H1a: Corruption has a significant impact on FDI.

## 2.2 Rule of law and FDI

The concept of rule of law is related to public ordering, which involves relying on formal public legal codes for rules and adjudication (Wu et al., 2012). Specifically, a strong rule of law can mitigate the lack of portfolio investments due to asymmetric information. In economies with a well-developed financial system, an effective rule of law is likely to increase the share of portfolio investments in total investments by better protecting shareholders' rights (Akisik, 2020). However, the concept of rule of law is being questioned in relation to large-scale land acquisitions in sub-Saharan Africa. The rule of law is being undermined in this context due to legal deficiency and elite capture. Weak rule of law is a characteristic of a relation-based governance environment

where private ordering, which involves reliance on informal and relational networks, is prevalent. On the other hand, strong public rule of law is a characteristic of a rule-based governance environment where public rules are present. In a family-based governance environment, public rules are absent (Wu et al., 2012) (German et al., 2013). Section 2 provides an overview of the concept of rule of law.

State-owned enterprises (SOEs) invest more in countries with poor rule of law than privately owned enterprises (POEs) (Knutsen et al., 2017). Interestingly, despite institutional risk factors, such as high levels of corruption and weak rule of law, SOEs' FDI does not seem to decline (Knutsen et al., 2017). However, there is no solid evidence indicating that SOEs invest more in countries with better rule of law (Knutsen et al., 2017). Maintaining a high level of rule of law is suggested to continue attracting FDI inflows in sub-Saharan Africa, as it has a positive and statistically significant effect on FDI inflows (Awadhi et al., 2022). This is supported by the Institutional FDI Fitness Theory, which suggests that institutional factors, including the rule of law, influence FDI inflows (Awadhi et al., 2022). Therefore, it is imperative to address legal deficiencies and elite capture, which undermine the rule of law in large-scale land acquisitions.

The rule of law is a crucial factor that can influence foreign direct investment (FDI) in a country. In fact, empirical analysis has shown that rule of law is a statistically significant factor in attracting FDI. This is particularly true for BRICS economies, where rule of law has been identified as a potential institutional and political determinant of FDI (Jadhav, 2012). Indeed, countries with a good rule of law are generally more attractive to foreign investors because they offer greater security and stability. By contrast, countries with a poor rule of law are often perceived as risky and unpredictable, which can deter foreign investors. Interestingly, the relationship between rule of law and FDI appears to be more complex when it comes to state-owned enterprises (SOEs) versus privately owned enterprises (POEs). Specifically, SOEs invest relatively more than POEs in countries with poor rule of law, but there is no solid evidence indicating that SOEs invest more in countries with better rule of law. Thus, maintaining a high level of rule of law is critical for attracting FDI, particularly in regions like sub-Saharan Africa where investment is needed for economic development.

H1b: Rule of law has a significant impact on FDI.

### 2.3 Political Stability and FDI

Political stability is a crucial factor influencing foreign direct investments (FDI) and is considered during the decision-making process of foreign investors. Countries with political stability are more likely to attract higher FDI inflows, while political instability negatively impacts FDI, leading to reduced economic growth (Malik & Mansur, 2017). It is also important to note that political factors play a significant role in explaining FDI flows (Kim, n.d.). The socio-political institutional environment affects FDI inflows, and countries with high levels of corruption and low levels of

democracy tend to have higher FDI inflows (Kim, n.d.) (Okara, 2023). However, the assessment of political stability is crucial for multinational enterprises to make the best decision about FDI, and they may avoid investing in regions with political instability (Caon, 2020). Political stability is assessed across various metrics including the strength of institutions, transparency and the rule of law, and factors like corruption, terrorism, strength of institutions, and rule of law can help assess political stability (Caon, 2020). Empirical results reveal that there are long and short-run relationships between political instability, FDI, and economic growth in Malaysia. A steady deterioration in political stability results in a decrease in FDI over time (Malik & Mansur, 2017) (Okara, 2023). However, FDI promotes political stability by generating economic opportunities, which fosters socio-political stability (Okara, 2023). Furthermore, greenfield FDI has greater socio-economic externalities resulting from directly generated new economic activity and jobs (Okara, 2023). There is a positive relationship between FDI and political stability, and the political stability index measures the socio-political institutional environment (Okara, 2023). Overall, political stability is an important factor to consider when assessing a potential FDI destination, as it can determine whether a country is attractive for investment or not.

Political stability is a crucial factor in determining the success of a country's economic policies, particularly in terms of foreign direct investment (FDI) (Schneider & Frey, 2002). Political risk factors, such as corruption, civil unrest or regulatory uncertainty, can significantly impact the relationship between FDI and financial development by shifting the threshold level of financial development required to attract investment. In other words, countries with higher political stability will be able to efficiently utilize FDI to benefit their financial institutions, as well as their overall economy. Conversely, political instability can adversely affect financial development and disrupt the flow of FDI (Dutta & Roy, 2011). Higher political stability allows investors to have confidence in the country's administration and its ability to provide a conducive environment for business operations. This confidence further encourages investors to invest more capital and resources in the country, leading to higher levels of economic growth (Dutta & Roy, 2011). In conclusion, political stability is a critical component in attracting foreign investment and promoting economic growth. Countries with high political stability are more likely to experience sustained economic development than those with political instability.

Political stability plays a vital role in foreign direct investment (FDI) as it affects the level and composition of FDI inflows. In fact, political instability is shown to significantly reduce the inflow of FDI (Nazeer et al., 2017). The effects of transition and political instability on FDI have been studied, and it has been found that FDI flows to transition economies that are unaffected by conflict and political instability are higher (Brada et al., 2006) (Brada et al., 2005). In addition, higher political stability aids financial institutions in efficiently reaping the benefits of FDI (Dutta & Roy, 2011). To understand the impact of political instability on FDI, researchers have analyzed various measures of political instability, including coups as a proxy for political risk (Asiedu, 2006). Though the empirical literature has revealed the implications of political instability on the level of expropriation predicted by the model, the causal relationships between political instability and FDI

remain ambiguous (Azzimonti & Sarte, 2012) (Nazeer et al., 2017). Policy makers and key decision makers would benefit from further research in this area to understand the impact of political instability on FDI, which is crucial for economic development. However, it should be noted that determining the effect of political instability on sectoral foreign direct investment is theoretically ambiguous (Burger et al., 2016).

H1c: Political stability has a significant impact on FDI.

## 2.4 Government effectiveness and FDI

Government effectiveness is a crucial aspect of governance, and it is assessed through various factors. These factors may include the quality of public services provided by the government, the level of bureaucracy, and the ability of the government to develop and enforce policies (Inter Consult Bulgaria Ltd. & Ionescu, 2010). The effectiveness of a government is determined by how successful it is in implementing and enforcing regulations and policies that promote social welfare and economic growth. The literature on institutional determinants of corruption relationships is relevant to understanding government effectiveness since corruption undermines trust in public institutions and hampers effective policy implementation (Inter Consult Bulgaria Ltd. & Ionescu, 2010). Thus, corruption is closely related to government effectiveness, and it is essential to tackle this problem to ensure good governance. Additionally, the impact of corruption on foreign direct investment also affects government effectiveness since investors are less likely to invest in countries with high levels of corruption (Inter Consult Bulgaria Ltd. & Ionescu, 2010). Therefore, governments must address corruption to attract investment and promote economic growth. In conclusion, government effectiveness is a multifaceted concept that encompasses various factors such as corruption, policy implementation, quality of public services, and bureaucracy. The ability of a government to function effectively and efficiently plays a crucial role in promoting social welfare and economic growth.

In order to gain a deeper understanding of the relationship between government effectiveness and foreign direct investment (FDI), it is important to consider the impact of corruption on FDI. Corruption is closely related to government effectiveness, and poor government effectiveness can lead to increased corruption, which in turn can discourage FDI. The identification of possible fraud and corruption risks, as well as the implementation of fraud and corruption risk assessments, are crucial in preventing corruption and improving government effectiveness. When government effectiveness is low due to corruption and inequality, it can lead to poor performance and an unfair legal system (Inter Consult Bulgaria Ltd. & Ionescu, 2010). Research has shown a strong negative relationship between corruption and FDI, with corruption acting as a significant barrier to FDI. In countries with high levels of corruption, investors may be hesitant to invest due to concerns about the stability and transparency of the regulatory environment. In contrast, countries with low levels of corruption and high government effectiveness are more attractive to foreign investors due to the perceived stability and predictability of the regulatory environment (Inter Consult Bulgaria Ltd. &

Ionescu, 2010). Therefore, improving government effectiveness by reducing corruption can have a positive impact on FDI.

While corruption can impact various industries and sectors, some may be more susceptible to the effects of poor government effectiveness. The literature suggests that corruption has a significant negative impact on foreign direct investment (FDI) (Inter Consult Bulgaria Ltd. & Ionescu, 2010). Sectors that rely heavily on FDI, such as manufacturing and finance, may be particularly vulnerable to the effects of corruption. In addition, industries that require a high level of government involvement or regulation, such as healthcare or energy, may also be more influenced by government effectiveness. This is because corruption can lead to a lack of enforcement of regulations and laws, which can result in poor performance and outcomes. Moreover, sectors that require a high level of transparency and accountability, such as the media or legal industries, may also be more susceptible to the effects of poor government effectiveness. This is because these industries rely on fair and impartial legal systems, which can be compromised by corruption. Hence, it is important to assess the risks of fraud and corruption in various industries and sectors, and to identify possible risks associated with poor government effectiveness in order to mitigate their impact.

H1d: Government effectiveness has a significant impact on FDI.

## 2.5 Regulatory quality and FDI

Regulatory quality is a critical factor when it comes to foreign direct investment (FDI) flows in ASEAN markets. The effectiveness and enforcement of investment regulations within the region are crucial determinants of inward and outward FDI flows. In recent years, there has been a decline in ASEAN FDI flows, which can be attributed to the deterioration of the effectiveness and enforcement of investment regulations (Rammal & Zurbruegg, 2006). Measuring regulatory quality is essential to understanding its impact on investment flows. One way to evaluate regulatory quality is by assessing factors such as price controls and excessive regulation in foreign trade and business development (Rammal & Zurbruegg, 2006). Regulatory effectiveness, coupled with good governance practices, also has an impact on the direction of outward FDI flows (Rammal & Zurbruegg, 2006). The principles for measuring regulatory quality were established through a three-step methodology that identified and synthesized proposals to overcome the limits of traditional regulation (Rammal & Zurbruegg, 2006). In order to assess regulatory quality, it is essential to consider the ability of the regulation to be participatory, decentralized, flexible, simple and clear, preventive, inducer of innovation, multi-instrumental, rigorous on enforcement, performance-based, planned and gradual, supported by adequate resources, measured and communicated, and reflexive. Moreover, regulatory quality refers to the quality and effectiveness of trade and investment regulations employed within the host country. Therefore, regulatory quality plays a significant role in determining the impact of regulatory factors on outward FDI from ASEAN countries to fellow member states (Rammal & Zurbruegg, 2006).

Foreign direct investment (FDI) is a type of investment that is made by a parent company in a foreign country through its affiliates (List & Co, 2002). FDI can be categorized as either efficiency-seeking or market-seeking based on its goal. The former aims to enhance the efficiency of the parent company's production process, while the latter aims to access new markets (List & Co, 2002). The measurement of FDI involves tracking the flow of financial resources and assets from the investing company to the foreign economy. Disaggregated data is employed to measure FDI, allowing for a more detailed analysis of the determinants of FDI (List & Co, 2002). FDI is related to economic growth, institutional quality, and manufacturing value added (Adams & Opoku , 2015). Institutional quality, along with economic growth and natural resources, plays a positive role in attracting FDI (Adams & Opoku , 2015). However, countries should consider both the positive growth effects and the adverse institutional effects of FDI when trying to attract it. Regulatory regimes of countries affect the FDI-growth relationship, with effective and quality regulations having a significant positive effect on economic growth (Adams & Opoku , 2015). The characteristics of Location Specific Factors (LSFs) are examined to understand the variability in FDI in Sub-Saharan Africa (SSA). Government consumption expenditure, inflation, GDP per capita, capital openness, and credits to the private sectors are the major deterring factors of FDI into the African continent (List & Co, 2002). Finally, governance infrastructure is a determinant of US FDI, with a minimum threshold of effective governance being necessary for a country to receive US FDI (Globerman & Shapiro, 2002).

The quality of regulatory institutions has an undeniable impact on foreign direct investment (FDI) in different regions. Doing Business rankings, which reflect the overall investment climate, can attract more FDI (Anderson & Gonzalez, 2020). The correlation between doing business indicators and FDI flows is also significant (Anderson & Gonzalez, 2020). A study used various measures of institutional quality to identify the impact of regulatory quality on FDI. The empirical results indicate a positive correlation between the quality of regulation and FDI in African countries. The quality of regulation positively affects the attractiveness of FDI in African countries, resulting in more investment in these regions (Bouchoucha & Benammou, 2018). Similarly, regulatory quality also has a positive impact on FDI in the context of Asia from 2001 to 2018 (Mohsin Abbas et al., 2021). Furthermore, firms establish subsidiaries abroad to acquire knowledge about the host institutional environment, which becomes an advantage for further expansion (Rammal & Zurbruegg, 2006). Host regulatory quality moderates taxation, highlighting the crucial role of institutions for firms originating in developed economies that lack sound institutions (Rammal & Zurbruegg, 2006). Sound institutions and lower tax rates abroad are extremely significant for domestic firms' internationalisation in developed economies with problematic regulations and high taxation (Rammal & Zurbruegg, 2006). Finally, FDI inflows towards environmental institutions and reforms in climate policies positively impact GHGs emissions reduction in Asia, demonstrating the importance of regulatory institutions for both economic growth and environmental sustainability (Mohsin Abbas et al., 2021).

H1e: Regulatory quality has a significant impact on FDI.

## 2.6 Voice and Accountability and FDI

Voice and accountability is a fundamental aspect of good governance, which plays a crucial role in attracting foreign direct investment (FDI) in developed countries. In democratic countries with secure freedom of speech rights and independent media, FDI flows steadily as investors are confident that their investments are safe and protected by a transparent legal and regulatory framework (Bouchoucha & Benammou, 2018). However, the same cannot be said for developing countries where the effect of voice and accountability on FDI is insignificant (Bouchoucha & Benammou, 2018). In African countries, voice and accountability is considered one of the measures of institutional quality that affect the attractiveness of FDI. A study revealed that the attractiveness of FDI to African countries is positively correlated with voice and accountability (Sabir et al., 2019). The results of the study suggested that improving the dimensions of governance and establishing good governance practices are necessary to attract FDI, including improving voice and accountability. Therefore, it is essential for developing countries to focus on improving their governance systems to attract FDI and to provide a conducive environment for businesses to thrive (Sabir et al., 2019).

According to the World Bank, voice and accountability is one of the three statistically significant governance indicators, signifying its importance in a country's overall governance structure (Gangi & Abdulrazak , 2012). Research has indicated that improving the overall state of governance, including voice and accountability, can have a positive impact on the investment climate and the inflow of FDI in African countries (Gangi & Abdulrazak , 2012). However, the text does not provide any information about the direct relationship between voice and accountability and economic growth. Nonetheless, studies have shown that there is a one-way causal relationship running from voice and accountability to economic growth and FDI. In countries where citizens can freely express their opinions and hold their government accountable, businesses are more likely to invest in such an environment, which in turn promotes economic growth (Gherghina et al., 2019). Therefore, it is safe to say that a higher level of voice and accountability in a country fosters an environment conducive to economic growth by attracting foreign investment.

Empirical evidence has shown that Voice and Accountability (VA) can have a significant positive impact on Foreign Direct Investment (FDI) inflows. In particular, studies have found that institutional factors such as control of corruption, government effectiveness, regulatory quality, rule of law and VA have a positive influence on FDI inflows and economic growth (Jadhav, 2012) (Gherghina et al., 2019). However, the relationship between VA and FDI is complex and mixed empirical evidence exists regarding the political and institutional determinants of FDI (Jadhav & Katti, 2012). Some studies have shown a positive correlation between VA and government effectiveness and rule of law, while others have found no significant relationship (Buchanan et al., 2011). Despite these mixed findings, studies have consistently found that improving institutional quality, including VA, can lead to a more favorable investment climate and increased FDI inflows (Bouchoucha & Benammou, 2018). Furthermore, the impact of institutional quality on FDI inflows

is greater in developed countries, indicating that improving VA is particularly important for developing countries seeking to attract FDI (Sabir et al., 2019). Overall, empirical evidence suggests that improving VA can be an effective means of attracting FDI and promoting economic growth.

H1f: Voice and accountability has a significant impact on FDI.

## 2.7 The impact of GDP and inflation on FDI

Foreign direct investment (FDI) is influenced by numerous factors, among them is Gross Domestic Product (GDP). GDP is one of the main determinants of FDI inflows as it serves as a proxy for market size (Jaiblai & Shenai, 2019). A higher GDP can attract more FDI inflows, indicating a positive relationship between GDP and inward FDI (Jaiblai & Shenai, 2019) (Sabir et al., 2019). GDP per capita, which is a measure of the level of development that influences FDI, is also a determinant of FDI inflows (Jaiblai & Shenai, 2019) (Sabir et al., 2019). Higher GDP per capita positively affects FDI since the level of development of a host country is an important determinant of inward FDI (Sabir et al., 2019). As the level of development increases, the population's ability to purchase goods and services increases, motivating foreign investors to invest in the host country (Sabir et al., 2019). Furthermore, market size, which is proxied with GDP per capita, is an important determinant of FDI in the host country (Sabir et al., 2019). There is a long-run relationship between FDI inflows and GDP. Countries that experience higher FDI inflows in relation to GDP are associated with periods of higher inflation, better infrastructure, lower income levels, and smaller markets (Jaiblai & Shenai, 2019). Therefore, GDP plays a significant role in attracting foreign investment, and its relationship with FDI can be a useful guide for policymakers to encourage investment in their countries.

Based on available research, it appears that inflation rate does not have a significant impact on foreign direct investment (FDI) in a host country. While higher GDP and market size, as measured by GDP per capita, are important factors that attract FDI inflows, inflation rate does not seem to be a significant determinant. In fact, some studies have found that inflation rate may have a negative relationship with FDI, but this relationship is not statistically significant (Opeyemi, 2020). On the other hand, the level of development of a host country is an important determinant of inward FDI. Countries with better infrastructure, higher human capital, and more efficient institutions tend to attract more FDI inflows in the long run. Therefore, while inflation rate may not be a significant factor in attracting FDI, other factors such as the level of economic development and market size are more important determinants of FDI inflows.

A study conducted in Bangladesh aimed to explore the relationship between economic indicators such as GDP, inflation rate, FDI and unemployment rate (Alam et al., 2021). The researchers found that GDP and FDI have a significant impact on the unemployment problem in Bangladesh (Alam et al., 2021). Furthermore, the results of the augmented Dickey Fuller test revealed that there is a

long-run relationship among GDP, inflation rate, FDI, and unemployment in Bangladesh (Alam et al., 2021). These findings suggest that an increase in GDP and FDI can lead to a decrease in unemployment rates, while inflation rates may not have a significant impact on FDI. Therefore, policymakers should focus on attracting foreign investment and promoting economic growth to reduce unemployment rates in Bangladesh. Additionally, controlling inflation rates may not be as effective in achieving this goal as previously thought. Further research could explore the relationship between these economic indicators in other countries as well.

## 3. Methodology

For data processing used pooled OLS, fixed and random effect estimates model to assess the impact institutional quality indicators on FDI in Western Balkan countries over the period 2000 to 2019. Also, we used the Hausman-Taylor with instrumental variables (IV) model which gives the opportunity of finding a solution for the endogeneity problem, Fetai, (2018). Pooled OLS is biased in the models with heterogeneous data and it violates the assumption related to standard errors which should follow a normal distribution with mean equal to zero and standard deviation equal to 1. Hausman Taylor model is based upon an instrumental variable estimator which uses both the between and within the variation of the exogenous variables as instruments (Baltagi, 2012). Wherefore, Hausman–Taylor solves endogenity problems, which are considered as an important issue from the econometrics point of view (Baltagi, Eger and Kesina, 2016).

We estimate the following model specification describing the determinants of FDI:

$$FDIi,t = \alpha + \beta 1CC\ i,t + \beta 2GE\ i,t + \beta 3PS\ i,t + \beta 4RQ\ i,t + \beta 5RL\ i,t + \beta 5VA\ i,t + \beta 3GDP\ i,t + \beta 3INF\ i,t + \varepsilon i,_1 \quad (1)$$

Where FDI is the Foreign Direct Investment in net inflows (% GDP), i is country and t is year, α is a constant, CC is control of corruption, GE is government effectiveness, PS is political stability, RQ is regulatory quality, RL is rule of law, VA is voice and accountability, GDP is the Gross Domestic Product growth (annual %), INFLA is the Inflation Rate for customer prices (annual %) and $\varepsilon i,t$ is the error term.

In Table 2 we have estimated descriptive statistics, FDI measured as net inflows (% of GDP) for Western Balkan countries between 2000-2019 range from 0.10 to 12.9% of GDP, with an average of 5.79 and standard deviation of 2.8. The lowest institutional quality, measured through governance quality indices, was shown within the political stability followed by rule of law. The highest rank within the listed institutional variables has political stability index followed by government effectiveness. The minimum GDP (annual %) is -7.2 and maximum value is 26.8. The minimum inflation (annual %) value is -2.4 and maximum value is 95.

**Table 2.** Descriptive statistics

| Variable | Obs | Mean | Std. Dev. | Min | Max |
|---|---|---|---|---|---|
| Year | 120 | 2009.5 | 5.79 | 2000 | 2019 |
| FDI | 109 | 5.104 | 2.844 | .106 | 12.973 |
| ControlofCorruption | 114 | -.347 | .306 | -1.177 | .392 |
| GovernmentEffectiv~s | 109 | -.169 | .415 | -.96 | .707 |
| PoliticalStability | 107 | -.175 | .526 | -1.643 | 1.007 |
| RegulatoryQuality | 108 | .035 | .333 | -.856 | .591 |
| RuleofLaw | 114 | -.341 | .32 | -1.272 | .409 |
| VoiceandAccountabi~y | 114 | .06 | .286 | -.739 | .658 |
| lnGDP | 119 | 3.813 | 3.389 | -7.226 | 26.888 |
| Inflation | 111 | 4.4 | 11.414 | -2.41 | 95.005 |

## 4. Empirical Results

In Table 3 we present the regression of the panel data, including OLS regression, fixed effects, random effects and Hausman-Taylor-IV. In the first column we present the Pooled OLS regression. The effects of fixed effects and random effects are presented in the second and third columns. To choose one of them we used the Hausman test. Hausman test chi-st. is 20.19 and p value is 0.01. This indicates that we should choose fixed effects estimator as its results are more consistent and should reject random effects estimator as it is less efficient. In the fourth column we have estimated the Hausman-Taylor method with instrumental variables (IV) technique to avoid problems that may arise with endogeneity and correlation between variables and error terms and we have concluded that this is the better choice that fixed and random effects.

During the application of this method, we have used lagged values of the independent variables as instruments of institutional quality. The results show that we accept *H1: The institutional quality indicators have a significant effect on FDI inflows in the Western Balkans*. While the political stability (PS) variable has a significant positive correlation with FDI means that that a 1 percent increase in the country's political stability affects the increase in FDI by 3.2% The rule of law (RL) has a significant negative correlation with FDI which means that a 1 percent increase in the rule of low reduces the FDI by 10.52%. Inflation (INF) has a positively significant correlation with FDI and inflation has a significant positive correlation with FDI which means any increase in inflation by 1 percent affects the increase in FDI by 3%.

**Table 3. Panel regression**

| VARIABLES | (1)<br>OLS | (2)<br>FE | (3)<br>RE | (4)<br>Hausman Taylor- IV |
|---|---|---|---|---|
| **ControlofCorruption** | -4.227** | -5.099** | -4.227** | -0.0644 |
| | (1.815) | (2.269) | (1.882) | (2.750) |
| **GovernmentEffectiveness** | 0.138 | 1.208 | 0.138 | 2.145 |
| | (1.951) | (2.180) | (1.535) | (2.075) |
| **PoliticalStability** | 0.724 | 0.239 | 0.724 | 3.299** |
| | (0.555) | (0.811) | (0.721) | (1.464) |
| **RegulatoryQuality** | 3.466** | 5.762*** | 3.466** | 0.631 |
| | (1.410) | (1.763) | (1.505) | (2.102) |
| **RuleofLaw** | -3.446* | -2.441 | -3.446* | -10.52*** |
| | (1.811) | (2.533) | (2.074) | (3.175) |
| **VoiceandAccountability** | 2.657 | 7.051*** | 2.657 | -0.444 |
| | (1.998) | (2.344) | (1.686) | (2.718) |
| **GDP** | 0.188** | 0.288*** | 0.188* | 0.127 |
| | (0.0881) | (0.100) | (0.102) | (0.102) |
| **Inflation** | 0.314*** | 0.268*** | 0.314*** | 0.315*** |
| | (0.0918) | (0.0934) | (0.0912) | (0.119) |
| **Constant** | 0.697 | -0.165 | 0.697 | 1.752* |
| | (0.732) | (1.118) | (0.772) | (1.011) |
| | | | | |
| **Observations** | 96 | 96 | 96 | 91 |
| **R-squared** | 0.426 | 0.339 | | 0.426 |
| **Number of country1** | | 6 | 6 | |

Standard errors in parentheses
*** p<0.01, ** p<0.05, * p<0.1

## 5. Conclusions

The Western Balkans are a favorable place for foreign investors due to the cheap labor costs, educated labor force, appropriate taxes, as well as the prospect of these countries becoming part of the EU. Through this paper, we have concluded that we accept H1 because two indicators of institutional quality, such as political stability and rule of law, have shown a significant effect on FDI in the Western Balkans over the period 2000–2019. Political instability has made these Balkan countries less attractive to foreign investors. Also, the rule of law, which includes numerous slow procedures and rules, has caused countries in the Western Balkans to collect a lower influx of foreign direct investment. The only comparison that is obvious between our research and other

research conducted on this topic is the non-significant effect of corruption on FDI. Comparing with other works that have analyzed these indicators over shorter periods of time as well as for individual cities, we see that control of corruption has a significant effect on FDI. Another result that should be discussed is that the increase in inflation also affects the increase in FDI. Based on other research, we see that inflation has a negative effect on FDI. Our results can be justified by the increase in prices, so inflation as an economic factor affects the increase in prices, and high prices have been shown to be more attractive to foreign investors in the Western Balkans.

In this research, we have some limitations that can be considered a guide for future research. Firstly, this research included only the countries of the Western Balkan. The research would be more complete if we made a comparison of the Western Balkans with the countries of Eastern Europe. Second, as controllable variables, we used only two: GDP and inflation. It would be better to get even more controllable variables, such as debts, employment rates, and trades, because lately they have had a high impact on economic growth and FDI inflows. Therefore, in future research, we can use the effect of the COVID-19 pandemic on FDI in the Western Balkans, as this global economic crisis has greatly affected the reduction of investment flows in these countries.

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