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«The Political Regime as a Determinant of Inward Foreign Direct Investment: The case of Western Balkans Transition Economies»

By

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Declaration

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Eirini Triarchi

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Abstract

This study analyses the political regime as a determinant of inward FDI. Above all, it examines the significance of the political system along with specific factors in stimulating or deterring FDI inflows in European transition economies. The sample countries consisted of those of the Balkan area that are non-EU members, thus the Western Balkan countries of Albania, Bosnia and Herzegovina, Kosovo, North Macedonia, Serbia and Montenegro.

The dissertation employs literature review to construct a theoretical framework. The literature review distinguishes certain factors that contribute to the institutional stability and credibility of host countries and as such, to the rise of FDI inflows. These political determinants are the property-rights protection, the signing of Bilateral Investment Treaties, human rights consisting of political participation rights, civil liberties and labour rights, and the quality of governance including the six dimensions of voice and accountability, political stability and absence of violence/terrorism, government effectiveness, regulatory quality, the rule of law, and control of corruption. The theoretical analysis of the political system in WB is based beyond the published studies, on official reports and policy studies over countries transition status.

The design of research's empirical model includes the variables that are related to the protection of foreign investors and measure the quality of governance along with the variable of political regime. The empirical analysis uses a panel dataset of the variables of interest for a period 1996-2018, across the six countries. Since European transition economies experience a new political reality, involving in the dispute of the relation between the political system and inward FDI specific features of host countries political surroundings, the extraction of unambiguous results is expected.

The findings of this dissertation shed more light in the political system- inward FDI nexus, contributing to the existing literature and providing a framework for transition economies to overcome specific political issues for achieving inward FDI's growth and developed as FDI destination.

Key Words: *Foreign Direct Investment, inward FDI, Political regime, Political system, Political determinants, Transition economies, Western Balkans, Governance, Bilateral Investment Treaties.*

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Acronyms and Abbreviations

3P	Public-Private-Partnership
ART	Adverse Regime Transition
ATQ	Average Transition Quality
BiH	Bosnia and Herzegovina
BITs	Bilateral Investment Treaties
CARDS	Community Assistance to Reconstruction, Development, and Stabilization
CEB	Council of Europe Development Bank
CEEC	Central Eastern European Countries
CEFTA	Central Europe Free Trade Area
CESEE	Central Eastern and Southeastern Europe
COSME	Competitiveness of Enterprises and SMEs
CP	Communist Party
CPE	Centrally Planned Economy
CSA	Country specific advantages
CSDP	Common Security and Defense Policy
DP	Democratic Party
DPA	Democratic Party of Albanians
DPS	Democratic Party of Socialists
DUI	Democratic Union for Integration
EAR	European Agency for Reconstruction
EBRD	European Bank for Reconstruction and Development
ECtHR	European Court of Human Rights
EDI	Electoral Democracy Index
EFF	Extended Fund Facility
EIDHR	European Instrument of Democracy and Human Rights
EMNE	Multinational Enterprise from Emerging economies
ERA	EU Reform Agenda
ERCAS	The European Research Centre for Anti-Corruption and State-Building
ERP	Economic Reform Programme
EU	European Union
EULEX	European Union's Rule-of-law mission
FBiH	Federation of Bosnia Herzegovina
FCA	Fiat Chrysler Automobiles
FDI	Foreign direct investment
FRY	Former Republic of Yugoslavia
FSA	Firm Specific Advantage
FSU	Former Soviet Union
FTA	Free Trade Agreement
FYROM	Former Yugoslav Republic of Macedonia
GDP	Gross domestic product
GFAP	General Framework Agreement for Peace
GoA	Government of Albania
HDZ-BiH	Croat nationalist Croatian Democratic Union (HDZ-BiH)

I-advantages	Internalisation advantages
ICR	International Civilian Representative
IDM	Institute of Democracy and Mediation
IMF	International Monetary Fund
KFOR	Kosovo Force (NATO)
KLA	Kosovo Liberation Army
KSF	Kosovo Security Force
L-advantages	Location advantages
LDI	Liberal Democracy Index
LDK	Democratic League of Kosovo
Li-advantages	Institution-related Location advantages
LLL	Linkage, leverage, learning
Lr-advantages	Resource- and asset-related Location advantages
MAP REA	Multiannual Action Plan for a Regional Economic Area
MNE	Multinational enterprise
NATO	North Atlantic Treaty Organization
NMS	New Member States
Oa-advantages	Ownership of Assets Ownership
O-advantages	Ownership advantages
OHR	Office of the High Representative
Oi-advantages	Ownership institutional advantages
OLI paradigm	Ownership-Location-Internalisation Paradigm
OSCE	Organization for Security and Cooperation in Europe
Ot-advantages	Ownership of the economies of common governance Ownership
PAR	Public Administration Reform
PGRF	Poverty Reduction and Growth Facility
PISG	Provisional Institutions of Self-Governance
PLA	Party Labour of Albania
PPP	Purchasing Power Parity
PTA	Political Terror Scale
RIRA	Regional Investment Reform Agenda
RoW	Regimes of the World
RS	Republika Srpska
SAA	Stabilisation and Association Agreement
SAF	Structural Adjustment Facility
SDA	Bosniak nationalist Party of Democratic Action
SDP	Social Democratic Party
SDSM	Social Democratic Union of Macedonia
SEE	South-Eastern Europe
SEEC	South-Eastern European Countries
SFRY	Socialist Federal Republic of Yugoslavia
SNS	Serbian Progressive Party
SNSD	Serb nationalist Alliance of Independent Social Democrats
SP	Socialist Party
SRSG	Special Representative of the UN Secretary-General
TIDZ	Technological Industrial Development Zones

UAE	United Arab Emirates
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNMIK	United Nations Interim Administration Mission in Kosovo
US	United States
USD	US Dollar
USSR	Union of Soviet Socialist Republics
VMRO-DPMNE	Internal Macedonian Revolutionary Organization – Democratic Party for Macedonian National Unity
WB	Western Balkans
WGI	World Governance Indicators

Chapter 1. Introduction and Overview

1.1 Problem Statement

From the 1990s onwards, host governments both in developed and developing countries followed market-friendly policies to improve the investment climate of their economies and grasp a larger share of inward foreign direct investment (FDI). The rise of competition among countries globally fueled FDI's growth which outstripped that of world exports and turned to be the most salient feature of the globalised economy (Kim and Paek, 2019, p. 295). Although the 2008 global financial market harmed the FDI activity, FDI grew in terms of both flows and stocks (Milner, 2014, p. 2) and in 2018 still recorded as the largest external source of finance for developing economies (UNCTAD, 2018a, p. xii).

In the transitional framework of Russia, Eastern Europe, and the former Soviet Union, FDI expected to complement domestic investments and to be an essential supplement for capital and investment shortages. Its indirect and dynamic effect on the economic growth of transition countries is expected through the rise of the stock of knowledge and the fostering of technological growth of a technologically inferior recipient economy (Silajdzic and Mehic, 2016, p. 904). FDI as a critical driver of international economic integration, under the right policy framework, it can serve to financial stability, to the promotion of economic development and enhancement of the well-being of societies.

To this extent, foreign capital inflows and the advance of multinational enterprises (MNEs) contributed to the restructuring process that began with the collapse of the Berlin Wall in 1989. This process aimed at the establishment of a capitalist market economy and western standards of democracy in Central, Eastern Europe (CEE) and the former Soviet Union (FSU) (Tokunaga and Iwasaki, 2017, p. 2771). Governments in transition economies designed policies to attract FDI, betting on the chance to have externalities or productivity spillovers, resulting in economic growth. The countries in CEE achieved to increase the level of economic development along with the restructuring of institutions, completing the transition process by

joining the EU, while six economies in South-eastern Europe (SEE) known as Western Balkans (WB) did not.

The transition economies of WB (Albania, Bosnia and Herzegovina, Kosovo, North Macedonia, Serbia and Montenegro) established a liberal framework to attract FDI inflows, by providing equal treatment of foreign and domestic investors, guarantees against expropriation and the free transfer of funds. They also proceed in joining regional agreements which enforce investment cooperation among the signatories parties like the Central European Free Trade Agreement (CEFTA), considered a path to EU accession. Nevertheless, these economies did not manage to develop as FDI destination.

WB achieved a better performance in inward FDI during the last decade, though they still lag behind the respective level received by the Central, Eastern European Countries (CEEC). Significant issues still exist for foreign firms' entry and operations in the WB region. These challenges originated from the war conflicts and political instability during the 1990s, continued to be endorsed by the slow pace of transition process combined with the low institutional quality. Meanwhile, the transition process requested the establishment of a democratic rule of governance. However, Balkans' distorted democratization of gains and losses left its stigma in the political practices along with the issue of divided states in which ethnic politics and parallel structures emerged. Central planning legacies facilitated the autocrats of these countries with the socialist past and their allies to keep control over critical economic assets, giving them incentives to fight any progress in democratic transition (Levitsky and Way, 2010, p. 87). A significant move towards democratisation occurred in the early 2000s across the WB states but did not last long since it was based on institutional design inadequate for the establishment of a consolidated democracy (Pavlović, 2019, p. 6).

The current rise of illiberal politics in WB countries inhibits their EU integration since democracy is one of the criteria for membership along with the development of a functioning market economy, and the capacity to cope with competitive pressure and market forces within the EU. Inward FDI's positive impact on economic growth can contribute to the achievement of the EU's economic conditionalities. Nevertheless, since WB countries still confront institutional and democratic

deficiencies, are not considered to have the typical pattern to attract FDI. Considering the importance of FDI for WB countries, this research will discover the extent to which the political system determines the foreign investors' decision to invest in these transition economies.

1.2 Purpose of the Research

The popularity of FDI in the modern world and its link to MNEs' activities continue to stimulate research on its determinants. MNE as a firm that controls operations or income-generating assets in more than one country (Jones, 1996, p. 4), uses FDI to build their global production networks and to service host markets (Milner, 2014, p. 2). FDI inflows are mainly company-centered, derived from MNE interest to invest in a specific country and not from the side of the country to invest. Given that investment decisions are made by MNEs, investment conditions are formed by the policies of the host government (Bak and Moon, 2016, p. 2001). Hence, MNEs' return on their FDI can be affected by host countries' political system.

This dissertation aims to identify whether the host's country's political regime determines the level of inward FDI flows. Above all, it seeks to examine the significance of the political system along with specific political factors in stimulating or deterring FDI inflows in WB's transition economies. Serving this purpose, this dissertation sets up the theoretical links between political regimes, political determinants and FDI. Since research's sample of countries is the six WB, it examines their transition process as well as the potential of their EU integration which necessitates the growth of inward FDI. The examination of the establishment of the political system in each of them over the post-socialist period contributes to the discussion of the empirical results.

The extant literature is limited to the two opposite types of political systems, democracy, and authoritarianism, ignoring their variations that are currently common in WB countries. Among the six WB countries, Serbia and Montenegro are electoral autocracies while the remaining four electoral democracies (please see chapters 5-9). The nature of the authoritarian regime generates a controversial environment for inward FDI, while democracy looks like, to attract more foreign investors. The positive association between democracy and FDI inflows received wisdom among scholars,

while FDI inflows in autocratic countries did it less (Moon, 2019, p. 1258). FDI characteristics of direct ownership by foreign investors, long-time horizon, and a relatively fixed asset make it politically sensitive to time-inconsistency issues as it is subject to ex-post government policy changes (Moon, 2019, p. 1258). Autocratic regimes are relatively closed compared to democratic ones and are subject to ex-post policy changes (Moon, 2019, p. 1258). Nevertheless, some scholars argue that autocracies attract more FDI since democracies limit MNEs' capacity to acquire a monopolistic position, may offer fewer fiscal incentives and are more subject to pressure from the electoral body to respect fundamental rights (Li and Resnick, 2003, p. 176). Unfortunately, the existing empirical research on the political regimes - inward FDI nexus provided conflicting and inconclusive results.

1.3 Significance of the Research

This dissertation provides new and more detailed insights into the determinants of inward FDI concerning political regime in European transition economies. The significance of this research is of being the first study to examine the six economies of WB, linking the analysis of inward FDI flows to political regime and political determinants. Also is one of the few studies on FDI that uses as sample countries the specific six countries of SEE.

This dissertation moves the interest to political features which their empirical analysis provides conclusive findings. Hence, its empirical results bring new evidence to the dispute of political system - inward FDI nexus. Furthermore, the use of new approaches in conceptualization and measurement of the research variables captures the latest developments in the political scene of the WB and the precise classification of the regime type. To this extent, it indicates how politics influence foreign investors' behaviour. The dissertation also contributes to the study of bilateral investment agreements and the quality of governance into the country's political system. Scholars in the discipline of political economy and international business will benefit from examining the impact of host country's political system on inward FDI provided evidence for its influence on the decision-making the process of MNEs to invest. Since research's results define the institutional variables weighting most for inward FDI,

would provide a framework under which government authorities, policymakers and other stakeholders in WB could design and implement effective policies aiming at receiving more FDI flows.

Finally, the research includes up-to-date knowledge about the disciplines of FDI, political regimes, transition economies of WB, and EU integration that considered to be of value to all interested professionals, scholars and students.

1.4 Research Design

The dissertation employs literature review to construct a theoretical framework. Although the voluminous literature on the motivations for FDI examined mostly economic factors, while political variables were often ignored (Büthe and Milner, 2008, p. 743), there are distinguished studies that set the underpinnings for the research on FDI-political regimes nexus. The literature review distinguishes certain factors that contribute to the institutional stability and credibility of host countries and as such, to the rise of FDI inflows. Since the European transition economies experience a new political reality, involving the dispute of the relation between the political system and inward FDI specific features of host countries political surroundings, the extraction of unambiguous results is expected.

To this extent, this quantitative research includes in the design of its empirical model besides the variable of political regime, distinguished from the literature review political determinants. These are the variables that are related to the protection of foreign investors and measure the quality of governance. Specifically, the empirical analysis uses a panel dataset of the variables of interest for a period 1996-2018, across the six WB economies, Albania, Serbia, Montenegro, Kosovo, Bosnia and Herzegovina, and North Macedonia. The six dimensions of governance, Voice and Accountability, Political Stability and Absence of Violence/Terrorism, Government Effectiveness, Regulatory Quality, Rule of Law, and Control of Corruption as defined by Kaufmann et al. (1999) for the World Bank (WGI project) are estimated in the empirical analysis. The clustering of institutional indicators into different dimensions allows us to study whether some dimensions of governance matter more for the decisions of foreign investors to invest in a specific region, while others do not. These indices are very

popular among researchers as there are available for an extensive sample of countries and provide a reliable assessment of the six dimensions of the institutional framework (Mengistu and Adhikary, 2011; Méon and Sekkat, 2007). The data provided for the years 1996-2018 reflect the views on governance of survey respondents like institutes, think tanks, non-governmental organizations, international organizations, and private sector firms worldwide (WGI, 2019). Also, this analysis uses the signing of the Bilateral Investment Agreements (BITs) instead of property rights as an independent variable to the empirical model. The data source for BITs is distinguished and not included in another governance dimension as the property rights. It is available from a listing published by UNCTAD International Investment Agreements Navigator which is continuously adjusted as a result of verification with, and comments from, UN Member States (UNCTAD International Investment Agreements Navigator, 2020a). The political regime's classification of WB countries is based on the V-Dem database, which is the newest approach to conceptualisation and measurement of democracy. It first released in 2016 and as such there are few published studies to use its multidimensional and disaggregated dataset to their research. The classification of the WB political regime by the V-Dem indices best captures country's transition into another political system through the years. The V-Dem project includes 28 million data points covering 202 political units over the period 1789-2019, more than 470 indicators, and numerous indices constructed from these indicators, about democracy and various other aspects of political life (V-Dem, 2020).

The research incorporates the latest advances in the presentation of FDI according to the directional principle under the Sixth Edition of the Balance of the Payments and International Investment Position Manual (BRM6). FDI data gathered from the Vienna Institute for International Economic Studies (WIIW) which provides data for the 23 countries in Central, East and Southeast Europe. This analysis is limited to inward FDI, not by intention to disregard the outward FDI as an essential source of competitiveness and development, but due to its sample of counties. While most of the economies worldwide have built their development on an equilibrium basis between inward and outward FDI, the transitional economies of WB depend mostly on inward FDI due to the absence of home-grown international firms (Kalotay, 2013).

Finally, the theoretical analysis of the political system in WB is based beyond the published studies, on official reports and policy studies over countries transition status.

1.5 Research Questions

Based on the problem statement and the purpose of the research, this dissertation in the literature review addresses the following research questions: Is it possible that specific factors of the host country's political environment to influence the amount of inward FDI flows beyond the type of political regime? The literature review concluded that certain factors contribute to the institutional stability and credibility of host countries and as such, to the rise of FDI inflows. In consequence, the main research question is whether the host's country's political regime determines the level of inward FDI flows, or it is a matter of specific factors as established in host country's political system?

For the extraction of distinct results, the empirical analysis examines the questions:

I. What is the effect of the political regime on inward FDI? Is there a significant statistical relationship between the political regime and FDI inflows?
II. What is the effect of the signing of the BITs is related on inward FDI? Is there a significant statistical relationship between the signing of the BITs and FDI inflows?
III. What is the effect of the governance on inward FDI? Is there a significant statistical relationship between each of the six governance dimensions (Voice and Accountability, Political Stability and Absence of Violence/Terrorism, Government Effectiveness, Regulatory Quality, Rule of Law, and Control of Corruption) and FDI inflows?

The discussion of the empirical results is adjusted to each country's theoretical analysis. In this line, the theoretical analysis addresses questions related to the way the transition process evolved in each WB country as well as each country's potential to EU membership. Furthermore, what growth of inward FDI recorded in each country and why, and how each country's political system formed over the post-socialist period.

1.6 Limitations of the Research

The research encountered data limitations. Specifically, there are data limitations to the extent that the region's inward FDI recorded officially since the mid-1990s, and in the case of Serbia and Montenegro in 2000. Also, data for Kosovo is not available for the entire examined period and not at all for the variable of the signing of BITs. Its limited statehood excludes it from official databases as this of UNCTAD. The variable of human rights is not examined in the dissertation's empirical model due to lack of available data for most of the WB countries in the examined period. In the empirical analysis of one country, the problem of the research's data set is the limited number of available observations. Hence, a panel data model used for the extraction of exact estimates and robust test statistics.

1.7 Operational Definitions

The official definitions of FDI and inward FDI follow the fourth edition of the OECD Benchmark Definition of Foreign Direct Investment (OECD, 2008, 2015). Specifically, OECD (2015, p. 5) defines FDI as "the establishment of a lasting interest in and significant degree of influence over the operations of an enterprise in one economy by an investor in another economy. Ownership of 10% or more of the voting power in an enterprise in one economy by an investor in another economy is evidence of such a relationship". Since the dissertation follows the directional principle in presentation of the FDI data (please see chapter 4) according to OECD (2008, p. 56) a compiling economy determines if the investment is inward on the basis that the the influence giving rise to it originated abroad, and that it resulted in the establishment by a non-resident direct investor of a direct investment enterprise resident in that economy. UNCTAD (2017a, p. 3) defines the term FDI flows as "flows of FDI comprise capital provided (either directly or through other related enterprises) by a foreign direct investor to an enterprise, or capital received from an investing enterprise by a foreign direct investor. FDI has three components: equity capital, reinvested earnings and intra-company loans". UNCTAD (2017a, p. 4) refers to the term of FDI stock as "the value of the share of their capital and reserves (including retained profits) attributable to the parent enterprise, plus the net indebtedness of affiliates to the

parent enterprise". Finally, according to UNCTAD (2017a, p. 3) multinational enterprises (MNEs) "are incorporated or unincorporated enterprises comprising parent enterprises and their foreign affiliates. A parent enterprise is defined as an enterprise that controls assets of other entities in countries other than its home country, usually by owning a certain equity capital stake. An equity capital stake of 10 per cent or more of the ordinary shares or voting power for an incorporated enterprise, or its equivalent for an unincorporated enterprise, is normally considered as the threshold for the control of asset".

The definitions of political regimes are provided in Chapter 2, of transition economy in Chapter 3, while the definitions of the variables are included in Chapter 4.

1.8 Structure of the Dissertation

This dissertation is organized in ten chapters, including this introduction. Chapter 1- Introduction and overview, is setting the background of the research and the research problem and presents the outline of the assignment.

Chapter 2 - Political regime as a determinant on inward FDI: a literature review, after the review of the FDI determinants literature, presents an extensive and critical review of the empirical studies on the relationship between political regimes and inward FDI and provide the theoretical links between political regimes, political determinants and FDI. It also includes an analysis of the types of political regimes and current developments.

Chapter 3-The transition economies of Western Balkans as host countries for FDI: a theoretical analysis, introduces the transitional economies of WB as host countries for FDI. Specifically, it presents Balkans' geopolitically development through history and defines the post-socialist transition process to a market-based economy. It also presents EU's and other actors' interest in the WB as well as the prospects of WB-EU integration. It includes an overview of WB's contemporary political environment. It analyses the role of inward FDI in the post-socialist countries EU accession and the current state of WB's inward FDI.

Chapter 4-Empirical analysis: Political System, Political Determinants and inward FDI in WB countries, provides the empirical analysis of the research, it

describes the variables and data, specifies the empirical model, and presents the empirical results.

Chapters 5-9 present each WB transition economy separately except for Serbia and Montenegro. The two countries are included in one chapter due to the same path they shared in their transition process for an extended period. The countries are examined with alphabetical order, beginning from Albania (Chapter 5 -the transitional economy of Albania as a host country for FDI) followed by Bosnia and Herzegovina (Chapter 6 - the transitional economy of Bosnia and Herzegovina as a host country for FDI), Kosovo (Chapter 7 - the transitional economy of Kosovo as a host country for FDI), North Macedonia (Chapter 8 - the transitional economy of North Macedonia as a host country for FDI) and lastly Serbia and Montenegro (Chapter 9 - the transitional economies of Serbia and Montenegro as host countries for FDI). These five chapters are structured the same following both theoretical and empirical analysis for defining the impact of the political system on inward FDI. Hence, each chapter includes the main issues in the country's transition process, the establishment of country's political system over the post-socialist period, an overview of inward FDI, the discussion of the empirical results of the panel data model adjusted for each WB transition economy, and concluding remarks with recommendations.

Finally, Chapter 10 – Conclusions and Recommendations, is the last of this assignment and as such, provides the overall conclusions and policy recommendations.

The next chapter 2 is the literature review.

Chapter 2. The Political Regime as a Determinant of Inward FDI: A literature review

2.1 Introduction

The voluminous literature on the motivations for FDI examined mostly economic factors, while political variables were often ignored (Büthe and Milner, 2008, p. 743). Nevertheless, distinguished empirical studies have examined the impact of host country's political system on FDI. These studies provide contradictory empirical results reflecting the serious disagreements among political scientists and economists.

Most of the first studies on the relationship between political systems and inward FDI framed the debate into the two opposite types of political regimes, democracy and authoritarianism. Although democracies and autocracies are still the most popular regimes types in empirical studies among major FDI emerging host countries (Guerin and Manzocchi, 2009, p. 76), current developments in the international political environment generated regime type variations. European transition economies experience this new political reality.

Given the complexities of this dispute and regarding thesis' research question, (please see Chapter 1) this chapter aims to discover an effective way to define the role of the host country's political environment in inward FDI and provide conclusive answers. By reviewing the empirical studies, this chapter examines the political system inward FDI nexus considering the host country's political determining factors alongside with the political regime. The chapter includes political variables that have a significant impact on inward FDI and deemed to increase the institutional stability and credibility of a regime. Due to the limitation of extant research for WB countries in this field, this literature review includes studies examining a wide range of developing countries.

This chapter of the dispute of the political environment's influence on inward FDI moves the interest to specific features of host countries' political surroundings. The empirical analysis of this dissertation (please see Chapter 4) includes most of these variables for the extraction of precise results, contributing to the literature of this field for the WB region.

The remaining of the chapter is organized as follows: Section two includes a short review of FDI theories, while section three presents the types of political regimes and their current developments. Section four examines the existing work on the impact of political regimes and political determinants on inward FDI and provide the theoretical links between political regimes, political determinants and FDI. The final section concludes.

2.2 A review of FDI determinants literature

Since the end of World War II, the tremendous growth of FDI flows globally, produced many theoretical causes to this phenomenon. The expansion of US companies' investments across borders in the UK, Germany, Canada, Japan and other developed countries and vice versa stimulated scholars' interest to examine what determines enterprises decisions for undertaking investments across borders (Park and Roh, 2019, p. 72). An enterprise can be motivated by a significant number of factors to engage in direct investments activities abroad. Many theories developed, including different motivations of firms' engagement in FDI, inhibiting the establishment of a single theory that can thoroughly explain the phenomenon of FDI (Jadhav, 2012; Park and Roh, 2019).

The first analysis of FDI focused on MNEs from leading Western economies investing abroad by exploiting their international leadership and competitive advantages, often in developing economies (Knoerich, 2017, p. 52). Early theories incorporated elements of economic and international trade theory to the cross-border movement of capital, following the relatively simple two-country, two-commodities and two-factor approaches and the assumption of perfect markets (Knoerich, 2017, p. 53).

In 1966, Vernon tried to explain the relationship between international trade and foreign production based on the theory of the product life cycle (Knoerich, 2017, p. 55). Vernon supported that firms producing innovative products in a leading industrialized economy like the US, decide to expand their production abroad when product standardization request more labour-intensive and cost-effective locations.

These firms are leading international actors from high-income countries investing in developing countries to benefit from lower-end economic activities (Knoerich, 2017, p. 55). The macro version of Vernon's product life cycle is also found in Kojima's dynamic comparative advantage theory in the 1970s.

The basis for subsequent theoretical development in FDI, came through the PhD thesis of Stephen Hymer completed in the 1960s and published in 1976 "*The International Operation of National Firms*" which distinguished FDI from portfolio investment in terms of control of operation that conferred to the firm only through FDI (Buckley, 2006, pp. 140–141). The exercise of control is strictly related to the vision of market imperfection. Hymer argued about market imperfections in terms of transaction costs, lack of perfect information, imperfect competition and contradicted the traditional neoclassical theory. He outlined that an MNE to obtain more profits needs to possess a "firm specific advantage" (FSA) proceeding to its internal exploitation rather than licensing it to an external organisation (Buckley, 2006, p. 146). FSAs can include superior technology, brand name, managerial skills and scale economies (Jadhav, 2012, p. 6). A firm requires a competitive advantage, also known as the monopolistic advantage, to compete successfully in overseas markets (Park and Roh, 2019, p. 73). Hymer stressed the importance of the ownership of a monopolistic advantage as a prerequisite for an MNE to enter a foreign country. Hymer moved the theory of FDI out of the neoclassical international theories of trade and finance, and into the industrial organization, the study of market imperfections (Hosseini, 2005, p. 532). This approach also became known as Hymer–Kindleberger paradigm, since Kindleberger set Hymer's theory within the framework of the traditional theory of industrial organisation (Hosseini, 2005, p. 532).

The internalisation theory based on a pioneering paper of Coase in 1937, only gained recognition for explaining FDI at the 1970s and 1980s through the works of distinguished economists such as Oliver Williamson (1975, 1981, 1985), McManus (1972), Buckley and Casson (1976), Hennart in 1982 (Jones, 1996, pp. 11–12), and Rugman in 1982 (Hosseini, 2005, p. 553). Internalisation is linked to imperfections in the markets for intermediate products that embrace all the different types of goods or services transferred between one activity and another within the production process. Firms expand across borders because the transactions costs incurred in

international intermediate products can be reduced by internalising these markets within the firm. Hence, internalisation's association with transaction costs is evident as well as its ability to explain both vertical and horizontal integration across borders (Jones, 1996, p. 12). Despite the criticism faced for being more a theory of market failure rather than of firm success and being overconcerned with the costs of organising transactions in markets ignoring the managerial costs incurred by firms, Dunning incorporated this theory to his eclectic paradigm.

At the time that the internalization theory emerged, a group of Scandinavian scholars, Johanson, Wiedersheim, Vahlne and Luostarinen examined the internationalization activities of enterprises from small, domestic markets as Scandinavian countries (Rugman et al., 2011, p. 762). The Scandinavian school approached internationalization as a cumulative, path-dependent process whereby a firm's international expansion pattern is a function of its past international experience and knowledge base.

Dunning brought together internalisation theory and traditional trade economics to establish the eclectic paradigm of FDI, synthesizing the reasons for enterprises to operate internationally (advantages) and the mode of entry (FDI, export and licensing) (Faeth, 2009, p. 171). The eclectic or OLI paradigm developed by Dunning in a series of publications during the 1980s and 1990s and distinguished among the other attempts to model the empirically observable determinants of FDI. Among the theories produced, the OLI paradigm considered as the most developed conventional perspective of FDI that provided a useful way of thinking about MNEs and encouraged a great deal of applied work in economics and international business (Park and Roh, 2019, p. 72). The OLI paradigm neither intended to be a theory of the MNE nor of the FDI per se (Wagner, 2020, p. 58). Dunning incorporates a large number of non-economic variables into the paradigm, and this interdisciplinary approach provides essential perspectives on many aspects of international business (Jones, 1996, p. 13). Political, legal and cultural influences can have a significant impact on ownership, location and internalisation factors.

"OLI" denotes ownership, location and internalisation, as the enterprise's advantages that may spark off its decision to become a multinational. The OLI paradigm is equally applicable to an analysis of either outward or inward FDI, with O-

advantages reflecting the outward FDI while L-advantages the inward FDI (Cantwell, 2015, p. 4). Dunning's paradigm developed and adapted to the changes in scholarly interest that arose when some substantial shifts in the international business field took place like globalization and MNEs from emerging economies (EMNEs).

Ownership (O) advantages referred to the MNE's production process, ensuring a competitive advantage over domestic firms. The O-specific advantages include ownership of assets (Oa) and the economies of common governance (Ot). The Oa refers to various tangible and intangible assets the firm owns, whether this is intellectual property rights like patents and trademarks or stocks of tacit knowledge or tangible superior technology, property and equipment (Lundan, 2009, pp. 54–55). The ownership of intangible assets diversifies the firm across borders allowing to exploit economies of scale and gain monopoly power (Li and Resnick, 2003, p. 179). The Oa advantages are in line with the resource-based view that a firm can hold its competitive position if the assets it possesses are valuable, rare, and difficult to imitate or substitute (Lundan, 2009, pp. 55–56). The Ot refers to strengths in coordinating and taking advantage of operating a network of geographically dispersed affiliates (Rugman et al., 2011, p. 761).

Dunning, in a revised version of the paradigm, incorporated the importance of institutions in O-advantages (Dunning and Lundan, 2008a). To this extent, the Ownership institutional advantages (Oi) represent the formal and informal institutions that enable firms and their international business networks to create and retain trust and legitimacy in the broader political and social environment (Cantwell, 2015, p. 13). Hence, Oi includes the institutions that govern the value-added processes within the firm, and between the firm and its stakeholders and are partly endogenous and exogenous in the firm (Dunning and Lundan, 2010; Lundan, 2009). Dunning and Lundan (2010, p. 1230) argue that "The exogenous element results from the degree to which the informal (and formal) institutions in the firm's home country, or important host countries, have impacted the way in which incentives are set within the firm. The endogenous influence is the result of entrepreneurial or managerial activity, which manifests itself in a particular kind of corporate culture, which may also be encapsulated in the firm's core values or a mission statement". Substantial Oi

advantages may be required for the firm to be able to exploit its existing Oa and Ot advantages(Lundan, 2009, p. 60).

The location (L) advantages are associated with foreign countries having some country-specific advantages (CSAs) over other countries (Rugman et al., 2011, p. 761). In particular, L-advantages are motives for producing abroad including access to capital, access to actual endowments such as richness of natural resources and skilled and low-cost labour force, control over transfer price, reduction in exchange risks, lead and lag payments. The L-advantages remain attractive for an MNE as long as there are transactional gains from operating in different locations (Elfakhani and Mackie, 2015, p. 101). The L-advantages include elements of the cultural, political and broad institutional environment in which the enterprise operates, making some countries more attractive than others. Dunning indicates the host country's market structure and government policies as potential L-advantages (Rugman et al., 2011, p. 761). The revised version of the paradigm presents the new classification of L-advantages (Dunning and Lundan, 2008a). Thus, the resource- and asset-related L advantages (Lr), such as access to natural and human resources or critical (knowledge-intensive) assets, and institution-related L- advantages (Li), referring to a host location's formal and informal institutions (Wagner, 2020, p. 69). Dunning (2008, p. 94) adjusting his paradigm in the changing world, identified globalization, technology and the emergence of new players to increase the significance of institutions and institutional distance as a location-specific determinant.

OLI's paradigm as a synthesizing framework indicates the key location advantages of four types of international production: natural resource-seeking, market-seeking, efficiency-seeking and strategic asset seeking (Rugman et al., 2011, p. 761). Although the O- and I- advantages provide the reasoning of why enterprises will move production to a foreign location they do not explain why an enterprise simply not license a foreign firm to produce the product for the patent firm (Jensen, 2003, p. 591). The internalisation (I) advantages affect the way an MNE chooses to operate in a foreign country, trading off the reduction in the cost of transactions and the holding-up costs of its wholly-owned subsidiary (Park and Roh, 2019, p. 72). The more significant the I- advantages, the more likely a firm is to engage in international production, instead of trading or leasing. Antitrust or competition-oriented regulation

can affect firms' exploitation of I-advantages (Li and Resnick, 2003, p. 179). It is in terms of the third element that Dunning's eclectic paradigm and the internalisation paradigm of Rugman, Buckley and Casson, are similar (Hosseini, 2005, p. 533). In the revised OLI version, Dunning and Lundan (2008b, p. 587) highlighted the institutional character of the I-factor in terms of the transactions costs related to FDI activities that an efficient institutional environment can reduce or in the opposite case of inefficiency, can increase.

Li and Resnick (2003) in their study on the effect of democratic institutions on FDI inflows proceed to their analysis incorporating the eclectic paradigm. A firm decides on investment sites based on how effectively their O- and I- advantages can harmonize with L-specific benefits. Host government policies establish L-specific conditions, affecting the way a firm can exploit its advantages(Li and Resnick, 2003, p. 180). The O-advantages are sensitive to property rights protection into the host country (Li and Resnick, 2003). A host country creates a good investment climate when its L-specific advantages enable the MNE to exploit its O- and I- advantages. A host government that provides favourable regulation, sound property rights protection and preference of foreign enterprises over domestic firms make the country attractive to FDI. Through the proper regulatory environment, a host government can enhance O- advantages by helping MNE to preserve its intangible aspects or monopolistic advantage over local firms (Blanton and Blanton, 2007, p. 145). The host state as it is responsible for providing preferential taxation policies, financial incentives, qualified labour force, political stability, is crucial in making the country a desirable location to FDI (Blanton and Blanton, 2007, p. 145). To the same line, Jensen (2003, p. 592) argues that political regimes that reduce the political risks will attract MNEs by lowering the costs of internalising production.

Dunning's paradigm enjoyed popularity, especially among British, Commonwealth and European scholars (Knoerich, 2019, p. 56). Inspired by Dunning's work, trade economists developed theoretical models that place MNEs in a general equilibrium position to explain firms'decision to invest across borders. These models focused on the economic determinants of FDI are Markusen's horizontal model in 1984, Helpman's vertical model in 1984 and the Markusen's hybrid of the two, known as the knowledge-capital model in 1997 (Choi and Samy, 2008, p. 85). Markusen

supports that MNEs dependence on knowledge capital provides a strong incentive for internalising O-advantages resulting in larger volumes of FDI (Jadhav, 2012, p. 6).

As the share of EMNEs in global FDI flows increases, there is a remarkable intensification of FDI theorization aimed at explaining their behaviour (Knoerich, 2019, p. 58). Knoerich (2019) propose a re-orientation of FDI theory to serve better the reasoning of FDI flows coming from EMNEs'. Thus, better to focus on the "demand-oriented approach" than on FSAs. This approach does not support that FSAs is a requirement for a firm to engage in FDI, but is considering the firm as an entity aiming to satisfy its demand for advantages, assets, resources abroad through FDI. Hence, EMNEs venture abroad to access resources that would otherwise be unavailable, and thereby establish a global position for themselves (Mathews, 2006, p. 17). Mathews (2006) developed the linkage- leverage, learning (LLL) approach, explaining the EMNEs in the 2000s companies. According to this approach, firms engage in FDI to develop competitive advantages via linkage, leverage and learning in the period that the worldwide web of the global economy emerged. Knoerich (2019, p. 63) argues that a demand-oriented perspective promotes a holistic view that includes all kinds of FDI by all kinds of firms.

Research on emerging economies in the 2000s acknowledged the importance of institutions in FDI. As unforeseen, the institutional-based view incorporated by Dunning at the revised version of his eclectic paradigm (Dunning and Lundan, 2008a). Mudambi and Navarra (2002, p. 636) pointed out that institutions are essential since they represent the major immobile factors in a globalized market. In contrast to firms and factors of production that are sensational mobile in the international environment, the legal, political and administrative systems are internationally immobile. Since institutions have an impact on firms capacity to interact, they affect the relative transaction and coordination costs of production and innovation, and as such, they affect the international attractiveness of a location (Mudambi and Navarra, 2002, p. 636).

Institutions and organizations are operating in the over-arching institutional environment, or institutional infrastructure, as Dunning (2004) calls it. Academics in the fields of economics, political science, sociology and other social sciences differentiated in their conceptions of the institutional environment and incorporated

in its definition different relative values. Mudambi and Navarra (2002, p. 638) indicate that the institutional environment "includes political institutions such as the regime type, the national structure of policy-making and the judicial system, economic institutions such as the structure of the national factor markets and the terms of access to international factors of production and socio-cultural factors such as informal norms, customs, mores and religions". The primary role of all institutions, formal, informal, modern and traditional is to reduce transaction costs and uncertainties arising from possible opportunism, moral hazards and incompleteness in commercial dealing (Dunning, 2004; Peng, 2014). An inefficient institutional environment with inadequate property rights, lack of regulated banking system, high corruption, underdeveloped financial markets and weak incentive structures is relatively costly in doing business and inhibits FDI into host economies (Dunning, 2004, p. 3). The main challenge of the transition economies has been to overcome their institutional weakness and to accelerate the building of an efficient and socially acceptable institutional environment to adjust to the demands of the free market economy and attract inward FDI (Dunning, 2004, p. 3).

Peng et al. (2008, p. 931) proposed an institution-based view, in combination with the industry- and resource-based views to explain the extent to which the engagement of the firms in international business is successful or not. Hence, a foreign investor building strong interpersonal relationships with the authorities (like government officials) of the host country, feel more secure. Peng (2014, p. 70) taking as an example the MNEs investing in Africa, concludes that MNEs with the best capabilities to manage the institutional conditions in the host market will be the ones performing successfully in such challenging environment. Regarding the country-level efforts to attract FDI, the host government must prioritize the building of strong institutions that reduce uncertainty and FDI-related costs for foreign investors (Grosse and Trevino, 2005, p. 140). Pajunen (2008) distinguished seven institutional factors in his research related to FDI inflows that were conceptualized and received explicit, empirical consideration,. These are corruption, labour regulation, justice and judicial system in a society, political rights and civil liberties, property rights and taxation policies.

Finally, Bitzenis (2003) pointed out that no theory is dominant in the decision-making process of MNEs regarding FDI, and on this basis, created a theoretical model named "The Universal Model". This broad model incorporates most of the dominant FDI theories, and it is subject to change since some theories become obsolete and the world economy evolves (Bitzenis and Papadimitriou, 2011, p. 352). Some of the FDI theories are static, including only the factors that lead to the decision of FDI and other dynamics, considering the evolution of the foreign enterprise and its interaction with host industry and the host country (Bitzenis, 2003; Bitzenis et al., 2012; Bitzenis and Papadimitriou, 2011). The Universal Model is less eclectic and more encompassing than Dunning's paradigm and defines the FDI's motives regarding their content (Vlachos et al., 2019, p. 270). The model connects all the FDI theories on the basis that the ultimate purpose of the firm is to ensure their profits. To this framework the categorization of motives are as market seekers, market seekers from a strategic point of view, factor seekers, efficiency seekers, locational seekers, exploiting ownership advantages, financial aspects hunters, political reasons and overcoming imperfections (Bitzenis, 2003; Bitzenis et al., 2012; Bitzenis and Papadimitriou, 2011). The universal model is not used as a whole but encourages the use of the above branches depending on the firm's profile and priorities. Its main benefit is that presents both the effects that a potential FDI project may have on a firm as well as firm's potential gains from this project (Bitzenis et al., 2012, p. 51).

According to the model's framework, when countries suffer form political or social instability like the transition one, the risk of investing in their market rises. The transition economies that hold significant delays in the transition process record an increase of their economic and political instability resulting to high investment risk and low inward FDI (Bitzenis and Papadimitriou, 2011, p. 364). These delays are caused due to unclear property rights, delays in restitution, low progress in privatisation, banking reforms and liberalisation, high bureaucracy, corruption and organized crime.

Summing up, FDI cannot be explained by a single theory but rather by a combination of theoretical models which complement each other. Regarding our study, Dunning's eclectic paradigm, the institutional approach and Bitzenis' Universal model have incorporated political factors in FDI research. Dunning included in his model political determinants and revised the model following the advances in

institutional theory. Some scholars on the debate of the relationship between political regime and inward FDI followed the eclectic paradigm and the institutional theory while others based on empirical findings of the extant literature. Adopting the argument that no single theory exists for FDI (Bitzenis, 2003; Jadhav, 2012; Park and Roh, 2019), our study for identifying the determinants that will be used in the empirical analysis (please see chapter 4) will examine the results of the related empirical studies (section 2.4).

2.3 Types of Political Regimes: Current Developments

Two types of political regimes dominated the empirical research on the impact of political regimes on FDI, thus either democracy or authoritarianism. However, the political reality records new forms of political regimes rooted either on the concept of democracy or the concept of authoritarianism, producing difficulties in distinct classification of countries political systems. Since the target countries of our research are transition economies of WBs, the reference to these regimes' variations will serve the analysis of their political environment in the following chapters.

Authoritarianism or autocracy (as interchangeably used) is a form of government characterized by liberty's limitations, the absence of parliamentary institutions, tradition-oriented society, and a clique of the military, religious leaders and bureaucrats exercising political power (Salami, 2015, p. 87). It is close to national political systems but not to totalitarianism as it is not a tyrannical regime and do not control the political beliefs of its citizens. Authoritarianism may look that achieves government stability, but the fundamental social basis for regime stability is absent (Feng, 2001, p. 272). There are different forms of authoritarianism, mainly categorized in non-electoral regime types and regimes with elections. The first category includes military regimes - that is the least stable version of authoritarianism - and monarchies, excluding the ceremonial or constitutional monarchies. In the second category, no-party regimes are found, in the sense that elections are held but no parties are allowed to participate in those elections, in reality, this is a rare situation (Wahman et al., 2013, p. 26).

Democracy means the power or rule of the people as designated by its ancient Greek etymological origin. Lindblom and Dahl in their effort to distinguish the two usages of the term democracy the one as a goal or ideal and the other as an actual political system ended to use the term polyarchy (Dahl, 1984). Polyarchy is differentiated from classical monistic democracy by the salience, power and legitimacy of political organizations in political surrounding and decisions on public matters (Dahl, 1984, p. 237). Democracy is understood in terms of the rule of majority as expressed through free and fair elections, though majoritarianism by itself does not constitute democracy (Plattner, 2010, p. 84). Morlino (2008, p. 42) argues that "a regime has to be considered a minimal democracy if it has at least universal adult suffrage; recurring, free, competitive and fair elections; more than one political party; and more than one source of information". A democratic regime prerequisite broad-based support and consensus to make its policy efficient and secure (Feng, 2001, p. 272). For a regime to be considered democratic in modern times, it also must protect the rights of individuals and minorities, that is to guarantee the freedom or liberty of its citizens. These guarantees are incorporated into the constitution, and the government is limited and constrained by the rule of law and to this extent democracy in today's world is often called constitutional or liberal democracy (Plattner, 2010, p. 84).

Beyond any definitions for democracy, the critical task is the constitution and the elementary principle that all members are to be treated under the constitution equally (Dahl, 2015, p. 37). Dahl (2015, pp. 37–38) argued that the political equality could be achieved through specific criteria that a democratic process must include, these are: (i) the effective participation, (ii) the voting equality, (iii) the enlightened understanding, in the sense of offering to all members equal and effective opportunities for learning about the relevant alternative policies and their possible consequences, (iv) the control of the agenda, referring to the exclusive opportunity provided to the members to decide how and what matters to be included on the agenda and (v) the inclusion of adults, in the sense that all adult permanent residents should have the full rights of citizens as described in the first four criteria.

The collapse of centrally administered socialism in the Soviet Union and Eastern Europe provoked a remarkable rise in the number of democracies, and since

1995 electoral democracies became the world's dominant form of regime, enclosing more than 60 per cent of all countries (Plattner, 2014, p. 5). Electoral democracies hold de-facto free and fair, multiparty elections in a pluralistic media and associational environment (Lührmann, Anna et al., 2019, p. 15). Polyarchy's framework approaches electoral democracy through two core conceptions. The minimalist conception approaching better Schumpeter's view of democracy (1942, p. 269) that "the democratic method is that institutional arrangement for arriving at political decisions in which individuals acquire the power to decide by means of a competitive struggle for the people's vote" and the maximalist conception is reflecting the Dahl's notion of polyarchy. The minimalist conception includes three institutional guarantees, the elected officials, the free, fair and frequent elections and the associational autonomy, while the maximalist conception adds two more the inclusive citizenship and the freedom of expression (Teorell et al., 2016, p. 5).

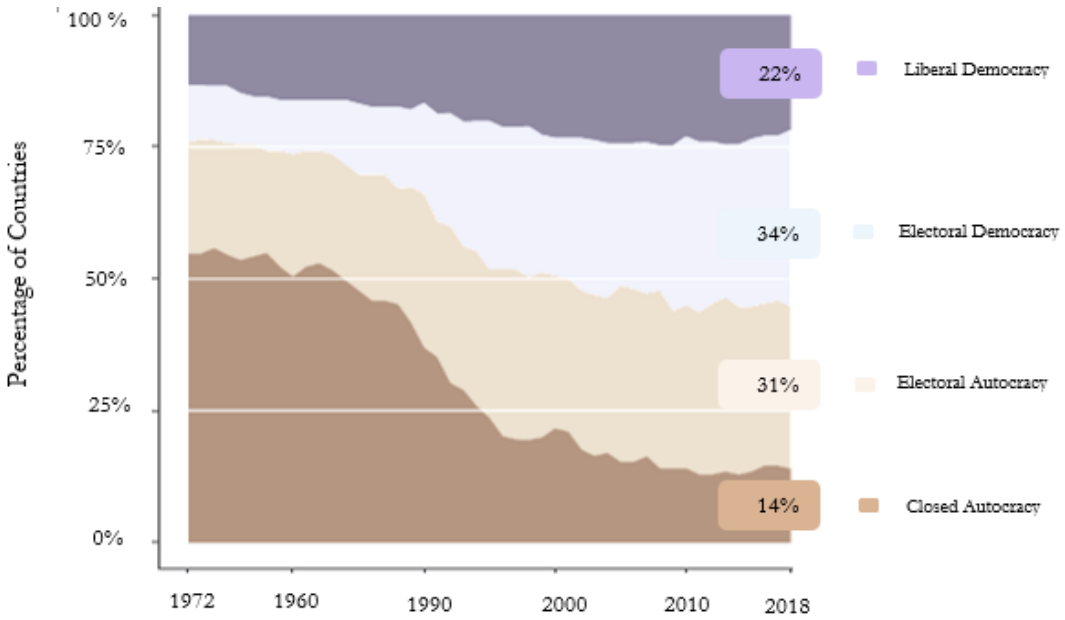
Democracy in transition countries questioned in terms of its consolidation. In consolidated democracy, legitimate pollical decisions are not threatened with being arbitrarily overridden by either a domestic or an external non-democratic actor (Cocozzelli, 2013, p. 2). In the 2000s, the failure of reformist governments in transition countries to break with their autocratic past and to establish consolidated democracies facilitated the re-emergence of some forms of authoritarianism (Bieber, 2018, p. 337). Hence, Eastern Europe being too long the world's most homogenous region turned to the most heterogenous, holding a distribution of regime types being in a grey political zone, thus between flawed democracy and weak forms of authoritarianism (Bogaards, 2009; Møller and Skaaning, 2013). The adjectives attributed to them are anocracies or hybrid regimes or democracies with characterizations such as unfinished, stalled, halted, transitional, frozen, weak and fragile (Van den Bosch, 2013, pp. 81–82). The term “anocracies” (created to enable the labelling of the middle field between democracies and autocracies in the POLITY IV Index) is used to describe the non-democratic, non-authoritarian regimes or competitive authoritarian regime. These regimes embed some of the institutions that are necessary but not enough to make a democratic regime and some of the institutions that characterize an authoritarian rule of governance.

The new regimes forms rooted on the concept of authoritarianism identified with adjectives such as 'electoral authoritarianism' or 'centre authoritarianism with subnational democracy', 'semi-authoritarianism' or 'competitive authoritarianism' (Bogaards, 2009, p. 406). Levitsky and Way (2010, p. 5) defined competitive authoritarian regimes as "civilian regimes in which formal democratic institutions exist and are widely viewed as the primary means of gaining power, but in which incumbents' abuse of the state places them at a significant advantage vis-à-vis their opponents. Such regimes are competitive in that opposition parties use democratic institutions to contest seriously for power, but they are not democratic because the playing field is heavily skewed in favour of incumbents. Competition is thus real but unfair". The multiparty competition is what characterizes democratic regimes, but this criterion is quite different in autocracies. Authoritarian multiparty refers to a cluster of regimes on the lower end of the democratic spectrum, that is the opposite of democracies that are at the higher end (Wahman et al., 2013, p. 21). The electoral autocracy is the most common type of authoritarianism in the world with a count of 55 countries among 80 countries under the authoritarian rule of governance in 2018 (Lührmann, Anna et al., 2019, p. 15).

During the last two decades, democracy has neither gain nor loss, although the global financial crisis reduced the attractiveness of the regime. Besides, some states under political systems that are in competitive authoritarianism political zone have increased hostility to the advance of democratic rule and to the establishment of institutions under international law that could enforce democracy and human rights. Democracy now is facing challenges globally such as governments' manipulation of media, civil society, the rule of law, and elections, followed by the toxic polarization in the public scene that results to the division of society into non-antagonistic camps, and finally the digitalization as being misused by governments to manipulate the information environment in their countries (Lührmann, Anna et al., 2019, p. 5). These issues reflect a decline of democracy and a rise of illiberal politics, reported both in consolidated democracies as well as in democracies with weak institutions (Bieber, 2018, p. 339). Nevertheless, democracy remains the most common type of regime. The 2019 V-DEM institute's annual report on democracy, counts 99 democracies representing, 56 per cent of the world's population and 80 autocracies in 2018. In

particular, the global share of liberal democracies declined from 25 per cent (44 countries) in 2014 to 22 per cent (39 countries) in 2018, while the share of electoral democracies increased from 10 per cent (17 countries) in 1972 to 34 per cent (60 countries) in 2018 (please see Figure 2.1). Respectively, the global share of the electoral authoritarian regimes has increased from 21 per cent (33 countries) to 31 per cent (55 countries). The state of the world compared to 1972 is improved, since after the fall of the Berlin Wall, the number of closed autocracies that is the autocracies that do not hold elections, declined. In 2018 their share accounted for 14 per cent (25 countries) (Lührmann, Anna et al., 2019, pp. 15–16).

Figure 2 1 - Share of Regime Types globally, for the period 1972-2018



Source: V-Dem Institute (2019, p. 16)

Democracy still holds its advanced legitimacy, satisfies the need of citizens for the respect of their human rights, and secures political freedom and political stability. The democratic regime holds an independent "virtue" of protest's rise, which can manage efficiently through its strong institutions and prevent any destabilizing threats. Democracy reduces political risk through its better access to information and better avenues for representation (Jensen, 2008a, p. 7). Democracy can at least institutionalize the redistribution system, support the reduction of income inequality restraining the possibility of the low-income class to expropriate the wealth of the

highest income. A country under a democratic rule of governance appears to have all the prerequisites for assuring foreigners that their investments will be protected through its strong institutions that manage efficiently and prevent any destabilizing threats. Thus, it appears that a democratic host country has the potential to attract more foreign capitals than a non-democratic host country. An argument that cannot be confirmed due to the intervention of other factors in political systems. Additionally, the zenith of confusion in existing regime classifications and the lack of a systematic way of measuring the new mode of autocratization (Lührmann and Lindberg, 2019, p. 1097) motivates this research to rely beyond the type of political regime on specific political determinants for the extraction of unambiguous results and not on the political regime itself.

To this context, property-rights protection, the signing of Bilateral Investment Treaties (BITs), human rights like political participation rights, civil liberties and labour rights, and governance, are presented in the following section as key political regime's determinants of inward FDI, in respect of the relevant empirical studies.

2.4 Political Regimes, Political Determinants and Inward FDI

This section presents research on the political regimes - inward FDI nexus, as well as, specific political variables that determine this nexus. The political determinants beyond their significant impact on inward FDI, also support the institutional stability and credibility of the host country's political system.

2.4.1 Political regimes and FDI

Several empirical studies recognize the impact of the host country's political regime on inward FDI. There are those supporting that autocratic policy foster domestic capital accumulation, FDI and growth. Some autocracies and hybrid regimes are more appealing to foreign investors than some democracies at a comparable development level (Zheng, 2011, p. 294). Countries like China, Indonesia, Malaysia, and Vietnam have attracted inward FDI under forms of authoritarian rule. There are authoritarian countries that followed efficiency-strengthening policies providing an improved business environment for fostering both domestic and foreign investments. They became more flexible in adopting and implementing the new market-friendly

policies despite any oppositions of domestic actors, and they even managed the volatility of their macroeconomic environment successfully (Madani and Nobakht, 2014, p. 77).

Early studies suggested that a cosy relationship exists between investors and autocrats and that investor-state collusion shields foreign capital in authoritarian countries (O'Donnell, 1978). The foreign investors that prefer an autocracy are because of the authoritarian capacity to suppress labour demands, repel protesters, and legislate tax laws for serving MNEs interests (Haggard, 1990; Greider, 1997). Some autocracies are better hosts of MNEs because of the expected high political risks associated with democracies (Jensen et al., 2012, p. 8). The high democratic risk also described as the "benefits of authoritarian rule", falls into the three following categories (Jensen et al., 2012, pp. 8–9).

i) The first is policy is instability. It is greater under democratic rule due to the government turnovers from one political party to another, and manoeuvres before elections, leading even to the nationalization of companies. This feeling of unpredictable policy environments creates uncertainties for investors.

ii) The second refers to the ability to compete with interest groups to push unfriendly policies to MNEs.

iii) The third is the redistribution "card" that populists in democratic regimes play in a tricky way, usually serving their political parties' interests.

Furthermore, there are authoritarian countries that want to grasp a share of FDI inflows from democracies by promoting their willingness to implement liberal economic policies and to sign an international investment treaty. However, there is always the risk of non-compliance to the treaty by authoritarian leaders, but it is limited in cases of a high level of public deliberation in the policymaking process. Bastiaens (2016, p. 141) supports that "[Bilateral Investment Treaties] BITs will be effective in attracting the most to authoritarian countries with high levels of public deliberation, as these regimes are credible in their liberal economic policy commitments".

Recently, the wide variation in the institutional architecture of authoritarian regimes has been revealed, reflecting on the differences in economic behaviour and investments that are recorded among them. Although authoritarian legislatures lead

to misunderstanding as may seem to impose constraints on gluttonous appetites of authoritarian leaders, their positive contribution is towards the strengthening of corporate governance rules and not to the risk of expropriation (Jensen et al., 2014, p. 656). This is opposed to MNEs' expectations of a long-lasting and robust ownership stake in a venture in a host country. The governments that are consistent to a high level of commitment to future economic policies conducive to MNEs' interests are those to achieve higher levels of inward FDI (Jensen, 2008b, p. 1043). In well-established democracies, investments are secure for a long time due to independent judiciaries, respect of law, and individual rights to property and contract (Olson, 1993, p. 572). Investors prefer a democratic regime to autocratic one since the first prevents the political uncertainty that derives from the irregular government change that often occurs in autocracies (Feng, 2001). Foreign firms are motivated by the credibility of government policy which is safeguarded by institutional checks being more effective in democracies (Zheng, 2011, p. 294).

Contrary to the argument of authoritarianism' benefits, the political risk under democracy is reduced, because of four factors (Jensen, 2008b, p. 1041). The first is that under democracy host country's policy is relatively stable and credible; the second refers to the ability of foreign firms to influence policy outcomes; the third is the openness and transparency that characterize policy and politics; the last address to governors in democratic regimes that they want to avoid the reputation costs and show unwillingness in expropriating multinational assets.

Another dimension in the MNEs' change of interest from non-democratic states to more democratic is given by Spar (1999), although it lacks reliable empirical evidence. MNEs interest for investing in repressive regimes changed over the years as a shift occurred in the structure of FDI flows from the primary sector towards the other two sectors of the economy (Spar, 1999, cited in Busse, 2003, p. 16). During the 1970s, foreign investors interests' were mainly on raw materials, and as such extractive MNEs did not hesitate to build strong relationships with the non-democratic governments of countries with abundant natural resources. While in the 1980s and 1990s, MNEs motives and interests moved to technology-intensive manufacturing and services where a much wider range of investment sites existed than of those in raw materials permitting MNEs to be less dependent on host governments' level of relationship and

rule of governance (Spar, 1999, cited in 2003, p. 17). This tendency combined with MNEs' anxiety to avoid activism's protests for their investments in non-transparent and non-democratic regimes led foreign agents' gradually to keep a distance from them (Busse, 2003, p. 22).

A significant number of academics are supportive of the argument that a host country under a democracy receives more FDI than under authoritarianism. Among researchers are those insisting on the distinct positive association between democracy and FDI (Ahlquist, 2006; Busse, 2004; Choi, 2009; Feng, 2001; Harms and Ursprung, 2002; Jakobsen and de Soysa, 2006; Jensen, 2003, 2008a, 2008b; Kerner, 2014; Olson, 1993). Jensen (2003, p. 612) identified the lack of empirical evidence for MNEs preference to invest in dictatorships over democratic regimes. Democracies experience low country risk due to the low risk of expropriation and *per se* attract more FDI flows (Jensen, 2003, 2008b; Li, 2009a). Ahlquist (2006, pp. 698–700) provided evidence for the significant positive effect of democracy on FDI based on MNEs' experience to host country's decision-making environment; thus, the longer MNEs' experience in democracies the more likely to increase their investments. Li and Resnick (2003) outlined two contradictory causal explanations focusing on democratic constraints and property rights protection, respectively that produced both positive and negative relations of democratic institutions with inward FDI. Choi and Samy (2008), and Choi (2009) motivated by Li and Resnick's (2003) research, indicated specific attributes of democracies that are positively related to FDI. Guerin and Manzocchi (2009) reiterate the positive relation of democracies to inflows of FDI, but propose that the type of democracy in host countries matters to this relation, finding that parliamentary are more likely to attract FDI than presidential democracies. The parliamentary type has a more positive effect than the presidential democracy on trade liberalization and property right protection.

Sometimes democracy by itself is not as decisively important as certain political factors which are often part and parcel with liberal democratic institutions, providing a hospitable investment climate (Biglaiser and Staats, 2010; Durmaz, 2017; Moon, 2015). Hence, the importance of the enforcement of property rights, the adherence to the rule of law, and reliable court systems are mainly related to foreign investors' concerns about the risk and their decision to invest (Biglaiser and Staats,

2010, pp. 518–519). Meanwhile, the effects of the political institutions are positively modified by the strength of property rights institutions that can attract FDI, even in the case of regimes that are not fully democratized (Moon, 2015, 2019).

Although democracies establish a better environment for the foreign investor, the role of the sectoral composition of FDI must not be ignored (Asiedu and Lien, 2011; Schulz, 2009). Research on the nexus regime type – inward FDI excluded the distinction between different types of FDI (Schulz, 2009). Thus, the aggregate effect of regime type on FDI flows may be positive, negative, or neutral depending on the sectoral composition of FDI. Schulz (2009) provided evidence that a democracy has a positive effect on the market- and efficiency-seeking FDI, but a negative effect on resource-seeking FDI. Even so, a democratic regime establishes a better environment for FDI (Schulz, 2009, p. 15). Asiedu and Lien (2011) answering the question "does democracy facilitate FDI?" identify the role of natural resources in host countries. The effect of democracy on FDI depends on the importance of natural resources in the host country's exports. Thus, democracy increases FDI inflows in countries where the share of natural resources in total exports is low (Asiedu and Lien, 2011, p. 109).

Democracy's role in attracting FDI may be positive in some countries, but in others like Pakistan, it has less power to influence FDI decisions of MNEs (Uddin et al., 2019). Democracy stimulates inward FDI in the short-run, whereas a military government in the long-run (Uddin et al., 2019, p. 355). There is no evidence of a systematic relationship between democracy and FDI inflows at least for the developing countries (Yang, 2007). Maybe it is not the democracy by itself but the political similarity between the home and host countries that attract FDI (Dang, 2015).

Finally, the regime type is not a significant indicator of FDI (Arel-Bundock, 2017; Biglaiser and DeRouen, 2006; Henisz, 2000; Oneal, 1994). Henisz (2000) employed even a new objective measure of particular interest to the formation of multinational business strategy (host policies that threaten the expected returns of the FDI) and not to the political regime conflict (autocracy versus democracy).

The multitudinous research, focusing on the relationship between the host country's political regime type and inward FDI, unfortunately, produces contradictory theoretical findings and ambiguous empirical results. Although, many studies produce

results that democratic regimes attract FDI, nevertheless, supplement by other factors, as well.

2.4.2 Political Determinants and Inward FDI

The political determinants analyzed below regarding inward FDI are property-rights protection, the signing of Bilateral Investment Treaties (BITs), human rights, and governance. Although countries commitments through BITs are mostly analyzed in the property rights determinant, due to BITs underlying importance, they deserve an independent investigation.

Property-rights protection

Two substitute or complementary ways to attract FDI are found. The first refers to the establishment of favourable FDI conditions - this, of course, does not apply to all investments- and the other to the mitigation of risk by improving the political and economic environment (Tobin and Rose-Ackerman, 2005). Risk reduction can be achieved through the definition of well-enforced property rights. Since FDI requests the acquisition or creation of productive capacity in a long-term horizon, implying the possibility of the loss of some assets during their removal, this fact generates the "obsolescing bargain". A term defined by Vernon in 1971, meaning once an MNE undertakes an FDI, part of the bargaining power is transferred to the host country's government, which can change unexpectedly to its advantage the terms of the investment (Büthe and Milner, 2008, p. 743). Expropriation may benefit the government directly by adding revenue in state accounts and enhancing domestic ownership (Henisz, 2000, p. 338). Although globalization increased the flows of FDI, it not ceased the risk of expropriation. FDI remained vulnerable to outright expropriation, especially in extractive industries, no matter the hazard mitigating measures taken by MNEs (Li, 2009a, p. 1099).

Risk reduction can be achieved through the definition of well-enforced property rights. There is a positive association between property rights protection to economic growth and investment (Knack and Keefer, 1995; Clague et al., 1996) and even of intellectual property rights (IPR) protection to the volume and composition of FDI (Lee and Mansfield, 1996; Javorcik, 2004; Branstetter and Saggi, 2009). Biglaiser

and DeRouen (2006) shared the argument that since the enforcement of property rights minimizes the expropriation risk, the FDI inflows are increased.

Both democratic and autocratic states expropriate FDI; the difference is that democracies do so less frequently (Li, 2009a, p. 1120). Well-established democracies secure property rights and provide an optimal environment for investors (Ali et al., 2010; Jakobsen and de Soysa, 2006; Jensen, 2008b; Li and Resnick, 2003; Olson, 1993). Although Li and Resnick (2003) discovered conflicting findings on the impact of democratic institutions on inward FDI; specifically, concerning the impact of property rights protections on FDI, the result was unambiguous. Thus, when a country proceeds to a commitment to the protection of property rights, it means that foreign investors will not have to face the arbitrary seizure of tangible and intangible goods by the state (Li and Resnick, 2003, p. 202).

Li and Resnick's (2003) research findings also held implications for countries experiencing a transition from democracy to autocracy. Transitional economies would have to persuade foreign investors into believing the credibility of their property rights protection. Only in the case of establishing a consolidated democracy, they will manage to provide offsetting improvements in property rights protection and sustain the prospect of getting more FDI inflows (Li and Resnick, 2003, p. 203). Jakobsen and de Soysa (2006) motivated by Li and Resnick's (2003) study, also concluded to the positive association between democracy and property rights protection. Jensen (2008b) revealed a strong correlation between democratic institutions and lower levels of political risk, and the importance of imposing constraints on executives in reducing risks for MNEs. The insurance industry identified the need for MNEs to mitigate political risk and offered the solution through the purchasing of insurance contracts. These contracts offer risk covering from direct nationalization and expropriation of assets along with breach of contracts between the MNE and government (Jensen, 2008b, p. 1043), providing political risk insurance ratings. Ali et al. (2010) argued that the protection of property rights is the most critical determinant for FDI over institutional attributes of democracy, corruption, political instability, and social tension in the host country. Nevertheless, the democratic regime remains essential in attracting FDI flows due to its inherent advantages in protecting property rights over autocracies (Ali et al., 2010, p. 204). Biglaiser and Staats (2010) also

identified property rights protection as the most determining factor for the rise of inward FDI in any given country, though they disregarded the importance of the regime type.

Autocratic countries with long time horizons can establish institutions similar to democratic countries and receive a larger volume of FDI flows than autocracies with short term horizons (Moon, 2015, 2019). Although democracies, on average, have better institutions, scholars must be open-minded to the possibility that high-quality institutions do not exist exclusively in democratic regimes (Moon, 2015, p. 353). Both democracy and autocracy have a privileged position for attracting FDI considering that the effect of property rights on FDI is time-varying and conditioned by the institutional structure and legitimacy of the country's regime type (Nieman and Thies, 2019, pp. 15–16). Nieman and Ties (2019) found that before 1995 all regime types held a negative relationship between the protection of property rights and FDI, with autocracies having the less negative, while after 1995 democracies have a positive marginal effect on the relationship between property rights and FDI.

The signing of Bilateral Investment Treaties (BITs)

Büthe and Milner's (2008) empirical study of 122 developing countries for the 1970–2000 period, provided evidence that countries in their effort to attract more FDI inflows proceeded to establish commitments favourable to foreign investors via international institutions. These international commitments are characterized by high credibility since relegation is exceptionally costly.

BITs are the most popular international commitments. BITs originated between developed and developing countries, meaning between the primary sources of FDI and vulnerable and risky business markets. The conclusion of the first BIT was between Germany and Pakistan in 1959, and its implementation occurred in 1962 (Egger and Pfaffermayr, 2004, p. 789). Over the past two decades, BITs evolved as the dominant international legal tool for the stimulation of FDI flows. This context refers to establishing a broad set of investor's rights that permit investors to sue a host government in an international tribunal in case of these rights' violation (Kerner, 2009, p. 73). BITs establish the terms under which nationals and companies of one country

can undertake investments in another country, acting as an institutional device that protects FDI (Jandhyala et al., 2011). BITs include certain guarantees for investors from the signatory countries, such as the right to transfer funds and assets freely, minimum treatment standards, protection from expropriation and mostly the right to international arbitration (Colen et al., 2016, p. 194). Hence, BITs' guarantees reduce the risk of an investment that the "obsolescing bargain" produces.

The United Nations Conference on Trade and Development (UNCTAD) (2009) survey's reports that MNEs recognize BITs as a commitment instrument in host developing countries and transition economies. UNCTAD supported BITs expansion by organized meetings in which developing and countries in transition concluded in BITs not only with each other but with the developed countries as well (UNCTAD, 2000 cited in Bubb and Rose - Ackerman 2007, p. 292). The majority of ratified BITs include similar provisions as they are conducted following the model treaties developed in home countries of great MNEs' (Tobin and Rose-Ackerman, 2005, p. 7).

Institutions like BITs were effective in restoring the reputation and credibility of unilateral FDI-related measures of transition economies, after the fall of centrally administered socialism (Berger et al., 2011, p. 272). Besides, institutions are more valuable commitment devices for non-democracies, which have fewer mechanisms to communicate with credibility their resolves to international audiences (Fang and Owen, 2011, p. 160).

Foreign investors tend to invest in authoritarian countries that are constrained from "above" and "below" (Bastiaens, 2016, p. 141). Through the signing of an international investment treaty, authoritarian regimes reduce foreign investors' expectations of profit loss and contract instability. However, in such regimes, there is always the risk of noncompliance by the authoritarian leader. The high level of public deliberation in the policymaking process of the authoritarian signatory country can ascertain foreign investors for the effectiveness of the treaty. The significance of the public deliberation theory, in addressing problems of the country's economic instability and growth proved in Chandra and Rudra's (2015) empirical study. Bastiaens (2016, p. 142) concludes that "in the long run, authoritarian countries with ratified bilateral investment treaties (BITs) and high levels of public deliberation

receive greater inflows of FDI than authoritarian regimes with bilateral investment treaties and low levels of public deliberation".

There is a positive relation between BITs and FDI (Falvey and Foster-McGregor, 2017; Grosse and Trevino, 2005; Kerner, 2009; Neumayer and Spess, 2005; Salacuse and Sullivan, 2005). Salacuse and Sullivan (2005) stated the positive contribution of BITs to inward FDI in determining BITs effectiveness concerning foreign investment protection, market liberalization, and investment promotion. A positive relation between BITs and FDI is recorded to those developing countries that sign mostly BITs with developed countries (Neumayer and Spess, 2005). Grosse and Trevino (2005) provided evidence for this positive relationship for 13 countries of Central and Eastern Europe (CEE) during 1990–1999. The reason is that MNEs regard BITs like facilitators to invest as they reduce the cost of doing business in CEE. Although Berger et al. (2011, p. 272) questioned the overall positive correlation of BITs on FDI, they agreed with their effectiveness mostly in the relatively small subset of host countries in CEE. Kerner's (2009) empirical analysis provided consistent evidence that BITs do attract FDI. BITs are more effective to countries that in the eyes of investors, are most in need of the treaty's assurances. To this line of argument, non-transparent countries with weak institutional and policy environment are seeking to sign BITs to establish stability, transparency, credibility, increasing FDI inflows. Whereas, countries with democratic regimes that already experience a conducive investment environment, entering into BITs will not substantially influence the level of FDI inflows (Rosendorff and Shin, 2012, pp. 34–35). There is a positive effect of BITs on bilateral flows of FDI, though it may disappear if large differences in the strength of political institutions between source and host countries exist (Falvey and Foster-McGregor, 2017, p. 653).

The effectiveness of a BIT relies on the risks to which MNEs exposed to the host country. Desbordes and Vicard (2009) are concerned in their analysis of the two kinds of political risks that usually confront foreign investors into host countries; thus, the systematic domestic risk, referring to the quality of domestic institutions and the idiosyncratic risk resulting from interstate political relations. The latter is considered to have a high impact on the investment locational decision-making process of MNEs. BITs should succeed in increasing the volume of bilateral FDI by preventing political juxtaposition between countries that usually lead to expropriation risks and

maintaining good quality in domestic institutions. They focused on the quality of political relations between the signatory states as a stimulant to FDI. BITs have a more significant impact on inward FDI between countries with political tensions, whereas they are insignificant between friendly countries. Additionally, they found evidence about the complementarity of BITs to strong domestic institutions (Desbordes and Vicard, 2009, p. 383).

Hallward-Driemeier (2003) examines bilateral FDI flows for a small sample of host countries and finds little support for the effectiveness of BITs. In particular, ratified BITs act complementarily to property rights in countries with weak domestic institutions while countries with strong domestic institutions are gaining even more from ratifying a treaty. The weak relationship between BITs and FDI is also described by Tobin and Rose-Ackerman (2005), stressing out the importance of political stability. The signing of a BIT it is not enough for acquiring a larger share in inward FDI if the country has not achieved its political stability first. Finally, the impact of BITs on a country's FDI flows must be examined within the context of its political, economic, and institutional environment and in the light of the global BITs regime (Tobin and Rose-Ackerman, 2011, pp. 28–29). Hence, as the coverage of BITs increases, overall FDI flows to low- and moderate-income countries increase (Tobin and Rose-Ackerman, 2011, pp. 28–29).

Summing up, most of the empirical studies conclude on the effectiveness of BITs in attracting FDI. BITs appear to be more valuable commitment devices for non-democracies and non-transparent countries, which have fewer mechanisms to communicate with credibility their resolves to international audiences.

Human Rights: Political Participation, civil liberties, and labour rights

The question arises whether guarantees of political participation and civil liberties or civil and political repression and curtailed labour rights boost FDI. Human rights repression drives "a race to the bottom" in that constraints of human rights are considered to create a more safe and favourable business environment for investors, who benefit from low labour costs and oppression of labour rights. The validity of this conventional wisdom that repressive states best serve the interests of foreign capital is questioned. Kucera (2002) finds no solid evidence in support of conventional

wisdom. The respect of human rights can also reduce the risk for FDI, by enhancing political stability and predictability and decreasing the vulnerability of investors to the costs associated with public sensitivity to human rights' repression (Blanton and Blanton, 2007, p. 144).

Garriga (2013) includes the issue of foreign investors' reputational concerns to the discussion of human rights violations influence on FDI. Garriga's empirical work in developing non-OECD countries provides evidence supportive of the argument that violations of physical integrity rights in countries characterized by a low commitment to human rights regimes work as a deterrent to FDI.

There is a positive relationship between political freedom and FDI (Busse, 2003, 2004; Harms and Ursprung, 2002; Rodrik, 1996). Rodrik's (1996, cited in Busse, 2004, p. 46) survey on democratic rights and FDI coming from the US, indicated that countries with stronger democratic rights attract more capital from US transnationals. MNEs are more interested in countries respecting civil liberties and political rights, and accepting an organized labour force than in non-democratic regimes suppressing residents' fundamental human and democratic rights (Harms and Ursprung, 2002, p. 653).

Busse (2003, 2004), confirming Rodrick's, and Harms and Ursprung's empirical findings, concluded that countries with improving democratic rights and liberties receive a larger volume of FDI per capita than will have been predicted based on other country characteristics. Busse's (2004) established the linkage between democracy and FDI, by using two separate indicators of "civil liberties" and "political rights", provided by Freedom House. Freedom House, established in 1941, is a non - governmental organization, based in the US. Since 1972, the organization is publishing “Freedom in the World”, an annual global report that assesses a large number of countries, concerning fundamental democratic rights, such as political rights and civil liberties. It is composed of numerical ratings and descriptive texts for each country and a select group of related and disputed territories. Other signature reports are the “Freedom of the Press” and “Freedom of the Net”, intending to monitor censorship, intimidation and violence against journalists, and public access to information (Freedom House, 2017a).

The political rights include the free participation of people in the political process, the right to vote, the competition for public office, and the election of representatives who have a decisive vote on public policies. Civil liberties include the freedom to develop views, institutions, and personal autonomy without interference from the state. Although Adam and Filippaios (2007) used the same indicators, their result is different for the indicator of civil liberties since they found that MNEs tend to invest in democratic countries with high political rights, but with low civil liberties. Tintin (2013) provided evidence that better institutions attract more FDI in transition economies of CEE, recognizing political rights and civil liberties as comprehensive institutional variables along with economic freedom and state's fragility (Tintin, 2013, p. 297). As well, Pajunen (2008) regarding the group of CEEC, identified political rights and civil liberties to exhibit causal relevance as a fundamental cause for becoming an FDI-attractive country (Pajunen, 2008, p. 663). Pournarakis and Varsakelis' (2004) research used the two indices with the variable of the freedom of the press for the CEEC. They concluded that more improvements in the civil rights level of a country, the more positive is the impact of an increase in per capita income on FDI (Pournarakis and Varsakelis, 2004, p. 89).

Madani and Nobakht (2014) used the Freedom House indices of "civil liberties" and "political rights" for the measurement of the types of political regimes (democracies or autocracies) across the Upper Middle-Income Countries (UMCs) in their research on political regimes-inward FDI nexus. They revealed the importance of the quality of political institutions in recipient countries and their findings are in favour of democratic regimes attracting higher levels of FDI than autocratic ones. In the same line, Durmaz (2017) examined the relationship between democracy and FDI in Turkey for the period 1977-2011. Durmaz's analysis presents democracy as a critical factor in MNEs' decisions for choosing Turkey to be a potential investment site. Since the last military intervention in 1980, the country experiences a more structured and stable government with policies and institutions providing improved political rights and more civil liberties. Hence, Turkey's institutional improvements support the country's development as a recipient of FDI (Durmaz, 2017).

The economic externalities generated concerning human rights makes countries attractive hosts of FDI (Blanton and Blanton, 2006, 2007, 2009). According

to Blanton and Blanton (2006, 2007), human rights act complementarily to political institutions in providing a friendly FDI environment, unlike countries under oppression. Furhermore, Blanton and Blanton (2007) examined the relationship between FDI and human rights in non-OECD countries. They used for the measurement of human rights conditions, the Political Terror Scale (PTS) that provides a narrow conceptualization of human rights as it focuses on violations of personal integrity rights. They found that developing countries that respect human rights, succeed in receiving more FDI than those in which human rights are curtailed. Blanton and Blanton (2009) proceeded to further assessment of the role of human rights, namely physical integrity rights, in investment decisions. They suggest human rights can be a significant determinant of FDI across sectors that value higher skills and integration within the host society.

In a later study, Blanton and Blanton (2012) questioned the extent to which labour rights within a potential host affects investment decisions. The labour rights is a rather challenging issue since it is reciprocally related to FDI; a relation which seems to rely on the different types of FDI. They proved that labour rights are negatively and significantly related to total FDI, as well as FDI in the services sector and vice versa, while a positive relationship exists in manufacturing investments. Furhermore, Blanton and Blanton (2012) discovered a "race to the bottom" dynamic concerning the FDI-labour rights nexus. Foreign investors that choose to invest in a stable society with a skilled labour force, they are not necessarily in favour of labour rights. MNEs are more willing to invest in countries that have a lower level of labour rights, which investments further undermine labour rights (Blanton and Blanton, 2012, p. 288).

For the same argument, Olney (2013, p. 203) provided evidence that labour protection rules are significantly related negatively to inward FDI and that countries following FDI-friendly strategies are competitively lowering their labour rights. In contrast, Busse et al., (2011) by using a sample of 28 source countries of FDI (including non-OECD countries) and 82 low and middle-income host countries, for the period proved that labour rights limitations in, for example, freedom of association and objective bargaining, decrease inward FDI.

Governance

Kaufmann et al. (1999) proceeded in organizing and summarizing the different indicators of governance that existed in the 1990s, based on individual notions. This effort led to the production of the Worldwide Governance Indicators (WGI) project that has been covering over two hundred countries and territories since 1996, for six dimensions of governance: Voice and Accountability, Political Stability and Absence of Violence/Terrorism, Government Effectiveness, Regulatory Quality, Rule of Law, and Control of Corruption (Kaufmann et al., 2011, p. 221). Across the literature, these indicators are used as variables in the examination of the inward FDI-political regimes nexus. Also, reference will be made for the variables of veto players and audience costs since some important research on the same issue used these determinants in the quality of governance. Finally, there are studies that in measuring the quality of governance use similar indicators, e.g. corruption instead control of corruption, law and order instead of the rule of law from a different data source. Due to their important empirical results, they also included in the analysis below.

Jensen (2003, 2008b) examined the relationship between FDI and democracy and concluded that since a democratic regime is characterized by credibility, a positive relation between democracy and a higher volume of inward FDI is present. One supportive mechanism for the high credibility of democratic governments is the number of veto players that the democratic political system involves (Jensen, 2008b, p. 1041). Veto players can include chambers of the legislature, a supreme court, separation of the executive and legislative branches of government, or federal actors (Jensen, 2003, p. 594). MNEs can enter foreign markets with the assurances provided by veto players that government policies will not change after entry (Jensen, 2003, 2008b). Even more significant for the positive association of inward FDI with democracy, is the host government's reputation. In the case that democratic leaders decide to call off commitments that made to foreign investors, then a bad reputation arises in the financial markets that will follow them to the polls where voters will express their dissatisfaction. This political process is defined as "audience costs" (Jensen, 2003, pp. 594–595). Hence, cost-benefit calculation results to discourage leaders from opportunistic behaviour. In a later study, Jensen and Johnston (2011) added the "resource curse" to distinguish the impact of audience costs to leaders of regimes with abundance in natural resources, like Chavez in Venezuela. In these

regimes, governments are lacking incentives to maintain a good reputation (Jensen and Johnston, 2011, p. 663). The wealth of natural resources continues to attract FDI despite the higher level of political risks and bad reputation associated with audience costs (Jensen and Johnston, 2011, pp. 680–81). Choi and Samy's (2008) empirical work for developing countries, provided evidence that institutional credibility enforced by veto players in democracies may contribute to a rise of FDI inflows, though political constraints produced by audience costs do not increase FDI.

Daude and Stein (2007) proved that the indicators of WGI, regulatory quality followed by government effectiveness act as the most potent stimulants of inward FDI. The importance of regulation as an institutional variable affecting inward FDI flow is also outlined in Uddin et al. (2019) research for Pakistan. Whereas Shan et al., (2018) indicated the voice and accountability in attracting Chinese FDI in Africa and respectively Staats Biglaiser (2012) suggested the rule of law for inward FDI in Latin America. Thus, countries in the region with greater judicial strength and the rule of law are receiving higher flows of FDI (Staats and Biglaiser, 2012, p. 200). Governance indicators such as the rule of law, control of corruption, regulatory quality, government effectiveness and political stability are positively related with FDI in Asian and Latin American countries (Gani, 2007, p. 756).

Governance indicators that enhance good governance are more important in determining FDI inflows than the political regime's democratic spirit (Busse and Hefeker, 2007; Mengistu and Adhikary, 2011; Shah and Afridi, 2015; Li et al., 2017; Rodríguez-Pose and Cols, 2017). Mengistu and Adhikary (2011) provided tangible evidence for political stability and the absence of violence, government effectiveness, the rule of law, and control of corruption as indicators to the quality of governance that have a significant role in attracting inward FDI. Although, regime type and favourable policy-mix are essential in stimulating inward FDI, the quality level of governance that enhances the rule of law, limits corruption, and ensures political stability turns to be the most important determinant of FDI (Mengistu and Adhikary, 2011, p. 295). Shah and Afridi (2015) who analyzed the impact of good governance for FDI inflows in five SAARC member countries for the period of 2006 – 2014, concluded to the same results. As well, Rodríguez-Pose and Cols (2017) underlined the contribution of the quality of governance in FDI's distribution in sub-Saharan Africa,

for the period 1996–2015. They provided evidence for the positive relation of the good institutions to FDI, in the sense that stable, more credible and effective, and less corrupt regimes, with sound and trustful legal system stimulate inward FDI (Rodríguez-Pose and Cols, 2017, p. 79). A later study of Bailey (2018) using also the WGI for the quality of governance confirmed these results.

Busse and Hefeker (2007) explore in detail the role of political risk and institutions in host countries as determinants of FDI for a data sample of 83 developing countries, covering 20 years period. Among the indicators of political risk and institutions they examined, the government stability, internal and external conflicts, law and order, ethnic tensions, and quality of bureaucracy are the highly significant determinant of inward FDI while to a lesser degree, corruption and democratic accountability (Busse and Hefeker, 2007, p. 412). In similar research, Li et al. (2017) differentiated from Busse and Hefeker's empirical study by disaggregating FDI inflows into various types and examining the impact of civil war on inward FDI into the three economic sectors. They concluded that government stability and control of corruption are more significant institutional variables in attracting inward FDI in developing countries than law and order, bureaucratic quality and a democratic political system (Li et al., 2017, p. 503). According to this later research, in the case that the host developing country experiences a civil war, the parameter of the industry sector must be considered. Thus, in secondary and tertiary sectors FDI is hindered, while in primary sector FDI inflows are not so sensitive in front of the outbreak of a civil war (Li et al., 2017, p. 502). The parameter of the productive economic sector seems to become popular in the examination of FDI and quality of governance relationship. In this context, Melo and Quinn (2015) develop a panel data set of 112 countries for the years 1999-2010 to identify how corruption affects FDI inflows and point out the case in which MNEs pursue natural resources. Corruption produces additional costs and risks in government institutions, hindering inward FDI.

Nevertheless, if a country is a significant oil producer, then corruption becomes insignificant to extractive MNEs (Melo and Quinn, 2015, p. 46). Regarding corruption, Méon and Sekkat (2005) insisted on that a country suffering from poor governance, meaning a weak rule of law, an inefficient government and political violence, then produces high corruption, discouraging inward FDI. Contrariwise, Egger and Winner

(2005) identified a positive long-run impact of corruption on a host developing country's attractiveness for foreign agents from developed countries. MNEs may accept the host country's corruption practices for promoting their interests; as such, corruption act as a "helping hand" to their profits' increase. Since MNEs profits outweigh their costs, then corruption will increase FDI (Egger and Winner, 2005, p. 935). This positive relationship between corruption and inward FDI confirmed Bellos and Subasat (2012) in their research for European transition economies. In these economies, the low quality of governance generate problems, that corruption can compensate by accelerating processes in a sluggish administration, by skipping the restrictive, bureaucratic regulatory framework, by providing incentives to poorly paid civil servants and by giving the license of a competitive auction to the more generous bribe (Bellos and Subasat, 2012, p. 566). Hence, in economies with transitional problems, corruption can stimulate FDI inflows.

However, most of the existing research for transition economies presents the opposite outcome for corruption as a determinant of FDI. Especially in their early transitional days, big government's corruption hindered any effort to implement structural reforms for their regime change and the establishment of a market economy (Bitzenis, 2006). Hellman et al. (2002, p. 21) suggested that corruption decreases inward FDI and as well attracts lower quality investment in terms of governance standards. This kind of investment can generate state capture and more corruption (Hellman et al., 2002). Less corrupt transition economies (such as Estonia or the Czech Republic) attract more FDI than more corrupt transition states (such as Azerbaijan or Uzbekistan) (Javorcik and Wei, 2009). Finally, credible government policies and the improved rule of law contribute at most in transforming post-socialist countries of Eastern Europe and Eurasia in FDI's recipient countries (Touchton, 2015).

A summary of the studies is included in Table 2.1.. Sixty-two studies are reported of which, 33 examine the impact of political regimes on FDI, incorporating the aforementioned political determinants. In particular, 11 of these papers find a positive impact of democracy on FDI, 8 an indirect positive impact, and 2 both positive and negative. Two of these papers find a positive impact of authoritarianism on FDI, and one an indirect positive impact. Nine studies determined an insignificant role of the regime on FDI. Concerning the impact of political variables on FDI, in the total of

62 studies, 2 of these papers find both positive and negative impact, 5 negative impact, while 54 positive impact on FDI.

Table 2 1 - Literature Findings on the Impact of Regime on Inward FDI based on Political Determinants

Political Determinants	Studies	Political Determinants Impact on FDI				Regime Impact on FDI						
		(+)	(-)	(+, -)	Ns	(+)		(-)		(+, -)		Ns
						D	A	D	A	D	A	D, A
Property-rights protection	Li and Resnick (2003)	●								●		
	Jakobsen and de Soysa (2006)	●				●						
	Biglaiser and DeRouen (2006)	●										●
	Jensen, (2008b)	●				○						
	Li (2009a)	●				○						
	Ali et al. (2010)	●										✳
	Biglaiser and Staats (2010)	●				○						
	Moon (2015)	●										●
	Moon (2019)	●					○					
	Nieman and Thies (2019)	●								●		
The signing of BITs	Hallward-Dreimeier (2003)	●										✳
	Grosse and Trevino (2005)	●										✳
	Neumayer and Spess (2005)	●										✳
	Salacuse and Sullivan (2005)	●										✳
	Tobin and Rose-Ackerman (2005)				●							✳
	Büthe and Milner (2008)	●										✳
	Desbordes and Vicard (2009)	●										✳
	Kerner (2009)	●				●						

	Berger et al. (2011)	●										✳
	Jandhyala et al. (2011)	●										●
	Tobin and Rose-Ackerman (2011)	●										●
	Rosendorff and Shin (2012)	●					●					
	Bastiaens (2016)	●					●					
	Falvey and Foster-McGregor (2017)	●										✳
Human Rights	Rodrick (1996)	●				●						
	Harms and Ursprung (2002)	●				●						
	Kucera (2002)	●										✳
	Busse (2003, 2004)	●				●						
	Pournarakis and Varsakelis (2004)	●										✳
	Adam and Filippaios (2007)			●		○						
	Pajunen (2008)	●										✳
	Blanton and Blanton (2006, 2007)	●										●
	Blanton and Blanton (2009)	●				○						
	Busse et al. (2011)	●										✳
	Blanton and Blanton (2012)		●									●
	Olney (2013)		●									✳
	Garriga (2013)	●				○						
	Tintin (2013)	●										✳
	Madani and Nobakht (2014)	●				●						
	Durmaz (2017)	●				●						
Governance	Hellman et al. (2002)		●									✳
	Jensen (2003)	●				●						

Egger and Winner (2005)	●								⁕
Méon and Sekkat (2005)		●							⁕
Bitzenis (2006)	●								⁕
Busse and Hefeker (2007)	●				○				
Daude and Stein (2007)	●								⁕
Gani (2007)	●								⁕
Choi and Samy (2008)	●				●				
Javorcik and Wei (2009)	●								⁕
Mengistu and Adhikary (2011)	●								⁕
Bellos and Subasat (2012)		●							⁕
Staats and Biglaiser (2012)	●								⁕
Shah and Afridi (2015)	●								⁕
Melo and Quinn (2015)			●						⁕
Touchton (2015)	●								⁕
Li et al. (2017)	●								●
Rodríguez-Pose and Cols (2017)	●								●
Bailey (2018)	●				○				
Uddin et al. (2019)	●				●				

Note: i) (+) The study reports a positive impact of the regime or political determinants on FDI, (-) The study reports a negative impact of the regime or political determinants on FDI, **(+) (-)** The study reports both positive and negative impact of the regime or political determinants on FDI, Ns: The study reports an insignificant impact of the regime or political determinants on FDI.
ii) ● represents the direct impact of the regime or political determinants on FDI, ○ represents the indirect impact of the regime or political determinants on FDI, ⁕ the regime type is not included in study's empirical analysis.
iii) D for Democracy, A for Authoritarian
iv) Table 2.2-ANNEX I provides more details for the studies

Therefore, besides the regime type, there are certain factors in the host country's political surroundings which influence inward FDI. To this context, the empirical analysis of this research will incorporate them.

2.5 Concluding Remarks

Most of the literature on the allocation of FDI around the world examine the influence of general economic phenomena discounting political conditions. Although limited in number, empirical studies are covering the FDI – political regimes nexus and add new dimensions on this relation and FDI literature in total. Despite their conflicting empirical results, these scientific efforts provide the underpinnings for further research on inward FDI's distribution, concerning current development in the international political environment.

The political system of democracy remains the most common system globally, despite the recorded democratic declines, and the rise of illiberal politics. A country under a democratic rule of governance, holding strong institutions, offers guarantees to foreign investors for the safety of their investments. Many studies share the argument that a democratic regime attracts more FDI than an autocratic, but few provide strong empirical evidence.

This chapter examining the extent to which host country's political system determines inward FDI, found specific factors that irrespective the type of the political regime affect the foreign investors' decision-making process. The dissertation follows the argument that FDI cannot be explained by a single theory but rather by a combination of theoretical models which complement each other. To this line, the identification of determinants that increase the regime's institutional stability and credibility, and as such influence, the inward FDI is based on the empirical results of the extant literature. The distinguished determinants are the property-rights protection, the signing of BITs, human rights (political participation rights, civil liberties and labour rights) and the quality of governance.

The findings of the Literature review suggest that the protection of property rights generates the optimal environment for foreign investors. The way the recipient country guarantees the protection of property rights, decreasing the risk of an investment that the "obsolescing bargain" produces, enhances stability and predictability for FDI, is the signing of BITs.

Conventional wisdom and sometimes assumption that foreign capital is best served by repressive states securing "desirable" to investors conditions seem to be rejected, as the respect of human rights can guarantee a healthier investment environment. When the host country's political environment provides guarantees of political participation and civil liberties, the country attracts more FDI inflows. A host country that through its political system can ensure institutional quality and establish political stability, greater judicial strength and the rule of law, activate multiple veto players, take into consideration possible audience costs and manage to control corruption, it will succeed in stimulating more FDI. Credible government policies and control of corruption are of high significance in transition countries. However, in some cases, when bad governance exists, then corruption can overcome distortions and attract FDI.

This chapter aims to set up the scenery for examining the relationship between the political system and inward FDI simply and effectively. The findings of the literature review are the basis for the design of the study's empirical model, including most of the identified factors that evolve in the political surroundings of the host country. These variables expected to shape in a better form the relationship between political regime and FDI, support the extraction of conclusive arguments and serve research's objectives (please see Chapter 1). Policymakers may benefit by directing their interest in the improvements of the specific features of the political environment, to encourage effective FDI policies that promote economic growth.

ANNEX I

Table 2 2 – Summary of Empirical Studies

Political Determinants	Studies	Empirical Analysis	Main Results	Regime Impact on FDI
Property-rights protection	Li and Resnick (2003)	D.V.: net FDI inflows P.M.: Polity IV Index A panel of 53 developing countries, 1982 – 1995.	Necessary the provision of improved **property rights protection as** a stimulus to inward FDI. New democracies in transitional economies may not be ready to provide superior property rights protection.	Positive and Negative Impact Democratic institutions affect inward FDI both positively and negatively.
	Jakobsen and de Soysa (2006)	D.V.: FDI inflows (logged) P.M.: Polity IV and Freedom House Indices A panel of 99 developing countries, 1984-2001.	The results are sensitive to sample selection. A positive link between democracy and **property rights protection**	Positive Impact Democracy to be the far more attractive political system for FDI.
	Biglaiser and DeRouen (2006)	D.V.: net FDI inflows as % of GDP P.M: Polity IV Index A panel of 15 Latin American countries, 1980 – 1996.	Enforcement of **property rights** influences FDI positively.	Insignificant Impact The level of inward FDI inflows is the same regardless of the regime type (democracy or autocracy).
	Jensen (2008b)	D.V.: The ordinal measure of the disaggregated ONDD expropriation risk price P.M.: Polity IV Index 134 countries, 15-year, political risk data, qualitative data from 28 interviews.	**Democratic institutions are related to lower levels of political risk, which includes the risk of expropriation.** Political risk mitigation is appealing to MNEs.	Indirect Positive Impact the level of political constraints.

	Li (2009)	D.V.: annual number of expropriation acts in a given country P.M.: Polity IV Index A panel of 63 developing countries, 1960-1990.	Both autocratic and democratic states **expropriate** FDI, the difference is that in the second on the rate of doing this is less frequent.	Indirect Positive Impact Since in democracies the frequency of expropriation is less, this can be appealing to MNEs
	Ali et al. (2010)	D.V.: net FDI inflows as % of GDP P.M.: International Country Risk Guide (ICRG) Data, PRS Group A panel of 69 developing countries, 1981 – 2005.	FDI is attracted to countries where institutions are strong, and **property rights** are secure. **Property rights protection** is the most important institutional host country's determinant for FDI.	No regime Impact* Property rights the main determinants for the stimulation of inward FDI.
	Biglaiser and Staats (2010)	D.V.: net FDI inflows as % of GDP P.M.: Political constraints (POLCON) index developed by Henisz (2000) A panel of 138 developing countries, 1976- 2004. Questionnaire to U.S. chief executive officers of MNEs	Countries that enforce **property rights,** adhere to the rule of law, and maintain effective court systems, are better positioned as host countries to FDI.	Indirect positive Impact Political institutions under democracy (and not democracy by itself) for FDI growth
	Moon (2015, 2019)	D.V.: FDI inflows (logged) P.M.: Contract Intensive Money (CIM) and IRCG data, PRS Group A panel of 86 autocratic countries, 1970 – 2008.	Autocratic countries with long time horizons can **protect property rights and enforce contracts** like democratic countries, attracting a larger volume of FDI flows than other autocracies.	Insignificant Impact Institutional features of the host country matters to foreign investors and not the regime type *per se* (Moon, 2015) Indirect positive Impact autocratic countries can take advantage of their political institutions to attract foreign capital (Moon, 2019)

	Nieman and Thies (2019)	D.V.: net FDI inflows (logged) P.M.: Polity IV Index 149 countries, 1970-2009	The effect of **property rights** is time-varying and is conditioned by a country's regime type, and this effect is time-varying.	Negative and Positive Impact Before 1995, all regime types have a negative marginal effect on the relationship between property rights and FDI, but autocracies less negative. After 1995, democracies are the one with a positive marginal effect.
The signing of Bilateral Investment Treaties (BITs)	Hallward-Driemeier (2003)	D.V.: the share of source country's FDI to host Y. P.M.: ICRG data, Kaufmann, Kraay, Zoido-Lobaton (KKZ) indicator. Bilateral FDI flows from 20 OECD countries to 31 developing countries, 1980-2000.	Ratified **BITs** are effective in countries with good institutional quality.	No regime Impact* Positive relation of ratified BITs and good institutional quality with inward FDI
	Grosse and Trevino (2005)	D.V.: FDI inflows P.M.: ICRG database 13 CEEC, 1990–1999.	The increasing number of **BITs** that CEE transitional countries signed increased FDI inflows	No regime Impact* A positive relation between BITs and FDI
	Neumayer and Spess (2005)	D.V.: FDI flows (logged) P.M: POLCON index 120 developing countries, 1984-1996.	Developing countries that sign more **BITs** with developed countries receive more FDI in return. The overall effect of signing up to **BITs** sometimes depends on the level of institutional quality	No regime Impact* A positive relation between BITs and FDI
	Salacuse and Sullivan (2005)	D.V.: FDI inflows (logged) P.M.: World Bank Indicators 100 OECD developing countries, 1991-2000.	**BITs** protect and promote FDI, particularly in developing countries.	No regime Impact* A positive relation between BITs and FDI
	Tobin and Rose-	D.V.: FDI inflows to low-income country i in time t as % of world FDI flows P.M.: ICRG data	A country must hold a minimum level of political stability before **BITs** have a positive	No regime Impact* A complex interaction between the level of political risk, BITs, and FDI

Ackerman (2005)	A sample of 176 low- and middle - income countries, 1984-2000.	effect on their ability to attract FDI. A weak relationship between BITs and FDI	
Büthe and Milner (2008)	D.V.: net FDI inflows as % of GDP P.M.: Arthur Banks's dataset of political events, Polity IV index A panel of 122 developing countries, 1970 – 2000.	Developing countries can make **commitments** to liberal economic policies more credible via international institutions, reassuring foreign investors.	No regime Impact* What increases FDI is the commitments via international institutions
Desbordes and Vicard (2009)	D.V.: bilateral FDI stock, P.M.: ICRG data 30 OECD countries & 32 non-OECD emerging countries, 1991–2000. Gravity model with the use of Poisson QMLE	The quality of political relations between the signatory states influences the level of bilateral FDI flows. **BITs** can be the commitment devices enabling host country governments to promote their credibility in guaranteeing the property rights of foreign investors	No regime Impact* The positive impact of BITs on FDI in the case of good interstate political relations
Kerner (2009)	D.V.: FDI flows P.M.: POLCON and Polity IV indices 127 OECD host countries, 1982-2001. OLS regression.	**BITs** do attract FDI, and both direct and indirect channels of influence play an essential role in this. Democratic countries are more likely to receive FDI as well as being more likely to ratify **BITs**	Positive Impact Positive impacts of BITs on FDI, A positive relation between democracy and FDI
Berger et al. (2011)	D.V.: bilateral FDI flows P.M.: POLCON index FDI flows from 14 source countries to 83 (developing) host countries, 1978-2004.	**BITs** stimulate FDI flows only in some post-socialist countries in CEE	No regime Impact * Positive impacts of BITs on FDI only in a relatively small subset of host countries
Jandhyala et al. (2011)	D.V.: dyadic BIT signing P.M.: POLCON and POLITY IV indices a data set of all possible dyads between 166 countries, 1970–2007.	The effects on the **BIT** signing of the potential for dyadic FDI flows, host country political systems, and transnational norm-based emulation variables will vary over time.	Insignificant Impact A positive relation between BITs and FDI

	.	**BITs** act as an institutional device that protects FDI.	
Tobin and Rose-Ackerman (2011)	D.V.: net FDI inflows (logged) P.M.: ICRG data, Polity IV index A panel of 97 low- and middle-income countries, 1984– 2007.	In countries with weak domestic institutions, **BITs** have a positive impact on FDI flows as complements to the domestic investment environment. The impact of **BITs** depends upon the global coverage of **BITs**	Insignificant Impact A complex interaction between the level of political risk, BITs, and FDI
Rosendorff and Shin (2012)	D.V.: net FDI inflows as % of GDP P.M.: Polity IV dataset 112 developing countries, 1970 – 2004.	Non-transparent countries suffering from weak institutional and policy environment are seeking to sign **BITs** to import stability, transparency, credibility, increasing FDI inflows.	Positive Impact BITs increase inward FDI in non-transparent autocracies more than in transparent autocracies, or in any kind of democracy.
Bastiaens (2016)	D.V.: net FDI inflows as % of GDP P.M.: PARCOMP (Marshall and Gurr, 2008, Polity) Panel data of 87 authoritarian countries, 1990-2008. Survey of US foreign investors.	The prerequisite for an authoritarian country with ratified **BITs** in receiving a more considerable amount of FDI inflows is to have high levels of public deliberation.	Positive Impact A positive relation between BITs and FDI in an authoritarian regime
Falvey and Foster-McGregor (2017)	D.V.: bilateral FDI stocks & flows P.M.: Investment Policy Hub, Henisz Index 22 OECD source countries & 101 host countries, 1985-2011	There is a positive effect of **BITs** on bilateral flows of FDI, though it may disappear if substantial differences in the strength of political institutions between source and host countries exist.	No Regime Impact* BITs increase FDI flows from source to host countries.

Human Rights: Political Participation, Civil Liberties and Labor Rights	Rodrik (1996)	D.V: Manufacturing FDI by US majority-owned foreign affiliates. P.M: Helliwell democracy indicator (derived from Freedom House indices of civil and political rights) Cross-section of 40 countries	US MNEs appeared to invest in countries where political rights and civil liberties are protected.	Positive Impact Countries with stronger democratic rights are related positively to FDI
	Harms and Ursprung (2002)	D.V.: FDI flows/population P.M.: Freedom House indices, ICRG data Cross-section and panel of 62 emerging markets and developing economies, 1989-1997.	Rejection of the argument that foreign investors prefer the non - democratic regimes that suppress residents' fundamental **human and democratic rights**.	Positive Impact A positive relation between FDI and more liberal regimes that respect political and civil liberties
	Kucera (2002)	D.V: FDI flows P.M.: Freedom House Indices 127 countries, 1993-1999.	No solid evidence in support of foreign investors preferring countries with lower **labour standards**	No Regime Impact * Countries with stronger worker rights have a positive impact on FDI inflows.
	Busse (2003, 2004)	D.V.: FDI flows/population P.M.: Freedom House Indices Cross-section and panel of 69 developing and emerging market countries, 1972-2001.	MNEs appeared to be attracted by countries where **political rights** and **civil liberties** are protected *(confirmed the empirical findings of Rodrick (1996) and Harm-Ursprung (2002).*	Positive Impact A strong positive link between democracy and FDI from the 1990s onwards, but no evidence for the period before
	Pournarakis and Varsakelis (2004)	D.V.: FDI inflows per capita P.M.: Freedom House Indices 11 transition economies in CEE, 1997-2001.	Improved institutions, respecting **political rights** have a positive impact on MNEs investment decisions.	No regime Impact* Positive impact political rights and civil liberties on FDI

	Adam and Filippaios (2007)	D.V.: US FDI flows as a % of GDP P.M.: Freedom House Indices A panel of 105 developing (*most of them under repressive regimes*) and developed countries, 1989-1997.	**Civil liberties**' repression may be an incentive for foreign investors, although **political rights** repression and non-democratic decision making, produce the opposite effect.	Indirect Positive Impact of democratic policies on the specific type of FDI motivated by other than efficiency reasons, A positive impact of Political rights on FDI, a negative impact of civil liberties on FDI
	Pajunen (2008)	D.V.: country's share of global FDI inflows to its share of global GDP P.M.: Freedom House Indices A fuzzy-set analysis of 47 host countries, 1999-2003.	**Political rights and civil liberties** in a country of **CEE** are important causes for its membership in the set of an FDI-attractive country. Political stability is also included.	No regime Impact* A positive relation between FDI and political rights and civil liberties
	Blanton and Blanton (2006, 2007)	D.V.: net FDI inflows as % of GDP P.M.: Political Terror Scale (PTS), POLCON index Developing Non-OECD countries, 1980-2003.	The economic externalities generated by respect for **human rights** makes countries attractive hosts of FDI.	Insignificant Impact A positive relation between FDI and respect for human rights, democracy was not a significant determinant of FDI to the developing world (Blanton and Blanton, 2007). Democracies are significant only in the extractive sector (Blanton and Blanton, 2009).
	Blanton and Blanton (2009)	D.V.: FDI stock (logged) P.M.: Polity IV index Developing, Non-OECD countries recipients of U.S. FDI, 1990 -2004		
	Busse et al. (2011)	D.V.: FDI flows P.M.: ICRG data 28 source countries *(including non-OECD countries)*, 82 low and middle-income host countries, 1984-2004.	**Labour rights** limitations, such as freedom of association and objective bargaining, discourage FDI inflows even in small and poor developing countries.	No regime Impact* A positive relation between FDI and labour rights

Blanton and Blanton (2012)	D.V.: FDI inflows (logged) P.M.: Polity IV index A sample of 35 developing countries, covering a limited time of 8 years for each country (mid-1990s-2002)	A "race to the bottom" dynamic in the FDI - **labour rights** nexus. There is a significant relationship between labour rights and FDI, though it varies across investment sector.	No regime Impact* Labour rights are negatively related to FDI, except in manufacturing investments.
Olney (2013)	D.V.: U.S. foreign affiliate sales in a country P.M.: POLCON Index 26 OECD countries, 1985-2007.	MNEs increase FDI when a reduction in **labour** protection rights occurs, and each host country undercut labour standards to dominate in the inward FDI.	No regime Impact* A negative relation between labour protection rules and FDI
Garriga (2013)	D.V.: net FDI flows (logged) P.M.: Freedom House, Polity IV indices Non-OECD Developing countries, 1982-2011.	Violations of **physical integrity rights**, in countries characterized by a low commitment to **human rights regimes**, work as a deterrent to FDI.	Indirect Positive Impact FDI is positively associated with capital openness and democracy. A positive relationship between human rights and FDI, for countries with worse human rights' violation
Tintin (2013)	D.V.: FDI inflows (logged) P.M.: Freedom House, Polity IV Indices A panel of 6 host CEEC, 1996–2009.	Better institutions attract more FDI in CEEC, **Political rights** and **civil liberties** used as comprehensive institutional variables with the addition of economic freedoms and state's fragility positive related to inward FDI.	No regime Impact* A positive relation between FDI and political rights & civil liberties
Madani and Nobakht (2014)	D.V.: net FDI inflows per capita P.M.: Freedom House Indices Panel pf 31 UMCs, 1990-2011.	The quality of political institutions in recipient UMCs is important in attracting FDI. Democracy associates with a higher level of FDI inflows to host countries by decreasing the political risks of FDI. The regimes which are freer received more points on **civil liberties** and **political rights** can attract more FDI inflows compared with autocracies.	Positive Impact Democracies are positively related to FDI.

	Durmaz (2017)	D.V.: net FDI inflows per capita P.M.: Freedom House Indices Turkey, 1977-2011.	Turkey emerged as an important recipient of FDI when its policies and institutions ensured the provision of improved **political rights** and **civil liberties**.	Positive Impact Improvements in a democracy have a significant positive impact on FDI.
Governance: Voice and Accountability Political Stability and Absence of Violence/Terrorism, Government Effectiveness, Regulatory Quality, Rule of Law, and Control of Corruption.	Hellman et al. (2002)	D.V.: FDI inflows P.M.: Business Environment and Enterprise Performance Survey (BEEPS) data 22 transition countries, 1999-2000	**Corruption** not only decreases inward FDI but attracts lower quality investment in terms of governance standard.	No regime Impact* A negative relation between FDI and corruption
	Jensen (2003)	D.V.: net FDI inflows as % of GDP P.M.: Polity III Index 79 countries, 1990-1997, 114 countries, 1970-1997 & 79 countries,1980-1998. Four sets of empirical tests	Host countries democratic institutions lead to higher levels of government credibility, lower country risk for multinational investors and attract more FDI. Democratic credibility is strengthened more by a theory of **audience costs** than the **veto player argument**.	Positive Impact Democracy has a robust positive impact on FDI.
	Egger and Winner (2005)	D.V.: inward FDI stocks P.M: Transparency International Index (TI), ICRG data, WGI A panel of 73 (developed and developing) host countries, 1995 and 1999.	A positive short-run impact of **corruption** on FDI, which supports a helping hand interpretation	No regime Impact* A positive relation between FDI and corruption
	Méon and Sekkat (2005)	D.V.: net FDI inflows as % of GDP P.M.: ICRG data, The Worldwide Governance Indicator (WGI) Developed and developing countries all over the world, 1970–1998.	A weak **rule of law**, an inefficient government and **political violence** enhance **corruption** that acts destructively on investment.	No regime Impact* A negative relation between FDI and control of corruption

Bitzenis (2006)	Statistical analysis of questionnaire in 64 MNEs, Bulgaria, 1998-1999.	**The legal framework, corruption** and bureaucracy as decisive barriers for MNEs to invest in Bulgaria	No regime Impact* A positive relation between FDI and control of corruption
Busse and Hefeker (2007)	D.V.: net FDI inflows per capita P.M.: ICRG data A panel of 83 developing countries, 1984-2003.	Foreign investors are highly sensitive to changes in political stability and the framework that the government operate. The indicators for political risk and institutions closely related to FDI are **political stability**, **internal and external conflicts**, **law and order,** ethnic tensions, and **quality of bureaucracy** and, to a lesser degree**, corruption** and **democratic accountability.**	Indirect Impact Less political risk and better institutions are positively related to FDI inflows.
Daude and Stein (2007)	D.V.: bilateral stock of FDI P.M.: WGI A sample of 34 source countries, most of them developed, to 152 host countries, 1982-2002.	**The regulatory framework and the effectiveness of the government** are the most sensitive aspects to foreign investors.	No regime Impact* Regulatory quality of host country and government effectiveness are related positively to FDI
Gani (2007)	D.V.: FDI inflows as % of GDP P.M.: WGI 17 countries from Asia, Latin America & the Caribbean regions, 1996-2002	Countries to attract foreign capital, therefore, need to improve and maintain various aspects of good governance, such as **the rule of law, control of corruption, regulatory quality, government effectiveness.**	No regime Impact* The rule of law, control of corruption, regulatory quality, government effectiveness and political stability are positively correlated with FDI
Choi and Samy (2008)	D.V.: net FDI inflows as % of GDP P.M.: Polity IV index A panel of 90 developing countries, period of twenty years.	**Multiple veto players** in democratic states linked to institutional credibility stimulate FDI inflows more than **audience costs**. However, a democratic hindrance may have a positive effect on inward FDI.	Positive Impact Multiple veto players in democracies and democratic hindrance related positively to FDI

Javorcik and Wei (2009)	D.V.: FDI entry mode P.M.: World Development Report (WDR) index by the World Bank, Neumann and KKZ indices, Firm-level data set - a survey by the EBRD, 22 Transition CEEC in the 1990s.	Less **corrupt** transition economies (such as Estonia or the Czech Republic) attract more FDI than more **corrupt** transition states (such as Azerbaijan or Uzbekistan).	No regime Impact* A positive relation between FDI and control of corruption
Mengistu and Adhikary (2011)	D.V.: FDI inflows (logged) P.M.: WGI 15 countries of Eastern, Southern and Southeastern Asia, 1996-2007.	**Political stability and absence of violence, government effectiveness, the rule of law,** and **control of corruption** are the key elements of the host country's 'good governance', playing a significant role for attracting inward FDI.	No regime Impact* Political stability and absence of violence, the rule of law, the control of corruption and government effectiveness are positively related to FDI
Bellos and Subasat (2012)	D.V.: bilateral FDI stock P.M.: ICRGS data, WGI A panel of 15 transition target countries, and 24 source countries, 1990–2005.	When bad governance exists, **corruption** can act as a catalyst to overcome the distortions caused by malfunctioning institutions and attract more FDI.	No regime Impact* A negative relation between FDI and control of corruption
Staats and Biglaiser (2012)	D.V.: net FDI inflows as % of GDP P.M.: Polity IV index, ICRG data A panel of 17 Latin American countries, US CEOs survey, 1996 – 2007.	Latin American countries with **greater judicial strength** and **the rule of law** are receiving a higher amount of inward FDI.	No regime Impact* A strong positive relationship between judicial strength-rule of law and FDI
Shah and Afridi (2015)	D.V.: net FDI inflows (logged) P.M.: WGI 5 SAARC member countries, 2006 – 2014.	"**Good governance**" is one of the most critical determinants for MNEs decision investment making process, especially in the SAARC countries.	No regime Impact* Political stability, regulatory quality positively related to FDI, control of corruption positively related to FDI.

	Melo and Quinn (2015)	D.V.: net FDI inflows as % of GDP P.M.: Corruption Perception Index (CPI) A panel of 112 countries, 1999-2010.	**Corruption** produces additional costs and risks in government institutions, sending away MNEs, except in the case of a significant oil producer-host country.	No regime Impact* A complex relation between FDI and corruption, The control of corruption has a negative impact on FDI only in major oil producer-host country.
	Touchton (2015)	D.V.: FDI per capita P.M.: WGI, Freedom House indices A panel of 24 Eastern European and Eurasian countries, 1996 - 2012.	Credible government policies and an improved **rule of law** play an essential role in transforming post-communist countries of Eastern Europe and Eurasia in FDI's recipient countries.	No regime Impact* A positive relation between FDI and the rule of law
	Rodríguez-Pose and Cols (2017)	D.V.: net FDI inflows as % of GDP P.M.: WGI A panel of 22 sub-Saharan African countries, 1996 – 2015.	Demonstrate the positive relation of the good institutions to FDI. More stable, credible, effective, and less corrupt regimes, with sound and trustful legal system, stimulate inward FDI.	No regime Impact* Political stability, government effectiveness, judicial strength and control of corruption are positively related to FDI.
	Li et al. (2017)	D.V.: FDI inflows by economic sector P.M.: ICRG data, POLITY IV index A panel of 128 developing countries (middle and low-income economies), 2003–2012.	What is of high importance in stimulating inward FDI in developing countries is **government stability** and **control of corruption** and not necessarily a democratic political system.	Insignificant Impact Government stability and control of corruption are positively related to FDI.
	Bailey (2018)	A sample of 91 published and six unpublished studies from 1976 to 2011 Hedges and Olkin Meta-Analytic procedure (HOMA) with the use of effect sizes to capture the associational strength of the relationship within each study	Host countries with stronger positively related institutions, **political stability** and the **rule of law** and **democratic institutions**, do appear to attract FDI.	Indirect Positive Impact A positive relationship between democratic institutions, political stability, the rule of law and FDI

	Uddin et al. (2019)	D.V: FDI inflows (logged) P.M.: Economic Freedom of the World-index (EFW) by the Fraser and the Cato Institutes, Freedom House Indices, POLITY IV Pakistan, 1972-2016.	If the recipient country enhances its public sector to provide **regulatory quality, political stability**, along with **political and civil rights,** then it will exert a positive impact on foreign investors. Both democracy and a military regime can FDI but for a different length of time.	Positive Impact Democracy positively related to inward FDI in short – run. Military government positively related to inward FDI in the long - run. Regulatory quality, political stability, political and civil rights positively related to FDI.

(*) The empirical analysis did not include the regime type.

Notes: D.V. refers to the dependent variable that the study uses, P.M. refers to the data used for the measurement of political regime or political determinant.

Chapter 3. The Transition economies of Western Balkans as host countries for FDI: A Theoretical Analysis

3.1 Introduction

The most challenging political development before the end of the twentieth century was the collapse of the Soviet Union in 1991. Soviet Union's dissolution signified the end of the international order upon which the former Yugoslavia, the largest Balkan country, was established (Simic, 2013, p. 127). The end of the bipolar world order changed the geopolitical landscape in Eastern Europe in a rather violently way.

The Balkans' crisis and the Yugoslav Wars brought to the fore stereotypes used through the centuries, about the Balkans and Balkanisation, the "other" to the Europe "proper." Once again, the West World associated Balkans to the "Powder Keg" of Europe that threatened the peace and democracy in the entire Continent (Simic, 2013). The breakup of the Yugoslav Federation in mid-1991 into smaller independent states was the starting point for the South Eastern European Countries (SEEC) transition process to the market economy. A surge of transition from nondemocratic to democratic political systems occurred denoting the "regime change," and their intention of joining the EU. A rather complicated process since each newly established state inherited different dynamics and followed diverging routes in implementing political, economic, and social reforms according to EU accession criteria. Meanwhile, the Central Eastern European Countries (CEEC) succeeded to limit the transition process and to gain EU membership at a period of eight to twelve years, in contrast to the SEEC that are still on hold.

This chapter introduces the six SEEC as target countries to our research. Due to their location in South-Eastern Europe, they are known as SEEC though they are also named Western Balkans (WB). This assignment uses the term WB following the EU institutions' definition for the countries of the Balkan area that are non-EU members. This chapter includes a geopolitical approach to deepen our understanding of the Balkans and distinguishing the WB countries that hold one of Europe's more unstable and varied political landscapes, with mixed and diverse national trajectories and resulted as the latecomers to Europe integration. Since the EU accession remains

a top priority for the six WB economies, the main question is to what extent their development as host countries of foreign direct investment (FDI) can support this objective. FDI can influence their economies positively and accelerate the transition process, following the success of the CEEC. Nevertheless, the WB countries do not have the typical pattern of economies attracting FDI. High barriers still exist for foreign firms' entry and operations since these economies did not settle in time significant issues such as macroeconomics' imbalances and political instability, unreliable legal systems, official corruption, organized crime, market imperfections, low managerial quality and organizational efficiency in the local businesses (Arslan et al., 2015, p. 998).

The purpose of this chapter is to discover the importance of WB's development as an FDI destination. Reference will be made to the impact of inward FDI on the WB's transition process to the market economy, crucial to their EU Accession. This thesis analysis is limited to inward FDI, not by intention to disregard the outward FDI as an essential source of competitiveness and development, but due to the limitations of the economies in transition. Although there are economies worldwide that have built their development on an equilibrium basis between inward and outward FDI, the transitional economies of WB are not yet strong in terms of home-grown international firms; hence it is more common to depend on inward FDI (Kalotay, 2013).

The chapter's structure is the following: Section two presents Balkans' geopolitically development through history. Section three defines the post-socialist transition process to a market-based economy, while section four presents EU's and other actors' interest in the WB as well as the prospects of WB-EU integration. Section four includes an overview of the contemporary political environment in WB. The role of inward FDI in the post-socialist countries EU accession and the current state of WB's inward FDI is included in sections six and seven, respectively. The last section concludes and recommends.

3.2 The Balkans, as a turbulent geopolitical region: a historical background

The Balkan Peninsula has been a borderland where empires and civilizations have succeeded one another. The Orthodox Byzantium, the Sunni Muslim Ottoman Empire, and Catholic Europe left each one its indelible mark to the region and all together

formed the "cultural layering," established a mosaic of nationalities and hence, set up the rather distinctive character of the Balkans (Biondich, 2011, p. 2).

The German geographer Johann August Zeune in 1809, first used the term "Balkan peninsula" (Balkanhalbeiland) to define this South-Eastern part of Europe (Todorova, 1994, p. 464). It is the easternmost of the three European peninsulas; the other two are Italy and Spain, in the Mediterranean area. In the Turkish, the word Balkan means 'wooded mountains' and defines the mountain mass that dominates in the Balkan peninsula (Pavlowitch, 1999, p. 1). The term used to describe the nineteenth-century Ottoman Successor states, Greece, Serbia, Bulgaria, Albania and the adjacent territories of the Habsburg Empire, Croatia, Bosnia-Herzegovina, and Transylvania (Biondich, 2011, p. 2). The names "Balkan peninsula" or simply "Balkans" were gradually spread and established embedding more the political rather than the geographical connotation (Todorova, 1994, p. 464). The "Balkan" term was also imbued with derogatory meanings and negative stereotypes. The Balkan peninsula is found in a particular liminal position, part of Europe and at the same time is regarded as a part of the "other" within. The "other" to Europe "proper" implied the political, social-cultural and ideological differences of the area that turned Balkans to Europe's shadow, and the disdained alter ego, a savage and backward Europe (Bakic-Hayden and Hayden, 1992; Davidova, 2015; Lindstrom, 2003; Razsa and Lindstrom, 2004; Todorova, 1994). These sharp differences are related to the history of the area. Since the Balkans had been under the Ottoman rule for four centuries, the Europeans minds created the region's associations with the "Orient" (Lindstrom, 2003, p. 316). Balkans, as a colony of oriental power, inherited a set of characteristics such as oriental despotism, violence, corruption, and which were incompatible with the European societies (Simic, 2013, p. 115).

Orientalism is for many wrongly related to the region since Balkanism is a discourse independent from Orientalism with a different history and geopolitically distinct from the near or the middle east (Davidova, 2015; Todorova, 1994). Balkanism became synonymous to the dark other of western civilization. In the dichotomy constructed between the so-called "civilized West" (Europe, North America) and the eastern world, the position of the Balkans questioned, since Europeans continuously excluded them. Their detest to the inhabitants of the Balkans was evident in their

reference to them as crossbreeds, racially and culturally inferior from them (Todorova, 1994, p. 476). However, the uniqueness of the Balkans was these primitive inhabitants. Although they belonged to different ethnic communities, they shared the same mentality, religion, cultural affinities, everyday life, experiences (Pavlowitch, 1999, p. 333). During the 18th and 19th centuries, West Europeans seem to realize that the European possessions of the Ottoman Empire had distinct identities from the other Ottoman provinces and needed to be treated as such (Todorova, 1994, p. 461). The Balkans managed to preserve their traditions and values even though the Ottoman system had condemned them to isolation and low development of the countryside.

The region had never stopped to be a place of great power rivalry, between Britain, Russia, and Austria, fighting to expand their power in the area or at least to block others from doing so. The Russians gained the most influence in the territory at the end of the 18th century. The landmark event was the Russo-Turkish Wars that ended with the Treaty of San Stefano in 1878 signed by the defeated Ottoman Empire and victorious Russia. Ottomans recognized the independence of Serbia, Montenegro and Romania, the autonomy of Bulgaria and the partial autonomy of Albania that was still part of the Ottoman Empire (Kostanick, 1963, p. 5). Bosnia-Herzegovina by then was a protectorate of Austria – Hungary. Greece existed as an independent state since 1830. In the pre-1914, these countries had been the basis of the modern Balkan state system (Jelavish and Jelavish, 2012, p. 170) (please see Map 3.1).

Map 3 1 - The Balkan States, 1914

Source: Jelavish and Jelavish (2012, p. 262)

The ascendant powers engraved boundaries more on strategic rather on ethnic considerations, provoking new tensions in the region. Balkans was “the Powder Keg” of Europe that threatened the entire continent (Lampe and Jackson, 1982; Simic, 2013). This European perception enforced since the Balkan wars of 1912-13 shook the European balance of power. As well, the assassination of Bosnian Serb Franz Ferdinand, heir to the Habsburg throne in 1914, triggered a chain of events leading to the outburst of the First World War (Lampe, 2014, p. 1).

At the end of the Great War, and the collapse both of the Austro-Hungarian and Ottoman Empires, and the establishment of new Balkan states, the “Balkanisation” term introduced (Simic, 2013, p. 118). The term invented to signify the fragmentation of multi-ethnic states into smaller, ethnically homogeneous but hostile to each other, such as the Kingdom of Serbs, Croats and Slovenes and later the Kingdom of Yugoslavia (Simic, 2013, p. 118). The “Balkanisation” reflected the conflicts and crimes that occurred, in which the "civilized" world interfered invoking humanitarians’ purposes. Behind the West World's goodwill were found significant

interests. To this context, the term also became a name for the proxy wars (Simic, 2013, p. 128).

In 1941, the Nazi German Army, supported by Hungarian and Bulgarian forces, attacked Yugoslavia (Map 3.2) and Greece. The objectives of Germany were to overthrow the newly established pro-Allied government in Yugoslavia, to enhance the stalling Italian invasion of Greece and to halt the planned Russian Invasion (National Army Museum, 2019). World War II, like all other major historical events, brought changes in the Balkan ethnic map. The Allies forces and the Red army won the Germans at the end and split the territory. In October 1944, the British Prime Minister Winston Churchill used the Balkans as a bargaining chip to secure a stable working relationship with the Soviet leader Joseph Stalin (Holdich, 1987). At Churchill's proposal, it was agreed that the Soviet Union would establish a dominant influence in Romania and Bulgaria while Greece belonged in the "British sphere of influence" (Holdich, 1987, pp. 33–34). Yugoslavia and Hungary would be shared equally. There was no explicit reference to Albania. Hence, a central planned administered authority established in most of the Balkans which lasted almost all the rest of the 20th century.

Map 3 2 - Balkans, 1941

Source: National Army Museum (2019), (https://www.nam.ac.uk/explore/war-Balkans)

The Russian dominance in Balkans, from the Empire to the Union of Soviet Socialist Republics (USSR), lasted until the fall of Berlin Wall in 1989. During the Soviet Union's dominance, the "other" to Europe "proper" was reinforced but this time was taking the form of an ideological - political geography of the democratic, capitalist West against the totalitarian, the socialist East (Bakic-Hayden and Hayden, 1992, p. 3). The Balkan socialist history was not a homogeneous regional experience as each state differentiated in its rule of governance. The creation of different national brands of socialism implied the variations that existed in the control of the communist party and ideology; such as totalitarian Albania to nationalistic Romania, to the "orthodox" socialist Bulgaria, and the more liberal, almost West - opened, Yugoslavia. Bulgaria's regime type replicated the Soviet prototype. Under USSR's supervision, the government restricted any cultural, ideological or ethnic expressions, following the highly centralized system of state's control over the economy and the agricultural collectivization (Anastasakis, 2013, p. 95).

Yugoslavia was more an experiment of the Cold War ideological competition. It was more a socialist state which instead of the central planning, adopted the 'self-management,' and inside its socialist country, there was an informal division between 'liberals' and 'conservatives' (Anastasakis, 2013, p. 95). During the cold war, Yugoslavs enjoyed economic prosperity and the freedom to travel and work abroad, and as such provoked the envy of the rest Eastern Europeans (Razsa and Lindstrom, 2004, p. 629). Apparently, except Yugoslavia that abandoned the centralized system in the early 1950s, the rest states for 45 years experienced the centrally administered rule in every aspect of their political, social, and cultural life. The command economy isolated the national economies from the world market, imposed restrictions to the mobility of labour and capital, and the drive towards self-sufficiency made every sector an item of planning (Veremis, 2008). Economic growth in South-Eastern Europe was rapid in the 1960s, lost momentum in 1970s and stalled in the 1980s (Veremis, 2008, p. 122).

The Socialist Federal Republic of Yugoslavia (SFRY) consisted of six republics, Bosnia and Herzegovina, Croatia, North Macedonia, Montenegro, Serbia (including the regions of Kosovo and Vojvodina) and Slovenia. The dissolution of the multinational and multicultural Yugoslav Federation occurred in 1991-2 from a small

episode in Slovenia to outburst of warfare in Croatia and Bosnia-Herzegovina. The firsts to declare independence in June 1991 were Croatia and Slovenia. The region stimulated the interest of the international community. The UN imposed an embargo on arms on all of Yugoslavia in September 1991 to end the crisis, though it did not prevent a war conflict. European Commission hesitated to interfere and showed reluctance to recognise the breakaway states in Yugoslavia, mainly to avoid embarrassing the Russian Leader (Bowker, 1998, p. 1248). Mikhail Gorbachev, at that time, was struggling to keep the USSR together. The USSR eventually collapsed in December 1991. The U.S. being more decisive and aggressive than the Europeans, grasped the chance to intervene in the Balkan affairs. In 1995, the NATO's bombing ended the Serbia advance into Bosnia, and the Dayton Peace Agreement signed, signalling the success of the US to provide a solution, regardless of the cost in human lives. The Croats seemed to be the victors of the Yugoslav wars since they had won back Croatia, get rid of the Serbs and become confederated to half of the Bosnia according to the Dayton agreement (Bowker, 1998, p. 1255).

The disintegration of Yugoslavia moved the heart of the crisis to Kosovo, which was excluded from the Dayton Agreement. From March to June 1999, NATO took a new military action to end the Kosovo war. Russia's role this time was not as important as that of the US, or even of the other European powers in the Balkan Peninsula from the side that itself was experiencing a severe internal crisis. Russia had lost a considerable part of its military, economic, political, and ideological power. Nevertheless, Russians did not lose their interest in the territory, and since the 2000s under Vladimir Putin's leadership, they started looking for their place in regional affairs, aiming at the restoration of their hegemonic role in Eurasia. Their intentions became evident in the veto imposed on any Western attempt to recognize Kosovo's independence in the Security Council, entreating Resolution 1244 of 1999, according to which Kosovo is part of Serbia (Veremis, 2008, p. 122).

Even the pass of a century, for the Western World, the Balkans and Balkanisation were still the "other" which begins on the border of Europe with the Balkans (Simic, 2013, p. 127). Region's trouble image remained and the reputation of "the Powder keg of Europe" revived, bringing its notorious past into forefront. The 20th-century's review is both terrifying and grievous. The region was engaged in six wars, the two

Balkan Wars, the two World Wars, the Greek Civil War and the Civil War in Yugoslavia, while its geographic centre - Belgrade- holds the record of the most-often bombarded European capital city (1914, 1915, 1941, 1944 and 1999) (Simic, 2013, p. 126). Meanwhile, since the mid-1940s, Greece entered in the "West sphere of influence," and no longer at least formally, considered to be a Balkan State. At the end of the cold war, Greece was in an incomparably better position than the Balkans neighbours, in terms of political stability, democratic institutions and economic strength (Armakolas and Triantafyllou, 2017, p. 614). Notably, Greece joined the EU and re-joined NATO in the early 1980s, while enjoyed the largest GDP compared to the other Balkan countries in the 2000s.

The response of Balkans to the new reality of one polar world was not the same. The region entailed different types of regimes breakdown, varying from Romania's famous revolutionary uprising to Bulgaria's internal coup, Yugoslavia's breakup and Albania's anarchic and chaotic change (Anastasakis, 2013, p. 97). These differences challenged the transition process in Balkans. After the USSR's dissolution, each country for building a new European identity denounced its socialist past, even though retained a place for the communist party in the political life. At that period, the political formations were unreformed or slightly reformed communist parties, anti-socialist electoral alliances, revived parties from the past and newly established political groups (Anastasakis, 2013, p. 97).

Most countries of East Europe pave the way for democracy, though SEEC for competitive authoritarian regimes that exploited structural weaknesses, and governance practices left over from the period of state socialism (Kapidžić, 2020, p. 6). Hence, WB democratization became more difficult and led to the entrenchment of newly elected elites. The authoritarian parties controlled regime change and politics during the 1990s to consolidate power and remain in power (Kapidžić, 2020, p. 6). This period characterized by the rise of illiberal politics along with the issue of divided states in which ethnic politics and parallel structures emerged. In the early transitional days, besides national politics, the national economies faced severe challenges, as well. Macroeconomic rates did not remain unaffected, meaning a decrease in GDP, an increase in current account and trade deficits, high budget deficits, and too high unemployment (Veremis, 2008, p. 124).

Since the 2000s, the second period of transition, politics seemed to go through a regular period of political pluralism, peaceful change of governments, reformed nationalist parties, new political elites and a wide range of political parties across the political arena, consensus with Europeans, and less extremism in politics (Anastasakis, 2013, p. 106). During this period, a more democratic agenda adopted towards media, society, minorities, human rights, justice, and institutions, to come close to the EU accession. Indeed, the EU activated in building relationships with the region and as such fortified a future membership for Bulgaria and Romania, established the Stability Pact for South-Eastern Europe, and the Stabilization and Association Process (SAP) (Anastasakis, 2013; Demetropoulou, 2002).

Except for Kosovo, the rest SEEC have officially expressed their intention to become members of the EU by filling a membership application valid until today. Regarding NATO's membership, its decision for the bombings in the 1990s could not be excused from countries like Bosnia and Herzegovina (BiH), and Serbia which refused to join NATO and instead of it, preferred to be part of the Partnership for Peace programme (OSCE Bih, 2019). Since the post-socialist countries of Eastern Europe included in their foreign policy agenda, the target to become a full member of the EU, the Europeanisation term came to the forefront. For the region, the precise term is the "Europeanization, Eastern Style." This phrase defined the differentiating process established by the EU for the inexperienced East European countries, to join the EU. It also expresses the transition of countries with a previously different political and economic system to democracy and a market economy, and adjustment to the requirements of the advanced models of the West (Anastasakis, 2005, p. 78). The rationale of the EU external policy towards the post-socialist countries is to promote political and economic reforms and safeguard security and stability, transforming them to full-fledged EU member states (Ioannides and Collantes-Celador, 2011).

The Croatian and Slovenian leaders were the first to start negotiations for the so-called final exit of their states from the Balkans and their come-back to Europe (Lindstrom, 2003, p. 314). Croatians called themselves Europeans as they thought to be more progressive, prosperous, hard-working, permissive, democratic, in contrast to their primitive, dawdler, bigoted, or backward Balkans, neighbours to the southeast (Razsa and Lindstrom, 2004, p. 630). Slovenians surpassed Croatians as they managed

more efficiently their return to Europe. Slovenians became a full-fledged member of both the EU and NATO in 2004, while Croatia in 2013. The accession of Croatia marked the EU seventh enlargement round in 2013 (Schwarz, 2016, p. 757). Slovenians disconnected from their past to such extent that now, nobody considers having ever been citizens of a Balkan country. Croatia was the first former Yugoslav country that had been deeply involved in the Balkan Wars in the 1990s and succeeded in joining the EU (Schwarz, 2016, p. 758). The EU had the power to impose a one-way, instructive, and patronizing process in which Bulgaria and Romania proved to respond successfully and gain EU membership in 2007. However, the rest countries located in the Western of the Balkan Peninsula failed to follow soon. An EU policy, causing troubles to WB's European integration is that the EU pools the sovereignty of member states and demands from them to embrace its decision-making process. This policy is in stark contrast to that of the post-conflict states, which require external sovereignty (Bieber, 2011, p. 1785).

The six countries in the Balkan Peninsula that are waiting for full membership are consisting of the leading target group of countries of this research (please see Map 2.3). The institutions of the EU for defining the countries of the Balkan area that are not yet EU members use the term of Western Balkans (WB). This non-EU Balkan area consists of five sovereign countries, but six economies: Albania, Bosnia and Hercegovina (BiH), the North Macedonia (before February 2019 called the Former Yugoslav Republic of Macedonia - FYROM), Montenegro, Serbia and the partially recognized Kosovo. Kosovo declared independence unilaterally in 2008, pending its recognition by the entire international community (Adebahr, 2018). For this analysis, it is acknowledged that Kosovo is a relatively separate economic entity.

Map 3 3 - Western Balkans, 2019

Source: OSCE Bih (2019), (https://www.oscebih.org/exploring-what-europe-can-do-for-western-balkans).

3.3 Post-socialist transition process to a market-based economy

Before we proceed further to our analysis, reference should be made to the transformational process of the post-socialist economies. The transformation of centrally administered socialist-style governmental institutions into market-based ones in the countries that emerged as a result of the disintegration of the former federal states, such as the former USSR, Yugoslavia and Czechoslovakia has been one of the most significant events of the end of the 20th century (Papava, 2005, p. 78). It is regarded as a global process of transition to a market economy. The aim of the transition was the establishment of political pluralism similar to Western Europe's, the substitution of the centrally administrative planning system with market-based decision-making, and the speedy integration into the world economy (Bitzenis et al., 2007, p. 71) . The transition process defined the way that these countries, among them the target group countries of this assignment, evolved as host countries for FDI.

The world transition reflects the passage from one state to another in the case of the economies in transition the passage from a centrally administered system to a market-based economy (Marangos, 2006, p. 133). Since in the 1990s, the dominant

economic policy was that of free market, deregulation, privatization and free trade, the only alternative for post-socialist economies was to transcend towards a free market economy. The definition of "economies in transition" is used mainly for the countries of East Europe, former Soviet republics, China and Mongolia, even though there are many countries globally that are at in similar status of transition (Papava, 2005, p. 79).

The main approaches to post-socialist transformation processes have been the Shock Therapy and the Gradualist that is further classified as gradualism and extreme gradualism (Mikeladze et al., 2016, p. 238). Papava (2005, p. 82) refers to the extreme gradualism as the "Third Road" referring to a transition process that is long, the privatisation programme is limited to small enterprises, and private ownership is allowed only in trade, services and tourism. The IMF was a supporter of shock therapy for providing financial support to post-soviet countries (Marangos, 2004, 2005a, 2007). The transition's shock therapy model as a neoclassical model incorporated the price liberalization, privatization, establishment of an independent central bank, achievement of a balanced budget, free trade and establishment of a fully convertible flexible currency at the immediate time (Marangos, 2005a, p. 70). Transition economies by implementing the shock therapy approach hopefully could meet the criteria of IMF, World Bank, and other advanced economies for securing substantial funding. The model also provided opportunities for debt cancellations and extensive financial assistance in the forms of grants and long-term loans (Marangos, 2004, p. 227). There seems to be a consensus of foreign investors and post-socialist elite at the start of the transition on the basis that private ownership would ensure profit-oriented corporate governance. At the same time, trade and prices liberalization would stimulate the competitive market forces that reward profitable activities (Hamm et al., 2012, p. 297). Hence, the neoliberal reforms would provide firms with incentives to restructure.

In transition economies, the development of market relations preceded the development of institutions appropriate to the market process. The establishment of a sophisticated institutional structure, although essential, was extraordinarily complicated and time-consuming (Marangos, 2005b, p. 393). The shock therapy process of transition by the use of market incentives internalised the developmental

process of institutions instead of depending on the government to the whole process (Marangos, 2005b, p. 394). Besides, governments' experience of centrally administered socialism system did not provide the knowledge base for the design of efficient market institutions.

Among the three significant policies of the neoliberal model, thus privatization, stabilization, and liberalization, the first one was the most difficult to implement in post-socialist economies and as such, produced different outcomes. Economists and policymakers knew stabilizing and liberalizing economies by increasing interest rates, constraining monetary emissions, freeing prices and trade but not to privatize entire economies at a limited time and with the absence of private investors (Hamm et al., 2012, p. 297). Hence, the classical privatization model was not appropriate to the post-socialist countries, which the majority of them followed a mass privatization policy. Governments on transition economies pushed to sell state assets and public utilities to MNEs as the only alternative due to the lack of domestic private capitalists (Marangos, 2005a, p. 75). Mature market economies promoted intentionally the selling to MNES as a unique solution, to ensure that foreign ownership was the only permissible "legal" medium of privatization (Bitzenis and Marangos, 2007, p. 430). The selling of national companies to MNEs was at a lower price compared to similar companies in Western countries, because of the underlying risk (Bitzenis and Marangos, 2008, p. 503).

FDI was a vehicle for economic modernization, and a means to improve productivity in inefficient state-owned firms and promote the expansion of private markets as well (Curwin and Mahutga, 2014, p. 1163). FDI inflows would be stimulated if the market mechanism achieved the conditions of political stability, free markets, a functioning legal environment, and a stable and convertible currency existed in the transitional economy (Marangos, 2007, p. 113). FDI played an essential role in the privatization on average, though the pace of inflow varied over time and across the transition economies. Beyond others, this is associated with the horizontal implementation of the market reforms to post-socialist countries, ignoring the diversity of conditions that characterised each of them. These countries differentiated in levels of development, physical and human infrastructures, production bases, degrees of Soviet dependence, historical backgrounds, in terms of facing different

internal and external challenges (Monastiriotis and Petrakos, 2010, p. 162). In some cases, the strategy of mass privatization was followed independently of FDI, like using voucher programs where shares of state-owned enterprises were available to citizens, or sold directly to well-off nationals (Curwin and Mahutga, 2014; Marangos, 2006).

The implementation of the shock therapy model in countries with weak fundamentals as the transition economies did not result in the expected outcomes, of economic restructuring and sustainable growth. Contrariwise it increased unemployment and stimulated inflation which in turn caused social and political instability, threatened the fragile democratic governments, and risked security (Marangos, 2007, p. 89). The promised financial support by mature economies was modest and, in some cases, totally inadequate (Marangos, 2001, 2004). Countries that followed the shock therapy path found themselves in a supply-side recession. Popov (2007, p. 12) argues that "an excessive speed of change in relative prices required the magnitude of restructuring that was simply non-achievable with the limited pool of investment". To this context, more than half of transition economies became non-competitive, their output continued to fall for several years, whereas the growth of output in competitive industries recorded limited growth (Popov, 2007). Between 1990 and 1996, per capita income in most of the former Soviet Union contracted by over 30 per cent slightly less than the decline in the US during the Great Depression (Hamm et al., 2012, p. 296). Monastiriotis and Petrakos, (2010, p. 156) referring to the Balkan transition countries, argue that the market liberalisation and the unravelling of market forces did not lead by default to economic development and welfare growth, but under specific conditions to a long-lasting deterioration of the economic and productive bases. The economies of Bulgaria and Albania in the late 1990s underperformed despite their eventual progress in required transitional reforms. In these countries, the sudden contraction of the public sector, the diminishing power of the previously dominant state-owned enterprises along with the widespread corruption, resulted to a prolonged period of instability (Monastiriotis and Petrakos, 2010, p. 156). While the share of the public sector in the most western European economies at that time averaged at 40 per cent, the privatization policy imposed the reduction of the respective shares for the small WB countries like Albania and the FYROM to the level of 20 per cent (Monastiriotis and Petrakos, 2010, p. 156). This

significant diminishing of the public sector inhibited any governmental initiative to intervene for stabilising the economy. Even in the early twenty-first century, macroeconomics issues as unemployment remained unresolved recording high rates as in Kosovo (40 per cent), BiH (40 per cent), Serbia (30 per cent), Croatia (20 per cent) and Albania (20 per cent) (Veremis, 2008, p. 124). There were the cases that the shock therapy did it better, as private enterprise (in the form of either FDI or domestic entrepreneurship) benefited of the profit opportunities produced from the devaluation of capital and the fast decreasing labour costs (Monastiriotis and Petrakos, 2010, p. 156).

The gradualistic strategy differs significantly from the shock therapy on the rate of speed of the transition process. It considers the gradual transformation of the economy into the market economy and prerequisites the Implementation of reforms in the country, considering high-level support from the government as well as the existence of resources for financing the reforms (Mikeladze et al., 2016, p. 238). Hence, for the implementation of the gradualist approach, a government should have vast reserves of financial resources (Papava, 2005, p. 83). Institutions would develop concurrently with market relations contradicting shock therapy approach (Marangos, 2005b, p. 396). China represents a classic example of gradual implementation of market reforms. Referring to Eastern Europe and former USSR, there was a change from the shock therapy approach to gradualism around the mid-1990s in Poland, Russia, Bulgaria, Estonia, in the Czech Republic, Latvia and Albania (Marangos, 2007, p. 118). For example in Albania, the shock therapy approach introduced together with authoritarianism and when the president of Albania Sali Berisha violently removed from his position, the reform process was disgraced, and the gradualist approach was followed (Marangos, 2007, p. 118). The implementation of the shock therapy model was short-lived since the people in transition economies experiencing the short-run cost of the shock therapy approach like the high unemployment and the low living standards expressed their frustration at the polls.

The final goal of transition was the establishment of a market economy along with the integration of the post-socialist economies in the global system through their EU membership (Bitzenis and Marangos, 2007, p. 429). The latter prerequisites an efficient Institutional structure to preserve democratic governance and human rights

and a functioning market economy. Since the WB countries have not yet gained EU membership, this reflects the ineffective reform policies that imposed on them. The next section presents the prospects of the WB EU membership while separate chapters in this assignment include the state of progress of each WB economy in fulfilling the EU membership criteria.

3.4 International Economic actors' interest in the Western Balkans

The WB region was always of significant geopolitical interest as already described in section 3.2 - holding strategic location at the heart of Europe, surrounded by EU member countries. The interests of the different external actors in the geopolitical game for political, economic and cultural influence differ substantially. The US and the EU goal for the entire region are to complete the liberal-democratic transformation processes towards NATO and EU membership (Freund and Petritsch, 2018, p. 59). Since EU interests in the WB-EU accession promotes countries economic development through FDI. The largest global investors countries in the region are EU members. There are also new actors in the region that choose FDI as a factor of influence on these fragile economies. Nevertheless, the EU remains the most influential external actor in the WB while US cedes its leading position to the EU. Meanwhile, old foreign players re-emerges competing with new ones to increase their influence in the region, as the below analysis presents.

3.4.1 The EU's interest and prospects for WB EU membership

People of the region and the EU have a common heritage, route in history, and anchor their future on shared opportunities and challenges. The EU is their largest trading partner, the primary source of FDI and the leading target country for outward migration. The region is serving as the shortest transit route between the South-East area of the EU (Greece, Bulgaria and Romania) and central European countries (Hungary, Croatia, Slovenia and Austria) which its importance came in front fore during the 2015-16 refugee crisis (Dabrowski and Muachenkova, 2018). The refugee crisis drew attention to the importance of the WB for the EU more in a security sense.

The EU had always shown a vital interest to pursue a coherent strategy to stabilize the volatile WB countries at its backyard. Although in the 1990s EU's

mediation efforts in former Yugoslavia enormously failed due to lack of consistent policy, lack of EU instruments and lack of enforcement mechanisms and experience (Bieber, 2015, p. 291). Following its failure to effectively manage the dissolution of Yugoslavia and prevent the atrocities of ethnic conflicts in Bosnia and Kosovo, the EU only took the lead role to ensure the stability in the early 2000s. It was the period that the EU had already launched the Stabilization and Association Process (SAP) for creating the prospects of the Balkans' Conditional EU's accession. The process of regional integration through SAP would include three phases. The first phase was preparatory, setting the path for the fundamental reforms and preparing each of the WB countries for signing the agreement with the EU. The second phase concerned the negotiation of the agreement and its adoption by the counterparts involved. The third phase would launch the enactment of the agreement and the implementation of the required reforms (Schenker, 2008, pp. 1–2). The SAP established as a post-conflict instrument, whose efficacy, though has been questioned. It would serve both to the regional stability objective and the integration. The SAP included a financial assistance programme for the WB countries over the 2000-6 period, the Community Assistance to Reconstruction, Development, and Stabilization (CARDS) (Uvalic, 2010).

To the line of effective aid delivery, the EU also proceeded to the foundation of the European Agency for Reconstruction (EAR) in charge of managing economic reconstruction projects in the Serbia, Montenegro, Kosovo and the FYROM (Uvalic, 2010). To enable the integration, the State Union of Serbia and Montenegro -as a successor to the Federal Republic of Yugoslavia- was established in 2002-2003 under EU auspices, both settling the issue of the joint state between Serbia and Montenegro and postponing the difficult decision over the status of Kosovo (Bieber, 2015, p. 291). It came to an end three years later after the referendum on independence in Montenegro in May 2006 (Bieber, 2011, p. 1784). Some of EU's further contribution to peace- and state-building in the region has been the European Union's Rule-of-law mission (EULEX) in Kosovo (EU's largest mission) aiming at training and guiding the country's police force (OSCE Bih, 2019). The EUFOR Operation ALTHEA under the "Berlin Plus" arrangements, for maintaining a safe and secure environment in Bosnia and Herzegovina, thus for securing the borders and tackling refugees flows and organized crime (EU, 2004; OSCE Bih, 2019). Lately, the "*Berlin Process"* that launched

in 2014. This initiative is a novel practice in the EU's enlargement toolbox aiming at maintaining the momentum of European integration in the WB (Marciacq, 2017, p. 5).

The EU has supported the integration of Balkans since 2003 by promoting fundamental rights in the area actively. The EU supported advances in democracy, human rights, and civil society in the WB through the European Initiative for Democracy and Human Rights (European Initiative), activated in 2000 and renamed to the European Instrument of Democracy and Human Rights (EIDHR) in 2007 (European Commission, 2006). The EU-WB Summit of Thessaloniki in June 2003 defined that the future of the Balkan States was in the EU. The EU underlined the prospect of membership and presented best practices for WB to move towards European integration. The European Partnership for potential candidates and the Accession Partnerships for candidates states introduced in the Summit, similar to those Partnerships of the CEE countries, targeting to the development of functioning market economies (Commission of The European Communities, 2004).

Following the Summit, WB countries stepped up the pace of required political and economic reforms and even managed to converge partially in income levels with the EU. Supportive to economic admission criteria was the enlargement of the Central European Free Trade Agreement (CEFTA) in 2006 that included six new parties from SEE. The CEFTA is a trade deal made by European countries that are not yet EU member states. The CEFTA 2006 included at that time besides Albania, BiH, North Macedonia, Montenegro, Serbia, the United Nations Interim Administration Mission in Kosovo (UNMIK) also Croatia and Moldova, (Cefta.int, 2019). The speed that the new parties ratified this agreement reflected their need to stimulate growth in their economies for being qualified as EU members. This rate of progress slowed down with the 2008 global financial crisis.

Any optimism existed from 2000 to 2008 for achieving higher rates of growth based on an increase in the inflows of FDI, ceased to exist due to the onset of a new crisis that hit the region although this time was not a bloody one but a financial. Before the crisis, the rise of inward FDI in WB states acted as a channel of growth, enhancing prospects of the EU accession. Indeed, at that period, the WB countries were not lagging the Eastern and Central European countries. However, the lack of national and

subnational FDI strategies to address the main challenges within WB states became evident in the long-term. Recently, the economic conditions in the region seem to be improved, yet not to the level achieved by the countries in the previous accession rounds. The WB faces structural issues concerning regulatory issues and infrastructure deficiencies. They must overcome these challenges to achieve sustainable comparative advantages and strengthen their position in the competitive EU market. The gap in living standards in comparison to EU states is widening, reflecting the turbulence past and the years of underperformance of the region. Referring to the regional averages for the year 2015 at the peak of the financial crisis, GDP per capita in the WB, adjusted for purchasing power parity, ends to half of that of eastern European EU countries, to one-third of that of southern EU members and a quarter of the wealthier EU members in western Europe (Sanfey et al., 2016, p. 2).

After 15 years, the WB countries still are in the EU's waiting list. The unresolved legacies of the 1990s, the slow pace of implementation of the required reforms according to the Copenhagen Accession Criteria, and the outburst of the financial and European debt crises negatively affected their effort to join the EU. The Copenhagen criteria were established by the European Council in June 1993 to define the main principles for the EU's enlargement policy. These criteria are falling into three main categories, namely the political, economic and institutional and were further enforced by the Madrid European Council in December 1995 (Kittova and Steinhauser, 2018; Schwarz, 2016). The political criteria are referring to the stability of institutions guaranteeing democracy, the rule of law, human rights, and respect for and protection of minorities. The economic criteria include the existence of a functioning market economy and the capacity to cope with the competitive pressure and market forces within the Union. Finally, the institutional criteria, to the ability to take on the obligations of membership, meaning that candidate countries are expected to align their legislation with EU law (acquis) (European Commission, 2018a).

Despite, the concerns over growing Russian, Chinese, Turkish and Arab influence, the EU remains by far the most crucial player in the WB, even though it has lost some of its attractiveness recently (Freund and Petritsch, 2018, p. 57). Re-engaging with the WB countries is the only way the EU can follow to maintain its influence in the region. The EU must remove the negative feelings produced from the

enlargement fatigue and keep alive the membership desire across the WB's population. To this extent, it should remind to WB that the economic promise it holds is higher than that of Russia. European policymakers are interested in accepting the WB membership for providing sustainable security and peace in this part of the European continent. They realize now the danger of losing WB that traditionally belong in Europe and in this context the European Commission's President Jean-Claude Juncker stated that if the EU invests in the stability and prosperity of the WB, then it invests in the security and future of the EU (Nawaz and Rafique, 2018). The EU released in 2015 "The new European Commission Enlargement Strategy" ensuring in the long-run all WB countries' European future. This latest strategy incorporates changes in the methodology for the assessment of the candidate WB country progress. The key areas still to be improved are (1) the rule of law, the functioning of the judiciary, fight against corruption and fight against organized crime, (2) public administration reform, and (3) key economic criteria in the presence of a functioning market economy and the capacity to cope with competitive pressures of market forces within the EU (Sanfey et al., 2016, p. 10). The new strategy regenerated enlargement process points out that the EU membership for the WB is in the EU's political, security and economic interest. According to the European Commission's report (2018b, p. 1) "It is a geostrategic investment in a stable, strong and united Europe based on common values. It is a powerful tool to promote democracy, the rule of law and the respect for fundamental rights. A credible accession perspective is the key driver of transformation in the region and thus enhances our collective integration, security, prosperity, and social well- being. It remains essential for fostering reconciliation and stability."

Furthermore, the EU, launching this new strategy, re-commits itself to the WB European perspective, demanding in turn from the countries of the region to fulfil their commitments and meet truly the membership conditions. More precisely, "all the Western Balkan countries must now urgently redouble their efforts, address vital reforms and complete their political, economic and social transformation, bringing all stakeholders on board from across the political spectrum and from civil society. Joining the EU is far more than a technical process. It is a generational choice, based on fundamental values, which each country must embrace more actively, from their

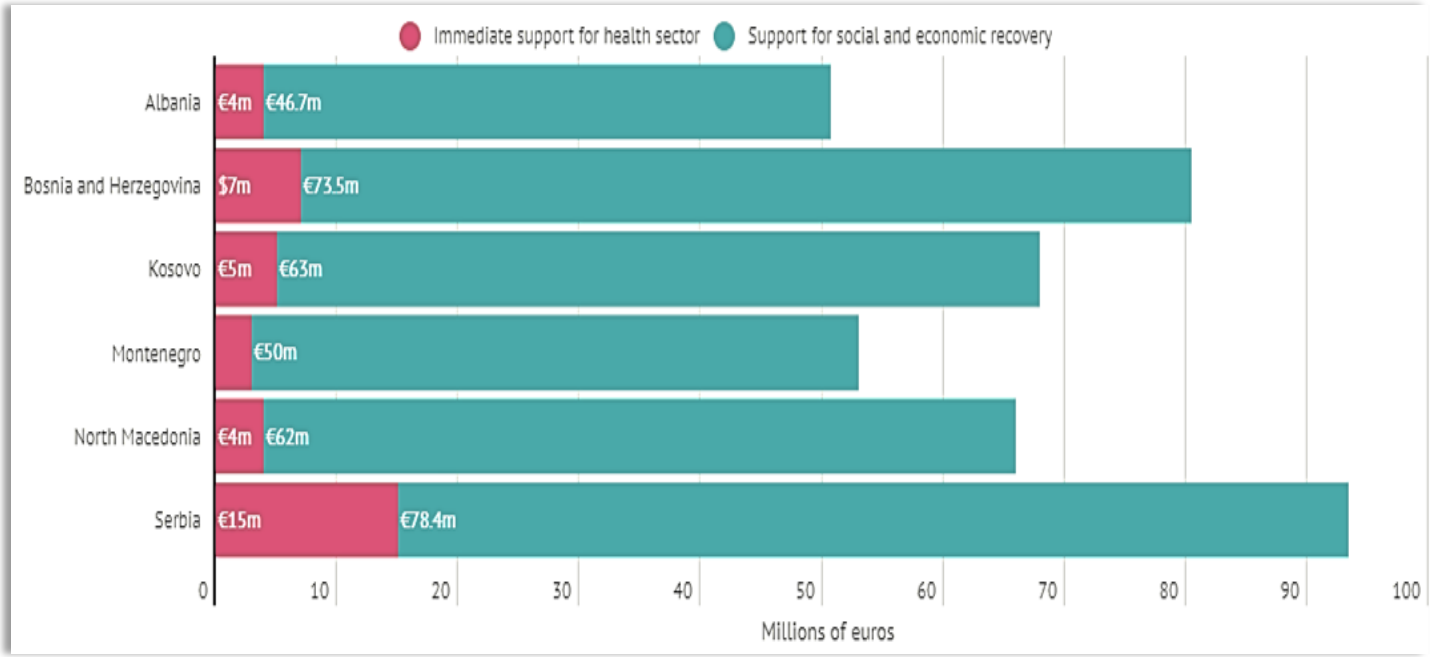
foreign and regional policies right down to what children are taught at school" (European Commission, 2018b, p. 2).

In the review of *the evolution of the Berlin Process*, Marciacq (2017, p. 5) identifies that the WB on their way towards the EU had to manage several issues such as their infrastructure gap and economic vulnerability; the lack of perspective perceived by the youth in WB societies. Moreover, the backsliding of their democratic regimes into stabilitocratic; the persistence of ethnonationalism under the surface of reconciliation; the destabilizing potential of bilateral disputes. Finally, the growing sphere of influence of Russia, China, Turkey and Gulf countries throughout the region. In the policy Notes and Reports of the Vienna Institute for International Economic Studies, Grieveson et al. (2018) define four significant challenges for the region the next decade, meaning the efficient management of political conflicts as the first step for economic growth, the bad governance, infrastructure deficiencies, and the small industrial base. Addressing them will help to solve other issues like the lack of employment opportunities, including the high unemployment and the low activity rates among young people (Grieveson et al., 2018, p. 14).

The current state of WB-EU accession process is as follows: North Macedonia has been a candidate country since December 2005 (but accessions talks have stalled due to Greece's reservations over the country's name). Montenegro attained candidate status since December 2010 but started membership negotiations in June 2012. Serbia filled in the EU membership application in December 2009, but the accession negotiations were only opened in January 2014 (Schwarz, 2016, p. 758). Albania has been a candidate state since June 2014. Bosnia applied to join in 2016 and still holds the potential candidate status, while Kosovo's Stabilization and Association Agreement (SAA) with the EU, was activated the same year. EU officials reiterate that WB countries membership to the Union by a target date necessitates acceleration in the adoption and implementation of the EU accession reforms. In 2018, and under the pressure of Brexit, the EC formally reenergized enlargement process by setting a new deadline of 2025 for the admission of at least two of the best WB candidates, Serbia and Montenegro (Dabrowski and Muachenkova, 2018). In March 2020, the EU gave the green light to Albania and North Macedonia to begin their long-awaited accession talks.

The coronavirus crisis is bringing in the surface the financial vulnerabilities of WB, as well as the need for EU fiscal intervention. The EU takes actions to maintain order in its geopolitical sphere and to respond to Russia and China pandemic aid in the region (please see section 3.4.2). To this context, EU mobilises a crisis relief package of EUR 410 million to support the region's health systems with resources to tackle the pandemic and support the social and economic recovery (Shehaj, 2020). The allocation of the package among WB is displayed in the following figure 3.1.

Figure 3 1 - EU Support Package for the COVID-19 crisis to the Western Balkans



Source: European Commission as cited in Shehaj (2020) (balkaninsight.com/2020/04/20/after-the-pandemic-perils-and-promise-for-western-balkans/)

Although the pandemic has challenged the EU's authority, it is an opportunity for EU to regain its credibility in WB and reaffirm recipient governments' political ties with the EU and to stop populists' political narrative of being abandoned by their EU neighbours (Shehaj, 2020).

Secure solutions to the existing problems and the new arising ones in the WB are not in sight. FDI can play a vital role in strengthening the weak position of WB states by fueling competitiveness and economic development to recipient countries, and meet the economic membership conditions as identified in the Copenhagen Criteria (Füle, 2013). The OECD (2020, p. 20) report on the Covid-19 Crisis in the Western

Balkans notes FDI as an essential tool to attenuate the impact of the health crisis on the basis that the FDI should serve the purpose of economic development, meaning innovation advances, decent and inclusive jobs, and sustainable production methods. Section 3.6 presents the role of FDI in the growth of the transitional Eastern European economies and the evolution of inward FDI in WB as well as its current state.

3.4.2 Remaining actors' interest in the WB

The delayed WB-EU enlargement creates a geopolitical vacuum that generates fears of destabilization of the region, which in turn can cross onto the EU. Concerns of re-emergence of intra-regional conflicts between Kosovo and Serbia and the threat of instability in Bosnia still exists (Grieveson et al., 2018). Already, outside players such as Russia, China, and Turkey exploit the opportunity to establish their presence in the region, to attain their economic and geopolitical goals and grasp part of the EU's share of influence. Russia is the most influential player based on its past. It always displays its close traditional bonds to the Slavic and Orthodox parts of the Western Balkans. Although Moscow had never seriously challenged the EU perspective for the WB before, this attitude changed in the dawn of the Ukraine crisis in 2014 (Bieri, 2015, p. 3). Russia's leading partner in the WB is Serbia in which provided political support for Kosovo's issue. Russia's importance as a strategic investor in Serbia has increased steadily as well as in BiH. Russia and Serbia concluded in the signing of BITs strengthening the economic relations between the two countries (Panagiotou, 2020, p. 5). However, what strengthens Russia's influence in the WB is the energy sector, in which its role is both of significant supplier as well as of key investor. Russia's energy influence is biggest in Serbia, North Macedonia, and BiH, where it supplies almost 90 per cent of natural gas needs (Panagiotou, 2020, p. 4). Russia intention is to exploit the value of the region and to replace gas transit through Ukraine with the Balkan route. Russian MNEs entered into Montenegro in the fields of real estate, tourism, leisure industries, food and drink, banking, agriculture and transport. One of the largest Russian investments was the acquisition of the Aluminum Combine Podgorica (KAP) accounted for 14 per cent of the Montenegro's GDP and more than 50 per cent of its exports (Panagiotou, 2020, p. 5).

Furthermore, Russian President Vladimir Putin is more interest to generate political capital by presenting Russia as a severe threat to WB's EU accession. The Euro Crisis enabled the Russian objectives since the extreme dependence of WB on the European economy turn to be problematic. Finally, the coronavirus pandemic provides Russia with a chance to convert its established assets in the WB into an even -greater role in the region (Samorukov, 2020). Already, Russia deployed a variety of pandemic-related assistance shoring up long-time friends and partners in the region such as Serbia and the Republika Srpska in BiH.

During the crisis' period, several connections to the EU get lost, though new ones created with China that entered in WB's market. Chinese firms' invest in infrastructure, like the rail link between Belgrade and Budapest, designed to connect the port of Piraeus in Greece with the continental European markets, as well as in power plants and roads in Serbia, BiH, and Montenegro (Bieri, 2015, p. 4). WB apart from Kosovo, whose independence China does not recognize supporting Serbia's sovereignty, are members of the China-Central Europe Cooperation format, or "17+1" (Przychodniak, 2020, p. 1). Prospects for further Chinese involvement seriously exist based on the completion of the ambitious "Belt and Road Initiative" (BRI) for building a Silk Road-style global trade network aimed at connecting Asia, the Middle East, Africa and Europe via land and maritime networks along with six corridors (Sanfey and Milatovic, 2018; UNCTAD, 2018a). WB, except for Kosovo, has signed cooperation agreements with China for the BRI (Przychodniak, 2020, p. 1). China also takes advantage of WB's investment needs. WB agreed on a cooperation scheme that applied to more than 90 per cent of the investment projects in the region. This scheme combines long-term loans and a majority share for Chinese firms in the implementation of the investments, which turns to increase the debt of WB states (Przychodniak, 2020, p. 1).

EU acknowledges a threat of further divisions as China is after Eastern European nations among them the non-EU states (DW, 2018). The pandemic of COVID-19 strengthens, even more, China's cooperation with WB countries, especially with Serbia, while EU response came late according to country's president (Przychodniak, 2020, p. 2). China uses the routes of the BRI to provide medical support to partner countries in need; a move called the "Health Silk Road" (Shepard, 2020).

Serbia was the largest recipient of medical equipment in the region, followed by North Macedonia, Albania and Montenegro (Przychodniak, 2020, p. 2). China in WB aims to be a counterweight to the EU by deepening cooperation with the EU candidate countries, in terms of economic cooperation and recently more in public diplomacy. The ultimate goal is by increasing its influence on the EU to reduce the importance of the US. The construction of the 5G network in the region is an example of China effort to limit further WB cooperation with the US, setting the ground for the "digital silk road" telecommunications connectivity (Vasovic, 2020).

Turkey, following the Russian paradigm, uses economic activity in the region for political purposes (Bieri, 2015, p. 4). Turkey, since the 2000s, pursued a deeper involvement in politics of the neighbouring regions. This policy represents the new era in Turkish foreign policy, thus, the shift from Kemalism to neo-Ottomanism, from an isolated Turkey to a country that envisages becoming the leader of Muslim and Turkic worlds and evolving as a key player in Eurasia. The Turkish engagement in the WB is attributed to numerous factors including the longstanding common history of Turkey with this region, the Turkish minorities and Muslim communities that live in WB, the geopolitical importance of the region as a buffer zone for Turkey and the increasing Turkish economic interests in the area (Türbedar, 2011, pp. 140–42). Overall, the revitalization of Ankara's interest in the WB and its active engagement reflects the current neo-Ottomanism policy. However, Turkey has not succeeded in building any permanent political and economic stronghold and playing the hegemonic role that it wishes, meeting the neo-Ottoman aspirations (Petrović and Reljić, 2011, pp. 161–2). Turkey's influence is limited to the Muslim population in the WB. The Muslims are the majority in three WB countries, Albania, BiH and Kosovo while they form the 30 per cent of the population in North Macedonia and have significant minorities in Montenegro and Serbia (Koppa, 2020, p. 1).

In the case of the WB, the use of Islam's religion is an instrument of foreign policy also for the Gulf States and Iran. For example, Kosovo's independence is supported by fifty-seven states of the Organization of Islamic Cooperation (Koppa, 2020, p. 8). All the Gulf States supported the Muslims in BiH in the early 1990 s, but Saudi Arabia provided the most significant aid in terms of military equipment, finance, humanitarian aid and reconstruction of mosques and schools (Liliyanova, 2017, p. 1).

Also, in 2017, Saudi Arabia deployed strategy for improving commercial and investment relations with the BiH and Serbia by forming a joint trilateral committee along with a broad investment project in the construction sector (Liliyanova, 2017, p. 2). Saudi Arabia, as well as UAE and Qatar, are evolving as significant economic actors though this is happening based on close political relations with the ruling elites of WB countries (Koppa, 2020, p. 8). Referring to Iran's influence as an Islamic state, since the end of the 90s retains close political ties with the political, academic and economic elite in Bosnia (Progonati, 2017, p. 203). Iran uses soft power in WB through cultural and research institutes. The Iranian Cultural Center promotes academic and cultural ties and finances a series of activities. Albania is the second focus of Iran's attention in the Balkans, after Bosnia. However, Iran effort to be an important external actor in the region is constrained by Saudi Arabia as a representative of a different Islamic doctrine, and Israel that fights the rise of radical Islam (Progonati, 2017, p. 215).

After US experienced the September 11 attacks withdrew from playing a leadership role in WB, though Bush's administration supported Kosovo independence (Domi, 2017, p. 83). Obama's administration gave up the region's leadership to the EU, supporting that any challenges in the region can be overcome through the EU accession process. Of course, the US did not lose its authority in the WB since Montenegro in 2017, and North Macedonia in 2020 joined NATO. The NATO membership means that the US will exercise control over the WB countries, which are member states of the mentioned alliance. However, Trump's administration seems reluctant to deepen its interest in the small WB states.

3.5 Contemporary Political environment in Western Balkans

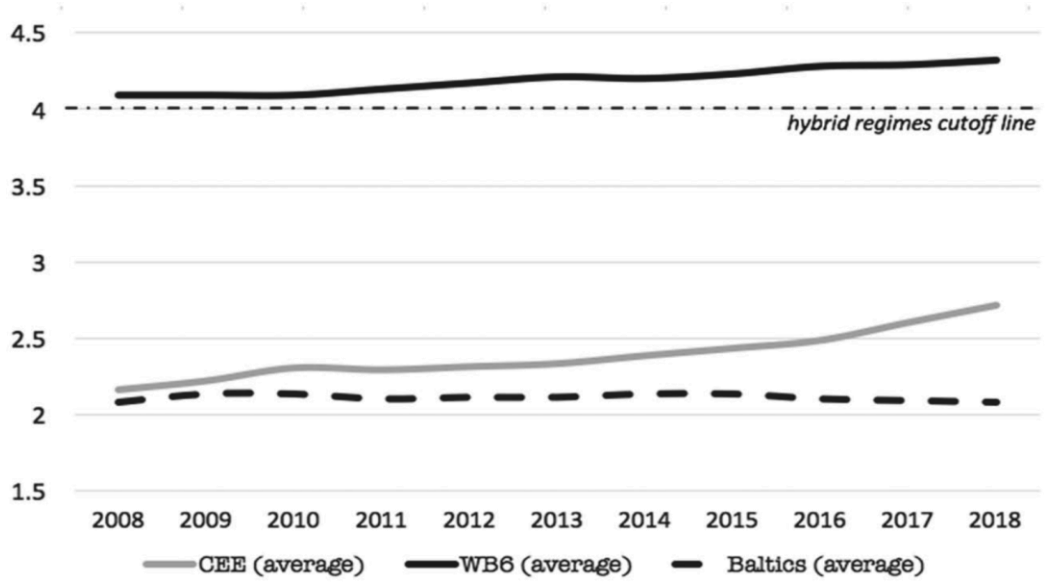
EU membership potential, along with policy conditionality, has been the vital promotional tools of democracy in the WB region. However, in the first transitional years, EU policy focused on the socio-economic side of democratisation, no giving priority to the building of strong political institutions and the enhancement of democratic actors. Indeed, humanitarian assistance came first, socio-economic development second and democracy third (Grimm and Mathis, 2015, p. 918). Hence, WB political initiative to support the democratic institution-building and capacity-

building delayed. Besides, central planning legacies facilitated the post-communist autocrats and their allies to retain control over critical economic assets, giving them incentives to fight any progress in democratic transition (Levitsky and Way, 2010, p. 87) and defining country's economic development. In each WB country, any structural reform for completing the transition process was undermined by the established political elite which worked effectively to perpetuate its status quo. The intentionally freezing of improvements in governance dimensions and property rights by the ruling party determined the performance of inward FDI.

Nevertheless, a significant move towards democratisation occurred in the early 2000s across the WB states. This democratic surge did not last long since it was based on institutional design inadequate for the establishment of a consolidated democracy (Pavlović, 2019, p. 6). From the late 2000s, the authoritarianism in the region has been re-emerging. The appearance of authoritarianism practices reveals how deeply rooted they were in the political culture of the WB countries. At the same time, the erected liberal democratic institutions proved too weak to vanish them and inefficient to manage the new threat of democracy arising from the global financial crisis. Population's anger and anxiety over economic inequality and the loss of personal status that the crisis produced gave space to new competitors on the left and right to cast existing elites as complicit in or taking advantage from the deterioration of citizens' living standards (Freedom House, 2019a, p. 2).

Until now, the WB's democracy score measured by Freedom House is low compared to the responding of CEE and Baltics (please see figure 3.2). The region's performance, between 4.0 to 4.5, is equivalent to this of a hybrid regime (the term is defined in Chapter 2) (Pavlović, 2019, p. 5). Freedom House rating is based on a scale of one (1) to seven (7), with one representing the highest level of democratic progress and seven the lowest. The low score of democracy is attributed to the worsening of the democratic process and the weakening of democratic institutions.

Figure 3 2 - The average Democracy score for WB, CEE and Baltics according to Freedom House's rating



Source: Pavlović (2019, p. 5)

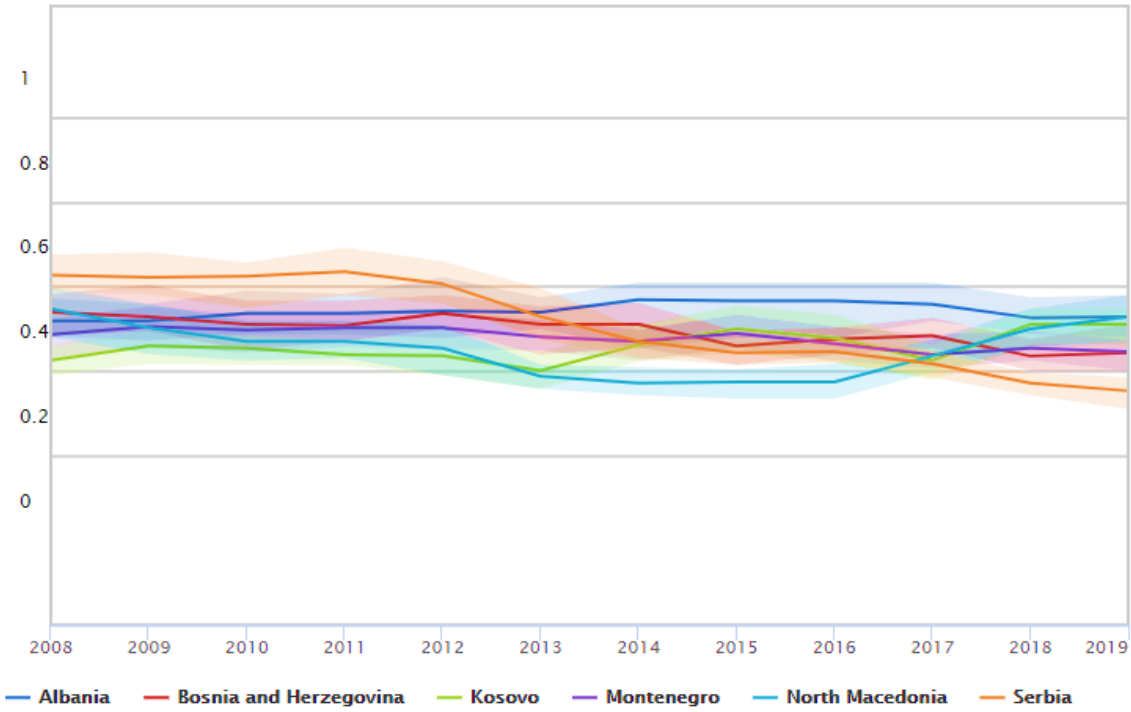
The rise of illiberal politics in recent years in WB is reflected in the abuse of power regarding elections, the rule of law, media and public finance. The most indicative cases found in the leading political parties in North Macedonia, in Serbia, in Bosnia and Herzegovina, and Montenegro, whereas all the countries have politicians who develop delinquent behaviour for the benefit of themselves and their parties (Kapidžić, 2020, p. 2). However, WB's governments retain the process of competitive multiparty elections.

The Varieties of Democracy index (V-Dem) that measures the quality of democracy confirms the incremental changes in levels of democracy in favour of authoritarianism (Kapidžić, 2020, p. 8). Figure 3.3 displays WB's countries V-Dem Liberal Democracy Index (LDI) between 2008 to 2019 that captures the region's democratic backsliding. The LDI combines both the electoral and liberal principles of democracy. The electoral component accounts for the regime's ability to hold reasonably free and fair multiparty party elections. At the same time, the liberal is more demanding since besides the above component comprises high degrees of the rule of law as well as horizontal – effective judicial and legislative – constraints on the executive (Lührmann, Tannenberg, et al., 2018, p. 1327). If a regime holds an average score on V-Dem's LDI above 0.8 is classified as a liberal democracy. The liberal

democracy scale runs on a continuous scale from low to high (0-1) with higher values indicating a more democratic dispensation.

The general trend for WB, according to the LDI, is shows stagnation at best and democratic regression at worst, far beyond the liberal democracy. Except for Serbia, which ended up with the largest democratic backsliding in 2019, the level of democracy in the region during the last decade changed gradually. Each country's regime's classification according to V-Dem indexes, would be analysed at separate chapters of this assignment.

Figure 3 3 – WB's Liberal Democracy Index (LDI) during the period 2008-2019



Source: Adapted from V-DEM Data (2020)

These countries, during their socialist past, did not experience regime changes like those they experience now, holding distributions of regime forms (Møller and Skaaning, 2013, p. 102). Governments in the WB states close to EU accession should insist on fostering the democratic rule and not engage in the resuscitation of the past political system. They should empower the democratic structures towards corruption and organized crime, limited media freedom, and strong dependence on informal control over the state administration by the power party (Bieber, 2018, p. 338).

Unfortunately, the pandemic COVID-19 that spread rapidly across the world provoked tensions between governing and opposition parties in nearly all WB

countries concerning disagreements on pandemic policies. Besides the threat of political instability, some of the measures taken to curtail the pandemic's expansion like the sealed borders, travel restrictions, banned large public gatherings, closed schools and local roads and time-specific restrictions on free movement revoke the government policies of the pro-1989 period (Shehaj, 2020). Perils for democratic losses exists, but the fight for democratic rights in WB endures more than thirty years, and it should not be sacrificed at the altar of the pandemic war (Shehaj, 2020).

For the remaining of the chapter, the regime formation will be presented for each WB state separately, taking into account the political determinants identified in the literature review and their impact on inward FDI (please see Chapter 2).

3.6 The role of Inward FDI in post-socialist countries' EU accession

The WB countries will unequivocally be able to join the EU once the criteria of Article 49 of the Treaty on EU, including the Copenhagen criteria, are met. In alignment with the economic EU's accession criteria, as defined at the Copenhagen European Council in 1993, candidate states should prove the existence of a functioning market economy and the capacity to cope with competitive pressure and market forces within the EU (European Council, 1993). None of the WB countries can currently be considered to achieve these criteria since there are critical parts of their economies that are still uncompetitive with excessive political interference and an underdeveloped private sector (European Commission, 2018b, p. 3).

The two economic criteria encompass the following groups of sub-criteria:

> macroeconomic stability, high quality of economic governance, business environment, privatisation and restructuring, efficient financial market, well-functioning labour market, the extent to which government policy and legislation influence competitiveness through trade policy or competition policy, and the degree and pace of economic integration a country achieves within the EU before accession (European Commission, 2018a, p. 2).

For economies in transition, a way to converge with the other EU member countries, especially in the area of economic criteria is the increase of their FDI flows.

Most of the empirical studies that focused on the set of European transition economies found a positive impact of FDI on economic performance (Tsitouras et al., 2017, p. 150). FDI is acknowledged as the primary form of capital flows from developed to developing and transition countries (Malovic et al., 2019).

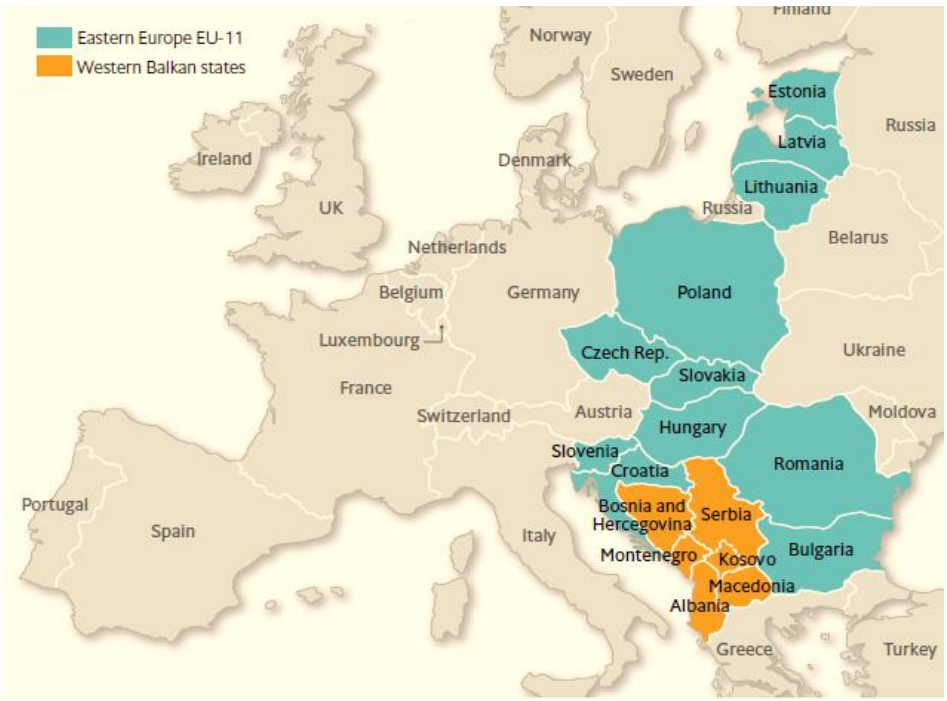
FDI inflows are welcomed to transitional economies since they considered to influence the rise on welfare positively. This positive impact is mainly due to advantages related to knowledge, organizational and technology transfer (know-how) to domestic firms and local labour force alike, enforcement of production spillovers, enhancement of intra-industry competition, and better access for exports abroad, notably in the source country (Botrić, 2010; Demekas et al., 2005; Malovic et al., 2019). Hence, FDI boosts competitiveness as well as the total factor productivity of the host country's output and increases domestic income. (Ali and Bohara, 2017; Malovic et al., 2019). The prospect of domestic income's growth and in turn of government revenue's growth via taxation motivates at most governments to implement FDI - friendly policies (Ali and Bohara, 2017, p. 159). FDI can be an effective method for financing external current account deficits based on its non-debt-creating mechanism, especially in those economies that have suffered too long from large deficits (Botrić, 2010; Demekas et al., 2005). Due to these benefits of FDI, when a country's economic system is changing, and the previous management methods are considered inadequate, then the country seeks ways for stimulating inward FDI.

The WB countries similar to their eleven Central and Eastern European peers (EU11), also known as the New Member States (NMS), (Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia), (please see Map 3.4), rely on foreign investors for the introduction of new capital that will materialize and speed up economic growth (Botrić, 2010; Jirasavetakul and Rahman, 2018). Indeed, after the fall of the socialist system, the shortage of capital and management skills made FDI a necessity, accompanied by direct liberalization, though without taken measures for the industrial protection as usually happens in emerging economies (Farkas, 2017, p. 9).

FDI played a significant role in the export-led growth of NMS and contributed to the rise of employment, the growth of productivity despite any cross-country variation (Jirasavetakul and Rahman, 2018, p. 3). These states have benefited from

the integration into global supply chains. Especially Poland, the Czech Republic, Slovakia, and Hungary (the Visegrád countries) by being part of the German supply chain in machinery and transport equipment sectors, turned to be export-driven, open economies (Farkas, 2017, p. 12).

Map 3 4 - EU-11 and the WB States

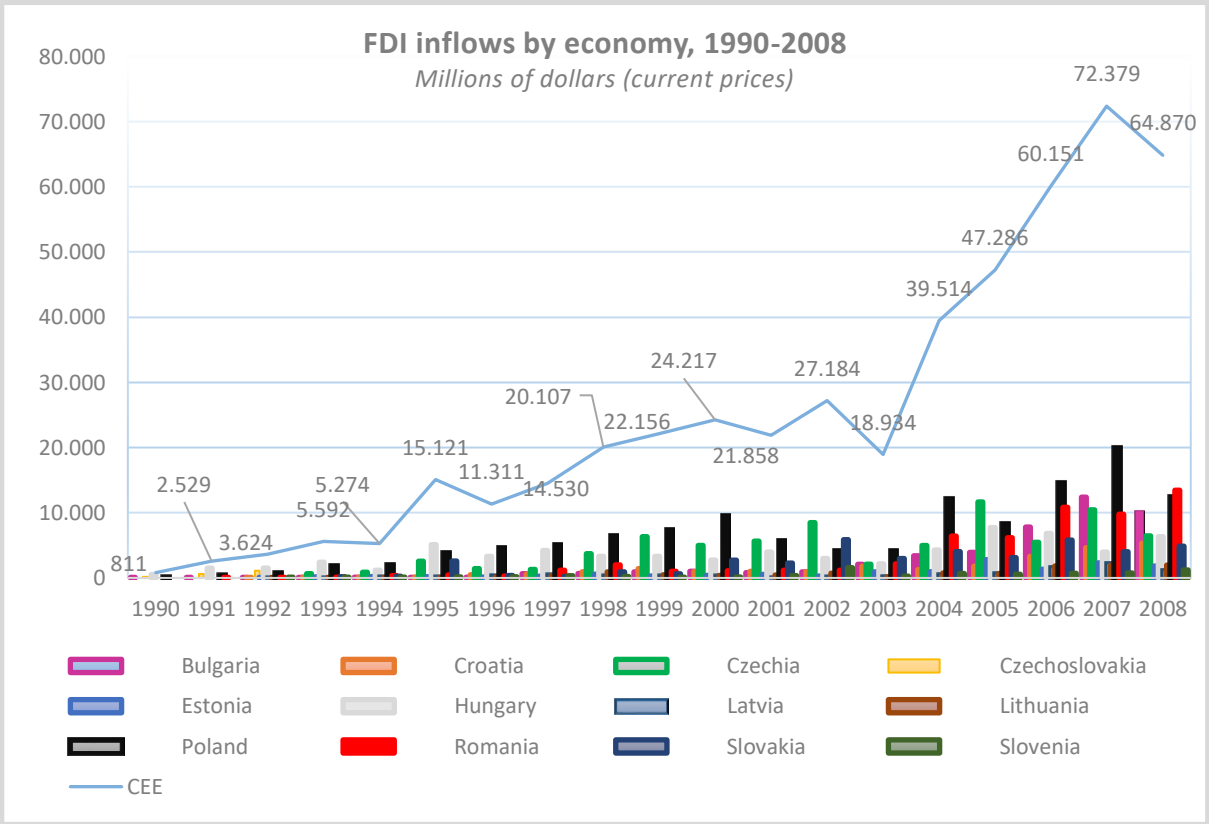


Source: The Economist Intelligence Unit (2018, p. 5)

Figure 3.4 records the upward trend of inward FDI in NMS from 1990 up to 2008, with milestone years the year 2004 in which eight of the eleven CEEC joined the EU, and year 2007 in which two more states gained membership, Bulgaria and Romania. Croatia became an official EU member state in 2013. In 2007 top recipients CEEC were in the following order Poland, Romania, Czech Republic, and Bulgaria, accounting for more than two-thirds of the NMS (UNCTAD, 2008, p. 74). Before their accession, the NMS pursued and succeeded in the improvements of several areas, like the political process of integration, the implementation of economic, social and institutional reforms, and the role of state institutions (Fullani and Tanku, 2013, p. 89). After they joined, foreign investors intensified their interest as the size of the inbound FDI reveals (please see figure 3.4). The positive impact of integration for market reforms, the building of institutions, and the economic benefits of the single market

contributed mostly to the rise of inward FDI. Hence, implying an interrelationship between EU membership and FDI growth. Poland FDI's outstanding performance is the best proof. In particular, in 2007 just before the outbreak of the 2008 global financial crisis, Poland recorded a steady and sizeable flow of FDI, amounted to USD 18 billion due to rapidly expanding domestic market, the flexible and skilled labour force and the stable banking system (UNCTAD, 2008, p. 74).

Figure 3 4 - FDI inflows by an economy in EU-11, during the period 1990-2008



Source: Adapted from UNCTAD (2018b), FDI inflows by region and economy, 1990-2017 FDI/MNC database (www.unctad.org/fdistatistics)

Consequently, the latecomers in integrating with Europe and obviously to the rest of the global economy, the WB countries should complete the establishment of a functioning free-market economy and eliminate the macroeconomic distortions inherited from earlier centrally planned systems by attracting more FDI flows (Kalotay, 2010). For NMS the average period to move from membership's application to EU accession, was ten years, while the respective period for WB has not yet been defined. The performance of WB's inward FDI is presented in the following section.

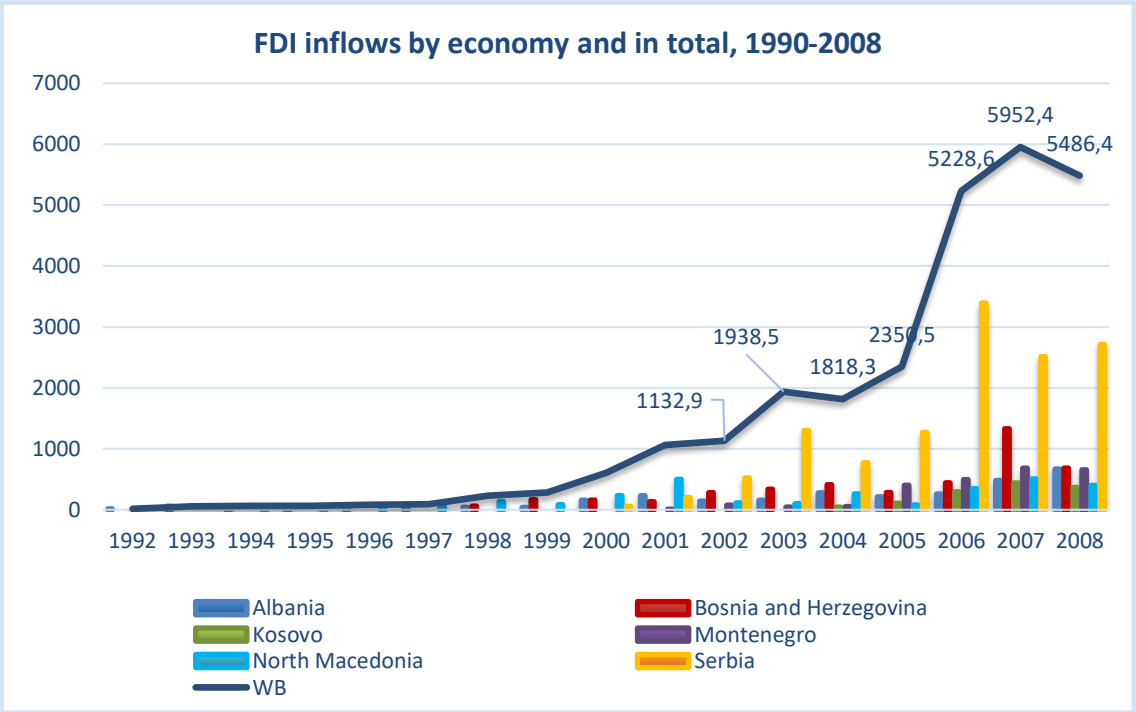
3.7 The current state of WB's Inward FDI

In the time following the fall of the Berlin Wall, the WB region lost valuable time due to the political, ethnic and national conflicts that vanished FDI inflows, despite the perceptions for economic opportunities. WB countries have been associated with the troubled image of wars and conflicts experienced through the 1990s. Their "notorious" past limited any potential for FDI growth vital for the region due to their limited domestic savings (Estrin and Uvalic, 2016a, 2016b). The external and internal shocks derived from the breakdown of the central planning system, the dissolution of the Soviet Union and the breakup of the Yugoslav Federation in mid-1991 into smaller independent states perplexed the transition process to a market economy (Bitzenis and Marangos, 2009, p. 71). Each newly established state inheriting different dynamics, followed diverging routes in implementing political, economic and social reforms. Since most of the new states are small by any standard, FDI inflows are less, relative to countries with a sizeable domestic market. Meanwhile, the embargos imposed on Kosovo, Serbia and Montenegro by the UN and EU, and on the FYROM by Greece restricted any prospects for political and economic stability and inhibited inward FDI, as well (Uvalic, 2010, p. 3).

Until the sign of Dayton Peace Accords in 1995 that put an end to the three and a half years war, no remarkable sign of inward FDI was recorded in the WB transition economies. The Dayton Accords peace agreements were a positive development to reduce political instability, to stabilize economies and to boost privatization facilitating the transition to the market economy (Brada et al., 2006, p. 675). Nevertheless, the Kosovo conflict at the late 1990s (1998-1999) postponed any progress and caused delays in the implementation of any major reforms that could rescue these deteriorating economies. Any prospects for FDI growth evaporated, proving that the costs of instability in terms of foregone FDI inflows are relatively high. In this vein, other transition countries in SEE less affected by conflicts such as Bulgaria and Croatia experienced a rise in the FDI inflows, specifically in telecommunications due to the starting one-off privatization policy in this sector. The FYROM also recorded an increase in FDI inflows directed to the oil refinery sector (UNCTAD, 2000, p. 66).

From 2000 onwards, the large-scale privatizations in the banking sector, telecommunications companies and the sale of mining concessions resulted in an upward trend in FDI inflows in WB. As figure 3.5 shows, the booming of inward FDI in the region took place during the years 2002-2003, recording an increase of 71.1 per cent from EUR 1.132,9 to EUR 1.938,5 million. The largest increase (122.45 per cent) recorded during 2005-2006, whereas the highest value on FDI inflows was in 2007.

Figure 3 5- FDI inflows by a WB economy during the period 1992-2008



Source: Adapted from wiiw FDI database (2020), FDI total, annual, (http://wiiw.ac.at/fdi-database.html)

FDI inflows in the region are mainly directed to the non-tradable sectors, suggesting the strengthening of domestic demand and the rise of imports. This direction of FDI stimulates a higher trade deficit than having flows to the tradable sector and inhibits the efficient restructuring of critical industries (Kinoshita, 2011; Uvalic, 2010). The EU enlargement of 2004 included eight countries of Central and Eastern Europe (CEE) and acted as a catalyst to Serbia and Montenegro to speed up reforms, for meeting the admission criteria. UNCTAD (2004, p. 75) reports that "Serbia and Montenegro permitted the free transfer of financial and other resources related to foreign investment, lifted previous limitations on the establishment of wholly-owned foreign affiliates in the telecom and public information industries and lifted

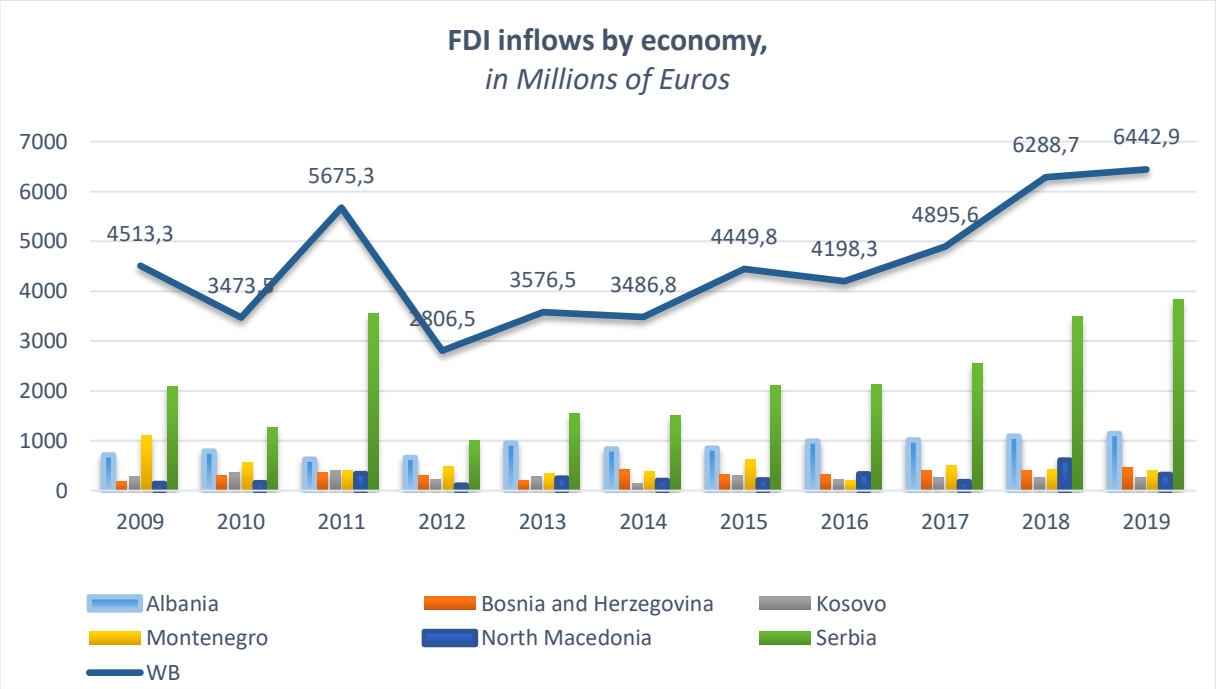
approval requirements for establishing foreign affiliates or for the acquisition of domestic companies (Foreign Direct Investment Law of 2003)". Since 2005, WB intensified their reform policies - also aimed at judicial independence, accountability, tackling of corruption and organized crime, protection against expropriation, the introduction of flat tax rate and fighting tax evasion-in line with their ambition to join the EU. Albania, BiH, Croatia (withdrew in July 2013 after joining the EU), the FYROM, Moldova, Montenegro, Serbia, and the United Nations Interim Administration Mission in Kosovo (UNMIK) on behalf of Kosovo, joined the CEFTA in 2006, boosting intra-regional investment, as well as, trade flows (Cefta.int, 2019; OECD, 2011, p. 20). Further, the six WB countries accelerated the privatization rate of public assets, especially those in telecommunication and energy (UNCTAD, 2007, pp. 65–66, 2008, p. 70).

The global economic crisis in the WB economies generated weak and unstable economic growth, high rate of unemployment, the rise of poverty and reverse in the pre-crisis investment climate (Sanfey and Zeh, 2012, p. 2). WB countries being depended mostly on the EU market for trade and investments were affected strongly by the Eurozone sovereign debt crisis. From the largest global investors countries that are in Europe, Germany, Switzerland, and the Netherlands are the central FDI source countries for Kosovo and North Macedonia. For the remaining examined countries received flows from Italy and smaller economies like Austria, Greece, Hungary and Slovenia (Kalotay, 2013, p. 254).

The recovery and integration into the global economy, deemed too difficult since the region lacked export-oriented projects involved in international productions networks that have proved to stimulate growth. As well, FDI inflows concentrated on the sectors most exposed to crisis those of finance and retail (UNCTAD, 2011, 2013). Nevertheless, the development of the financial sector facilitated access to funds for firms and households, contributing to the mid-2000s FDI's boom (IMF, 2014, p. 6). The sector of manufacturing regarded as a channel of efficiency, in terms of transfer of technology, organisation of the firm and superior managerial skills, still underperforms in the region with the exceptions of Serbia and North Macedonia (Kalotay, 2013; Malovic et al., 2019).

From 2009 onwards, FDI inflows in the region of WB fluctuated, recording only recently a better performance but not reaching the pre-crisis period (see please figure 3.6). Reporting the current state of inward FDI in the WB, Serbia is the largest economy of the region and the most important FDI target. In 2011 the country reached its peak FDI flows, as it received EUR 3.548,0 million (please see figure 3.6), thus 62.5 per cent of the total inward FDI in the region. In 2017, FDI in Serbia grew by 20 per cent, however much of this growth was due to reinvested earnings and intracompany loans to foreign affiliates (UNCTAD, 2018a). From 2018 onwards, the rise in FDI inflows is attributed to a significant surge of equity capital (UNCTAD, 2019, 2020a). More than half of the FDI inflows in 2019 originated in the EU (UNCTAD, 2020a, p. 59). Since 2010, Albania is the second-largest recipient of FDI inflows in WB due to the implementation of FDI projects on the energy sector (Trans Adriatic Pipeline and the Devolli hydropower plant projects) and mining. These projects are almost completed, and as such, the established foreign investors initiated investments in renewable energy projects, pushing FDI to grow slightly (UNCTAD, 2018a). During 2016-2017, North Macedonia had a reduction of 31.5 per cent in inward FDI, due to mounting political uncertainty. In 2018, the positive political developments for the resolution of the long-lasting dispute for the country's name increased significantly inward FDI though a new dramatic fall recorded in 2019 (please see Chapter 9- section 9.4).

Figure 3 6 - FDI inflows by a WB economy during the period 2009-2019

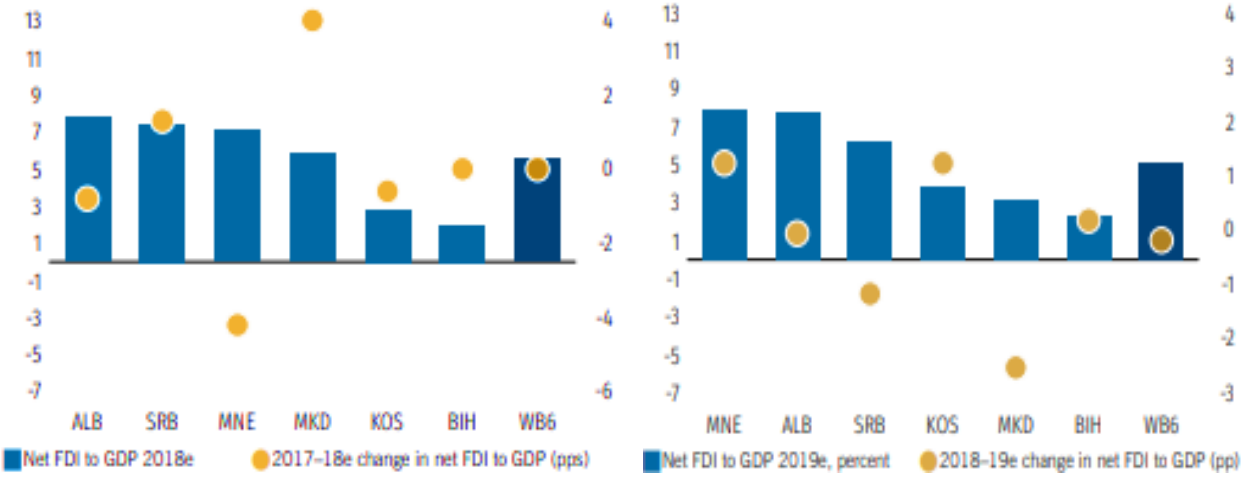


Source: Adapted from wiiw FDI database (2020), FDI total, annual, (http://wiiw.ac.at/fdi-database.html)

On average, the 2018 FDI inflows for the region accounted for 5.5 per cent of regional GDP, slightly less than the 5.7 per cent average of the 2015-2018 period (please see figure 3.7). The inward FDI performed as such since the large net FDI-financed infrastructure projects in Montenegro are almost completed, and the other WB countries like BiH did not succeed to improve the business environment (World Bank, 2019a, p. 33). Figure 3.7 presents Albania to rank first among the six WB countries on FDI-to-GDP ratio (7.8 per cent of GDP) mainly by FDI received in energy infrastructure and manufacturing. Serbia and Montenegro followed by FDI inflows of 7.4 per cent of GDP and 7.1 per cent respectively. In North Macedonia, FDI inflows estimated at around 5.8 per cent of GDP in 2018 due to the resolution of the political crisis (World Bank, 2019a, p. 34). According to the World Bank Group economic report on Western Balkans (2019a), BiH finished last, due to the country's risky political environment and the low progress in the required reforms. In 2019 the total inward FDI for the region expected to end up at 5.2 per cent of GDP, slightly less than in 2018 because Albania, North Macedonia, and Serbia received fewer inflows as a per cent of GDP than those in 2018 (World Bank, 2019b, p. 28).

FDI had supported the growth in WB countries but the recorded investment levels considered too low to ensure sustainable growth for the long term. Although greenfield investment peaked in 2018, a large share of FDI continues to go into non-tradable sectors such as real estate and retailing, which do not contribute directly to exports(World Bank, 2019b, p. 28).

Figure 3 7 - Net FDI inflows as a percentage to GDP, periods 2017-2018 &2018-2019

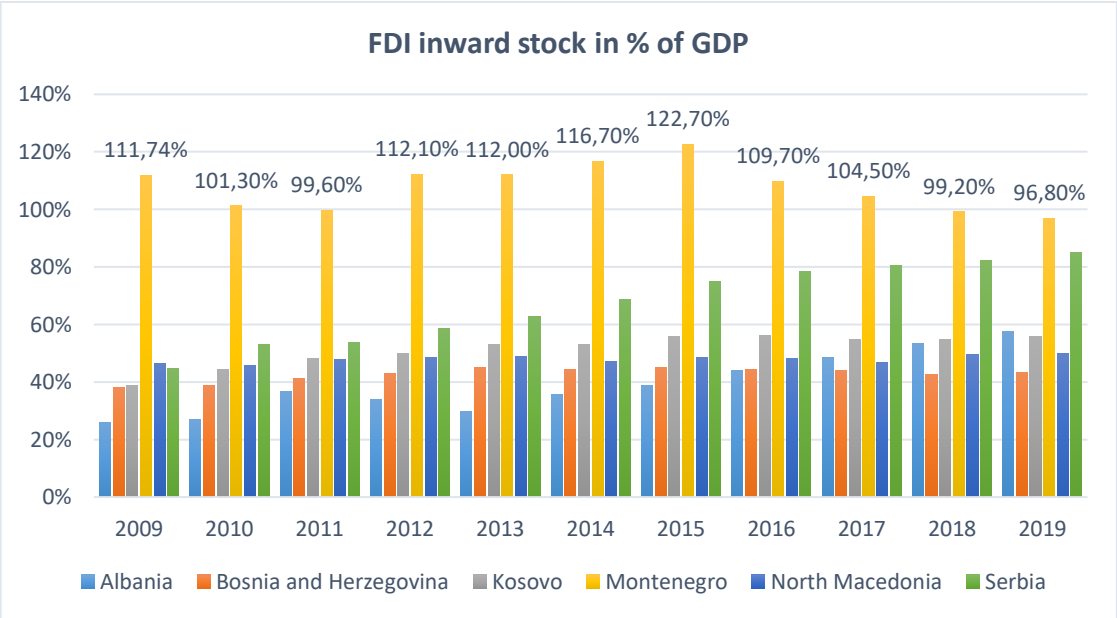


Source: World Bank-Western Balkans Regular Economic Reports (2019a, p. 33, 2019b, p. 28)

Since 2009, Montenegro holds the highest FDI intensity reaching the 122.7 per cent of inward FDI stock as a percentage of GDP in 2017 due to Azerbaijan and Russian real estate investments (Hunya and Schwarzhappel, 2016; UNCTAD, 2018a) (please see figure 3.8). From 2010 onwards Serbia has the second largest FDI intensity (over 80 per cent of inward FDI stock as a percentage of GDP). Between 2017-2019 Albania is third (with an average of 53,2 per cent) of inward FDI stock as a percentage of GDP (UNCTAD, 2018c) (please see figure 3.8). BiH increased the percentage of inward FDI stock to GDP from 39 per cent in 2009 to 44 per cent in 2017 due to a doubling of reinvested earnings (UNCTAD, 2018c) (please see figure 3.8). The vital comparative advantages that still holds foreign interest to invest in the WB countries beyond being considered as a natural gateway to Europe are flexibility in labour policies, low labour costs combined with a relatively educated population, favourable taxation and the perspective of EU membership. The main difference from the pre-crisis period is that although the bulk of FDI inflows are still originating from European countries, China

has emerged as an essential source of FDI investing in finance, aviation, and tourism. The ambitious "Belt and Road Initiative" (BRI) grants China with new dynamics in the region. After its completion, expected results would be regional integration, the growth of trade and sustainable economic growth. The budget is projected to amount to USD 1 trillion. BRI includes up to now 70 countries, including WB, from Beijing to Athens and connecting with Belgrade, Sarajevo, Skopje, Budapest, Tirana and other capitals (Bennett, 2017; EBRD, 2019a).

Figure 3 8 - FDI inward stock as a percentage to GDP, by WB economy, 2009-2019

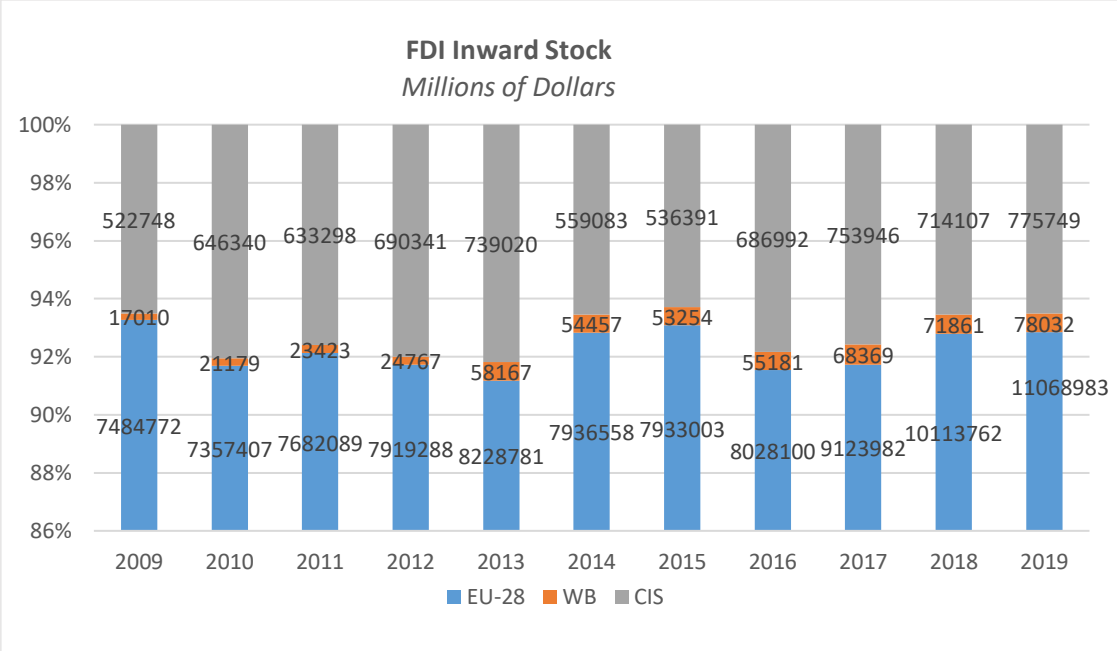


Source: Adapted from wiiw FDI database (2020), FDI total, annual, (http://wiiw.ac.at/fdi-database.html)

In the aftermath of the global and Eurozone crises, WB countries continue to have fiscal and competitiveness issues and face external vulnerabilities. This background prevails in the region, while it is still positioned as the last "land of opportunity" in Europe, repeating the success of CEEC in achieving a satisfactory level of economic prosperity and political freedom (Fullani and Tanku, 2013). Crisis reminded to all the main disincentives for engaging in FDI in the region, such as the small size of the domestic market with low per capita income, natural resources lacking strategic importance (only exception the Serbian lithium), the high external debts and budget deficits fueled by cross-border non-performing loans. To continue, the high risk of the region being vulnerable to social and political instability, the slow pace in structural reforms, the high unemployment rate and the low productivity in

the private sector lagging well behind EU standards. Finally, the existence of the weak public infrastructure, the high level of corruption in the economy, the low institutional and administrative capacity reflecting the institutional and political deficiencies. The lower quality of bureaucracy and the weak capacity of policymaking elites have been dominated in the region, since the Ottoman rule and reproduced through the education system and the legacy of bureaucratic malpractices (Economist Intelligence Unit, 2018, p. 12). In this context, WB countries are not considered as functioning competitive market economies and do not hold a satisfactory level of stock of FDI inflows, compared to EU28 and Commonwealth of Independent States (CIS), according to data presented in figure 3.9.

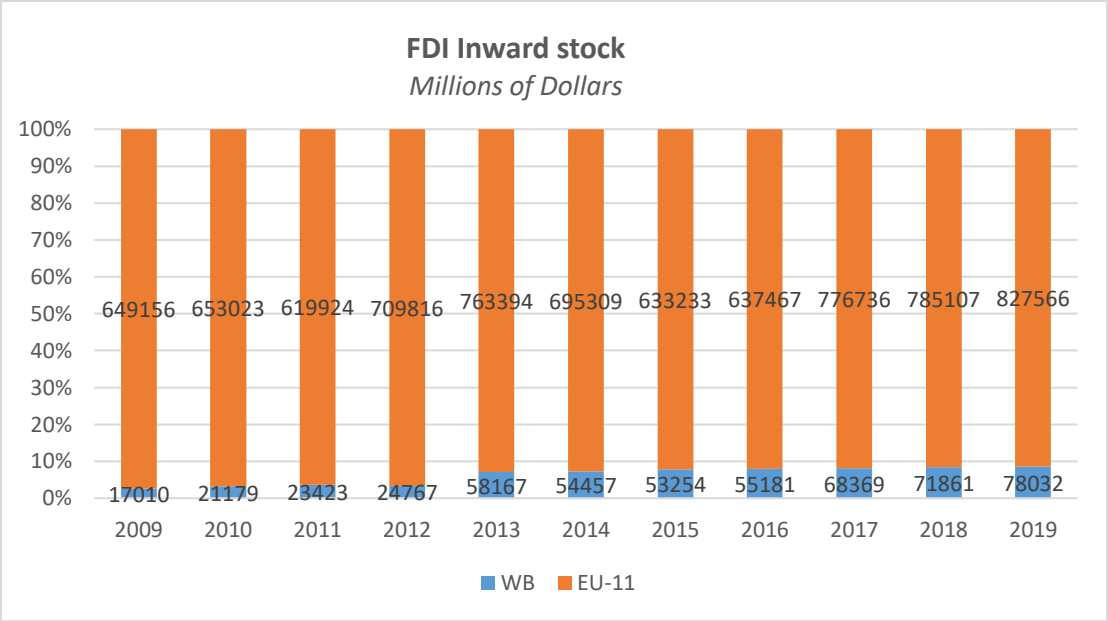
Figure 3 9 - FDI inward stock by region during the period 2009-2019



Source: Adjusted from UNCTAD (2020), FDI inward stock by region and economy, 1990-2017 FDI/MNC database (www.unctad.org/fdistatistics)

The comparison of WB with their EU-11 peers is also in favour of the latter (please see figure 3.10). Despite the gradual increase during the last decade, WB economies still are lagging in terms of inward FDI stock. The catch-up potential is apparent.

Figure 3 10 - FDI inward stock in SEE and EU-11 during the period 2009-2019



Source: Adjusted from UNCTAD (2020), FDI inward stock by region and economy, 1990-2019 FDI/MNC database (www.unctad.org/fdistatistics)

The European Commission (2018b) recommends that WB countries should raise investments through the building of strong economic governance and the implementation of efficient structural reforms that target increases of competitiveness.

The outburst of coronavirus pandemic alters any potential previously developed in the WB's inward FDI. The latest OECD report for the COVID-19 Crisis in the Western Balkans (2020, p. 19) highlights the high dependency of region's inward FDI from sources seriously affected by the pandemic crisis such as the EU as well as the UK, the US and the Russian Federation. To this extent, it is likely a future decrease in FDI inflows in WB. Therefore, the OECD report (2020, p. 20) recommends WB economies to continue paying attention to protect sensitive assets in strategic sectors while promoting market openness. Further, in a period that capital and investment will be stretched the private investment will mostly contribute to the development finance equation. Finally, OECD report insists on improving the clarity, reachability, and predictability of legal frameworks for FDI for increasing the legibility of the investment environment during this crisis.

The UNCTAD's prospects for FDI growth in the economies in transition including the WB as recorded in the 2020 World Investment Report (UNCTAD, 2020a,

p. 56) are that FDI inflows will be declined by about 38 per cent, similar to the world average due to the pandemic crisis. Those economies in SEE with broad exposure to the tourism and hospitality industries will also be affected seriously. Finally, in all transition economies, reinvested earnings will transmit the negative 2020 operational results of MNE investors to FDI (UNCTAD, 2020a, p. 56).

Inward FDI by WB economy is analytically presented at separate chapters in this assignment.

3.8 Concluding Remarks -Recommendations

The WB region failed to abolish the stigma of the "other" to Europe "proper" and to get rid of its trouble image and the reputation that gained through centuries as "the Powder keg of Europe." The fall of centrally administered system catalytically affected the WB countries. Each country adapted to the new reality differently and tried to discover its new identity rejecting in many cases its socialist past. These transition economies provoked the international interest since they had been ruled under authoritarianism for a long time and during the last decades engaged to a set of structural transformations supportive to their "democratization" and to transition to the market economy. Balkans' distorted democratization of gains and losses left its stigma in the political practices of the 1990s along with the issue of divided states in which ethnic politics and parallel structures emerged. In the early transitional days, WB politics was not the only in a mess, but national economies as well. The inward FDI that could have served as the engine of growth and competitiveness, strengthening the weak position of WB economies, according to CEEC example, and meeting the economic membership conditions as defined in the Copenhagen criteria, was limited.

From the 2000s onwards, the WB followed a more democratic agenda towards media, society, minorities, human rights, justice and institutions, reflecting their EU accession prospects. EU engaged in the WB states' vision to gain membership and introduced the "Europeanization, Eastern Style." The rationale of the EU external policy towards Balkans has been to introduce political and economic reforms and safeguard security and stability metamorphosing these post-conflict counties to full-fledged EU member states. EU has always been interested in the region due to its

significant geopolitical interest. However, the unresolved legacies of the 1990s, the slow pace of implementation of structural reforms and the financial and European debt crises delayed the integration of the six WB economies.

Lately, EU formally reenergized enlargement process by setting a new deadline of 2025 mainly due to the presence of other powers in the region that managed to increase their sphere of influence, such as Russia, Turkey and China and due to the pressure of Brexit. The delayed WB-EU enlargement creates a geopolitical vacuum that generates fears of destabilization of the region, which in turn can cross onto the EU. EU already wounded, would not be able to cope with a new crisis in its backyards. Since, WB – EU accession process is a two-way relationship, EU launches a new strategy for accelerating the new enlargement but demands in turn from the WB economies to meet truly the membership conditions. However, the WB countries have had difficulty making such commitments and spurring growth since there are critical parts of their economies that are still uncompetitive with excessive political interference and an underdeveloped private sector. There is considerable variation regarding the level of democratic consolidation and commitment to the rule of law over time in conjunction with social and economic welfare, within WB countries as well as between them.

Consequently, the WB is still lagging to their peers in the EU11 and the other emerging-market regions, in attracting FDI. To this end, the EU provides substantial funding through the Instrument for Pre-Accession Assistance (IPA). This regional IPA may be the starting point for change in WB's investments policy. IPA's focus is on developing investment opportunities, where economies can provide comparative advantages through their value chains. The prospects of the region's EU accession are once again an opportunity for restoring investors' confidence and supporting the building of a strong image as an investment destination. The higher the FDI flows region receives, the greater the export capacity and the upraise of the value chain. In turn, this would enhance the per capita income convergence with EU member states. The crucial point for the WB countries is to get rid of their previous differences and to cooperate supplementing each other. This policy will mitigate the complexities and risks of investing in the region, will create a broader integrated market and improve the region's visibility. At the 2017 Western Balkans Trieste Summit, the six WB

economies committed to working together for promoting economic cooperation and regional integration. The Multi-Annual Action Plan for Regional Economic Area in the Western Balkans (MAP REA) was established to support this commitment. If the WB countries follow the MAP REA reform agenda, then they will be aligned with EU and international best practices, and standards. In consequence, the region will be developed as an attractive destination for investment and commerce and succeed convergence with the EU.

The crucial role of the FDI in the European future of these economies is evident. Since the turbulent political environment in the WB peninsula determined its history as well as its route after the end of the Cold War, this thesis' analysis chooses to discover the inward FDI – political system nexus by incorporating in the empirical analysis (please see Chapter 4) the political determinants that identified in the literature review (please see Chapter 2). Consequently, both theoretical analysis and empirical results will provide useful conclusions and policy recommendations for the development of the region as an FDI destination.

The following chapter presents the research's empirical analysis.

Chapter 4. Empirical Analysis: Political System, Political Determinants and inward FDI in WB countries.

4.1 Introduction

The main question to be examined is whether the host country's political regime determines the level of inward FDI flows. Ideally, the literature on FDI would have concluded to an empirical specification for the role of the political system on FDI inflows. Though, the spectrum of empirical conclusions is so varied and conditional that their universal validity shrinks to specific cases. The literature review in Chapter two outlines the contradictory and ambiguous findings of empirical studies on the role of the host country's political system in variations of inward FDI. To this context, the literature review concludes that it is preferable to focus on, beyond the political regime, and to specific factors of political surroundings as well. These are individual variables that contribute to the institutional stability and credibility of a regime, and as such foster country's growth of FDI. Consequently, the empirical research model of this dissertation will also examine the impact of each of these determinants on FDI inflows. Therefore, the empirical analysis of political regime - inward FDI nexus in the six WB economies would be based on the analysis of their political landscape as it shaped by their political system and individual political variables consistent with the extant literature.

The rest of the chapter is organized as follows: Section two provides the variables description and data, while section three specifies the empirical model. Section four presents the empirical results and concludes.

4.2 Variables Description and Data

Dependent Variables

There are different measures of FDI in the literature, the two most used is the net FDI inflows as a percentage of GDP (Ali et al., 2010; Asiedu and Lien, 2011; Bastiaens, 2016; Biglaiser and DeRouen, 2006; Biglaiser and Staats, 2010; Blanton and Blanton, 2006, 2007, 2009; Büthe and Milner, 2008; Choi and Samy, 2008; Jensen,

2003; Melo and Quinn, 2015; Méon and Sekkat, 2005; Rodríguez-Pose and Cols, 2017; Rosendorff and Shin, 2012; Staats and Biglaiser, 2012) and the natural log of net FDI inflows (Blanton and Blanton, 2012; Jakobsen and de Soysa, 2006; Mengistu and Adhikary, 2011; Moon, 2015; Salacuse and Sullivan, 2005; Tintin, 2013; Uddin et al., 2019). Li (2009b) notes that the net FDI inflows as a percentage of GDP and net FDI inflows are not conceptually equivalent. The net FDI inflows as a percentage of GDP captures the relative importance of FDI inflows to a country's economy, while net FDI inflows is an indicator of the amount of level of FDI inflows a country attracts (Li, 2009b, p. 174).

FDI net inflows include those investments that acquire a lasting management interest of 10 per cent or more of voting stock, in an enterprise operating in an economy other than that of the investor (Li and Resnick, 2003, p. 188). 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 measure of FDI represents the amount of FDI that flows into a country net of divestment in the period (Li, 2009b, p. 174). The measurement of FDI in these studies was on the previous editions of guidelines for FDI data in which the directional principle prevailed.

Studies used the net FDI inflows as a percentage of GDP as the main dependent variable cannot draw correct conclusions about the impact of democracy on the amount of inward FDI (Li, 2009b, p. 180). The logarithm measure is considered to reduce the effects of outliers and is less problematic than using a proportional index to measure FDI (that is, using FDI as a percentage of GDP as the key-dependent variable) (Blanton and Blanton, 2012; Li, 2009b; Nieman and Thies, 2019). Li and Resnick (2003) answering the question "Does increased democracy promote or jeopardize FDI inflows to less-developed countries?", Jakobsen and de Soysa (2006) examining "if democracy actually increases FDI", and Moon (2015, 2019) explaining "different FDI inflows among autocracies" considered logged net FDI inflows more appropriate to be used in their empirical model. Therefore, this analysis addressing the question of whether the host country's political system defines the level of inward FDI uses as the main dependent variable the measurement of FDI as the natural log of net FDI inflows.

To this point, we will refer to the significant changes in the presentation of FDI that occurred in late years, and most of the empirical studies of the literature review (please see Chapter 2), are referred to the previous framework of the FDI statistics. In particular, from 2014 onwards, many countries implemented the new guidelines for the compilation of FDI data based on the Sixth edition of the Balance of Payments and International Investment Position Manual (BPM6) and the Fourth edition of OECD Benchmark Definition of Foreign Direct Investment (BD4) (OECD, 2015; UNCTADstat, 2020a). BPM6 and BD4 introduced the presentation of FDI on an asset/liability basis in contrast to the directional principle that the previous editions of these guidelines recommended (OECD, 2015; UNCTADstat, 2020a).

Referring to the asset/liability basis, direct investment statistics (financial and income flows and positions) are organized according to whether the direct investment transaction and position relate to an asset or a liability for the reporting country (OECD, 2015; UNCTADstat, 2020a). Whilst, the directional principle classifies the financial and income flows and positions according to the direction of the investment of the reporting country, that is either inward or outward (OECD, 2015; UNCTADstat, 2020).

The purpose of the analysis indicates which of the two measures is best to use. The asset/liability basis is appropriate for macroeconomic analysis, such as the impact on the Balance of Payments, while the directional principle for examining the motivations and impacts of FDI and as such it is used by policymakers and governments to formulate investment policies (OECD, 2015; UNCTADstat, 2020a). Hence, for this analysis's purpose, the FDI data used are according to the directional principle under BPM6 and gathered from the FDI database of the Vienna Institute for International Economic Studies (WIIW). The WIIW database provides data for the 23 countries in Central, East and Southeast Europe. The inward FDI of non-residents in the reporting country is on a net basis. Net basis reflects the gross investment minus disinvestment, meaning that, FDI inflows can take a negative sign. FDI inflows comprise the equity and reinvestment of earnings from 2008 and debt instruments from 1999. The reporting principle in the WIIW FDI database is to cover FDI by the directional principle (based on BPM6). The value of FDI inflows is on EUR calculated from USD until 1995 (wiiw, 2020).

Independent variables

The literature review (please see Chapter 2) identifies as key individual variables having an impact on the level of inward FDI the property-rights protection, the signing of Bilateral Investment Treaties (BITs), human rights, and governance. The latter includes six dimensions, as analyzed by Kaufmann et al. (1999) these are, Voice and Accountability, Political Stability and Absence of Violence/Terrorism, Government Effectiveness, Regulatory Quality, Rule of Law, and Control of Corruption. Kaufmann et al. (1999) analysis' produced the Worldwide Governance Indicators (WGI) project that has been covering over two hundred countries and territories since 1996, reporting aggregate and individual governance indicators for the six dimensions of governance (Kaufmann et al., 2011; Kaufmann and Kraay, 2019; WGI, 2019).

This empirical analysis includes as independent variables a regime variable, the signing of BITs, voice and accountability, political stability and absence of violence/terrorism, government effectiveness, regulatory quality, the rule of law, and control of corruption. The property rights protection is not examined as an independent variable since the data source for its measurement is included in the rule of law indicator (Kaufmann and Kraay, 2019). BITs, the most common and primary legal agreements protecting foreign investors, are strongly related to the protection of property rights. BITs are designed to reduce the risk of state-led expropriation (Kerner, 2009, p. 76). Since the data source for BITs is distinguished and not included in another variable, we choose to use BITs, instead of property rights, as an independent variable in our empirical model. Data on BITs is available from a listing published by UNCTAD International Investment Agreements Navigator that documents the parties to every BIT, the date of signature, and the date of entry into force. The count of BITs by the country for the examined period is based on the reporting dates during that period.

Furthermore, due to data limitations for the six economies of WB, human rights as a political determinant is not included in our empirical model. Besides, the dimension of governance, voice and accountability measures perceptions of the extent to which the state respect the freedoms of the citizens. On this basis it is constructed by data sources comprising individual indexes, some of which are the human rights, political rights, civil liberties, electoral process, freedom of press,

expression, and association, and democratic accountability. To this context, for human rights, we may have useful conclusions through the examination of voice and accountability. Regarding the regime variable, the indicator of the level of liberal democracy is considered. Finally, to improve the explanatory power of the model and at the same time to decrease possibilities of omitted variable problems, the market size and the rate of growth of each WB country are incorporated as control variables due to their widespread use in extant studies.

Regime Variable: Liberal Democracy Index

In order to determine whether regime type affects FDI, we use the V-Dem dataset to operationalize democracy. Most of the studies in the literature review used other indices since V-Dem's first dataset released just in 2016. V-Dem is a new approach to conceptualization and measurement of democracy based on a multidimensional and disaggregated dataset. Since 2016, the V-Dem institute has expanded its database, achieving in 2020 to contain some 28 million data points covering 202 political units over the period 1789–2019, more than 470 indicators, and numerous indices constructed from these indicators, about democracy and various other aspects of political life (V-Dem, 2020). The V-Dem project distinguishes between five high-level principles of democracy: electoral, liberal, participatory, deliberative, and egalitarian, and collects data to measure these principles.

We choose the Liberal Democracy Index (LDI) to measure the effectiveness of the regime type on inward FDI. The liberal model is concerned with the use of political power by the government, and it judges the quality of democracy by the limits placed on government (V-Dem, 2020). Besides the liberal aspects of democracy, the LDI also captures the electoral aspects of democracy, where several institutional features guarantee free and fair elections (Lührmann et al., 2020, p. 32). The country's LDI rating will define its political system's classification. Following the Regimes of the World (RoW) typology, the country can be classified into the four regime-types, closed autocracies, electoral autocracies, electoral democracies, and liberal democracies (Morgan et al., 2019, p. 5). Any substantial and significant decline in V-Dem's LDI reflects either a democratic regression or an autocratic one. While, any substantial and significant improvement on the LDI scale depicts either liberalization in

autocracies or deepening in democracies (Lührmann et al., 2020, p. 11). The change is considered substantial if the absolute value of the change on the LDI is greater than 0.05. The transition countries of our model over their post-socialist period experienced this kind of change. Since the LDI captures country's transition into another political system through the years, adjust its classification, respectively.

Through the literature review, the host country's political system emerged as a controversial factor. Some autocracies and hybrid regimes have been more appealing to foreign investors than some democracies at comparable development levels (Zheng, 2011). Some autocracies turned to be more flexible in adopting and implementing new market-friendly policies despite any opposition of domestic actors, and they have even successfully managed the volatility of their macroeconomic environment (Madani and Nobakht, 2014). Thus, those autocracies, competing democracies, developed as host countries to FDI. On the opposite, a significant number of academics are strongly supporting the argument that democracies receive more FDI than autocracies (Ahlquist, 2006; Busse, 2004; Choi, 2009; Feng, 2001; Harms and Ursprung, 2002; Jakobsen and de Soysa, 2006; Jensen, 2003, 2008a, 2008b; Kerner, 2014; Olson, 1993). Finally, some like Oneal (1994) and Biglaiser and DeRouen (2006) argue that regime type is simply not the case in explaining the variations of inflows of FDI into host countries. Regime type is not significant though it is positively related to FDI (Biglaiser and DeRouen, 2006, p. 64).

The signing of Bilateral Investment Treaties (BITs)

BITs evolved as the international standard governing FDI (Jandhyala et al., 2011, p. 1047). These International Investment Agreements (IIAs) between two sovereign countries have as purpose to attract FDI in the capital importing country by establishing a broad set of investors rights of the capital-exporting country based on which, investors can sue the recipient states in an international tribunal in any case of these rights' violation (Kerner, 2009, p. 53). To this extent, the conclusion of BITs considers enabling the investment decision – making the process of MNEs due to guarantees provided for international law's protection and other risks' prevention (Egger and Pfaffermayr, 2004). Tobin and Rose-Ackerman (2005) argue for a complex interaction between the level of political risk, BITs, and FDI and question the strong

positive impact of BITs on FDI in the case of a host country with high political risk. Nevertheless, most of the empirical studies are supportive to the positive relationship between BITs and FDI (Bastiaens, 2016; Berger et al., 2011; Büthe and Milner, 2008; Grosse and Trevino, 2005; Jandhyala et al., 2011; Kerner, 2009; Neumayer and Spess, 2005; Rosendorff and Shin, 2012; Salacuse and Sullivan, 2005). This variable is expected to hold a positive sign.

Governance

This indicator refers (i) to the process of selection, monitoring and replacement of governments, (ii) to the effectiveness of government to set up and implement sound policies and (iii) to the respect from the side of citizens and state for the institutions that govern economic and social interactions among them (WGI, 2019). The governance consists of six dimensions, that are Voice and Accountability, Political Stability and Absence of Violence/Terrorism, Government Effectiveness, Regulatory Quality, Rule of Law, and Control of Corruption as defined by Kaufmann et al. (1999) for the World Bank (WGI project). The six indices have become very popular among researchers as there are available for an extensive sample of countries and provide a reliable assessment of the six dimensions of the institutional framework (Mengistu and Adhikary, 2011; Méon and Sekkat, 2007). This clustering of institutional indicators into different dimensions allows us to study whether some dimensions of governance matter more for the decisions of foreign investors to invest in a specific region, while others do not. The aggregate indicators are based on several hundred individual underlying variables, taken from a wide variety of existing data sources. The data provided for the years 1996-2018 reflect the views on governance of survey respondents like institutes, think tanks, non-governmental organizations, international organizations, and private sector firms worldwide (WGI, 2019). The estimate of governance ranges from approximately -2.5 (weak) to 2.5 (strong) performance. The description of the following sub indicators is according to the definitions produced by the WGI (2019).

(i) ***Control of Corruption*** measures perceptions of the extent to which public power is exercised for private gain, comprising both low and high forms of

corruption, as well as "capture" of the state by elites and private interests (WGI, 2019). Corruption produces bottlenecks, raises uncertainty, and increases costs (Habib and Zurawicki, 2002, p. 292). Control of corruption is essential in attracting foreign investors (Bailey, 2018; Bitzenis, 2006; Busse and Hefeker, 2007; Gani, 2007; Hellman et al., 2002; Javorcik and Wei, 2009; Li et al., 2017; Mengistu and Adhikary, 2011; Méon and Sekkat, 2005; Rodríguez-Pose and Cols, 2017; Shah and Afridi, 2015; Smarzynska and Wei, 2001). Melo and Quinn (2015) stress out a complex relation between FDI and corruption in the sense that corruption may positively influence inward FDI only in major oil producer-host country. Egger and Winner (2005) and Bellos and Subasat (2012) find control of corruption to influence negatively FDI inflows, which supports a helping hand interpretation. Finally, Cleeve (2012) and Shan et al. (2018) results' reveal an insignificant relationship between corruption and FDI. In this analysis, it is expected to be positively related to inward FDI.

(ii) ***Rule of Law*** *is the variable that* measures perceptions of the extent to which agents have confidence and conform to the rules of society, particularly as they relate to contract enforcement, property rights, the police and courts, and the likelihood of crime and violence (WGI, 2019). The rule of law measures perceptions on the effectiveness and predictability of the judiciary, as well as contracts' enforceability. An improved rule of law act as a stimulus to FDI inflows (Bailey, 2018; Cleeve, 2012; Gani, 2007; Mengistu and Adhikary, 2011; Méon and Sekkat, 2005; Rodríguez-Pose and Cols, 2017; Shah and Afridi, 2015; Staats and Biglaiser, 2012; Touchton, 2015) and is expected to hold a positive sign.

(iii) ***Voice and Accountability*****:** This dimension of Quality of Governance measures perceptions of the extent to which a country's citizens can participate in their government selection, as well as freedom of expression, freedom of association, and free media (WGI, 2019). Besides the variables in the aspects of political participation, it comprises individual variables covering crucial aspects such as human rights, respect for the rights and freedoms of minorities (ethnic, religious, linguistic, immigrants), freedom

to leave the country, freedom of entry for foreigners, freedom of movement for nationals around the world, degree of transparency in public procurement and reliability of state. Busse and Hefeker (2007), Cleeve (2012), and Shan et al., (2018) agree that an increase in the country's voice and accountability may raise the amount of inward FDI flows. It is expected to be positive.

(iv) ***Political Stability and Absence of Violence/Terrorism*** measures perceptions of the likelihood that the government will be destabilized by unconstitutional or violent means, including politically motivated violence and terrorism (WGI, 2019). The political stability enhances the host country's legitimacy and increases its attractiveness to MNEs, while political instability generates just the opposite effect by creating an unpredictable environment (Bailey, 2018, p. 140). Empirical evidence for its positive association with inward FDI is found across the literature (Bailey, 2018; Busse and Hefeker, 2007; Gani, 2007; Li et al., 2017; Mengistu and Adhikary, 2011; Rodríguez-Pose and Cols, 2017; Shah and Afridi, 2015; Uddin et al., 2019). It is expected to be positive.

(v) ***Government Effectiveness*** measures perceptions of the quality of public and civil services, and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government commitment to such policies (WGI, 2019). An effective government provides to civilians the best quality services and a life free from political pressures. Concerning MNEs, government effectiveness facilitates their operation due to guarantees for not an unexpected change in policies' implementation (Shah and Afridi, 2015, p. 40) and less bureaucratic procedures. A positive association with inward FDI is expected (Busse and Hefeker, 2007; Daude and Stein, 2007; Gani, 2007; Mengistu and Adhikary, 2011; Rodríguez-Pose and Cols, 2017; Shah and Afridi, 2015).

(vi) ***Regulatory quality*** measures perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development. Regulatory quality is the

dimension of governance that measures the country's market-friendly policies, like the lifting price controls or inadequate bank supervision and other efforts to lessen excessive regulation in areas of foreign trade and business development. Its degree determines how likely foreign investors are to receive their expected benefits. Indeed, the regulatory intrusion into market enterprise activities can enhance corruption and larger informal activities that are against the interest of foreign investors. To this line, most studies are supportive of the positive relation of regulatory quality to FDI inflows (Busse and Hefeker, 2007; Daude and Stein, 2007; Gani, 2007; Mengistu and Adhikary, 2011; Shah and Afridi, 2015; Uddin et al., 2019). Hence, a positive sign is expected.

Market Size

The market size is the most used determinant of FDI. Large markets are more likely to attract FDI based on an expected stream of future returns (Blanton and Blanton, 2007; Gani, 2007; Li and Resnick, 2003; Mengistu and Adhikary, 2011; Zheng, 2011). Market size is measured by using GDP, and the unit used is US dollars taken from the World Bank's World Development Indicators (Asiedu and Lien, 2011; Jakobsen and de Soysa, 2006; Li and Resnick, 2003; Shan et al., 2018). Market size is expected to have a positive impact on FDI inflows.

Growth

Economic growth is related to the increase of inward FDI flows. Fast-growing economies usually attract foreign investors for taking advantage of future market opportunities (Busse, 2004; Gani, 2007; Jakobsen and de Soysa, 2006; Jensen, 2003; Li and Resnick, 2003). Growth is measured by using the annual percentage growth rate of GDP taken from the World Bank's World Development Indicators. Growth is expected to have a positive impact on FDI inflows.

4.3 Model Specification

This empirical analysis uses a panel dataset of the variables of interest for a period from 1996 to 2018, across the six transition economies of WB. However, due to missing observations over some years, our panel data set becomes unbalanced. Table 4.1 presents a short description of the variables included in the empirical model, their coding, and sources of data.

Table 4 1 - Variables description and Coding

Variables	Description	Code	Source of Data
Dependent Variable			
FDI inflows	The natural log of net FDI inflows	*lnfdi*	wiiw-FDI database
Independent Variables			
1. LDI	The aggregate index that describes features of democracy at the highest level	*ldi*	V-Dem Dataset (V.10)
2. The signing of Bilateral Investment Treaties (BITs)	The conclusion of an IIA between two countries for the promotion and protection of FDI	*bit*	UNCTAD-International Investment Agreements Navigator
3. Governance Indicators	A set of traditions and institutions by which authority in a country is exercised.		
3a *Voice and Accountability*	The dimension of Quality and Governance	*voice*	Worldwide Governance Indicators (WGI)
3b. *Political Stability and Absence of Violence/Terrorism*	The dimension of Quality and Governance	*polstab*	
3c. *Government Effectiveness*	The dimension of Quality and Governance	*goveffe*	
3d. *Rule of Law*	The dimension of Quality and Governance	*rule*	
3e. *Control of Corruption*	The dimension of Quality and Governance	*cc*	
3f. *Regulatory Quality*	The dimension of Quality and Governance	*regq*	
Controlling-non governance indicators			
4. Growth	Annual percentage growth rate of GDP	*gdp_growth*	

5. Market Size	GDP at constant 2010 prices in US dollars	*GDP*	World Bank-World Development Indicators database

Descriptive statistics for all variables by country are presented in Table 4.2. They include total observations available for the variables along with minimum, maximum, mean, and standard deviation for each of them.

Table 4 2 - Descriptive statistics by country

	Variable	Obs	Mean	Std.Dev.	Min	Max
ALBANIA	*lnfdi*	23	19.574	1.119	17.466	20.811
	ldi	23	0.424	0.053	0.330	0.500
	cc	20	-0.680	0.171	-1.030	-0.410
	rule	20	-0.582	0.195	-1.010	-0.330
	voice	20	0.019	0.218	-0.650	0.210
	polstab	20	-0.115	0.346	-0.540	0.490
	goveffe	20	-0.337	0.264	-0.760	0.110
	gdp_growth	23	0.045	0.044	-0.109	0.129
	GDP	23	2.265	0.313	1.663	2.678
	bit	23	1.000	1.000	0.000	3.000
	regq	20	0.011	0.257	-0.470	0.280
BOSNIA-HERZEGOVINA	*lnfdi*	21	19.506	0.629	17.902	21.008
	ldi	23	0.427	0.073	0.140	0.510
	cc	20	-0.368	0.096	-0.570	-0.240
	rule	20	-0.403	0.170	-0.660	-0.150
	voice	20	-0.030	0.140	-0.240	0.210
	polstab	20	-0.453	0.211	-0.820	0.020
	goveffe	20	-0.693	0.216	-1.190	-0.390
	gdp_growth	23	0.093	0.189	-0.030	0.890
	GDP	23	2.666	0.297	1.841	2.998
	bit	23	1.000	1.128	0.000	3.000
	regq	20	-0.308	0.266	-0.910	-0.030
KOSOVO	*lnfdi*	15	19.283	0.596	17.575	19.904
	ldi	19	0.308	0.061	0.150	0.380
	cc	17	-0.439	0.326	-0.730	0.390
	rule	17	-0.541	0.244	-0.850	-0.010
	voice	20	-0.402	0.406	-1.700	-0.120
	polstab	11	-0.396	0.667	-1.040	1.010
	goveffe	13	-0.398	0.091	-0.580	-0.200
	gdp_growth	18	0.050	0.058	-0.007	0.270
	GDP	19	1.700	0.233	1.181	2.038

	bit	23	0.000	0.000	0.000	0.000
	regq	12	-0.093	0.125	-0.300	0.110
MONTENEGRO	*lnfdi*	17	19.614	0.922	17.595	20.818
	ldi	20	0.380	0.022	0.340	0.410
	cc	19	-0.174	0.211	-0.460	0.520
	rule	19	-0.039	0.235	-0.780	0.340
	voice	19	0.086	0.233	-0.590	0.260
	polstab	13	0.360	0.293	-0.060	0.820
	goveffe	14	0.089	0.149	-0.220	0.350
	gdp_growth	21	0.026	0.042	-0.094	0.086
	GDP	22	1.332	0.179	1.066	1.635
	bit	23	1.000	1.128	0.000	3.000
	regq	14	0.028	0.200	-0.330	0.360
NORTH MACEDONIA	*lnfdi*	17	19.203	0.596	18.162	20.236
	ldi	23	0.399	0.072	0.280	0.520
	cc	20	-0.333	0.229	-0.800	-0.020
	rule	20	-0.318	0.135	-0.570	-0.050
	voice	20	-0.063	0.178	-0.390	0.280
	polstab	20	-0.525	0.332	-1.160	0.260
	goveffe	20	-0.176	0.273	-0.750	0.140
	gdp_growth	23	0.027	0.022	-0.031	0.065
	GDP	23	2.122	0.201	1.814	2.419
	bit	23	1.696	1.964	0.000	6.000
	regq	20	0.149	0.287	-0.350	0.520
SERBIA	*lnfdi*	19	20.987	1.045	17.844	21.990
	ldi	23	0.403	0.133	0.180	0.540
	cc	20	-0.491	0.324	-1.200	-0.230
	rule	20	-0.558	0.389	-1.270	-0.120
	voice	20	-0.019	0.441	-1.220	0.340
	polstab	20	-0.480	0.597	-2.140	0.240
	goveffe	20	-0.244	0.361	-1.060	0.190
	gdp_growth	23	0.032	0.047	-0.122	0.102
	GDP	23	3.573	0.236	3.168	3.873
	bit	23	2.043	2.078	0.000	7.000
	regq	20	-0.279	0.334	-0.860	0.160

Notes:

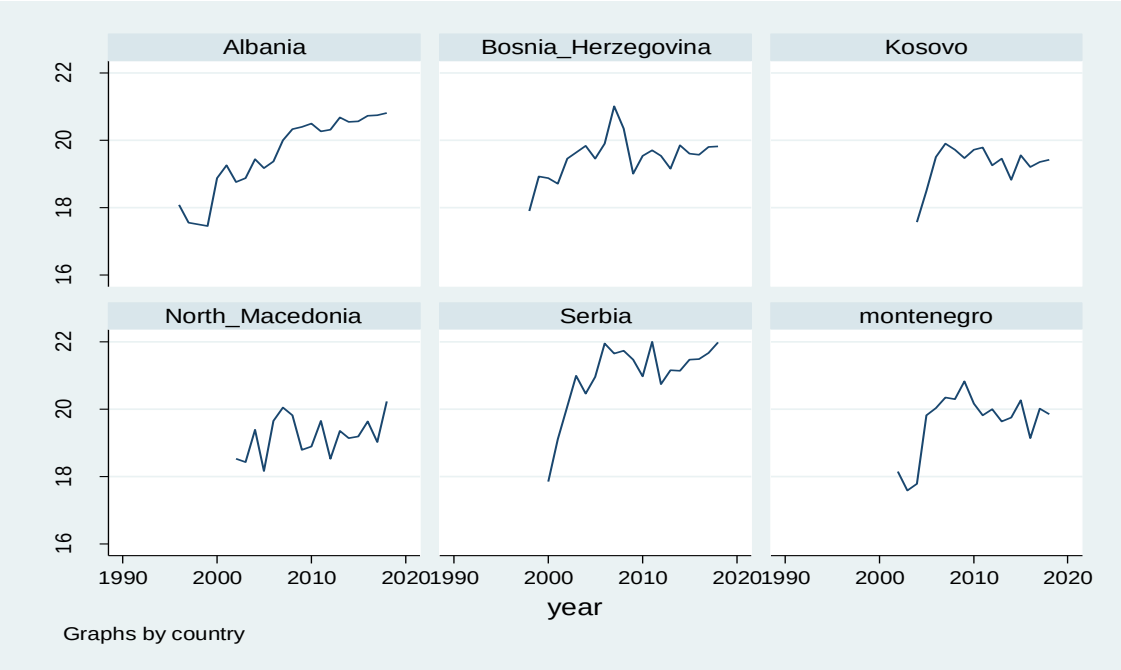
(1) The variable FDI in our data set is always positive, so there is no problem with missing observations because of the log transformation.

(2) The variable of GDP has quite different orders of magnitude, so a simple technique to deal with scale issues is to simply divide by a specific number (usually by a power of 10). Additionally, if we take their natural log, the variable is getting onto a scale close to whole units of the dataset and make coefficients more interpretable as well. Hence, in this analysis, the ln*GDP* variable is used as the log of GDP.10^{-9}.

Figure 4.1 depicts the time series (1996-2018) of the empirical model's variables for the six WB countries. Figure 1a, plots the dependent variable, Figures 1(b), (c), (d), (e), (f), (g), (h), (i) the independent variables while Figures 1(j), (k) the control variables against time. All the countries record the same tendencies with the exemption of Kosovo. Data for Kosovo is not available for the entire period and especially for the *bit* variable. Its limited statehood until now excludes Kosovo from official organizations' databases (e.g., UNCTAD). Finally, each country's chapter provides analysis consistent with variables performance.

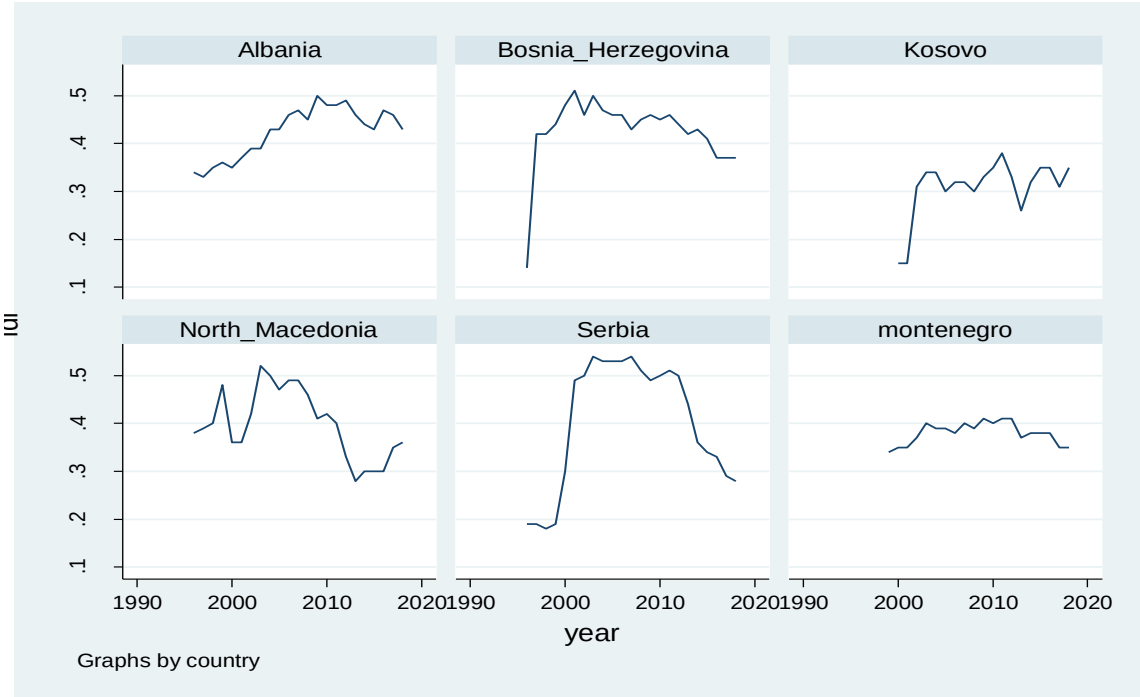
Figure 4 1 – Time series of the variables for the sample countries

(a) FDI net inflows (lnfdi) by country



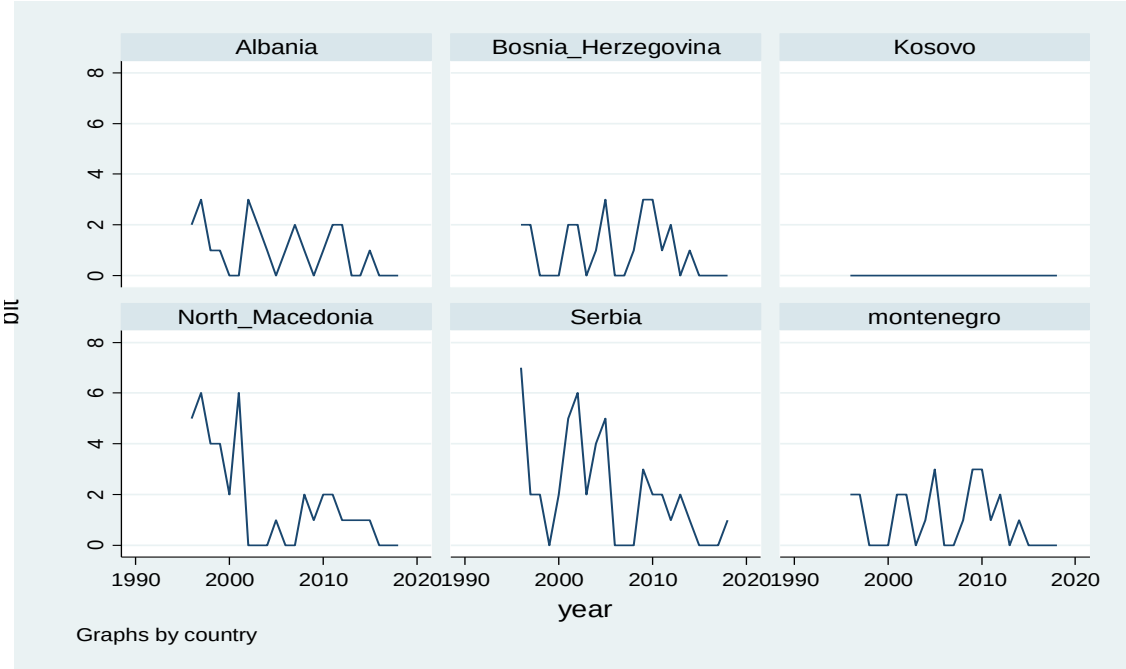
There is an upward trend of inward FDI through the examined period in all countries except Kosovo and Montenegro, where, since 2008, no noticeable trend has observed.

(b) Regime type by country



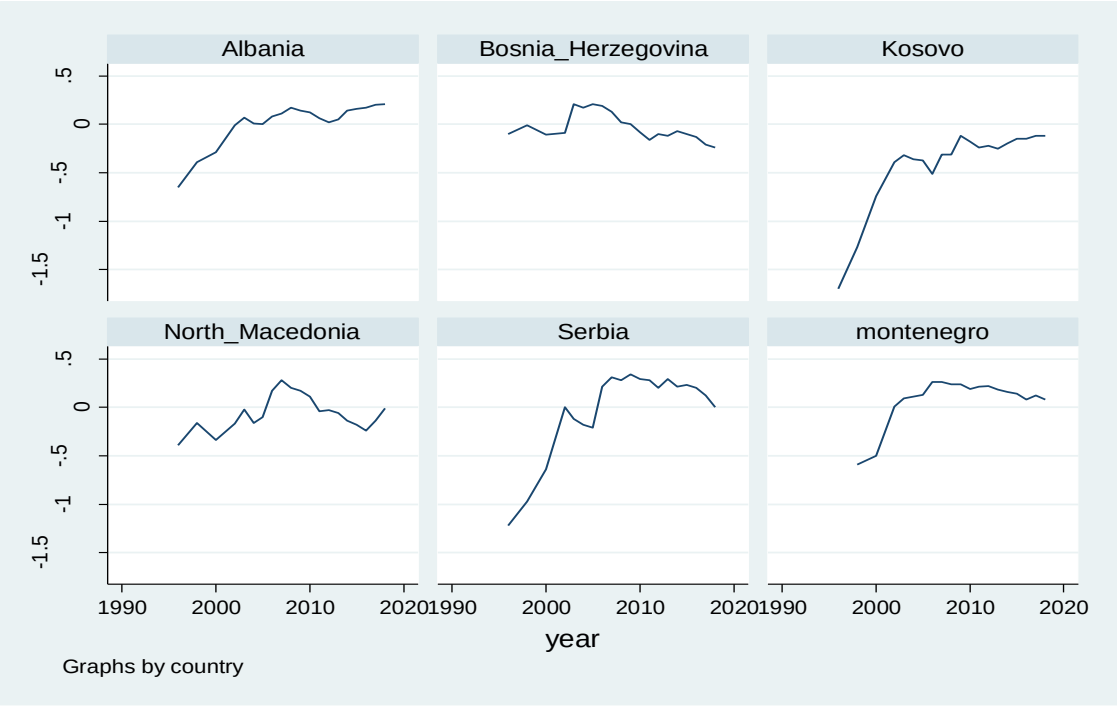
The LDI records democratic backslides in all countries with the more intense in Serbia, experiencing a democratic erosion since 2012 (please see Chapter 6 - Section 6.3).

(c) The signing of BITs by country



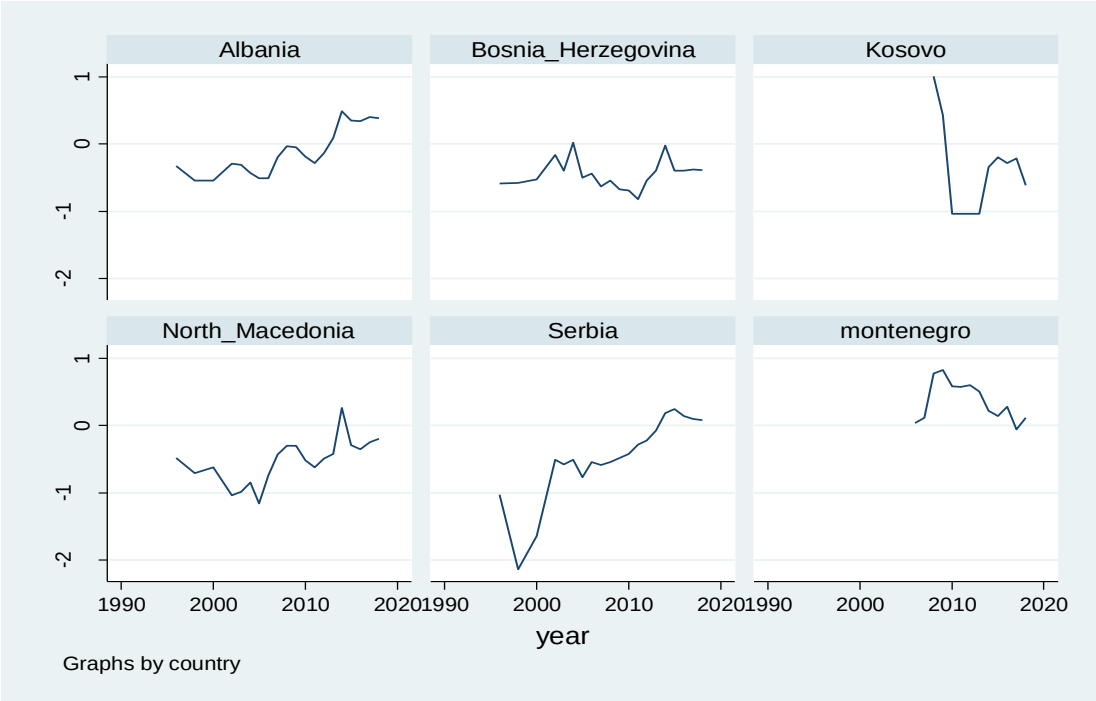
The rate of WB's engagement in BITs fell substantially over the examined period. Especially since 2015, only Serbia entered into a new BIT.

(d) Voice and accountability by country



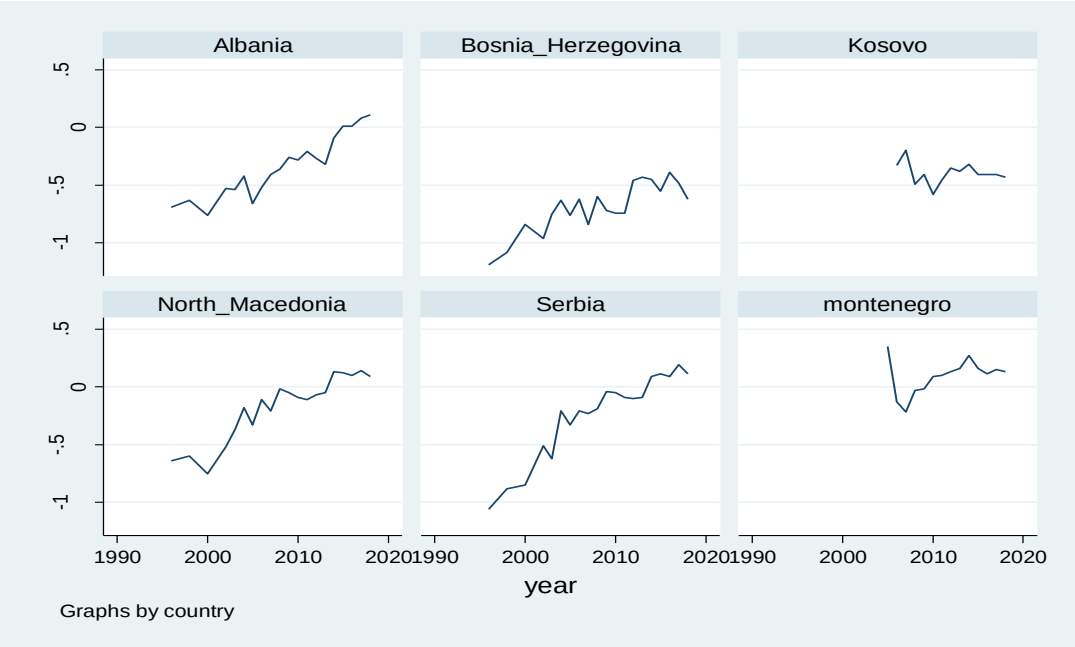
This variable holds low performance in all countries. Among them, Albania has the best performance, while Bosnia and Herzegovina the worst.

(e) Political stability by country



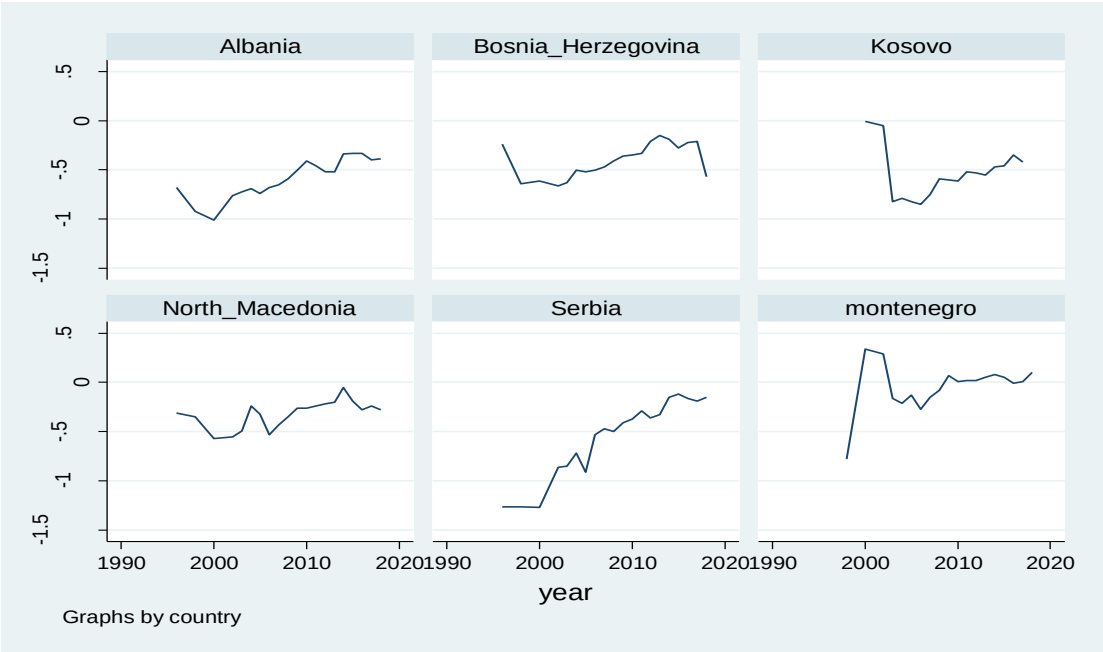
Countries' graphs depict the high levels of political instability in the WB region through time.

(f) Government Effectiveness by country



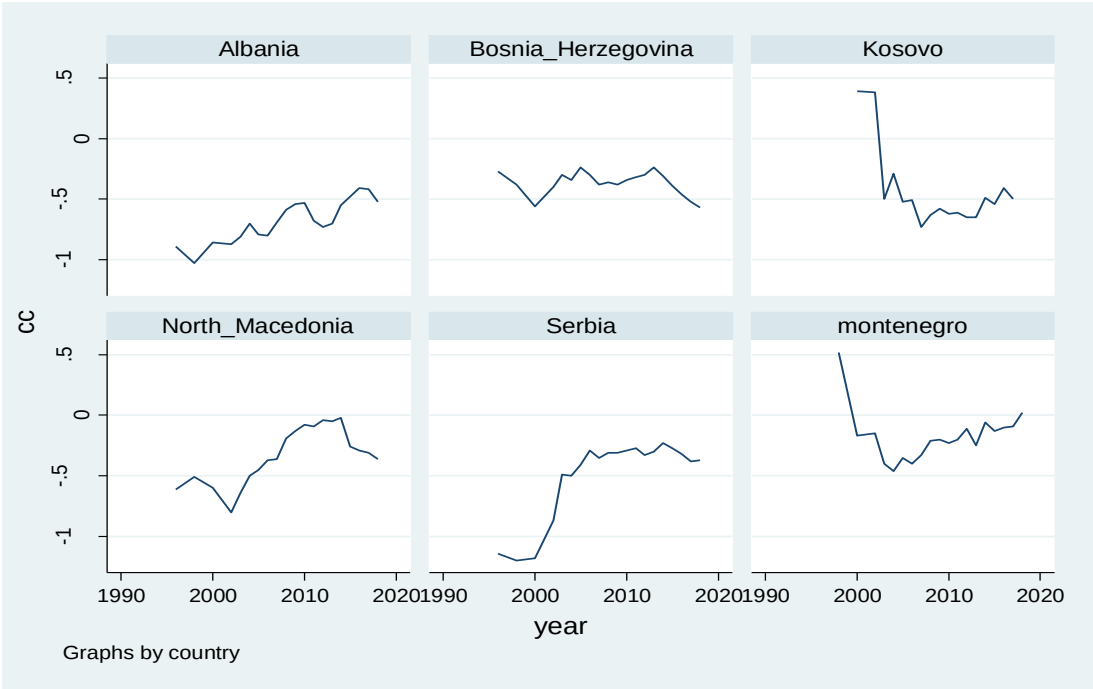
There is an upward trend in this variable in all countries. Reforms implemented in each country contributed to improved performance; however, there are many more to be done.

(g) The rule of law by country



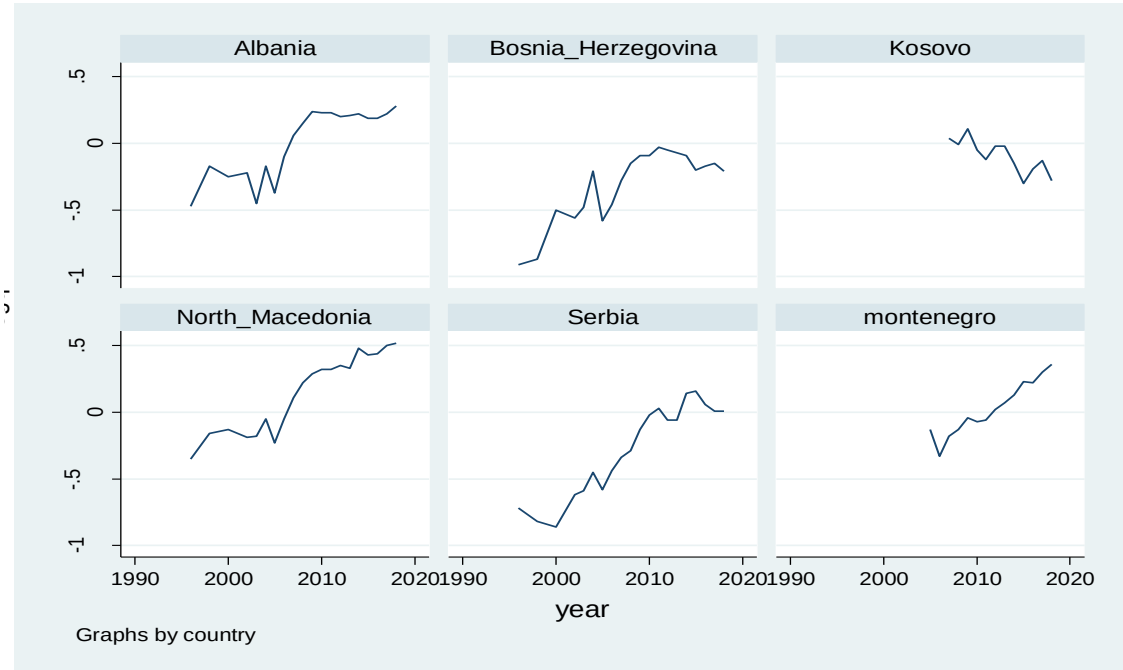
Reforms on the rule of law contributed to the improved score of this variable in all countries, though there are many more to be done to retain the increasing rate and achieve better performance.

(h) The control of corruption by country



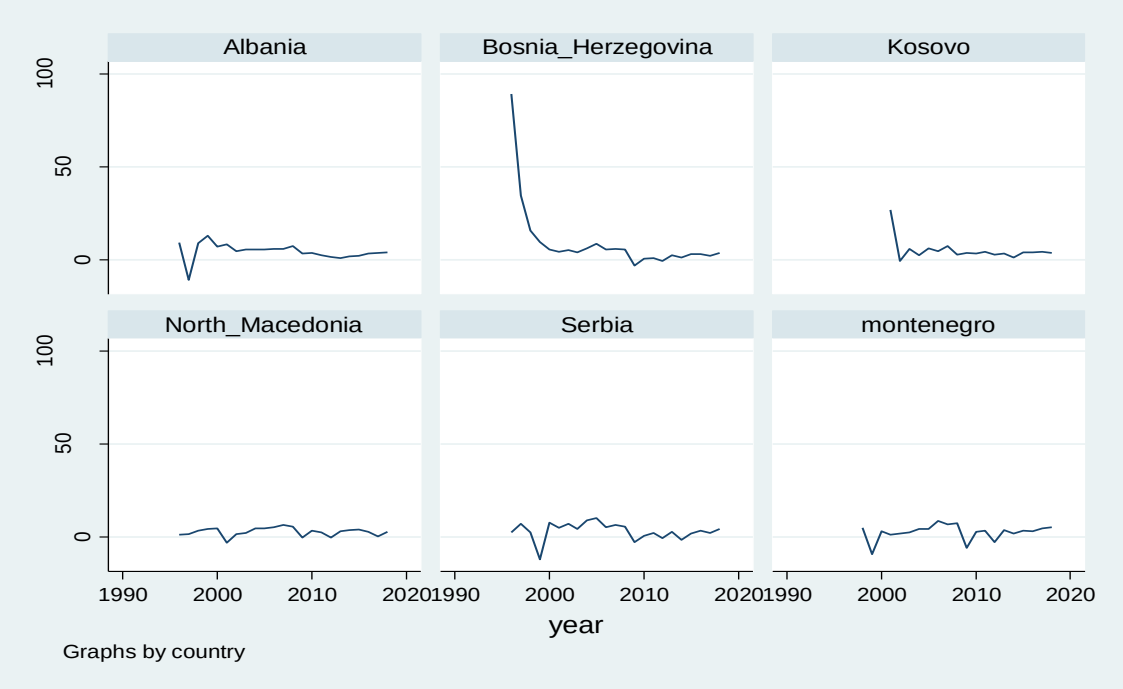
The upward trend reflects each country's effort to reduce corruption over the examined period. Nevertheless, intensified efforts required to improve the variable's performance.

(i) The regulatory quality by country



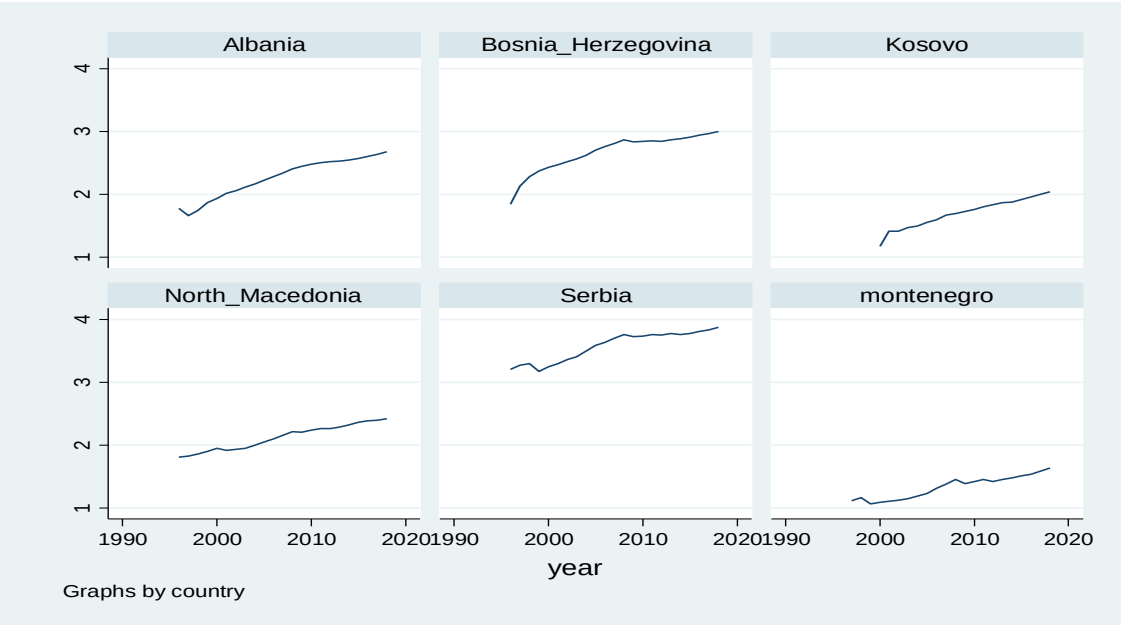
With Kosovo's exemption, all the rest economies are making substantial improvements in regulatory quality.

(j) Growth by country



All the WB countries record the same level of growth.

(k) Market size by country



All the countries experience an increase in their market size over the post-socialist period.

For this analysis' purposes, we proceed to the estimation of the model below:

$$y_{it} = x'_{it}\beta + u_{it} \qquad (4.1)$$

with $X'X' = \{$ *LDI, cc , rule, voice, polstab, regq, goveffe, bit, GDP_growth, GDP, time, country dummies* $\}$

and y: the dependent variable represented by the log of *fdi (lnfdi).* We have used a log transformation of the dependent variable to eliminate any heteroscedasticity problems as well as to reduce the influence of potential outliers of those observations where the errors satisfy the equation:

$$u_{it} = \rho_i u_{i,t-1} + \varepsilon_{it}$$

Since our panel data has few cross-sectional units related to time series length, then the cross-section effects can be incorporated into independent variables as dummy-variable regressors. Concerning time-specific effects, rather than trying to deal with these in ways analogous for the short panel, we take advantage of the natural ordering of time and include in the model a linear trend in time.

Hence, we focus on the above model where the repressors x_{it} include an intercept, the time variable, and a set of specific dummies to allow the intercepts to differ by country. Like other studies (Busse and Hefeker, 2007; Jensen, 2003), we have lagged by one year all the independent variables (except the time trend variable) to strengthen the hypothesized causal effect.

Table 4.3 shows statistics for the pooled sample. The variables of logged net FDI inflows (*lnfdi),* LDI *(ldi)* and market size (*lnGDP)* do not record significant variations over the study's period holding low Coefficient of Variation (CV). The average *lnfdi* is 19.712 varies from a minimum value of 17.466 to about 21.990 with the coefficient of variation (CV) of 5.25 per cent. The mean of *ldi* is 0.393 varies from 0.140 to 0.540, with CV of 21.63 per cent, while the mean of control variable *lnGDP* is 2.301 varies from 1.066 to 3.873, with CV of 33.07 per cent. These minimum average fluctuations indicate that the three variables exhibit similar characteristics across the six WB under study.

Table 4 3 - Sample Summary Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
lnfdi	116	19.712	1.035	17.466	21.990
ldi	131	0.393	0.085	0.140	0.540
cc	116	-0.415	0.280	-1.200	0.520
rule	116	-0.406	0.303	-1.270	0.340
voice	119	-0.069	0.327	-1.700	0.340
polstab	104	-0.299	0.503	-2.140	1.010
goveffe	107	-0.308	0.339	-1.190	0.350
gdp_growth	131	0.046	0.090	-0.122	0.890
GDP	133	2.301	0.7609	1.066	3.873
bit	138	1.123	1.516	0.000	7.000
regq	106	-0.087	0.311	-0.910	0.520

Table 4.4 presents the pairwise correlations matrix, providing an approximation of the relationship between inward FDI with the other variables in the model.

Table 4 4 - Pairwise correlations of the variables

	lnfdi	$ldi_{(t-1)}$	$cc_{(t-1)}$	$rule_{(t-1)}$	$voice_{(t-1)}$	$polstab_{(t-1)}$	$goveffe_{(t-1)}$	$bit_{(t-1)}$	$regq_{(t-1)}$	$gdp\_growth_{(t-1)}$	*lnGDP*
lnfdi	1.000										
$ldi_{(t-1)}$	0.364	1.000									
$cc_{(t-1)}$	0.234	-0.005	1.000								
$rule_{(t-1)}$	0.121	-0.217	0.794	1.000							
$voice_{(t-1)}$	0.598	0.437	0.520	0.444	1.000						
$polstab_{(t-1)}$	0.271	-0.168	0.359	0.539	0.443	1.000					
$goveffe_{(t-1)}$	0.365	-0.174	0.556	0.701	0.456	0.522	1.000				
$bit_{(t-1)}$	0.118	0.319	-0.054	-0.208	0.002	-0.069	-0.080	1.000			
$regq_{(t-1)}$	0.010	-0.288	0.421	0.601	0.209	0.386	0.707	-0.231	1.000		
$gdp\_growth_{(t-1)}$	-0.120	0.094	-0.337	-0.521	-0.194	-0.241	-0.407	-0.010	-0.536	1.000	
GDP	0.613	0.389	0.039	-0.198	0.180	-0.229	-0.049	0.244	-0.188	-0.069	1.000

The problem of multicollinearity does not significantly affect our estimates, considering that the pairwise correlations of the independent variables found up to 80 per cent (one at 79.4 per cent and the others below 71 per cent). Hence, multicollinearity is not a problem for the estimation results, and this study's regressions include these variables. Finally, we use the pooled feasible generalized least square estimations of this model under the following assumptions about the error term:

We consider that, within panels, there is first-order autocorrelation and that the coefficient of the AR(1) process is specific to each panel. So we use an estimator that calculates panel-corrected standard error (PCSE) estimates for linear cross-sectional time series models where the parameters are estimated by Prais–Winsten regression (Prais and Winsten, 1954). According to this method, $y_{it} - \hat{\rho} y_{i,t-1}$ is regressed on $x_{it} - \hat{\rho} x_{i,t-1}$ for *t>1* whereas for the first observation (*t=1*), $\sqrt{1-\hat{\rho}^2} y_{i,1}$ is regressed on $\sqrt{1-\hat{\rho}^2} x_{i,1}$ (Greene, 2003, pp. 273-276,360). Hence, the Prais-Winsten method maintains the first observation, that is an important advantage for small samples.

Moreover, we assume that the disturbances are, by default, heteroskedastic and contemporaneously correlated across panels. Overall, to deal with the problem of heteroscedasticity, we followed the procedure below (Greene, 2003; Wooldridge, 2006). STATA 14.2 is used for the estimations.

1. We estimated the model (4.1) with OLS and calculated the residuals u_{it}
2. Then by regressing $log(\widehat{u_{it}^2})$ on x'_{it} we obtain the fitted values , let it be $\widehat{g_{it}}$: $\widehat{g_{it}} = \widehat{log(u_t^2)}$
3. We obtained the estimates of $\hat{h}_{it}$: $\hat{h}_{it}=exp(\widehat{g_{it}})$
4. Finally, we estimate the following transformed model by the aforementioned Prais-Winsten method : $\frac{y_{it}}{h_{it}} = \frac{b_0}{h_{it}} + b_1 \frac{x_{it,1}}{h_{it}} + .. + b_n \frac{x_{it,n}}{h_{it}} + error_{it}$

   All standard errors of the equation with transformed data are asymptotically valid (Wooldridge, 2006, p. 441).

4.4 Empirical Results – Conclusions

The empirical results of the model based on Prais-Winstein estimation methods indicate that the explanatory variables, voice, and accountability *(voice),* political stability **and absence of violence/terrorism** *(pol_stab), the* rule of law *(rule),* regulatory quality *(regq)*, as well as the control variable market size *(lnGDP)* are significantly associated with inward FDI (Table 4.5).

Table 4 5 - Estimations of the model

Dependent Variable : *lnfdi*

	Coef.	Std. Err.	z	P>z	[95% Conf.	Interval]
ldi(t-1)	0.744	1.131	0.660	0.511	-1.473	2.960
cc(t-1)	-0.116	0.459	-0.250	0.800	-1.015	0.783
rule(t-1)	-1.081	0.455	-2.370	0.018	-1.973	-0.188
voice(t-1)	0.956	0.376	2.540	0.011	0.218	1.694
polstab(t-1)	0.365	0.162	2.250	0.025	0.047	0.683
goveffe(t-1)	0.559	0.671	0.830	0.404	-0.755	1.874
bit(t-1)	-0.052	0.041	-1.270	0.204	-0.132	0.028
regq(t-1)	-0.956	0.396	-2.420	0.016	-1.731	-0.180
gdp_growth(t-1)	0.005	0.020	0.230	0.819	-0.035	0.045
GDP	3.906	0.815	4.790	0.000	2.308	5.504
time	-0.034	0.038	-0.890	0.376	-0.108	0.041
Country dummies						
Bosnia_Herzegovina	-1.619	0.383	-4.230	0.000	-2.369	-0.869
Kosovo	1.896	0.536	3.540	0.000	0.846	2.947
North_Macedonia	0.500	0.287	1.750	0.081	-0.061	1.062
Serbia	-3.982	1.088	-3.660	0.000	-6.114	-1.849
Montenegro	3.779	0.823	4.590	0.000	2.165	5.393
cons	10.50299	1.425635	7.37	0.000	7.709	13.297

At this point, we should mention that the results below are presented shortly since the following chapters (5-9) include further discussion adjusted to each country theoretical analysis. Each chapter responds to each WB country with the exemption of Serbia and Montenegro, both included in one chapter. Consequently, policy recommendations will be adjusted to each country's analysis.

- The coefficient of *voice* is found positive and statistically significant at 95% CI (p-value: 0.011). This positive link confirms the literature findings that improvements in this government dimension can stimulate FDI inflows.

- The coefficient of *pol_stab* is found positive and statistically significant at 95% CI (p-value: 0.025). This positive link confirms the literature findings that the political stability of host countries is essential for fostering the confidence of foreign economic agents in undertaking long-term investment in the recipient markets.
- The coefficients of *rule* and *regq* are found negative and statistically significant at 95% CI (p-value: 0.018 and p-value: 0.016, respectively). The negative link of the *rule* is not consistent with literature findings, which support the positive relationship between the rule of law and the inward FDI flows. Although the possibilities for *regq* of being positive were high, the case of the negative sign was not ruled out. The reasoning of these variables' negative sign may be found in the behavior of foreign agents who have invested in WB to benefit from the low standards of governance in those countries. These are investors that have the expertise of coping with the weak rule of law and low regulatory quality and generate substantial gains. Hence, a high level of these governance dimensions may constrain their activities.
- The coefficient of *ldi* is found positive and not statistically significant at any CI (p-value: 0.511). Since the literature review includes many conflicting results concerning the impact of political regime on FDI inflows, the positive sign of the regime variable is consistent with the argument that more democratic regimes are appealing to foreign investors. However, the role of this factor is not vital in affecting the level of FDI inflows.
- The coefficient of *cc* is found positive and not statistically significant at any CI (p-value: 0.800). The variable has an expected positive impact on FDI inflows that is justified through many empirical studies though not significant. There are also arguments for the insignificance of the specific relationship through the literature. This result may imply that foreign investors are feeling more confident in investing in a less corrupted system; however, the prospect of corruption is not so frightening to them.
- The coefficient of *goveffe* is found positive and not statistically significant at any CI (p-value: 0.404). Although the positive association expected, the insignificant no.

- The coefficient of *bit* is found negative and not statistically significant at any CI (p-value: 0.204). This negative and insignificant link was unexpected. However, a possible explanation may be the level of political risk in the countries of the sample based on Tobin and Rose-Ackerman's (2005) argument (see above section of independent variables).
- The coefficient of *GDP* is found positive and statistically significant at 95% CI (p-value: 0.00). The larger the market size of a host country in WB, the more considerable the amount of FDI flows will receive. The result is consistent with the literature findings.
- The coefficient of *gdp_growth* is found positive and not statistically significant at any CI (p-value: 0.819). Although the positive association expected, the insignificant no. Though few studies have pointed out that control variables like growth rate may also be insignificant, depending on the specification of the FDI model (mergers and acquisitions vs. greenfield investments) (Busse, 2004, p. 50). If the FDI type of mergers and acquisitions prevails in a host country, then insignificance is attributed to its no direct contribution to the economic growth (Mencinger, 2003, pp. 499–500).

The empirical findings suggest that MNEs investing in WB transition economies are looking for a hospitable investment climate that political stability, along with voice and accountability, can generate, whether their political systems are democratic or not. A host country with a more liberal regime, which fights corruption and improves government effectiveness, may influence in a second rate MNEs investment decisions. Finally, these MNEs have the experience to overcome the obstacles that a poor rule of law and low regulatory quality create and use them for their benefit.

Chapter 5. The transitional economy of Albania as a host country for FDI.

5.1 Introduction

Albania was under a centrally administered socialism rule of governance for almost half a century (1944-1992). Albania experienced the most oppressive, isolated and under-performing political system in Eastern Europe (Kajsiu, 2016, p. 283). The idealisation of national self-reliance cut off the country from outside influences and information (Jarvis, 2000, p. 2). Albania was the windbreaker against the winds of change that were blowing across Eastern Europe in the late 1980s. As such, Albania became the last of the six WB countries to enter the transition from communism and central economy to democracy and a free-market economy. This process proved to be for the country tough, demanding, burdensome, and endless.

One of the main priorities of Albania has been to attract FDI to serve sustainable economic growth, accelerating the transition process, and accomplishing the EU accession criteria. However, the country through the transition process did not develop as an attractive investment destination, affected by deficiencies in terms of institutional weakness, informal economy, infrastructure, and network problems, weak property rights protection, political instability with distorted democratisation, corruption and organised crime (Bajrovic and Satter, 2014; Jarvis, 2000; Pearce, 2008). Given such a context, it is crucial to examine, if and to what extent, Albania's political landscape have influenced FDI inflows.

Therefore, serving the purpose of this dissertation of identifying the role of the political system in variations of country's inward FDI (please see Chapter 2 - section 2.1) this chapter along with the theoretical analysis uses the results of the empirical model (please see Chapter 4) to answer whether Albania's political regime determines the level of inward FDI flows.

It is essential to identify which of the political variables that the literature review (please see Chapter 2) outlined has the greatest impact on FDI flows that Albania receives. Despite any data limitations, our results hold important implications for the country's potential to be established as an investment destination. Empirical

results will indicate alternatives to the heated debate political regime – FDI nexus through hypotheses about the relative influence of established determinants in Albania's political surroundings, such as the dimensions of governance as constructed by Kaufmann et al. (1999) for the World Bank (known as WGI project). The theoretical analysis of Albania's political landscape in the transition period and the country's FDI performance is built on official analytical reports, and published research and policy studies.

The chapter is structured as follows: Section two addresses the main issues in Albania's transition process by chronological order. Section three presents the establishment of the country's political system over the post-socialist period, while section four provides an overview of inward FDI in Albania. Section five presents and discusses the empirical results. Finally, the sixth section summarises the key findings providing recommendations.

5.2 Albania: A Country in Transition

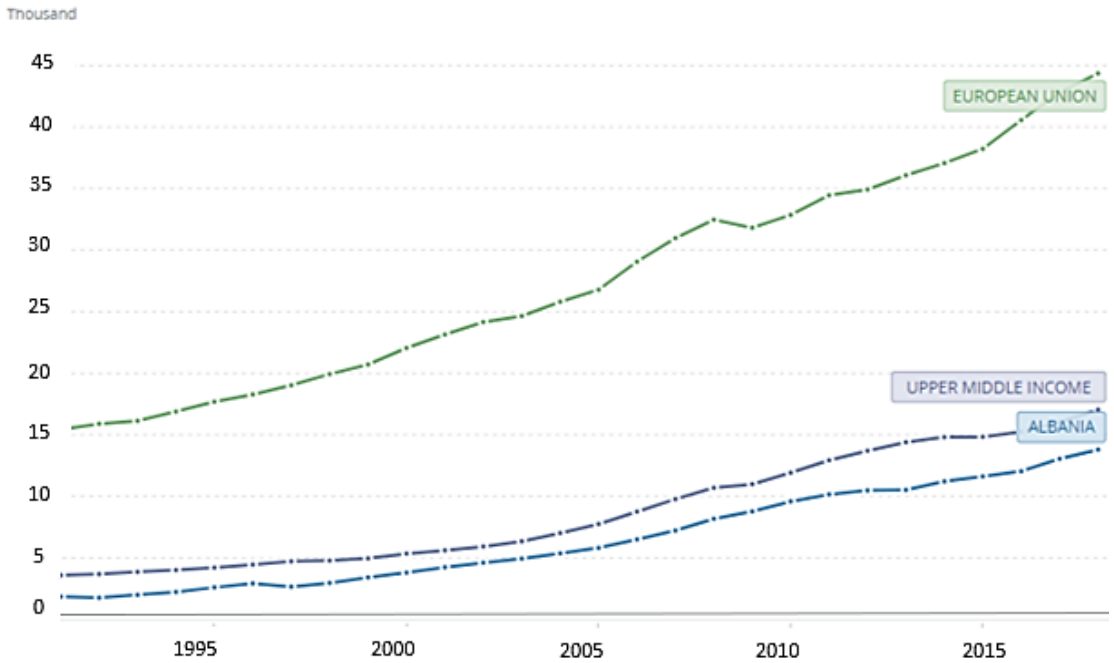
During the 1990s' the wind of change that blew in rest of Eastern Europe overtook Albania, the last of SEE countries that engaged to political pluralism starting the transition process from a centralised administered economy to the institutional arrangements of a free market economy (Alexiou and Toro, 2006; Kolodko, 2000; Pulaj and Kume, 2013). A centralised administered economy is characterised by initial conditions such as the prevalence of state property, central control of the entire economy and the discouragement of non-material incentives (Marangos, 2018, p. 49) The government of Albania (GoA) like the other governments in transition economies, neither had the mandate nor desired to reimpose state direction of the economy and politics (Marangos, 2006, p. 149). The citizens felt contented about the regime change and full of hopes for the country's near future, accepted the free-market ideology entered into the new era with "euphoria" (Bodgani and Loughlin, 2007, p. 37).

The transition to a market economy in the Central Eastern and South-Eastern Europe (CESEE) as well as in the former Soviet Union (FSU) followed the shock therapy model of transition (Marangos, 2004, 2005a, 2006, 2007, 2011). This model required the rapid implementation of the price liberalisation, privatisation, establishment of an independent central bank, achievement of a balanced budget, the introduction of free

trade and establishment of a fully convertible flexible currency (Marangos, 2005a, p. 70). The results would be the free market, free enterprise economy, full employment, stability and growth (Marangos, 2004, p. 222).

When Albania engaged in the transitional period, it was Europe's poorest country, measured as GDP per capita at purchasing power parity (PPP) (Kaser, 2006, p. 1). The low GDP per capita (please see figure 5.1) placed the country in the African category of low- income countries (Elbasani, 2004, p. 33).

Figure 5 1 - Albania GDP per capita PPP (current international$), aggregates comparison, for the period 1991-2018



Source: Adapted from Word Bank database - international-comparison-program-(icp) World Bank (World Bank, 2020a) (www.worldbank.org/en/programs/icp)

The country had experienced the severest post-socialist production decline in Eastern Europe outside the war-torn former Yugoslavia. The primary production sector dismantled, the infrastructures ruined, and as in all the former centrally planned economies, the Albanian economy suffered from macroeconomic distortions (Kaser, 2006, p. 5). The output fell by half between 1989-1992, and inflation climbed to triple digits from 36 per cent in 1992 to 193 per cent in 1993 (Jarvis, 2000; Kaser, 2006). Consequently, in 1991 Albania joined the IMF, pursuing a stabilisation programme for closing the "two gaps" the fiscal and the external and in 1993 accorded a Structural Adjustment Facility (SAF1) for the period 1993-1995 (Kaser, 2006, p. 5).

IMF, World Bank, and the European Bank for Reconstruction and Development (EBRD) became by then the primary financial resources of Albania. In 1997, IMF provided a Post-Conflict Emergency Facility and then an Enhanced Structural Adjustment Facility for 1998-2001. Meanwhile, it re-designated a Poverty Reduction and Growth Facility (PGRF1) in 1999, followed by PGRF2 in mid-2001 for the period 2002-2005 (Kaser, 2006, p. 5). Between 1993 and 1995, the country improved its macroeconomic performance. In particular, controls loosened, early privatisation schemes in agriculture, retail trade and small and medium-sized enterprises implemented, and financial discipline at the budgetary and state enterprise levels went better (Jarvis, 2000, p. 2).

The devotees of neoliberalism described Albania's performance at that time as a success story since it had achieved growth rates similar to those of East-Asian countries for four successive years (Kajsiu, 2010, p. 239). However, the increased economic indicators like GDP's growth (please see figure 5.2) were mostly enhanced by emigration and remittances, which reflected the 20 per cent of the country's GDP in the years 1994-95 (Kajsiu, 2010, pp. 239–240). The 1996 growth rates were supported by "the firms", implying the semi-formal financial pyramid schemes, that gathered the savings of the citizens by offering interest rates as high as 100 per cent a month (Kajsiu, 2010, p. 240).

Figure 5 2 - Albania GDP growth annual (%), for the period 1991-2018

Source: Adapted from World Development Indicators (World Bank, 2020b)

The main argument for the transition process has been the introduction of the market economy would improve competitiveness and efficiency (Kolodko, 2000, p. 3). Financial reforms announced, targeting at the monitoring of inflation, restricting the budget deficit, solving the foreign debt problem and creating a two-tier banking system (Bezemer, 2001, p. 4). The broad conviction was that a country's economy after a short period of transitional contraction, and the establishment of the new market liberated system, would achieve recovery and faster growth rates (Capolupo, 2012; Kolodko, 2000). This argument proved inconsequent to the case of Albania. The transitional recession lasted longer than expected. During the first period, particularly in the mid-1990s, structural problems re-emerged in critical areas like the banking sector, where the informal credit market originated at the time that the transition process began (Jarvis, 2000, p. 3). Bank of Albania implemented restrictive monetary and fiscal policies to succeed in the objectives of the financial reforms, such as the decline in official credit expansion, in government expenditures and in broad money relative to GDP. However, these strict policies limited the establishment of formal financial intermediaries while facilitated the increase of informal financial activities (Bezemer, 2001, p. 4). Surprisingly, the economic authorities did not deem the informal financial sector as a problematical. To this framework, the Ponzi or pyramids schemes emerged offering savers attractive interest rates between 30 and 50 per cent monthly over the 8 per cent that regularly the formal financial sector offered (Bezemer, 2001, p. 5). Also, a smuggling trade of oil and other goods have been flourishing in the country through the period of UN sanctions against the Socialist Federal Republic of Yugoslavia (SFRY).

Albanian economy destabilised due to outbursts of devastating events, such as the 1997 spectacular collapse of the financial pyramid schemes causing a social and political crisis and the 1999 Kosovo conflict that provoked disorder in the WB region (Capolupo, 2012; Jarvis, 2000; Kaser, 2006). Albania confronted intense political, economic, and social challenges. The magnitude of the pyramid schemes' scandal was unprecedented compared to the size of the economy since, at the pyramid schemes' peak, their nominal value liabilities accounted for the half of 1996 country's GDP (Bajrovic and Satter, 2014; Jarvis, 2000). The scandal reflected the irregularities of the formal financial system, the inefficiency of the legal framework, the corruption in the

public sector, the lack of transparency and accountability, the fragile political environment, and the organised crime (Jarvis, 2000; Pearce, 2008). The official corruption and the Mafia-style crime were incompatible with the establishment of a free-market economy (Marangos, 2005b, p. 396). In the banking sector, three state-owned banks, unreliable as intermediaries of savings, but holding over the 90 per cent of deposits dominated, while the private banks were emerging, interested mostly in trade financing (Jarvis, 2000, p. 3). Enterprises involved in pyramid schemes had been laundering money for the Italian Mafia (Jarvis, 2000, p. 13).

The collapse of the pyramid schemes provoked the sudden breakdown of the Albanian economy, which was viewed by IMF as a result of Albanians mistaken notion of capitalism (Bezemer, 2001, p. 2). However, the improvements achieved in macroeconomic variables at the peak time of pyramids schemes, that of inflation, unemployment, GDP, budget deficit and exchange rates, praised by the IMF and World Bank. GDP measured in the basis of investment and income, instead of real production, following the methodology employed by IMF and World Bank (Bezemer, 2001, p. 13). Hence, this accounting perspective was misleading to the real macroeconomic performance of Albania.

After the uncovering of the scandal, political instability and strikes, high prices and low wages, high unemployment, and poverty, followed, racking the country severely (Pulaj and Kume, 2013, p. 297). The spread of violent riots led to the fall of the government, to anarchy, and the death of 2.000 citizens provoking the outburst of civil war (Jarvis, 2000, p. 1). The country faced even the mass emigration of Albanian's to neighbours' countries of Italy and Greece. From 1990 up to 1996, almost half a million Albanians (the majority of them young) of the three million country's population left their country (Kajsiu, 2010, p. 237). "Disillusionment" followed the "euphoria" that had prevailed at the beginning of the transition process. This period describes the transition stage in which unrest had taken place, and any hopes for the rise of employment and living standards had faded (Bodgani and Loughlin, 2007, p. 37). Furthermore, the political, social and economic chaos gave birth to the "nostalgia syndrome" especially for the elderly, feeling frustrated from the high costs of transition and the adjustment to unknown policies, recalled the past as a period of settled security (Bodgani and Loughlin, 2007, p. 37).

In the period followed, several reforms and regulations ran to prevent the country from the repetition of "shadow" schemes phenomena but proved insufficient since more than 50 per cent of the country's economy continued to rely on the informal sector (Pearce, 2008, p. 148). The country subsequently recovered, and the economy re-energised, but bribery, inefficiency, outflows of migration, and corruption remained (Pearce, 2008, p. 148). In 2000, the EU commenced negotiations for a Stabilisation and Association Agreement (SAA) with Albania. The new transition phase for Albania has started with high aspirations. Albania's EU integration entered as a matter of high priority. Besides Albania, in geographical terms has always been part of the European continent. Albanian governments showing off their European intentions concluded free trade agreements (FTAs) with the neighbouring countries, sometimes even at the expense of their interests (Kajsiu, 2010, p. 242). In the years followed, the progress toward the EU was slow and eventually halted in 2005. It was the outcome of reforms' bad implementation and expanded corruption. Albania had succeeded only in joining the NATO in 2009.

Up to the outburst of the global financial crisis, Albania had achieved economic progress that introduced the country to the group of middle-income countries. This progress reduced poverty, as from 2002 up to 2008, the poverty rate declined from 25.4 per cent to 12.5 per cent (World Bank, 2015, p. 32). During the same period, an average increase of 5.5 per cent in the annual growth rate in GDP recorded (please see figure 5.2). Growth before 2008 was due to rising domestic consumption, propelled by a real estate boom on the coast, and by remittances reflecting the 10.8 per cent of GDP from high levels of out-migration (World Bank, 2015, p. 12). However, the crisis revealed that country's growth model was weak and had to change from consumption-fueled to investment and export-led growth (World Bank, 2020c). Between 2010 and 2015, the average annual GDP growth was 2.2 per cent, less than half of the pre-crisis period (European Commission, 2018b, p. 45) (please see figure 5.2). The slowdown in economic growth accompanied by fiscal indiscipline and reform suspension exposed severe macroeconomic imbalances such as speedy growth in public debt and arrears, shortfalls in the energy sector, and acceleration of non-performing loans in the banking sector (World Bank, 2015, p. 12). Although the annual GDP growth, accelerated to 3.8 per cent in 2017 (please see figure 5.2), and averaged

4.2 per cent in the first three quarters of 2018, the per capita GDP at purchasing power parity was only 29 per cent of the EU-28 average in 2017, making it difficult to succeed in the convergence's objective (European Commission, 2018a, p. 45). World Bank (2020c, p. 3) estimates that Albania will lose 1.4 per cent of GDP in 2020 due to measures taken to restrict the spread of COVID-19 especially in the fields of manufacturing, trade, tourism and other non-tradable services.

The country now is Europe's poorest performing economies, where the large informal economy, the bad governance, and high levels of corruption inhibit further its EU accession. The 2013 EU Assessment Report had defined that Albania would be granted candidate status only on the condition to fulfil the required political and economic reforms (USAID, 2018).

The latest report of the European Commission on Communication on EU Enlargement Policy (2019a, pp. 5–31) for the progress of Albania's reform Agenda, outlines regarding:

I. The political criteria, the ongoing strong polarisation in the political sphere. Its recommendations to the political parties concern mainly their re-engagement in the democratic institutions.
II. The Public Administration, the further advancements that need to take place to achieve efficiency, de-politicisation, and professionalism. An important issue is the simplification of administrative procedures.
III. The judicial system, the establishments of the new institutions for the self-governing of the judiciary. It represents a crucial step towards its independence, impartiality, professionalism, and accountability.
IV. The fight against corruption, progress on the adoption of the new Action Plan 2018-2020 for the implementation of Inter-sectoral Strategy to fight corruption. Also, amendments to the law on the Declaration & Audit of Assets, Law on Public Procurement, adoption of the Code of Conduct for Parliament members, and the establishment of Anti-corruption Task Force. However, further achievements are required since corruption is deeply rooted in many areas.
V. The fight against organised crime, it is established international police cooperation with EU Member states, resulting in effective extensive law

enforcement operations to tackle the production and trafficking of cannabis. This progress must continue along with the efforts in countering money laundering and confiscating assets originating from crimes and other unjustified wealth.

VI. The fundamental rights, that progress should be made on the consolidation of property rights, and the exercise of freedom of expression.

VII. Economic Criteria, the steady but low progress in developing a functioning market economy. The current account deficit narrowed, the high public debt-to-GDP ratio decreased although the pace of fiscal consolidation remained slow, the banking sector remained stable. The business environment is slightly better, but expectations for further improvement and rise of investments exist due to the implementation of comprehensive justice reform. Qualitative and effective institutions enforce the labour market. Nevertheless, the employment rate and labour market participation are still low, and the informal economy remains the foremost job provider. Concerning the Albanian economy's capacity to counter the competitive pressure and market forces within the EU and to achieve integration into international value chains, the inadequacy of productive know-how, the low education levels, and the technology transfers are main weaknesses.

The World Bank (2020c) reports that the Government of Albania is currently implementing structural reforms that will increase productivity and competitiveness in the economy, raise employment, improve governance, and public service delivery. For accomplishing faster growth, governmental new broad-based reform program focuses on regional connectivity, access to regional and global markets along with export and market diversification, macroeconomic and fiscal stability, financial sector stabilisation, energy concerns, and territorial administration. The new conditions enhance business confidence and domestic demand and encourage investments and exports (World Bank, 2020c). Although the country has to address the emergency and reconstruction responses to the COVID-19 pandemic and November 2019 earthquake, it must also be consistent with the new reform agenda, for attaining the expected

economic growth and accomplishing the EU membership status (World Bank, 2020c, p. 1).

In March 2020, the EU gave the green light to Albania and North Macedonia to begin their long-awaited accession talks. EU's decision reflects its intention to consolidate the relationship with WB further and to inhibit Russia and China to deepen their footprints in the region. However, the formal date for the commencement of formal talks is not announced and maybe take several years before the candidate merit a full membership.

5.3 The evolution of Political System over the post-communist period

Albania was part of the Ottoman Empire until the early 20th century, time that turned into an authoritarian monarchy. In the late 1920s entered into the sphere of influence of the Italian Dictator Mussolini's, and at the end of World War II, it became a centrally administered socialist country (Elbasani, 2004, p. 33). Albania pronounced itself as "the state of the dictatorship of the proletariat" and was one of the most repressive communist regimes around the world (Bodgani and Loughlin, 2007, p. 23). Like the other centrally administered socialist states, only one party, the "leading role party" had the monopoly of power (Marangos, 2018, p. 10), which is the Party Labour of Albania (PLA) known as the Communist Party (CP). The CP governed as a rigid Stalinist version of centrally administered socialist regimes, meaning society's total obedience to its rule, and extended control overall the levels of social, political, and economic life (Elbasani, 2004, p. 33). In particular, the regime forbade political and civic pluralism, democratic institutions, private sector activity and private property, and all religious institutions or even beliefs (Bodgani and Loughlin, 2007, p. 23). Country's socialist past is associated with a leader who ruled as a dictator until he died in 1985, named Enver Hoxha. He was responsible for turning Albania into the most isolated country in the world, maintaining only semi-formal relationships with few Latin-American and African Marxist-Leninist countries (Bodgani and Loughlin, 2007, p. 24). Even his successor Ramiz Alia, determined to prolong the regime as long as he could, resisted to any changes that Gorbachev at that time initiated in the Soviet Union and maintained the dictatorship of the proletariat until the 1989 Romanian revolution (Elbasani, 2004).

Albania had never experienced liberal democracy, and this lack of democratic culture was the origin of many future reforms during the transition process. The democratisation process in the transition countries and especially in Albania, was arduous (Pridham, 2000, p. 16). Besides, the country's inexperience in more democratic institutions, the democratisation by itself is a multi-stage and multidimensional process. Multi-stage refers to the collapse of the authoritarian or totalitarian rule during the transition phase and the consolidation until new democracies are set up, while multidimensional describes the functioning of the liberal democracies (Pridham, 2000, p. 17). Sometimes, the democratisation generates a type of regime that may be a different form of authoritarianism or a hybrid regime (Pridham, 2000, p. 17).

After the fall of centrally administered socialism, the Albanian mono-party system came to an end, and the country organised its first multiparty election in March 1991. The first opposition party, the Democratic Party (DP) expressing the "right" wing, established by a small group of intellectuals. This group consisted mostly of young people and students, proponents of a western European free market, of the protection of human rights, and a liberal democratic system. The motto " A return to Europe" was one of the great promises of this newly emerging opposition party in the early 1990s (Pearce, 2008, p. 149). Even though DP managed to garner the 38 per cent of votes, the CP was the one that won a ruling majority. By 1991, the Albanian society appeared divided into these two major antagonistic parties.

The reformed socialist government in June collapsed under the pressure of strikes, demonstrations and riots that threatened the economic viability of the country. An interim coalition government took the reins of the country in June 1991 until March 1992, signalling the official end of centrally administered socialist. The Democrats gained a clear majority and ruled the country until 1997. The DP created aspirations for establishing a democracy to the level of the "West". DP's leader Sali Berisha, a former member of the CP, became the first democratic president in Albania, (Elbasani, 2004, p. 34). The DP raised its flag to the war against communism by overemphasising the CP menace to democracy and freedom as threats against society (Kajsiu, 2010, p. 235). The country became more extroverted and started contacts with Western countries, especially the US. The Berisha government showing its obedience

to IMF undertook sweeping neoliberal reforms, in line with a shock therapy treatment of closing down factories and accelerating privatisation process (Kajsiu, 2010). However, Berisha ruled as an autocrat, and during his governance, the political interference in the judiciary was evident, as well as, the enforcement of organised crime (Elbasani, 2004, p. 34). Public demand for a new constitution expressed through a referendum held in 1994. The Albanian population comprehending the intentions of president Berisha and under their experience of 50 years totalitarianism, rejected any constitution that allowed excessive decision-making powers to the president (De Waal, 2007, p. 9). In 1996, despite the serious accusations of manipulating the results, the outcome of the general elections was in favour of DP (De Waal, 2007, p. 9).

In 1997, the collapse of the Ponzi or pyramid schemes provoked the collapse of the DP's government. The two-thirds of Albanians lost their savings in these schmes. The newly impoverished citizens filled the streets across the country protesting and denouncing the government's role in the affair (Bajrovic and Satter, 2014, p. 144).The government not only did not warn the investors about the dangers but also promoted the schemes through the frequent appearance of pyramid managers and government officials side by side at public events and television (Bezemer, 2001, p. 7). The Albanian state destabilised and anarchy prevailed for months until a multinational peacekeeping force intervened for ending the disorder (Bajrovic and Satter, 2014, p. 145). The associations of government with the pyramid schemes were clear even from the electoral period during which Berisha used the slogan "with us everybody wins" indicating, in reality, the profits one can get from schemes' high-interest rates (Kajsiu, 2010, p. 240). Hence, the first attempt for democracy has failed tremendously, and in the 1997 elections, the Socialist Party (SP) (former CP) came to power.

The SP governed from 1997 until 2005 seeking a market economy with a social direction. During its governance, SP proceeded in deepening neoliberal reforms that it had hugely criticised in the past. In 1998 a popular referendum ratified country's new constitution that is in effect up to now and established Albania as a parliamentary republic (KPMG, 2017, p. 11). The bi-polarisation existed, but in reality, the policy distance between the two major parties had almost vanished, and points of convergence recorded in the context of EU integration. Since then, the policy and historical differences between the two parties began to fade away (Kajsiu, 2016, p.

289). The SP formed an identity of “centre-left”, “modern” and “progressive” party with a European orientation.

The 2002 socialist government set as a priority the improvement of the legal framework and the business climate (Kajsiu, 2010, p. 240). This setting expressed the feelings of the SP elite, consisted of the communist regime’s privileged families with well-educated members and former directors of state-owned enterprises. The latter was the first to be benefited from the 1990-91 liberalisation policies and started their private companies at the expense of the state enterprises that they used to manage (Kajsiu, 2010, p. 241). In this context, the SP not only took distance from its centrally administered socialist past but fully embraced the neoliberal policies and worked closely with the World Bank and IMF (Kajsiu, 2010, p. 241). Thus, even an ex-CP supported Albania’s EU accession through the consolidation of democracy and establishment of a market economy. However, the SP proved to be unable to lead the country to the new European era. Socialists, like their predecessors, were regarded both at home and abroad as corrupt. Hence, in 2005 the SP lost the elections creating an institutional vacuum that lasted three months (Jano, 2008, p. 99). In 2006, the SP as an opposition party, elected for a new leader Edi Rama, an anti-communist intellectual who used successful rhetoric of change, political renewal and moved away from the past, to gain popularity. Edi Rama managed to be elected Prime minister in 2013, a position that holds until now due to his last win in the 2017 parliamentary elections.

From 1991 onwards, the Albanian political scene remained highly polarised, since the rule of governance has been sharing between the SP and the DP, unveiling country’s democratic deficiencies. Although in western societies, the two-party system is a sound basis for democracy, in the sense of governmental stability and adequate representation, in Albania produced just the opposite results (Jano, 2008). The two parties acted as authoritarian organisations, without distinct political identity and position, and limited to making promises with “catchy statements” such as joining the EU, fighting corruption, poverty alleviation, the rise of employment and many other reliefs without actually fulfilling them (Jano, 2008, p. 91). Since 1997, the between them ideological and political differences smoothened, allowing the two

parties gradually to build their power on institutional arrangements, clientelistic networks and polarisation of political discourses (Kajsiu, 2016, p. 290).

During the last three decades, both parties before every general election made changes to the electoral system for retaining their power. Although the multiparty system in Albania has been a better version of the mono-party totalitarian system, it inherited the authoritarian political culture, excluding real party competition, political dialogue or cooperation and share of power between legislative, executive and judicial institutions (Jano, 2008). The Albanian case proves that the establishment of a multiparty system does not necessarily generate democracy since the parties' elite and their political tradition determine the rules of democratic institutions. Consequently, Albania's regime is more a "hybrid" type with democratic institutions but still autocratic political behaviour and not a consolidated liberal democracy (Jano, 2008, p. 100).

The civil society of Albania is now in a political crisis. The Institute of Democracy and Mediation (IDM) (2019) expresses its concerns for the crisis consequences for Albanians' expectations for consolidation of the rule of law, democracy and development reforms – as well as country's EU accession. Freedom house rating for 2018 is 4.11 classifying Albania to the status of Partly Free (3.0 to 5.0), and as such, the country qualifies for electoral but not liberal democracy.

Freedom House publishes the most cited international regime categorisation; it creates an annual index of the state of political rights and civil liberties in different sovereign countries. Freedom House classifies countries into three categories, Free, Partly Free and Not Free according to whether the average of the political rights and civil liberties is 1.0 to 2.5 for "free", 3.0 to 5.0 for "partly free", or 5.5 to 7.0 for Not Free. Most Free countries considered as liberal democracies, while some Partly Free countries might qualify as electoral, but not liberal, democracies (Freedom House, 2019b). The 2018 ratings reflect the period January 1 through December 31, 2017.

Accordingly, to the Freedom House rating, the rating of Varieties of Democracy (V-DEM) project reflects the country's shortcomings in Liberal Democracy. V-DEM approach conceptualises and measures democracy using a multidimensional and disaggregated dataset. The V-Dem dataset, first released in 2016, now contains some 28 million data points covering 202 political units over the period 1789–2019. It

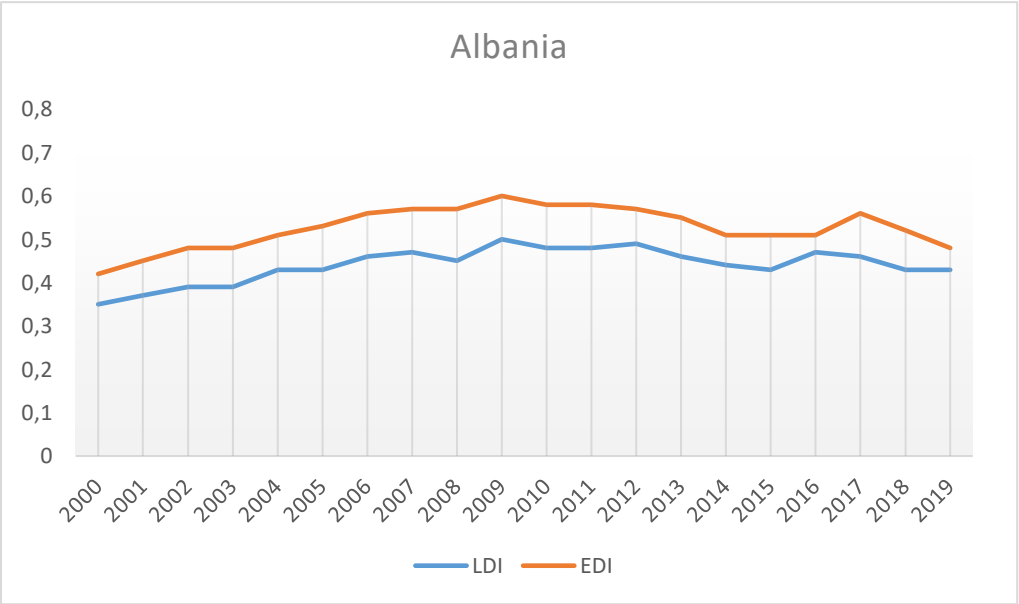
provides over 470 variables on democracy, human rights, governance, the rule of law, and corruption. The V-DEM project incorporates the complexity of the concept of democracy based on data to measure five high-level of democracy: electoral, liberal, participatory, deliberative, and egalitarian (V-Dem, 2020).

Albania was a liberal democracy in 2016 and downgraded to electoral democracy in 2017 (Morgan et al., 2019, p. 6). Figure 5.3 displays the country's V-Dem's Liberal Democracy Index (LDI) and V-Dem's Electoral Democracy Index (EDI) between 2008 to 2019, and its adverse regime transition (ART). An ART occurs when a country moves down the Regimes of the World (RoW) index from one year to the next in a two-year window, reflecting a decline in the democratic qualities of a country's political regime (Morgan et al., 2019, p. 2). For example, when a country goes form an electoral autocracy to a closed autocracy from one year to the next (Morgan et al., 2019, p. 5). Based on the RoW classification for being classified as an electoral democracy it requires just holding reasonably free and fair multiparty party elections and an average score on V - Dem's EDI above 0.5 (Lührmann, Mechkova, et al., 2018, p. 1327). This index classifies political regimes as either a closed autocracy, electoral autocracy, electoral democracy, or liberal democracy, considering the quality of a country's electoral institutions, its liberal characteristics, as well as the regime's record across various civil liberties indices (Morgan et al., 2019, p. 5).

Concerning the LDI, Varieties of Democracy (V-DEM) (2020) analysis based on that "the liberal principle of democracy emphasises the importance of protecting individual and minority rights against the tyranny of the state and the tyranny of the majority. The liberal model takes a "negative" view of political power insofar as it judges the quality of democracy by the limits placed on government. This is achieved by constitutionally protected civil liberties, the strong rule of law, an independent judiciary, and effective checks and balances that, together, limit the exercise of executive power". This index combines both the electoral and liberal principles of democracy and as such, includes the two main components of democracy. The first is the level of electoral democracy (EDI) and second is the liberal component index (LCI), harbouring on the liberal tradition. The liberal democracy scale runs on a continuous scale, from low to high (0-1), with higher values indicating a more democratic dispensation.

Accordingly for the EDI, the Varieties of Democracy (V-DEM) (2020) analysis based on that "The electoral principle of democracy seeks to embody the core value of making rulers responsive to citizens, achieved through electoral competition for the electorate's approval under circumstances when suffrage is extensive; political and civil society organisations can operate freely; elections are clean and not marred by fraud or systematic irregularities, and elections affect the composition of the chief executive of the country". Further, the electoral process must respect the freedom of expression and independent media. The V-Dem conceptual scheme regards electoral democracy as a critical element of any other conception of representative democracy (liberal, participatory, deliberative, egalitarian, or some other). The electoral democracy scale runs on a continuous scale, from low to high (0-1), with higher values indicating a more democratic dispensation.

Figure 5 3 – Albania V-Dem's Liberal Democracy Index (LDI) and Electoral Democracy Index (EDI) during the period 2000-2019



Source: Adapted from V-DEM data (2020)

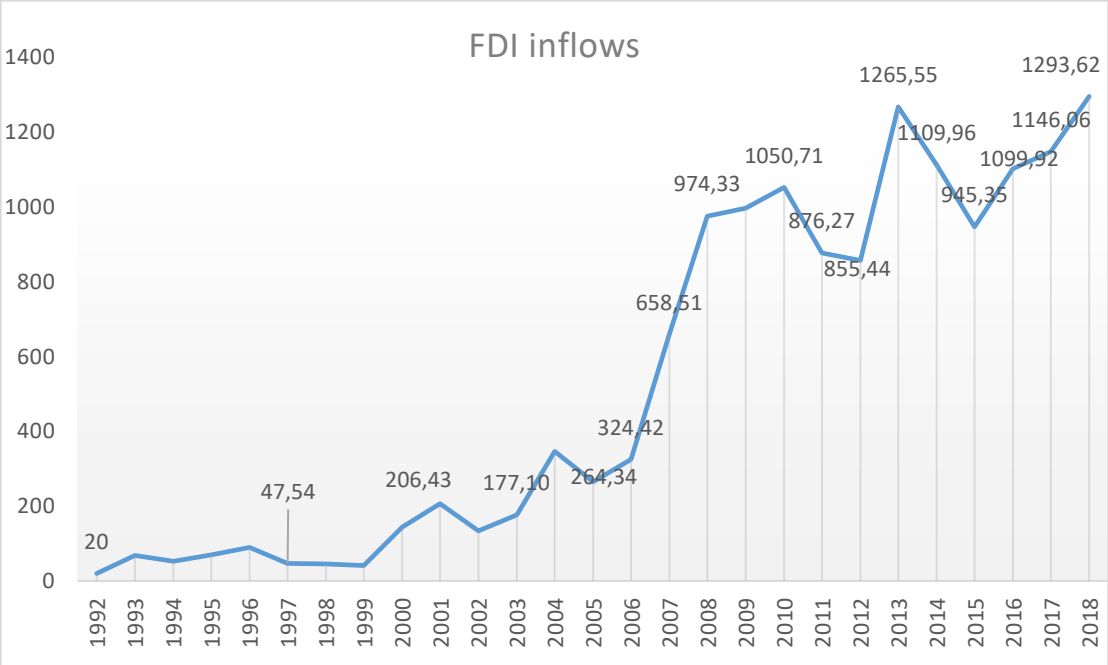
The democratic institutions in Albania have shallow roots. The ratings reflect that the state retains the highly polarised political environment along with the problems of corruption, organised crime and the powerful interests in business, political, and media as obstacles to the production of entirely independent news outlets (Freedom House, 2019c). Albania is between to improve governance but at the same time to give rise to authoritarian tendencies (Kajsiu, 2018, p. 3). The RoW Index estimates that Albania will be classified as a low-level liberal democracy since its struggling to solidify

significant liberalisation reforms (Morgan et al., 2019, p. 18). However, no improvement on the average score of LDI recorded during 2019 (stable at 0.43), while the average score of EDI slightly fell 0.48 (please see figure 5.3). Albania is positioning 11th in the list of the top twenty countries that share the risk of ART for the period 2019-2020 (Morgan et al., 2019, p. 3).

5.4 Inward FDI in Albania

Since the early 2000s, FDI inflows in Albania have been rising steadily, recording a growth rate by 31.3 per cent, and for the period 2008-2017 averaging close to USD 1 billion per year (a growth rate by 4.2 per cent) despite the global economic crisis (please see figures 5.4, 5.5). Inward FDI increased in 2007 by almost 51 per cent and recorded the highest performance in 2013, amounted to USD 1.27 billion, while the second-best in 2017, accounted for USD 1.12 billion (UNCTAD, 2008, 2014, 2018a), (please see figure 5.4).

Figure 5 4 - Inward FDI flows in Albania in millions of US Dollars (at current prices) for the period 1992-2018

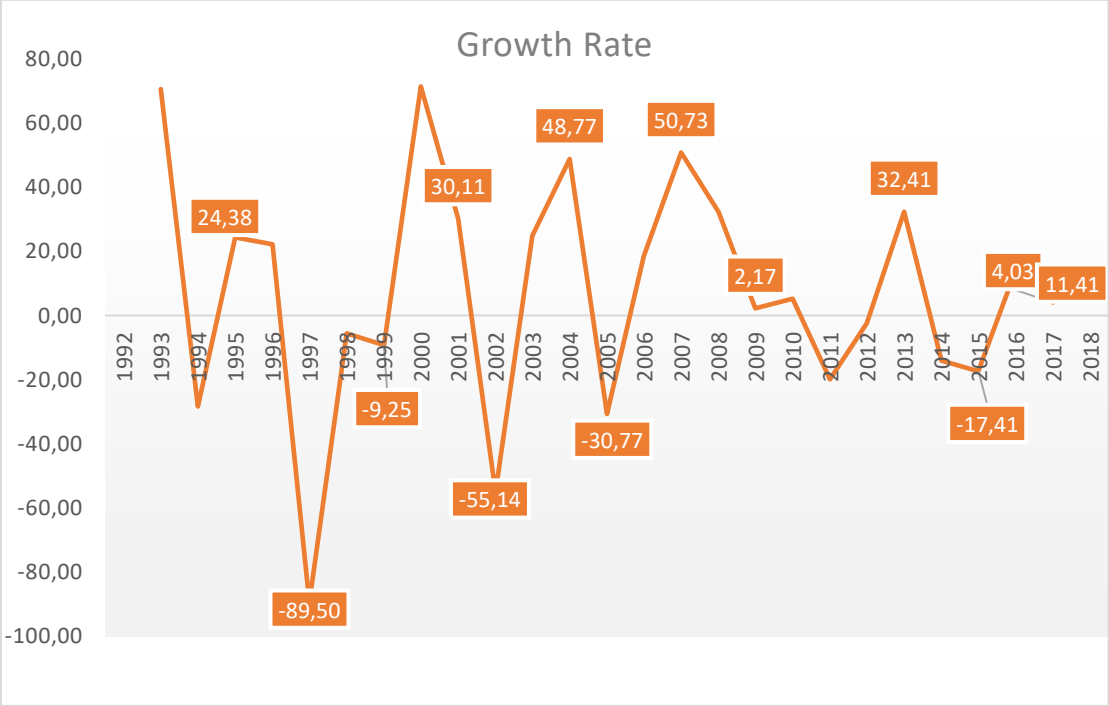


Source: Adjusted from UNCTADstat (2020b) (www.unctadstat.unctad.org)

The various privatisation initiatives of the GoA in sectors such as banking, telecommunications, manufacturing, and energy, especially hydroelectricity, along

with the improvements in the business environment, such as the introduction of a flat tax regime, the reduction of the underground economy and the rate of tax evasion, reboot inward FDI (KPMG, 2017; UNCTAD, 2008).

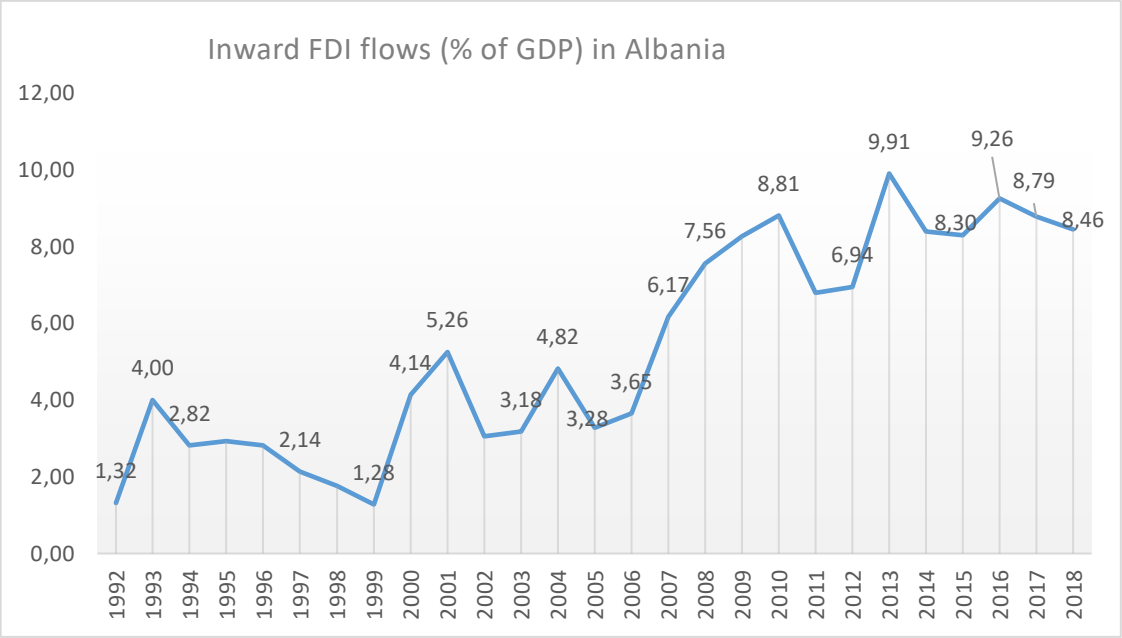
Figure 5 5 - The annual growth rate of Inward FDI flows in Albania in millions of US Dollars (at current prices) for the period 1992-2018



Source: Adjusted from UNCTADstat (2020b) (www.unctadstat.unctad.org)

FDI received annually by a host country, typically runs at about 2-3 per cent of the size of host economy measured by its GDP and when it exceeds 5-6 per cent of GDP each year, then it is considered as a significant performance (TheGlobalEconnomy.com, 2019). At the first transitional years, Albania never exceeded the limit of 5 per cent of GDP in the inflows of FDI that received. Figure 5.6 reveals that it needed a ten years period from the beginning of its transition process to achieve a 5.3 per cent record in 2001. This performance lasted only one year and repeated in 2007, a year in which the inward FDI as a percentage of GDP climbed to 6.2 per cent. Since then, the rate's performance has been maintained always higher of 6 per cent, despite the recorded downslides between 2010-2012 (please see figure 5.6). Its highest value over the past 26 years was 9.9 per cent in 2009, while its lowest value was 1.3 per cent in 1999. In 2018, the FDI-to-GDP ratio was at 8.5 per cent of GDP, driven by FDI in energy infrastructure and manufacturing (World Bank, 2019a, p. 33).

Figure 5 6 - Inward FDI flows in Albania as a percentage of GDP, for the period 1992-2018



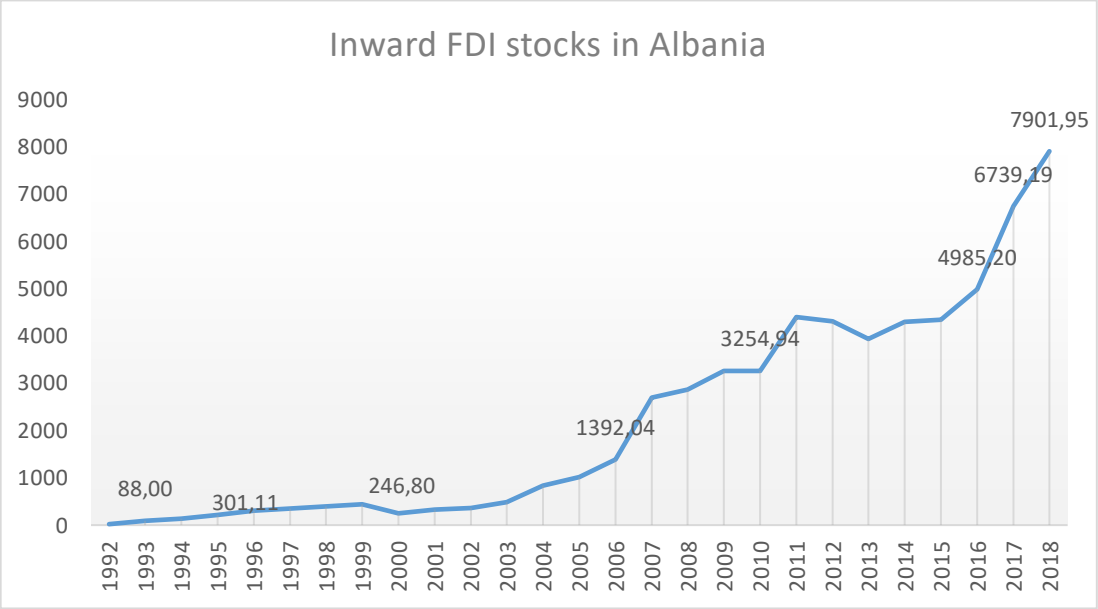
Source: Adjusted from UNCTADstat (2020b) (www.unctadstat.unctad.org)

The UNCTAD (2017b, p. 81) reports that since 2016, Albania comes in the forefront as another growing recipient of FDI, attracting both traditional and new investors. Key FDI source countries for Albania, are Greece (the two largest telecommunication companies in the country have Greek capital), Switzerland (holding investments related to the Trans Adriatic Pipeline), and the Netherlands (related to the Hydro Power Plants in Devolli River) (LLOYDS Bank, 2019; Santander TradePortal, 2019a). Although Albania's leading trade partner Italy holds the highest number of foreign companies in the country, due to their small size ranks fourth in terms of FDI. Italian Ambassador to Tirana Alberto Cutillo to an interview concerning the Italian FDI in Albania, said that the lack of large investments projects from italaian companies is due to corruption, property issues and the weak judicial system (Invest in Albania, 2018). Besides the traditional European investor countries, there is an increasing interest from China. Chinese firms are mainly interested in road construction projects, obtaining the concession for Tirana International Airport and getting access to country's natural resources (oil, chromium, copper and coal) (UNCTAD, 2017b, p. 81). In 2017, Albania and China reached the agreement for

cooperation on the construction of "One Belt, One Road initiative" (Invest in Albania, 2019).

Albania's inward FDI stock, representing the value of investors' equity and net loans to enterprises resident in the reporting economy, had reached USD 6.82 billion in 2017, reflecting nearly 55.4 per cent of the country's GDP (Santander TradePortal, 2019a). A significant increase compared to the USD 0.25 billion in 2000, less than a decade after the political change signifying the country's transition to democracy and a market economy when still major enterprises were under state control, and more than a double compared to USD 3.2 billion at the end of 2010 (please see figure 5.7). However, only about half of the annual FDI inflows received the last 25 years (USD 12.98 billion) remains inside the country, as Albania's final FDI stock record exposes. The last reflects the existing challenges in country's investment climate such as problems encountered in public administration, a lack of transparency in public procurement, weak enforcement of contracts, property rights, the legal system, corruption, inadequate electricity supply and infrastructure (KPMG, 2017; US Department of State, 2018).

Figure 5 7 - Inward FDI stocks in Albania in millions of US Dollars (at current prices), for the period 1992-2018



Source: Adjusted from UNCTADstat (2020b) (www.unctadstat.unctad.org)

Foreign investors view the troublesome investment climate and perceive the country as a difficult place to do business. They are concerned on the use of legislation

and regulations to favour only the politically connected companies as well as on the frequency of unpurposive change of regulations and laws defining business activity (US Department of State, 2018). In particular, the US State of Department's (2019a) report on Investment Climate in Albania, records that foreign investors feel pressure for hiring specific, politically connected subcontractors. They express concerns about compliance with the Foreign Corrupt Practices Act during their investment activities in Albania since reports on corruption in government procurement are often. The intensive use of public-private-partnership (3P) contracts restricts competition in infrastructure and other sectors. The drafting and monitoring of the 3P contracts are based on weak cost-benefit analyses and inefficient technical expertise. The government had signed more than 200 3P contracts by the end of 2018 (US Department of State, 2019a).

The GoA announced in 2018 its intention to create a comprehensive investment legal framework for foreign investors compatible with best international practices and to establish a mechanism for responding efficiently to investor complaints, resulting to the rise of investment retention (Republic of Albania, 2018, p. 45). Although the law on strategic investments is relatively new in 2015, the GoA is planning a unified investment law to replace it along with the Law on Foreign Investment (1993). New law's objectives will be to ensure compliance with labour and adherence to safety and environmental standards and legislation, to increase guarantees for investors, for reducing the expropriation risk, and to establish new procedures for facilitating business registration and market entry (Republic of Albania, 2018; Santander TradePortal, 2019a). Government's prospects for FDI growth are in the sectors of energy and power, tourism, water supply and sewerage, road and rail, mining, and information communication technology (Santander TradePortal, 2019a; US Department of State, 2018). The proposed reform is part of the priorities of the government's programme, the Economic Reform Programme (ERP) 2018–2020, Integrated Growth of SEE 2020, and Business Improvement District Strategy 2014–2020, targeting to encourage FDI and strengthen country's competitiveness (Republic of Albania, 2018, p. 45).

5.5 Empirical Analysis

Chapter 4 presents the empirical analysis of this dissertation on the political system's impact on inward FDI inflows. Thus, it provides variables descriptions, data, model specification and empirical results concerning the total of the six transition economies of WB. The empirical analysis uses a panel dataset of the variables of interest for a period from 1996 to 2018. Table 5.1 presents a short description of the variables included in the empirical model, their coding, and sources of data.

Table 5 1 - Variables description and Coding

Variables	Description	Code	Source of Data
Dependent Variable			
FDI inflows	The natural log of net FDI inflows	*lnfdi*	wiiw-FDI database
Independent Variables			
1. LDI	The is aggregate index that describes features of democracy at the highest level	*ldi*	V-Dem Dataset (V.10)
2. The signing of Bilateral Investment Treaties (BITs)	The conclusion of an IIA between two countries for the promotion and protection of FDI	*bit*	UNCTAD-International Investment Agreements Navigator
3. Governance Indicators	A set of traditions and institutions by which authority in a country is exercised.		
3a *Voice and Accountability*	The dimension of Quality and Governance	*voice*	Worldwide Governance Indicators (WGI)
3b. *Political Stability and Absence of Violence/Terrorism*	The dimension of Quality and Governance	*polstab*	
3c. *Government Effectiveness*	The dimension of Quality and Governance	*goveffe*	
3d. *Rule of Law*	The dimension of Quality and Governance	*rule*	
3e. *Control of Corruption*	The dimension of Quality and Governance	*cc*	
3f. *Regulatory Quality*	The dimension of Quality and Governance	*regq*	
Controlling-non governance indicators			
4. Growth	Annual percentage growth rate of GDP	*gdp_growth*	

5.	**Market Size**	GDP at constant 2010 prices in US dollars	*GDP*	World Bank-World Development Indicators database

Variables Data for Albania

The data used for Albania is presented below

Dependent variable

lnFDI

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Net FDI Inflows	72,0	42,3	40,0	38,5	156,6	230,7	141,4	156,9	278,4	212,6	258,6	481,1	669,7	716,9	793,3	630,4	665,8	953,2	836,6	852,4	994,4	1017,0	1092,1

Notes: The net FDI inflows are in EUR mn

Source: http://wiiw.ac.at/fdi-database.html

Independent variables

ldi

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
LDI	0.34	0.35	0.33	0.36	0.35	0.37	0.39	0.39	0.43	0.43	0.46	0.47	0.45	0.50	0.48	0.48	0.49	0.46	0.44	0.43	0.47	0.46	0.43

Source: www.v-dem.net/en/analysis/CountryGraph

bit

Albania's Bilateral Investment Treaties

No	Short Title	Date of signature
1	Albania-United Arab Emirates BIT	15/10/2015
2	Albania-San Marino BIT	18/05/2012
3	Albania-Azerbaijan BIT	09/02/2012
4	Albania-Qatar BIT	18/10/2011
5	Albania- Malta BIT	27/01/2011
6	Albania-Cyprus BIT	05/08/2010
7	Albania-Bosnia and Herzegovina BIT	17/06/2008
8	Albania-Kuwait BIT	12/12/2007
9	Albania-Lithuania	28/03/2007
10	Albania-Poland BIT	01/11/2006
11	Albania-Moldova BIT	11/06/2004
12	Albania-Korea BIT	15/12/2003

13	Albania-Spain BIT	05/06/2003
14	Albania-Serbia BIT	26/11/2002
15	Albania-Iran BIT	18/11/2002
16	Albania-Ukraine BIT	25/10/2002
17	Albania-BLEU (Belgium-Luxembourg EU) BIT	01/02/1999
18	Albania-Portugal BIT	11/09/1998
19	Albania- FYROM BIT	04/12/1997
20	Albania-Slovenia BIT	23/10/1997
21	Albania-Finland BIT	24/06/1997
22	Albania-Israel BIT	29/01/1996
23	Albania-Hungary BIT	24/01/1996

Source: https://investmentpolicy.unctad.org/international-investment-agreements

Governance Indicators

Index Year	*cc*	*rule*	*voice*	*polstab*	*goveffe*	*regq*
1996	(0.89)	(0.68)	(0.65)	(0.33)	(0.69)	(0.47)
1997						
1998	(1.03)	(0.92)	(0.39)	(0.54)	(0.63)	(0.17)
1999						
2000	(0.86)	(1.01)	(0.29)	(0.54)	(0.76)	(0.25)
2001						
2002	(0.87)	(0.76)	(0.01)	(0.29)	(0.53)	(0.22)
2003	(0.81)	(0.72)	0.07	(0.31)	(0.54)	(0.45)
2004	(0.70)	(0.69)	0.01	(0.43)	(0.42)	(0.17)
2005	(0.79)	(0.74)	0.00	(0.51)	(0.66)	(0.37)
2006	(0.80)	(0.68)	0.08	(0.51)	(0.52)	(0.10)
2007	(0.69)	(0.65)	0.11	(0.20)	(0.41)	0.06
2008	(0.59)	(0.59)	0.17	(0.03)	(0.36)	0.15
2009	(0.54)	(0.50)	0.14	(0.05)	(0.26)	0.24
2010	(0.53)	(0.41)	0.12	(0.19)	(0.28)	0.23
2011	(0.68)	(0.46)	0.06	(0.28)	(0.21)	0.23
2012	(0.73)	(0.52)	0.02	(0.14)	(0.27)	0.20
2013	(0.70)	(0.52)	0.05	0.09	(0.32)	0.21
2014	(0.55)	(0.34)	0.14	0.49	(0.09)	0.22
2015	(0.48)	(0.33)	0.16	0.35	0.01	0.19
2016	(0.41)	(0.33)	0.17	0.34	0.01	0.19
2017	(0.42)	(0.40)	0.20	0.38	0.08	0.22
2018	(0.52)	(0.39)	0.21	0.38	0.11	0.28

Source: https://info.worldbank.org/governance/wgi/Home/Reports

gdp_growth & GDP

Index Year	GDP growth annual (%)	GDP (constant 2010 US$)
1996	9,10	5.923.813.842,25
1997	(10,92)	5.276.934.313,44
1998	8,83	5.742.892.241,65
1999	12,89	6.483.145.121,10
2000	6,95	6.933.726.049,65
2001	8,29	7.508.536.794,66
2002	4,54	7.849.421.409,81
2003	5,53	8.283.498.399,55
2004	5,51	8.739.919.053,11
2005	5,53	9.223.229.131,15
2006	5,90	9.767.407.393,47
2007	5,98	10.351.496.601,01
2008	7,50	11.127.855.695,12
2009	3,35	11.500.646.360,25
2010	3,71	11.926.962.834,96
2011	2,55	12.230.542.521,63
2012	1,42	12.403.913.447,07
2013	1,00	12.528.199.259,32
2014	1,77	12.750.510.497,86
2015	2,22	13.033.412.635,73
2016	3,31	13.465.444.817,31
2017	3,82	13.979.970.426,90
2018	4,15	14.559.473.464,47

Source: https://databank.worldbank.org/source/world-development-indicators

Table 5.2 presents the descriptive statistics for all variables. They include total observations available for the variables along with minimum, maximum, mean, and standard deviation for each of them.

Table 5 2 - Descriptive statistics

	Variable	Obs	Mean	Std.Dev.	Min	Max
ALBANIA	*lnfdi*	23	19.574	1.119	17.466	20.811
	ldi	23	0.424	0.053	0.330	0.500
	bit	23	1.000	1.000	0.000	3.000
	cc	20	-0.680	0.171	-1.030	-0.410
	rule	20	-0.582	0.195	-1.010	-0.330
	voice	20	0.019	0.218	-0.650	0.210
	polstab	20	-0.115	0.346	-0.540	0.490
	goveffe	20	-0.337	0.264	-0.760	0.110
	regq	20	0.011	0.257	-0.470	0.280
	gdp_growth	23	0.045	0.044	-0.109	0.129
	GDP	23	2.265	0.313	1.663	2.678

In Chapter 4 the model $y_{it} = x'_{it}\beta + u_{it}$, with *X'={ ldi, cc , rule, voice, polstab, regq, goveffe, bit, GDP_growth, GDP, time, country dummies}* and *y* : the dependent variable represented by the log of *fdi (lnfdi),* estimated for analysis including the six economies of WB. The analysis used a log transformation of the dependent variable both to eliminate heteroscedasticity problems and reduce the influence of potential outliers of those observations where the errors satisfy equation, $u_{it} = \rho_i u_{i,t-1} + \varepsilon_{it}$ (please see Chapter 4-Section 4.3).

As we have already mentioned, having data overtime for the six WB countries, the decision to use panel data techniques is based on the ability to export robust results. Running the regressions only for Albania following the Prais-Winsten procedure, although we correct for autocorrelation and avoid the spurious regression problem as described in Chapter 4-Section 4.3, the estimates may be biased and inconsistent due to the limited number of observations. Table 5.3 presents along with the panel data model (detailed analysis in Chapter 4) the time series estimates for Albania. The coefficients in the panel data model are significant for four explanatory variables and one control variable while in single time series model there are no significant impacts estimated.

Table 5 3 – Comparison of regressions

	Panel Data Model	Albania
Dependent Variable :	**lnfdi**	**lnfdi**
Ldi(t-1)	0.744	-1.596
	(0.66)	(-0.31)
cc(t-1)	-0.116	2.062
	(-0.25)	(1.33)
rule(t-1)	-1.081*	-2.397
	(-2.37)	(-2.13)
voice(t-1)	0.956*	0.142
	(2.54)	(0.26)
polstab(t-1)	0.365*	0.484
	(2.25)	(1.13)
goveffe(t-1)	0.559	-1.820
	(0.83)	(-1.12)
bit(t-1)	-0.0519	0.138
	(-1.27)	(1.07)
regq(t-1)	-0.956*	0.452
	(-2.42)	(0.85)
gdp_growth(t-1)	0.00467	-0.00917
	(0.23)	(-0.16)
GDP (t-1)	3.906***	4.427
	(4.79)	(1.36)
time	-0.0336	0.0168
	(-0.89)	(0.14)
Country dummies		
Bosnia_Herzegovina	-1.619***	
	(-4.23)	
Kosovo	1.896***	
	(3.54)	
North_Macedonia	0.500	
	(1.75)	
Serbia	-3.982***	

	(-3.66)	
Montenegro	3.779***	
	(4.59)	
_cons	10.50***	9.403
	(7.37)	(1.84)
N	92	19

T -statisitcs in parentheses. (*) Significant at p<0.05, (**) Significant at p<0.01, (***) Significant at p<0.001.

In the case of one country, the major problem of the research's data set is the limited number of available observations (235 over 1317 of the panel data model). Hence, with pure time-series analysis, the extraction of explicit estimates and powerful test statistics is constrained. Panel data sets contain more variability to exploit, more efficiency and offer more information than pure time-series data or cross-sectional data. According to the existing literature, panel data methods can detect and measure statistical effects that pure time-series or cross-sectional analysis cannot. Additionally, panel data set lets us to control for unobservable, something that time series does not allow. Hence, the adaption of the panel data technics helps to obtain more accurate and more robust estimates. The next section discusses the empirical results of the panel data model adjusted in the case of Albania.

5.5.1 Empirical results – Discussion

The empirical analysis (please see Chapter 4) based on panel data and Prais-Winstein estimation method indicates that the explanatory variables, voice & accountability *(voice),* political stability & absence of violence/terrorism *(pol_stab),* the rule of law *(rule),* regulatory quality *(regq)*, as well as the control variable of the market size *(GDP)* are significantly associated with inward FDI. Three of which, the voice and accountability, the political stability, and the market size are positively related to FDI while the rule of law, and regulatory quality negatively. The political regime's impact on FDI is positive in the sense that a more democratic regime is more appealing to foreign investors but does not determine the amount of FDI flows that the country receives. Control of corruption, government effectiveness, and growth found positive as expected though insignificant. The signing of the BITs in the case of these economies is negatively and insignificantly related to FDI.

The significant and positive relationship between political stability and FDI inflows is consistent with the literature (please see Chapter 2). Besides, the political reality in the country confirms this result. In Albania, the break of FDI inflows in specific periods coincides with periods of political instability. For example, the collapse of the pyramid's schemes in 1997, caused a political crisis and violence, the 1999 Kosovo conflict provoked general disorder in the region, and the 2005 elections challenged country's political scene. Concerning the last, Albania experienced critical political conditions since the outcome of the elections created an institutional vacuum. This gap, accompanied by an intense energy crisis caused the downturn in FDI inflows in 2005 (please see figure 5.4). In 2006 the local government elections stabilised the governing coalition that had emerged after the three months rotation of power. From 2006 onwards, net FDI inflows recorded a clear upward trend until 2011. At that time series of anti-government protests in cities around Albania following 18 months of political conflict over alleged electoral fraud by the opposition occurred, increasing the political risk. In 2017 the elections once again challenged the political stability and provoked a drop to inward FDI (please see figure 5.4). The little respect that exists for the electoral process is evident in the burst of violence often during the election period. Hence, each time that the political setting in Albania is under the threat of destabilisation or overthrown by unconstitutional or violent means, including politically - motivated violence, then inward FDI is decreasing.

The literature (please see Chapter 2) confirms the positive and significant relationship of voice and accountability with inward FDI. The rational of this positive association relies on that voice & accountability measures the perceptions of the extent to which a country's citizen can participate in their government elections, including the confidence about the honesty of elections. As already seen, whatever concerns elections is crucial for Albania's political stability and, as such, for inward FDI. Therefore, an increase in voice and accountability will encourage FDI flows.

The rule of law includes a competent, impartial, and transparent legal system that protects property and individual rights. As such, a positive sign of this variable expected, confirming the existing literature (please see Chapter 4 - sections 4.2, 4.4). However, the empirical analysis provided evidence for its negative though significant impact on FDI inflows. Referring to Albania, its long unruly transition established a

system where well organised political and institutional actors, profited from the weak rule of law system, have used every opportunity to obstruct meaningful progress (Bertelsmann Stiftung, 2018a, p. 3). These actors determine how the polity and economy operate, and the foreign investors in the Albanian market learned to deal with them in a way that guarantees the protection of their investments. Despite the additional costs that such shadow activities may comprise, it enables MNEs to exclude competition and to make a profit from illegal practices in the long-term. Therefore, further research on the profile of foreign investors in Albania may provide more insights into the significant negative relationship between the rule of law and inward FDI.

The negatively significant relationship between regulatory quality and FDI inflows contradicts many previous empirical studies which reported a positive relationship (please see Chapter 4 - sections 4.2, 4.4). However, to the extent that MNEs behave in compliance with the rules, the empirical result of regulatory quality is explained. The risk that their ordinary business operations become more costly due to a new stricter regulatory environment discourages MNEs that have gained more in the past from the beneficial provisions of the lax regulations. Hence, in the case of Albania, an improved regulatory quality act as a hindrance to FDI.

Government effectiveness holds the expected positive sign (please see Chapter 4) though not significant. The prevalence of red tape, thus the degree to which bureaucratic delays hinder business activity, is evident in Albania's public administration. Its limitation is an essential component for good governance infrastructure that plays a positive role but in the case of Albania, not a determining one in attracting FDI.

The empirical result of control of corruption is not contradicting the extant literature since most of the studies support the positive relation of this indicator with inward FDI (please see Chapter 4 - sections 4.2, 4.4). Corruption challenged many times various areas of the social, economic, and political life of Albania. Corruption identified as an obstacle, challenging the growth of the economy, the investment climate, as well as the country's EU accession process (analytically presented in sections 5.2 and 5.3). The high level of corruption produces bottlenecks, raises uncertainty, and increases costs (Habib and Zurawicki, 2002, p. 292). In particular,

corruption reduces transparency in local bureaucracy increasing the cost of doing business, negatively influences the foreign economic agent's decision to conclude on a local joint venture partnership and rises the value of a local partner to a foreign investor (Javorcik and Wei, 2009; Smarzynska and Wei, 2001). The non-significance in the relationship between control of corruption and inward FDI indicates that there are foreign agents that invest in Albania, but due to corruption, they avoid to engage in large projects, as the Italian investors (please see section 5.4). Of course, there is the case that foreigners who invest in Albania are not thrilled with the prospect of corruption, but it is not what frightens them. For example, Chinese investors already started to engage in large projects in the region (please see section 5.4). There are empirical studies providing evidence that Chinese investors are not particularly concerned about corruption in the host country since they have the experience of dealing with corruption at home (Shan et al., 2018, p. 144).

Regime type is not significant in this model though it is positive. Chapter 2 presents in detail the contradictory and fuzzy results of the impact of the host country's political system on inward FDI. There are empirical studies that confirm our survey's result (Biglaiser and DeRouen, 2006; Oneal, 1994). Over the last thirty years, Albania has made substantial progress to its transition from the most repressive communist regime around the world to a democratic one. Although Albanians strongly supported democracy, their inexperience in this type of regime produced troubles in assessing how well democracy is functioning and evaluating the work of specific democratic institutions (Bertelsmann Stiftung, 2018a, p. 18). These difficulties explain the decline in V-Dem LDI in 2017 that led to a change regime's classification from liberal democratic to electoral democratic, a status that holds until now. Whatever improvements in democracy made, they do not play a decisive role in the amount of inward FDI in Albania. Therefore, the likelihood of FDI inflows in Albania is the same whether democracy is strong or weak.

BITs generate a reasonable expectation to the foreign investors that the host country will not expropriate foreign firms' funds and assets. Especially, for developing and transition countries that had suffered from high political risk, unreliable governments, less efficient norms, and weak institutions, the signing of a BIT considered to increase their credibility and as such, to stimulate inward FDI (Berger et

al., 2011; Büthe and Milner, 2008; Kerner, 2009; Neumayer and Spess, 2005; Rosendorff and Shin, 2012). The non-significant negative relationship between BITs and FDI inflows contrasts with the literature (please see Chapter 4 - Sections 4.2, 4.4). A justification of the result may be the argument of Tobin and Rose-Ackerman (2011). In their empirical study, they discussed BITs complementarity to the host country's domestic conditions, referring to the host country's capacity to absorb FDI. According to them, a country with a small market may benefit from BIT in receiving FDI, but the extra FDI it receives will be smaller than the FDI received by a large country. Besides, there is an increasing number of countries entering into BITs to promote their improvements in the investment environment, rising the competition for which will grasp the largest share of FDI inflows (Tobin and Rose-Ackerman, 2011, p. 7). Hence, the relative benefit to a country of signing one more BIT may fall as competition for FDI inflows rises globally. Hallward-Driemeier (2003) discussed the complementarity of BITs to domestic institutions, arguing that countries with weak domestic institutions, including protection of property, have not gotten significant additional benefits from signing a BIT. Therefore, in the case of Albania, given that BITs act complementary to domestic institutions, its small market and weak institutions in conjunction with the intense competition for FDI from broader markets with ratified BITs globally, may justify our survey's empirical result.

Summing up, the variables of voice & accountability, political stability & the absence of violence, the rule of law and the regulatory quality are those determining the FDI decision-making of MNEs in Albania.

5.6 Conclusions - Recommendations

This chapter followed both theoretical and empirical analysis to serve the research purpose of defining the impact of the political environment on inward FDI in Albania, as one of the six transition economies of WB.

Albania was the last of the SEEC that engaged in the transition process from a centrally administered socialist economic system to democracy and the free-market economy. Since Albania was Europe's poorest country in terms of GDP per capita, the

country prioritised the rise of FDI inflows as the path to achieving enough growth for completing the transition and accomplishing EU membership.

The 2019 EU report of European Commission on Communication on EU Enlargement Policy for the progress of Albania's reform Agenda recommended the enforcement of democratic institutions, the de-politicisation of public administration, the achievement of independence and accountability in the judicial system, intensification of the fight against corruption and organised crime. Further, improvements in the consolidation of property rights and acceleration of the pace for establishing a functioning market economy that counters the competitive pressure and market forces within the EU and can achieve integration into international value chains. The above conditions challenge the country's investment environment, and as such, the growth of inward FDI. However, the indicator of inward FDI as a percentage to GDP after the financial crisis records a satisfying performance (over 6 per cent).

Regarding Albania's political progress, indeed went a long way from "the state of the dictatorship of the proletariat" to an electoral democracy as it is classified today. However, Albania holds the promise of improved governance as well as the danger of authoritarianism since it is still struggling to solidify significant liberalisation reforms.

The result produced from the empirical analysis of the impact of the political landscape, as it shaped by the political regime and individual political variables, on inward FDI, identified specific dimensions to have a greater impact on FDI than others.

The empirical analysis resulted in that four variables of governance and one control variable display significant effects. Three of which, voice & accountability, political stability & the absence of violence and the market size found with the expected positive sign. Positive also found the variables of governance, control of corruption, and government effectiveness, though statistically insignificant. This relation depicts that from the dimensions of governance the foreign economic agents are judging most the voice & accountability as well as the political stability & the absence of violence, in their decision to invest in Albania. Whereas, Albania's political system by itself is not a determining factor to FDI inflows.

Surprisingly, the explanatory variables of the rule of law and regulatory quality have a significant negative association with inward FDI, the signing of the BIT also a negative though non-significant. On the one hand, the weak rule of law and the low

regulatory quality are not barriers to FDI, and this is good in the sense that country has severe delays in their reform. On the other hand, since stringent regulations reduce the opportunities for Albania's cross border investors to continue exploiting the system for enhancing the profitability of their ventures, they tend to provoke further delays to country's institutional improvements. To this extent, the rate of reforms' progress is slowing. Hence, foreign investors activity can be both beneficial and harmful to Albania. An increase of FDI inflows may stimulate growth but MNEs policies to increase their profit may halt reform progress towards EU accession.

These results could be a wake-up call for policymakers to give attention to enhancing good governance environment in terms of improving voice & accountability and stabilising the political environment which in Albania's case are currently crucial for receiving more FDI. Further, if the Albanian leaders want to follow the EU recommendations, they may think to attract MNEs that their particular needs are in consistency with country's commitment to complete the required reforms for achieving EU membership. Hence, to attract those foreign investors that now avoid entering into Albanian market since they are concerned on the use of legislation and regulations that favour only the politically connected companies as well as on the frequency of unpurposive change of regulations and laws defining business activity.

This dissertation raises issues for future research on whether the country is benefiting from foreign investors that prefer a less regulated investment environment towards those that are in favour of stringent regulations and more robust governance.

Besides, regarding the latest development of the opening of the long-awaited accession talks, Albania's political leaders must display a sincere willingness to address the institutional shortcomings that have plagued the country's development and ensure that any improvements will be in line with EU conditions and on a long-term basis.

Following the same structure of analysis, the next chapter presents the impact of the political environment on inward FDI in Bosnia and Herzegovina.

Chapter 6. The transitional economy of Bosnia and Herzegovina as a host country for FDI.

6.1 Introduction

Bosnia and Herzegovina (hereafter BiH) one of the six former Yugoslav republics had experienced an enormous human and economic cost in the 1990s. This cost was the consequence of the civil war that raged from 1992 to 1995, during the dissolution of the former Socialist Federal Republic of Yugoslavia (SFRY). The legacy of the war significantly complicated BiH transition process. The postwar BiH has to undergo a threefold transition, that is from conflict to peace, from centrally administered socialism rule of governance to democracy and a market economy, and from membership in a federation to independent statehood (Bertelsmann Stiftung, 2018b, p. 28).

BiH's political environment and complex government structures as developed in the post-socialist period, create significant obstacles to economic development and FDI. The country is open to FDI, though investors entering the Bosnian market confront corruption, non-transparent business procedures, insufficient protection of property rights, and a weak judicial system, complex regulatory frameworks, and government structures (U.S. Department of State, 2017, p. 2).

This chapter follows both theoretical and empirical analysis to discover the role of the political environment in variations of BiH's inward FDI. The empirical results will provide new insights to the debate, political regime – FDI nexus, through hypotheses about the relative influence of the specific variables that the literature review indicated (please see Chapter 2). Adjusting the empirical results to the analysis of BiH's political system, recommendations can be made for the country's development as foreign investment's destination.

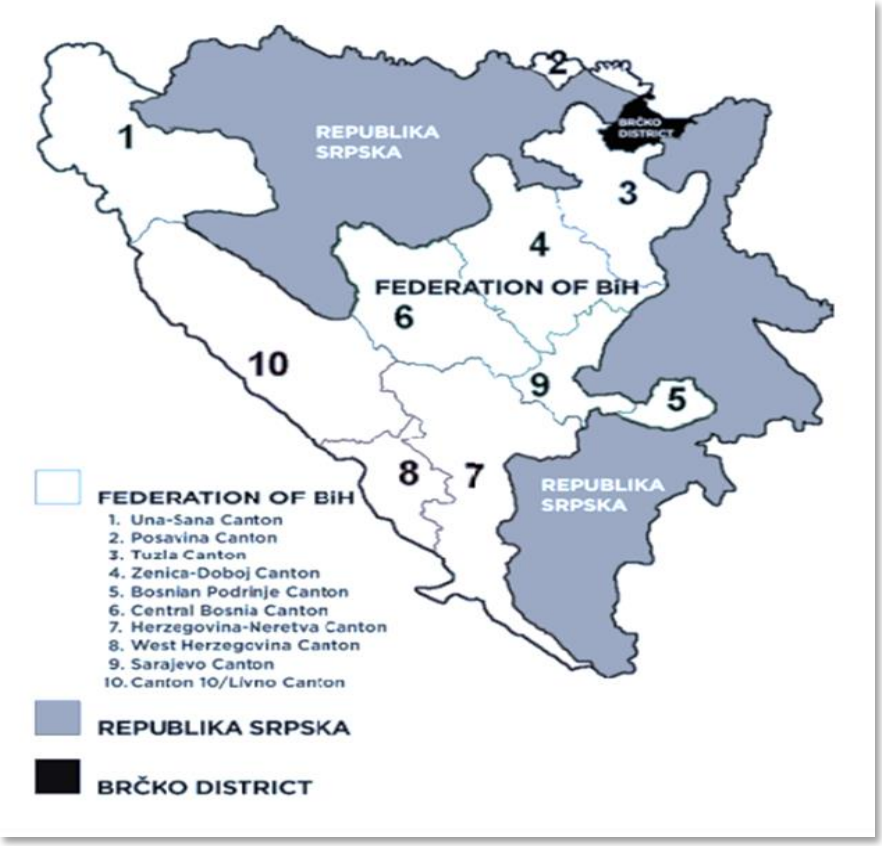
The chapter is structured as follows: Section two addresses the main issues in BiH transition process. Section three analyses the establishment of the political system over the post-socialist period. Section four presents BIH's inward FDI, while section five discusses the empirical results. The last section concludes and recommends.

6.2 Bosnia -Herzegovina in Transition

When the war began in 1992, at that time, the EU and US recognised BiH as an independent state, and the UN approved its membership. The process of SFRY's dissolution had put in question the nature and very existence of the Bosnian state, posed Bosnia's leaders with a dilemma and strained relationships between its main national groups. The population of the republic consisted by that time of Muslims who adopted the term of Bosniaks and had a relative majority of 44 per cent, the Serbs 31 per cent, and the Croats 17 per cent, while the self-identified Yugoslavs made up 5.5 per cent of the population, and "others" the remaining 2.5 per cent (Belloni, 2009, p. 357).

The country came out from the war divided into three zones, dominated by illiberal wartime ethnic-nationalist elites. The signing of the General Framework Agreement for Peace (GFAP) at Dayton/Paris in 1995 put an end to a bloody three-and-a-half-year war and established the state of BiH in its present form, transforming it from a former Yugoslav republic into an independent country (Kartsonaki, 2016, p. 497). The implementation of the agreement introduced one of the most wide-ranging peacebuilding interventions the world had seen to that day (Belloni and Ramović, 2020, p. 42). The main ethnic parties (the Bosniac, Croat and Serb) agreed on the independent state, with Sarajevo as its capital. NATO forces were to implement the accord for a certain period, followed by international bodies like the Organization for Security and Co-operation in Europe (OSCE), the Office of the High Representative (OHR) and the UN (Stojanov, 2004, p. 18). The Dayton GFAP fixed state's external borders established two internal entities, the Federation with ten cantons and with 51 per cent of the territory, and Republika Srpska with 49 per cent (Map 6.1). The accord outlined the constitution of the state, which permitted the full freedom of movement of persons, goods, services and capital (Stojanov, 2004, p. 18). Although BiH defined as an independent state with a multi-ethnic and democratic government, it held limited functions in foreign, economic, and fiscal policy. The post-conflict agendas hindered the progress of the transition process.

Map 6 1 – Bosnia - Herzegovina



Source: Gavrić et al. (2013, p. 8)

The Dayton GFAP created a complex institutional structure, making Bosnia the state with the highest number of presidents, prime ministers, and ministers per capita worldwide and transferred the conflict from the military to the political arena (Belloni, 2009, p. 359). The peace settlements of the Dayton GFAP legitimised and installed a regime of division along ethnic lines, enabling the conflicting parties to continue in the political stage their wartime agenda (Kartsonaki, 2016, p. 498). The dramatic process of disintegration and division that BiH witnessed in the early 1990s was followed by another of reconstruction, reconciliation, and slow state-level building. Efforts to build democratic institutions and establish a functioning market economy moved on simultaneously with efforts to reconstruct the state's infrastructure, boost economic development, enable the return of refugees, and united the divided country's social groups (Bertelsmann Stiftung, 2018b, p. 5). Many in the country supported a BiH firmly anchored in Europe and believed that all these efforts would lead to BiH integration into European Territory (Juncos, 2005, p. 91). However, the period that emerged from

the instalment of peace onwards is associated with entering into a political-economic order of disparities and dispossession, not only of the means of a dignified livelihood but of a future and the institutions' capacities to form a more prosperous future (Gilbert and Mujanović, 2015, pp. 605–606).

For most of this time, BiH has been a partial protectorate with the OHR exercising power and influence over the government, holding the ability to dismiss elected and appointed officials and to impose legislation (Bieber, 2014, p. 188). The EU limited OHR's power gradually and became the prime international actor in the state. However, the EU has failed to provide sufficient incentives for reform and to prevent the country from falling into a stalemate (Bieber, 2014, p. 188).

In 2007, BiH became a full member of the Central European Free Trade Agreement (CEFTA) and one year later it signed the Stabilisation and Association Agreement (SAA) with the EU along with an Interim Agreement which regulates trade and trade-related matters. Although SAA ratified by all EU Member States by 2011, it entered into force in 2015. The time gaps between the signing, the ratification and the entry into force were due to delays from the country's political leaders to proceed on the implementation of the 2009 decision of the European Court of Human Rights (ECtHR) in the Sejdić-Finci case (European Commission, 2019b, p. 5). In 2009, the ECtHR found BiH in violation of the European Convention on Human Rights for not permitting a Roma and a Jew to stand in elections for the state Presidency and the second chamber of the Bosnian parliament, the House of Peoples (Bieber, 2014, p. 186). Due to the inability of the Bosnian institutions to revise the constitution and the electoral law for accommodating this ruling, the European Council has set the implementation of this judgement, as a condition for a country's potential application for EU membership (Bieber, 2014, p. 186). Leading political parties' representatives have agreed on a universally acceptable compromise in 2015, and as such, the BiH was in the position to apply for EU membership in 2016. At the same year, BiH signed a three-year USD 608 million IMF loan programme under the Extended Fund Facility (EFF) (The World Factbook, 2020). The IMF and the EU are and will be in the mid- to long-term the main structural and economic reform agents in the BiH even if full EU membership considered as only a distant option.

Economy in Transition

In 1998 about 60 per cent of the country's population lived in poverty, employment was low, production was lower than before the war, and whatever increases achieved were relatively disappointing. In the early 2000s, its transition to the market economy seemed to be a long and painful process.

BiH's economy is transitional with a highly decentralised government that hampers economic policy coordination and reform, while excessive bureaucracy, the weak rule of law and a segmented market discourage FDI (The Heritage Foundation, 2019a; The World Factbook, 2020). Bosnian economy relies heavily on the export of metals, chemical, weapons, energy, textiles, furniture and Chinese infrastructure investment, particularly in the energy sector, as well as on remittances and foreign aid (Bertelsmann Stiftung, 2018b; The World Factbook, 2020). The financial inflows from remittances and aid have been fueling consumption which in 2015, accounting over 100 per cent of GDP. The post-war economy has not created foundations for sustainable economic growth since has been based on consumption rather than production (Goldstein et al., 2015). Consumption still is the main contributor to GDP growth (IMF, 2018a). Tourism sector seemed to have the growth potential, but the rise of migrants arrivals in the region has constrained resources (The Heritage Foundation, 2019a).

Since the value-added tax reform in 2006, a substantial increase in public sector employment and social benefits, supporting consumption recorded (The World Bank Group, 2015). It produced an essential source of revenue for the government and at least in the beginning bridled the informal market activity, but the public perceptions of government corruption and misuse of taxpayer money has revived informal sector of the economy (The Heritage Foundation, 2019a; The World Factbook, 2020). The informal sector in the country is large, at 30 per cent to 50 per cent of GDP, provides a vast number of unregistered jobs and distorts market-based competition (Bertelsmann Stiftung, 2018b, p. 20).

BiH's banking system is in its greatest extent in line with international standards and dominated by foreign-owned banks, whose assets comprise over 90 per cent of total assets (Bertelsmann Stiftung, 2018b, p. 21). The national currency is the konvertibilna marka (convertible mark), pegged to the euro through a currency board

arrangement, that has generated confidence for the currency and has facilitated trade with European partners (The World Factbook, 2020). The foreign trade is liberalised, with uniform, low tariffs, and no fundamental state intervention in free trade, in line with the SAA and an Interim Agreement on trade with the EU (Bertelsmann Stiftung, 2018b, p. 20). The EU is the BiH's leading trading partner, though non-tariff barriers such as sanitary standards hamper the export of BiH products to the EU, especially those of agriculture. Although trade is an engine of growth, BiH's entrepreneurial environment remains one of the region's most burdensome, hindering the development of the private sector. The country's weak competitiveness is reflected in the worth of exports which is one of the lowest in Europe (30 per cent of GDP). The poor business climate, the high cost of employment and poor transport connections hold back BiH from being developed as a competitive market (Goldstein et al., 2015). BiH is lagging its WB peers on global competitiveness lists. In 2019, the country ranked 92nd among 141 economies in 2019 World Economic Forum's Global Competitiveness Index and ranked 100th in the areas of institutions, product and labour market, business dynamism and innovation capability (EBRD, 2020, p. 3)

BiH has a disproportionately large public sector, which even the magnitude of the recent financial crisis left untouched, with public spending amount to almost half of GDP and if the state-owned enterprises (SOEs) along with costs from corruption are taken into account, then the size of the public sector is larger amounting for the 70 per cent of GDP (Goldstein et al., 2015). The progress on privatisation or restructuring of the SOEs is slow. These companies are usually characterised by weak transparency, accountability, performance, and political intervention. Since the SOEs are burdened by excess employment and debts, turn to be loss-makers and consequently they pose risks to macroeconomic performance, fiscal sustainability and competitiveness of the BiH's economy (EBRD, 2020, p. 3)

During the financial crisis (2009-2015) the growth rate was low around 0.4 per cent, and GDP per capita based on international PPP ranged around 30.3 per cent of the relative to the EU average since 2008 (please see table 6.1). Per capita GDP remains one of the lowest in the WB, standing at only 33 per cent of the EU average during 2017-2019 (please see table 6.1).

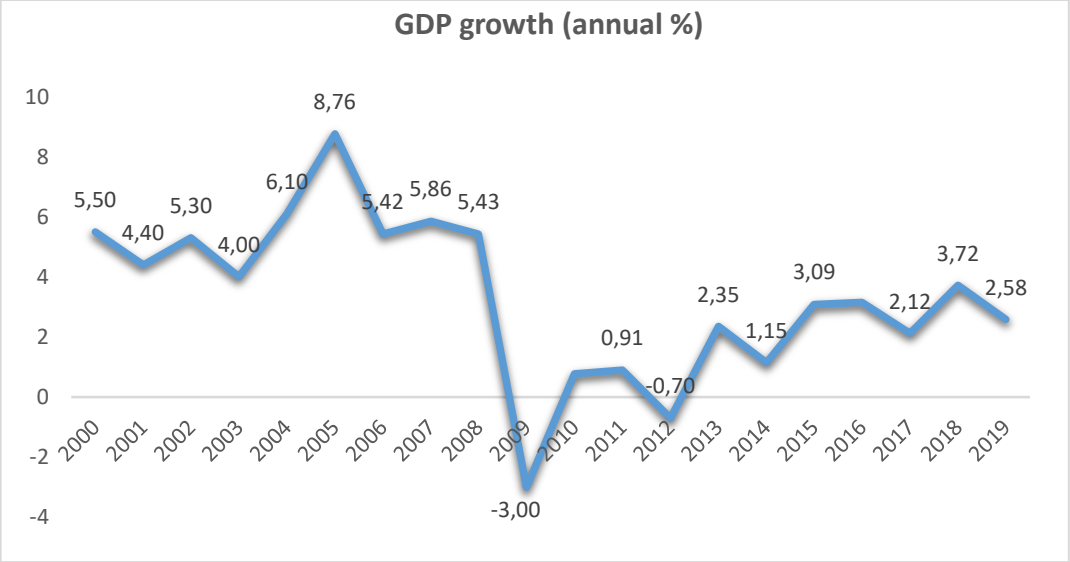
Table 6 1 - BiH and EU GDP per capita, PPP (constant 2017 international $), BiH's GDP per capita compared to the EU average for the period 2000-2019

Index Year	BiH	EU	BiH's % GDP per capita compared to EU average
2000	7209,44	34669,30	21
2001	7517,96	35407,81	21
2002	7908,26	35772,43	22
2003	8218,50	36033,64	23
2004	8715,14	36895,03	24
2005	9475,66	37528,09	25
2006	9988,73	38776,44	26
2007	10581,05	39934,74	26
2008	11180,55	40153,84	28
2009	10898,05	38342,67	28
2010	11071,95	39078,49	28
2011	11307,69	39870,99	28
2012	11403,64	39527,55	29
2013	11877,22	39427,54	30
2014	12222,31	39983,09	31
2015	12793,54	40871,50	31
2016	13363,92	41654,80	32
2017	13788,48	42792,25	32
2018	14419,63	43711,32	33
2019	14894,79	44369,60	34

Source: Adjusted from World Development Indicators (World Bank, 2020b)

Between 2008-2012 the Bosnian economy experienced a double-dip contraction followed by a moderate recovery in 2013 with a real GDP growth rate of 2.35 per cent (please see figure 6.1). Unfortunately, the May floods in 2014 provoked severe loss of output and reduced growth to only 1.15 per cent (please see figure 6.1). In 2015 BiH's economy accelerated recording a rate of growth of 3.09 per cent while in 2018 this rate increased to 3.72 per cent, the highest since 2008 (please see figure 6.1). During 2017-2019, drivers of growth have been domestic demand, particularly private consumption, and an increase in industrial production, partly reflecting increasing external demand.

Figure 6 1 – Bosnia and Herzegovina GDP annual average growth for the period 2000-2019



Source: Adjusted from World Development Indicators (World Bank, 2020b)

The future growth of GDP is dependent on the progress of the reforms concerning improvements in the business climate and standards of governance, and the advancement of the country's EU integration agenda, along with the performance of the leading export market, the eurozone (EBRD, 2020). The value-added increased most in the agriculture sector as well as in electricity production. Although unemployment stood at 27.7 per cent in 2015, it dropped below 20 per cent in 2019. BiH average inflation rate was around 1 per cent in 2019.

The Dayton agreement has generated a complex institutional structure going hand in hand with the creation of an unwieldy administrative apparatus. This development created an inefficient and corrupt economy, gave the control of the jobs in the public sector to nationalist political parties and established a large bureaucracy structure (Belloni and Brunazzo, 2017, p. 47). The World Bank Group (2015, p. 10) report of country partnership framework for BiH for the period FY16-FY20, proposes that for the creation of a well-functioning market economy, the size of the public sector must be reduced, the institutional environment must be strengthened, and deep structural reforms must be carried out to address allocative inefficiencies in the factors of production. The EBRD transition report 2019-2020 for BiH records as key priorities (i) the improvement of the business climate, one of the most complicated in Europe, characterised by increased "red tape" and para-fiscal charges, (ii) the

depoliticisation and restructuring of the SOEs through a renewed and credible process of privatisation, and (iii) the reform of public administration. The Republika Srpska should adopt the 2018-22 strategic framework of public administration reform, and the country should accelerate the developing of a professional, de-politicised and merit-based civil service (EBRD, 2020).

The route to EU membership

In 2015, the authorities made an effort to undertake structural reforms and advance on the path to EU accession. To this line, the governments adopted a comprehensive Reform Agenda which laid out the main plans for socio-economic and related reforms of all levels of government (IMF, 2018a, p. 7). The Reform Agenda was partially successful, though short-lived (Bertelsmann Stiftung, 2018b)

In 2016 the EU Council accepted BiH's application to become a candidate for EU membership and in 2018 the European Commission stated that BiH with sustained effort and engagement could become an EU candidate (European Commission, 2019b, p. 3). The European Commission assesses BiH's application based on the country's capacity to meet the criteria set by the European Council in Copenhagen in 1993, as well as in Madrid in 1995, regarding the BiH's administrative capacity, the conditions of the Stabilisation and Association Process (SAP), country's track record in implementing its obligations under the SAA (European Commission, 2019b, pp. 3–4).

In May 2019, the European Commission adopted the Opinion on BiH's EU membership application. The Opinion indicated 14 key priorities, in the areas of democracy/functionality, the rule of law, fundamental rights and public administration reform, which the country needs to complete to progress with EU accession (EBRD, 2020). The Opinion concluded to that BiH does not yet satisfy the Copenhagen criteria related to the stability of institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities (European Commission, 2019b, p. 13).

The European Commission (2019b, pp. 13–14) among others for the BiH to achieve the necessary degree of compliance with the membership criteria, recommended the following:

- BiH's needs to strengthen its institutions to guarantee democracy, the rule of law, human rights, and respect for and protection of minorities
- BiH's constitutional framework should be aligned with the European standards and ensure the functionality of institutions to EU obligations. BiH has a decentralised state structure which is compatible with EU membership, though its institutions need to be reformed in order to participate in EU decision-making and to implement and enforce the acquis fully.
- The electoral framework and the functioning of the judiciary require improvements. BiH needs to pay special attention to the fight against corruption and organised crime, including money-laundering and terrorism, as well as the effective functioning of border management, including migration and asylum systems. It should also strengthen the protection of fundamental rights of all citizens, including by establishing an enabling environment for civil society and reconciliation and the protection and inclusion of vulnerable groups. The state of public administration calls for urgent reform.
- BiH needs to speed up its decision-making procedures and to improve the business environment as well as the efficiency and transparency of the public sector, especially of public enterprises. The country should halt the obstacles to the proper functioning of market mechanisms, such as a weak rule of law, red tape, corruption, lengthy and overly complicated administrative procedures and high fragmentation of the internal market. In order to cope with the competitive pressure and market forces within the EU, the country needs to improve the quality of education and its orientation towards labour market needs, the quality of the physical capital, such of transport and energy infrastructure and the slow adjustment of the country's economic structure.

6.3 BiH's Political environment over the post-socialist period

For a post-socialist state, the period of transition is a rather difficult and complicated process of overcoming the political past and adopting a democratic political system. BiH's political transformation began with the decline of the authoritarian regime and the conduct of a free democratic election in 1990. The first

post-war elections held in 1996 under the new state constitution as formed in Dayton GFAP, aiming to create a democratic federation with democratic institutions and the capacity to impose and implement (Gavrić et al., 2013, p. 20). However, the history of the country's bequeathed its constitution and institutions. Dayton constitution was not the outcome of a unanimous agreement between the local actors, but of the foreign institutions to put an end to the war conflict. It was not ratified, either in a referendum or in a democratic elected representative body but it was imposed by an international decree and signed by the presidents of Croatia and Serbia and the leader of Bosnian Muslims; thus two out of three signatories were not BiH's citizens (Kasapović, 2018, p. 254).

Since its implementation, it affected the model of decision-making and provoked continuous political blockades and stalemates (Gavrić et al., 2013, p. 70). It introduced a complex governmental set up that at that time regarded as necessary, though it evolved as the major hindrance towards the establishment of a unified nation. BiH's political system is one of the most complicated and interesting political systems in the world, consisting of 13 federal units, 14 governments and parliaments (Gavrić et al., 2013, p. 12). The complex federal structure is divided into two subnational entities, the Federation of BiH (FBiH) and the Republika Srpska (RS) (Kapidžić, 2019, p. 5). In the FBiH each of the ten cantons possesses its government and full autonomy in the areas of cultural policy and policing, and relative autonomy in local issues such as education and health care. The RS is more centralised with a more powerful office of the president compared to the one in the FBiH, and it holds its own unicameral parliament. Both share a common state-level presidency with three members – a Bosniak, a Croat, and a Serb – as well as a state-level parliament consisting of the House of Representative and House of Peoples, and a common government. The entities are the primary level at which nationally collected financial resources are distributed. Also, they regulate the largest portion of civil and political rights (Kapidžić, 2019, p. 5). The eastern province of Brčko is country's multicultural district which falls inside the territory of both the FBiH and the RS and is administered jointly by both entities (Turp, 2019) (please see Map 6.1). The BiH's Constitutional Court is the main hybrid institution in the country, composed by six local judges (two Bosniaks, two Croats, and two Serbs) and three international judges selected by the

ECtHR (Belloni and Ramović, 2020, p. 48). The 2018 BTI country report for BiH (Bertelsmann Stiftung, 2018b, p. 12) records that the non-compliance to Constitutional Court rulings is a crime, that is rarely prosecuted, and the Parliaments hardly execute their oversight function, remaining only voting machines for the ruling parties' leaders.

A political system submissive to nationalist manipulation, with the international community both attempting to guarantee stability, though of nationalist character, and trying to support the building of a functional state by enforcing central institutions, established in post-war BiH (Belloni and Ramović, 2020, p. 46). The Dayton GFAP institutionalised ethnicity of all levels of governance and as such guaranteed the post-war prominence of the same political parties and individuals who started the conflict (Belloni and Ramović, 2020, p. 47). The constitution recognises Bosniacs, Croats and Serbs as the three constituent peoples, while citizens may declare themselves as "others", either by identifying with another ethnic group or by choosing not to affiliate with any group (OSCE, 2019, p. 4). Hence, BiH's post-war democracy's develop in a framework of institutionalised power – sharing between the three main ethnic groups. To this context the country functions as a consociational democracy with several political parties represent each of three main ethnic groups (Kapidžić, 2019, p. 4).

BiH's constitutional system incorporates the international democratic standards related to electoral systems such as universal suffrage, equal voting rights, direct ballot, secret ballot, and limited right to stand for elections (Gavrić et al., 2013, p. 63). However, the consecutive wins of the nationalistic parties during the 2000s which preserved their illegal network reflected the polarisation and fragmentation of BiH's political scene as well as the failure to gain the status of stable democracy besides the establishment of the free and fair elections (Gavrić et al., 2013, p. 20). Even, the last elections of October 2018 were led by the BiH's three entrenched nationalist blocs, that are, the Bosniak nationalist Party of Democratic Action (SDA), the Croat nationalist Croatian Democratic Union (HDZ-BiH), and the Serb nationalist Alliance of Independent Social Democrats (SNSD). Even though the country has an unusually large number of political parties (67 in the 2018 elections) in proportion to

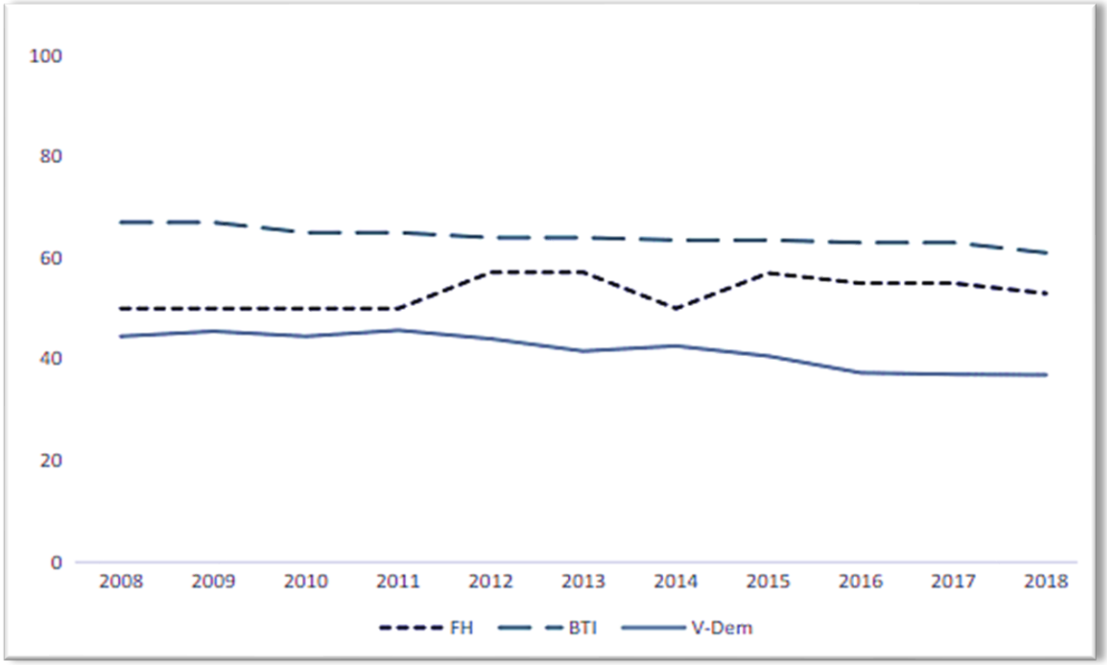
its small population (3.5 million), two or three parties of each ethnic group tend to alternate in government (Bertelsmann Stiftung, 2018b, p. 16).

The elections in BiH are held regularly, and there is turnover in government, though there are serious deficiencies such as insufficient legal framework, outdated voter registries, biased media coverage or manipulations in the composition of polling station commissions (2019, p. 13). BiH's electoral process under the deficient legislative framework is characterised by insufficient safeguards to prevent abuse of state resources for campaigning, the influence of money on electoral outcomes, and non-transparent financial accounts of parties and candidates (Kapidžić, 2019, p. 14). Ethnicity is behind every political action in BiH (Arnautović, 2019, p. 94). Political parties and leaders want to hold power unifying the ethnic group they represent by serving exclusively group's interest at the expense of democracy. Clientelism, in the form of patronage, is based on control of SOEs is a major driver of electoral outcomes in the country (Kapidžić, 2019, p. 15). Specifically, employment opportunities and resources of SOEs are placed in the political contest for luring the voters. Since political parties appoint SOEs governing boards, they can use to fulfil their electoral promises, at the expense of public interest and this is the main form of patronage in the BiH.

All domestic and international actors acknowledge that country's political system requires reform, but the fragile post-war consociationalism power balance makes an attempt towards this direction hard. The introduction of democracy de jure was not a guarantee for the development of the BiH's regime as a liberal democracy. Country's political regime is more as a hybrid regime with the elements of the authoritarianism to be notified when it comes to the implementation of democratic practices. Kapidžić (2019) finds that there are subnational variations between the FBiH and the RS, with the former to hold a competitive authoritarian regime and the latter an electoral democracy. During the period 2008-2018, the level of democracy has been low, having a decreasing tendency (please see figure 6.2). As the figure 6.2 displays based on the analysis of Kapidžić, the three indices, Freedom House (FH), the Bertelsmann Transformation Index (BTI) and the Varieties of Democracy (V-Dem) Liberal Democracy Index (LDI) agree on this incremental decline. The BTI places BiH in the category of defective democracies (Bertelsmann Stiftung, 2019). The definition of defective democracy is based on Merkel's (2004, p. 43) concept of democracy, which

is that five partial regimes together constitute an embedded democracy: elections, political participation rights, civil rights, horizontal accountability, and effective government. If one of the partial regimes of an embedded democracy is damaged in such a way that it changes the entire logic of a constitutional democracy then a defective economy arises (Merkel, 2004, p. 48)

Figure 6 2 – Democracy measurements for BiH for the period 2008-2018



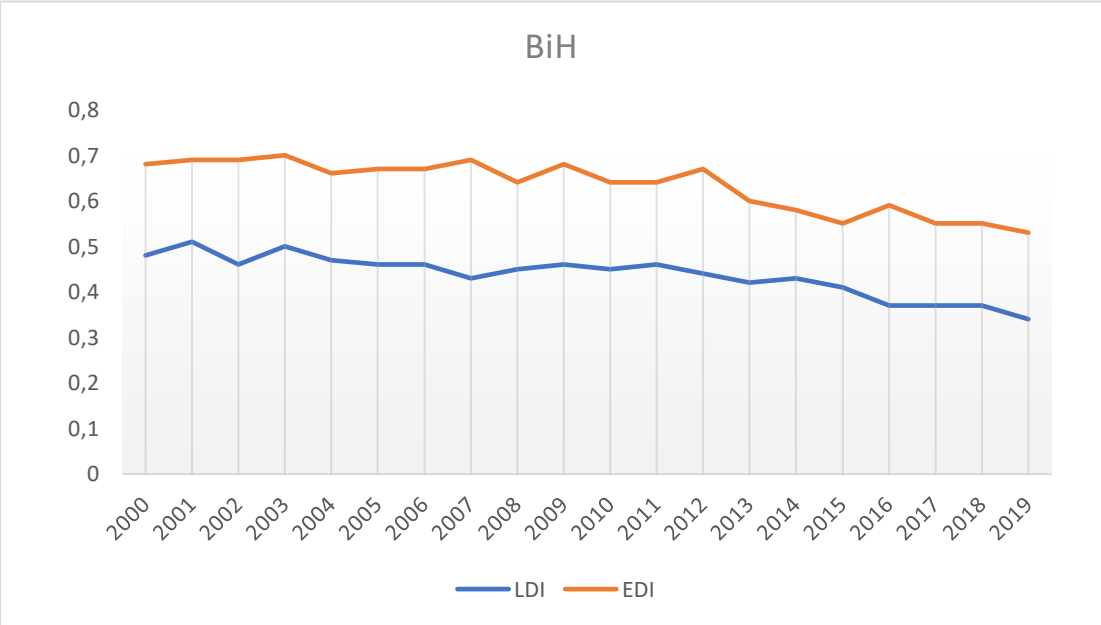
Source: Kapidžić (2019, p. 4)

The Freedom House Nations in transit report for BiH (2018a, p. 1) recorded a slight decline of the state's democracy in 2018 due to the mal performance of the electoral process, local democratic governance and judicial framework and independence. Specifically, the long period of stagnation in improving electoral legislation regarding ECtHR rulings on not respecting the rights of minorities and fixing electoral rules, cause a decline in the electoral process in 2018. Local Democratic governance proved to be inefficient to provide essential services to citizens due to institutional deadlocks. The deficient judicial system, the complex institutional structure along with the widespread political pressure and the non-implementation of Constitutional Court decisions had a negative impact to democracy (Freedom House, 2018a, p. 3). Besides the V-DEM's LDI (please see figure 6.2), also V-DEM's Electoral Democracy Index (EDI) presents a democratic decline in BiH. Figure 6.3 displays the

progress of democratic score in BiH measuring by V-Dem's LDI and EDI during 2000-2019.

BiH with a score of 0.34 in LDI and a score of 0.53 in EDI is an electoral democracy, ranking 9th in a list of the top twenty countries that share the risk of Adverse Regime Transition (ART) (Morgan et al., 2019). From 2011 onwards, the democracy declines in such a rate that there is a threat BiH to fall from electoral democracy to electoral autocracy based on the 0.53 score that recorded in 2019. An ART occurs when a country moves down the RoW index from one year to the next in a two-year window, reflecting a decline in the democratic qualities of a country's political regime (Morgan et al., 2019, p. 2). For example, when a country goes form an electoral autocracy to a closed autocracy from one year to the next (Morgan et al., 2019, p. 5) . Based on the RoW typology for being classified as an electoral democracy it requires just holding reasonably free and fair multiparty party elections and an average score on V - Dem's Electoral DI above 0.5 (Lührmann, Mechkova, et al., 2018, p. 1327). The same index defines a country as a liberal democracy when records a score of at least 0.8 in V-Dem's Liberal Democracy Index (LDI). The V-DEM's EDI as well as LDI run on a continuous scale, from low to high (0-1), with higher values indicating a more democratic dispensation.

Figure 6 3 –BiH's Electoral Democracy Index (EDI) & Liberal Democracy Index (LDI) during the period 2000-2019



Source: Adapted from V-DEM data (2020)

The 2018 elections took place among political stagnation, insufficient economic growth, and among the population's feelings of disappointment for the public institutions (OSCE, 2019, p. 4). Public institutions perceived as inefficient, unfair, and unpredictable. Beyond their inefficiency, the decentralised way that their provision of services is based, making welfare support dependent on the place of citizens' residence, in fact on ethnic criteria, preserves societal divisions (Belloni and Ramović, 2020, p. 50). The report of European Forum for Democracy and Solidarity (2019) referring to the political situation in BiH as it developed after the 2018 elections, records that citizens went to vote in 2018 for the general elections to decide whether the country will move towards the EU membership and NATO integration or whether the society will continue to live along the lines of the ethnic fragmentation. The outcome of the last elections did not change the balance between nationalist versus citizens, though the Social Democratic Party (SDP) gain more support on the national level from 9.5 to 13.9 per cent, as well as other multi-ethnic parties. Once more the nationalist parties will form ruling majorities, but this time there is an optimism that there is a change towards multi-ethnic politics and reform (European Forum for Democracy and Solidarity, 2019, p. 1). Nevertheless, the formation of a new state government took 14 months due to main Bosniak, Croat and Serb parties' disagreements while BiH faces more political upheaval in the run-up to local elections before the end of 2020 (Latal, 2020).

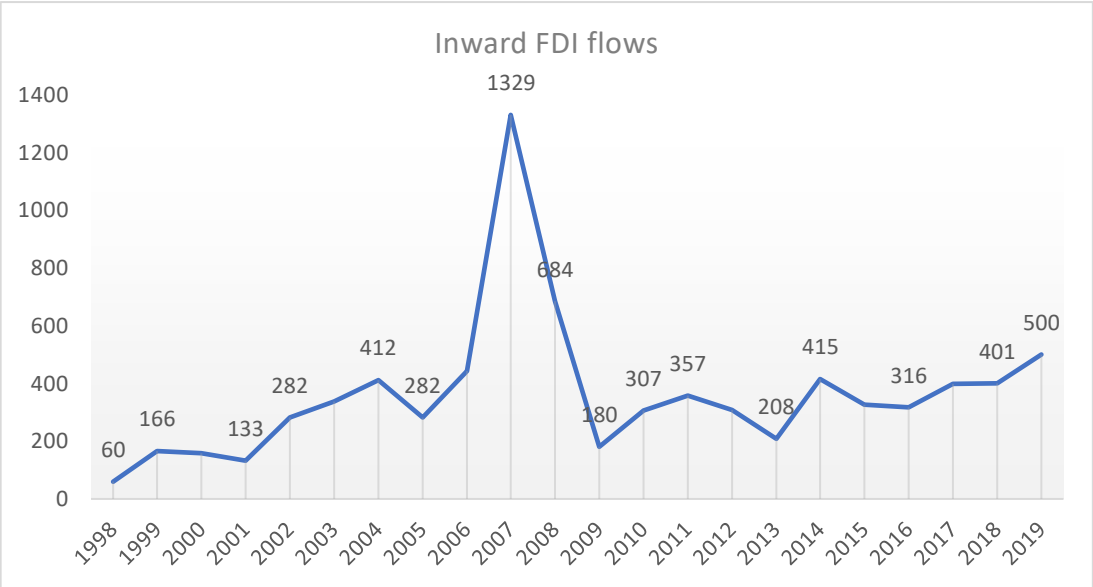
6.4 Inward FDI in BiH

The role of FDI in transitional economies with a low rate of development is of specific importance. FDI contributes to the establishment of sustainable economic underpinnings, and as such to economic prosperity, thus meeting the EU economic accession criteria, according to the analysis of Chapter three (section 3.6).

Since BiH has formally entered the accession process to the EU and is working to achieve economic integration with the regional bloc, the enforcement of inward FDI will enable this process. However, BiH as a recipient of FDI flows lagged behind those post-socialist countries that joined EU in the 2004 and 2007 enlargements and only in 2007 managed to attract a considerable amount of inward FDI (Deichmann, 2012, p. 8) (please see figure 6.4). In fact, in the 2000s, the BiH's government took measures

for attracting FDI as the privatisation of some large SOEs, that resulted in the largest registered inward FDI flows of 1.329 million EUR in 2007 and the largest FDI increase by 200.62 per cent in country's history (please see figure 6.5) (Bakota, 2019, p. 1) (please see figure 6.4). To the privatisation also is attributed the largest inward FDI as a percentage of GDP, that is 11.5 per cent (please see figure 6.6), while in 2008 no major privatisations occurred and the inflows decreased to 684 million EUR (please see figure6.4). Privatisations took place in the telecommunications and energy sector. Specifically, Telekom Srbija acquired a 65 per cent stake in Telekom Srprska for a reported 646 million EUR, the biggest investment in BiH's, and Russian Zarubezhneft acquired two oil refineries and a network of fuel pumps for 121 million EUR (UNCTAD, 2015, p. 2). Deichmann (2012, p. 8) records that BiH at that time was "plagued by weaknesses in the business environment, an uncompetitive tendering process, and the inefficiencies caused by the divided structure of the country and its bureaucracy". Hence, even before the 2008 global financial crisis, BiH has not been able to attract adequate for its economic growth, amounts of foreign capital.

Figure 6 4 - Inward FDI flows, in BiH, in millions of EUR for the period 1998-2019

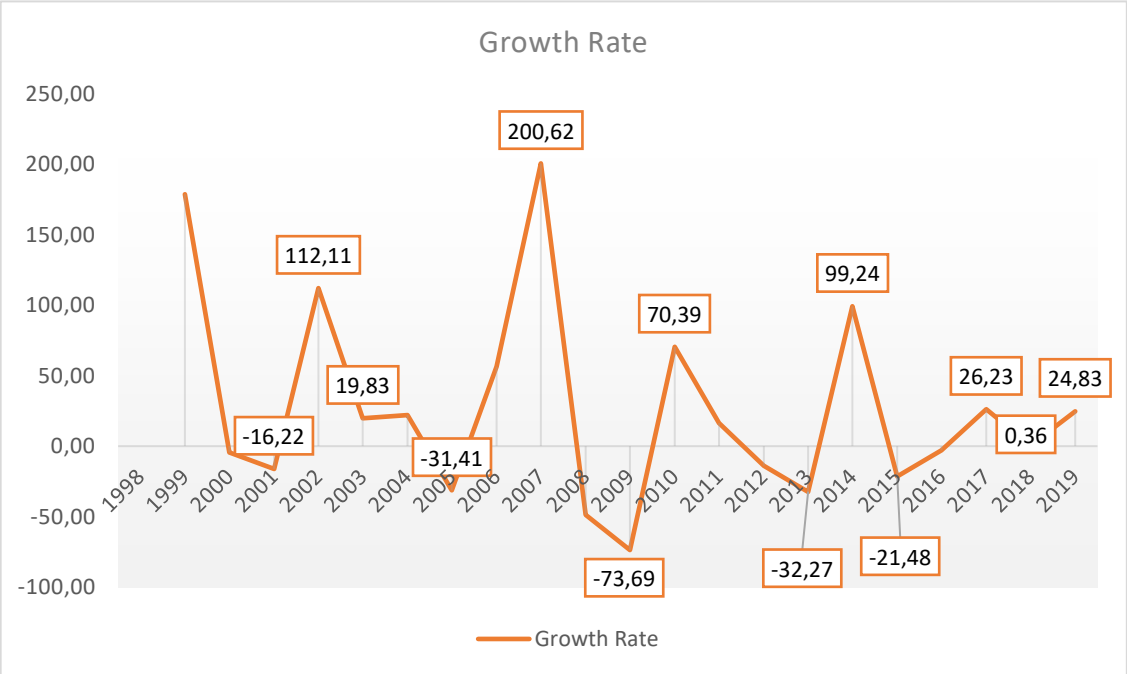


Source: Adapted from wiiw FDI Database (wiiw, 2020), FDI: total, annual

The global financial crisis struck BiH severely as a host country of FDI and in 2009 recorded the lowest level of inward FDI, that is only 180 million EUR. Despite any slight increase during 2010-2011, in 2013 FDI inflows downslide (please see figure 6.4). This sluggish performance of FDI is mostly related to the slow economic recovery of the EU, BiH's leading trade and investment partner (UNCTAD, 2015, p. 2). In 2017 an

increase of 26.23 per cent has recorded which fell to 0.36 per cent in 2018 due to political instability that the governmental elections produced (please see figure 6.5). In recent years FDI inflows consisted mainly of reinvested earnings, while greenfield investment remained very low, in all sectors except tourism (European Commission, 2019b, p. 73). The BiH overall performance in FDI attraction is weak. The process of privatisation, giving remarkable outcome in the past, is stalling mainly in SOEs due to the lack of political will, while some of the SOEs are engaged in purely commercial activities and are not expected to attract foreign investors (UNCTAD, 2015, p. 3).

Figure 6 5 – Growth rate of FDI inflows in BiH for the period 1998-2019

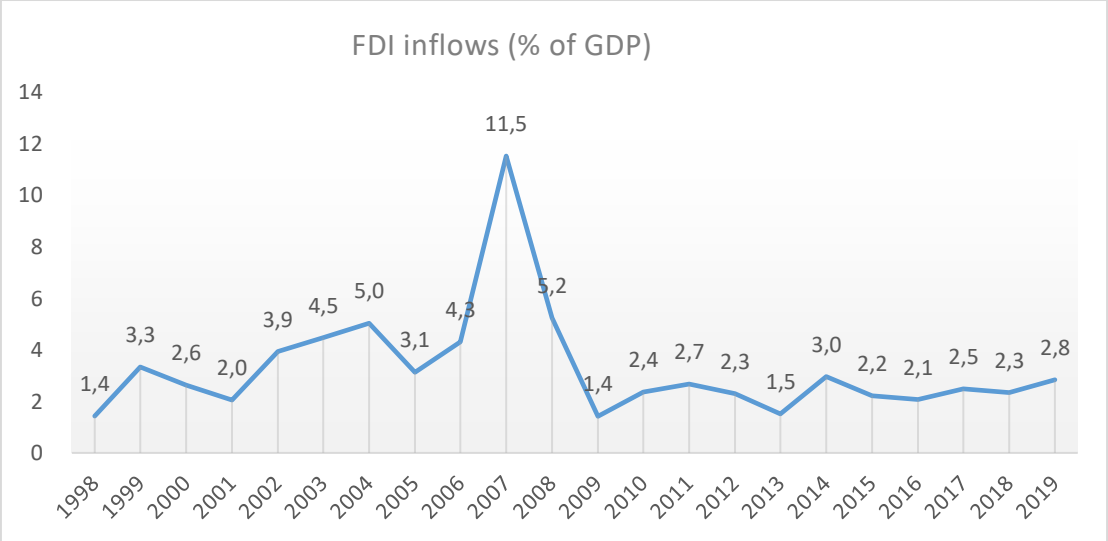


Source: Adapted from wiiw FDI Database (wiiw, 2020), FDI: total, annual

In terms of FDI inflows, the biggest investor country in 2018 was Russia (71.7 million EUR), followed by Croatia (54.2 million EUR) and the Netherlands (48.1 million EUR). Others countries registered as leading investors are Austria (44.5 million EUR), Germany (42.8 million EUR), UK (41.6 million EUR) (FIPA, 2019, p. 4).

FDI received annually by a host country, typically runs at about 2-3 per cent of the size of host economy measured by its GDP and when it exceeds 5-6 per cent of GDP each year, then it is considered as a significant performance (TheGlobalEconnomy.com, 2019). From 2008 onwards, the inward FDI to GDP runs below the down limit of 5 per cent. For the period 2014-2019 this indicator accounting for some 2.5 per cent on average (please see figure 6.6).

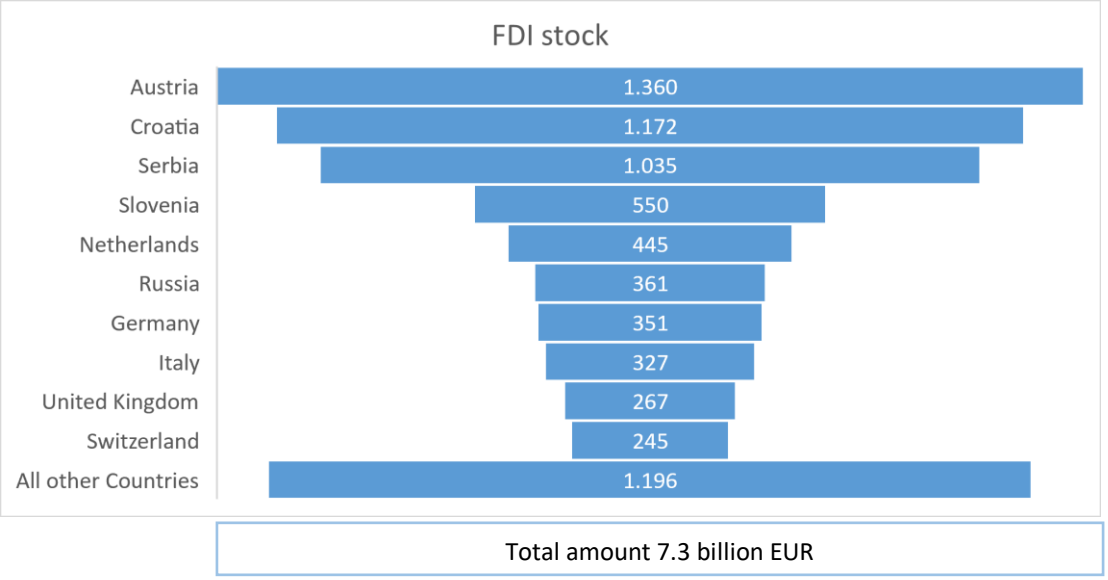
Figure 6 6 – Inward FDI flows in BiH as a percentage of GDP, for the period 1998-2019



Source: Adapted from wiiw FDI Database (wiiw, 2020), FDI total, annual

The total amount of inward FDI stock in 2018 was 7.3 billion EUR. In the structure of FDI, for the period May 1994 till December 2018, equity and reinvested earnings were 5.6 billion EUR, and other capital was 1.7 billion EUR (FIPA, 2019, p. 2). As figure 6.7 displays, the FDI stock by investor countries in the post-war period originated mainly from EU countries. Austria is holding the largest share (1.4 billion EUR) following by BiH's peers in the region Croatia (1.2 billion EUR) and Serbia (1.0 billion EUR) (FIPA, 2019, pp. 2–3).

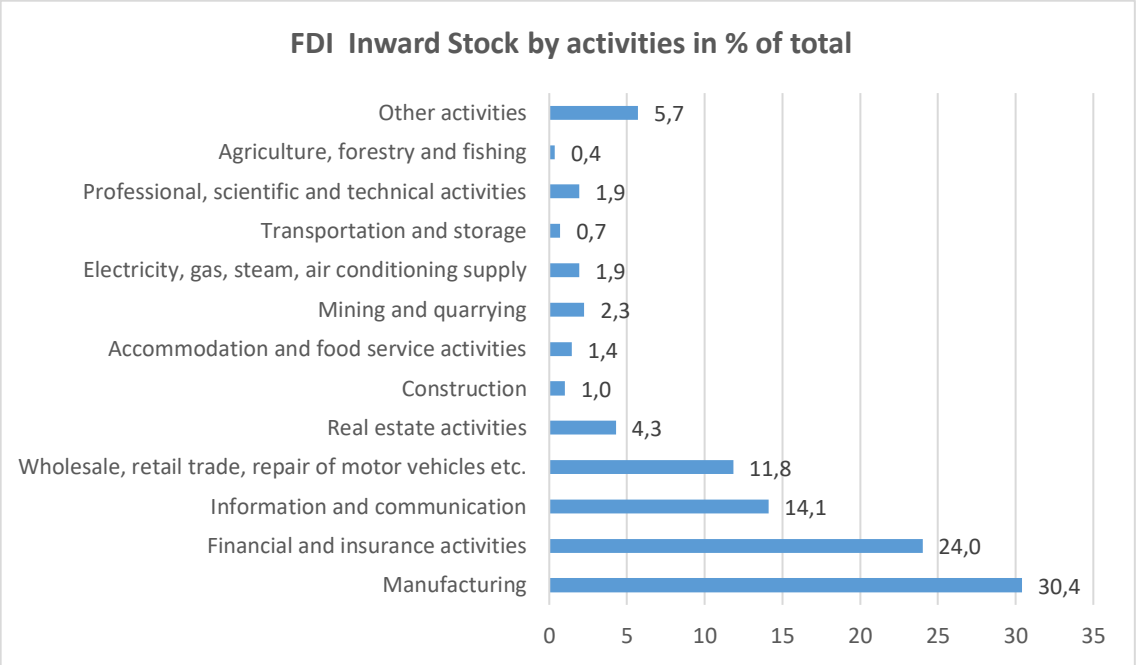
Figure 6 7 – FDI stock by top investor countries in BiH, in millions of EUR, for the period 1994-2018



Source: FIPA (2019, p. 3)

FDI stock is concentrated in the manufacturing sector, the financial sector, in the ICT sector, trading and the electricity sector, and real estate (please see figure 6.8). The notable resurgence of the metal sector and related industries have stimulated FDI in the auto-parts industry, which developed as one of the most successfully export-oriented industries (UNCTAD, 2015, p. 1). BiH's is the only net exporter in SEE, holding significant reserves in fossil fuels and renewables, like hydropower, where an estimated one-third of total potential is being used (UNCTAD, 2015, p. 1). ICT is a fast-growing sector in BiH due to young software developers establishing their start-ups, upgrading the digitalisation process in the country, and are now working side by side with large outsourced MNEs (Deloitte, 2019, p. 12).

Figure 6 8 - BiH's FDI Inward stock by activities in the percentage of the total, the average for the period 2010-2018



Source: Adapted from wiiw FDI Database (wiiw, 2020), FDI by activities

BiH has the potential to attract higher levels of FDI inflows across various sectors and reinforce the country's bid for EU and WTO membership. Factors such as an educated workforce coupled with competitive labour costs, abundant energy available in competitive price, a simplified tax structure (17 per cent VAT and 10 per cent flat income tax), a liberal trade regime with trade access to major European consumer markets, can support country's development as an attractive destination for investment (U.S. Department of State, 2019a; UNCTAD, 2015). The country's legal framework is open to FDI; there is no discrimination against foreign investors, rather

than a few restrictions. The Law on the Policy of FDI permits foreign investors to invest most of the economy's sector in the same form and under the same conditions as residents. They are restricted to invest into the defence industry, publishing and media that face a restriction of 49 per cent while in the electric power transmission face a total restriction (U.S. Department of State, 2017, p. 4).

Most of the investment partners countries have built long term strong relations with BiH, since they have acquired the experience of doing business in the country's complicated environment, mainly stemming from country's highly decentralised government and public administration (UNCTAD, 2015, p. ix). However, a new foreign investor in BiH has to overcome hurdles such as political instability, complex legal and regulatory frameworks and government structures, non-transparent business procedures, substantial red tape, insufficient protection of property rights, and a weak judicial system to succeed (European Commission, 2019b; U.S. Department of State, 2019a). Furthermore, the high level of corruption can be a significant disadvantage for them and not for the established local companies, especially those with backing by various levels of government. Hence, the highly fragmented and politicised economy with the multi-tiered legal and regulatory framework is not conducive so far to attracting foreign investors.

Despite the existence of a state law and entity legislation on FDI and some regulatory improvements, European Commission's report (2019b, p. 142) on assessing BiH's application for membership of the EU records, records as central problems in stimulating FDI inflows, the lack of a countrywide strategic framework. The China-CEE Institute report on FDI in BiH, conducted by Bakota (2019) presents the pessimist projections of country's economists on BiH's ability to grasp a share of the significant investment wave that is expected in the WB, and to improve FDI performance for catching up at least its neighbouring countries Serbia and Montenegro.

6.5 Empirical Analysis

The empirical analysis of this research on the political system's impact on inward FDI inflows is included in Chapter 4. Thus, it provides variables descriptions, data, model specification and empirical results concerning the total of the six transitional WB. The empirical analysis uses a panel dataset of the variables of interest for a period from

1996 to 2018. Table 6.2 presents a short description of the variables included in the empirical model, their coding, and sources of data.

Table 6 2 - Variables description and Coding

Variables	Description	Code	Source of Data
Dependent Variable			
FDI inflows	The natural log of net FDI inflows	*lnfdi*	wiiw-FDI database
Independent Variables			
1. LDI	The is aggregate index that describes features of democracy at the highest level	*ldi*	V-Dem Dataset (V.10)
2. The signing of Bilateral Investment Treaties (BITs)	The conclusion of an IIA between two countries for the promotion and protection of FDI	*bit*	UNCTAD-International Investment Agreements Navigator
3. Governance Indicators	A set of traditions and institutions by which authority in a country is exercised.		
3a *Voice and Accountability*	The dimension of Quality and Governance	*voice*	Worldwide Governance Indicators (WGI)
3b. *Political Stability and Absence of Violence / Terrorism*	The dimension of Quality and Governance	*polstab*	
3c. *Government Effectiveness*	The dimension of Quality and Governance	*goveffe*	
3d. *Rule of Law*	The dimension of Quality and Governance	*rule*	
3e. *Control of Corruption*	The dimension of Quality and Governance	*cc*	
3f. *Regulatory Quality*	The dimension of Quality and Governance	*regq*	
Controlling-non governance indicators			
4. Growth	Annual percentage growth rate of GDP	*gdp_growth*	World Bank-World Development Indicators database
5. Market Size	GDP at constant 2010 prices in US dollars	*GDP*	

Variables Data for BiH

The data used for BiH is presented below

Dependent variable

lnFDI

BiH	
Index Year	**Net FDI inflows** *in EUR mn*
1998	59,6
1999	165,9
2000	158,6
2001	132,8
2002	281,8
2003	337,6
2004	411,7
2005	282,4
2006	442,2
2007	1329,2
2008	683,8
2009	179,9
2010	306,6
2011	357,2
2012	307,3
2013	208,1
2014	414,7
2015	325,6
2016	316,2
2017	399,1
2018	400,6

Notes: The net FDI inflows are in EUR mn

Source: http://wiiw.ac.at/fdi-database.html

Independent variables

Ldi

BiH	
Index Year	**Liberal Democracy Index (LDI)**
1996	0,14
1997	0,42
1998	0,42
1999	0,44
2000	0,48
2001	0,51
2002	0,46
2003	0,50
2004	0,47
2005	0,46
2006	0,46
2007	0,43

2008	0,45
2009	0,46
2010	0,45
2011	0,46
2012	0,44
2013	0,42
2014	0,43
2015	0,41
2016	0,37
2017	0,37
2018	0,37

Source: www.v-dem.net/en/analysis/CountryGraph

Bit

Country: BiH

A/A	Short title	Date of signature
1	Bosnia and Herzegovina - San Marino BIT (2011)	02/08/2011
2	Albania - Bosnia and Herzegovina BIT (2008)	17/06/2008
3	Bosnia and Herzegovina - Slovakia BIT (2008)	02/06/2008
4	Bosnia and Herzegovina - Lithuania BIT (2007)	07/06/2007
5	Bosnia and Herzegovina - India BIT (2006)	12/09/2006
6	Bosnia and Herzegovina - Jordan BIT (2006)	02/07/2006
7	Belarus - Bosnia and Herzegovina BIT (2004)	29/11/2004
8	Bosnia and Herzegovina - Denmark BIT (2004)	24/03/2004
9	BLEU (Belgium-Luxembourg Economic Union) - Bosnia and Herzegovina BIT (2004)	03/03/2004
10	Bosnia and Herzegovina - France BIT (2003)	12/12/2003
11	Bosnia and Herzegovina - Switzerland BIT (2003)	05/09/2003
12	Bosnia and Herzegovina - Moldova, Republic of BIT (2003)	09/04/2003
13	Bosnia and Herzegovina - United Kingdom BIT (2002)	02/10/2002
14	Bosnia and Herzegovina - Hungary BIT (2002)	26/09/2002
15	Bosnia and Herzegovina - China BIT (2002)	26/06/2002
16	Bosnia and Herzegovina - Spain BIT (2002)	25/04/2002
17	Bosnia and Herzegovina - Czech Republic BIT (2002)	17/04/2002
18	Bosnia and Herzegovina - Portugal BIT (2002)	13/03/2002
19	Bosnia and Herzegovina - Ukraine BIT (2002)	13/03/2002
20	Bosnia and Herzegovina - Serbia BIT (2001)	18/12/2001
21	Bosnia and Herzegovina - Germany BIT (2001)	18/10/2001
22	Bosnia and Herzegovina - Pakistan BIT (2001)	04/09/2001
23	Bosnia and Herzegovina - Kuwait BIT (2001)	13/06/2001
24	Bosnia and Herzegovina - Slovenia BIT (2001)	30/05/2001
25	Bosnia and Herzegovina - Romania BIT (2001)	20/02/2001
26	Bosnia and Herzegovina - Macedonia, The former Yugoslav Republic of BIT (2001)	16/02/2001
27	Bosnia and Herzegovina - Greece BIT (2000)	13/12/2000

28	Bosnia and Herzegovina - Finland BIT (2000)	01/11/2000
29	Bosnia and Herzegovina - Sweden BIT (2000)	31/10/2000
30	Austria - Bosnia and Herzegovina BIT (2000)	02/10/2000
31	Bosnia and Herzegovina - Italy BIT (2000)	19/05/2000
32	Bosnia and Herzegovina - Qatar BIT (1998)	01/06/1998
33	Bosnia and Herzegovina - Netherlands BIT (1998)	13/05/1998
34	Bosnia and Herzegovina - Egypt BIT (1998)	11/03/1998
35	Bosnia and Herzegovina - Turkey BIT (1998)	21/01/1998
36	Bosnia and Herzegovina - Iran, Islamic Republic of BIT (1996)	27/07/1996
37	Bosnia and Herzegovina - Croatia BIT (1996)	26/02/1996

Source: https://investmentpolicy.unctad.org/international-investment-agreements

Governance Indicators

BiH						
Index Year	***cc***	***rule***	***voice***	***polstab***	***goveffe***	***regq***
1996	-0,27	-0,24	-0,1	-0,59	-1,19	-0,91
1997	.	.	.	.	.	.
1998	-0,38	-0,64	-0,01	-0,58	-1,08	-0,87
1999	.	.	.	.	.	.
2000	-0,56	-0,61	-0,11	-0,53	-0,84	-0,5
2001	.	.	.	.	.	.
2002	-0,4	-0,66	-0,09	-0,16	-0,96	-0,56
2003	-0,3	-0,63	0,21	-0,4	-0,75	-0,48
2004	-0,34	-0,5	0,17	0,02	-0,63	-0,21
2005	-0,24	-0,52	0,21	-0,5	-0,76	-0,58
2006	-0,3	-0,5	0,19	-0,44	-0,62	-0,46
2007	-0,38	-0,47	0,13	-0,63	-0,84	-0,28
2008	-0,36	-0,41	0,02	-0,54	-0,6	-0,15
2009	-0,38	-0,36	0	-0,67	-0,72	-0,09
2010	-0,34	-0,35	-0,08	-0,69	-0,74	-0,09
2011	-0,32	-0,33	-0,16	-0,82	-0,74	-0,03
2012	-0,3	-0,21	-0,1	-0,54	-0,46	-0,05
2013	-0,24	-0,15	-0,12	-0,4	-0,43	-0,07
2014	-0,31	-0,19	-0,07	-0,02	-0,45	-0,09
2015	-0,39	-0,28	-0,1	-0,4	-0,55	-0,2
2016	-0,46	-0,22	-0,13	-0,4	-0,39	-0,17
2017	-0,52	-0,21	-0,21	-0,38	-0,48	-0,15
2018	-0,57	-0,57	-0,24	-0,39	-0,62	-0,21

Source: https://info.worldbank.org/governance/wgi/Home/Reports

gdp_growth & GDP

BiH		
Index Year	**GDP** growth annual (%)	**GDP** (constant 2010 US$)
1996	88,96	6.303.135.042,93
1997	34,39	8.470.756.370,09
1998	15,60	9.792.194.055,79
1999	9,60	10.732.244.665,08
2000	5,50	11.322.518.168,43
2001	4,40	11.820.708.911,99
2002	5,30	12.447.206.515,91
2003	4,00	12.945.094.784,68
2004	6,10	13.734.741.266,21
2005	8,76	14.937.802.510,81
2006	5,42	15.747.023.557,68
2007	5,86	16.669.103.897,50
2008	5,43	17.573.690.592,73
2009	-3,00	17.045.996.152,56
2010	0,77	17.176.781.336,76
2011	0,91	17.332.789.318,86
2012	-0,70	17.211.525.255,87
2013	2,35	17.616.174.497,48
2014	1,15	17.818.414.204,83
2015	3,09	18.368.686.543,38
2016	3,15	18.946.501.375,79
2017	2,13	19.349.615.814,45
2018	3,62	20.050.758.075,29

Source: https://databank.worldbank.org/source/world-development-indicators

Table 6.3 presents descriptive statistics for all variables. They include total observations available for the variables along with minimum, maximum, mean, and standard deviation for each of them.

Table 6 3 - Descriptive statistics

	Variable	Obs	Mean	Std.Dev.	Min	Max
BiH	*lnfdi*	21	19.506	0.629	17.902	21.008
	ldi	23	0.427	0.073	0.140	0.510
	cc	20	-0.368	0.096	-0.570	-0.240
	rule	20	-0.403	0.170	-0.660	-0.150
	voice	20	-0.030	0.140	-0.240	0.210
	polstab	20	-0.453	0.211	-0.820	0.020
	goveffe	20	-0.693	0.216	-1.190	-0.390
	gdp_growth	23	0.093	0.189	-0.030	0.890

GDP	23	2.666	0.297	1.841	2.998
bit	23	1.000	1.128	0.000	3.000
regq	20	-0.308	0.266	-0.910	-0.030

In Chapter 4 the model $y_{it} = x'_{it}\beta + u_{it}$, with $X' = \{$ *ldi, cc , rule, voice, polstab, regq, goveffe, bit, GDP_growth, GDP, time, country dummies* $\}$ and y: the dependent variable represented by the log of *fdi (lnfdi),* estimated for analysis including the six economies of WB. The analysis used a log transformation of the dependent variable both to eliminate heteroscedasticity problems and reduce the influence of potential outliers of those observations where the errors satisfy the equation, $u_{it} = \rho_i u_{i,t-1} + \varepsilon_{it}$ (please see Chapter 4-Section 4.3).

It has already notified that having data overtime for the six WB countries, a decision to use panel data techniques is based on the ability to export robust results. The Prais-Winsten procedure followed to run regressions as in the case of Albania (please see Chapter 5-Section 5.5). Although we correct for autocorrelation and avoid the spurious regression problem as described in Chapter 4-Section 4.3, the estimates are biased and inconsistent due to the limited number of observations. Table 6.4 presents along with the panel data model (detailed analysis in Chapter 4) the time series estimates for BiH. The coefficients in the panel data model are significant for four explanatory variables and one control variable while in the single time series model, only one significant impact estimated.

Table 6 4 – Comparison of regressions

	Panel Data Model	**BiH**
Dependent Variable :	**lnfdi**	**lnfdi**
Ldi(t-1)	0.744	-11.77
	(0.66)	(-1.93)
cc(t-1)	-0.116	3.343*
	(-0.25)	(2.49)
rule(t-1)	-1.081*	-0.741
	(-2.37)	(-0.27)
voice(t-1)	0.956*	1.008
	(2.54)	(0.66)
polstab(t-1)	0.365*	0.650

	(2.25)	(1.27)
goveffe(t-1)	0.559	-1.244
	(0.83)	(-0.81)
bit(t-1)	-0.0519	-0.247
	(-1.27)	(-1.81)
regq(t-1)	-0.956*	-2.177
	(-2.42)	(-1.22)
gdp_growth(t-1)	0.00467	-0.157
	(0.23)	(-1.95)
GDP (t-1)	3.906***	4.962
	(4.79)	(1.26)
time	-0.0336	-0.119
	(-0.89)	(-0.74)
Country dummies		
Bosnia_Herzegovina	-1.619***	
	(-4.23)	
Kosovo	1.896***	
	(3.54)	
North_Macedonia	0.500	
	(1.75)	
Serbia	-3.982***	
	(-3.66)	
Montenegro	3.779***	
	(4.59)	
_cons	10.50***	13.52
	(7.37)	(1.49)
N	92	18

T -statisitcs in parentheses. (*) Significant at p<0.05, (**) Significant at p<0.01, (***) Significant at p<0.001.

The major problem of the research's data set for BiH is the limited number of available observations (233 of BiH over 1317 of the panel data model). Hence, with pure time-series analysis, the extraction of exact estimates and robust test statistics is constrained. Panel data sets contain more variability to exploit, more efficiency and

offer more information than pure time-series data or cross-sectional data. According to the existing literature, panel data methods can detect and measure statistical effects that pure time-series or cross-sectional analysis cannot. Additionally, panel data set lets us control for unobservable, something that time series does not allow. Hence, the adaption of the panel data technics helps to obtain more accurate and more robust estimates. The following section discusses the empirical results of the panel data model adjusted for the country of BiH.

6.5.1 Empirical results - Discussion

Based on the above analysis, study's empirical results provide evidence that the explanatory variables, political stability & absence of violence/terrorism *(pol_stab),* voice & accountability *(voice),* the rule of law *(rule),* regulatory quality *(regq)*, as well as the control variable of the market size *(GDP)* are significantly associated with inward FDI. Specifically, political stability & absence of violence/terrorism, the voice & accountability, and the market size are positively related to FDI while the rule of law, and regulatory quality negatively. The variable of political regime influences positive inward FDI, meaning that a more democratic regime is more attractive to foreign agents, though it is not a determinant to FDI flows that the country receives. Control of corruption, government effectiveness, and growth also found positive and insignificant. The signing of the BITs in the case of the WB economies is negatively and insignificantly related to FDI. The more detailed discussion of the empirical results follows.

As expected, the variable of political stability & the absence of violence found significant positive (please see Chapter 4-sections 4.2, 4.4). Although the war ended in 1995, issues of political instability and security remained in BiH. The US Department of State in 2019 Investment Climate Statement (2019a, p. 15) reports that BiH still faces risks from occasional, localised political and criminal violence. Furthermore, every time that elections take place in the country, the formation of government is an arduous and long-lasting process due to state's complex institutional structure and the contrasting political aspirations between the nationalistic political parties (please see section 6.3). For example, it took 15 months to form the Council of Ministers of BiH after the 2010 elections, six months to assemble ruling coalitions and form

governments at the state and entity level after the 2014 general elections, and respectively 14 months after the 2018 general elections (Bertelsmann Stiftung, 2018b; Latal, 2020). The complicated state structure as defined in Dayton GFAP established a model of government with collective rights and collective representation, almost imposing the need for broad coalitions among the political parties (Gavrić et al., 2013, p. 70). The negotiations between the political elite for the formation of government is the source of political violence and ethnic conflict. These continuous political challenges discourage potential foreign investors. Hence, the lack of political stability poses constraints in the growth of inward FDI (please see figures 6.4, 6.5) which during the post-socialist period has recorded low performance (please see figure 6.6). Therefore, the more political instability and rise of violence, including the politically or ethnically motivated violence, the country experiences, the less the amount of inward FDI flows receives.

The empirical result for the variable of voice & accountability is consistent with the literature (please see Chapter 4 - Sections 4.2, 4.4). Voice & accountability measures the perceptions of the extent to which a country's citizens can participate in their government elections, as well as freedom of expression, freedom of association, and a free media (WGI, 2019). Also, it includes individual variables for human rights, respect for the rights and freedoms of minorities. In these terms, the country confronts serious challenges provoked by the ethnic divisions. Specifically, the European Commission report on BiH's application for membership of the EU (2019b, p. 17) identifies the possibility of citizens not to be allowed effectively to exercise their right to vote and stand for elections. The delays in the implementation of the 2009 decision of the ECtHR in the Sejdić-Finci case confirms that country faces issues of discrimination and human rights violations towards minorities. The European Commission also (2019b, p. 43) records cases delivered in the ECtHR in 2018 finding that the country still violates rights related to the protection of property, human life and discrimination on the grounds of ethnic origin. The minorities are subjected to threats and harassment, including hate speech and intolerance by the media and politicians (Gavrić et al., 2013). The media landscape is not diversified and pluralistic and is segmented based on ethnic, business, and political affiliation. The European Commission (2019b, pp. 46–50) reports political pressure and intimidation against

journalists and associations dealing with war crimes, fight against corruption and human rights protection. Since the ethnic divisions prevail in the political and social life of the country, they stimulate acts of violence. Governance with low voice and accountability is associated with rise of violence which is consistent with the above analysis of the variable of political instability & the absence of violence results to the reduction of inward FDI. Therefore, the enforcement of the voice and accountability in the country will increase the amount of FDI inflows the country receives.

The empirical result for the variable of the rule of law is significant though negative in contrast with the literature findings (please see Chapter 4 - sections 4.2, 4.4). The rule of law is addressing in the scope of good governance, measuring the perceptions on effectiveness and predictability of the judiciary, as well as contracts' enforceability (WGI, 2019). The European Commission report on BiH's application for membership of the EU (2019b, p. 11) identified the lack of independence in the judiciary which is inefficient to protect it from all forms of politicisation and pressures. Ethnic-based veto rights also adversely affect the work of the Parliamentary Assembly and entity legislatures (European Commission, 2019b, p. 14). Parliaments are mainly voting machines for the ruling parties' leaders. A high number of court rulings are not implemented, even though non- adherence to Constitutional Court rulings is a crime (Bertelsmann Stiftung, 2018b, p. 12). Any reform to the rule of law is undermined by the elites' politics, which works effectively to perpetuate the status quo. Also, the associations of politicians with illegal networks are evident to the pressure they exercised to the non-implementation of the law against corruption and organised crime (Bertelsmann Stiftung, 2018b, p. 33). The weak rule of law may discourage some foreign investors from entering the country's market, though it leaves space for the strengthening of others' position. MNEs close to political parties maintain a strong influence on policies and decision-making to protect their interests, and businesses and have significant gains. The US Department of State report on 2019 BiH Investment Climate indicates that (2019a, p. 1) the foreign companies that are willing to address country's challenges and establish a presence in BiH have a good return on their investment over time. Therefore, in the Bosnian case, a weak rule of law enforces inward FDI.

Respectively to the significant negative relationship between the rule of law and inward FDI, also regulatory quality holds the same relationship. This outcome contradicts the findings of previous empirical studies which indicated a positive relationship (please see Chapter 4 - sections 4.2, 4.4). The governance's dimension of regulatory quality captures perceptions of the ability of the government to design and implement sound policies and regulations that permit and promote private sector (WGI, 2019). The US Department of State report on 2019 BiH Investment Climate (2019a, p. 2) characterises the country's regulatory framework as duplicative, contradictory, and a source of frustration for foreign investors. The same report assessing the transparency of the Regulatory quality attributes the lack of openness and transparency to the multitude of state, entity, cantonal, and municipal administrations – each with the power to establish laws and regulations, that affects business (U.S. Department of State, 2019a, p. 4). However, the lack of transparency provides opportunities to MNEs with strong political connections to achieve their targets and gain monopoly power. A reform in the regulatory framework will threaten their privileges, resulting in significant financial losses. Hence, foreign investors that have benefited from the country's institutional weakness will target other markets with lax regulations. To this extent, a more regulatory environment in BiH will reduce FDI inflows.

The empirical results of the rule of law and the regulatory quality, provide ground for future research. An in-depth analysis of foreign investors' profile that enters in the Bosnian market may provide further insights for the significant negative relationship between the rule of law, the regulatory quality, and inward FDI.

The variable of government effectiveness found positive as expected (please see Chapter 4) though not significant. This component of governance measures government effectiveness in terms of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies (WGI, 2019). From 2000 onwards, BiH has gone through a lengthy public administration reform (PAR) process, but instead public administration system to be improved, worsened over the last decade (Bertelsmann Stiftung, 2018b, p. 31). There is no political support on the PAR since the political

parties have instrumentalised the public administration for entrenching their power. For example, public employment is based on political party membership and nepotism rather than on a merit-based system (Bertelsmann Stiftung, 2018b, p. 31). To this context, the public employment always is in rise, building a dysfunctional and disproportional in size public administration system. Besides, the uniquely complex institutional state's infrastructure creates a complex with overlapping competencies public administration sector (EBRD, 2020, p. 3). The 2019 report of the European Commission (European Commission, 2019b, p. 23) for the application of BiH for the membership of the EU on the functioning and organisation of public administration, notifies the need for the introduction of a coordinated countrywide public administration reform framework with a coordinated monitoring and reporting system. Since the public administration institutions operate within a complex governance structure with separate decision-making competences in public policies, it ends up being inefficient to deliver services to citizens and businesses and to implement sound policies. Coupling the highly complex and inefficient administrative structures with the high political and regulatory uncertainty, the cost of doing business in BiH ends up to be high (IMF, 2018a, p. 10). Hence, a poor quality in public administration that produces delays in business activities, increasing their cost, maybe a source of pain for foreign investors. An improvement government effectiveness as a good governance dimension plays a positive role in rise of inward FDI, though not a determining one.

The variable of control of corruption measures 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 (WGI, 2019). Control of corruption found to be positive with inward FDI, confirming most studies' empirical results (please see Chapter 4 - sections 4.2, 4.4). European Commission's report for the application of BiH for the membership of the EU (2019b, p. 28) records the widespread corruption as an issue of concern. The legislative framework for the fight against in BiH is inadequate and remains fragmented across the various government levels (European Commission, 2019b, p. 40). The outcome is that the number of officials convicted of abuse of office and corruption in BiH is small. Accurately, the Bertelsmann Stiftung report on BiH (2018b, p. 13) records 296

confirmed indictments in the country between September 2015 and August 2016 and 173 convictions, a majority of which led to suspensions. Any anti-corruption strategy adapted, suffered from a lack of coordination and harmonisation and a low degree of implementation (2018b, p. 33). Given the high level of corruption, foreign investors can be at a significant disadvantage to well-established local companies, with formal or informal backing by countries' various levels of government (U.S. Department of State, 2017, p. 3). The prevalence of corruption raises the costs of doing business in BiH. Paying bribes to obtain necessary business licenses and construction permits, or simply to accelerate the approval process creates a costly business environment. Hence, a successful fight against corruption will improve the country's business environment and its image as a foreign investment destination. However, the insignificance relationship between control of corruption and inward FDI, reveals that in the case of MNEs decision to invest in BiH's the high corrupted environment is not an influential factor.

The empirical result for the political regime's type variable confirms those empirical studies that provide evidence for a positive though an insignificant relationship between country's political regime and inward FDI (Biglaiser and DeRouen, 2006; Blanton and Blanton, 2007; Jandhyala et al., 2011; Li et al., 2017; Moon, 2019; Oneal, 1994). The Dayton GFAP established BiH's political system as a consociational democracy after the dissolution of Yugoslavia and the Bosnian war (please see section 6.3). Figures 6.2, 6.3 display a gradual decline in the state's democracy for the reasons presented in section 6.3. Since 2000, both V-DEM indices, EDI and LDI, incrementally decline (please see figure 6.3). BiH is now an electoral democracy facing the risk of ART. Although a democratic regime will contribute to the country's better image as a foreign investment destination, BiH's political system does not have a significant impact on the level of FDI flows the country receive. For example, in 2007, BiH received the most massive registered inward FDI flows in its post-socialist history (see please figure 6.4) with a not satisfactory score in LDI (please see figure 6.3).

The variable of the signing of the BITs found to be insignificant and negatively related to inward FDI. The empirical result is unexpected since many scholars argue for BITs importance to increase the credibility of developing and transition countries

that produce uncertainties to foreign investors due to issues relating to countries' level of political stability and quality of institutional infrastructure (Berger et al., 2011; Büthe and Milner, 2008; Kerner, 2009; Neumayer and Spess, 2005; Rosendorff and Shin, 2012). In such cases, the conclusion of a BIT can create favourable conditions for foreign agents to make investments in a safe environment from the risk of nationalisation, expropriation or subjected to measures with an effect equivalent to nationalisation or expropriation. However, variable's negative sign is following Hallward-Driemeier (2003) and Falvey and Foster-McGregor (2017) arguments for the negative relationship between the signing of the BIT and the level of FDI flows a country receives. According to them, BITs are less useful in a weak institutional environment whose role is limited to complement domestic institutions. Tobin and Rose-Ackerman (2011)'s study besides the complementarity argument, provides the insight of the competition between the countries for inward FDI share, concluding to that a country with small market signing a BIT may benefit in receiving FDI. However, any extra FDI aims to receive will be smaller than the respectively received by a host country with a larger market. To this line, BiH's small market and weak institutional environment give ground to our empirical finding.

Summing up, the governance dimensions of political stability & the absence of violence, voice & accountability, the rule of law and regulatory quality count most in determining the level of inward FDI in BiH.

6.6 Conclusions - Recommendations

The chapter has used both theoretical and empirical analysis to identify the extent to which the country's political system influence FDI inflows in BiH, as a transitional economy of WB. The BiH's transition to peace and independent statehood, to democracy and a market economy, evolved to a rather complicated and challenging process.

The Dayton GFAP ended the bloody three-and-a-half-year war in BiH, though this consociational settlement introduced at that time one of the most wide-ranging peacebuilding interventions and a too complicated political system. The international interventionist approach often pursued through illiberal means, established an

institutional system based on ethnicity, which is what divided civil society. Indeed, the agreement instead of establishing conditions for reducing the nationalist element incorporated ethnicity to constitutional design. The governance fragmented into national and subnational levels strengthening the role of ethnic parties. The competing interests and the colliding lines of the ethnic parties undermine the level of democracy of BiH's political system, which is on the verge to fall from electoral democracy to electoral autocracy.

Ethnicity continues to be the reason for deadlocks, frustration, violence, instability, corruption, jeopardising every effort for the implementation of reforms that aim at country's advances in democracy and market economy, and on the EU membership path. European Commission's 2019 report for the application of BiH for the membership of the EU, recommends BiH's political authorities to implement the Reform Agenda fully. The issues of concern are the weak rule of law, the protection of fundamental rights of all citizens and especially of minorities, the electoral framework, and the functioning of the judiciary. BiH needs to pay special attention to the fight against corruption and organised crime, the misuse of public resources for clientism, the acceleration of the decision-making procedures and the improvement of the business environment. The implementation of EU recommendations is also significant for BiH investment climate, which is not conducive to foreign investors. Better performance in inward FDI will increase market competitiveness and lead to economic growth.

The empirical analysis of the impact of the political landscape as it formed by host country's political regime and individual political variables on inward FDI, indicated specific governance's dimensions to be more influential on inward FDI flows than others. The variables that found to hold a significant positive relation with inward FDI are voice & accountability, and political stability & the absence of violence/terrorism. The significant negative relationship between the rule of law and the regulatory quality provides ground for further research on the profile of foreign investors that decide to invest in BiH. The foreign agents may welcome a more democratic regime, but this does not define BiH's inward FDI.

Since the ruling elite's entrenched patronage interests prevent the implementation of any structural reforms, the development of the country as a foreign

investment destination is a challenging issue for BiH's policymakers. They must be mindful of the consensus' necessity over the required structural reforms considering the fragmented political and administrative system. The absence of a consensus on the state is the leading cause of the political crisis in the post-socialist BiH. Policies should target at reducing the ethic disparities and removing discriminatory provisions that harm the country's voice & accountability and political stability & violence, which in turn determine at most BiH's inward FDI.

Following the same structure of analysis, the next chapter presents the impact of the political landscape on inward FDI in Kosovo.

Chapter 7. The transitional economy of Kosovo as a host country for FDI.

7.1 Introduction

Kosovo, along with Serbia, stands at the centre of the WB and holds a key strategic position at the social, political, and geographic crossroads between Eastern and Western Europe. After the dissolution of the Socialist Federal Republic of Yugoslavia (SFRY), Kosovo was part of the Serbia and Montenegro Union though mostly independent of any direct influence from Belgrade. Milošević revoked its autonomy, and soon a war conflict between Serbia's police and armed forces, and the Kosovo Liberation Army broke up which ended by the interference of NATO. Since then and until 2008, the UN Security Council Resolution 1244 (1999) placed Kosovo under a transitional administration, the U.N. Interim Administration Mission in Kosovo (UNMIK)(Wet, 2009, p. 83). The case of Kosovo differed from the rest of WB economies. The uncertainties concerning the question of its statehood reflected differences as to the official goals of its transition. For the new authorities of Kosovo, the transition has been targeting a fully-fledged independent state, while the Serbian Government, has been claiming the transition should be towards a strong self-governance part of Serbia (Woehrel, 2013, p. 3). Under UN supervision, Kosovo developed the structures of an independent country, and in 2008 it formally declared independence from Serbia, but it has not managed to achieve its full uncontested international recognition (Visoka, 2018, p. 3). However, Kosovo is the only country in contested and limited statehood which is on the path to EU integration.

FDI can contribute to meeting the economic EU's accession criteria referring to the establishment of a functioning market economy and the capacity to cope with competitive market forces within the EU, though Kosovo is not an appealing foreign investment destination. Kosovo still faces daunting challenges beyond its buttle for international recognition and the status of its ethnic minorities (Woehrel, 2013, p. 5). The country is suffering from institutional weakness, including the judiciary and law enforcement, high levels of government corruption and well-organised crime networks.

This chapter, along with the theoretical analysis uses the results of the empirical model (please see Chapter 4) to identify the role of the political environment in variations of Kosovo's inward FDI. Despite any data limitations, empirical results will indicate alternatives to the heated debate political regime – FDI nexus through hypotheses about the relative influence of the specific variables that the literature review (please see Chapter 2) indicated. The empirical findings adjusted to the analysis of Kosovo's political landscape, hold important implications for Kosovo's potential to be developed as a recipient FDI country.

The chapter is structured as follows: Section two addresses the main issues in Kosovo transition process. Section three analyses the establishment of the political system over the post-socialist period. Section four presents Kosovo's inward FDI, while section five presents and discuss the empirical analysis' results. The last section concludes and recommends.

7.2 Kosovo in Transition

International presence in Kosovo

Kosovo is a rather particular case since its final status is still unresolved. An intense dispute between Albanians and Serbs in Balkans for the control over the Yugoslav province of Kosovo existed for most of the 20th century. The Province of Kosovo acquired inner autonomy after Yugoslavia was named the Socialist Federal Republic of Yugoslavia in 1953. It was a de facto Socialist Republic within the Federation which evolved as a Socialist Autonomous Province within the Socialist Republic of Serbia (Roukanas and Sklias, 2007, p. 269). Yugoslavia's political leader Josip Broz Tito respected the autonomy of the Province of Kosovo while the 1989 Serbia's president Slobodan Miloševic did not. Under Miloševic's rule, an unfair and discriminatory system was established in which Belgrade provided privileges to Kosovar Serbs while not only excluded the Kosovar Albanians showily from the public sector but systematically repressed them as well (Freedom House, 2004).

Serbia has been claiming Kosovo as part of its territory even though ethnic-Albanian Kosovars accounted for nine-tenths of the populace and have always resisted rule from Belgrade (Tansey, 2009, p. 154). During the 1990s, an uneasy though nonviolent status quo was maintained between the Yugoslav Government and the

Kosovo Albanians (Freedom House, 2003). However, as Serb repression worsened, this status quo was increasingly questioned, and in 1998 an ethnic conflict broke out between the Kosovo Liberation Army (KLA) and Serb forces which by 1999, it had escalated involving elements of ethnic cleansing (Roukanas and Sklias, 2007; Tansey, 2007, 2009). NATO intervened calling humanitarian purposes by launching a 78-day air campaign forcing Belgrade to pull out all Serbian forces and to allow an international presence, both civil and military, in Kosovo (Freedom House, 2003; Tansey, 2009). Since 1999, the UN Security Council passed Resolution 1244 for the establishment of the UN Interim Administration Mission in Kosovo (UNMIK) which would safeguard people of Kosovo autonomy within the FRY, while the NATO's force (KFOR) would provide a secure environment for the population and the international presence (Tansey, 2007, p. 133). UNMIK's task was to promote the establishment of substantial autonomy and democratic self-government by holding elections and supervising the development of new institutions. During UNMIK's administration, 1999–2008, the international community had unlimited powers to design the new institutions, enforce-related rules and manage the course of state-building (Elbasani, 2018, p. 150). In official terms, Kosovo was part of the Serbia and Montenegro Union though it was mostly independent of any direct influence from Belgrade and it was administered mainly by the UN mission (Tansey, 2007, p. 133). UNMIK is still in Kosovo for enhancing the constructive engagement between Pristina and Belgrade, the Serb and Kosovar communities in northern Kosovo, and between regional and international actors with interests in Kosovo (Morelli, 2018, p. 2).

Kosovo existence without international recognition of statehood raised issues of its transition to a democratic regime. The laggards in the transition process have been countries and territories with unresolved post-conflict relations and with unstable political and economic systems (Gligorov, 2007, pp. 1–2). There is a restrictive approach that for establishing a democratic regime in a territorial entity, it must first be recognised as a sovereign state since the sovereignty is a prerequisite to democracy (Tansey, 2007, p. 131). However, the years of international governance has provided Kosovo with the core structures of a democratic regime. In late 2005, the UN began an initiative to clarify Kosovo's final status; nevertheless, the 2006-07 negotiations ended without agreement between Belgrade and Pristina (Bergmann,

2018, p. 243). The UN insisted on this policy and issued a comprehensive report on Kosovo's final status, endorsing independence.

On 17th February 2008, the Kosovo Assembly declared Kosovo's independence from Serbia, a celebration day for ethnic Albanians and a day of disappointment for Serbia, and the Kosovo Serb minority (Wet, 2009; Woehrel, 2013). After all, the Serbs viewed Kosovo as their cultural and religious heartland. Kosovo had committed itself to implement the Comprehensive Proposal for the Kosovo Status Settlement, proposed by U.N. envoy Martti Ahtisaari. According to Ahtisaari's document, Kosovo's status of independence should be initially overseen by the international community. To this framework, an International Civilian Representative (ICR) was appointed by an international steering group which lasted until 2012 (Woehrel, 2013, p. 1).

Further, this document protected the rights of ethnic Serbs and other minorities. Another important international body that established in Kosovo besides ICR has been the European Union's rule-of-law mission (EULEX) operating under the EU's Common Security and Defense Policy (CSDP) (Morelli, 2018, p. 2). Due to the lack of consensus of all EU members on Kosovo's independence, EULEX evolved as a "status-neutral" organisation, monitoring and advising Kosovo's Government on issues related to the rule of law and intervening in specific criminal cases (Woehrel, 2013, p. 2). The weak institutions in Kosovo imposed the EULEX's competence in the rule of law. However, the weak rule of law in the country even now is evident. The 2019 Index of Economic Freedom reports that "there are numerous property issues between Kosovar Albanians and the Serb minority. The constitution provides for an independent judiciary but does not always ensure due process. The administration of justice is slow, and there is insufficient accountability for judicial officials, who are prone to political interference. The efficiency of case resolution has improved, but a backlog remains. The weak rule of law fails to constrain endemic corruption" (The Heritage Foundation, 2019b). Hence, EULEX efforts for capacity -building did not bear fruit, especially in the high-risk area of fighting organised crime and controlling corruption. However, the mission continues to support rule-of-law institutions in Kosovo for enforcing their ability to provide effectiveness, sustainability, multiethnicity, and accountability, excluding any political interference and complying completely with EU best practices (Morelli, 2018; Proksik, 2018). Since there are NATO

member states which do not recognise Kosovo's independence, KFOR also evolved as a status-neutral body in Kosovo. The NATO-led peacekeeping body having the role of ensuring country's overall security, being also in charge for the training of the 2,500-strong Kosovo Security Force (KSF) called for by the Ahtisaari plan, while for the policing duties responsible were the local authorities and EULEX (Woehrel, 2013, p. 2). WIIW research report on Kosovo signifies that foreign or international presence for the administration of the unresolved post-conflict state of affairs has not enhanced economic development, though it has contributed to local and regional security and stability (Gligorov, 2007, p. 2). Nevertheless, the international community did not inhibit the development of the province in the early 2000s as a European hub for Albanian organised-crime syndicates. It turned into a source, transit and destination country for human trafficking for commercial, sexual exploitation (Proksik, 2018, pp. 407–408).

Economy in transition

In 2006, after years of stagnation and despite the decline of foreign financial aid, Kosovo recorded better economic outcomes through domestic consumption and increased exports. Financial sector improved affecting inflation positively, and privatisations started, FDI picked up and trade increased due to country's engagement with the Central Europe Free Trade Area (CEFTA), supported at most the export-oriented industries (Gligorov, 2007, p. 4). Kosovo's tie to the euro has sustained low inflation. However, the high external imbalances and the decline of employment tortured the economy of Kosovo (Gligorov, 2007, p. 5). A year after Kosovo declared its independence, in 2009 it suffered from poverty, particularly severe in rural areas and among Roma and other ethnic minorities, extremely highly unemployment over 40 per cent with youth unemployment being over 70 per cent, and lack of economic opportunity (Woehrel, 2013, p. 7). Although the unemployment rate in 2017 declined, it still high at 33 per cent with a youth unemployment rate near 60 per cent. These high records have acted as a stimulus to emigration and informal economic activities (Bertelsmann Stiftung, 2018c, p. 18). The human trafficking for sexual reasons became one of the primary source of income in Kosovo after arms and drugs for the Kosovar-Albanian mafia network (Proksik, 2018, p. 404). During 2014-2015, thousands of

Kosovars left the country seeking a better future within the EU (Bertelsmann Stiftung, 2018c, p. 18) The formal labour market is yet not fully developed while the informal labour activity is flourishing (The Heritage Foundation, 2019b). The informal sector is estimated to account for between 30 to 35 per cent of GDP, creating unfair competition and weakening labour rights (Bertelsmann Stiftung, 2018c; European Commission, 2019c).

Kosovo experienced its first federal budget deficit in 2012, due to sharply rise of government expenditures (Bertelsmann Stiftung, 2014, p. 17). Kosovar Government's mal- performance disappointed the IMF and the EU that restricted Kosovo's funding (Woehrel, 2013, p. 7). Since 1999, the EU's financial aid reached the amount of €2.3 billion, turning the EU by far to the single largest donor of Kosovo (Morelli, 2018, p. 13). Country's growth model has been highly dependent on international financial aid and remittances to fuel consumption (World Bank, 2019b). The latter is the driving force behind a structural chronic trade deficit well above 30 per cent of GDP (Gjeka and Deuber, 2019).

The high levels of corruption, the poorly defined and enforced property rights, insufficient transport infrastructure, low energy dependability, limited connectivity to the rest of the world, and inadequate and unreliable energy supply, in Kosovo, have deterred potential investors (Bertelsmann Stiftung, 2018c; Morelli, 2018; Woehrel, 2013). Small and inefficient farms dominated in Kosovo along with little large-scale industry and few exports. Nevertheless, the economy has enjoyed lower labour costs than the rest of the WB region and has sufficient resources for metal and lignite (Woehrel, 2013, p. 7). Hence, the European Commission and World Bank guidance to Kosovo has been to improve the investment climate to attract inward FDI, which in turn will stimulate growth (Woehrel, 2013, p. 7). Recently, growth has been produced by public and private investments, a development that may encourage a more sustainable (internally-driven) economic development (Gjeka and Deuber, 2019).

Kosovo is the third poorest country in Europe in terms of GDP per capita despite the tripling of income per capita over the past 18 years from USD 1,010 in 2000 to USD 4,300 in 2018 (World Bank, 2019c) (please see figure 7.1). About 30 per cent of the population is below the poverty line (Bertelsmann Stiftung, 2018c, p. 18). The

global financial crisis did not affect its economy as much as the other WB countries, given that it has already been in a low base (World Bank, 2019c). During the period 2009–18, the real GDP grew on average by 3.5 per cent, driven by consumption and service exports and supported by investment (World Bank, 2019c). The non-tradable sectors are dominant in the production and employment; services is the largest sector with a share of value-added at more than 50 per cent of GDP, while industry by regional standards at 17.5 per cent of GDP, of which manufacturing is 11 per cent and agriculture at 8.3 per cent of GDP in 2018 (World Bank, 2019c).

Figure 7 1 – Kosovo GDP per capita (current USD) for the period 2000-2018

Source: Adjusted from World Development Indicators (World Bank, 2020b)

During the last years, Kosovo's economy recorded progress in transitioning to a market-based system, in maintaining macroeconomic stability supported by fiscal rules that have been placed by a healthy banking system, in limiting growth in current spending and by the international guidance in privatising most of its state-owned enterprises (World Bank, 2019c). However, the progress in privatisation remains slow (European Commission, 2018a, p. 48). The country managed to establish some political stability and create a better business climate that enables productive investments. Foreign and domestic investors are treated equally under the law (The Heritage Foundation, 2019b). However, the international donor assistance holds 10

per cent of GDP, while the remittances from the diaspora are estimated to account for the 17 per cent of GDP. Massive agricultural and energy-related subsidies provided by the Government and international donors account for more than one-third of Kosovo's GDP (The Heritage Foundation, 2019b).

Status recognition, international agreements, and the EU Reform Agenda (ERA)

The European interest in the region has been evident, and despite the ambiguous status and the lack of unanimity between EU member states on recognition Kosovo's independence, Kosovo has been recognised by the EU as a potential candidate for membership since 2008 (Morelli, 2018; Woehrel, 2013). The period of Supervised Independence ended in 2012, and since then, the international community is promoting Kosovo as a sovereign, multi-ethnic, and democratic country. Kosovo is an emerging state and recognised by 115 countries out of 193 UN members in 2018, including all its immediate neighbouring states except Serbia (European Commission, 2019c; Visoka, 2018; World Bank, 2017a). Emerging state (also named new and nascent state) is the state-like entity that possesses most of the attributes of modern sovereign statehood but is characterised by the lack of full international recognition (Visoka, 2018, p. 6). Serbia insists on its refusal as well as Russia, China, and five EU member countries (Cyprus, Greece, Romania, Slovakia, and Spain). Serbia in 2018 lead even an anti-recognition campaign to make countries to revoke their recognition for Kosovo, reducing the UN member countries to 97 (Turp-Balazs, 2020). Serbia's hostile behaviour is a severe impediment to inflows of FDI and the modernisation of the country's key economic sectors (World Bank, 2017a, p. 2).

Kosovo realised early enough the importance of being integrated into the international community and has pursued bilateral recognitions and memberships in international organisations. Hence, it joined the CEFTA in 2006, the IMF and the World Bank in 2009, the European Bank for Reconstruction and Development (EBRD) in 2012, the Council of Europe Development Bank (CEB) in 2013 and the Council of Europe's Venice Commission and the International Olympic Committee in 2014 (Morelli, 2018, p. 1). In 2013, the governments of Kosovo and Serbia signed the "First Agreement of Principles Governing the Normalisation of Relations" between the two (Morelli, 2018, p. 10). In 2015, as part of the EU - facilitated normalisation process between Serbia

and Kosovo, Kosovo concluded agreements with its counterpart on the movement of people, energy, telecom, community rights—though its implementation has been difficult (World Bank, 2017a, p. 2). Disagreements over the ownership status of economic assets within Kosovo exist, such as the Trepca mining conglomerate (USAID, 2017, p. 21). In 2014 Kosovo signed the SAA with the EU, which came into force in 2016, signifying the first contractual relationship between the EU and Kosovo (Bertelsmann Stiftung, 2018c; Morelli, 2018). In 2014, nearly 60 per cent of customs duty-eligible imports into Kosovo were EU goods. To guide reforms under the implementation of the SAA, the European Commission and Kosovo adopted in 2016 the European Reform Agenda (ERA) for Kosovo, which outlines priority actions in the fields of good governance and the rule of law, competitiveness and investment climate, and employment and education (European Commission, 2019c, p. 90). In 2017 the SAA council approved the Framework Agreement between the EU and Kosovo on the general principles for the participation of Kosovo in Union programmes and 2018, Kosovo joined the Erasmus plus, Competitiveness of Enterprises and SMEs (COSME), Europe for Citizens and Creative Europe programmes (European Commission, 2019c, p. 90). In 2017, the U.S. Government's Millennium Challenge Corporation and the Government of Kosovo signed a USD 49 million "threshold program," including reforms aiming at economic growth and private investment (Morelli, 2018, p. 16). In 2018 Kosovo ratified a border demarcation agreement with Montenegro. The EU regards Kosovo as one of the six WB countries that will be in the position to join the EU once it meets the accession criteria. However, the opening of accession negotiations requires the unanimous approval of all EU member states. Unless Kosovo and Serbia agree over the status of the former, then the EU will proceed with Kosovo's accession given its progress in meeting the admission criteria (Morelli, 2018, p. 13). Table 7.1 displays the progress of the Kosovo reform Agenda as it is recorded to the 2019 report of the European Commission.

Table 7 1 - Progress of Kosovo in meeting the fundamentals of its reform EU- Agenda

	Kosovo
Political Criteria	Kosovo made progress in the implementation of specific critical EU-related reforms, as regards the improvement of the legal framework in the areas of the rule of law and public administration. However, the excessive size of the Government affects its credibility and effectiveness. Domestic politics in Kosovo remained highly polarised, and the situation in the north of the state remains particularly challenging.
Public Administration	Serious efforts are needed to restrict the political influence on the recruitment of senior civil servants. Some progress has been made with the adaption of the package of laws on the functioning and organisation of public administration, on public officials and salaries. Other achievements are the adoption of guidelines on strategic planning and the start of the implementation of the action plan on the rationalisation of agencies. The revised legal framework is an essential step towards establishing a modern and professional civil service and improving accountability.
Judicial System	The state is at an early stage for applying the *acquis* and the European standard in this area. Some progress has been made through the adaptation of the law on the Disciplinary Liability of Judges and Prosecutors and the Law on Mediation. The judiciary is still vulnerable to undue political influence. The administration of justice remains slow and inefficient, and the rule of law institutions need to build up their capacities.
Fight Against Corruption	It is still at an early stage, although some progress has been made through significant legislative reforms in the rule of law area and in investigating and prosecuting of high-level cases. Progress recorded on preliminary confiscation of assets while final confiscations remain low. Overall, corruption is widespread and is an issue of primary concern.
Fight Against Organised Crime	Some progress has been made through legislative reforms in the rule of law area, in investigating and prosecuting high-level cases and on the preliminary freezing of assets. The situation of organised crime in the north of Kosovo continues to challenge law enforcement agencies. Progress recorded in the fight against terrorism, in the sense of establishing better conditions for rehabilitation and reintegration of foreign terrorist fighters and their families. State authorities ought to be more effective in fighting money laundering; the relevant law should be brought in line with EU *acquis* and international standards.
Fundamental Rights	The implementation of human rights legislation and strategies is often undermined by inadequate financial and other resources, particularly at a local level, limited political prioritisation and lack of coordination. More needs to be done to protect the rights of persons belonging to minorities, including Roma and Ashkali, and displaced persons, to ensure gender equality, to establish an integrated child protection system and to protect the cultural

	heritage. The freedom of expression is enshrined in the Constitution of Kosovo.
Economic Criteria	Kosovo is at an early stage, and there is some progress in developing a functioning market economy. Economic growth recorded, but the labour market is under pressure. Fiscal rule adopted by spending concerning social benefits for specific groups of the population and public employees' wages threatens the public finance and private sector's development. The expanded informal economy, the slow and inefficient judiciary, the widespread corruption and the weak rule of law put pressures on the business environment. There are issues in the railway and energy infrastructure, in securing stable energy supply. The economy remains dependent on the domestic trade sector; service exports lead export growth to the diaspora; the absence of product diversification limits the growth of good exports.
Good neighbourly relations and regional cooperation	The thorny issue of Kosovo's decision to impose a 100 per cent tariff on imports from Serbia and BiH inhibits the regional cooperation efforts.
The normalisation of relations with Serbia	The tariff issue undermines the conclusion of a legally binding agreement with Serbia required to advance on the European path
European Standards	Kosovo needs to improve its administrative capacity and coordination, across all sectors, to ensure effective implementation of the acquis

Source: Author's adjustment from the European Commission (2019c)

Beyond EU accession, Kosovo targets memberships in the UN and NATO.

7.3 Kosovo's Political environment over the post-socialist period

Since the 1999 conflict, the political surroundings of Kosovo have been evolving under question for both country's future status and the possibility of establishing a political regime of democratic self-government (Tansey, 2007, p. 133). Domestic political leaders have insisted on claiming independence for Kosovo, while the international community refused to grant it at once and proceeded it to the sharing of governance between domestic and international actors (Tansey, 2007, p. 133). The power granted to the UNMIK along with those afforded to KFOR and the Organization for Security and Cooperation in Europe (OSCE) resulted to the most long-

drawn and invasive post-conflict reconstruction effort ever undertaken for a nation (Hehir, 2019, p. 587). Kosovo has been the objective of the most ambitious internationally driven, state-building project that emerged since the end of the cold war (Capussela, 2016; Hehir, 2019; Tadić and Elbasani, 2018). State – building includes the development of transparent and accountable political institutions, the establishment of a sustainable economic system, a formal public administration and civilian – controlled security forces (Capussela, 2015, p. 13). The state-building project in Kosovo beyond seeking to maintain peace and security, set a target to establish a pluralist, multi-ethnic democracy with an extensive range of human rights guarantees (Hehir, 2019, p. 587). However, the worst ethnic violence since the end of the 1999 conflict erupted across Kosovo in 2004 resulting to the destruction of Serbian religious sites and an exodus of Kosovo's Serbs from main cities, like Prizren and the capital Pristina, undermining the goal of forming a multi-ethnic Kosovo (Hehir, 2019, p. 589).

The first democratic elections in Kosovo organised by the UNMIK in 2001, and that signified its instrumental role in setting the foundations of a democratic regime (Bertelsmann Stiftung, 2018c; USAID, 2017). The UN mission had four pillars each to be managed by a separated international agency, but with a Special Representative of the UN Secretary-General (SRSG) holding the overall authority and coordinating the involved international agencies (Tansey, 2007, p. 134). This structure of UNMIK has authorised the UN and the OSCE to set the lines for Kosovo's political development in the aftermath of the 1999 conflict along with the domestic political parties (Tansey, 2007, p. 135). The UN mission created Provisional Institutions of Self-Governance (PISG), administered a series of free and fair democratic elections and directed the political development. Many of local power holders had little experience in governance and viewed the PISG as outlander (USAID, 2017, p. 9). Their inexperience stigmatised country's ability to address critical issues such as building state institutions, integrating the Kosovo Serb minority, controlling rampant corruption, strengthening democracy, and improving public services (USAID, 2017, p. 9). This left space for a criminal elite to involve in Kosovo's political, economic and judicial institutions.

The polity's lack of sovereignty – being too long under the political authority of FRY and Serbia in the past and the UN afterwards- inhibited Kosovo from achieving

consolidated democracy (Cocozzelli, 2013). It claimed full sovereignty and declared itself "a democratic, secular and multi-ethnic republic" on 17th February (Calu, 2018, p. 92). Kosovo in the year of its declaration of independence had many democratic deficiencies and as Tansey (2009, p. 161) reported "While the structures of democracy have been established, and many of its practices entrenched, key features associated with the genuine democratic rule are missing. The conflict's most damaging legacy is the almost total social and political segregation of the Albanian and Serb communities. The party system contains only parties that represent one ethnic community or the other; no party spans the communal divide". The declaration of independence was the foundation towards self-rule and democracy in Kosovo (Cocozzelli, 2013, p. 2). Following the declaration, Kosovo's constitution defined the Republic of Kosovo as an independent, sovereign, democratic, unique, and indivisible state, and as a "multi-ethnic society consisting of Albanian and other Communities, governed democratically with full respect for the rule of law through its legislative, executive and judicial institutions" (Calu, 2018, p. 92). For the first time, it seemed that authorities acknowledge the importance of establishing a democratic consolidated country. However, the unprecedented international involvement, and substantial opposition that followed, proved that if there are not efficient institutions in handling the unilateral declaration of independence, then the country may be exceedingly precarious and unbelievably volatile (Ruwanthika Gunaratne and Public International Law, 2008). In less than a month (9th March 2008), the Serbian Prime Minister Vojislav Kostunica resigned, claiming his government's irreparably division after Kosovo's declaration of independence (United Nations-Security Council Report, 2020).

Into independent Kosovo, ethnic violence existed. In September 2011 violent clashes between Kosovo Serbs and NATO forces along the disputed border recorded while in April 2012 a bomb attack took place in Mitrovica, the central city in predominantly Serb northern Kosovo. The explosion was condemned as a "criminal and terrorist act" (United Nations-Security Council Report, 2020). Besides, the electoral process in Kosovo was like a dreaded call for unrest, and this is evident in a statement, of Germany concerning the parliamentary and local elections in Kosovo on May 2012. Specifically, Germany suggested NATO and the EU to consider the current KFOR numbers as insufficient to appropriately respond to possible Kosovo-wide

security incidents in connection with the elections (United Nations-Security Council Report, 2012). In November 2013, the electoral process for the mayoral and municipal assembly stigmatised by political violence and criminal actions in Northern Kosovo (United Nations - Security Council, 2014a, pp. 3–4). Northern Kosovo during 2014 continued to be on the formation of municipal authorities following the 2013 local elections (United Nations - Security Council, 2014b, pp. 4–5). The presidential elections in 2016 retained the tense and device situation in the political scene of Kosovo (United Nations - Security Council, 2016, p. 1).

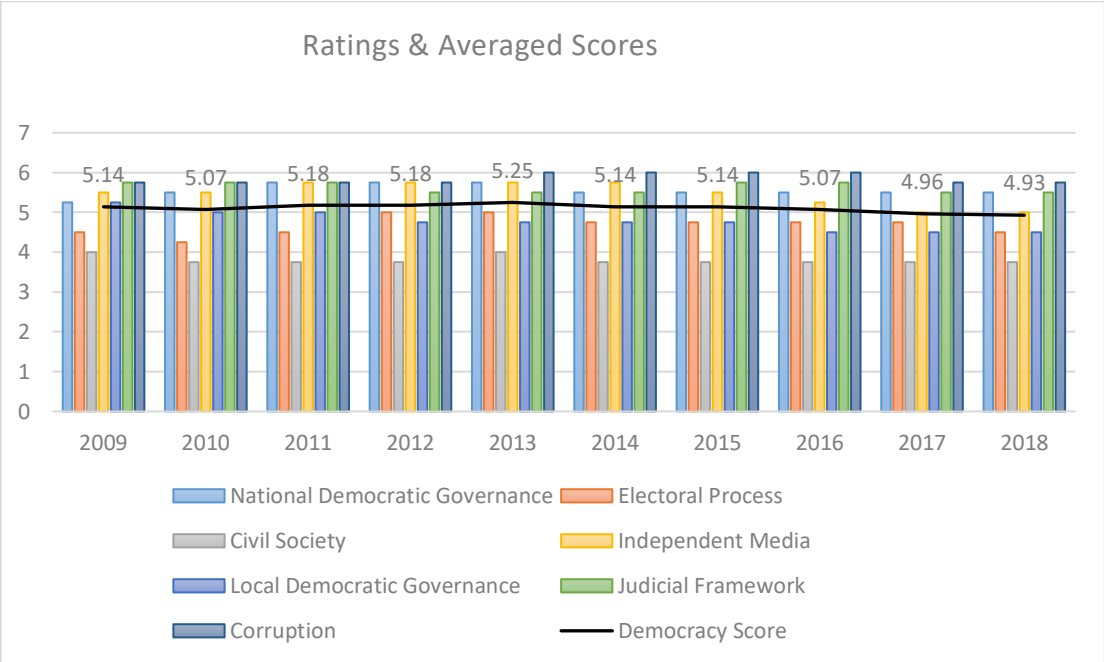
In the post-independence period, local layers of authority took over to resettle the rules and formally exercise governmental power, launching a rule transfer process to local 'ownership' (Elbasani, 2018, p. 156). The supervised independence officially ended in 2012 marking the new area of Kosovo's state-building under domestic political leaders, though in 2013 it still hosted international structures that operated without transparency or formal public and institutional mechanisms of monitoring (Elbasani, 2018, p. 157). Both the "local -turn" in power and the convolution of international and local actors of authority, triggered off a hybridised form of state-building, challenging country's democratic transition (Elbasani, 2018; Gashi, 2014).

National institutions had weak underpinnings and characterised by lack of democratic accountability, high levels of corruption in the privatisation process existed along with severe shortages in the legislative process, reflecting the inability of the members of the parliament and the cabinet to respect fundamental rights, such as the freedoms of media and association (Gashi, 2013, p. 284). The fight against corruption and organised crime lacked the real political will (Gashi, 2014, p. 316). In 2015 the pace in Kosovo's democratic consolidation was slow, while small improvements in the judiciary, independent media and corruption recorded in 2016 (Gashi, 2017, p. 1). The Bertelsmann Stiftung Index 2018 for Kosovo recording the democratically elected political representatives' effective power to govern, reports that this has been seriously undermined by the following main factors. First, the attitude of Serbia and her international allies as Russia and China to insist on refusing Kosovo's independence, second the denial on the part of Kosovo-Serb residents and political actors in the majority – Serbian northern part of Kosovo, to consent the political decisions taken in Kosovan institutions. Third, the Kosovo-Albanian nationalist

Self-Determination opposition party Vetevendosje orchestrated violent protests against the Brussels Agreement on the integration of Kosovo-Serb majority municipalities into the country and the border demarcation agreement between Kosovo and Montenegro. Finally, proofs found that informal networks control Kosovan democratic institutions by undermining formal procedures of appointments and decision-making (Bertelsmann Stiftung, 2018c, p. 11).

Two decades of international state-building activities and a decade of independent statehood affected Kosovo's political surroundings and defined country's route to democracy. Figure 7.2 presents the ratings and averaged scores of the fundamentals in a democracy that result in the score of democracy as it evolved in the post-independence period of the country. The democracy score is in consistency with the preceding analysis.

Figure 7 2 – Kosovo Democracy Score during the period 2009-2018



Note: According to the Freedom House Nations in Transit Reports "The ratings reflect the consensus of Freedom House, its academic advisers, and the author(s) of this report. The opinions expressed in this report are those of the author(s). The ratings are based on a scale of one (1) to seven (7), with one representing the highest level of democratic progress and seven the lowest. The Democracy Score is an average of ratings for the categories tracked in a given year" (Group for Legal and Political Studies, 2018)

Source: Author's adjustment from Freedom House Nations in Transit Reports for Kosovo as conducted by Group for Legal and Political Studies (2018, p. 1)

The Freedom House Nations in transit report for Kosovo in 2018 (Group for Legal and Political Studies, 2018, p. 3) recorded the slight improvement of the state's Democracy score from 4.96 in 2017 to 4.93 in 2018 (please see figure 7.2) due to the better performance of the Central Election Commission in managing two electoral campaigns without serious incidents and providing sufficient remedies. Nevertheless, the report classifies the regime as a transitional government or hybrid regime.

The Regimes of the World (RoW) Index classifies Kosovo as an electoral democracy. Based on the RoW typology for being classified as an electoral democracy it requires just holding reasonably free and fair multiparty party elections and an average score on V - Dem's Electoral DI above 0.5 (Lührmann, Mechkova, et al., 2018, p. 1327). The same index defines a country as a liberal democracy when records a score of at least 0.8 in V-Dem's Liberal Democracy Index (LDI). The V-DEM's EDI, as well as LDI, run on a continuous scale, from low to high (0-1), with higher values indicating a more democratic dispensation.

The Varieties of Democracy (V-DEM) (2020) analysis for the EDI based on that "The electoral principle of democracy seeks to embody the core value of making rulers responsive to citizens, achieved through electoral competition for the electorate's approval under circumstances when suffrage is extensive; political and civil society organisations can operate freely; elections are clean and not marred by fraud or systematic irregularities, and elections affect the composition of the chief executive of the country". Further, the electoral process must respect the freedom of expression and independent media. The V-Dem conceptual scheme regards electoral democracy as a critical element of any other conception of representative democracy (liberal, participatory, deliberative, egalitarian, or some other).

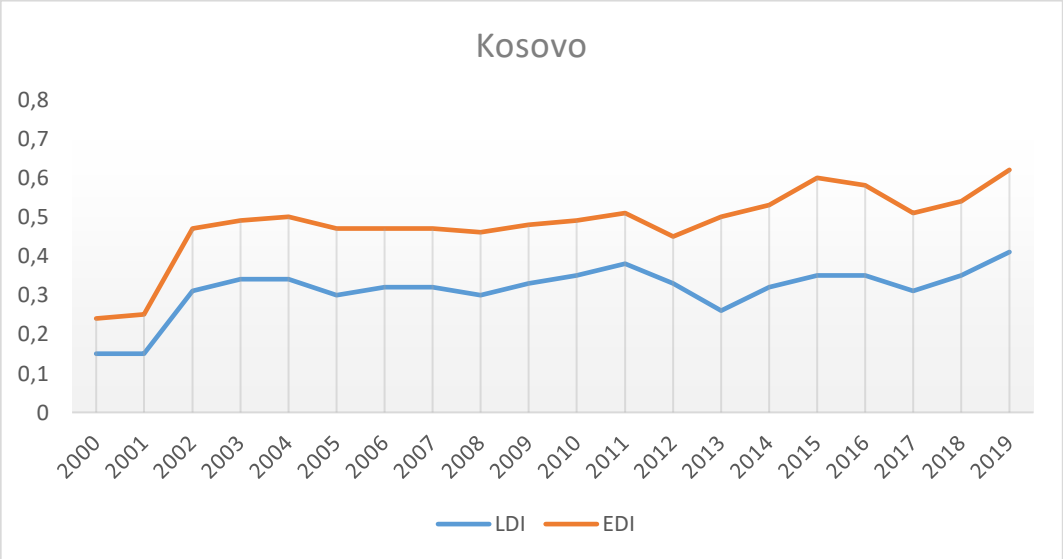
Concerning the LDI, V-DEM (2020) analysis based on that "the liberal principle of democracy emphasises the importance of protecting individual and minority rights against the tyranny of the state and the tyranny of the majority. The liberal model takes a negative view of political power insofar as it judges the quality of democracy by the limits placed on Government. This is achieved by constitutionally protected civil liberties, the strong rule of law, an independent judiciary, and effective checks and balances that, together, limit the exercise of executive power". This index combines both the electoral and liberal principles of democracy and as such, includes the two

main components of democracy. The first is the level of electoral democracy (EDI) and second is the liberal component index (LCI), harbouring on the liberal tradition.

Kosovo with a score of 0.41 in LDI and a score of 0.62 in Electoral Democracy Index (EDI) is an electoral democracy, holding an estimated risk of Adverse Regime Transition (ART) of 22.8 per cent for the years 2019-2020, ranking sixth in a list of the top twenty countries that share the same risk (Morgan et al., 2019). An ART occurs when a country moves down the RoW index from one year to the next in a two-year window, reflecting a decline in the democratic qualities of a country's political regime (Morgan et al., 2019, p. 2). For example, when a country goes form an electoral autocracy to a closed autocracy from one year to the next (Morgan et al., 2019, p. 5).

Figure 7.3 displays the progress of democratic score in Kosovo measuring by V-Dem's Liberal Democracy Index (LDI) and Electoral Democracy Index (EDI). From 2013 onwards, democratic developments have been recorded, and the country's performance in 2019 is better than expected.

Figure 7 3 – Kosovo's Electoral Democracy Index (EDI) & Liberal Democracy (LDI) during the period 2000-2019



Source: Adapted from V-DEM data (2020)

The elections of the 6th October 2019 in Kosovo resulted to the peaceful transition of power to a new government formed for the first time by the previous opposition on 3rd February 2020, signifying the change in country's political landscape (United Nations - Security Council, 2020). However, four months of negotiations between the

Movement for Self-Determination and the Democratic League of Kosovo needed for the formation of a coalition government. Albin Kurti, of the Movement for Self-Determination, elected as Prime Minister of Kosovo and Vjosa Osmani, of the Democratic League of Kosovo (LDK), as the first woman President of the Assembly (United Nations - Security Council, 2020, p. 2). After new Government's formation, some positive steps recorded such as the greater representation of women in the leadership of the assembly and the executive as well as in the dialogue between Pristina and Belgrade (United Nations - Security Council, 2020, p. 11). Nevertheless, the coalition ended in May 2020. The failure to achieve an agreement with Serbia along with Prime Minister's decision to dismiss the LDK's interior following a dispute over the handling of coronavirus prevention measures led Mr Kurti out of power (Bami, 2020a). On 3rd June 2020, Kosovo's parliament elected a new government with Prime Minister Avdullah Hoti, of the centre-right LDK. The new Prime Minister promised to normalise ties with Serbia that would enable to achieve the UN membership (Bytyci, 2020). Hence, the unresolved dispute with Serbia remains a source of political instability.

7.4 Inward FDI in Kosovo

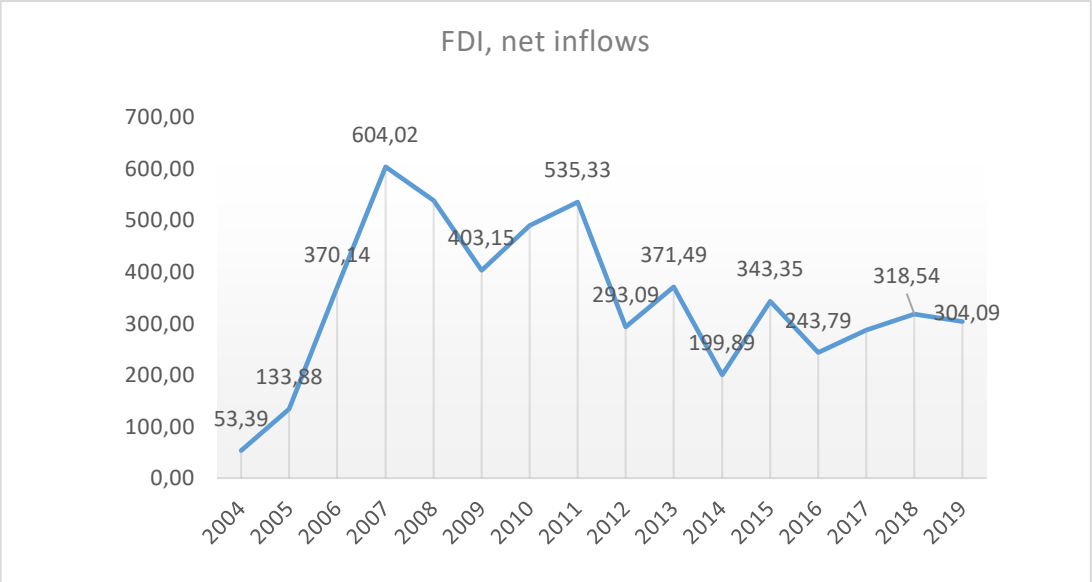
The role of FDI in transitional economies with a low rate of development is of specific importance. FDI contributes to the establishment of sustainable economic underpinnings, and as such to economic prosperity, thus meeting the EU economic accession criteria, according to the analysis of Chapter three (section 3.5).

Before 2004 there is no available reliable data for the performance of inward FDI in Kosovo. Due to the lack of unanimity between EU member states as well as UN member states on the recognition of Kosovo's independence relevant databases did not include Kosovo (e.g. the UNCTAD does not provide any kind of data for Kosovo). On the contrary, the World Bank databank provides economic indicators for the measurement of FDI flows in the Kosovan economy. Taking into account the world development indicators (World Bank, 2020b), the highest amount of FDI inflows ever received in the Kosovan economy is 604 million of USD and occurred in 2007 (please see figure 7.4). This outcome can be attributed to the better performance of the economy in 2006, to the beginning of privatisations, to special merits attributed to

foreign investors especially in the telecommunication sector, to the country's engagement with the CEFTA, and the stabilisation of political environment.

The overwhelming share of FDI flows (75.3 per cent) for the period 2007-2014 has been directed into the non-tradable sectors of the economy especially into construction and services, whereas only slightly over 15 per cent of total FDI flows into manufacturing (Gashi, 2015, p. 19). The direction of FDI to the tertiary sector fueled further the consumptive character of the economy. Since 2012, the privatisation process has been directed to less productive sectors such as real estate and construction in a range of 95 per cent of the total inward FDI in 2018 (European Commission, 2019d, p. 19). In 2018 the sectoral FDI structure had been dominated by real estate and renting, which made up over the 85 per cent in 2018 (European Commission, 2019d, p. 5). The purchase of the real estate by Kosovo's diaspora and public investments have contributed to this outcome. Switzerland, Germany, Turkey, Austria and the United Kingdom are countries that have invested and continue to be the leading investors in Kosovo (Bellaqa and Bajrami, 2019, p. 22). For the period 2012-2016, Turkey ranked at the top of the list of source countries with EUR 274 million or 23 per cent of total FDI followed by Switzerland with EUR 258.4 million (22 per cent) and Germany with EUR 171.6 million (14 per cent) (Bellaqa and Bajrami, 2019, p. 25). Turkey's higher FDI volume is partly attributable to privatisations that occurred during this period, particularly in distribution and electricity supply, as well as investments made from the Turkish state to the new terminal at Pristina airport. The primary sources of FDI inflows in 2018 are Switzerland with EUR 71 million (26.1 per cent), followed by Germany with EUR 60.3 million (22.2 per cent), UK with EUR 57.4 million (21.1 per cent), US with EUR 35.5 million (13 per cent) and Albania with EUR 22.3 million (8.3 per cent) (wiiw, 2020).

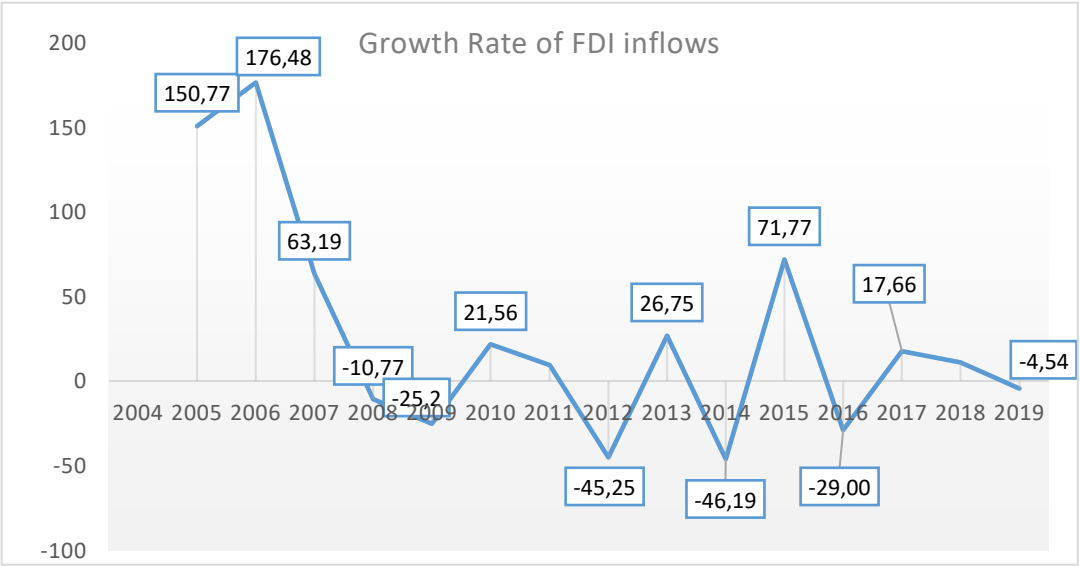
Figure 7 4 – Inward FDI flows in Kosovo in millions of US Dollars (at current prices) for the period 2004-2019



Source: World Development Indicators (World Bank, 2020b)

Since Kosovo declared its independence, the inward FDI began to lose ground and recorded the first negative growth rates during 2008-2009 (please see figure 7.5). Kosovo did not avoid experiencing a severe drop of FDI inflows following the global financial crisis as the other WB countries. However, this fall did not hit the economy as much due to its weak integration with financial networks and international trade (Çollaku, 2018).

Figure 7 5 – Growth rate of FDI inflows in Kosovo for the period 2004-2019



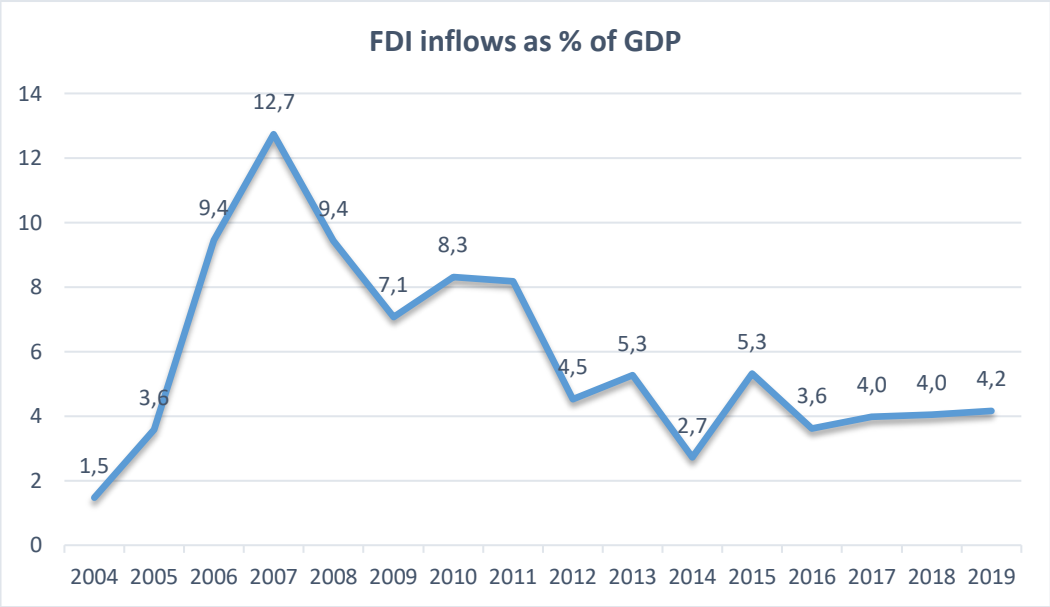
Source: World Development Indicators (World Bank, 2020b)

From 2009 and onwards, the FDI inflows are low with intense fluctuations (see please figures 7.4, 7.5) and the long-term trend is down. The variations of FDI can be attributed to country's struggles for recognition and political instability along with the financial crisis that created an uncertainty to foreign investors, and the lack of a sound strategy for the development of FDI (Çollaku, 2018). The Eurozone crises led European countries which had to hold the largest share of FDI in Kosovo to invest less. Furthermore, the persistence of the weak rule of law, the high levels of corruption, and organised crime in Kosovo have also largely contributed to the sharp decline of FDI (Pula et al., 2017, pp. 16–17). The process of privatisation which encouraged FDI in the pre-crisis period decelerated and remained slow even in the aftermath of the crisis due to political issues including the successive early elections produced by the lack of legitimacy of the governments, serious border disputes with Serbia and Montenegro, the problem of the Association of Serb Municipalities and the controversies about the ownership status of specific economic assets within Kosovo (Çollaku, 2018).

Inbound FDI in Kosovo rose slower compared to GDP during 2009-2018. Despite GDP growth since 2008 (please see figure 7.1), FDI has decreased substantially since 2012. The economic growth in Kosovo in 2014 was mainly driven by the rise of consumption, suggesting that FDI has not significantly affected the composition of GDP (Pula et al., 2017, p. 17).

FDI received annually by a host country, typically runs at about 2-3 per cent of the size of host economy measured by its GDP and when it exceeds 5-6 per cent of GDP each year, then it is considered as a significant performance (TheGlobalEconnomy.com, 2019). During 2007-2015, this indicator achieved satisfactory rates (please see figure 7.6), but since 2016 is moving steadily below the limit of 5 per cent. The European Commission's 2019 Report for Kosovo (2019, p. 46) analysing the decline of total FDI inflow to 3.6 per cent of GDP in 2016 (please see figure 7.6) which ended to cover less than a half of the current account deficit gives as leading causes the higher repatriation of foreign firms' profits for debt repayments, which reduced the scope for reinvestment of earnings.

Figure 7 6 – Inward FDI flows in Kosovo as a percentage of GDP for the period 2000-2019



Source: Adapted from wiiw FDI Database (wiiw, 2020), FDI total, annual

While governments in other developing economies had put as a priority, the improvement of the business environment for attracting FDI this is not the case for Kosovo. Country's inward FDI in Kosovo in 2014 and during 2017-2018 was the lowest in the WB region (please see table 7.2).

Table 7 2 – Inward FDI in Western Balkans in millions of euros (at current prices) for the period 2009-2019

Country / Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Albania	717	793	630	666	953	837	852	994	1017	1092	1100
Bosnia and Herzegovina	180	307	357	307	208	415	326	316	399	401	500
Kosovo	**287**	**366**	**394**	**229**	**280**	**151**	**309**	**220**	**255**	**272**	**300**
Montenegro	1099	574	401	482	337	375	630	205	494	415	400
North Macedonia	145	160	344	111	252	205	217	338	182	614	200
Serbia	2085	1273	3548	1011	1546	1505	2116	2125	2548	3495	4000

Source: Adapted from wiiw FDI database (wiiw, 2020), FDI total, annual

Foreign investors do not perceive Kosovo as investment destination given its vast deficiencies in the rule of law and widespread corruption, slow judicial procedures, lack of intellectual property rights protection, competition from unlicensed vendors

and irregularities in procedures for public procurement, political instability, lack of financial incentives and poor infrastructure, and high poverty rates (Santander TradePortal, 2019b). Kosovo ranks behind for ease of getting electricity, increasing the costs for business, and this is the biggest obstacle to attracting high-quality FDI (European Commission, 2019d, p. 13). The 2017 Policy report by the group for Legal and Political studies for the FDI in Kosovo reports about the Austrian investors in Kosovo that distinguish as main obstacles to FDI the high corruption, insufficient support for foreign investment, and administrative procedures. The above policy report is conducted as part of the project entitled "Promoting the Stabilization Association Agreement and launching a public-discourse for Kosovo's European Future", financed by the Embassy of the Kingdom of the Netherlands in Kosovo and implemented by Prishtina Institute for Political Studies and Group for Legal and Political Studies (Pula et al., 2017). In the same report, the German Ambassador has pointed out the overdependence of Kosovo's economy on consumption rather than investment. He exceptionally stressed as disincentives for investments the unfavourable business environment and the lack of investment guarantees (Pula et al., 2017, p. 23)

The European Commission Report on ERP of Kosovo (European Commission, 2019d) regarding the investment activity in the country assesses that Kosovo has the potential to attract more FDI taking advantage of its strategic location, the young population and the relatively low labour costs. As impediments to the future FDI influx, the report indicates "the recent imposition of a 100 % tariff on all imports from Serbia and BiH puts in question Kosovo's commitments to international agreements and may have long-term consequences for the investment climate. Among other key issues affecting FDI are a lack of basic infrastructure and stable electricity supply, poor education skills, a weak rule of law, corruption and the slowdown in the privatisation process" (European Commission, 2019d, p. 19).

A peaceful resolution of Kosovo-Serbia issues reaching a final agreement will contribute to a better investment environment in both countries. However, the imposition of the tariff as a response to Serbia's diplomatic campaign against recognition of Kosovo's independence worsens the in between the two countries relations. Under the pressures of the international community, led by the US, Kosovo

in March 2020 decided the partial abolition of import fees for Serbia and the full for BiH (Bami, 2020b). At the same time, the US and European actors called upon Serbia to end the "de-recognition campaign against Kosovo" (United Nations - Security Council, 2020, p. 3). The international actors strongly propose the removal of these obstacles for the continuation of productive dialogue and the normalisation of relations between the two countries (United Nations - Security Council, 2020, p. 11). Belgrade and Pristina assure for their engagement to conclude in an agreement, though both sides remain firm in their positions regarding the conditions under which the dialogue could be resumed.

Nevertheless, Kosovo's can improve its attractiveness to foreign investors since the country records dynamic growth rate (estimated average of 3.8 per cent during 2009-2018) and provides a flat corporate tax rate at 10 per cent (Çollaku, 2018). In order to attract FDI, dividends are tax-exempted, while the low tax burden has been considered to fuel the informal economic activities, Kosovo's tax policy is not as much contribute to informality as the institutional weaknesses (European Commission, 2019d, p. 12). Kosovo can build a more appealing investment environment if it uses effectively (i) the ratified Law on Strategic Investments for facilitating the market access to investors in critical sectors, (ii) the Credit Guarantee Fund for providing access to credit and (iii) the Law on Bankruptcy for improving commercial legislation (Çollaku, 2018). The Government should establish a central entity for the coordination of all FDI opportunities. Furthermore, EU enforces Kosovo to proceed to the implementation of all the aspects of the Regional Economic Area Multi-Annual Action Plan (REA MAP), based on EU standards, in order to ease country's integration in regional and European value chains and in this context to increase the attractiveness of the economy for FDI in tradable sectors (European Commission, 2019d, p. 20)

7.5 Empirical Analysis

Chapter 4 presents the empirical analysis of this research on the political system's impact on inward FDI inflows. Thus, it provides variables descriptions, data, model specification and empirical results concerning the total of the six transition economies of WB. The empirical analysis uses a panel dataset of the variables of interest for a

period from 1996 to 2018. Table 7.3 presents a short description of the variables included in the empirical model, their coding, and sources of data.

Table 7 3 - Variables description and Coding

Variables	Description	Code	Source of Data
Dependent Variable			
FDI inflows	The natural log of net FDI inflows	*lnfdi*	wiiw-FDI database
Independent Variables			
1. LDI	The is aggregate index that describes features of democracy at the highest level	*ldi*	V-Dem Dataset (V.10)
2. The signing of Bilateral Investment Treaties (BITs)	The conclusion of an IIA between two countries for the promotion and protection of FDI	*bit*	UNCTAD-International Investment Agreements Navigator
3. Governance Indicators	A set of traditions and institutions by which authority in a country is exercised.		
3a *Voice and Accountability*	The dimension of Quality and Governance	*voice*	Worldwide Governance Indicators (WGI)
3b. *Political Stability and Absence of Violence/Terrorism*	The dimension of Quality and Governance	*polstab*	
3c. *Government Effectiveness*	The dimension of Quality and Governance	*goveffe*	
3d. *Rule of Law*	The dimension of Quality and Governance	*rule*	
3e. *Control of Corruption*	The dimension of Quality and Governance	*cc*	
3f. *Regulatory Quality*	The dimension of Quality and Governance	*regq*	
Controlling-non governance indicators			
4. Growth	Annual percentage growth rate of GDP	*gdp_growth*	World Bank- World Development Indicators database
5. Market Size	GDP at constant 2010 prices in US dollars	*GDP*	

Variables Data for Kosovo

The data used for Kosovo is presented below

Dependent variable

lnFDI

Kosovo	
Index Year	**Net FDI inflows** *in EUR mn*
2004	42,9
2005	107,6
2006	294,8
2007	440,7
2008	366,5
2009	287,4
2010	365,8
2011	393,9
2012	229,1
2013	280,2
2014	151,2
2015	308,8
2016	220,0
2017	255,4
2018	272,1

Notes: The net FDI inflows are in EUR mn

Source: http://wiiw.ac.at/fdi-database.html

Independent variables

Ldi

Kosovo	
Index Year	**Liberal Democracy Index (LDI)**
2000	0.15
2001	0.15
2002	0.31
2003	0.34
2004	0.34
2005	0.30
2006	0.32
2007	0.32
2008	0.30
2009	0.33
2010	0.35
2011	0.38
2012	0.33
2013	0.26
2014	0.32
2015	0.35
2016	0.35

2017	0.31
2018	0.35

Source: www.v-dem.net/en/analysis/CountryGraph

bit

There is no available data for Kosovo

Governance Indicators

Kosovo						
Index Year	***cc***	***rule***	***voice***	***polstab***	***goveffe***	***regq***
1996	.	.	-1,7	.	.	.
1997	.	.	.	.	.	.
1998	.	.	-1,27	.	.	.
1999	.	.	.	.	.	.
2000	0,39	-0,01	-0,74	.	.	.
2001	.	.	.	.	.	.
2002	0,38	-0,05	-0,39	.	.	.
2003	0,50	-0,82	-0,32	.	.	.
2004	-0,29	-0,79	-0,36	.	.	.
2005	-0,52	-0,82	-0,37	.	.	.
2006	-0,51	-0,85	-0,51	.	-0,33	N/A
2007	-0,73	-0,75	-0,31	.	-0,2	0,04
2008	-0,63	-0,59	-0,31	1,01	-0,49	-0,01
2009	-0,58	-0,6	-0,12	0,43	-0,41	0,11
2010	-0,62	-0,61	-0,18	-1,04	-0,58	-0,05
2011	-0,61	-0,52	-0,24	-1,04	-0,46	-0,12
2012	-0,65	0,53	-0,22	-1,04	-0,35	-0,02
2013	-0,65	-0,55	-0,25	-1,04	-0,38	-0,02
2014	-0,49	-0,47	-0,20	-0,34	-0,32	-0,15
2015	-0,54	-0,46	-0,15	-0,20	-0,41	-0,30
2016	-0,41	-0,35	-0,15	-0,28	-0,41	-0,19
2017	-0,50	-0,42	-0,12	-0,21	-0,41	-0,13
2018	-0,52	-0,37	-0,12	-0,61	-0,43	-0,28

Source: https://info.worldbank.org/governance/wgi/Home/Reports

gdp_growth & GDP

Kosovo		
Index Year	**GDP** growth annual (%)	**GDP** (constant 2010 US$)
1996	.	.
1997	.	.
1998	.	.

1999	.	.
2000	.	3.256.044.505,48
2001	26,97	4.134.327.275,08
2002	-0,70	4.105.347.778,79
2003	5,98	4.350.853.553,17
2004	2,61	4.464.503.363,03
2005	6,03	4.733.857.108,04
2006	4,50	4.947.024.196,89
2007	7,29	5.307.468.485,20
2008	2,64	5.447.724.667,69
2009	3,60	5.643.687.002,83
2010	3,31	5.830.415.894,04
2011	4,38	6.085.613.682,12
2012	2,81	6.256.596.647,13
2013	3,44	6.471.915.487,58
2014	1,22	6.551.054.237,01
2015	4,10	6.819.338.311,82
2016	4,07	7.096.905.291,16
2017	4,23	7.396.826.710,69
2018	3,81	7.678.890.905,23

Source: https://databank.worldbank.org/source/world-development-indicators

Table 7.4 presents descriptive statistics for all variables. They include total observations available for the variables along with minimum, maximum, mean, and standard deviation for each of them.

Table 7 4 - Descriptive statistics

	Variable	Obs	Mean	Std.Dev.	Min	Max
Kosovo	*lnfdi*	15	19.283	0.596	17.575	19.904
	ldi	19	0.308	0.061	0.150	0.380
	cc	17	-0.439	0.326	-0.730	0.390
	rule	17	-0.541	0.244	-0.850	-0.010
	voice	20	-0.402	0.406	-1.700	-0.120
	polstab	11	-0.396	0.667	-1.040	1.010
	goveffe	13	-0.398	0.091	-0.580	-0.200
	gdp_growth	18	0.050	0.058	-0.007	0.270
	GDP	19	1.700	0.233	1.181	2.038
	bit	23	0.000	0.000	0.000	0.000
	regq	12	-0.093	0.125	-0.300	0.110

In Chapter 4 the model $y_{it} = x'_{it}\beta + u_{it}$, with $X' =\{$ *ldi, cc , rule, voice, polstab, regq, goveffe, bit, GDP_growth, GDP, time, country dummies*$\}$ and y: the dependent variable represented by the log of *fdi (lnfdi),* estimated for analysis including the six economies of WB. The analysis used a log transformation of the

dependent variable both to eliminate heteroscedasticity problems and reduce the influence of potential outliers of those observations where the errors satisfy the equation, $u_{it} = \rho_i u_{i,t-1} + \varepsilon_{it}$ (please see Chapter 4-Section 4.3)

We have already mentioned that having data overtime for the six WB countries, the decision to use panel data techniques is based on the ability to export robust results. As in the cases of Albania (please see Chapter 5-Section 5.5), BiH (please see Chapter 6-Section 6.5), so with Kosovo, we run the regressions following the Prais-Winsten procedure. Although we correct for autocorrelation and avoid the spurious regression problem as described in Chapter 4-Section 4.3, the estimates are biased and inconsistent due to the limited number of observations. Table 7.5 presents along with the panel data model (detailed analysis in Chapter 4) the time series estimates for Kosovo. The coefficients in the panel data model are significant for four explanatory variables and one control variable while in the single time series model, there are no significant impacts estimated.

Table 7 5 – Comparison of regressions

	Panel Data Model	**Kosovo**
Dependent Variable :	**lnfdi**	**lnfdi**
Ldi(t-1)	0.744	5.116
	(0.66)	(1.92)
cc(t-1)	-0.116	4.051
	(-0.25)	(2.37)
rule(t-1)	-1.081*	-4.078
	(-2.37)	(-1.79)
voice(t-1)	0.956*	0.115
	(2.54)	(0.07)
polstab(t-1)	0.365*	
	(2.25)	
goveffe(t-1)	0.559	0.602
	(0.83)	(0.74)
bit(t-1)	-0.0519	
	(-1.27)	

regq(t-1)	-0.956*	1.327
	(-2.42)	(1.23)
gdp_growth(t-1)	0.00467	0.0136
	(0.23)	(0.29)
GDP (t-1)	3.906***	0.655
	(4.79)	(0.32)
time	-0.0336	
	(-0.89)	
Country dummies		
Bosnia_Herzegovina	-1.619***	
	(-4.23)	
Kosovo	1.896***	
	(3.54)	
North_Macedonia	0.500	
	(1.75)	
Serbia	-3.982***	
	(-3.66)	
Montenegro	3.779***	
	(4.59)	
_cons	10.50***	17.07
	(7.37)	(3.55)
N	92	11

T -statisitcs in parentheses. (*) Significant at p<0.05, (**) Significant at p<0.01, (***) Significant at p<0.001.

The major problem of the research's data set for Kosovo is the limited number of available observations (184 of Kosovo over 1317 of the panel data model). Hence, with pure time-series analysis, the extraction of exact estimates and robust test statistics is constrained. Panel data sets contain more variability to exploit, more efficiency and offer more information than pure time-series data or cross-sectional data. According to the existing literature, panel data methods can detect and measure statistical effects that pure time-series or cross-sectional analysis cannot. Additionally, panel data set lets us control for unobservable, something that time series does not

allow. Hence, the adaption of the panel data technics helps to obtain more accurate and more robust estimates. The following section discusses the empirical results of the panel data model adjusted for the country of Kosovo.

7.5.1 Empirical results - Discussion

Based on the above analysis, this section discusses the empirical results of panel data model presented in Chapter 4. Hence, panel data and Prais-Winstein estimation method indicate that the explanatory variables, voice & accountability *(voice),* political stability & absence of violence/terrorism *(pol_stab),* the rule of law *(rule),* regulatory quality *(regq)*, as well as the control variable of the market size *(GDP)* are significantly associated with inward FDI. The voice and accountability, political stability, and the market size are positively related to FDI while the rule of law, and regulatory quality negatively. The political regime's impact on FDI is positive in the sense that a more democratic regime is more appealing to foreign investors but does not determine the amount of FDI flows that the country receives. Control of corruption, government effectiveness, and growth found positive as expected though insignificant. The signing of the BITs in the case of these economies is negatively and insignificantly related to FDI. The more detailed discussion of the empirical results follows.

Political stability & the absence of violence proved to be positive and significant, in consistency with the literature (please see Chapter 4-sections 4.2, 4.4). Figure 7.4 displays that the level of inward FDI is extremely low in 2004, the first year that official data for FDI inflows in Kosovo is available. Coupling this result with the analysis of Kosovo's political environment over the post-socialist period (please see section 7.3), the FDI's underperformance in 2004 is associated with ethnic violence that erupted across Kosovo the same year and provoked a severe setback in 1999 efforts of the international community to establish a multi-ethnic Kosovo with both the government and civil society respect in human rights. Furthermore, at the immediate aftermath of 2008 independence, Kosovo was an exceedingly precarious and volatile state. The instant government's fall produced political instability, and a series of electoral battles followed (United Nations-Security Council Report, 2020). Hence, while the inward FDI in 2007 hit a record level, in the years followed, 2008-2009, recorded the first negative growth rates (please see figures 7.4, 7.5). The

electoral process in Kosovo was accompanied mostly by actions of violence. The criminal incidents that took place in Northern Kosovo during the mayoral and municipal assembly elections in 2013-2014 retained a risky political environment and a declining trend in FDI inflows (please see figures 7.4, 7.5). Even the 2016 presidential election produced political tension and division with FDI recording further drop. Therefore, the more political instability and rise of violence, including the politically or ethnically motivated violence, the country experiences, the less the FDI inflows receives.

The voice & accountability is significant and positive to inward FDI as expected (please see Chapter 4 - Sections 4.2, 4.4). Voice & accountability measures the perceptions of the extent to which a country's citizens can participate in their government elections, including the confidence about the honesty of elections (WGI, 2019). Also, it comprises individual variables for human rights, respect for the rights and freedoms of minorities. Political participation and respect for human rights are issues of primary concern in Kosovo. The increased violence during the electoral process includes attacks over the ethnic minorities' who experience a constant violation of their rights. The latest report of the European Commission on Communication on EU enlargement policy (European Commission, 2019c, p. 23) confirms that the disrespect of human rights especially on ethnic minorities is a remaining issue and recommends the necessity of progress on strengthening the efficiency and effectiveness of the mechanisms for the coordination and implementation of human rights, including the rights of persons belonging to minorities. The Bureau of Democracy, Human Rights and Labor of the US Department of State (2018, p. 23) also report on the institutional and societal discrimination and violations of fundamental rights that face the ethnic minorities in Kosovo. Hence, the indicator of voice & accountability is associated with the electoral process in Kosovo, which is a source of political instability. Since political instability reduces FDI in consistency with the above analysis a decrease in voice & accountability has also a negative impact on inward FDI.

The significant negative result of the rule of law is unexpected (please see Chapter 4 - sections 4.2, 4.4). The rule of law measures the perceptions on the effectiveness and predictability of the judiciary, contracts' enforceability and property

rights (WGI, 2019). The European Research Centre for Anti-Corruption and State-Building (ERCAS) (2010) records that the post-conflict Kosovo was marked by the new interest groups which entered the political and business, and the legal and the rule of law vacuum that the war created. Both trends left heavy traces on Kosovo's rule of law infrastructure (Sadiku, 2010, p. 2). The European Commission (2019c) reports that in Kosovo now the judiciary is still vulnerable to undue political influence. The way the judiciary functions, leave space to the entrenched elites to involve in Kosovo's political, economic, and judicial institutions and despite their illegal actions to enjoy impunity. The executive branch politically influences Kosovo's courts for providing special treatment or selective justice for high-profile, well-connected individuals. The policy report by Group for Legal and Political Studies on how friendly is Kosovo for FDI (Pula et al., 2017, p. 33) records that ongoing unfair tendering procedures, bribes, clientelism, and politically affiliated businesses are prevalent in doing business in Kosovo (US Department of State, 2019b). On the environment of the weak rule of law and weak legislative implementation, foreign investors in Kosovo realise that the Kosovan government sees them as a mean to fill budgetary deficit rather than a vehicle to economic development. Also, they report cases that local authorities assisted other competitive firms leading to unfair competition (Pula et al., 2017, p. 31). Although some foreign investors are dissatisfied by these practices, others benefit from governmental preferential treatment. Hence, MNEs that feel ethically well to ensure benefits to politicians for excluding their competitors, evaluate the weak rule of law, positively. These may be MNEs having corporate characteristics such as lousy leadership behaviour and a corrupt corporate culture or coming from a country that experience the same institutional weakness (Frei and Muethel, 2017, p. 421). Besides, Kosovo's diaspora in engaged in FDI, holding investments in real estates and constructions, the fields that record rise in FDI inflows (see please section 7.4). Kosovo's diaspora has secure political connections, and a weak rule of law is not an obstacle to developing investments activities in the country. Therefore, an improved rule of law may discourage inward FDI flows.

Respectively to the rule of law's analysis, the significant negative effect of regulatory quality does not confirm most of the literature findings for a positive relationship with inward FDI (please see Chapter 4 - sections 4.2, 4.4). Indeed, the

variable's negative sign is related to the result of the rule of law. Regulatory quality captures perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector (WGI, 2019). To the extent that current foreign investors enjoy a preferential treatment with unique privileges, a new stricter regulatory environment will provide equal opportunities for business to other competitors. Therefore, an improved regulatory environment will be an obstacle to entrenched foreign agents to continue their investments activities in Kosovo.

Concerning the empirical results of the rule of law and the regulatory quality, they provide ground for future research. Specifically, an in-depth analysis of foreign investors' profile in Kosovo may provide further insights for the significant negative relationship between the rule of law, the regulatory quality, and inward FDI.

Government effectiveness measures the quality of public and civil services and the degree of its independence from political pressures (WGI, 2019). The politicisation of Kosovo's political administration is a serious issue. There are two noxious results of this political influence, the employment of civil servants by political loyalty rather than professional competence, and a fragmentation of responsibilities across a growing set of government ministries and agencies (USAID, 2017, p. 17). The USAID political economy analysis report on Kosovo (2017, p. 17) highlights the country's large cabinet of 22 ministries where many of them have unclear roles and responsibilities, while five ministries administered by five different political parties. The 2019 report of the European Commission (2019c, pp. 10–13) for the progress of Kosovo's reform Agenda records improvements on the package of laws on the functioning and organisation of public administration, the adoption of guidelines on strategic planning and the start of the implementation of the action plan on the rationalisation of agencies. The EU on public administration reform (PAR) for Kosovo, agreed with country's government on the simplification, merging and repealing of licenses and permits for businesses, since these procedures are held in a public sector with low capacities and cross-ministerial in nature (European Commission, 2019d, p. 26). Since the inefficiency of public services produces delays in business activities, raising the cost of doing business in Kosovo, the progress on PAR will provide incentives to potential foreign investors to enter the Kosovan market. Hence, despite the variable's insignificance in determining

inward FDI, government effectiveness may have a positive influence on inward FDI flows confirming the literature (please see Chapter 4 - sections 4.2, 4.4).

Control of corruption found to be positive with inward FDI, confirming most studies' empirical results (please see Chapter 4 - sections 4.2, 4.4). Corruption in Kosovo is endemic and is widespread in public life and public institutions (European Commission, 2019c; Sadiku, 2010). The 2019 report of the European Commission (2019c, p. 18) for the progress of Kosovo's reform Agenda stresses the importance of a strong political will to effectively address corruption issues, as well as a robust criminal justice response to high-level corruption. Corruption reduces citizens' faith in government, creates an unfavourable business environment, inhibits private sector development, discourages investments and limits economic growth (Bertelsmann Stiftung, 2018c; Pula et al., 2017). Corruption undermines firms' operational efficiency and raises the risks and costs associated with doing business (Pula et al., 2017, p. 23). The policy report by the group for legal and political studies (2017) assessing how friendly is Kosovo for FDI, records that corruption in the country established unfair market where inconsistency and lack of enforcement of trade and business regulations prevails, facilitating firms to operate informally, evade taxes or customs duties, and avoid licensing restrictions. Immense levels of perceived corruption negatively impact the image of Kosovo amongst foreign investors (Pula et al., 2017, p. 23). However, the empirical result revealed that the control of corruption is a non-significance variable to inward FDI. This relation is indicative of foreign investors' having behaviour to proceed to their investment projects in corrupted countries though they are in their knowledge the risk of doing business in such an environment. For example, foreign investors from Turkey, the country that ranked at the top of the list of source countries during 2012-2016 (please see section 7.4) have the experience of dealing with corruption at home. The 2019 European Commission report (2019e, p. 3) on Turkey notifies that corruption in the country is widespread and remains an issue of concern. Therefore, although the control of corruption can increase the possibilities of attracting FDI inflows, it does not determine the MNEs' decision to enter the Kosovan market.

The political regime type's variable found to be positive, though insignificant. This result is in consistent with other empirical studies' findings (Biglaiser and

DeRouen, 2006; Blanton and Blanton, 2007; Jandhyala et al., 2011; Li et al., 2017; Moon, 2019; Oneal, 1994). By declaring independence in 2008, Kosovo made a viable claim at self-rule and opened the possibility of consolidated democracy (Cocozzelli, 2013, p. 2). Despite this vital step towards democracy, the level of inward FDI in 2008 declined (please see figure 7.4). From 2013 onwards, Kosovo achieved improvements towards democracy with 2019's democratic performance better than expected (please see figure 7.3). Kosovo, following the V-DEM classification, is an electoral democracy, a significant achievement concerning that is the only country in WB with contested and limited statehood. However, the level of FDI inflows during 2013-2019 fluctuated with the long-term trend being down (please see figure 7.4). Although a more democratic regime can be appealing to foreign investors in the case of Kosovo plays little role in stimulating FDI inflows.

Research's empirical model (please see Chapter 4), examines the variable of the signing of BITs based on data available from a listing published by UNCTAD International Investment Agreements Navigator, which excludes Kosovo (please see section 7.5). Hence, we will not further discuss this variable for the case of Kosovo.

Summing up, among all institutional variables discussed, the variables of voice & accountability, political stability & the absence of violence, the rule of law, and the regulatory quality have a significant impact on foreign investors' decision to invest in Kosovo.

7.6 Conclusions - Recommendations

This chapter followed both theoretical and empirical analysis for defining the impact of the political system on inward FDI in Kosovo, as a transition economy of WB. The internationally contested statehood differentiates Kosovo from the rest WB countries.

Kosovo declared itself an independent state in 2008, but the lack of unanimous international recognition continues to divide the international community on the status and future of the province. The international community involved in all stages of Kosovo development from NATO's controversial humanitarian intervention, the peacebuilding/state-building by UNMIK, EU, OSCE and other international donors, and

the post-independence Europeanization process and the EULEX mission. The post-socialism and post-conflict transition characterised by illiberal practices, ethnic, social, and political fragmentation, lack of nation's cohesion, political instability, security issues, economic dependency, and institutional weakness.

Two decades of international state-building activities and a decade of independent statehood affected Kosovo's political surroundings and defined country's route to democracy. However, from 2013 onwards the country achieved improvements in democracy and regime's classification as an electoral democracy.

Kosovo's ambiguous status and the lack of unanimity between EU member states on the recognition of its independence did not prevent the EU to accept Kosovo as a potential candidate for membership. The 2019 EU report of the European Commission on Communication on EU Enlargement Policy for the progress of Kosovo's reform Agenda recommends Kosovo's government to prioritise improvements in the fragmented and polarised political environment. The rule of law, and the judicial system, the public administration, minority rights, gender equality, the informal economy are fields of great concern. Corruption and organised crime need to be tackled efficiently as well as neighbourly relations, regional cooperation and normalisation of relations with Serbia.

The implementation of EU recommendations is also significant for Kosovo's efforts to attract FDI. FDI for Kosovo is of strategic importance for increasing its market competitiveness and achieving economic growth. Until now, Kosovo underperforms in inward FDI compared to rest of WB economies as the above conditions continue to challenge the country's investment climate.

The empirical results indicated specific governance's dimensions to be more influential on inward FDI flows than others. A democratic regime may be appealing to foreign investors but has little impact on the rise of FDI inflows. Voice & accountability, and political stability & the absence of violence/terrorism are significantly positively related to inward FDI while the rule of law and the regulatory quality are significantly negatively related. The unexpected empirical results of the rule of law and the regulatory quality, provide ground for further research.

Kosovo is not a perfect example of institutional coordination, including adequate policies and practices to stimulate FDI. The fragile state requires the building

of stable institutions. Governance and institutional issues continue to determine the investment environment. To be successful, the Government of Kosovo must concentrate on continually strengthening the electoral process, improving political stability as well as voice and accountability by enforcing the respect of human rights, especially on ethnic minorities rights. Although an efficient anti-corruption strategy and the reform of the public administration include the risks of alienating parts of the political elite and the electorate, they will contribute to improvements in the business environment. Therefore, above all, the government must succeed in promoting security, stability, and respect for human rights in Kosovo and the region, to be developed as an investment destination.

Following the same structure of analysis, the next chapter presents the impact of the political environment on inward FDI in North Macedonia.

Chapter 8. The transitional economy of North Macedonia as a host country for FDI.

8.1 Introduction

North Macedonia on declaring independence in 1991 with the dissolution of Yugoslavia, became the only country to exit the Yugoslav union peacefully (Crowther, 2017, p. 745). Its independence triggered a transition towards the establishment of newly independent state institutions, multi-party democracy and market-oriented economy (Gjuzelov and Hadjievska, 2019, p. 3). A small landlocked country with low economic development as Macedonia usually depends on good neighbouring to access larger markets. However, since its independence, North Macedonia has been involved to the legal name-related dispute with Greece and the legacy of uneven relations with other neighbours who, at different times, raised questions about the nation's identity, history, name, religious autonomy, and borders (Sanfey and Milatovic, 2019, p. 5). North Macedonia created an unpropitious geopolitical environment at most of its post-socialist history, which challenged its transition process and its EU and NATO membership.

During the transition period, the rule of law, human rights protection, and freedom of the media deteriorated while political polarisation and corruption thrived. The country did not avoid political crisis and democratic backsliding especially after the 2015 consequential wiretapping scandal which exposed the corruption, electoral fraud and criminality at the senior levels of government (Armonaite, 2019, p. 2). Nevertheless, the country has overcome many of the obstacles of the past, and prospects of completing transition that will reinforce internal stability and democracy are higher than ever. The completion of required reforms is of high importance for the successfully EU integration, given the structural weaknesses that continue to affect the country's economy, competitiveness, and concern potential foreign investors.

The Chapter, along with the theoretical analysis uses empirical analysis to identify the impact of the political environment on inward FDI. The empirical results will provide new insights to the debate, political regime – FDI nexus, through hypotheses about the relative influence of the specific variables that the literature

review indicated (please see Chapter 2). The empirical analysis adjusted to the analysis of North Macedonia's political landscape, hold important implications for the country's development as an FDI destination.

The Chapter is structured as follows: Section two addresses the main issues in North Macedonia transition process. Section three analyses the establishment of the political system over the post-socialist period. Section four presents North Macedonia's inward FDI, while section five discusses the empirical results. The last section concludes and recommends.

8.2 North Macedonia in Transition

North Macedonia started its transition process form a low point, thus being among the least developed republics of the Socialist Federal Republic of Yugoslavia (SFRY) in the early 1990s (Sanfey and Milatovic, 2019, p. 5). Since its peaceful independence in 1991 has been exposed to an unpropitious geopolitical environment, including the legal name-related dispute with Greece and conflicting regional relationships. Specifically, when the country declared its independence from the SFRY chooses to call itself the Republic of Macedonia, as the name of a region in northern Greece in which the second-largest city in the country, Thessaloniki is located. On the Greek side, this decision reflected a veiled expansionist claim on northern Greek territory (Armonaite, 2019, p. 1). At once, Greece announced the blockade of Macedonian efforts to gain UN membership if the name "Macedonia" was used. In 1992, the country was recognised as the Former Yugoslav Republic of Macedonia (FYROM) and admitted to the UN in 1993 while at the same time it agreed to UN-sponsored negotiations on the name dispute. North Macedonia joined NATO's Partnership for Peace in 1995 and commenced its Membership Action Plan in 1999 (US Department of State, 2020). Regarding the country's accession to NATO and the EU, Greece effectively ensured that this would happen on resolving the legal name dispute.

The year 2001 turned to be a landmark for North Macedonia due to a series of events, beginning with an armed inter-ethnic conflict in March. This armed clash was the outcome of the escalation of the Ethnic Albanian grievances over perceived political and economic inequities that ended with the internationally brokered Ohrid

Framework Agreement in August 2001 (Karajkov, 2008, p. 451). The agreement established guidelines for constitutional amendments and the creation of new laws that enhanced the rights of minorities. The signing of a Stabilisation and Association Agreement (SAA) with the EU amid the conflict, reflected the effort of the EU to ensure peace and stability in the region and as such it made the North Macedonia the first country in WB to sign this form of agreement. However, it was in 2004 that the agreement came in to force, and in 2005 that the European Council officially announced the North Macedonia's EU-membership candidate status (Armonaite, 2019, p. 8). In 2008, Kosovo and North Macedonia completed the demarcation of their boundary (Karajkov, 2008, p. 459). Since 2009, the European Commission has recommended to the Council to open accession negotiations with North Macedonia.

All these years, the formal accession invitation to become a member of NATO and the accomplishment of the EU membership were made dependent on the resolution of the long-standing name dispute with Greece. Besides, a wide range of disputes with Bulgaria was posing more obstacles to accession efforts. By 2018 all the disputes were finished, and good neighbourly relations began. Specifically, a good neighbourhood agreement with Bulgaria was preceded in 2017 followed by the agreement on the name of North Macedonia with Greece in June 2018. The historic agreement with Greece (also known as the "Prespa Agreement") recognised as a significant breakthrough and an example of reconciliation for the region and beyond (European Comission, 2019, p. 3). A consultative referendum followed in September 2018 whereby an overwhelming majority of voters who cast their ballots, supported changing the country's name to the Republic of North Macedonia for facilitating the opening of accession negotiations with EU and NATO. From the side of Greece, the longest-standing diplomatic disputes in Europe came to a formal end, when the Greek parliament ratified the agreement in January 2019. Consequently, in February 2019 the EU is notified officially about the entry into force of the Prespa agreement and a few months later in May 2019, the European Commission recommended the opening of the EU accession negotiations (European Comission, 2019). On February 2020 North Macedonia officially became the 30th member of the NATO military alliance.

EU membership: current status

The European Commission in 2016 provided to North Macedonia the possibility of full membership if it overcomes the obstacles of the disputes created over the past with the neighbours, Greece and Bulgaria (Nikolovski, 2019). Further, the European Commission would offer financial assistance to North Macedonia to meet the required membership criteria and deliver tangible results in their implementation. Hence, the European Commission promoted to North Macedonia as well as to the other WB a credible enlargement perspective.

North Macedonia's EU accession found support among some EU member states, with Germany to provide the strongest. The political initiative "the Berlin Process" launched in 2014, acted as the harbinger of the encouraging stance of German Chancellor Angela Merkel over the WB's EU accession. The Berlin Process' goals are to achieve reform progress, in resolving major bilateral and internal issues, in enforcing reconciliation within and between the societies in the WB, in enhancing regional economic cooperation and creating underpinnings for sustainable growth (The Berlin Process - Information and Resource Centre, 2019). The Berlin process supplements the individual countries' institutional EU integration process, based on the adoption of *the acquis communautaire*.

North Macedonia succeeded in resolving the main problem on its Euro-Atlantic path by signing the "Prespa" Agreement with Greece in 2018, though country's accession to the EU remained in question. Unlike Germany, other EU member states, like France, argued that the "Prespa Agreement" by itself is not enough to open accession talks with North Macedonia if the reform agenda is not sufficiently implemented (Nikolovski, 2019). France, as well as the Netherlands, sounded skepticism over country's track records on democracy and the fight against corruption, expressing fears of new members joining the EU at a time when the European cohesion was damaged by "Brexit" (Armonaite, 2019, p. 9). The absence of a unanimous stance on the European integration of North Macedonia between the EU member states weakened the EU's credibility among the generally pro-EU citizens (Nikolovski, 2019). Table 8.1 displays the progress of the North Macedonia reform Agenda as it is recorded to the latest Report of European Commission on Communication on EU Enlargement Policy (European Comission, 2019).

Table 8 1 - Progress of North Macedonia meeting the fundamentals of its reform EU-Agenda

Political Criteria	Maintenance of a steady pace of implementation of EU reforms: Government ○ works for restoring checks and balance, the strengthening of democracy and the rule of law, ○ delivers tangible results in critical areas such as the judiciary, fight against corruption and organised crime, intelligence services reform and public administration, ○ maintains peace in the inter-ethnic situation overall, ○ improves the climate in which civil society organisations operate ○ achieves reforms in the system for interception of communications (the new Operational Technical Agency) and its intelligence services in cooperation with NATO and other partners.
Public Administration	Moderately prepared. Intensified efforts needed to ensure accountability and prevent its politicisation. The principles of transparency, merit and equitable representation are threatened.
Judicial System	Although good progress achieved in addressing the 'Urgent Reform Priorities' and recommendations from the Venice Commission and the Senior Experts' Group on systemic Rule of Law issues, the judicial system is moderately prepared.
Fight Against Corruption	Some level of preparation is recorded. Progress is notified in investigating, prosecuting and trying high-level corruption cases and through changes to the legislative framework. However, corruption remains an issue of concern.
Fight Against Organised Crime	Some level of preparation is recorded. The legislative framework is broadly in line with European standards. Progress is notified in improving the track record, stepping up law enforcement cooperation, substantially improving the operational capacity to fight trafficking in human beings and improving the effectiveness of the National Coordination Centre for the Fight against Organised Crime.
Fundamental Rights	Their protection is in line with EU standards. Progress is recorded in increased protection against hate crime and discrimination with amendments to the Criminal Code and the adoption of the Law on Prevention and Protection from Discrimination. The country is moderately prepared in the area of freedom of expression.

Regional Cooperation	Historic steps to improve good neighbourly relations made such as the entry into force of the "Prespa" agreement and of the BIT with Bulgaria.
Economic Criteria	The country is at a good level of preparation for a functioning market economy. It is moderately prepared to cope with competitive pressures and market forces within the EU. Trade and investment integration with the EU progressed more. Exports and manufacturing output diversified further towards higher-value products. Deficiencies are still existing in the areas of labour productivity, the competitiveness of the economy, investments, and public infrastructure.
Ability to assume the obligations of membership	Moderate level of preparation in most areas such as competition, public procurement, transport, and energy, Good level of preparation in areas such as company law, customs union, trans-European networks, and science and research, Early stage of preparation in areas such as the free movement of workers as well as financial and budgetary provisions, Intensified efforts needed into the administrative capacity and effective implementation, Improved its alignment with the EU declarations and Council decisions on Common Foreign and Security Policy.

Source: Author's adjustment from the European Commission (2019)

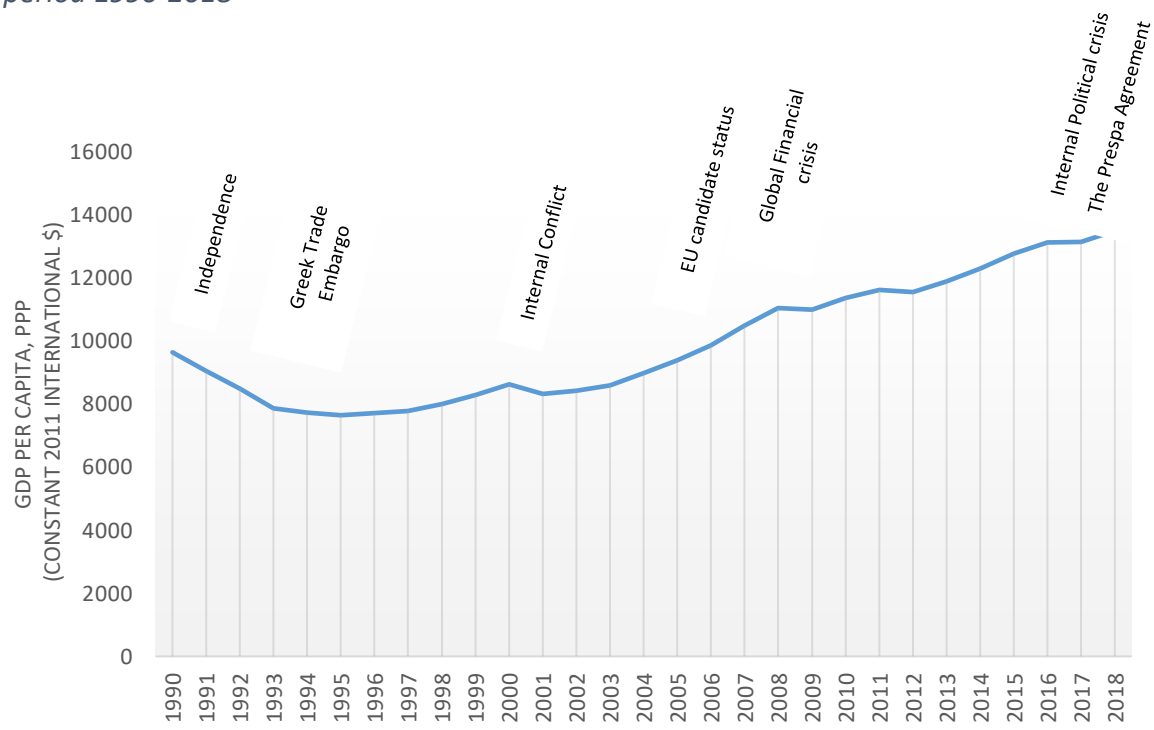
The first step towards enlarging the 27-member EU, since the UK quit the bloc in January 2020, made in March 2020. Finally, the EU gave the green light to Albania and North Macedonia to begin their long-awaited accession talks (European Commission, 2020). EU's decision reflects its intention to consolidate the relationship with WB further and to inhibit Russia and China to deepen their footprints in the region (European Council on Foreign Relations, 2020). Even Paris and the Hague eased their objections, and the beginning of accession talks gained momentum despite the coronavirus crisis. However, the formal date for the commencement of formal talks is not announced and may take several years before North Macedonia merits full membership.

Economy in Transition

A small landlocked country like North Macedonia usually depends on close relationships with its neighbours to access larger markets. However, North Macedonia is not an example of good neighbouring (World Bank, 2018, p. 2). Indeed, in 1994

Greece imposed a unilateral trade embargo, and closed borders with North Macedonia cutting off its access to the nearest seaport as the result of the between them, name dispute. The hit was enormous to the already suffering country's economy as it had to overpass the loss of its most important trading partner, Serbia. UN's and EU's economic sanctions imposed on the Milosevic regime, also lead to the borders' closure. Also, the high transportation and transaction costs made it even harder to conduct international trade. The new government had to deal with the lack of international reserves, with the new currency's fluctuations and the hyperinflation, passed down from the Yugoslav economy (World Bank, 2018, p. 3). The breakup of former chains of production and the loss of markets made many North Macedonian firms to close, leading to the rise of unemployment and the deterioration of living standards. The 2001 internal conflict disrupted any effort of setting up underpinnings for growth. Hence, during the period 1991-2001, the economy of North Macedonia recorded a low growth, and its transition process, from a state planning to a market-driven economy, was slow. The political events determined the economic development of the country (please see figure 8.1).

Figure 8 1 - Economic impact of significant events in North Macedonia during the period 1990-2018



Source: Adapted from the World Development Indicators (World Bank, 2020b)

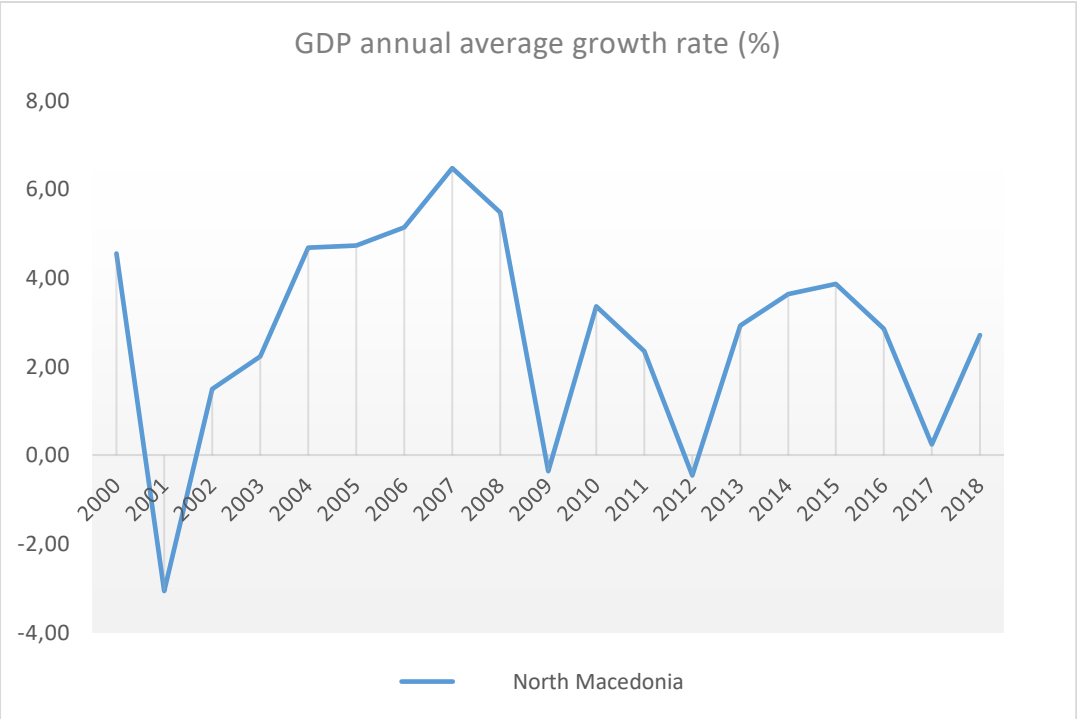
Only by 2006, per capita GDP rebound to its pre-independence level, and in 2008 the country reached the upper-middle-income status (please see figure 8.1) (World Bank, 2018, p. 3). The improved performance in North Macedonian economy came from its Euro-Atlantic perspective, the stabilisation of its macroeconomic policy and the implementation of market-oriented reforms by a new technocratic government (Bertelsmann Stiftung, 2018d, p. 5). Country's accession to the World Trade Organization (WTO) in 2003 and the CEFTA entry into force in 2004, promoted international trade.

During the period 2001-2018, the average economic growth was 2.7 per cent compared to a 1.5 per cent in the EU (please see figure 8.2), suggesting that North Macedonia has been catching up only gradually towards EU living standards. The World Bank Systematic Country Diagnostic (SCD) Report for North Macedonia (2018, p. 4) based on this growth rate performance estimates that when the newborn child grows up to 75 years old, he will experience country's income levels to converge with the EU's, while at an annual growth rate of 5 per cent this convergence will come 40 years earlier. The average growth rate over the pre-crisis period of 2001-2008, was just 3.4 per cent, below regional comparators (EBRD, 2019b, p. 8). During this period GDP growth relied heavily on consumption, accounting for almost 96 per cent of GDP, compared to an average of 78 per cent. Private consumption, fueled by private transfers from abroad and credit growth forced the rise in external imbalance, as imports of consumer goods surpassed growth in exports (World Bank, 2018, p. 4)

During the post-crisis period of 2009-2018, the best GDP's average growth rate performance of 3.5 per cent was recorded in the years 2013-2015 due to rising private consumption and public investment. However, two times the country recorded a negative growth rate of 0.4 per cent in 2009, following the global financial crisis, and 0.5 per cent in 2012, following the Eurozone debt crisis (Sanfey and Milatovic, 2019, p. 22). The prolonged political crisis, which started in 2015 and escalated in 2017, affected the growth that fell almost at the rate of zero (0.2 per cent) (please see figure 8.2) by having a measurable negative impact on confidence and investment (EBRD, 2019b, p. 8). In 2018 the political stability along with the impact of the rising minimum wage and other social protection measures on private consumption produced a growth rate of 2 per cent.

In the post-crisis period, the poverty rate declined from 29 per cent in 2009 to 20.5 per cent in 2018, though poverty is still entrenched in rural areas of the north and among ethnic minorities, and the middle class is expanded modestly (World Bank, 2018, p. 6). Unemployment is consistently high, but its measurement is not reliable due to the possibility of an overstatement on the existence of an extensive grey market. The country's informal economy is considerable, even though it declined over a ten - year period from 40-45 per cent of GDP to 24 per cent (Bertelsmann Stiftung, 2020, p. 20).

Figure 8 2 - North Macedonia annual average growth rate for the period 2000-2018



Source: Adapted from UNCTADstat (2019) (www.unctadstat.unctad.org), Gross domestic product: growth rates, annual

North Macedonia managed to maintain macroeconomic stability and grew reserves through the global financial crisis by conducting prudent monetary policy, keeping the domestic currency pegged to the euro, and inflation at a low level (Bertelsmann Stiftung, 2018d, 2020). The fiscal policies were lax, with unproductive public expenditures, including a rise in subsidies and pensions, and increasing guarantees for the debt of SOEs. Thus, fiscal targets were consistently missed. In 2017, public debt stabilised at about 47 per cent of GDP, still relatively low compared to its Western Balkan neighbours and the rest of Europe. Concerning the external debt, it has been rising since 2009, on the back of heavy public sector borrowing abroad and

rising intercompany debt. The high degree of euroisation of banks' loans and deposits challenged, even more, the external side. At the end of 2018, the external debt accounted for 74 per cent of GDP, higher by 4pps than the average in 2013-2017 (European Comission, 2019, p. 48)

In 2018 the country made some progress at a good level of preparation in developing a functioning market economy. Its low tax rates and free economic zones have helped to attract foreign investment, though remained muted relative to the rest of Europe. Corruption and the weak rule of law, opaque regulations and unequal enforcement of the law are significant problems in the business environment (EBRD, 2019b, p. 3) . IMF's Selected Issues paper on the Republic of North Macedonia (2019a, p. 2) reports that country's economic performance and business environment is hampered by an underutilised labour force, a large shadow economy, and systemic weaknesses in governance, the judiciary and public administration.

The 2019 EBRD North Macedonia Diagnostic report (2019) made estimations for current increases of (i) credit to the economy as lending conditions ease amid the accommodative monetary policy and (ii) exports in the short term in light of the strengthening of economic prospects in the EU, the country's key trading partner. The same report bases the 2019 forecast of 3 per cent growth rate "on the assumption of continued political stability, the unblocking of further reforms and the arrival of much-needed investments, with a similar or even slightly higher rate in the years to come. However, downside risks remain significant, and investor sentiment could deteriorate if political uncertainty were to increase" (Sanfey and Milatovic, 2019, pp. 22–23). Table 8.2 displays the six qualities of a sustainable market economy in North Macedonia, according to which the EBRD measures the progress in transition.

Table 8 2 - Main transition gaps in North Macedonia concerning the six desirable qualities of a sustainable market economy

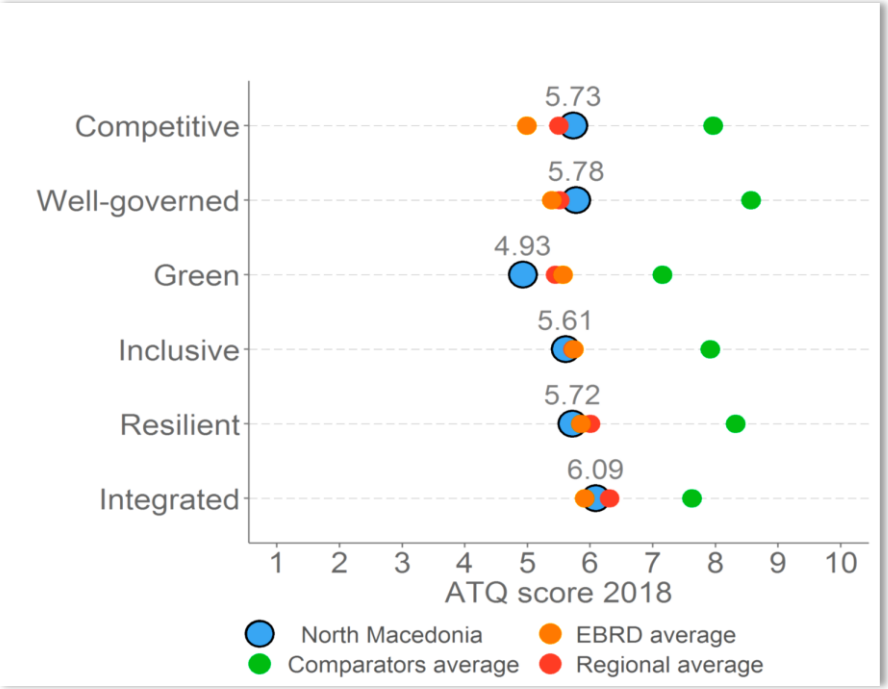
Qualities	(+) Strengths	(-) Weaknesses
Competitive	Most competitive among the WB-6 peers, Excellent performance in World Bank's ease of doing business ranking -10th among 190 countries	Enforcing contracts and resolving insolvency are the most problematic areas Productivity is below the average for the WB-6, well below EU standards Unfair competition from the informal economy major obstacle The country is assessed as an intermediate Knowledge - economy, constrained by reduced skill availability. The country faces an overall medium gap across the five dimensions in SME development. • Non-bank financing and business skills & standards are the two most problematic of the five Enforcement of competition policy is weak
Well-governed	Successful administrative reforms reduced the administrative and regulatory burdens on firms. Corporate governance is better in North Macedonia than in many regional peers	Affected by political instability, the weak rule of law and inadequate control of corruption, Corruption increased: the country is ranked 93rd among 180 countries, compared to 66th three years ago Many people see political connections as the key to success in life
Green	The country ranks among the most energy-intensive economies in the region due to the high share of coal and oil in primary energy production. The country currently supports renewable energy projects with feed-in tariffs via a PPA with the market operator.	Around half of the country's generation capacity (both thermal and hydropower plants) is scheduled to close in the next 15 years. The country is vulnerable to climate change and is at a high risk of natural disasters. Water and wastewater infrastructure are aged and in poor condition, need urgent reconstruction and replacement

Inclusive		High youth unemployment and low labour participation among women, combined with a projected decline in the working-age population constitute the main threats to prospects for inclusive growth. Skills mismatch is one of the key drivers of youth inactivity. Significant gender inclusion gaps concerning access to finance and labour practices
Resilient	Financial sector stability has been strong, supported by a well-anchored monetary policy The banking sector is profitable. Credit activity is picking up. Euroization is moderate and mostly stable	Development of non-banking financial services and the stock market is at an early stage, and capitalisation is low.
Integrated	North Macedonia's five-year average trade openness [(exports + imports)/GDP] is 107 per cent, above the EBRD average of 92 per cent and close to the EU average (120 per cent). The quality of transport infrastructure is ranked in the WEF's Global Competitiveness Index as higher on average than in other WB-6 countries. North Macedonia has a relatively high level of ICT infrastructure as well as a fully competitive market for retail Internet access services.	FDI levels are low. Cross-border energy integration is slowly improving.

Source: Author's adjustments from the 2019-2024 EBRD country strategy report for the Republic of North Macedonia (2019) and the 2019 EBRD North Macedonia Diagnostic report (2019).

Figure 8.3 presents the transition gaps in North Macedonia concerning its WB's and EU-11 peers, based on the above six qualities. Each quality is assessed on a scale of one (1) to ten (10). The average transition quality (ATQ) score for North Macedonia is 5.64, on a scale of 1 to 10.

Figure 8 3 - North Macedonia scores of six qualities of a sustainable market economy



Source: EBRD North Macedonia Diagnostic report (2019, p. 13)

The country is generally at the same level or ahead of its WB peers, while lags in all qualities when compared with EU-11 peer countries (please see figure 8.3). North Macedonia has made progress towards a sustainable market economy but has some distance to cover.

8.3 North Macedonia Political environment over the post-socialist period

Since 1990, the three different electoral regimes the country experienced (that is, majoritarian in both 1990 and 1994, mixed in 1998, and proportional since 2002), led to the party system's fragmentation (Casal Bértoa and Taleski, 2016, p. 546). Similar to other post-authoritarian countries, the first democratically elected parliament in North Macedonia, was the one that constitutionalised parties and enacted the first party and finance law (Casal Bértoa and Taleski, 2016, p. 561). From 2002 onwards, the proportional electoral system produced block coalitions in elections. Since 2008 there have been five calls for early election in the country in a row 2008, 2011, 2014, 2016 and 2020. The frequency of early elections indicates long term dysfunctions or

disruptions that prevent the incumbent government of successful implement its policies (Vangeli, 2019, p. 1)

In 2001, the Ohrid Framework Agreement that ended the inter-ethnic conflict necessitated constitutional amendments and the adoption of a consociational model of democracy, characterised by qualified majority procedures in the parliament, decentralisation, equitable representation in the public administration and extended rights for the use of minority languages (Gjuzelov and Hadjievska, 2019, p. 4). Even after the signing of the agreement, the societies' division between ethnic North Macedonian and Albanian communities remained and expressed politically by the two most successful parties in each community. For the North Macedonian side, these parties are the Internal Macedonian Revolutionary Organization – Democratic Party for Macedonian National Unity (VMRO-DPMNE) on the ideological right, and the Social Democratic Union of Macedonia (SDSM) on the left. Respectively for Albanian party system, the most popular parties are the Democratic Union for Integration (DUI), a successor to the National Liberation Army which involved in 2001 conflict, and the Democratic Party of Albanians (DPA). This political structure in which ethnicisation of party politics was dominant inhibited the democratic consolidation of the country (Gjuzelov and Hadjievska, 2019, p. 5). The EU promoted changes to party legislation for state's democratisation in 2004.

For over a decade, 2006-2017, North Macedonia ruled by a coalition government led by Nikola Gruevski, which was characterised mainly in its latter half by widespread abuse of power. During this period, North Macedonia was balancing between the poles of democracy and authoritarianism, governed by elites that achieved through their actions to monopolise power beyond constitutional limits (Gjuzelov and Hadjievska, 2019, p. 2). In particular, the rule of VMRO-DPMNE and their ethnic Albanian coalition partner DUI, between 2008-2017 is a typical example of illiberal politics. Illiberal politics is recognised as a specific set of policies and actions undertaken by governing parties for establishing an uneven playing field serving their goal to remain in power indefinitely (Gjuzelov and Hadjievska, 2019, p. 2). The VMRO-DPMNE was in the head of this government and used the executive branch to dominate into the legislature and judiciary, and to expand its power into all aspects of society, including media, academia, and economy (Kacarska, 2017, p. 2). This

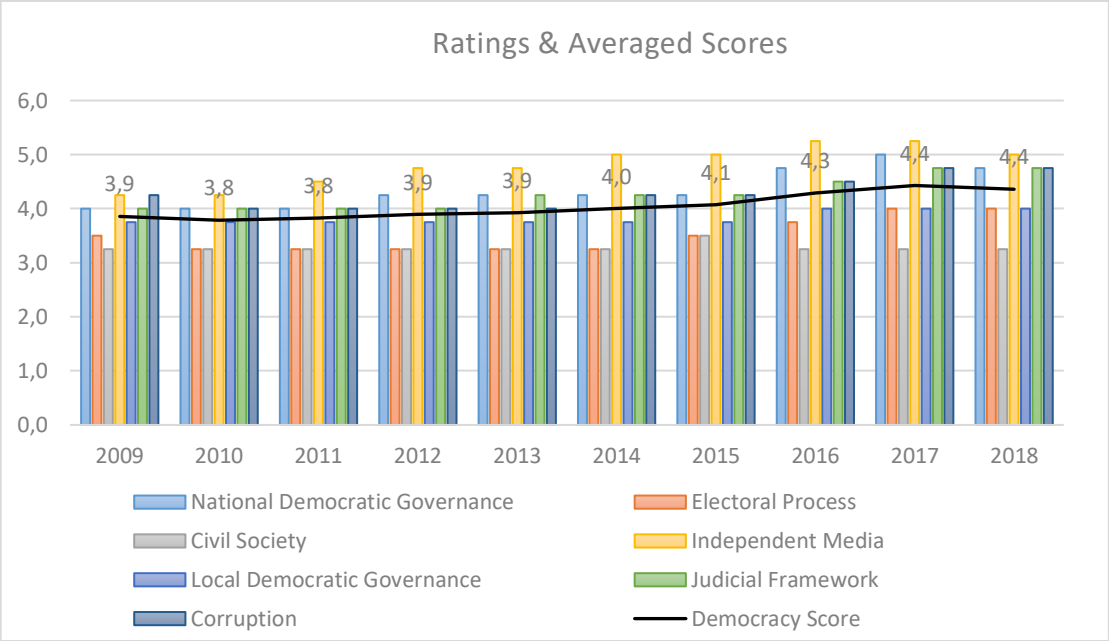
privileged access to resources, media and law gave to the VMRO-DPMNE electoral victories in succession as well as legitimacy. During this period, in the electoral process, numerous deficiencies were recorded, that extended from insufficient separation between the state and the party structures to bullying of voters and biased and pro-governmental media reporting (Gjuzelov and Hadjievska, 2019, p. 5). The institutional aspects of illiberal politics that involve the political abuse of state institutions and resources that cultivate unfair political competition is like those in competitive authoritarianism.

In early 2015, a political crisis engulfed by a wiretapping scandal revealing widespread corruption, massive infringements on private communications, and a lack of control over the state intelligence apparatus. EU's experts reported at that time that the wiretapping was conducted by state's secret police confirming the accusation of the leader of the opposition, about government's massive failure in respecting and upholding the rule of law (Bertelsmann Stiftung, 2018d, p. 3). This crisis provoked even a short, violent interethnic event between an armed group, composed mainly of Kosovo Albanians, and North Macedonian security forces.

In the fall of 2016, the European Commission expressed its concerns about the institutions in the country being subject to state capture and questioned the functioning of the checks and balances system in the Republic of Macedonia (Kacarska, 2017, p. 2). The Global Coalition against Corruption - Transparency International (2020) defines this term as a situation where influential individuals, institutions, companies or groups within or outside a country use corruption to shape a nation's policies, legal environment and economy to benefit their private interest. This situation reflected the sharp decline of North Macedonia's democratic score (Kacarska, 2017, p. 2). The Freedom House Nations in Transit report (2017) recorded at that time a backsliding in democracy tied to stagnation in North Macedonia's EU and NATO integration. During the years 2016-2018, the democracy's score ranged between 4.3 - 4.4 (please see figure 9.4) which, according to Freedom House regime types' categorisation is placed to transitional or hybrid regimes. Countries with scores between 4.00 - 4.99 are typically electoral democracies with weak democratic institutions, and the protection of political rights and civil liberties are seriously challenged (Freedom House, 2018b, p. 22).

Figure 8.4 displays the democratic progress in North Macedonia according to the latest report of Freedom House Nations in Transit (2018b).

Figure 8 4 - North Macedonia Democracy score during the period 2009-2018



Note: Freedom House provides numerical ratings for each country on the seven indicators, based on a scale of one (1) to seven (7). The highest level of democratic score is one (1) while seven (7) is the lowest level. The average of its ratings on all seven indicators represents the country's Democracy Score covered by Nations in Transit (Freedom House, 2018b, p. 22).

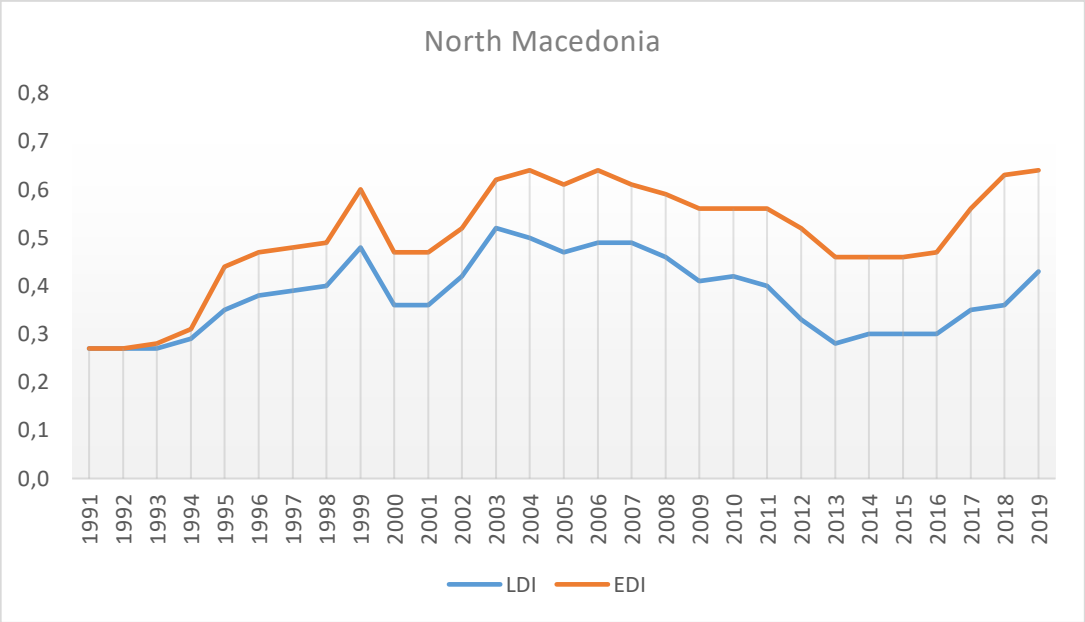
Source: Adapted from Nations in Transit 2018 Report: Confronting Illiberalism (Freedom House, 2018b, p. 16)

Figure 8.5 displays the progress of democratic score in North Macedonia measuring by V-Dem's Liberal Democracy Index (LDI) and Electoral Democracy Index (EDI) since the country's independence in 1991, and it is in line with the above analysis of country's political environment. Although the LDI's low score of 0.27 at the beginning of the transition process is excused, it is not when it repeated after 15 years (2014-2016). The highest LDI score of 0.5, achieved during the years 2004-2006. The V-DEM classification defines a country as a liberal democracy when records a score of at least 0.8 in V-Dem's Liberal Democracy Index (LDI). LDI run on a continuous scale, from low to high (0-1), with higher values indicating a more democratic dispensation. Given, the low LDI rating, North Macedonia has never been classified as a liberal democracy.

In 2016, Macedonia's score on the EDI was 0.53 slightly above the threshold for electoral democracy (Lührmann, Tannenberg, et al., 2018, p. 6). Based on the RoW typology for being classified as an electoral democracy it requires just holding reasonably free and fair multi-party party elections and an average score on V - Dem's Electoral DI above 0.5 (Lührmann, Mechkova, et al., 2018, p. 1327). Respectively to LDI, also the EDI, runs on a continuous scale, from low to high (0-1), with higher values indicating a more democratic dispensation. Due to the lower bound of EDI score that was 0.48, the country was falling within the range of electoral autocracy. To this context, the ROW typology labelled the country as electoral democracy lower bound.

From 2017 onwards, there is an incremental rise of democracy based on the change of the government coalition and its achievements. The parliamentary elections at the end of 2016 and local elections in 2017 changed the country's political surroundings. Although the turnover of power does not guarantee the end of the state capture, at least creates hopes for it. The new government coalition formed six months after the elections in May 2017, between the SDSM, the DUI, and the DPA with the leader of SDSM party, thus Mr. Zoran Zaev. The new governing parties engaged to freeing state institutions by reforming the judiciary and public administration and fighting corruption, employing the process of EU and NATO accession as external anchors (Kacarska, 2017, p. 5). The settlement of the long-standing issue with Greece over the country's constitutional name, followed by NATO membership and the opening of EU accession talks, are attributed to the more Western-oriented Zaev's government compared to Russia-friendly Gruevski's government (Naunov, 2019, p. 49). The quality of democracy in North Macedonia improved slightly during Mr. Zaev's governance, but his critics believe he should do more to strengthen the judiciary or to control corruption (Kingsley, 2020).

Figure 8 5– North Macedonia's Electoral Democracy Index (EDI) & Liberal Democracy Index (LDI) during the period during the period 1991-2019



Source: Adapted from V-DEM data (2020)

North Macedonia's political regime based on LDI and EDI average scores for the years 2018-2019 that are 0.40 and 0.64 respectively, is classified as an electoral democracy. In the Regimes of the World (RoW) Index, country's classification as an electoral democracy is based on the quality of a country's electoral institutions, its liberal characteristics, as well as the regime's record across various civil liberties indices (Morgan et al., 2019, p. 26). Country's estimated risk of Adverse Regime Transition (ART) for 2019-2020 is 0.069 per cent holding the 45th position in a list of 169 countries that share the same risk (Morgan et al., 2019). An ART occurs when a country moves down the RoW index from one year to the next in a two-year window, reflecting a decline in the democratic qualities of a country's political regime (Morgan et al., 2019, p. 2). For example, when a country goes from an electoral autocracy to a closed autocracy from one year to the next (Morgan et al., 2019, p. 5). Therefore, the risk of adverse regime transition from electoral democracy to electoral autocracy is low.

In July 2020, and amid the coronavirus crisis, the first general election in North Macedonia since the country changed its name took place. Although Zoran Zaev led North Macedonia into NATO and brought the country closer to the EU application by settling long-standing disputes with Greece and Bulgaria, he failed to win a majority

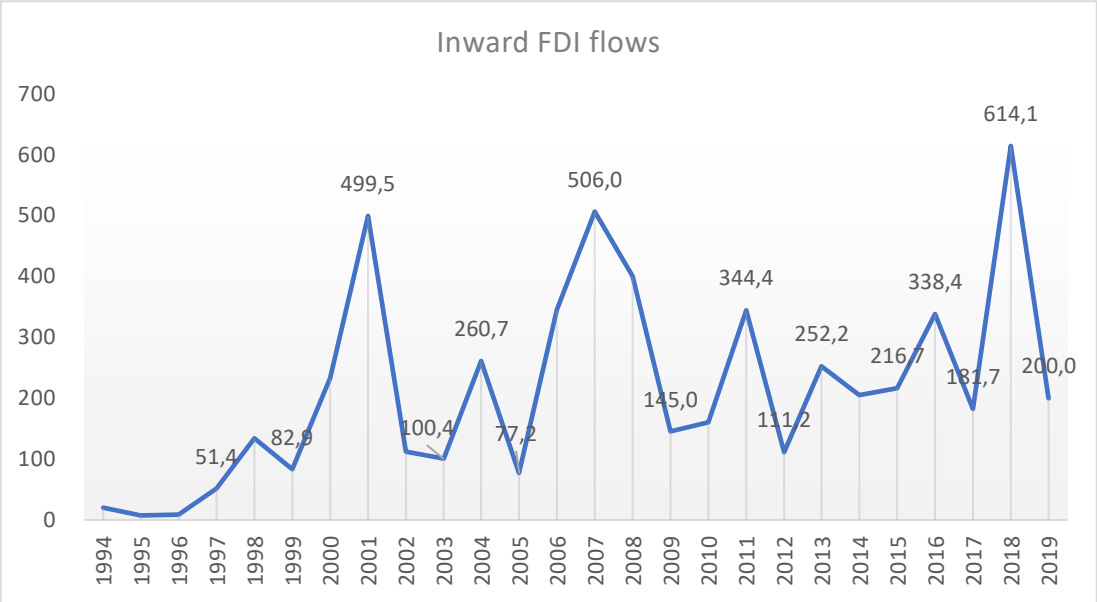
(Kingsley, 2020). The coalitions talks for the formation of new government arise as a threat to political stability, democracy, and diplomatic balance, since Zaev's primary opponent, the nationalist VMRO-DPMNE could gain power with the support of smaller parties representing the country's ethnic Albanian minority (Kingsley, 2020). The nationalists are supportive of the NATO membership and the EU application, but they desire to reexamine the recent deals with the neighbours.

8.4 Inward FDI in North Macedonia

The role of FDI in transitional economies with a low rate of development is of specific importance. FDI contributes to the establishment of sustainable economic underpinnings, and as such to economic prosperity, thus meeting the EU economic accession criteria, according to the analysis of Chapter three (section 3.5).

The beginning of the privatisation process in 2000 along with the re-establishment of peace led to the booming of inward FDI in 2001 reaching almost the amount of EUR 500 million (please see figure 8.6) and accounting for 12.1 per cent of country's GDP (please see figure 8.8). This large amount of FDI inflows was attributed to the selling of the national telecommunications operator to Magyar Telekom, the Hungarian affiliate of Deutsche Telekom in 2001 (Kikerkova, 2017, p. 940). However, the increased political risk and vulnerabilities in the business environment reduced the inward FDI substantially until 2006 (please see figure 8.6). FDI rebound in 2007, hitting a record of EUR 506 million due to the privatisation of a part of the state monopoly for production and distribution of electricity – Elektrostopanstvo from Skopje.

Figure 8 6 - Inward FDI flows in North Macedonia, in millions of EUR for the period 1994-2019



Source: Adapted from wiiw FDI database (wiiw, 2020) FDI: total, annual

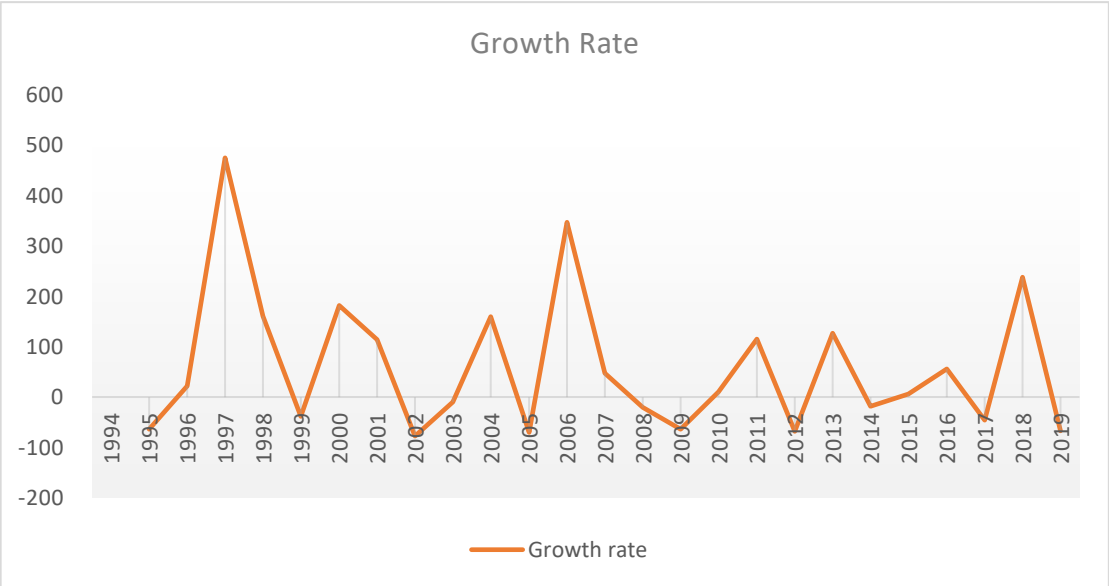
During the period 2006-2016, the government made efforts to attract FDI by implementing friendly FDI policies such as the opening of free economic zones, the offering of a 10 per cent flax tax and state aid for foreign investors (Bertelsmann Stiftung, 2018d, p. 18). The legal environment has been reformed and included a legal framework that is non-discriminatory for the foreign investor. However, the free economic zones never became operational, and the government decided to proceed to a new law comprising more incentives and establishing the zones under a new name that of Technological Industrial Development Zones (TIDZ) (Kikerkova, 2017, p. 941). The TIDZ changed the form of investing in the country in favour of greenfield investments. In 2011, greenfield investments managed to acquire a 38 per cent of the total amount of FDI while the rest percentage accounted for the popular mode of FDI entry, that of mergers and acquisitions (Kikerkova, 2017, p. 945). Regulations and procedures were simplified for foreign investors operating in TIDZ. The tax incentives have included exemption from customs duties, various tax holidays and specific tax relief measures. The labour costs have remained competitive, but the shortage of skilled labour was a problem.

Since the country's one of the main interests was the creation of new jobs to restrain emigration and brain drain, the government tried to stimulate FDI inflows in labour-intensive cluster industries, like in the automobile industry. Indeed, several US

and German industries of the field engaged in greenfield investments in North Macedonia but did not improve as expected the country's employability (Bertelsmann Stiftung, 2018d, p. 18). North Macedonia's vulnerable points as host country to FDI have been despite high structural unemployment and training deficit, the size of the shadow economy, inadequate transport infrastructure, significant indebtedness of the private sector accounting for 93 per cent of GDP at the end of 2014, conflicting political environment, and tensions in society between ethnic minorities.

In 2018, net FDI flows to Macedonia more than tripled to a record EUR 737 million, compared to EUR 181.7 million in 2017, doubled the average rate of the previous five years (please see figures 8.6, 8.7). This performance of inward FDI flows reflects both favourable international demand for the output of foreign firms located in the country's TIDZ and positive political developments in the dispute about the country's name (UNCTAD, 2019, p. 75). Most FDI targeted the export-oriented investment cluster of North Macedonia, primarily automotive production, located in the TIDZ. A remarkable example is the large FDI deal of the US-based car parts manufacturer Dura Automotive Systems in the Skopje 2 Free Zone (UNCTAD, 2019, p. 57). However, net FDI flows to North Macedonia decreased significantly in 2019 by 67.43 per cent and reached EUR 200 million in 2019, compared to EUR 614 million one year before. As the UK proceeded to disinvestment (EUR 66 million), it influenced the level of FDI negatively flows the country received during 2019 (investinsee.com, 2020).

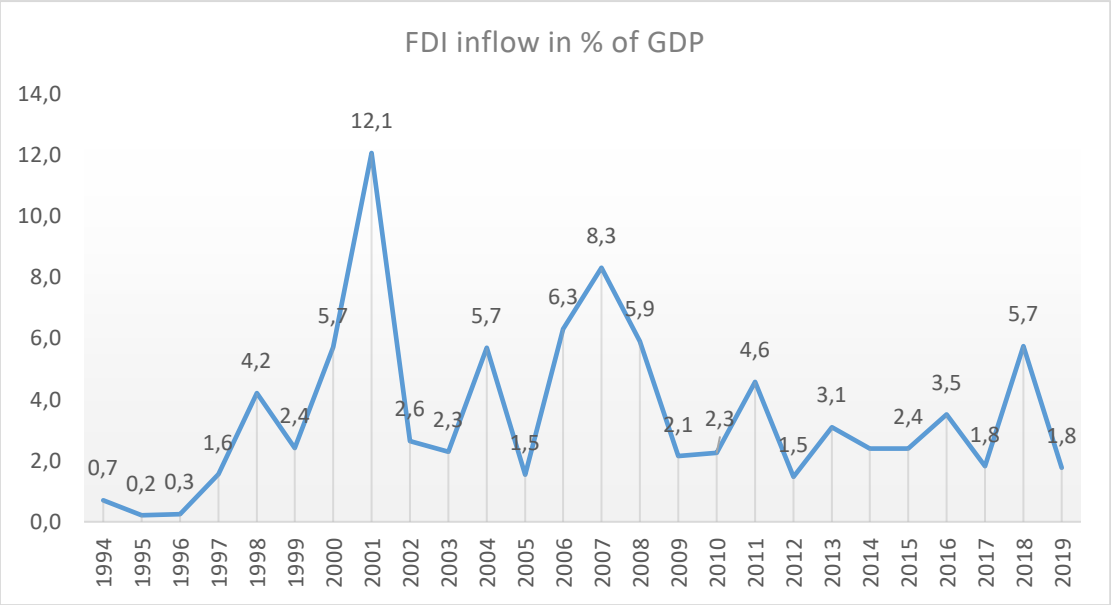
Figure 8 7 - Growth rate of FDI inflows in North Macedonia for the period 1994-2019



Source: Adapted from wiiw FDI Database (wiiw, 2020), FDI: total, annual

FDI received annually by a host country, typically runs at about 2-3 per cent of the size of host economy measured by its GDP and when it exceeds 5-6 per cent of GDP each year, then it is considered as a significant performance (TheGlobalEconnomy.com, 2019). The ratio of FDI inflow in the percentage of GDP before the financial crisis had two peaks in 2001 and 2008, while in the post-crisis period slightly managed to surpass the down limit of 5 per cent in 2018 (please see figure 8.8). During the crisis, the sluggish performance of FDI is mostly related to the slow economic recovery of the EU, North Macedonia's leading trade and investment partner.

Figure 8 8 -Inward FDI flows in North Macedonia as a percentage of GDP for the period 1994-2019



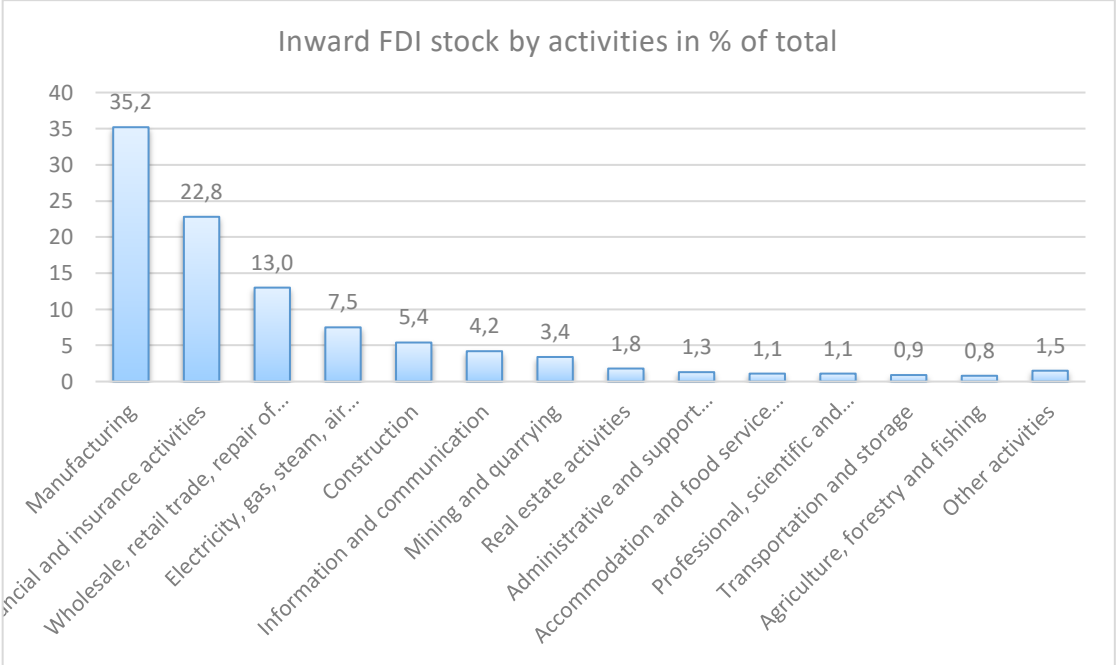
Source: Adapted from wiiw FDI Database (wiiw, 2020), FDI: total, annual

The first economic sector in terms of FDI stock is service, though it held a declining share from 51.5 per cent in 2009 to 47.6 in 2018. The manufacturing sector is following with an increasing share from 30.3 per cent in 2009 to 35.2 per cent in 2018 (2020). The intensified investment in the TIDZ strengthened the increasing FDI inflows in the manufacturing sector. The average inward FDI stock for the period 2009-2018 is concentrated in the manufacturing sector, the financial sector, trading and the electricity sector, construction, and the ICT sector (please see figure 8.9). During these years, the manufacturing sector, the production of electricity and gas, and

construction managed to narrow the gap with the service sector. The latter, along with agriculture and mining, account for 50 per cent of the total FDI.

Based on the Vienna Institute for International Economic Studies databases (wiiw, 2020), in terms of origin, the EU is by far, the largest investor in North Macedonia. However, during the years EU's share of inward FDI stock declined from 81.9 per cent in 2010 to 75.3 per cent in 2018. Turkey followed, holding an increasing share from 1.5 per cent in 2010 to 5.3 per cent in 2018. On the contrary, Switzerland had a declining share from 4.6 per cent in 2010 to 3.3 per cent in 2018. China, not an investor country in the region in 2010, now ranked fourth in 2018 with a 2.5 per cent share.

Figure 8 9 - North Macedonia's FDI Inward stock by activities in the percentage of the total, the average for the period 2010-2018



Source: Adapted from wiiw FDI Database (wiiw, 2020), FDI by activities

The new rule of governance in 2017 set as a critical component of its strategic objectives to increase competitiveness and achieve higher economic growth and development through FDI. The signing of the "Prespa Agreement" opening the road to NATO and EU accession, rekindled foreign investor's interest. After all, the country is a member of the WTO and offers free access to a market of over 650 million customers through multilateral free trade agreements like SAA, EFTA and CEFTA

member countries and BITs. In particular, North Macedonia has signed about 40 BITs, including countries members of OECD (UNCTAD International Investment Agreements Navigator, 2020b). In 2019 many countries and MNES announced investments in the North Macedonia and new operations in the TIDZ (U.S. Department of State, 2019b).

North Macedonia is making significant effort to attract more manufacturing FDI, which must be export-oriented given the country's limited local market (UNCTAD, 2019, p. 74). The TIDZ serve this purpose and also contribute to specific development goals such as job creation, compliance with high environmental standards, production based on new technologies and high energy efficiency (UNCTAD, 2019, p. 168).

The EBRD report on Republic of North Macedonia Strategy for 2019-2024 (2019b, p. 12) on the country's strategic priorities indicated that the Insufficient enforcement and implementation of a reliable investment framework limit FDI. North Macedonia based on the Regional Investment Reform Agenda (RIRA), adopted in May 2018 in the context of the Multiannual Action Plan for a Regional Economic Area (MAP REA) introduced a National Investment Reform Action Plan in 2019. The World Trade Organization Report for the trade policy of the Republic of North Macedonia (2019, p. 32) on this latest effort of the government to improve country's attractiveness to FDI outlines that "the Plan provides a detailed set of reform actions with specific implementation periods, lead agencies, expected outputs, and donor support that will be required to achieve the targets set out in the RIRA. The policy areas covered by the Plan include investment entry and establishment; investment protection and retention; and investment attraction and promotion (including streamlining incentives and improving their transparency and governance). The reform actions are to be implemented by end-2020".

8.5 Empirical Analysis

Chapter 4 presents in details the empirical analysis of this research on the political system's impact on inward FDI inflows. Thus, it provides variables descriptions, data, model specification and empirical results concerning the total of the six transitional WB. The empirical analysis uses a panel dataset of the variables of interest for the

years 1996 - 2018. Table 8.3 displays a short description of the empirical model's variables, their coding, and sources of data.

Table 8 3 - Variables description and Coding

Variables	Description	Code	Source of Data
Dependent Variable FDI inflows	The natural log of net FDI inflows	*lnfdi*	wiiw-FDI database
Independent Variables 1. **LDI**	The is the aggregate index that describes features of democracy at the highest level	*ldi*	V-Dem Dataset (V.10)
2. **The signing of Bilateral Investment Treaties (BITs)**	The conclusion of an IIA between two countries for the promotion and protection of FDI	*bit*	UNCTAD-International Investment Agreements Navigator
3. **Governance Indicators**	A set of traditions and institutions by which authority in a country is exercised.		
3a *Voice and Accountability*	The dimension of Quality and Governance	*voice*	Worldwide Governance Indicators (WGI)
3b. *Political Stability and Absence of Violence/Terrorism*	The dimension of Quality and Governance	*polstab*	
3c. *Government Effectiveness*	The dimension of Quality and Governance	*goveffe*	
3d. *Rule of Law*	The dimension of Quality and Governance	*rule*	
3e. *Control of Corruption*	The dimension of Quality and Governance	*cc*	
3f. *Regulatory Quality*	The dimension of Quality and Governance	*regq*	
Controlling-non governance indicators 4. **Growth**	Annual percentage growth rate of GDP	*gdp_growth*	World Bank-World Development Indicators database
5. **Market Size**	GDP at constant 2010 prices in US dollars	*GDP*	

Variables Data for North Macedonia

The data used for the country is presented below

Dependent variable

lnFDI

North Macedonia	
Index Year	**Net FDI inflows** *in EUR mn*
1996	9,0
1997	51,4
1998	134,2
1999	82,9
2000	233,4
2001	499,5
2002	112,1
2003	100,4
2004	260,7
2005	77,2
2006	344,8
2007	506,0
2008	399,9
2009	145,0
2010	160,5
2011	344,4
2012	111,2
2013	252,2
2014	205,1
2015	216,7
2016	338,4
2017	181,7
2018	614,1

Notes: The net FDI inflows are in EUR mn

Source: http://wiiw.ac.at/fdi-database.html

Independent variables

Ldi

North Macedonia	
Index Year	**Liberal Democracy Index (LDI)**
1996	0.38
1997	0.39
1998	0.40
1999	0.48
2000	0.36
2001	0.36
2002	0.42
2003	0.52
2004	0.50
2005	0.47

2006	0.49
2007	0.49
2008	0.46
2009	0.41
2010	0.42
2011	0.40
2012	0.33
2013	0.28
2014	0.30
2015	0.30
2016	0.30
2017	0.35
2018	0.36

Source: www.v-dem.net/en/analysis/CountryGraph

bit

Country: North Macedonia

No.	Short title	Date of signature
1	Denmark - The FYROM BIT (2015)	08/05/2015
2	The FYROM - Viet Nam BIT	15/10/2014
3	Azerbaijan - The FYROM BIT (2013)	19/04/2013
4	Kazakhstan - The FYROM BIT (2012)	02/07/2012
5	The FYROM - Qatar BIT (2011)	01/10/2011
6	Lithuania - The FYROM BIT (2011)	08/03/2011
7	The FYROM - Montenegro BIT (2010)	15/12/2010
8	The FYROM - Morocco BIT (2010)	11/05/2010
9	The FYROM - Slovakia BIT (2009)	25/06/2009
10	Kuwait - The FYROM BIT (2008)	08/04/2008
11	India - The FYROM BIT (2008)	17/03/2008
12	The FYROM - Spain BIT (2005)	20/06/2005
13	Czech Republic - The FYROM BIT (2001)	21/06/2001
14	Belarus - The FYROM BIT (2001)	20/06/2001
15	Hungary - The FYROM BIT (2001)	13/04/2001
16	Austria - The FYROM BIT (2001)	28/03/2001
17	Bosnia and Herzegovina - The FYROM BIT (2001)	16/02/2001
18	Finland - The FYROM of BIT (2001)	25/01/2001
19	Iran, Islamic Republic of - The FYROM of BIT (2000)	12/07/2000
20	The FYROM - Romania BIT (2000)	12/06/2000
21	Egypt - The FYROM BIT (1999)	22/11/1999
22	The FYROM- Taiwan Province of China BIT (1999)	09/06/1999
23	Bulgaria - The FYROM BIT (1999)	22/02/1999
24	BLEU (Belgium-Luxembourg Economic Union) - The FYROM BIT (1999)	17/02/1999
25	The FYROM - Netherlands BIT (1998)	07/07/1998
26	The FYROM - Sweden BIT (1998)	07/05/1998
27	The FYROM - Ukraine BIT (1998)	02/03/1998
28	France - The FYROM BIT (1998)	28/01/1998
29	Albania - The FYROM BIT (1997)	04/12/1997

30	The FYROM - Malaysia BIT (1997)	11/11/1997
31	The FYROM - Russian Federation BIT (1997)	21/10/1997
32	Korea, Dem. People's Rep. of - The FYROM BIT (1997)	15/10/1997
33	China - The FYROM BIT (1997)	09/06/1997
34	Italy - The FYROM BIT (1997)	26/02/1997
35	Macedonia, The FYROM - Poland BIT (1996)	28/11/1996
36	Macedonia, The FYROM - Switzerland BIT (1996)	26/09/1996
37	Germany - The FYROM BIT (1996)	10/09/1996
38	The FYROM - Serbia BIT (1996)	04/09/1996
39	The FYROM - Slovenia BIT (1996)	05/06/1996

Source: https://investmentpolicy.unctad.org/international-investment-agreements

Governance Indicators

Index Year	*cc*	*roule*	*voice*	*polstab*	*goveffe*	*regq*
1996	-0,61	-0,31	-0,39	-0,48	-0,64	-0,35
1997	.	.	.	.	.	.
1998	-0,51	-0,35	-0,16	-0,71	-0,6	-0,16
1999	.	.	.	.	.	.
2000	-0,6	-0,57	-0,34	-0,62	-0,75	-0,13
2001	.	.	.	.	.	.
2002	-0,8	-0,55	-0,17	-1,04	-0,52	-0,19
2003	-0,64	-0,49	-0,02	-0,99	-0,37	-0,18
2004	-0,5	-0,24	-0,16	-0,85	-0,18	-0,05
2005	-0,45	-0,32	-0,1	-1,16	-0,33	-0,23
2006	-0,37	-0,53	0,17	-0,74	-0,11	-0,05
2007	-0,36	-0,43	0,28	-0,43	-0,21	0,11
2008	-0,19	-0,35	0,2	-0,3	-0,02	0,22
2009	-0,13	-0,26	0,17	-0,3	-0,05	0,29
2010	-0,08	-0,26	0,11	-0,52	-0,09	0,32
2011	-0,09	-0,24	-0,04	-0,62	-0,11	0,32
2012	-0,04	-0,22	-0,03	-0,49	-0,07	0,35
2013	-0,05	-0,2	-0,06	-0,42	-0,05	0,33
2014	-0,02	-0,05	-0,14	0,26	0,13	0,48
2015	-0,26	-0,19	-0,18	-0,29	0,12	0,43
2016	-0,29	-0,28	-0,24	-0,35	0,1	0,44
2017	-0,31	-0,24	-0,14	-0,25	0,14	0,5
2018	-0,36	-0,28	-0,01	-0,2	0,09	0,52

Source: https://info.worldbank.org/governance/wgi/Home/Reports

gdp_growth & GDP

North Macedonia

Index Year	GDP growth annual (%)	GDP (constant 2010 US$)
1996	1,19	6.134.622.058,79
1997	1,44	6.222.959.471,51
1998	3,38	6.433.216.821,48
1999	4,34	6.712.355.895,07
2000	4,55	7.017.710.078,97
2001	-3,07	6.802.458.901,68
2002	1,49	6.904.064.881,55
2003	2,22	7.057.514.742,03
2004	4,67	7.387.414.384,87
2005	4,72	7.736.376.122,17
2006	5,14	8.133.795.710,16
2007	6,47	8.660.335.906,48
2008	5,47	9.134.229.607,67
2009	-0,36	9.101.472.903,23
2010	3,36	9.407.168.702,43
2011	2,34	9.627.285.730,15
2012	-0,46	9.583.392.749,46
2013	2,92	9.863.680.783,27
2014	3,63	10.221.697.015,46
2015	3,86	10.615.805.818,61
2016	2,85	10.918.190.832,99
2017	0,24	10.944.451.376,29
2018	2,66	11.236.076.339,97

Source: https://databank.worldbank.org/source/world-development-indicators

Table 8.4 presents descriptive statistics for all variables. They include total observations available for the variables along with minimum, maximum, mean, and standard deviation for each of them.

Table 8 4 - Descriptive statistics

	Variable	Obs	Mean	Std.Dev.	Min	Max
NORTH MACEDONIA	*lnfdi*	17	19.203	0.596	18.162	20.236
	ldi	23	0.399	0.072	0.280	0.520
	cc	20	-0.333	0.229	-0.800	-0.020
	rule	20	-0.318	0.135	-0.570	-0.050
	voice	20	-0.063	0.178	-0.390	0.280
	polstab	20	-0.525	0.332	-1.160	0.260
	goveffe	20	-0.176	0.273	-0.750	0.140
	gdp_growth	23	0.027	0.022	-0.031	0.065
	GDP	23	2.122	0.201	1.814	2.419
	bit	23	1.696	1.964	0.000	6.000
	regq	20	0.149	0.287	-0.350	0.520

In Chapter 4 the model $y_{it} = x'_{it}\beta + u_{it}$, with $X' =\{$ *ldi, cc , rule, voice, polstab, regq, goveffe, bit, GDP_growth, GDP, time, country dummies*$\}$ and y: the dependent variable represented by the log of *fdi (lnfdi),* estimated for analysis including the six WB economies. The analysis used a log transformation of the dependent variable both to eliminate heteroscedasticity problems and reduce the influence of potential outliers of those observations where the errors satisfy the equation, $u_{it} = \rho_i u_{i,t-1} + \varepsilon_{it}$ (please see Chapter 4-Section 4.3)

It has already notified that having data overtime for the six WB countries, the decision to use panel data techniques is based on the ability to export robust results. The Prais-Winsten procedure followed to run regressions as in the previous cases of Albania (please see Chapter 5-Section 5.5), BiH (please see Chapter 6-Section 6.5) and Kosovo (please see Chapter 7-Section 7.5) and. Although we correct for autocorrelation and avoid the spurious regression problem as described in Chapter 4-Section 4.3, the estimates are biased and inconsistent due to the limited number of observations. Table 8.5 presents along with the panel data model (detailed analysis in Chapter 4) the time series estimates for BiH. The coefficients in the panel data model are significant for four explanatory variables and one control variable while in the single time series model, there are no significant impacts estimated.

Table 8 5 – Comparison of regressions

	Panel Data Model	**North Macedonia**
Dependent Variable :	**lnfdi**	**lnfdi**
Ldi(t-1)	0.744	0.376
	(0.66)	(0.05)
cc(t-1)	-0.116	-2.211
	(-0.25)	(-0.69)
rule(t-1)	-1.081*	0.332
	(-2.37)	(0.11)
voice(t-1)	0.956*	6.208
	(2.54)	(1.20)
polstab(t-1)	0.365*	-0.0690
	(2.25)	(-0.04)

goveffe(t-1)	0.559	0.398
	(0.83)	(0.16)
bit(t-1)	-0.0519	0.487
	(-1.27)	(1.15)
regq(t-1)	-0.956*	-4.096
	(-2.42)	(-1.53)
gdp_growth(t-1)	0.00467	0.0766
	(0.23)	(0.78)
GDP (t-1)	3.906***	-21.34
	(4.79)	(-1.49)
time	-0.0336	1.027
	(-0.89)	(2.72)
Country dummies		
Bosnia_Herzegovina	-1.619***	
	(-4.23)	
Kosovo	1.896***	
	(3.54)	
North_Macedonia	0.500	
	(1.75)	
Serbia	-3.982***	
	(-3.66)	
Montenegro	3.779***	
	(4.59)	
_cons	10.50***	49.83
	(7.37)	(1.88)
N	92	16

T -statisitcs in parentheses. (*) Significant at p<0.05, (**) Significant at p<0.01, (***) Significant at p<0.001.

The major problem of the research's data set for North Macedonia is the limited number of available observations (229 of North Macedonia over 1317 of the panel data model). Hence, with pure time-series analysis, the extraction of exact estimates and robust test statistics is constrained. Panel data sets contain more variability to exploit, more efficiency and offer more information than pure time-series

data or cross-sectional data. According to the existing literature, panel data methods can detect and measure statistical effects that pure time-series or cross-sectional analysis cannot. Additionally, panel data set lets us control for unobservable, something that time series does not allow. Hence, the adaption of the panel data technics helps to obtain more accurate and more robust estimates. The following section discusses the empirical results of the panel data model adjusted for the country of North Macedonia.

8.5.1 Empirical results - Discussion

The study's empirical results indicate the significant relationship between the explanatory variables, political stability & absence of violence/terrorism *(pol_stab),* voice & accountability *(voice),* the rule of law *(rule),* regulatory quality *(regq)*, as well as the control variable of the market size *(GDP).* Specifically, political stability & absence of violence/terrorism***,*** voice & accountability, and the market size are positively related to FDI while the rule of law, and regulatory quality negatively. The variable of the political regime has a positive impact on inward FDI; thus, foreign investors are tempted by a more democratic regime, though it does not influence their decision to invest in a WB economy. The variables of control of corruption, government effectiveness, and growth also hold a positive and insignificant relationship to FDI. The signing of the BITs found to be insignificant but negative related to FDI. The more detailed discussion of the empirical results follows.

The significant positive relationship between political stability & absence of violence is in line with the extant literature (please see Chapter 4-sections 4.2, 4.4). Indeed, in the case of North Macedonia, the political instability, and the rise of violence during the examined period coincide with low performance in inward FDI. Specifically, the acceleration of privatisations in 2000 resulted in a large amount of FDI flows the country received in 2001, but the burst of the inter-ethnic conflict reduced them substantially afterwards (please see figure 8.6). Ethnic identification in North Macedonia is strong and used for political mobilisation (Bertelsmann Stiftung, 2020, p. 8). Although the armed conflict lasted a few months, it provoked political unbalances and vulnerabilities for years, discouraging foreign investors. Two years of massive anti-government protests followed the wiretapping scandal in 2015, including

an assault on parliament and intense ethnic violence. The political turmoil and the rise of violence produced uncertainties making foreign agents lose their interest in the North Macedonian market. Thus, a low performance of inward FDI recorded (please see figures 8.6, 8.8). Since the political polarisation was mounting during the 2016 parliamentary elections, a peaceful transfer of power seemed impossible (Bertelsmann Stiftung, 2018d, p. 4). The election's outcome increased further the political instability due to political parties' disagreement on forming coalitions, harming, even more, the inward FDI in 2017 (please see figures 8.6, 8.8). Mr Zaev's government in 2017 underwent fundamental changes in an inclusive and open political atmosphere, brought a short serenity to the inter-ethnic tensions and normalisation of relations with its neighbouring countries (please see section 8.3). The prevalence of political stability and the lack of violence are conducive to increased investors' confidence as the increased inward FDI level in 2018 proves (please see figure 8.6). However, the trade-off of changing the country name for the prospect of quick EU negotiations started new tensions since it did not happen at the expected moment (please see section 8.2). The announcement of early elections in 2020 because of the new political unrest, harmed FDI inflows which precipitated in 2019 (see please figure 8.6). Therefore, each time that the political setting in North Macedonia experiences imbalances and increased violence, including the politically or ethnically motivated violence, the FDI inflows are decreasing.

Respectively to political stability, governance's dimension voice & accountability is also significantly positively related to inward FDI, in consistency with the literature (please see Chapter 4-sections 4.2, 4.4). The variable of voice & accountability includes the perceptions of the extent to which a country's citizens can participate in their government elections, including the confidence about the honesty of elections, as well as freedom of expression, freedom of association, and a free media (WGI, 2019). Also, it incorporates individual variables for human rights, respect for the rights and freedoms of minorities. Since the electoral process is associated with political stability is also with voice & accountability. For example, the political crisis of 2015 wiretapping scandal revealed beyond others, electoral fraud calling the special public prosecutor to improve conditions for free and fair elections and to form a technical government to administer the elections (Bertelsmann Stiftung, 2018d, p. 9).

As aforesaid during the scandal period, the inward FDI deteriorated. The elections in 2016 rescheduled many times and excluded the engagement of civil society from policymaking and the political process, and subjected to verbal attacks from VMRO-DPMNE officials and pro-government media (Freedom House, 2017b). Hence, at that time, the government respect for citizens' fundamental rights was severely questioned. The media landscape was polarised with public institutions intimidated journalists linked to the opposition, with practices of physical assaults, death threats and the confiscation or destruction of media equipment (Bertelsmann Stiftung, 2018d, p. 11). Policies and actions that target the personnel independence of media and journalists and that censor media or lead to self-censorship are an example of illiberal politics that reduce voice and accountability (Kapidžić, 2019, p. 5). Therefore, political instability is associated with a low voice & accountability, which also hurts FDI inflows.

The rule of law surprisingly, and in contrast to the literature, findings are significantly negatively related to inbound FDI (please see Chapter 4 - sections 4.2, 4.4). The rule of law in the scope of good governance measures the perceptions on effectiveness and predictability of the judiciary, as well as contracts' enforceability (WGI, 2019). The wiretapping scandal stigmatised the political life of North Macedonia since it revealed the over abuse of power by the ruling elite and especially its absolute control over the judiciary. The VMRO-DRMNE government used the legal framework for its benefit. For example, in the field of business, it proceeded with the tolerance of the law to irregular privatisations in favour of political-elite interest, though settling a dysfunctional private sector. The 2020 Bertelsmann Stiftung's Transformation Index (BTI) Report (2020, p. 23) assessing country's quality of governance notifies the hostile takeovers of companies by other companies and individuals with strong political connections. Also, it provided to foreign investors subsidies and reduced institutional safeguards, as in terms of labour rights. The same report though records improvements in the rule of law due to implementation of reforms from the new government of Zoran Zaev, it identifies that political control of the judiciary remains a problem (Bertelsmann Stiftung, 2020, p. 12). The European Commission's 2019 Report on Communication on EU Enlargement Policy (2019, p. 15) recommends the government to insist on the implementation of reforms to prove that the independence of the judicial system is respected and promoted at all levels, protecting

it from any risk of political interference. The same report concerning contract enforcement refers to North Macedonia's weak institutional capacity to enforce the law. Therefore, the empirical result is in line with the remaining problems in the rule of law in which foreign companies with political connections enjoy special treatment when they enter North Macedonia's market. In such a case, an improved rule of low will reduce inward FDI.

The variable of the regulatory quality holds the same negative significant relationship with inward FDI and contrasts with the relevant literature, as the rule of law's variable. The rational of this association relies on that regulatory quality incorporates the perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development. The deficiencies in the legislative framework leave space for the growth of the informal economy that prevents the development of the private sector (WGI, 2019). The European Commission's 2019 Report on Communication on EU Enlargement Policy (2019, p. 45) recommends the government to implement measures to reduce the informal sector for improving the functioning of the competitive market economy. Companies indicate the significant size of the informal economy as an impediment for doing business and disincentive for investments (2019, p. 49). The lack of transparency in the country's regulatory environment is also identified as a matter of concern for business activities in the latest US Department of State Investment Climate Statement on North Macedonia (2019c). In conjunction with the rule of law's analysis, foreign investors that have substantial financial gains from the privileges that governance with weak institutional framework provides, they continue investing in the specific market. Hence, an improved regulatory quality will reduce inward FDI. Further research on the profile of foreign investors' entering the North Macedonia market can provide additional insights for the study's empirical results concerning the governance dimensions of the rule of law and regulatory quality.

The variable of government effectiveness holds the expected positive sign though an insignificant relationship with inward FDI (please see Chapter 4). Government effectiveness is addressing in the scope of good governance, measuring the quality of public and civil services, and the degree of its independence from

political pressures (WGI, 2019). The European Bank for Reconstruction and Development (EBRD) report on North Macedonia's strategy 2019-2024 (2019b, p. 9) assessing the quality of governance records that political instability, the weak rule of law and corruption has adversely affected public governance. The 2018 World Bank's systematic country diagnostic report (2018, p. 156) states that employees in public administration have been subjected to systematic political pressure, as the 2015 scandal revealed. The 2020 Bertelsmann Stiftung's Transformation Index (BTI) Report (2020, p. 4) refers that the country is overburdened with an unwieldy public administration. The same report identifies significant challenges to the implementation of reforms in public administration, as the clientelistic networks. Accusations of the employment of the public servants by political loyalty rather than merit are prominent (Bertelsmann Stiftung, 2020, p. 38). Even after the latest early parliamentary and local elections, several senior deputy positions were introduced without merit criteria (European Comission, 2019, p. 12). Concerning the quality of service delivery to citizens and businesses, political will and funding are needed to be improved (European Comission, 2019, p. 14). The low quality of public services raises the cost of doing business in North Macedonia and as such, frustrates foreign investors to invest in the country. Therefore, improvements in government effectiveness will stimulate foreign investors interest, even though it is not a critical factor in their investment decision-making process.

Control of corruption measures the extent to which public power is exercised for private gain, as well as "capture" of the state by elites and private interests (WGI, 2019). Study's empirical result confirms literature (please see Chapter 4-sections 4.2, 4.4). Chapter's analysis indicates that corruption appears to be political elite-driven. Between 2006 and up to mid-2017, thus during the ruling of VMRO-DRMNE, corruption widely spread. The large scale of corruption officially revealed in the wiretapping scandal. The EBRD's country diagnostics report on North Macedonia (2019, p. 5) refers to corruption in the country as a systemic problem "behind which was the blurring of the line between the ruling party and the state or, de facto, the capture of the state by a political party". The same report indicates that the expansion of corruption in recent years and that scandal followed by the political crisis had a negative impact on corruption perceptions (Sanfey and Milatovic, 2019, p. 9). Hence,

the relation of political instability with corruption is evident and given political stability's positive sign, the positive sign of control of corruption is explained. However, the insignificance relationship between this governance dimension and the inward FDI indicates that MNEs are investing in the corrupted North Macedonian market, not considering corruption as an obstacle to doing business. The behaviour of foreign companies' is explained as they have the experience of dealing with corruption at home, like in the case of Chinese companies (Shan et al., 2018, p. 144). For example, Chinese investors that are increasing their presence in North Macedonia (please see section 8.3) are dealing efficiently with the corruption, like in the case that revealed of the funding of two highways in North Macedonia (Naunov, 2019, p. 56). Turkey is also an FDI source country for North Macedonia, which companies facing a corrupted business environment at home, can easily be adjusted to a risky foreign market. Therefore, controlling corruption may contribute to the country's improved image as an FDI destination, but it is not what determines the level of FDI inflows it receives.

The variable of the political regime is found non-significant positively related to inward FDI in line with relevant empirical studies (Biglaiser and DeRouen, 2006; Blanton and Blanton, 2007; Jandhyala et al., 2011; Li et al., 2017; Moon, 2019; Oneal, 1994). In the period between 2006–2017, North Macedonia under Gruevski's rule of governance experienced the decline of democracy and the rise of illiberal politics (please see section 8.3). Figures 8.4 and 8.5 present the incremental decline in the state's democracy. In 2017, the change of government in North Macedonia had created cautious optimism for enforcement of democracy, reaching the satisfying democratic benchmark for EU integration. The latest developments of the disputes resolution with the neighbouring countries gave new dynamics in North Macedonia to be one of the WB countries that seems to break the democratic backsliding (Kapidžić, 2019, p. 13). Although a better democratic performance in 2019 is recorded in both V-DEM indices, EDI and LDI (please see figures 8.5, 8.6) at the same year, the inward FDI substantially decreased (please see figure 8.6). Therefore, a more democratic regime supports the country's effort to build a more conducive image to FDI but is not what determines the level of FDI inflows.

The not-significant negative relationship between the signing of the BITs and inward FDI is in contrast with most of the literature expect the few studies that argue

for BITs reduced effectiveness when a host country suffers from weak political institutions (please see Chapter 4 - sections 4.2, 4.4). In a weak institutional environment, BITs' role is limited to complement domestic institutions (Falvey and Foster-McGregor, 2017; Hallward-Driemeier, 2003). Also, the increased competition between the countries for inward FDI share reduces the significance of BITs as a determinant to FDI. Tobin and Rose-Ackerman (2011) support that a host country with small market signing a BIT may gain FDI inflows, though any extra FDI aims to receive will be smaller than the respectively received by a host country with a larger market. As in the rest WB countries, North Macedonia's small market and weak institutions may explain this study's unexpected empirical result and give ground for further research.

Summing up, the institutional variables that found to hold a significant relationship with FDI, political stability & the absence of violence, voice & accountability, the rule of law and regulatory quality, are the ones to define the political environment's impact on inward FDI in North Macedonia.

8.6 Conclusions - Recommendations

North Macedonia's transition to a market-oriented economy and democracy stigmatised by a series of events like the inter-ethnic conflicts, the legal name-related dispute with Greece, conflicting regional relationships, global financial crisis and political scandals. The wiretapping scandal in early 2015 though it deeply marked the country and caused an unprecedented political crisis, it also liberated it from the political regime that had led the country to a situation of state capture. For the period 2006-2017, North Macedonia departed from its democratisation route due to ruling elite monopolisation of power and abuse of state institutions and resources. The ethnic ruling coalition VMRO-DPMNE also used strong populist and ethnic-nationalist narratives which intentionally deepened divisions in the society. The largely isolated state capture tarnished the image of North Macedonia as a destination for international investors.

The change of the government in 2017 stopped the democratic backsliding stabilising the regime to the electoral democracy status. Also, it removed the main

obstacles for the country's EU and NATO integration, thus the name dispute and regional cooperation. European Commission on 2019 Report on Communication on EU Enlargement Policy for the progress of North Macedonia's reform Agenda recommends the new government to maintain peace in the inter-ethnic situation and to intensify reforms. Specifically, to restore the rule of law and to increase the independence of the judicial system at all levels. Furthermore, to ensure public administration's accountability and prevent its politicisation, to tackle corruption and organised crime. Concerning the economic criteria, though the level of preparation for a functioning market economy is good, the competitiveness of the economy and the level of investments are low.

The results produced from the empirical analysis of the impact of the political surroundings, as it shaped by the political regime and individual political variables on inward FDI, identified specific dimensions of governance to influence more inward FDI than others. Political stability & the absence of violence/terrorism, voice & accountability are significantly positive related to inward FDI while the rule of law and the regulatory quality are significantly negative related. The political regime variable found not significant even though with a positive sign.

The 2015–17 political crisis should be a reminder of the detrimental effects of political instability on FDI and economic growth. North Macedonia now stands at a turning point in its history. NATO's membership and the forthcoming of the EU will make possible the achievement of the security realm, and a higher level of economic development, competing with EU peers on an equal footing. Hence, the government is well-positioned to project a new country image, one that dissociates from high political and economic risks. This challenge requires a long-term commitment and a robust political consensus. Individuals and businesses planning for the long term will benefit from an environment of stability and trust. The policymakers prioritising the building of effective governance through political stability and voice & accountability will improve the investment environment and as such, the economy's sustainability.

Following the same structure of analysis, the next chapter presents the impact of the political environment on inward FDI in the countries of Serbia and Montenegro.

Chapter 9. The transitional economies of Serbia and Montenegro as host countries for FDI.

9.1 Introduction

Serbia and Montenegro shared the same path in the transition process for an extended period. From the breakup of the Socialist Federal Republic of Yugoslavia (SFRY) in the early 1990s and the 2003 establishment of "Serbia and Montenegro" Union up to the 2006 declaration of Montenegro's independence. Both states experienced regional conflicts and international isolation that crippled their economy and delayed the beginning of their transition to a market economy and a democratic political system. Both transitional economies are examined as host countries for FDI in this Chapter, given the in-between close relationship.

The two remnants of the ex-socialist Yugoslav federation, as separate and sovereign republics now, realize the importance of terminating their transitional period and successfully joining the EU. However, their European Integration process is lingering due to the slow pace of reforms in the fundamental issues of the EU enlargement Policy Agenda. FDI can contribute to meeting the economic EU's accession criteria referring to the establishment of a functioning market economy and the capacity to cope with competitive market forces within the EU. There is a momentum that both states can take advantage since the EU formally re-energized the enlargement process by setting a new deadline of 2025, distinguishing Serbia and Montenegro as the best WB candidates to achieve full membership by 2025 (Dabrowski and Muachenkova, 2018). However, the absence of the political initiative to support the institutions' buildings inhibits the development of the two countries as significant foreign investment destinations. These countries are suffering from corruption, organized crime, informal activities, political interference, low functioning of the rule of law, and political instability with democratic shortages.

Thus, serving this dissertation purpose of identifying the role of the variations of the political system in country's inward FDI (please see Chapter 2 - section 2.1) this Chapter along with the theoretical analysis uses the results of the empirical model to answer the main research question. It is essential to identify which of the political

variables that the literature review (please see Chapter 2) outlined has the most significant impact on FDI flows that Serbia and Montenegro receive. Despite any data limitations, our results hold important implications for the countries' potential to be established as investment destinations. Empirical results will indicate alternatives to the heated debate political regime – FDI nexus through hypotheses about the relative influence of established determinants in Serbia and Montenegro's political surroundings, such as the dimensions of governance as constructed by Kaufmann et al. (1999) for the World Bank (known as WGI project). The theoretical analysis of these countries' political landscape in the transition period and their inward FDI performance is built on official analytical reports, and published research and policy studies.

The Chapter is structured as follows: Section two addresses the main issues in Serbia and Montenegro transition process. Section three analyses the establishment of the political system over the post-socialist period in both countries. Section four presents an overview of inward FDI in both countries. Section five presents and discusses the empirical analysis' results. Finally, the sixth section summarises the key findings providing recommendations.

9.2 Serbia and Montenegro: Countries in Transition

The transition process for WB was much more intense and longer than the process of post-socialist structural transformation of CEEC. For Serbia and Montenegro, a series of events such as the dismantling of the Socialist Federative Republic of Yugoslavia in 1991, Bosnia and Herzegovina's (BiH) wars in the first half of the 1990s, economic sanctions by the UN Security Council against the Federal Republic of Yugoslavia (FRY), the 1999 Kosovo war, NATO's military intervention against Milosevic's regime, the FRY turning into a two-member federation the State Union of Serbia and Montenegro (SCG) and, finally, the 2006 referendum on Montenegro's independence, challenged their transition journey (Darmanovic, 2007; Milenkovic and Milenkovic, 2012; Uvalic, 2007; Vuković, 2010).

Until 2000, the Milosevic's internationally isolated FRY restricted any prospects for a smooth and fast transition process of Serbia and Montenegro. When the Milosevic's regime collapsed, thorny issues such as the multiple harmful legacies of

the past, the complexities of the inherited institutional architecture and the perplexed relations between the two components republics of the FRY, blocked the implementation of any transitional structural reforms (Vejvoda, 2004, p. 37). Serbia defeated from the wars, lost its leadership position within the former Yugoslavia, and had to deal with the toxicity of post-Milosevic politics and the necessity of cooperation with the Hague Tribunal and Kosovo (Massari, 2005, p. 262). Serbia had to meet the conditions of the UN membership through its compliance with the directives of the International Criminal Tribunal for the Former Yugoslavia (ICTY) (Vejvoda, 2004, p. 39). The state following the path of European integration had to confront beyond the legacies of the war, the political turmoil that erupted from the assassination of Serbian Prime Minister Zoran Djindjic in 2003, the humanitarian crisis of refugees, the large number of internally displaced persons, the stalling economy, the escalation of the shadow economy, the structural weakness of the society, the malfunction of public administration, the weak rule of law and democratic deficiencies (Vejvoda, 2004, pp. 39–40).

In 2000, that Serbia began the transition process, GDP had shrunk by less than half of its 1989 level; foreign trade volumes had declined recording fall in exports by 61 per cent and imports down by 31 per cent compared to 1989 levels; the financial sector had completely ruined (World Bank, 2003). The foreign debt climbed to USD 12.2 billion, reflecting the 136 per cent of GDP in 2000 (World Bank, 2003). Montenegro also had lost its international sympathy that had gained during the Kosovo intervention for its opposition to Milosevic's regime, due to the establishment of dysfunctional institutions (Massari, 2005, p. 263). The political changes in Belgrade reduced the strategic importance of Montenegro to regional stability and limited the external subsidies of the past years (ESI, 2001a). Montenegro had received substantial financial unconditional aid of nearly DM 765 million from the EU and the US, for the period 1999-2001. These foreign net transfers had made the average Montenegrin substantially better off than the Serbian counterpart, enjoying almost double net wages and pensions (ESI, 2001a).

On 14 March 2002, the EU brokered the "Belgrade Agreement" aiming to avoid further territorial fragmentation in the region by the establishment of a loose three-year state union (SCG) simply called" Serbia and Montenegro "and bringing the states

closer to the EU (Freedom House, 2006; Massari, 2005). However, forming this Union, Serbia and Montenegro turned to be not the normal transition states. The agreement primarily endorsed Belgrade's position with a veto on unilateral secession by referendum and one international-law subject, while Montenegro would lack an international legal personality (Meurs, 2003, p. 68). To balance the situation, the EU agreed with the prospect of a referendum in Montenegro for independence after three years and provided proportional international representation by rotation (Meurs, 2003). The standard policy defined by the new agreement included demands from both sides concerning the fields of defence and foreign policy, common-market and currency, and economic relations. The harmonization in trade and customs policies via EU monitoring and assistance set as a target along with the establishment of a functioning common-market (Meurs, 2003, p. 70). The republics will be responsible for the free flow of goods, capital, people, and services inside the market.

The new state union suffered from numerous problems produced most of the significant disparity in size between the two republics (ESI, 2001b; Freedom House, 2006). Table 9.1 presents the union's asymmetries. Montenegro was almost one-tenth of the size of Serbia in population and reflected a minor part of the "Serbia-Montenegro" economy, while it held parity representation in governmental institutions (ESI, 2001b; Freedom House, 2006).

Table 9 1 – Disparities between the two Republics

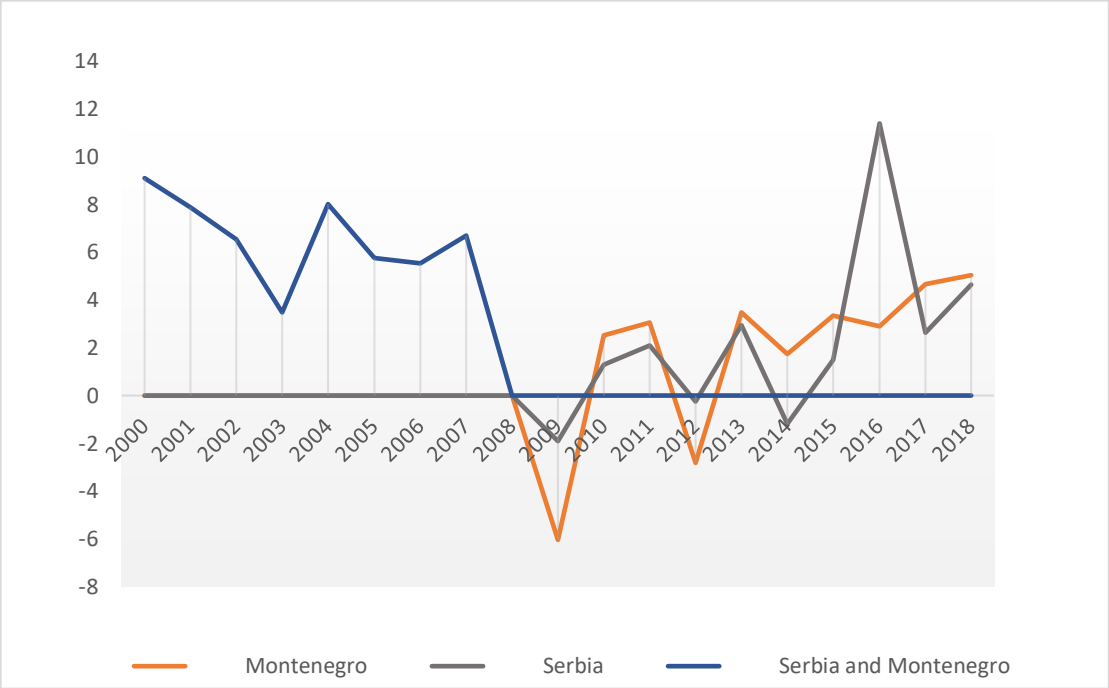
	Serbia	*Montenegro*	*The total of the two Republics*
Population	7,7 million (92%)	0.7 million (8%)	8.4 million
GDP in DM	16,424m (92.5%)	1,332 (7.5%)	17,756m
Federal Budget in DM	1.529m (100%)	0 (0%)	1,529m
FRY government positions	5 (50%)	5 (50%)	10 positions

Source: Adapted from ESI (2001b, p. 2)

The World Bank (2003) reported that Serbia and Montenegro positioned as a lower-middle-income country with Gross National Income (GNI) per capita of USD 1,400, with falling annual growth rate of GDP from 2000 up to 2003 (please see figure 9.1). In 2003 the GDP per capita at PPP in Serbia and Montenegro was at about 23 per

cent of the EU average (Uvalic, 2007, p. 199). Altmann (2004), for the conditions the SCG experienced, then reported about the absence of a competitive free market, the inefficient and fragment social security system, the stagnation of public revenues. Moreover, the increasing unemployment (25 per cent in 2002); the fragile industrial base; the suffering agriculture sector warning for an imminent food crisis; the severe ecological disaster; the lack of funds for education and research purposes; the rise of social disparities caused by the last wars, and finally the high number of refugees from Kosovo, Croatia and BiH (approximately at 600,000).

Figure 9 1 – Serbia and Montenegro GDP annual average growth rate per capita for the period 2000-2018



Source: Adjusted from UNCTADstat (2020b) (www.unctadstat.unctad.org)

After the ousting of Milosevic, there were hopes for the elimination of corruption, improvements of the economic environment, eradication of poverty, and the stabilization of the political environment (Ramet, 2010, p. 286). Any optimism backed by the renewal of Serbia's membership in the IMF in 2000, as well as, its rejoint in the World Bank and European Bank for Reconstruction and Development (EBRD) (Index Mundi, 2018). These expectations partially realized, and only a few structural reforms implemented. Reform initiated in the banking sector, the trade liberalized, the inflation fell from 120 per cent in 2000 to 8 per cent in 2003, and foreign reserves increased as from 2002 onwards the dinar has been convertible. The new privatization

law in 2001 accelerated the privatization of small enterprises (Altmann, 2004, p. 82). However, many large enterprises in the industries of power utilities, telecommunications, and natural gas remained under state control (Index Mundi, 2018). Although corruption declined in comparison to what existed in the Milosevic era, it remained high (Freedom House, 2006; Ramet, 2010). Serbia and Montenegro positioned 97th out of 159 countries in Transparency International's 2005 Corruption Perceptions Index (CPI) (Freedom House, 2006), revealing that the post-Milosevic governments had not prioritized the fight against corruption despite their promises (Ramet, 2010, p. 286).

The replacement of FRY with SCG proved to be a progress brake in the required progress towards European integration. The Action Plan for the harmonization of the economies of the two states that would result in a single market and customs area failed pushing the EU foreign ministers in 2004 to admit the ineffectiveness of the State Union in the transition process (Vejvoda, 2004, p. 41). They adopted a "two-track mechanism" to guide the two republics toward EU membership allowing them to work on the accession process separately concerning the required technical, economic and administrative reforms based on the EU agenda of integration, but to acceding the EU as a joint state (Vejvoda, 2004, p. 41). Indeed, the SCG maintained the different economic systems of each member state, with its central bank, different currencies, and tax regime (Altmann, 2004, p. 81). The euro is the official currency in Montenegro while in Serbia is the dinar (Freedom House, 2006). In September 2005, the World Bank referred to "Serbia and Montenegro" as the leading reformer for the year of a group of 12 transition countries, followed two months later by EU's approval for the beginning of negotiations for a Stability and Association Agreement (SAA) (Freedom House, 2006).

Since its creation, the SCG has been unpopular in both member states, and the local media referred to it as a "Frankenstein" state or "Solania." The last referred to a nickname inspired from Javier Solana - the EU's High Representative for the Common Foreign and Security Policy- emphasizing his catalytic role in the establishment of this undesired -for the citizens of the republics - State Union (International Crisis Group, 2006, p. 2). Since the state union's charter provided the exit option via referendum of independence for the member states, this acted as a harbinger of union's dissolution

at least after the three years limit period. Indeed in May 2006, Montenegro held the independence referendum with success, gathering 86 per cent in voter turnout and 55.5 per cent of positive answers, a result that allowed the state to declare formal independence (Džankić, 2014; Freedom House, 2008). This declaration put an end in the long-term relationship between the two republics, which existed one way or another for almost 90 years.

Montenegro, since its independence, joined in December 2006 NATO's Partnership for Peace program; in January 2007, the World Bank and IMF; in October 2007, signed the SAA with the EU, while in July 2007 embraced by World Bank for its fantastic progress (Freedom House, 2008). In May 2010, the SAA entered into force (ESI, 2012). The economy grew by over 6 per cent in 2006, and the FDI tripled. However, all these have taken place in an environment of high corruption, blocked by other economic shortages such as high levels of foreign indebtedness, significant fiscal and current account deficits, and ethnic divisions to evolve as a severe threat to future stability (Freedom House, 2008). Just before the outburst of the global financial crisis, IMF (2009) reported positively on Montenegro progress in overhauling its economy, particularly on the improved inflation performance through the adoption of the euro; the restructuring on the banking sector; the rise of privatizations; the strengthening of the economy's infrastructure and the improvement in fiscal consolidation. The acceleration of reforms following the independence had been noticed by the foreign agents and large FDI inflows received into the tourism sector and associated real estate, and banking. However, the global crisis exerted heavy blows on Montenegrin economy endorsed by missteps from the authorities and recorded a significant decline in GDP during 2008-2009 (please see figure 9.1) (IMF, 2011). The economy started to recover at the end of 2010 with a sharp deceleration of inflation, and the current account deficit halved to around 26 per cent of GDP (IMF, 2011). The excellent 2010 summer tourist season paired with metal-price developments emerged the secondary and tertiary sector of Montenegro's economy and stimulated GDP's growth from the disappointing - 6 per cent in 2009 to 2.5 per cent in 2010 (World Bank, 2012) (please see figure 9.1). The dynamic rates of growth did not last as the industrial sector was vulnerable and payment arrears recorded within the private sector squeezing once again the growth of GDP's in 2012 (World Bank, 2012) (please see figure 9.1).

In 2010, the European Council declared Montenegro as an official candidate to join the EU after the European Commission's proposal, while a year later, it announced the opening of accession negotiations, which officially started in 2012 (ESI, 2012). Just before the opening of the negotiations, in December 2011, Montenegro was granted membership in the World Trade Organization (WTO) (World Bank, 2012). The term set by the European Council in Montenegro was the implementation of the required reforms (ESI, 2012). In 2013 the European Parliament was in favour of Montenegro's EU membership, but on the condition the government to support the protection of media's freedom, women's rights, and gender equality (BBC, 2018). In 2017, it became a full member of the NATO alliance (Baća and Morrison, 2018).

IMF (2017) reported on the growth of the Montenegrin economy that at the end of 2016 has bolstered by large investment projects and tourism; conditions on the banking sector improved and a well-specified fiscal adjustment strategy adopted. From its independence, the state has made progress in legislative reform and institution building, but the recorded weaknesses in the financial sector and regulatory framework could create vulnerabilities to corruption (IMF, 2019b). In 2019 Montenegro is a small, open tourism-dependent economy suffered from high public debt due to the construction of major infrastructure project the Bar-Boljare highway. The authorities seem to prioritize the necessity of structural reforms and rise of competitiveness to reduce the country's development gap relative to the EU average and increase the quality of life of all its citizens (IMF, 2019b). Montenegro's EU accession envisaged in 2025 at the earliest.

With Montenegro's exit from the Union, Serbia had been cut off from the Adriatic Sea and has become landlocked. Since the beginning of its lonely path, Serbia has confronted shocking events such as the 2008 global financial crisis and the 2014 disastrous floods. At the storm of the crisis, in 2010, the government had to implement market reforms and sustainable fiscal policies even at the expense of social policies, especially in healthcare and pension systems (Freedom House, 2011). IMF's Staff Report for the 2013 Article IV consultation (2013, p. 4) outlined that "The global financial crisis exposed Serbia's unsustainable growth model and its key vulnerabilities: (i) an overreliance on the non-tradable sector, (ii) weak domestic savings and excessive external borrowing, (iii) widespread euroization, and (iv) high

and volatile inflation". Along with the crisis, Serbia experienced a major diplomatic defeat when the International Court of Justice (ICJ) legitimated the secession of Kosovo (Freedom House, 2011).

Given that in 2014 the Serbian economy was just beginning to recover from the crisis and had begun implementing financial reforms in terms of government debt and risk management, a devastating physical phenomenon halted any progress (World Bank, 2017b). The historic floods hurt more than 20 per cent of the population due to the destruction in the agricultural and energy sector (World Bank, 2017b). The catastrophe around the country destabilized the financial system leading to the deterioration of GDP approaching a negative level in 2014 (World Bank, 2017b) (please see figure 9.1). Since 2017 growth rebounded, reaching its fastest pace during the last ten years (IMF, 2019c, p. 4). In 2018 growth is continuing; inflation is well under control; fiscal discipline contributes to the restriction of public debt, and FDI covers the current account deficit (IMF, 2019c, p. 26). However, the economic prospects in the country are low, the low wages and the increased unemployment encourage high emigration rates, especially of young and high educated people to the advanced EU neighbours (Bertelsmann Stiftung, 2018e, p. 28).

In 2019 Serbia completed a decade since it formally applied for EU membership. Since 2012, the country holds the EU candidate status. In 2013, an SAA between the EU and Serbia entered into force, while a year later, EU membership talks began (European Neighbourhood Policy And Enlargement Negotiations, 2019). The European Council decided to open Negotiations due to Serbia's progress in the reforms and its commitment to stabilize its relation with Kosovo (European Commission, 2014, p. 1). The overall pace of negotiations is dependent on this relation and the pace of reforms on the rule of law (European Commission, 2019f). The EU insists on a conducive environment to the conclusion of a legally binding agreement between Serbia and Kosovo. However, the Serbia–EU integration process has been accompanied by strict political conditionality that has halted the entrenchment of contractual relations.

During the period 2007-2013, the EU provided financial assistance of USD 1.4 billion to Serbia via the Instrument for Pre-accession Assistance (IPA) (European Commission, 2014). Under IPA II, the state continues to benefit with a total allocation

of EUR 1.5 billion covering the period 2014-2020 for addressing the challenges of migration, terrorism, and violent extremism, climate change, and economic governance (European Commission, 2019f, p. 97). Like the case of Montenegro, the EU in 2018 declared 2025 as a potential year of Serbia's accession.

Table 9.2 displays the progress of the two states reform Agenda as is recorded to the latest Report of European Commission on Communication on EU Enlargement Policy (European Commission, 2019f, 2019g).

Table 9 2 - Progress of Serbia and Montenegro meeting some of the fundamentals of their reform EU- Agenda

	Serbia	*Montenegro*
Political Criteria	The establishment of a broad pro-European consensus through the creation of a genuine cross-party debate is required. Further, the government should respond to requests for freedom of the media and free and fair elections of opposition parties, promptly and effectively.	There is a low level of trust in the electoral framework. The political environment is fragmented, polarised with the absence of dialogue, and all political parties must enhance parliamentary accountability. A new legal framework and methodology on strategic planning can improve governance in terms of transparency, stakeholders' participation, and the government's capacity to implement reforms. Despite improvements in the legal, institutional, and financial environment of civil society organizations, their inclusion in the policy-making process must come into force.
Public Administration	Further advancements should be made, such as the establishment of a coordinated monitoring and reporting system of the public administration reform strategy along with a public financial management reform program.	The government must proceed to the de-politicization of the public service, and the optimization of the state administration, the inclusive and evidence-based policy development, the delegation of decision-making and managerial accountability.
Judicial System	It must continue the constitutional reform process targeting to align the constitution with the EU standards for the judiciary. Political influence should be restricted.	Some progress recorded, but there are still issues in increasing the independence and professionalism of the judiciary.

Fight Against Corruption	A revised law on the Anti-Corruption Agency adopted in May 2019. The law on organization and jurisdiction of government authorities in suppression of organized crime, terrorism, and corruption, entered into force in March 2018. Too early to access the effectiveness of these reforms. Corruption is still dominant.	Corruption remains an issue of concern. Despite some improvements in the operational capacity of institutions, these are not behaving proactively. There are problems in credibility, independence, and priority-setting of the Anti-Corruption Agency. The criminal justice response against high-level corruption is ineffective. It is a necessity for the establishment of Independent institutions, protected from excess influence.
Fight Against Organized Crime	It just started the implementation of the new economic Chapter of the criminal code and the law on organization and jurisdiction of state authorities in the fight against organized crime, terrorism and corruption, and adapted cybercrime strategy for 2019-2023. However, the number of convictions for organized crime is low.	The state remains moderately prepared. International police cooperation is productive as it increased the number of high-profile international operations, arrests, and drug seizures. Still, it is lagging in the fight of the more complex types of organized crimes such as money laundering, trafficking in human beings and tobacco smuggling, as well as in the confiscation of proceeds of crime.
Fundamental Rights	Improvements to the legislative framework related to national minorities were adopted. There is not any progress on freedom of expression. More measures needed for the protection of the rights of persons, facing discrimination and other vulnerable individuals	A more robust institutional framework and effective protection of human rights are required. The Roma and Egyptian's minority is the most vulnerable and discriminated community. Gender-based violence and violence against children remain issues of concern.

Economic Criteria	The country is moderately prepared for a functioning market economy. Current conditions are: High external imbalances exist; inflation is under control; debt sustainability improved; the financial sector is stable; the labour market's performance is improving except the youth activity rate. The slow pace of structural reforms is in public administration, the tax authority, and state-owned enterprises. The government intervenes in the economy; the private sector is weak and restricted by deficiencies in the rule of law and the competition's practices.	The country is moderately prepared for a functioning market economy. Current conditions are: The improved labour market outcomes despite the high unemployment; high current account deficit empowered by domestic demand and partially financed by net FDI inflows; high levels of public debt due to financing needs for a large highway project. The weaknesses in the business environment, the judiciary, and a high prevalence of informality reflecting the dysfunctionality of state institutions to enforce the rule of law and market competition, all these formulate a vulnerable business environment with the restricted private sector. Progress recorded to state's ability to cope with competitive pressures and market forces within the EU. Still, there is a mismatch between education outcomes and labour market needs.

Ability to assume the obligations of membership	There is an adequate level of preparation in areas such as company law, intellectual property, transport policy, science and research, education and culture, and customs. It improved the linking of its investment planning to budget execution. There is a moderate level of preparation in areas such as public procurement, statistics, external relations, social policy and employment, monetary policy, and financial services. Good progress is in agriculture and in aligning with the EU transport *acquis.* Limited progress is in developing a single mechanism for prioritizing all investments accordingly with the governmental public finance management reform program, in the energy sector and environment and climate change policies. Recommendations for intensified efforts in: non-compliance with the SAA, regarding issues such as state aid control, fiscal discrimination on imported spirits, restriction to competition in the card-based payment system, and alignment with EU common foreign and security policies.	There is an adequate level of preparation in areas such as company law, intellectual property law, energy, and foreign, security, and defence policy. The state's level is moderate in free movement of goods, competition policy, agriculture and rural development, food safety, veterinary and phytosanitary policy, as well as enterprise and industrial policy. There is some level of preparation in the environment and climate change and social policy and employment. Progress is in the areas of right of establishment and freedom to provide services, intellectual property law, agriculture and rural development, and food safety, veterinary and phytosanitary policy. Recommendations for intensified efforts in: competition policy, environmental policies, public procurement, enforcement of the administrative capacity, and the alignment with all EU standard foreign and security policies.

Source: European Commission (2019f, 2019g).

The European integration process for the two countries is lingering due to the slow pace of reform in the fundamental issues listed in table 9.2. European Commission expresses concerns for Montenegro's accession due to the lack of progress in critical areas and to the political dialogue being in a state of crisis (Cuckić, 2019). Referring to Serbia's case Srdjan Majstorović, the president of the Belgrade-based European Policy Centre's steering committee, stated that "the year 2025 is not impossible, but is not too realistic at this time because neither side is trying too hard" (Simić, 2019).

9.3 The political environment of Serbia and Montenegro over the post-socialist period

Parallel with the economic transition Serbia and Montenegro committed to developing a democratic system to ensure the consolidation of democracy and to not allow in any case the return of a non-democratic order. The establishment of a consolidated democratic system refers on the principle that citizens are more pro democratically oriented than the elite since democracy fuels citizens with more benefits than non-democratic regimes (Jakšić and Praščević, 2011, p. 551). On the contrary, non-democracy better serves the elite's interest, increasing their economic prosperity. Therefore, the vital issue to a successful democratic transition is sufficient public support along with an elite that has neither the motivation nor the strength to jeopardize it (Jakšić and Praščević, 2011, p. 553). The new democratic system requires for its evolution the new political foundations of individual freedom and liberalism (Jakšić and Praščević, 2011, p. 554).

Since 2000, the FRY's governments had realized that democracy is a learning process, and they must intensify their effort on the part of the government and civil society, public administration and individuals (Vejvoda, 2004, p. 51). Political parties that evolved acknowledged that at the post-communist political life, single-party majorities should no longer exist. During the democratic transition, the parties must work together within their broad political scene, learn how to balance their interest with the public interest, and secure the citizens' well-being beyond constituencies (Vejvoda, 2004, p. 51).

The semi-authoritarian regime of the 1990s along with a high level of nationalism and a fragmented opposition caused the delay in the FRY's transition process and made Serbia be the last of the other CEEC to experience a democratic regime change, starting in October 2000 (Bieber, 2003, p. 73). The political system under the rule of Milosevic was more like a hybrid regime holding in surface some democratic elements such as political opposition and opponents participation in elections but with distinct authoritarian origin in the governmental control of the media, public administration, and economic and security resources (Bieber, 2003, p. 73). At the beginning of the post-Milosevic period, the legacy of authoritarian politics

continued to influence the nature of the democratization process and the establishment of a functional state. The democratization in FRY, as well as in CEEC, was causally linked with their Europeanization, though Serbia, surrounded by the ruins of a collapsed Yugoslav federation, was too far from the EU (Vuković, 2010, p. 60).

In the immediate aftermath of the ousting of Milosevic, Serbia had momentum for clarifying its status and the contours of its state, which it lost it. Although the plan of a "Greater Serbia" had faded, Serbia had shown an unwillingness to realize the new geopolitical balance and redefine its relationship with Kosovo and Montenegro (Rupnik, 2004, p. 107). The relation with Kosovo is still a pain point to Serbia's transition process. The post-Milosevic democratization process of Serbia was stigmatized by the assassination of pro-reform Prime Minister Zoran Djindjic in 2003, revealing politics' association with the mafia (Pasic, 2016). Under the existence of democratic institutions and processes, the elected parties with democratic orientation left-wing and right-wing alike all have involved in corruption cases during the conclusion of privatization deals. The governmental implication is ongoing as exposed in the secret privatization deals of the sales of the auto industry, steel factories, and Yugoslav Air Company (Pasic, 2016).

The current Serbian political system is highly fragmented, moderately polarised, and dominated by individuals who have been in the political scene for more than twenty years (Bertelsmann Stiftung, 2018e). The procedure of elections is free and competitive, but the use of biased media and the undue advantages for governing elites relying on administrative funds, decrease the quality of the election process. The governing Serbian Progressive Party (SNS) has gradually confined political rights and civil liberties, putting pressure on independent media, the political opposition, and civil society organizations (Freedom House, 2019d). The Bertelsmann Stiftung (BIT) (2018e, p. 3) report mentions, "The independence and pluralism of the mass media system have declined. The judiciary is not operating completely independently from political influence and is further plagued by inefficiency, nepotism, and corruption. The anti-corruption policy is not consistent, since there are few judicial verdicts regarding high state officials, and envisaged activities and measures from the anti-corruption strategy and action plan are not fully implemented".

In Montenegro's early transitional years, the exploitative reconstruction of the state by the political elite was evident. It was the period that the most severe threat to the security of Montenegro, the Milosevic's regime, had faded and the dilemma of the state to be an equal partner in the FRY with the larger Serbia was dominant in the country's political life. The opinion polls were unveiling that the citizens tended towards Montenegro's independence (Vuković, 2010, p. 65).

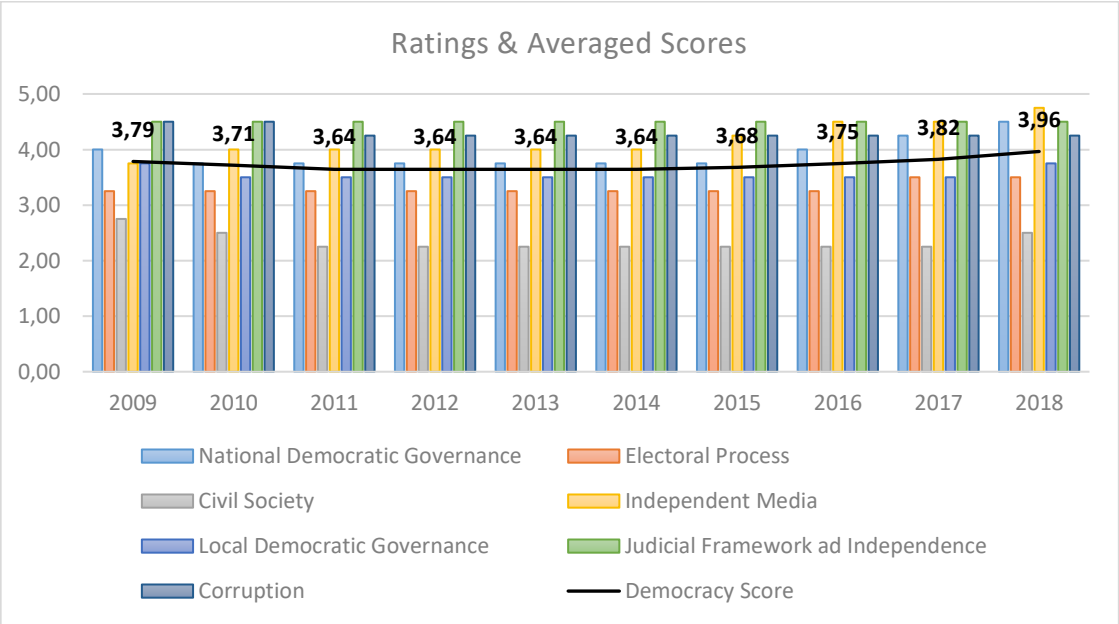
From the 2006 year of independence onwards, the country's progress towards the EU was evident, but protests existed for deficiencies in democracy. A single party has influenced the state's social and political transformation, the Democratic Party of Socialists (DPS), that has governed since the fall of socialism (Bertelsmann Stiftung, 2018f, p. 5). While the Montenegrin ruling party seemed to work towards the entrenchment of the new democratic system, in reality, was increasing its control over state institutions and resources, targeting its political survival (Vuković, 2010, p. 62). After it has exercised political control over the public and judicial sector alongside the establishment of clientelistic political and social networks, it has cultivated a culture of passivity in public institutions authorized with law enforcement (Bertelsmann Stiftung, 2018f). The Bertelsmann Stiftung's report (2018f, p. 5) mentions that "institutional inactivity and futile political opposition opened huge space for the civil society and media sectors, which have been extremely vocal and active." Montenegro incorporated elements and institutions of democracy, such as elections, judiciary, and parliament. However, the DPS, along with its political leader Milo Djukanovic, being in power either as a Prime Minister or a President since the 1990s, deepened the roots of political elitism and corruption (Pasic, 2016). Milo Djukanovic accused of corruption over the privatization of Niksicka Banka named now First Bank, which is owned by him and his siblings, and it bailed out by the government during the crisis (Pasic, 2016). The Mafia State is best describing the current orientation of the country. Montenegro's party system suffers from high fragmentation, strong polarisation, and moderate voter volatility (Bertelsmann Stiftung, 2018f, p. 15).

Although the EU authorities are strictly monitoring the required reforms according to the integration agenda, true democratization cannot be imposed externally, but it should be developed internally (Pasic, 2016). In both cases, despite the establishment of democratic institutions, practices, and regulations, neither the

political agents nor the electorate seems to have realized what the real democracy demands (Pasic, 2016; Živković, 2015). The weak rule of law, corruption, nepotism and party state, social inequality, limitations in media freedom, and financial mismanagement are apparent in both states, and there is an emergency for the political system to be disconnected from organized crime (Pasic, 2016; Živković, 2015).

The figures 9.2, 9.3 record the ratings and averaged scores of fundamentals in a democracy that result in the score of democracy in each state as it formed during the last decade. The results are following the above analysis.

Figure 9 2– Serbia Democracy Score during the period 2009-2018



Note: According to the Freedom House Nations in Transit Report, "The ratings reflect the consensus of Freedom House, its academic advisers, and the author(s) of this report. The opinions expressed in this report are those of the author(s). Ratings are on a scale of one (1) to seven (7), with one (1) representing the highest level in democratic progress while seven (7) the lowest. The Democracy Score is an average of ratings for the categories tracked in a given year" (Damnjanović, 2018)

Source: Author's adjustment from Freedom House Nations in Transit Report for Serbia as conducted by Damnjanović (2018).

Figure 9.2 displays the decline in Serbia's democracy score from 3.82 in 2017 to 3.96 in 2018, given that in the rating scale (1-7), one (1) accounts for the highest level in democratic progress while seven for the lowest. The democratic decline of Serbia during the last four years is due to the deterioration of fundamental freedoms and democratic institutions (Damnjanović, 2018, p. 2). The national democratic

governance, independent media, judicial framework and independence, and corruption retain the lowest progress towards democracy during all the years (please see figure 9.2). In particular, the Freedom House Nations in transit report for Serbia in 2018 (Damnjanović, 2018, p. 3) interprets Serbia's decline based on score changes recorded in

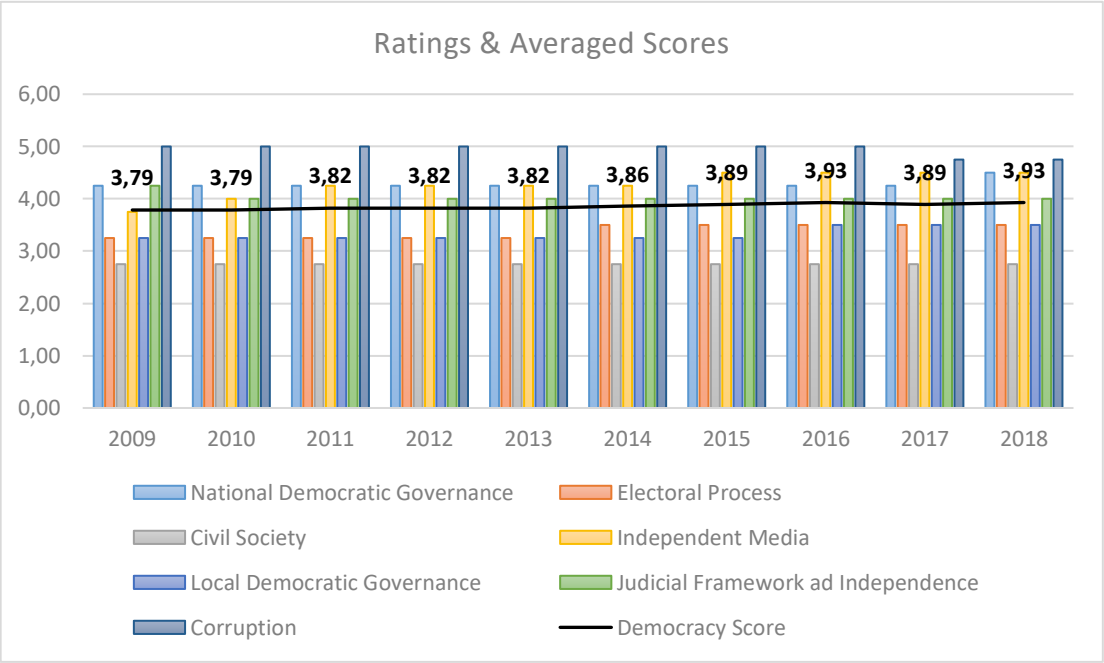
(i) the national democratic governance is due to the centralization of power to Serbian President Aleksandar Vučić,

(ii) the civil society because of animosity against those that have been critical to the government,

(iii) the independent media due to restrictions of press freedom, continuing purges of the independent journalists and the financial pressures towards the independent media outlets,

(iv) the local democratic governance due to the ruling party's policy to distort the will of the people and the elections' outcome.

Figure 9 3 – Montenegro Democracy Score during the period 2009-2018



Source: Author's adjustment from Freedom House Nations in Transit Reports for Montenegro as conducted by Baća and Morrison (2018).

Montenegro ratings are close to this of Serbia since the lowest progress is recorded in the same areas during the last decade. The Freedom House Nations in transit report for Montenegro in 2018 (Baća and Morrison, 2018, p. 3) recorded the

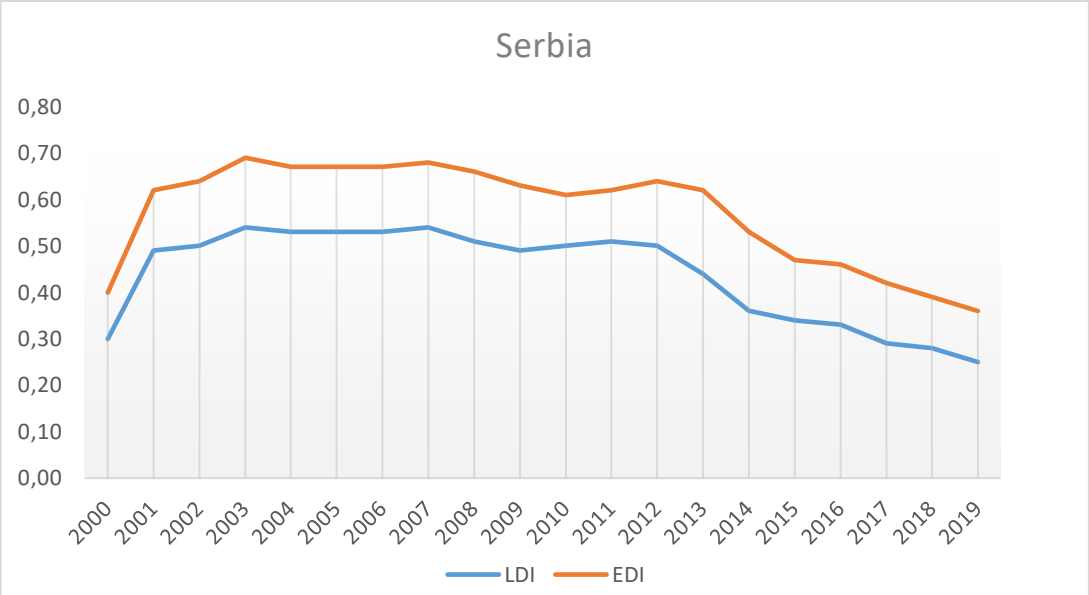
falling of the state's Democracy score from 3.89 in 2017 to 3.93 in 2018 due to the score change in the National Democratic Governance (please see figure 9.3). As the leading cause of this change is the opposition's persistent boycott of parliament, questioning the legitimacy and functioning of the government (Baća and Morrison, 2018, p. 3).

The Serbian government may not be a dictatorship, but it is not a democracy since beyond the ratings of Freedom House, also the rating of Varieties of Democracy (V-Dem) project indicates the fall of democracy in the country. The V-Dem rating for Serbia displays serious shortcomings in Liberal Democracy as well as in Electoral Democracy. The 2020 Democracy report of V-Dem Institute (2020, p. 26) classifies the country as an electoral autocracy in 2019, recording a downward movement during the last years.

At the time of the dissolution of FRY, Serbia positioned low on the Electoral Democracy index but scrambled high in 2007 and registered in an efficient for democracy level until 2011 (please see figure 9.4). Serbia ceased qualifying as an electoral democracy in 2015 and classified as an electoral autocracy in 2016 (Lührmann, Anna et al., 2019, p. 23). The score of the liberal democracy index in Serbia in 2019 is only 0.25, substantially below the threshold of 0.80, that is required for a regime to be classified as a liberal democracy, reflecting the distance of regime's formation from consolidated democracy. Based on the Regimes of the World (RoW) classification for being classified as an electoral democracy it requires just holding reasonably free and fair multiparty party elections and an average score on V - Dem's EDI above 0.5 (Lührmann, Mechkova, et al., 2018, p. 1327). The V-DEM's EDI, as well as LDI, run on a continuous scale, from low to high (0-1), with higher values indicating a more democratic dispensation. Remarkable is that the 2019 scores are lower than that recorded in 2000, the year of the fall of Milosevic's dictatorship. A rather disappointing outcome, reflecting the democratic breakdown in Serbian politics but inevitable considering that the Serbian president and several members of his Cabinet served as ministers in Milosevic's government. The gradual democratic erosion in Serbia started around 2012 under the current president and former prime minister, Vučić. The 2019 V-Dem annual report (Lührmann, Anna et al., 2019, p. 5) included

Serbia in one of the 24 countries severely affected by what has been termed a "third wave of autocratization".

Figure 9 4 – Serbia Liberal Democracy Index (LDI) Electoral Democracy Index (EDI) & during the period 2000-2019



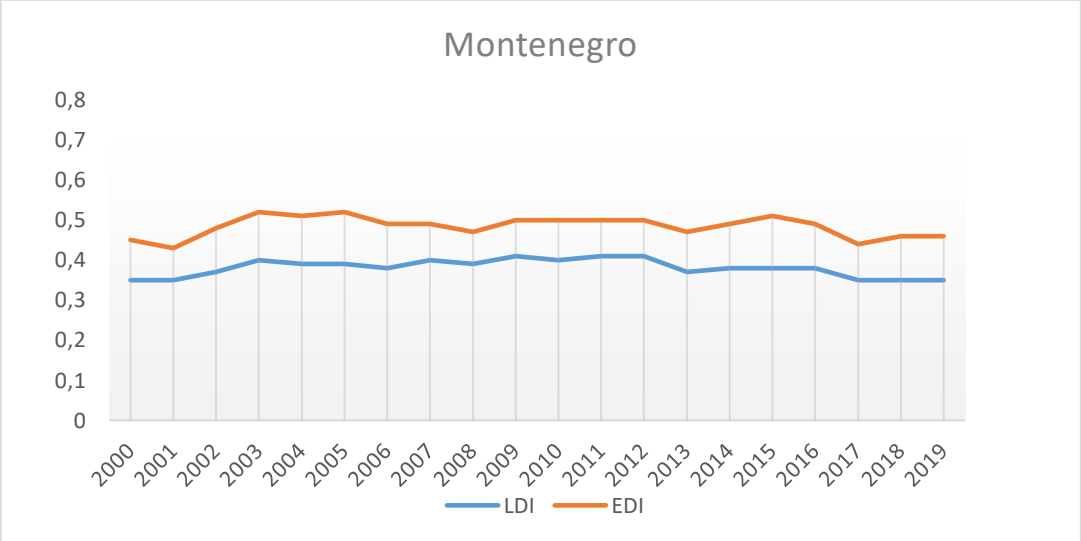
Source: Adapted from V-DEM data (2020)

Concerning the LDI, Varieties of Democracy (V-DEM) (2020) analysis based on that "the liberal principle of democracy emphasises the importance of protecting individual and minority rights against the tyranny of the state and the tyranny of the majority. The liberal model takes a negative view of political power insofar as it judges the quality of democracy by the limits placed on government. This is achieved by constitutionally protected civil liberties, a strong rule of law, an independent judiciary, and effective checks and balances that, together, limit the exercise of executive power". This index combines both the electoral and liberal principles of democracy and as such, includes the two main components of democracy. The first is the level of electoral democracy (EDI) and second is the liberal component index (LCI), harbouring on the liberal tradition.

The V-DEM (2020) analysis for the EDI based on that "The electoral principle of democracy seeks to embody the core value of making rulers responsive to citizens, achieved through electoral competition for the electorate's approval under circumstances when suffrage is extensive; political and civil society organisations can operate freely; elections are clean and not marred by fraud or systematic

irregularities, and elections affect the composition of the chief executive of the country". Further, the electoral process must respect the freedom of expression and independent media. The V-Dem conceptual scheme regards electoral democracy as a critical element of any other conception of representative democracy (liberal, participatory, deliberative, egalitarian, or some other).

Figure 9 5 – Montenegro Electoral Democracy Index (EDI) & Liberal Democracy Index (LDI) during the period 2000-2019



Source: Adapted from V-DEM data (2020)

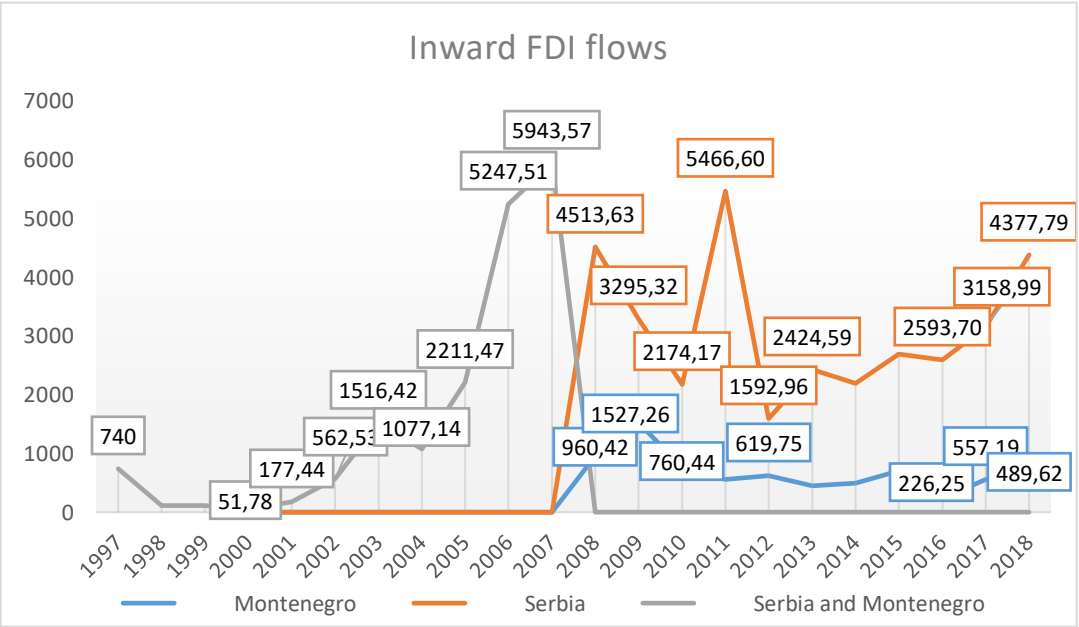
Respectively, the V-Dem rating for Montenegro reveals a significant democratic gap. Figure 9.5 presents the level of democratization in Montenegro, between 2000 to 2019. Although both indexes are slightly better than the equivalent of Serbia, Montenegro as well is classified as electoral autocracy (Lührmann, Tannenberg, et al., 2018). Djukanovic and his DPS, dominating Montenegro's political scene for years, leaving no space for the emergence of democratic alternatives, are responsible for this distance of the country's regime's formation from democracy.

9.4 Inward FDI in Serbia and Montenegro

FDI had a crucial role in the economic development of the SEE region through the industry's reconstruction, which in turn contributed at most to the national prosperity of each country. Since 2000 "velvet revolution" in Serbia and the establishment of the first government in 2001, the investment climate characterized by political instability

(World Bank, 2004, p. 6) which, resulted in a low level of inbound FDI (please see figure 9.6). Significant issues like the future of the Serbia and Montenegro Union and of the Kosovo status; the ICTY Hague criminal tribunal; and the state's dubious creditworthiness generated an unsafe environment for foreign investors (World Bank, 2004, p. 18). After all, investment risk minimization is the general criterion for an MNE's decision to choose the direct investment's location (Bitzenis and Žugić, 2016, p. 229). To this context, during 2001-2004 major policy steps took place towards the development of a conducive environment to FDI such as the achievement of fiscal stability and trade liberalization, reforms in the tax system and legal framework, introduction of privatization law along with leasing, collateral and concessions laws, and the Law on Foreign Investments (Šabić et al., 2012; World Bank, 2004). The adaptation of the Law on Foreign Investments in 2002 provided equal rights and obligations both to foreign and domestic investors, stimulating the growth of FDI (Šabić et al., 2012, p. 74). Tax rates concluded to be the lowest in Europe, and the country's tax system provided the possibility of a 10-year corporate profit tax holiday for inward FDI, particularly in the manufacturing sector (Šabić et al., 2012, p. 75). During these first years, almost all FDI in Serbia related to privatization (World Bank, 2004, p. 7).

Figure 9 6 – Inward FDI flows in Serbia and Montenegro in millions of US Dollars (at current prices) for the period 2000-2018



Source: Adjusted from UNCTADstat (2020c) (www.unctadstat.unctad.org)

The Serbia and Montenegro Union experienced growth rates in inward FDI over 100 per cent during the last two years of its existence, thus 2005-06 (please see figure 9.7). From the Union, Serbia was the leading host country of FDI inflows, which their rise in 2006 attributed to the broader growth of inward FDI throughout the entire WB region (please see figure 9.6). Indeed, Serbia received the highest amount of FDI among the SEE countries (Radenković, 2016, p. 25). The outstanding performance of Serbian inward FDI which its share to GDP exceeded the 10 per cent (reaching the 14.11 per cent) (please see figure 9.8) was due to the significant privatizations in the Serbian mobile telecommunications operator 'Mobtel', purchased by Norwegian 'Telenor' (KPMG, 2014; Radenković, 2016; Šabić et al., 2012). While the FDI flows towards new infrastructure, capital goods, and workers, meaning the FDI type of greenfield investments was at a lower level. Representative investments of this type have been the Ball Packaging, Vip Mobile, and Microsoft's Development Center holding the status of the larger greenfield investments in the Serbian market for more than a decade (2000-2011) (Radenković, 2016, p. 25).

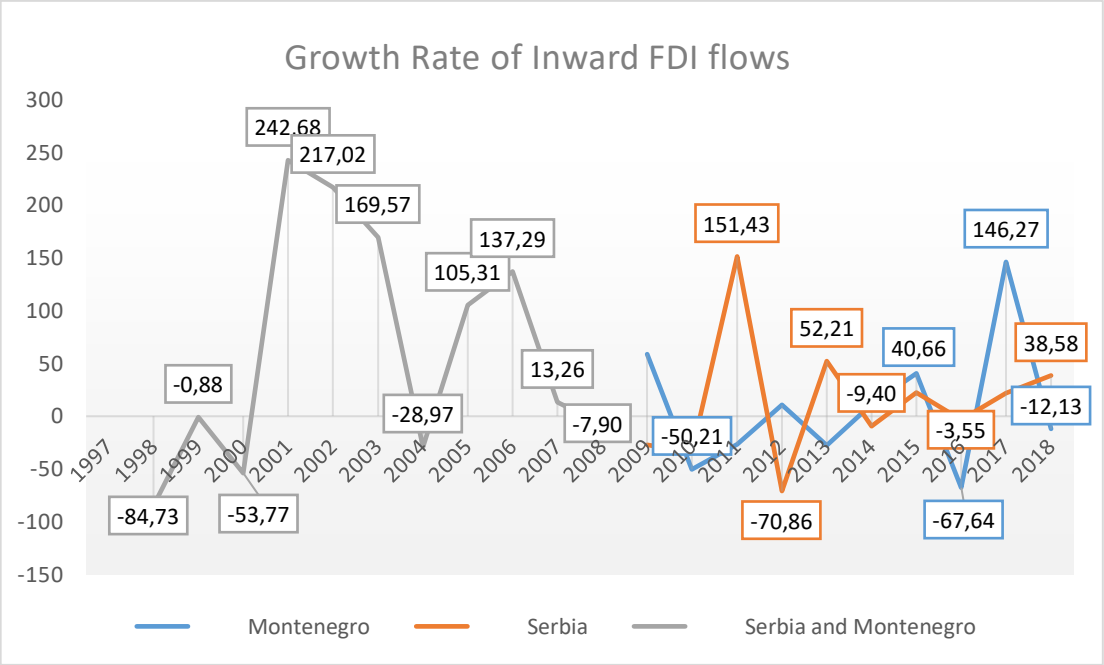
The split up with Montenegro, the elections and the unstable political environment decreased the inward FDI substantially in Serbia (from USD 4.5 billion in 2008 to USD 3.3 billion in 2009 (Šabić et al., 2012; UNCTAD, 2011) (please see figure 9.6) which even recorded negative growth rates (please see figure 9.7). This downward trend enhanced by the advent of the global financial crisis and continued until 2010 (UNCTAD, 2011, p. 64) (please see figure 9.6).

The crisis arrived at the worst time since it reduced the Serbian dynamics for economic growth that two important FDI projects would otherwise have produced. In particular, Russia and Serbia signed in 2008 an oil and gas agreement for the acquisition of state-owned oil company by GazpromNeft (KPMG, 2014, p. 18) while a few months later the large import-oriented production project between the "Fiat Chrysler Automobiles (FCA)" and the Republic of Serbia – establishing a joint-venture company – announced (KPMG, 2014; Šabić et al., 2012). The last investment remained by far the largest in the history of the country's industry and contributed to the transformation of an old-fashioned industrial site into one of FCA'S most modern factories. The prospects of the EU accession motivated the FCA to implement a project designed to develop a competitive manufacturing platform and instilling an influential

industrial culture, with a highly qualified and competitive workforce (European Investment Bank, 2019, p. 10). Many car industry suppliers followed FCA and started their production in Serbia, like Johnson Controls, YURA, Draxlmeier, and Denso (KPMG, 2014, p. 18). The most significant inward FDI flows between the years 2000-2010 have been related to privatization and capital market and not to greenfield investments (Šabić et al., 2012, p. 76). To attract greenfield investments that have the advantage of increasing employment rate, the establishment of an entrepreneurial environment involving fewer risks and more business transparency is a prerequisite (Šabić et al., 2012, p. 76).

Serbian government provided incentives for stimulating flows of FDI by granting non-refundable funds to firms activated in manufacturing, internationally marketable services sector, and the research and development (R&D) through the decree on the Terms and Conditions of Attracting Direct Investments (KPMG, 2014, p. 20). The primary source countries have been EU member states, the US and Russia, especially in the sectors of finance, telecommunications, energy, cement, oil, and tobacco industries. A large amount of inward FDI concentrated in the three highly profitable sectors: financial services, retail trade, and telecommunication. Inflows of FDI infused mainly in the service sector, reaching 60 per cent of total FDI (Radenković, 2016, p. 29). Recently, China, through the "Belt and Road Initiative" (BRI) (please see Chapter 3 - Section 3.4.2), increased its presence in the region and, consequently, in Serbia, which holds the largest market among the WB countries. Although China's contribution to FDI is just 3 per cent, this will be increased through a series of Chinese investments in the Serbian economy (Day, 2019). For example, the construction of a Chinese owned Shandong Linglong Tire Company factory in the Serbian city of Zrenjanin, a USD 1.46 billion investment by the Zijin Mining group over the next six years into the Serbian RTB-Bor mines and the plan for the establishment of an industrial park near Belgrade hosting over 1,000 Chinese companies, being the biggest Chinese industrial park in Europe express this trend (Day, 2019).

Figure 9 7 – Growth Rate of Inward FDI flows in Serbia and Montenegro for the period 2000-2018



Source: Adjusted from UNCTADstat (2020c) (www.unctadstat.unctad.org)

However, the country's disadvantages, like the poor infrastructure quality, the overregulated economy, corruption, and inadequate level of law security prevented Serbia from hosting the number of FDI flows it could otherwise receive (Milenkovic and Milenkovic, 2012, p. 161). Serbian economy in 2012 underperformed, the unemployment rate stood at 22.4 per cent, and the FDI growth rate was negative (please see figure 9.7) (Kaczmarski, 2013). To this context, the resurgence of foreign investors' interest was a matter of high importance for the government. Indeed in 2013, FDI inflows were rising, but the catastrophic floods of 2014 have immediately reversed this upward course. From 2017 onwards along with the growth of the economy, Serbia has gradually rebound in inward FDI (please see figure 9.6) which managed to keep it inside the country as the final FDI stock record exposes (please see figure 9.9).

Serbia is the largest country in WB in terms of landmass and population. It is relatively diversified and, as such, the region's top FDI destination considering that it has attracted 60 per cent of all FDI projects into the WB since 2003 (Shehadi, 2019; UNCTAD, 2019). In 2017, Serbia managed to be in the list of top 15 countries in terms of the number of projects in FDI, which was 118 reflecting, a 157 per cent increase

relative to 2016 (Lloyds Bank International Trade Portal, 2019a). Serbia accounts for 70 per cent of the total WB greenfield investments, with a record of USD 6 billion invested into 105 projects (Harper, 2019). In 2018 Serbia experienced remarkable growth in inbound FDI, from USD 3.2 billion in 2017 to USD 4.4 billion in 2018 (please see figure 9.6). A surge in equity capital stimulates this growth (UNCTAD, 2019, p. 57).

The recorded factors that boost FDI the recent years are the economic reforms the country undergoes as part of its EU accession process and the IMF agreement. The accomplishment of relative macroeconomic stability during the last decade privatized banking sector with low-interest rates, and free trade agreements beyond the EU, with Russia, Turkey and countries members of the CEFTA improved country's performance as a recipient of FDI (Lloyds Bank International Trade Portal, 2019a; Perić, 2019). Finally, the country holds a strategic location in Balkans peninsula and its characterized by a high-quality educated staff and low-cost skilled labour force. According to the location assessment tool, "fDi Benchmark," Serbia is one of the cheapest locations, especially for manufacturing (Shehadi, 2019).

The 2019 World Investment Report (UNCTAD, 2019, p. 57) referring to the developments in Serbian inbound FDI, stresses the importance of:

> "The country's strategic location facilitates logistics investment, such as the Vinci Airports (France) stake in Nikola Tesla Airport in Belgrade. Its natural resources (especially copper) are also attracting resource-seeking firms. The Zijin Mining Group (China), for example, acquired RTB Bor's copper production. FDI in Serbia's growing automotive cluster (e.g., the projects of the United Kingdom-based wire producer Essex Europe and Japan-based cable producer Yazaki) benefits from the country's skilled labour force. Finally, the country's knowledge base is attracting R&D centres, such as German tire maker Continental's development centre in Novi Sad".

However, Serbia is not an ideal host country since it has a massive and inefficient public sector, low productivity, inadequate road, and electricity transport infrastructure and suffers from a reduction in population. The shadow economy accounts for 24 per cent of the total economic activities. Economic growth and political stability are not at the expected levels to accelerate the transition process and accomplish EU and WTO accession (Lloyds Bank International Trade Portal, 2019a;

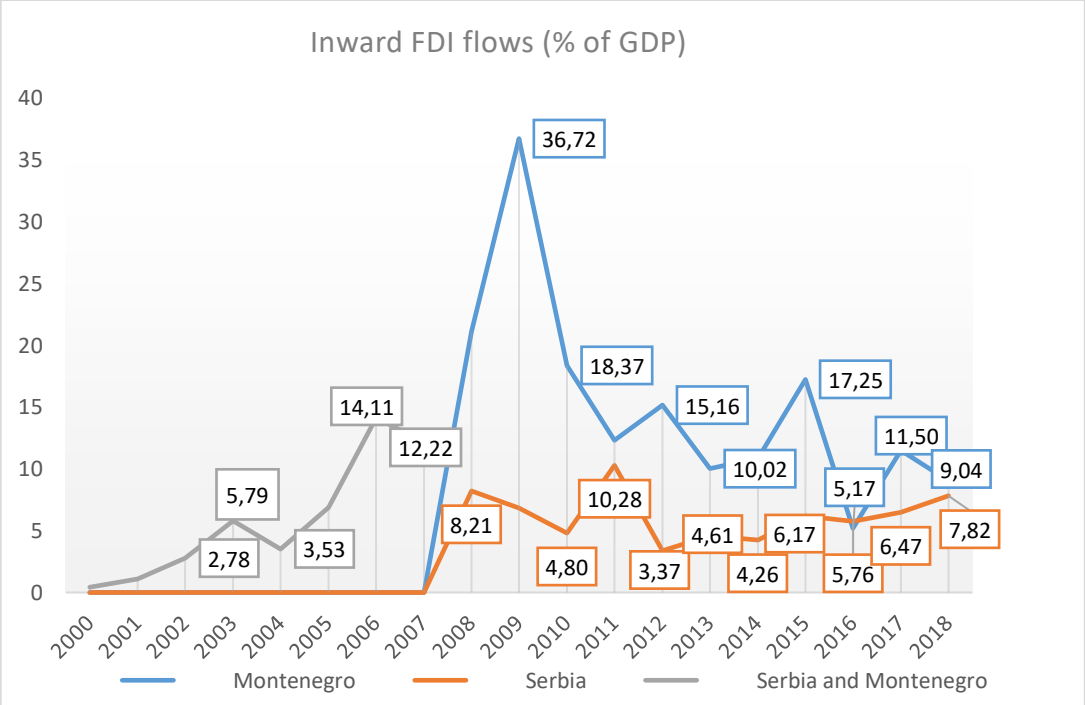
Perić, 2019). The business environment is highly bureaucratic, dominated by corruption and political interference, poor market reputation and low functioning of the rule of law. Serbia's position in the ease of doing business deteriorated from 43rd place in 2018 to 48th in 2019 (Lloyds Bank International Trade Portal, 2019a).

FDI inflows in Montenegro in 2007 reached almost USD 1 billion while in 2008 surpassed this limit for the first time (please see figure 9.6), turning this small economy to the top recipient of FDI per capita in the region (UNCTAD, 2008, 2010). Montenegro joining World Bank, IMF, and concluding an SAA at the same period had contributed at most to this positive outcome. The flows of FDI mainly directed to real estate with a particular interest in land on the country's coast (ESI, 2007). In 2009, Montenegro achieved 37 per cent of GDP in the flows of inward FDI (TheGlobalEconomy.com, 2019a). FDI received annually by a host country typically runs at about 2-3 per cent of the size of the host economy measured by its GDP, and when it exceeds 5-6 per cent of GDP each year, then it is considered as a significant performance (TheGlobalEconomy.com, 2019b). Serbia and Montenegro Union, before its dissolution in 2006, exceeded almost at double the limit of 6 per cent of GDP in FDI inflows (please see figure 9.8). Since 2010 although it recorded a downward trend, it never fell below the limit of 5 per cent, and the annual net FDI has averaged 12 per cent of GDP. The financial crisis reduced investments (please see figure 9.6) recording, even negative growth rates (please see figure 9.7). In 2011, the state adopted the Foreign Investment Law for the establishment of a secure legal framework in harmonization with the EU, providing guarantees to foreign firms of the protection of their investments (MIPA, 2019, p. 29). Montenegro had set serious underpinnings for its development as a host country to FDI through its economic system offering a high degree of economic freedom and stable currency to foreign agents (Toskovic et al., 2016, p. 23). In 2015 a large amount of FDI inflows received, which moderated during the years 2017-2018, almost at 10 per cent of GDP (please see figure 9.8). In particular, total FDI inflows in Montenegro decreased from USD 557 million in 2017 to USD 490 million in 2018, while the FDI stock accounted for USD 5.5 billion (please see figure 9.9), representing 102.9 per cent of the country's GDP in 2018 (Lloyds Bank International Trade Portal, 2019b). The performance of Montenegro's inward FDI considered being high compared to regional peers (WB countries average). The

reasoning of this is given in IMF 2019 Article IV Consultation for Montenegro (IMF, 2019b, p. 57) which reports that:

"large government Eurobond issuances have increased net portfolio investment liabilities as government financing needs have grown, and other investment flows also increased in 2015-18 as the government received large external loans from China Ex-Im Bank for highway construction and secured several syndicated bank loans from international banks".

Figure 9 8 – Inward FDI flows in Serbia and Montenegro as a percentage of GDP for the period 2000-2018

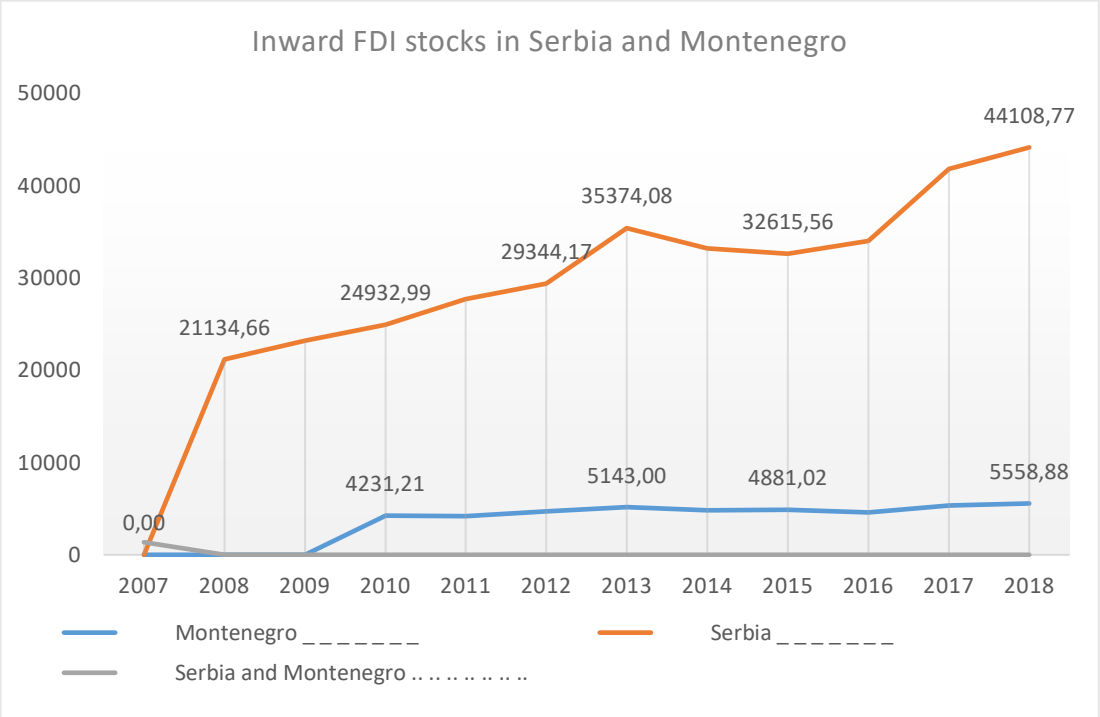


Source: Adjusted from UNCTADstat (2020c) (www.unctadstat.unctad.org)

In Montenegro, investment per capita is one of the highest in Europe, and investments in real estate grew by 10.6 per cent (EUR 147.2 million) in 2018 (Lloyds Bank International Trade Portal, 2019b). The sectors receiving most of FDI flows are tourism, real estate, energy, telecommunications, banking, and construction. Eventually, FDI in the tourism and energy sectors would increase the country's export capacity (IMF, 2018b, p. 57). The biggest source countries in 2017 were Norway, Russia, Italy, Azerbaijan, and Hungary, while in 2018, the largest investor in Montenegrin economy was Italy, followed by Russia and Serbia (Lloyds Bank International Trade Portal, 2019b; Montenegrin Investment Promotion Agency -

MIPA, 2019). Montenegro's entry into the NATO Alliance in 2017 improved the conditions provided for the safety of foreign investors. Montenegro holds an attractive tax system including a 9 per cent corporate and capital gains tax rates, one of the lowest in Europe, low barriers to entry for new businesses, property rights, and a price-competitive, qualified young labour force (Aol, 2019). Despite the government's will to remain a competitive and open economy to MNEs, corruption, organized crime, the politicization of justice, an unreliable land registry, and high bureaucracy are impediments to FDI (Lloyds Bank International Trade Portal, 2019b).

Figure 9 9 – Inward FDI stocks in Serbia and Montenegro in millions of US Dollars (at current prices) for the period 2000-2018



Source: Adjusted from UNCTADstat (2020c) (www.unctadstat.unctad.org)

9.5 Empirical Analysis

Chapter 4 presents the empirical analysis of this dissertation on the political system's impact on inward FDI inflows. Thus, it provides variables descriptions, data, model specification and empirical results concerning the total of the six transition economies of WB. The empirical analysis uses a panel dataset of the variables of interest for a period from 1996 to 2018. Table 9.3 presents a short description of the variables included in the empirical model, their coding, and sources of data.

Table 9 3 - Variables description and Coding

Variables	Description	Code	Source of Data
Dependent Variable			
FDI inflows	The natural log of net FDI inflows	*lnfdi*	wiiw-FDI database
Independent Variables			
1. LDI	The is aggregate index that describes features of democracy at the highest level	*ldi*	V-Dem Dataset (V.10)
2. The signing of Bilateral Investment Treaties (BITs)	The conclusion of an IIA between two countries for the promotion and protection of FDI	*bit*	UNCTAD-International Investment Agreements Navigator
3. Governance Indicators	A set of traditions and institutions by which authority in a country is exercised.		
3a *Voice and Accountability*	The dimension of Quality and Governance	*voice*	Worldwide Governance Indicators (WGI)
3b. *Political Stability and Absence of Violence/Terrorism*	The dimension of Quality and Governance	*polstab*	
3c. *Government Effectiveness*	The dimension of Quality and Governance	*goveffe*	
3d. *Rule of Law*	The dimension of Quality and Governance	*rule*	
3e. *Control of Corruption*	The dimension of Quality and Governance	*cc*	
3f. *Regulatory Quality*	The dimension of Quality and Governance	*regq*	
Controlling-non governance indicators			
4. Growth	Annual percentage growth rate of GDP	*gdp_growth*	World Bank-World Development Indicators database
5. Market Size	GDP at constant 2010 prices in US dollars	*GDP*	

Variables Data for Serbia and Montenegro

The data used for Serbia and Montenegro is presented below

Dependent variable

lnFDI

Net FDI inflows *in EUR mn*		
Index Year	**Serbia**	**Montenegro**
2000	56,2	.
2001	198,3	4,7
2002	521,3	76,4
2003	1299,8	43,8
2004	771,9	52,7
2005	1268,1	402,6
2006	3392,4	495,8
2007	2512,6	682,7
2008	2711,5	655,7
2009	2084,7	1099,4
2010	1273,1	574,2
2011	3548,0	401,4
2012	1010,7	482,4
2013	1545,9	336,9
2014	1504,6	374,6
2015	2115,9	630,3
2016	2124,9	204,5
2017	2547,9	494,4
2018	3495,1	414,8
2019	4000,0	400,0
2007	2512,6	682,7
2008	2711,5	655,7
2009	2084,7	1099,4
2010	1273,1	574,2
2011	3548,0	401,4
2012	1010,7	482,4
2013	1545,9	336,9
2014	1504,6	374,6
2015	2115,9	630,3
2016	2124,9	204,5
2017	2547,9	494,4
2018	3495,1	414,8
2019	4000,0	400,0

Notes: The net FDI inflows are in EUR mn

Source: http://wiiw.ac.at/fdi-database.html

Independent variables

Ldi

Liberal Democracy Index (LDI)		
Index Year	**Serbia**	**Montenegro**
1996	0.19	N/A

1997	0.19	N/A
1998	0.18	N/A
1999	0.19	0.34
2000	0.30	0.35
2001	0.49	0.35
2002	0.50	0.37
2003	0.54	0.40
2004	0.53	0.39
2005	0.53	0.39
2006	0.53	0.38
2007	0.54	0.40
2008	0.51	0.39
2009	0.49	0.41
2010	0.50	0.40
2011	0.51	0.41
2012	0.50	0.41
2013	0.44	0.37
2014	0.36	0.38
2015	0.34	0.38
2016	0.33	0.38
2017	0.29	0.35
2018	0.28	0.35

Source: www.v-dem.net/en/analysis/CountryGraph

bit

Country: Serbia

A/A	Bilateral Investment Treaty	Date of signature
1	Serbia - Turkey BIT (2018)	31/01/2018
2	Canada - Serbia BIT (2014)	01/09/2014
3	Morocco - Serbia BIT (2013)	06/06/2013
4	Serbia - United Arab Emirates BIT (2013)	17/02/2013
5	Algeria - Serbia BIT (2012)	13/02/2012
6	Indonesia - Serbia BIT (2011)	06/09/2011
7	Azerbaijan - Serbia BIT (2011)	08/06/2011
8	Kazakhstan - Serbia BIT (2010)	07/10/2010
9	Malta - Serbia BIT (2010)	02/07/2010
10	Montenegro - Serbia BIT (2009)	29/10/2009
11	Portugal - Serbia BIT (2009)	19/09/2009
12	Denmark - Serbia BIT (2009)	15/05/2009
13	Serbia - Switzerland BIT (2005)	07/12/2005
14	Cyprus - Serbia BIT (2005)	21/07/2005
15	Egypt - Serbia BIT (2005)	24/05/2005
16	Finland - Serbia BIT (2005)	23/05/2005
17	Lithuania - Serbia BIT (2005)	29/03/2005

18	Israel - Serbia BIT (2004)	28/07/2004
19	BLEU (Belgium-Luxembourg Economic Union) - Serbia BIT (2004)	04/03/2004
20	Libya - Serbia BIT (2004)	18/02/2004
21	Kuwait - Serbia BIT (2004)	19/01/2004
22	Iran, Islamic Republic of - Serbia BIT (2003)	05/12/2003
23	India - Serbia BIT (2003)	31/01/2003
24	Albania - Serbia BIT (2002)	26/11/2002
25	Serbia - United Kingdom BIT (2002)	06/11/2002
26	Serbia - Spain BIT (2002)	25/06/2002
27	Serbia - Slovenia BIT (2002)	18/06/2002
28	Nigeria - Serbia BIT (2002)	01/06/2002
29	Netherlands - Serbia BIT (2002)	29/01/2002
30	Bosnia and Herzegovina - Serbia BIT (2001)	18/12/2001
31	Austria - Serbia BIT (2001)	12/10/2001
32	Hungary - Serbia BIT (2001)	20/06/2001
33	Serbia - Turkey BIT (2001)	02/03/2001
34	Serbia - Ukraine BIT (2001)	09/01/2001
35	Italy - Serbia BIT (2000)	11/12/2000
36	Ghana - Serbia BIT (2000)	25/04/2000
37	Korea, Dem. People's Rep. of - Serbia BIT (1998)	26/08/1998
38	Croatia - Serbia BIT (1998)	18/08/1998
39	Czech Republic - Serbia BIT (1997)	13/10/1997
40	Greece - Serbia BIT (1997)	25/06/1997
41	Guinea - Serbia BIT (1996)	22/10/1996
42	Serbia - Zimbabwe BIT (1996)	19/09/1996
43	The FYROM - Serbia BIT (1996)	04/09/1996
44	Poland - Serbia BIT (1996)	03/09/1996
45	Belarus - Serbia BIT (1996)	06/03/1996
46	Bulgaria - Serbia BIT (1996)	13/02/1996
47	Serbia - Slovakia BIT (1996)	30/01/1996

Source: https://investmentpolicy.unctad.org/international-investment-agreements

Country: Montenegro

A/A	Bilateral Investment Treaty	Date of signature
1	Moldova, Republic of - Montenegro BIT (2014)	20/06/2014
2	Montenegro - United Arab Emirates BIT (2012)	26/03/2012
3	Montenegro - Turkey BIT (2012)	14/03/2012
4	Azerbaijan - Montenegro BIT (2011)	16/09/2011
5	Macedonia, The former Yugoslav Republic of - Montenegro BIT (2010)	15/12/2010
6	Malta - Montenegro BIT (2010)	07/04/2010
7	BLEU (Belgium-Luxembourg Economic Union) - Montenegro BIT (2010)	16/02/2010
8	Montenegro - Serbia BIT (2009)	29/10/2009

9	Montenegro - Qatar BIT (2009)	17/02/2009
10	Denmark - Montenegro BIT (2009)	11/02/2009
11	Finland - Montenegro BIT (2008)	14/11/2008
12	Montenegro - Switzerland BIT (2005)	07/12/2005
13	Cyprus - Montenegro BIT (2005)	21/07/2005
14	Lithuania - Montenegro BIT (2005)	29/03/2005
15	Israel - Montenegro BIT (2004)	28/07/2004
16	Montenegro - Spain BIT (2002)	25/06/2002
17	Montenegro - Netherlands BIT (2002)	29/01/2002
18	Austria - Montenegro BIT (2001)	12/10/2001
19	Ukraine - Montenegro BIT (2001)	09/01/2001
20	Czech Republic - Montenegro BIT (1997)	13/10/1997
21	Greece - Montenegro BIT (1997)	25/06/1997
22	Montenegro - Poland BIT (1996)	03/09/1996
23	Montenegro - Slovakia BIT (1996)	30/01/1996

Source: https://investmentpolicy.unctad.org/international-investment-agreements

Governance Indicators

Index	*cc*		*rule*		*voice*		*polstab*		*goveffe*		*regq*	
Year	Serbia	Montenegro	Serbia	Montenegro	Serbia	Montenegro	Serbia	Montenegro	Serbia	Montenegro	Serbia	Montenegro
1996	-1,14	.	-1,26	.	-1,22	.	-1,03	.	-1,06	.	-0,72	.
1997	.	.	.	.	.	.	.	.	.	.	.	.
1998	-1,2	0,52	-1,26	-0,78	-0,97	-0,59	-2,14	.	-0,88	.	-0,82	.
1999	.	.	.	.	.	.	.	.	.	.	.	.
2000	-1,18	-0,17	-1,27	0,34	-0,64	-0,5	-1,64	.	-0,85	.	-0,86	.
2001	.	.	.	.	.	.	.	.	.	.	.	.
2002	-0,87	-0,15	-0,86	0,29	0	0,01	-0,51	.	-0,51	.	-0,62	.
2003	-0,49	-0,4	-0,85	-0,16	-0,12	0,09	-0,58	.	-0,62	.	-0,59	.
2004	-0,5	-0,46	-0,72	-0,21	-0,18	0,11	-0,51	.	-0,21	.	-0,45	.
2005	-0,41	-0,35	-0,91	-0,13	-0,21	0,13	-0,77	.	-0,33	0,35	-0,58	-0,13
2006	-0,29	-0,4	-0,53	-0,27	0,21	0,26	-0,54	0,04	-0,21	-0,13	-0,44	-0,33
2007	-0,35	-0,33	-0,47	-0,15	0,31	0,26	-0,59	0,11	-0,23	-0,22	-0,34	-0,18
2008	-0,31	-0,21	-0,5	-0,08	0,28	0,24	-0,54	0,77	-0,19	-0,03	-0,29	-0,13
2009	-0,31	-0,2	-0,41	0,07	0,34	0,24	-0,48	0,82	-0,04	-0,02	-0,13	-0,04
2010	-0,29	-0,23	-0,37	0,01	0,29	0,19	-0,42	0,58	-0,05	0,09	-0,02	-0,07
2011	-0,27	-0,2	-0,29	0,02	0,28	0,21	-0,28	0,57	-0,09	0,1	0,03	-0,06
2012	-0,33	-0,11	-0,36	0,02	0,2	0,22	-0,22	0,6	-0,1	0,13	-0,06	0,02
2013	-0,3	-0,25	-0,33	0,05	0,29	0,18	-0,08	0,5	-0,09	0,16	-0,06	0,07
2014	-0,23	-0,06	-0,15	0,08	0,21	0,16	0,18	0,22	0,09	0,27	0,14	0,13
2015	-0,27	-0,13	-0,12	0,05	0,23	0,14	0,24	0,14	0,11	0,16	0,16	0,23
2016	-0,32	-0,1	-0,16	-0,01	0,2	0,08	0,14	0,28	0,09	0,11	0,06	0,22
2017	-0,38	-0,09	-0,19	0,01	0,12	0,12	0,10	-0,06	0,19	0,15	0,01	0,3
2018	-0,37	0,02	-0,15	0,10	0	0,08	0,08	0,11	0,11	0,13	0,01	0,36

Source: https://info.worldbank.org/governance/wgi/Home/Reports

gdp_growth & GDP

Index Year	GDP growth annual (%) Serbia	 Montenegro	GDP (constant 2010 US$) Serbia	 Montenegro
1996	2,43	.	24.629.059.461,80	.
1997	7,18	.	26.398.616.216,11	3.056.198.493,45
1998	2,43	4,90	27.040.223.134,51	3.205.952.424,80
1999	-12,15	-9,40	23.755.758.797,56	2.904.592.851,78
2000	7,76	3,10	25.599.017.868,51	2.994.635.235,52
2001	4,99	1,10	26.877.103.625,55	3.027.571.513,11
2002	7,12	1,90	28.789.621.363,48	3.085.214.474,11
2003	4,42	2,48	30.060.802.352,79	3.161.809.840,05
2004	9,05	4,43	32.780.256.764,22	3.301.753.218,00
2005	10,15	4,18	36.108.864.270,56	3.439.786.363,46
2006	5,11	8,57	37.953.228.464,57	3.734.452.893,54
2007	6,44	6,81	40.397.237.063,69	3.988.772.862,25
2008	5,66	7,22	42.681.934.261,26	4.276.873.549,04
2009	-2,73	-5,80	41.515.968.963,92	4.029.024.755,41
2010	0,73	2,73	41.819.468.691,83	4.139.192.052,98
2011	2,04	3,23	42.671.028.407,71	4.272.823.814,84
2012	-0,68	-2,72	42.380.208.648,26	4.156.441.979,12
2013	2,89	3,55	43.606.113.041,61	4.303.954.683,47
2014	-1,59	1,78	42.912.989.891,79	4.380.723.550,43
2015	1,78	3,39	43.675.263.640,68	4.529.248.516,20
2016	3,34	2,95	45.134.162.454,38	4.662.831.394,83
2017	2,05	4,72	46.059.098.996,64	4.882.752.203,81
2018	4,39	5,08	48.082.123.894,72	5.130.691.534,69

Source: https://databank.worldbank.org/source/world-development-indicators

Table 9.4 presents descriptive statistics for all variables. They include total observations available for the variables along with minimum, maximum, mean, and standard deviation for each of them.

Table 9 4 - Descriptive statistics

	Variable	Obs	Mean	Std.Dev.	Min	Max
SERBIA	*lnfdi*	19	20.987	1.045	17.844	21.990
	ldi	23	0.403	0.133	0.180	0.540
	bit	23	2.043	2.078	0.000	7.000
	cc	20	-0.491	0.324	-1.200	-0.230
	rule	20	-0.558	0.389	-1.270	-0.120
	voice	20	-0.019	0.441	-1.220	0.340
	polstab	20	-0.480	0.597	-2.140	0.240
	goveffe	20	-0.244	0.361	-1.060	0.190

	regq	20	-0.279	0.334	-0.860	0.160
	gdp_growth	23	0.032	0.047	-0.122	0.102
	GDP	23	3.573	0.236	3.168	3.873
MONTENEGRO	*lnfdi*	17	19.614	0.922	17.595	20.818
	ldi	20	0.380	0.022	0.340	0.410
	bit	23	1.000	1.128	0.000	3.000
	cc	19	-0.174	0.211	-0.460	0.520
	rule	19	-0.039	0.235	-0.780	0.340
	voice	19	0.086	0.233	-0.590	0.260
	polstab	13	0.360	0.293	-0.060	0.820
	goveffe	14	0.089	0.149	-0.220	0.350
	regq	14	0.028	0.200	-0.330	0.360
	gdp_growth	21	0.026	0.042	-0.094	0.086
	GDP	22	1.332	0.179	1.066	1.635

In Chapter 4 the model $y_{it} = x'_{it}\beta + u_{it}$, with *X'={ ldi, cc , rule, voice, polstab, regq, goveffe, bit, GDP_growth, GDP, time, country dummies}* and y: the dependent variable represented by the log of *fdi (lnfdi),* estimated for analysis including the six economies of WB. The analysis used a log transformation of the dependent variable both to eliminate heteroscedasticity problems and reduce the influence of potential outliers of those observations where the errors satisfy the equation, $u_{it} = \rho_\iota u_{i,t-1} + \varepsilon_{it}$ (please see Chapter 4-Section 4.3)

We have already mentioned that having data overtime for the six WB countries, the decision to use panel data techniques is based on the ability to export robust results. As in the previous cases of Albania (please see Chapter 5-Section 5.5), BiH (please see Chapter 6-Section 6.5), Kosovo (please see Chapter 7-Section 7.5), North Macedonia (please see Chapter 8-Section 8.5), so with Serbia and Montenegro, we run the regressions only for them following the Prais-Winsten procedure. Although we correct for autocorrelation and avoid the spurious regression problem as described in Chapter 4-Section 4.3, the estimates are biased and inconsistent due to the limited number of observations. Table 9.5 presents along with the panel data model (detailed analysis in Chapter 4) the time series estimates for Serbia and Montenegro. The coefficients in the panel data model are significant for four explanatory variables and one control variable while in the single time series model, for Serbia and Montenegro, only Montenegro presents significance in two variables.

Table 9 5 – Comparison of regressions

	Panel Data Model	Serbia	Montenegro
Dependent Variable :	**lnfdi**	**lnfdi**	**lnfdi**
Ldi(t-1)	0.744	-2.289	-43.12*
	(0.66)	(-0.82)	(-29.65)
cc(t-1)	-0.116	3.430	15.75*
	(-0.25)	(1.74)	(17.49)
rule(t-1)	-1.081*	-0.699	10.02
	(-2.37)	(-0.11)	(2.48)
voice(t-1)	0.956*	4.749	-7.788
	(2.54)	(1.54)	(-3.96)
polstab(t-1)	0.365*	-1.822	0.882
	(2.25)	(-1.47)	(3.69)
goveffe(t-1)	0.559	3.645	-10.11
	(0.83)	(1.27)	(-3.51)
bit(t-1)	-0.0519	0.131	
	(-1.27)	(0.60)	
regq(t-1)	-0.956*	-1.944	-14.18
	(-2.42)	(-0.66)	(-8.16)
gdp_growth(t-1)	0.00467	0.163	0.119
	(0.23)	(2.09)	(3.96)
GDP (t-1)	3.906***	-10.65	-11.86
	(4.79)	(-1.33)	(-5.48)
time	-0.0336	0.323	0.427
	(-0.89)	(1.23)	(2.73)
Country dummies			
Bosnia_Herzegovina	-1.619***		
	(-4.23)		
Kosovo	1.896***		
	(3.54)		
North_Macedonia	0.500		
	(1.75)		

Serbia	-3.982***		
	(-3.66)		
Montenegro	3.779***		
	(4.59)		
_cons	10.50***	55.55	51.33*
	(7.37)	(2.35)	(22.47)
N	92	17	12

T -statisitcs in parentheses. (*) Significant at p<0.05, (**) Significant at p<0.01, (***) Significant at p<0.001.

The major problem of the research's data set for Serbia and Montenegro is the limited number of available observations (432 for Serbia and Montenegro over 1317 of the panel data model). Hence, with pure time-series analysis, the extraction of exact estimates and robust test statistics is constrained. Panel data sets contain more variability to exploit, more efficiency and offer more information than pure time-series data or cross-sectional data. According to the existing literature, panel data methods can detect and measure statistical effects that pure time-series or cross-sectional analysis cannot. Additionally, panel data set lets us control for unobservable, something that time series does not allow. Hence, the adaption of the panel data technics helps to obtain more accurate and more robust estimates. The following section discusses the empirical results of the panel data model adjusted for the countries of Serbia and Montenegro.

9.5.1 Empirical results - Discussion

The empirical analysis (please see Chapter 4) based on panel data and Prais-Winstein estimation method indicates that the explanatory variables, voice & accountability *(voice),* political stability & absence of violence/terrorism *(pol_stab),* the rule of law *(rule)*, regulatory quality *(regq)*, as well as the control variable of the market size *(GDP)* are significantly associated with inward FDI. Three of which, the voice and accountability, the political stability, and the market size are positively related to FDI while the rule of law, and regulatory quality negatively. The political regime's impact on FDI is positive in the sense that a more democratic regime is more appealing to foreign investors but does not determine the amount of FDI flows that

the country receives. Control of corruption, government effectiveness, and growth found positive as expected though insignificant. The signing of the BITs in the case of these economies is negatively and insignificantly related to FDI.

The empirical result for the variable of political stability & the absence of violence is consistent with the literature (please see Chapter 4 - sections 4.2, 4.4). During the years of Serbia and Montenegro common route in the FRY, during the period of their membership in the SCG, during the period followed union's dissolution in 2006, along with, the successive parliamentary and presidential elections (held in 2003, 2004, 2007 and 2008), a series of events caused political instability and violence, harming FDI inflows. For example, the 1999 NATO's air strikes against Serbian targets, ousting of Milosevic in 2000, the assassination of Serbian Prime Minister Zoran Djindjic in 2003 as well as Serbia's split up with Montenegro in 2006, provoked a political turmoil and rise of violence. In consequence, at the times of these events, the level of inward FDI diminished (please see figure 9.6) and recorded a negative growth rate (please see figure 9.7). In 2011 an armed event with Kosovo once again raised anxieties in political surroundings and limited the inward FDI substantially (please see figure 9.6). Three parliamentary elections and two presidential elections took place from 2012 to 2017 in Serbia. The Serbian Prime Minister Aleksandar Vučić had operationalized the call for early elections at the expense of political stability. In 2016 the parliamentary elections held together with the local elections. Vučić decided this to ensure a new mandate until 2020 and to increase its party power in local elections (Boban, 2016). His victory in presidential elections in 2017 was the cause of unrest which retained FDI to a low level (please see figure 9.6). Therefore, each time that the political setting in Serbia and Montenegro is under the threat of destabilization and rise of violence, including the politically or ethnically motivated violence, then inward FDI is decreasing.

The literature (please see Chapter 4 - Sections 4.2, 4.4) confirms the positive and significant relationship of voice and accountability with inward FDI. The rational of this positive association relies on that voice and accountability measures the perceptions of the extent to which a country's citizens can participate in their government elections, including the confidence about the honesty of elections. The Serbian prime minister faces the accusations of the opposition and civic society of

having established autocratic rule and full control over media, as he uses them to campaign against opponents (Euractiv, 2018). To this extent, the latest report of the European Commission on Communication on EU enlargement policy (2019f) recommends the Serbian authorities strictly to respond to requests for freedom of media and free and fair elections of opposition parties. Respectively, in Montenegro's case, large street protests were asking for the transitional government to organize free and fair elections in 2015. Also, according to an opinion poll conducted by DeFacto Agency in February 2016, 61 per cent of citizens in Montenegro do not believe that elections are free and fair, revealing a severe decline of public trust in the election process (Bertelsmann Stiftung, 2018f, p. 8). As already seen, whatever concerns elections is crucial for the countries' political stability and, as such, for inward FDI. Hence, an increase in voice and accountability will stimulate FDI inflows.

The significant negative result of the rule of law contradicts the existing literature (please see Chapter 4 - sections 4.2, 4.4). This governance's dimension measures the perceptions on the effectiveness and predictability of the judiciary, as well as contracts' enforceability (WGI, 2019). In Serbia, the functioning of the judiciary continues to leave room for undue political influence, and this is an issue of concern (European Commission, 2019f, p. 14). Respectively, challenges to the independence, credibility, and professionalism in the functioning of the Judiciary in Montenegro exist (European Commission, 2019g, p. 15). Both countries' judiciary is very prone to political influences, and as such, the enforcement of laws lies in serving the interests of well-organized political and institutional actors, like in the case of laws concerning the privatization policies. Foreign investors entering these markets were primarily interested in profiting from the privatization of formerly state-owned companies (Šabić et al., 2012, p. 79). Since privatization is the instrument of political positioning, a foreign investor to prevail over competitors in the privatization process has to ensure benefits to politicians. The privatization of "Telekom Serbia," which was sold to Greek and Italian partners, raised government popularity (Ivanovic et al., 2014, p. 62). Therefore, a weak rule of law enforces such practices that benefit both politicians and MNEs. An improved rule of law emerges as a threat to the status quo and drive out these MNEs, decreasing the level of inward FDI.

The regulatory quality measures perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development (Kaufmann and Kraay, 2019). Reforms in regulations are strongly linked to competitiveness, which increases national economies' efficiency (Penev and Marušic, 2011, p. 108). The significant negative result contradicts many previous empirical studies that reported a positive relationship (please see Chapter 4 - sections 4.2, 4.4). However, it is related to the above analysis of the rule of law. To the extent that MNEs do not benefit from a new stricter regulatory environment, they are not supporting a regulatory reform that threatens their privileges and enhances the creation of a friendlier business environment, attracting new competitors. Hence, an improved regulatory environment is unattractive for such foreign investors.

Therefore, further research on the profile of foreign investors in Serbia and Montenegro may provide more insights into the significant negative relationship between the rule of law, the regulatory quality, and inward FDI.

Although government effectiveness holds the expected positive sign (please see Chapter 4 - sections 4.2, 4.4), this is insignificant. Since this dimension of governance measures the quality of public and civil services, the fact that the public sector in Serbia is very inefficient, with large numbers of employees and low quality of services provided, is an issue of concern (Bertelsmann Stiftung, 2018e, p. 31). Respectively, the European Commission (2019g) recommends the Montenegrin government for the need for the optimization of the state administration. Public administration in Montenegro is oversized and expensive, lacks efficiency and administrative capacities (Bertelsmann Stiftung, 2018f, p. 34). The inefficiency of public services produces delays in business activities, which raise the cost of doing business. Therefore, government effectiveness in Serbia and Montenegro as a critical component of good governance infrastructure plays a positive role, though, not a determining one in attracting FDI.

The empirical result of control of corruption is consistent with the existing literature since most of the studies support the positive relation of this indicator with inward FDI (please see Chapter 4 - sections 4.2, 4.4). Both Serbia and Montenegro suffer from corruption. In Serbia, the post-Milosevic governments had not prioritized in their reform agenda, the fight against corruption despite their promises. It is

evident why there is an absence of political will to eradicate corruption. The control of corruption will close many opportunities for personal gains of officials (Bertelsmann Stiftung, 2018e, p. 33). Respectively, in Montenegro, corruption is prevalent in many areas and remains an issue of concern (European Commission, 2019g, p. 20). Control of corruption is vital for rising transparency in local bureaucracy, decrease the cost of doing business, and positively influences the foreign economic agent's decision to conclude on a local joint venture partnership (Javorcik and Wei, 2009; Smarzynska and Wei, 2001). The fight against corruption holds the lowest rate in progress in these societies and provokes severe delays in accessing the EU and the WTO, putting constraints in countries' economic growth (please see section 8.3). However, the empirical result revealed that the control of corruption holds a non-significance relation to inward FDI. This relation is indicative of foreign investors' behaviour to proceed to their projects in corrupted countries though they acknowledge the risk of doing business in such an environment. For example, the EU, as the significant source FDI country see Chinese investors in the territory as being dangerous competitors due to their difference in morals and pragmatic approach to doing business (Day, 2019). There are empirical studies providing evidence that Chinese investors are not particularly concerned about corruption in the host country since they have the experience of dealing with corruption at home (Shan et al., 2018, p. 144). Therefore, foreign investors are positively positioned to a less corrupted environment, but this is not the crucial factor that will influence their decision to invest in Serbian and Montenegrin market.

Chapter 2 presents in detail the contradictory and fuzzy results of the impact of the host country's political regime on inward FDI. The regime type found in the empirical analysis in Chapter 4 to hold a positive relationship with inward FDI, but not a significant one. Empirical studies are confirming our survey's result (Biglaiser and DeRouen, 2006; Oneal, 1994). Over their transitional years, Serbia and Montenegro seem to fail to realize what true democracy demands. Since 2009, the fundamentals freedoms and democratic institutions such as national democratic governance, independent media, judicial framework and independence, and corruption record the lowest progress (please see section 8.3). The shortcomings in Serbia's democracy explain its downgrading in V-DEM LDI from electoral democracy in 2015 to an electoral

autocracy in 2016, a position that holds until now. Montenegro shares the same classification. From 2015 onwards, the inward FDI flows in Serbia show an upward trend, while in Montenegro a downward trend (please see figure 9.4.). Therefore, the regime type does not play a decisive role in the amount of FDI inflows that these economies receive.

BITs generate a reasonable expectation to the foreign investors that the host country will not expropriate foreign firms' funds and assets. Especially, for developing and transition countries that had suffered from high political risk, unreliable governments, less efficient norms, and poor institutions, the signing of a BIT considered to increase their credibility and as such, to stimulate inward FDI (Berger et al., 2011; Büthe and Milner, 2008; Kerner, 2009; Neumayer and Spess, 2005; Rosendorff and Shin, 2012).

Most studies support that BITs aim to encourage FDI inflows from generally high-income countries to lower-income recipients, by guaranteeing specific levels of treatment for foreign investors (Berger et al., 2011; Büthe and Milner, 2008; Kerner, 2009; Neumayer and Spess, 2005; Rosendorff and Shin, 2012). Hence, the non-significant negative relationship between BITs and inward FDI contrasts with the extant literature (please see Chapter 4 - sections 4.2, 4.4). However, some studies leave space for this negative relationship based on the argument that BITs are less effective in an environment of weak political institutions, and is thus supportive of a complementary relationship between domestic political institutions and BITs (Hallward-Driemeier, 2003) (Falvey and Foster-McGregor, 2017). Hence, the positive effect of BITs on FDI flows fades away when there are relatively large differences in the strength of political institutions between source and host countries (Falvey and Foster-McGregor, 2017, p. 653). Since both countries, Serbia and Montenegro, suffer from weak institutions, BITs may act complementary to domestic institutions, and this is in line with our empirical finding.

Summing up, the variables of voice & accountability, political stability & the absence of violence, the rule of law, and the regulatory quality should be ascribed to the highest weight among all institutional variables in explaining the FDI decision-making of MNEs in Serbia and Montenegro.

9.6 Conclusions - Recommendations

This Chapter followed both theoretical and empirical analysis to serve the research purpose of defining the impact of the political environment on inward FDI in Serbia and Montenegro, as two of the six transition economies of WB. The two countries shared the same history for too long, and as such, are examined together.

Among the six WB countries in the EU waiting room, only Serbia and Montenegro have started membership talks. In 2018 the EU adopted a Strategy for the WB, which mentioned 2025 as a potential year of Serbia's and Montenegro's accession. However, the assessment is that both countries are lagging in meeting the fundamentals of their reform EU-Agenda. The 2019 EU reports of the European Commission on Communication on EU Enlargement Policy for the progress of Serbia's and Montenegro's reform Agenda recommended their governments to prioritize improvements in the fragmented and polarized political environment. The freedom of the media, free and fair elections, freedom of expression, public administration and the judicial system are fields of deep concern. The countries need to step up their efforts to combat corruption and organized crime and to develop a functioning market economy to deal with competitive pressure and market forces within the EU. Unless they display fast progress towards meeting the EU criteria, they will fail to join the EU by the reported date.

Although Serbia is the largest country in WB and region's top FDI destination, and Montenegro holds one of the highest performance in investment per capita, the conditions described above challenge the country's investment environment and, as such, the growth of inward FDI. However, the inward FDI as a percentage to GDP, from the 2014 disaster event of floods onwards, records satisfactory performance (over 6 per cent) for these countries, though with an upward trend for Serbia and downward for Montenegro.

The transition to democracy for Serbia and Montenegro is not regarded as successful. Indeed, both countries' regimes downgraded during 2016-2017 from the category of electoral democracies to the classification of electoral autocracies.

The results produced from the empirical analysis of the impact of the political landscape, as it shaped by the political regime and individual political variables, on

inward FDI, indicated specific dimensions to have a more significant impact on FDI than others. The empirical analysis resulted in that four variables of governance and one control variable display significant effects. Three of which, voice & accountability, political stability & the absence of violence, and the market size found with the expected positive sign. Positive also found the variables of governance, control of corruption, and government effectiveness, though statistically insignificant. This relation depicts that from governance's dimensions, the foreign investors are judging most the voice & accountability, as well as, the political stability & the absence of violence, in their decision to invest in Serbia and Montenegro. Whereas their political system by itself is not a determining factor to inward FDI. Unexpectedly, the variables of the rule of law and regulatory quality found to be significantly negatively related to inward FDI; the signing of the BIT also negative though non-significantly. The weak rule of law and the low regulatory quality are not barriers to FDI, and this has a positive side since both countries display slow progress in their reform. However, it endangers their EU accession progress. In contrast, improvements in the rule of law and regulatory quality may move away MNEs following a shadow approach of doing business, which is acceptable in these markets. Therefore, further research on the profile of foreign investors in Serbia and Montenegro may provide more insights into the relationship between these variables and inward FDI.

Serbia's and Montenegro's policymakers must retain countries' images of the most advanced in acquiring EU membership. Policies of increasing voice & accountability and political stability limiting any form of violence, including the politically or ethnically-motivated violence for encouraging FDI inflows, are in line with the EU recommendations on the progress of required reforms for their EU membership by 2025. The development of these countries as an FDI destination supports the EU economic criteria of developing functioning market economies having the capacity to cope with competitive pressure and market forces within the EU. Serbia and Montenegro's European perspective will provide an image of reliable, credible, and stable markets attracting foreign investors that prefer a more regulated investment environment with more robust governance.

Next chapter is the final of the dissertation providing conclusions and recommendations.

Chapter 10. Conclusions and Recommendations

10.1 Introduction

This dissertation examined the political regime as a determinant on inward FDI in the case of the European transition economies. The sample countries consisted of those of the Balkan area that are non-EU members, the WB (Albania, Bosnia and Herzegovina, Kosovo, North Macedonia, Serbia, and Montenegro). The mixed unstable and varied political landscapes, with mixed and diverse national trajectories, made their transition process difficult and as such their EU integration. These countries are far from an ideal investment destination due to political instability, democratic decline, limitations in freedom of media and expression, human rights violation, dysfunctional legal systems and public administration, high corruption and organized crime, informal economy, market imperfections, low managerial quality, and organizational efficiency in the local businesses. However, WB needs inward FDI to achieve EU's membership criteria, following the example of the CEEC. Hence, the examination of the extent to which the political environment of WB countries with distorted democratization and weak institutions influence the amount of FDI inflows, provides definite results for concluding our research.

The dissertation consists of ten chapters, including this which summarizes and discuss research's findings of all the other chapters and recommends policies. This chapter concludes providing suggestions for future research.

10.2 Summary of the Findings

The study employed a literature review to construct research's theoretical framework. Besides, research adapted the argument that FDI cannot be explained by a single theory but rather by a combination of theoretical models which complement each other. Hence, the review of relevant empirical studies indicated the determinants that increase the regime's institutional stability and credibility, and as such influence, the inward FDI. The specific factors that irrespective the type of the political regime affect the foreign investors' decision-making process are the property-rights protection, the signing of BITs, human rights consisting of political participation rights, civil liberties and labour rights, and the quality of governance. The protection

of property rights generates the optimal environment for foreign investors. Through the signing of BITs, the recipient country guarantees the protection of property rights, decreasing the risk of an investment that the "obsolescing bargain" produces, enhances stability and predictability for FDI. The literature review findings also suggest that respect for human rights can guarantee a healthier investment environment as well as the guarantees of political participation and civil liberties. If host country's political system can ensure institutional quality and establish political stability, greater judicial strength and the rule of law, activate multiple veto players, take into consideration possible audience costs and manage to control corruption, it will attract more FDI inflows. However, there are cases of bad governance in which corruption can surpass the institutional deficiencies and stimulate FDI. Many studies share the argument that a democratic regime attracts more FDI than an autocratic, but few provide strong empirical evidence. Therefore, for overcoming the contradictory and ambiguous findings of empirical studies on the role of the host country's political system in variations of inward FDI, is preferable to focus on, beyond the political regime, and to specific factors of political surroundings as well.

The case of the transition economies of WB both theoretically and empirically examined. WB did not manage to leave behind the reputation of "the Powder keg of Europe", reminding to all potential foreign agents these countries' notorious past. The fall of the centrally administered socialist system affected the region, which broke up into small states by any standard having an impact on MNEs' decision to invest in such size of markets. WB transition economies stimulated the international interest since they had been ruled under authoritarianism too long and during the last decades engaged to a set of structural transformations supportive to their "democratization" and to transition to the market economy. EU has always been interested in the region due to its significant geopolitical position. However, the unresolved legacies of the 1990s, the slow pace of implementation of structural reforms and the financial and European debt crises delayed the integration of the six WB economies. The delayed WB-EU enlargement creates a geopolitical vacuum that generates fears of destabilization of the region, which in turn can cross onto the EU. Whereas the EU launches a new strategy for accelerating the new enlargement, WB economies are still uncompetitive with excessive political interference and an underdeveloped private

sector. Their inward FDI performance is substantially low compared to their EU-11 peers. A considerable variation exists within WB countries as well as between them, concerning the level of democratic consolidation and commitment to the rule of law over time in conjunction with social and economic welfare.

The empirical analysis uses a panel dataset of the variables of interest for a period from 1996 to 2018, across the six transition economies of WB. The dependent variable is the natural log of net FDI inflows. The independent variables are the regime variable, the signing of BITs, and the six governance dimensions, voice and accountability, political stability & absence of violence/terrorism, government effectiveness, regulatory quality, the rule of law, and control of corruption as defined by Kaufmann et al. (1999) for the World Bank (WGI project). Table 10.1 summarizes research's empirical findings on the impact of political regime and political determinants on inward FDI. The empirical analysis of the model based on Prais-Winstein estimation methods found positive and statistically significant two dimensions of governance, thus voice and accountability, political stability & absence of violence/terrorism, confirming the literature findings. The rule of law and regulatory quality found negative, statistically significant, and inconsistent with the literature. The regime variable, as well as the control of corruption and government effectiveness, hold a positive sign, though a statistically insignificant relation to FDI inflows. The signing of the BITs is negatively and insignificantly related to inward FDI.

Table 10 1 - Political regime, Political Determinants impact on inward FDI in WB countries

Impact on FDI				Albania	BiH	Kosovo	North Macedonia	Montenegro	Serbia
Political Regime	Electoral Democracy	Significant	+						
			-						
		Non-Significant	+	●	●	●	●		
			-						
	Electoral Autocracy	Significant	+						
			-						
		Non-Significant	+					●	●
			-						
The Signing of the BITs		Significant	+						
			-						
		Non-Significant	+						
			-	●	●	●	●	●	●

Voice & Accountability	Significant	+	●	●	●	●	●	●
		-						
	Non-Significant	+						
		-						
Political Stability & Absence of Violence/ Terrorism	Significant	+	●	●	●	●	●	●
		-						
	Non-Significant	+						
		-						
Government Effectiveness	Significant	+						
		-						
	Non-Significant	+	●	●	●	●	●	●
		-						
Rule of Law	Significant	+						
		-	●	●	●	●	●	●
	Non-Significant	+						
		-						
Control of Corruption	Significant	+						
		-						
	Non-Significant	+	●	●	●	●	●	●
		-						
Regulatory Quality	Significant	+						
		-	●	●	●	●	●	●
	Non-Significant	+						
		-						

Therefore, these empirical findings suggest that MNEs investing in WB transition economies are looking for a hospitable investment climate that political stability and the absence of violence/terrorism, along with voice and accountability, can generate, whether their political systems are democratic or not. A host country with a more liberal regime, which fights corruption and improves government effectiveness, may influence in a second rate MNEs investment decision. Finally, MNEs investing in WB seem to have the experience to overcome the obstacles that a poor rule of law and low regulatory quality create, using them for their benefit.

10.3 Discussion of the findings

The discussion of the findings is adjusted to each country's analysis. The countries are presented following the dissertation's structure.

Albania was the last of the WB that engaged in the transition process from a centrally administered socialist economic system to democracy and the free-market

economy. The country prioritized the rise of FDI inflows as the path to achieving enough growth for completing the transition and accomplishing EU membership. Country's political progress is remarkable considering its past as "the state of the dictatorship of the proletariat" and the current state of electoral democracy. However, Albania holds the promise of improved governance as well as the danger of authoritarianism since it is still struggling to solidify significant liberalization reforms. The empirical analysis identified specific dimensions to have a more significant impact on FDI than others. The foreign economic agents are judging most the voice & accountability as well as the political stability & the absence of violence, in their decision to invest in Albania.

Meanwhile, the country's political system by itself is not a determining factor to FDI inflows. The weak rule of law and the low regulatory quality are not barriers to inward FDI, and this has a positive side due to the government's severe delays on the implementation of structural reforms in these fields. If authorities proceed to stringent regulations, then they reduce the opportunities for Albania's cross border investors to continue exploiting the system for enhancing the profitability of their ventures. This governmental approach produces further delays to the country's institutional improvements, and as such, the rate of reforms' progress is slowing down. The 2019 report of the European Commission on Communication on EU Enlargement Policy confirms Albania's slow progress on its reform agenda. Hence, foreign investors activity can be both beneficial and harmful to Albania. An increase of FDI inflows may rise growth, though MNEs policies to increase their profit may halt reform progress towards EU accession.

BiH's transition to peace and independent statehood, to democracy and a market economy, evolved to a rather complicated and challenging process. The consociational settlement of the Dayton GFAP that ended the three-and-a-half-year war was one of the most wide-ranging peacebuilding interventions in the world. The agreement, instead of establishing conditions for reducing the nationalist element, incorporated ethnicity to constitutional design. The competing interests and the colliding lines of the ethnic parties created shortages in democracy and a fragile political system, which is on the verge to fall from electoral democracy to electoral autocracy. Ethnicity continues to be the reason for deadlocks, frustration, violence,

instability, corruption, jeopardizing every effort for the implementation of reforms that aim at country's advances in democracy and market economy, and on the EU membership path. Every time that elections take place in the country, the formation of government is a painful and long-lasting process due to the state's complex institutional structure and the contrasting political aspirations between the nationalist political parties. The negotiations between the political elite for the formation of government is the source of political violence and ethnic conflict. The continuous political challenges discourage potential foreign investors proving the significant positive relationship of political stability with inward FDI. Governance with low voice and accountability is associated with the rise of violence, which is consistent with the analysis of the variable of political instability and results in the reduction of inward FDI. Foreign investors in BiH that have benefited from the country's institutional weakness in case of reforms in the rule of law and regulatory quality will target other markets with lax regulations. Although a democratic regime will contribute to the BiH's better image as a foreign investment destination, its political system does not have a significant impact on the level of FDI flows the country receive.

The internationally contested statehood differentiates Kosovo from the rest WB countries. Although Kosovo declared itself an independent state in 2008, the lack of unanimous international recognition continues to divide the international community on the status and future of the province. The post-socialism and post-conflict transition characterised by intense international community intervention, illiberal practices, ethnic, social, and political fragmentation, lack of nation's cohesion, political instability, security issues, economic dependency, and institutional weakness. During the last decade, Kosovo achieved to hold an electoral democratic regime and be accepted by the EU as a potential candidate for membership. Kosovo addresses the same issues as Serbia and Montenegro along with the large informal economy, disrespect for minority rights, gender equality and unneighborly relations. These conditions discourage inward FDI, which records the worst performance compared to the rest of the WB economies. Coupling the empirical result for the variable of political stability with the analysis of Kosovo's political environment over the post-socialist period, the FDI's underperformance is associated with ethnic violence and political instability that electoral battles produced continuously. The indicator of voice &

accountability is also associated with the electoral process in Kosovo, which is a source of political instability and as such, harm inward FDI. The weak rule of law is positively evaluated by MNEs that enjoy corporate characteristics such as lousy leadership behaviour and a corrupt corporate culture or coming from a country that experiences the same institutional weakness. MNEs behaviour justifies the empirical result for the rule of law and the regulatory quality. The immense levels of perceived corruption negatively impact the image of Kosovo amongst foreign investors. However, there are those MNEs having experience of dealing with corruption at home and do not hesitate to invest in such a risky market. From 2013 onwards, Kosovo achieved improvements towards democracy with 2019's democratic performance better than expected, whilst in the respective period, the level of FDI inflows fluctuated confirming the empirical result of the insignificance of the political regime in attracting foreign investors.

North Macedonia's transition to a market-oriented economy and democracy was challenged by a series of events like the inter-ethnic conflicts, the legal name-related dispute with Greece, conflicting regional relationships, global financial crisis and political scandals. Between the years 2006-2017, the ruling elite's monopolisation of power and abuse of state institutions and resources stigmatised country's route to democracy and led the country to a situation of state capture. This situation harmed the country's image as an FDI destination. In the case of North Macedonia, the political instability, and the rise of violence during the examined period coincides with low performance in inward FDI. The 2015 wiretapping scandal revealed the low level of voice & accountability, which negatively influenced the inward FDI. The empirical analysis is in line with the remaining problems in the rule of law and regulatory quality in which foreign companies with political connections enjoy special treatment and financial gains when they enter North Macedonia's market. Country's democratic performance in 2019 did not manage to stimulate the interest of foreign investors, and this proves that the political regime does not determine the amount of FDI flows North Macedonia receives.

The transition economies of Serbia and Montenegro concerning their potential to attract FDI flows examined together given the in-between close relationship. From the six WB states, these two have been the first to take the green light by the EU to open accession negotiations. Although Serbia is the largest country in WB and region's

top FDI destination, and Montenegro holds one of the highest performances in investment per capita, many issues challenge the investment environment and result to low performance of inward FDI. These are the fragmented and polarised political environment, limitations in the freedom of the media and freedom of expression, challenges in the electoral process, deficiencies in public administration, high corruption, and organised crime. Both countries' transition to democracy is not considered successful. Indeed, their political regimes downgraded during 2016-2017 from the category of electoral democracies to the classification of electoral autocracies. The empirical result for the variable of political stability & the absence of violence/terrorism is consistent with countries political history. Thus, each time that the political setting in Serbia and Montenegro is under the threat of destabilisation and rise of violence, including the politically or ethnically motivated violence, then inward FDI is decreasing. Whatever concerns elections is crucial for the countries' political stability and, as such, for inward FDI. Hence, an increase in voice and accountability will stimulate FDI inflows. An improved rule of law, as well as an improved regulatory quality, emerges as a threat to MNEs status quo, driving them out and ending to the decrease of FDI inflows. Foreign investors are positively positioned to a less corrupted environment, but this is not the crucial factor to influence their decision to invest in Serbian and Montenegrin market. Although since 2015 democracy recorded a decline to the extent that the regimes in both countries changed classification from electoral democracy to electoral autocracy, the same period the inward FDI flows in Serbia increased, while in Montenegro decreased confirming the empirical result that regime type does not play a decisive role in the amount of FDI inflows these economies receive. Finally, since both countries suffer from weak institutions, BITs may act complementary to domestic institutions, and this is in line with the empirical finding of an insignificant negative relationship with FDI.

10.4 Conclusions and Policy Recommendations

The dissertation included both theoretical and empirical analysis to address the issue whether the host's country's political regime determine the level of inward FDI flows or it is a matter of specific factors as established in host country’s political

system. The findings of the literature review concerning the role of the political system were inconclusive, suggesting that democratic regimes attract more FDI, though without providing strong empirical evidence. Nevertheless, the frequency that certain factors included in the empirical analysis of most of the literature generating significant outcomes in their relation to inward FDI led us to incorporate most of them in dissertation's empirical model. The empirical results proved that the political determinants related to the dimensions of governance are more important than the political regime itself in attracting FDI (please see sections 10.2, 10.3). These are individual variables that improve the institutional stability and credibility of the political system and as such foster country's growth.

The findings of this dissertation shed more light in the political system- inward FDI nexus, contributing to the existing literature and providing a framework for transition economies to overcome specific political issues for achieving FDI's growth. This research addresses a gap in the literature on the variation of FDI inflows to countries with democratic shortages. It reveals for the first time the importance of improved governance in attracting FDI, for the six WB transition economies. The extant literature primarily compared democracies and autocracies in their ability to stimulate inward FDI without disaggregating the factors within regimes that contribute to this phenomenon. This research included new approaches in conceptualization and measurement of the political system, broadening the research to variations of democracy and authoritarianism. Despite the limited number of the sample of the countries, this included a range of regimes from electoral democracy to electoral autocracy capturing the contemporary political reality. The precise classification of the political system defined its relation to FDI and produced a distinct result giving directions to governments, policymakers to design and implement policies for improving the specific dimensions of governance. Therefore, based on our theoretical development and empirical analysis, policy recommendations can be made to government authorities, policymakers, and other stakeholders in WB for making their countries more attractive to foreign investors.

The empirical results can be a wake-up call for policymakers to give attention to enhancing good governance environment in terms of improving voice & accountability and stabilising the political environment and limiting any form of

violence, including the politically or ethnically-motivated violence, for stimulating FDI inflows. In Albania's case, the country's leaders considering the EU recommendations should think to attract MNEs that their particular needs are in line with the country's commitment to complete the required reforms for achieving EU membership. Hence, to attract those foreign investors that now avoid entering into Albanian market since they are concerned on the use of legislation and regulations that benefit only the politically connected companies as well as on the frequency of unpurposive change of regulations and laws defining business activity. The opening of the long-awaited accession talks should motivate the Albanian government to accelerate the completion of reforms.

BiH's policymakers must overcome the ruling elite's entrenched patronage interests that halt the implementation of any structural reforms. A consensus on the state over the reform policy agenda is required to achieve BiH political stability, to reduce ethic disparities and remove discriminatory provisions, that reduce the country's attractiveness to MNEs.

Kosovo is not a fully-fledged independent state, and as such is not an ideal market for investments but EU's acceptance as a potential candidate for membership leaves space for better performance in FDI. The fragile state requires the building of stable institutions. Government of Kosovo must concentrate on strengthening the electoral process, establishing political stability, and improving voice and accountability by enforcing the respect of human rights, especially on ethnic minorities rights. Improvements in the business environment can be achieved by implementing the anti-corruption strategy and reforms on public administration.

Since North Macedonia surpassed the main obstacles for the country's EU and NATO integration, is well-positioned to project a new country image, one that dissociates from high political and economic risk. A long-term commitment and a robust political consensus are required to build stability and trust in the country's market. The policymakers designing strategies for effective governance will improve the investment environment and as such, the economy's sustainability.

Serbia and Montenegro must retain and take advantage of the image of the most advanced WB countries in achieving EU membership. The prospect of EU membership by 2025 fuels FDI growth which in its turn accelerate the process of EU

accession since it supports the developing of functioning market economies having the capacity to cope with competitive pressure and market forces within the EU. The image of reliable, credible, and stable markets will attract those MNEs that prefer a more regulated investment environment with more robust governance.

The COVID-19 crisis tests the resilience of WB economies. Significant current account deficits will need to be financed by FDI inflows. However, since the crisis ceases much of economic activity in the region and economic uncertainty is not resolved, new FDI inflows may be delayed. The new reality demands WB countries to put aside their previous differences and cooperate supplementing each other. The building of strong cooperation will mitigate the complexities and risks of investing in the region, will lead to the creation of a broader integrated market and improve the region's visibility. There is already established a Multi-Annual Action Plan for Regional Economic Area in the Western Balkans (MAP REA) reform agenda, which can use for their alignment with EU and international best practices, and standards. In consequence, the region will be developed as an attractive destination for investment and commerce and succeed convergence with the EU.

10.5 Recommendations for Further Research

This dissertation produced important findings concerning political factors determining FDI and provides ground for further research. The dissertation was conducted at a period when essential reforms on the examined variables were still in progress. For future study about political determinants of FDI in WB, this framework may need to be adapted to fit with the time that reforms have been completed. It will be interesting to examine the extent to which improved governance will lead to inward FDI growth. Further research on the profile of foreign investors in WB may provide more insights into the significant negative relationship between the rule of law, the regulatory quality, and inward FDI. Finally, this research completed while the COVID-19 pandemic started to threat economies and societies generating high uncertainty for the future. The role of governments in managing the health crisis and tackling the dramatic economic slowdown will define countries sustainable recovery,

including FDI growth. This dissertation wraps up with the recommendation for future research incorporating data of the pandemic crisis in this field of study.

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